Taking Flight - Tax aspects of aircraft ownership.

by Victor C. Anvick

EXECUTIVE SUMMARY

» Following 9/11 companies of all sizes increased their purchases of business aircraft to make travel easier and more convenient for employees and executives. CPAs should be aware of the tax, financial, operational and regulatory issues involved in acquiring and operating a business aircraft.

» The first step is to document why the company needs to purchase its own aircraft. To help decide what class of aircraft the company should buy, CPAs should develop a travel profile including the number of passengers, average trip length and amount of baggage.

» Another critical decision is whether to set up a separate entity to acquire the aircraft. If yes, be careful not to violate the FAA rules that carrying company officials on a company aircraft must be incidental to the entity's business.

» Each state has its own sales and use taxes for aircraft. CPAs should carefully research the relevant taxes and not depend on the sales representative's advice.

» The American Jobs Creation Act and IRS Notice 2005-45 changed the tax treatment for personal use of company aircraft. All expenses for recreation, entertainment or amusement use by "specified individuals" are disallowed unless those individuals impute the aggregate value as income on their W-2. The notice provides two methods for calculating the disallowed expenses.

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Since 9/11 increased security measures and travel restrictions have boosted sales of new and used aircraft sales, as well as fractional share programs, prepaid flight cards and air charter usage among companies of all sizes, from small businesses to international conglomerates. With the recent FAA certification of the first very light jet (VLJ) and other companies planning to enter the market, private jet travel is now affordable for many more sole proprietorships and small to medium-sized businesses.

This article introduces some of the tax, financial, operational and regulatory issues involved in acquiring and operating a business aircraft. It is intended primarily for CPAs advising clients or employers who are aircraft owners or who are interested in purchasing a business aircraft.

Business Aircraft: Facts and Figures

» About 15,000 business aircraft are in operation in the United States with just 3% of them flown by *Fortune* 500 companies.

» Some 86% of business aviation flyers are midlevel professional or technical staffers.

» Companies operating business aircraft earn 140% more in cumulative shareholder returns than companies without business aircraft.

Source: National Business Aviation Association, Washington, D.C.,

A CAVEAT

The acquisition and operation of a business aircraft can be divided into distinct phases, including preacquisition planning, acquisition, delivery and operation. Each phase has its own planning opportunities that can offer companies considerable savings—while they still operate within the bounds of regulatory compliance.

If aircraft owners don't address these issues, lost tax deductions, penalties and interest may be the least of their problems. If an accident or other incident occurs, job losses and unnecessary liability exposure far in excess of the enterprise's net worth could result from the failure to follow aircraft regulations.

A CASE STUDY

The only fictional element in the following case study is the name of the entities Greenacre Group and Greenacre Consulting LLC. All other elements are based on actual scenarios accumulated over 20 years of advising clients on the tax, financial and regulatory aspects of aircraft acquisition and operation.

The facts. Greenacre Group is a consortium of privately held entities, linked by common ownership, involved in diverse activities such as real estate, manufacturing and auto dealerships, with locations throughout the Western United States. The group wants to expand into additional markets not conveniently serviced by commercial airlines. It needs to establish firmer control over daily operations, protect its current markets from competition and develop closer relationships with customers, vendors and suppliers. In the event of an emergency, senior management wants to be on-site as soon as possible. Depending on charter or shared aircraft would be too expensive because the group's aircraft use is expected to be well over 200 hours a year. Accordingly, Greenacre Group decides to investigate acquiring its own plane.

THE PREACQUISITION PHASE

The first step is to document why Greenacre needs its own plane following the ordinary, necessary and reasonableness issues of IRC section 162 and the regulations, cases and other citable authority. Experience has shown that clients who cannot cite a bona fide reason for aircraft acquisition before the purchase have greater difficulty justifying it to an IRS agent three years *after* the purchase.

Greenacre has identified several cancelled or interrupted business trips as well as examples of strained relations with customers and the inability to have senior management at a branch office quickly in the event of a crisis. These incidents go well beyond the ordinary and necessary standard in section 162. Acquiring an aircraft seems to be mandatory if the group is to continue its profitable existence and future expansion. The cost of owning and operating an airplane is necessary in the sense that it is "appropriate and helpful" to the development of Greenacre's business. It is ordinary in the sense that it is a "normal and natural response" to the conditions under which Greenacre does business. (See *Commissioner* v. *Tellier,* 383 US 687, 689 (1966).)

The next step is to develop a travel profile. Factors such as the number of passengers, average trip length, amount of baggage, destinations and number of trips per month will dictate the class of aircraft the company buys. Only then does it make sense to start collecting cost data. For example, if Greenacre's management needs to go to Hawaii for a once-a-year industry convention and insists on taking the company aircraft rather than a charter or commercial flight, many fine aircraft will be eliminated from consideration because of lack of range. On the other hand, if Greenacre can charter a plane for the Hawaii trip and purchase an aircraft that will satisfy most of its continental U.S. needs, it could realize substantial acquisition savings as well as save on fuel, maintenance, insurance, property taxes, sales taxes and other costs.

Planning tip. Don't buy more or less airplane than the company needs. Look for a plane that will satisfy 80% to 90% of your current and anticipated travel requirements for no more than the next three years. (The average ownership period for most business turboprops or jets is about 32 months.)

Greenacre decides to hire an aircraft acquisition consultant to evaluate its current and anticipated travel needs and work with its CPA to develop acquisition costs, operating and nonoperating expenses, budgets and tax projections.

During the preacquisition phase companies also should decide whether an existing business will purchase the aircraft or whether they should form a separate entity. Because of liability issues, it has become increasingly popular for aircraft owners to set up a limited liability company or S corporation to own and operate the plane.

Unfortunately, many such single-purpose entities or "flight department companies" operate outside FAA regulations. They have no business plan or ascertainable business activity other than carrying company officials, employees and guests. The preamble to Amendment 91-101, cited in FAA Chief Counsel Opinion 1989-22, says carrying company officials on a company aircraft must be "incidental to the company's business." If not, an FAA operating certificate issued under part 121 or 135 is required. The FAA issues part 121 certificates to major airlines and part 135 certificates to air taxi/air charter operators.

Obviously, Greenacre Group does not intend to become an airline or charter operator. Therefore, it must either purchase the airplane through a current operating company or set up another entity that has a primary business other than providing air transportation. Any such transportation must be incidental to the entity's main business.

Greenacre decides to outsource all of its marketing, management and event planning functions to a new internal entity called Greenacre Consulting LLC. It will perform bona fide services for the group and any air transportation services will clearly be incidental to its consulting business. The LLC also can render fee-based services to nonrelated businesses. It will not charge Greenacre Group for aircraft use, but will charge consulting, marketing and management fees under contracts with various Greenacre entities.

Since no charges will be made for aircraft use, federal excise taxes will not apply and passive activity classification will not be an issue. Operating the aircraft in this manner will not require an airline or charter certificate.

Planning tip. In *Parker* v. *Commissioner,* TC Memo 2002-76, the Tax Court ruled a taxpayer who was active in aviation for more than 34 years was operating as a hobby, in large part because he lacked a business plan. To avoid hobby loss classification, CPAs can help their clients or employers develop a basic business plan for the entity that owns the aircraft.

Now that the entity structure issues are resolved and a travel profile has been developed, Greenacre is ready to select a suitable class of aircraft. Acquisition costs are largely a function of aircraft size and speed. Usually the more you want to carry and the faster and higher you want to fly, the higher the costs.

THE ACQUISITION

Greenacre decides to purchase a jet in the $5 million to $10 million range and enters into purchase negotiations. It's also time for Greenacre to get its financing in order. Acquisition consultants can help here as they typically have several financing sources.

A company's CPA should analyze a draft of the aircraft purchase contract as soon as it is available to calculate a proper income and property tax basis. Items such as pilot and mechanic training normally are included in the price of new business aircraft. These items should not be depreciated as long as they are separately stated on the purchase invoice. They also are not subject to property taxes in most jurisdictions.

Planning tip. Ask the manufacturer to "unbundle" the sales price as a condition of sale. This helps uncover items the company can expense vs. capitalize.

Timing can have a material effect on the purchase price. The aircraft industry is managed on a quarterly basis. Salespeople who have not met their quotas may be more willing to negotiate at the end of a quarter, especially at yearend, for qualified prospects ready to "buy now." Depending on the make and model, you also may save by purchasing a nearly new aircraft—complete with all factory warranties—instead of a new one if you can move quickly.

Planning tip. Due to the increase in private aircraft ownership since 9/11, many popular models are sold out for 12 to 18 months or longer. Companies should be prepared to make a deposit promptly to avoid losing their desired aircraft.

AIRCRAFT DELIVERY

Each state has its own sales and use tax laws—especially for aircraft. The taxes imposed on aircraft purchases may be fixed regardless of aircraft cost or range from zero to 8.25% or more of the purchase price. The state in which you accept delivery may have its own aircraft-use taxes, even though the company may not have any nexus with that jurisdiction. Don't try to register an aircraft in states such as Delaware or Oregon that have no tax to evade your own state's taxes unless you have an office in that state and intend to base the aircraft there. Some states have penalties of up to 300% for residents who improperly register an aircraft to avoid sales taxes.

CPAs should carefully research state and local aircraft sales and use taxes in their client or employer's jurisdiction before delivery. Some states, such as California, exempt aircraft used in interstate commerce or for air charter; others offer a sales and use tax credit when you trade in one aircraft for another.

Planning tip. Don't depend on the aircraft broker or factory sales representative to have current knowledge on this subject. Do the research yourself or hire an aircraft tax specialist.

DEPRECIATION

Since Greenacre LLC will use the plane only for its own business and not make it available for public charter, its operation falls under Federal Aviation Regulation 14 CFR part 91. The appropriate asset depreciation class is 00.21 with a MACRS life of five years as long as annual business use exceeds 50% of total operation time. Even though airplanes are listed property, there are no limitations as there are for luxury automobiles. If Greenacre does use the aircraft predominantly for public charter, the appropriate asset class would be 45.0 with a MACRS life of seven years.

All appropriate half-year and midquarter conventions apply, regardless of whether the company qualifies for the five- or seven-year MACRS treatment. These depreciable lives apply to new or used aircraft. Aircraft on public charter flights are operated under Federal Aviation Regulation (FAR) 14 CFR part 135. This can dramatically increase maintenance and insurance costs due to higher standards and additional liability.

Greenacre LLC will not use tax depreciation for financial statement presentation. Instead, it may use a large salvage value and depreciate the remaining balance over a longer period. To show higher net book values, salvage values in the 70% to 80% range, with a book life of 10 to 12 years, are not uncommon based on the make, model and onboard equipment. Companies that have loan covenants with financial institutions that impose capital ratio requirements should consider using different book treatment to avoid having the bank call their loan.

TAX LAW CHANGES FOR PERSONAL USE

This section provides basic guidance in an extremely complex area resulting from the American Jobs Creation Act of 2004 and IRS Notice 2005-45. Any CPA who gives advice in this area should be thoroughly familiar with the client or employer's facts and circumstances as well as these two pronouncements.

Notice 2005-45 mandates the tax treatment for flights on or after July 1, 2005. All expenses, including depreciation, for maintaining and operating the aircraft allocable to "recreation, entertainment or amusement" flights by "specified individuals" are disallowed unless the specified individuals include the imputed value of those expenses as income on their W-2s if they are employees or as a guaranteed payment if they are partners or LLC members. Expenses include, but are not limited to, fuel, pilot salaries, personnel assigned to the aircraft, flight crew meals and lodging, take-off and landing fees, maintenance and maintenance flights, onboard refreshments, amenities, gifts, hangar and parking costs, management fees, depreciation and special expensing amounts under IRC section 179. (*Note*: If you charter an airplane, all charter costs, as well as payments on leased aircraft, are subject to the same disallowance provisions.)

"Specified individuals" include:

» Individuals subject to section 16(a) of the Securities Exchange Act of 1934.

» Direct or indirect owners of more than 10% of any class of any registered equity security issued by the taxpayer.

» Officers, directors or other individuals who are more than 10% owners of C or S corporations.

» Partners who hold more than 10% equity interest in the partnership, general partners, officers or managing members of a partnership.

» Directors or officers of tax-exempt entities.

» Spouses of specified individuals, as well as other related business entities, also may be specified individuals.

Disallowed aggregate expenses. Notice 2005-45 provides two ways to calculate the disallowed expenses—the occupied-seat-miles or the occupied-seat-hours method. Taxpayers can use whichever method produces the more favorable result.

Under the occupied-seat-miles method, total aircraft costs and depreciation are divided by total occupied seat miles to arrive at per-seat-mile cost for the year. In this case, one passenger occupying a seat for one mile is an occupied seat mile.

Under the occupied-seat-hours method, total costs are divided by total occupied seat-hours to arrive at a seat-hour cost factor. One passenger occupying a seat for one hour results in one occupied seat-hour. To arrive at disallowed expenses, multiply the occupied recreation, entertainment or amusement miles or hours used by specified individuals over the course of the year by the per-mile or per-hour cost factors.

Example 1. An aircraft owner elects to use the per-hour method. The company incurs $10 million in aircraft costs and depreciation for the year. Total occupied passenger seat-hours are 5,000 hours; the cost per occupied seat-hour is $2,000. If specified individuals used 1,000 occupied seat-hours, then $2 million of depreciation and other deductions would be disallowed if none of the specified individuals reimbursed the company or had any portion of the $2 million added to their W-2s.

Example 2. A company flies 20 business trips and eight entertainment trips during the year. All passengers are specified individuals. Each business round-trip has three passengers and is four hours long for a total of 240 occupied-business-seat-hours for the year. Each of the eight entertainment round-trips is also four hours long; eight passengers a trip total 256 entertainment occupied-seat-hours. The total occupied-seat-hours for the year is 496. However, since 256 hours are allocated to entertainment use, 51.6% of all deductions, including depreciation, will be disallowed unless the executives reimburse the company or have the $2 million of entertainment seat value added to their W-2s as additional income. If the executives impute $500,000 of additional income, the company will lose only $1.5 million in aircraft deductions provided those executives are not also classified as "covered employees" subject to section 162(m). (Covered employees generally are the four highest-paid employees of public companies, with salaries in excess of $1 million.)

While example 2 may be an extreme case with lower-than-average total annual hours for a business aircraft, it illustrates that a few fully loaded entertainment flights can deplete the tax deductions for many bona fide business trips with relatively few passengers. Trips with children, nannies and other family members could be particularly expensive and troublesome for a business that needs maximum tax benefits from aircraft expenditures.

Planning tip. Instruct clients or employers not to accept any reimbursement in the form of a personal check or other compensation for entertainment, recreation or amusement use by specified or non-specified individuals. If a company accepts such payments, it must pay a 7.5% federal excise tax and segment fees. But that's the least of its problems—the FAA will consider the employer as having furnished commercial air transportation services and may impose fines and sanctions if the flight was not conducted under FAR part 135. In addition, the pilots who flew the aircraft could have their licenses revoked. >This is one instance where the FARs supersede any creative tax planning. The IRS doesn't care whether the employee reimburses the employer for transportation. It just wants its federal excise taxes on the value of air transportation services.

Planning tip. Since notice 2005-45 does not define the terms *recreation*, *entertainment* or *amusement*, CPAs should help employers and clients develop definitions based on their own facts and circumstances. For example, a bereavement flight to attend a funeral hardly falls into one of the three tainted categories, but is "other personal use." Thus it is eligible for much more favorable treatment, using the standard industry fare level (SIFL) rates published by the IRS semiannually in combination with Treasury regulations section 1.61-21(g) to assign the imputed income values. Narrowing the definition of *tainted categories* makes it possible to mitigate the severe impact of this IRS notice.

Practical Tips

» Don't buy more or less airplane than the company needs. Look for a plane that will satisfy 80% to 90% of travel requirements for the next three years.

» Ask the aircraft manufacturer to "unbundle" the sales price to help uncover items the company can expense vs. capitalize.

» Carefully research all applicable taxes. Don't try to register the aircraft in a nontax state unless you have an office and intend to base the plane there.

READY FOR TAKEOFF

With a seat on a new VLJ aircraft expected to cost about the same as a fully refundable coach ticket—without the problems of long security lines, lost baggage, missed connections and the like—CPAs will find business aircraft ownership can be a cost-effective alternative for clients and employers. CPAs should track any additional income made possible by using a private aircraft. It's not uncommon for additional income, the value of time savings or increase in portfolio value to exceed the acquisition cost of an aircraft in two to three years.