A TAX BREAK FOR THE WORKING MAN

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Rufus Johnson***** was born in Eastern North Carolina during the latter part of the Great Depression. He dropped out of school before the eighth grade, worked in the tobacco fields, developed a passion for dirt track racing and antique cars and eventually made a modest living as a small town automobile mechanic.

I met Rufus just after he had been released from the hospital suffering from respiratory problems; he wanted to talk about several estate planning issues and asked me to draft a Will and General Power of Attorney that would reflect his wishes. Rufus had two (2) primary assets – a small farm with a house and barn located on about seventy-five (75) hard scrabble acres and a classic antique Hudson automobile which Rufus had meticulously restored over the years into exquisite condition. At that time, the real property was worth about Two Hundred Thousand Dollars ($200,000.00) and the Hudson automobile was valued at a jaw-dropping Two Hundred Fifty Thousand Dollars ($250,000.00).

Mr. Johnson wanted to retire and continue to live on his farm but his Social Security benefits were his only source of retirement income and those benefits were inadequate to meet his needs for food, utilities, insurance, taxes, home mortgage, healthcare needs, etc. Rufus concluded that his only option was to sell his antique Hudson and draw down on the net sale proceeds as needed to supplement his retirement income for the remainder of his life.

The problem with this strategy was that Rufus had very little basis in this highly valuable automobile. When he sold the Hudson, nearly all the proceeds would be subject to tax, thereby significantly reducing the assets available to supplement his retirement income. Furthermore, without adequate investment assistance, Rufus would likely place the cash in low yielding bank CDs which would further erode the available assets if the interest rate failed to keep pace with inflation. I advised Rufus that what he needed was a plan that would “unlock” the equity in his car, reduce the tax consequences for the sale of that car and keep his sale proceeds well invested. I suggested the following plan using a Section 1031 tax deferred exchange:

- Find a buyer for the Hudson automobile and enter into a contract to sell the car to a qualified intermediary;
- Identify three (3) other antique cars with a total value of at least Two Hundred Fifty Thousand Dollars ($250,000.00);
- Complete a timely, fully qualified Section 1031 tax deferred exchange at which time Mr. Johnson would purchase the three (3) identified antique cars from the qualified intermediary. Rufus would experience no immediate tax consequences as a result of this timely and successful Section 1031 Exchange, although the three (3) cars obtained by Rufus in the exchange would assume the same low basis that he previously held in the Hudson;
- Rufus could plan to sell the three (3) antique cars obtained in the exchange, one at a time, as his cash needs dictated. He would pay taxes only on the proceeds from the sale of the selected antique car – the remaining cars still in his name would continue to increase in value; and
- In the event Rufus died while still the owner of one or more valuable antique cars, those vehicles would assume the date of death value and have the basis "stepped up" in the hands of the beneficiary.

The working man who owns a debt-free home, is not involved in an IRA or other qualified retirement plan and does not participate in college tuition plans or payroll deduction Section 125 Cafeteria Plans has very few tax exemptions available to him. This tax deferred exchange of like-kind personal property works similar to the more common real property like-kind exchange under Section 1031 of the Internal Revenue Code. I highly recommend that middle class and working class taxpayers take a more serious look at the numerous opportunities available to utilize Section 1031 exchanges to gain significant tax deferrals for both real and personal property transactions.

***** *Rufus Johnson is a fictitious person. He represents a compilation of clients with tax savings needs for whom I have designed strategies which included Section 1031 tax deferred exchanges.*