CONDUCTING A REVERSE TAX-FREE EXCHANGE

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1. Background

While the courts and the IRS have long sanctioned deferred like-kind exchanges where there is a gap in time of up to six months between an aircraft owner's sale of an existing aircraft (the "trade-in aircraft") and its purchase of a new aircraft, until recently, there has been significant uncertainty about whether the owner may acquire a new aircraft before disposing of the old one in a tax free exchange - - a so-called reverse like-kind exchange. As there are frequently many reasons to want to purchase a new aircraft prior to selling an existing one, the IRS's failure to address this issue has been of particular concern to aircraft owners. Even a one-day gap between purchase and sale could cause significant uncertainty, or make tax benefits unavailable. Luckily, this situation has changed, due to new guidance issued by the IRS. Aircraft owners can now clearly obtain the substantial tax deferral benefits of a like-kind exchange, and, at the same time, effectively acquire the new aircraft on their preferred time schedule.

In order to understand the IRS's new guidance, it may be helpful to understand how these transactions were carried out in the era of uncertainty before the guidance was issued. The new guidance mirrors the techniques used by creative attorneys to accomplish these transactions and effectively endorses them. In the past, the most common technique has been the use of a "parking company." Typically, the parking company borrows funds, acquires the new aircraft, and leases it to the client. The client holds title to the trade-in aircraft until a sale can be arranged. The client then exchanges the trade-in aircraft for the new aircraft with the parking company, and the parking company sells the trade-in aircraft to its ultimate buyer. This article will refer to this type of reverse exchange as a "back-end" exchange, because the exchange of the new aircraft for the trade-in occurs at the end of the transaction.

In contrast, in a "front-end" reverse exchange, the parking company will acquire the new aircraft and immediately enter into an exchange with the client, so that the parking company ends up holding the trade-in aircraft and leasing it to the client. The client then arranges a sale of the trade-in aircraft and assigns the sale contract to the parking company. The parking company may obtain the purchase money from a bank loan guaranteed by the client, or it may be borrowed from the client.

The objective of tax planning for reverse exchanges with a parking company is to assure that the parking company is not viewed as the agent of the client, but until now there has been significant uncertainty about the effectiveness of different planning techniques in achieving a separation between client and parking company that will be respected for federal tax purposes. As of September 15, 2000, the IRS has removed much of this uncertainty in Revenue Procedure 2000-37, 2000-40 IRB 1 (Sept. 15, 2000) that sets forth the requirements for a parking company that will not be viewed as the client's agent.

2. Detailed Explanation of Provisions

Effective for transactions occurring on or after September 15, 2000, the IRS will respect a reverse exchange accomplished through the use of a qualified exchange accommodation arrangement ("QEAA"). A QEAA has six elements:

1. title to the new aircraft and the trade-in aircraft must be transferred to and held by an "exchange

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accommodation title holder" ("parking company");

2. at the time the parking company acquires title to the new property in a back-end reverse exchange or to the trade-in property in a front-end reverse exchange, the client has a "bona fide intent" to enter into a like-kind exchange;
3. within five (5) days of the parking company acquiring title to either aircraft, the client enters into a written "qualified exchange accommodation agreement" that makes reference to Rev. Proc. 2000-37 and the intent of the parties to enter into an exchange;
4. within forty-five (45) days, in a back-end reverse exchange, the client properly identifies the trade-in aircraft (alternative and multiple aircraft may be identified);
5. within one hundred and eighty (180) days, the new aircraft is transferred to the client in a back-end reverse exchange, or the trade-in aircraft is sold by the parking company in a front-end reverse exchange; and
6. the combined period of time that the trade-in aircraft and the new aircraft are held in a QEAA does not exceed one hundred and eighty (180) days.

There are several additional requirements regarding the parking company. It must hold "qualified indicia of ownership" in the aircraft, meaning legal title or other beneficial ownership under applicable principles of commercial law. The parking company cannot be related to the client or exempt from federal income tax either because it is a foreign corporation or a U.S. based non-profit; nor can the parking company have performed services for the client as a broker, attorney, employee, accountant, or agent during the two (2) years prior to the transaction. If the parking company is a partnership or an S corporation, it must be 90 percent owned by partners or shareholders who are subject to federal income tax. Lastly, the parking company must hold title continuously during the time between its acquisition of the new property and the expiration of the QEAA. The parking company may be a single member limited liability company that is disregarded for federal tax purposes, as long as the LLC's owner is not a related party or exempt from federal income tax.

Revenue Procedure 2000-37 specifically endorses certain techniques commonly used to enable the parking company to acquire the property or to shift risk to the client and away from the parking company. Prior to the Revenue Procedure, these techniques were subject to challenge on the theory that they made the client - - not the parking company - - the true owner of the new property or the trade-in property. In particular, the IRS will allow the client to loan purchase money funds directly to the parking company, to guarantee a purchase money loan, and to lease the property from the parking company. Additionally, the client and the parking company may agree to fixed formula prices or puts and calls - - effective not more than 185 days - - that are designed to assure that changes in the value of the new property or the trade-in property held by the parking company do not adversely affect the parking company's interests. Finally, in front-end reverse exchanges, the written agreement governing the QEAA may specify that the client will advance its own funds or receive funds to equalize any variation from the estimated value of the trade-in property on the date of the exchange.

This Revenue Procedure is not intended to be the exclusive means of accomplishing a reverse exchange. It is, in effect, a safe-harbor, and the IRS makes clear that it does not intend any inference to be drawn that reverse exchange transactions completed prior to September 15, 2000 are suspect if they did not follow the new requirements.

3. Broker/Dealer's Attempt to Serve as Parking Company Without a QEAA Fails

The importance of following the new rules to conduct a reverse exchange is illustrated by the outcome of a more recent ruling involving a broker/dealer. In TAM 200039005 (released Sept. 29, 2000), the IRS disapproved and made taxable a defective deferred exchange, on the grounds that it amounted to an unauthorized reverse exchange. The client had initially intended to enter into an IRS sanctioned deferred exchange with a broker/dealer, where the broker/dealer would sell the client's trade-in property and use the proceeds to purchase new property.

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The contract for the purchase of the new property had already been signed, but closing had not yet occurred.

When the sale of the trade-in property fell through, the seller of the new property insisted that the client complete its purchase. The client attempted to remedy the situation by causing title to the new property to be transferred to the broker/dealer, asserting that the broker/dealer was the "qualified intermediary." The broker/dealer later sold the trade-in property and transferred the replacement property to the client.

In part, because there was no written agreement in place, governing the exchange (such as a QEAA) and, in part because the broker/dealer received title to the new property prior to obtaining title to the trade-in property, the IRS held that the broker/dealer was, for tax purposes, the client's agent. Accordingly, the broker/dealer's purchase of the new property was viewed as equivalent to the client's buying the property for its own account. Finding no evidence of "mutuality of intent" - - a requirement that might have been satisfied with a written agreement among all the parties (again, such as a QEAA) - - the IRS found that the sale of the trade-in and the purchase of the new property could not be integrated, making the sale of the trade-in fully taxable.

4. Summary and Conclusion

The new IRS guidance is a welcome development for aircraft owners who find themselves needing to acquire a new aircraft prior to the sale of an existing one. In the past, even one day gap between purchase and sale could deny aircraft owners the benefit of tax deferral on the sale of depreciated aircraft assets. The guidance is restrictive, and there is a great deal more planning and documentation involved in arranging a reverse exchange, as compared to a deferred exchange, but it effectively allows aircraft owners to strategically time the purchase of a new aircraft before the sale of a trade-in aircraft without significant uncertainty about the ultimate tax outcome.

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