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*By Jeff Nelson*

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# IRS Issues Two Like-Kind Exchange Rulings Friendly to Lessors

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Two recent rulings from the Internal Revenue Service benefit lessors with respect to like-kind exchanges. Lessors should examine the structure of their existing lease financing with an eye toward adaptations consistent with the facts and structure of the internal legal memorandum.

The benefits of like-kind exchange (LKE) programs for equipment lessors are clear. LKEs allow lessors to reinvest 100% of equipment disposition proceeds back into their business by refraining from using part of the cash proceeds to pay federal and state taxes on gains. If a lessor's applicable federal and state tax rate is 40%, this gain deferral provision means that for every \$1 million in taxable gain, lessors will have additional cash of \$400,000 to reinvest in their leasing business. For the typical lessor, this additional cash can generate increased ROI for its lease portfolio of 75 to 150 basis points. As a result, LKEs provide significant economic advantages.

In spite of these advantages, some lessors still choose not to implement an LKE program specifically because of a concern that they may need to maintain significant LKE-related cash

balances or because LKE administrative rules and regulations provide too many unresolved questions for the uneducated or unwary.

Fortunately, the Internal Revenue Service (in this case the IRS Chief Counsel) occasionally reaches a conclusion that not only is 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's holding in two recent rulings, internal legal memorandum ILM 201325011 and technical advice memorandum (TAM) 201437012.

## **INTERNAL LEGAL MEMORANDUM 201325011**

ILM 201325011 involved an equipment leasing/rental company (let's call it LeaseCo) that had implemented a like-kind exchange program to

systematically defer income taxes on gains generated when LeaseCo disposed of its off-lease equipment. While the IRS did not question the overall operation of LeaseCo's LKE program, it did question whether LeaseCo could immediately use cash generated from the sale of its equipment (in this case, the exchange proceeds) to immediately repay a general line of credit. That line of credit was used not only to finance LeaseCo's equipment purchases but was also used to fund LeaseCo's general business operations and to purchase non-LKE property.

Specifically, the IRS questioned whether LeaseCo could use exchange proceeds to repay debt that was borrowed for purposes unrelated to the equipment being exchanged. In this case, the IRS Chief Counsel ruled in favor of LeaseCo.

## **Why Is This IRS Guidance Important to Lessors?**

In a like-kind exchange program, the general rule requires that lessors exchange old property "solely" for "like-kind" new property acquired as many as 180 days after the sale of the old property. During that 180-day period, lessors are generally not allowed to use disposition proceeds for any purpose other than the acquisition of like-kind new property.

However, there are exceptions to this general rule. Specifically, where the equipment being exchanged is collateral for a loan and the loan requires that proceeds from the sale of collateral must be used to repay the loan, then an immediate loan repayment with exchange proceeds is allowed. This applies even when cash from the original borrowing was used for purposes unrelated to the acquisition of the exchanged equipment.

This ruling is especially important for lessors that may hold the same assets not only for tax lease purposes (which qualify for LKE) but also for inventory or resale purposes separate and apart from their leasing activity.

Prior to the issuance of this ruling, many lessors were concerned that the adoption of an LKE program for their lease dispositions might require that they retain large, unproductive cash balances from dispositions while waiting for an opportunity to acquire “like-kind” replacement equipment as many as 180 days later.

Equipment leasing is an extremely competitive business in which success and failure can often be measured in increments of positive cash flow or a couple of basis points in yield. A requirement to maintain significant unproductive cash balances to support a lessor’s LKE program increases the lessor’s overall cost of capital.

It also may prevent the lessor from taking advantage of other profitable business opportunities. All things being equal, lessors would prefer to immediately use cash from lease dispositions to either pay down expensive borrowings or to fund profitable new business.

In this case, the IRS’s legal memorandum clarifies that lessors are allowed to do both. Specifically it first 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 that 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.

### **TECHNICAL ADVICE MEMORANDUM 201437012**

TAM 201437012 also involved a LeaseCo that had implemented an LKE Program for dispositions of its off-lease equipment. As in the case of ILM 201325011, the IRS did not question the overall operation of LeaseCo’s LKE program. However, it did question whether certain previously

unmatched equipment acquisitions were eligible to be treated as replacement equipment in an LKE where other equipment was deemed ineligible pursuant to an IRS audit.

In this case, LeaseCo argued that it had previously unmatched replacement equipment (for which the IRS had no eligibility issues), which LeaseCo could “rematch” in substitution for the equipment that the IRS now determined was ineligible. The IRS argued that this substitution (or rematching) was not allowed; furthermore, LeaseCo was bound by its original formulation of its exchanges representing a match of eligible relinquished equipment with ineligible replacement equipment. Once again, the IRS Chief Counsel ruled in favor of LeaseCo.

### **Why Is This IRS Guidance Important to Lessors?**

Where lessors meet the requirements of the statute (IRC Section 1031), like-kind exchange treatment is mandatory. The treatment cannot be waived or disavowed by either LeaseCo or the IRS. In this case the IRS attempted to invent a new rule that made LeaseCo’s original formulation of its exchanges (with what is later determined to be ineligible

replacement equipment) an irrevocable choice: one that LeaseCo could not later correct with the rematching of other, eligible replacement equipment that was previously available but had not been matched in any exchange.

The Chief Counsel disagreed, ruling that where dispositions and acquisitions of old and new like-kind property otherwise meet the requirements of LKE, then the equipment must be matched or rematched in an exchange regardless of LeaseCo’s original tax return treatment.

This ruling is especially important for lessors that may hold the same assets not only for tax lease purposes (which qualify for LKE) but also for inventory or resale purposes separate and apart from their leasing activity (which do not qualify for LKE). In these cases, the ruling reaffirms the mandatory nature of LKE and it clarifies that, regardless of LeaseCo’s original formulation of its exchanges, where LeaseCo acquires sufficient eligible like-kind replacement equipment, then LeaseCo can later reformulate its exchanges with other eligible equipment in response to an IRS audit adjustment or disqualification of individual assets.

### **WHAT SHOULD LESSORS DO NOW?**

Both of the recent LeaseCo friendly rulings discussed above, as well as many other rulings and judicial decisions over the last several years, provide lessors with important roadmaps for more efficient LKE cash management as well as increased certainty surrounding LKE program processes.

Regarding LKE cash management, lessors with pre-existing LKE programs as well as lessors considering the implementation of a new LKE program should examine the structure of their existing lease financing to determine whether they can make adaptations consistent with the facts and circumstances outlined in the internal legal memorandum.

Although the memorandum can be used as precedent only by the taxpayer for whom it was issued, it does indicate the IRS’s position on this issue. Adaptations made consistent with the collateral and repayment processes outlined in the memorandum should give lessors increased 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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Based in Minneapolis, Jeff Nelson is a managing director and initiative leader for PricewaterhouseCoopers LLP's like-kind exchange and tax depreciation services practice. In that role, he has been a leader in developing and implementing creative tax solutions that enable companies to take advantage of automated fixed-asset solutions for all types of business and investment assets. Included among his clients are numerous companies in banking, lease/finance, vehicle fleet management, trucking, and machinery and equipment rentals. Before joining PwC as a senior managing director, Mr. Nelson practiced as a tax partner in the real estate/construction services group of a large regional CPA firm. He is a frequent national speaker and author on the topic of like-kind exchanges for business and investment property. He is also a member of the ELFA Federal Tax Committee. Mr. Nelson received his BSB in accounting at the University of Minnesota, Carlson School of Management, Minneapolis, and his master's of tax (MST) from DePaul University in Chicago.

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