1031 Exchanges of Business Aircraft
by
Kevin C. Austin and Timothy L. Austin
Aero Law Group pllc

Attorneys at Aero Law Group have participated in the purchase, sale and exchange of over 3,000 business and commercial aircraft; *however,* prospective clients continue to ask one question more than any other:

"Really? - I can do a 1031 Exchange with my airplane? Wow, I didn't know that!"

Just like in real estate, a business aircraft may be exchanged for another business aircraft under §1031 of the Internal Revenue Code. The first question we typically ask our clients though, is:

"<u>Should</u> you do a 1031 Exchange with your airplane?"

Before anyone moves forward with a 1031 Exchange, it is always important to sit down with your tax attorney or tax accountant and do a *Net Present Value* analysis of the taxes, tax deferrals, costs and cash flows associated with a 1031 Exchange, considering your (or the company's) varying federal and state tax rates, in order to determine how much you are really saving versus the alternative. It's simple economics. The result should almost always show a positive number, but you need to know how much and with relative certainty.

Current Market. Now is a GREAT time to upgrade or trade up in aircraft because of the worldwide economic crisis. Although the value of your current aircraft is depressed, so is the value of the aircraft that you may want to purchase. In raw dollars, it will take much less of your money (i.e., new equity) to trade up now, than ever before. Manufacturers have "whitetails" (aircraft manufactured but currently without a buyer) stashed around the countryside – and they are incentivized to unload these by quarter end or fiscal year end. There are fantastic opportunities out there for anyone buying. However, the lower value of aircraft will also affect the net present value analysis of your 1031 Exchange.

Lingo. If you are considering a 1031 Exchange for your aircraft, there are eight terms you should be familiar with:

"Relinquished Aircraft" – This is the aircraft you want to get rid of.

***"Replacement Aircraft"* -** This is the aircraft you want to acquire.

"Forward Exchange" – This is when you sell the Relinquished Aircraft **before** you acquire the Replacement Aircraft.

"Reverse Exchange" – This is when you sell the Relinquished Aircraft **after** you have acquired the Replacement Aircraft.

"QI or Qualified Intermediary" – This is the party that helps you turn a three-party transaction into a two-party "exchange" that qualifies for 1031 Exchange treatment.

"EAT or Exchange Accommodation Titleholder" – This is the party that holds title to one of your aircraft while you complete a reverse exchange. The EAT is usually affiliated with the QI.

"Parking" – This is what they call it when you give title to your Relinquished or Replacement Aircraft to the EAT.

"Boot" – This is the money, debt forgiveness or other property you took out of the exchange – and will be taxed on immediately – because you didn't follow certain rules or meet certain requirements. Boot is also what happens when the value of, or your equity in, the Replacement Aircraft is less than what you had invested in the Relinquished Aircraft.

Rules. There are a few basic requirements you need to meet to qualify your transaction as a tax-deferred exchange: *First*, both the Relinquished and Replacement Aircraft must be held for productive use in a trade or business (or for investment). This typically disqualifies an aircraft that is used for personal reasons, or at least the portion that is. This will also: (a) disqualify the Relinquished Aircraft, if it was recently acquired and **has** not been held in the business for a reasonable period (as determined by the IRS), or (b) disqualify the Replacement Aircraft, if you intend to promptly dispose of it or convert it to personal use, and it **will** not be held in the business for a similar reasonable period. *Second*, the exchange must be a reciprocal transfer of aircraft-for-aircraft (i.e. a trade) – and not "a sale" of one aircraft and "a purchase" of another. *Third*, the Relinquished Aircraft must be of "like kind" to the Replacement Aircraft. This means you can trade a business aircraft for a business aircraft, but you can't trade a business aircraft for a farm tractor or cruise ship.

Types. We have participated in all kinds of exchanges. Direct Trade-in, Forward Exchange and three types of Reverse Exchanges: (a) Parking the Relinquished Aircraft with the EAT, (b) Parking the Replacement Aircraft with the EAT, and (c) Parking both the Relinquished and Replacement Aircraft with the EAT at different times (Yep, we did that). In all but the last case, the Internal Revenue Code provides Safe Harbors – clear rules – which, if followed to the letter, can provide you with comfort that you have done everything right, and that your transaction should avoid challenge by the IRS.

Dates. Forward and reverse exchanges have specific time periods in which you must identify (45 days) and acquire (180 days) the Replacement Aircraft or complete the exchange. Watch out if your tax return becomes due and you are still in the middle of the exchange; this may shorten those periods. There are also rules on how you will identify the Replacement Aircraft(s).

The current aircraft market makes it very difficult to sell your Relinquished Aircraft in the time period allotted by the Internal Revenue Code. If you are coming up on the end of the exchange period and haven't closed the deal – re-analyze the net present value of your exchange before you make a decision to sell the Relinquished Aircraft at a reduced price. Many times, breaking up the exchange and paying taxes in the current tax period, plus the resulting increase in tax basis on the Replacement Aircraft, is a better option than accepting a "fire sale" price on your Relinquished Aircraft. Don't be driven by this year's tax payment; you need to look at future tax years as well.

When to Call for Help. You need to consult with an experienced aviation attorney or aircraft tax advisor in any 1031 Exchange involving aircraft, but particularly if your transaction involves any of the following circumstances:

- The Relinquished or Replacement Aircraft is a fractional or partial interest in an aircraft.
- You are relinquishing or acquiring multiple aircraft.
- The Relinquished or Replacement Aircraft is or will be owned by a partnership or multi-member LLC.
- The Relinquished or Replacement Aircraft is still under construction or "green" (a term used to define a bare aircraft without a completed interior and other outfitting).
- The Relinquished or Replacement Aircraft is predominantly used in charter (commercial operations) and the other aircraft is used predominantly in your business.

Also, when pursuing an exchange, make sure you consider local sales, use and property taxes on aircraft, as the multiple transactions required to perform a 1031 Exchange can create multiple taxable events. Sales and use taxes are real dollars that can far exceed the value of the 1031 Exchange when proper planning has not occurred.

Recommendations. There are no reasons to take risks.

Contact us for more information (877) 596-1031

One South Main Street, 8th Floor, Salt Lake City, UT 84133-1109 | *Telephone* (801) 596-1031 *Fax* (801) 524-4848

- Plan ahead.
- Do things in the proper order.
- Use a reputable and established 1031 Exchange Accommodator to facilitate your transaction, especially one that has experience dealing with the special issues affecting aircraft. Engage them before you start the process of selling or acquiring an aircraft; *otherwise*, you might disqualify the exchange.
- Make sure that any exchange funds are held in a Qualified Trust account in a regulated financial institution with FDIC insurance.
- Make sure that your QI won't be "disqualified" by having a family or agency relationship with you or your company, such as your mother, a related entity, or an attorney, accountant, investment banker or broker that has worked for you or will work for you, outside of providing certain routine services as specified in the Internal Revenue Code.

Don't cut corners, do it right!

Summary. A 1031 Exchange of aircraft can be a great tax minimization tool for business aircraft. It allows you to defer taxes from a current transaction until a future date. And, you can repeat the process again and again, moving up and up in aircraft, deferring your income taxes on each transaction into infinity and beyond; or just until your death, when you get the ultimate reward from the IRS, a "step up" in your asset's tax basis.

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AERO LAWGROUP, PLLC
www.law.aero
P.O. Box 50228, Bellevue, WA 98015-0228
11120 NE 2nd Street, Bellevue, WA 98004-8332
Telephone (425) 456-1800 Facsimile (425) 456-1801

Contact us for more information (877) 596-1031