

Have Your Cake And Eat It Too:

How to have a federal tax-free exchange AND obtain state sales tax trade-in. by Gary I. Horowitz

Having it all is nice: Cake without calories, muscles without exercise, both are fantasy. But selling and buying an aircraft without incurring taxes? That's distinctly possible! When it comes to taxes on an aircraft acquisition, there is a tension that exists between Federal income tax and state sales tax that makes it difficult to achieve perfect Federal and state tax harmony — that is, incurring neither Federal income tax nor state sales tax on a multiple aircraft purchase and sale transaction.

However, under the right circumstances, and with the proper planning and implementation, it is possible to substantially minimize both the Federal and state tax consequences of a multiple aircraft transaction. One particular opportunity to do this involves structuring a used aircraft sale so that it qualifies as a tax-free exchange of that aircraft for a new aircraft, and at the same time minimize state sales taxes on the purchase of the new aircraft by using a state sales tax trade-in credit. This can be an exceptional structure because the aircraft owner does not have to realize Federal income tax on the used aircraft sold or pay state sales tax on the new aircraft purchased. Achieving this result, however, requires a deft hand on the yoke.

TAX-FREE EXCHANGES: SELLING AN AIRCRAFT WITHOUT PAYING FEDERAL INCOME TAX

Under Internal Revenue Code Section 1031, an aircraft may be exchanged tax-free for another aircraft. Such an exchange allows the owner to defer the Federal income tax on any gain from the sale of the used aircraft. In today's supply-tight market, used aircraft may sell for more than their original purchase price, so this gain can be tax-deferred. Also, any tax depreciation deductions taken on the aircraft can be preserved, and this is a particular benefit because "depreciation

recapture" on the sale of depreciated property is subject to income tax at ordinary income tax rates, not the lower capital gains rates.

TRADE-IN CREDITS: REDUCING STATE SALES TAXES ON THE PURCHASE OF AN AIRCRAFT

Most states impose a sales tax that an aircraft buyer must pay at the time of purchase. The sales tax is based upon the "purchase price" of the aircraft. So, on a \$40 million aircraft, a 5% sales tax means a \$2 million sales tax liability.

However, many states allow a buyer to reduce the "purchase price" for purposes of calculating the sales tax if the buyer is "trading-in" property at the same time that it is purchasing property. Therefore, if a buyer can "trade-in" a \$30 million aircraft at the same time that it purchases a \$40 million aircraft, the "purchase price" for the new aircraft is only \$10 million for state sales tax purposes. By using the "trade-in" credit under these circumstances, the state sales tax liability has been reduced from \$2 million to \$500,000 - a substantial savings that can pay for both cake and fitness trainers.

A trade-in credit also has certain advantages over other sales and use tax minimization strategies. A common technique used in aircraft acquisitions is the "sale for resale" structure in which an entity purchases an aircraft sales tax-free for leasing purposes only, and not for the buyer's personal use, thereby avoiding sales tax on the aircraft's purchase price. However, this structure is not completely sales tax-free, since it requires sales tax payments to be made on the lease or rent payments received for use of the aircraft. With a trade-in credit, there is no sales tax to the extent of the trade-in credit.

In addition, with a trade-in credit as compared to a "sale for resale" exemption claim, there is no state sales tax reason to set up a leasing structure for the ownership and oper-

ation of the aircraft, which obviously has some degree of administrative burden and expense. Where a state sales tax trade-in credit is unavailable, a "sale for resale" exemption is a viable option. In some circumstances, however, taxpayers can use BOTH a trade-in credit and sale-for-resale structure for the same aircraft, but that's another day's dessert.



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COMBINING A 1031 TAX-FREE EXCHANGE WITH TRADE-IN CREDITS

In order to combine a 1031 tax-free exchange on a used aircraft's disposition with state sales tax trade-in credits on a new aircraft's purchase, there are several things to be aware of:

1. The 1031 tax-free exchange must be properly planned and structured under the Federal income tax laws, keeping in mind that not all 1031 exchange structures are compatible with trade-in credits. Most 1031 exchanges are "deferred exchanges" - meaning that there is a time gap between the used aircraft's disposition and the new aircraft's acquisition. In this regard, Federal tax law indulges a fiction - an exchange of property will be recognized as tax-free, even when the transfer does not occur simultaneously, as long as the transfer occurs within specifically defined statutory periods.

However, some state sales tax trade-in credit statutes do not clearly allow for a gap in time between the trade-in of the old property and the new property's acquisition. In addition, it is unlikely that you can have a "reverse" 1031 exchange and also obtain a

trade-in credit. In a “reverse” 1031 exchange, the new aircraft is acquired before the used aircraft is disposed of.

Under Federal tax law, this can be achieved through the use of an intermediary called an Exchange Accommodation Titleholder (EAT). However, under state sales tax laws, it is unlikely that a trade-in credit will be available if the new property has been purchased without first trading-in the old property.

2. Not all states have a trade-in credit, so the new aircraft needs to be delivered in a state where the credit is available. Each state also has its own particular rules and procedures for claiming the trade-in credit. These rules must be carefully followed because sales tax exemptions such as the trade-in credit are the exception to the rule that all sales are subject to sales tax, and therefore state taxing authorities narrowly construe these rules and look for any deviation by the taxpayer as an opportunity to deny the trade-in credit.

3. In order for a new aircraft buyer to obtain a trade-in credit on the value of its used aircraft, the new aircraft seller must acquire the used (or trade-in) aircraft. The new aircraft

seller may not want to buy the trade-in aircraft, but there is often a third party that does.

In this case, the new aircraft seller needs to agree to take title to the trade-in aircraft, give the buyer a credit (equal to the trade-in aircraft’s value) against the new aircraft’s purchase price, and then transfer the trade-in aircraft to the third party. This must be properly done, however, because the IRS could seek to deny 1031 tax-free exchange treatment on the basis that the new aircraft seller is an “agent” of the taxpayer disposing of the trade-in aircraft. In order for a 1031 exchange to be respected for Federal income tax purposes, the seller cannot be the taxpayer’s “agent”.

Instead, the “benefits and burdens” of the trade-in aircraft’s ownership must pass to the seller, who should be legally obligated in a binding purchase agreement to purchase the trade-in aircraft.

4. Keep your paperwork in order. The Aircraft Purchase Agreement for both the trade-in aircraft and the new aircraft should reflect that the parties intend to have both a 1031 tax-free exchange and obtain a trade-in credit.

The new aircraft seller will probably need to take title to the trade-in aircraft and be required to deliver title to the ultimate purchaser of the trade-in aircraft, with an FAA Bill of Sale and possibly a Warranty Bill of Sale. The seller will also need to provide the new aircraft buyer with an invoice showing a credit towards the new aircraft’s purchase price in an amount equal to the trade-in aircraft’s purchase price.

CONCLUSION

Having both a 1031 tax-free exchange and obtaining state sales tax trade-in credits on a multiple aircraft transaction can be a complicated affair, and will not work in some circumstances. However, when both can be achieved, the benefits are certainly worth the effort.

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