



Enhancing Tax Savings Through The Use of Disregarded Entities

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Designing An Entity Respected For Legal Purposes, but Ignored For Tax Purposes Can Shift Deductions Where You Need Them

It is often appropriate to separate legal ownership of an aircraft from the company that operates it. This may be dictated by a variety of legal and business issues including the Federal Aviation Regulations, state sales tax issues, insurance limitations, financial statement presentation, or liability concerns. Although these non-income tax issues may direct the owner to legally separate ownership, there are many circumstances in which tax benefits are more effective if consolidated in the operator. The use of a disregarded entity may prove to be an efficient consolidating tool.

A disregarded entity is a distinct legal taxpayer that has elected to treat all of its income tax operations as though they were consummated by its owner. The entity reports all of its activity on the income tax return of its owner and therefore assumes all of the owner's tax attributes. This may greatly reduce exposure to a number of issues often confronted by stand-alone entities.

Consider the following income tax issues that may arise if an individual owner of a closely-held corporation contemplates forming an additional S corporation to hold his aircraft for non-income tax reasons. These include the following:

1. The new entity will generally be required to limit first-year depreciation to reflect that it was not in existence the entire year. The entity will be required to reduce otherwise allowable deductions by the percentage of the year that elapsed prior to formation. For example, an entity formed on December 1 would lose 11/12ths of its otherwise allowable depreciation.
2. If the new aircraft is financed, it is likely that income tax-basis limitations will arise and prevent the flow through of losses to the owner. Income tax basis of an S corporation shareholder includes only his equity, not the debt borrowed by the entity, even if the debt is guaranteed by the shareholder. Because the aircraft is depreciated over a 5-year period, and the debt is amortized over a 15-year period, basis limitations are inevitable.
3. The new entity will be required to rebut the presumption that it is a hobby if it fails to show a profit in three out of five years of operation. Due to the significant depreciation

allowed in the early years of ownership, taxable income is unlikely during this period. This could result in a disallowance of deductions because the activity was not entered into for profit. Although it may be appropriate to combine the entities for the hobby loss rules, that position may be contested by the Internal Revenue Service.

4. If the mechanism for separating ownership from operation is a dry lease, passive activity limitations may result in a suspension of deductions. These rules may greatly reduce the value of deductions for taxpayers who do not generate net passive activity income from other sources. Although these losses may be subject to reclassification through other tax elections, these elections are often limited to selected taxpayers.
5. If an owner incurs costs that must be capitalized in the operation of his aircraft, the expanded expensing election under Section 179 may allow him to immediately write-off up to \$100,000. However, this deduction is limited to the taxable income of the taxpayer. As alluded to above, a stand-alone entity is unlikely to have taxable income in its early years of aircraft ownership.

The solution to each of these potential issues is found in the use of disregarded entities. If the S corporation shareholder would form a qualified subchapter S subsidiary, (QSUB), rather than a brother/sister entity, the results are significantly different. Consider the following:

1. A disregarded entity is not a new taxpayer for purposes of the depreciation short-year rules. The entity adopts the year end of its parent, and is entitled to a full year's depreciation. It also qualifies as the same taxpayer as its parent for purposes of the like-kind exchange rules.
2. There is no separate basis limitation imposed on a disregarded entity. The basis of the shareholder will be determined on his basis of the parent entity, normally significantly greater than that of the new brother/sister entity.
3. Because the two operations are combined, there is no separate test for the hobby loss rules at the shareholder level. Assuming the aircraft use in the primary business is ordinary and necessary, there is little hobby loss exposure to the combined entity.
4. If there is a dry lease between the parent and its disregarded subsidiary it will be eliminated in combination. This should result in the elimination of a passive activity classification of the lease transaction.
5. The taxable income of the parent and its disregarded subsidiary is combined for purposes of the expensing election taxable income test; therefore, assuming the combined entity is profitable, it will be available.

In addition to the QSUB illustration outlined above, single-member limited liability companies, (SMLLC), can also elect disregarded entity status. This is often most effective when the operator is an individual or a limited liability company. Whenever business, legal, or other tax reasons dictate isolation of ownership of the aircraft, the owner should consider recouping income tax benefits through the use of a disregarded entity.

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