



THE GREAT AIRCRAFT TAX SHELTER: CAREFUL PLANNING REQUIRED

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Among the most attractive tax sheltering devices in the U.S. Internal Revenue Code (the "Code") is the accelerated depreciation deduction available to the owners of aircraft that are used in a trade or business. Business aircraft benefit from the same general depreciation regime as commercial aircraft that are not used to provide commercial transportation service (e.g., an air-tax service), the depreciation regime as commercial aircraft. However, in the case of aircraft that are not used to provide commercial transportation service (e.g., an air-taxi service), the depreciation term is 5 years, rather than 7-year term applicable to aircraft used in commercial air transportation service.

If certain conditions are met, the depreciation is front-end loaded (i.e., accelerated) and, under the 5-year program, a full 52% of the purchase price can be deducted in the first two years. So where a taxpayer pays \$10,000,000 cash for an aircraft, the 52% deductions in Years 1 and 2 means that the taxpayer does not have to pay income tax on a like amount of income, so at a 40% tax rate the taxpayer saves about \$2,000,000, which equal a 10% after-tax return on investment per annum.

And if, for example, the taxpayer finances 80% of the purchase price with recourse debt, the after-tax return on investment jumps to 50% per annum. That is, the same 52% depreciation over Years 1 and 2, which again equates to about \$2,000,000 in dollar-for-dollar tax savings, translates into a full recovery of the taxpayer's \$2,000,000 out of pocket investment in a two-year period. Now this is a real shelter.

The key question here is whether the taxpayer can always count on enjoying these tax benefits? For

purposes of the article, we assume that the taxpayer uses the aircraft in a qualifying trade or business. Therefore, assuming the aircraft is used in a qualifying trade or business. Therefore, assuming the aircraft is used in a qualifying trade or business, the answer depends upon whether the Code's passive activity loss ("PAL") rules apply to the taxpayer and, under the PAL rules, whether the taxpayer's investment in the aircraft is categorized to be passive or nonpassive. The PAL rules apply to individual owners of pass-through entities (e.g., S corporations, partnerships, LLCs) and, to a limited extent, to closely LLCs) and, to a limited extent, to closely held C corporations. The rules do not apply to widely held C corporations.

If aircraft ownership is a passive activity of the taxpayer, the net losses therefrom may not be used to offset net income from the taxpayer's nonpassive activities until the passive activity is disposed of in a taxable transaction. So unless a taxpayer has enough net passive income from other activities to absorb the net passive losses from aircraft ownership, the accelerated depreciation deductions do not serve as an effective shelter.

The PAL rules are of labyrinthine complexity but, in short, the taxpayer's net income and loss from an activity (i.e., aircraft ownership) is passive if either (1) the activity is a rental activity or, (2) if not a rental activity, where the taxpayer does not participate in the activity to a considerable extent. For purposes of liability limitation, FAR Part 90 compliance, or to generate charter revenue, many aircraft ownership structures call for the aircraft to be leased-out by the owner entity, thus failing squarely within the passive category.

Fortunately, there are some methods under the PAL rules, which if available can provide relief from passive treatment where a rental is involved. For instance, where a lessee of the aircraft is an operating company (e.g., manufacturing, consulting, development) that is also owned by the owner(s) of the lessor, and where the lessee's revenues are more than 4 times greater than the lessor's revenues, the PAL rules may allow the two activities of the individual taxpayer to be grouped together as one, and the rental activity of the lessor is ignored for PAL purposes.

Other strategies may be revealed upon careful analysis. But if there is no way around the rental/passive classification, the aircraft buyer should know this before he puts himself in a shelter that leaks. In any event, in order to ensure the comprehensive integrity of the aircraft ownership and operating strategy, the taxpayer should have the advice of a professional with a thorough understanding of applicable Federal Aviation Rules and regulations combined with strong tax expertise.



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