

# Tax-Free Aircraft Exchanges Under IRC 1031 and Bonus Depreciation Updates

**GKG Law, P.C. Webinar Series**

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## Your Tax Concerns

- Your aircraft has been fully (or nearly fully) depreciated for tax purposes
- Your aircraft has significant market value



## Your Tax Concerns Cont...

- ✈ You want to sell your aircraft and use the proceeds to buy another aircraft, but the sale of your “old” aircraft could result in millions of dollars of recapture, all of which could be taxable at ordinary tax rates



## Your Solution

→ If you "exchange" your old aircraft for your "new" aircraft in a transaction qualifying under Section 1031 of the Internal Revenue Code, you may be able to defer recognition of some or all of the gain from the sale of the old aircraft



# Issues?

- Qualifying a transaction under Section 1031 can be complicated
- Transaction form and timing are critical



## Issues Cont...

- An inadvertent or relatively minor timing or documentation error in an otherwise properly structured transaction can cause the whole transaction to fail to qualify under Section 1031



# Statutory Elements of a Tax-Free Exchange

- You must have held your old aircraft for productive use in a trade or business, or for investment
- You must hold your new aircraft for productive use in a trade or business, or for investment





## Statutory Elements of a Tax-Free Exchange Cont...

- Your new aircraft must be “like-kind” to your old aircraft
- You must NOT sell your old aircraft and purchase your new aircraft in separate transactions, but rather must exchange your old aircraft for your new aircraft



## Statutory Elements of a Tax-Free Exchange Cont...

- ➔ You must recognize gain to the extent of any cash or any other non-qualifying property received in the exchange
- ➔ Your basis in your new aircraft will be adjusted downward by the amount of gain deferred by the exchange



# Multi-Party Exchange and Deferred Exchange Safe Harbors

- ➔ If you are not actually selling your old aircraft to the same party from whom you will purchase your new aircraft (e.g. an OEM), the transaction must be structured as a multi-party exchange



## Multi-Party Exchange and Deferred Exchange Safe Harbors Cont...

- In multi-party exchanges, the sale of the old aircraft and the purchase of the new aircraft may occur simultaneously, or up to 180 days apart



## Multi-Party Exchange and Deferred Exchange Safe Harbors Cont...

- ➔ If you will close the purchase of your new aircraft within 180 days subsequent to the closing of the sale of the old aircraft, you must structure the transactions as a “Forward Exchange”



## Multi-Party Exchange and Deferred Exchange Safe Harbors Cont...

- ➔ If you will close the purchase of your new aircraft within 180 days prior to the closing of the sale of the old aircraft, you must structure the transactions as a “Reverse Exchange”



# Forward Exchange Basics

- Authorized by Treasury Regulations § 1.1031(k)-1
- Qualified Intermediary (“QI”) acts as middleman in sale of the old aircraft and acquisition of new aircraft



## Forward Exchange Basics Cont...

- ➔ You and QI enter into an Exchange Agreement which restricts your rights to receive proceeds from the sale of the old aircraft
- ➔ Proceeds from the sale of the old aircraft are held in a qualified escrow account or a qualified trust account pending purchase of the new aircraft





## Forward Exchange Basics Cont...

- You **must** either acquire the new aircraft, **or** specifically identify the aircraft that will be acquired, **within 45 calendar days** after completion of the sale of the old aircraft.
- You may be allowed to identify multiple and/or alternate aircraft



## Forward Exchange Basics Cont...

- You **must** complete your acquisition of the new aircraft no later than the earlier of:
- (1) the **180th calendar day** after completion of the sale of the old aircraft; or . . .



## Forward Exchange Basics Cont...

(2) the due date (including extensions) of your Federal income tax return for the taxable year in which the sale of the old aircraft occurred



# Reverse Exchange Basics

- Authorized by IRS Revenue Procedure 2000-37, 2000-40 IRB 1 (September 15, 2000)



## Reverse Exchange Basics Cont...

- ➔ Procedures are similar to Forward Exchange, except that an Exchange Accommodation Titleholder ("EAT") holds title to either the old aircraft (a "Front-End Reverse Exchange"), or the new Aircraft (a "Back-End Reverse Exchange") until a closing of the sale of the old aircraft can be arranged. (The EAT usually also performs the QI function)



## Reverse Exchange Basics Cont...

- You and EAT must enter into a Qualified Exchange Accommodation Agreement



## Reverse Exchange Basics Cont...

→ You **must** either complete a sale of the old aircraft to a third-party buyer, or specifically identify the aircraft that will be sold, within **45 calendar days** after the acquisition of the new aircraft by you in a Front-End Reverse Exchange, or by the EAT in a Back-End Reverse Exchange



## Reverse Exchange Basics Cont...

- The sale of the old aircraft **must** be completed no later than: the **180th calendar day** after the acquisition of the new aircraft by you in a Front-End Reverse Exchange, or by the EAT in a Back-End Reverse Exchange; OR
- The due date of the taxpayer's federal tax return, including extensions, if prior to 180 days





# Common Questions

- 1) Who may and who may not serve as Qualified Intermediaries and/or Qualified Exchange Accommodation Titleholders? (e.g., Lawyers, Accountants, Aircraft Brokers)



## Common Questions Cont...

→ 2) Are OKC escrow accounts "Qualified" escrow accounts?



## Common Questions Cont...

→ 3) In a forward exchange, can I take title to a **green** aircraft in exchange for my old aircraft?



## Common Questions Cont...

→ 4) Can I make progress payments on a new aircraft?



## Common Questions Cont...

- 5) Can I exchange my aircraft for:
1. An interest in a partnership that owns a different aircraft?
  2. A 100% interest in a limited liability company that owns a different aircraft?
  3. A fractional interest in a new aircraft?



## Common Questions Cont...

→ 6) Can I trade two old aircraft for one new aircraft in a single 1031 transaction?



## Common Questions Cont...

- 7) What happens if I do a Reverse Exchange and can't sell my old aircraft within 180 days of the purchase of my new aircraft?



## Common Questions Cont...

- 8) Will my exchange qualify as a “trade-in” for state sales and use tax purposes?





# Bonus Depreciation Update



# Legislation

- “**Bonus Depreciation**” was originally enacted after the September 11 terrorist attacks, and expired a few years later.
- The **Economic Stimulus Act of 2008** (the “2008 Act”) re-introduced the concept of Bonus Depreciation into the Tax Code for certain “Qualified Property” placed in service in 2008 (and, under certain circumstances, in 2009).
- The **American Recovery Reinvestment Act of 2009** (the “2009 Act”) extended each of the placed in service deadlines of the 2008 Act by an additional year (to 2009/2010).
- The **Small Business Jobs Act of 2010** (the “First 2010 Act”) extended each of the placed in service deadlines of the 2008 Act by yet another year (to 2010/2011).



# Legislation

- The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “Second 2010 Act”)
- extended each of the placed in service deadlines of the 2008 Act by two more years (to 2012/2013).
  - increased Bonus Depreciation Allowance from 50% to 100% for Qualified Property acquired between Sept. 8, 2010 and Dec. 31, 2011, and placed in service prior to January 1, 2012 (2013 for Certain Aircraft and Property having Long Production Times).



# Legislation

- The **American Taxpayer Relief Act of 2012** (the “2012 Act”)
- extended each of the placed in service deadlines of the 2008 Act by yet another year (to 2013/2014).
  - did not extend the 100% bonus depreciation provisions (bonus reverted to 50% after expiration of the 100% bonus depreciation deadlines).



# Bonus Depreciation

- The depreciation deduction for the taxable year in which “**Qualified Property**” is placed in service includes an allowance equal to either 50 or 100 percent, as applicable, of the adjusted basis of the Qualified Property (i.e., after adjustments under other sections of the IRC (e.g., Section 179)).



# Bonus Depreciation

- Exception: for “Properties Having Long Production Periods” (defined later) that are placed in service in 2014, the bonus depreciation allowance applies only to that portion of the adjusted basis thereof attributable to manufacture, construction, or production before January 1, 2014.



# Bonus Depreciation

- A taxpayer's remaining basis after deducting the 50% allowance is depreciated under standard depreciation principles (i.e., MACRS). (Obviously, does not apply to property qualifying for 100% bonus).
- For example, assuming an aircraft depreciable under a five-year MACRS depreciation schedule, and the half-year convention, total first year deduction is 60% (i.e., 50% Bonus Depreciation Allowance, plus 20% of the remaining 50% under MACRS).



# What is “Qualified Property”?

- “Qualified Property” is property which meets each of the following four requirements:
1. has a recovery period of 20 years or less (e.g., aircraft);
  2. the “Original Use” of the property commences with the taxpayer after December 31, 2007;





# What is “Qualified Property”?

→ 3.

- (i) is acquired by the taxpayer after December 31, 2007, and before January 1, 2014, but only if no “Written Binding Contract” for the acquisition was in effect before January 1, 2008, or
- (ii) is acquired by the taxpayer pursuant to a “Written Binding Contract” which was entered into after December 31, 2007, and before January 1, 2014; or
- (iii) in the case of Self Constructed Property, the taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2014; and



## What is “Qualified Property”?

- 4. is placed in service by the taxpayer before January 1, 2014, or, in the case of “Certain Aircraft” or “Property Having Long Production Periods”, before January 1, 2015.



## What is “Original Use”?

→ “Original Use” means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer.



## What is a “Written Binding Contract”?

- Regulations provide that a contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision); however, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount.
- In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account.



# What are “Certain Aircraft”?

- “Certain Aircraft” are aircraft which:
- are not “Transportation Property”;
  - on which such purchaser, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of 10% of the purchase price, or \$100,000;
  - have an estimated production period exceeding 4 months; and
  - have costs exceeding \$200,000.



# What is “Transportation Property”?

- ✈ “Transportation Property” is tangible personal property used in the trade or business of transporting persons or property. This could include all corporate aircraft that are predominantly used in charter, however, no definitive guidance exists.



# What is “Self-Constructed Property”?

- “Self Constructed Property” includes property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business (or for its production of income).



# Self-Constructed Property

- ➔ Treasury Regulations provide an example indicating that newly manufactured aircraft purchased from the manufacturer would be considered self-constructed property where a buyer entered into a contract to purchase the aircraft prior to commencement of construction of the aircraft.





# Self-Constructed Property

- ➔ Manufacture, construction, or production of property begins when physical work of a significant nature begins.
- ➔ Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching.



## Self-Constructed Property Safe Harbor

- Taxpayers generally may elect to determine when physical work of a significant nature begins in accordance with a Safe Harbor. However, when property (e.g. an aircraft) is manufactured, constructed, or produced for the taxpayer by another person, the safe harbor test must be satisfied by the taxpayer.
- Under the Safe Harbor, physical work of a significant nature will not be considered to begin before the taxpayer incurs (in the case of an accrual basis taxpayer) or pays (in the case of a cash basis taxpayer) more than 10 percent of the total cost of the property.



## Self-Constructed Property Safe Harbor

- For example, if an aircraft is to be constructed by an OEM for a cash basis taxpayer for the total cost of \$20,000,000, construction should be deemed to begin for purposes of this safe harbor when the taxpayer has paid more than 10 percent (\$2,000,000) of the total cost of the aircraft.



## Self-Constructed Property Safe Harbor

- A taxpayer chooses to apply the safe harbor by making a notation on the income tax return for the placed-in-service year indicating the date when physical work of a significant nature began consistent with the safe harbor.



## What is “Property Having Long Production Periods”?

- In order for property placed in service in 2014 (other than “Certain Aircraft”) to qualify for Bonus Depreciation, the property must satisfy each of the following four tests:
- (1) the property must meet all the requirements of “Qualified Property” discussed above;
  - (2) the property must either have a recovery period of at least 10 years or be “Transportation Property”;



## What is “Property Having Long Production Periods”?

- (3) the property must be subject to IRC Section 263(A) (which applies to real or tangible personal property produced by the taxpayer); and
- (4) the property must have an estimated production period (i.e., the time from the date production actually begins until the date the aircraft is ready to be placed in service) **exceeding 1 year**, and a cost exceeding \$1,000,000.



## What is “Property Having Long Production Periods”?

- This last requirement will eliminate many business-class aircraft that are “Transportation Property” and are placed in service in 2014 from qualifying for Bonus Depreciation under the “Property Having Long Production Periods” provision. Notwithstanding the fact that many makes/models of business aircraft have waiting lists that are several years long, few corporate jets actually have production periods exceeding 1 year.



## What is “Property Having Long Production Periods”?

- If an aircraft placed in service in 2014 qualifies as “Property Having a Long Production Period,” the bonus depreciation allowance applies only to that portion of the adjusted basis of such aircraft attributable to manufacture, construction, or production before January 1, 2014.





## What is “Property Having Long Production Periods”?

- How do you calculate that portion of the adjusted basis of such aircraft attributable to manufacture, construction, or production before January 1, 2014?



## What is “Property Having Long Production Periods”?

- Neither the statute, nor the regulations answer the question. However, Congress did state that it intended that rules similar to Section 46(d)(3) of the Internal Revenue Code that was in effect prior to the Tax Reform Act of 1986 should be employed to determine what portion of such costs are attributable to production before January 1, 2014.
- Consistent with Section 46(d)(3), the amounts that would be attributable to production before January 1, 2014, would likely be the lesser of (i) the amounts paid before January 1, 2014, or (ii) the amount which represents that portion of the overall cost of the construction which is properly attributable to that portion of such construction which is completed before January 1, 2014.



# Summary

## Placed in Service

Type of Property	Jan 1, 2008 to Sep 8, 2010	Sep 9, 2010 to Dec 31, 2011	Jan 1, 2012 to Dec 31, 2012	Jan 1, 2013 to Dec 31, 2013	Jan 1, 2014 to Dec 31, 2014
<b>Certain Aircraft</b>	50%	100%	50% or 100% (See Note)	50%	50%
<b>Long Production Times</b>	50%	100%	50% or 100% (See Note)	50%	50% of Pre-2014 Production Cost
<b>Other Qualified Property</b>	50%	100%	50%	50%	None

Note:

Property acquired Sep 9, 2010 - Dec 31, 2011, but placed in service in 2012, qualifies for 100%.

Property acquired and placed in service in 2012, qualifies for 50%



## Special Rules: Predominant Use

Bonus depreciation does not apply to aircraft used predominately outside the United States.

→ 50% test

→ Aircraft operated to and from the United State



# Special Rules: Like-Kind Exchanges

- Bonus Depreciation applies in the year the replacement property is placed in service.
- Both the **Carryover Basis** (i.e., the basis in the relinquished aircraft), and the **Excess Basis** (i.e., additional cash paid in the exchange), are eligible for Bonus Depreciation.
- Depreciation (Bonus and MACRS) is computed separately for the Carryover Basis and the Excess Basis.



# Special Rules: Like-Kind Exchanges

- ➔ Deduction Attributable to Relinquished Aircraft in Year of Exchange has 3 components:
  1. MACRS deduction applicable to that portion of the year preceding the exchange (apply applicable convention).
  2. Bonus Depreciation on remaining Carryover Basis.
  3. MACRS deduction applicable to that portion of the year after the exchange (apply applicable convention).



# Special Rules: Like-Kind Exchanges

- ➔ Deduction Attributable to Replacement Aircraft in Year of Exchange usually has 2 components, but may have 3 components if Section 179 expensing also applies:
- Section 179 expensing deduction, if applicable.
  - Bonus Depreciation.
  - MACRS deduction.



# Flipping an OEM Contract

- A Treasury Regulation example indicates that where a taxpayer enters into a written binding contract prior to January 1, 2008 (September 11, 2001 in the example), and then subsequently transferred the rights to own and use the property to another unrelated taxpayer, the transferee taxpayer can qualify for bonus depreciation.
- The use of the phrase “transferred the rights to own and use” in the Treasury Regulations is ambiguous, and it is not clear whether the phrase implies an assignment of the original OEM agreement, or a back-to-back title transfer of a new aircraft without an assignment of the OEM agreement, or both.





## Special Rules: OEM Demonstrators

- New aircraft used by a manufacturer or dealer for demonstrator purposes prior to sale to a customer should qualify. In such situations, the “Original Use” of the aircraft is considered to be by the taxpayer and not by the dealer or manufacturer.



## Special Rules: Fractional Aircraft

- ➔ If, in the ordinary course of its business, a taxpayer sells fractional interests in property to third parties unrelated to the taxpayer, each first fractional owner of the property is considered as the original user of its proportionate share of the property.



## Special Rules: Rebuilt Aircraft

- Rebuilt and reconditioned aircraft do not qualify.
- The cost of new upgrades and improvements (e.g., new engines and new avionics) purchased by a taxpayer for an aircraft the taxpayer already owns can qualify; but if the taxpayer purchases a used aircraft after the upgrades and improvements have been made, the aircraft will be considered rebuilt or reconditioned and no part of the total acquisition cost will qualify.



# Closing Remarks

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