



Like-Kind Exchange Matching Application Program Overview

The Like-Kind Exchange Matching (LKEM) application was developed to take advantage of the like-kind exchange tax rules under Section 1031 of the Internal Revenue Code. The application was designed specifically for entities with high volumes of leasing or rental activities. Application of the like-kind exchange tax rules allows for the deferral of gains on property sold by the leasing entity.

The following paragraphs describe both the tax law surrounding like-kind exchange and the functionality of the LKEM application.

Like-Kind Exchange Overview

The LKEM program permits lessors of vehicles to take advantage of the tax benefits of the like-kind exchange rules and regulations under Internal Revenue Code Section 1031. These benefits allow lessors to defer the recognition of gain on the sale (relinquishment) of leased property.

The general income tax rules provide for the realization and recognition of gain on the sale of an asset. The amount of gain equals the amount realized (proceeds) minus the adjusted basis (cost less accumulated depreciation). The lessor depreciates vehicles over five years under MACRS. As a result, a vehicle that originally cost \$30,000 will have an adjusted basis of \$5,184 after four years (accumulated depreciation of 82.72%). If this vehicle sold for \$15,000, the proceeds (\$15,000) minus adjusted basis (\$5,184) would result in \$9,816 of gain. Under the tax code rules for asset sales, the lessor would pay a tax of \$3,435 (\$9,816 multiplied by a tax rate of 35%) on that gain.

The like-kind exchange rules permit lessors to defer recognition of gain by contracting with a qualified intermediary (QI) to conduct sales of relinquished property and purchases of replacement property. Under their "Exchange Agreement", upon the termination of a lease, the QI is required to sell all property that the lessor previously owned, leased and depreciated. The QI uses the proceeds from such a sale to purchase replacement property. Generally, the proceeds from the sale will not be enough to purchase the replacement vehicle, so the lessor will fund a supplementary account that the QI will use to make up the difference.

LKEM achieves gain deferral by matching sales of sold (relinquished) property with purchases of replacement property. As a result, unlike the example above, the lessor does not pay tax on exchanges that qualify for LKEM. Going forward, the tax basis of the purchased (replacement) property is the tax basis of the sold (relinquished) property plus any additional cash used to purchase the replacement property. This amount is then depreciated and the LKE process begins anew.

LKEM Application Overview

The LKEM Application is an application written using Oracle Developer 2000 and an Oracle database. The primary objectives of the application are to:

- Significantly improve after-tax profitability through the application of like-kind exchange tax laws.
- Match leases and track details of each like-kind exchange for the purpose of creating a tax benefit allowable by the IRS.
- Generate necessary reports to be delivered to the IRS for annual income tax reporting, as well as provide information for quarterly estimated tax payments.

The application performs the like-kind exchange matching process through an extraction of data from the client's production lease accounting application and the performance of a series of batch processes. Some minor screen interactions are provided to set up system parameters, generate reports or maintain the system. This application was developed to support the quarterly estimated payment process and the annual income tax return process. The primary segments of the application are as follows:

- **Application Setup:** Prior to loading data into the LKEM application, certain parameters must be set. These parameters include file directories for importing data, criteria to be followed during the matching process, code definitions for certain fields of the extract file and depreciation method definitions.
- **File Import:** Two files are required in order to run the batch processing of the LKEM application, an extract file and a control file. The extract file contains all of the lease records to be imported, and the control file is used to verify that the extract file is imported correctly. The two files are placed in the specified import directory, where a phantom script running on the server will recognize them. Once the two files are detected, the script will start the batch processing, which begins with the transfer of data from the extract file to the table containing all lease data for the application.
- **Vehicle Matching:** Once the lease records are imported into the database, the matching process begins. Vehicles are first categorized as eligible or ineligible as replacement or relinquished property. The application then attempts to match as many of the relinquished properties as possible through a process of sorting and scanning. Matched vehicles are recorded and marked as ineligible for future matching.
- **Reporting:** Once the matching process is completed, the user can navigate through a series of screens to prepare reports for tax as well as administrative purposes. Reports can be printed, displayed on screen or saved to a file.

Automated Processes Overview

The automated processes of the LKEM application run in the background as batch processes and provide the core functionality of the application. These processes do not require any interaction from the application user, except to place the extract and control files in the specified staging directory.

The automated processes of the application cover three major aspects of the application functionality. These three areas can be summarized as follows:

- **File Loading:** In this process, data is imported from the extract file and placed in the import directory to the Oracle database. The extract file is the source text file and is populated with lease like-kind properties and their attributes. A control file is used to verify that data is imported accurately. Designated “.log” files are generated by the import process to document information about the data imported. Designated “.bad” files contain a list of property not imported due to invalid data.
- **Data Update:** Once the initial file loading process is completed, the application updates the Oracle tables with any new information imported. Once all updates have been made, the application determines the matching eligibility of all of the vehicles in the system.
- **Property Matching:** After all leases have been marked as eligible or ineligible for matching, the matching process begins. During this process, the application first tries to match as many relinquished vehicles as possible to available replacement properties, and then tries to match any replacement vehicles.

Once all of the above procedures are complete, the extract file and control file are placed in a History file specified in the Environment Parameters screen, along with the corresponding “.log” and “.bad” files.