MAXIMIZING FEDERAL TAX DEDUCTIBILITY OF AIRCRAFT OPERATING EXPENSES

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I. Achieving Deductibility

A. Complete Obstacles to Deduction

1. That's Personal

Often, the easiest of claims for the IRS agent to make is that your business aircraft is a personal expense in part or in whole. If a business aircraft is not at least partially associated with a "trade or business," you are not entitled to deduct depreciation or any of the costs of owning and operating the aircraft. The determination as to whether your operation qualifies as a trade or business may be straightforward if the aircraft is owned by a large company with significant revenues and operations, but if, as is often the case, the aircraft is owned by a passthrough entity (e.g. an LLC or S corporation) owned or controlled by a wealthy individual, there may be a question about whether this aircraft owning entity truly exists to make a profit.

The IRS lists nine factors that it uses to determine the validity of a claimed profit motive: (1) the manner in which the activity is carried on; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) expectation that the aircraft or other assets may appreciate in value; (5) the success of the taxpayer in carrying on similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits, if any; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. None of the foregoing factors is determinative, and the ultimate decision is a "facts and circumstances" analysis.

In addition to the above factors, there is a statutory presumption that if the gross income of the entity does not exceed expenses for at least 3 years out of any five-year period, the entity was not formed to make a profit. This presumption can be rebutted by showing evidence of changed circumstances, or other objective evidence tending to show that the taxpayer truly intended to make a profit. In practice, the courts have been sympathetic to taxpayers who were able to show a pro forma analysis of profitability, prepared before any investment was made, establishing that the enterprise would make a profit, net of economic (not tax) depreciation on aircraft held by the enterprise.

Ultimately, the standard is subjective. The guidance available from the courts and the IRS is full of generalities and often confined to a very particular set of facts. The best defense against the lack of a "trade or business" claim is not to fail the 3 out of 5 year test, but, if you will fail that test, make sure you have records establishing that you intended to make a profit. Other common strategies include restructuring, prior to acquisition, so that the aircraft is owned by an entity with sufficient income to offset anticipated aircraft related deductions, and transforming the aircraft owning entity into a transportation services company, with the help of an FAR Part 135 operator. As a last resort, if achieving profitability is implausible, it may be beneficial to apportion the aircraft asset between personal and business use, and to limit deductions to the business related use. Even if the business related activity loses money, it may still pass the "trade or business" test if it can be shown that there was a reasonable expectation of profitability.

2. Not Just Nice But Ordinary and Necessary

Once the trade or business hurdle is cleared, the IRS agent may question whether aircraft related expenses are "ordinary and necessary." Like the "trade or business" standard, this is primarily a judgment call that often results in a disagreement between the government and taxpayers. Nevertheless, aircraft expenditures have been allowed as deductions by the courts in cases where taxpayers could show that the aircraft was appropriate and helpful in the development of the taxpayer's business.

The Tax Court and the 9th Circuit Court of Appeals, for example, have found that aircraft expenditures were "ordinary and necessary" in cases where companies or individuals used their aircraft to perform functions that would otherwise be impossible. In the famous Noyce case, involving Robert Noyce of Intel Corporation, the 9th Circuit found that Mr. Noyce's need to travel frequently on short notice, and his position as the head of a major public company, made it reasonable for him to acquire an aircraft and deduct depreciation and operating expenses as unreimbursed business expenses associated with his job as chairman. The court found that Intel's corporate culture prevented a full reimbursement of Mr. Noyce's costs, and therefore, because the unreimbursed cost of the aircraft was not out of proportion to his compensation, it was not unreasonable for Mr. Noyce to assume the costs himself. Subsequent changes to the tax law have made Mr. Noyce's strategy ineffective, because unreimbursed business expenses can only rarely be deducted by high net worth taxpayers.

In another case, the Tax Court allowed aircraft related deductions where the airplane allowed a salesman to have a more flexible schedule and to maximize sales. Similarly, the courts have found the "ordinary and necessary" test to be met where aircraft are used to attract clients to investment opportunities, to perform management services for geographically distant business interests more efficiently, or to respond quickly to emergencies. On the other hand, the Tax Court and other federal courts have disallowed aircraft expenditures in cases where it was possible to reproduce the executive's schedule on commercial airlines with little or no impact on productivity, where the costs of aircraft use are unreasonable in relation to alternatives, or where the localized nature of a business and the aircraft's infrequent use makes it unlikely that the aircraft would add value to the company. The key to achieving deductibility, in this area, is to build the strongest case possible for the aircraft as a contributor to bottom line profitability. It may also help to gather intelligence on what competitors are doing with their aircraft. Such information could be used to support the argument that the aircraft use is "ordinary."

B. Limits on Deduction

1. Passive Loss Rules

Once the "trade or business" and "ordinary and necessary" thresholds are crossed, there can no longer any question about whether aircraft costs are deductible, but the IRS may still have something to say about when. Aircraft, particularly aircraft owned by "passthrough entities" such as LLCs or S corporations, tend to generate enough depreciation that they place the entity in a loss position. The passive loss rules are the most common tool that the IRS uses to delay taxpayer's ability to use aircraft related losses to offset other income. The rules work by suspending losses derived from investments in LLCs or S corporations in which the taxpayer does not materially participate. Material participation can be achieved by passing one of seven tests, the most common of which is the 500-hour rule. Under this rule, an investor in a passthrough entity is subject to limitations on the losses he is entitled to deduct unless he spends at least 500 hours per year (approximately 10 hours per week) on the activity during the year in which he claims the deduction.

Even if the investor materially participates, the losses may still be subject to passive loss limitations if the passthrough entity derives some or all of its income from a "rental activity." A rental activity, generally speaking, is a long-term lease. Because of Federal Aviation Administration rules that favor dry leases, FAR Part 91 aircraft ownership structures are often plagued by the effect of the rental activity rule. A complex set of regulations defines when a rental activity exists, and when the rental activity is de minimus and may be combined with the passthrough entity's other activities.

The ultimate effect of the passive activity loss rules is to suspend losses characterized as passive until the taxpayer generates "passive income." If the taxpayer already has passive income, for example, from an investment in a pre-existing, profitable passthrough entity, the passive losses can be used immediately and the rules have no effect. If, however, the taxpayer has no passive income, the taxpayer must wait until the passthrough entity generates income (for example, by selling the aircraft), or the taxpayer must sell his interest in the entity in order to make the losses freely available to offset other income.

While avoiding the passive activity loss rules is always a challenge, there is some synergy with "trade or business" planning. Where the owner/investor is willing to restructure so that the aircraft owning entity both owns aircraft and performs other functions that the owner/investor would have done in any event, the owner/investor may be able to exceed the 500-hour threshold without substantially changing his daily routine.

2. At Risk Rules and S Corporation Basis Issues

A more easily avoided set of rules limit investors' ability to deduct losses to their basis in the entities in which they invest. The "at-risk" rules prevent investors in LLCs, Limited Partnerships, and General Partnerships from deducting losses in excess of the cash, property, or indebtedness upon which they are personally at risk. The loss deductions are deferred until the taxpayer acquires additional at-risk basis by contributing cash, property, or guaranteeing indebtedness. Where at-risk rules are likely to become an issue in aircraft transactions, the borrowing can generally be structured in such a way as to minimize their effect. The most common technique is to have the entity borrow directly from the commercial lender, and to have the investor personally guarantee the borrowed funds. The aircraft may be pledged as collateral for the original loan, as long as the investor remains liable (as a guarantor) for the indebtedness.

A similar rule prevents S corporation shareholders from taking advantage of losses generated by aircraft expenses or depreciation. S corporation shareholders are entitled to deduct losses only to the extent of their basis in S corporation stock and the amount of any loans they have made to the S corporation. The basis of an S corporation shareholder is increased by money or property contributed to the company, but, unlike an LLC, an S corporation shareholder gets no increase in basis for commercial borrowing obtained by the entity or for guarantees of the entity's borrowing.

A technique similar to the technique used to address the "at-risk" rules is effective for S corporation planning. Instead of guaranteeing the borrowed funds, the S corporation shareholder borrows directly from a commercial lender, and contributes the proceeds to the S corporation. The investor thereby achieves an increase in basis of his S corporation stock equal to the principal amount of the indebtedness.

