PROGRAM EXCHANGES

Program exchanges are one of the more creative uses for Section 1031 exchanges. A program exchange is one in which a continuous stream of dispositions and acquisitions is structured as a series of like-kind exchanges. Program exchanges are frequently used by lessors of vehicles, railcars, and other depreciable tangible property. Leasing companies regularly sell vehicles and equipment coming off-lease, and replace their fleets with new vehicles and equipment. Vehicles and equipment depreciate quickly for tax purposes, yet retain significant economic value at the end of the lease term, generating significant taxable gain. Since the gain will be taxable at ordinary income rates, lessors have great incentive to implement a like-kind exchange program to efficiently recycle capital into new assets.

In a program exchange, Compass will work with the client ("Lessor") and its tax advisors and bankers to review the mechanics of sale and purchase transactions, movement of funds, and draft documents that will structure the sales and purchases as tax-deferred exchanges. Compass will also work with Lessor and its bankers to establish written procedures for the notification of assignments to the qualified intermediary and for the transfer of funds, striving to maintain consistency with existing practices to the greatest extent possible.

The IRS approved many like-kind exchange programs in a series of private letter rulings. Subsequently, the IRS issued Revenue Procedure 2003-39 establishing safe harbors for a number of practices that had been previously permitted in past private letter rulings. Revenue Procedure 2000-39 applies to ongoing exchanges of more than 100 items of tangible personal property through a single qualified intermediary.

Lessor and QI must enter into a master exchange agreement that limits Lessor's rights to receive, pledge, borrow, encumber, or otherwise receive the benefits of the money or property held by the qualified intermediary as required by the safe harbor Regulations. Essentially, the sales proceeds from the off-lease vehicles must be placed in a restricted account. The Revenue Procedure permits the use of a collection account in order to separate exchange proceeds from non-exchange proceeds (such as lease payments, security deposits, and proceeds from vehicles for which no exchange will be undertaken -- for example, vehicles sold at a loss or leased for less than one year). Exchange funds from the collection account typically are deposited daily into an investment or holding account. As vehicles are acquired, proceeds are transferred from the investment account into a disbursement account from which electronic transfers are made to dealers to purchase new vehicles coming on-lease. The Revenue Procedure permits the accounts to be jointly held in the name of the QI and the Lessor. The QI must approve of transfers from a joint account in order to satisfy the requirements that the taxpayer not have actual or constructive receipt of the exchange funds.

The Revenue Procedure permits the netting of obligations between a dealer and leasing company. If the taxpayer regularly engages in lending, and loans the purchase price to a buyer of a vehicle, the receipt of the note will not be considered actual or constructive receipt of money.

The QI must be assigned rights in each vehicle sold and acquired. The Revenue Procedure permits a blanket assignment of rights to the QI. This blanket assignment may be for future sales not yet under agreement. Written notice of this assignment must still be given to the buyers and sellers. Notice is given in either the vehicle transfer documents or electronically.

In most program exchanges, the replacement vehicles are acquired within 45 days from the date of the sale of the old vehicle. No written identification is required unless the replacement vehicles will be acquired after the end of the 45-day identification period. Most large program exchanges use sophisticated matching software to do a "best fit" analysis of how to match one or more sales to one or more acquisitions. Matching is particularly important to track the depreciable basis of replacement vehicles, and compute taxable and deferred gain for Form 8824. One of the most important benefits of Rev. Proc. 2003-39 is that the taxpayer has until the due date of the return (with extensions) to complete the matching of relinquished and replacement properties.

Compass' principals have participated in implementing many sophisticated vehicle and equipment exchange programs for leasing companies in the *Monitor 100*, and would be pleased to consult with any potential client or tax advisor that may wish to implement a program exchange for vehicles or equipment.