Global Transportation Finance Newsletter

August 2018

In This Issue

EU Risk Retention Undertakings in U.S. General Equipment ABS: Evolving Market Practice.

For companies seeking to finance general equipment assets via asset backed securitization (ABS) instruments, risk retention has become an important consideration. In response to the latest financial crisis, both the U.S. and the EU adopted regulations mandating that ABS issuers retain credit risk in such transactions. U.S. companies desiring to market ABS instruments in the EU must be cognizant of the EU risk retention rules, including certain key differences from the U.S. risk retention regime. This article discusses certain of these differences and the evolution of compliance approaches used in the market to date.

Under the European Capital Requirements Regulation[1] (the EU CRR), a securitization is compliant where the originator, the sponsor or the original lender agrees to retain, during the life of the transaction, a "material net economic interest" of not less than 5 percent of the credit risk.[2] Unlike the credit risk retention rules enacted under the Dodd-Frank Act,[3] the EU CRR holds the investor, rather than the issuer, liable for non-compliance.[4] To ensure the originator or sponsor of the ABS maintains this position following closing, the EU CRR prohibits selling, transferring or hedging any of the retained interest during the life of the securitization.

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1 Regulation (EU) No. 575/2013, effective January 1, 2014.

2 EU CRR, Article 405. Similar to the United States, the EU CRR provides for (i) vertical retention of 5 percent of the face value of each class of instruments, (ii) horizontal retention of 5 percent of the first loss position of the entire securitization or (iii) a combination of the two.

3 Section 15G of the Securities and Exchange Act of 1934, as amended, as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

4 EU CRR, Article 405.

Honors & Awards

Chambers USA 2018 Nationwide Transportation: Aviation: Finance ranks Vedder Price **Band 1.** Shareholders Cameron A. Gee, Dean N. Gerber, Geoffrey R. Kass, Ronald Scheinberg and Jeffrey T. Veber are individually ranked. Adam R. Beringer is listed as a Recognized Practitioner.

Chambers USA 2018 Nationwide Transportation: Shipping/Maritime: Finance ranks Vedder Price **Band 2.** Shareholder Francis X. Nolan, III is individually ranked.

Chambers High Net Worth: Private Aircraft ranks Vedder Price **Band 1**. Shareholders Edward K. Gross, David M. Hernandez and Derek Watson are individually ranked as leading lawyers for client services related to private aircraft and wealth management.

In 2018, Mark J. Ditto was nominated for "Best in Aviation" in *Euromoney Legal* Media Group's inaugural *Americas Rising Star Awards*, which celebrate rising attorneys under the age of 40 across a number of practice areas.

A European credit institution or investment firm[5] investing in an ABS will avoid non-compliance penalties by demonstrating that (i) it has undertaken certain due diligence in respect of its investment position, the underlying assets and the relevant sponsor and (ii) the sponsor has explicitly disclosed to the investor that it will retain, on an ongoing basis, a net economic interest of not less than 5 percent in respect of certain tranches or asset exposures.[6] An EU investor satisfies the due diligence requirements by demonstrating a "comprehensive and thorough understanding" of the securitization and having implemented formal policies and procedures commensurate with their investment risk.[7] This means the EU investor comprehends:

- the net economic interest retained by the originator;
- the risk characteristics of the notes the investor plans to purchase;
- the risk characteristics of the loans or leases that are being securitized;
- the reputation and loss experience of previous securitizations issued by the originator; and
- the transaction structure that could have a material impact on the performance of the securities, such as cashflow structures, liquidity and credit enhancements and events of default.

The EU CRR also requires EU investors to review their compliance at least annually.

EU investors rely heavily on undertakings from the sponsor to maintain a comprehensive understanding of the securitization and as a means of obtaining evidentiary support of compliance. U.S. companies have generally followed one of two approaches with respect to these undertakings depending on their marketing needs. U.S. companies not needing to market to EU investors have acknowledged the requirements imposed by the EU CRR, but neither undertook to provide the information necessary for EU investors to satisfy the due diligence and monitoring requirements nor made any representations regarding the regulatory compliance of their investment in the securitization.

On the other hand, U.S. companies needing to attract EU investors have provided robust undertakings

Honors & Awards

Legal 500 US 2018 recognizes Vedder Price as a **Tier 1** firm in **Transport: Aviation and Air Travel–Finance.** Dean N. Gerber and Geoffrey R. Kass are recognized as Leading Lawyers. Robert J. Hankes is recognized as a **Next Generation Lawyer.** In addition, Adam R. Beringer, John T. Bycraft, Mark J. Ditto, Michael E. Draz, Cameron A. Gee, Raviv Surpin and Jeffrey T. Veber are all recommended.

Legal 500 US 2018 recognizes Vedder Price as a **Tier 1** firm in **Transport: Rail and Road–Finance.** John T. Bycraft, Michael E. Draz, Cameron A. Gee and Jeffrey T. Veber are all recommended.

Legal 500 US 2018 recognizes Vedder Price as a **Tier 2** firm in **Transport: Shipping–Finance.** John E. Bradley, Marc L. Klyman and Francis X. Nolan, III are all recommended.

Geoffrey R. Kass has been inducted into the *Legal 500 US Hall of Fame*, an honor for only a select group of *Legal 500* Elite Leading Lawyers recognized over a period of at least six consecutive years.

5 EU CRR, Part One, Title I, Article 4. The EU CRR defines (i) a "credit institution" as an "undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account" and (ii) an "investment firm," by reference to Article 4(1) of Directive 2014/65/EU, as "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis."

6 EU CRR, Article 406.

7 EU CRR, Article 406.

regarding their risk retention position and ongoing compliance. These undertakings included, among others:

(i) to retain, on an ongoing basis, a material net economic interest of not less than 5 percent transaction credit risk, without exception;

(ii) not to sell, hedge or otherwise mitigate the retained credit risk;

(iii) to take further action and provide further information as required to satisfy the EU CRR;

(iv) to confirm in writing continuing compliance with (i) and (ii) on a monthly basis and at certain other times; and

(v) to promptly notify investors if for any reason (A) the risk retainer ceases to hold the required 5 percent retention, (B) the risk retainer fails to comply with the undertakings set out in (ii) or (iii) in any way or (C) any of the representations with respect to the EU CRR contained in the underlying transaction documents failed to be true on any date.

Consequently, in such situations the balance of risk between the investor and the issuer tipped in favor of the investor.

Recently, however, this balance has begun to shift in the opposite direction, as U.S. companies have been able to chip away at these undertakings and still successfully market ABS instruments in the EU. First, there was in practice an implied obligation for issuers to top-up their risk retention to maintain the 5 percent interest during the life of the transaction without exception. However, in recent transactions issuers have mitigated this obligation. Specifically, in the event losses under the underlying contracts cause the retained interest to drop below the 5 percent threshold, issuers have successfully introduced language permitting the risk retention percentage to drop so long as the losses are absorbed by the issuer's first loss position in the retained risk.

Similarly, issuers have obtained carve-outs allowing for decreased retention obligations resulting from amendments to the EU CRR. For instance, if the EU CRR, by way of amendment, repeal or otherwise, decreases the retention requirement from 5 percent, the issuer could decrease its retention obligation accordingly without running afoul of its undertaking. Conversely, issuers have resisted obligations to increase the retained interest if required by amendments to the EU CRR. As a consequence, the monthly confirmations given by these issuers

Honors & Awards

(continued)

Vedder Price advised clients in three *Airfinance Journal* 2017 Deals of the Year.

Editors Deal of the Year – Vedder Price represented Aero Capital Solutions (ACS) in connection with a warehouse facility to finance its mid-life investing strategy, which included many bespoke features designed to facilitate efficient portfolio management by ACS.

Bank Loan Deal of the Year – Vedder Price represented Credit Agricole Corporate and Investment Bank and DVB Bank SE in the pre-delivery payment financing of fifteen Airbus model A320ceo aircraft for DAE Capital.

Used Deal of the Year – Vedder Price represented DVB Bank in a secured term loan financing for Altavair involving two Boeing model 777-200LR aircraft on lease to Emirates.

Industry Leadership

Shareholder Francis X. Nolan, III was elected President of the Maritime Law Association of the United States, the premier professional maritime organization committed to improving maritime law. Mr. Nolan has served on the Board of Directors and as Vice President and Chair of the Marine Financing Committee.

Mr. Nolan was also recently recognized for his work to amend and modernize the Republic of Liberia's maritime laws. Mr. Nolan has now been the principal draftsman of the finance lease of both the Marshall Islands and Liberian maritime laws, two of the world's largest ship registers.

no longer cover undertaking (i). Instead, the issuers only undertake to disclose the current level of retention, whether 5 percent or lower.

With respect to undertaking (iii), issuers have been able to eliminate the obligation to take further action, which correlates somewhat to the elimination of the top-up obligation, and have also limited their obligation to provide further information. With respect to the latter, they have agreed to provide such information only upon an investor's reasonable request and only if it is not subject to any duties of confidentiality.

Finally, the notification obligations set forth in undertaking (v) appear to be disappearing entirely. In some ways this is a natural consequence of the other changes discussed above. For instance, undertaking (v)(A) is no longer relevant if the issuer has the ability to hold less than the required 5 percent under certain circumstances. Undertaking (v)(B) arguably has become unnecessary because of the monthly confirmation of undertaking (ii) and the limitations on undertaking (iii) discussed above. With respect to undertaking (v)(C), its absence seems simply to be a risk investors are willing to bear in light of current market conditions for U.S.-issued ABS instruments.

In conclusion, the evolution of EU risk retention undertakings has allowed U.S. companies to limit their obligations and exposure while still successfully marketing ABS instruments to EU investors. Whether this shift and success will continue will likely be a function of the risk appetite of the underwriters, banks and credit institutions involved in these transactions. In the near term, this almost certainly will be driven (for better or worse) by the continued market "frothiness" for U.S. ABS instruments around the globe.

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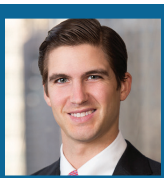

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Recent Speaking Engagements

July 3–4, 2018
Corporate Jet Investor's UK School of Corporate Jet Finance, Surrey

- Partner Derek Watson presented **The Tri-Partite Agreement & Case Study.**
- Shareholder Edward K. Gross presented **Debt Finance.**
- David M. Hernandez participated in three different sessions, **Negotiating an LOI, Managing Risks: What Can Go Wrong?** and a case study on **Managing a Hostile Repossession.**

June 29–30, 2018
Southeastern Admiralty Law Institute, Amelia Island

Shareholder Francis X. Nolan, III, as President of the Maritime Law Association of the United States, was the conference's featured Luncheon Speaker.

June 18–20, 2018
Marine Money Week, New York City

Shareholder Francis X. Nolan, III moderated **What to Do When Cash Flow and NAV Turn Negative**, exploring options available to company owners wishing to avoid exiting at the bottom of the market—from joint ventures to private equity to recapitalization and reorganization.

June 13–14, 2018
Corporate Jet Investor Asia, Singapore

Shareholder David M. Hernandez moderated **The Rise and Rise of the U.S.** where he and panelists discussed:

- What is driving U.S. sales
- Moving aircraft between the U.S. and Asia
- How to bring Asian and U.S. buyers and sellers together culturally

June 4–5, 2018
29th Annual Canadian Airline Investment Forum, Toronto

Shareholder Kevin A. MacLeod moderated a panel discussion titled **The Canadian EETC Saga Continues**, exploring lessons learned from recent Canadian EETC transactions.

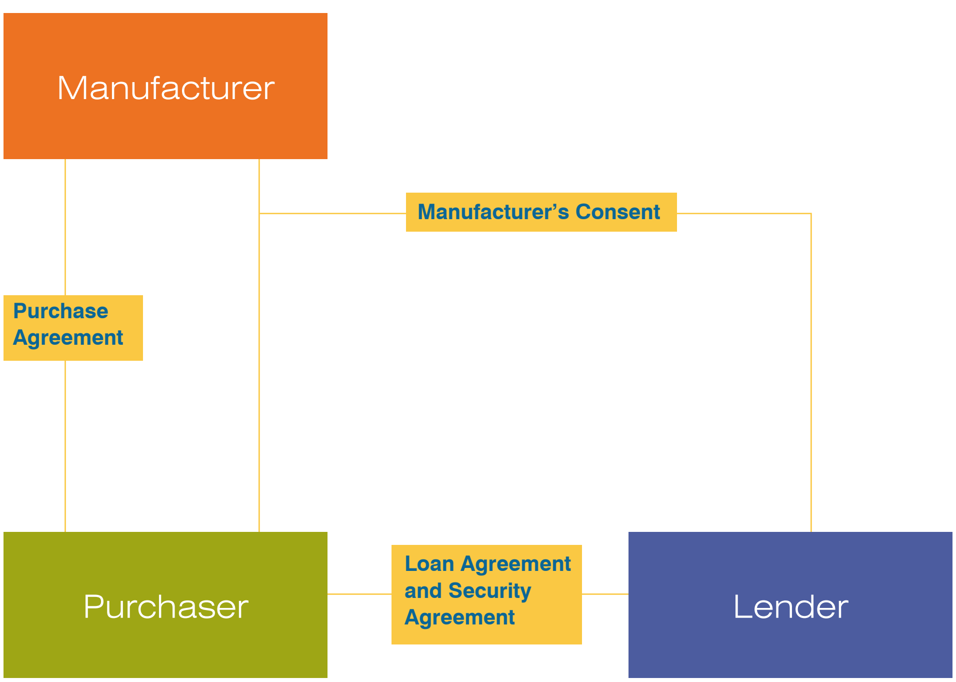
PDP Financing: An Overview

This article discusses pre-delivery payment—or PDP—financing transactions for aircraft. PDPs are progress payments that a purchaser makes to a manufacturer while new aircraft are being built.

The Basic Structure

In a normal PDP financing the lender finances PDPs by advancing a secured loan. Interest is payable throughout the term of the loan and principal is repayable upon delivery of each aircraft securing the loan. The purchaser grants a lien in favor of the lender over its rights in an aircraft purchase agreement. The purchaser also arranges a tripartite agreement with the manufacturer (called a manufacturer's consent or step-in agreement). This includes the manufacturer's acknowledgment of the lender's lien and agreements as to the parties' rights to the aircraft and the PDPs following a default by the purchaser. A structure diagram for a traditional PDP financing is as follows:

Typical PDP Financing Structure



Recent Speaking Engagements

(continued)

May 23, 2018
Marine Money's China Ship Finance & Offshore Summit, Shanghai

Shareholder Ji Woon Kim moderated the session **Optimizing the Structure of Lease Finance**; the event brought together several hundred borrowers, lenders and investors from around the world to network, exchange ideas and learn about the current worldwide ship finance trends.

May 6–8, 2018
Equipment Leasing and Finance Association's Legal Forum, Washington, DC

Shareholders Denise L. Blau, Edward K. Gross and Marc L. Klyman presented on the following topics:

- **The Fruits and Pit(falls) of Tax Reform**
- **Air, Rail, Marine**
- **Securitization**

Event Highlights

5th Annual Women in Transportation Finance Reception

Vedder Price hosted its 5th Annual Women in Transportation Finance Reception on June 13, 2018. Women leaders in the transportation finance industry gathered for a great evening in New York City.

The manufacturer's consent sets forth the price at which the lender can purchase an aircraft if the lender steps in following a purchaser default. The purchase price may be impacted by changes to the aircraft that occur during production, escalation of the purchase price or other factors. Such purchase price adjustments are usually addressed by requiring prepayment of the loan or the posting of cash collateral in the amount of the increased cost.

The lender values its collateral based on the purchase price for the aircraft set forth in the manufacturer's consent, less the amount of "equity" PDPs that have been paid by the purchaser directly. Equity PDPs are not funded by the lender and are applied to reduce the total of the purchase price payable by the lender upon enforcement.

The manufacturer's consent will also contain the manufacturer's agreements not to set off or reapply PDPs and/or an agreement that if it does set off or reapply PDPs it will give the lender a credit for the difference.

Enforcement Mechanics

Manufacturer's consents provide that following either termination of the purchase agreement or an event of default by the purchaser, the lender has the right, but not the obligation, to elect to step in and replace its borrower as purchaser of the aircraft. The consequence of not making this election is often that the lender loses its rights to its already-funded PDPs and its rights in the collateral.

This presents the lender with a difficult choice upon enforcement. It must either step in and be responsible for all of the obligations of the purchaser under the purchase agreement—including an obligation to pay an amount to take delivery of the aircraft that is many times the amount of the PDPs funded by the lender—or walk away from all or a significant portion of its collateral.

If the lender steps in, it will want to be able to dispose of its collateral as soon as possible, by assigning its right to purchase the aircraft before delivery. The lender will not want to wait for the aircraft to be delivered before disposing of its collateral, which may not be for a number of years. Manufacturer's consents often restrict the assignment right, but should allow assignment subject to consent (not to be unreasonably withheld).

Manufacturer's consents also give the manufacturer a "purchase option", giving the manufacturer the right, but not the obligation, to buy out the lender's loan during a relatively short window of time following the lender exercising its purchase right. The buy-out is usually exercisable for the full amount of principal, plus a negotiated amount of interest and other amounts.

Event Highlights

Chi-Stat™ Celebrating Chicago's Commercial Aviation Presence

Vedder Price Sponsored the 24th Annual Chi-Stat Reception on June 6 at Chicago's Landmark Navy Pier

Vedder Price and hosts Nick Popovich, Sage-Popovich; Michael Stern, Stern Consulting Group; Stan Chmielewski, Aircastle Advisor; Chris Cox, Blue Star Aviation; Tom Heimsoth, Willow Aviation Services; Greg May, Delta Air Lines; and over 1,000 industry leading professionals celebrated Chicago's commercial aviation presence.

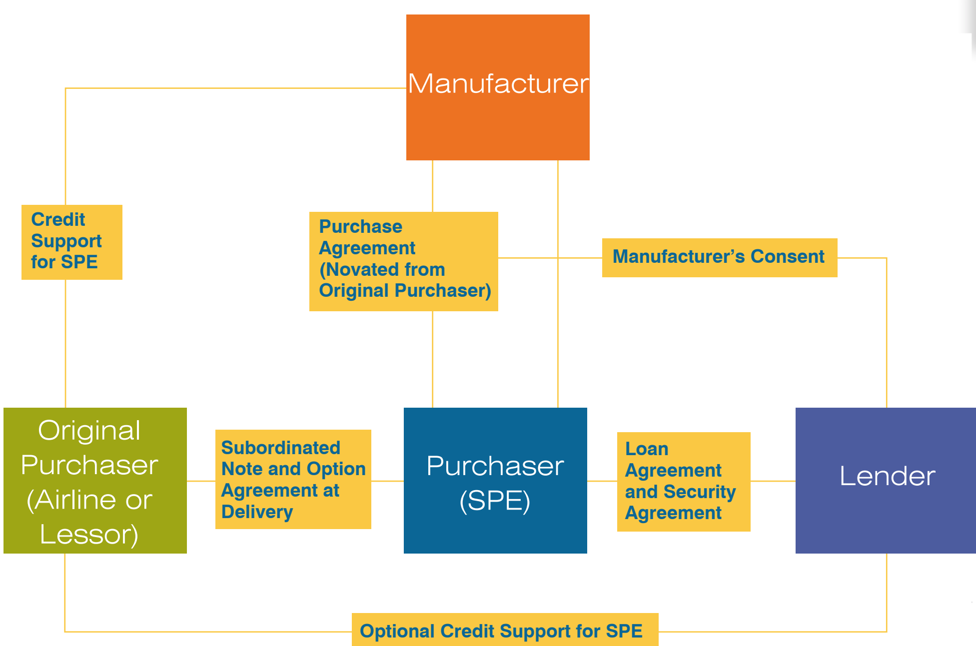
Bankruptcy Issues

Bankruptcy issues are of particular importance in PDP financing. Lenders must rely on general bankruptcy principles dealing with executory contracts, and do not have the benefit of an equivalent of Section 1110 of the Bankruptcy Code, which requires that an air-carrier debtor keep current on its obligations under an aircraft financing or lose the protection of the automatic stay 60 days after the commencement of a Chapter 11 bankruptcy case.

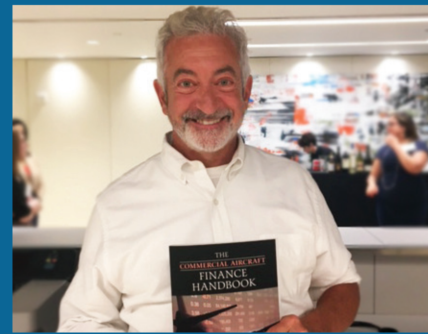
In addition, "claw-back" risk is a concern for both lenders and manufacturers. This arises in the context of a purchaser bankruptcy, where the debtor or administrator of the purchaser's bankrupt estate claims that the manufacturer must repay the PDPs made by the purchaser, leaving either the lender to pay the PDPs to the manufacturer a second time, or requiring the manufacturer to deliver an aircraft for which it has not been fully paid.

Some manufacturers and lenders have been more likely to accept claw-back risk if a "bankruptcy-remote" structure is used. In such a structure the purchase agreement is transferred to a special purpose entity, with the intention that the special purpose entity will be shielded from a bankruptcy of the original purchaser. The idea of using such a structure is to reduce the likelihood of the purchaser becoming bankrupt to such an extent that the allocation of claw-back risk becomes theoretical. A diagram of a typical bankruptcy-remote PDP structure is as follows:

PDP Financing Structure Using Bankruptcy Remote Special Purpose Entity (SPE)



Event Highlights



Launch Party for the Second Edition of the *Commercial Aircraft Finance Handbook*

Colleagues and clients gathered at Vedder Price's New York office on May 3, 2018 to celebrate the launch of the second edition of Shareholder Ron Scheinberg's *Commercial Aircraft Finance Handbook*.

To learn more about *the Commercial Aircraft Finance Handbook* or to purchase a copy, please click here.

Thought Leadership

Shareholder Edward K. Gross and Associate Erich P. Dylus's article from the April 2018 GTF Newsletter ***Aircraft Lender Not Responsible for Customer's Structuring Strategy*** was reprinted in the July/August 2018 issue of *The Banking Law Journal*. The article reviews a recent case between a guarantor of an aircraft acquisition loan and a lender whose outcome serves as an important reminder to lenders, and other financing providers that they should generally refrain from providing structural and/or ownership advice to their customers beyond financing.

Bankruptcy remoteness is more tenable in jurisdictions where courts look solely to formal, documented separateness of the original purchaser and the special purpose entity in considering whether they should be consolidated. Because of this, market practice is to utilize special purpose entities in non-United States jurisdictions with insolvency laws that do not apply United States law "true sale" and "substantive consolidation" concepts, and where the economic substance of the transaction does not play into the separateness analysis. This is particularly the case for transactions where the original purchaser also has no United States nexus.

In light of the possible consolidation risk affecting "bankruptcy remote" PDP structures in some jurisdictions, parties also occasionally resort to alternative financing structures to mitigate the parties' insolvency risks. Some transactions have been implemented that reduce claw-back risk even more than bankruptcy remote structures.

More Information?

The article above is a summary of a more detailed piece that has been published in the Spring 2018 edition of *The Journal of Structured Finance*, which is available at http://jsf.iijournals.com/content/early/2018/04/17/jsf.2018.1.064 (subscription may be required).

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Thought Leadership


Getting the Deal Through has published its annual report, ***Q&A, Marshall Islands***, written by Shareholders Francis X. Nolan, III and Ji Woon Kim, providing international analysis in key areas of law and policy, including vessel due diligence under Marshall Islands law, repayment, registration of vessels, ship mortgages and other liens over vessels, tax considerations for vessel owners and much more.


Getting the Deal Through has also published ***Aviation Finance & Leasing 2018***, which includes "Aircraft operating leases—New York law or English law?," an article co-authored by Shareholder Thomas A. Zimmer and Partner Neil Poland, and a jurisdictional chapter on U.S. law authored by Mr. Zimmer.

Tax Reform's Impact on Transportation Finance Transactions

Overview

New tax legislation was signed into law on December 22, 2017 (the Act).[1] The Act lowers the corporate rate from a top graduated rate of 35 percent to a flat rate of 21 percent. Under the Act individuals and certain non-corporate taxpayers (including trusts and estates) are allowed to deduct 20 percent of "qualified business income" earned through partnerships, S corporations or sole proprietorships, subject to various limitations.

In addition, the Act generally eliminates the two-year net operating loss (NOL) carryback provision for NOLs incurred in taxable years ending after December 31, 2017 but permits indefinite carryforward of such NOLs, subject to a limitation that only 80 percent of taxable income can be offset by NOLs arising in taxable years beginning after December 31, 2017.

Finally, the Act makes a number of additional changes relevant to transportation finance transactions that are highlighted below.

New 100 Percent Bonus Depreciation

In general, the Act expands bonus depreciation rules to permit 100 percent immediate expensing (rather than depreciation over time) of the cost of the certain tangible property, including aircraft, railcars and ships, in each case acquired and placed into service after September 27, 2017 but before January 1, 2023. These bonus expensing provisions begin to phase down by 20 percent each year in which such tangible property is placed into service beginning in 2023.

In addition to immediate expensing of the cost of new property, the Act provides that used equipment is eligible for such bonus depreciation, which is a significant expansion of the bonus depreciation rules. For used tangible property to qualify for bonus depreciation, the taxpayer must have paid or incurred the cost to purchase such tangible property (so that this property is acquired in a taxable, arm's-length transaction), and the taxpayer may not have used this property prior to its acquisition. However, there is no limitation on such expensing with respect to a sale-leaseback of tangible property, even though the user of such tangible property remains the same. Thus, an aircraft that was purchased by a taxpayer could continue to be used by such taxpayer while such taxpayer engages in a sale-leaseback transaction with a third party (perhaps with a goal of repaying the debt that such taxpayer incurred in acquiring such aircraft originally, although such a sale would trigger taxpayer's gain in such aircraft), and such third party would be permitted to immediately expense the purchase price.

The 100 percent immediate expensing under the Act is also available for certain tangible property (other than the aircraft discussed in this paragraph) that is referred to as a longer production period property (LPPP) which (i) is acquired before January 1, 2027 and placed into service before January 1, 2024 (rather than 2023), (ii) has at least a 10-year depreciation recovery period (but not more than a 20-year depreciation recovery period) or is "transportation property" (i.e., property that is used in the trade or business of transporting persons or property) and (iii) satisfies certain additional requirements. In addition, the 100 percent immediate expensing under the Act applies to an aircraft (that is not "transportation property" other than for agricultural or firefighting purposes) which is acquired before January 1, 2027 and that is placed into service before January 1, 2024 if such aircraft has an estimated production period exceeding four months and satisfies certain additional requirements. In the case of both LPPP and such aircraft, the phase down of immediate expensing is by 20 percent each year beginning in 2024 (rather than 2023).

Here is a summary of the bonus depreciation schedule with respect to applicable tangible property:

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[1] All section references are to sections of the Internal Revenue Code of 1986, as amended (Code).

Portion of Cost of Qualified Property Acquired after Sept. 27, 2017 That Is Available for Immediate Expensing

	General rule	LPPP and certain aircraft
Sept. 28, 2017 to Dec. 31, 2022	100 percent	100 percent
2023	80 percent	100 percent
2024	60 percent	80 percent
2025	40 percent	60 percent
2026	20 percent	40 percent
2027	None	20 percent
2028 and thereafter	None	None

It should be noted that 100 percent immediate expensing should be elected with caution. In light of the limitation mentioned above that only 80 percent of taxable income can be offset by NOLs arising in taxable years beginning after December 31, 2017, if this 80 percent limitation is likely to be reached, it may make sense in certain cases not to make this election. After all, if this election is not made, although the depreciation deduction will be taken on a less accelerated basis, this 80 percent limitation may be less likely to apply, and, depending on the facts of any given case, the taxpayer may thus come out ahead.[2]

It should also be noted that some taxpayers may think they qualify for this deduction even in the case of mainly personal use of their means of transportation (such as an aircraft). However, this expansion has application only to property that is predominantly used in a qualified business use in a given taxable year.[3]

Limitations on Interest Deductions

Under the Act, a business may not deduct net interest expense that exceeds 30 percent of business's adjusted taxable income (which is defined generally as EBITDA through 2021, and EBIT thereafter), although the disallowed interest may be carried forward indefinitely. Thus, businesses that seek financing that could be subject to this new limitation on interest deductions may be incentivized not to seek debt financing. Instead, these businesses may consider structuring their financing using a sale-leaseback (or leveraged lease) technique. If such structuring is not available and debt financing is unavoidable, perhaps these businesses could employ rent structuring using Section 467 so as to create deemed interest income that would offset the interest expense from such debt financing (since the 30 percent limitation applies to the net interest expense—i.e., interest expense net of interest income).

Hobby Loss Limitations

Prior to the Act, the hobby loss rules under Section 183 permitted deductions for associated expenses to offset the income from activities not engaged in for profit (i.e., hobbies) of individuals, S corporations, trust and estates, and partnerships.[4] These deductions were treated as miscellaneous itemized deductions and thus, although available, were subject to certain limitations under the Code. The Act has eliminated this deduction entirely for any taxable year beginning after December 31, 2017 and before January 1, 2026. As a result, if an activity is found to be a hobby, rather than engaged in for profit, the income generated by such activity would be subject to tax but no associated deduction would be available within such eight-year timeframe (assuming this change in law is not made permanent). So, it has become even more significant for an activity involving aircraft (or any other transportation vehicle) to be determined to be engaged in a for profit activity, rather than a hobby.

FET Changes

As a general matter, domestic air transportation of persons and property is subject to certain federal excise taxes (FET) under Sections 4261 and 4271, respectively, on the amounts paid therefor. In 2012 the Internal Revenue Service

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[2] The 100 percent immediate expensing election applies to all assets in a given depreciation class, not on an asset-by-asset basis. That is, cherry-picking of assets in a given depreciation class is not permitted.

[3] Qualified business use for this purpose is, with certain exceptions, use by the taxpayer in a trade or business of such taxpayer. Section 280F(d)(6). Also, property is predominantly used for this purpose if the percentage of the use of such property during a given taxable year in a qualified business use exceeds 50 percent. Section 280F(b)(3).

[4] The determination of whether an activity is a hobby generally requires a facts and circumstances analysis, applying various factors. However, there is a presumption that if "gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity," then such activity is not a hobby. Sec. 183(c).

(IRS) issued Chief Counsel Advice[5] advising taxpayers that the management company's services to the owner of the aircraft were subject to FET if the management company made basically all decisions with respect to operation and maintenance of the owner's aircraft, even though the aircraft was not used for charters with third parties. This created significant uncertainty in the transportation industry, although the IRS has since scaled back its audit efforts on this issue. The Act provides much needed clarification. Under the Act, the payments by an aircraft owner (or a lessee that leases the aircraft other than under a disqualified lease)[6] to a management company for services related to maintenance and support of such aircraft or flights on such aircraft are exempt from FET. Also, the Act lists various specific instances of such services, such as provision of pilots and crew, and has a general catch-all for all other services that are necessary to support flights operated by an aircraft owner (or a lessee that leases the aircraft other than under a disqualified lease).

It should be noted that in the legislative history under the Act it is indicated that ownership of stock in a commercial airline and participation in a fractional ownership aircraft program are not intended to qualify one as an aircraft owner, so amounts paid for transportation on such flights continue to be subject to FET.[7]

Elimination of Corporate AMT

The Act eliminates corporate alternative minimum tax (AMT). Before the implementation of the Act, taxpayers subject to corporate AMT avoided acquiring title to capital assets like equipment, since a portion of the associated depreciation was not permitted under corporate AMT. Instead, such taxpayers benefitted, from a tax perspective, by leasing such equipment. Now that corporate AMT has been eliminated, all available equipment financing options should be explored or reassessed.

Elimination of 1031 Exchanges

The Act limits tax-free exchanges pursuant to Section 1031 to real property only (with certain transition rules with respect to exchanges that were initiated on or prior to December 31, 2017). Thus, as a general matter an aircraft can no longer be exchanged for another aircraft without recognition of gain to both aircraft owners in the exchange.

The elimination of Section 1031 exchanges for non-real property is ameliorated by the new provision discussed above permitting immediate expensing of as much as 100 percent of the cost of certain tangible property. Still, the phase down of these bonus depreciation provisions will generally mean that over time transactions may require significant planning to minimize tax impact.

Conclusion

This article is only a brief summary of certain provisions implemented or revised by the Act. Future guidance will hopefully clarify various aspects of the Act and its impact on state or local taxation. One thing is clear, however; the Act represents a major overhaul of the U.S. federal tax system.

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5 Office of Chief Counsel, I.R.S., Chief Counsel Advice No. 201210026 (Mar. 9, 2012).

6 A "disqualified lease" for this purpose is a lease from a provider of management services (or a related person) if such lease is for a term of 31 days or less.

7 Flights under the fractional ownership aircraft program are not subject to FET if such flights are subject to an additional fuel surtax of 14.1 cents per gallon under Section 4043.

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