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Tax Group Client Alert: Tax Cuts and Jobs Act Implications for Aircraft Portfolio Sales

Congress has passed, and the President on December 22, 2017 signed the Tax Cuts and Jobs Act (the "Act") making very significant changes to the Internal Revenue Code. The Act generally provides lower tax rates for business income and moves towards a territorial type system on foreign earnings within non-U.S. corporate subsidiaries.

Discussed below are some of the provisions most likely to be relevant in the case of portfolio sales of aircraft to U.S. buyers. The focus of the discussion is on portfolio sales of aircraft to U.S. carriers, leasing companies or to U.S. investment funds and investors through ABS and similar structures. The discussion is not intended to address the impact on the aviation industry and aircraft leasing sector more generally.

The discussion does not address state and local tax implications. It is not yet clear to what extent states and localities will conform to, or revise their own tax laws to respond to the federal changes.

Further, the legislative process adopting the Act was unusually rapid for legislation adopting such fundamental changes to the U.S. tax system. The import (and legislative intent) of many of the relevant provisions is not clear in all respects and future technical corrections through legislation or regulatory guidance may change the law and conclusions below.

EXPENSING AND DEPRECIATION

A U.S. purchaser of an aircraft which is placed in service generally may, subject to generally applicable limitations, deduct depreciation using (1) 7 year MACRS if the aircraft is not "predominantly used outside the United States" or (2) a 12 year straight line basis if the aircraft is predominantly used outside the United States.

In the case of aircraft eligible for MACRs depreciation, under prior law it was generally possible to initially expense 50% of the acquisition cost ("bonus depreciation"), although the bonus depreciation percentage was phasing down over a number of years.

The Act will in certain cases permit U.S. buyers of aircraft portfolios to elect higher bonus depreciation (initially, to claim 100% bonus depreciation and fully expense the purchase). This bonus depreciation percentage phases down over a number of years, however. Importantly, and contrary to bonus depreciation rules under prior law, bonus depreciation may now apply to purchases of used aircraft purchased from unrelated parties as well as new aircraft purchases. Bonus depreciation is not, however, available for purchases from related parties so if the seller of aircraft is not a third party entirely unrelated to the buyer this will necessitate a more complex analysis.

Specifically, aircraft purchased and predominantly used within the United States should continue to qualify for MACRS and therefore potentially also qualify for bonus depreciation at the new higher bonus depreciation percentage. Moreover, aircraft predominantly used within the United States should qualify as transportation property, and therefore have a slightly extended timeline for being placed-in-service and qualifying for the range of possible bonus depreciation percentages below:

- in the case of property placed in service after September 27, 2017, and before January 1, 2024, 100 percent.
- in the case of property placed in service after December 31, 2023, and before January 1, 2025, 80 percent,
- in the case of property placed in service after December 31, 2024, and before January 1, 2026, 60 percent,
- in the case of property placed in service after December 31, 2025, and before January 1, 2027, 40 percent, and
- in the case of property placed in service after December 31, 2026, and before January 1, 2028, 20 percent.

As under prior law, aircraft predominantly used outside the United States will not be eligible for bonus depreciation.

More accelerated depreciation permitted by the Act is likely to be beneficial to many institutional U.S. carriers and leasing company buyers who can take advantage of the more accelerated depreciation schedule. Although beyond the scope of this memorandum, full expensing combined with new limitations on interest deductibility discussed below may make leasing of aircraft more attractive than purchases for some potential buyers.

However, the impact on investment fund buyers is complex and more nuanced. An investment fund's investor base typically includes multiple LP investors with different tax profiles (US C corporations, U.S. individuals, pension plans and non-U.S. investors). Individual LP investors are subject to various limitations such as the passive

activity loss limitation and a new business loss limitation (mentioned below) that limit their use of any net losses that may result from more accelerated depreciation which flow through to them from the fund. Tax exempt and foreign investors generally are indifferent about U.S. depreciation. Further, because of tax concerns of the tax exempt investors and non-U.S. LPs, many investment funds invest in aircraft on lease to U.S. carriers using limited life, special purpose "blocker" corporations. It is often the case that even applying regular 7 year MACRS, after deducting interest and other expenses, the "blocker" generates net losses during its initial years and must carry forward the losses to offset positive income in later years after assets are fully depreciated. Further accelerating the depreciation schedule of its portfolio may in some cases merely increase the net losses to be carried forward which could be detrimental because of the taxes incurred when net operating losses are used (as discussed below). Each fund will need to weigh the impact of the bonus depreciation changes on its own disparate investor base given its fund structure which makes it difficult to predict the effect on investment fund's aircraft purchase decisions.

NEW LIMITATIONS ON INTEREST DEDUCTIBILITY

The Act limits the net interest expense deduction for most businesses, regardless of form, to 30 percent of adjusted taxable income (ATI). Taxpayers may, however, generally carry forward any unused business interest expense indefinitely. (Special rules govern the manner in which the limitation will apply to certain pass-through entities and their owners, which this memorandum does not address.) The new limitation replaces prior law Section 163(j).

Net interest expense means the amount of interest paid or accrued by the taxpayer during the tax year, less the amount of interest income includable in the taxpayer's gross income for the year.

ATI generally is a business's taxable income computed without regard to:

- any income, deduction, gain, or loss not properly allocable to a trade or business;
- business interest income and expense;
- any net operating loss deduction;
- the new "qualified business income deduction" (i.e., the new 20 percent deduction for certain pass-through income described below); and
- for tax years beginning before Jan. 1, 2022, any deduction allowable for depreciation, amortization, or depletion.

For tax years beginning in 2018 through 2021, the computation of ATI should approximately reflect a business' earnings before interest, taxes, depreciation, and amortization (EBITDA). During this period, the impact of the limitation may be less material for businesses with substantial depreciation expense. For tax years beginning after 2021, the ATI definition will change automatically. ATI would then approximate earnings before interest and taxes (EBIT), because depreciation, amortization, and depletion deductions will no longer be excluded from ATI. This change generally would decrease ATI and, as a result, decrease the maximum amount of deductible business interest expense.

Other interest rules governing interest capitalization, deduction disallowance, and deduction generally will apply prior to applying new section 163(j), according to the legislative history.

It is unclear whether and how the U.S. Treasury will address non-debt arrangements having time value of money elements (e.g., operating leases) in light of this new interest limitation. Because U.S. aircraft buyers typically incur substantial debt to finance aircraft portfolio purchases, absent any regulatory relief, the new limitations are likely to be detrimental for certain buyers and make leasing rather than purchasing aircraft more attractive given rental expense will remain fully deductible.

NEW NOL LIMITATIONS; REPEAL OF CORPORATE AMT

Prior law permitted taxpayers to reduce taxable income by deducting net operating losses (NOLs), which could be carried back two years and carried forward 20 years. However, the alternative minimum tax effectively limited the benefit of NOLs by imposing an alternative minimum tax (at a 20% rate in the case of corporations) on alternative minimum taxable income. No more than 90% of alternative minimum taxable income could be offset with NOLs. In effect, a 20% tax was imposed on the 10% of taxable income that could not be offset with available NOLs (which could be viewed as an effective 2% "toll charge" tax on the use of NOLs).

The Act generally limits the deduction for NOLs generated in tax years beginning on or after January 1, 2018 to 80% of taxable income (determined without regard to the deduction) for losses. Taxpayers are allowed to carry those NOLs forward indefinitely under the Act but they cannot be carried back as pre-2018 NOLs can under existing law. At a 21% corporate rate, there is effectively an approximately 4% toll charge on using newly created NOLs. On the other hand, the Tax Act also repeals the corporate alternative minimum tax including those provisions that effectively imposed a 2% toll charge tax on the use of NOLs. NOLs generated in taxable years beginning before January 1, 2018, are not subject to the 80% limitation on use.

This change may adversely affect some U.S. aircraft buyers. As mentioned above, investment funds often acquire aircraft portfolios and hold the portfolio (or part of the portfolio) through a special purpose blocker corporation. The timing benefits of accelerated tax depreciation relative to true economic depreciation, combined with interest and other deductible expenses often results in such a corporation generating NOLs in earlier years that is expected to be offset by matching positive taxable income in later years. There will now be a higher cost to using the NOLs carried forward against the future income. The increased cost may lead certain taxpayers to not apply bonus depreciation, or apply bonus depreciation selectively to minimize loss carryforwards and generate additional deductions in years that the taxpayer is likely to otherwise have taxable income.

CORPORATE TAX RATE REDUCTION

After the Act, U.S. buyers that are taxable "C corporations" will be taxed at a lower 21% marginal rate rather than a 35% rate as under prior law. On the one hand, and subject to the potential countervailing impact of other changes described in the memorandum, this will improve the after-tax return of any businesses conducted in U.S. C corporation form. On the other hand, it will reduce the tax-effected benefit of tax "shield" from items like interest and depreciation.

Under the U.S. tax system, in addition to income tax at the corporate level, shareholders are subject to income tax on dividends or gain from disposing of their equity in the C corporation. As a general matter, this will continue to be the case under the Act although non-corporate income tax rates for shareholders that are U.S. taxpayers have also been somewhat reduced for tax years prior to 2026. Non-U.S. shareholders generally will continue to be subject to potential withholding taxes on dividends at the same rates as under prior law.

PASS-THROUGH BUSINESS DEDUCTION AND EXCESS BUSINESS LOSS LIMITATIONS

U.S. buyers that are not C corporations do not qualify for the lower 21% corporate tax rate. However, depending on the business the buyer conducts with the aircraft, whether directly or through pass-through entities, a buyer may be entitled to a deduction that reduces its generally applicable tax rate with respect to that business income.

At a high level, for tax years through 2025, a partner in a partnership that owns an aircraft portfolio used in a qualified business generally may claim a deduction equal to 20% of the business income, reducing its effective individual tax rate on the income. However, this deduction is generally capped based on the partner's share of the greater of (1) 50% of the W2 wages paid by the business to its employees or (2) the sum of 25%

of such W-2 wages and 2.5% of the unadjusted tax basis immediately after its acquisition of all qualified depreciable property used in the partnership business (whose depreciable life is not over). For non-corporate buyers of aircraft portfolios, whose business is often managed by independent contractors like third party servicers rather than employees (and who therefore pay no W2 wages to employees), the annual cap effectively becomes 2.5% of the purchase price of depreciable aircraft portfolio.

The Act also adopted a new rule requiring non-corporate taxpayers to carry forward excess business losses rather than deducting them against other categories of income currently.

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Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Tax Group.

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