

# BUSINESS AVIATION UPDATE

## BONUS DEPRECIATION EXPANDED AND EXTENDED FOR NEW AIRCRAFT PURCHASERS



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*With over 25 years of experience dealing with a broad spectrum of business law issues, Ed has developed expertise in the areas of Business Aviation and Aircraft Finance. Ed provides value-added counseling and advice to clients on a variety of business aviation issues, including the structuring of ownership and operation of business aircraft to comply with FAA regulatory, tax, and risk management planning concerns and objectives; leasing and finance; acquisitions; sales; Federal income tax; depreciation and expenses; excise, sales, use, and property taxes; and like-kind exchanges. Ed is the Immediate Past Chairman of the National Business Aviation Association Tax Committee, Past Chairman of the Associate Member Council of the National Aircraft Resale Association, and an active member of the National Aviation Finance Association. Ed is also actively involved in the leadership and formation of both the Rhode Island and Massachusetts Business Aviation Associations.*

Tax law changes enacted in late 2010 include some good news for both recent and prospective aircraft buyers. Bonus Depreciation benefits have been expanded and extended. A significant portion of the new Bonus Depreciation benefits expire at the end of 2011, so swift action on the part of taxpayers is imperative. This article will explore and summarize Bonus Depreciation and will examine some practical considerations for taking advantage of this benefit. In brief, many deliveries of new aircraft in 2011 will qualify for 100% Bonus Depreciation. If certain qualifying conditions are met, aircraft placed in service in 2012 may also qualify for 100% Bonus Depreciation treatment. Even if a 2012 aircraft delivery fails to qualify for 100% Bonus Depreciation, such aircraft may still qualify for 50% Bonus Depreciation.

Before exploring how Bonus Depreciation may benefit aircraft owners, let's address a few misconceptions about Bonus Depreciation. First, the term "Bonus Depreciation" is a bit of a misnomer. Bonus Depreciation eligible assets do not generate "more depreciation" than non-eligible assets. Bonus Depreciation merely entitles the owner of an eligible asset to realize depreciation benefits more quickly. Simply stated, Bonus Depreciation is "faster depreciation" not "more depreciation." A second misconception is that Bonus Depreciation is a "business aircraft benefit." Not true. Bonus Depreciation is available for a wide variety of capital assets.

What then is Bonus Depreciation? Briefly stated, for new aircraft and other assets placed in service in 2011 as well as for certain other aircraft placed in service in

2012, 100% of the cost of such property may be deducted in the year the property is acquired. Bonus Depreciation benefits are reduced to 50% of the acquisition cost for most assets placed in service in 2012.

In order to be Bonus Depreciation eligible, an asset must be "MACRS property." This means that property used less than 50% of the time for business purposes and property used predominantly outside the United States will not be eligible for Bonus Depreciation. In addition, in order for an asset to be eligible for Bonus Depreciation, the asset must be "new." Pre-owned aircraft do not qualify.

### EXAMPLE

To illustrate the benefit of 100% Bonus Depreciation, assume that Taxpayer A acquires a new aircraft for \$10,000,000. Without 100% Bonus Depreciation, Taxpayer A's depreciation schedule for the aircraft will be as follows: [1]

### FIVE-YEAR MACRS PROPERTY WITHOUT BONUS DEPRECIATION.

YEAR	PERCENTAGE DEDUCTION	DEPRECIABLE BASIS	DEPRECIABLE AMOUNT
1	20.00 x	\$10,000,000	= \$2,000,000
2	32.00 x	\$10,000,000	= \$3,200,000
3	19.20 x	\$10,000,000	= \$1,920,000
4	11.52 x	\$10,000,000	= \$1,152,000
5	11.52 x	\$10,000,000	= \$1,152,000
6	5.76 x	\$10,000,000	= \$ 576,000
<b>TOTALS:</b>	100.00		\$10,000,000

[1] The Tables provided illustrate the benefit of depreciation and 100% Bonus Depreciation for a "non-commercial" aircraft depreciated on a five-year schedule. "Commercial" aircraft, generally including aircraft used predominantly in charter service, will be depreciated over a longer seven-year schedule. The levels of depreciation in each year will be lower for seven-year property, but the impact of 100% Bonus Depreciation will be the same. Any qualifying aircraft will remain eligible for depreciation benefits equal to 100% of the cost of the aircraft in the year it is placed in service.

Now assume that Taxpayer A acquires the same \$10,000,000 aircraft but that the aircraft is eligible for 100% Bonus Depreciation. Taxpayer A's depreciation benefits will be as follows:

#### FIVE-YEAR MACRS PROPERTY WITH 100% BONUS DEPRECIATION.

YEAR	PERCENTAGE DEDUCTION	DEPRECIABLE BASIS	DEPRECIABLE AMOUNT
Bonus (Yr. 1)	100.00 x	\$10,000,000	= \$10,000,000
Years 2-6	0.00 x	\$10,000,000	= \$0
<b>TOTALS:</b>	100.00		\$10,000,000

As the tables illustrate, 100% Bonus Depreciation provides dramatic tax benefits in the year that an asset is acquired. However, no depreciation benefits are available in the following years. While the *total* depreciation benefit over the depreciable life of the aircraft remains the same (i.e., 100% of the acquisition cost), Bonus Depreciation accelerates the benefits and yields greater time-value returns.

#### TIMING/PLACED IN SERVICE

Let's now turn our attention to what makes an aircraft or other asset "qualifying property" for Bonus Depreciation purposes. The Internal Revenue Code sets forth specific criteria for "qualifying property."

Aircraft whose *original use* commences with the taxpayer in 2011 are eligible for 100% Bonus Depreciation. In addition, the aircraft must be "*placed in service*" prior to the end of 2011. There are some limited extensions of the 2011 "*placed in service*" date for "transportation property" and "certain aircraft." Furthermore, only aircraft for which there was "*no written binding contract for the acquisition ... in effect before January 1, 2008*" or for which "*a written binding contract ... was entered into*" prior to January 1, 2012 will qualify for Bonus Depreciation.

In prior years, long delivery backlogs made it extremely difficult to find an aircraft which could meet both the contract formation and "placed in service" requirements. However, the current economic slowdown has freed up many delivery positions. As a practical matter, it is now possible to enter into a contract this year and still meet the relatively short "placed in service" deadlines.

The "placed in service" date requirement has been extended through 2012 for two types of aircraft,

"*transportation property*" and "*certain aircraft*." The statute and regulations do not provide much guidance as to what constitutes "transportation property" other than to say that "transportation property" includes tangible personal property used in the trade or business of transporting persons or property. Presumably, this would include an aircraft that is used predominantly for charter missions. It is not likely that an aircraft used less than half the time in charter service will qualify. Although the "placed in service date" is extended through 2012 for transportation property, the 100% Bonus Depreciation benefit is limited "only to the extent of the adjusted basis attributable to manufacture, construction or production before January 1, 2012."

The "placed in service" requirement is also extended through 2012 for "certain aircraft." "Certain aircraft" are defined as aircraft which are not "transportation property," cost more than \$200,000, and have an estimated production period exceeding four months. Virtually all jets and turboprops meet these additional criteria. In addition, at the time of contract for purchase, the purchaser is required to make a nonrefundable deposit of at least the lesser of 10% of the cost or \$100,000. Aircraft which do meet all these standards are deemed to be "certain aircraft" for which the extended "placed in service" date applies.

Although the "placed in service" date is extended through 2012 for "transportation property" and "certain aircraft," the other Bonus Depreciation eligibility requirements must still be satisfied. Thus, for example, a charter aircraft contracted for in 2007 would not, absent another exception to the general rules, qualify for 100% Bonus Depreciation.

However, aircraft deliveries in 2012 which do not meet the criteria of either "transportation property" or "certain aircraft" could still qualify for 50% Bonus Depreciation. Deliveries of "transportation property" or "certain aircraft" in 2013 may also qualify for 50% Bonus Depreciation.

Purchasers who entered into their delivery contracts as far back as 2008 for aircraft which deliver in 2011 are now 100% Bonus Depreciation eligible. In addition, aircraft which qualify as either "transportation property" or "certain aircraft" which are placed in service in 2012 may also qualify for 100% Bonus Depreciation. Prior to the most recent tax law changes, these aircraft would not have qualified for 100% Bonus Depreciation. For

example, an aircraft contracted for in 2008 which is neither “transportation property” nor “certain aircraft” scheduled to be “placed in service” in 2011 would not have qualified for 100% Bonus Depreciation. With the extensions of placed in service dates, these aircraft will now qualify for 100% Bonus Depreciation. Purchasers of aircraft acquired pursuant to contracts entered into in prior years should review their situations, as their aircraft may now be eligible for 100% Bonus Depreciation in either 2011 or 2012 or for 50% Bonus Depreciation in 2012.

#### FRACTIONAL AIRCRAFT

Bonus Depreciation may also prove a valuable tool for aircraft owners who are acquiring assets other than whole aircraft. The Service’s Temporary Regulations specifically state that fractional aircraft interests may qualify for Bonus Depreciation. Current fractional interest inventory availability makes acquisition of a qualifying fractional interest relatively easy. However, in order for a fractional interest to qualify, there may be no previous owner of the share other than the fractional program itself. In addition, Bonus Depreciation may prove valuable for taxpayers making capital acquisitions related to their aircraft, such as tugs, engine replacements, or major avionics or interior upgrades.

#### SELF CONSTRUCTED PROPERTY

“Self constructed property” is granted some relief from the requirement that there be no written binding contract in place at the beginning of 2008 if the manufacture, construction, or production of the property begins on or after January 1, 2008 and prior to January 1, 2013. The Temporary Regulations include “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...” within the definition of “self constructed property.” As few new aircraft are being built on spec, many business aircraft would seem to meet this criterion. In order to qualify, the production of the aircraft would have to begin in or after 2008 but before the beginning of 2013. The Temporary Regulations state that “construction of property begins when physical work of a significant nature begins” and that “physical work of a significant nature will not be considered to begin before the taxpayer incurs or pays... more than 10 percent of the total cost of the property” or the taxpayer is able to demonstrate qualification of their purchase under a

“facts and circumstances” test. Therefore, aircraft whose production began after 2008 or for which only small payments were made or relatively minor amounts of work completed in prior years may qualify for Bonus Depreciation as self-constructed property.

#### WRITTEN BINDING CONTRACT

In past years, historically long delivery backlogs combined with the “written binding contract” requirement prevented many new aircraft contracts from qualifying for Bonus Depreciation. For example, absent another exception to the general rules, an aircraft contracted for in 2007 would not qualify for Bonus Depreciation even if placed in service in 2011. However, the Temporary Regulations define “written binding contract” in a manner which might allow many older aircraft contracts to qualify for 100% Bonus Depreciation. If, upon breach of the contract by the seller/manufacturer, the contract provides for a full refund of the purchase price in lieu of any other damages allowable by law, the contract is not considered to be a “written binding contract.” Many new aircraft contracts have provisions which limit a buyer’s remedy to a refund of any progress payments made. Although both the buyer and seller in a new aircraft contract will no doubt consider that they have an effective and binding contract, the Temporary Regulations may allow the buyer to reach the conclusion that the contract is not “binding” within the meaning of the statute. Such aircraft may qualify for Bonus Depreciation, but the reader is cautioned to take such a position only after careful examination of their contract and the law and regulations.

How do the new Bonus Depreciation rules impact holders of delivery positions who wish to sell their positions and the buyers of such positions? Long delivery backlogs often incited persons to enter into new aircraft contracts with the intention of selling their positions to potential end users. In addition, the current economic slowdown has caused many taxpayers with long-term delivery positions to reevaluate their need for a new aircraft and to consider the sale of their delivery positions.

There is a variety of methods used to accomplish the sale of an aircraft delivery position, including sales of interests in a Limited Liability Company which owns a delivery position, assignments of the purchase contracts, so-called “back-to-back” transactions, and eventual resales of a newly acquired aircraft. Taxpayers should be

aware that the Service may challenge the Bonus Depreciation eligibility of such transactions, as these transactions seem to fall outside of the stated Congressional and Presidential intentions of stimulating the production and sale of new capital assets. The success or failure of any such challenge is likely to hinge on the particular facts and circumstances and the method of documentation of each transaction. An examination of the various types of assignments and the availability of Bonus Depreciation is beyond the scope of this article, but anyone considering such a transaction should do so with an awareness that they may be taking an aggressive reporting position and are relying upon interpretation of the legislation that runs counter to the stated purpose behind the adoption and extension of Bonus Depreciation.

Sale leaseback and syndication transactions continue to enjoy favorable treatment provided by the Temporary Regulations. Aircraft originally placed in service by an end user, sold to a leasing company, and leased back to the end user within three months after the original "placed in service" date remain eligible for Bonus Depreciation. Aircraft sold from one leasing company to another within three months of the original "placed in service" date remain eligible for Bonus Depreciation in the hands of the second leasing company. In addition, it is possible to "stack" a sale-leaseback and syndication transaction such that the syndication transaction may occur up to six months after the original acquisition of the aircraft.

## CONCLUSION

Changes in the Bonus Depreciation eligibility rules provide some significant benefits for purchasers of new business aircraft. Swift action is necessary to qualify

before the window of 100% Bonus Depreciation eligibility closes. Contracts must be in place by year-end for all aircraft. In order to qualify for 100% Bonus Depreciation, aircraft which are not "certain aircraft" or "transportation property" must be delivered and placed in service prior to the end of 2011. Aircraft which qualify as either "certain aircraft" or "transportation property" must be delivered and placed in service prior to the end of 2012 in order to receive 100% Bonus Depreciation and prior to the end of 2013 in order to receive 50% Bonus Depreciation treatment.

This article has highlighted some of the strategies for qualifying for either 100% Bonus Depreciation in 2011 or 2012 or for 50% Bonus Depreciation in 2012 on a new aircraft purchase. The reader is cautioned that this article is not intended to be more than an introduction to the topic. Anyone considering taking Bonus Depreciation benefits for a new aircraft not only should read the law and Temporary Regulations, but should retain independent legal, tax, and accounting advice to determine if their aircraft is eligible for Bonus Depreciation and to properly structure their acquisition. [2]

[2] Please Note: Bonus Depreciation has previously been available in years 2003 through 2010. Although the basic principles of Bonus Depreciation in prior years are essentially the same as in its current iteration, the eligible dates for "original use," "placed in service" and contract formation are different. Please consult the author's prior articles for discussions of Bonus Depreciation in prior years.

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