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Aircraft Transactions: Tax-Free Like-Kind Exchanges of Aircraft (Part 2)

Attorney Chris Younger continues his explanation of IRS procedures related to deferring capital gains taxes when a company replaces an existing business aircraft with a similar piece of equipment.

The IRS has endorsed two reverse like-kind exchange structures. They are commonly referred to as a "front-end" reverse like-kind exchange and a "back-end" reverse like-kind exchange. In each of these types of exchanges, the company is required to enter into a Qualified Exchange Accommodation Agreement (QEAA) with an unrelated third party, who will act as a Qualified Exchange Accommodation Titleholder (QEAT).

The Qualified Exchange Accommodation Agreement must contain certain terms as set forth in applicable IRS guidance. The Qualified

Exchange Accommodation Titleholder fills a role that is essentially similar to the Qualified Intermediary (QI) in a forward like-kind exchange, which enables the creation of a direct exchange of aircraft between the company and the QEAT.

In a front-end reverse like-kind exchange, the company 'sells' its existing aircraft to the QEAT. The QEAT then holds title to the relinquished aircraft until such time as it is purchased by a third-party >



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buyer. The QEAT acquires title to the replacement aircraft before transferring that title to the company to complete the like-kind exchange at the 'front-end' of the transaction. The company then owns the replacement aircraft, and the QEAT holds title to the relinquished aircraft until the sale of that aircraft to a third-party unrelated purchaser (which must typically be accomplished within 180 days of the acquisition of the replacement aircraft by the company).

When the QEAT acquires title to the relinquished aircraft, it issues its promissory note to the company in an amount equal to the estimated fair market value of the relinquished aircraft. When the relinquished aircraft is sold, the amount of the note is adjusted to match the purchase price proceeds (per applicable IRS guidance), which are then 'paid' by the QEAT to the company in exchange for the cancellation of the QEAT's note.

BACK-END REVERSE LIKE-KIND EXCHANGE

In a back-end reverse like-kind exchange, the QEAT first takes title to the replacement aircraft and holds that title until such time as the company is able to complete the sale of the relinquished aircraft. The QEAT typically acquires the funds to purchase the replacement aircraft by borrowing them from the aircraft owner. Thus the QEAT owns the replacement aircraft until the sale of the relinquished aircraft occurs, at which time title to both aircraft is transferred into the hands of their rightful owners.

In either a front-end form of a reverse like-kind exchange or back-end reverse like-kind exchange, the fiction of a direct exchange is maintained through the use of the Qualified Exchange Agreement Titleholder. In this way, like-kind exchange treatment is preserved, the IRS sanctioned reverse like-kind exchange procedures are followed and, provided that all other requirements (including the 180-day time limitation for completion of the transaction) are met, the IRS should respect the tax deferred character of the like-kind exchange transaction.

RELATED/ANCILLARY ISSUES

There are several related/ancillary issues that a Board must consider when engaging in a forward or a reverse like-kind exchange of aircraft. The newly acquired aircraft in a like-kind exchange typically takes a carry-over basis valuation that is equal to the company's basis in the relinquished aircraft. The characterization of gain recognized upon the eventual sale of the replacement aircraft (e.g., depreciation recapture) is also retained. For these reasons, the Board must always consider whether engaging in a like-kind exchange of aircraft makes financial sense given that recognition of gain is merely deferred rather than being eliminated.

In a like-kind exchange of aircraft, the Board must also consider state sales and use taxes. If not structured properly, the mere transfer of title to an aircraft may trigger liability for sales that could completely or partially negate the income tax benefit of engaging in the exchange. Furthermore, in many instances, the procedures required for engaging in a like-kind exchange of aircraft will impact the availability of cer-



tain credits or exemptions from sales and use taxes (such as the credit for the value of an aircraft trade-in that is available in many states).

A Board must also recognize that while most sophisticated buyers and sellers of aircraft and aircraft lenders understand like-kind exchanges and will be prepared to work with the company to enable it to complete the exchange, occasionally there are parties who are unfamiliar with the requirements for properly implementing a like-kind exchange.

In such a case, it helps to have an intermediary party who can work with the uninformed aircraft seller or buyer to give that person the comfort they need to proceed with the transaction. Likewise, if a lender is involved in the transaction, the Board must communicate with the lender before making the determination that the company will engage in a like-kind exchange.

There is much complexity involved in the completion of a like-kind exchange of aircraft, and there are many ancillary issues that must be addressed. Whether or not a like-kind exchange of aircraft makes financial sense will often depend on a complete analysis of these issues and a comparison of the financial savings resulting from the like-kind exchange versus the outcome of trading aircraft without the use of a like-kind exchange. Expert legal counsel is a necessity.

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
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