



WELCOME

IRS Tax Consequences from Selling Your Aircraft


July 16, 2015



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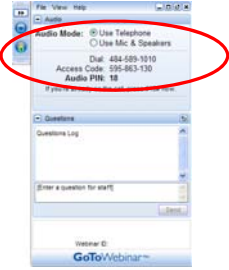


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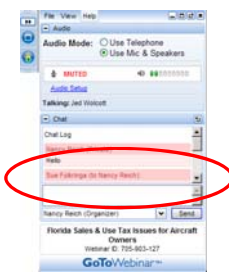
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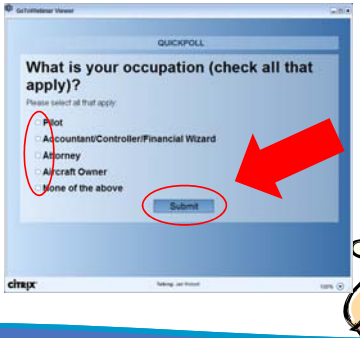


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IRS Tax Consequences from Selling Your Aircraft

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Topics in Today's Discussion


- Calculating Gain or Loss at Sale from Tax Returns
- Suspended Depreciation from Entertainment Use
- Bifurcating Depreciation
- Reporting Passive Gains
- 3.8% Investment Income Tax
- Effects of a 1031 Exchange

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Calculating Gain or Loss at Sale from Tax Returns

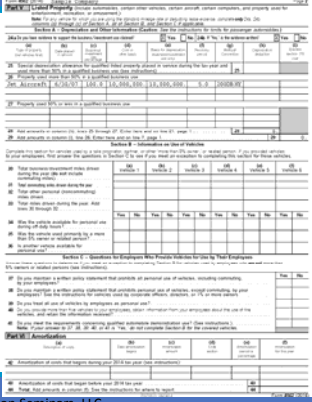
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The Aircraft

- Original Cost = \$10 million
- Owned for 8 years
- Taxpayer reported MACRS depreciation. Aircraft is fully depreciated
- The company is an S-Corporation
- Sale price = \$6 million

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12/31/14 2014 Federal Depreciation Schedule Page 1
 Client SAMPLE Sample Company

Line	Description	Date Acquired	Cost	Salvage	Useful Life	Recovery Period	Convention	Depreciation Method	Depreciation	Gain/Loss	Gain/Loss	Gain/Loss	Gain/Loss
1	Jet Aircraft	6/30/12	10,000,000						10,000,000	10,000,000	2000	12	0
	Total Jet Aircraft		10,000,000	0	0	0	0	0	10,000,000	10,000,000			0
	Total Depreciation		10,000,000	0	0	0	0	0	10,000,000	10,000,000			0
	Book Total Depreciation		10,000,000	0	0	0	0	0	10,000,000	10,000,000			0

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Gain on Sale Calculation


Original aircraft cost	\$ 10,000,000
Depreciation on return	<u>-10,000,000</u>
Basis	<u>- 0 -</u>
Sale price	6,000,000
Basis	<u>- 0 -</u>
Taxable gain	<u>6,000,000</u>

\$6,000,000 gain X .396 = \$2,376,000 income tax

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Suspended Depreciation from Entertainment Use


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The Aircraft

- Original Cost = \$10 million
- Owned for 8 years
- Taxpayer reported depreciation based on Modified Accelerated Cost Recovery System (200% accelerated). Fully depreciated with disallowance from entertainment use
- Sale price = \$6 million
- Entertainment use net = 40%
- SIFL imputed income = \$ 1 million over the ownership period

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What Happens to the Disallowed Basis?

Does it add back to basis or is it lost?

- According to the Final Entertainment Disallowance Regulations issued August 1, 2012, pro rata costs, expenses, and depreciation from entertainment passengers are disallowed
- Disallowed entertainment depreciation is *suspended* until disposition of the aircraft
- At disposition, the suspended entertainment depreciation is added back to basis
- Disallowed costs and expenses are lost and are not recoverable

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What Happens to the Disallowed Basis?

Does it add back to basis or is it lost?

- Disallowed entertainment depreciation, also called "suspended basis," adds back to basis at disposition, per Treas. Reg. § 1.274-10(f)(1), which states:
"If any deduction for depreciation is disallowed under this section...the basis of an aircraft is not reduced for the amount of depreciation disallowed under this section."

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What Happens to the Disallowed Basis?

Factors to Consider in the Calculation 10300

- Treas. Reg. § 1.274-10(d)(3) permits use of straight line depreciation for the disallowed depreciation
- Depreciation is often aggregated into an overall line-item *entertainment disallowance* adjustment; to calculate gain you must back out the depreciation from the other disallowed costs
- Entertainment SIFL reduces the disallowance; test if it has been included in the original disallowance calculation
- Reimbursements, such as timeshares, may reduce the disallowance; test if it has been included in the original disallowance calculation

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Where do you Find the Disallowed Costs and Depreciation?

Statement 1
Form 1120, Line 26
Other Deductions

Airport Service Fees	\$	17,500.
Bank Charges		7,605.
Charting & Mapping		16,800.
Disallowed Depreciation		-208,000.
Disallowed Expenses		-100,962.
Dues & Subscriptions		2,119.
Entertainment SIFL Imputed Income		31,308.
Fuel		458,500.
Ground Transportation		238.
Total	\$	233,099.


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Review Tax Returns

Year	Annual Depr	%	Disallowed MACRS	Disallowed SL Depr.
2007	\$2,000,000	40%	\$840,000	\$400,000
2008	3,200,000	40%	1,216,000	\$800,000
2009	1,920,000	40%	748,800	\$800,000
2010	1,152,000	40%	472,320	\$800,000
2011	1,152,000	40%	460,800	\$800,000
2012	576,000	40%	213,120	\$400,000
2013	0		0	0
2014	0		0	0
Totals	\$10,000,000	40%	\$4,000,000	\$4,000,000

Disallowed entertainment depreciation, net of SIFL = 40%


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Treatment of Prior Disallowed Depreciation

Original aircraft cost	\$ 10,000,000	
Depreciation on return	<u>-10,000,000</u>	
Basis	- 0 -	
Add back entertainment depreciation	<u>+ 3,000,000</u>	Entertainment Depreciation, Net of \$1 million SIFL
Adjusted Basis	3,000,000	
Sale price	6,000,000	
Adjusted Basis	<u>- 3,000,000</u>	
Gain on sale	\$ 3,000,000	


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Bifurcating Depreciation

Bifurcation means dividing depreciation into two amounts, prorating between business use and entertainment use

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Is Bifurcation Even Required?

...And if yes, how is it calculated?

- There is no direct, authoritative requirement for bifurcation in the depreciation regulations
- Bifurcation, if required, finds its basis in the final entertainment regulations at Treas. Reg. § 1.274-10(f)(2) *Pro rata disallowance*, which states:
 If any deduction for depreciation is disallowed under this section, the rules of § 1.274-7 apply. In that case, the basis of an aircraft is not reduced for the amount of depreciation disallowed under this section.
- Confusing and contradictory? You bet!

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Bifurcating Depreciation

Rev. Rule 72-111 60134

- 1972 Revenue Ruling discusses the computation for reporting deductible loss when tangible personal property is sold.
- The ruling uses an example of an automobile used 75% for business and 25% for personal purposes
- The conclusion is that the proceeds from sale should be divided between the business and personal use
- The allocation method was percentages of business (75%) and personal (25%)
- Loss attributable to the personal portion was not allowed as a deduction


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Bifurcating Depreciation

- Wigfall v. Commissioner, 1982* - Taxpayer sold home and reported no gain. IRS said gain had to be reported on the portion of home used as home office. Court agreed, said bifurcation was required 60133
- Snyder v. Commissioner, 1975* - IRS denied loss deduction on sale of airplane. Court allocated basis between personal and business use; result was gain on business portion and nondeductible loss on personal use portion 60134
- Sharp v. U.S.A., 1961* - IRS required a partnership to allocate the gain from the sale of an aircraft between business use (74%) and personal use (26%). Court agreed, stating "Any loss on the personal use...is not deductible because of its personal nature and is disregarded" 60135
- O'Larey v. U.S.A., 1963* - Defendant and Plaintiff agreed to allow the court to determine the amount of deductible business use and non-deductible personal use of an aircraft. The court applied hours of use each year, and determined that 43.9% were personal hours for 1956, and 10.5% for 1957, and applied those percentages to the net costs each year and to the proceeds of sale 60136

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Bifurcating Depreciation

No Standard Method of Calculation

- There was no consistency in the method of calculating the bifurcation in the cases
- The Courts recognize the differences in calculation methodology, and give the taxpayers latitude to determine a logical approach
- The key point is to separate the business and entertainment use, and disallow any loss from the entertainment use
- Examples of different approaches in calculating disallowances for aircraft:
 - Determine disallowances and calculate year-by-year
 - Determine disallowances in the aggregate, calculating one percentage for the entire period of ownership
 - Use the non-business use percentage in the year of sale

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Bifurcating Depreciation

Applying Bifurcation to Aircraft Sales Requires:

- Business use (Treas. Reg. § 1.162 ordinary and necessary use rules)
- Entertainment (Treas. Reg. § 1.274-10 entertainment use)
- SIFL imputed income (\$1 million for owner) or other reimbursements for entertainment flights reduce non-business losses
- The IRS's goal in requiring bifurcation is to disallow losses from entertainment use of an employer-provided aircraft

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Bifurcating Depreciation

Sale	W/out Bifurcation	
Cost	10,000,000	
Depreciation	-10,000,000	
Unused Depr.	+ 3,000,000	\$4 million suspended depreciation less \$1 million of SIFL
Basis at Sale	3,000,000	
Sales Price	6,000,000	
Basis at Sale	-3,000,000	
Gain (Loss)	-3,000,000	

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Bifurcating Depreciation

Sale	W/out Bifurcation	Business @ 60%	Ent't @ 40%
Cost	10,000,000	6,000,000	4,000,000
Total Depreciation	-10,000,000	-6,000,000	-1,000,000
Basis at Sale	3,000,000	0	3,000,000
Sales Price	6,000,000	3,600,000	2,400,000
Basis at Sale	-3,000,000	0	-3,000,000
Gain (Loss)	3,000,000	3,600,000	-600,000

Taxable Gain without Bifurcation

Loss with Bifurcation is not deductible

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Bifurcating Depreciation

Consequence of Bifurcating


Gain without Bifurcation	3,000,000
Maximum tax rate	X .396
Tax	<u>1,188,000</u>
Gain with Bifurcation	3,600,000
Maximum tax rate	X .396
Tax	<u>1,425,600</u>

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Passive Gains and Losses


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Reporting Passive Activity

- Leasing an aircraft, such as to a charter operator, is generally a passive activity, resulting in passive losses, including depreciation
- The application of passive activity takes place at the taxpayer level
- If the passive depreciation (and other passive losses) were not used to offset passive income, the passive portion of depreciation is available to offset passive income, including gain on sale
- If there is a complete disposition of a passive activity, the loss is available to offset other non-passive income


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How Passive Losses are Recognized

Taxpayer 1040 — Taxpayer's ability to use or defer passive losses are determined here

Company with Aircraft — Passive losses from aircraft activity flow to the taxpayer



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Reporting Passive Activity Rules

What Happens if the Taxpayer had Passive Income?


- If any passive depreciation had been used to offset passive income, that portion of the depreciation will not be available to carry forward
- Remaining passive depreciation would carry over to the acquired aircraft
- The decision to treat and apply passive depreciation (and other passive losses) takes place at the taxpayer level. That return has to be analyzed to determine the availability of suspended passive depreciation

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3.8% Investment Income Tax

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3.8% Investment Income Tax

Applies to Passive Activity Gains

- New Affordable Care Act Investment Income Tax applies to tax years beginning January 1, 2013 and thereafter
- The 3.8% tax applies to:
 - (i) gross income from interest, dividends, annuities, royalties, rents, substitute interest payments, and substitute dividend payments
 - (ii) other gross income derived from a trade or business described in Reg. Section 1.1411-5, and
 - (iii) net gain attributable to the disposition of property
- In general, the Investment Income Tax does not apply to property used in business, **unless the business activity was passive**

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Who Pays the Medicare Investment Tax?

Effective January 01, 2013

- Taxpayers will pay the additional 3.8% Medicare tax on the lesser of:
 - Taxpayer's "net investment income," or
 - The taxpayer's "modified adjusted gross income (MAGI)" ...less the "applicable threshold; specifically:
 - For married taxpayers filing jointly, \$250,000
 - For married taxpayers filing separately, \$125,000
 - For all other taxpayers, \$200,000
- Since this calculation is a "lesser of" rather than a "greater of," calculation, the tax only applies if the taxpayer's MAGI exceeds the above limits
- Sorry, Mr. Aircraft Owner

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Reporting the 3.8% Investment Income Tax

If all the gain had been passive and subject to bifurcation:

	Total Gain 100%
Gain	\$ 3,600,000
Med tax .038	136,800
Inc. tax .396	1,425,600
Total tax	1,562,400


Note that the amount of taxable gain subject to the 3.8% tax is reduced by suspended losses carried over from previous years

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Effects of a 1031 Exchange

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1031 Overview

Types of 1031 Exchanges

- There are multiple forms of 1031 Tax Free Exchange:
- The simplest form of 1031 exchange is a trade-in
- For 3-party exchanges, the replacement property must be identified within 45 days of the transfer of the relinquished property, and the replacement property received by the earlier of:
 - The 180th day after the date the taxpayer transfers the relinquished property, or
 - The due date (including extensions) of taxpayer's tax return for the year of transfer of the relinquished property
- **Transferred depreciation has the same tax characteristics as it had in the relinquished property**

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1031 Overview

The Tax Treatment of a 1031

- Sec 1031 states: "no gain or loss" takes place in a 1031 tax-free exchange
- Tax attributes from the relinquished property, including remaining basis, if any, transfers to the acquired property
- If, as part of the exchange, the selling taxpayer also receives other, not like-kind property or money, gain is recognized to the extent of the other property and money received
 - Example: Cash boot; "cash " is not like-kind property, and is subject to tax when received in a 1031 trade.

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Depreciation Transfer Rules

Reporting a Like-Kind Exchange (Treas. Reg. §1.168(i)-6(c)): 10700

- Remaining basis in the relinquished property carried over to the new property is depreciated on the same schedule as was originally being depreciated
- Thus, if relinquished property depreciated over 7 years is exchanged in year 5, the remaining basis would be depreciated over two years (i.e., its original depreciation schedule)
- The inference is that suspended depreciation due to entertainment disallowance would remain suspended in the replacement aircraft

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The Aircraft

1031 Exchange

- Original Cost = \$10 million
- Owned for 8 years
- Taxpayer reported depreciation based on Modified Accelerated Cost Recovery System (200% accelerated) depreciation
- Entertainment use 40%
- **IRC § 1031 exchange for \$16,000,000 aircraft**

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Treatment of Exchange

Under Section 1031

▪ Details of transaction:		
▪ Value of relinquished aircraft		\$6,000,000
▪ Additional financing		10,000,000
▪ Value of acquired aircraft		\$16,000,000
▪ Details of deferred gain		
▪ Value of acquired aircraft		16,000,000
▪ Cash paid		-10,000,000
▪ Gross gain from relinquished aircraft		6,000,000
▪ Adjusted basis of relinquished property		
▪ Deferred entertainment	\$4,000,000	
▪ Entertainment SIFL add-back	-1,000,000	
▪ Basis not depreciable		3,000,000
▪ Deferred gain		3,000,000 *
▪ Details of basis		
▪ Depreciable basis (cash paid)		10,000,000

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Depreciation Transfer Rules

Taxpayer Election (Treas. Reg. §1.168(i)-6(i)(1)):

- Allows taxpayer to elect out of the depreciation regulations under I.R.C. § 1031.
- Provision states if the taxpayer elects out, the following applies:
"[F]or depreciation purposes only, the sum of the exchanged basis and excess basis, if any, in the replacement MACRS property is treated as property placed in service by the taxpayer at the time of replacement and the adjusted depreciable basis of the relinquished MACRS property is treated as being disposed of by the taxpayer at the time of disposition"
- The election treats the total basis in the replacement aircraft as if it were an amount paid to purchase the aircraft, and suspended entertainment basis is added to total depreciable basis

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Depreciation Transfer Rules

Taxpayer Election (Treas. Reg. §1.168(i)-6(i)(1)): 10700

- To make the election for an aircraft, figure the depreciation deduction for the new property in Part III of Form 4562 (listed property)
- Attach a statement indicating "Election made under section 1.168(i)-6(i)" for each property, and for each person acquiring replacement property
- The election must be made on a timely-filed return (including extensions)
- Once the election is made, the election cannot be revoked without IRS permission

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Treatment of Exchange with Election

Under Section 1031

▪ Details of transaction:		
▪ Value of relinquished aircraft		\$6,000,000
▪ Additional financing		10,000,000
▪ Value of acquired aircraft		\$16,000,000
▪ Details of deferred gain		
▪ Value of acquired aircraft		16,000,000
▪ Cash paid		-10,000,000
▪ Gross gain from relinquished aircraft		6,000,000
▪ Adjusted basis of relinquished property		
▪ Deferred entertainment	\$4,000,000	
▪ Entertainment SFIL add-back	-1,000,000	
▪ Adjusted Tax Basis		3,000,000
▪ Deferred gain		3,000,000
▪ Details of basis		
▪ Cash paid		10,000,000
▪ Adjusted basis from suspended entertainment use		3,000,000
▪ Depreciable Basis		13,000,000

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Comparison of Calculations

	Gain	Tax @ .396
Using Tax Return Only	6,000,000	2,376,000
With Entertainment Disallowance	3,000,000	1,188,000
Bifurcating Depreciation	3,600,000	1,425,600
1031 Exchange	Deferred	Deferred
If Gain is all Passive	3,600,000	1,562,400

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Summary:

- Generally, the tax return alone will not have all the information required to properly report the elements of a sale or exchange
- Keep tax returns and working papers for the entire aircraft ownership period, even if more (longer) than the statute requiring retention of records
- In a 1031 exchange, depreciation transferred to an acquired aircraft retain their tax characteristics from the relinquished aircraft
- Consider applying exemption Reg. 1.168(i)-6(i) to re-characterize depreciation transferred in a 1031
- Plan a 1031 exchange well in advance
- Reporting passive gains and losses take place at the taxpayer level
- Suspended passive losses do not effect basis, but accrue at the taxpayers level. Unapplied passive losses carry over on Form 8582

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Thank You Very Much!

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