

New Depreciation Rules Under the 2017 Tax Act

Disclaimer: This NBAA article is intended to provide members with an introduction to the rules that relate to bonus depreciation. This article is not intended to provide more than an illustrative introduction to the subject matter, and since the information is general in nature, it is no substitute for the advice of legal and tax advisors addressing a specific set of facts that readers may face.

This article discusses important changes to the rules for depreciating aircraft for tax purposes that were passed into law as part of the 2017 Tax Cuts and Jobs Act (the "Act").

100 PERCENT BONUS DEPRECIATION

In 2015, Congress extended 50 percent bonus depreciation for qualified property (including commercial and non-commercial aircraft) through 2019, with a phase-down over time from 50 percent to 30 percent. See *Extension of Bonus Depreciation*, by John B. Hoover and Richard C. Farley, Jr. (Dec. 18, 2015), available at: www.nbaa.org/admin/taxes/depreciation/bonus/

Under the Act the current law is amended to provide for 100 percent bonus depreciation, allowing taxpayers immediate deduction of the cost of aircraft acquired and placed in service after Sept. 27, 2017 and before Jan. 1, 2027 (Jan. 1, 2028 for longer production period property and certain aircraft discussed later in this article). Through the efforts of NBAA and a coalition of general aviation groups, the new law permits 100 percent bonus depreciation for both factory-new and pre-owned aircraft so long as it is the taxpayer's first use of the aircraft.

As revised by the Act, qualified property is eligible for 100 percent bonus depreciation if it meets certain requirements, including the following:

- Depreciable property of a specified type, including tangible personal property with a recovery period of 20 years or less, such as commercial and non-commercial aircraft;
- The original use of the property is the taxpayer's or the property was not used by the taxpayer at any time prior to its acquisition by the taxpayer; and
- The depreciable property is placed in service by the taxpayer after Sept. 27, 2017 and before Jan. 1, 2027.

Aircraft that are placed in service on or before Sept. 27, 2017 are still eligible for 50 percent bonus depreciation under prior law. See below for more information regarding the effective date of 100 percent bonus depreciation and tables showing the depreciation schedule for 100 percent bonus, 50 percent bonus, five-year Modified Accelerated Cost Recovery System (MACRS) without bonus, and the Alternative Depreciation System (ADS).

PHASE DOWN OF BONUS DEPRECIATION RATES

For tax years after 2022, the Act provides for a phase down of bonus depreciation of aircraft and other tangible personal property in increments of 20 percent each year for qualified aircraft acquired and placed in service before Jan. 1, 2027 (Jan. 1, 2028 under a transition rule for longer production period property (LPPP) and "Certain Aircraft"), as follows:

Transition Rule For Property Placed in Service	Standard Rule	LPPP and Certain Aircraft
Sept. 28, 2017-Dec. 31, 2022	100 percent	100 percent
Jan. 1, 2023 - Dec. 31, 2023	80 percent	100 percent
Jan. 1, 2024 - Dec. 31, 2024	60 percent	80 percent
Jan. 1, 2025 - Dec. 31, 2025	40 percent	60 percent
Jan. 1, 2026 - Dec. 31, 2026	20 percent	40 percent
Jan. 1, 2027 - Dec. 31, 2027	0	20 percent

TRANSITION RULE FOR LONGER PRODUCTION PERIOD PROPERTY (LPPP) AND CERTAIN AIRCRAFT

As shown above, LPPP and Certain Aircraft are eligible for a one-year extension of the "placed in-service" date. Under this one-year extension, LPPP and Certain Aircraft that are subject to a binding written purchase agreement at the end of one year can qualify for that year's bonus depreciation percentage, even though they are placed in service in the next year.

LPPP includes "transportation property." Transportation property includes, in turn, aircraft used in the trade or business of transporting persons or property. In contrast, Certain Aircraft generally includes aircraft that do not qualify as transportation property.

For an aircraft to qualify as Certain Aircraft, there is an additional requirement: the taxpayer must have made, at the time of the contact for purchase, a non-refundable deposit of at least the lesser of 10 percent of the cost of the aircraft or \$100,000.

LPPP, including transportation property, is subject to a special basis rule that does not apply to Certain Aircraft. Under this rule, the qualifying basis eligible for bonus depreciation is limited to the adjusted basis related to manufacture, construction or production before the end of the year in which the binding written contract to acquire the aircraft was entered into. Thus, basis added in later years will not qualify for the bonus depreciation rate applicable to the contract year, but must instead be depreciated using the rate applicable to the year the aircraft is placed in service.

For property constructed by a third party, this basis limitation applies to the lesser of the amount paid or percentage of work performed as of the end of the year in which the binding written contract was entered into. Thus, taxpayers should ensure that their percentage of payments are equal to the percentage of work performed by the end of that year.

For example, suppose an aircraft qualifying as transportation property is subject to a binding written purchase contract prior to the end of 2025, and it is placed in service in 2026. The portion of the basis paid or accrued by the end of 2025 would qualify for 40 percent bonus depreciation under the transition rule, while the basis added in 2026 would qualify for 20 percent bonus depreciation under the standard rule. Note that depreciation is never permitted prior to the date the aircraft is placed in service, so both of these depreciation amounts would be claimed on the taxpayer's 2026 tax return.

EFFECTIVE DATE

The amendments to the depreciation rules are effective for property both acquired and placed in service after Sept. 27, 2017. However, the Act goes on to say that "property shall not be treated as acquired after the date on which a written binding contract is entered into for such acquisition."

Thus, an aircraft subject to a written binding purchase contract on or before Sept. 27, 2017 will be deemed acquired prior to Sept. 28, 2017, and therefore would not be eligible for the new 100 percent bonus depreciation. An aircraft that is both acquired (or subject to a binding written contract) and placed in service on or before Sept. 27, 2017, would be subject to 50 percent bonus depreciation under prior law. However, this rule does not apply to used aircraft that are acquired and placed in service on or before Sept. 27, 2017. For more information on bonus depreciation under prior law, see *IRS: 50 Percent Bonus Depreciation Available for Certain New Aircraft Contracted for in 2017 or 2018 and Placed in Service in 2018*, by Derek Bloom and Scott Burgess at www.nbaa.org/admin/taxes/depreciation/bonus/nbaa-bonus-depreciation-new-aircraft.pdf.

An aircraft that is acquired (or subject to a written binding contract) on or before Sept. 27, 2017, but placed in service after Sept. 27, 2017, is subject to 50 percent bonus depreciation and to phase down and transition rules similar to the phase down and transition rules applicable under prior law. However, given that the definition of qualified property now includes used aircraft, aircraft subject to this rule would appear to include used and new aircraft.

WRITTEN BINDING CONTRACTS

The “written binding contract” requirement is important to (i) the phase-down of bonus depreciation rates shown in the schedule above, (ii) the transition rules for LPPP and Certain Aircraft discussed above, and (iii) the effective date requirement discussed above. The requirement, which has been in the law for many years, generally means that the purchase contract must be enforceable under state law. However, § 1.168(k)-1(b)(4)(ii) of the IRS regulations adds the requirement that if the contract provides for liquidated damages imposed on the buyer, the amount of the liquidated damages must be at least five percent of the total contract price. It is not clear whether this requirement also applies to liquidated damages imposed under the contract on the seller.

REQUIREMENTS REGARDING PREDOMINANT BUSINESS USE AND USE OUTSIDE THE U.S.

The Act does not change the requirements to use the alternative depreciation system under IRC § 168(g) (which requires the straight-line method over the class life of the property) if the aircraft fails either (i) the requirement in IRC § 280F that listed property, such as aircraft, be used predominantly for qualified business use in any taxable year or (ii) the requirement in IRC § 168(g)(1) that tangible property, such as aircraft, be used predominantly inside the U.S.

The predominant business use requirement in IRC § 280F is particularly onerous for aircraft owners who lease the aircraft to a related party, because currently the IRS appears to take the view in that situation that all use of the aircraft by a five-percent owner or related persons must be excluded from the numerator in determining the qualified business use percentage. Aircraft purchasers who wish to take advantage of 100 percent bonus depreciation must still comply with these requirements.

APPLICATION TO PRE-OWNED AIRCRAFT

Bonus depreciation was originally intended to apply (with some exceptions, such as aircraft operated by the manufacturer as a “demonstrator”) only to factory-new property. The Act extends bonus depreciation to property acquired by the taxpayer so long as the property “was not used by the taxpayer at any time prior to such acquisition.” This means that pre-owned property can also be subject to 100 percent bonus depreciation. The application of this to aircraft, however, may lead to some uncertainty. Aircraft buyers often select aircraft to purchase precisely because they are familiar with them, perhaps because they chartered the aircraft or rode on the aircraft when it was owned by a friend or business associate. It is not clear whether such flights will count as prior “uses” by the buyer that would disqualify the aircraft from eligibility for 100 percent bonus depreciation.

STRAIGHT LINE ELECTION FOR ENTERTAINMENT DISALLOWANCE

The revival of 100 percent bonus depreciation in the Act presents an opportunity for taxpayers that use their aircraft to a significant extent for nondeductible entertainment travel. Under § 1.274-10(d)(3)(i) of the IRS entertainment disallowance regulations, a taxpayer can claim 100 percent bonus depreciation on a new aircraft but elect to apply the annual entertainment use disallowance percentages to depreciation on the aircraft calculated on a straight-line basis. This regulation caps the entertainment disallowance with respect to depreciation in each year to the amount of depreciation actually deducted in that year. Due to this cap, the entertainment disallowance with respect to depreciation is zero in all years after the year in which 100 percent bonus depreciation was

deducted. Furthermore, the entertainment disallowance with respect to the first year is relatively minimal, since it is calculated by multiplying the entertainment disallowance percentage in the first year by only the straight-line depreciation amount in that year. While the better strategy for tax purposes is not to use the aircraft for entertainment flights in the year that 100 percent bonus depreciation is claimed, this election provides an opportunity for taxpayers who use their aircraft for entertainment flights in such year to minimize the entertainment disallowance. For more information on this election, see *Final Regulations on Entertainment Use of Business Aircraft*, by Ruth Wimer and John B. Hoover (March 11, 2013), available at:

www.nbaa.org/admin/taxes/personal-use/jobs2004/

ELECTION OUT OF BONUS DEPRECIATION

While the straight-line election for entertainment disallowance purposes discussed above is intended to maximize tax deductions, some taxpayers may prefer to avoid reporting 100 percent bonus depreciation due to the concern that it may increase the chance of an IRS audit. Such taxpayers can elect out of accelerated and bonus depreciation and instead depreciate their aircraft using the alternative depreciation system (straight-line method over its class life). This approach has the advantage of allowing taxpayers to avoid the complexity of the IRC § 280F predominant business use test as well as the rule that only aircraft used predominantly inside the U.S. may qualify for accelerated depreciation.

Additionally, the Act does allow a taxpayer to elect to use 50-percent bonus depreciation for qualified property placed in service by the taxpayer during the first taxable year ending after Sept. 27, 2017.

LIKE-KIND EXCHANGES

Under prior law, when property (including business aircraft) held for productive use in the taxpayer's trade or business or for investment is exchanged for property that is "like-kind," a special rule under IRC § 1031 provided that no gain or loss was recognized to the extent that the replacement property was also held for productive use in a trade or business or for investment purposes.

The Act provides that only real property can qualify for like-kind exchange treatment. As a result, taxpayers will no longer be eligible to defer taxable gain on the sale of aircraft via a like-kind exchange, and therefore the gain on the sale of the aircraft will be fully taxable. This provision is effective for transfers after 2017 and is a permanent repeal of the application of IRC § 1031 rules to exchanges involving aircraft and other tangible personal property.

However, a transition rule preserves like-kind exchanges of personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before Dec. 31, 2017. Thus, the gain on an aircraft sold in December of 2017 pursuant to a properly structured exchange can qualify for like-kind exchange treatment under the prior rules of IRC § 1031, even though the replacement aircraft is purchased in 2018, as long as the other requirements for a like-kind exchange are met.

100-percent depreciation of new and used property helps to compensate for the repeal of like-kind exchanges for tangible personal property, though unlike such repeal and as noted above, 100 percent expensing is scheduled to be phased out beginning in 2023.

DEPRECIATION TABLES (FIVE-YEAR PROPERTY)

Assuming a taxpayer purchases a \$10 million aircraft and qualifies for the five-year MACRS depreciation, the following tables compare depreciation deductions under 100 percent bonus depreciation, 50 percent bonus depreciation, five-year MACRS and six-year ADS. The tables also assume that the mid-quarter convention does not apply, which would reduce the payment in Year 1 and increase payments in subsequent years.

100 Percent Bonus Depreciation

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Basis	0 (after bonus)	0	0	0	0	0
Depreciation Percent	100%	0	0	0	0	0
Depreciation Expense	0	0	0	0	0	0
Bonus Depreciation	\$10,000,000	0	0	0	0	0
Total Depreciation	\$10,000,000	0	0	0	0	0

50 Percent Bonus Depreciation

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Basis	\$5,000,000 (after bonus)					
Depreciation Percent	20.00%	32.00%	19.20%	11.52%	11.52%	5.76%
Depreciation Expense	\$1,000,000	\$1,600,000	\$960,000	\$576,000	\$576,000	\$288,000
Bonus Depreciation	\$5,000,000	0	0	0	0	0
Total Depreciation	\$6,000,000	\$1,600,000	\$960,000	\$576,000	\$576,000	\$288,000

Five Year MACRS (Half-Year Convention)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Depreciation Basis	\$10,000,000					
Depreciation Percent	20.00%	32.00%	19.20%	11.52%	11.52%	5.67%
Depreciation Expense	\$2,000,000	\$3,200,000	\$1,920,000	\$1,152,000	\$1,152,000	\$576,000
Bonus Depreciation	0	0	0	0	0	0
Total Depreciation	\$2,000,000	\$3,200,000	\$1,920,000	\$1,152,000	\$1,152,000	\$576,000

Six Year Straight-Line ADS (Half-Year Convention)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Depreciation Basis	\$10,000,000						
Depreciation Percent	8.33%	16.67%	16.67%	16.67%	16.66%	16.67%	8.33%
Depreciation Expense	\$833,000	\$1,667,000	\$1,667,000	\$1,667,000	\$1,666,000	\$1,667,000	\$833,000
Bonus Depreciation	0	0	0	0	0	0	0
Total Depreciation	\$833,000	\$1,667,000	\$1,667,000	\$1,667,000	\$1,666,000	\$1,667,000	\$833,000

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About NBAA

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