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DEFENDING YOUR AIRCRAFT DEDUCTIONS BEFORE THE IRS

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The Internal Revenue Service has developed a specialized examination procedure for aircraft owners. Although income tax examinations by the Internal Revenue Service are adjusted as needed, you should anticipate a review of the following items:

1. Is your aircraft undertaking a trade or business, or a non-deductible hobby?
2. Do you have an “honest expectation of economic profit”?
3. Do you have a business plan, and was it written before you were notified that you were being examined by the Service?
4. Have you made an election to group the aircraft undertaking with another trade or business undertaking for purposes of complying with the “hobby loss” rules?
5. Do you materially participate in this activity, and have you kept contemporaneous documentation of your time devoted to the undertaking?
6. Have you made an election to group your aircraft undertaking with your other business undertakings for purposes of the “passive activity” classification?
7. How have you documented personal use, and what adjustments have been made as a result of the use?
8. Have you kept a contemporaneous record of the business purpose of each passenger on the aircraft?
9. Have all charges for transportation services, including reimbursements from shareholders and related parties, been subjected to federal excise taxes and the related tax remitted?
10. Are the expenses incurred ordinary, necessary, and reasonable in amount?

The first avenue of attack by the Service will generally be an attempt to reclassify the aircraft undertaking as a nondeductible hobby. Regulations promulgated by the Service outline nine non-exclusive factors designed to reflect the taxpayer’s intent.

These include: the manner in which the taxpayer carries on the activity; the expertise of the taxpayer or his advisors; the time and activity expended by the taxpayer in carrying on the activity; the expectation that the assets used in the activity may appreciate in value; the success of the taxpayer in carrying on other similar or dissimilar activities; the taxpayer’s history of income or loss with respect to the activity; the amount of occasional profits, if any; the financial status of the taxpayer; and the involvement of elements of personal pleasure or recreation.

Although these factors generally are self-explanatory, the Service is primarily concerned on whether or not you treat this activity like a business. Do you have separate books and records, separate budgets, have you made adjustments to make

the activity profitable, and are you actively involved?

The second issue, also related to the hobby loss rules, is whether or not you have the “honest expectation of economic profit”. This issue deserves closer analysis. It does not require a profitable execution of a plan wherein you immediately create taxable income. The test is not whether or not you ultimately are successful, but was your expectation of profit an honest one. Of great importance to aircraft operators is also the recognition of the distinction between economic profit and taxable income.

Non-commercial aircraft are normally depreciated over a five-year basis using double declining balance depreciation. Economic depreciation occurs over a much longer period and at a far lower rate. It is not uncommon for aircraft to appreciate in value, and this information as to aircraft valuation is widely available. Economic profit requires income covering economic, not tax, depreciation. An aircraft owner may realize significant economic profit while enjoying tax losses from depreciation.

The Service will request a copy of your business plan. They will also ask you if the plan was written independent of you receiving notice that you were being examined by the Service. The business plan should outline in general form the aircraft undertaking and any related businesses which it supports. It can provide a significant outline of your profit expectations on a stand alone or combined basis.

You have the right to group aircraft undertakings with other undertakings when the aircraft undertaking supports those other activities. This grouping election is at your discretion and will generally be accepted by the Commissioner provided there are adequate organizational and economic inter-relationships, and a common business purpose. If you make a valid grouping election under the hobby loss rules, the aircraft undertaking will be combined with the other trade or businesses for purposes of the nine tests outlined in question one, as well as the expectation of profit test.

Is the aircraft undertaking an active trade or business in which you materially participate, or is it passive? If you are successful in showing that the aircraft undertaking is indeed a trade or business, you will not, by necessity, enjoy that deduction from the undertaking if they are determined to be passive. Any loss classified as a passive activity by individuals, partnerships, trusts, and small corporations will generally only be deductible to the extent of net passive income.

A loss will be classified as passive if either it is a rental activity, or you do not materially participate. Material participation generally requires that you devote 500 hours a year in the undertaking, or 100 hours a year and more time than any other individual. The nature of the time invested is also relevant to the material participation issue. If the Service can show that the activity was passive, then the loss will be suspended until such time that the undertaking is disposed of.

The Service will also be concerned as to what type of documentation you have relating the time devoted to the undertaking. Although the records need not be contemporaneous, they should contain sufficient detail to outline both the time invested, and the nature of the services rendered to the undertaking. This time record will be relevant for purposes of determining both material participation and

possible classification as a hobby.

It is possible for you to make a grouping election for passive activity purposes. Similar to the rules outlined above relating to the hobby loss test, a taxpayer has the right to make an election to combine various undertakings into a single undertaking for purposes of the passive activity test.

The Service will be concerned as to how personal use of the business aircraft is accounted for. Personal use of a business asset may result in a disallowance of a deduction and result of a constructive dividend. Personal use that is taxed to an employee as compensation is not personal use to the entity. However, for personal flights after October 22, 2004, there has been an amendment made to the entertainment facility rules which may result in a disallowance of a deduction for a compensatory use by a 10% shareholder or officer.

Because an aircraft can be considered an entertainment facility, there is a statutory requirement that contemporaneous records be maintained reflecting its use. These records should reflect the business purpose of each passenger on the aircraft for each trip of the year. There should be reconciliation between total hours flown and the contemporaneous log.

Have you collected fees for transportation services from any third parties which are subject to the Federal Excise Tax on transportation of persons or property? The tax law includes an exception for transportation charges between members of a parent and subsidiary controlled group. However, these exclusions do not apply to funds collected from brother/sister entities or from shareholders. If a brother/sister entity or shareholder reimburses cost to a related third party, they generally will be subject to federal excise taxes.

In order for an expense of a trade or business to be deductible, it must be ordinary, necessary, and reasonable in amount. The courts generally recognize that the bona fide use of an aircraft and the furtherance of a taxpayer's trade or business is a valid deduction even if it is not the least expensive mode of transportation. The courts have generally recognized the value of accessibility, the efficiency of corporate travel, and the effectiveness of it as a valuable business tool.

With proper planning, the trauma associated with an examination by the Internal Revenue Service can be greatly diminished. There is a significant body of tax law, including an opportunity to make important elections that can be more effective through proper planning. When operating a corporate aircraft, the time to plan for a tax examination is well in advance of receiving the notice.

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