Integrating Like-Kind Exchanges into an Aircraft Transaction

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PRESENTED BY:

Keith Swirsky, President
GKG Law, P.C.
Telephone (202) 342-5200
kswirsky@gkglaw.com

Jeff Towers, Vice President
TVPX
Telephone (978) 610-1234
jtowers@tvpx.com

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Taxpayer’s Concerns

- Taxpayer’s aircraft has been fully (or nearly fully) depreciated for tax purposes
- The aircraft has significant market value
- Taxpayer wants to sell its aircraft and use the proceeds to buy another aircraft, but the sale of the “old” aircraft could result in millions of dollars of “depreciation recapture”, all of which could be taxable at ordinary tax rates

Depreciation

Regular Depreciation

- The cost of acquiring a business aircraft is depreciated under either a MACRS or straight line system
- To determine which depreciation system applies the taxpayer must consider the use of the aircraft, the location where it will be used and the type of aircraft

Depreciation

Regular Depreciation

- MACRS applies if the aircraft is predominantly (more than 50%) used for “qualified business use” and if the aircraft is predominantly used in the U.S.

- If MACRS applies, fixed wing aircraft which are not used for commercial or contract carrying of passengers or freight and all helicopters use a 5 year schedule and all other aircraft use a 7 year schedule

Depreciation

Regular Depreciation

- If straight line applies, fixed wing aircraft which are not used for commercial or contract carrying of passengers or freight use a 6 year schedule and all other fixed wing aircraft use a 12 year schedule

Depreciation

Bonus Depreciation

- Bonus Depreciation applies in the year the new aircraft is placed in service
- Both the Carryover Basis (i.e., the remaining basis in the old aircraft), and the Excess Basis (i.e., additional cash paid in the exchange), are eligible for Bonus Depreciation
- However, depreciation (both Bonus and MACRS) is computed separately for the Carryover Basis and the Excess Basis

Depreciation

Bonus Depreciation

- In the year of the exchange, the depreciation deduction attributable to Carryover Basis from the old aircraft 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 (apply applicable convention) on Carryover Basis remaining after Bonus Depreciation deduction.

Depreciation

Bonus Depreciation

- In the year of the exchange, the depreciation deduction attributable to Excess Basis 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 on Excess Basis.
  3. MACRS deduction on Excess Basis remaining after Bonus Depreciation deduction (apply applicable convention).

Example

- Taxpayer is selling a fully depreciated aircraft for $10 million and buying another aircraft for $17 million
- If Taxpayer is subject to a 40% effective combined state and federal income tax rate it could have $4 million in tax liability upon the sale
  - Depreciation recapture is taxed at ordinary income rates

The Solution

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

Issues

- Transaction form and timing are critical
- An inadvertent or relatively minor timing or documentation error in an otherwise properly structured transaction can cause the entire transaction to fail to qualify as a like kind exchange under Code Section 1031

Statutory Elements of a Tax-Free Exchange

- Taxpayer must have held its old aircraft for productive use in a trade or business, or for investment
- Taxpayer must hold its new aircraft for productive use in a trade or business, or for investment
- Taxpayer's new aircraft must be "like-kind" to its old aircraft
- Taxpayer must NOT sell its old aircraft and purchase its new aircraft in separate transactions, but rather must exchange the old aircraft for the new aircraft

Statutory Elements of a Tax-Free Exchange

(cont.)

- To get the full tax-deferral benefit, the taxpayer must purchase a new aircraft worth at least as much as the old aircraft and must reinvest all of its equity from the old aircraft into the new aircraft

- Taxpayer must recognize gain to the extent of any cash or any other non-qualifying property received in the exchange

- Taxpayer's tax basis in its new aircraft will be adjusted downward by the amount of gain deferred by the exchange

Multi-Party / Deferred Exchange Safe Harbors

- If Taxpayer is selling its old aircraft to the same party from whom it will purchase its new aircraft (e.g. a trade-in to an OEM or to a fractional program) and both closings will occur on the same day, a qualified intermediary is not required
- If taxpayer is not selling its old aircraft to the same party from whom it will purchase its new aircraft, the transaction must be structured as a multi-party exchange, using a qualified intermediary
- The sale of the old aircraft and the purchase of the new aircraft may occur simultaneously, or up to 180 days apart
- If taxpayer will close the purchase of the new aircraft within 180 days after the closing of the sale of the old aircraft, taxpayer must structure the transactions as a "Forward Exchange"
- If taxpayer will close the purchase of the new aircraft within 180 days prior to the closing of the sale of the old aircraft, taxpayer must structure the transactions as a "Reverse Exchange"

Forward Exchange Basics

- Qualified Intermediary (“QI”) acts as middleman in sale of the old aircraft and acquisition of new aircraft
- Taxpayer and QI enter into an Exchange Agreement which restricts taxpayer’s rights to receive proceeds from the sale of the old aircraft
- Proceeds from the sale of the old aircraft should not be commingled with the QI’s own funds and may be held in a qualified escrow account or a qualified trust account pending purchase of the new aircraft

Forward Exchange Basics

(cont.)

- Taxpayer 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.

- Taxpayer may be allowed to identify multiple and/or alternate aircraft

Forward Exchange Basics

(cont.)

- Taxpayer must complete its 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 . . .
- (2) the due date (including extensions) of taxpayer's 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)

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

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

Reverse Exchange Basics

(cont.)

- Taxpayer 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 the EAT in a Back-End/Exchange Last Reverse Exchange

- The sale of the old aircraft must be completed no later than: the 180th calendar day after the acquisition of the new aircraft by the taxpayer in a Front-End/Exchange First Reverse Exchange, or by the EAT in a Back-End/Exchange Last Reverse Exchange

Common Questions

- Who may and who may not serve as a Qualified Intermediary and/or a Qualified Exchange Accommodation Titleholder? (e.g., Lawyers, Accountants, Aircraft Brokers)
- If a taxpayer has its funds from a sale held in a OKC escrow account and then paid by the escrow agent toward the purchase of the new aircraft can the taxpayer call the transaction an exchange?
- In a forward exchange, can a taxpayer take title to a green aircraft in exchange for its old aircraft?
- Can a taxpayer make progress payments on a new aircraft?

Common Questions

(cont.)

- Can a taxpayer exchange its aircraft for:

  1. An interest in a partnership (or an LLC that is taxed as 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.)

- Can a taxpayer trade two old aircraft for one new aircraft in a single 1031 transaction?

- What happens if taxpayer does a Reverse Exchange and can't sell its old aircraft within 180 days of the purchase of its new aircraft?

- Will a 1031 exchange automatically qualify as a “trade-in” for state sales and use tax purposes?

Important Issues for Lenders

Forward Exchange

- General comment – like-kind exchanges are financially advantageous to taxpayers/borrowers

- Taxpayer (or other entity holding title) will take title and register new aircraft and grant security interest to lender

- Taxpayer's equity from old aircraft must be reinvested in new aircraft
  - May affect loan amount, as loan on new aircraft must allow for equity from old aircraft to be invested in new aircraft
  - As part of loan term sheet preparation, lender should always ask if a like-kind exchange is being conducted

Important Issues for Lenders

Front End/Exchange First Reverse Exchange

- On day one EAT will take title and register old aircraft and assume existing loan obligations to lender on nonrecourse basis with guaranty by taxpayer. An assignment and assumption agreement and guaranty are typical. Lenders will need to waive any applicable pre-payment penalty

- Taxpayer (or other entity holding title) will take title and register new aircraft and grant security interest to lender, in the same manner as if no tax free exchange was conducted

- Taxpayer's equity from old aircraft must be reinvested in new aircraft
  - May affect loan amount

Important Issues for Lenders

Front End/Exchange First Reverse Exchange (cont.)

- Since Taxpayer has not realized its equity on the old aircraft Taxpayer may not have sufficient liquid funds to borrow a reduced amount on the new aircraft

Important Issues for Lenders

Front End/Exchange First Reverse Exchange (cont.)

- Front End/Exchange First structure permits Taxpayer/Borrower to commence depreciating new aircraft earlier

- Permits Taxpayer to utilize bonus depreciation, if applicable

- Permits Taxpayer to use an occasional sale/casual sale sales tax exemption

Important Issues for Lenders

Back End/Exchange Last Reverse Exchange

- On day one EAT will take title and register new aircraft and grant security interest to lender on a nonrecourse basis with guaranty by taxpayer

  - Loan documents should permit pay down without penalty upon sale of old aircraft so that equity may be reinvested by taxpayer if needed

- Upon the sale of the old aircraft the loan will be paid down if needed and Taxpayer (or other entity holding title) will take title and register new aircraft and assume existing loan obligations to lender. Assignment and assumption provisions are required in loan documents

Important Issues for Lenders

Back End/Exchange Last Reverse Exchange (cont.)

- Back End/Exchange Last structure permits EAT to borrow any amount from 3rd party lender and avoids dilemma in a Front End/Exchange First structure of needing to reinvest equity before sales proceeds from old aircraft are actually available
- Back End/Exchange Last structure is advantageous when closing on purchase of new aircraft is occurring soon
  - Only need to coordinate closing on new aircraft
  - Don’t need to change FAA or loan documents on old aircraft
- Back End/Exchange Last structure may have benefits when taxpayer needs both a reverse exchange and a sales tax trade-in

Questions?

Thank you!

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National Business Aviation Association 1200 G Street NW, Suite 1100 Washington, DC 20005 (202) 783-9000 www.nbaa.org