

Aircraft depreciation and expensing

Getting the most from the new tax laws.

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Thanks to new laws allowing 50% bonus depreciation of aircraft and other big-ticket capital goods, there may never be a better time to invest in a new bizjet or helicopter.

On May 28, 2003 President George W Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003. In its attempt to provide economic stimulus and encourage the purchase of capital goods, the Act contains provisions that range from reducing the capital gains tax rate and the tax rate on dividend income, to reducing rates on personal holding companies.

As far as business aircraft operators are concerned, the most appealing changes in this law are the 50% bonus depreciation incentives for new aircraft and equipment, as well as new expensing provisions that apply to new or used aircraft and other types of equipment. In other words, changes in IRS policy mean there has never been a better time to acquire a new jet aircraft, at least from a tax standpoint.

The new law increases the 30% bonus depreciation level to 50% for a new aircraft, a fractional share of a new aircraft, new equipment additions to a used aircraft and the “adjusted basis” of a new aircraft acquired in a like-kind exchange or involuntary conversion.

In addition, a recent discussion with an IRS chief counsel reveals that a new income tax regulation expected by late Sep 2003 will also permit bonus depreciation on the undepreciated portion of your old aircraft that is used to purchase a new aircraft. Any remaining tax basis in your old aircraft will be depreciated according to its original schedule, as if the exchange or trade-in had never occurred.

But just as with the Job Creation and Worker Assistance Act of 2002—which promulgated a 30% first-year bonus depreciation for new aircraft and other personal property—the 2003 law has qualification tests that must be met before claiming the 50% bonus depreciation.

For an aircraft to qualify for bonus depreciation, it must be new property. That is, its first use must commence with the named taxpayer. There must not have been a binding contract to purchase the aircraft or new equipment in existence prior to May 6, 2003.

Aircraft operated under Part 91 must be placed in service prior to Jan 1, 2005, although aircraft

operated under Parts 135 or 121 may be able to qualify for an extended in-service date of Dec 31, 2005 if the production period exceeds one year and the cost of the aircraft exceeds \$1,000,000.

All applicable aircraft must be used predominantly in the United States, and depreciation of the aircraft must not be required under the Alternative Depreciation System (ADS). Bona fide business use of 50% or less in the acquisition year will require the use of the ADS, and thus will disqualify the aircraft.

Advantages

The obvious advantage of taking the 50% bonus depreciation—as can be clearly derived from the accompanying spreadsheet—is the extremely rapid depreciation of the aircraft during the first 3 years of useful life, as compared with the MACRS-only depreciation method.

Part 91 aircraft—no bonus depreciation			
Cost of aircraft		\$10,000,000	
No bonus		\$0	
Depreciable basis		\$10,000,000	
Tax Year	MACRS rate	Deduction	Cumulative
2003	NO BONUS	\$0	\$0
2003	20.00%	\$2,000,000	\$2,000,000
2004	32.00%	\$3,200,000	\$5,200,000
2005	19.20%	\$1,920,000	\$7,120,000
2006	11.52%	\$1,152,000	\$8,272,000
2007	11.52%	\$1,152,000	\$9,424,000
2008	5.76%	\$576,000	\$10,000,000
	100.00%	\$10,000,000	

Still, neither the 50% bonus depreciation nor the MACRS component of the total depreciation will generate any alternative minimum tax preference items per the Internal Revenue Code, IRC § 168(k)(2)(F). And, like the 30% bonus depreciation, the 50% rule is not subject to a short taxable year.

For example, if a new-calendar-year limited liability company (LLC) was formed on Dec 1, 2003, and the LLC purchased and took delivery of a new aircraft on Dec 26, 2003 (placing the aircraft in service immediately), the 50% bonus depreciation could be claimed on the return filed for the short taxable year of Dec 1, 2003 to Dec 31, 2003.

In the case of fractional ownership, if an aircraft manufacturer or other entity sells fractional shares in its normal course of business to unrelated 3rd parties, then the original use of the aircraft begins with the first user of each fractional interest, as each share owner is considered the original user of its proportionate share of the aircraft.

Disadvantages

On the down side, not all states adopted last year’s 30% bonus depreciation allowance. Given the budget deficits in most states, it remains to be seen whether many additional states will choose to adopt the 50% bonus depreciation. Thus, for many states accountants will have to maintain 2 depreciation schedules.

Part 91 aircraft—30% bonus depreciation			
Cost of aircraft		\$10,000,000	
Less: 30% bonus		-\$3,000,000	
Depreciable basis		\$7,000,000	
Tax year	MACRS rate	Deduction	Cumulative
2003	BONUS	\$3,000,000	\$3,000,000
2003	20.00%	\$1,400,000	\$4,400,000
2004	32.00%	\$2,240,000	\$6,640,000
2005	19.20%	\$1,344,000	\$7,984,000
2006	11.52%	\$806,400	\$8,790,400
2007	11.52%	\$806,400	\$9,596,800
2008	5.76%	\$403,200	\$10,000,000
	100.00%	\$7,000,000	

Currently, the only states that are in full conformity with the federal depreciation schedules are Alabama, Alaska, Colorado, Delaware, Kansas, Louisiana, Montana, New Mexico, North Dakota, Oregon and Utah. It makes sense to consult your local tax advisor, however, as any of these states may decide to “decouple” from the federal depreciation rules.

In addition, the 50% bonus depreciation is subject to the “ordinary, necessary and reasonableness” standards of IRC section 162, and can thus be disallowed quite easily as compared with regular MACRS depreciation.

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. Aircraft owners whose business use is 50% or less who try to use the standard industry fare level (SIFL) rates to “gross up” their business use to 100% may be in for a surprise in the event of an IRS examination.

Other considerations

Therefore, aircraft owners who seek to claim the 50% bonus depreciation should always 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.

Part 91 aircraft—50% bonus depreciation			
Cost of aircraft		\$10,000,000	
Less: 50% bonus		<u>-5,000,000</u>	
Depreciable basis		\$5,000,000	
Tax year	MACRS rate	Deduction	Cumulative
2003	0.00%	\$0	\$0
2004	20.00%	\$1,000,000	\$1,000,000
2005	32.00%	\$1,600,000	\$2,600,000
2006	19.20%	\$960,000	\$3,560,000
2007	11.52%	\$576,000	\$4,136,000
2008	11.52%	\$576,000	\$4,712,000
	5.76%	\$288,000	\$5,000,000
	<u>100.00%</u>	<u>\$10,000,000</u>	

They should also work to develop a business plan that integrates the operation of the aircraft into the day-to-day activities of the entity that owns the aircraft, in addition to other related entities whose business activities are enhanced by the aircraft operation.

It is also recommended that personal use of an aircraft claimed under the 50% bonus depreciation be severely limited. In the case of fleet replacements, the 50% as well as the 30% bonus depreciation must be used or elected out for all Part 91, 135 or 121 aircraft placed in service during the year.

For example, say ABC Corp wants to replace its entire fleet. Due to prior tax planning, however, the 50% depreciation bonus is not needed on all its Part 91 or Part 135 aircraft. ABC will have to opt out of the bonus depreciation for all its Part 91 or 135 aircraft, as the new law provides that bonus depreciation must be uniformly applied to an entire class of property for a given tax year.

So, Congress made the new law much less flexible than it could have been for our industry, as well as many others.

Planning points

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 bonus depreciation for a Part 91 aircraft and retain the bonus depreciation for the Part 135 aircraft under IRC § 168(k)(2)(C)(iii). You could also place the Part 91 aircraft in service in 2003 and the Part 135 aircraft in service in 2004.

Aircraft owners who qualify for the 50% bonus depreciation may elect to use the 30% bonus or a 0% bonus. This strategy may also 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 when the bonus depreciation could be claimed.

Special expensing

Prior to the enactment of the new 2003 tax law, taxpayers who met the requirements of IRC §

179 could elect to expense up to \$25,000 for qualifying property having a maximum cost basis of \$200,000.

These 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 over \$400,000.

Thus, an aircraft costing \$500,000 would not be eligible for any expensing election deductions under IRC § 179. So, in contrast to the 50% and 30% bonus depreciation provisions, the special expensing elections can be applied to new or used aircraft or equipment.

To qualify for special expensing, an aircraft must be used in connection with an active trade or business, and must be used predominantly in the United States. 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.

The special expensing deduction is limited to the individual's taxable income. An individual with 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 IRC § 179(b)(3)(B).

Partnerships, LLCs and Subchapter S corporations must make the election at the entity level. The 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, per 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 \$100,000 could not be fully utilized by the member, partners, etc, per IRS Reg § 1.179-1(f)(2).

Remember that 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.

Also, the new law requires that the property be placed in service in taxable years beginning in 2003, 2004 or 2005. Airplanes that are acquired through a trade-in or like-kind exchange will not be entitled to the full expensing limitation.

For example, consider a new airplane priced at \$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. 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.

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 be a federal-only issue.

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

Taking it all in

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 and many states may not recognize the expanded expensing provisions either.

Aircraft owners who 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.



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