



# Like Kind Exchanges

## What are the Current IRC Section 1031 Trends?

Keith Swirsky describes in layman's terms the benefits and complications of deferring taxable gains from selling an existing business aircraft and replacing it with another business aircraft.



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Typically business aircraft remain suitable for service longer than the time allowed to fully depreciate their purchase price.

When sold, gains resulting from the difference between sale price and depreciated value are taxable, although the timing of when those gains must be taken is extended if the owner replaces the aircraft with another model according to the provisions of Internal Revenue Code (IRC) Section 1031.

Also known as a like kind exchange, transactions covered by IRC Section 1031 permit the current owner of a business aircraft to defer recognition of gain, such as tax depreciation

recapture, on the sale of its current aircraft (heretofore 'relinquished aircraft') and the purchase of a replacement aircraft.

In its simplest format, an aircraft owner agrees to sell its relinquished aircraft, enters into an agreement with a qualified intermediary to hold the sales proceeds, identifies a replacement aircraft within 45 calendar days of the sale of the relinquished aircraft, and closes on the acquisition of such replacement aircraft within 180 days of the sale of the relinquished aircraft. The qualified intermediary will apply any funds it holds, to be used in connection with the purchase of the replacement aircraft.

Exchanges structured in this simplest format are referred to as 'forward exchanges'. In today's business aircraft market, very few forward exchanges are structured, as most aircraft owners will identify and acquire their replacement aircraft prior to selling their relinquished aircraft.

### Reverse Exchange

For such situations we utilize what is called a reverse exchange, which has many of the very same procedural/mechanical requirements as a forward exchange. In this structure, either the relinquished aircraft or the replacement aircraft is transferred to a third party known as the exchange accommodation title (EAT) holder.

The EAT is typically the same party as the qualified intermediary, and this aspect of the structure is seamless to an aircraft owner. However, it is important that whichever aircraft is transferred to the EAT is then leased to the aircraft owner, so the aircraft owner may operate such aircraft.

If the relinquished aircraft is transferred to the EAT, the transaction is structured as a sale with a lease of the relinquished aircraft back to the owner. If the replacement aircraft is acquired by the EAT, the transaction is structured as an assignment of the purchase contract for the replacement

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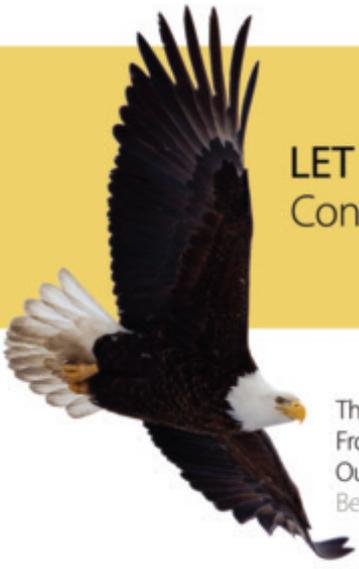
aircraft to the EAT, who then acquires the replacement aircraft and leases it to the aircraft owner.

For purposes of this article, we will refer to the acquisition of the relinquished aircraft by the EAT as a “front end exchange,” because the 1031 exchange technically occurs at the time of closing on the replacement aircraft, and we will refer to the transaction where the EAT acquires the replacement aircraft as a “back end exchange,” because the 1031 exchange technically occurs at the time the relinquished aircraft is sold to a third party buyer. [Although conducting a reverse exchange is complex, the attorneys at GKG Law who provide reverse exchange and EAT services have structured and implemented 1031 exchanges for almost 31 years, and understand the nuances of reverse exchanges prescribed by the Internal Revenue Code and regulations promulgated thereunder.]

### Tax Planning

What's new and interesting about reverse exchanges is coordinating federal income tax structuring requirements with state sales and use tax planning techniques, such as a sales tax trade-in credit strategy. A state law trade-in credit statute, in general, allows for an aircraft owner to reduce



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the amount of sales or use tax due on the acquisition of the replacement aircraft, by netting the sale proceeds from the relinquished aircraft against the purchase price of the replacement aircraft. As more states clamp down on utilization of "sale for resale" leasing structures as means for minimizing sales and use tax, trade-in credit tax strategies have become more compelling, however.

State sales and use tax law, like Internal Revenue Code Section 1031, is mechanically and procedurally oriented, and requires strict adherence to the statutory methodology. In many cases the statutory methodology may require the use of a "retailer" who holds a sales tax license or permit, as well as other procedural requirements. Reconciling the procedural requirements of federal tax law with state tax law rules is challenging. A single set of exchange documents must accomplish all of the tax structuring.

In many cases, the requirements of the federal law and the state tax law are simply not harmonious, thus an aircraft owner must choose to structure the transaction to comply more squarely with one or the other. It is also true that state sales and use tax statutes and regulations tend to be vague on many procedural points, requiring an experienced "guess" on the structuring requirements.

In connection with the decision to structure the reverse exchange as either a front end exchange or a back end exchange, it is also necessary to consider federal income tax and state sales and use tax issues. For example, if the replacement

aircraft is newly manufactured, in order to preserve the entitlement for bonus depreciation, a front end exchange must be structured. Even without the consideration of bonus depreciation, it is generally preferential to structure the exchange as a front end exchange, to enhance overall depreciation deductions.

Conversely, in the event that sales or use tax had been paid in full on the relinquished aircraft, structuring the reverse exchange as a front end exchange may be less desirable, as an additional sales tax can result on the transfer of the relinquished aircraft to the EAT. Existing debt and new debt issues also heavily factor in the structuring analysis.

These are just a few of the nuances of structuring 1031 exchanges in a manner that meets all of the aircraft owner's tax objectives. These subtleties create a melting pot of competing issues that must be identified, analyzed and considered before engaging in the exchange. Therefore, it is important to consult an experienced aviation tax advisor early in the process. ■

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