Aviation Tax Issues From The New Tax Changes: Opportunities, Challenges & Questions
Sue Folkringa, CPA
Wolcott & Associates, P.A. - What We Do

• We are an aviation-dedicated firm of CPAs and accounting professionals.
• Our clients are aircraft owners, operators, and accounting firms that have aircraft owner-clients.
• We specialize in the preparation of aircraft income tax returns, state tax matters, IRS audits, structuring aircraft ownership, and related aviation tax and financial matters.
• We identify, protect and preserve tax deductions for your aircraft and those of your clients!
2017 Tax Cuts and Jobs Creation (TCJA) Act Provisions Directly Affecting Aircraft

- 100% Expensing (Bonus Depreciation)
- Elimination of Like-Kind Exchanges
- Prohibition on Deduction of Employees’ Commuting Expenses
- Disallowance of Entertainment Travel Expenses “Directly Related” to Business
- Repeal of Miscellaneous Itemized Deductions
- Transportation Excise Tax Does Not Apply to Owner Flights on Managed Aircraft
- New Limitations on Interest Deductions
- New Restrictions on Application of Net Operating Losses
New: 100% Expensing for Purchases

- New depreciation rules are effective for property both acquired and placed in service after September 27, 2017
- New rules allow the buyer to write off 100% of the cost of acquiring an aircraft or equipment
- Available for both new and pre-owned aircraft and equipment
- Deduction applies to the year the aircraft/equipment is purchased and placed in service
- Phase down of 20% per year begins in 2023
- Taxpayer cannot have had prior use of the aircraft
One-Year Bonus Extension for “Longer Production Period Property” (LPPP) and “Certain Aircraft”

• LPPP are aircraft used in the trade or business of transporting persons or property. The aircraft must have a production period exceeding 1 year and the aircraft must have an estimated production cost exceeding $1 million. (P121/P135)

• “Certain Aircraft” include aircraft that do not qualify as transportation property, is acquired before January 01, 2027, requires that the taxpayer must have made a non-refundable deposit of at least 10% of the cost of the aircraft, or $100,000. Taxpayer must be the original owner, or if pre-owned, it was not used by the taxpayer prior to acquisition. (P91)

• Additional rules apply for both.
“Longer Production Period Property (LPPP)” and “Certain Aircraft” are eligible for a one-year extension.

<table>
<thead>
<tr>
<th>Property Placed in Service</th>
<th>Standard Rule</th>
<th>LPPP and Certain Aircraft</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sept. 28, 2017-Dec. 31, 2022</td>
<td>100 percent</td>
<td>100 percent</td>
</tr>
<tr>
<td>Jan. 1, 2023 - Dec. 31, 2023</td>
<td>80 percent</td>
<td>100 percent</td>
</tr>
<tr>
<td>Jan. 1, 2024 - Dec. 31, 2024</td>
<td>60 percent</td>
<td>80 percent</td>
</tr>
<tr>
<td>Jan. 1, 2025 - Dec. 31, 2025</td>
<td>40 percent</td>
<td>60 percent</td>
</tr>
<tr>
<td>Jan. 1, 2026 - Dec. 31, 2026</td>
<td>20 percent</td>
<td>40 percent</td>
</tr>
<tr>
<td>Jan. 1, 2027 - Dec. 31, 2027</td>
<td>0</td>
<td>20 percent</td>
</tr>
</tbody>
</table>
Additional Rules and Concerns

• N-registered aircraft must be used predominantly within the U.S.
• Aircraft purchased or subject to a written binding contract on or before September 27, 2017, but placed in service after that date, are eligible for 50% bonus depreciation, and the aircraft must be a new aircraft
• Aircraft must meet the IRC Sec. §280F listed property rules to qualify for 100% bonus or MACRS accelerated depreciation
Sec. 280F Depreciation Qualifications

• 100% Bonus and MACRS Depreciation requires meeting the § 280F predominant business use test

• 280F requires at least 50% qualified business use (QBU) in the owner’s trade or business
  – All business flights count towards the 50% test
  – Personal business flights count if treated as compensatory (SIFL’d)

• Special Rule for Aircraft: There must be 25% QBU by:
  – Business use by persons other than 5% owners
  – 5% owner’s company business use

• Flights qualifying for 25% QBU automatically apply to meet the 50% test
• Many exceptions apply
Sec. 280F Related Party Leasing Structures (a/k/a Leasing Company Trap)

• The Leasing Company Trap is when one company owns the aircraft and dry leases it to a related company or individual who uses it for business and non-business

• For the 25% Test:
  – Non-5% owner business passengers flights are QBU
  – 5% owners and owner-equivalents are not QBU, regardless of business or personal purpose

• For the 50% Test:
  – If 25% test is passed, all 25% passengers are QBU for the 50% test
  – Personal business flights count if treated as compensatory (SIFL’d)

• A lease between a SM-LLC and an operating company is not a Leasing Company Trap lease because the SM-LLC is disregarded for IRS
Sec. 280F Recapture

- If 50% Test is failed, IRS rules require recapture of accelerated depreciation
  - In year 1, use Alternative Depreciation System (straight line over class life)
  - After year 1, recapture “Excess Depreciation” at beginning of year and use ADS
- Excess Depreciation is:
  - Allowable depreciation under accelerated method, minus
  - Allowable depreciation under ADS
- Excess Depreciation is amount after personal/entertainment disallowance
- Failing the 50% Test after plane is fully depreciated can cause recapture
- Recapture of Excess Depreciation is intended to put taxpayer in the same position as if the taxpayer had used ADS from the start
# Available Depreciation Rates

<table>
<thead>
<tr>
<th>Rate</th>
<th>Must Meet Sec 280F Regs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% Bonus on new and used</td>
<td>√</td>
</tr>
<tr>
<td>50% Bonus on new aircraft</td>
<td>√</td>
</tr>
<tr>
<td>MACRS 200% accelerated</td>
<td></td>
</tr>
<tr>
<td>- 5 years for mostly Part 91</td>
<td>√</td>
</tr>
<tr>
<td>- 7 years for mostly Part 135</td>
<td></td>
</tr>
<tr>
<td>ADS straight line</td>
<td></td>
</tr>
<tr>
<td>- 6 years for mostly Part 91</td>
<td>Not required</td>
</tr>
<tr>
<td>- 12 year for mostly charter</td>
<td>Not required</td>
</tr>
</tbody>
</table>
§ 168(k) Bonus Depreciation

<table>
<thead>
<tr>
<th>Bonus</th>
<th>Prior Law</th>
<th>TCJA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relevant Dates</td>
<td>Placed in Service &lt; 09/28/17</td>
<td>Acquired and PIS &gt; 09/27/17</td>
</tr>
<tr>
<td>Rate</td>
<td>50%</td>
<td>100% (through 2022)*</td>
</tr>
<tr>
<td>Elect Out of 100% (Back to 50%)</td>
<td>N/A</td>
<td>Yes, for 1st year ending &gt; 09/27/17</td>
</tr>
<tr>
<td>New or Used Prop</td>
<td>New Only</td>
<td>New and Used</td>
</tr>
</tbody>
</table>

*80% (2023); 60% (2024); 40% (2025); 20% (2026); 0% (2027)
Proposed Amendments & Clarification

- Advocacy by NBAA got airplane issues added to this document
- Proposed Regs issued by the IRS on August 8, 2018
- Examples for such things as placed in service date and original use
- [https://federalregister.gov/d/2018-16716](https://federalregister.gov/d/2018-16716)
Straight Line Election for Entertainment Disallowance

- 100% bonus depreciation renews importance of the Straight line Election for reporting Entertainment Disallowance
- Final entertainment regulations permit election to replace actual depreciation with straight line depreciation in entertainment disallowance calculation
  - Applies to 100% and MACRS accelerated depreciation
  - Available for employer-provided aircraft
  - Probably not useful for sole proprietorship structures
Example: In an effort to take advantage of the 100% Depreciation Deduction, Company Acquires an Aircraft on December 28, 2017 for $10 million

• The company immediately places it in service with a flight of 6 business passengers
• The business flight is followed by a 2017 end-of-year flight with 2 entertainment passengers
• 2017 Business use is 75%, entertainment use is 25%
• Company intends to claim 100% depreciation, less depreciation disallowed by entertainment passenger use
• Entertainment disallowance: $10,000,000 X 25% = $2,500,000
• What will be the reportable depreciation expense for 2017?
Calculating the Depreciation Disallowance

- Aircraft purchased for $10,000,000
- Taxpayer reports 100% Bonus Depreciation
- Taxpayer has 25% entertainment use

**Reporting:**
- Report full depreciation deduction $10,000,000
- Calculate straight line depreciation:
  \[
  \frac{10,000,000}{6 \text{ years}} = 1,666,667; \\
  1,666,667 \times .50 \text{ mid-year convention} = 833,333 \\
  833,333 \times .25 \text{ entertainment use} = 208,333
  \]
- **Net bonus depreciation deduction** $9,791,667

Formula: $10 million ÷ 6 years = $1,666,667;
$1,666,667 x .50 mid-year convention = $833,333
$833,333 x .25 entertainment use = $208,333

Include in Part V Form 4562
2% Effective Tax Disallowance
List as contra-expense in list of other deductions
Increased Risk of Audit when Reporting 100% Bonus Depreciation

- Aircraft are *Listed Property*, and reporting 100% bonus depreciation on an aircraft will be obvious on the income tax return
- Historically, reporting 50% bonus depreciation resulted in a high percentage of examinations
- Expect that the 100% bonus-reporting year will be carefully examined; disallowing a claim of bonus would be a big win for the IRS examiner
- Leasing use will be subject to passive loss limitation scrutiny
- Business use will be carefully examined
  - Audits happen 3+ years in the future
  - Have your documentation in order NOW while you still remember the details
Elimination of 1031 Like-Kind Exchanges
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• Permanent repeal of IRC § 1031 for tangible personal property
• Means no more tax-free exchanges for aircraft after December 31, 2017
• Safe harbor for partially completed exchanges if at December 31, 2017:
  – The taxpayer has disposed of the relinquished property (forward exchange), or
  – Acquired the replacement property (reverse exchange)
  – Requisite agreements and intermediaries must be in place
• Congress believed that the impact to buyers was reduced through 100% expensing
Prohibition on Deduction of Employees’ Commuting Expenses
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• Under previous regulations, employee commuting expenses were deductible as a compensatory fringe benefit (i.e., SIFL’d)
• Amended regulations at Sec. §274(l) now denies any deduction for commuting by employees
• New language: (l) *In general, No deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or other payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee’s residence and place of employment, except as necessary for ensuring the safety of the employee*
• NBAA has requested guidance on this topic
Prohibition on Deduction of Employees’ Commuting Expenses – To Whom Does This Apply?

• Common law employees subject to employment taxes are definitely subject
• S Corp shareholders who are also common-law employees receiving a W-2 form would likely be subject to the new restriction
• Partners or members of entities reportable as partnerships would likely not be subject to Sec 274(l)
• Sole proprietors would likely not be subject to the commuting prohibition
• Independent contractors would also not be likely to be subject to Section 274(l)
• Key word in previous slide: employee
Disallowance of Entertainment Travel Expenses “Directly Related” to Business
Disallowance of Entertainment Travel Expenses “Directly Related” to Business

• Under old rules, entertainment travel expenses were deductible if the entertainment was “directly related” to the conduct to the taxpayer’s trade or business

• Travel directly preceding or following a substantial bona fide business discussion “associated with” the active conduct of the taxpayer’s trade or business, was also deductible

• Under the 2017 TCJA, such deductions are no longer deductible
Repeal of Miscellaneous Itemized Deductions, Including Employee Business Expenses
Repeal of Misc. Itemized Deductions Subject to 2% Floor

• Under old rules, taxpayers could deduct unreimbursed employee business expenses, expenses for the production of income, and deductible hobby expenses (MID’s)
• The deduction was subject to the 2% AGI limitation
• Per 2017 TCJA, MID’s are repealed for tax year beginning after December 31, 2017 and before January 1, 2026
• As a result:
  – The cost of using aircraft in pursuit of portfolio income (interest, dividends of cap. gains) are no longer deductible
  – Hobby income is still taxable, but hobby expenses that were previously deductible as MID’s are no longer deductible (common result of an audit)
  – Attorney fees, investment advisory fees, safe box rental, cost to prepare personal income tax return, unreimbursed business travel, and other such MID’s are no longer deductible
Transportation Excise Tax Does Not Apply to Owner Flights on Managed Aircraft
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• Historically - IRS sought to assess FET on all amounts paid by an aircraft owner/lessee to aircraft management companies that provided support services (e.g., flight crew, maintenance, flight and dispatch support, etc.) provided by the management company to the operator to operate the aircraft.

• Under the 2017 TCJA, IRC §4261 was amended to state that payments to a management company by an aircraft owner (or qualified lessee) for support services for owner/qualified lessee flights on its own aircraft are exempted from FET.

• There are now two requirements to qualify for the exemption:
  – The payments must be amounts paid by an aircraft owner
  – The payments must be for aviation management services or flights related to the owner’s aircraft
Transportation Excise Tax Does Not Apply to Owner Flights on Managed Aircraft

• The new regulations make clear that the provision was intended to not impose FET on the party that brings the aircraft to the management company.

• No additional guidance has been issued, and many questions remain, such as:
  – Does the law apply equally to aircraft operated under both Part 91 and Part 135?
  – “Qualified Lessee” is not defined
  – Inconsistencies between section 13822 and Publication 510 (Rev. March 2018) regarding third-party chartering and fractional programs being covered by the exemption
  – The new law does not clarify who the “owner” is, for example, if the aircraft is owned by a Single-Member LLC, is the owner the SM-LLC or the single member?
  – NBAA and others have requested the IRS provide additional guidance
Business Interest Limitation
Business Interest Limitation

• Beginning in 2018, interest deduction is limited to 30% of “Adjusted Taxable Income”
• Adjusted Taxable Income is computed without regard for:
  – Business interest income or expense
  – Items of income or loss not allocable to the business, such as the sale of assets held for investment
  – Any net operating loss carryback or carryforward
  – Any deduction for certain pass-through income under section 199A (the new 20% qualified business income deduction)
  – Any deduction for depreciation, amortization, or depletion through 2021
Business Interest Limitation

• The interest limitation does not apply to investment interest, and certain other specifically identified types of companies
• Does not apply to small businesses with average annual gross receipts over the prior three years of $25 million or less
• “Quick and dirty” test: Start with annual net income, add back depreciation, and multiply by 30%. The result approximates the total allowable interest expense. Interest, actual or projected, that exceeds the calculation may not be deductible. Analyze carefully.
Net Operating Loss (NOL) Carryforward Limitation
NOL Carryforward Limitation

• IRC Sec. 172 Old Rules:
  – NOLs would carryback 2 years and forward 20 years
  – NOL carryovers and carrybacks could fully offset taxable income (unless certain limitations at IRC Sec 382 applied for post-loss year change of ownership apply)
NOL Carryforward Limitation

- Sec. 172 Amended Rules:
  - Disallow NOL carrybacks
  - No time limit on NOL carryforwards
  - Deduction is limited to 80% of taxpayer’s pre-NOL deduction taxable income
  - Applies to NOL’s occurring in any year beginning January 2018
  - NOL’s existing at December 31, 2017 are not affected by the new rules
- If large bonus depreciation deduction creates a loss, then the carryforward of that loss will be limited to 80%