IRS OKs Repayment of Lessor's Debts with Like-kind Exchange Receipts
By: Jeff Nelson

Occasionally, the IRS (in this case the IRS Chief Counsel) reaches a conclusion that is not only consistent with the technical and legislative intent of the law but is also in harmony with business economics and practicalities. Such is the case with the IRS' holding in its recent internal legal memorandum ILM 201325011.

ILM 201325011 involved an equipment leasing/rental company (let's call them "Rentco") that was using a Like-kind Exchange ("LKE") program to systematically defer paying income taxes on taxable gains from dispositions of their construction rental/lease equipment. In the ILM, the IRS allowed Rentco to use cash collected from the sale/exchange of its construction equipment to immediately pay down its general obligation lines of credit ("LOC"). The LOCs in question were used, not only to finance RentCo's acquisitions of rental equipment, but also to fund RentCo's general business operations including the purchase of inventory assets which did not qualify for LKE.

In this case, RentCo's LOCs were secured by virtually all of RentCo's assets (including the construction equipment being exchanged as part of its LKE program). In addition, the LOCs specifically required that RentCo use any and all proceeds from the sale/exchange of rental equipment to pay down any outstanding balances on the LOCs. This immediate debt repayment allowed RentCo to minimize the cost of its LOC borrowings while simultaneously allowing its lender to automatically adjust its outstanding borrowings relative to its fluctuating collateral position.

Background – Why is this IRS guidance important to Lessors?

Where a lessor's dispositions of tax leased assets are replaced with "like-kind" assets of equal or greater value then any Federal and most State taxable gain from the exchange is deferred as a reduction of the depreciable basis of the replacement asset. In effect, a Lessor's implementation of LKE on a "Program" basis (i.e. where LKE processes are institutionalized as part of the Lessor's normal business processes) results in a tax environment where little or none of the Lessor's tax lease dispositions result in a tax liability on either a Federal or State level.

The tax deferral from an LKE Program can be substantial. This is especially true in the case of vehicle and equipment leasing where the disposed assets retain their resale/residual value well in excess of their depreciating tax value or in the case of leased assets where the Lessor previously took advantage of recent 30%, 50% and 100% "bonus" depreciation. In both cases, the resulting taxable gains are deferred and the immediate cash savings generated can often exceed 35 to 45% of disposition proceeds. To illustrate, let's assume a Lessor sells a lease asset with a $100,000 taxable gain. Without LKE, the Lessor would have to use $40,000 of the cash generated from the sale to pay a combined 40% Federal and State tax on the gain. With LKE, the tax bill is deferred and the Lessor has full use of the entire $100,000 to reinvest back into its business. This deferral can be stretched out indefinitely as long as the Lessor continues to exchange new like-kind assets as replacements for their old assets.

> *Note - Eventually, the Lessor may need to recognize the previously deferred gain when, for whatever reason, the Lessor fails to take advantage of LKE and it finally recognizes the long deferred gain. However, even in this case, LKE may represent a substantial opportunity if, as is currently being discussed, Congress reduces federal tax rates and the gain is ultimately recognized in a year when those lower tax rates are in effect.*

The above tax savings are not achieved without some effort on the part of Lessors. First and foremost, LKE is one of the few areas of the Tax Code where the form of the transaction is far more important than its substance. The administratively complex requirements are typically facilitated by a third party Qualified Intermediary (or "QI"), and Lessors must be certain to "dot the i's and "cross the t's" in order to achieve the desired result.

Many of the requirements of LKE Programs revolve around the proper handling of cash generated from dispositions where a disposition of the assets can occur as much as 180 days prior to the acquisition of like-kind replacement assets. In these instances, LKE rules say that a Lessor executing an LKE must *not receive, or constructively receive, either the cash proceeds, or the benefits of the cash proceeds, before it receives the actual replacement asset.* As a result, many Lessors were concerned that they might need to retain large, unproductive cash balances in their exchange accounts while awaiting the origination of a new tax lease involving a "like-kind" replacement asset with which to complete their exchanges.

Obviously, these large, unproductive cash balances are not desirable, especially where they must be funded with expensive borrowings or where an inability to put the cash balances to productive use elsewhere in the business prevents Lessors from taking advantage of other opportunities (for example: the funding of profitable new leases or loans).

What does the IRS' new LKE position mean for Equipment Lessors and Lenders?

Equipment leasing is an extremely competitive business where success and failure can often be measured in increments of positive cash flow or a couple additional bps yield on a lease. A requirement to maintain significant unproductive cash balances to support a Lessor's LKE Program increases the Lessor's overall cost of capital and may prevent the Lessor from taking advantage of other profitable business opportunities. All things being equal, Lessors would prefer to immediately utilize cash from lease dispositions to either pay down expensive borrowings or to fund profitable new business.

In this case, the Service's legal memorandum clarifies that Lessors are allowed to do both. First, it specifically clarifies that Lessors can pledge the collateral value of their LKE assets to secure the general debt obligations of the Lessor. Second, it also clarifies, where LKE assets secure a Lessor's debt and the lending arrangement requires it, cash proceeds from LKE asset dispositions can immediately be put to use in order to repay general obligation debt. Based on this ruling it is clear that Lessors do not need to retain large balances of LKE disposition proceeds solely to fund the acquisition of replacement assets.

What should Lessors do now?

The benefits of Lessor LKE programs are clear. LKEs allows lessors to avoid using cash generated from lease dispositions to pay federal and state taxes on gains and instead allows them to reinvest 100% of their cash proceeds back into their businesses. If the Lessor's applicable federal and state tax rate is 45%, this means for every $1,000,000 in taxable gain, Lessors will have additional cash of $450,000 available to reinvest in their leasing business. This is a significant economic business advantage that could determine success or failure and it cannot be ignored.

In spite of the significant advantages of LKEs, some Lessors choose not to implement LKEs specifically because of a concern that they would need to maintain significant disposition-related cash balances with the qualified intermediary to support their LKE programs. The IRS' legal memorandum in this case provides a potential mechanism to eliminate that concern.

Lessors with pre-existing LKE Programs as well as Lessors considering the implementation of a new LKE Program should re-examine the structure of their existing lease financing to determine whether they can make adaptations consistent with the facts and circumstances outlined in this ILM. While this memorandum can only be used as precedent by the taxpayer for whom it was issued, it does indicate the IRS' position on this issue which should provide some confidence for other taxpayers who are able to implement similar processes. Adaptations made consistent with the collateral and repayment processes outlined in this memorandum should give Lessors confidence that they can take advantage of LKE for their tax lease portfolio with minimal negative impacts on their cash flows and cost of borrowings.

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