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TAX REFORM 201: AIRCRAFT ACQUISITION AND THE "LEASING TRAP" IN A WORLD OF 100% BONUS DEPRECIATION

The 2017 Tax Cuts and Jobs Act provides a wonderful opportunity for business aircraft purchasers of both new and pre-owned aircraft to take 100% bonus deprecation on the aircraft purchase price in the year of acquisition pursuant to Section 168(k), provided that the aircraft is placed in service for business use in that year. This purchase incentive, designed to spur economic activity in equipment sales, can serve as a valuable tool to free up capital and encourage business investment and activity. As business aircraft owners are well aware, depreciation deductions are subject to limitation based upon the aircraft use profile, but a straight-line election is available pursuant to Reg. 1.274-10, which can preserve close to full depreciation deductibility for almost all business aircraft with a mixed-use profile, provided that the aircraft is predominately a business tool. Simple, right? Not so fast. For the unwary, what the Congress giveth, the IRS taketh away. All prospective business aircraft owners must be aware of the potential trap of Section 280F.

UNDERSTANDING ACCELERATED DEPRECIATION AND SECTION 280F

Unlike the new bonus provisions enacted in December 2017, Section 280F has limited the depreciation deduction and expensing election of certain "listed property" for over twenty years. In 1984, Congress enacted Section 280F to prohibit taxpayers from depreciating certain assets on an accelerated schedule (MACRS), including business aircraft, when such aircraft are used half or more for personal purposes. Section 280F requires that in order to depreciate a business aircraft under MACRS (or to receive bonus depreciation) in any given tax year, more than 50% of the use of the aircraft needs to be use in a trade or business of the taxpayer, with at least 25% of the use meeting a more narrow definition of "qualified business use (QBU)." The legislative history of Section 280F clearly indicates that the provision was intended to limit deductibility based upon personal use of the aircraft by "owners and related parties" but the highly technical provision has, in recent years, been read by the Internal Revenue Service to create a trap for aircraft subject to a leasing arrangement between related companies. This technical reading can cause fully substantiated business flights to be deemed non-QBU and can lead to disallowance of the bonus depreciation taken on the aircraft, a significant economic consequence. Efforts by leading practitioners to seek either a technical correction or corrective legislation to fix this reading have not been successful to date. Accordingly, Section 280F is properly viewed as an additional hurdle to cross, in addition to the requirements of Section 162 (ordinary and necessary business expenses) and Section 274 (substantiation of business use by passenger seat) in order to protect aircraft depreciation deductions.

Qualified Business Use and the Leasing Trap

So, what exactly is "qualified business use" under Section 280F? QBU is business use of the aircraft that is not: 1) use of aircraft to provide compensation to any person who is a 5% owner or more of the company, or a related person, 2) use of the aircraft to provide compensation to any other person unless an amount is included in the gross income of such person with the respect to the use and withholding that was done by the partner, or 3) the leasing of the aircraft to any person who owns 5% or more of the taxpayer, or to any related person (within the meaning of Section 267(b) of the IRC). On its face, 280F seems reasonably designed to deny accelerated forms of depreciation to business aircraft that are not used at least 25% of the time for non-compensatory use by owners and their family members or leased to such people to be used personally. However, when applied in a technically restrictive manner, as has been IRS practice, Section 280F can serve to exclude clear business use from QBU treatment.

Why? Leasing arrangements between related companies are common practice in business aviation operations. These leasing arrangements are often a FAA requirement to establish operational control of the aircraft, or they meet other important business and tax objectives. When the leasing QBU exclusion is read broadly, it treats all flights, regardless of their business objective, as non-QBU if the entity leasing the aircraft from the aircraft ownership entity is a 5% owner, or a related party pursuant to Section 267(b). Section 267(b) allows the IRS to look through ownership structures to attribute entity ownership, deeming the leasing activity between two companies with common ownership non-QBU use. For example, an aircraft LLC that is a separate taxpayer may lease the aircraft to an S-Corporation for the S-Corporation's clear business use such as calling on clients or traveling between business locations. This leasing structure may have been established for a variety of common business concerns, including liability protection or confidentiality. While such use is clearly business, the lease may, depending on entity ownership, exclude the trips from "QBU" treatment for that necessary 25%.

The IRS has left some room for portions of related-party leased flights to be considered QBU by allocating seat hours or seat miles of non-owner business passengers aboard leased business flights. This methodology, delineated in Technical Advice Memorandum 200945037, is complex and requires sophisticated recordkeeping paired with knowledgeable counsel. The seat mile or seat hour methodology must be applied consistently across flights in the tax year to determine eligibility for MACRS.

So, May I Take Bonus Even if I Have a Mixed-Use Profile?

280F was not designed to convert a business asset subject to the benefits of 168(k) bonus and 179 expensing into non-MACRS eligible property. While this article highlights significant concerns that 280F poses, knowledgeable tax counsel should be able to navigate you through these traps to preserve the deductions available even when your aircraft is used for a variety of business and non-business purposes. It is critical that 280F be considered at the initial planning and structuring stages of the aircraft acquisition in order to prevent exposure to the traps. Additionally, careful monitoring of aircraft usage, especially in the year bonus depreciation is taken and the years immediately succeeding the bonus year is critical both to determine eligibility and to adjust the usage mid or late year to preserve deductions. Flight tracking software that includes passenger information is a critical tool in preserving the tremendous value of the depreciation deductions Congress clearly intended for business aircraft. No business aircraft owner wants a few additional passengers or year-end flights to cost the business's ability to take accelerated depreciation deductions.

Thinking Ahead

The Tax Reform and Jobs Act provides an economic opportunity for businesses to become more productive and efficient through the use of general aviation business aircraft, perhaps more affordably than ever before. The next couple of years may provide a once in a lifetime opportunity to begin, expand, or upgrade your general aviation fleet. Through thoughtful planning beforehand coupled with assisted contemporaneous monitoring of use, your company can avoid falling into an unforeseeable tax trap, allowing you to spend more time up focused on your business and enjoying your aircraft and less time arguing with the Internal Revenue Service.

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Advocate Consulting Legal Group, PLLC is a law firm whose practice is limited to serving the needs of aircraft owners and operators relating to issues of income tax, sales tax, federal aviation regulations, and other related organizational and operational issues.

This article provides an introduction to a complex, and often ambiguous, area of law. Knowledgeable people may disagree as to outcomes in particular cases. Always consult with your advisor.