

Separating business and pleasure for tax purposes

Legislation may soon modify bonus depreciation extension and how IRS sees personal aircraft use.

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Editor's note

As of press time uncertainty existed over the final form and disposition of the bonus depreciation extension or treatment of personal use of business aircraft. If the anticipated legislation becomes law, we will have another article explaining the new legislation along with any planning opportunities.



Proper documentation for business trips is mandatory for tax purposes and, where more expensive aircraft are concerned, a “no personal use” policy may be advisable.

Current tax law provides that if a new aircraft is purchased and placed in service by Dec 31, 2004, a 30% or 50% bonus depreciation is available in addition to regular MACRS depreciation, as long as the qualified business use is in excess of 50%.

Example: A business entity purchases a jet for \$10 million and places it in service during Aug 2004. It will use the aircraft only for FAR Part 91 operations. Assuming 100% business use, the amount of depreciation deductible on the 2004 federal tax return is \$5 million of bonus depreciation and \$1 million of regular depreciation, giving a total of \$6 million.

If the taxpayer fails to place the aircraft in service by Dec 31, 2004, the aircraft will not be eligible for the bonus depreciation and will only be eligible for \$2 million in regular depreciation, ie, 20% of \$10 million for 2005.

The problem is that while many businesses may want to purchase an aircraft in 2004, most manufacturers have already sold out their available 2004 delivery slots. Even though you sign a purchase contract and make a nonrefundable deposit in 2004, if the aircraft is not delivered until 2005 you get no bonus depreciation.

An exception is available for aircraft used predominantly for Part 135 operations—provided they cost more than \$1 million and took one year or longer to build. These aircraft need not be placed in service until Dec 31, 2005 and will be depreciated over a 7-year life, as opposed to a 5-year life for Part 91 aircraft.

Proposed Senate legislation

On May 11, 2004 the US Senate, by a vote of 92 to 5, passed the Jumpstart Our Business Strength (JOBS) Act of 2004. One provision of this Act would extend the 50% bonus depreciation for aircraft placed in service as late as Dec 31, 2005, as long as the aircraft was purchased in 2004, cost \$200,000, had a production period of at least 4 months and was subject to a nonrefundable deposit equal to the lesser of \$100,000 or 10% of the aircraft purchase price.

Proposed House legislation

On Jun 17, 2004 the US House of Representatives passed the American Jobs Creation Act of 2004, HR 4520. This Bill also contains a provision for extending bonus depreciation for aircraft which are placed in service by Dec 31, 2005.

Unlike the Senate legislation, which requires that an aircraft be purchased in 2004 and placed in service by the end of 2005, the House Bill permits an aircraft or other new personal property to be purchased in 2004 or 2005. As long as the aircraft is placed in service by 2005, it would qualify under the House Bill HR 4520 for bonus depreciation.

In a separate action, House of Representatives Bill HR 4352 was introduced on May 12, 2004. This Act is called the Corporate Jet Tax Shelter Reform Act of 2004.



Personal use of corporate aircraft has captured Congressional attention. The excerpt from the Congressional Record above is from Jun 18, 2004, and refers to the American Jobs Creation Act.

The purpose of this Act is "to amend the Internal Revenue Code of 1986 and to deny a deduction for the portion of employer-provided vacation flights in excess of the amount of such flights which is treated as employee compensation."

Current case law, together with Sutherland Lumber—Southwest vs Commr, 114 TC 197 and a general counsel memorandum, provides that, if a business aircraft is used for personal use, such as executive vacations or golf outings, and the value of the personal use is computed using

the standard industry fare level (SIFL) tables and added to the executive's personal income, the aircraft may still be depreciated as if it were used 100% for business.

Operating and non-operating expenses may also be deducted at the 100% level even though business use is only 5%, per Chief Counsel Advice ILM 200344008 dated Jul 1, 2003.

Many within the IRS viewed the Chief Counsel's opinion as "giving away the farm," as did tax advisors, many in the general aviation industry and, especially, a number of members of the US Senate and House of Representatives.

Proposed personal use restriction

Both the Senate and House Bills, which would extend bonus depreciation for another year, also have amendments—or are accompanied by separate Bills—that severely limit deductions for personal use of business aircraft as a way of paying for the 1-year bonus depreciation extension.

The Senate JOBS Act of 2004 contains an amendment, which was accepted without any debate, that would limit depreciation and other deductions for personal flights to the amount of additional compensation recognized by the executive for such personal use.

Example: Assume that depreciation, fuel, insurance and other aircraft deductions for 2005, at 100% business use, are \$2 million. In fact, however, the aircraft was only used 60% for business trips and 40% for personal executive vacations with a SIFL rate value of \$25,000 for the year for vacation flights.

Under the Senate amendment, the deductions for depreciation, operating and non-operating expenses would amount to \$1.2 million for the business trips (60%), plus \$25,000 for the value of the personal use imputed to the executive's W2. Overall, the business entity would lose \$775,000 in deductions for

depreciation and other expenses because of personal aircraft use. At a 35% tax rate, that amounts to \$271,250 in additional taxes.



Inaccurate financial reporting could lead ultimately to criminal sanctions.

This Senate amendment would only apply for personal use from the date of enactment through 2005, and would apply to all aircraft—not just the aircraft that were eligible for bonus depreciation.

In other words—if the language survives the Conference Committee negotiations—you could have purchased a used aircraft in 2004, with a minimal amount of personal use, not be eligible for bonus depreciation, and still have your overall deductions affected by this Senate amendment.

In the US House of Representatives, things are even more ominous. The Corporate Jet Tax Shelter Reform Act 2004, HR 4352, provides the same type of treatment for personal use of business aircraft. However, the House language remains effective from the date of enactment, with no expiration date. Thus, if HR 4352 becomes part of the law, all business aircraft with any personal use will suffer until the legislation is repealed, if it ever is.

Observation: In as little as 2 to 3 years, with a personal use factor of only 5–10%, the amount of bonus depreciation benefits enjoyed by a relative handful could be eclipsed by loss of deductions for personal aircraft use as provided by current law. This is true because the anticipated restrictions on personal use will apply to every business aircraft. Even aircraft that have long since been fully depreciated will lose a portion of their deductions for fuel, insurance or other expenses. Whether the aircraft is the newest intercontinental bizjet or the oldest single-engine piston aircraft, deductions will be lost as long as there is any element of personal use.

Paying for bonus depreciation extension

Politicians in the US Senate and House of Representatives apparently view the legislative reversal of the Sutherland Lumber and other cases as a way to “pay for the extension of bonus depreciation.”

This belief is based on the assumption that every aircraft owner who was eligible for bonus depreciation actually claimed that bonus depreciation and that all aircraft are used extensively for personal use. Nothing could be further from the truth.

Judging from my own clients, and from an informal survey of other tax advisors, the bonus depreciation, combined with low interest rates, certainly caused many taxpayers to buy new business aircraft and accelerate expenditures for plant, property and equipment. However, when it came time to actually file the 2001, 2002 and 2003 tax returns, only about half the clients actually claimed the bonus depreciation on all classes of new property.

The reasons cited by tax preparers range from the bonus depreciation having actually created too large a deduction to the desire to spread the depreciation deductions uniformly over a longer period of time in order to match income and deductions, etc.

Many preparers say they wish it were not a requirement to claim the fixed percentages of 30 or 50%, but instead claim only what was needed in the current year and carry the remainder over to future years to be used when needed.

The fact that only about 15 states have adopted the bonus depreciation provisions also plays a part when it comes to opting out of bonus depreciation. Apparently some taxpayers (and their accountants) simply didn't want to be burdened with the responsibility of keeping 2 sets of depreciation records for the same assets.

Another fact of which Congress is ignorant is that depreciation only provides a tax deferral, as opposed to a permanent tax reduction as in the case of fuel expenses, etc. For example, when the aircraft is sold, the bonus depreciation and regular depreciation are recaptured in the year of sale. If the aircraft is used as a trade-in, the depreciation may not be recaptured and taxed as ordinary income, but it reduces the depreciable basis for the replacement aircraft dramatically. In the final analysis, depreciation really costs the US Treasury very little over the life cycle cost of an aircraft.

The cost of personal use

In the event that Congress authorizes some form of extension of bonus depreciation, it is likely that it will be accompanied by severe restrictions on the deductibility of depreciation and other expenses allocated to personal use of business aircraft through 2005 or possibly beyond.

No matter which version of the US Senate or House legislation finally becomes law, we can expect personal use of multi-million-dollar business aircraft to become vastly more expensive than it is now.



Pending legislation could make personal use of large corporate aircraft prohibitive. Here a Gulfstream III (L) and a Dassault Falcon 2000 sit on the ramp at MCO (Intl, Orlando FL).

Suppose your business jet costs \$10 million in 2005 and is used on average 80% for business purposes during its depreciable life. If the Corporate Jet Tax Shelter Act of 2004, HR 4532, becomes law, some \$2 million of depreciation, plus 20% of all fuel, insurance and other costs for the entire ownership period will be non-deductible. If the Senate amendment passes, only 20% of depreciation and other expenses from the date of enactment through 2005 will be at risk.

Either way, the price of a 1-year extension of bonus depreciation will be paid by every aircraft owner with any personal use, regardless of whether that particular aircraft is eligible for the bonus depreciation benefits. Opting out of bonus depreciation will not protect you from having to make adjustments as a result of personal use.

If personal use is not being tracked and accounted for accurately at least quarterly, CEOs, CFOs and others may be at risk of incurring personal and corporate liability.

Corporate liability

While the most obvious cost of personal aircraft use may be loss of tax deductions, the greatest cost may be in the form of loss of public confidence in the accounting procedures used by public and private companies who own and operate business aircraft.

On Jun 30, 2002, Congress passed the American Competitiveness and Corporate Accountability Act of 2002, more commonly referred to as Sarbanes-Oxley Act. For the most part the provisions of Sarbanes-Oxley were directed at restoring investor confidence in public companies following corporate accounting scandals.

Standards for conduct for auditors, board members and corporate management are a central thrust of the regulations. One of the requirements of the Act is for the CEO and CFO to personally certify and attest to the accuracy and fairness of the financial statements. The CEO must also sign the tax return.

In order to avoid potential corporate or personal liability, aircraft owners should be sure to track and account for personal use at least on a quarterly basis, so as to ensure that their quarterly estimated tax payments are correct and to avoid claiming too much depreciation and other aircraft expense deductions on their tax returns. If the tax return is inaccurate, it's likely that the provision for federal and state income taxes will be incorrect. It follows that the financial statements will be inaccurate, as will reports filed with the Securities and Exchange Commission. And if these reports are incorrect, the chief executive and

financial officers may be subject to criminal sanctions, not to mention the stock market's loss of confidence in the company overall.

Even though Sarbanes-Oxley focuses on public companies, private companies may also want to hold themselves to the higher standards of conduct because:

1. The standards constitute good business practice.
 2. The private company may want to go public in the future.
 3. The private company may want to position itself to be acquired by a public company.
 4. The private company may want to become involved in an initial public offering (IPO).
- Lenders may require private companies to adhere to various provisions before granting a loan.

If your company is considering any of these courses of action, I recommend consulting your independent CPA firm to determine your company's status vis-à-vis Sarbanes-Oxley.

Summary

Given the anticipated legislative actions of Congress in the near future, the current financial and tax regulations, and possible exposure for corporate and personal criminal sanction, all business aircraft operators need to be diligent in accounting for personal use of business aircraft. The more expensive the aircraft, the more costly the executive trip to a homecoming game or round of golf will be.

If the purchase price of a business jet is more than \$10 million, a case could be made for buying one of the new light jets, fractional shares, a used aircraft or use of charter aircraft for the personal trips.

In the case of a \$25-million aircraft, the loss of 20% of depreciation and all other deductible expenses over a 3 to 5-year ownership period could more than pay for the projected cost of any new light jet currently in the design and certification phase.

Accordingly, it may be advisable to adopt a policy of "no personal use" of the most expensive aircraft. Major cost savings may be available for those who consider other aircraft alternatives for personal use while reserving the most expensive equipment for business only.



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