



# THE TAX IMPACT OF CHARTERING YOUR AIRCRAFT – PASSIVE ACTIVITY LOSS RULES

GKG Law, P.C. Webinar Series

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## Tax Impact of Chartering - Overview

- ➔ If aircraft is used entirely for personal non-deductible purposes, then chartering adds a business use that creates tax deductions (costs must be pro-rated)
- ➔ If aircraft is primarily used in a trade or business (not a widely held “C” corp) and charter revenue paid to owner equals or exceeds 2% of the FMV (or unadjusted basis if lower) of the aircraft, then chartering hours and related costs must be separately pro-rated
  - generally these deductions will be treated as passive tax losses



## Overview – Cont.

- Passive tax loss characterization can be adverse due to:
  - Prohibition on netting against non-passive income and
  - Suspension of excess passive losses
  
- Additional issue of lengthening depreciation schedule from 5/6 to 7/12



## Who Can Benefit From Chartering?

- Any owner that has little or no business use of their aircraft
- Any owner that has business use, but a high recreational use percentage
- Any “C” corporation (caveat, closely held “C” corporations)
- Any owner with substantial passive income
- Anyone whose aircraft is fully depreciated

We'll come back to this later



# Tax Analysis

- IRC § 469 provides that certain activities are considered to be passive activities
  - Activities in which the taxpayer does not materially participate
  - Activities that are rental activities, regardless of taxpayer participation, unless an exception applies
- Providing an aircraft to a charter company is in essence a rental of the aircraft for use by the charter company in charter to the public
- All tax attributes from a rental of an aircraft would therefore be treated as passive, generally resulting in excess passive losses when factoring in depreciation



## Exceptions

- IRC § 469 contains several exceptions to the general rule characterizing rentals as passive
  
- Two exceptions are generally useful
  - “extraordinary personal services”
  - Rentals “incidental” to a trade or business activity



## Exceptions – Cont.

- ➔ “Extraordinary personal services” has generally been construed to mean the provision of crew
- ➔ In addition to the provision of crew, IRC § 469 also requires the individuals receiving K-1s to “materially participate” in the chartering activity, on a substantive level
  - For most presidents/CEOs this is not practical or defensible
  - Most charter companies would not allow the owner to get involved in the chartering business, on a substantive level
  - 500 hour safe harbor





## Exceptions – cont.

- Rentals “incidental” to a trade or business requires that:
- The aircraft must be used predominantly (i.e. >50%) in the business during the year, or 2 of the preceding 5 years; and
  - Gross rental income is <2% of the FMV (or unadjusted cost basis if lower) of the aircraft, determined annually



## Exceptions - Cont.

- Assuming an aircraft has a \$10M FMV (and a higher cost basis), then the 2% test would limit gross rental income to \$200K
  - We are talking about the owners' percentage - typically 85% of the charter rate
  - On a \$10M aircraft with a charter rate of \$3,500, at 85%, this would cap total charter hours at 67 annually
  - Difficult test to meet



## Aggressive Planning

- Aggressive tax planning might suggest creating an entirely new business arrangement whereby owner requires charter company to bear all the expenses and pay a lower rental rate, thereby increasing the permissible number of charter hours
- Charter must remain below 50% of total hours during the year, or 2 of the preceding 5 years



## Who Can Benefit – Revisited

- Any owner who has little or no business use of their aircraft will have enhanced deductions, albeit passive characterization, without meeting an exception
- Any owner that has business use, but a high recreational percentage
  - recreational use percentage is reduced by addition of charter hours;
  - total deductible percentage increases, albeit passive characterization, without meeting an exception



## Who Can Benefit – Revisited

→ Any “C” corporation

- “C” corporations are not subject to IRC § 469 (caveat, closely held “C” corporations may only offset operational income – not portfolio income)

→ Any owner with substantial passive income

- All tax losses allocated to chartering are currently usable to offset other passive income
- Define passive income

→ Anyone whose aircraft is fully depreciated

- Charter revenue may approximate “allocable” losses, resulting in full “write-off” of losses



# Closing Remarks



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