

## One-year extension of bonus depreciation—the implications

### New legislation makes personal use of business aircraft more problematic - and more expensive

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**Any personal use of business aircraft will reduce deductions for depreciation and other expenses.**

#### Author's note

*This article is a follow-up to one that appeared in the Oct 2004 edition. It examines the effects of the American Jobs Creation Act of 2004. After reading this article you may wish to route it to your tax preparer.*

*On Oct 22, 2004, President George Bush signed the American Jobs Creation Act into law. For the aircraft industry, the new law extends the placed-in-service date until Dec 31, 2005 for certain aircraft to obtain the benefits of bonus depreciation. It also makes personal use of all business aircraft very expensive.*

*The new legislation is poorly worded and creates many unresolved issues with regard to personal use of business aircraft. It is doubtful that the Internal Revenue Service (IRS) will be able to provide the necessary guidance prior to the filing deadlines for most 2004 tax returns.*

New aircraft that were purchased in 2004 and placed in service by Dec 31, 2005 can qualify for bonus depreciation as long as the following regulation tests are met per new Internal Revenue Code Section 168(k)(2)(C).

1. The aircraft must not be transportation property, ie, tangible personal property used in the trade or business of transporting persons or property.

The statutory language does not provide for any relief if the aircraft is used 50% or less for FAR Part 135 operations. In addition, taxpayers should obtain guidance from the IRS in the form of a private letter ruling before the aircraft is used for any Part 135 operations in order to avoid a potentially costly disallowance of bonus depreciation.

2. At the time of purchase, which must be before Jan 1, 2005, the purchaser must have made a nonrefundable deposit equal to the lesser of 10% of the purchase price or \$100,000.

3. The aircraft must have a cost in excess of \$200,000 and have 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 built pursuant to a contract 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 actual physical delivery date.

#### Restrictions on personal use

As a way of paying for the 1-year bonus depreciation extension, depreciation and deductions for operating and nonoperating expenses are reduced for any personal use by "specified individuals" that occurs on or after Oct 22, 2004.

Specified individuals include officers, directors and owners of 10% or more of private and publicly held companies.

Example: Assume that depreciation, fuel, insurance and other aircraft deductions for 2005 are \$2 million at 100% business use. However, the aircraft was only used 60% for business trips and 40% for personal executive vacations with a SIFL rate value of \$25,000 during the year for the vacation flights.

Under the new provisions, the deductions for depreciation, operating and nonoperating expenses would amount to \$1.2 million for the 60% business trips, plus \$25,000 for the value of the personal use imputed to the executive's W2. Overall, the business entity would lose \$775,000 in deductions for depreciation and other expenses because of the executive vacations. At a 35% federal tax rate, that amounts to a cost of \$271,250 in additional taxes. In high-tax rate states such as California and New York, the cost of those 2005 vacations could easily exceed \$300,000.

Over a 5 or 7-year depreciable life, the accumulated vacation costs will be enough to have purchased a fractional share, a

very light jet, charter time, used aircraft or some combination of alternatives, with a good deal of “change” to spare.

Please keep in mind that the new law is effective for personal use that occurs on or after Oct 22, 2004. There is no sunset date provision. Therefore, this new Internal Revenue Code subsection could be with us long after the eligible new 2005 FAR Part 91 aircraft are relegated to the bone yard.

### Unresolved issues

The following list of unresolved issues and observations only address a portion of the challenges which will need to be faced by aircraft owners beginning in 2004.

1. For personal use that occurred prior to Oct 22, 2004 we can still use the old law, ie, the Sutherland Lumber-Southwest v Commr, 225 F3d 495 (8th Cir 2001) aff'g 114 TC 197, methodology, for calculation of depreciation operating and nonoperating expenses. Personal use that occurs on or after Oct 22, 2004 will reduce deductions for all aircraft expenses. Thus, preparing the 2004 tax returns will be especially challenging for tax preparers who are not thoroughly familiar with the new provisions.

Accountants should be particularly aware of the need to account for book income versus taxable income differences, ie, Schedule M adjustments. Since the 2004 tax forms for partnership and corporate returns will highlight differences between “book income” and “taxable income” to a greater degree than in prior years, I believe that more “aircraft” returns may be selected for audit.

2. Calculating the percentage of business use will be the most important factor for 2004 and future tax returns. Tax preparers will need to develop and maintain extensive schedules to track the tax basis of the aircraft in the event of a sale or exchange. Obviously, when the airplane is sold, you don't want to recapture more depreciation than was actually deducted. As a caution to all accountants, beware of the “allowed or allowable” trap when calculating gain on sale or the basis of the replacement aircraft obtained as part of a like-kind exchange.

3. Unfortunately, the new law provides no guidance as to the treatment of flights that are part business and part personal. While the new language does not rule out use of the old empty seat rule as provided by Internal Revenue Regulation 1.61-21(g), the new language does not specifically authorize its use either. Until we get guidance from the IRS, I suggest that, for flight segments where 50% or more of the normally configured passenger seats are occupied by people on business, we continue to count the value of the non-business guest seats as zero and regard that segment as a business flight. I recommend this course of action because neither the House nor Senate Committee report says anything about amending Internal Revenue Code Section 61 or its accompanying regulations.

4. The intent of the restrictions on personal use is clearly to target the entertainment element of such use. The plain language of the statute does not address the executive who uses the aircraft to attend a board meeting for another, unrelated, business. In these cases, so as to avoid losing any deductions, you should keep documentation that clearly shows that the purpose of the flight was not personal entertainment.

Records should also be maintained showing how the executive's participation as a board member of another company benefits his current employer. Perhaps each company could draft corporate resolutions attesting to the benefits derived from the intercompany relationship. These documentation procedures would build a stronger case for those flights being classified as business trips.

5. Since depreciation deductions are greatest in the first 3 years of ownership, try to keep personal use to an absolute minimum during those years in order to lose as little depreciation as possible.

### Market facts

Before this piece of work was signed into law, most manufacturers of turbine-powered business aircraft had already sold most of their 2005 delivery slots.



**The American Jobs Creation Act of 2004, signed into law by the President on Oct 22, 2004, may eliminate more jobs from general aviation than it creates.**

Some of the more popular models had already sold through 2005 production and well into 2006 delivery positions. Recently, some factory sales reps have disclosed that a few models are sold out beyond the third quarter of 2006.

Given the fact that FAR 121, 125 and 135 aircraft were excluded from the benefits of this quagmire legislation, what was the reason for the intense lobbying efforts by the “alphabet soup” organizations and others for the legislation in the first place? In the long term, this legislation has harmed our industry's overall best interests. Even if a particular flight was for purely personal reasons, fuel still had to be purchased and a host of other services had to be provided. Under the former US Tax Court decisions, jobs were preserved, if not created.

Ironically, the American Jobs Creation Act of 2004 may end up eliminating more jobs for our industry over the long term

than it creates in the short run.

Those aircraft buyers who need to upgrade equipment during 2005 or early 2006 may have to look to the used market. Given the lack of availability of 2005 and early 2006 delivery positions, prices on those aircraft are sure to increase.

### **Summary**

The general aviation industry would have been better off without this legislation in its current form. Unless additional legislation is brought in quickly to restore the provisions of Sutherland Lumber, we'll all pay a very high price in order to benefit a relative few. Obviously, every owner will now be carefully evaluating their need to attend their alma mater homecoming or other festivities.

Documentation of business usage and quarterly tracking of business versus personal use, coupled with a clear understanding of the basic concepts of depreciation, recapture, gain on sale, Schedule M adjustments, like-kind exchange, equity balancing calculations, etc, will be required of anyone who offers advice that relates to aircraft acquisition, operation or disposition.



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