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IRS Says Aircraft Leasing Entity is Eligible for 1031 Tax Free Exchange Treatment Despite Leasing to Related Companies at No Profit

A new IRS Chief Counsel memo says that an aircraft leasing partnership that trades in an aircraft that is leased to a related entity is eligible for §1031 tax free exchange treatment, even though the related entity lease rate was so low that it produced tax losses during the term of the lease. This is good news for a combined state sales tax planning structure frequently used for aircraft acquisitions, to be followed by a trade-in of the aircraft when a new plane is desired.

Under this sales tax planning transaction, a company wanting to acquire an aircraft sets up a separate entity to purchase the aircraft (aircraft leasing company or ALC). The aircraft is solely used by the ALC for purposes of leasing the same to its parent company or other related entities on a “dry lease” basis – which is a lease of the aircraft only, without a pilot or crew. Most states (with some exceptions) allow the ALC to purchase the aircraft exempt from sales tax, as a sale for resale, because the aircraft is being purchased for the purpose of leasing it – analogous to a rental car company which does not pay sales tax when it purchases automobiles to lease to its customers. Instead of paying sales tax on the purchase of the aircraft, the ALC charges sales tax on the lease payments paid by its lessee. Then, when the company wants a new aircraft, it can trade in the leased aircraft under Section 1031 and avoid recognizing recapture gain (and if the new aircraft is leased under a dry lease to a related party, no sales tax on the new purchase).

The upfront sales tax savings in such a structure are significant, at the cost of paying relatively small amounts of sales tax on the lease payments over the course of the ownership of the aircraft. For example, assume an aircraft purchase price of \$10 million, and a sales tax rate of six percent. The upfront sales tax savings on the purchase of the aircraft by the ALC would be \$600,000. Now, assume an hourly lease rate of \$2,000 per hour (not including fuel, maintenance or pilot) for 500 flight hours a year. The sales tax on the \$1 million in lease payments per year would be \$60,000—a major savings compared with the one-time \$600,000 up front sales tax that would have been paid if the ALC structure is not utilized.

The benefits of the above sales tax structure will be enhanced if the lease rate can be set at a low amount, since this will reduce the sales tax on the rental income. But that can cause a technical problem for a trade-in under §1031 when it is time for a new aircraft. That’s because a typical aircraft trade-in can only be tax-free if it qualifies under §1031, and it can

only qualify under §1031 if the aircraft that is being traded in has been “held for productive use in a trade or business or for investment.” The concern is that if there is no taxable income produced due to the low lease rate, the IRS could argue that the “trade or business” or “investment” standards were not met, and deny the taxpayer the right to defer the taxable gain on the trade-in.

In the specific situation addressed by the new IRS Chief Counsel Advice memo, the lease rate was so low that it produced losses during the lease term. The field agent asked the Chief Counsel’s Office whether the trade-in qualified for §1031 exchange treatment on the grounds that the losses indicated that the aircraft was not held for productive use in a trade or business or for investment. The field agent argued that the ALC had no profit motive, and therefore could not qualify for §1031 exchange treatment with respect to the aircraft, which would mean that the trade-in for a replacement aircraft would trigger taxable income to the ALC.

Remember, the lower the dry lease payment on the aircraft, the less sales tax paid on the lease, so it is common to charge as low a lease payment as will pass muster with the state tax authority – but low lease payments will result in losses to the ALC, and the potential sales tax savings by reducing the lease payment would be dwarfed by the income tax hit on a trade-in if §1031 treatment is not allowed.

Fortunately, CCA 201601011 concluded, based on the facts in that case, that the low lease rate did not disqualify the trade-in from §1031 tax free exchange of the aircraft. A win-win for companies purchasing aircraft, as they are able to save sales tax on the purchase, and income tax on the trade-in.

A Few Caveats:

- > First, this Chief Counsel Advice is not binding on the IRS, and it could change its position on this in the future. Furthermore, the specific facts involved in the lease under consideration might be different from your particular situation.
- > Second, the amount of the lease payment cannot be nominal. Such lease payments need to bear some relationship to fair rental value in order for the sales tax planning technique to work – otherwise a state taxing authority might say that the lease is a sham, so that the ALC cannot acquire the aircraft exemption from sales tax on the purchase price. The hourly lease rate should be supported by an aircraft broker’s opinion on the lowest possible reasonable lease rate.
- > Third, a well-crafted dry-lease agreement is necessary. Note, that since the aircraft will be leased on a dry lease basis to its parent or other related companies, the ALC will need to either enter into an aircraft management services agreement with an operator licensed by the FAA to provide the pilot, crew, and proper oversight of maintenance and repair services, or contract directly for the necessary pilot, crew, and maintenance.
- > Fourth, it is imperative to keep in mind that under an ALC structure, the only permitted use of the aircraft by the ALC is to lease it on a dry lease basis to a third party (as such additional activities would indicate that the property is not held for the purposes of leasing). Any other use by the ALC will trigger sales and use tax on the fair market value of the aircraft.
- > Fifth, the foregoing is a summary. It is necessary to check the rules of the specific state where the aircraft will be based to make sure that the state allows a resale exemption for the contemplated ALC structure.
- > Finally, the Chief Counsel Advice memo only deals with the issue of whether the aircraft leasing company can qualify for a §1031 exchange even though there is a loss on the related party dry lease transaction – it does not address any other income tax issues – such as the disallowance of losses that might otherwise be used to offset other sources of income.

The full text of Chief Counsel Advice 201601011 can be found [here](#).

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