Legacy Advisors Group

M & A UPDATE®

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The Coming Importance of the Like-Kind Exchange

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Introduction

Taxes on capital gains are about to increase substantially effective January 1, 2011. The tax cuts established during the first few years of the Bush Administration will, or are at least slated to, automatically sunset as of January 1, 2011. Not only will capital gains taxes increase, but an additional tax of 3.8% will also be incurred by high income earners making over $200,000 (single taxpayer) and $250,000 (married) shortly thereafter. These two changes will increase the top capital gains rate from 15% to 23.8% in only a few years time. For business owners looking to sell or exit, not everyone will be able to exit their businesses before these new rates come about. It is with this in mind, that the like-kind exchange or Internal Revenue Code Section "1031 Exchange" will become critically important once again.

Background

The Internal Revenue Code states that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property received in exchange is of like-kind and is held for productive use in a business or for investment. Non-recognition does not apply to stocks, bonds and notes, certificates of trust, beneficial interests, partnership interests, or securities. Like-kind exchanges also do not apply to exchanges of property the taxpayer uses for personal purposes. Personal use property includes personal residences and personal automobiles among other property. With that said, it is important to understand why the law is in existence and what it means. Congress is always interested in promoting investments in the economy. Taxes typically stifle investment value. In an attempt to limit the amount of taxes that are charged in investment transactions, Congress, long ago, created a section of the code that eliminates taxes due on appreciated property in specific transactions, known as Section 1031 transactions.

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A CASE STUDY

The IRS has ruled that a C Corporation may carry back a net operating loss (NOL) to offset portfolio income from a prior year when the corporation was a closely-held corporation. Under the Internal Revenue Code, a closely-held C corporation is one that at any time during the last half of the tax year, more than 50% in value of its stock is owned, directly or indirectly, by not more than five individuals. The corporation in the case was a closely-held corporation in years 2 and 3 of existence with earned portfolio income in each year. In year 4, a change of ownership caused the corporation to lose its closely-held status. However, this did not prevent the corporation from carrying back a NOL from year 4 to offset portfolio income earned in years 2 and 3. The IRS ruled that the passive activity loss rule of IRC Section 469 do not limit the offset.

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CoverStory

Exchanges of Non-Real Property

Property eligible for exchange treatment is best classified into two categories for simplicity. The two categories are non-real and real property. The first category, non-real property or personal use property is the more difficult of the two categories to handle. Non-real property is divided into different classes of goods which are simply too many to list here.

However, some of the easier transactions in the non-real property categories include the following: light trucks must be exchanged for light trucks, animals must be exchanged for essentially the same animal, and similar equipment must be exchanged for other similar equipment.

Exchanges of Real Property

This has been said to be exchanging "dirt-for-dirt". The requirements for exchanging real property are not nearly as stringent as for non-real property. As a matter of public tax policy, this is probably because real property typically appreciates in value and non-real or personal property will tend to depreciate with business use.

Tax Savings Effect

When exchanging like-kind property for like-kind property, no gain or loss is recognized. The basis or amount on the books for the property remains the same. Therefore, when the property is exchanged the result is that no tax is due or payable on the transaction.

For those looking to exit a business, consider exchanging your building for a productive property in the country, of which you could possibly make partial personal use of in the future. The person desiring your business in this instance, if he/she doesn't already own productive land that you want, can purchase land and exchange it with you for your building. There are all kinds of ways one can structure a like-kind exchange. Simply stated, you are not limited to doing a simple swap.

Conclusion

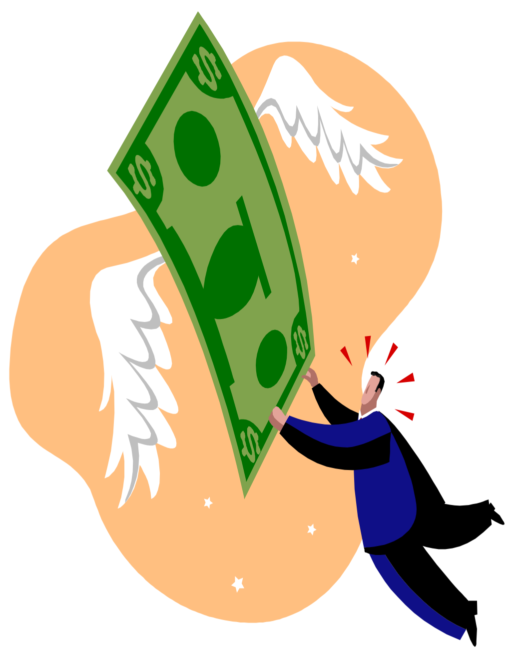
Because capital gains taxes will increase in the near future, efficient tax planning has become absolutely critical to retirement planning. Facing a business sale of a multi-million dollar operation once the tax rates go up, may mean paying hundreds of thousands of dollars more in taxes if the proper tax planning is not taken into account. Using like-kind exchanges is one approach that a succession specialist can use to reduce tax liabilities when the time comes for an owner to exit a business.

Like-kind exchanges were enacted to encourage efficient use and exchange of assets. Structuring transactions to use this code section will defer tax expense until a later fiscal year in most cases. The tax savings can be substantial, and the time and cash value of the deferral, especially on an exchange of real property, can be enormous. Contact the professionals at The Center for further advice on this tax strategy.

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

A CASE STUDY CONTINUED:

Editor's Comment: The taxpayer wins with this ruling for a couple of reasons. First, while IRC Section 469 generally deals with passive losses, this ruling indicates that active losses may be used to offset other categories of income. Second, the taxpayer gains ease of mind in knowing that a change in corporation classification did not affect the outcome. When selling or buying a corporation, contact the professionals at The Center for assistance in structuring the deal to ensure yourself the best possible tax scenario.



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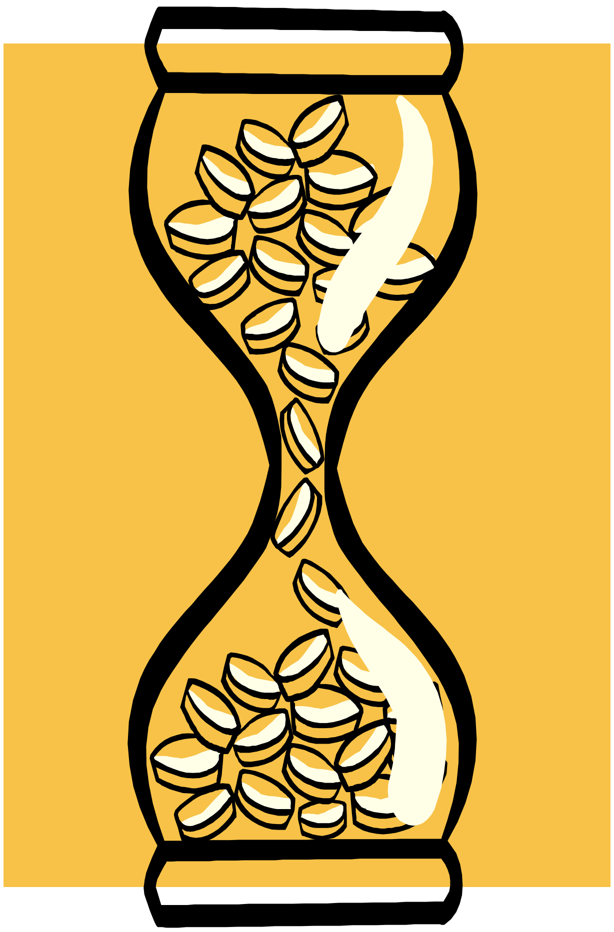
Points of Interest

- **The tax cuts established during the first few years of the Bush Administration will, or are at least slated to, automatically sunset as of January 1, 2011.**
- **The requirements for exchanging real property are not nearly as stringent as for non-real property.**
- **Because capital gains taxes will increase in the near future, efficient tax planning has become absolutely critical to retirement planning.**



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Words of Wisdom From A Business Owner's Death Bed – Part I

Mike Ertel, CBI/ M&AMI/ CM&AA

A colleague of mine relayed the following words of wisdom which he acquired from a client that had to sell his company from his death bed. The client and his family dictated these bits of wisdom in one long visit, and I feel privileged to now share them with you:

1. Life isn't fair, but it's still good.
2. When in doubt, just take the next small step.
3. Life is too short to waste time hating anyone.
4. Don't take yourself so seriously. No one else does.
5. Pay off your credit cards every month.
6. You don't have to win every argument. Agree to disagree.
7. Cry with someone. It's more healing than crying alone.
8. Save for retirement starting with your first paycheck.
9. When it comes to chocolate, resistance is futile.
10. Make peace with your past so it won't screw up the present.
11. It's OK to let your children see you cry.
12. Don't compare your life to others. You have no idea what their journey is all about.
13. If a relationship has to be a secret, you shouldn't be in it.
14. Life is too short for long pity parties. Get busy living, or get busy dying.
15. You can get through anything if you stay put in today.
16. A writer writes. If you want to be a writer, write.
17. It is never too late to have a happy childhood. But the second one is up to you and no one else.
18. When it comes to going after what you love in life, don't take no for an answer.
19. Burn the candles, use the nice sheets, and wear the fancy lingerie. Do not save it for a special occasion. Today is special.
20. Over prepare, and then go with the flow.
21. Be eccentric now. Don't wait for old age to wear purple.
22. The most important sex organ is the brain.

To Be Continued…

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In closing, if you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me at mertel@legacyadvisorsgroup.com

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Frequently Asked Questions…

Q: Under the Small Business Jobs Act of 2010, is there any effect on Built In Gains (BIG) Taxes for S corporations that were once C corporations?

A: Yes, under the Small Business Jobs Act of 2010, BIG taxes will temporarily have a shortened holding period. Ordinarily, the holding period was 10 years. It then became 7 years. In 2011, as long as the fifth year of holding precedes the beginning of 2011 and the sale is made during 2011, BIG will not be taxable.

Q: I am selling my business this year under an installment agreement. Can I elect to recognize the taxes this year as to avoid the higher tax rates?

A: Yes, you can elect, on installment sales, to have the future proceeds be taxed in the current year, thus saving you 5% of the total. For those with million dollar capital gains, the savings could be $50,000 or more in taxes alone. It is definitely an option worth exploring if you sold your business this year or if you are receiving installment income in the future.

Q: Under the Small Business Jobs Act of 2010, what are the adjustments to Section 179 expensing?

A: Section 179 expensing has been increased from $250,000 to $500,000. The $500,000 limit is retroactive to purchases made from January 1, 2010 and runs until the end of 2011. Additionally, 50% Bonus depreciation is back as well this year. Bonus depreciation is not dependent on any investment limit like Section 179 is.

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