Aircraft Transactions:
Tax-Free Like-Kind Exchanges of Aircraft (Part 1)

Chris Younger is a partner at GKG Law, P.C. practicing in the firm's Business Aircraft Group. He focuses his legal practice on business aircraft transactions as well as issues relating to federal and state taxation and regulation of business aircraft ownership and operations. Mr. Younger can be contacted at cyounger@gkglaw.com

U.S. Tax Code allows for the disposal of an asset, such as a business aircraft, and the acquisition of its replacement without generating a current tax liability associated with capital gains from selling the first asset. Attorney Chris Younger summarizes the procedures as they apply in practice to Business Aviation.

When a company upgrades from one aircraft to another, the Board must consider whether or not to engage in a tax-free like-kind exchange of the asset. The key benefit to engaging in a like-kind exchange is the deferral of gain recognition and concomitant income tax liability arising from the sale of the relinquished aircraft.

Even in an economy where aircraft values are static or declining, the recapture of this depreciation can result in a significant income tax liability to the company and its shareholders. There are, however, many issues - both legal and financial - that a Board must analyze when determining whether to structure the company's aircraft upgrade as a like-kind exchange.

This article is the first in a series of two that will provide a brief primer on (i) the key issues a Board must consider when determining whether to engage in a like-kind exchange, (ii) the basic requirements for implementing a like-kind exchange and the factors influencing the structure of the exchange, and (iii) ancillary issues that a Board must consider when determining whether to implement a like-kind exchange.

FORWARD LIKE-KIND EXCHANGE

A direct exchange of aircraft between two owners is the simplest form of like-kind exchange. However, because a direct exchange of aircraft is not normally practical, the Internal Revenue Service has sanctioned several methods of utilizing a like-kind exchange that allow an aircraft owner to accomplish the exchange and defer its tax gain when the purchaser of a relinquished aircraft and the seller of a replacement aircraft are not identical.

Selling an existing aircraft before purchasing its replacement may utilize a forward like-kind exchange structure. In this situation the company creates a fictional aircraft purchaser/seller, referred to in tax parlance as a Qualified Intermediary (QI), who takes title to the aircraft being sold and transfers that title to the purchaser of that aircraft. Thereafter, the QI takes title to the newly acquired aircraft from its seller and transfers it to the company.

The direct exchange of aircraft between the company and the QI occurs, thereby allowing the company to defer ›

Aircraft Index see Page 4

recognition of gain on the sale of the relinquished aircraft. However, the company must follow specific safe-harbor procedures set forth by the IRS to take advantage of a forward like-kind exchange structure.

First, prior to selling the relinquished aircraft, the company must engage a QI. The company and the QI enter into an exchange agreement that sets forth each party's rights and responsibilities as they relate to the exchange process. The exchange agreement also provides a roadmap for the implementation of the like-kind exchange. A well drafted exchange agreement will contain provisions ensuring that:

- The QI is properly qualified to act as a qualified intermediary (i.e., that QI is not considered the company's agent or its "alter ego");
- The QI holds proceeds received from the sale of the relinquished aircraft in a qualified escrow until they are used to purchase the replacement aircraft (because the company may not have actual or constructive receipt of the sales proceeds during this period);
- The company correctly identifies replacement aircraft within 45 days of the sale of the relinquished aircraft and purchases the replacement aircraft within 180 days of the sale of the relinquished aircraft; and
- Title to both the relinquished aircraft and the replacement aircraft is correctly transferred between the company and the QI and such transfers are documented adequately.

Since the potential tax liability resulting from the incorrect implementation of a like-kind exchange that fails to meet IRS requirements could be large, it is always advisable for the Board to engage aviation tax counsel to review the exchange agreement on behalf of the company. This procedure will give the company maximum assurance of its rights and responsibilities as well as those of the QI with respect to the implementation and completion of the like-kind exchange.

REVERSE LIKE-KIND EXCHANGE

If a company must acquire its replacement aircraft before it is able to sell its existing aircraft, it will need to engage in a reverse like-kind exchange of aircraft. This is typically the case when the company purchases a used aircraft and takes delivery prior to closing on the sale of its existing aircraft. The company may also want to ensure that it has no gap in aircraft availability by acquiring its replacement aircraft before it sells the relinquished aircraft.

As is the case with a forward like-kind exchange of aircraft, the company must comply with a set of very specific IRS procedures. It must be noted, however, that these procedures are substantially more complicated than the steps to be followed in a forward like-kind exchange.

Next month, we will describe the nature of reverse like-kind exchanges.

Note: This article should not be construed as legal advice or legal opinion on any specific facts or circumstances. The reader is urged to consult legal counsel or other advisors concerning his/her own situation and specific legal questions. Please be advised that, to ensure compliance with requirements imposed by the IRS, any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Do you have any questions or opinions on the above topic? Get them answered/published in World Aircraft Sales Magazine. Email feedback to: Jack@avbuyer.com

Business Aviation and the Boardroom continues on Page 66

"It is always advisable for the Board to engage aviation tax counsel to review the exchange agreement on behalf of the company."