

OVERVIEW OF AIRCRAFT LIKE-KIND EXCHANGES

When a business sells or otherwise disposes of property, the excess of the amount realized from the sale or disposition over the adjusted basis (generally, the cost of the property adjusted by such items as depreciation), results in gain or loss¹, which is taxable unless otherwise excepted.² One such exception is that “no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment” (a “like-kind exchange”).³ Although no gain is recognized at the time of the exchange, the basis of the new, or “replacement”, property will be reduced by the amount of gain deferred on the sale of the old, or “relinquished” property; therefore, when the replacement property is sold, the taxpayer will recognize the deferred gain (unless the taxpayer engages in another like-kind exchange).

The first requirement for a like-kind exchange is that real or personal property is required to be exchanged. The like-kind exchange rules generally do not apply to stock in trade or other property held primarily for sale (inventory), stocks, bonds, notes, certificates of trust, beneficial interests, partnership interests, securities or evidences of indebtedness or interest.⁴ However, the acquisition of 100% of the membership interests in a single member limited liability company (“LLC”) is treated as the acquisition of the property held by the LLC,⁵ as a single-member LLC that does not elect to be treated as a corporation is disregarded as an entity separate from its owner,⁶ and a disregarded entity is completely ignored, with the result that the property of the disregarded entity is treated as held directly by the owner of the disregarded entity. For instance, the receipt of replacement property in a like-kind exchange by a disregarded entity was treated as the receipt of like-kind property by the taxpayer,⁷ and the receipt of the sole ownership interest in a disregarded entity owning like-kind property was treated as the receipt of like-kind property by the taxpayer.⁸

The second requirement for a like-kind exchange is that both the property transferred (i.e., relinquished property) and the property received (i.e., replacement property) be held by the taxpayer either “for productive use in a trade or business or for investment.”⁹ There is no length of time specified that the taxpayer must hold either the relinquished property or the replacement property, however, the IRS has taken the position that if the taxpayer’s property was acquired immediately before the exchange, the taxpayer acquired the property primarily to dispose of it, rather than hold it for

¹ IRC § 1001(a).

² IRC § 1001(c).

³ IRC § 1031(a)(1).

⁴ IRC § 1031(a)(2); Reg. § 1.1031(a)-1.

⁵ PLR 200118023.

⁶ Reg. § 301.7701-2(a).

⁷ IRS Letter Ruling 9807013.

⁸ IRS Letter Ruling 200118023.

⁹ IRC § 1031(a)(1).

productive use in trade or business or for investment.¹⁰ Likewise, the IRS has taken the position that if replacement property is disposed of immediately after the exchange, it was not held for qualified purposes.¹¹

The third requirement for a like-kind exchange is that property relinquished must be like-kind with replacement property. The Regulations provide that depreciable tangible personal property is considered to be like-kind property if it is exchanged for property that is either like-kind or like-class.¹² (An exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a like class. These regulations in effect provide a “safe harbor” for property contained in the same class.)

Property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674.¹³ Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) are in asset class 00.21.¹⁴ Since green aircraft would be in the same General Asset Class (00.21) as a completed aircraft, it most likely could be considered like kind. (The IRS has not ruled on this issue, and therefore, whether a green aircraft would be considered like-kind to a completed aircraft is somewhat uncertain.)

Aircraft used in commercial transportation may be exchanged for an aircraft to be used in non-commercial operations even though the aircraft would not be in the same General Asset Class as an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of like class.¹⁵ In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class.¹⁶ Thus, the IRS has found that an automobile and an SUV, although not in the same class, are like kind property because the differences between an automobile and an SUV do not rise to the level of a difference in nature or character but are merely a difference in grade or quality.¹⁷ In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration nature or character of the properties as distinguished from their grade or quality. Significantly, as the standard for comparison, section 1031(a) refers to property of a like—not an identical—kind. The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character.”¹⁸

¹⁰ Rev. Rul. 84,121, 1984-1 CB 168; Rev. Rul. 77-337, 1972 CB 305; Rev. Rul. 57-244, 1957-1 CB 247.

¹¹ Rev. Rul. 75-292, 1975-2 CB 333.

¹² Reg. § 1.1031(a)(2).

¹³ Reg. § 1.1031(a)-2(b)(2).

¹⁴ Reg. § 1.1031(a)-2(b)(2)(iv).

¹⁵ Reg. § 1.1031(a)-2(a).

¹⁶ Reg. § 1.1031(a)-2(a).

¹⁷ PLR 200450005, 12/10/2004.

¹⁸ *Koch v. Commissioner*, 71 TC 54 (1978).

The IRS has indicated, with regard to real estate, that an undivided fractional interest was like-kind to a fee (maximal legal ownership) interest,¹⁹ and although there is no definitive authority, it seems reasonable to conclude that under the above analysis, a fractional interest in aircraft could be like-kind to a whole aircraft.

The fourth requirement for a like-kind exchange is that an exchange is required.²⁰ Although an exchange in its purest form would be simultaneous (see Diagram 1), it is not necessary that the sale of the relinquished property be simultaneous with the purchase of the replacement property; under the like-kind exchange rules, it is possible to structure a deferred (nonsimultaneous) exchange; e.g., the relinquished aircraft is transferred to the third party buyer, but the receipt of the replacement aircraft is deferred (see Diagram 2).²¹ For purposes of the timing requirements listed below, property is transferred when the property is disposed of within the meaning of I.R.C. § 1001(a), i.e., when titled is transferred.²² To structure a deferred exchange, a qualified intermediary (“QI”) will be necessary. The QI will be assigned the rights to the sale and purchase contracts. The QI will receive the proceeds from the sale of the relinquished property and use them to purchase the replacement property. To qualify, the following time limits must be met:

- (1) The aircraft to be received (the “replacement aircraft”) must be “identified” no later than the day that is 45 days after the relinquished aircraft is transferred. Identification must be made in writing and clearly describe in appropriate detail the property to be transferred.²³ Up to three aircraft of any value may be identified, or more than three aircraft up to a total value of 200% of the relinquished aircraft. Note that if aircraft that, in the aggregate, exceeds the 200% Rule are identified, 95% of the identified aircraft must be purchased.²⁴
- (2) The actual transfer of the replacement aircraft must occur no later than the earlier of:
 - (a) the day 180 days after the relinquished aircraft is transferred,²⁵ or
 - (b) the due date (including extensions) of the exchangor’s tax return for the year in which the property in the exchange was given up.²⁶

It is also possible to accomplish a “reverse” deferred exchange if, for example, the purchase of the replacement aircraft will occur before the identification of the relinquished aircraft.²⁷ A QI, as well as an exchange accommodation titleholder (“EAT”)

¹⁹ Rev. Rul 73-476, 1973-2 C.B. 300; PLR 9525042 (March 22, 1995).

²⁰ I.R.C. § 1031(a)(1).

²¹ Reg. § 1.1031(k)-1.

²² Reg. § 1.1031(k)-1(b)(2)(iv).

²³ Reg. § 1.1031(k)-1(b)(1)(i); Reg. § 1.1031(k)-1(c).

²⁴ Reg. § 1.1031(k)-1(c)(4).

²⁵ (Reg. § 1.1031(k)-1(b)(2)(ii)).

²⁶ Reg. § 1.1031(k)-1(b)(2)(ii).

²⁷ Rev. Proc. 2000-37.

to hold title to either the relinquished or replacement property until the relinquished property is sold (see Diagrams 3 and 4).

In order to fully defer the gain, at least as much value and at least as much equity in the replacement aircraft must be retained as what was in the relinquished aircraft (i.e., you cannot “cash out”), as gain is recognized or taxed to the extent of net “boot” received by the taxpayer.²⁸ Boot received is the money or the fair market value of other property received by the taxpayer in an exchange. Since only the net boot received is taxed, certain offsets are allowed, such as liabilities assumed offset liability relief²⁹, cash paid by the taxpayer in the exchange offsets liability relief of the taxpayer,³⁰ and cash paid by the taxpayer in some circumstances offsets cash received by the taxpayer³¹, however cash received by the taxpayer during the exchange period may not be offset by cash subsequently paid by the taxpayer for the acquisition of the replacement property.³² The receipt of “mortgage boot” also needs to be considered. The general rule is that liabilities assumed by the taxpayer in an exchange may offset liability relief in the exchange.³³ Cash paid by the taxpayer in the exchange also offsets liability relief of the taxpayer in the exchange;³⁴ however, cash received by the taxpayer does not offset debt incurred by the taxpayer,³⁵ i.e., “mortgage boot” given does not offset “cash boot” received.

There are special rules for exchanges between related parties.³⁶ If a taxpayer exchanges property with a related person, there is nonrecognition of gain or loss to the taxpayer under Section 1031 of the Internal Revenue Code with respect to the exchange of such property, and before the date 2 years after the date of the last transfer which was part of such exchange the related person disposes of such property, or the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer, there shall be no nonrecognition of gain or loss under section 1031 to the taxpayer with respect to such exchange.³⁷ Any gain or loss recognized by the taxpayer by reason of subsection 1031(f) shall be taken into account as of the date on which the disposition described above occurs. The term “related person” means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).³⁸ Section 1031 shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of subsection 1031(f).³⁹ The running of the 2 year period set forth in 1031(f)(1) is suspended with respect to property during which the holder’s risk of loss with respect to the property is substantially diminished by the holding of a put with respect to such property, the holding

²⁸ IRC § 1031(b).

²⁹ Reg. § 1.453-12(a).

³⁰ Reg. § 1.1031(d)-2; Rev. Rul. 79-44.

³¹ Reg. § 1.1031(d)-2; Rev. Rul. 72-456.

³² Reg. § 1.1031(k)-1(j)(3), Example 2.

³³ Reg. §§ 1.1031(b)-1(c) and 1.1031(d)-2, Example (2).

³⁴ Reg. § 1.1031(d)-2; Rev. Rul 79-44.

³⁵ Reg. § 1.1031(d)-2, Example 2(c); Rev Rul 79-44.

³⁶ IRC § 1031(f).

³⁷ IRC § 1031(f)(1).

³⁸ IRC § 1031(f)(3).

³⁹ IRC § 1031(f)(4).

by another person of a right to acquire such property, or a short sale or any other transaction.⁴⁰

⁴⁰ IRC § 1031(g).

Diagram 1

Simultaneous Exchange

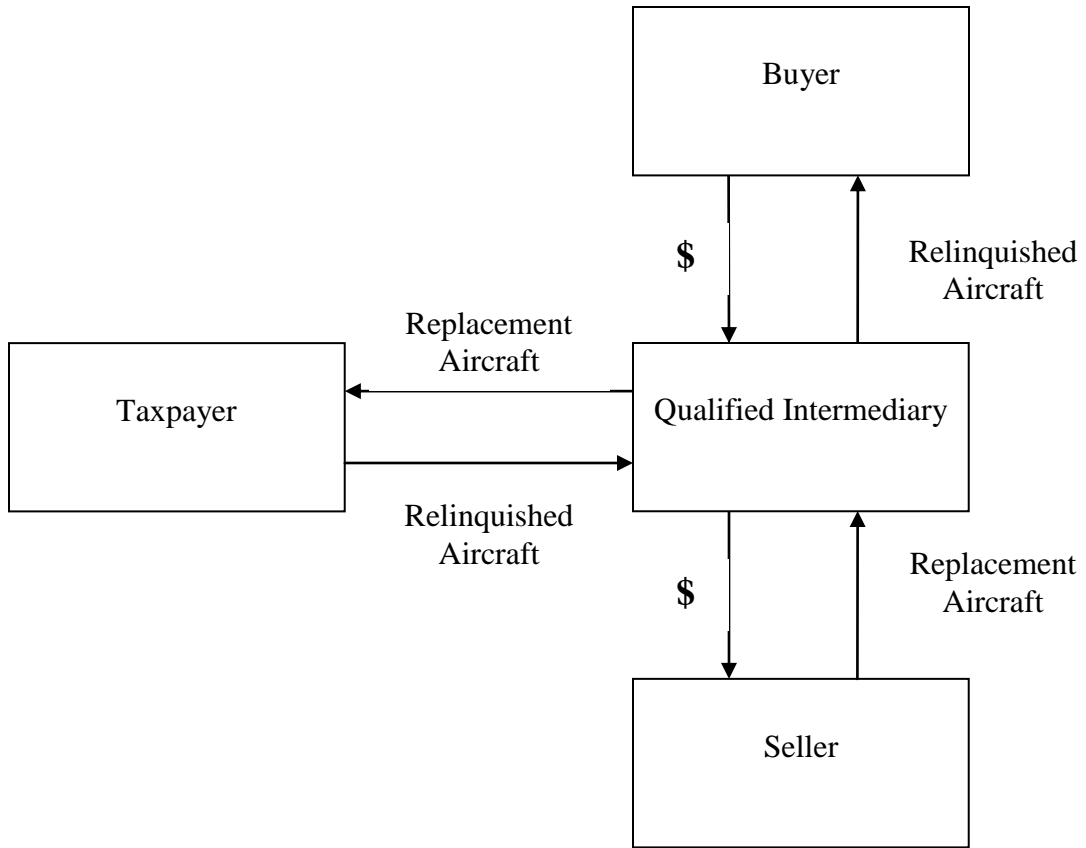
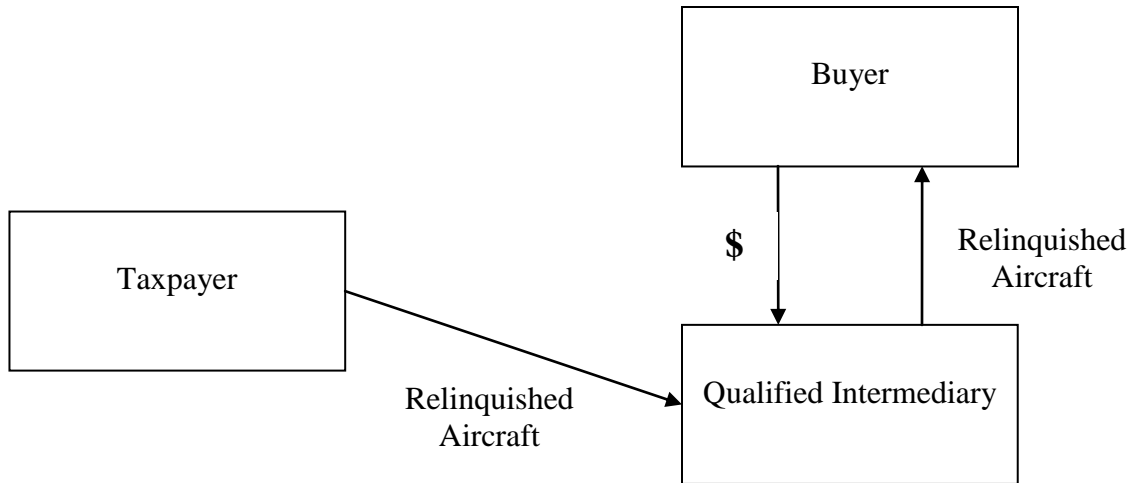


Diagram 2
Forward/Deferred Exchange
(Relinquished Aircraft Sold before Purchase of Replacement Aircraft)



Within 180 Days:

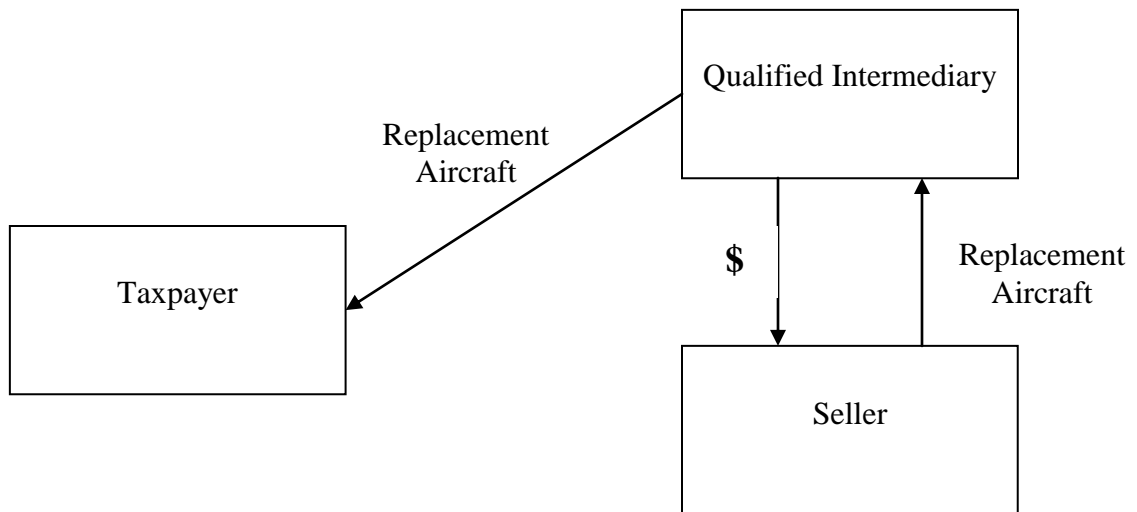
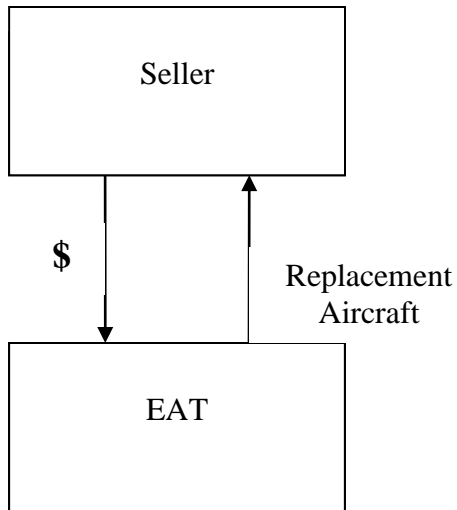


Diagram 3
Reverse Exchange
Exchange-Last/Replacement Aircraft Parked
(Replacement Aircraft Purchased Before Sale of Relinquished Aircraft)



Within 180 Days:

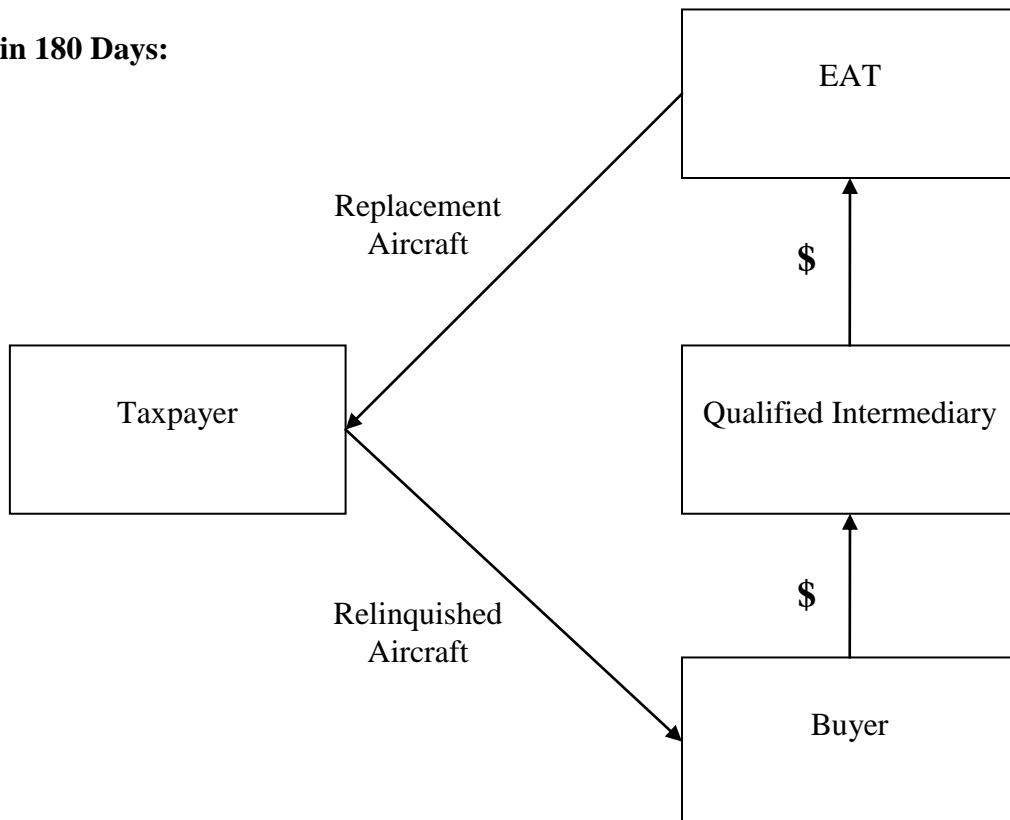
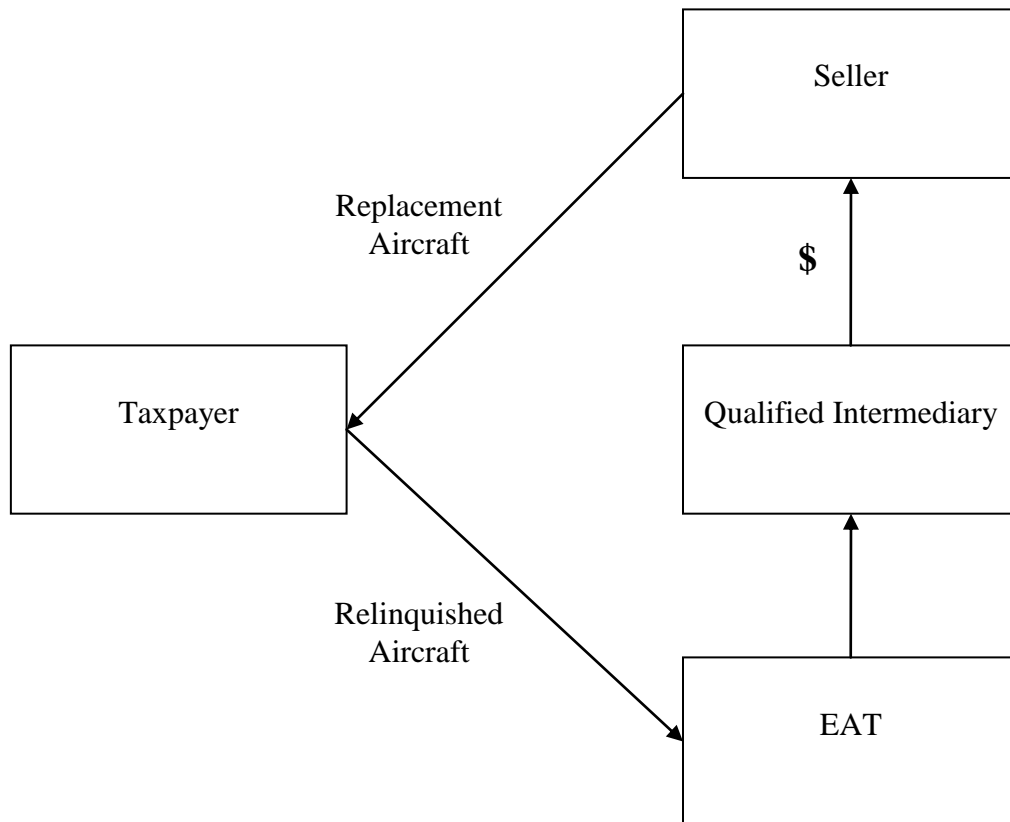


Diagram 4
Reverse Exchange
Exchange-First/Relinquished Aircraft Parked
(Replacement Aircraft Purchased Before Sale of Relinquished Aircraft)



Within 180 Days:

