

Taxing Situations

by Jeff Wieand

Tax planning has two basic objectives: avoiding or at least minimizing taxes you pay and maximizing deductions to reduce taxes you can't avoid. Business jets present significant challenges regarding both goals. Here's help, in the form of a plain-English introduction to the various taxes and tax deductions affecting business aircraft.



First, some good news: aircraft ownership, while expensive, offers many tax benefits. A business jet may generate, say, \$2 million of out-of-pocket costs annually, but if all of those costs are deductible against taxable income, your after-tax out-of-pocket costs might be only \$1.2 million.

To achieve this kind of savings, of course, you have to be entitled to the tax deductions, and for that, you must (ignoring other sources of deduction, such as gifts to charity) employ the aircraft in a trade or business. This sometimes inspires taxpayers to try to create a business that can justify the deductions, and sometimes these “businesses” lack a genuine profit motive. If an activity is merely a hobby, the IRS won’t permit deductions against income in excess of the income specifically generated by the hobby. An activity that doesn’t generate gross income in excess of tax deductions for at least three out of five consecutive years will be presumed to be a hobby and not a for-profit enterprise, but it is possible (though often difficult) to overcome this presumption and still qualify as a for-profit business.

There is a common misconception that more than 50 percent of an aircraft’s usage must be busi-

ness-related for its expenses to be deductible. In reality, the expenses are deductible to the extent that you use the aircraft in a trade or business. In other words, you’re still entitled to deduct aircraft expenses arising from use in a trade or business even if you use the aircraft principally in another activity. But, as we shall see, the percentage of non-business use may have an impact on how fast you can take depreciation on the aircraft for tax purposes.

While depreciation expense is capitalized and recognized over time, you can deduct most business-related aircraft expenses in the year you incur them. These costs include fixed expenses such as hangar, crew salaries and insurance, and the direct operating costs of flights, such as fuel and landing fees. Most maintenance expenses are also currently deductible, although the IRS may require you to capitalize maintenance expense that materially adds to the aircraft’s value or prolongs its useful life.

Dealing with Depreciation

For many business aircraft buyers, the most appealing tax benefit of ownership is the ability to write off depreciation expense. Aircraft owners

can be thankful that tax depreciation bears little or no relation to real depreciation.

A common assumption is that, over time, business jets depreciate at an average rate of 4 percent per year. At this rate, they would be worthless after 25 years, but most business jets remain in service far longer than that. Tax depreciation, on the other hand, occurs at an even faster rate. Assuming an aircraft is employed annually in a qualified business more than 50 percent of the time, you can write it off in only six years (eight if you use it mostly in commercial operations, including charter flights) on a schedule that is heavily front-loaded. The IRS calls this “accelerated depreciation,” and indeed it is. On an accelerated schedule, a two-year-old noncommercial aircraft that is still under warranty and that the marketplace regards as almost new will have only 48 percent of its tax life remaining. If this seems like a windfall, it is worth remembering that Congress in 2002 and again in 2003 further accelerated depreciation deductions for aircraft by enacting “bonus depreciation” rules. Under the 2003 legislation, the buyer of a

factory-new aircraft could actually write off 60 percent of the cost in the first year.

Though bonus depreciation is no longer available, regular accelerated depreciation remains a siren song for many airplane buyers. You might think the way to optimize the benefit of tax depreciation would be to make your purchase on December 31, and thereby get a whole year's depreciation even though the aircraft is in service for only one day that first year. But the IRS decided that, instead of looking to see exactly when during the year an asset such as an aircraft is placed in service, it would simply assume that it is placed in service halfway through the year. This is known as the half-year convention. A second convention—the mid-quarter convention—says that if more than 40 percent of the aggregate basis of assets placed in service that year are placed in service during the fourth quarter, the assets will be deemed to be placed in service midway through that quarter. Consequently, if you buy the aircraft on December 31, and (as is often the case) it's the major asset placed in service that year, the most you are entitled to is one eighth of the first-year depreciation percentage, not 50 percent.

Making Tax-Free Exchanges

The effect of tax depreciation is dramatic: if you buy a \$20 million aircraft, you can shelter \$20 million of income from tax over six years (a savings of \$8 million at a 40-percent tax rate). But this is really an interest-free loan from the government, not an outright savings. The value of tax depreciation is that you have the temporary use of funds you would otherwise pay in taxes. Meanwhile, the tax basis of the aircraft is reduced over time to zero. When you sell it, it is time to pay off the "loan," and consequently, any proceeds from the sale will be taxable, a chastening phenomenon known as depreciation recapture. These days, when aircraft owners sometimes sell airplanes for more than they paid for them, it's important to remember that

the portion of the sale proceeds in excess of original cost represents taxable capital gain.

A sure-fire way to avoid recapture is to die before you sell your aircraft. Your estate will then get a tax-free step-up in basis of the aircraft to fair market value. A more attractive strategy from the owner's standpoint, though less attractive from a tax standpoint, is to postpone depreciation recapture further by doing a tax-free or "like-kind" exchange.

Suppose you purchase a Hawker 800XP for \$10 million. Under accelerated depreciation schedules, its tax basis after six years is zero. If you then sell the jet for \$8 million, you'll have \$8 million of taxable income. Alternatively, if you use the Hawker to make a tax-free exchange for a \$22 million Challenger 604, there will be no recapture of any income on its sale. The quid pro quo is that your tax basis in the Challenger will be reduced by \$8 million, so that your tax basis for depreciation in the Challenger going forward will be \$14 million.

Section 1031 of the Internal Revenue Code sanctions tax-free exchanges, and for that reason they are often called "1031 exchanges." The key to complying with Section 1031 is to avoid two independent transactions: the sale of the existing aircraft and the purchase of the new one. Instead, you basically need to

exchange one aircraft for another. In some cases, this is easy—for example, when trading in an aircraft to a manufacturer for a new model. More often, though, owners sell an existing aircraft to one party and purchase the new aircraft from another. To transform such transactions into an exchange, you will probably want to retain a professional exchange company to act as an intermediary. Section 1031 permits you to wait 180 days after selling your aircraft to take title to the replacement, though you are required to identify the replacement aircraft with some specificity within 45 days after the sale. A policy published by the IRS in 2000 also permits this process to work in reverse: you can acquire the new aircraft first through an intermediary as long as you sell the existing aircraft within 180 days.

Paying for Personal Use

Business executives sometimes use corporate jets for non-business flights. The treatment of these flights for tax purposes has been a subject of great controversy in recent years.

Personal use involves two main tax issues: recognition of income for the executive and deduction of expenses for the company operating the aircraft. Let's consider these in turn.

If you take a free personal flight on the company aircraft, the IRS considers that you have received a taxable fringe benefit. You could eliminate this benefit by paying for the flight, but because of one of the more notorious disjunctions between FAA regulations and IRS requirements, you may find it difficult (without violating FAA rules) to pay an amount sufficient to wipe

out all, or even any, of the fringe benefit. Fortunately, in lieu of paying fair value for the flight, IRS regulations permit you to receive imputed income for it, using an attractive valuation formula called SIFL. The SIFL rules, which are based on first-class airfare, generally result in income far less than the actual cost of the transportation to the company, let alone what you would pay for an equivalent charter flight.

Turning now to the company's tax position, the IRS and aircraft owners battled in the courts and elsewhere for years about the correct amount of expenses the company should be entitled to deduct for personal flights. Initially, the IRS lost this battle, and the agency conceded that a company was generally entitled to write off all expenses of a personal flight. But the IRS enjoyed the last

Avoiding State Taxes

State taxes often receive less attention than they deserve. The states impose some of the largest and most difficult-to-avoid taxes relating to business jets. Here is a closer look.

The first state tax an aircraft buyer encounters is the sales tax, which almost all states impose on the purchase price of a business jet. For a sales tax to be due to a state, the sale must occur in that state. So sales tax is relatively easy to avoid: you simply move the aircraft to a state that generally does not tax its sale and close the transaction there. (These states include Connecticut, Delaware, Massachusetts, Montana, New Hampshire, Oregon and Rhode Island.)

Sometimes it isn't so easy to accomplish this, however. One problem may be that a piece of the aircraft (typically an engine) isn't installed when the closing takes place, because it is undergoing maintenance in a different state that has a sales tax. Careful planning may be needed in such a case to ensure that the engine isn't subject to that tax. Moreover, the whole aircraft may be undergoing maintenance in a state with a sales tax and not be flyable when the parties want to close. In this case, many states have a "fly-away" rule that exempts the transaction from tax as long as the aircraft leaves the state within a specified period. Finally, several states cap the tax at a very reasonable level—in the case of South Carolina, only \$300.

But even if you avoid sales tax, you may have to contend with its more intractable counterpart, the

use tax. No one would ever pay sales tax on any expensive purchase (especially mobile equipment like an aircraft) if all they had to do to avoid it was consummate the purchase in a state with no sales tax. So states with sales tax on aircraft also impose a "use tax" (typically in an amount equivalent to the sales tax) on the privilege of using the aircraft in the state.

Avoiding use tax can be difficult. A common technique is to try to come within a commercial exemption in the state. Sometimes, by operating an aircraft under the FAA charter rules (Part 135), it is possible to structure compliance with a commercial exemption.

Other exemptions, such as a "casual sale" exemption, may also apply. If you can't avoid use tax altogether, you may be able to significantly reduce it by means of a lease. That's because, in many states, use tax on the purchase of an aircraft for lease to another entity is levied on periodic lease payments as opposed to the purchase price.

The states have a tool chest full of other taxes that they can impose on business jets, including registration fees, property taxes and forms of income tax. A state might impose an annual tax on the value of corporate assets in the state, including any aircraft owned. Moreover, a state's treatment of income tax (deductions, for example), may vary from the treatment imposed by the IRS.

—J.W.

