



GUARDIAN JET, LLC  
1445 Boston Post Road  
Guilford, CT 06437  
203-453-0800  
[www.guardianjet.com](http://www.guardianjet.com)

Federal Taxation of Corporate Aircraft: MACRS and "Bonus"  
Depreciation Eligibility, Passive Loss Limitations and "Like-Kind"  
Exchanges"

*By Michael B. Schiraldi, Legal Analyst*

June 1st, 2012

# Federal Taxation of Corporate Aircraft: MACRS and "Bonus" Depreciation Eligibility, Passive Loss Limitations and "Like-Kind" Exchanges"

By Michael Schiraldi  
06/09/2012

## I. Introduction

The business aviation industry has enjoyed explosive growth over the last two decades due to recognition by corporate leaders that aircraft can be remarkably effective business tools. Besides serving as an efficient means of executive level transportation, business aircraft ownership also offers substantial tax benefits. Under the Internal Revenue Code ("the Code"), a taxpayer that purchases a business aircraft can through depreciation deductions reduce its taxable income by the full purchase price over a short time period (usually 5 years). Of course, the useful life of most aircraft, in economic terms, far exceeds five years. Thus the amount of each depreciation deduction provided by the Code typically results in a tax savings well above any actual decrease in the market value of the aircraft. Furthermore, most business aircraft qualify for accelerated depreciation under the MACRS system, with new aircraft eligible for bonus depreciation (at least through the end of 2012). Since a dollar of tax savings now is worth more than dollar of tax savings in future years, the net present value of accelerated depreciation can be substantial. Additionally, an exchange of a used business aircraft for another new or used aircraft generally results in no tax liability. This result follows from the Code's non-recognition treatment of "like-kind" exchanges.

This whitepaper will provide an outline of the requirements an aircraft owner must meet to qualify for the MACRS and bonus depreciation systems. Obtaining like-kind exchange treatment under Section 1031 of the Code for in-kind aircraft transactions will also be discussed. However, meeting the MACRS and bonus depreciation requirements does not insure that one

receives the full benefit of their potential deductions. Certain anti-tax shelter provisions, notably Section 469's passive activity loss rule, can limit or disallow aircraft related depreciation and expense deductions. Accordingly, the potential limitations on aircraft deductions by the passive loss rule will also be discussed in this article.

## II. Tax Depreciation of Business Aircraft

Most business aircraft qualify for accelerated depreciation under the Modified Accelerated Cost Recovery System ("MACRS"). Under the MACRS statute, taxpayers are enabled to claim a greater percentage of the depreciation attributable to a business aircraft in the first few years of their ownership than if they used a strait-line method to calculate depreciation deductions. When a taxpayer of a depreciable aircraft fails to satisfy the requirement for MACRS treatment, it must use the generally less favorable Alternative Depreciation System ("ADS"). Under ADS property is depreciated using a straight-line method. This results in equal depreciation deductions each year during the applicable recovery period. Recovery periods under the ADS also tend to be longer than under MACRS for the same property.

An aircraft's *type*—airplane or helicopter—and its *intended use*—commercial, business or personal—determine whether the taxpayer may depreciate it and if so, the proper depreciation method and recovery period. Based on their type and use, all aircraft can be placed in one of the following three asset classes:

- (1). Aircraft, other than helicopters, used in the commercial or contract carrying of passengers and freight by air. Aircraft in this category generally may be depreciated under MACRS over a recovery period of seven years or under ADS over twelve years.<sup>1</sup>
- (2). Aircraft used for qualified business purposes or for the production of income and helicopters used in the commercial or contract carrying of passengers and freight by

---

<sup>1</sup> Asset Class 45.0. Rev. Proc. 87-56, 1987-2 C.B. 671.

air. Aircraft in this category is generally depreciable under MACRS over a recovery period of five years or under ADS over six years.<sup>2</sup>

- (3). Aircraft held as inventory or stock in trade and personal use aircraft. Aircraft in this category generally may not be depreciated.

### 1. Qualified Business Uses

A qualified business use is generally any use in a trade or business for which a deduction would be allowed under I.R.C. § 162. Certain uses of an aircraft by a business entity that would otherwise be considered qualified business uses, however, may be disallowed by I.R.C. § 280F(d)(6)(C). Specifically, use of a business aircraft falling within one of the following three categories will not be treated as a business use for depreciation purposes *unless* all of the taxpayer's other business uses of the aircraft comprise at least 25% of the aircraft's total utilization during the taxable year:

- a. Leasing the aircraft to any person who owns 5% or more of the company, or to any person who is related (within the meaning of I.R.C. § 267(b)) to a 5% owner.<sup>3</sup>
- b. Using the aircraft to provide compensation to any person who owns 5% or more of the company, or to a person related to a 5% owner.<sup>4</sup>
- c. Using the aircraft to provide compensation to any other person unless an amount is included in the gross income of that person reflecting their use of the aircraft, and any required income tax was withheld.<sup>5</sup>

Personal use of a business aircraft by a business's employees that is intended as a form of compensation ordinarily is deductible under I.R.C. § 162, provided the value of the flight is imputed to the employee's income using the Noncommercial Flight Valuation Rule. However,

---

<sup>2</sup> Asset Class 00.21. Rev. Proc. 87-56, 1987-2 C.B. 671.

<sup>3</sup> I.R.C. § 280F(d)(6)(C)(i)(I).

<sup>4</sup> I.R.C. § 280F(d)(6)(C)(i)(II).

<sup>5</sup> I.R.C. § 280F(d)(6)(C)(i)(III).

where the employees are owners of 5% or more of the business, personal use of the aircraft by such persons will constitute a qualified business use only if the 25% test is satisfied.<sup>6</sup>

## **2. Mixed Qualified Business and Commercial Use**

Many companies that own and operate business aircraft to support the transportation needs of their own non-aviation businesses offset some of the ownership costs by chartering the aircraft when it is not otherwise being utilized. This can affect the asset class, and hence the depreciation schedule, applicable to the aircraft. As was noted in the above list, aircraft used for business purposes are generally eligible for MACRS depreciation over a period of five years while aircraft used in the commercial or contract carrying of passengers are designated a seven year recovery period. Treasury regulations specify that when property is used for different purposes at various times, the property must be included in the asset class for the activity in which the property is primarily used.<sup>7</sup> The primary use an aircraft is put to determines its classification even though the activity in which it is used is insubstantial in relation to all of the non-aviation activities of the taxpayer.<sup>8</sup> While the regulations do not further define "primarily used," the standard can be understood to require that an aircraft will be depreciated under MACRS over a five year recovery period if the proportion of the time it is used for qualified business purposes exceeds that for which it is used in commercial or contract carrying of passengers and freight by air.<sup>9</sup> Conversely, if the proportion for which the aircraft is used for commercial or contract carrying of passengers predominates, it will generally still be eligible for MACRS but must use the longer seven year recovery period.

---

<sup>6</sup> I.R.C. § 280F(d)(6)(C)(i)(II)

<sup>7</sup> Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b) (2000).

<sup>8</sup> Id.

<sup>9</sup> Troy A. Rolf, "Taxing the CEO's Jet: Federal Taxation of Corporate and Private Aircraft Ownership and Operations," 66 J. Air L. & Com. 1605, 1614 (2001).

The regulations do not specify a method (e.g., total flights, total flight hours, total days of use) of measuring various types of use. However, any such method is likely to be by the IRS if it is undertaken in good faith and the taxpayer arrives at a reasonably accurate result. One must also remember that to determine the appropriate asset class for a mixed commercial and business use aircraft, the taxpayer looks only to the primary use of the aircraft during its first taxable year in service.<sup>10</sup> A change in the primary use of the property after the taxable year in which it was first placed in service will not affect its classification.

### **3. Effect of Personal Use on Depreciation**

When an aircraft is used in part for qualified business purposes, and/or in the commercial or contract carrying of passengers ("Depreciable Uses") and part of the time for personal use, the depreciation deduction is disallowed to the extent of the fraction of total use representing personal use. The depreciable basis of the aircraft must nevertheless be reduced by the entire amount of depreciation that would have been allowed had the aircraft's only use during the year been Depreciable Use.

Once the taxpayer determines the share of its aircraft's use that is depreciable (e.g. non-personal use), it must ascertain whether MACRS or the less favorable ADS depreciation is available for the depreciable portion of the aircraft's use. The result depends on whether depreciable use or personal use predominates.<sup>11</sup> An aircraft is predominantly used for qualified business purposes during any taxable year if the business use percentage for such taxable year exceeds 50 percent.<sup>12</sup> If this test is met, the share of depreciation attributable to business use will be entitled to MACRS depreciation. However, if less than 50 percent of the aircraft's use is for non-personal business use, the portion of the aircraft that may be depreciated must be

---

<sup>10</sup> Reg. § 1.167(a)-11(b)(4)(iii)(b).

<sup>11</sup> I.R.C. § 280F(b)(1).

<sup>12</sup> I.R.C. § 280F(b)(3).

depreciated using the ADS system. The most efficient way to establish and meet the 50% test is to maintain a log of one's flight hours and document whether such flight hours were for business or pleasure.

If a taxpayer that has been depreciating its aircraft on an accelerated basis (e.g. using MACRS or bonus depreciation) allows its business use to drop below 50% for a given tax year, it must switch to straight-line depreciation in the year of the change.<sup>13</sup> In addition, Section 280F(b)(2) requires the taxpayer to recapture the prior accelerated depreciation deductions and include them in its income for the year the aircraft's business use falls below 50%. This will generally result in substantial adverse income tax consequences because the amount recaptured may be quite large. The recapture amount is equal to the amount by which each prior year's MACRS or 168(k) depreciation deductions for the aircraft exceeded the deduction that would have been obtained under ADS's straight-line method.

### III. "Bonus" Depreciation Under 168(k)

In an effort to stimulate the economy, towards the close of 2010 Congress enacted and President Obama signed into law the Small Business Jobs Act (SBJA), and the Tax Relief Act (TRA). These laws provided the aviation industry with some valuable, but time-limited, tax benefits. Prior to their enactment, the 50-percent additional first year depreciation deduction allowed under § 168(k)(1) for qualified property acquired and placed into service after 2007 was set to expire January 1, 2011 (January 1, 2012 for "certain aircraft"). Section 2022(a) of the SBJA extended the placed-in-service date to before 2011 (before January 1, 2012 in the case of "certain aircraft"). The TRA conferred additional tax benefits to business aircraft purchasers by extending the "placed in service" deadline for qualified property to receive 50-percent bonus depreciation to January 1, 2013 (January 1, 2014 for "certain aircraft"). Most significantly, the

---

<sup>13</sup> I.R.C. § 280F(b)(2).

TRA also added § 168(k)(5) to the Code. This provision authorizes a 100-percent additional first year depreciation deduction for qualified property acquired and placed in service before January 1, 2012 (January 1, 2013 in the case of certain aircraft).

For a business aircraft purchase to qualify for bonus depreciation it must meet the statutory test for "qualified property." The acquisition must also fulfill additional statutory requirements demanded by the definition of "certain aircraft." "Qualified property" is: (1) MACRS property with a MACRS recovery period no longer than 20 years; (2) the original use of the property must begin with the taxpayer after December 31, 2007; (3) the property must be acquired by the taxpayer either (i) after December 31, 2007 and before January 1, 2013, and no written binding contract for the acquisition can be in effect before January 1, 2008, *or* (ii) under a written binding contract entered into after December 31, 2007 and before January 1, 2013; and (4) the property must be placed in service by the taxpayer before January 1, 2013, except "certain aircraft" is qualified property if it is placed in service before January 1, 2014.<sup>14</sup> For aircraft, as with qualified property in general, "original use" generally requires the taxpayer to have acquired a new aircraft. However, if the taxpayer acquired the aircraft from a dealer whose only prior use of the aircraft was in providing demonstration flights to prospective customers, such use does not constitute a "use" for purposes of the original use requirement under the bonus depreciation rules.<sup>15</sup>

Assuming the aircraft fulfills the above listed "qualified property" requirements of § 168(k), the availability of bonus depreciation is contingent on the acquisition constituting a "certain aircraft." "Certain aircraft" means an aircraft that is not "transportation property" as

---

<sup>14</sup> I.R.C. § 168(k)(2)(A), Reg. § 1.168(k)-1(b)(1).

<sup>15</sup> PLR 200502004



defined in the statute.<sup>16</sup> If the predominant use of the aircraft is intended to be Part 91, causing it to be depreciated pursuant to a MACRS five year schedule, the aircraft would be considered “certain aircraft”. If, however, the predominant use was to be Part 135, such that the aircraft was depreciable under MACRS with a seven year recovery period, it would be “transportation property”. In addition to not constituting "transportation property," the "certain aircraft" definition also requires that, at the time a contract for purchase is entered into, the aircraft purchaser must make a nonrefundable deposit of 10 percent of its cost or \$100,000, whichever is less.

Qualifying one's acquisition as a "certain aircraft" rather than “transportation property” is likely to confer greater tax benefits from bonus depreciation. "Transportation property" may qualify for the Dec. 31, 2013 placed in service deadline for bonus depreciation only to the extent that the aircraft's adjusted basis (purchase price) is attributable to manufacture, construction or production activity that occurred before Jan. 1, 2013.<sup>17</sup> Depreciation deductions arising from "certain aircraft" acquisitions, in contrast, are not encumbered by this statutory limitation.

### **1. "Green Delivery" Aircraft**

Bonus depreciation confers a substantial tax benefit by allowing taxpayers to effectively expense a multimillion dollar capital asset during the first year of acquisition. However, as discussed above, bonus depreciation is set to expire at the end of 2013. For many potential purchasers of business aircraft, this dynamic creates a large incentive to take measures that attempt to ensure that one's desired aircraft can be acquired before the deadline. To be eligible for bonus depreciation under 168(k), qualifying property must be "placed in service" prior to January 1, 2014. The Treasury regulations explain that: "Property is first placed in service when

---

<sup>16</sup> See I.R.C. § 168(k)(2)(B)(iii).

<sup>17</sup> Rev. Proc. 2011-26 .03(b)(2) Internal Revenue Bulletin: 2011-16 April 18, 2011

first placed in a condition or state of readiness and availability for a specifically assigned function . . . in a trade or business."<sup>18</sup> In the aircraft context this usually requires, at a minimum, the flying of an actual mission by the taxpayer in the year the depreciation benefits are desired to begin for the aircraft.

In an effort to satisfy the "placed in service requirement" as swiftly as possible, some enterprising taxpayers have attempted to schedule a "green delivery" of a business aircraft. "Green delivery" involves taking delivery of an aircraft for which an airworthiness certificate has been issued, but remains unfinished. For example, the aircraft may be unpainted with an unfinished interior and cabin upon delivery. A common tactic employed by purchasers of an aircraft in "green" condition is to take delivery in Tax Year 1, after the aircraft has left the main production facility, and then fly a pro-forma mission in the aircraft. Shortly thereafter, the aircraft is returned to the manufacture's completion center and re-delivered to the taxpayer in completed form during Tax Year 2.

Unfortunately, this strategy is too clever by half. A green delivery will generally fail to meet the "placed in service" requirement because the aircraft being delivered is incapable at that time of serving as a corporate jet. This result follows from the regulatory definition provided above. The "specifically assigned function" of an aircraft intended for business use is to serve a corporate jet. Because aircraft intended for such use are not "in a condition . . . of readiness" to serve as a corporate jet when they lack, for instance, finished interiors or have yet to be painted, the fact that they can fly is insufficient to render them "placed in service." The IRS supported this interpretation in a 1982 Private Letter Ruling. There it found that an aircraft delivered to a taxpayer in unpainted condition and without a finished interior would not be considered "placed in service" until the taxpayer "completed its work on the aircraft's interior."

---

<sup>18</sup> Reg. § 1.167(a)-11(e)(1)(i)

Not every completely unfinished aircraft is per se incapable of being deemed "placed in service" upon delivery. In close cases, a facts and circumstances test would need to be applied to determine whether the aircraft is capable of present use as a corporate jet. Nevertheless, attempting to take delivery before the aircraft is ready for use as a business aircraft is a high risk tax planning strategy that is very likely to fail. After all, a "green delivery" generally has no business purpose for the taxpayer other than attempted tax reduction. Given that such a brazen approach is likely to attract IRS attention and fail to survive the Service's scrutiny, "green deliveries" should be avoided as a tax planning tool.

#### IV. Passive Loss Limitations on Aircraft-related Deductions

Section 469 is an important anti-tax shelter provision in the Code that must be taken into account by individual aircraft owners, along with pass-through entities such as partnerships and LLCs. In particular, those taxpayers which charter their business aircraft when not otherwise using it may see some or all of the deductions (including depreciation) attributable to the costs of the charter activities, limited. Section 469 requires taxpayers to classify their income, losses and credits as being derived from either "passive activities" or "non-passive activities." Passive activity deductions (including depreciation and net operating losses) may only be used to offset income from passive activities.<sup>19</sup> Those passive activity losses which cannot be used currently because the taxpayer has insufficient passive income are carried forward to the next year and treated as passive activity losses then.<sup>20</sup> Passive activity losses carry forward without time limitation until enough passive income is available to absorb them. Additionally, these suspended losses are generally allowed in full when the taxpayer disposes of her interest in the

---

<sup>19</sup> I.R.C. § 469(a)(1), (d)(1),(2).

<sup>20</sup> I.R.C. § 469(b).

passive activity.<sup>21</sup> Thus when passive activity rules apply, they will result in the deferral but not the permanent disallowance of excess deductions generated by passive activities.

### **1. "Material Participation" and Rental Income**

A passive activity involves the conduct of any trade or business in which the taxpayer does not materially participate. For a taxpayer's participation to be considered material, it must be regular, continuous and substantial.<sup>22</sup> Material participation may be found "based on all the facts and circumstances."<sup>23</sup> The regulations also provide seven alternative tests that provide precise, quantitative standards by which a taxpayer can satisfy the material participation statutory requirement. Regardless of whether the taxpayer is a material participant, however, a rental activity is generally deemed a passive activity subject to Section 469. The regulations provide that an activity is a rental activity for a taxable year if during that year: (1) tangible property held in connection with the activity is used, or held for use, by customers; and (2) the gross income derived from the activity represents amounts paid principally for the use of the tangible property.<sup>24</sup>

The chartering of a business aircraft is considered a rental activity. Accordingly, deductions for depreciation and operating expenses attributable to an aircraft's Part 135 use will generally be limited to the income derived from the charter activity. However, there are a few narrow exceptions to the requirement that rental activities must be classified as passive. Two of these regulatory exceptions are relevant to business aircraft chartering.

#### **A. Rendering of "Extraordinary Personal Services"**

---

<sup>21</sup> I.R.C. § 469 (g)(1)(A).

<sup>22</sup> I.R.C. § 469(h)(1).

<sup>23</sup> Temp. Reg. § 1.469-5T(a)(7), (b).

<sup>24</sup> Temp. Reg. § 1.469-1T(e)(3)(i).

First, if "extraordinary personal services" are rendered by the aircraft's owner in connection with the chartering, the activity will not be treated as a rental activity. "Extraordinary personal services" are provided in connection with a rental activity only if the customers' use of the rental property is incidental to their receipt of the services. This is a fairly rigorous standard. In the aircraft chartering context it requires that the aircraft's owner (not a separate flight management company) provide significant flight related services to its charter customers. The services provided by the aircraft owner's air transportation staff must be of such a nature and quality that the use of a seat on the aircraft by charter customers can be reasonably characterized as incidental to those passengers' receipt of the personal services. In a 2005 Revenue Ruling the IRS suggested that this standard might be satisfied if the taxpayer provides, in connection with its chartering activities, "air transportation services to [charter customers], including, but not limited to, the use of the aircraft, with pilot and crew, fuel, and food."<sup>25</sup>

#### **B. Rental Activity Incidental to a Taxpayer' Trade or Business**

The other significant exception to the general rule that rental income is per se passive may be easier for some business aircraft owners to meet. If the chartering activity is deemed "incidental to a nonrental activity of the taxpayer," it will be excluded from the definition of rental activity. The rental of property is incidental to a nonrental trade or business activity of the taxpayer during the taxable year only to the extent that:

- (1) the taxpayer owns an interest in the trade or business activity;
- (2) the property was predominantly used in that trade or business activity during the taxable year or during at least two of the five taxable years that immediately precede the taxable year; and

---

<sup>25</sup> See Rev. Rul. 2005-64, I.R.B. 2005-39, dated Sept. 26, 2005.

(3) the gross rental income from the rental property for the taxable year is less than two percent of—(i) the property's unadjusted basis; or (ii) its fair market value, whichever is less.<sup>26</sup>

A company that's primary business involves something other than providing Part 135 flight services could satisfy the above requirements through careful planning. Specifically, it must ensuring that it's charter revenue does not exceed two percent of the lesser of its aircraft's acquisition price (unadjusted basis) or its current market value.

## V. Like Kind Exchanges

As a general rule, gains or losses realized on the sale or exchange of property must be recognized by the taxpayer in the tax year of the transaction. However, Section 1031 of the Code provides that no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for property of "like kind" that is to be held for productive use in a trade or business or for investment. Section 1031's non-recognition rule, is based on the notion that the property received in a like kind exchange represents merely a continuation of the taxpayer's investment, albeit in a modified form. Section 1031 defers, rather than permanently excludes, the recognition of gain or loss. The unrecognized gain or loss is preserved, through the basis mechanism, in the like kind property received. The property received is assigned a "substituted basis" derived from the total bases of all the properties given up and reduced by any money received. Nevertheless, according to at least one tax commentator, a like-kind exchange of personal property (including aircraft) under Section 1031 is "probably one of the last remaining great tax shelters available."<sup>27</sup>

### 1. "Like Kind" Requirement

---

<sup>26</sup> Temp. Reg. § 1.469-1T(e)(3)(vi).

<sup>27</sup> Bert J. Zerb, "Like Kind Exchanges with Aircraft," CPA Journal, Thursday April 1, 2010, at 40.

For property received in an exchange to qualify for non-recognition treatment under Section 1031, it must be of "like kind" to the property relinquished by the taxpayer. According to the regulations, "like kind" refers to the nature or character of property, or its kind or class; the property's grade or quality is not considered.<sup>28</sup> In 1991 the IRS promulgated regulations that provide considerable guidance regarding which exchanges of personal property satisfy the like kind requirement.<sup>29</sup> Under these regulations, the like kind requirement is satisfied if depreciable tangible personal property is exchanged for property of either a like kind *or* of a "like class." Depreciable tangible personal properties are of a "like class" if both are within the same "General Asset Class."<sup>30</sup> Revenue Procedure 87-56 classifies depreciable tangible property into 13 asset classes. One of these asset classes (Class 00.21) encompasses most business aircraft: "Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines)."

Section 1031(a), it should be noted, expressly removes "interests in a partnership" from the type of property eligible for like-kind treatment.<sup>31</sup> Thus an individual taxpayer will find it difficult to execute a 1031 exchange involving aircraft if the taxpayer's ownership interest in either the relinquished or newly acquired aircraft is derived solely from the taxpayer's equity interest in a partnership or LLC that holds (or is to hold) title to the aircraft.

#### **A. Fractional Aircraft Interests**

As fractional aircraft ownership has gained popularity recently, it may become important for some taxpayers to determine whether an exchange of an interest in a whole aircraft for a

---

<sup>28</sup> Reg. § 1.1031(a)-1(b).

<sup>29</sup> See Reg. § 1.1031(a)-2.

<sup>30</sup> Reg. § 1.1031(a)-2(b)(1). Depreciable tangible personal properties are also of like class if within the same "Product Class." See Reg. § 1.1031(a)-2(b)(1). A Product Class consists of depreciable tangible personal property listed in a six-digit product class within certain sectors of the North American Industry Classification System. Reg. § 1.1031(a)-2(b)(3).

<sup>31</sup> I.R.C. § 1031(a)(2)(D).

fractional interest, or vice versa, would qualify as an exchange of "like-property" under 1031. While the properties being exchanged are the same (aircraft), the form of ownership is different. Unfortunately, there is a lack of regulatory guidance on this issue which makes any firm conclusions difficult to reach. For real property, Revenue Ruling 73-473 provides that an undivided fractional interest (such as a tenancy in common) in one piece of real property may be exchanged for another lot of land that is owned outright (e.g., fee simple). Some commentators have suggested that a fractional interest in an aircraft could, similarly, be considered like-kind to an outright ownership interest in an aircraft.<sup>32</sup>

However, the analogy between a fractional interest in an aircraft and a joint-tenancy in land seems misplaced. After all, each joint-tenant has an undivided right to possess the whole real property.<sup>33</sup> The typical fractional aircraft ownership arrangement may be more analogous to a timeshare in land than to a joint tenancy. Under that interpretation, a taxpayer exchanging a fractional ownership share in an aircraft for outright ownership of a another aircraft would not qualify for non-recognition treatment. That said, bright lines are difficult to draw here and much of the determination would depend on the precise terms of the contract governing the fractional jet ownership arrangement. Given the uncertainty in this area, caution is advised. It is safe to assume that an exchange involving fractional aircraft interests for which a taxpayer seeks like-kind treatment will be subject to IRS scrutiny and evaluated on a case-by-case basis.<sup>34</sup>

## **2. The Holding Requirements**

Section 1031(a) requires that the property exchanged must have been "held [by the taxpayer] for productive use in [its] trade or business or for investment" and that property acquired is "to be held [by the taxpayer] either for productive use in [in its] trade or business or

---

<sup>32</sup> See Zerb, *supra* note 27.

<sup>33</sup> See Joseph William Singer, *Introduction to Property* 354 (2d Ed. 2005).

<sup>34</sup> See Zerb, *supra* note 27.



for investment." Personal-use property is thus excluded from the scope of Section 1031. Accordingly, the exchange of an aircraft that was used predominantly for business purposes for another aircraft which the taxpayer intends to put to primarily personal use does not satisfy the "to be held" requirement. It must be noted, however, that the applicability of Section 1031 to one party to an exchange does not depend on its applicability to other parties. For example, say Taxpayer A exchanges an aircraft it had used for business purposes for an aircraft belonging to Taxpayer B, which Taxpayer B had used as her personal aircraft. So long as Taxpayer A intends to put Taxpayer B's aircraft to business use, Taxpayer A will qualify for non-recognition treatment under Section 1031 even though Taxpayer B will not (due to her personal use of the relinquished aircraft.)

There is generally no express requirement the property being relinquished in a like-kind exchange be held for any particular period of time. In 1989, however, Congress did amend Section 1031 to impose a two-year holding period on exchanges between related persons.<sup>35</sup> If, in such a related parties transaction, the holding requirements are not satisfied, the gain or loss that was not recognized on the exchange is reported in the year the subsequent, disqualifying transfer occurs.<sup>36</sup>

### **3. "Solely" for Like Kind Property and the Presence of "Boot"**

Usually, the aircraft transferred in a Section 1031 exchange are of unequal in value. As a result, at least one of the parties also transfers cash or other non-like kind property (known as "boot" in tax parlance) to even up the exchange. Fortunately, despite its use of the phrase "solely for like kind property," Section 1031 does not disqualify this exchange. Rather, it requires a taxpayer to recognize gain on the like kind property relinquished by an amount equal

---

<sup>35</sup> I.R.C. § 1031(f), (g).

<sup>36</sup> I.R.C. § 1031(f)(1).

to the sum of the money and the fair market value of any non-like kind property received. For example, if Taxpayer A utilizes Section 1031 to exchange an aircraft worth \$15,000,000 to Taxpayer B for an aircraft worth \$12,000,000 and \$3,000,000 cash, Taxpayer A must recognize a \$3,000,000 gain on the boot received. Furthermore, the gain a taxpayer receiving both a like-kind aircraft and cash or other boot in a 1031 exchange will be required to recognize is limited to the amount, if any, of gain realized in the transaction. Recognition of loss on like kind property, however, is prohibited.

#### **A. Treatment of Liabilities**

Sometimes, one or more of the aircraft in a like kind exchange are transferred subject to a liability which the other party agrees to assume. Such liability relief is treated under Section 1031 as money received by the taxpayer relieved of the liability.<sup>37</sup> Liability relief is thus a form of boot. For example, if Taxpayer A transfers an aircraft worth \$12,000,000, but subject to \$2,000,000 debt, to Taxpayer B in return for an aircraft worth \$10,000,000, Taxpayer A is treated as having received \$2,000,000 in cash. However, if both properties in a like kind exchange are transferred subject to liabilities, only the net liability relief constitutes money received.<sup>38</sup>

#### **4. Sale or Exchange**

To qualify for 1031 treatment the transaction must in substance be an exchange of like-kind property rather than a sale. The IRS has defined an exchange as, "ordinarily, a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration

---

<sup>37</sup> I.R.C. § 1031(d) (last sentence).

<sup>38</sup> Reg. § 1.1031(d)-2 Ex. 2.

only."<sup>39</sup> Thus, the receipt of only cash in return for one's aircraft, even if the proceeds are immediately invested in like kind property, is fatal to Section 1031 treatment.

#### **A. "Deferred" Exchanges**

Taxpayers often are confronted with situations where they have a buyer for their aircraft but would prefer to have the benefit of Section 1031 treatment rather than have the transaction be regarded as a taxable sale. Taxpayers usually prefer such deferred or "forward exchanges" because these methods ensure that the taxpayer will have funds available to invest in the replacement aircraft. Section 1031 does not require that the exchange of properties be simultaneous. The statute does, however, disqualify a taxpayer from obtaining like-kind treatment if it takes possession or control of the cash proceeds from the relinquished property and then later obtains the replacement property. The regulations provide a convenient method for taxpayers to overcome the logistical difficulties Section 1031 would otherwise present deferred exchanges by permitting the use of a "qualified intermediary."<sup>40</sup> The taxpayer who uses the qualified intermediary safe harbor will not be in actual or constructive receipt of money or other property on account of such use. Careful compliance with the safe harbor's requirements is essential for ensuring the transaction will receive 1031 treatment.

To satisfy the regulatory requirements for a "forward" like-kind exchange, first, the taxpayer should enter into an agreement with an independent third party (e.g. not a family member, personal accountant, or lawyer) to serve as a "qualified intermediary." Next, the taxpayer must assign to the intermediary its rights to payment under the aircraft sale contract the taxpayer previously entered into. To ensure the assignment's validity the intermediary must accept the assignment and the other party to the sale contract must be notified of it. After the

---

<sup>39</sup> Reg. § 1.1002-1(d)

<sup>40</sup> Reg. § 1.1031(g)(4).

assignment is in effect, the sale of the taxpayer's aircraft that is to be relinquished in the 1031 exchange may close. The sales proceeds—less closing costs and liabilities—must be *immediately* deposited in full with the qualified intermediary.

The regulations require that within a 45-day "identification period" starting on the date of the sale, the taxpayer must create a list of potential replacement aircraft and deliver it to the qualified intermediary.<sup>41</sup> The taxpayer will then negotiate a purchase contract for the replacement aircraft and assign its rights under the contract to the intermediary. Under Section 1031(a)(3), the taxpayer must receive the replacement aircraft within the "exchange period." This period is defined as no later than 180 days after the transfer of the relinquished property or the due date (including extensions) of the taxpayer's tax return for the year of the transfer, whichever is earlier.<sup>42</sup> After the assignment of the purchase contract to the intermediary, the acquisition closes and the intermediary then transfers the deposited funds to the seller of the replacement aircraft on the taxpayer's behalf. Furthermore, at the closing, direct deeding of the aircraft from the seller to the taxpayer is permitted.

Those in need of a "qualified intermediary" to facilitate a like kind aircraft exchange should have no trouble finding one. A host of financial institutions and other entities with aviation expertise offer to serve as qualified intermediaries for business aircraft owners that wish to obtain non-recognition treatment through a "forward" Section 1031 exchange.

## VI. Conclusion

Accelerated depreciation and non-recognition treatment through like kind exchanges offer tremendous potential tax benefits for current or prospective business aircraft owners. As discussed above, however, qualifying for these tax benefits requires careful attention to

---

<sup>41</sup> Reg. § 1.1031(k)-1(b)(2)(i).

<sup>42</sup> Reg. § 1.1031(k)-1(b)(2)(ii).

numerous specific, and sometimes counterintuitive statutory and regulatory requirements. Furthermore, the passive loss rules can present complications for business aircraft owners that derive substantial revenue from chartering activities. Given the stakes involved, a prudent taxpayer should obtain specialized advice from legal and tax professionals in connection with any aircraft transaction where tax objectives are a central concern. An informed appreciation of these tax considerations can help ensure that one will maximize the financial benefits of their business aircraft ownership while avoiding regulatory traps for the unwary.