Conducting Aircraft Tax Free Exchanges

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Your Tax Concerns

- ✈Your aircraft has been fully (or nearly fully) depreciated for tax purposes
- ✈Your aircraft has significant market value

Your Tax Concerns Cont…

- You want to sell your aircraft and use the proceeds to buy another aircraft, but the sale of your “old” aircraft could result in millions of dollars of recapture, all of which could be taxable at ordinary tax rates

Your Solution

- ✈If you "exchange" your old aircraft for your "new" aircraft in a transaction qualifying under Section 1031 of the Internal Revenue Code, you may be able to defer recognition of some or all of the gain from the sale of the old aircraft

Issues?

- Qualifying a transaction under Section 1031 can be complicated
- Transaction form and timing are critical

Issues Cont…

- An inadvertent or relatively minor timing or documentation error in an otherwise properly structured transaction can cause the whole transaction to fail to qualify under Section 1031

Statutory Elements of a Tax-Free Exchange

- You must have held your old aircraft for productive use in a trade or business, or for investment
- You must hold your new aircraft for productive use in a trade or business, or for investment

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Statutory Elements of a Tax-Free Exchange Cont…

- Your new aircraft must be “like-kind” to your old aircraft
- You must NOT sell your old aircraft and purchase your new aircraft in separate transactions, but rather must exchange your old aircraft for your new aircraft

Statutory Elements of a Tax-Free Exchange Cont…

- You must recognize gain to the extent of any cash or any other non-qualifying property received in the exchange
- Your basis in your new aircraft will be adjusted downward by the amount of gain deferred by the exchange

Multi-Party Exchange and Deferred Exchange Safe Harbors

- If you are not actually selling your old aircraft to the same party from whom you will purchase your new aircraft (e.g. an OEM), the transaction must be structured as a multi-party exchange

Multi-Party Exchange and Deferred Exchange Safe Harbors Cont…

- In multi-party exchanges, the sale of the old aircraft and the purchase of the new aircraft may occur simultaneously, or up to 180 days apart

Multi-Party Exchange and Deferred Exchange Safe Harbors Cont…

- If you will close the purchase of your new aircraft within 180 days subsequent to the closing of the sale of the old aircraft, you must structure the transactions as a "Forward Exchange"

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Multi-Party Exchange and Deferred Exchange Safe Harbors Cont…

- ✈ If you will close the purchase of your new aircraft within 180 days prior to the closing of the sale of the old aircraft, you must structure the transactions as a “Reverse Exchange”

Forward Exchange Basics

- Authorized by Treasury Regulations § 1.1031(k)-1
- Qualified Intermediary ("QI") acts as middleman in sale of the old aircraft and acquisition of new aircraft

Forward Exchange Basics Cont…

- You and QI enter into an Exchange Agreement which restricts your rights to receive proceeds from the sale of the old aircraft
- Proceeds from the sale of the old aircraft are held in a qualified escrow account or a qualified trust account pending purchase of the new aircraft

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Forward Exchange Basics Cont…

- You must either acquire the new aircraft, or specifically identify the aircraft that will be acquired, within 45 calendar days after completion of the sale of the old aircraft.
- You may be allowed to identify multiple and/or alternate aircraft

Forward Exchange Basics Cont…

✈ You must complete your acquisition of the new aircraft no later than the earlier of:

(1) the 180th calendar day after completion of the sale of the old aircraft; or . . .

Forward Exchange Basics Cont…

(2) the due date (including extensions) of your Federal income tax return for the taxable year in which the sale of the old aircraft occurred

Reverse Exchange Basics

- Authorized by IRS Revenue Procedure 2000-37, 2000-40 IRB 1 (September 15, 2000)

Reverse Exchange Basics Cont…

- Procedures are similar to Forward Exchange, except that an Exchange Accommodation Titleholder ("EAT") holds title to either the old aircraft (a "Front-End Reverse Exchange"), or the new Aircraft (a "Back-End Reverse Exchange") until a closing of the sale of the old aircraft can be arranged. (The EAT usually also performs the QI function)

Reverse Exchange Basics Cont…

- You and EAT must enter into a Qualified Exchange Accommodation Agreement

Reverse Exchange Basics Cont…

- You must either complete a sale of the old aircraft to a third-party buyer, or specifically identify the aircraft that will be sold, within 45 calendar days after the acquisition of the new aircraft by you in a Front-End Reverse Exchange, or by the EAT in a Back-End Reverse Exchange

Reverse Exchange Basics Cont…

- The sale of the old aircraft must be completed no later than: the 180th calendar day after the acquisition of the new aircraft by you in a Front-End Reverse Exchange, or by the EAT in a Back-End Reverse Exchange; <u>OR</u>
- The due date of the taxpayer's federal tax return, including extensions, if prior to 180 days

Common Questions

✈1) Who may and who may not serve as Qualified Intermediaries and/or Qualified Exchange Accommodation Titleholders? (e.g., Lawyers, Accountants, Aircraft Brokers)

Common Questions Cont…

- 2) Are OKC escrow accounts "Qualified" escrow accounts?

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Common Questions Cont…

- 3) In a forward exchange, can I take title to a green aircraft in exchange for my old aircraft?

Common Questions Cont…

- 4) Can I make progress payments on a new aircraft?

Common Questions Cont…

- 5) Can I exchange my aircraft for:

  1. An interest in a partnership that owns a different aircraft?
  2. A 100% interest in a limited liability company that owns a different aircraft?
  3. A fractional interest in a new aircraft?

Common Questions Cont…

- 6) Can I trade two old aircraft for one new aircraft in a single 1031 transaction?

Common Questions Cont…

- 7) Can I exchange my old aircraft for a new aircraft of lesser value and receive the price difference in cash tax-free?

Common Questions Cont…

- 8) What happens if I do a Reverse Exchange and can't sell my old aircraft within 180 days of the purchase of my new aircraft?

Common Questions Cont…

- 9) Will my exchange qualify as a "trade-in" for state sales and use tax purposes?

Special Rules: Like-Kind Exchanges

- Bonus Depreciation applies in the year the replacement property is placed in service
- Both the Carryover Basis (i.e., the basis in the relinquished aircraft), and the Excess Basis (i.e., additional cash paid in the exchange), are eligible for Bonus Depreciation
- Depreciation (Bonus and MACRS) is computed separately for the Carryover Basis and the Excess Basis

Special Rules: Like-Kind Exchanges

- ✈ MACRS tables can be used to calculate annual depreciation on that portion of the Excess Basis that remains after deducting Bonus Depreciation

Special Rules: Like-Kind Exchanges

- Deduction Attributable to Relinquished Aircraft in Year of Exchange has 3 components:
  1. MACRS deduction applicable to that portion of the year preceding the exchange (apply applicable convention)
  2. Bonus Depreciation on remaining Carryover Basis
  3. MACRS deduction applicable to that portion of the year after the exchange

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Special Rules: Like-Kind Exchanges

- Deduction Attributable to Replacement Aircraft in Year of Exchange usually has 2 components, but may have 3 components if Section 179 expensing also applies:
  1. Section 179 expensing deduction, if applicable
  2. Bonus Depreciation
  3. MACRS deduction

Closing Remarks

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