In the wake of the 2017 Tax Cuts and Jobs Act, the atmosphere surrounding the taxation of business jet acquisitions has been significantly altered, the most important of which is a modification to Internal Revenue Code § 168(k), which now allows for a full 100 percent taxable deduction of the purchase price of newly acquired aircraft.¹ This alteration has shifted aircraft ownership from being an unattainable aspiration to an actuality in the lives of many business owners.² This excerpted paper seeks to analyze these recent tax changes brought about through the TCJA, while applying these changes to the world of aircraft acquisitions.

Relevant Provisions

In the wake of the TCJA, those business professionals who found themselves seeking to make a first-time purchase or upgrade to their airborne transportation turned to tax planning professionals for guidance on how to navigate the numerous restructurings to the tax laws that govern purchases of this nature. Specifically, the TCJA provided numerous tax incentives for businesses to purchase new or used aircraft or upgrade a pre-existing aircraft. These incentives, their implications, and additional Internal Revenue Code (IRC) sections relevant to an aircraft acquisition are outlined below.

Bonus Depreciation: I.R.C. § 168(k)

First, the TCJA allows for an immediate depreciation deduction of 100 percent of the cost of certain qualified property classified as a business expense—including the purchase of an aircraft—for a limited amount of time.³ This deduction, referred to as “bonus depreciation” goes above and beyond typical depreciation allowances offered by the IRC.⁴ Notably, this bonus depreciation deduction for business expenses is limited in time and scope. Specifically, the newly enacted 100 percent bonus depreciation deduction is allowed to be taken by taxpayers for qualified business property that is placed into service after Sept. 27, 2017, and before Jan. 1, 2023. Subsequently, deductions are reduced to 80 percent of the cost of the qualified property in 2023, 60 percent in 2024, 40 percent in 2025, and 20 percent in 2026.⁵ Absent future legislation, the depreciation schedule then reverts back to the original depreciation schedule under §§ 168(a) through (f).⁶

Importantly, there exist certain qualifications an aircraft must meet in order for the aforementioned bonus depreciation deduction to be taken. Under § 168(k)(2)⁷ the aircraft must fit the category of “qualified property.” Fortunately, business aircraft generally meet this requirement.⁸ Additionally, the aircraft must have been “placed in service” within the allotted timeframe.⁹ In order to take advantage of the 100 percent bonus deduction currently available, the aircraft in question must have been placed in service after Sept. 27, 2017, and before Jan. 1, 2023.¹⁰ However, the IRC provides for another year to place the property in service where the property meets the requirements of “longer production period property.”¹¹ Therefore, where property is properly classified as “longer production period property,” the 100 percent bonus depreciation allotment extends through 2023.
For regular “qualified property,” the deadline is then adjusted to Dec. 31 in subsequent years, beginning in 2022, to account for the reduction in the allowable bonus depreciation percentage. Notably, the IRS has issued proposed regulations in which the placed-in-service requirement takes into account situations where a written binding contract exists between the buyer and seller of the aircraft. Therefore, where a written binding contract exists prior to Sept. 27, 2017, and the property is placed in service after this date, the property is only allowed a 50 percent bonus depreciation allowance as governed by the pre-TCJA tax law. The IRS has retained its property is only allowed a 50 percent bonus depreciation allowance requirement to be classified as qualified property, he received a 100 percent bonus depreciation deduction, providing his company with substantial tax savings. Others, like Don Catalano, president of a really company in New York, are planning to upgrade previous business aircraft platforms to bigger, faster, more capable aircraft. Catalano noted his company would never have pursued the purchase of a new aircraft without the changes to the applicable tax law provided by the TCJA, saying, “Would we have wanted it? Yes. Would we have done it? No.” These are two brief examples of companies that have taken advantage of opportunities for tax savings while stepping into (or trading up in) the world of corporate aviation.

Like Kind Exchanges: I.R.C. § 1031

While § 168(k) has allowed for businesses to take significant bonus depreciation deductions—up to the cost of the new or used aircraft itself—the commonly used former method of aircraft acquisition has been repealed by the TCJA. Prior to the TCJA, § 1031 set forth the law of like kind exchanges as applied to aircraft acquisitions; however, this provision can no longer be used as a tool for tax savings when acquiring an aircraft. Formerly, § 1031 allowed a business seeking to upgrade their business aircraft to do so without triggering recognizable gain through trading in their former aircraft to offset the cost of the new aircraft, which allowed for the deferral of taxes resulting from ordinary or capital gains. This was possible because business aircraft generally fell under the category of “like kind” property. As such, instead of selling Aircraft A to fund the purchase of Aircraft B, an entity could simply exchange Aircraft A in part for Aircraft B. This would then allow the entity to avoid the taxable gain from the sale of Aircraft A. However, after 2017, aircraft transactions no longer fall under the umbrella of like kind property, as the amended § 1031 limits like kind exchanges to those involving real property. Therefore, § 1031 is no longer of use to businesses seeking to limit or defer taxable gain throughout the course of an aircraft acquisition.

Business Entertainment Allowance: I.R.C. § 274

While the TCJA has been widely recognized for its generous bonus depreciation rules under § 168(k), and the repeal of § 1031 for all exchanges other than those dealing in real property, the TCJA made additional, lesser known changes that affect aircraft acquisitions. First, the rules governing the expensing of business entertainment costs have been amended through the new legislation. Specifically, business entertainment expenditures that were formerly treated as deductible under § 274(a) if they were “directly related to, or in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with the active conduct of the taxpayer’s trade or business …” are no longer offered deductions. Alongside this change, the TCJA eliminated the ability of businesses to deduct the costs associated with business aircraft used for entertainment directly related to business activities. Therefore, businesses must now ask the question, “What is
the primary purpose of this trip that requires us to use our company aircraft? Should the answer be strictly business related, the costs of air travel via the company’s aircraft will remain deductible under pre-TCJA tax rules. However, where the answer is tied to purposes of entertainment or personal travel, the trip’s expenses will no longer be deductible. Additionally, the regulations provide for rules governing the air travel of employees and other individuals who are not “specified individuals.” In sum, the TCJA eliminated the ability of a business to deduct expenditures associated with air travel via company aircraft, unless the primary purpose of the incurred expenses are business related.

Limitation on Depreciation Where Certain Property is Used for Personal Purposes: I.R.C. § 280F

Finally, while the TCJA did not amend the relevant portions of § 280F, taxpayers involved in aircraft acquisitions must be aware that such rules still exist and remain relevant. Specifically, interested buyers of business aircraft must understand that depreciation recapture rules under this provision may create complications should the business wish to take the 100 percent bonus depreciation deduction currently allowed by the bonus depreciation rules previously discussed under § 168(k). Under the depreciation recapture rules, there exists a limitation where the business use of listed property is not greater than 50 percent. Specifically, “if any listed property is not predominantly used in a qualified business use for any taxable year, the deduction allowed under § 168 with respect to such property for such taxable year and any subsequent taxable year shall be determined under § 168(g) (relating to alternative depreciation system).” The IRC continues on to explain that where the business use of listed property is not greater than 50 percent. Specifically, “if any listed property is not predominantly used in a qualified business use for any taxable year, the deduction allowed under § 168 with respect to such property for such taxable year and any subsequent taxable year shall be determined under § 168(g) (relating to alternative depreciation system).” The IRC continues on to explain that where the business use of listed property is not greater than 50 percent. Specifically, “if any listed property is not predominantly used in a qualified business use for any taxable year, the deduction allowed under § 168 with respect to such property for such taxable year and any subsequent taxable year shall be determined under § 168(g) (relating to alternative depreciation system).”

Therefore, while § 280F does not directly apply to the acquisition of a new or used aircraft, entities seeking to acquire a business aircraft—while taking advantage of the new bonus depreciation rules—must be cognizant of the fact that the aircraft’s predominant use must be a “qualified business use.” Should the entity not use the aircraft in a manner consistent with the depreciation recapture rules, the original decision to take bonus depreciation will be negated, as the value of the previously taken depreciation deductions will then partially be incorporated into the entity’s gross income, requiring the payment of taxes on such sums.

Conclusion

In closing, there remains no doubt the passage of the TCJA of 2017 significantly overhauled the world of aircraft acquisitions. While the implementation of 100 percent bonus depreciation through the amendments to § 168(k) provided the greatest change, the repeal of § 1031 dealing with like kind exchanges in the aircraft context, and the alterations to § 274 granting business entertainment deductions have proven to be anything but trivial. Overall, the TCJA has seemingly resulted in a taxpayer favorable refurbishment of the IRC when it comes to aircraft acquisitions and the tax implications of such transactions.

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Endnotes

6 The former bonus depreciation schedule afforded qualified property a 50 percent bonus depreciation deduction.
8 See I.R.C. § 168(k)(2)(C) (2018) (This provision provides that aircraft generally fall under the definition of “qualified property” as set forth in I.R.C. § 168(k)(2)(A)).
13 Id. (The placed-in-service deadlines move to Dec. 31, 2022, for the 80 percent bonus depreciation deduction, Dec. 31, 2023, for the 60 percent deduction, Dec. 31, 2024, for the 40 percent reduction, and Dec. 31, 2025, for the 20 percent deduction.).
16 Treas. Reg. § 168(k)-1(b)(4)(ii).
17 Id.
19 I.R.C. § 168(k)(2)(A)(ii) (2016) (stating “qualified property” can only be properly so called when “the original use of [the property] commences with the taxpayer…”).
20 I.R.C. § 168(k)(2)(A)(ii) (2018) (stating “qualified property” is classified as such when “the original use of [the property] begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of clause (ii) of subparagraph (E)).
21 See I.R.C. § 168(k)(2)(E)(ii)(II) (2018) (stipulating the acquisition of the property can not be from a “related taxpayer” as defined by I.R.C. § 267(b)).
There is a revolution in how students pay for higher education. Colleges like the University of Purdue and coding academies like Lambda Inc. have offered students the ability to sign an income-sharing agreement (ISA), an arrangement whereby a student receives immediate funding from a third party (usually the college or education provider) “in exchange for agreeing to pay a percentage of his or her future income for a period of time.” The third party receives a claim dependent on “the personal financial success of the student, without a ‘guaranteed return of principal.'” Many scholars have addressed the thorny ethical and practical concerns that the ISA arrangement bring, but fewer scholars have addressed the tax implications of these arrangements. And as many have noted, the lack of a clear tax characterization has likely inhibited the growth of these innovative agreements.

Most parties, like Purdue, claim these ISAs are a form of derivative contract governed by the open transaction doctrine. Parties also claim that students who do not pay back enough of the ISA need to recognize cancellation of debt (COD) income. But as this paper explains, both of these positions are normatively incorrect. Before explaining why these positions are wrong from a tax policy perspective, this paper provides some background.

A Normative Guide to the Taxation of Education ISAs
by Robert Daily

There is a revolution in how students pay for higher education. Colleges like the University of Purdue and coding academies like Lambda Inc. have offered students the ability to sign an income-sharing agreement (ISA), an arrangement whereby a student receives immediate funding from a third party (usually the college or education provider) “in exchange for agreeing to pay a percentage of his or her future income for a period of time.” The third party receives a claim dependent on “the personal financial success of the student, without a ‘guaranteed return of principal.'” Many scholars have addressed the thorny ethical and practical concerns that the ISA arrangement bring, but fewer scholars have addressed the tax implications of these arrangements. And as many have noted, the lack of a clear tax characterization has likely inhibited the growth of these innovative agreements.

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Current Law

To explain the tax consequences of the ISA, take an example. Assume a college enters into an ISA with a student under these terms: the college will pay the cost of tuition and fees, $10,000, on behalf of the student; the student must pay back 5 percent of her salary for 10 years; the student need not repay any additional amounts under the ISA once she pays back 2.5 times of the funding amount ($25,000); and the student need not pay anything if she makes less than $25,000.8

At its core, ISAs represent a new transaction, one that does easily fit into one of the Tax Code’s set of binary characterizations. The ISA could be debt because a payback ratio looks like interest; could be equity because the student seems to sell a piece of her earnings; or could be a partnership because the college and student are unified in trying to find a high-paying job for the student. But these characterizations fail: the ISA is not debt because the amount is not definite enough; not equity because the lender does not have enough control over the student; and not a partnership because the parties do not have enough intent to join one.

Instead, most ISA lenders treat these ISAs as financial contracts governed by the open transaction doctrine. This characterization is partially right. The contract does seem like a financial contract, and, more specifically, like a variable prepaid forward contract. No commentator or ISA provider has suggested this characterization, but the variable prepaid forward characterization seems most apt under current law given that the characterization acts as a backstop. When tax practitioners believe that a particular financial instrument does fit into a traditional debt, equity, or partnership characterization, they often call the instrument a variable prepaid forward contract.9 The government may challenge this characterization and argue that the instrument is debt because the tax consequences of debt are much less favorable to private parties. But the government will likely be unsuccessful: neither the amount nor the interest rate is fixed; the amount is unsecured by any asset; and the lender may receive nothing if the student fails to ever obtain a job.

But this characterization is subject to tremendous uncertainty. We need more clarity regarding the tax consequences of ISAs. Yet we also need to consider whether these tax consequences are normatively good or bad. We should ask, how ought we tax these agreements?

Unified Approach?

A gating question is whether we should adopt a unified approach to how we tax education ISAs. Should Congress or the U.S. Treasury write rules that treat all ISAs the same? And should there be bright-line rules to encourage clarity and promote investment in ISAs or broad standards that might prevent abuse? Many scholars have weighed in on the standards versus rules debate. The takeaway for this paper is that rules are better when we want to promote clarity and broad standards that might prevent abuse? Many scholars have weighed in on the standards versus rules debate. The takeaway for this paper is that rules are better when we want to promote clarity and promote investment in ISAs or line rules to encourage clarity and promote investment in ISAs or rules that treat all ISAs the same? And should there be bright-

COD Income

Start with the student’s perspective. The biggest questions are whether the student needs to recognize income when she enters into the ISA and if the student does not pay back the full “funding amount,” whether she needs to recognize COD income. If the variable prepaid characterization is appropriate, the answer to question one is easy: the student should not need to pay any income tax at the time of funding. The student’s tax liability is in flux until determination of the amount the student makes payments under the ISA.

The second question should also be an easy one given the variable prepaid characterization: students only need to recognize COD income when they do not pay back their debts. Because the variable prepaid forward is a derivative contract and not debt, they need not recognize COD income.22 But most lenders—including the most prominent issuer of ISAs, Purdue—require that students recognize COD income when the student fails to pay back the funding amount of the ISA.23 In the example from earlier in the paper, the student would recognize COD income if the student did not make total payments of at least $10,000.

An analogy is that an ISA is like a typical sports contract with incentives and uncertain payment terms.21 A player may receive the
highest amount only under the contract if the player meets certain performance objectives. Failing to meet those objectives does not create COD income to any party; rather, the implicit assumption is that the contract had uncertain payment terms. The ISA and a typical sports contract are not debt, they are contracts with a contingent payment unknown at the time of funding.

But if derivative contracts do not trigger COD income, why do so many lenders insist that it does trigger income? One reason is that the lenders believe the debt characterization may actually be more appropriate. Maybe lenders and the debt-like structure of the ISA makes the debt characterization seem likely in the eyes of the IRS. But such an argument is unavailing because the parties do many things to avoid the debt characterization for tax and nontax reasons. Another more nefarious reason is that the lender may want to take a “loss” on the ISA if the student fails to pay back the full lending amount. With the student recognizing COD income, there is at least a plausible (although probably spurious) argument that the lender should receive basis in the ISA to take a loss.

It is inappropriate for students to need to pay back COD income when they pay back an amount under the ISA that is less than the funding amount. Paying any amount of COD income is contrary to the plain meaning of the Tax Code.

Open Transaction
The party who enters into the ISA with the student likely cares most about the timing of the transaction. Under the variable prepaid characterization, the lender does not recognize income at the time of funding and would either recognize income each year it receives payment (installment sale) or would recognize income after it recovers all of its basis (open transaction doctrine). Although no ISA contract has given the variable prepaid forward label to the instrument, each contract states that the parties agree to recognize income via the open transaction doctrine, which posits that a party recognizes no gain attributable to a sale until the party recovers the entire amount of their basis. This doctrine is an enormous tax benefit that effectively acts as a zero-interest loan to lenders.

Applying the open transaction doctrine to these variable prepaid forward contracts seems inappropriate under current law. Specifically, as many commentators have argued, the open transaction treatment is not justified unless Congress creates an exception. Instead, it is more likely that the ISA would be treated as an installment sale under § 453.

Congress can recognize another open transaction exception to ISA lenders, but should it? There are two reasons why such an exception may be appropriate. First, the exception will encourage more private taxable investors, like Lambda School, to create ISAs. Those who create ISAs will benefit from paying tax in a later tax year. Investors will flock to these ISA programs, as long as the open transaction benefit is commonly understood in the market. This benefit does not accrue to nonprofits like Purdue University who enter into ISAs with their own students, but nonprofits would benefit if those universities securitize these ISAs.

Second, the open transaction treatment is more administrable than using the installment sale rules. Under the installment sale rules, ISA lenders would need to estimate the profit from the ISA each year to comply with their tax obligations. Lenders would prefer not to pay expensive accountants and lawyers to figure out this amount. It is likely this added administrative cost would disincentive those from investing in the ISA market. With the open transaction treatment, lenders can easily comply with their tax obligations and would be more likely to create more ISAs.

But the actual cost of applying the open transaction treatment is unknown. Applying open transaction treatment to education ISAs would essentially create another education subsidy, a program that will bring in less tax revenue and that will encourage and subsidize the cost of higher education. Although four sessions of Congress have proposed bills regarding the tax treatment of ISAs, no member of the Treasury or the Joint Committee on Taxation has even calculated the potential revenue loss.

The open transaction treatment is normatively correct only if we consider the cost of extending such treatment. For example, assume that traditional loans were replaced with ISAs—in this scenario, the cost of Open Transaction treatment would be significant. Before we consider whether using this treatment is appropriate, we need to know the true cost. It is at least possible that the open transaction subsidy may cost more than many other education incentives. We need to consider the open transaction subsidy with these incentives so Congress can decide how much taxpayer money we should use to subsidize higher education.

Summary
Even with the over trillion dollars of student debt facing borrowers, some commentators have suggested that we need to increase investment in higher education. ISAs offer an effective subsidy that could spur even more investment in higher education. To help guide this discussion, this paper has offered thoughts on two normative aspects of taxing education ISAs: whether students should recognize COD income and whether lenders should obtain the open transaction treatment.

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Endnotes
4 Ring, supra note 3.
5 See Oei & Ring, supra note 3; Leff & Hughes, supra note 3.
education-through-income-share-agreements_083548906610.pdf (noting that the tax and "legal uncertainty" of these contracts "has made it difficult to attract investors and has prevented the market from developing on a larger scale").

*Supra* note 1.

These terms are taken from the Purdue Back a Boiler program sample ISA. See *id*.


*Oei & Ring, supra* note 3, at 686.

*Id. at* 709. Professors Oei and Ring mention some of the possible policy concerns. On one hand, the ISAs may "offer a more realistic means for financing higher education than traditional loans" because the agreement "taps into new sources of credit," protects "against earnings shocks," and may make it easier for the student to obtain funding. *Id. at* 707-08. On the other hand, the ISAs "raise important questions regarding personal autonomy, free choice, and self-determination," may exacerbate "likely inequalities in who gets funded (e.g., based on race, gender, or profession)," and may have "potential design laws (moral hazard and adverse selection)." *Id. at* 708.

*Id. at* 710-11.

*Schwartz, supra* note 3, at 1175; AEI Report, *supra* note 6 ("[ISAs] are not about control, but instead grant students freedom from the constraints, anxiety, and financial risk that accompany traditional loans. Through their income-based payment structure, ISAs transfer the financial risk of investing in higher education from students to ISA providers who, by investing in large groups of students, can diversify it.").

*James Surowiecki, The New Futurism, New Yorker* (Nov. 4, 2013), https://www.newyorker.com/magazine/2013/11/04/the-new-futurism ("The old way of borrowing was predicated on a world in which the job market was stable and everyone had a steady income. That world of work is changing. The way we finance it needs to change, too.").

*The government should also be vigilant to ensure that ISAs actually improve higher education financing and do not perpetuate existing norms, but those concerns can be corrected through regulation. See, e.g., Schwartz, supra* note 3, at 1174.

*Farber, supra* note 9, at 637 ("Once one has figured out how to determine whether an instrument is a [nondebt instrument] … the next task is to determine how the instrument is taxed.").

*See I.R.C. § 108(a) noting that a taxpayer “indebtedness” before she recognizes COD income.

*See ISA Sample Contract, supra* note 9.

*See, e.g. Reuben Fischer-Baum, Ricky Williams’s Awful NFL Contract Never Gave Him A Chance, Fivethirtyeight* (Sept. 30, 2016, 12:57 PM), https://fivethirtyeight.com/features/ricky-williams-awful-nfl-contract-never-gave-him-a-chance (describing Ricky Williams’ initial NFL contract that was loaded with incentives that were never achieved).

*See Burnet v. Logan, 283 U.S. 404 (1931).

*See Jeffrey L. Kwall, Out with the Open-Transaction Doctrine: