

# Like-Kind 1031 Exchanges with Aircraft

By Bert J. Zarb

Owni ng an aircraft for business purposes is typically undertaken for efficiency and for keeping up with the constantly changing business environment. Acquiring an aircraft usually entails a hefty capital outlay, coupled with significant maintenance and operating costs.

Corporate aircraft ownership has, for a long time, attracted the attention of the IRS, the SEC, the media, and investors. In one notable case, the CEOs of the “big three” U.S. auto makers were chastised by members of Congress for using their respective corporate jets to fly to Washington, D.C., to plead for federal bailout funds.

There exist myriad laws, rules, and regulations aimed at identifying and preventing abuses in corporate aircraft ownership. Some of these rules come into play when an aircraft is sold or disposed of. Because aircraft retain a high resale value, the sale or disposal of an aircraft could result in a substantial realized gain with significant tax consequences. If depreciation is taken on an aircraft, part of any realized gain may also be subject to the depreciation recapture provisions of IRC section 1245. Consequently, taxpayers may avoid selling the aircraft so as not to be subject to tax. (In the case of corporations, capital gains and ordinary income are taxed at the same corporate tax rate. This contrasts sharply with the lower capital gains rate for individuals.)

A technique that can be used to alleviate the incidence of such a tax is to exchange the aircraft under the provisions of IRC section 1031. A section 1031 tax-deferred exchange remains one of the most powerful tax deferral strategies available, and it can be applied to several high-cost items other than aircraft, such as boats, buildings, machinery, equipment, cranes, and bulldozers.

## Section 1031 Exchange

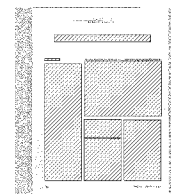
Typically, when a business asset such as an aircraft is disposed of at a gain, that gain will be taxable in the year it is realized. Such a gain will not be currently taxed, however, if the transaction is structured as a like-kind exchange under the provisions

of IRC section 1031. In order to qualify as a tax-free event, it must involve a direct exchange of like-kind realty or like-class personalty. A section 1031 exchange defers the payment of tax that would otherwise be due upon the sale of business or investment property, but it does not eliminate the tax. This deferral of tax on a gain from an exchange stems from the fact that when a business exchanges an old aircraft for a new aircraft, the investment in the new (replacement) aircraft is considered to be a continuation of the investment in the old (relinquished) aircraft. When the replacement aircraft is subsequently disposed of—in what will be deemed a taxable transaction—the tax on the gain is due. The tax can be deferred indefinitely, as long as the replacement aircraft is continually exchanged for like-kind property.

The application of the like-kind exchange provisions under section 1031 is mandatory rather than elective. This means that if a taxpayer desires to recognize a gain or a loss, the transaction will have to be structured in such a way that it will fail the statutory requirements for a like-kind exchange. In such a case, the tax basis of the aircraft received is increased by any gain recognized up to its fair market value.

In order for a like-kind exchange to qualify under the tax-free provisions of IRC section 1031, no “boot” should be received. Although the term boot does not appear either in the tax code or the regulations, it is tax practitioners’ jargon for cash, debt relief, or the fair market value of non-like-kind property received or given in the exchange. Thus, if the value of the replacement property is greater than the value of the relinquished property and boot is received, then that receipt of boot triggers recognition of gain in the amount of the lesser of the boot received or the realized gain.

While the replacement aircraft should be of equal or greater value than the relinquished aircraft in order to fully defer all tax, the gain deferral on the exchange of aircraft used in a trade or business or held for investment will be lost if the exchange



is between related parties and either aircraft is sold within two years of the exchange. IRC section 267 defines related parties as including—

- a shareholder and a corporation that is more than 50% owned;
- members of a family;
- an individual and a corporation, when the individual owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation;
- two corporations that are members of a controlled group (IRC section 1563(a));
- two S corporations, if the same persons own more than 50% in the value of the outstanding stock of each corporation; and
- two partnerships, if the same persons own, directly or indirectly, more than 50% of the capital interest.

IRC section 267(e) extends the definition of related parties by providing that any person who, directly or indirectly, owns stock in an S corporation is considered to be a related party to that S corporation. Likewise, a partner is considered to be a related party to that partnership.

Tangible personal property held for productive use in a trade or business is considered like-kind property if it is exchanged for property that is within either the same general business asset class or same product class. Revenue Procedure 87-56 classifies depreciable tangible property into 13 general business asset classes. The purpose of these classes is to determine the applicable depreciation method, the applicable recovery period, and the applicable convention. Property is classified based on its class life or assigned class life. If the property does not fall within the definition of any of the general business asset classes, any exchange will be deemed to be like-kind if the property falls within the same product class as determined by the North American Industry Classification System (NAICS).

Under the NAICS, product classes are determined with reference to a six-digit NAICS code. In 2003, the NAICS replaced the four-digit Standard Industrial Classification (SIC) coding system that was established in 1987 by the Office of Management and Budget. Aircraft are covered under Industry Group 336411, Aircraft Manufacturing (SIC 3721). Aircraft engines and engine parts are covered under section

336412 (SIC 3724), while other aircraft parts and auxiliary equipment manufacturing are covered under section 336413 (SIC 3728). Generally, property that is listed under a product class may be exchanged for items within the same class and qualify for a like-kind exchange. If aircraft engines are exchanged for other aircraft engines attached to a fully functional aircraft, two independent transactions may be structured, in which one transaction will involve the exchange of engines and the other will involve the purchase or sale of the balance of the aircraft. If an exchange of tangible personal property does not fall within the same general business asset class or product class, the IRS may determine that the exchange still falls under the requirements of IRC section 1031 (IRB 2004-38).

To benefit from the deferment of taxes, the owner cannot have any direct or indirect control over the sales proceeds from the time of the sale of the relinquished aircraft until the purchase of the replacement aircraft. Anything received directly or indirectly by the seller, no matter how insignificant, disqualifies the entire transaction and results in recognition of the entire gain. This can be avoided by appointing a “qualified intermediary,” such as a bank or a specialist dealing in 1031 exchanges, to hold the sales proceeds.

In order to successfully complete a 1031 exchange, therefore, the first step would be to enter into an agreement with a truly independent third party “qualified intermediary” (not a family member, personal accountant, or lawyer). Once this agreement is in place, the sale of the aircraft used in business or as an investment property is made with the sales proceeds—less closing costs and liabilities—being immediately deposited in full with the qualified intermediary. The IRS requires that, within a 45-day period starting from the date of the sale, a list of potential replacement aircraft must be drawn up and given to the qualified intermediary. The replacement aircraft, identified on the 45-day list, must be acquired within 180 days of the sale of the relinquished aircraft, using the funds deposited with the qualified intermediary. These deadlines are strictly implemented and are neither extended by holidays or weekends nor can they be added together. Additionally, title to the replacement aircraft has to be taken in exactly the same legal name in

which the relinquished aircraft was owned, and the value of the replacement aircraft must be equal to or greater than the value of the relinquished aircraft.

### Forward 1031 Exchanges

Most section 1031 exchanges are structured as “forward exchanges.” These types of exchanges are also known as delayed, deferred, or Starker exchanges. They occur when the owner of an aircraft exchanges the relinquished aircraft first and then acquires the like-kind replacement aircraft. This type of exchange is usually preferred because the taxpayer will have funds available to invest in the replacement aircraft. A Starker exchange takes its name from *Starker v. United States* (602 F. 2d 1341 [9th Cir. 1979]), in which the court held that such a forward exchange qualified for tax deferral under IRC section 1031.

### Reverse 1031 Exchanges

If taxpayers find an aircraft that they would like to acquire before they sell their current aircraft, a reverse 1031 exchange may be structured. Under a reverse 1031 exchange, ownership of the replacement aircraft may be secured before the sale of the original aircraft, thus ensuring that the opportunity of acquiring the replacement aircraft is not lost to a competitor. A reverse exchange entails carrying two aircraft for a period of time, because it might be necessary for the exchanger to continue to use the relinquished aircraft. Revenue Procedure 2000-37, as modified by Revenue Procedure 2004-51, provides safe harbor guidelines for ensuring these tax-free exchanges.

In a “reverse first” exchange, a taxpayer transfers title to the relinquished aircraft to an exchange accommodation titleholder (EAT) and then receives title to the replacement aircraft. In a “reverse last” exchange, the taxpayer buys the replacement aircraft and transfers title to the EAT. When the relinquished aircraft is sold, title is transferred to the buyer, and the EAT transfers title to the replacement aircraft to the taxpayer.

Taking advantage of a reverse first or a reverse last exchange depends upon how the replacement aircraft is purchased. If the replacement aircraft is purchased using cash or private financing, either can be

used. If it is purchased by using conventional financing, however, a reverse first exchange is generally preferred, because lenders might object to having a third party (i.e., the EAT) on the title of the property securing the loan or refuse to lend the funds to purchase the aircraft unless the taxpayer takes title to it.

Because the taxpayer cannot own the replacement aircraft and the relinquished aircraft at the same time, the rules for reverse exchanges are more complicated. There must exist bona fide intent, evidenced in writing, to do a like-kind exchange, and the exchange must be completed within 180 days after the EAT receives ownership. If the exchanger owns an aircraft intended to qualify as a replacement aircraft within five days before transferring title to an EAT, then the tax-free treatment will not apply.

Revenue Procedure 2000-37 allows certain activities to take place within the context of “parking” transactions. These include allowing the exchanger to provide the financing so as to facilitate the EAT in acquiring the parked aircraft; allowing the exchanger to lease the parked aircraft during the time in which the EAT holds the aircraft; granting an option to the exchanger to acquire the parked aircraft in the event that the exchange should not occur; and allowing the exchanger to provide management services to the parked aircraft.

### Aircraft Forms of Ownership

Although two aircraft may qualify as a like-kind exchange under section 1031, their form of ownership could be quite different. This is because an aircraft may be owned outright (similar to a “fee interest or fee simple” in real property), or used under a lease agreement. In the case of real estate, the rules under Treasury Regulations section 1.1031(a)-1(c)(2) are quite straightforward. The IRS considers a lease of 30 years or more to be of like-kind to a fee interest (outright ownership) in real property. Conversely, exchanges of short-term leases of real property are not considered to be of like-kind to outright ownership.

There is a paucity of guidance as to whether a lease of personal property, such as an aircraft, could be considered like-kind to outright ownership. It has been argued that the same rule that applies to real property should apply to personal property—in other words, a long-term lease of an aircraft should be treated as like-kind with

respect to an aircraft that is owned outright. The issue, however, revolves around defining what constitutes a long-term lease for different types of personal property such as aircraft. The literature suggests that while a 30-year lease in real property is considered long term, a lease of an aircraft—or any other personal property, for that matter—does not necessarily have to last 30 years to be considered long term. In fact, a common argument suggests that the class life specified in each general business asset class should be used in determining whether a lease of personal property is long term or not. In the case of non-commercial aircraft, this would be six years. Nevertheless, the tax-free treatment of exchanges in like-kind personal property having different forms of ownership remains uncertain.

### **Fractional Ownership of Aircraft**

As fractional ownership of aircraft has gained momentum over the past several years, an issue may arise in the exchange of an interest in a whole aircraft for a fractional interest. While the properties being exchanged are the same, the form of ownership is different. The lack of definite guidance makes this issue a challenge. In the case of real property, Revenue Ruling 73-473 (1973-2 CB 300; PLR 9525042) provides that an undivided fractional interest (i.e., tenancy in common) may be exchanged for another real property that is owned outright (i.e., fee interest or a fee simple). The literature suggests that a fractional interest in an aircraft should be considered like-kind to an outright ownership interest in an aircraft. In trying to run a parallel between real property and personal property, a further complication arises due to the fact that fractional interests in real property are defined by state law, whereas fractional interests in personal property are governed by private contract. Thus, in the absence of specific guidance, it would be safe to assume that such an exchange would be subject to IRS scrutiny on a case-by-case basis.

### **The Tax Deferral Advantage**

Under IRC section 1031, an exchange of like-kind personal property, such as aircraft, is probably one of the last remaining great tax shelters available because it permits taxpayers to dispose of business assets while simultaneously deferring—at times even permanently—federal and state income taxes on gains. It is important to keep in mind that certain requirements have to be met in order to execute a like-kind exchange under section 1031. These criteria include the stipulation that both the relinquished and the replacement aircraft must be used in a trade or business or held for investment purposes; the exchanged aircraft must be of like-kind as specified under the general business asset classes or the NAICS product class; the 45- and 180-day deadlines must be honored; there cannot be actual or constructive control of any of the proceeds received from the sale of the old aircraft; the titleholder of the relinquished aircraft must be the same as the titleholder of the replacement aircraft; and, finally, the value of the new aircraft must be equal to or greater than that of the old aircraft.

While IRC section 1031 exchanges may be structured as either forward exchanges or reverse exchanges, depending upon the circumstances, differences in ownership must be addressed.

Exchanging an aircraft that is owned outright with an aircraft that is leased or fractionally owned might present a challenge because the tax treatment under such circumstances is still uncertain. (See [www.1031cpas.com/documents/1031ExchangeManual.pdf](http://www.1031cpas.com/documents/1031ExchangeManual.pdf) and [aaahq.org/AM2008/display.cfm?Filename=SubID\\_738.pdf&MIMEType=application%2Fpdf](http://aaahq.org/AM2008/display.cfm?Filename=SubID_738.pdf&MIMEType=application%2Fpdf).)

Although the disadvantage of a section 1031 exchange is that it creates a reduced tax basis for depreciation on replacement property, the safe harbor rules provided by IRC section 1031, together with the supporting revenue pronouncements, provide a very strong tax deferral benefit that will not only help taxpayers acquire a newer or larger aircraft but will also help them save a substantial amount on taxes, thereby increasing cash flow and net worth. □

**Bert J. Zarb, MBA, DBA, CPA**, is an associate professor of accounting in the college of business at Embry-Riddle Aeronautical University, Daytona Beach, Fla.

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