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## **BONUS DEPRECIATION**

### **NEW REVENUE PROCEDURE EXPANDS PLANNING OPPORTUNITIES**

On March 29, 2011, the Internal Revenue Service issued Revenue Procedure 2011-26, 2011-16 IRB which now permits taxpayers to elect 50% rather than 100% bonus depreciation. The Rev. Proc. also permits taxpayers to amend their calendar year 2010 tax return or any other tax year that includes September 9, 2010, in order to step down from 100% to 50% bonus depreciation. **Author's Note:** While we now have more flexibility and planning opportunities to use bonus depreciation, aircraft owners also need to be aware that the bonus depreciation regulations contain many traps for the unwary. Because of the immediate and drastic recapture provisions of the Internal Revenue Code that come into play when business use drops to 50% or less for bonus and accelerated depreciation, as well as the special expensing provisions, only those taxpayers who are prepared to embark upon a demanding program of aircraft record keeping and a disciplined methodology for aircraft business use for long periods of time should consider claiming bonus or even regular MACRS depreciation. Accordingly, the purpose of this article is to discuss the provisions of the new Rev. Proc., procedures for amending your tax return to take advantage of Rev. Proc. 2011-26 and to briefly discuss some additional bonus depreciation pitfalls and considerations that are *not* covered by Rev. Proc. 2011-26.

My purpose is not to discuss whether or not your aircraft might qualify for bonus depreciation, regular depreciation or the special expensing provisions. I assume you have already discussed those issues with your tax advisor and that your tax preparer will analyze any flight logs and other documentation in order to determine whether or not you meet the 25% qualified business use requirements for aircraft addressed by Internal Revenue Code section §280F(d)(6). **Rev. Proc. 2011-26, 2011-16 IRB**

Under prior law, it was a well established provision that taxpayers could elect to claim 30% bonus depreciation rather than 50% bonus depreciation if they felt that the reduced deduction was better suited to their particular facts and circumstances. However, until the recent issuance of Rev. Proc. 2011-26 no such provision existed for taxpayers to claim 50% bonus depreciation rather than 100% if they felt that the lower deduction was more favorable to their situation. As a result, many aircraft owners did not claim any bonus depreciation and elected out of bonus depreciation on their tax returns.

This situation was addressed by the Joint Committee on Taxation, JCT, "General Explanation of Tax Legislation Enacted by the 111<sup>th</sup> Congress, i.e. "The Blue Book." The Blue Book states, "a taxpayer may elect 50 percent (rather than 100 percent) bonus depreciation with respect to all property in any class of property placed in service during a taxable year," footnote 1597, page 560. Thus the Blue Book permits an unlimited choice for the taxpayers to use either 50% or 100% bonus depreciation. By issuing Rev. Proc. 2011-26, the Internal Revenue Service has partially reversed its original position as currently stated in the instructions of Form 4562 Depreciation and Amortization for 2010. Those instructions specifically state that, "If you elect out of the 100% special depreciation allowance ... the

property does not qualify for the 50% special depreciation allowance.” The instructions to Form 4562 were published in January of 2011, prior to issuance the current Rev. Proc.

**Amending your tax return... you must act promptly.** September 9, 2010 is a critical date for those aircraft owners who wish to take advantage of this new opportunity. For aircraft owners who already timely filed their 2010 calendar year tax returns, fiscal year or short year returns that include the date September 9, 2010 and elected 100% bonus depreciation or elected out of bonus depreciation altogether and have now changed their minds, there is a solution. Pursuant to Reg. § 301.9100-2 taxpayers may now take advantage of an automatic 6 month extension to amend their tax returns.

Example (1): A calendar year individual taxpayer has already filed his 2010 tax return by April 18, 2011 and claimed 100% bonus depreciation. Now the aircraft owner changed his mind and decided that he wants to claim only 50% bonus depreciation in order to save some depreciation for future years. This owner now has until **October 18, 2011** to amend his 2010 calendar tax return and step down to 50% bonus depreciation. Reg. § 301.9100-2(c) and Reg. § 301.9100-2(d) require that taxpayers attach a statement to their amended tax return stating that it is being filed pursuant to Reg. § 301.9100-2.

If I were preparing the amended return, I would print in bright red ink at the top of each page of the return, “Amended Pursuant to Reg. § 301.9100-2.” I would do this in addition to drafting a statement to be signed by the client and also attached to the amended return. Do not leave any doubt with the IRS that you are taking advantage of this favorable provision.

Example (2): An aircraft owner has not yet filed his calendar year tax return for 2010 and has placed his tax return on extension. At first blush, the relief language contained in the Blue Book seems to indicate that in order to step down to the 50% deduction, all the taxpayer has to do is claim 50% bonus depreciation on the return and timely file it by the extended due date. However, to be prudent, you will want to attach a brief election statement to your return which states: Pursuant to Section 4.02 of Rev. Proc. 2011-26 the taxpayer elects to claim 50% bonus depreciation rather than 100% bonus depreciation for the following classes of property placed in service during the tax year ended December 31, 2010. Include a list of the classes of property that you want the election to cover.

Example (3): Fiscal year 2009 and short year 2010 returns are also covered by the new provisions for some taxpayers. These taxpayers did not claim the 50% bonus depreciation, i.e., “elected out” of bonus depreciation that was in effect for the fiscal 2009 tax year that began in 2009 and ended in 2010 or have a short taxable year that begins and ends in 2010. The Rev. Proc. now permits these taxpayers to change their minds and revoke that election by filing an amended tax return for their fiscal 2009 tax year or the short year 2010 tax return. Time is of the essence for these taxpayers as well. Amended returns for these years must be filed by the **later** of (1) June 17, 2011, or (2) before the federal return is filed for the next year succeeding the fiscal 2009 return or the short year 2010 tax return.

No specific statement appears to be required to be attached to the amended returns filed by these taxpayers by Rev. Proc. 2011-26. However, if I were preparing the amended returns for these entities, I would have the client sign a statement to the effect that the return was being amended pursuant Rev. Proc. 2011-26 section 5.03. Attach the statement to the return and indicate “Amended pursuant to Rev. Proc 2011-26 sec. 5.03” in bright red ink at the top of every page of the amended return.

#### **Other Bonus Depreciation Issues Not Covered by Rev. Proc. 2011-26**

**Availability:** First of all, bonus depreciation is not available in many states. At last count there were only approximately a dozen or so states that allowed taxpayers to claim bonus depreciation on their state income tax returns. This has been the case since the inception of the current form of bonus depreciation in 2001.

**Bonus Depreciation – Ordinary and Necessary?** The Joint Committee on Taxation's Technical Explanation of the Job Creation and Worker Assistance Act of 2002, The Blue Book, states, "The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A." (Please see Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 107<sup>th</sup> Congress (JCS -1-03), January 24, 2003 footnote # 205). Since that Blue Book was issued in 2003, I have not seen any court cases where the government has prevailed in disallowing bonus depreciation by using the ordinary, necessary or reasonableness standards of Code section §162. However, I and other tax advisors continue to encounter many situations where IRS agents attempt to disallow depreciation deductions on the grounds that the depreciation deduction is subject to the ordinary, necessary or reasonableness standards of the Code. Using that same logic, the agents also attempt to classify the aircraft activity as a hobby loss pursuant to Code section §183. The agents are in error. In *Noyce v. Comm'r*, 97 T.C. 670 (1991), the court stated, "the section 168 depreciation deduction should not be included in the amount of business expense, the reasonableness of which is to be determined." Since the Noyce case was issued there have many other cases which have cited Noyce and have been decided in the taxpayer's favor.

**50% Business Use Means Depreciation Recapture:** There seems to be a widespread misconception within a segment of the professional tax community, i.e., the "50 percenters", that as long as business use is 50% or more for any particular year that the taxpayer is entitled to bonus depreciation, MACRS depreciation or the special expensing provisions of Internal Revenue Code Section §179. That is wrong.

Generally speaking, the tax forms used to prepare tax returns are in compliance with the tax law. That is why I have attached the 2010 form 4797 titled Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) to this article. Page 2, Part IV of the form is titled "Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use drops to 50% or Less" emphasis added. Please note that this form is well known to most tax preparers and has been in use for at least two or more decades.

Section 280F contains the listed property depreciation rules. Airplanes are considered as listed property. Section 280F(b)(2) provides that if business use is not greater than 50% in any taxable year after it is placed in service, then in the year that business drops to 50% or less, bonus and MACRS depreciation in excess of what would have been allowable under the straight line method, alternative depreciation system, ADS, will be will recaptured in that year. The alternative depreciation system provides a depreciable life of 6 years for FAR Part 91 aircraft and a 12 year life for FAR Part 135 aircraft. Section §168(k)(2)(F)(ii) provides a coordination with the listed property rules for recapture of bonus depreciation. Thus FAR Part 91 aircraft owners have a 6 year period where they have to be concerned about business use slipping to 50% or less. FAR Part 135 aircraft owners are subject to a 12 year exposure period. Obviously, if your business use is 50% or less in the year the aircraft is placed in service, you do not qualify for any bonus depreciation as you must use the ADS system to depreciate the aircraft. In cases where the use of the ADS is mandatory, no bonus or MACRS depreciation is permissible Internal Revenue Code §168(k)(2)(D).

Section 179 contains similar rules for recapture of any amounts deducted under the special expensing provisions of the Internal Revenue Code. See form 4797 attached and Internal Revenue Code Section 179 and the regulations thereunder when business use drops to 50% or less during the respective 6 and 12 year periods for FAR Part 91 and Part 135 aircraft.

**Substantiation and Record Keeping Requirements** Internal Revenue Code section §274(d) states that no deductions will be allowed unless taxpayers maintain records that indicate the date, amount of the expense, time and place of travel, business purpose and “business relationship to the taxpayer of any persons entertained.” In the event that a trip also contains elements of entertainment, amusement or recreation, you must also be able to show that, “the item was directly related to”, or “that such item was associated with, the active conduct of the taxpayer’s trade or business” per Internal Revenue Code section §274(a).

The importance of maintaining a good set of contemporaneous records cannot be overstated. This is true for tax as well as non tax reasons. Aircraft owners should make sure that their aircraft is fully integrated into their business activities, well documented and be prepared to go the extra mile in order to support their tax position by all means necessary by including several examples of citable authority contained in their permanent tax files in the event of a regulatory challenge.

As a defensive tactic, please be sure to retain copies of new contracts or follow on orders from current customers that would not have been possible without the use of the airplane. Be able to show that no other form of reasonably available transportation would have been able to capture the new business. This kind of documentation has proven invaluable especially for cases that are on appeal and subject to settlement.

## Summary

Revenue Procedure 2011-26 contains a step down opportunity from 100% bonus depreciation to 50% bonus depreciation for those owners who wish to preserve depreciation for future years, those who may have expiring net operating loss carryovers, etc. It even contains provisions to amend prior year tax returns for many taxpayers who have changed their minds concerning the deductibility of bonus depreciation. Those aircraft owners who wish to take amend their prior year returns need to act quickly.

Bonus depreciation is not for everyone. It is not available in most states for state income tax purposes. Only those taxpayers that have taken the time to fully integrate their aircraft into their business activities and are ready and able to embark upon a demanding, long term program of copious record keeping should even consider using bonus or accelerated depreciation. In addition to the substantiation requirements of Internal Revenue Code section §274(d) listed above, you should also record the business purpose of each passenger for each trip segment.

Contemporaneous records are the most preferred by regulatory authorities and the courts. In order to determine if your records meet the definition of contemporaneous as accepted by the U.S.Tax Court, as well as other courts, consider using the memory aid, “CRAP.” Contemporaneous Records are maintained At or near the time of the event by a Person with knowledge of the event.

Because of the economy, many owners are flying less. Each hour represents a greater portion of the total. Therefore, it is easier to have your business use drop to 50% or less. If that happens during the applicable 6 or 12 year exposure periods, the depreciation and special expensing recapture traps will have immediate catastrophic effects. To ensure compliance imposed by the IRS, we hereby inform you that any U.S. Federal Tax Advice contained in this communication (including any continuation pages or attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or tax related matter(s).

## Current version of IRS Form 4797

<b>Form 4797</b>	<b>Sales of Business Property</b> <b>(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))</b>					OMB No. 1545-0184
Department of the Treasury Internal Revenue Service (99)		▶ Attach to your tax return.			▶ See separate instructions.	
						<b>2010</b> Attachment Sequence No. 27
						<b>Identifying number</b>
1 Enter the gross proceeds from sales or exchanges reported to you for 2010 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)						1
<b>Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)</b>						
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale
3	Gain, if any, from Form 4684, line 42					3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37					4
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824					5
6	Gain, if any, from line 32, from other than casualty or theft					6
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:					7
<b>Partnerships (except electing large partnerships) and S corporations.</b> Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.						
<b>Individuals, partners, S corporation shareholders, and all others.</b> If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.						
8	Nonrecaptured net section 1231 losses from prior years (see instructions)					8
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)					9
<b>Part II Ordinary Gains and Losses (see instructions)</b>						
10	Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less)					
11	Loss, if any, from line 7					11
12	Gain, if any, from line 7 or amount from line 8, if applicable					12
13	Gain, if any, from line 31					13
14	Net gain or (loss) from Form 4684, lines 34 and 41a					14
15	Ordinary gain from installment sales from Form 6252, line 25 or 36					15
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824					16
17	Combine lines 10 through 16					17
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:					
a	If the loss on line 11 includes a loss from Form 4684, line 38, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions					18a
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14					18b
For Paperwork Reduction Act Notice, see separate instructions.						
Cat. No. 13086I						
Form 4797 (2010)						
<b>* SEE PAGE 2</b>						

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**Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**  
(see instructions)

<b>19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:</b>	<b>(b) Date acquired (mo., day, yr.)</b>	<b>(c) Date sold (mo., day, yr.)</b>
A		
B		
C		
D		
<b>These columns relate to the properties on lines 19A through 19D. ►</b>		
<b>20 Gross sales price (Note: See line 1 before completing.)</b>	<b>20</b>	
<b>21 Cost or other basis plus expense of sale . . .</b>	<b>21</b>	
<b>22 Depreciation (or depletion) allowed or allowable . . .</b>	<b>22</b>	
<b>23 Adjusted basis. Subtract line 22 from line 21 . . .</b>	<b>23</b>	
<b>24 Total gain. Subtract line 23 from line 20 . . .</b>	<b>24</b>	
<b>25 If section 1245 property:</b>		
a Depreciation allowed or allowable from line 22 . . .	<b>25a</b>	
b Enter the <b>smaller</b> of line 24 or 25a . . .	<b>25b</b>	
<b>26 If section 1250 property:</b> If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.		
a Additional depreciation after 1975 (see instructions) . . .	<b>26a</b>	
b Applicable percentage multiplied by the <b>smaller</b> of line 24 or line 26a (see instructions) . . .	<b>26b</b>	
c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e . . .	<b>26c</b>	
d Additional depreciation after 1969 and before 1976 . . .	<b>26d</b>	
e Enter the <b>smaller</b> of line 26c or 26d . . .	<b>26e</b>	
f Section 291 amount (corporations only) . . .	<b>26f</b>	
g Add lines 26b, 26c, and 26f . . .	<b>26g</b>	
<b>27 If section 1252 property:</b> Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).		
a Soil, water, and land clearing expenses . . .	<b>27a</b>	
b Line 27a multiplied by applicable percentage (see instructions) . . .	<b>27b</b>	
c Enter the <b>smaller</b> of line 24 or 27b . . .	<b>27c</b>	
<b>28 If section 1254 property:</b>		
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions) . . .	<b>28a</b>	
b Enter the <b>smaller</b> of line 24 or 28a . . .	<b>28b</b>	
<b>29 If section 1255 property:</b>		
a Applicable percentage of payments excluded from income under section 126 (see instructions) . . .	<b>29a</b>	
b Enter the <b>smaller</b> of line 24 or 29a (see instructions) . . .	<b>29b</b>	

**Summary of Part III Gains.** Complete property columns A through D through line 29b before going to line 30.

- |   |           |
|---|-----------|
| <b>30 Total gains for all properties. Add property columns A through D, line 24 . . .</b>   | <b>30</b> |
| <b>31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13 . . .</b>  | <b>31</b> |
| <b>32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 36. Enter the portion from other than casualty or theft on Form 4797, line 6 . . .</b> | <b>32</b> |

**Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less**  
(see instructions)

- |   | <b>(a) Section 179</b> | <b>(b) Section 280F(b)(2)</b> |
|---|------------------------|-------------------------------|
| <b>33 Section 179 expense deduction or depreciation allowable in prior years. . .</b>                     | <b>33</b>              |                               |
| <b>34 Recomputed depreciation (see instructions) . . .</b>  | <b>34</b>              |                               |
| <b>35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report . . .</b> | <b>35</b>              |                               |

Form 4797 (2010)