

## **Creating Tax Advantages and Business use of Aircraft**

**North Florida Flight Training  
855-1 St. Johns Bluff Rd  
Jacksonville, Florida 32225  
904 642-3912**

**Disclaimer: The information presented in this packet “Tax Advantages and Business Use of Aircraft”, and at the related seminar is for informational purposes only and presented to our pilot friends at no charge only as an aid to make an informed decision on aircraft purchases. Each person's specific situation must be taken into consideration. Proper planning is advised by seeking legal and/or accounting advice through attorneys and/or CPA's that are knowledgeable and have worked with Aviation businesses.**

**Legal fees for the proper set-up of the business entity can run from \$1,000-\$1,500. This is a small price to pay when the tax savings available is so high. It could mean the difference between being able to take the tax savings on the down payment only and being able to take the tax savings on the full cost of the airplane.**

### **The Leaseback Concept**

For years, big corporations and investor groups have utilized sale/leaseback agreements to maximize benefits and minimize the costs of owning a business aircraft.

Now through the new Cessna Leaseback program, we're making it easy for most individuals and small companies to qualify for these same business deductions and incentives- to substantially reduce the monthly net cost of buying and flying a brand new Cessna or to own one or more as an income producing investment.

#### **Here's how it works:**

First, you become the owner of a new Cessna Single-Engine aircraft, usually through your own Corporation set up specifically for the aircraft. We can recommend professionals to assist you in the proper set up of your corporation, registering your new business with the State of Florida and proper tax planning. Proper set up will eliminate paying state sales tax, you will pay a monthly Use Tax, there is no property tax in the State of Florida on an airplane. If you choose to use your own Attorney or CPA, it is of the utmost importance they understand Aviation Tax laws.

Once you have purchased your airplane, you place it on a management agreement with a flight school for use by other pilots on an hourly rental basis. This agreement, backed with the proper documentation, essentially puts you into the aircraft rental business- thus qualifying you for certain business tax benefits and incentives not otherwise available to individual aircraft buyers.

Overall, it is a win-win opportunity for both you and your flight school. They get an attractive new aircraft to offer in their rental program, you get rental revenues and valuable equity in the airplane, plus significant tax advantages.

Currently interest rates are at an all time low with flexible terms and low down payments. Typically the loan rate is a small percentage over prime.

### Numbers on a Typical Leaseback

The cash flow numbers to make a Cessna leaseback work are fairly straightforward. Many owners will trade the plane after 18-24 months or 4 years. Trading within 18-24 months can provide the greatest benefit in that resale is relatively easy due to less hours on the plane, remaining factory warranty and keeping newer aircraft on line for rental (the newer planes will always tend to rent more).

The cash flows are determined by revenue from rental, expense of operation, loan payments, management fee and tax savings through depreciation. The depreciation schedule allowed by the IRS will increase your effective cash flow substantially

You as the aircraft owner should see a break-even point of expenses and cost of ownership at about 45-50 hours of rental time per month, 172SP's are averaging 65 hours per month rental in the State of Florida.

<b>Aircraft Rental Analysis Data</b>					
<b>5 Year Cash Flow Forecast</b>					
<b>Skyhawk SP, G1000</b>					
	<b><u>Year 1</u></b>	<b><u>Year 2</u></b>	<b><u>Year 3</u></b>	<b><u>Year 4</u></b>	<b><u>Year 5</u></b>
<b>Total Rental Revenue:</b>	<b>\$ 96,480</b>	<b>\$ 98,892</b>	<b>\$ 101,364</b>	<b>\$ 103,898</b>	<b>\$ 106,496</b>
<b>Less Operating Costs:</b>					
fixed operating costs	\$ 13,205	\$ 12,649	\$ 12,097	\$ 11,547	\$ 10,326
variable operating costs	\$ 49,993	\$ 50,480	\$ 59,301	\$ 60,022	\$ 60,760
<b>Less Other Expenses:</b>					
Sales/Use tax	\$ 1,735	\$ 1,735	\$ 1,735	\$ 1,735	\$ 1,735
Property Tax	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Net Revenue:</b>	<b>\$ 33,282</b>	<b>\$ 35,762</b>	<b>\$ 29,966</b>	<b>\$ 32,329</b>	<b>\$ 35,409</b>
Aircraft Loan Payments	\$ 23,745	\$ 23,745	\$ 23,745	\$ 23,745	\$ 23,745
<b>Net Cash Flow before Taxes</b>	<b>\$ 9,537</b>	<b>\$ 12,017</b>	<b>\$ 6,221</b>	<b>\$ 8,584</b>	<b>\$ 11,664</b>

Tax Savings/(payment) on P & L	<u>\$ 11,229</u>	<u>\$ 20,266</u>	<u>\$ 11,263</u>	<u>\$ 3,707</u>	<u>\$ 2,358</u>
<b>After Tax Cash Flow</b>	<b>\$ 20,767</b>	<b>\$ 32,283</b>	<b>\$ 17,484</b>	<b>\$ 12,290</b>	<b>\$ 14,022</b>
<b>After Tax Cumulative Cash Flow</b>	<b>\$ 20,767</b>	<b>\$ 53,049</b>	<b>\$ 70,533</b>	<b>\$ 82,824</b>	<b>\$ 96,846</b>
Sale of Aircraft		\$ 202,440			\$ 144,600
Payoff of Loan Balance		\$ (199,650)			\$ (168,623)
Initial Investment (down payment)		<u>\$ (24,100)</u>			<u>\$ (24,100)</u>
<b>Net Cash After 2 &amp; 5 Years</b>		<b>\$ 31,740</b>			<b>\$ 48,723</b>

**You can have a plane and fly it for free, all expenses have been accounted for.**

### Depreciation and Resale Value

The incredible value retention for which Cessna Single Engines are famous has historically rewarded owners with a higher-than-average return on their investment at resale time. Although business airplanes are classified as “five-year property” for depreciation purposes, most property placed in service during a tax year is qualified for activation under mid-year or mid-quarter depreciation conventions. Consequently, most five-year property takes six tax years to fully depreciate. Under MACRS, the depreciation schedule on your new Cessna would typically look something like this at a 35% tax bracket, married:

172SP Nav III T182 Nav III 206 Nav III

\$241,000 \$355,050 \$480,160

Year Percentage Tax Savings Tax Savings Tax Savings

1 20% \$ 22,831 \$ 24,854 \$ 33,751

2 32% \$ 36,529 \$ 33,766 \$ 54,002

As you can see, the tenacious resistance of new Cessna's to economic depreciation combined with favorable tax depreciation rates give you the absolute maximum advantage from a cash flow standpoint. Meanwhile, your revenue stream from leaseback rental is steadily growing as well as your equity in a highly marketable asset.

## Maximizing Aircraft Tax Savings through Planning

**There are few tax saving opportunities as effective as fully depreciating an aircraft on a five (5) year accelerated basis. In today's interest rate environment, a well-structured transaction often results in little or no after tax cash flow holding costs during the early years of acquisition.**

Income tax deductions do not spring from mere ownership however; the Internal Revenue Code provides “there shall be allowed as a deduction all ordinary and necessary business Expenses incurred in carrying on any trade or business.”<sup>1</sup> **However, once it is determined that an expense is ordinary and necessary, it may be deductible in full even if it exceeds gross income from the undertaking.**<sup>2</sup>

### The Ordinary and Necessary Test

The first element in the test requires that an expense be ordinary, in light of the common and accepted practice in the industry at the time and place of the circumstance.<sup>3</sup> The courts readily recognize the use of a private aircraft in the furtherance of a taxpayer's business is often a common practice, and therefore the ordinary test is generally not a barrier to deductibility. The courts have determined that the necessary requirement mandates a finding that the taxpayer's use of the aircraft is “appropriate” and “helpful.”

This test requires the showing of a direct relationship between the expense and the furtherance of the business. The third test requires the expense must be reasonable in relation to its purpose. **It is not necessary for the taxpayer to incur the least expensive mode of transportation, but merely in light of the facts and circumstances, the selected mode was reasonable.**

### How the Courts Apply the Ordinary/Necessary

#### Requirement to Private Aircraft

A traveling salesman used his aircraft to do business with clients throughout the western states when he found the use of commercial airlines was inefficient. He could prove that the flexibility gained by traveling in his own airplane increased sales, and was entitled to full deductions even though the cost of operating the aircraft exceeded the bonuses he received from the incremental sales.<sup>5</sup> A government employee was entitled to deduct the excess of the cost of flying his own aircraft over the mileage reimbursement he received from his employer. His reimbursement was initially 16 cents per mile and was eventually raised to 45 cents per mile. A representative from his government employer testified that although he was not required to use his own airplane, or fly other than by commercial means, “travel by a privately owned aircraft has been determined as more advantageous to the government.” Thus, the taxpayer was entitled to deduct the excess of the cost of operating his aircraft over the reimbursements from his employer.<sup>6</sup>

**Perhaps one of the most critical holdings for operators of aircraft is the recognition by the courts that depreciation is not used in determining the reasonableness of an expense. The court has stated that the ordinary and necessary requirement does not apply for depreciation deductions, which are deductible otherwise under their own provisions.**<sup>12</sup>

Thus, the court held in determining whether taxpayer's expenses for business travel in his own airplane are reasonable, depreciation is not taken into account.<sup>14</sup>

In summary, taxpayers who seek to deduct the cost of operating their aircraft as ordinary and necessary business expenses incidental to their primary business, should document the direct relationship between the use of the aircraft, and the furtherance of their business. ***Business aviation users quickly recognize the substantial benefits of private aircraft travel, and are encouraged to document its value in business meetings, and minutes relating to the expansion of private aircraft fleet.***

### **Aircraft Ownership as a Separate Trade or Business**

It is well settled that a taxpayer may perform services on behalf of a corporation and for purposes of ordinary and necessary business deductions, such taxpayer is considered to be in a trade or business of being an employee separate and apart from the trade or business of its corporate employer.<sup>15</sup> Taxpayers who could not integrate the use of their aircraft with their business, or as an employee, may nonetheless, still have an opportunity to secure income tax deductions by operating a separate trade or business in the aircraft rental and management field. This business normally takes on the form of acquiring an aircraft for leaseback, or piggyback to a charter operator operating under and **placing the aircraft in a flight school, or a fixed based operator's line for rental or leasing an aircraft on a block rental basis under FAR Part 91 to other operators.**

The primary impediment to deductibility from a trade or business structured in this fashion relates to whether or not the taxpayer has engaged in an activity for profit, or as merely seeking deductions of a personal "hobby." The IRS has promulgated regulations that provide that the determination of whether or not an activity is engaged into for profit will be based on all the facts and circumstances in each case. **It is not necessary that profit actually be derived, but the facts and circumstances indicate that the taxpayer entered into the activity with the objective of making a profit.** The Regulations provide nine relevant factors to assist in evaluation of profit intent.<sup>15</sup> The first three of these tests consist of the manner in which the taxpayer carries on the activity, the taxpayer or his advisor's expertise in the activity, and the taxpayer's time and effort. The success of meeting these three tests often depends not on the taxpayer's actual conduct or expertise, but on his ability to document his efforts and expertise. The taxpayer must show that he handled the activity in a businesslike and commercially reasonable manner, he maintains complete and accurate books and records in a manner similar to other activities of the same nature that are profitable, and that he expends a reasonable amount of effort, relies on experts when necessary and appropriate, and modifies his operations when necessary to improve profitability. Taxpayers rarely acquire a capital asset of significance such as

an aircraft for the purpose of leasing it out, without thoroughly investigating and analyzing its profit potential. Nonetheless, they often discard original projections, or their financial information that details the investment decision. The retention of this information is vital to the defense of the hobby loss challenge.

**The fourth test involves the expectation of appreciation of the assets of a business. Those with any significant experience in aviation recognize that the long-term appreciation of metal aircraft has been both substantial and systematic.** Inventory turnover rates appear to be increasing; we are beginning to return to periods of steady, increasing prices. We would encourage aircraft owners to obtain and retain historical information that justifies their anticipation of appreciation. It is also important to note in this regard, that when determining losses for purposes of the hobby loss rule, depreciation is economic depreciation, not tax depreciation. This very often converts tax losses into economic gains.

The next three tests relate to the taxpayer's previous success in other businesses, prior income and losses of this activity, and the amount of profits in relation to losses in taxpayer's investments. These tests obviously turn on the reasonable anticipation of the taxpayer to convert his profit motive into profit realization. A history of such behavior will certainly assist in the taxpayer's defense of the reasonableness of the profit motive.

The financial status of the taxpayer may also help determine motive for an investment. Lack of a profit motive may be indicated if the taxpayer has substantial income from other sources and the activity generates substantial tax or recreational benefits.

Furthermore, a taxpayer who needs to rely on the financial success of the business may use that fact as further evidence of his profit intent.

The final test is whether or not the activity is a source of significant personal pleasure or recreation. This will, of course, vary significantly based on the facts and circumstances.

It is unlikely that the taxpayer could obtain significant personal or recreational benefit from leasing an aircraft to a FAR Part 135 charter company, the local flight school or FBO. If on the other hand, the leasing activity is incidental to personal use, the taxpayer's challenges will be more significant.

In summary, often the most overlooked element of a taxpayer confronting the hobby loss rules is the necessity for documentation. It is not merely the profit motive that is essential, but the documentation that substantiates the underlying profit motivation. This documentation requires that one conducts the activity in a businesslike manner, devotes significant time to it, and seeks competent help in making it successful.

Finally, it is important that a taxpayer not only meet the hobby loss rules related to his trade or business activity, but also the passive activity rules. This requires him to materially participate in the activity that is properly structured. Passive activity rules may serve to suspend, or disallow otherwise allowable deductions.

- 1 Internal Revenue Code § 162(a)
- 2 US v Haskel Engineering & Supply Co., 380 F2d 786, (1967)
- 3 Welch v Helvering, 290 US 111, (1933)
- 4 Marshall v Commissioner 63 TCM 1976, (1992)
- 5 S.F. Sartor v Commissioner, 48 TCM 150, (1984)
- 6 D.W. Marshall v Commissioner, Supra
- 7 E.L. Potter v Commissioner, 18 BTA 549, (1929)
- 8 S.E. Penn v Robertson, 29 F.SUPP 386 (1939)
- 9 J.B. Walliser v Commissioner, 72 TC 433 (1979)
- 10N.J. Fisher v US, 59 TC 696, (1973)
- 11 A.L Sanderson v Commissioner, 16 TCM 105 (1957); R.G. Fairburn v Commissioner, 28 TCM 438 (1969); J.M. French v Commissioner, 59 TCM 966, (1990)
- 12 R.N. Noyce v Commissioner, Supra
- 13 S.M. Kurzet v Commissioner, 2000-2 USTC 50,671 (2000)
- 14 Noland v Commissioner, 269 F2d 108, (1959)
- 15 Reg. 1.183-2(b)

### **Creating Business Use through Rental**

Many taxpayers will have the opportunity to use their aircraft directly in their business and deduct all of its expenses as an ordinary and necessary business expense. You may also be able to save a substantial amount of money by avoiding the **state sales tax and paying a much smaller monthly use tax.**

Many other taxpayers, however, are unable to use their aircraft in their primary business due to either the nature of the business, or restrictions placed on them by their employer. *These taxpayers may also have an opportunity to expense both operating expenses and depreciate their aircraft through a properly constructed rental agreement.*

**A logical business operation would include providing an aircraft for a rental pool, or a flight school operation. In order to qualify for business treatment it must be properly structured and undertaken with profitable intent. The key here being the *Intent* to make a profit not whether you made a profit.**

### **Tax Losses Resulting from Depreciation are Deductible even if Tax Losses are Regular and Continuous**

The Internal Revenue Service has prescribed rules under Regulation 1.183-2(b) intended to prohibit taxpayers from deducting losses from *hobbies* rather than business interest.

These *hobby* losses. will be presumed to be for a non-business purpose unless the taxpayer makes a profit in three out of five years. The courts have recognized, however, that the profit mandated by the hobby loss rules is not showing a net taxable income, but of economic profit. *This distinction is clearly beneficial to aircraft owners, in that an aircraft that economically depreciates over 40 years is depreciated for tax purposes over five years, and over 50% of that depreciation is allowed in the first two taxable years of ownership.* In Kurzet vs. Commissioner, 222 F3d 830, the court recognized that aircraft did not depreciate economically at the rate allowed for income tax purposes, and depreciation is allowable exclusive of the ordinary and necessary test. *It is therefore clear that the profitable intent required as a prerequisite of deductibility does not include the requirement of net taxable income, but a reasonable expectation of economic profit.*

*Therefore a taxpayer who has continuous losses over the depreciable life of the asset will not automatically have losses disallowed merely because he sustains tax losses during the early years of ownership.*

### **Structuring the Transaction to Comply with Passive Activity**

#### **Limitations**

The taxpayer who incurs a loss in a business designated as a *passive* activity will only be allowed to deduct the loss to the extent he has passive activity income from other sources. *A passive activity includes the long-term rental of real or personal property, and any business loss in which the taxpayer does not materially participate. These tests are mutually exclusive, in that regardless of a taxpayer's material participation in a rental activity it will automatically be classified as passive.* In William Warren Kelly, T.C. Memo 2000-32, an aircraft owner leased several aircraft to a Seattle flight school. The IRS conceded that the taxpayer materially participated in the endeavor, but because the transaction took the form of a one-year lease to the flight school this was nonetheless disallowed. *The principal exception available to most aircraft owners in the avoidance of the per se disallowance for rental is an exclusion of property that is rented for an average period of seven days or less. Had Mr. Kelly structured his agreement with the flight school wherein the customers of the flight school became his customers, his average period of rental would have been measured in terms of hours, and obviously*

*well below the average period of use of seven days or more.* Because Mr. Kelly admittedly materially participated in the business, a mere change in the form of the agreement would likely have resulted in a taxpayer victory. It is likely that most traditional rental agreements could substantively meet the needs of both the taxpayer and the flight school operator with a mere change in form, and not substance. ***In our experience the accepted form the contract should take is as a management agreement.*** Under this type of agreement you are literally contracting with the flight school to manage the airplane for you and acquire renters as well as make sure all maintenance is taken care of.

## **A Properly Constructed Agreement Still Requires Material**

### **Participation**

Although it is likely that a taxpayer may avoid the per se classification of his aircraft operation as automatically passive as a rental activity, it will still be necessary for him to materially participate in the business activity. Material participation generally requires substantial, continuous participation in the activity measured in both quantity and quality of time invested. Whenever a taxpayer participates more than 500 hours a year in his business activity he will be deemed to materially participate. Often in rental situations it is difficult, if not impossible for a taxpayer to expect to reasonably comply with this test.

**A second more achievable test requires the taxpayer to spend more than 100 hours per year in the activity and more time than any other individual (Flight Schools are a company, not an individual). It is likely that a taxpayer who makes a significant investment in an aircraft, who has responsibility for reviewing of maintenance, reviewing of profitability, and general management, will spend more than 2 hours a week in this activity. Of course it is important not only that the taxpayer reasonably invest the time in the activity but he properly document it.**

It is also important to note that a taxpayer who leases his aircraft to his core business may generally elect to treat the time invested in that business as time invested in the rental activity for purposes of meeting the passive rules. It is therefore possible for him to meet his passive activity time investment requirement using a combination of time invested in his core business and rental business.

## **Carry-Over Basis of Traded Property Not Considered In Calculation of Section 179 Expense Deduction**

A tax law also allows an expensing deduction of up to \$102,000 for taxpayers designated as “small businesses”. A small business is one defined as a business that spends less than \$500,000 in total capital expenditures during the year. However, for purposes of determining both the amount invested and total capital improvements during the year, only the additional investment is considered.

The following professionals are very familiar with Aviation and we would recommend consulting with them if your current advisors are not familiar with Aviation.

**Aviation Accountant**

Martin Prague

545 N. Park Ave.

Winter Park, FL

407-644-2322

**Attorney for Corporate Paperwork**

Charles Harrison

1413 Trovillion Ave.

Winter Park, FL

407-644-6445

**Aircraft Financing**

Cessna Finance Corp. 800-551-5787 [www.cessnafinance.com](http://www.cessnafinance.com) (offers 100% financing on next Cessna)

Jet Dollars Mark Baumgartner (broker) (407) 971-9992 [www.jetdollars.com](http://www.jetdollars.com)

Aircraft Banking Centers David Madden (broker) (407) 895-7001  
[www.aircraftbankingcenters.com](http://www.aircraftbankingcenters.com)