

December 3, 2017

Fellow AMAC and NBAA Board Members:

This may sound surprising, but as it was passed Friday evening, the Senate's version of the tax bill has what will be some of what I believe to be very negative and perhaps even dire consequences to our industry. These may not have been intended by Congress, but I think they will be very real.

The good:

- The "Bonus Depreciation" piece of the legislation gives a much needed shot in the arm to the manufacturers that have been dealing with a depressed pre-owned market with values at low levels that have made the sale of new aircraft a challenge. This ability for a purchaser of a new aircraft to take all of the depreciation as an expense in year one will of course help that effort along (however see below) and I applaud it. Both the House and the Senate's version of the bill had provisions for this.

The bad:

- Although the House's version of the bill allowed for 100% depreciation in year one for new AND pre-owned aircraft, the Senate's version allowed this benefit only for new aircraft and not pre-owned. Fundamentally I believe this is OK and a sound decision. This is how bonus depreciation has been allowed in prior years, on brand new aircraft only.
- What the Senate's version of the bill went on to do, was to remove the ability for aircraft owners to do IRS Code 1031 tax deferred exchanges. This is not just for aircraft owners, the ability to do these exchanges evaporates for any sort of equipment, but stayed in place for real estate exchanges. Therein lies the flaw with this tax policy. Bonus depreciation on new equipment only and 1031 exchanges on used equipment will now be disconnected unlike years past, in a way that may not be obvious to our lawmakers. In order to sustain a healthy preowned marketplace for ANY market that relies on the residual values of heavy equipment, the two concepts need to be reconnected and continue to function in concert, the same way they have worked together since bonus depreciation on new aircraft has been allowed over the last 10-15 years.

Currently, IRS Code 1031 "Like Kind" exchanges do what their name implies. In abridged terms they allow deferment of tax on gains made by the sale of an asset, as long as the asset is replaced with a like kind asset. Please allow me to provide examples of the profound effects the elimination of 1031 exchanges could have on the aircraft market, both pre-owned and very likely, to the manufacturers (exactly who this was intended to help), and therefore our industry as a whole.

Example of current laws and the proposed Senate bill:

Under the existing laws now, let's assume ABC Company purchased a new or pre-owned aircraft 5 years ago in 2012 for \$30,000,000. They have operated the aircraft for 5 years and taken the benefit of the depreciation expense, and therefore the aircraft is on the books with a tax basis of zero. Let's assume that the current market value of the aircraft is now \$18,000,000. If they decide to replace the aircraft

with a newer, more capable aircraft whether new or pre-owned that costs \$40,000,000 today, they can do a 1031 exchange, sell the \$18,000,000 aircraft at market value, and if executed properly the 1031 exchange precludes ABC Company from paying the recapture on the \$18,000,000 gain. To reiterate, the gain that is deferred is the \$18,000,000 of recapture, because the aircraft is depreciated to zero. There is no negative tax consequence and therefore the incentive to trade up remains driven by the desire or the need to do so. The tax consequence only comes when ABC Company sells their LAST aircraft and they do not replace it.

Here is an example of what this same scenario looks like under the Senate's version of the bill.

When ABC Company sells the \$18,000,000 aircraft, they will be required to pay the recapture, which is taxed as income, not capital gain. So even under the proposed new laws, if a 25% (assume combined state and federal) corporate tax rate is applied, \$4,500,000 in recapture tax is due, and there is no way for it to be avoided. The net proceeds that come to ABC Company from an \$18,000,000 sale would be \$13,500,000. If they are trading up into another pre-owned aircraft, they will not be able to defer the tax as they can under current law using a 1031 exchange. This added cost will serve as a barrier to selling. Buying a brand new aircraft is not an option for everyone for a host of reasons (cost, availability etc), and as used aircraft inventories build, the market could break down.

From bad to worse. The rate reduction delay:

Furthermore, Section 1031 Exchanges on used aircraft under this legislation will be abolished on Jan 1 2018, yet the corporate tax rate reduction to 20% is not scheduled to be reduced until 2019. I cannot fathom the additional calamitous and unknown negative effects this will have on our industry. One would think a transition rule at the very least would make sense here. New aircraft sales depend in large part on the trading of used aircraft among the existing user base. The rate reduction delay has the potential to freeze the market for a year.

WHAT ALL OF THIS MEANS:

- If a current owner who has taken full depreciation wishes to sell their aircraft and upgrade to another pre-owned or new aircraft, there is a dis-incentive to do so equal to approximately 25% (2019 and after, 2018 its roughly 40% depending on state income tax rates) of the sale price of the existing aircraft. Assuming the market hasn't collapsed at this point, it will cost ABC Company \$4,500,000 more than it does today to make this move from a pre-owned to a pre-owned aircraft.
- LESS PEOPLE WILL TRANSITION UP BECAUSE OF THE COST OF RELINQUISHING THE EXISTING AIRCRAFT.
- THE VALUES OF PRE-OWNED AIRCRAFT WILL COLLAPSE FURTHER JUST AFTER THEY WERE BEGINNING TO STABILIZE
- AIRCRAFT THAT HAVE BEEN FINANCED COULD BE DEEP UNDERWATER
- LEASE PORTFOLIO VALUES COULD CRASH AND THE LIQUIDITY AVAILABLE TO FINANCE NEW AIRCRAFT COULD EVAPORATE
- OWNERS WILL HOLD ONTO AIRCRAFT LONGER
- POTENTIAL FOR A FROZEN MARKETPLACE NEXT YEAR AND THE GREATER UNKNOWN NEGATIVE EFFECTS

- Without the ability for aircraft owners to avoid recapture on the existing fleet of thousands of depreciated aircraft, 100% bonus depreciation on new aircraft will act like a Cortisone shot for the manufacturers. It will ease the pain but will not fix the problem, and the pain will come back in much stronger fashion. Manufacturers will be able to book more sales in the short term (maybe), however the values of the preowned aircraft will possibly collapse due to the cost of relinquishing the existing aircraft. The manufacturers collectively have done a commendable job over the last several years of weathering the storm and keeping pricing up as high as they could by refusing to discount new aircraft deeply enough to steal away pre-owned aircraft sales in many cases. They have done this to preserve their pricing and residual values for their organizations and the existing owners of their products. Those efforts and sacrifices may go to waste if residual values crash due to legislation that cripples the residual value of their own products but promotes sale of new aircraft in the short term.
- This industry is a “bottom up” rather than “top down” environment. Aircraft owners typically start small and finish big. Many aircraft owners who currently own large, late model aircraft did not start out there. They started with a smaller aircraft, perhaps they upgraded twice over the years into two different larger and more capable pre-owned aircraft, and finally arrived upon owning the large aircraft. Many of those transactions utilized a 1031 exchange which functioned as a catalyst to making those transactions possible. This progression will now simply be too expensive to do. Paying the recapture each time will just not be feasible. If it is less feasible, there will be less demand to trade up. Less demand to trade up means less transactions, which means lower values
- **If pre-owned values drop as a result of the cost to upgrade, the manufacturers over time will not be able to hold pricing up no matter what tax incentives exist. Therefore, they will not be able to sell new units, putting this industry right back where it started (or worse) by not solving the problem that we thought the tax bill would address, and the manufacturers will be in perhaps an exacerbated position down the road.**
- Less transactions means less:
 - Initial pilot training
 - Financing
 - Pre-purchase inspections and related upgrades
 - Attorney’s fees
 - Pilot and aviation personnel placement
 - Aircraft brokerage fees
 - Issuance of new insurance policies
 - Eventually less new aircraft sales

The above list sums up what all of us on the AMAC rely upon. Currently there are over 4000 corporate aircraft for sale, most of them likely owned by NBAA members. I think this organization owes it to them and the greater NBAA membership as a whole, to get the word out about what this means.

Asset values need to hold for this industry to be healthy. If aircraft wore out every 5 years and were recycled, this might make sense. **But they don't.** NBAA put forward a strong effort late last week and as a result, Senator Inhofe (R-OK) sponsored an amendment to the Senate's bill that proposed keeping 1031 Exchanges intact, but unfortunately the amendment did not get enough traction. I think we as AMAC members and the NBAA owe it to our industry that we all are devoted to, to continue the push and contact our representatives in the House and the Senate while they go through the reconciliation period to finalize this bill. This needs to be immediate, as the reconciliation process may only be a matter of a week or two. Urge them to support our manufacturing base by continuing to offer incentives for the purchase of new capital equipment, **but keep the IRS Code 1031 Tax Deferred Exchange rules in effect for used equipment.**

My guess is that people who deal in any sort of heavy equipment that owners use depreciation as an expense for are waking up to this harsh reality that occurred Friday night. The NBAA ought to make sure that our particular industry stays intact by doing whatever we can to keep 1031 exchanges intact for not just real estate as the Senate bill contains now, but for all sorts of heavy equipment including aircraft.

Best Regards,

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