GKG Law

Aviation Tax Law Webinar
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Bonus Depreciation

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Overview

- 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.
- The Small Business Jobs Act of 2010 (the "2010" Act) extended each of the placed in service deadlines of the 2008 Act by yet another year.

Bonus Depreciation

- The depreciation deduction for the taxable year in which "Qualified Property" is placed in service includes an allowance equal to 50 percent 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 2011, the 50% bonus depreciation allowance applies only to that portion of the adjusted basis thereof attributable to manufacture, construction, or production before January 1, 2011

Bonus Depreciation

- A taxpayer's remaining basis after deducting the 50% allowance is depreciated under standard depreciation principles (i.e., MACRS, ADS).
- 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, 2011, 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, 2011; 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, 2011; and

What is "Qualified Property"?

- 4.
  - is placed in service by the taxpayer before January 1, 2011, or, in the case of "Certain Aircraft" or "Property Having Long Production Periods"), before January 1, 2012.

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 yet 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 2011 (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 2011 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 a "Transportation Property" aircraft placed in service in 2011 qualifies as "Property Having a Long Production Period", as previously stated, the 50% bonus depreciation allowance applies only to that portion of the adjusted basis of such aircraft attributable to manufacture, construction, or production before January 1, 2011.

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, 2011?

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, 2011.
- Consistent with Section 46(d)(3), the amounts that would be attributable to production before January 1, 2011, would likely be the lesser of (i) the amounts paid before January 1, 2011, 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, 2011.

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:
  1. Section 179 expensing deduction, if applicable.
  2. Bonus Depreciation.
  3. 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.

Special Rules: Sale-Leasebacks

- If an original buyer places an aircraft in service after December 31, 2007, and within three months after the aircraft was placed in service, the original buyer sells the aircraft to a leasing company and leases it back from the leasing company, the leasing company may treat the aircraft as originally placed in service not earlier than the date on which the leasing company leased the aircraft back to the original buyer.

Special Rules: Syndications

- If a leased aircraft is placed in service after December 31, 2007, and within three months after the aircraft was placed in service the lessor sells the aircraft, but the lessee does not change, the aircraft will be treated as originally placed in service not earlier than the date of the sale.

Special Rules; Predominant Use

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

Example 1

- Facts:
  - Prior to January 1, 2008, a cash-basis taxpayer entered into a written binding contract with OEM to build an aircraft, and paid more than 10% of the purchase price. Taxpayer subsequently accepts delivery of the aircraft late in 2010 and immediately places aircraft in service.

Example 1 (Cont.)

- Result:
  - Aircraft does not qualify for bonus depreciation.

Example 2

- Facts:
  - Prior to January 1, 2008, a cash-basis taxpayer entered into a written binding contract with OEM to build an aircraft, and paid more than 10% of the Purchase Price. Prior to accepting title and delivery of the aircraft from OEM, taxpayer "transferred the rights to own and use" the aircraft to another, unrelated (within the meaning of IRC 267(b) or 707(b)) taxpayer. The transferee taxpayer subsequently places aircraft in service in 2010.

Example 2 (Cont.)

- Result:
  - Notwithstanding the fact that the aircraft would not qualify for bonus depreciation in the hands of the original taxpayer (see example 1), the aircraft nevertheless should qualify for bonus depreciation in the hands of the transferee taxpayer because the transferee taxpayer had not entered into a written binding contract for the aircraft prior to January 1, 2008, and the "Original Use" of the aircraft was with the transferee taxpayer.

Example 2 (Cont.)

- Caveat 1:
  - 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 an OEM agreement, or a back-to-back title transfer of a new aircraft without an assignment of the OEM agreement, or both.

Example 2 (Cont.)

- Caveat 2:
  - Many transactions of this nature are structured as a sale of the entity that owns the OEM contract in order to avoid violating OEM prohibitions on assignment of their contracts. In the case of a sale of a SMLLC, the SMLLC is disregarded for tax purposes, and sale of the entity should be treated as a sale of the entity's assets (i.e., the OEM contract). Conversely, in the case of a sale an S Corp, the S Corp is not disregarded, so the sale would not result in a change in the identity of the "taxpayer" for bonus depreciation purposes.

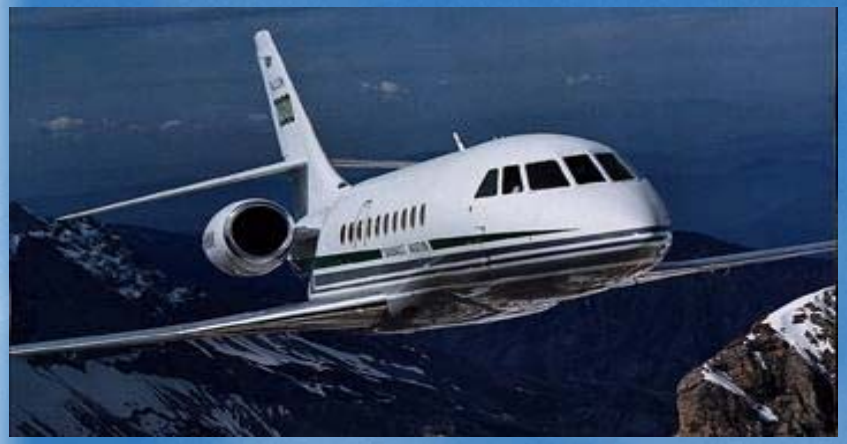
Example 3

- Facts:
  - In the ordinary course of its business, FraxJets sells fractional interests in aircraft to unrelated parties. FraxJets holds out for sale eight equal fractional interests in an aircraft.
  - On January 1, 2010, FraxJets sells five of the eight fractional interests in an aircraft to five unrelated customers, and these five customers begin to use their proportionate shares of the aircraft.
  - On November 1, 2010, FraxJets sells to the remaining unsold 3/8 fractional interests in the aircraft to three other customers.

Example 3 (Cont.)

- Result:
  - All eight customers are considered to be the "Original Users of their respective 1/8th interests, notwithstanding the fact that the first five customers had been operating the aircraft for several months before the last three customers bought their respective 1/8th interests.

Closing Remarks



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