

Aircraft Incentives and Pitfalls of the Economic Stimulus Act of 2008

Highlights of Legislation that Affect the Aircraft Industry

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President George Bush signs HR 5140 - the Economic Stimulus Act of 2008 - into law in the East Room of the White House.

On Feb 13, 2008, President Bush signed the Economic Stimulus Act of 2008 into law. For the aircraft industry, the act provides a revival of the 50% bonus depreciation allowance as well as an enhanced expensing election under Internal Revenue Code, IRC § 179.

The act is complex, contains many pitfalls and lacks clarity in many key areas. Additional guidance is needed from the IRS in several areas. Accordingly, aircraft owners seeking to take advantage of the new laws may wish to route this article

to their tax advisors and perform tax projections to see if their aircraft purchases are eligible, or if making use of these provisions is in their best interest. Specific Internal Revenue Code section cites, in addition to the ones listed, are available to professional tax advisors upon request.

For most taxpayers, the new provisions will be “federal only” benefits, as many states have not passed the necessary conformity legislation to permit the bonus depreciation and enhanced expensing provisions to be deducted on various state income tax returns.

Another factor that will further limit access to these tax benefits is the lack of availability of aircraft with 2008 or 2009 delivery positions. This resembles the market conditions that existed when the 2004–05 bonus depreciation and increased expensing provisions were enacted. Most turbine equipment manufacturers have already sold out of their 2008 delivery positions — and most 2009 positions for many of their most popular models. Phil Winters, VP of aircraft sales for Western Aircraft, points out that he has no more delivery positions available for the Pilatus PC12 for 2008 or 2009. Hawker Beechcraft Regional Sales Director Frederick Clarey says only a few positions are still available for some King Air models and the Premier IA for 2008 and 2009. For the piston market, Rich Manor of Tom’s Aircraft notes that many Cessna aircraft are available for delivery in 2008 and 2009.

Bonus Depreciation

In order to be eligible for the 50% bonus depreciation, qualifying property must meet the following criteria per amended Internal Revenue Code (IRC) § 168(k).

1. The property must have a recovery period of 20 years or less.
2. A written, binding contract must be entered into between Jan 1, 2008 and Dec 31, 2008. The purchaser must have made a nonrefundable deposit equal to the lesser of 10% of the purchase price or \$100,000 at the time the purchase agreement is entered into.
3. The property must have a cost exceeding \$200,000 and an estimated production period exceeding 4 months. Although the new law does not contain specific language as to how taxpayers or manufacturers are to determine the estimated length of the production period, Regulation 1.263A-8(d)(2)(iv)(A) does provide that the production period of property can begin as

early as the date of the purchase contract. The production period ends when the aircraft is placed in service by the taxpayer. In most cases, the earliest date would be the physical delivery date. Most airframe manufacturers take the position that their production periods exceed 4 months. This is true even for single-engine piston aircraft.

4. The general rule states that the qualifying property must be placed into service during 2008. However, an additional 1-year extension is available for Part 91 aircraft. Since those aircraft are not defined as transportation property, in that they are not used in the business of transporting persons or property for hire, these aircraft may be placed into service as late as Dec 31, 2009 per IRC § 168(k)(2)(C), as long as the down payment, minimum production period and cost requirements are met.

5. The original use of the aircraft must begin with the taxpayer. Factory-new demo aircraft will qualify, as they are still maintained in inventory and thus have not been “placed in service” by the factory. The original use is considered to have started with the retail customer. Fractional shares of new aircraft will also qualify. Each fractional shareowner is considered the original user of its respective share per Committee Report paragraph 5003 of the act.

6. Aircraft used in Part 135 operations should be placed into service in 2008 because the statutory language for bonus depreciation does not provide any “predominant use” relief if the aircraft is used 50% or less for charter. Predominant-use language only exists for regular MACRS depreciation. Those aircraft used predominantly in Part 91 operations qualify for 5-year MACRS as long as the business use is over 50%. Part 135 aircraft are depreciated using 7-year MACRS. If the aircraft is merely listed on a Part 135 certificate, this could be enough to disqualify it from the 50% bonus depreciation provisions. Further guidance from the IRS in the form of a private letter ruling should be obtained by taxpayers before the aircraft is used for any Part 135 operations in order to avoid a potentially costly disallowance of bonus depreciation if the aircraft is not placed into service before 2009. An exception is provided for aircraft used for agricultural or firefighting purposes per IRC § 168(k)(2)(C)(ii).

Planning Points

The aircraft must be used more than 50% for business purposes during the first year placed in service and for every year thereafter. All bonus and accelerated depreciation in excess of straight-line depreciation will be recaptured in any year that business use falls to 50% or less.

Another pitfall of the 50% bonus depreciation is that the amount deducted as bonus depreciation is subject to the much harsher disallowance standards of IRC § 162, ie, the ordinary, necessary and reasonableness provisions of the Code. Bonus depreciation can be disallowed quite easily compared with regular MACRS depreciation.

Bonus depreciation is not subject to alternative minimum tax, nor is it affected by a short taxable year. For example, if a new entity’s tax year begins on Dec 15, 2008 and ends on Dec 31, 2008, an aircraft that is placed in service on Dec 28 would qualify for the bonus depreciation. However, the regular MACRS depreciation would be subject to the mid-quarter convention rules.

Also, it may be difficult to justify the bonus depreciation as being ordinary, necessary or reasonable for only 1 or 2 business trips in the short taxable year.

For aircraft that qualify for bonus depreciation, regular 5-year MACRS depreciation is available on the balance of the tax basis. For instance, a calendar-year business entity purchases a jet in Jan 2008 for \$10 million and places it in service by Sep 30, 2008. The aircraft will be used only for Part 91 operations. Assuming 100% business use, the amount of depreciation deductible on the 2008 federal tax return is \$5 million of bonus depreciation and \$1 million of regular depreciation, for a total of \$6 million.

Economic Stimulus Act of 2008

Comparative depreciation analysis—0%, and 50% bonus depreciation

(All calculations assume 100% business use)

Part 91 aircraft

NO BONUS DEPRECIATION ELECTED				50% BONUS DEPRECIATION			
Cost of aircraft		\$10,000,000		Cost of aircraft		\$10,000,000	
Less: 50% bonus		\$0		Less: 50% bonus		\$5,000,000	
Depreciable basis		\$10,000,000		Depreciable basis		\$5,000,000	
Tax Year	MACRS rate	Deduction	Cumulative	Tax Year	MACRS rate	Deduction	Cumulative
2008	NO BONUS	\$0	\$0	2008	BONUS	\$5,000,000	\$5,000,000
2008	20.00%	\$2,000,000	\$2,000,000	2008	20.00%	\$1,000,000	\$6,000,000
2009	32.00%	\$3,200,000	\$5,200,000	2009	32.00%	\$1,600,000	\$7,600,000
2010	19.20%	\$1,920,000	\$7,120,000	2010	19.20%	\$960,000	\$8,560,000
2011	11.52%	\$1,152,000	\$8,272,000	2011	11.52%	\$576,000	\$9,136,000
2012	11.52%	\$1,152,000	\$9,424,000	2012	11.52%	\$576,000	\$9,712,000
2013	5.76%	\$576,000	\$10,000,000	2013	5.76%	\$288,000	\$10,000,000
	100%	\$10,000,000			100%	\$10,000,000	

Part 135/121 aircraft

NO BONUS DEPRECIATION ELECTED				50% BONUS DEPRECIATION			
Cost of aircraft		\$10,000,000		Cost of aircraft		\$10,000,000	
Less: 50% bonus		\$0		Less: 50% bonus		\$5,000,000	
Depreciable basis		\$10,000,000		Depreciable basis		\$10,000,000	
Tax Year	MACRS rate	Deduction	Cumulative	Tax Year	MACRS rate	Deduction	Cumulative
2008	NO BONUS	\$0	\$0	2008	BONUS	\$5,000,000	\$5,000,000
2009	14.29%	\$1,429,000	\$1,429,000	2009	14.29%	\$714,500	\$5,714,500
2010	24.49%	\$2,449,000	\$3,878,000	2010	24.49%	\$1,224,500	\$6,939,000
2011	17.49%	\$1,749,000	\$5,627,000	2011	17.49%	\$874,500	\$7,813,000
2012	12.49%	\$1,249,000	\$6,876,000	2012	12.49%	\$624,500	\$8,438,000
2013	8.93%	\$893,000	\$7,769,000	2013	8.93%	\$446,500	\$8,884,500
2014	8.93%	\$893,000	\$8,662,000	2014	8.93%	\$446,500	\$9,331,000
2015	8.93%	\$893,000	\$9,555,000	2015	8.93%	\$446,500	\$9,777,500
2016	4.45%	\$445,000	\$10,000,000	2016	4.45%	\$222,500	\$10,000,000
	100%	\$10,000,000			100%	\$10,000,000	

Section 179 Special Expensing Election

The new provisions increase the expensing limitation to \$250,000 for qualifying property with a maximum cost basis of \$800,000. The \$250,000 amount is reduced on a dollar-for-dollar basis for assets costing in excess of \$800,000. An aircraft costing \$1,050,000 would not be eligible for any expensing election deductions under IRC § 179.

In contrast to the 50% bonus depreciation provisions, the special expensing elections can be applied to new or used aircraft or equipment. New equipment added to a used aircraft will qualify for both bonus depreciation and the special expensing election.

Qualifying Tests for Special Expensing

1. The aircraft must be used in connection with an active business.
2. It must be used predominantly in the US.
3. Business use must be over 50%. In any future year where business use falls to 50% or less, the special expensing amount is recaptured immediately.
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 \$200,000 must be carried over to future taxable years per IRC § 179(b)(3)(B).

5. Partnerships, LLCs and subchapter “S” corporations must make the election at the entity level. The maximum dollar limitation - \$250,000 - and the taxable income limitations apply to the partnership, LLC or Subchapter “S” corporations and the respective partners, members or shareholders. IRC § 179(d)(8), § 179(b)(3)(A).

There is 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 \$250,000 could not be fully utilized by the member, partners, etc, per IRS Reg § 1.179-1(f)(2). Thus, if you can’t use the full \$250,000 Section 179 deduction, do not claim all of it, as you will only be reducing the amount of bonus and MACRS depreciation that can be claimed in the current year.

Economic Stimulus Act of 2008			
Section 179 expensing calculations			
EXPENSING ELECTION AND 50% BONUS DEPRECIATION			
Cost of aircraft		\$800,000	
Less: Sec 179 Maximum		-\$250,000	
Balance		\$550,000	
Less: 50% bonus		-\$275,000	
Depreciable basis		\$275,000	
Tax Year	MACRS rate	Deduction	Cumulative
2008	Sec. 179	\$250,000	\$250,000
2008	BONUS	\$275,000	\$525,000
2008	20.00%	\$55,000	\$580,000
2009	32.00%	\$88,000	\$668,000
2010	19.20%	\$52,800	\$720,800
2011	11.52%	\$31,680	\$752,480
2012	11.52%	\$31,680	\$784,160
2013	5.76%	\$15,840	\$800,000
	100%	\$800,000	

6. An extensive tax analysis and tax projection should be performed before assuming 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 2008. There is no increased expensing election available for taxable years beginning in 2009.

7. Airplanes that are acquired through a trade-in or like-kind exchange will not be entitled to the full expensing limitation. For example, in the case where a new aircraft costs \$675,000, an aircraft dealer allows you a trade-in allowance of \$625,000 for your old airplane. (Your maximum Section 179 expense election is only \$50,000.) This is because the special expensing election can only be applied to the new cash or debt coming into a purchase of new or used property.

8. Section 179 expenses must be taken before bonus depreciation and MACRS depreciation. The table above indicates the required order of calculations.

9. Again, most states have not adopted the new federal legislation. For taxpayers residing in states that do not pass conforming legislation, the higher expensing election will only be a federal issue.

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. Aircraft or equipment improvements that are placed in service in tax years beginning in 2009 are not eligible for the increased expensing election.

Summary

While the Economic Stimulus Act of 2008 provides incentives for the industry, market conditions and production capabilities will limit the benefit of these provisions to a relative few.

For many taxpayers, these benefits will only apply to their federal tax returns. Those who can make use of the 50% bonus depreciation and enhanced expensing provisions need to monitor business and personal use in order to avoid a costly, immediate depreciation and expense recapture taxed at ordinary income tax rates.

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