Tax Considerations for Reporting Business Aircraft

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Today's Handouts:

- Course materials have been provided to you, however you can also access them on our website:
  www.aviation-cpa.com
  Resource Library ID = **50123**
- Tax code references shown on slides can also be accessed on the website 10404
- Please call our office if you need assistance
  (866) 791-6092

Topics – Overcoming the Hurdles

1. The "Big Four" IRS code and regulation sections dealing with aircraft
2. Depreciation and other IRS code and regulation concerns for business aircraft owners and operators
3. State tax issues for aircraft

 3

"Big Four" IRS Code & Reg. Sections

1. Ordinary and necessary — IRC §§162, 212
2. Hobby losses — IRC §183
3. Passive loss limitations — IRC §469
4. Personal use of company aircraft — IRC §1.61-21 & IRC §1.274-10

 4

Ordinary and Necessary Business Use

Justifying the Use and Expense Write-Off of Private Aircraft

IRC § 162

 5

Ordinary and Necessary Business Expense - IRC §162

- IRS rules and regulations that determine when and if use of an aircraft is appropriate and deductible
- 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
  - Appropriate for the mission
  - Not "lavish" or "exorbitant"

 6

Ordinary and Necessary Business Expense - IRC §162

- § IRC 162(a)(2): traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business, are deductible business expenses

 7

Ordinary and Necessary Business Expense - IRC §162

- Three hurdles must be overcome to qualify aircraft costs and expenses as deductible:
  - Air transportation is required
  - Air transportation need may only be met by private aircraft
  - The aircraft type is appropriate for the company's needs

 8

Hobby Loss Limitations

Limits on Deductions from Companies That Consistently Lose Money

IRC § 183

 9

Hobby Loss Rules

- IRS restricts use of losses against other taxable income if activity is not considered "for profit"
- IRS presumes activity is a hobby if company has losses in 3 out of 5 years
- IRS often cites Hobby Loss rules when aircraft is owned by a single-purpose entity (SPE)
- Hobby Losses are always a problem for SPE's due to depreciation

Hobby Loss Rules – IRC §183

- IRS often cites Hobby Loss rules when aircraft is owned by a single-purpose entity (SPE)
  - Includes S-Corps., multi-member LLC's, and Schedule C's for individually-owned aircraft
  - Cash in often equals cash out, meaning no profit from day-to-day operations; activity operates at break even cash
  - SPC's often have consistent loss years due to depreciation

Hobby Loss Rule Defenses

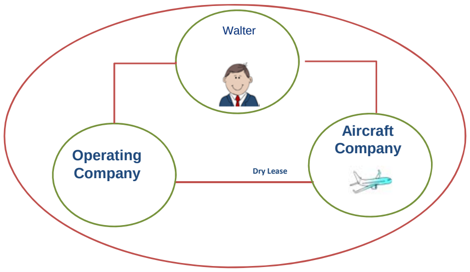
- IRS regulations provide a list of nine factors to test if an activity is for profit (Treas. Reg. § 1.183-2(b))
- If examined, taxpayer may substitute economic depreciation for tax depreciation in determining losses*
- A key defense is if there is positive cash flow
- Establishing a Unified Business Enterprise** may attribute a potential hobby loss activity with an entity intending to make a profit to overcome the hobby loss classification

* See Portland Golf Club vs. Commissioner, No 89-530 (1989)

**See Morton vs. Commissioner, 107 A.F.T.R. 2nd (2011)

Hobby Loss Rules – Treas. Reg. § 1.183-2(b)

- Consider aggregating the hobby activity with a profitable activity, Treas. Reg. § 1.183-1(d)



 13

Typical IRS Auditor Positions

- Hobby Loss Rules are dangerous because they allow IRS to disallow excess operating costs, ownership costs, and depreciation. Can be big win for IRS
- (Hint) IRS auditor report sometimes lists Hobby Loss rules as a primary position, and other code sections as a secondary position. May indicate the IRS will forgo the Hobby Loss position if the taxpayer is willing to settle on the secondary position

 14

Passive Activity Loss Rules

Limitations from Leasing and Lack of Adequate Material Participation

IRC § 469

 15

Passive Activity Loss (PAL) Limitations IRC §469

- IRS limits use of losses from:
  - Rental activities, per se
  - Inadequate trade or business participation of owner
- Causes:
  - Dry leases
  - When aircraft owner does not materially participate in activity (> 500 hrs.)
- Passive losses can only be used to offset passive income and often cannot be used by Taxpayer in current years
- Suspended losses are released upon disposition

 16

Why Are Passive Activity Loss Rules a Concern for Aircraft Owners?

- There are many occasions where aircraft are used by someone other than the owner:
  - Lease to 135 charter operator or rental company
  - Lease to a flight school
  - Lease to another company or individual
- Use of an aircraft by anyone other than the owner for remuneration is a de facto lease
- When the owner relinquishes possession, command and control of the aircraft, material participation requirements may no longer be met

 17

PAL - Relevant Exceptions:

- There are 6 exceptions to the per se rental limitations. Temp. Treas. Reg. §1.469-1T(e)(3)(ii)
- There are 7 "tests" to determine if material participation limitations can be overcome. Temp. Treas. Reg. § 1.469-5T
- Grouping with another activity may be available to overcome rental or material participation limitations – the Taxpayer must establish the existence of an Appropriate Economic Unit

 18

PAL - Grouping of Activities
Appropriate Economic Units

Factors to consider in determining if a grouping is appropriate:

- Similarities and differences in types of business. Do the businesses complement each other?
- Extent of common control
- Extent of common ownership
- Geographical location; are the entities related geographically?
- Business interdependence among the activities, such as shared customers or employees, similar products, use of joint computer or bookkeeping systems
- Note that activities owned through C-corporations cannot be grouped with rental activities

PAL - Grouping of Activities
Appropriate Economic Units

- Rental activity is not eligible to be grouped with non-rental activity unless:
  - Rental activity is insubstantial compared to non-rental activity
  - Non-rental activity is insubstantial compared to rental activity
  - Identical ownership in both activities (same persons in same proportions)

Passive Activity Loss Limitations IRC §469

- The Passive Activity Loss Limitation (PAL) rules apply to:
  - Individuals
  - Trusts
  - Estates
  - S-Corporation (Flows to shareholder via K-1)
  - Partnerships (Flows to partner/member via K-1)
- PAL rules do not apply to C-Corporations unless they are:
  - Personal service corporations
  - Closely held corporations

Non-Business Use of Business Aircraft

Personal Use of a Business Aircraft Treas. Reg. §1.61(g)(21) and Treas. Reg. §1.274-10

- IRS rules and regulations that govern reporting non-business use of a company aircraft are complicated and must be applied to all passengers on all flight legs
- For employees: Imputed fringe benefit from non-business use – Standard Industry Fare Level (SIFL)
- For company:
  - Entertainment cost disallowance for employee personal use of company aircraft
  - Primary purpose reporting for aircraft owned by individuals

Taxing the Employee for Non-Business Use
Standard Industry Fare Level (SIFL)

Employee Is Taxed For The Non-Business Transportation

- Non-employees, family members, or guests are taxed, but not to the passenger
- Such additional passengers are taxed to the employee authorizing the travel
- The employee does not have to be on the aircraft to be taxed for the flight
- Children under age 2 years are never taxed

 25

Standard Industry Fare Level (SIFL)

- SIFL is based on a cents-per-mile cost published by the Department of Transportation
- Calculation is based on the number of non-business passengers and the size of the aircraft
- Different rates for control vs. non-control employees (i.e. the "Boss" vs. employees)
- Reg §1.61-21(g)(1-14)

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 26

Standard Industry Fare Level (SIFL)

- Includes a terminal charge, also determined by the Department of Transportation
- Use of the Statutory Method provides a "Safe Harbor" for calculating the employee's taxable income fringe benefit
- More popular of the two methods; less tax consequences to the employee
- Reg §1.61-21(g)(1-14)

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 27

Information Required For Use Of SIFL

- Airport-to-airport (or point-to-point) distance in statute miles
- Maximum Certified Takeoff Weight (MTOW) of the aircraft
- Control status of the employee
- Sufficient data to separate and analyze multiple legs and passenger mix
- Current SIFL rates and terminal charges

Control vs. Non-Control Employee Status

- Control employee:
  - Owns 5% or more of company, or
  - Paid in the top 1% of the company
  - Most Officers or Directors
  - Retired former control employees
  - Flights for control employees are valued at a higher aircraft multiple than non-control employees
  - General rule:

If an employee can authorize a personal-use flight, the employee is probably a control employee

Control vs. Non-Control Employee (cont.)

- Non-control employee:
  - Everyone else
  - Lower valuation multiple used, therefore a non-control employee pays less tax
- Note, that if a control employee invites a non-control employee on a flight, the non-control employee files at the control employee's rate

50% Seating Capacity Rule, Spousal Travel

- If employees traveling on company business fill 50% of the passenger seats:
  - Then no SIFL income is imputed for non-business travel by an employee, spouse or dependent children
  - SIFL for guests of the control employee is computed at non-control employee rates
- Spousal travel is generally taxable to the employee, unless:
  - 50% seating capacity rule is met, or
  - Spouse is a paid employee of the company, and
  - Travel is for a legitimate business purpose

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 31

"Bona Fide" Security Programs

- Permits executive to fly on company plane for non-business flights at reduced SIFL rates
- Requires that a security study be performed. A separate study is required for family members if they travel alone. The study must conclude that a security risk to the executive exists
- The security plan must be part of a complete security program (24 hours)
- Provides "Safe Harbor;" use 200% multiple regardless of weight of aircraft
  - Can result in significant savings to the employee for use of large aircraft

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 32

Aircraft Multiples

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%

 33

Standard Industry Fare Level (SIFL) Rates

Mileage Range	1st Half 2015	2nd Half 2015	1st Half 2016
0 – 500 Miles	$0.2490	$0.2341	$0.2144
501 – 1,500 Miles	$0.1898	$0.1785	$0.1635
Over 1,500 Miles	$0.1825	$0.1716	$0.1572
Terminal Charge (per passenger)	$45.52	$42.79	$39.19

 34

SIFL Calculation Example

The company executive, spouse, and two guests take a 1,750 statute mile non-business trip on the company's 300% multiple jet aircraft

Here is the SIFL calculation:

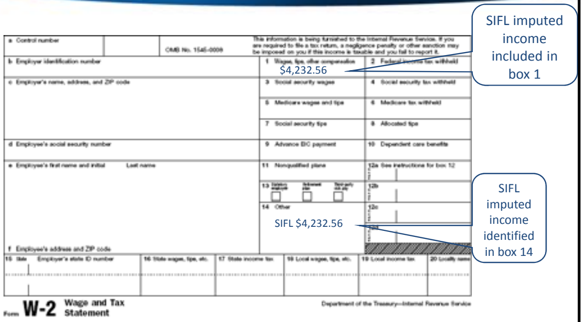
 35

Manual SIFL Calculation

1,750 Statute Miles 300% aircraft 4 Passengers, Sept 01, 2015	
0-500 miles @0.2341	117.05
501-1500 miles @0.1785	178.50
1501 + @ 0.1716	42.90
Subtotal	338.45
Multiple by Aircraft Multiple	X 300%
	1,015.35
Terminal Charge @ 42.79	42.79
Subtotal	1,058.14
Multiply by # of Passengers	X 4
SIFL Charge to Employee	4,232.56

 36

Sample Form W-2



 37

Taxing the Company for Non-Business Use

Entertainment Cost Disallowance

IRC § 1.274-10

 38

Entertainment Cost Disallowance Rules

- Entertainment cost disallowance rules apply to passengers on *Employer-Provided Aircraft*
- The rules are applied on a Per-Capita basis
- The owner must classify and document every passenger on every flight leg
- Applies to fully-owned aircraft, leased aircraft, fractional aircraft, or chartered aircraft

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 39

Entertainment Cost Disallowance Rules

- Overall objective is to develop an annual percentage of entertainment passenger use that will reduce costs, expenses and depreciation of the aircraft for tax reporting
- Disallowing costs increases taxable income, and the company pays more income tax
- Entertainment passengers create additional income taxes for the company (or the company's owners)

 40

What Is Entertainment?

- Entertainment, Amusement or Recreation
  - "Entertainment" means any activity which is generally considered to constitute entertainment, amusement or recreation: Treas. Reg. 1.274-2(b)(1) 10304
  - "Entertainment use is an amusement or recreational activity, such as traveling to a sporting event or a vacation destination" Notice 2005-45 10307
  - An activity not "directly related to" or "associated with" the active conduct of a trade or business

 41

Passengers Classifications

- Business passengers: These passenger flight costs are fully deductible
- Non-Business Non-Entertainment passengers: (called NBNE). These are passengers that are:
  - On business, but not the business of the company that owns the aircraft, or
  - Non-business passengers that do not have an entertainment component
  - Pro rata flight costs are deductible
- Entertainment passengers: These are passengers on the aircraft for an entertainment purpose
  - Pro rata flight costs are NOT deductible

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 42

Spousal Travel, Commuting Flights

- Spouses traveling for business are judged to a higher standard
- IRS will always consider a spouse to be an entertainment passenger
- Commuting flights follow the Tax Home rules for employees
- Commuting flights are generally NBNE for the employee
  - This means charge SIFL to the employee
  - Cost is deductible to the company

Deadhead Flights

- Deadhead flights are flights with no passengers
- Deadhead flights must be treated as passenger flights for calculating the entertainment disallowance
- “Passengers” are “ghosted” and classified according to the previous or subsequent passengers for the flights they are associated with

Disallowance Calculation Methods

1. Occupied Seat Miles: Annual entertainment passenger seat miles divided by total passenger flight seat miles
2. Occupied Seat Hours: Annual entertainment passenger seat hours divided by total passenger flight seat hours
3. Flight-By-Flight Miles: Annual entertainment flight miles divided by total flight miles
4. Flight-By-Flight Hours: Annual entertainment flight hours divided by total flight hours

Louisiana Personal Property Taxes on Aircraft

- Aircraft are subject to personal property tax assessed by each parish
- Aircraft and helicopters engaged in transporting passengers and/or property for hire on regularly scheduled flights are exempt
- Antique aircraft manufactured at least 25 years ago and not used in commerce are exempt
- Crop dusting aircraft are exempt

Thank You Very Much!

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