

# The Future of Business Jet Sales: Legal, Business and Tax Changes

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## Introduction

"*May you live in interesting times.*" The origins of this proverb are in dispute, as is the underlying tone. Some take it at face value as well-wishing, while others see it as a veiled curse, as in "*May you garner the attention of powerful people.*" One thing is for certain: For those of us who create or rely on the business aircraft market, we are certainly living in interesting times.

The legal, business and tax landscape of general aviation over the last few years has been marked with uncertainty, the unexpected and change, with no let-up in sight. Under these conditions, what are aircraft buyers, sellers and advisers to do? Well, there are decisions made well (based on the information at hand, regardless of the outcome), and there are good decisions (in part due to luck). To help decisions be made well for future aircraft transactions, this article will review recent legal, business and tax events affecting general aviation.

## Uncertain Legal Landscape

### *FAA Reauthorization Lapse*

The Federal Aviation Administration (FAA), which is the agency responsible for the safety of our airways and the efficiency of the air transportation system, has been a political football since President Obama was elected, and for some time before then. FAA programs (NextGen air traffic management) have languished while the political parties joust over budgets. The funding and programs are clearly needed and universally favored. Ironically, the need to upgrade air and ground traffic control systems has been ameliorated by the extended economic downturn that has suppressed discretionary travel.

## The Public Relations War on Business Aviation

It was a challenge to have the name "Monica" in the 1990s, and it is a challenge to be a "business jet owner" today. Business jet owners and hedge fund managers have become shorthand for "people, we can all agree, who need to pay more taxes." The tax changes and their tangible impacts are discussed below. The intangible impact of this demonization is continued pressure to avoid being labeled a business jet owner.

## **Shifting Business Practices**

### *Pricing on New and Used Aircraft*

At some point in 2010 it appeared that aircraft values had found a bottom. The supply of aircraft on the market stabilized, and demand ticked upward. Aircraft loans that spent months in limbo were in "workout" mode and were eventually resolved. Lenders with repossessed aircraft have become more realistic about the value of their collateral, and their willingness to absorb a loss to clear inventory.

At the same time, manufacturers have controlled production to minimize the number of "white tails" (completed aircraft without buyers) by conditioning buyers to aircraft.

Unfortunately, aircraft values seem at best to have flattened out as demand from overseas has failed to take up much slack.

## **Lenders**

The good news is that lenders are back. The underwriting is tighter than it was in 2007, but lenders are returning to what is a lucrative market for good loans. The relative stability of aircraft values has a lot to do with this trend.

Buying a repossessed aircraft from a lender can be an opportunity to acquire an aircraft at a good value, but dealing with lenders, with all due respect, is challenging. Lenders that are involuntary owners due to repossession do not want to warrant clear title to what they are selling, and their documents are onerous. Fortunately, title examination and title insurance can close the gap.

## **Lease Financing/True Leases**

Aircraft acquirers will always have the option of using an institutional financier to purchase their aircraft and lease it to them. In general, it takes the aircraft off the balance sheet, it allows the acquirer to avoid the "business jet owner" label, and it pushes the tax benefits over to the financier. With the future of depreciation in flux, lease financings are going to be a difficult business to price, and presumably leasing companies will protect themselves by shifting the risk of changes in the tax laws to the aircraft acquirer/lessee.

## **Fractional Aircraft Ownership**

The recent difficulties in the whole aircraft ownership market has been a boon to fractional aircraft programs, which, according to the National Business Aviation Association, have seen increased sales and customers moving down from whole aircraft ownership into fractional ownership. According to Steve Santo, CEO of Avantair, "Particularly for public companies or private companies in a heavily scrutinized environment, fractional ownership really presents a number of pluses. First, you can size your ownership to match your actual use so that expensive aircraft are not underutilized. Secondly, for Avantair, our fleet of Piaggio P180s offer significant fuel as well as price advantages while not sacrificing speed or cabin comfort."

## **Charter Activity**

Charter activity is emerging both as a stepping stone to aircraft ownership and as an alternative and step-down option for aircraft owners. If you charter aircraft, then you do not (generally) own the aircraft, and unless you are a hedge fund manager, you are out of the bull's-eye for political and tax pressures.

A charter customer is simply paying a third party for transportation. This is often simpler for tax reporting, income attribution and SEC reporting purposes. As the benefits of aircraft ownership get eroded (by tax changes discussed below), charter may become more popular.

We are seeing a trend where aircraft owners choose to put their own aircraft into charter service and charter back their own aircraft. In addition to the simplicity (for tax and SEC reporting), this structure greatly diminishes the liability profile for the aircraft owner because it is no longer in the business of operating an aircraft.

### **New Aircraft Delivery Positions**

Many new aircraft purchase agreements signed in 2006 through 2008 were deeply regretted in 2009; and with the new deliveries scheduled for 2010 through 2013, there has been a lot of activity as buyers have backed out, renegotiated and assigned contract positions. Pressure points are the larger progress payments, which often force a regretful buyer to act. The draconian anti-assignment clauses that manufacturers put into contracts to prevent profiteering have actually restricted transactions in which the seller was willing to take a heavy loss.

Depending on the circumstances (manufacturer, aircraft model and customer profile) the manufacturers will be flexible, and above all you can expect them to do what makes economic sense for them. That may mean taking customer deposits, terminating contracts and walking away; or it may mean extending terms and allowing contract holders to develop an "exit strategy."

### **Unexpected Tax Events**

#### *Federal Excise Taxes – Expiration and Reinstatement*

Certainly the most unexpected tax event of 2011 affecting private jet chartering (and commercial aviation) was the temporary expiration of federal excise taxes on air transportation services and fuel. Before July 23, 2011, the Internal Revenue Code imposed excise taxes on amounts paid for taxable air transportation of persons and property, and on aviation gasoline and fuel sales. On July 23, 2011, all these taxes expired due to congressional inaction. Accordingly, air transportation providers could not collect these taxes for air transportation services purchased on and after July 23, 2011. However, on August 5, 2011, President Obama signed a law reinstating the taxes as if they had never expired, even though air transportation providers did not (and could not) collect the expired taxes that legally did not exist until retroactively created by law. In light of the fact that no air transportation providers own time machines, the IRS issued a notice that no tax collection or payment will be required on air transportation purchases for which payment was made after July 22, 2011 and before August 8, 2011. The expiration of these federal excise taxes was uncommon, but it could happen again since the law signed by President Obama was only a temporary extension of the taxes.

### **President Obama versus Private Aviation**

Speaking of President Obama, the oddest tax event of 2011 for private aircraft owners was President Obama's proposal to change the tax depreciation deduction schedule for corporate jet owners from five years to seven years in order to reduce the federal deficit.

Under current law, private aircraft used primarily for business can be depreciated for tax purposes over five years, compared to aircraft used primarily in charter or commercially, which can be depreciated over seven years. It was estimated that this change in the tax law would generate \$3 billion in tax revenue over 10 years, which is 0.075% of the \$4 trillion in deficit reduction that President Obama sought. Regardless of the fact that this tax change would generate just a tiny fraction of the \$4 trillion in deficit reductions that are said to be needed by the U.S. government, and that existing policies accelerating depreciation were intended to promote the sale of new corporate jets - most of which are produced in the United States - President Obama repeatedly made a big deal about ending this "tax break for corporate jets." Many business aviation trade groups publicly objected to the president's tax proposal and words, and for tax practitioners, it was very unexpected to see a president discussing tax depreciation schedules. Even stranger was that, not so long ago in December 2010, President Obama signed a law allowing companies purchasing new aircraft to deduct 100% of the cost of a new jet in the first year of ownership instead of taking depreciation deductions over time. So, President Obama supported accelerated, or "bonus," depreciation for new corporate aircraft purchases, but otherwise promotes longer depreciation deduction schedules for corporate jets. This is not a coherent tax policy that allows for taxpayers to make long-term, thoughtful business decisions.

### **Bonus Depreciation**

Bonus depreciation is another area of tax law in flux. Under current tax law, as mentioned above, a company can write off 100% of the cost of a new, qualifying business aircraft purchased, delivered and used in 2011. However, it is only a 50% write-off in 2012. It is also 50% in 2013, but only for certain aircraft and long-term production period property. There is no bonus depreciation in 2014. Got it? Not so fast, because President Obama proposed 100% bonus depreciation for 2012 as part of his American Jobs Act, which has not yet passed into law. Given what we know, it's probably fair to assume that some form of bonus depreciation will continue to apply to the purchase of qualifying business aircraft for several years to come.

### **Federal Income Tax Rates Going Up?**

Are federal income tax rates going? Yes, and maybe no. We know that, beginning in 2013, there is a new 3.8% surtax on investment income (i.e., capital gains, dividends and interest). Also, the "Bush Tax Cuts" are set to expire on December 31, 2012, so unless those are extended again, the highest marginal income tax rate will rise from 35% to 39.6%, and long-term capital gain rates will go up from 15% to 20%.

Historically, most aircraft owners looking to sell a currently owned, depreciated aircraft and also purchase a new aircraft will structure the transaction as a tax-deferred Section 1031 exchange in order to avoid being subject to ordinary income from the sale of a depreciated aircraft through the "depreciation recapture" rules. For example, if a depreciated aircraft is sold, and there is \$10 million of depreciation taken, under current law the seller could be subject to federal income taxes for "depreciation recapture" at a 35% rate (instead of the 15% long-term capital gain rate). In order to avoid this, a seller may engage in a tax-deferred Section 1031 exchange, and just carry over the depreciation taken on the old aircraft into the new aircraft, thus deferring an income tax event until the new aircraft is sold (or deferred again by another Section 1031 exchange). However, in recent years we have seen clients forego tax-deferred exchanges, and instead pay tax on the depreciation recapture now because of concerns about higher income tax rates in the future.

### **State Taxes on Private Aircraft**

Let's not forget the states. As is well known, many states are suffering from budget shortfalls and are looking to generate additional revenue by taxing aircraft through increased sales and use tax enforcement activity. There have also been several misguided efforts by states to impose new aircraft taxes. For example, recently proposed legislation in Massachusetts would subject aircraft to sales tax, and the governor of Connecticut proposed that an annual personal property tax be imposed on private aircraft. Government officials sometimes think private aircraft are just easy sources of revenue, forgetting entirely that private aircraft are movable assets that tend to move away from states with unnecessary taxes, often taking local jobs away in the process. Needless to say, both the Massachusetts and Connecticut tax proposals were abandoned, but there is little doubt that states will continue to test the waters for taxing private aircraft wherever they think they can.

### **Conclusion**

It is never impossible to engage in sound decision-making. Gather facts, analyze carefully, consider contingencies and decide. Whether a well-made decision becomes a good decision will depend on the contingencies and how they develop. When the contingencies underlying a decision (applicable taxes, public perception, residual values and fees) are in flux, well-made decisions may become regretted decisions. Lessons for 2012? Buy an aircraft on the assumption that residual values are likely to be unstable and certainly not rising (but we learned that three years ago). Buy an aircraft if you can absorb the loss of current tax benefits. Buy an aircraft if you can endure the pain of being a labeled a "business jet owner" (or if you are already a hedge fund manager).