



MAXIMIZING AIRCRAFT TAX SAVINGS THROUGH PLANNING

There are few tax saving opportunities as effective as fully depreciating an aircraft on a five (5) year accelerated basis. In today's interest rate environment, a well-structured transaction often results in little or no after tax cash flow holding costs during the early years of acquisition.

Income tax deductions do not spring from mere ownership however; the Internal Revenue Code provides "there shall be allowed as a deduction all ordinary and necessary business expenses incurred in carrying on any trade or business."¹ However, once it is determined that an expense is ordinary and necessary, it may be deductible in full even if it exceeds gross income from the undertaking.²

THE ORDINARY AND NECESSARY TEST

The first element in the test requires that an expense be ordinary, in light of the common and accepted practice in the industry at the time and place of the circumstance.³ The courts readily recognize the use of a private aircraft in the furtherance of a taxpayer's business is often a common practice,⁴ and therefore the ordinary test is generally not a barrier to deductibility. The courts have determined that the necessary requirement mandates a finding that the taxpayer's use of the aircraft is "appropriate" and "helpful." This test requires the showing of a direct relationship between the expense and the furtherance of the business. The third test requires the expense must be reasonable in relation to its purpose. It is not necessary for the taxpayer to incur the least expensive mode of transportation, but merely in light of the facts and circumstances, the selected mode was reasonable.

¹ Internal Revenue Code § 162(a)

² US v Haskel Engineering & Supply Co., 380 F2d 786, (1967)

³ Welch v Helvering, 290 US 111, (1933)

⁴ Marshall v Commissioner 63 TCM 1976, (1992)

HOW THE COURTS APPLY THE ORDINARY/NECESSARY REQUIREMENT TO PRIVATE AIRCRAFT

A traveling salesman used his aircraft to do business with clients throughout the western states when he found the use of commercial airlines was inefficient. He could prove that the flexibility gained by traveling in his own airplane increased sales, and was entitled to full deductions even though the cost of operating the aircraft exceeded the bonuses he received from the incremental sales.⁵ A government employee was entitled to deduct the excess of the cost of flying his own aircraft over the mileage reimbursement he received from his employer. His reimbursement was initially 16 cents per mile and was eventually raised to 45 cents per mile. A representative from his government employer testified that although he was not required to use his own airplane, or fly other than by commercial means, “travel by a privately owned aircraft has been determined as more advantageous to the government.” Thus, the taxpayer was entitled to deduct the excess of the cost of operating his aircraft over the reimbursements from his employer.⁶

A taxpayer who used his aircraft solely for entertainment purposes, (in one year he entertained only his accountant and his lawyer), was not allowed to deduct the cost of operating his aircraft because it was unnecessary in the furtherance of the taxpayer’s medical practice. The court found that because the practice was situated entirely in their local community, and the benefits by holding business discussions on a noisy airplane were not sufficient to qualify the cost as necessary business expenses.⁷

The courts have also often recognized that an executive may incur expenses that are both necessary and reasonable in light of their responsibilities. The courts make a distinction and hold that one standard should apply for executives, and another for rank and file employees. Executives have been able to treat travel in privately-owned planes as ordinary and necessary business expense, when this mode of travel allows direct access, more flexible travel arrangements, and saves time. Even exclusive of the time saving test, the courts have held that an executive may be entitled to larger travel expenses due to the fact that he has a more direct interest in the employer’s business, and broader responsibilities than other employees.⁸ The 4th Circuit has held that because an executive normally receives a larger salary, a larger travel expense may be reasonable relative to that larger salary.⁹

The courts also have generally allowed corporate officers, or other high ranking employees to deduct unreimbursed expenses that are incurred to enable them to better perform their duties, and therefore, have a direct bearing on the amount of the

⁵ S.F. Sartor v Commissioner, 48 TCM 150, (1984)

⁶ D.W. Marshall v Commissioner, *Supra*

⁷ R.N. Noyce v Commissioner, 97 TC 670, (1992)

⁸ E.L. Potter v Commissioner, 18 BTA 549, (1929)

⁹ S.E. Penn v Robertson, 29 F.SUPP 386 (1939)

individual's compensation, or chances for advancement.¹⁰ Furthermore, if his corporate employer requires an individual to incur expenses in the course of discharging his duties, he may deduct unreimbursed expenses actually paid as ordinary and necessary business expenses of being a corporate executive.¹¹ However, when a corporation has a policy of reimbursing its employees for direct expenses in the furthering of its trade or business, and does not reimburse a particular expense, that expense is prima facie personal, either because the employee or officer voluntarily assumed it, or because the expense did not arise out of the business needs of the corporation.¹²

Perhaps one of the most critical holdings for operators of aircraft is the recognition by the courts that depreciation is not used in determining the reasonableness of an expense. The court has stated that the ordinary and necessary requirement does not apply for depreciation deductions, which are deductible otherwise under their own provisions.¹³ Thus, the court held in determining whether taxpayer's expenses for business travel in his own Learjet are reasonable, depreciation is not taken into account.¹⁴

In summary, taxpayers who seek to deduct the cost of operating their aircraft as ordinary and necessary business expenses incidental to their primary business, should document the direct relationship between the use of the aircraft, and the furtherance of their business. Emphasis should be placed on the incremental value of saving time and resources of flying direct to the thousands of airports not available by commercial airlines, by the saved time and expense required by increased security measures, by the importance of avoiding cancelled or unavailable flights, and by the possibility of making multiple stops in a single business trip. Business aviation users quickly recognize the substantial benefits of private aircraft travel, and are encouraged to document its value in business meetings, and minutes relating to the expansion of private aircraft fleet.

AIRCRAFT OWNERSHIP AS A SEPARATE TRADE OR BUSINESS

It is well settled that a taxpayer may perform services on behalf of a corporation and for purposes of ordinary and necessary business deductions, such taxpayer is considered to be in a trade or business of being an employee separate and apart from the trade or business of its corporate employer.¹⁵ Taxpayers who could not integrate the use of their aircraft with their business, or as an employee, may nonetheless, still have an opportunity to secure income tax deductions by operating a separate trade or business in the aircraft rental and management field. This business normally takes one of three forms; first, acquiring an aircraft for leaseback, or piggyback to a charter operator operating under FAR Part 135; second, placing an aircraft in a flight school, or a fixed based operator's

¹⁰ J.B. Walliser v Commissioner, 72 TC 433 (1979)

¹¹ N.J. Fisher v US, 59 TC 696, (1973)

¹² A.L. Sanderson v Commissioner, 16 TCM 105 (1957); R.G. Fairburn v Commissioner, 28 TCM 438 (1969); J.M. French v Commissioner, 59 TCM 966, (1990)

¹³ R.N. Noyce v Commissioner, Supra

¹⁴ S.M. Kurzet v Commissioner, 2000-2 USTC 50,671 (2000)

¹⁵ Noland v Commissioner, 269 F2d 108, (1959)

line for rental; or third, leasing an aircraft on a block rental basis under FAR Part 91 to other operators.

The primary impediment to deductibility from a trade or business structured in this fashion relates to whether or not the taxpayer has engaged in an activity for profit, or as merely seeking deductions of a personal “hobby.” The IRS has promulgated regulations that provide that the determination of whether or not an activity is engaged into for profit will be based on all the facts and circumstances in each case. It is not necessary that profit actually be derived, but the facts and circumstances indicate that the taxpayer entered into the activity with the objective of making a profit. The Regulations provide nine relevant factors to assist in evaluation of profit intent.¹⁶ The first three of these tests consist of the manner in which the taxpayer carries on the activity, the taxpayer or his advisor’s expertise in the activity, and the taxpayer’s time and effort. The success of meeting these three tests often depends not on the taxpayer’s actual conduct or expertise, but on his ability to document his efforts and expertise. The taxpayer must show that he handled the activity in a businesslike and commercially reasonable manner, he maintains complete and accurate books and records in a manner similar to other activities of the same nature that are profitable, and that he expends a reasonable amount of effort, relies on experts when necessary and appropriate, and modifies his operations when necessary to improve profitability. Taxpayers rarely acquire a capital asset of significance such as an aircraft for the purpose of leasing it out, without thoroughly investigating and analyzing its profit potential. Nonetheless, they often discard original projections, or their financial information that details the investment decision. The retention of this information is vital to the defense of the hobby loss challenge.

The fourth test involves the expectation of appreciation of the assets of a business. Those with any significant experience in aviation recognize that the long-term appreciation of aircraft has been both substantial and systematic. In the last few months prices have generally not appreciated as inventory swelled, but a reasonable taxpayer may conclude that this represents a buying opportunity, not the end of aircraft appreciation. Inventory turnover rates appear to be increasing, and industry leaders are hopeful that we will soon return to periods of steady, increasing prices. We would encourage aircraft owners to obtain and retain historical information that justifies their anticipation of appreciation. It is also important to note in this regard, that when determining losses for purposes of the hobby loss rule, depreciation is economic depreciation, not tax depreciation. This very often converts tax losses into economic gains.

The next three tests relate to the taxpayer’s previous success in other businesses, prior income and losses of this activity, and the amount of profits in relation to losses in taxpayer’s investments. These tests obviously turn on the reasonable anticipation of the taxpayer to convert his profit motive into profit realization. A history of such behavior will certainly assist in the taxpayer’s defense of the reasonableness of the profit motive. The financial status of the taxpayer may also help determine motive for an investment. Lack of a profit motive may be indicated if the taxpayer has substantial income from other sources, and the activity generates substantial tax or recreational benefits.

¹⁶ Reg. 1.183-2(b)

Furthermore, a taxpayer who needs to rely on the financial success of the business may use that fact as further evidence of his profit intent.

The final test is whether or not the activity is a source of significant personal pleasure or recreation. This will, of course, vary significantly based on the facts and circumstances. It is unlikely that the taxpayer could obtain significant personal or recreational benefit from leasing an aircraft to a FAR Part 135 charter company, or the local FBO. If on the other hand, the leasing activity is incidental to personal use, the taxpayer's challenges will be more significant.

In summary, often the most overlooked element of a taxpayer confronting the hobby loss rules is the necessity for documentation. It is not merely the profit motive that is essential, but the documentation that substantiates the underlying profit motivation. This documentation requires that one conducts the activity in a businesslike manner, devotes significant time to it, and seeks competent help in making it successful.

Finally, it is important that a taxpayer not only meet the hobby loss rules related to his trade or business activity, but also the passive activity rules. This requires him to material participate in the activity that is properly structured. Passive activity rules may serve to suspend, or disallow otherwise allowable deductions. Our next scheduled tax memorandum will explore in detail the workings of the passive activity rules, and suggestions for documentation to assist in their compliance.

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