

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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subject: Section 1031 Aircraft Exchange

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

P	=
O	=
A	=
B	=
Year 1	=
Relinquished Aircraft	=
Replacement Aircraft	=

ISSUE

Does P hold relinquished aircraft and replacement aircraft “for productive use in a trade or business” within the meaning of § 1031 of the Internal Revenue Code if the aircraft, which are leased to a related entity that that is owned by the same individuals who own P, are P’s only operating assets and do not generate an economic profit for P?

CONCLUSION

P holds both the relinquished and replacement aircraft “for productive use in a trade or business” within the meaning of § 1031.

FACTS

Partnership P owns multiple aircraft which are leased to Partnership O. O is the primary business entity of the O group of entities, which includes P and other entities. O’s business activities involve air travel, particularly by its executives. For both business and legal reasons, the aircraft are owned by P, in an entity separate from the main business entity, O, and leased to O. The aircraft are the only operating assets of P, but P also owns interests in other entities in the O group of entities. The aircraft are principally used by two of O’s senior executives—A and B. A and B use the aircraft variously for business purposes and for personal purposes. Thus, the aircraft serve a business purpose for O both in terms of business travel and as an employment perk for its senior executives. To the extent A and B use the plane for personal purposes, they include the required amount in income as compensation under IRS regulations. A and B, who own interests in O through wholly-owned entities, also own 50 percent each of P through wholly-owned entities.

In Year 1, P exchanged the relinquished aircraft for the replacement aircraft. Both the relinquished and replacement aircraft were leased under a so-called “dry” lease, under which the lessee provides flight crew and other services pertaining to the aircraft. The lease payments for the relinquished aircraft approximated the fair market rental value of the aircraft whereas the lease payments for the replacement aircraft were below market. Nevertheless, in both cases, the lease payments were designed to cover the aircraft’s carrying costs and were not designed to generate meaningful economic profit.

The field’s position is that P did not hold either the relinquished or replacement aircraft for productive use in a trade or business. Because the term “held for productive use in a trade or business” is not defined in the Code or Regulations, the field relies on § 183 and accompanying cases and regulations to determine whether P held the aircraft for productive use in a trade or business. See, e.g., Treas. Reg. §§ 1.183-2(b) and 1.183-1(d)(1); Campbell v. Commissioner, 868 F. 2d 833 (6th Cir. 1989), aff’g. in part and rev’g. in part T.C. Memo 1986-569. In addition, the field contends that, in making the evaluation under § 183, entities should be examined solely on an entity by entity basis, and the profit motive of one entity should not be attributed to another entity, even if the two entities are closely related. See, e.g., United States v. Basye, 410 U.S. 441 (1973);

Moline Properties v. Commissioner, 319 U.S. 436 (1943); Polakof v. Commissioner, 820 F. 2d 321 (9th Cir. 1987), cert. denied, 484 U.S. 1025 (1988). Using the standards under § 183, the field concludes that P did not hold the aircraft for productive use in a trade or business.

Finally, the field did not raise the issue of whether P is a valid partnership and not a sham entity. If P is a sham entity then A and B, not P, are the owners of the aircraft. In that case, our analysis would be different than provided below and the conclusion may be different as well. Thus, our assumption is that P is a valid partnership.

LAW AND ANALYSIS

Section 1031(a)(1) provides that: “No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”

Whether the property is held for productive use in a trade or business or for investment is a question of fact. The manner in which the relinquished property is held at the time of the exchange controls not the manner in which it was held when acquired. Similarly, replacement property is held for productive use in a trade or business or held for investment if it is so held at the time of acquisition. Wagensen v. Commissioner, 74 T.C. 653 (1980).

Section 183 applies to limit the deductions of an individual or an S corporation engaging in an activity without a profit motive. There is no authority suggesting that the standards of § 183 should be used to evaluate whether property is held for productive use for purposes of § 1031. Consequently, we do not agree that the § 183 standards should be used to evaluate whether the aircraft are property held for productive use in a trade or business.

The facts indicate that the rent P charges O for use of the relinquished property and the replacement property is insufficient for P to make an economic profit on the aircraft rental to O. However, many businesses hold and use properties in a way that, if the use of the property were viewed as an activity, do not and could not generate profit. Nevertheless, the property itself is held for productive use in that business. Thus, P’s lack of intent to make an economic profit on the aircraft rental does not establish that the aircraft fails the productive use in a trade or business standard of § 1031. In addition, we agree with the field that A’s and B’s use of the property for personal purposes is not relevant in determining whether P holds the aircraft for productive use in a trade or business.

Moreover, it is important to point out that businesses, for any number of reasons, opt to hold property, especially aircraft, in a separate entity. In the present case, O, which operates a legitimate business enterprise, requires private aircraft to be available to its

senior executives, both for business travel and as an employment perk. However, for business and legal reasons, the aircraft are owned not by O but by P, a related entity. If O owned the aircraft, or was the 100 percent owner of P, we doubt that the field would have raised the issue of whether the aircraft were held for productive use in a trade or business. Were we to disallow § 1031 treatment based on the entity structure presented here, businesses would be forced to structure their transactions in inefficient and potentially risky ways to achieve § 1031 treatment. Thus the entity structure in the present case should not be used as grounds that the aircraft fails to qualify as property held for productive use in a trade or business.

In sum, O operates a legitimate business enterprise and requires private aircraft to be available to its senior executives. For business and legal reasons, O has structured its affairs so that the aircraft are owned through P and leased to O for an amount not intended to generate a profit for P. On these facts, the aircraft are held for productive use in a trade or business.

We are sensitive to two facts raised by the field: P charges below-market rent for the replacement aircraft and A and B, rather than O, own P. While these facts do not disqualify the property from being held for productive use in a trade or business for purposes of § 1031, it may be that other tax provisions such as § 280F or 482 may apply to disallow tax benefits or impose a tax treatment different from the treatment claimed by P, O or A and B.

Finally, our analysis extends only to whether the relinquished and replacement aircraft meet the held for productive use in a trade or business requirement in § 1031(a). We do not express or imply an opinion on whether the exchange met the other requirements under § 1031 to qualify as a like-kind exchange. Nor do we express or imply an opinion regarding other tax aspects of the transaction.

Please call _____ at (_____) _____ if you have any further questions.