Tax-Free Exchanges of Aircraft Under Section 1031

Keith G. Swirsky, Esquire
Galland, Kharasch, Greenberg, Fellman & Swirsky, P.C.
1054 Thirty-first Street, N.W., Suite 200
Washington, D.C. 20007
Telephone: 202.342.5251
Facsimile: 202.342.5219
E-mail: kswirsky@gkglaw.com

GALLAND, KHARASCH, GREENBERG, FELLMAN & SWIRSKY, P.C.
CANAL SQUARE
1054 THIRTY-FIRST STREET, N.W.
WASHINGTON, D.C. 20007-4492

(202) 342-5200

KEITH G. SWIRSKY

Keith G. Swirsky is a partner with Galland, Kharasch, Greenberg, Fellman & Swirsky, P.C., one of the nation's leading aviation law firms. The law firm provides a diverse range of services in all sectors of worldwide aviation, representing the needs of general aviation, manufacturers, airlines and airports. As part of our global transportation practice, the Business Aviation Group provides legal and consulting services to the business aviation industry.

Mr. Swirsky represents the aviation industry from many perspectives -- the aircraft owner and corporate flight department, the fractional program manager, the aircraft charter and management company, the equipment manufacturer and distributor, the lender, the airline and the airport. Mr. Swirsky and the members of the Business Aviation Group provide legal and consulting services to the business aviation industry, including:

- development of fractional ownership programs
- purchase and sale negotiations and documentation
- development of aircraft ownership and operating structures to meet regulatory, tax and liability protection planning concerns
- tax-free exchanges of aircraft
- taxation of aircraft use and ownership, including depreciation deductions and federal excise taxes
- state sales and use taxes
- personal use of corporate aircraft
- IRS, FAA and DOT compliance, enforcement actions and regulatory filings
- acquisition financing and leasing
- creation of business plans and financial models

Mr. Swirsky currently serves on the Tax Committee for the National Business Aircraft Association and is a regular speaker at the NBAA's Tax Conferences as well as other industry trade association and continuing education conferences. Mr. Swirsky received his J.D. and LL.M. in Taxation from Georgetown University Law Center and his B.S. in Business and Accounting from Cornell University.

In connection with conducting and documenting aircraft tax-free exchanges, the law firm will serve as the Qualified Intermediary at no additional fee and it has developed planning techniques for acquisition of the replacement aircraft prior to sale of the relinquished aircraft.

Galland, Kharasch, Greenberg, Fellman & Swirsky is based in Washington, D.C.. For additional information, please contact Keith G. Swirsky at (202) 342-5251, e-mail to ***kswirsky@gkglaw.com*** or visit our website at ***www.gkglaw.com***.

TAX-FREE EXCHANGES
UNDER SECTION 1031

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TAX-FREE EXCHANGES
UNDER SECTION 1031

OVERVIEW

The Internal Revenue Code ("IRC") provides a special exception to the general taxation of sales of property. Under IRC § 1031 (all § references herein are to the IRC), business property may be exchanged tax-free for other business property if both properties are of "like-kind." The rationale for this rule is that, when a business exchanges old property for new property of the same kind, the investment in the new property is somehow a continuation of the owner's investment in the old property. While this transaction is referred to as tax-free, it would be more accurate to call it tax-deferred. Taxable income from a like-kind exchange is effectively postponed until the new property received in the exchange is subsequently disposed of in a taxable transaction. If the new property is itself exchanged later for a third piece of like-kind property, the income may be postponed continually. On the other hand, if a like-kind exchange is not executed, a taxable event occurs and the tax basis of the property received is increased by any gain that is recognized, up to its fair market value. The like-kind exchange is therefore a powerful tax-planning device, but one that requires careful attention to many specific and technical requirements.

Hereafter, the old property disposed of in a like-kind exchange will be referred to as "relinquished property" and the new property acquired in a like-kind exchange will be referred to as "replacement property." The person (e.g., corporation, trust, partnership or individual) engaging in the exchange transaction shall be referred to as the “taxpayer”.

STATUTORY REQUIREMENTS

There are three general requirements imposed by statute in order for a transaction to qualify as a tax-free § 1031 exchange.

1. The relinquished property and the replacement property must be held either for productive use in a trade or business, or for investment.

2. The exchange must be reciprocal, i.e., a transfer of property in exchange for other property (as opposed to a sale and purchase).

3. The relinquished property and the replacement property must be of "like-kind."

A. Held For Productive Use In a Trade or Business, or For Investment

1. Business Use vs. Personal Use

For a transaction to qualify for tax-free treatment under § 1031, the relinquished property and the replacement property must be held for investment or used in a trade or business in which the taxpayer is engaged. An exchange of non-business

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property or property used for personal reasons would not satisfy this requirement. According to the IRS, an exchange in which two (2) parties swap both business property and personal property would be viewed as two simultaneous transactions, a tax-free exchange with respect to the business property and a taxable one with respect to the non-business property. P.L.R. 8221054 (February 24, 1982).[1] The IRS has also ruled that property that is used solely for business purposes except for some minimal amount of time (e.g., ten days per year) should qualify as trade or business property for purposes of the statute. P.L.R. 8103117 (October 27, 1980).

2. **Holding Requirement**

Section 1031 states that a like-kind exchange will be tax-free only if the relinquished property has been "held for productive use . . . or for investment" and the replacement property "is to be held either for productive use . . . or for investment." This requirement reflects the notion that the replacement property represents a kind of continuation of the owner's investment in the relinquished property. While the statute clearly requires that relinquished property be held before the exchange, it does not specify how long the relinquished property must be held before the exchange. Similarly, while the statute clearly requires that the replacement property be "held" after the exchange, it does not specify how long the replacement property must be held after the exchange before it can be disposed of.

With respect to how long before or after an exchange one must hold the replacement property, the IRS has indicated that two (2) years of business use is sufficient. P.L.R. 8429039 (April 17, 1984). Where the disposition of the replacement property is required by circumstances unrelated to the exchange, the IRS has approved a holding period of less than six (6) months. P.L.R. 8126070 (March 31, 1981).

[1] Please note that as a general rule Private Letter Rulings ("PLRs") may not be cited as precedent. PLRs, however, do tend to reveal the position of the IRS on controversial areas and are useful for planning purposes even if they technically can not be used in matters in controversy.

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Accordingly, the IRS has historically taken the position that property that is the subject of a tax-free exchange under § 1031 may not be transferred (to the taxpayer) immediately before or (by the taxpayer) after that exchange. Rev. Rul. 84-21, 1984-2 C.B.168 ; Rev. Rul. 77-337, 1977-2 C.B. 305; Rev. Rul. 75-292, 1975-2 C.B. 333; P.L.R. 8221054 (February 24, 1982).[2] Recent decisions, however, have suggested that the courts will allow a tax-free transfer of the exchange property immediately before or after the exchange when that transfer merely alters the form of ownership, without altering the beneficial economic ownership of the property in question. The Tax Court and Ninth Circuit Court of Appeals have both concluded that a taxpayer who receives business property tax-free (e.g., in a corporate liquidation, reorganization or a §351 contribution) may immediately exchange that property tax-free for property of like kind. *Mason v. Commissioner*, 55 T.C.M. 1134 (1988); *Bolker v. Commissioner*, 81 T.C. 782 (1983), *aff'd*, 760 F.2d 1039 (9th Cir. 1985). The Ninth Circuit has gone further still, suggesting that any newly acquired business property may be exchanged immediately in a like-kind exchange. The appeals court reasoned that the intent to exchange property for like-kind property constitutes an intent to continue to hold the original investment in property, albeit in different form. *Id*. at 1045. *See also, 124 Front Street v. Commissioner,* 65 TC 6 (1975).

Moreover, the Tax Court and Ninth Circuit have held that replacement property may immediately be contributed to a partnership, because such a contribution changes only the form of ownership, without affecting the substance of the investment. *Magneson v. Commissioner*, 81 T.C. 767 (1983), *aff'd,* 753 F.2d 1490 (9th Cir. 1985). Similarly, the Tax Court has ruled that a corporation may acquire property in a like-kind exchange, then immediately transfer the replacement property received to its shareholder(s) by liquidating. *Maloney v. Commissioner*, 93 T.C. 89 (1989). *But see, Barker v. Commissioner*, 668 F.Supp. 1199 (C.D. Ill. 1987); *Regals Realty,* 127 F.2d 931 (2d Cir. 1942).

Notwithstanding these judicial rulings in favor of pre-exchange and post-exchange transfers, the IRS has so far refused completely to concede the issue. The IRS may be expected to view such transfers as a failure to satisfy the "held for productive use" requirement, rendering the like-kind exchange a taxable transaction. Certainly, where such transfers are required by unforeseen circumstances, the IRS is more likely to recognize the existence of the requisite intent. Moreover, the IRS has recently shown more leniency in its original position when the taxpayer has not cashed out its investment in the relinquished property in any significant way. *See,* P.L.R. 9751012 (September 15, 1997); P.L.R. 9152010 (September 13, 1991). In P.L.R. 9751012 the Service ruled that the acquisition of replacement property by a taxpayer corporation, through the use of two wholly owned LLCs (see discussion below), was allowed to be accomplished tax free under § 1031 despite the fact that

[2]Revenue Rulings, while reflective of the position of the IRS and eligible for use as precedent, are not binding on courts and have a more limited precedential value in such proceedings than court cases. *SDI Netherlands B.V. v. Commissioner,* 107 T.C. 161 (1996).

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the relinquished properties had been held by predecessor corporations which were related to, and liquidated and merged into, the taxpayer corporation.

3. Use of Single Member LLC's as a Planning Tool

There are some situations where the taxpayer's use of a separate legal entity to hold the replacement property may be preferable due to regulatory, state tax or business considerations. Such considerations are often at odds with the position of the IRS regarding the "held for" requirement when the taxpayer is seeking to make a tax-free exchange under § 1031. In the past, taxpayers caught in that situation were often faced with a difficult choice between taking a conservative position with respect to their tax-free treatment on the exchange and obtaining the benefits associated with the use of a separate entity to hold the replacement property. Recent changes in state corporate law, as well as new regulations regarding the federal tax treatment of single member limited liability companies ("LLCs"), now allow the taxpayer to obtain both objectives under certain circumstances.

Limited liability companies have been accepted as an alternative business vehicle in one form or another by all fifty states and the District of Columbia. LLCs combine some of the more favorable attributes of corporations and partnerships. The state statutes authorizing limited liability companies generally adopt the corporate traits of limited liability as well as clearly defined and effective governance rules. At the same time, the arrangements that can be made by the owners under those rules are relatively flexible, allowing for more participation of the owners in the day-to-day affairs of the company, if that is the preferred mode of operation. Traditionally such flexibility and widespread management had been the hallmark of partnerships.

The IRS now allows both LLCs and partnerships overtly to elect whether to be treated as a corporation or partnership for federal tax purposes. Treas. Reg. § 301.7701-1. This election, in turn, provides even more flexibility for LLCs in drafting their internal rules and has contributed to their increasing popularity.

While most state statutes initially required an LLC to have more than one member, some of the more recent enactments and amendments to LLC statutes have liberalized this requirement and now allow for the formation of a LLC by a single member.[3] The permissibility of single member LLCs, when combined with the treatment of such entities under the federal tax regulations as described below, provides a powerful planning option.

Specifically, the tax regulations declare that a single member LLC may be either treated as a corporation or disregarded as a distinct entity for federal tax purposes,

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[3]Texas, Delaware, New York and Maryland are all examples of states whose laws now provide for the formation of single member LLC's. There is little authority or reason to believe that other states will not respect the distinct nature of such LLCs or the limitation on liability, subject to the rules governing the piercing of the corporate veil. In fact, it is arguable whether a state could deny single member LLCs recognition without running afoul of the U.S. Constitution.

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at the election of the taxpayer. Treas. Reg. § 301.7701-2. The availability of the "tax nothing" option allows taxpayers some flexibility in obtaining certain business, regulatory or state tax objectives through the use of a single member LLC. Since the single member LLC is disregarded for federal tax purposes (if so elected by the taxpayer), the transfer of the (to be) relinquished or the replacement property to such an entity does not jeopardize a tax-free exchange. The IRS has confirmed this conclusion in recent rulings. *P.L.R. 9807013* (November 13, 1997); *P.L.R. 9751012* (September 15, 1997). The absence of recognition for the single member LLC for federal tax purposes also may provide other tax planning options. This may include the ability of the taxpayer to overcome passive loss implications that might otherwise result from renting aircraft between related entities.
The separate existence of the LLC, however, is often respected for liability, regulatory or state sales and use tax purposes. This may allow taxpayers to take advantage of some of the benefits of holding aircraft in a separate entity, such as the protection of assets from the liability associated with the operation of an aircraft or a state sales and use tax exemption, while not creating a Section 1031 or passive loss problem.

B. The Exchange Requirement

For purposes of § 1031, a transaction constitutes an exchange if there is a reciprocal transfer of property for property, as opposed to a transfer of property for money only. For many years, the IRS took the position that, in order to qualify as a reciprocal transfer of property, a like-kind exchange must be simultaneous. The Ninth Circuit decided otherwise, however. *Starker v. U.S.*, 602 F.2d 1341 (9th Cir. 1979). The 1984 Tax Reform Act resolved the issue in favor of according tax-free treatment to non-simultaneous exchanges, but imposed two important time limitations: from the day of the sale of the relinquished property, (i) the replacement property must be identified within forty-five (45) days, and (ii) the replacement property must be acquired within one hundred eighty (180) days. These statutory changes were amplified by regulations issued by the Department of Treasury in 1991 (the "Regulations"). The Regulations, which will be discussed in greater detail below, specify that all aspects of a like-kind exchange must constitute an integrated, mutually dependent transaction. In evaluating whether an exchange has taken place, the Tax Court looks to interdependence, intent, timing, and commitment of the parties to the exchange.

The courts have also determined that, in order for a transaction to qualify as an exchange, the parties involved must have intent at the time of the transaction to engage in an exchange. An attempt retroactively to treat a completed sale as an exchange will not be respected by the IRS or the courts. *Mars v. Commissioner*, 54 T.C.M. 636 (1987). On the other hand, mere intent to engage in an exchange is not sufficient to transform a sale into an exchange. A taxpayer who purchases property and finances the purchase by immediately selling a different property has not engaged in an exchange, no matter the taxpayer's intent. *Bezdjian v. Commissioner*, 845 F.2d 217 (9th Cir. 1988); *Dibsy v. Commissioner*, 70 T.C.M. 918 (1995).

C. Like-Kind Requirement

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Section 1031 requires that the relinquished property and the replacement property be of "like-kind." The statute provides no guidance on how to determine whether one property is of like-kind with respect to other property. Over time, two interpretations of the term "like-kind" have developed, one with respect to real estate, the other with respect to personal property (i.e., non-real estate). When real estate is exchanged for other real estate, the like-kind principle has been applied quite liberally. For example, an interest in minerals was found to be like-kind with respect to an interest in a hotel. *Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941). With respect to personal property, on the other hand, like-kind property has been construed more narrowly. For instance, the Ninth Circuit has ruled that numismatic coins (i.e., coins held for collection
purposes) are not like-kind to foreign currency used as a medium of exchange. *California Federal Life Insurance Co. v. Commissioner*, 680 F.2d 85 (9th Cir. 1982). Since 1991, the Regulations have provided a new set of rules for determining whether two (or more) kinds of personal property are of like-kind. These are discussed in detail below.

Property received in a like-kind exchange that is not like-kind, such as money, is called "boot." Boot also includes any liabilities assumed or attaching to property received in an exchange. Generally, a taxpayer that receives boot in a like-kind exchange must pay tax on the boot or on the taxpayer's "realized gain," whichever is less. Realized gain means the excess of the amount realized over the adjusted basis of the relinquished property. The amount realized in the exchange is the sum of the fair market value of the properties received, cash received and liabilities assumed by the other parties. For purposes of calculating realized gain, one may deduct all non-deductible expenses related to the transaction. What kind of payments may be used to offset boot received in a like-kind exchange is discussed in detail below.

D. Excluded Property

1. Generally

Limitations are imposed upon the means by which one may transfer certain aircraft under § 1031 based upon the ownership structure. Section 1031 also excludes certain types of aircraft based upon the characterization of the aircraft in the hands of the taxpayer. The exclusions of § 1031 include, but are not limited to:

1. Inventory - aircraft held primarily for sale;

2. Beneficial interests in an ownership trust;

3. Interests in a partnership which owns an aircraft (discussed below);

4. Certain securities or evidences of indebtedness in an entity that owns an aircraft.

§ 1031(a)(2).

2. Partnership Interests - Aircraft Ownership by a Partnership or LLC

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After a lengthy battle in the courts between the IRS and taxpayers over whether the exchange of partnership interests would qualify for like-kind treatment, Congress sided with the Treasury Department and declared in 1984 that partnership interests were not to be considered like-kind property to other partnership interests. The IRS has issued regulations requiring the strict application of this rule. The exchange of partnership interests, whether in the same partnership or in different partnerships, or in general

partnerships or limited partnerships, is completely excluded from tax-free exchange treatment under § 1031.[4]

These rules may be particularly relevant in connection with "fractional ownership" or "joint ownership" arrangements which sell units in a partnership rather than interests in an aircraft. The rule against the application of § 1031 to partnership interests can also be seen as restricting the means by which a like-kind exchange of an aircraft can be effectuated. This is particularly true where some of the historic beneficial owners of the aircraft or partnership do not want to engage in an exchange and some do. In such circumstances careful attention to the manner in which the transactions are consummated and a command of the recent authority on related party exchanges (see below) will be necessary in order to obtain the tax goals of the respective parties with the minimum amount of risk.

For example, in *P.L.R. 9818003*, the IRS ruled that tax deferral treatment under § 1031 was not available when replacement properties were deeded directly to partners, instead of to the partnership that had disposed of the relinquished property. On the other hand, the Tax Court has previously indicated that the formation of a partnership in connection with the receipt of property in a § 1031 exchange would not deny the taxpayers tax deferral. *Maloney v. Commissioner*, 93 T.C. 89 (1989). It would seem that the above mentioned authority, along with the rules regarding single member LLCs and the ability of taxpayers to exchange fractional interests in real property, would lead one to conclude that the ability of multiple owners to obtain disparate results (i.e., exchange and non-exchange treatment) on their disposition of an aircraft entails some amount of tax risk and good counsel to minimize that risk.

3. Inventory (Stock in Trade or Other Property Held Primarily for Sale)

The disposition of "(s)tock in trade or other property held primarily for sale" does not qualify for like-kind exchange treatment. § 1031(a)(2). The exclusion of stock in trade and other property held primarily for sale incorporates inventory concepts found elsewhere in the IRC. *See,* § 1221, 1231.

Generally, whether or not an aircraft is considered to be held primarily for sale is determined under a primary purpose test. *See, Malat v. Riddell*, 383 U.S. 569 (1966)*; PLR 9811004.* If the principal purpose of purchasing and owning the aircraft is for the purchasing entity to use the aircraft in its trade or business or for the production of income, then the aircraft will not be considered inventory. Hence, an aircraft that is leased for or committed to the

[4] These regulations and the attendant prohibition on like kind exchange treatment should also apply to interests in LLCs that are treated as partnerships for federal tax purposes.

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taxpayer's business should not be treated as inventory. This is true even for taxpayers who might be aircraft dealers. The IRS has taken the position, however, that as soon as such an aircraft is removed from leasing activity or discontinues being used in connection with the business itself and is held for sale, it will immediately become an inventory item.

Certain factors should be considered in evaluating whether or not an aircraft should be considered to be inventory. One such factor would be what was the taxpayer's motive in purchasing the aircraft and what is the probability that such aircraft will be used by the taxpayer itself (including leasing activity), as opposed to being sold. The past history of the taxpayer, and possibly related entities, should also be considered in determining whether the aircraft will be considered to be inventory. Another factor to be considered is whether the taxpayer, and possibly related entities, are viewed by the public and others as a company in the business of selling aircraft, or merely engage in occasional or casual sales as an incidental consequence of its other business activities.

The test for whether or not an aircraft is to be considered to be stock in trade or held primarily for sale is largely one of facts and circumstances. Careful planning is required for aircraft dealers to qualify for § 1031 deferral treatment on an exchange of such an aircraft.

MULTI-PARTY EXCHANGES

The original intent of the like-kind exchange statute was to provide the tax-free treatment to a taxpayer upon the exchange of properties with one (1) other party. Today, however, it is accepted that the person from whom a taxpayer receives the replacement property need not be the same person to whom the taxpayer surrenders the relinquished property. One may engage in a tax-free like-kind exchange that involves three (3) or even four (4) parties. A three-party exchange involves:

1. a taxpayer (A) who owns property that he wishes to dispose of,
2. a prospective purchaser (B) of the taxpayer's property, and
3. a prospective seller (C) of the replacement property which the taxpayer wishes to acquire.

In many circumstances, neither the prospective purchaser (B) nor the prospective seller (C) may be willing to engage in an exchange. In such case, the transaction will also involve:

4. a fourth-party (D) who will, for a fee, serve as an intermediary. In a four-party exchange, (D) will (i) acquire the relinquished property from (A), (ii) sell that property to (B), (iii) acquire the replacement property from (C), and (iv) transfer it to (A).

The Regulations prescribe specific procedures for three- and four-party exchanges to ensure that such transactions qualify for tax-free treatment. These procedures are discussed below.

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DEFERRED EXCHANGES

It is now accepted that a like-kind exchange may be non-simultaneous or "deferred." The Code and Regulations provide extensive guidance on the proper structuring of deferred exchanges.

A. **Time Limitations**

In a transaction that is structured as a deferred exchange, the replacement property is acquired after closing on the sale of the relinquished property. Section 1031 requires that replacement property in a like-kind exchange must be (1) identified as replacement property on or before midnight on the forty-fifth (45th) day after the date on which the taxpayer transfers the relinquished property, and (2) received on or before the earlier of (i) midnight of the one hundred eightieth (180th) day after the date on which the taxpayer transfers the relinquished property, or (ii) the due date (determined with regard to extensions) for the taxpayer's return for the taxable year in which transfer of the relinquished property occurs. According to the Regulations, to identify replacement property properly, the property must be unambiguously described in a written document or agreement; for example, if the taxpayer is exchanging aircraft, this requirement will be satisfied by a general description by type and manufacturer and serial number specification of the airframe.

If a taxpayer transfers more than one relinquished property in the same deferred exchange, and the relinquished properties are transferred on different dates, then the 45-day identification period and the 180-day exchange period are determined by reference to the earliest date in which a transfer occurs. In order to avoid the effect of this rule, it may sometimes be advisable to separate a multi-property transfer into independent transactions with respect to each of the relinquished properties.

B. **Identification of Multiple Properties**

The maximum number of replacement properties that a taxpayer may identify are: (a) three (3) properties, without regard to their fair market value, or (b) any number of properties as long as their aggregate fair market value as of the end of the forty-five (45) day identification period does not exceed 200% of the aggregate fair market value ("FMV") of all relinquished properties as of the date the relinquished properties were transferred by the taxpayer. In the case of replacement property being modified or enhanced, the fair market value for purposes of the 200% rule is its estimated fair market value as of the date it is expected to be received by the taxpayer.

If, as of the end of the identification period, the taxpayer identifies more replacement properties than is permitted, the taxpayer generally is treated as if no replacement property had been identified. Despite this rule, the taxpayer is treated as having properly identified (a) any replacement property received before the end of the identification period, and (b) any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if

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before the end of the exchange period, identified replacement property with a FMV of at least 95% of the aggregate FMV of all identified replacement properties is received.

C. Regulatory Safe Harbors

In an effort to provide clear rules for deferred transactions, the Regulations provide a number of so-called "safe harbors," i.e., specific procedures which, if properly followed, render an exchange immune from challenge by the IRS). The safe harbors protect a taxpayer, for example, from an argument by the IRS that the exchange is really a sale, based upon such general principles as agency and constructive receipt. Tax advisers usually seek to comply with the deferred exchange safe harbor because the rules outside the safe harbors are uncertain. Indeed, it is arguable that meeting the requirements of the Regulations is the exclusive means to qualify a non-simultaneous, forward *Starker* transaction (i.e. the relinquished property is transferred prior to receipt of the replacement property) for § 1031 tax-deferred treatment. *See,* Preamble, former Prop. Reg. 1.1031(a) (stating that the Treasury expected transactions falling outside of the safe harbor to be carefully scrutinized). *In practical terms, this means that a trade-in of an aircraft to a manufacturer prior to delivery by that manufacturer of a new aircraft may not qualify for 1031 treatment unless the specific requirements of the Regulations are met.*

1. Use of A Qualified Intermediary

Under one safe harbor, a taxpayer may transfer the relinquished property to the taxpayer's agent provided (a) the agent is a "qualified intermediary" and (b) the taxpayer's rights to receive money or other property from the qualified intermediary are limited to certain specified circumstances. A qualified intermediary is a person who is not the taxpayer or a "disqualified person" (defined below) and who, for a fee, enters into an agreement with the taxpayer, and as required by the agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and then transfers the replacement property to the taxpayer. The transfer of property in a deferred exchange that is facilitated by the use of a qualified intermediary may occur *via* a "direct deed" of legal title by the current owner of the property to the ultimate owner.

2. Use of Qualified Escrow Accounts and Qualified Trusts

A second safe harbor relates to the use of qualified escrow accounts or trusts for the proceeds from the sale of the relinquished property. It is necessary that the taxpayer who is transferring relinquished property not receive, actually or constructively, the proceeds from the sale of the replacement property. The safe harbor provides that the purchaser of the replacement property may pay for the replacement property at the closing by depositing it into a "qualified" escrow account or "qualified" trust, without the taxpayer constructively receiving the purchase price. For an escrow or trust to be qualified, the escrow holder or trustee must not be the taxpayer or a "disqualified person" (defined below) and the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account or by the trustee, must not occur, generally, until the exchange is completed or terminated before closing for non-compliance with the procedural rules.

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3. **"Disqualified Person" Defined**

As referenced above, a qualified intermediary, trustee, or escrowee is a "disqualified person" if:

a.. Such person is the "agent" (defined below) of the taxpayer at the time of the transaction; or

b. Such person and the taxpayer bear any of the following relationships: brother-sister, husband-wife, ancestor-descendant, a more-than-10% stockholder-corporation, a more-than-10% partner-partnership, a corporation-corporation in same controlled group, a partnership-partnership (where one person owns more than 10% of each), a trust fiduciary-trust grantor, a trust fiduciary-trust beneficiary, a corporation-partnership (where one person owns more than 10% of each), or certain other similar relationships enumerated in § 267(b); or

c. Such person bears a relationship described in (b) above to an "agent" (defined below) of the taxpayer at the time of the transaction.

4. **"Agent" Defined**

Persons who have acted as a taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker during the two-year period immediately preceding the taxpayer's transfer of the first relinquished property are treated as agents of the taxpayer at the time of the transaction for purposes of (a) above. Performance of services with respect to exchanges intended to qualify under § 1031, routine financial, title insurance, or escrow or trust services performed for the taxpayer by financial institutions, title insurance companies or escrow companies will be excluded for these purposes.

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EXCHANGES OF PERSONAL PROPERTY

A. **The Definition of "Like-Kind" for Personal Property**

The Regulations provide a so-called "safe harbor" for the purpose of determining whether personal property is like-kind with respect to other personal property. Under this safe harbor, depreciable tangible personal property will be considered exchanged for like-kind property if it is exchanged for property of a "like-class." Properties are of a "like-class" if they are within either the same "General Business Asset Class" or the same "Product Class."

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1. **General Business Asset Classes**. There are 13 General Business Asset Classes. They were established by the IRS for another purpose, but now serve also to determine which properties are like-kind for purposes of § 1031. Any property that falls within one General Business Asset Class is like-kind to any other property in the same General Business Asset Class. The General Business Asset Classes, established in Rev. Proc. 87-56, 1987-2 C.B. 674, are as follow:

   a. Office furniture, fixtures and equipment;
   b. Information systems (computers and peripheral equipment);
   c. Data handling equipment, except computers;
   d. Airplanes (airframes and engines), <u>except those used in commercial or contract carrying of passengers or freight</u>, and all helicopters (airframes and engines);
   e. Automobiles, taxis;
   f. Buses;
   g. Light, general purpose trucks;
   h. Heavy, general purpose trucks;
   i. Railroad cars and locomotives, except those owned by railroad transportation companies;
   j. Tractor units for use over-the-road;
   k. Trailers and trailer-mounted containers;
   l. Vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction; and
   m. Industrial steam and electric generation and/or distribution systems.

2. **Product Classes**. Any property that does not fall into one of the General Business Asset Classes will be like-kind with respect to property in the same Product Class. Product Classes are determined by reference to a 4-digit Product Code. These Product Codes were established as part of the Product Coding System of the Standard Industrial Classification Codes set forth in the Standard Industrial Classification Manual (Office of Management and Budget, 1987), which is indexed and available in most libraries. Industry Group No. 372 covers Aircraft and Parts. The four-digit Product Classes in this Industry Group are as follows:

   a. 3721, covering aircraft and helicopters;

   b. 3724, covering aircraft engines and engine parts including, for example, aircraft engine cooling systems, heaters, engine mount parts, exhaust systems, external power units, lubricating systems and internal combustion components; and

   c. 3728, covering aircraft parts and auxiliary equipment, not elsewhere classified, including, for example, ailerons, body assemblies, power transmission equipment, brakes, lighting, propeller parts, deicing equipment, flaps, fuel tanks, landing gear, refueling equipment, rudders, wheels, wiring assemblies and seat ejectors. Many other

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parts, exclusive of aircraft engines and engine parts, are lumped into this category.

In general, property listed in each four-digit Product Class may be exchanged for other items within the same class. The IRS has not yet formalized its position on whether aircraft engines may be exchanged for other aircraft engines attached to a fully functional airframe (i.e., an aircraft). In such a circumstance, it may be advisable to structure the exchange in the form of two mutually independent transactions, one involving a tax-free exchange of engines, the other a purchase or sale of the balance of the aircraft.

3. **Other Personal Property.** Other property involved in a like-kind exchange may include: intangible personal property, non-depreciable personal property, or personal property held for investment. These types of property are not assigned to specific like-kind classes. There is so much variety within such categories of property that no classification system is feasible. Little guidance in this area currently exists.

4. **Goodwill.** The Regulations provide that goodwill (or going concern value) of a business activity is not like-kind to goodwill of another business activity, regardless of whether the business activities are similar.

B. The Definition of "Like-Kind" for Fractional Ownership and Other Forms of Ownership

1. Exchanges of Leaseholds [in Fractional Interests] for Fee Interests

Even when two properties are of like-kind under the conditions outlined above, they may differ from one another with respect to the form of their ownership. For example, one property may be owned outright (a "fee interest"), while another may be possessed under the terms of a lease. As the fractional ownership industry evolves, the marketing of multi-year term leaseholds is inevitable. In such a circumstance, do leasehold and fee interests constitute property of like-kind?

The answer with respect to real estate is clear. The Regulations provide that a lease with thirty (30) years or more remaining is of like-kind with respect to a fee interest in real estate. Treas. Reg. § 1.1031(a)-1(c)(2). Evidently, a long-term lease is viewed by the IRS as equivalent to full ownership for purposes of § 1031. Leases of real estate which are of a shorter duration are not considered to be like-kind to a fee interest.

With respect to personal property (such as aircraft), no clear authority exists on whether and when a leasehold could be considered like-kind to a fee interest. It seems reasonable to assume that the rule applying to real estate should apply equally to non-real estate, *viz.*, a long-term lease of personal property should be of like-kind with respect to a fee interest in such property. If so, one must also determine what constitutes a "long-term" lease with respect to different kinds of personal property. While a thirty-year lease is sufficiently long for real estate, it seems that a leasehold in aircraft or an automobile need not be thirty (30) years in length in order to be considered long-term. One might argue that the appropriate length of a long-term lease should be the "class life" assigned to each General Business Asset Class. The class life for non-commercial aircraft, for example, is (6) six years. *As a legal*

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matter, until this matter is addressed in regulations or precedential tax authority, the tax-free treatment of an exchange of a leasehold in personal property for a fee interest in the same kind of property remains uncertain.

2. Exchanges Involving Fee Interests in Whole Aircraft for Fractional Interests

The like-kind issue arises also with respect to an exchange of a fee interest in a whole aircraft for a fractional interest. In such a circumstance, the properties being exchanged are of like-kind, but the respective forms of ownership differ: a fee interest represents absolute and exclusive ownership of property, while a fractional interest represents partial ownership.

As with the leasehold-fee interest question discussed above, the issue of fractional interests has been resolved for real estate, but not for personal property. With respect to real estate, the IRS has indicated that a taxpayer may exchange tax-free an undivided fractional interest (a "tenancy in common") for a fee interest. Rev. Rul. 73-476, 1973-2 C.B. 300; P.L.R. 9525042 (March 22, 1995). However, with respect to personal property, no definitive authority exists. It seems reasonable to assume that, as with real estate, a fractional interest in personal property, such as aircraft, should be of like-kind with respect to a fee interest in such property. Such an analogy between real and personal property may draw support from a recent change in the IRC which states that personal property predominantly used within the United States is not to be considered like-kind with personal property that is predominately used outside of the United States. P.L. 105-34 § 1052(a). This provision is codified alongside a similar rule that is applicable to real estate. § 1031(f). However, the analogy of personal property to real estate should not be assumed to apply in every case. The ownership of fractional interests in real estate is generally defined by state statute, while the ownership of fractional interests in personal property is generally governed by contract.

The IRS can be expected to examine each such contract on a case-by-case basis, in order to determine whether the particular fractional interest in personal property provides ownership rights that are equivalent to the rights enjoyed by an owner of a fractional interest in real estate. To the extent that such a contract does provide equivalent rights, a fractional interest should be considered like-kind to a fee interest. In fact, the contracts and agreement utilized by the aircraft fractional ownership programs may have to be carefully reviewed and revised to avoid undermining customary "ownership" rights. *Until such time as this matter is addressed in regulations or precedential tax authority, the tax-free treatment of such a transaction remains uncertain.*

3. Exchanges Involving Fee Interests in Whole Aircraft for Multiple Fractional Interests

The Regulations permit the exchange of multiple assets in a single tax-free exchange provided the assets to be exchanged are all within the same General Business Asset Class. Consequently, one should be able to exchange a fee interest in a whole aircraft for one or more fractional interests without recognizing gain on the transaction, provided

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that the value of the aircraft relinquished is less than or equal to the aggregate value of the fractional shares acquired. However, if the value of the aircraft relinquished exceeds the aggregate value of the fractional shares acquired, the program participant would be required to recognize gain on the difference.

MULTI-ASSET EXCHANGES

Basis Issues in Multi-Asset Exchanges

As mentioned above, one who engages in a like-kind exchange generally recognizes no income on the disposition of one's relinquished property; instead, that income becomes taxable if and when the replacement property is disposed of in a taxable transaction. This deferral of income is accomplished by assigning one's "basis" in the relinquished property to the replacement property. Such deferral, however, is not accomplished without a price. The taxpayer will obtain a reduced basis in the replacement aircraft which will reduce the amount of any available depreciation deductions while the replacement aircraft is owned by the taxpayer.

The computation of basis is also important in exchanges involving boot, because one may be liable for tax to the extent of gain realized, which is the difference between the basis in the relinquished property and the FMV of property received in the transaction. When a transaction involves more than one relinquished property or more than one replacement property, however, the determination of basis in the replacement property is somewhat more complicated.

In the case of an exchange of multiple properties, the Regulations generally require a property-by-property comparison for computing the gain realized and basis of replacement property received in a like-kind exchange. However, if the various relinquished properties transferred by a taxpayer in an exchange can be assigned to two or more "Exchange Groups," gain and basis may be determined on an Exchange Group-by-Exchange Group basis. For these purposes, an Exchange Group consists of all relinquished and replacement properties in one exchange which are of like kind. All properties of like kind or like class must be grouped together in the same Exchange Group. In other words, all properties within the same General Business Asset Class and within the same four-digit Product Code, respectively, would be in the same Exchange Group.

No gain will be recognized if the aggregate value of the relinquished properties in each Exchange Group transferred equals the aggregate value of the replacement properties in the same Exchange Group. Within one Exchange Group, if the aggregate FMV of the replacement property exceeds the aggregate FMV of the relinquished property, the excess is allocated to other Exchange Groups. Such excess value allocated is treated as "other property or money" received in the exchange (i.e., boot) and is therefore taxable.

BOOT NETTING RULES

A. Minimizing Boot

A party who receives boot (i.e., money or other non-like-kind property) in a like-kind exchange will generally be liable for tax on the amount realized (as defined above) from the exchange to the extent of the boot. Therefore, it is highly desirable to minimize the amount of boot received in a like-kind exchange. According to the IRS, non-deductible expenses paid in connection with a transaction may be used to offset boot received in the exchange. Rev. Rul. 72-46, 1972-2 C.B. 468. Such expenses may include: attorneys' fees in connection with structuring the exchange, attorneys' fees in connection with the transfer of the properties and the closings, accountants' fees, brokers' fees for the property transferred and/or acquired, mortgage fees, appraisal fees, intermediary fees and trustees' fees.

Note that these expenses may be used to offset boot only. A taxpayer may earn interest income on funds deposited in a qualified trust or escrow. Generally, such interest income would be taxable. Could transaction expenses be used to offset this interest income? The answer may depend upon whether the interest income falls under the definition of "boot." The Regulations define boot as money or other property received in a like-kind exchange. It would seem, then, that interest income would be boot subject to offset only if it were received in the exchange.

In addition, the Regulations establish the following “Rules” for offsetting boot received in a like-kind exchange:

1. Debt assumed on the acquisition of replacement property offsets debt relief on the disposition of relinquished property.

2. Debt assumed on the acquisition of replacement property will not offset cash received on the disposition of relinquished property.

3. Cash paid on the acquisition of replacement property offsets debt relief on the disposition of relinquished property.

B. Mortgages and Boot

The above rules deal specifically with a case in which debt is assumed as part of the exchange. For example, if a taxpayer disposes of relinquished property that is subject to a mortgage, the assumption of that mortgage by another party would ordinarily constitute taxable boot to the taxpayer. However, under Rule 1, if the replacement property acquired by the taxpayer is also subject to a mortgage, the taxpayer's assumption of that debt will offset the boot from the relief of the taxpayer's debt.

In some transactions, however, a mortgage on relinquished property may not be subject to assumption, but may require being paid off in cash. If a taxpayer receives cash from the purchase of the relinquished property and uses the cash to pay off the mortgage, a question arises whether the cash received constitutes taxable boot. On this issue, the Tax Court has ruled that cash received in an exchange will not be boot if the taxpayer is contractually required to use the cash to pay off the debt on the relinquished property at the time of the exchange. *Barker v. Commissioner*, 74 T.C. 555 (1980). The Tax Court reasoned that, where a taxpayer is contractually required to pay off the mortgage with the cash received, the taxpayer never "receives" the cash in a meaningful sense, but serves merely as a conduit for the money. Note, however, that this rule applies only where the use

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of the cash is restricted to mortgage payment and such mortgage payment is a necessary condition of the overall exchange agreement.

CAVEAT: If property to be exchanged in a like-kind exchange transaction is refinanced prior to the like-kind exchange transaction, at a time when the like-kind exchange is anticipated or being discussed or planned, the Service may re-characterize such refinancing as "cash received on the disposition of relinquished property," and if such cash is not used to acquire the replacement property, this may constitute boot and therefore result in current taxation.

REVERSE EXCHANGES

There may be situations where it is necessary for a taxpayer to receive the replacement property before the transfer of the relinquished property. Technically, this structure would not constitute a deferred exchange, because the Regulations define a deferred exchange as one in which the taxpayer transfers property and subsequently receives qualifying property in exchange. The IRS may take the position, and has in the past, that a "reverse" exchange structure, whereby the replacement property is received by a taxpayer before the transfer of the relinquished property, does not qualify as a like-kind exchange under § 1031.

Notwithstanding the IRS opposition to reverse exchanges, there is nothing in § 1031 indicating that the relinquished property must be transferred before the replacement property has been acquired. There is no judicial authority denying tax-free treatment to a reverse exchange. In 1993, the American Bar Association Tax Section prepared a report advocating the promulgation of regulations that would allow reverse exchanges. *Pending IRS action, cautious taxpayers should try to avoid the reverse exchange structure.*

To avoid such a reverse exchange structure, it may be advisable for a taxpayer to obtain a leasehold interest in the replacement property. Options to purchase or exchange may also be acquired as long as the taxpayer is not treated as acquiring the property for tax purposes. In some cases, a taxpayer may be able to leave the replacement property in the possession of a qualified intermediary until the taxpayer is ready to transfer the relinquished property, at which time the parties would engage in a simultaneous exchange. Alternatively, the taxpayer may be able to sell the relinquished property to the qualified intermediary or other third party, such as a financial institution, which would retain the relinquished property until a party could be found who would be interested in acquiring such relinquished property .

It is of critical noteworthiness that the IRS and the courts have consistently held that the transfer of title to the aircraft is not conclusive as to whether there has been a transfer of ownership of the aircraft for tax purposes. The question as to when a transfer of ownership is completed, in connection with planning to

avoid a reverse exchange, is essentially one of fact to be resolved by a consideration of all of the facts and circumstances. The critical determination is whether the taxpayer has disposed of (or has acquired, as the case may be), the burdens and benefits of ownership of the aircraft. In making this determination, the IRS and the courts will examine such factors as:

- the passage of title to the aircraft;

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- the transfer of possession to the aircraft;
- the transfer of risk of loss to the aircraft;
- the intent of the parties and their treatment of the transaction;
- the transfer of the economic risks and benefits of ownership to the aircraft; and
- the performance of the contractual conditions.

Careful consideration of these factors is essential to planning to avoid a reverse exchange.

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SEEKING PROFESSIONAL ASSISTANCE; CHOOSING A QUALIFIED INTERMEDIARY

Although the 1991 Regulations provide guidance, there are many detailed and/or procedural rules and traps for the unwary. A taxpayer who is able to comply with these rules can be reasonably confident of getting the desired, and favorable, tax treatment.

There are, however, a variety of complex issues which invariably come up in the process of planning and implementing an exchange. For example:

- the old or replacement aircraft may be, or become, subject to debt or operating leases, or contractual rights and obligations associated with a fractional ownership program (the fractional ownership documentation issue being whether or not the taxpayers' contractual rights in the replacement aircraft are "like-kind" to the old aircraft);

- the old aircraft may be held by one entity and the replacement aircraft is targeted to be held by a different entity (generally due to state sales tax considerations);

- the buyer of the old aircraft may tender notes instead of cash, or, if a "parking" mechanism is used, in connection with a possible "reverse" exchange, no cash proceeds will exist until ultimate resale and the taxpayer will not want to give up the economic upside in the aircraft value;

- there may be nonrefundable deposits that have been previously tendered or the replacement aircraft contract requires progress payments prior to the old aircraft being sold and/or which are so large that the final payment is less than the proceeds from the sale of the old aircraft;
- there may be multiple aircraft bought and/or sold;

- the seller of the replacement aircraft may require transfer of title to the taxpayer prior to the aircraft interior completion or modifications, raising issues of timing and "reinvestment" of the proceeds from the old aircraft; or

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- there may be avionics, spare engines (typically in commercial deals) or other items that are part of the deal.

Recent years have seen a proliferation of organizations in the business of serving as qualified intermediaries, qualified escrow account agents and qualified trust trustees. Typically, these organizations supply initial drafts of all of the documents necessary to effect a deferred like-kind exchange. These documents should be closely scrutinized, however, as they are likely to be "form" documents only and are not guaranteed to satisfy all of the requirements of § 1031 and the Regulations thereunder. In fact, the documents will almost always contain a provision in which the organization explicitly disclaims any responsibility for compliance with the requirements of § 1031.

Choosing an experienced tax/aviation attorney will allow the taxpayer to obtain the necessary documentation, which will be customized for the particular deal circumstances, as well as proper tax advice and planning concerning the innumerable issues that may have to be considered. Further, it is normal for a variety of regulatory (e.g., Federal Aviation Regulations) issues to arise and experienced aviation counsel will be able to guide the taxpayer through these and other issues.

STEPS TO ACCOMPLISH A QUALIFIED INTERMEDIARY EXCHANGE

Step 1: The qualified intermediary and the taxpayer enter into an exchange agreement.

Step 2: The taxpayer assigns its rights under the contract to sell the relinquished property to the intermediary; the intermediary accepts the assignment; the other party to the contract is notified of the assignment.

Step 3: The intermediary participates in the transfer of the relinquished property to the buyer of that property; the transfer may be accomplished by direct deeding from the taxpayer to the buyer.

Step 4: Within forty-five (45) calendar days from the date of closing on the relinquished property, the taxpayer provides notice to the intermediary of the identity of the replacement property.

Step 5: The taxpayer negotiates a purchase contract for the replacement property and assigns its rights under the purchase contract to the intermediary; the intermediary accepts the assignment; the other party to the contract is notified of the assignment.

Step 6: After the assignment of the purchase contract to the intermediary, the intermediary makes the necessary deposit.

Step 7: The intermediary participates in the transfer of the replacement property to the taxpayer; at closing, direct deeding from the seller to the taxpayer is permitted.

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