Should I Make My Aircraft Available to a Management Company for Charter?

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Should you make your business aircraft available to a management company for charter? Keith Swirsky, reveals that the short and simple answer is a qualified 'yes' - but that certain issues can tilt the balance to 'no' for some.

There are cash flow benefits and potential tax advantages to making your aircraft available for charter. However, there are economic and tax issues that can tilt the balance to "no" for some aircraft owners. So the answer to whether you charter your aircraft out is 'yes' on the one hand, and on the other hand 'no'. Spoken like a true lawyer.

Let us first examine the short and simple answer. The simple cash flow analysis is that the gross charter revenue, minus the charter commission, minus the direct operating costs (DOCs) should provide a positive cash flow. On the tax side, using an aircraft for public charter is generally viewed by the IRS as a "for profit" activity that entitles the aircraft owner to take allocable depreciation deductions, as well as deductions for the DOCs and allocable fixed costs. Assuming that this is the case, these deductions will shelter the owner's share of the charter revenue.

There is also potentially favorable sales tax treatment for allowing a charter company to use your aircraft in charter. For example, New York exempts rent paid by a charter company to the aircraft owner when the aircraft is used in interstate commerce more than 50% of the time, and California exempts the purchase of the aircraft itself from sales tax if the aircraft is chartered more than 50% of its hours and other requirements are met.

Yet in each case, it is appropriate to examine whether these cash flow and tax benefits provide a complete picture. With respect to cash flow, are there any additional costs that could turn a seemingly positive cash flow into an economic loss?

• Will an additional crew member be needed at some level of total flying hours?

• Will the pilots require an additional training event annually?

• Will additional maintenance be incurred?

• Will there be increased interior and exterior wear and tear resulting in an accelerated refurbishment allowance?

• Will additional airframe time mean a reduced aircraft value upon resale?

PASSIVE ACTIVITY

Relative to tax depreciation, the “activity” of an owner providing the aircraft for charter to the management company is a “rental activity,” which for all types of entities other than “C” corporations, is deemed “per se passive” under IRS regulations. The “passive” characterization of the activity means that the allocable tax depreciation may only shelter passive income. In addition, the DOCs and related fixed costs are also passive losses. Fortunately the corresponding rental income from the charter activity is passive income which is sheltered by the passive losses.

Since tax depreciation and allocable operating expenses will exceed the passive income, there will be an excess passive loss from this activity, which will therefore only be available to shelter unrelated passive income. Passive income is typically generated from rental real estate, equipment rental, sports franchises, or other similar investments, when the owner does not materially participate in such activities. Few individuals have a significant amount of passive income.

Passive loss characterization, of course, can be beneficial to an aircraft owner who has passive income, and in particular, can be beneficial to an aircraft owner whose primary use of the aircraft is personal in nature, where little or no depreciation would otherwise be deductible.

Additionally, there are several exceptions to the passive loss rules in IRS regulations which, with thoughtful planning, can potentially reveal a structure that avoids passive loss characterization. It is also noteworthy that aircraft utilized predominantly in charter activities are subject to a longer depreciation schedule. Aircraft predominantly used in charter are subject to a 7-year accelerated cost recovery and/or 12-year straight line schedule, versus 5-year accelerated/6-year straight line for aircraft predominantly used for purposes other than charter.

THOUGHTFUL PLANNING

So, how should an executive or board of directors analyze all of this seemingly conflicting information? I would suggest by starting with a state sales tax analysis. In other words, will public charter enhance a sales tax planning strategy?

Sales tax savings may be significant enough to overshadow any passive loss concerns. Second, the cash flow considerations may still add a positive contribution to the overall budget; by limiting charter use to the maximum number of total hours that may be flown without creating a need to hire an additional full-time crew member, the owner will maximize cash flow benefits.

Thoughtful planning may allow some owners to avoid passive loss characterization. The requirement to use a prolonged depreciation schedule, or the inability to utilize depreciation deductions currently due to passive loss characterization are mostly timing considerations. In other words, current use of depreciation deductions reduces depreciation available to offset income in future years, and may result in depreciation recapture if the aircraft is eventually sold in a taxable transaction.

Finally, the executive or board of directors must consider the issue of scheduling coordination. The initial decision to purchase a corporate aircraft was premised upon the need to provide a convenient and efficient means of meeting the corporate executives' travel requirements. The potential cash flow benefits and tax implications of allowing the aircraft to be operated in charter must always be viewed in connection with this issue to ensure that the aircraft will be available when needed by those executives.

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