

TAX ROULETTE: BUYING A BUSINESS JET IN 2017 – WHY FOLLOWING THE PATRIOT’S EXAMPLE MAY LEAD TO A JACKPOT

Authors

Beate Erwin
Stanley C. Ruchelman

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Five-time Super Bowl champions the New England Patriots have earned a new title: the first team in NFL history to buy their own fleet of planes. The aircraft – two Boeing 767s – were purchased from American Airlines and retrofitted with all first-class seats,¹ to provide the team a more comfortable mode of transport to and from out-of-town games. While the decision to own a plane is unique for an NFL team, it is not unheard of in other major U.S. sports franchises. NBA and NHL teams in Dallas and Detroit have all turned to private aircraft for team travel,² and other teams may be wise to follow suit. Earlier this year, American Airlines announced that it will be dropping charter services for six NFL teams during the 2017-2018 season. A spokeswoman for the airline attributed the decision to a desire to “ensure we have the right aircraft available for our passenger operation.”³ Nonetheless, these teams will be seeking alternative transportation, and a number of political and economic factors indicate that 2017 may be the right time to purchase a private jet for business use.

The current availability of tax benefits like a 50% bonus depreciation allowance and Code §179 expensing election, along with the potential for a large-scale overhaul of the U.S. tax code, could lead to a “perfect storm” of tax savings for aircraft purchasers in 2017.⁴ If the Trump administration is able to push the president’s tax reform plan through Congress, the combination of significant tax savings in the current year and lower tax rates in future tax years could enhance the benefits of buying a business-use aircraft this year, before the changes take place.

BUSINESS EXPENSE DEDUCTION

Apart from the obvious convenience and the potential adjustments to accommodate needs specific to athletes (think of the size of the average athlete compared to a plane seat in the coach section), ownership of a plane may come with some additional tax benefits. Standard benefits include tax deductions for business expenses such as food, beverages, medical supplies, and other items consumed during business flights and flights to a game. These are tax deductible whether the plane is chartered or owned. However, plane owners should also be able to deduct expenses for ordinary maintenance, hangar costs, pilots, insurance, and Federal Aviation Administration compliance.

¹ [“Patriots Become First NFL Team to Have Own Planes.”](#) *ESPN*, August 9, 2017.

² [“Patriots Become First NFL Team to Own Team Jet for Travel.”](#) *New York Daily News*, August 8, 2017.

³ [“American Airlines Drops Charter Flights for Six NFL Teams Including Dolphins and Steelers.”](#) *Forbes*, April 15, 2017.

⁴ The following assumes that the aircraft is placed into service in the year of acquisition (*i.e.*, 2017).

DEPRECIATION DEDUCTION

One of the biggest aircraft expenses – and thus tax deductions – is depreciation. Since the useful life of a business jet extends over many years, the I.R.S. will not allow a full write-off of the purchase price in the year of acquisition. However, a write-off exceeding actual depreciation in the market may be granted. The standard straight-line schedule – that is, the Alternative Depreciation System (“A.D.S.”) under Code §168(g) – requires an annual deduction of equal amount over an extended period of time. However, many businesses can write off an aircraft in only five to seven years using a schedule published by the I.R.S. under the Modified Accelerated Cost Recovery System (“M.A.C.R.S.”).⁵ In many cases, this accelerated, front-loaded schedule allows a taxpayer to write off more than half of the aircraft’s adjusted basis – generally the purchase price – in the first two years. In addition, costs for upgrading the plane (e.g., the Patriot’s retrofitting of the seats) should qualify as capital improvements that are eligible for a depreciation deduction.

BONUS DEPRECIATION

In order to “accelerate purchases of equipment, promote capital investment, modernization, and growth, and . . . help to spur an economic recovery,”⁶ Congress has provided an additional first-year depreciation allowance (“Bonus Depreciation”) for certain property placed in service during the calendar years 2008 through 2019.⁷ For 2008 through 2017, Bonus Depreciation is usually 50% of the adjusted basis of “qualified property.”⁸ The allowance is reduced to 40% for items placed in service during 2018 and 30% for items placed in service during 2019 and, under certain circumstances, 2020.⁹ Under current law, the allowance disappears at the end of 2019.¹⁰ Only new planes – unlike the ones acquired by the Patriots – predominantly

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⁵ Code §168; Treas. Reg. 1.168(a)-1 et seq.

⁶ HR Rep. No 251, 107th Cong., 1st Sess. 20 (2001).

⁷ Code §168(k)(1). Bonus Depreciation provisions initially applied to an earlier period, which has expired, and Congress has repeatedly deferred the sunset date of the current bonus. See, e.g., Pub. L. No. 114-113, Div. Q, §143, 129 Stat. 2242 (2015); Pub. L. No. 111-312, §401(a), 124 Stat. 3296 (2010); Pub. L. No. 111-240, §2022, 124 Stat. 2504 (2010); Pub. L. No. 111-5, §1201, 123 Stat. 115 (2009); Pub. L. No. 110-185, §103, 122 Stat. 613 (2008). In many instances, the allowance expired a year or more before Congress restored it retroactively. See Rev. Proc. 2016-48, 2016-37 IRB 348, §4 (guidance on issues arising from retroactive restoration of allowance for 2015).

⁸ Code §168(k)(1)(A). Note that Bonus Depreciation is not allowed in determining earnings and profits.

⁹ Code §168(k)(6).

¹⁰ The phaseout rules generally provide an extra year of Bonus Depreciation for qualifying aircraft. E.g., 30% Bonus Depreciation is available if a written binding contract is signed before the end of 2019 and the aircraft is put in service in 2020. A contract is binding if it is enforceable under state law and does not include any liquidated damage clause that amounts to less than 5% of the aircraft or equipment sales price. Additional requirements are set forth for non-commercial aircraft (such as (i) a non-refundable deposit greater than 10% of the aircraft price and capped at \$100,000, (ii) a purchase price of more than \$200,000, and (iii) a production period for the aircraft that exceeds four months).

used within the U.S. qualify for this rule.¹¹ Depreciation is not increased but accelerated under this provision. This is a cash-flow benefit in the form of reduced tax payments in early years of ownership but not necessarily a financial statement benefit. A deferred tax liability arises immediately in the form of reduced depreciation for income tax purpose in later years, which leads to increased tax payments for those years. Increased tax payments in future years are booked as a liability for the year in which accelerated depreciation is claimed. This is discussed in greater detail below.

CODE §179 DEDUCTION

To eliminate the burden of maintaining depreciation accounts for items of personal property with relatively small value, the statute permits taxpayers to elect to expense limited amounts of depreciable personal property.¹² Eligible property is generally depreciable personal property that is acquired by purchase for use in the active conduct of a trade or business. If certain requirements are met (see the limitation described below), the acquisition of an aircraft may qualify for the Code §179 deduction. Unlike the Bonus Depreciation, the Code §179 deduction is also applicable to the purchase of used aircraft. This deduction is subject to an annual dollar limitation, reduced by a phaseout amount. Both the dollar limitation and the phaseout amount have varied over the years in response to shifting political and economic pressures.

In the Protecting Americans from Tax Hikes (“P.A.T.H.”) Act of 2015,¹³ the dollar limitation was permanently set at \$500,000 and the phaseout amount was set at \$2 million, both indexed for inflation and possible adjustment.¹⁴ Until made permanent, these amounts are the same as the ones temporarily allowed from 2010. For 2017, the inflation-adjusted dollar limitation is \$510,000 and the phaseout amount is \$2.03 million.¹⁵ The phaseout provision provides that the dollar limitation for any taxable year is reduced, dollar for dollar but not below zero, to the extent that the cost of the qualifying Code §179 property placed in service during such taxable year exceeds the phaseout amount.¹⁶ The operation of this limitation is illustrated below.

Example 1

In 2017, Taxpayer A purchases a plane for \$350,000 and puts it in service the same year. No other qualifying purchases are made in this year. Taxpayer A may elect to deduct the entire \$350,000 in the current year.

Example 2

The facts are the same as in Example 1 except that Taxpayer A purchases

¹¹ In determining whether an aircraft has been predominantly used within the U.S., the I.R.S. applies a test under which an N-registered aircraft (*i.e.*, an aircraft registered in the U.S.) is required to make, on average, a flight to or from the U.S. at least once every two weeks over the course of a year.

¹² Code §179(a).

¹³ P.L. 114-113, §124(a)(1) and (2), Div. Q.

¹⁴ Code §§179(b)(1), 179(b)(2).

¹⁵ Rev. Proc. 2016-55, 2016-45 I.R.B. 707.

¹⁶ Code §179(b)(2).

an additional \$2.5 million of qualifying property. Therefore, the deductible amount is zero (\$510,000 limitation reduced by \$850,000, excess of the cost of qualifying property, \$2.85 million, over the \$2.03 million phaseout amount in 2017).

The amount eligible for the expense election cannot exceed the taxable income from any active trade or business of the taxpayer for the taxable year. In other words, a loss cannot be generated by means of this deduction. However, unused amounts can be carried forward.¹⁷ If a taxpayer qualifies for M.A.C.R.S., Bonus Depreciation, and the Code §179 deduction, the latter is to be applied first, followed by Bonus Depreciation and finally M.A.C.R.S. In applying the latter two, the basis must be adjusted appropriately each time expensing and depreciation deductions are claimed. See Example 4, below.

M.A.C.R.S., BONUS DEPRECIATION, AND THE CODE §179 DEDUCTION LIMITATIONS



The 50% Bonus Depreciation deduction and the Code §179 deduction are subject to the “more than 50%” M.A.C.R.S. rules. If a taxpayer is under the more-than-50% threshold (explained below), it may not deduct Bonus Depreciation or utilize the Code §179 deduction and is subject to the considerably slower depreciation schedule under A.D.S.¹⁸

In 1984, Code §280F was enacted to prohibit taxpayers from using the beneficial M.A.C.R.S. to depreciate assets that frequently are used for business and personal use. These types of assets are called “Listed Property,” a term that encompasses certain motor vehicles, photographic equipment, computer equipment, and aircraft. Code §280F shares the same policy as the hobby loss rules where taxpayers claim deductions for businesses that do not generate net operating income and reflect activities customarily found in hobbies, such as farming or horse raising. Under Code §280F, Listed Property must be predominantly (*i.e.*, more than 50%) used for a qualified business in order to qualify for M.A.C.R.S. depreciation. If the qualified business use falls below the threshold, the taxpayer must utilize A.D.S., which provides for longer recovery periods.

Language intended to limit potential abuse in this context comes with one specific exception: If aircraft is used at least 25% for qualified business purposes, leasing or compensatory flights of a 5% or more owner can be treated as qualified business use.¹⁹ This is a huge exception for business aircraft owners. If the aircraft ownership is structured carefully, the owner is able to include certain personal flights in the calculation to reach the “more than 50%” threshold that triggers the ability to use M.A.C.R.S., Bonus Depreciation, and the Code §179 deduction for aircraft.

The following examples illustrate the availability of benefits with and without the exception.

¹⁷ Code §179(b)(3).

¹⁸ Code §280F(b)(1).

¹⁹ Code §280F(d)(6)(C)(ii). The exception also covers leasing to a 5% or more owner of the aircraft company and compensation for any other person under certain circumstances.

Example 3

Taxpayer A is the sole member of Aero L.L.C. Aero L.L.C. purchases a plane for \$1,000,000 in October 2016. Taxpayer A determines that in 2016 the use of the plane is divided as follows: 37% business flights, 28% personal non-entertainment flights, 25% personal entertainment flights, and 10% maintenance flights. Without the exception, 37% of the flights would be categorized as qualified business use. Consequently, Taxpayer A would not be eligible for Bonus Depreciation or the Code §179 deduction in 2016. Thus, Taxpayer A's allowable depreciation in 2016 would be \$83,333 (*i.e.*, \$1 million depreciated over a period of six years under A.D.S. applying the half-year convention = \$1 million / 6 x 0.5).

Example 4

The facts are the same as in Example 3. However, because of the exception for aircraft, Taxpayer A is allowed to count both personal non-entertainment flights (28%) and business flights (37%) as qualified business use, thereby comfortably satisfying the more than 50% M.A.C.R.S. threshold. As a result, the taxpayer may also take advantage of both accelerated first-year deductions, which results in an allowable deduction of \$578,750 in 2016 on that same \$1,000,000 plane (*i.e.*, \$500,000 from the Code §179 deduction, \$75,000 from the 50% Bonus Depreciation, and \$3,750 from 5% M.A.C.R.S. depreciation in first year of a five-year period). This is nearly 58% of the total cost – a huge difference.

It should be noted that any excess depreciation taken under M.A.C.R.S. must be recaptured in income. A similar recapture rule applies to Bonus Depreciation and Code §179 deduction.

RECAP UPON THE SALE OF THE AIRCRAFT

Typically, accelerated depreciation deductions come at a price. As mentioned above, depreciation is a timing deduction that allocates the cost of a wasting asset to each year of its useful life. Nonetheless, it is a zero-sum computation over the useful life of the asset. As a result, if a greater amount is allocated to an early year of useful life, a reduced amount must be allocated to a later year. Consequently, accelerated depreciation merely results in a deferral of tax. However, many entrepreneurs look at deferral as the equivalent of absolute savings in tax – as if the day of retribution never arrives.

In any event, in the later years of useful life the tax is increased because depreciation is pushed to earlier years, and upon the sale of the aircraft, tax benefits generated by the depreciation deduction, Bonus Depreciation, and the Code §179 result in increased recognition of gain. The I.R.S. computes any taxable gains or losses on the sale by subtracting the aircraft's "adjusted basis" from the sales price. Generally, the starting point for the adjusted basis is the purchase price. However, the aircraft's adjusted basis will be reduced each year by the amount of depreciation taken as a deduction, as illustrated below.

Example 5

A used plane is sold for \$710,000. It was originally purchased for \$1,000,000



and depreciation deductions since acquisition amount to \$762,500. Hence, the adjusted basis is \$237,500. The gain on the sale is \$472,500 (*i.e.*, \$710,000 less \$237,500).

The gain on the sale is entirely related to the depreciation recapture. Accordingly, it will be treated as ordinary income, subject to income tax at a rate of up to 43.4%²⁰ for individuals (*e.g.*, if owned via an L.L.C.). To the extent the gain exceeds the depreciation recapture, it be treated as capital gain and taxed at 20%²¹ if the asset was held for more than 12 months (long-term capital gain). Thus, the owner must be able to sell the aircraft for a price exceeding the acquisition price (*i.e.*, more than \$1,000,000) after a one-year holding period.

Nonetheless, there is a happy ending for an entrepreneur. If, instead of a sale, the owner exchanges the plane for another aircraft used in his or her trade or business, the gain may be rolled over through a carryover basis in the newly acquired aircraft under certain circumstances. While a full analysis of this option is beyond the scope of this article, a common example helps to illustrate this principle. Readers who have traded-in an old car at the time of acquiring a new one from a dealer may have recognized that local sales taxes are not imposed on the credit for the trade-in. The same general principle applies to a like-kind exchange under Code §1031 for depreciable property used in a trade or business. Because that section imposes several hurdles before gain is deferred on an exchange of property, taxpayers should seek advice before making such a decision.

BENEFITS UNDER PROPOSED TAX REFORM

If a taxpayer is already on the fence about making a new aircraft purchase, upcoming changes to the Bonus Depreciation regime are a serious consideration for the timing of the investment. While the benefits of Bonus Depreciation have been set to expire each year since 2012 only to be renewed by Congress, some commentators anticipate that the phaseout under the P.A.T.H. Act will not be extended as a means of “paying for” a general reduction in tax rates. Further, there is a possibility that Congress will repeal the accelerated depreciation incentive after the 2017 tax year if the expected overhaul of the tax code is successful. Even if an overhaul does not occur, the current timeline for the expiration of these benefits places a new sense of urgency on business owners trying to decide on an aircraft purchase.

Currently, if aircraft owners in an L.L.C., partnership, or S-Corporation recognize gain from recapture of depreciation at time of sale, that gain is treated as ordinary income and is taxed at ordinary income rates (as high as 43.4%). Under President Trump’s proposal, most corporate tax expenditures would be eliminated,²² while or-

²⁰ *I.e.*, the progressive income tax rate of up to 39.6% plus 3.8% Net Investment Income Tax under current law.

²¹ This rate applies to individuals in the highest tax bracket (*i.e.*, those with taxable income exceeding \$418,401 in 2017 as single filers or \$470,701 for couples filing jointly).

²² An exception applies to the research and development credit and expenditures for capital investments by manufacturing companies (subject to the condition they forego the deduction for interest expense). For a breakdown of the proposal as of early 2017, see “Trump and the Republican-Led Congress Seek

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dinary income from L.L.C.’s, Partnerships, and S-Corporations would be taxed at the new corporate rate of 15%.²³ If an aircraft owner is able to deduct depreciation on the acquisition cost of the aircraft now and use the deductions against income taxed at a 43.4% rate while being subject to a 15% tax rate on the recapture of depreciation upon the sale of the aircraft in future years, a net tax savings of 28.4% will be realized.

Compare this with the consequences of tax reform under the House Republican Tax Reform Blueprint (the “Blueprint”), a plan released in June 2016 by the G.O.P.-led House Ways and Means Committee. According to the Blueprint, the cost of capital investment would be fully and immediately deductible rather than depreciated over time. Unlike the president’s proposal, the immediate expensing of capital investment would be automatic, thus a taxpayer would not be required to make an election in order to expense the cost of the capital investment. Such expensing would be available for all business investments (including tangible and intangible assets) other than land. The intended effect of immediate expensing is to transform the U.S. corporate tax system from income-based to cash-flow or consumption-based. The costs of acquisition would be 100% tax deductible in the year of acquisition. The tax rate would be reduced to 20% for corporations and 25% for L.L.C.’s, partnerships, and S-Corporations, resulting in a net effective tax rate of 20% and 25%, respectively, upon sale of the aircraft (sale price less adjusted basis of zero).

While the Blueprint offers an even greater incentive in particular for large scale capital investments, it remains to be seen whether a lower tax rate in combination with this significant acceleration of deductions could find a majority in Congress to pass the required legislation. A reduction in individual and corporate income tax rates by itself is already subject to heavy discussions. Taxpayers may choose the bird in the hand over the two in the bush.

CONCLUSION

The current tax environment provides the opportunity to purchase business-use aircraft, new or used, and deduct a significant amount of the acquisition cost in 2017. With the top tax rate at 43.4% on ordinary income for high earners, every deduction counts in reducing what could amount to a massive tax burden.

A significant future reduction in tax rates could also benefit aircraft owners if taxable income is reduced at the current higher rates and lower rates apply when the recapture of depreciation occurs upon the sale. While there are no guarantees that there will be a major overhaul to the U.S. tax code, signs point in that direction. Both the White House and House representatives have repeatedly signaled their commitment to realize this plan. If a taxpayer has ever considered an aircraft purchase or postponed the decision to find the right time, this may be the best opportunity in a decade to capitalize on the tax benefits to make that purchase.

Overhaul of International Tax Rules.” A later version, released on April 26, 2017, did not bring further illumination to the president’s plans.

²³ Most recently, President Trump reconfirmed his plan for a 15% rate on August 30, 2017.