NBAA

October 5, 2018

Office of Associate Chief Counsel (Income Tax & Accounting)
Attention: Elizabeth R. Binder
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Via regulations.gov portal

RE: Comments on REG–104397–18 (Proposed Regulations Relating to § 168(k)[1] Additional First Year Depreciation Deduction)

Dear Ms. Binder:

The National Business Aviation Association (NBAA) appreciates the opportunity to provide comments on the proposed regulations relating to additional first year depreciation deductions as requested in the *Federal Register* on August 8.

NBAA represents more than 11,000-member companies and is the leading organization for companies that own or operate general aviation aircraft to make their businesses more efficient, productive and successful.

In general, NBAA is supportive of the proposed regulations, however, we believe additional guidance is needed to address application of the requirement that a contract "not limit damages to a specified amount" within the "binding contract" provisions of Prop. Reg. § 1.168(k)-2(b)(5)(iii).

Since the proposed regulations retain the prior definition of a binding contract, we believe this comment period presents an opportunity to address the issue and provide clarity for taxpayers. Under the existing regulations in § 1.168(k)-1(b)(4)(ii), a binding contract is a contract that is binding on the purchaser. However, the regulation as currently drafted, leaves open a potential interpretation that a contract will not be regarded as a binding contract, if it provides for liquidated damages of less than 5% of the contract price in the case of breach by the purchaser *or by the seller*. NBAA requests guidance to clarify that the liquidated damages threshold applies only with regard to breach by the *purchaser*.

While this issue is of specific interest to NBAA members, the impacts are likely applicable to many industries where tangible personal property changes hands among taxpayers.

[1] Unless otherwise noted, section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

Regulatory Analysis

Based on our analysis of the regulatory history, we believe the liquidated damages thresholds should be applicable only with regard to breach by the purchaser.

The definition of a "binding written contract" in § 1.168(k)-1(b)(4)(ii) of the Final Regulations (2006, TD9283) and § 1.168(k)-2(b)(5)(iii) of the Proposed Regulations (2018) is:

> (A) In general. A contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). For this purpose, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable written contract to purchase an asset for $100 and the contract contained no provision for liquidated damages, the contract is considered binding notwithstanding the fact that the asset had a fair market value of $99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation, the contract is not considered binding.

Because only a taxpayer who is purchasing qualified property can realize the benefit of bonus depreciation, the term "taxpayer" in the definition of a binding contract can only mean the purchaser. While this language requires binding contracts to be enforceable against purchasers, it makes no such requirement for sellers. This makes sense as the seller's intent is not relevant to the taxpayer (i.e. purchaser) under the general principle that a taxpayer's financial commitments drive its tax treatment.

This conclusion is supported in Private Letter Ruling 88-200-80 (Feb. 24, 1988) where the IRS provides an analysis of what constitutes a written binding contract for purposes of determining the amount of an investment tax credit. The ruling cites a House/Senate Conference Report which provides the same definition of binding written contract as § 1.168(k)-2(b)(5)(iii) of the Proposed Regulations. In the private letter ruling, the IRS National Office explained that the liquidated damages provision is applicable only to the purchaser:

> [T]he EPC Contract A and the EPC Contract B do not, by their terms, limit the amount of the damages payable by Partnership A and Partnership B [the purchasers]. **The above cited language from the Conference Report that addresses limiting damages to a specified amount pertains to those damages for which the party claiming the benefit of the binding contract rule (i.e., Partnerships A and B) would be liable.**

In the case of bonus depreciation available under § 168(k), only the purchaser is claiming the benefit of the tax treatment which means that language limiting damages to a specified amount should only be applicable to purchasers.

The purpose of the written binding contract provision, as it pertains to § 168(k), appears to be to require that taxpayers are reasonably committed to the expenses and liabilities of a contract, before benefiting from the binding contract treatment. Therefore, the requirement that the contract not limit damages to a specified amount, like the requirement of enforceability, would apply only to purchasers. The liquidated damages threshold seems intended only to identify a circumstance in which a contract is not binding as an economic matter. Since the general rule is that a binding contract is one that is binding on the purchaser, the liquidated damages provision should likewise only require that the contract not permit the purchaser to breach the contract and be liable for only relatively minimal damages.

Conversely, interpreting this language to mean that neither the purchaser nor the seller could limit their damages to a specified amount would be an unreasonable interpretation, because it would be at odds with the deliberate use of "the taxpayer" in the first clause of § 1.168(k)-1(b)(4)(ii) of the Final Regulations and § 1.168(k)–2(b)(5)(iii) of the Proposed Regulations. Had the intent been to create a mutually binding requirement, the definition of a binding contract would more likely have provided that a contract is binding, if it is enforceable under State law against "both parties," or enforceable against "purchaser and seller."

Using the plain meaning of the regulation, the most reasonable interpretation of this language is that the limitation on damages only applies to purchasers. Since the taxpayer is necessarily the purchaser, the limitation on damages only makes sense for purchasers. Thus, the definition of binding contract in the first sentence of § 1.168(k)-1(b)(4)(ii) of the Final Regulations and § 1.168(k)–2(b)(5)(iii) of the Proposed Regulations should be read to mean that a contract is binding only if it is enforceable under State law against the purchaser, and it does not limit damages for which the purchaser is liable to a specified amount, such as liquidated damages, less than 5 percent of the total contract price.

Further, this approach is necessary when looking to the limitation on damages in the context of contractual law. In particular, liquidated damages are permitted only where, at the time of contracting, it would not be practical to estimate the amount of damages required to make the aggrieved party whole. This is the case under the legal theory that contractual damages are appropriate to make an aggrieved party whole, and conversely penalties are void as a matter of law.

Because purchasers, unlike sellers, usually incur actual damages for out-of-pocket expenses, applying the 5% threshold to the seller's default would likely be deemed void as a penalty, and thus disqualify nearly all new aircraft purchases, and many pre-owned aircraft purchases, as binding written contracts. Consequently, applying the limitation on damages to sellers would cause the binding contract definition to foreclose the ability of taxpayers to seek the tax treatment allowed under § 168(k) contrary to the intent of the regulation.

Background and History

In 2003, Treasury issued Proposed and Temporary Regulations § 1.168(k)-1T. Within the acquisition rules of these regulations was the general definition of binding contract. § 1.168(k)-1T(b)(4)(ii) read:

> (ii) Definition of binding contract--(A) In general**. A contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision).** For this purpose, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable written contract to purchase an asset for $100 and the contract contained no provision for liquidated damages, the contract is considered binding notwithstanding the fact that the asset had a fair market value of $99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation **by the seller**, the contract is not considered binding.

During the comment period, a commentator suggested that the definition above be clarified to be only by a breach by the purchaser. Final Regulations TD 9283 (2006) stated in the Preamble:

> The final regulations also modify in three respects the rules contained in the temporary regulations defining a binding contract. First, the temporary regulations provide that if a contract provides for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation by the seller, the contract is not considered binding. A commentator suggested that this rule should apply to a breach or cancellation by the buyer, not the seller. However, the IRS and Treasury Department believe that this rule relates to a breach or cancellation by either party. Accordingly, the final regulations provide that if a contract provides for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation, the contract is not considered binding.

In the Final Regulations, the change made based on the commentator request was to only remove the words “by the seller” from the last sentence. The above statement from the preamble offers no reason for applying the liquidated damages provision to both the buyer and the seller. Furthermore, this edit merely confused the application of the damages provision to the entire definition of binding contract. Where a seller **or** buyer breach causes a refund of all deposits, it may be interpreted to mean that the contract is not a binding contract. However, in the first sentence, the contract must be binding under state law only on the purchaser and the second clause is silent as to whom the limitations of damages prohibition apply.

Legal Theory on Contractual Damages

The general legal principle on damages in the context of contracts is that damages should make the aggrieved party whole for any losses it incurs resulting from the other party's default under the contract. Liquidated damages are generally appropriate when: (1) the injury resulting from the breach is uncertain or difficult to quantify; (2) the stipulated amount is reasonable in relation to the actual or anticipated harm; and (3) the damages are structured to approximate that harm and not as a penalty.

The applicable provisions of the Uniform Commercial Code (U.C.C.) state:

> "Damages for breach by either party may be liquidated in the agreement only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty." U.C.C. §2-718(1).

An example of typical liquated damages contract language is:

> Upon a material default of the Purchaser, Seller, as its sole and exclusive remedy, may: (i) terminate this Agreement, (ii) proceed otherwise to sell or dispose of the Aircraft and (iii) retain the Deposit, which the parties hereto expressly agree is, after prior negotiation between Purchaser and Seller, a reasonable estimate of the damages that would be incurred by Seller in the event of such a breach, and not a penalty. The retention of such amount shall be the sole and exclusive remedy of Seller for a breach by Purchaser under this Agreement.

In other words, liquidated damages are appropriate when it would be impractical to prospectively estimate the amount of damages required to make the aggrieved party whole. In the context of business aviation, the potential damages may vary considerably given that the aircraft market is particularly sensitive to changing economic conditions, relatively few market participants, and at times, rapidly depreciating asset values.

After the parties have entered into a contract for the sale of an aircraft, the seller may forego the opportunity to sell the aircraft to another purchaser. In the event the purchaser defaults, the amount of the theoretical sales price to another purchaser is inherently speculative, so there is not a method for calculating the damages necessary to make the seller whole. Further, should the purchaser default, the value of the aircraft could change significantly, given various market factors, including the risk of an economic downturn, an additional aircraft of that type entering the market, release of a new model, etc.

In the absence of an amount that would make the seller whole for the purchaser's default under the aircraft purchase agreement, purchasers will usually place a deposit in escrow to provide some security for the risks the seller is taking. The amount of the deposit, which can vary considerably, is a commonly

negotiated business point. This deposit is usually paid to the seller as liquidated damages for the purchaser's default under the aircraft purchase agreement.

Unlike sellers, purchasers are unlikely to incur substantial market risks because aircraft values rarely trend upwards. In addition, the purchasers' actual damages are usually readily quantifiable. For example, prior to the purchase of a pre-owned aircraft, purchasers incur specific costs, for example, legal fees to negotiate the aircraft purchase agreement; travel expenses to perform visual inspections, maintenance facility visits to perform technical inspections, etc. These amounts are actual, and readily quantifiable, damages.

An example of typical language that makes the purchaser whole in the sale of a pre-owned aircraft is:

> Failure by Seller to deliver the Aircraft in accordance with the terms of this Agreement, upon the performance by Purchaser of its obligations under this Agreement, or any other material failure of Seller to perform its obligations hereunder, shall constitute a breach by Seller hereunder, and the parties hereto expressly agree that in the event of such breach as Purchaser's sole remedy: (i) Purchaser may terminate this Agreement; (ii) Escrow Agent shall promptly pay the Deposit to Purchaser; and (iii) Seller shall promptly reimburse Purchaser for all out-of-pocket costs and expenses incurred in the drafting, negotiation and performance of this Agreement, including, without limitation, any costs and expenses of Purchaser associated with the Inspection, Test Flight and movement of the Aircraft.

As discussed in greater detail below, an aircraft purchase agreement for a new aircraft would almost universally limit the purchaser's remedy to the return of any amounts it paid to the seller, in addition to an agreed amount of interest.

In consideration of the legal theories on contract damages in the context of the typical practices in business aviation, it would be unreasonable to require a seller to agree to pay damages in excess of 5% of the total contract price for its default under an aircraft purchase agreement in order for the purchaser to qualify for the otherwise expected tax treatment under §168(k). Beyond being out of sync with industry standards, requiring damages in excess of the 5% threshold for the seller's default would likely be viewed as punitive and an unreasonable estimate of the purchaser's exposure to harm, and as such would run the risk of being considered void as a matter of law.

<u>Typical Treatment of Damages in Aircraft Sales</u>

The standard practice in aircraft purchase agreements is to expressly stipulate the damages available to both sellers and purchasers to provide both parties with a degree of certainty as to the damages the aggrieved party may be liable for as a result of its breach of the contract.

In a typical aircraft purchase agreement, in the event of a purchaser's default, the seller is entitled to keep the purchaser's deposit as liquidated damages; and in the event of a seller's default, the purchaser

is entitled to a return of its deposit plus: (i) for a new aircraft, interest on the funds paid to the seller (i.e. the deposit), or (ii) for a pre-owned aircraft, a negotiated reimbursement of certain out-of-pocket costs described above.

These remedies are designed to make each party whole based on its circumstances (i.e. by making the purchaser whole through reimbursement of the purchaser's actual damages, and by making the seller whole by means of an agreed amount representing an estimate of the seller's otherwise speculative damages).

Estimating the seller's damages is appropriate because the seller's potential for injury carries more uncertainty. For example, upon entering into an aircraft purchase agreement, the seller will usually remove the aircraft from the market, make it available for the purchaser's inspection, incur the costs to address any issues discovered in the inspection, and ready it for delivery. This process usually takes several months for pre-owned aircraft, and longer for new aircraft. During that time, the seller has been exposed to market fluctuations that could produce a missed opportunity for a higher sales price before the default or a lower sales price to a subsequent purchaser after the default. Further, the seller has lost the ability to use its aircraft during this time.

Recommendation

In the context of § 1.168(k)-2(b)(5)(iii) of the Proposed Regulations, damages to make a seller whole for a purchaser's default in the amount of the agreed deposit would often satisfy the 5% threshold necessary for binding contracts. If that were not to be the case, the taxpayer has the option to increase the amount of the deposit at risk or forego qualifying as a binding contract.

As described above, sellers in aircraft transactions are unlikely to meet the 5% threshold because they are generally only required to return the deposit with interest for new aircraft sales, or return the deposit and reimburse the purchaser for its out-of-pocket expenses for pre-owned sales.

This means that if the binding contract provisions were interpreted to apply to both the taxpayer and the seller, virtually every new aircraft purchase, and many pre-owned aircraft purchases, would fail to qualify as binding written contracts. Additionally, as described above, requiring such damages may well render the amounts paid to purchasers for the seller's breach unenforceable as a penalty under state law, which is particularly important given that the underlying enforceability of such damages is also a prerequisite for a binding contract under § 1.168(k)-2(b)(5)(iii) of the Proposed Regulations.

From a policy perspective, the determination of a written binding contract should be based on the taxpayer's commitment to the expenses and liabilities under the contract. Accordingly, a taxpayer's contract should qualify as a binding contract so long as the taxpayer is obligated to pay sufficient damages to the seller in the event of the purchaser's default to evidence this commitment, and the contract is adequately enforceable against the purchaser.

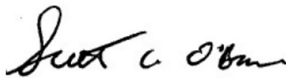
Requiring sellers to *also* meet these requirements would put the taxpayer's tax treatment out of its hands and also be contradictory to the basic contractual limitations on the treatment of damages. Finally, this requirement is impractical, because purchasers simply do not have the bargaining power to negotiate such damages from the seller given the nature of the business aviation industry as described above. The ultimate effect of applying the 5% limitation on damages to sellers, in order for purchasers to qualify as having a binding contract, would be to allow the binding contract definition to foreclose the ability of the taxpayer to seek the tax treatment allowed under § 168(k).

In consideration of the comments above, NBAA respectfully requests that "in the case of breach by the taxpayer or a predecessor" be added after "a specified amount" in the definition of a "binding written contract" found in §1.168(k)-2(b)(5)(iii) of the Proposed Regulations. With this change, the language would read:

> "A contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount **in the case of breach by the taxpayer or a predecessor** (for example, by use of a liquidated damages provision)."

Thank you for your consideration of these comments, please contact me at (202) 783-9451 or sobrien@nbaa.org should you have further questions.

Sincerely,



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