

CLIENT UPDATE



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Ed advises the business aviation community on a wide range of transactions and issues. With over twenty-five years of experience in aircraft and equipment acquisitions and finance, Ed's strategic solutions enable his clients to achieve their business aircraft ownership and operating objectives.

BONUS DEPRECIATION RETURNS FOR BUSINESS AIRCRAFT PURCHASES

The Economic Stimulus Act reintroduces Bonus Depreciation benefits. Briefly stated, property eligible for Bonus Depreciation will yield a Bonus Depreciation deduction equal to 50% of its cost in its year of acquisition. The remaining cost or “basis” of the property remains eligible for depreciation according to normal depreciation rules.

In order for Bonus Depreciation to be available, an asset must qualify as 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.

Furthermore, in order to be eligible for Bonus Depreciation an asset must be “new.”

Before exploring Bonus Depreciation further, it is important to consider the reasons behind the Economic Stimulus Act of 2008. The President and Congress determined that the American economy needed stimulation. Bonus Depreciation was introduced with the expectation that Bonus Depreciation benefits would incent taxpayers to make capital acquisitions that they would not otherwise be able or willing to make. If Bonus Depreciation works as intended, taxpayers will be incented to acquire more capital assets than they would without the benefit. Consider, for example, Taxpayer A, the owner of a small machine shop. The availability of Bonus Depreciation might incent Taxpayer A to acquire a new lathe for Taxpayer A's operation. Presumably, the decision to acquire a new lathe by Taxpayer A will result in the production of one more lathe than would otherwise be produced. The economy is thus stimulated.

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

FIVE-YEAR MACRS PROPERTY WITHOUT 50% BONUS

YEAR	PERCENTAGE DEDUCTION	DEPRECIABLE BASIS	DEPRECIABLE AMOUNT
1	20.00 x	\$10,000,000	= \$2,000,000
2	32.00 x	\$5,000,000	= \$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

TOTALS: 100.00 \$10,000,000

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

FIVE-YEAR MACRS PROPERTY WITH 50% BONUS

YEAR	PERCENTAGE DEDUCTION	DEPRECIABLE BASIS	DEPRECIABLE AMOUNT
Bonus (Yr. 1)	50.00 x	\$10,000,000	= \$5,000,000
1	20.00 x	\$5,000,000	= \$1,000,000
2	32.00 x	\$5,000,000	= \$1,600,000
3	19.20 x	\$5,000,000	= \$960,000
4	11.52 x	\$5,000,000	= \$576,000
5	11.52 x	\$5,000,000	= \$576,000
6	5.76 x	\$5,000,000	= \$288,000

TOTALS: 100.00 \$10,000,000

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As the tables illustrate, Bonus Depreciation provides dramatic tax benefits in the year that an asset is acquired and results in lower levels of benefits in the following years. Nevertheless, the total depreciation benefit over the depreciable life of the asset remains the same.

Bonus Depreciation is only available for “qualifying property” as defined in Section 168 (k) of the Internal Revenue Code. In the current hot aircraft market, it may prove to be difficult to qualify a new turbine aircraft acquisition for Bonus Depreciation.

The Bonus Depreciation statute extends the placed in service date through 2009 for two types of business aircraft, “transportation property” and “certain aircraft.”

Only those aircraft whose original use commences with the taxpayer in or after 2008 are eligible for Bonus Depreciation. In addition, the aircraft must be “placed in service” in 2008. There are some limited extensions of the placed in service date through 2009 for “transportation property” and “certain aircraft” described in the Code.

The more troubling Bonus Depreciation eligibility requirement relates to the date on which a contract was entered into for the acquisition of the aircraft. 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” in 2008 will qualify for Bonus Depreciation. However, almost all turbine business aircraft that will deliver in 2008 were contracted for prior to the beginning of the year and virtually all turbine business aircraft positions in 2008 are now sold out. Given the current state of the business aviation market, it seems to be virtually impossible for any turbine aircraft to qualify for Bonus Depreciation.

However, after a careful reading of Section 168 (k) and the Bonus Depreciation Temporary Regulations enacted in 2003, it is possible to conclude that certain new aircraft acquisitions may be eligible for Bonus Depreciation.

As noted above, the key stumbling blocks for qualifying a new business aircraft purchase for Bonus Depreciation are that there may be no written binding contract in place at the beginning of 2008 and that the aircraft must be placed in service prior to the end of 2008. In the current business aircraft market, these requirements are significant obstacles to the typical new aircraft transaction.

The Temporary Regulations specifically note that fractional aircraft interest purchases may qualify for Bonus Depreciation. The absence of large backlogs for fractional purchases mean that it is possible to enter into a contract for the acquisition of a fractional interest in 2008 and take delivery of the share in 2008.

The Bonus Depreciation statute extends the placed in service date through 2009 for two types of business 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 it 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, but it is unclear if an aircraft used less than half the time in charter service would qualify. In addition, although the

placed in service date is extended through 2009 for transportation property, the Bonus Depreciation benefit is limited “only to the extent of the adjusted basis attributable to manufacture, construction or production before January 1, 2009.”

The placed in service requirement is also extended through 2009 for “certain aircraft.” “Certain aircraft” are defined as aircraft which are “not transportation property,” which cost in excess of \$200,000 and with estimated production periods exceeding four months. In addition, at the time of contract for purchase, the purchaser is required to make a nonrefundable deposit of the lesser of 10% of the cost or \$100,000.

Note should be taken of the fact that although the placed in service date is extended through 2009 for “transportation property” and “certain aircraft,” the other Bonus Depreciation eligibility requirements still apply. Thus, for example, an aircraft contracted for in 2007 to be used in charter service would not, absent another exception to the general rules, qualify for Bonus Depreciation.

“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 during 2008. 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...” As few aircraft are being built on spec, many new business aircraft would seem to meet this definition. In order to qualify, the production of the aircraft would have to begin and be completed in 2008. 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 so demonstrate considering the relevant “facts and circumstances. Therefore, aircraft whose production begins in 2008 or for which only small payments were made or relatively minor amounts of work completed prior to the beginning of the year may qualify for Bonus Depreciation under this provision of the statute.

As we have seen, the requirement that there be no written binding contract in place prior to the beginning of 2008 is a major obstacle for many new aircraft contracts. The Temporary Regulations define “written binding contract” in a manner which excludes many new aircraft contracts. 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 a “written binding contract” for Bonus Depreciation purposes. 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 support the position that the contract is not “binding” within the meaning of the statute and allow the subject aircraft to qualify for Bonus Depreciation.

With long manufacturing periods and large backlogs, it has become a fairly common practice for persons to enter into new aircraft contracts with the intention of selling their positions to potential end users. There are a variety of methods used to accomplish this result including, sales of interests in an LLC that is the buyer under the agreement, assignments of the purchase contracts, so-called “back-to-back” transactions and eventual resales of a newly acquired aircraft. These transactions seem to fall outside of the stated Congressional and Presidential intentions of stimulating the production of new capital assets. Consequently, it is not hard to imagine that the Service will challenge such transactions. Nevertheless, 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

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 purchaser to reach the conclusion that the contract is not “binding” within the meaning of the statute and allow the subject aircraft to qualify for Bonus Depreciation.

with an awareness that they are taking an aggressive reporting position and are relying upon interpretation of the legislation in such a way that runs counter to the purpose behind the adoption of the Bonus Depreciation benefit.

Sale leaseback and syndication transactions continue to enjoy favorable treatment provided by the Temporary Regulations. Aircraft originally placed in service in 2008 by an end user and 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.

SUMMARY AND CONCLUSIONS

The Economic Stimulus Act of 2008 provides some significant benefits for owners of business aircraft including the return of Bonus Depreciation.

However, given the current large backlog of new aircraft orders, many aircraft will not qualify for the benefit. There are several provisions in the new legislation and the existing Temporary Regulations that may prove useful for new aircraft purchasers. In this article, some of the strategies for taking Bonus Depreciation on a new aircraft purchase have been discussed. The reader is cautioned that this article is intended

only to acquaint the reader with the issues and that anyone seriously considering taking Bonus Depreciation benefits for a new aircraft should not only read the Statute and Temporary Regulations, but should also retain independent legal, tax and accounting advice to determine if their aircraft is eligible for Bonus Depreciation. Finally, keep in mind that Bonus Depreciation is intended to incent the production and acquisition of new capital assets. Due to the backlog in turbine aircraft orders, few, if any, new business aircraft will be built solely as a result of the Economic Stimulus Act of 2008. Consequently, anyone attempting to qualify an aircraft purchase for Bonus Depreciation should do so with the knowledge that their position will be closely scrutinized by the Service.

If you have any additional questions regarding this Update or have any other Corporate & Business needs, please contact any member of the Corporate & Business Law Group.

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