

Bonus Depreciation Entering Annual Phasedown in 2023

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Executive Summary

This article describes the phasedown of bonus depreciation that begins in 2023 and discusses several issues with respect to claiming bonus depreciation during the phasedown period.

Generally, aircraft that are placed in service prior to Jan. 1, 2027, and meet certain requirements are eligible for a one-year delay of the annual 20% phasedowns with respect to bonus depreciation without entering into a written binding contract to purchase the aircraft in the year preceding the year the certain aircraft is placed in service. For aircraft placed in service in 2027, the purchaser must enter into a written binding contract prior to Jan. 1, 2027, to purchase the aircraft to be eligible for the one-year deferral of the placed-in-service requirement in 2027.

YEAR PLACED IN SERVICE	APPLICABLE PERCENTAGE UNDER GENERAL RULE	CERTAIN AIRCRAFT AND TRANSPORTATION PROPERTY
2022	100%	100%
2023	80%	100%
2024	60%	80%
2025	40%	60%
2026	20%	40%
2027	0%	20%*
2028	0%	0%

* To be eligible for the one-year delay in the phasedown for "Certain Aircraft" and Transportation Property, a written binding contract to purchase the aircraft must be entered into prior to 2027 when the aircraft will be placed in service in 2027. In 2018, NBAA published an article, [New Depreciation Rules Under the 2017 Tax Act](#), which stated that entry into such a written binding contract in the year prior to the year the aircraft is placed in service was needed to invoke the one-year delay in the phasedown in all years during the phasedown period. However, as written, the statute providing for a one-year deferral of the placed in service requirement for "Certain Aircraft and Transportation Property" does not impose this requirement.

Background

On Dec. 22, 2017, the Tax Cuts and Jobs Act of 2017 (the "TCJA") was enacted. The TCJA provides for 100% bonus depreciation for the cost of qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023.¹ The TCJA includes an annual 20% phasedown of the 100% bonus depreciation deduction applicable to qualified property placed in service after Dec. 31, 2022.² In other words, qualified property acquired and placed in service in 2023 would be eligible for 80% bonus depreciation, followed by 60% in 2024, 40% in 2025, and 20% in 2026.³

As revised by the TCJA, bonus depreciation applies to qualified property if it meets certain requirements, including the following:

- (i) it must be depreciable property of a specified type, including tangible personal property with a recovery period of 20 years or less, such as commercial and non-commercial aircraft;
- (ii) the taxpayer must be the original user of the property or, alternatively, the taxpayer must not have used the property at any time prior to its acquisition by the taxpayer; and
- (iii) the taxpayer must place the depreciable property in service after Sept. 27, 2017, and before Jan. 1, 2027.⁴

Through the efforts of NBAA and a coalition of general aviation groups, the TCJA therefore permits bonus depreciation for both factory-new and pre-owned aircraft, so long as it is the taxpayer's first use of the aircraft.⁵

Potential Delay of Bonus Depreciation Phasedown

For longer production period property⁶ and certain aircraft⁷, the annual 20% phasedown is effectively delayed one year if such property is placed in service before Jan. 1, 2028.⁸

Transportation Property

"Longer production period property" includes aircraft that are transportation property, meaning that the aircraft is used primarily in the trade or business of transporting persons or property.⁹ For an aircraft qualifying as transportation property to be eligible for the one-year delay of the bonus depreciation phasedown, the aircraft must have an estimated production period exceeding one year and a cost exceeding \$1,000,000.¹⁰ Since non-commercial aircraft usually do not have a production period exceeding one year, it is typically difficult for such aircraft used primarily for charter service (i.e., transportation property) to qualify for the one-year delay applicable to longer production period property.

Furthermore, for transportation property, only the adjusted basis attributable to manufacture, construction or production before Jan. 1, 2027, is eligible for the 20% bonus depreciation available under the one-year delay in 2027.¹¹ Basis added in later years

¹ Tax Cuts and Jobs Act of 2017, H.R.1 – An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018

² IRC Section 168(k)(6)(A)(ii).

³ IRC Section 168(k)(6)(A)(ii)-(v).

⁴ IRC Section 168(k)(2)(A), Treas. Reg. 1.168(k)-2(b).

⁵ IRC Section 168(k)(2)(ii); Treas. Reg. 1.168(k)-2(b)(3).

⁶ IRC Section 168(k)(2)(B).

⁷ IRC Section 168(k)(2)(C).

⁸ IRC Section 168(k)(6)(B).

⁹ IRC Section 168(k)(2)(B)(iii).

¹⁰ IRC Section 168(k)(2)(B)(i)(VI), IRC Section 263A(f)(1)(B)(iii). In addition, the aircraft must be subject to Section 263A.

¹¹ IRC Section 168(k)(2)(B)(ii).

must be depreciated using the rate applicable to the year the aircraft is acquired and placed in service.¹²

Certain Aircraft

“Certain Aircraft” generally includes aircraft that do not qualify as transportation property.¹³ The IRS has historically declined to treat FAA regulations as determinative for tax purposes.¹⁴ However, as a practical matter, Certain Aircraft are aircraft operated by the owner or lessee of the aircraft for its own purposes (which typically means aircraft operated under FAA Regulations Part 91). In contrast, aircraft used to provide charter service (which typically means aircraft operated under FAA Regulations Part 135) would be Transportation Property.¹⁵

For an aircraft to qualify as Certain Aircraft, there are two additional requirements.

First, the aircraft must have (i) an estimated production period exceeding 4 months, and (ii) a cost exceeding \$200,000.¹⁶ The vast majority non-commercial aircraft, including used aircraft, meet the 4 month production period requirement.

Second, at the time of the contract for purchase, the purchaser of the aircraft must make a non-refundable deposit of at least the lesser of (i) 10% of the aircraft’s cost, or (ii) \$100,000.¹⁷ This second requirement has been the subject of debate amongst practitioners since the TCJA was published, but has been particularly relevant with the impending bonus depreciation phase-down scheduled to commence on qualified property acquired and placed in service after Dec. 31, 2022.

There are two critical issues: (i) whether a contract needs to be executed prior to the year the delayed bonus depreciation is being sought, and (ii) whether a deposit is nonrefundable.

As currently written, the statute does not require a written binding contract be entered into prior to the year the delayed bonus depreciation is being sought, except as applicable to aircraft placed in service in 2027 as described below.¹⁸ Under the plain language of the statute and the Treasury Regulations relating to same, a taxpayer may enter into a contract in 2023 with a non-refundable deposit made at that time and be eligible for 100% bonus depreciation in tax year 2023, provided the aircraft is placed in service in 2023. The eligibility for the delayed placed in service date without the need for a written binding purchase contract entered into in the year prior thereto appears to be a Congressional oversight. Nevertheless, the IRS would not appear to have any basis on which to challenge the position due to the plain language of the statute.

The IRS has not defined or otherwise promulgated factors to consider when determining whether a deposit is nonrefundable.¹⁹ Absent any guidance, practitioners should apply a reasonableness standard to mitigate risk when drafting agreements, limiting any refund to action or inaction beyond a purchaser’s control. An aircraft purchaser’s right to a deposit refund upon seller’s default or seller’s inability to satisfy all delivery conditions would appear to have a low risk of a successful IRS challenge regarding whether the deposit was nonrefundable to the purchaser, whereas a purchaser’s right to a refund upon purchaser’s inability to obtain financing may be a higher risk position to take.

Aircraft Acquired and Placed in Service in 2027

For aircraft acquired and placed in service in 2027, the one year delay of the 20% bonus depreciation requires that a written binding purchase contract must be entered into before Jan. 1, 2027.²⁰ A contract is binding only if it is enforceable under state

¹² IRC Section 168(k)(2)(B)(iii).

¹³ IRC Section 168(k)(2)(C)(ii).

¹⁴ Rev. Rul. 78-75, 1978-1 C.B. 340.

¹⁵ Rev. Proc. 87-56, 1987-1 C.B. 27.

¹⁶ RC Section 168(k)(2)(C)(iv).

¹⁷ IRC Section 168(k)(2)(C)(iii).

¹⁸ IRC Section 168(k)(2)(C)(iii).

¹⁹ IRC Section 168(k)(2)(C)(iii).

²⁰ IRC Section 168(k)(2)(B)(i)(III).

law against the taxpayer (or a predecessor) and does not limit damages to a specified amount, such as a liquidated damages provision.²¹ To the extent a contractual provision limits damages to an amount equal to at least 5% of the total contract price, such a provision will not be treated as limited damages to a specified amount.²² While the regulations provide an example where the purchaser fails to perform, it is not clear whether the aforementioned damages requirement also applies to a seller's failure to perform.²³ As noted above, for transportation property, only the adjusted basis attributable to manufacture, construction, or production before Jan. 1, 2027 can be included in the 20% bonus depreciation available for such aircraft acquired and placed in service in 2027.²⁴

Qualified Business Use

Notwithstanding the requirements described above, the aircraft must be predominantly used inside the United States and satisfy the qualified business use requirements.²⁵ For an aircraft to be eligible for bonus depreciation, the qualified business use percentage for the year the aircraft is placed in service must equal or exceed 50%.²⁶ However, under a special rule, the qualified business use threshold for aircraft is effectively reduced to 25%.²⁷ Taxpayers utilizing a disregarded entity structure, who meet the 25% qualified business use threshold, may include as qualified business use for the 50% test any otherwise excluded use (e.g., lease to a 5% owner or related person, personal use properly imputed as compensation).²⁸

Taxpayers should be mindful of potential pitfalls to ensure eligibility for bonus depreciation in the year the aircraft is placed in service as well as to avoid depreciation recapture in any subsequent year.²⁹ One common pitfall is a taxpayer's utilization of an ownership and operational structure where an owner leases the aircraft to a 5% owner or related person. As noted above, use by a 5% owner or related person is not counted for determining the business use percentage for purposes of the 25% threshold.³⁰

Placed in Service

Property is placed in service when it is in a condition or state of readiness and availability for its intended use.³¹ Case law supports the conclusion that an asset is placed in service for tax purposes when it is made available for its intended use on a regular, ongoing basis.³² Where an aircraft is placed in service and subsequently removed from service for repairs, improvements, modifications or maintenance, taxpayers should consult a knowledgeable tax advisor to assess the facts and circumstances relative to the Tax Court's unfavorable ruling in *Brown v. Commissioner*.³³

In *Brown v. Commissioner*, the Tax Court ruled that the taxpayer failed to place the aircraft in service in 2003, since certain

21 Treas. Reg. 1.168(k)-1(b)(4)(ii).

22 Treas. Reg. 1.168(k)-1(b)(4)(ii)(A).

23 Treas. Reg. 1.168(k)-1(b)(4)(ii)(A).

24 IRC Section 168(k)(2)(B)(ii).

25 IRC Section 168(g)(1)(A). Note, other limitations for eligibility of bonus depreciation exist, such as leasing the aircraft to a tax-exempt entity and purchasing with tax-exempt financing.

26 IRC Section 280F(b), Treas. Reg. 1.280F-6.

27 IRC Section 280F(b), Treas. Reg. 1.280F-6.

28 IRC Section 280F(b)(6)(C)(ii), Treas. Reg. 1.280F-6(d)(2)(ii)(B).

29 IRC Section 280F(b)(6)(C)(ii), Treas. Reg. 1.280F-6(d)(2)(ii)(B). Taxpayers utilizing a disregarded entity structure are generally unable to benefit from the 25% qualified business use threshold, as personal use is not imputed as compensation.

30 IRC Section 280F(b)(1)-(2).

31 IRC Section 280F(b)(6), Treas. Reg. 1.280F-6(d).

32 Treas. Reg. 1.167-11(e)(1)(i)

33 *Brown v. Commissioner*, T.C. Memo 2013-275.

modifications to the aircraft in 2004 were necessary to place the aircraft in a condition of readiness for its intended use.³⁴ The Tax Court's ruling emphasized the taxpayer's inconsistent testimony, where the taxpayer testified that the modifications (e.g., adding the conference table and upgrading display screens) were "needed" and "required."³⁵ Practitioners should confirm and carefully document the considerations leading to the conclusion of when the aircraft is made available for its intended use on a regular, ongoing basis. Contemporaneous records and substantiation are certainly best practice.

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³⁴ Brown v. Commissioner, T.C. Memo 2013-275, 41.

³⁵ Brown v. Commissioner, T.C. Memo 2013-275, 41.