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Tax Issues for Owner Pilots

October 22, 2013| 1:00 p.m. – 2:00 p.m.

PRESENTED BY:
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Tax, Regulatory & Risk Management Conference | Las Vegas, NV | October 20 – 21, 2013

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Wolcott & Associates, PA:

- We are an aviation-dedicated group of CPAs and accounting professionals
- Our clients are aircraft owners and operators, pilots, and owner-pilots
- Our practice is limited to the preparation of aircraft income tax returns, state tax matters, IRS audits, structuring aircraft ownership, and related aviation tax and financial matters

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Resource Lookup

www.aviation-cpa.com

50117

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TOPICS

1. Ownership structures
2. What is (and what isn't) business use?
3. Reporting business and non-business use of the aircraft on your tax return
4. Hobby loss trap
5. Renting and leasing issues
6. Depreciation
7. Deducting aircraft expenses by a W-2 employee
8. State tax issues

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Types of Ownership Structures

- Aircraft owned by the individual
  - Including a single-member LLC
- Aircraft owned by operating company
  - S-corp., C-corp., or partnership
  - Operating company uses the aircraft in it's business
  - Files a separate tax return from the owner/pilot
- Aircraft owned by Special Purpose Company (SPC)
  - S-corp. or partnership
  - Only asset is the aircraft
  - Files a separate tax return from the owner/pilot

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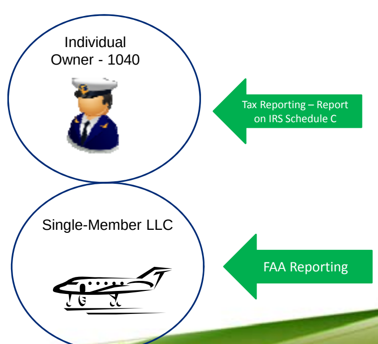
Aircraft Owned by the Individual



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Single-Member LLC

- Single-member LLCs (SM-LLCs) are entities that are legally separate from the owner/member
- Disregarded by IRS - means does not file a separate tax return – reports on member's return
- FAA registration lists the LLC as owner
- Permits aircraft ownership and registration to be in an entity separate from the owner for liability purposes
- No tax benefit or drawback to the owner/member

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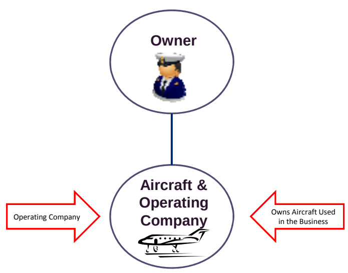
Aircraft Owned by Operating Company



(Best Practice)

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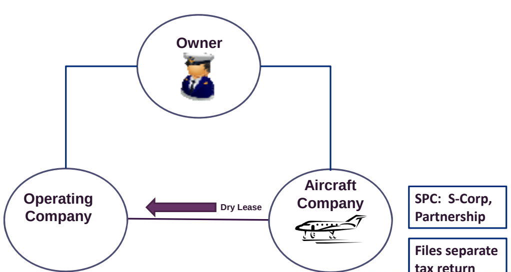
Aircraft Owned by Special-Purpose Company (SPC)



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Ownership Structure Summary

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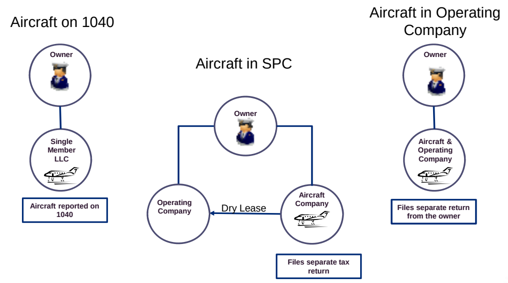

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TOPICS

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1. Ownership structures and their tax consequences
2. What is (and what isn't) business use?
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Aircraft Use Must Be "Ordinary and Necessary" for the Business

10103

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- The ordinary and necessary rules apply to any asset or business segment
- The aircraft must be "incidental" to the business
- The IRS ordinary and necessary business expense standard requires that an expense be:
  - Appropriate
  - Helpful in carrying on the taxpayer's business
  - A common and accepted practice
  - Reasonable in amount
  - Not "lavish" or "exorbitant"

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What Is Business Use?

- Questions the IRS auditor will always ask:
  - Is the aircraft truly incidental to the company business, or
  - Is the aircraft an expensive perk for the benefit of the owners and/or company executives?
- In general:
  - Company must have a need for air transportation
  - Air transportation need can be best met by private air transportation
  - Aircraft size must be appropriate for the company's use

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What Is Business Use?

- Investment activities are not business use
  - Flights to inspect potential business ventures or rental property are subject to reporting as Sec A Itemized Deductions, subject to Alternative Minimum Taxes limitations, 2% floor on AGI, and itemized deduction limitations
- IRS may try to limit deductions because the aircraft was inappropriate for specific travel requirement
  - Could limit deduction to first class airfare equivalent
  - May substitute reduced hourly operating rate
  - May disallow all costs, expenses and depreciation if IRS considers the aircraft unnecessary or lavish

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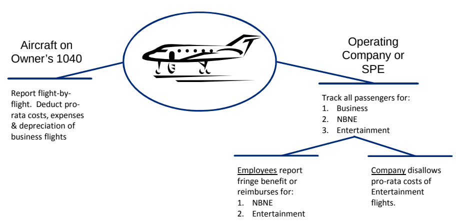
Overview; Reporting Business Use Depends on the Ownership Structure

- <u>1040 owners</u> report use on a *per flight* basis 10200
  - Document flights in logbook or spreadsheet
  - Deduct business-use costs, expenses and depreciation on a pro rata basis of business use
- <u>Company owners</u> report use on a *per passenger* basis 10307
  - <u>Employees:</u> Company reports fringe benefit income on W-2 or the employee reimburses for non-business flights 10400
  - <u>Company</u> disallows pro rata portion of entertainment passenger's costs, expenses and depreciation 10300

Your log book is now part of your tax return

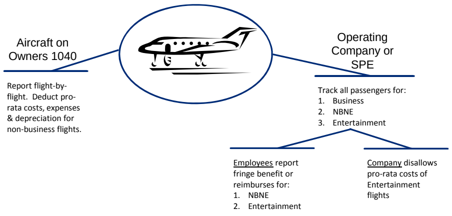
Reporting Taxable Use of Business Aircraft



Aircraft Reported on Owner's 1040

- Track annual taxable use on a *per flight* basis, as either:
  - Business, or
  - Non-business
- Ignore the presence of others on the aircraft
- Calculate percentages of business and non-business use
- Deduct business-use percentage of all cash-basis costs, expenses, and depreciation
- Report all income received from outside sources
- Reimbursements from the owner are of no consequence

Reporting Taxable Use of Business Aircraft



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Company Passenger Flight Types 10307

- *Business* passengers are on the aircraft for business purposes of the company that owns the aircraft
- *Non-Business Non-Entertainment (NBNE)* passengers are on the aircraft for business other than that of the aircraft owner, or as travel companions for the business passengers
- *Entertainment* passengers are on the flight for purposes of personal entertainment. Pro-rata costs and depreciation are disallowed. Travel must be taxed as compensation to the owner or employee that invited them on the aircraft

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Reporting Employee Use in an Operating Company or SPE

- Employee's non-business flights are a taxable fringe benefit *to the employee*
- Employee (at the company's option) reports either imputed income or reimburses for:
  - NBNE flights
  - Entertainment flights
- Imputed income is calculated by Standard Industry Fare Level (SIFL).
- Reimbursement must at least equal SIFL rates to meet the SIFL reporting requirement
- Failure to observe imputed income rules could cause the company to lose it business aircraft deductions

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Reporting Employee Use in an Operating Company or SPE

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- SIFL rates are published by the DOT every 6 months
- There are separate rates for control (i.e., the boss) and for non-control employees
- SIFL rates increase by aircraft weight
- Guests are charged SIFL to the employee
- SIFL amounts for the year are added to the employee's W-2

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Standard Industry Fare Level (SIFL) Rates

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Mileage Range	1st Half 2013	2nd Half 2013
0 – 500 Miles	$0.2655	$0.2654
501 – 1,500 Miles	$0.2024	$0.2024
Over 1,500 Miles	$0.1946	$0.1946
Terminal Charge	$48.54	$48.53

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Aircraft Multiples

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Maximum Certified Takeoff Weight of the Aircraft	Aircraft Multiple for a **Control** Employee	Aircraft Multiple for a **Non-Control** Employee
6,000 lbs or less	62.5%	15.6%
6,001 – 10,000 lbs	125%	23.4%
10,001 – 25,000 lbs	300%	31.3%
25,000 lbs or more	400%	31.3%

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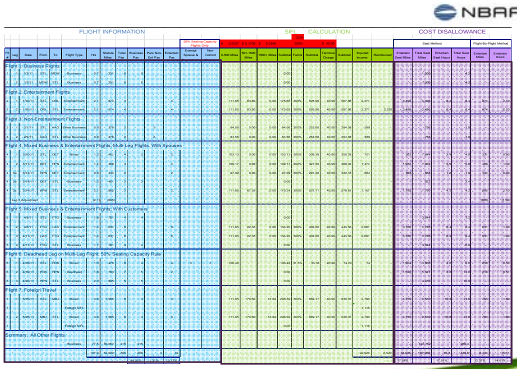
SIFL Formula

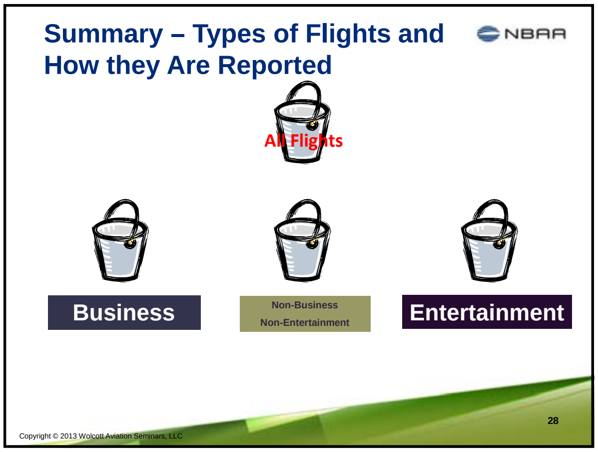
Formula
Statute Miles
X
SIFL Rate
Sub-Total
X
Aircraft Multiple
Sub-Total
+
Add the Terminal Charge
Sub-Total
X
of Passengers
SIFL Charge to Employee

Disallowing Entertainment Use by the Company

10307 10300

- Passengers are tracked separately using seat miles, seat hours, or flight-by-flight miles or hours
- The company "disallows" the pro rata percentage of aircraft costs, expenses and depreciation from entertainment passengers
- The annual disallowance is reduced by SIFL or employee reimbursements (i.e., the company gets credit for SIFL or reimbursements)
- Track flights by spreadsheet or software




Summary – Types of Flights and How they Are Reported
NBAA
All Flights
Business
Non-Business
Non-Entertainment
Entertainment
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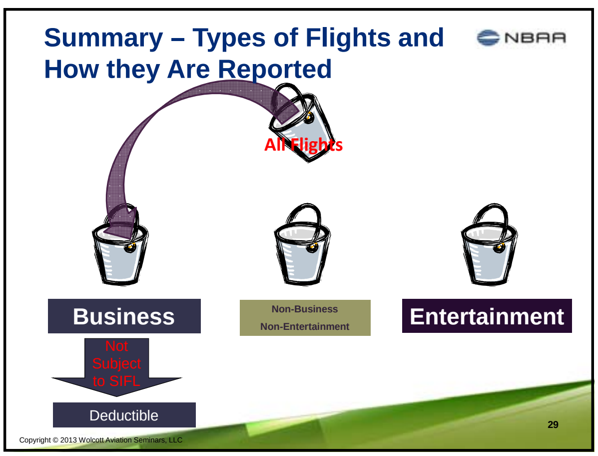
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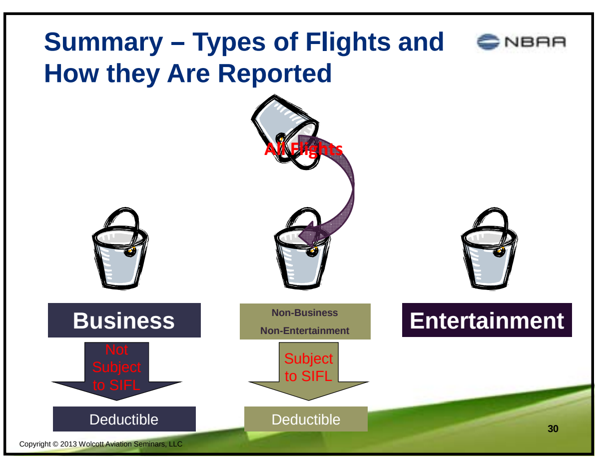
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Summary – Types of Flights and How they Are Reported

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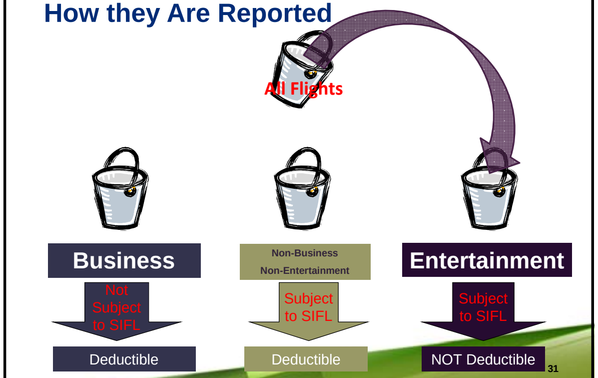

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Documentation Rules 10305

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- The owner must keep records for each flight leg
  - Flight date
  - Origin of flight
  - Destination of flight
  - Number of seats available on the aircraft
  - Name of each passenger
  - Relationship of the passenger to the owner or the company, and
  - Whether the passenger was traveling for company business, personal business, or personal entertainment
- Professional flight crew on the aircraft are not reported
- Owner-pilots are treated as passengers for IRS reporting

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Leasing to the Company Owner/Pilot to Avoid the Entertainment Disallowance 10290

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- When the aircraft is owned by a company owned by the pilot, consider dry-leasing the aircraft to the owner/pilot for entertainment flights
- Lease must be at fair market value leasing rates
  - Have a lease written to FAA “truth in leasing” standards
  - The IRS will disallow if the lease rate is sub-standard
  - Document with 3rd party industry cost analysis or lease apprasial

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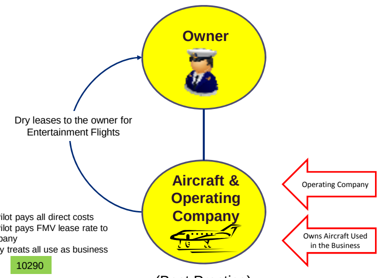
Aircraft Owned by Operating Company



- Owner/Pilot pays all direct costs
- Owner/Pilot pays FMV lease rate to the company
- Company treats all use as business

10290

(Best Practice)

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Hobby Loss Rules 10500

- Restricts use of losses against other taxable income if activity is not "for profit"
- Hobby loss rules apply to S-corps, partnerships, and 1040 Schedule Cs for individually-owned aircraft
- IRS presumes activity is a hobby if the activity has losses in 3 out of 5 years
- Hobby loss rules are dangerous because IRS will limit or disallow all costs and depreciation. Can be big win for IRS

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Hobby Loss Rules

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- Depreciation can cause multiple years of losses
- Hobby income is treated as taxable
- Hobby expenses are reported as an itemized expense subject to limitations, and are subject to Alternative Minimum Tax (AMT)
- Aircraft in SPCs and reported on Schedule Cs are often hobby loss targets

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Hobby Loss Rules

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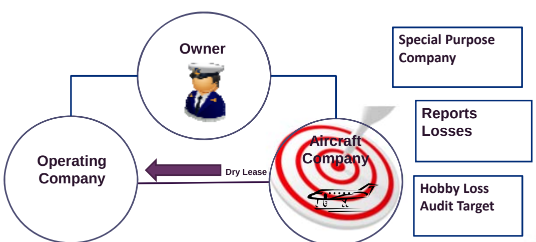
Example of SPC Hobby Loss Structure



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Hobby Loss Rules

10502

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- If there are not 3 profitable years out of 5, IRS regulations provide a list of factors to test if an activity is for profit, such as:
  - Manner in which taxpayer carries on the activity
  - Expertise of the taxpayer or advisors
  - Time and effort expended
  - Expectation of future profits
  - Taxpayer's success in carrying on similar activities
  - Taxpayer's history of income or losses with the activity or were losses beyond the taxpayer's control or from startup activities
  - Amount of occasional profits, if any
  - Financial status of the taxpayer
  - Elements of personal pleasure or recreation

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Hobby Loss Rules

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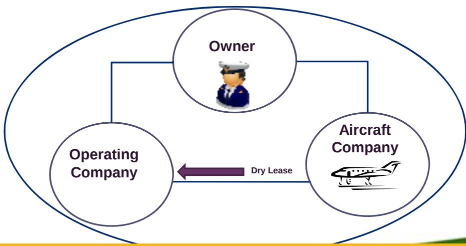
11003

Taxpayer may aggregate "hobby" activity with a profitable activity



NOTE: Include grouping decision reference in each tax return

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Passive Activity Loss Rules (PAL)

- Passive loss rules apply to:
  - Leasing activities 10600
  - Activities in which the owner does not materially participate in the activity 10602
- *Either* condition will cause a loss to be treated as passive
- Passive losses will only offset passive income

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Passive Activity Loss Rules (PAL)

- The Passive Loss Limitation rules apply to:
  - Individuals
  - Trusts
  - Estates
  - S-Corporations (but generally not C-Corporations)
- If there is not passive income, then PAL is suspended until:
  - Passive income becomes available, or
  - The aircraft is sold; accumulated PAL will offset taxable gain on the disposition

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What is Passive Income?

- Rental income, providing more than 30% of the unadjusted basis is subject to depreciation
- Income from activities where the taxpayer does not have material participation
- Gain on disposition of an interest in a passive activity
- Gain on sale of property used in a passive activity

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Types of Passive Use

- Lease to a 135 charter operator
- Lease to a flight school
- Dry lease to another company or individual
- Dry lease to rental company or FBO
- Leasing to an affiliated (non-arm's length) operating company

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Passive Activity Loss Rules – Exceptions, Grouping, and Reporting

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- There are 6 exceptions to PAL leasing rule 10601
- There are 7 "tests" in the PAL material participation rules 10603
- PAL grouping rules may overcome the passive activities rules 10604

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Passive Activity Grouping 10603

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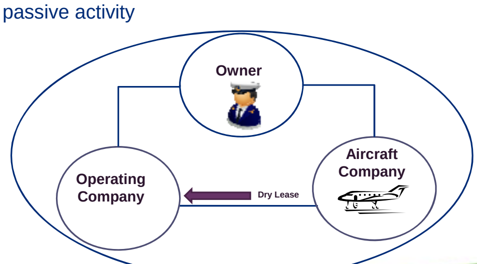
Taxpayer might "group" active business activity with a passive activity



NOTE: Include grouping election in each tax return

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Grouping Rules 11003

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- In the past, taxpayers were not required to identify members of the grouping in the tax return(s)
- For tax years beginning January 25, 2010 and after, taxpayers must file a written statement for:
  - First year of grouping
  - Whenever there is a change in the group
- We recommend adding a statement electing both passive activity grouping and hobby loss grouping whenever there are multiple entities for owning and operating the aircraft

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Depreciation Deduction

- Capitalize and depreciate:
  - Aircraft
  - Upgrades and overhauls
  - Capital improvements
- Percentage of business use determines the amount of the depreciation deduction
  - Apply business use percent to total available depreciation to determine amount of annual write off
  - Depreciation can represent a substantial tax deduction

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Depreciation Deductions

- Deduction rate is based on percentage of business use
  - >50% business use - you can use accelerated depreciation
  - <50%, must use straight-line
  - Accelerated depreciation just means "faster", not more
- Deprecation life depends upon predominant use
  - 5-year life for Part 91 aircraft (7 years if <50% business use)
  - 7-year life for Part 135 aircraft (12 years if <50% business use)
- Depreciation recovery period and method can change each year depending upon use

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Bonus Depreciation 10704

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- 2013 purchases:
  - Taxpayer has option to claim or not
  - Applies to new property only
  - Must qualify for accelerated depreciation (>50% business use)
  - Applies to 50% of the cost of the property
  - Depreciate non-bonus portion using normal depreciation methods
  - Owner may take delivery of a new aircraft in 2014 providing the purchase was under contract before 01/01/14
  - Congress has not yet extended bonus provisions to 2014 purchases
- Taxpayer deducts business use % x bonus amount in 1st year of business use
- Owner must continue to meet >50% business use test in subsequent years or recapture all bonus taken

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Sec. 179 Depreciation Benefits 10707

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- Applies to new and used property
- In 2013: Expense capital improvements up to $500,000
  - Subject to $2,000,000 ceiling
- In 2014: Expense capital improvements up to $25,000
  - Subject to $200,000 ceiling
- Depreciate remainder of cost under normal methods
- NOTE: Section 179 cannot be used to create or increase a loss. Deduction only offsets taxable income

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Use of Aircraft by W-2 Employee

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10100

- IRS expects a business aircraft to be an asset of an operating company, not owned by an employee
- Aircraft owned and used by employees are "challenging" to deduct

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Reporting Unreimbursed Aircraft Business Expenses for a W-2 Employee

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- Deduct total expenses for the flight(s) from the amount of reimbursement to get net unreimbursed expenses
- Add unreimbursed business expenses to Form 2106
- Form 2106 carries forward to Schedule A - Itemized Expenses
- Note: Such expenses are subject to a 2% AGI limitation
- Expenses need to exceed 2% of adjusted gross income in order to be included in your itemized deductions.
- If all of your itemized deductions do not exceed the standard deduction, you will not be able to deduct these expenses

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Training Costs for Owner-Pilot

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- Primary training costs for either owner-pilot or professional pilot are not deductible
- Additional training = facts and circumstances
- Maybe as a personal tax deduction (as opposed to a business deduction)
- Lifetime Learning Credit may be applicable:
  - Be careful: Are you acquiring or improving job skills?
  - If you are an airline pilot, possibly
  - If you are a salesman, probably not

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State Sales Taxes

- Enforcement is increasing
  - States need revenue and aircraft are big $$
- States have easy access to information
  - Internet flight tracking software
  - Access to FAA public-use registration data
  - States collect FBO rent rolls and hangar-tenant lists in order to locate untaxed aircraft

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State Sales Taxes

- 43 States levy aircraft sales and use taxes
- Sales Tax – applies to aircraft located in a state at the time of purchase
- Use Tax – applies to purchases made outside of the state but brought into a state assessing sales tax
- If no sales tax has been paid, state where aircraft is based has use-tax nexus

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State Sales Taxes

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- Typical sales tax exemptions
  - Fly-away exemption
  - Use by air carrier (generally means 135)
  - Aircraft weight
  - Commercial use
- Leasing deferral (not all states)
  - Permits deferring sales taxes over the life of a lease
  - Generally must be set up prior to closing
- All rules vary by state; plan in advance
  - NBAA website: State Tax Reports
  - Conklin & de Decker

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Ad Valorem Taxes

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- 25 States levy ad valorem taxes on aircraft
- Ad valorem taxes are administrated by local municipality tax appraisers
- Tax is calculated on millage basis of cost or value
- Rates vary by county and airport
- Typical exemptions (where applicable):
  - Commercial use
  - % of use in the state vs. use outside the state (landings)
  - Owners can sometimes provide proof that aircraft was not in state on valuation date

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Parting Thoughts

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- If you have a business and you own an aircraft, use your aircraft in your business
- Don't fear deducting your aircraft and aircraft related expenses; you are entitled to the deductions
- Don't fear reporting non-business use; the IRS will question if non-business use is limited
- Keep contemporaneous records and follow the reporting rules

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Does Reporting Aircraft Cause Audits?

Aircraft don't cause audits *per se*

- When auditors find aircraft they tend to examine carefully
- Poorly-planned ownership structure can increase IRS audit exposure

Best practices:

- Place aircraft in a profitable company that can absorb the costs and depreciation
- Avoid single-purpose companies that only owns and reports the aircraft
- Document all business use

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Thank You Very Much!

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