Impact of Tax Cuts and Jobs Act: Focus on Non-Traditional Aircraft Ownership Structures

By George Rice and Alvaro Pascotto[1]

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Introduction

The Tax Cuts and Jobs Act (the "Act") signed into law on Dec. 22, 2017, brings with it many new and improved benefits for businesses organized as corporations. Most notably, the advent of 100 percent expensing, or "bonus depreciation," may well prove to be an economic boost to many corporations. This feature, combined with the new and dramatically lower corporate tax rate of 21 percent and the elimination of Alternative Minimum Tax on corporations, should provide a whole new era of corporate tax planning and financial growth. However, some provisions in the Act are likely to present challenges for business aviation, including the repeal of like-kind exchange provision for personal property.

Prior to the Act, the tax planning options for aircraft owned in non-traditional ownership structures, including family offices and other special purpose entities, family trusts or individually, were limited when compared to aircraft owned directly by a trade or business entity.

Under the Act, aircraft owned in such non-traditional structures will face additional tax planning challenges. Of concern is the elimination of the entire category of miscellaneous itemized deductions as well as new limitations on noncorporate business losses.

Repeal of Miscellaneous Itemized Deductions Subject to 2 Percent Floor

Until the passage of the Act, individual taxpayers had been allowed to deduct a broad range of miscellaneous itemized deductions (MID), including unreimbursed employee business expenses, and expenses paid for the production of income (i.e., investment advisory fees, certain attorneys' fees, business-related travel deductible under IRC § 212), as well as hobby expenses that are deductible under IRC § 183. All such MID were limited to the aggregate amount in excess of 2 percent of the taxpayer's adjusted gross income for the year. Under the Act, all MID's that are subject to the 2-percent-of-AGI limit are temporarily repealed for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

The deductibility of various expenses outside the context of a "trade or business", but nonetheless incurred in the production of income is provided for under IRC § 212. If such expenses are not deductible "above the line," meaning in the calculation of adjusted gross income on the first page of Form 1040, they are not deductible at all under the Act.

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For example, the cost of using an aircraft in pursuit of portfolio income, such as interest, dividends or capital gains were previously deductible as a MID (to the extent allowed). However, such aircraft operating costs are no longer deductible. On the other hand, the allocation of reasonable travel expenses to an "above the line" activity, such as travel costs in the pursuit of "rental or royalty" income, are fully deductible. As rental income is reported "above the line" on Schedule E, where rent, royalty, partnership and subchapter S income and losses are reported, those reasonable travel expenses would be deductible. The tax courts have generally held that managing even a single piece of rental property provides tax treatment similar to being in a "trade or business."

Prior to the Act, hobby expenses were deductible as MID to the extent there was hobby income. Because aircraft are often owned and operated in leasing structures, there is a risk that upon examination, IRS could determine that the leasing activity is not profit motivated and falls under IRC § 183 hobby loss rules. Under the Act, income earned in a hobby activity remains taxable without any benefit of a corresponding deduction for expenses incurred in conducting the hobby.

In summary, unless the expenses can be allocated to an "above the line" activity, there will be no deduction.

Net Operating Loss Changes

The Act has significantly changed the rules with regard to net operating losses (NOL). The Act eliminates the two-year carry back provisions for NOL's arising after 2017, however NOL's may now be carried forward indefinitely. Previously the carry-forward provision was limited to twenty years. In addition, the NOL that is carried forward can only offset 80 percent of taxable income (determined without regard to the NOL deduction itself) with the balance to be carried in the future. Now the NOL must be carried forward, with the limitation, until it is fully consumed. The effect of these NOL limitations for aircraft ownership structures is more fully explained below.

Limitation of Excess Business Losses for Noncorporate Taxpayers

The Act imposes a limitation on the deductibility of business losses. As described above, any disallowed excess loss is treated as a net operating loss carryover to the following tax year. Under prior law, net losses from business incurred by noncorporate taxpayers, after applying "at risk" and "passive loss" limitations, could be deducted and used to offset all other sources of income in the year, without limitation.

Effective for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, a taxpayer's excess business losses (EBL) are disallowed. EBL is equal to the excess of the aggregate deductions that are attributable to the taxpayer's trades or businesses over the gross income or gain from such businesses, plus $250,000 ($500,000 for a joint return). This limitation is adjusted annually for inflation and is determined at the partner and/or shareholder level.

The implementation of this new excess business loss limitation could have a significant impact on aircraft owned in non-traditional structures, especially when considering bonus depreciation.

For example, an individual owns two profitable businesses organized as S corporations and actively participates in both. S-corporation "A" earns approximately $5 million in net income as does S-corporation "B." The taxpayer decides to purchase a used aircraft for $15 million in S-corporation "A" (which is used 100 percent for business purposes) and elects to take 100 percent bonus depreciation. As a result, S-corporation "A" would flow through to the individual owner a $10 million active loss. At the individual level, this $10 million loss would then be combined with the $5 million of active income resulting in a "excess business loss" of $5 million. The taxpayer, filing a joint return, would only be entitled to a current year loss deduction of $500,000 with $4.5 million of the loss treated as an NOL carry forward to the subsequent years and subject to the limitations of the usage of an NOL discussed above.

Bonus Depreciation

Property acquired and placed in service after Sept. 27, 2017, unless subject to a binding written contract to acquire before Sept. 28, 2017, is eligible for 100 percent bonus depreciation, provided that in the case of listed property such as aircraft, the aircraft is predominantly used in a "qualified business use." The property may be "pre-owed" and still qualify, so long as it was not previously used by the taxpayer or a related party. The 100 percent bonus depreciation provision of the Act is a scheduled phase down to 80 percent starting in 2023 and ending at 20 percent in 2026, after which the provision is set to expire. For more details on bonus depreciation, which is beyond the scope of this article, review NBAA's bonus depreciation resource: **https://www.nbaa.org/bonus-depreciation**

New Restrictions on Like-Kind Exchanges

Only real property now qualifies for like-kind exchange treatment. Given the relatively short depreciable life of an aircraft, and the availability of bonus depreciation, the tax basis of an aircraft is likely to be far lower than its fair market value. In the past, with the use of the like-kind exchange provisions, if the aircraft was sold to trade up, the gain on the sale of the

relinquished aircraft was deferred. This is no longer the case. However, the adverse effect can be reduced (or eliminated) by electing bonus depreciation on the purchase of the new (or used) replacement aircraft.

Business Interest Limitation

Business interest expense was not limited under pre-2018 law. The Act limits the business interest expense deduction to the sum of interest income plus interest expense times 30 percent of adjusted taxable income (but not below zero). This provision only is effective if there is a trade or business. This limitation is applied at the entity level with provisions to prevent double counting which could increase the allowable limit from business interest flowing from pass-through entities. However, the provision only applies to a taxpayer whose average gross receipts are in excess of $25 million.

Other Limitations or Repeals

Entertainment Expenses: Entertainment expenses were previously not deductible unless such entertainment was "directly related" to the active conduct of the taxpayer's trade or business or directly preceding or following a substantial bona fide business discussion "associated with" the active conduct of the taxpayer's trade or business. The Act removed this exception and such entertainment expenses are no longer deductible.

Commuting Expenses: Expenses for travel between an employee's residence and place of employment (i.e., commuting) are no longer deductible under the Act, except as necessary for ensuring the safety of the employee. This applies to any expense incurred, payment or reimbursement for commuting.

Conclusion

While 100 percent bonus depreciation is a very favorable expensing feature for individual taxpayers, especially as it now applies also to used aircraft, the elimination of miscellaneous itemized deductions, the limitation of excess business losses, the business interest limitations, and the other limitations or repeals described above may create additional tax planning challenges. For individual taxpayers, who relied on non-traditional structures to meet their business aviation goals, tax reform creates a new set of challenges to analyze with your advisers.