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

GKG Law, P.C. Webinar Series

Presenter: Keith G. Swirsky
President
GKG Law, P.C.
Phone: (202) 342-5251
kswirsky@gkglaw.com

Presenter: Robert Seidel
Senior Vice President
Jet Aviation Holdings USA, Inc
Phone: (201) 462-4433
Robert_Seidel@jetaviation.com
Disclaimers

This presentation is being provided for general information and should not be construed as legal advice or legal opinion on any specific facts or circumstances. You are urged to consult your attorney or other advisor concerning your own situation and for any specific legal question you may have.

IRS CIRCULAR 230 DISCLOSURE - To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.
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
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
“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
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

Keith G. Swirsky
GKG Law, P.C.
1054 31st St. NW, Suite 200
Washington, D.C. 20007
Tel: (202) 342-5251
Fax: (202) 965-5725
E-mail: Kswirsky@gkglaw.com