EXTENSION OF BONUS DEPRECIATION RULES NEW LIMITS ON DEDUCTIBILITY FOR PERSONAL USE OF BUSINESS AIRCRAFT/ PLANNING IDEAS

By Keith G. Swirsky, Esq., and Troy A. Rolf, Esq.
Galland, Kharasch, Greenberg, Fellman & Swirsky, P.C.

Extension of Bonus Depreciation Rules for Business Aircraft.

The American Jobs Creation Act of 2004 (the "Act"), signed into law by President Bush on October 22, 2004, contains a generous tax incentive for companies that act quickly to purchase certain new aircraft for delivery in 2005. This provision extends the popular "Bonus Depreciation" tax incentive to certain aircraft purchased for delivery in 2005.

In order for an aircraft to qualify for Bonus Depreciation, the aircraft must be purchased pursuant to a written, binding contract entered into after September 10, 2001, and before January 1, 2005. The amount of Bonus Depreciation an aircraft buyer may claim depends on when within the September 10, 2001, to January 1, 2005, timeframe mentioned above the buyer entered into a binding contract to purchase the aircraft. If the buyer entered into the binding contract after September 10, 2001, and before May 6, 2003, the buyer would be entitled to 30% Bonus Depreciation. If the buyer entered into the binding contract after May 5, 2003, and before January 1, 2005, the buyer would be entitled to 50% Bonus Depreciation. These provisions apply both to aircraft placed in service prior to 2005, and those placed in service during 2005. However, in order for an aircraft placed in service during 2005 to qualify for Bonus Depreciation, the Act requires that the following additional requirements be satisfied: (i) the aircraft must cost more than $200,000, (ii) the estimated production period of the aircraft must exceed 4 months, (iii) the aircraft must not be "transportation property" ("transportation property" is defined by statute as tangible personal property used in the trade or business of transporting persons or property), and (iv) at the time of the contract for purchase, the buyer must make a non-refundable deposit of 10% of the cost of the aircraft, or $100,000, whichever is less.

An aircraft that qualifies as "transportation property" may still qualify for 50% Bonus Depreciation if placed in service before January 1, 2006. However, the law permits Bonus Depreciation for transportation property only with respect to that portion of the basis of the property attributable to manufacture, construction, or production before January 1, 2005.

At the time of writing this article, the authors have already been contacted by several buyers seeking to sign contracts to purchase new aircraft that have been advertised as "Bonus Depreciation Eligible." Due to the Acts many constraints, and by virtue of many "soft obligations" provided in the manufacturer's typical purchase agreement, it is advisable to consult knowledgeable aviation tax counsel before proceeding, to ensure the greatest likelihood of obtaining these tax benefits.

New Limits on Deductibility for Personal Use of Business Aircraft/Planning Ides.

The Act contains a provision which essentially overrides the Eighth Circuit's Sutherland Lumber decision by limiting taxpayers' ability to deduct aircraft operating expenses associated with personal non-business travel provided to certain owners and employees as a fringe benefit. This provision is intended to produce additional tax revenues and is, in effect, a back-door tax increase that will have a detrimental effect on the corporate and business aviation industry.

© 2005 All Rights Reserved

Until October 21, 2004, under Sutherland Lumber, and numerous cases, rulings and IRS advice memoranda, taxpayers were permitted to deduct from income all ordinary, necessary and reasonable expenses paid or incurred during a taxable year in carrying on a trade or business, including the costs of using aircraft for personal, non-business travel, so long as the company treated the personal use as a taxable fringe benefit to the employee. There was no requirement limiting companies' deductions for aircraft expenses attributable to personal flights to the amounts imputed to their employees as fringe benefit income. Consequently, the Standard Industry Fare Level (a.k.a. "SIFL") method of imputing income for personal use was preferred over the "fair charter value" method because the SIFL method usually resulted in an amount of income being imputed to an employee that was substantially less than the actual cost to conduct the flight. By using the SIFL method, the amount imputed to an employee as fringe benefit income for a personal flight could be minimized, while the employer benefited from the ability to deduct the full cost of operating the flight.

Effective October 22, 2004, the deduction permitted to companies for the expenses associated with operating personal, non-business flights for certain "Specified Individuals" will be limited to the amount imputed to the "Specified Individuals" as fringe benefit income. The term "Specified Individuals" includes any person who is the direct or indirect owner of more that 10% of any class of equity security of the company, and any officer or director of the company. The Act does not limit the deduction permitted to companies for the expenses associated with operating personal, non-business flights for employees who are not "Specified Individuals".

The ability to fully deduct the cost of operating personal, non-business flights has helped boost business aviation because companies have been more willing to allow their executives to use the corporate aircraft. The provisions of the Act, however, will create tax disincentives to the employer, and could result in lower utilization rates for corporate aircraft.

Planning Problems and Ideas.

The Act does not address the continued ability to deduct expenses associated with operating mixed-use flights during which some passengers are traveling primarily or solely for business purposes, and other passengers are traveling primarily or solely for personal, non-business purposes, for which fringe benefit income will be imputed. Arguably, Congress did not intend to penalize companies by limiting deductions for flights during which some executives are traveling for business purposes, and "guests" are invited on board to occupy the empty seats. The Act also does not address the situation whereby non Specified Individuals are traveling, and are accompanied by a Specified Individual.

Because the Act only addresses limits on the corporate deduction for personal use of the corporate aircraft by a Specified Individual, it leaves for continued planning considerations use by executives pursuant to timesharing, dry leasing, and chartering arrangements.

Most importantly, the Act does not specifically address which "expenses" incurred in operating a flight are subject to the new limitation. Certainly, Congress intended the Act to apply to the incremental expenses incurred to operate non-business flights, including the costs of fuel and any other out-of-pocket expenses that would not have been incurred had the flight not occurred. An interpretation of the Act's language limiting its scope to such incremental expenses would definitely soften the blow somewhat. However, the law appears to go beyond incremental expenses to encompass fixed operating expenses and depreciation as well. A broad interpretation of the Act's language disallowing deductions for that portion of the fixed operating expenses and depreciation attributable to personal, non business use by a company's Specified Individuals could be devastating to many small businesses, particularly those operating aircraft that have not yet been fully depreciated for tax purposes. This is because the tax and financial implications of such an interpretation would be most severe in the first few years of ownership of any particular aircraft when the amount of the depreciation deductions otherwise permitted under the Modified Accelerated Cost Recovery System ("MACRS"), and hence the potential amount of any disallowance of depreciation, is greatest. Taxpayers who have purchased, or will purchase, a newly manufactured aircraft in 2004 or 2005 could be hit

© 2005 All Rights Reserved

particularly hard as some of the Bonus Depreciation to which they may be otherwise be entitled could be disallowed if the aircraft is used some of the time for personal, non-business flights by Specified Individuals after October 22, 2004.

Until further clarification of the Act is forthcoming, and since new record keeping is necessary commencing with flights on and after October 22, 2004, companies should promptly consult with their aviation tax counsel to agree upon the best tax reporting options.

Keith G. Swirsky chairs the firms business aviation group. Both Keith and Troy are business aviation and tax partners concentrating in the areas of business aircraft transactions and operations in the law firm of Galland, Kharasch, Greenberg, Fellman & Swirsky, 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. Mr. Rolf can be reached at the firm's Minnesota office, 700 Twelve Oaks Center Drive, Suite 204, Wayzata, MN, 55391, telephone: (952) 449-8817, facsimile (952) 449-0614, e-mail trolf@gkglaw.com. Mr. Swirsky can be reached at the firm's Washington, DC office, 1054 31st Street, NW, Suite 200, Washington, DC 20007, telephone: (202) 342-5251, facsimile (202) 965-5725, e-mail kswirsky@gkglaw.com.

© 2005 All Rights Reserved