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2003 NEW AIRCRAFT DEPRECIATION and EXPENSING PROVISIONS

On May 28, 2003 President Bush signed the Jobs and Growth Tax Reconciliation Act of 2003.

For the aircraft industry, the new law contains a 50% first year bonus depreciation for:

1. A new aircraft;
2. Fractional share of a new aircraft;
3. New equipment additions to a used aircraft;
4. The “adjusted basis” of a new aircraft acquired in a like-kind exchange or involuntary conversion. (A recent discussion with an IRS Chief Counsel disclosed that a new income tax regulation will be issued approximately late September 2003. It will also permit bonus depreciation on the undepreciated portion of your old aircraft that is used to purchase a new airplane. Any remaining basis in your old aircraft will be depreciated on its original schedule as if the exchange had not occurred). (Revised Section)

Similar to the Job Creation and Worker Assistance Act of 2002 which promulgated a 30% first year bonus depreciation for new aircraft and other personal property, this new law for 2003 also has qualification tests that must be met before claiming the 50% bonus depreciation.

Qualification Test

1. New property . . . the first use must commence with the taxpayer.
2. There must not have been a binding contract to purchase this aircraft or new equipment in existence prior to May 6, 2003.
3. Aircraft operated under 14CFR Part 91 must be placed in service prior to January 1, 2005.

4. Aircraft operated under 14CFR Parts 135 or 121 may be able to qualify for an extended in service date of December 31, 2005 if the production period exceeds one year and the cost is in excess of \$1,000,000.
5. The aircraft must be predominantly used in the United States.
6. The aircraft must not be required to be depreciated under the ADS, Alternative Depreciation System.

Advantages

1. The obvious advantage as can be clearly seen from the tables and examples below is the extremely rapid depreciation of the aircraft during the first three years of useful life as compared to the MACRS only depreciation method.
2. Neither the 50% bonus depreciation or the MACRS component of the total depreciation will generate any alternative minimum tax preference items. I.R.C. § 168(k)(2)(F).
3. The 50% bonus depreciation like the 30% bonus depreciation is not affected by a short taxable year. For example: If a new calendar year LLC was formed on December 1, 2003, purchased and took delivery on December 26, 2003 and immediately placed the airplane in service in connection with the active trade or business of the LLC, the 50% bonus depreciation could be claimed on the return filed for the short taxable year of December 1, 2003 - December 31, 2003.
4. If an aircraft manufacturer or other entity sells fractional shares in its normal course of business to unrelated third parties, then the original use of the aircraft begins with the first user of each fractional interest as each fractional owner is considered the original user of its proportionate share of the aircraft.

Disadvantages

1. Not all states adopted last year's 30% bonus depreciation allowance. Given the budget deficits in most states, I doubt whether many states will adopt the 50% bonus depreciation. Thus, for many states accountants will have to maintain two depreciation schedules. (Please see my article in *Professional Pilot Magazine*, March 2003, also on this website under the articles tab.)

Currently, the only states that are in conformity with the federal depreciation schedules are: Alabama, Alaska, Colorado, Delaware, Florida, Kansas, Louisiana, Michigan, Montana, New Mexico, North Dakota, Utah, Vermont and West Virginia. But consult your local tax advisor as any of these states may decide to "decouple" from the federal depreciation rules.

2. The 50% bonus depreciation is also subject to the ordinary, necessary and reasonableness standards of Internal Revenue Code section 162 and thus can be quite easily disallowed as compared to regular MACRS depreciation. (See the above-referenced March 2003 article for further elaboration of this point.)

3. Because the 50% bonus depreciation is treated as depreciation, it would be subject to immediate recapture in any year that *bona fide* business use fell to 50% or less. Therefore, those aircraft owners that claim the 50% bonus depreciation should:
 - (a) Implement procedures and retain documentation that will clearly support high levels of *bona fide* business use throughout the entire period of ownership of each aircraft.
 - (b) Develop a business plan that integrates the operation of the aircraft into the day-to-day activities of the business.
4. Severely limit personal use of any 50% bonus depreciation aircraft.

Depreciation Planning Points

1. You may elect out of the bonus depreciation for any class of property. Part 91 aircraft are treated as a different class of property than Part 135 aircraft. Thus, you could elect out of the bonus depreciation for a Part 91 aircraft and retain the bonus depreciation for the Part 135 aircraft. I.R.C. § 168(k)(2)(C)(iii).
2. Aircraft owners who qualify for the 50% bonus depreciation may elect to use the 30% bonus or a 0% bonus. This strategy may be helpful for taxpayers who anticipate higher taxable income in future years or for those taxpayers who may be using net operating loss carryovers in years that the bonus depreciation could be claimed.

Special Expensing Election

Prior to the enactment of the new 2003 tax law, taxpayers that met the requirements of I.R.C. § 179 could elect to expense up to \$25,000 for qualifying property having a maximum cost basis of \$200,000.

The new provisions increase the expensing limitation to \$100,000 for qualifying property with a maximum cost basis of \$400,000. The \$100,000 amount is reduced on a dollar-for-dollar basis for assets costing in excess of \$400,000. Thus, an aircraft costing \$500,000 would not be eligible for any expensing election deductions under I.R.C. § 179.

Qualifying Tests and Other Considerations

1. The aircraft must be used in connection with an active trade or business.
2. It must be used predominantly in the United States.
3. Business use must be over 50%. In any future year where business use falls to 50% or less, the special expensing amount is immediately recaptured.

4. The special expensing deduction is limited to the individual's taxable income. An individual who has a taxable income of \$50,000 after deducting aircraft depreciation, regular business expenses, etc., can only deduct \$50,000 of the special expensing election for that year. The remaining \$50,000 must be carried over to future taxable years per I.R.C. § 179(b)(3)(B).
5. Partnerships, LLCs, Subchapter "S" corporations, must make the election at the entity level. The maximum dollar limitation, \$100,000, and the taxable income limitations apply to the partnership, LLC or Subchapter "S" corporations and the respective partners, members or shareholders. I.R.C. § 179(d)(8), § 179(b)(3)(A).

CAVEAT: The partnership, LLC or Subchapter "S" corporation must reduce its basis in the aircraft by the amount of the special expensing election even though the full \$100,000 could not be fully utilized by the member, partners, etc., per I.R.S. Reg. § 1.179-1(f)(2).

6. An extensive tax analysis and tax projection should be performed before you assume that you will even be able to take advantage of the increased special expensing provisions.

The new law requires that the property be placed in service in taxable years beginning in 2003, 2004 or 2005.

7. Airplanes that are acquired through a trade-in or like-kind exchange will not be entitled to the full expensing limitation. (Example: A new airplane costs \$275,000. An aircraft dealer allows you a trade-in allowance of \$225,000 for your old airplane. Your maximum Section 179 expense election is only \$50,000.)
8. Not all states will adopt the new federal legislation. For taxpayers residing in states that do not pass conforming legislation, the higher expensing election will be a federal only issue.

Planning Point

In cases where assets with longer lives are acquired, you may wish to consider using the Section 179 election for those assets and the bonus depreciation on the aircraft.

Summary

While the provisions of the new tax law will prove advantageous to many, a detailed multi-year tax analysis should be performed before any acquisition is finalized.

Most states do not allow the 30% or 50% bonus depreciation. Many states may not recognize the expanded expensing provisions either.

Aircraft owners that do take advantage of the new provisions should implement documentation procedures, formulate aircraft business integration policies and prepare business plans that will justify maximum bona fide business use.

Should you need assistance with any of the above items, please don't hesitate to call me at (661) 269-9441. As always, professional tax or legal advisors are invited to discuss specific client concerns.

New Tax Law 2003

Comparative Depreciation Analysis - 0%, 30% and 50% Bonus Depreciation (All Calculation Assume 100% Business Use)

PART 91 AIRCRAFT												
NO BONUS DEPRECIATION				30% BONUS DEPRECIATION				50% BONUS DEPRECIATION				
Cost of Aircraft		\$10,000,000		Cost of Aircraft		\$10,000,000		Cost of Aircraft		\$10,000,000		
Less: 50% Bonus		\$0		Less: 30% Bonus		-\$3,000,000		Less: 50% Bonus		-\$5,000,000		
Depreciable Basis		\$10,000,000		Depreciable Basis		\$7,000,000		Depreciable Basis		\$5,000,000		
Tax Year	MACRS RATE	DEDUCTION	CUMULATIVE	Tax Year	MACRS RATE	DEDUCTION	CUMULATIVE	Tax Year	MACRS RATE	DEDUCTION	CUMULATIVE	
2003	NO BONUS	\$0	\$0	2003	BONUS	\$3,000,000	\$3,000,000	2003	BONUS	\$5,000,000	\$5,000,000	
2003	20.00%	\$2,000,000	\$2,000,000	2003	20.00%	\$1,400,000	\$4,400,000	2003	20.00%	\$1,000,000	\$6,000,000	
2004	32.00%	\$3,200,000	\$5,200,000	2004	32.00%	\$2,240,000	\$6,640,000	2004	32.00%	\$1,600,000	\$7,600,000	
2005	19.20%	\$1,920,000	\$7,120,000	2005	19.20%	\$1,344,000	\$7,984,000	2005	19.20%	\$960,000	\$8,560,000	
2006	11.52%	\$1,152,000	\$8,272,000	2006	11.52%	\$806,400	\$8,790,400	2006	11.52%	\$576,000	\$9,136,000	
2007	11.52%	\$1,152,000	\$9,424,000	2007	11.52%	\$806,400	\$9,596,800	2007	11.52%	\$576,000	\$9,712,000	
2008	5.76%	\$576,000	\$10,000,000	2008	5.76%	\$403,200	\$10,000,000	2008	5.76%	\$288,000	\$10,000,000	
	100.00%	\$10,000,000			100.00%	\$10,000,000			100.00%	\$10,000,000		

PART 135 / 121 AIRCRAFT												
NO BONUS DEPRECIATION				30% BONUS DEPRECIATION				50% BONUS DEPRECIATION				
Cost of Aircraft		\$10,000,000		Cost of Aircraft		\$10,000,000		Cost of Aircraft		\$10,000,000		
Less: 50% Bonus		\$0		Less: 30% Bonus		-\$3,000,000		Less: 50% Bonus		-\$5,000,000		
Depreciable Basis		\$10,000,000		Depreciable Basis		\$7,000,000		Depreciable Basis		\$5,000,000		
Tax Year	MACRS RATE	DEDUCTION	CUMULATIVE	Tax Year	MACRS RATE	DEDUCTION	CUMULATIVE	Tax Year	MACRS RATE	DEDUCTION	CUMULATIVE	
2003	NO BONUS	\$0	\$0	2003	BONUS	\$3,000,000	\$3,000,000	2003	BONUS	\$5,000,000	\$5,000,000	
2003	14.29%	\$1,429,000	\$1,429,000	2003	14.29%	\$1,000,300	\$4,000,300	2003	14.29%	\$714,500	\$5,714,500	
2004	24.49%	\$2,449,000	\$3,878,000	2004	24.49%	\$1,714,300	\$5,714,600	2004	24.49%	\$1,224,500	\$6,939,000	
2005	17.49%	\$1,749,000	\$5,627,000	2005	17.49%	\$1,224,300	\$6,938,900	2005	17.49%	\$874,500	\$7,813,500	
2006	12.49%	\$1,249,000	\$6,876,000	2006	12.49%	\$874,300	\$7,813,200	2006	12.49%	\$624,500	\$8,438,000	
2007	8.93%	\$893,000	\$7,769,000	2007	8.93%	\$625,100	\$8,438,300	2007	8.93%	\$446,500	\$8,884,500	
2008	8.93%	\$893,000	\$8,662,000	2008	8.93%	\$625,100	\$9,063,400	2008	8.93%	\$446,500	\$9,331,000	
2009	8.93%	\$893,000	\$9,555,000	2009	8.93%	\$625,100	\$9,688,500	2009	8.93%	\$446,500	\$9,777,500	
2010	4.45%	\$445,000	\$10,000,000	2010	4.45%	\$311,500	\$10,000,000	2010	4.45%	\$222,500	\$10,000,000	
	100.00%	\$10,000,000			100.00%	\$10,000,000			100.00%	\$10,000,000		