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* * * **LEGISLATIVE ALERT** * * *

BONUS DEPRECIATION EXTENDED ANOTHER YEAR

*By Troy A. Rolf, Esq.
GKG Law, P.C.*

The American Taxpayer Relief Act of 2012 (the “2012 Act”), which prevented the nation from going over the so-called fiscal cliff, included a one year extension of the popular Bonus Depreciation provisions contained in Section 168(k) of the Internal Revenue Code. The extension permits taxpayers who place “Qualified Property” in service before the end of 2013, or in some cases, before the end of 2014, to write off 50% of the adjusted basis of the Qualified Property in the year the Qualified Property is placed in service.

The 2012 Act did not, however, extend the period during which certain Qualified Property would qualify for Bonus Depreciation at the 100% level; the deadline to place Qualified Property in service in order to claim Bonus Depreciation at the 100% level has passed.

The paragraphs that follow provide a review of the Bonus Depreciation rules. Clients who believe they may qualify for Bonus Depreciation for recent or planned aircraft acquisitions should contact one of the aviation attorneys at GKG Law, P.C. for further information.

Bonus Depreciation Overview

Bonus Depreciation is a special tax depreciation deduction allowance granted to taxpayers who place certain “Qualified Property” in service in the years from 2008 through 2013, or, in some cases, in 2014. For most Qualified Property, the allowance is 50% of the adjusted basis of the Qualified Property (*i.e.*, after adjustments under other sections of the Internal Revenue Code (“IRC”) (*e.g.*, Section 179)), but this allowance is increased from 50% to 100% for Qualified Property placed in service after September 8, 2010 and before January 1, 2012, or before January 1, 2013 for aircraft qualifying under the rules for “Certain Aircraft” (defined below) and aircraft qualifying under the rules for “Property Having Longer Production Periods” (defined below).

Congress first enacted Bonus Depreciation legislation to help boost the economy in the years immediately following the September 11th attacks on the World Trade Center and the Pentagon, but the Bonus Depreciation incentives expired a few years later. Congress and the Bush Administration subsequently revived (albeit on a temporary basis) the Bonus Depreciation incentives as part of the Economic Stimulus Act of 2008. The Obama administration previously extended Bonus Depreciation three times. Specifically,

Bonus Depreciation was extended by the American Recovery and Reinvestment Act of 2009, then again by the Small Business Jobs Act of 2010, and then yet again by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Bonus Depreciation Basics

Qualified Property. The “Qualified Property” to which Bonus Depreciation applies is property that meets all of the following requirements: (1) the property must be property having a tax recovery period of 20 years or less (*e.g.*, aircraft); (2) the “Original Use” of the property must commence with the taxpayer after December 31, 2007 (“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); (3) the property must be acquired by the taxpayer either (a) after December 31, 2007, and before January 1, 2014, but only if no “Written Binding Contract” for the acquisition was in effect before January 1, 2008, or (b) pursuant to a Written Binding Contract which was entered into after December 31, 2007, and before January 1, 2014; and (4) the property must be placed in service by the taxpayer before January 1, 2014, or before January 1, 2015 for aircraft qualifying under the rules for “Certain Aircraft” and aircraft qualifying under the rules for “Property Having Longer Production Periods”.

Written Binding Contracts. 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). For this purpose, 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.

Self-Constructed Property. The Bonus Depreciation provisions provide an exception of sorts to the rule excluding property purchased pursuant to a contract entered into prior to January 1, 2008, by providing that in the case of a taxpayer manufacturing, constructing, or producing property for the taxpayer’s own use, the requirement that property be acquired by the taxpayer after December 31, 2007, and before January 1, 2014, or be acquired by the taxpayer pursuant to a Written Binding Contract which was entered into after December 31, 2007, and before January 1, 2014, shall be “treated as met” if the taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2014. Obviously, few companies (other than aircraft manufacturers) build aircraft for their use. However, IRS regulations provide that “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) is considered manufactured, constructed or produced by the taxpayer.”

While the statutory and regulatory provisions addressing property built for a taxpayer by another person clearly require that the contract be entered into prior to commencement of construction, and that construction begin after December 31, 2007, they do not explicitly state one way or the other whether the construction contract also must have been entered into after December 31, 2007. This ambiguity leaves the door open for aggressive taxpayers to assert a position that in such cases the focus shifts from “when was the contract signed” to “when did construction commence”, and that as long as construction did not commence prior to January 1, 2008, the property could qualify for Bonus Depreciation regardless of when the construction contract was signed. It is not yet known whether the IRS or the courts would agree with such a position.

Deductibility of Remaining Basis. A taxpayer’s remaining basis, if any, after deducting the Bonus Depreciation allowance is depreciated under standard depreciation principles, provided, however, that ADS property will not qualify if ADS is required because the aircraft is either non-US property or does not meet 50% qualified business use under Section 280F(b) of the Internal Revenue Code. For example, for aircraft that qualify for the 100% Bonus Depreciation allowance (*i.e.*, aircraft placed in service from September 8, 2010 through December 31, 2011, or, in some cases, December 31, 2012), the taxpayer’s entire basis in the aircraft would be deductible in the year the aircraft was placed in service, and the taxpayer would not have any basis remaining to depreciate in subsequent years. However, for aircraft that qualify for Bonus Depreciation allowance at the 50% level, assuming the aircraft is depreciable under a five-year MACRS depreciation schedule, and that the half-year convention applies, the total first year depreciation deduction would be 60%, which is the sum of the 50% Bonus Depreciation special allowance, plus the normal year 1 MACRS depreciation allowance of 20%, which, in this case, is 20% of the 50% basis remaining in the property after deducting the 50% Bonus Depreciation special allowance (*i.e.*, 20% of 50% equals 10%).

It’s important to note that the Bonus Depreciation special allowance does not increase the total amount of depreciation a taxpayer will be entitled to claim over the depreciable life of an asset. As a general rule, under the MACRS system taxpayers are entitled to depreciate 100% of the cost basis of most tangible personal property assets over a period of several years. Bonus Depreciation does not change that. Rather, the Bonus Depreciation special allowance allows taxpayers to deduct a larger portion of the cost basis of an asset in the year that the asset is placed in service than would otherwise be allowed. This of course results in reduced depreciation deductions being available in future years.

Interplay of Bonus Depreciation and 1031 Like-Kind Exchanges. When property eligible for Bonus Depreciation is acquired in a Like-Kind Exchange, Bonus Depreciation applies in the year the replacement property is placed in service. Both the Carryover Basis (*e.g.*, the basis in the relinquished aircraft at the time of the exchange), and the Excess Basis (*e.g.*, 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. Ordering of deductions attributable to relinquished aircraft/carryover basis is as follows: (1) MACRS deduction on unadjusted basis of the relinquished

property to date of disposition (apply applicable recovery period and convention); (2) Bonus Depreciation on remaining Carryover Basis; and (3) MACRS deduction on Carryover Basis for date of acquisition of replacement aircraft forward (apply applicable recovery period and convention). Caution: if you have used MACRS schedules to calculate one or more years' depreciation deductions for relinquished property prior to deducting Bonus Depreciation, you should not continue to use MACRS table percentages after deducting Bonus Depreciation. The MACRS tables merely provide a shortcut for determining the appropriate depreciation deductions each year; the percentages are themselves derived from the double-declining balance formula. However, deducting Bonus Depreciation at any time after one or more depreciation deductions have been claimed throws off the percentages in the tables. Consequently, you (or your tax advisor) will need to apply the double-declining balance formula and do the math the hard way.

Fractional Ownership Program Aircraft. If, in the ordinary course of its business, a taxpayer sells fractional interests in aircraft to third parties unrelated to the taxpayer, each first fractional owner of the property is considered as the original user of its respective proportionate share of the aircraft.

Used Aircraft/Upgrades. Used Aircraft, including 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.

Demonstrator Aircraft. New aircraft used by an OEM or dealer for demonstrator purposes prior to sale to a customer should qualify for Bonus Depreciation. In such situations, the Original Use of the aircraft is considered to be by the taxpayer and not by the dealer or manufacturer.

Sale-Leasebacks. If an original buyer placed 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. Similarly, 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.

Alternative Minimum Tax. For purposes of determining alternative minimum taxable income, the bonus depreciation for qualified property will be determined without regard to any adjustment under IRC Section 56.

Aircraft Must Not Be Used Predominately Outside the United States. Bonus Depreciation does not apply to aircraft used predominately outside the United States.

Special Provisions Applicable to Aircraft Placed in Service in 2014

While any “Qualified Property” (including any business aircraft) placed in service in the years 2008 through 2013 may qualify for Bonus Depreciation if all the statutory requirements are met, the statute also extends by one year, *i.e.*, to the end of 2014, the deadline for placing in service “Certain Aircraft” and “Property Having Long Production Times”. Depending on certain circumstances, a business aircraft could qualify under either the “Certain Aircraft” provision, or the provision governing “Property Having Long Production Times”, or neither provision. In the case of an aircraft placed in service in 2014 under the “Property Having Long Production Times”, only a portion of the cost basis of the aircraft may qualify for Bonus Depreciation, as discussed below. Such limitation does not appear to apply to aircraft qualifying under the “Certain Aircraft” provision, so the full cost basis of “Certain Aircraft” should qualify for Bonus Depreciation. Of course, an aircraft placed in service in 2014 that does not meet the requirements of either the “Certain Aircraft” provision or the provision governing “Property Having Long Production Times” will not qualify for any Bonus Depreciation at all.

Certain Aircraft. The term “Certain Aircraft” refers to Aircraft (a) that *are not* “Transportation Property”; (b) 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; (c) that have an estimated production period exceeding 4 months; and (d) that cost more than \$200,000. The statute defines “Transportation Property” simply as tangible personal property used in the trade or business of transporting persons or property. This probably includes business jet aircraft that are used in on-demand charter operations. However, no definitive guidance yet exists to determine whether a specific aircraft is or is not “Transportation Property”. This is of particular concern where a business aircraft is used part of the time in the owner’s own business, and part of the time in on-demand commercial charter operations. Regulations governing MACRS specify that when property is used for different purposes at various times in such a manner that the property could potentially be classified into more than one asset class, the property shall be included in the asset class for the activity in which the property is *primarily* used. It seems reasonable that a similar test could be utilized to determine whether an aircraft is “Transportation Property” in situations where an aircraft is used part of the time in the owner’s own business, and part of the time in on-demand commercial charter operations. However, no such primary use test is set forth in the Bonus Depreciation statute or regulations, so it is also possible that the IRS could take the position that any use of an aircraft in the trade or business of transporting persons or property would cause the aircraft to be classified as “Transportation Property”. Until such time as the IRS provides further guidance on the issue, conservative planning would be to assume that any use of an aircraft in the trade or business of transporting persons or property *could* cause the aircraft to be classified as “Transportation Property”, and that if the aircraft is primarily used in the trade or business of transporting persons or property, such aircraft more than likely *would* cause the aircraft to be classified as “Transportation Property”.

Property Having Long Production Periods. In order to qualify for Bonus Depreciation for property (such as an aircraft) placed in service in 2014 under this provision, the statute requires that the property 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”; (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 meet the requirements of clause (iii) of section 263A(f)(1)(B) (determined as if such clause also applied to property which has a long useful life (within the meaning of section 263A(f))). The aforementioned Clause (iii) of section 263A(f)(1)(B) requires that property have a cost exceeding \$1,000,000, and 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. This last requirement eliminates many corporate-class jets from qualifying for Bonus Depreciation under the “Property Having Long Production Periods” provision. Notwithstanding the fact that many makes/models of corporate jets, have waiting lists that are several years long, few corporate jets actually have production periods exceeding 1 year.

As stated above, in the case of an aircraft placed in service in 2014 under the “Property Having Long Production Times,” only a portion of the cost basis of the aircraft may qualify for Bonus Depreciation. The portion of the cost basis of the aircraft that qualifies for Bonus Depreciation is limited to that portion of the adjusted basis of the property that is attributable to production *before* January 1, 2014. The IRS has not provided specific guidance for calculating the portion of the adjusted basis of property that is attributable to production before January 1, 2014. According to the Technical Explanation of the Revenue Provisions of the Economic Stimulus Act of 2008 prepared by the Staff of the Joint Committee on Taxation, Congress 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 such date. According to Section 46(d)(3), where property is produced for a taxpayer by another party, the amounts that would be attributable to production before January 1, 2014, would likely be the lesser of (i) the amounts actually paid prior to January 1, 2014, and (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 prior to January 1, 2014.

Conclusion

Over the past several years, GKG Law has been contacted by several potential aircraft buyers seeking either to sign contracts to purchase new aircraft either from an OEM or from another person who has a contract with an OEM to acquire an aircraft and hopes to flip the aircraft. Anyone entering into any such a transaction with the expectation of being entitled to Bonus Depreciation should protect themselves by seeking the assistance of an aviation attorney or tax advisor familiar with the rules governing Bonus Depreciation. Having an experienced aviation attorney or tax advisor guide you can help to ensure that the aircraft you’re buying will actually qualify for Bonus Depreciation.

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Troy A. Rolf is a business aviation and tax attorney concentrating in the areas of business aircraft transactions and operations in the law firm of GKG Law, P.C. The firm's business aircraft practice group provides full-service tax and regulatory planning and counseling services to corporate aircraft owners, operators and managers. The group's services include Section 1031 tax-free exchanges, federal tax and regulatory planning, state sales and use tax planning, and negotiation and preparation of all manner of transactional documents commonly used in the business aviation industry, including aircraft purchase agreements, leases, joint-ownership and joint-use agreements, management and charter agreements, and fractional program documents. Troy manages the firm's Minnesota office, at 700 Twelve Oaks Center Drive, Suite 700, Wayzata, MN, 55391, telephone: (952) 449-8817, facsimile (952) 449-0614, e-mail: trolf@gkglaw.com.