



Get 'Em While They're Hot! Bonus Depreciation Is Back, But Only For A Limited Time

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The Economic Stimulus Act of 2008 (the "Act") contains a generous tax incentive for companies that act quickly to purchase certain new aircraft for delivery in 2008 or 2009. This provision brings back for a limited time the popular "Bonus Depreciation" tax incentives that were available in the years immediately following the September 11th attacks on the World Trade Center and the Pentagon.

Overview:

The so called "Bonus Depreciation" is a special tax depreciation deduction allowance granted to taxpayers who place certain "Qualified Property" in service in 2008, or, in some cases, in 2009. The Bonus Depreciation allowance may be deducted on the taxpayer's tax return in the year the Qualified Property is placed in service.

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 IRC (e.g., Section 179)). However, for certain property having long production times, including "Transportation Property", the 50% Bonus Depreciation allowance applies only to the extent of the adjusted basis thereof attributable to manufacture, construction, or production before January 1, 2009.

What is "Qualified Property"?

The "Qualified Property" to which the Act 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 (a) must be acquired by the taxpayer after December 31, 2007, and before January 1, 2009, but only if no "Written Binding Contract" for the acquisition was in effect before January 1, 2008, or (b) must be acquired by the taxpayer pursuant to a Written Binding Contract which was entered into after December 31, 2007, and before January 1, 2009; or (c) in the case of "Self Constructed Property", the taxpayer must begin manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2009; and (4) the property must be placed in service by the taxpayer before January 1, 2009, or, in the case of property having long production periods (including "Transportation Property") or "Certain Aircraft", before January 1, 2010.

What is "Transportation Property"?

"Transportation Property" is tangible personal property used in the trade or business of transporting persons or property. This could include corporate aircraft that are predominantly used in charter, however, no definitive guidance yet exists to determine whether a specific aircraft is or is not "Transportation Property". Furthermore, there is also no

guidance addressing how to calculate the adjusted basis attributable to manufacture, construction, or production before January 1, 2009. However, a reasonable methodology may be to look at how much a taxpayer has paid (or how much is due) with respect to the manufacturer prior to January 1, 2009.

What are “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 costs more than \$200,000.

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). 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.

Deductibility of Remaining Basis:

A Taxpayer's remaining basis after deducting the 50% 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, assuming an 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. The Act 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.

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). Existing 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.

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. 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 used.

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. For example, if an aircraft is to be constructed by an original equipment manufacturer (an "OEM") for a cash basis taxpayer for the total cost of \$20,000,000, construction is 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.

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.

MISCELLANEOUS ISSUES

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

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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.

Conclusion:

At the time of writing this article, the author has already 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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