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How to Qualify Your Flight School Aircraft As an Active Trade or Business

AVOIDING THE PASSIVE ACTIVITY CLASSIFICATION THROUGH CONTRACTS AND DOCUMENTATION

The use of an aircraft in a trade or business generally results in deductible expenses. These expenses include deductions for both operating expenses and depreciation deductions. Due to accelerated depreciation deductions, tax deductions of the aircraft business will generally exceed taxable income even when the business operates at an economic profit.

Any loss generated from the business is generally available to offset other income of the taxpayer. One potential barrier to the right to offset other income is the classification of the business as a "passive activity". A loss generated by a business classified as a passive activity is only available to offset income from other passive activities.

AVOIDING PASSIVE ACTIVITY CLASSIFICATION ON A FLIGHT SCHOOL AIRCRAFT

The passive activity classification applies to all rental activities and non-rental activities in which the taxpayer does not "materially participate". The first step is to avoid having the business activity classified as a rental activity. An activity is a rental activity if (1) during the taxable year the tangible property held in connection with the activity is used or held for use by customers, and (2) the gross income attributable to the conduct of the activity represents amounts paid for the use of the tangible property. The regulations provide several exceptions where activities involving tangible property will not be considered rental activities. Section 1.469-1T(e)(3)(ii) provides that if the period of customer use is seven days or less, the activity involving the use of tangible personal property is not a rental activity.

There are two distinct methods of placing an aircraft with a flight school; the owner can lease it to the flight school or lease it to the customers of the flight school through a marketing agreement. Although the economic results of the agreements are often identical, the tax consequences may differ significantly. If the taxpayer leases the aircraft to a flight school who takes responsibility for maintaining it and leasing it to their customers, the activity is passive regardless of the level of participation of the aircraft owner. If the aircraft owner leases the aircraft on a short-term basis to the customers of the flight school, the average period of customer use is less than 7 days; it may therefore be possible to avoid the automatic classification as a passive activity as rental.

If the aircraft owner avoids the classification of the activity as a rental activity, it is still necessary for them to "materially participate" in the business. Material participation requires that the business owner be involved in the activity on a regular, continuous basis. This includes the owner's participation in the business of more than 100 hours per year and more time than any other individual.

For a flight school aircraft to constitute an active trade or business, the owner must meet a two-pronged test.

- The agreement between the owner and the flight school must not constitute a lease. It should take the form of a marketing agreement.
- The aircraft owner must demonstrate that he is regularly and continuously involved with the business, and he participates more than 100 hours a year. He should maintain a contemporaneous diary that provides the time, place, and nature of his involvement.

In William Warren Kelly v. Commissioner, TC Memo 2000-32, the Tax Court found that when an aircraft is leased on an annual basis to a flight school, ". . . petitioner's leasing of the aircraft is a rental activity and, as such, is a passive activity under the statute and the regulations. While petitioner may have materially participated in the activity, material participation does not exempt the activity from the passive loss rules contained in section 469."

For further discussion of the "passive activity" and the "hobby loss" rules please visit www.advocatetax.com.

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