DEDICATED TO HELPING BUSINESS ACHIEVE ITS HIGHEST GOALS.

Federal Tax 101 for Schedulers and Dispatchers

Friday, February 10, 2017| 10:15 a.m. – 11:30 a.m.

PRESENTED BY:

Daniel Cheung, CPA   Aviation Tax Consultants, LLC

Jonathan Levy, Esq.   Advocate Consulting Legal Group, PLLC

Sue Folkringa, CPA, ATP   Wolcott & Associates, P.A.

SCHEDULERS & DISPATCHERS CONFERENCE

February 7-10, 2017 | Fort Worth, TX

IRS CONCEPTS FOR BUSINESS AIRCRAFT

How to speak and sound like a “tax pro”

- Understanding these basic concepts can help your employer or client aircraft owners avoid headaches dealing with the IRS
  - Passive Activity Loss Rules, Section 469 (as opposed to active loss)
  - Hobby Loss Rules, Section 183 (profit motive)
  - “Ordinary and Necessary”, Section 162 (smell test)

Sources: enter sources here

Passive Activity Loss (PAL)

Understanding passive activity loss rules

- What is it?
- Why is it important?
- How does that apply to your employer / client?

Passive Activity Loss (PAL)

Classification of Income

- Three buckets of income
  - Active income / loss – wages, commissions, business income
    - Income is earned with performance of service
    - Opposite of “passive” income
  - Portfolio income / loss – interest, dividend, capital gains from stock trades
    - Not passive income
    - Capital gains from sale of passive real estate holdings can be passive income
  - Passive income / loss – business income without material participation
    - Retired partner in an active business entity
    - Rents

Passive Activity Loss (PAL)

Definition of a Passive Activity

- Section 469(c)
  - (1) In general The term “passive activity” means any activity—
    - (A) which involves the conduct of any trade or business, and
    - (B) in which the taxpayer does not materially participate.
  - (2) Passive activity includes any rental activity
    - Rental real estate
    - Rental of personal property, including aircraft

Internal Revenue Code Section 469

Passive Activity Loss (PAL)

Importance of passive activity rules

- (a) Disallowance
  - (1) In general: If for any taxable year the taxpayer is described in paragraph (2), <u>neither</u>
    - (A) the passive activity loss, nor
    - (B) the passive activity credit,
      - <u>for the taxable year shall be allowed.</u>
- Key: passive losses can only reduce passive income

Internal Revenue Code Section 469

Passive Activity Loss (PAL)

Importance of passive activity rules

- Business aircraft generates significant amount of deductions and losses, mostly from depreciation
- Many taxpayers intend to utilize these deductions and losses to reduce their overall income tax burden
- If aircraft losses are considered “passive”, a taxpayer will not be able to realize reduction of current year income tax liability
- Business aircraft are prone to PAL limitation because it is a very common to set up an aircraft ownership entity and lease the aircraft to an operating business
- Many taxpayers inadvertently falls into PAL limitation

Passive Activity Loss (PAL)

Importance of passive activity rules

- Material Participation by taxpayer can help support a business activity is not passive, therefore, losses can be deducted against active business income
  - Work 500 hours per year in a business
  - Work 100 hours per year AND more than anyone else in a business
  - Grouping work hours with another business

Internal Revenue Code Section 469

Related-Party Leasing

Why is leasing to multiple related parties so common?

- Driven by FAA concern about commercial carriage.
- Operational control must transfer to lessee; lessee has choice of pilot.
- FAA Constraints (briefly):
  - Truth in Leasing: written lease, containing certain language; copy onboard; FSDO first-flight notification 48 hours before flight; lease mailed to FAA 24 hours before flight.
  - For RVSM operations (29,000 to 41,000 MSL), each lessee needs a LOA. Expedited procedure where prior LOA was granted based upon similar operations.
- Also note: check that insurance covers lease; lending bank consent.

Sources: FAR 91.23; Notice N8900.250; 8900.1 CHG 324 (1/24/2014).

Related-Party Leasing

Tax Considerations

- Payments are subject to sales tax.
- Risk rendering the aircraft activity **passive**. Particularly harmful due to accelerated depreciation.
- Tracking each taxpayers set of **costs** and **usage.**

Related-Party Leasing

Passive Activity

- “Passive” losses cannot offset “active” income for tax purposes.
- A passive activity is one where either (1) you don’t materially participate (e.g., 500 hours worked per year), or (2) it is “rental.”
- Passive activity rules can make taxable income exceed actual income.

Sources: 26 USC 469.

Related-Party Leasing

Passive Activity

- IRS wants: Your income = Active; Your losses = Passive; ∴ More tax paid
- 3 avenues to avoid passive-activity trap:
  - Use **disregarded** leases (lessee and lessor within the same **taxpayer**).
  - Use leases that are outside the **rental** definition. (Generally, lessor scheduling discretion.)
  - **Group** the leasing with a non-passive **activity.** Requires **election filed with tax return.**

Sources: 26 USC 469; Rev. Proc. 2010-13.

Related-Party Leasing

Passive Activity – Grouping*

LLC

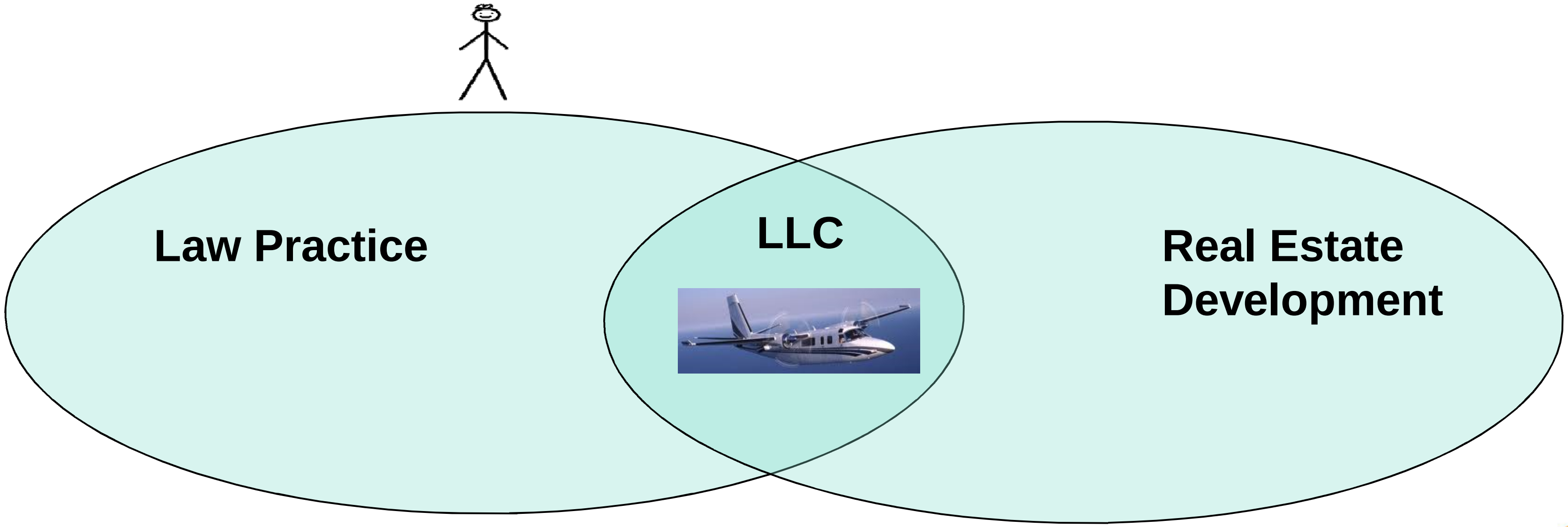
Law Practice

Real Estate Development

***Grouping is complex; this is a conceptual overview.**

Related-Party Leasing

Passive Activity – Grouping*



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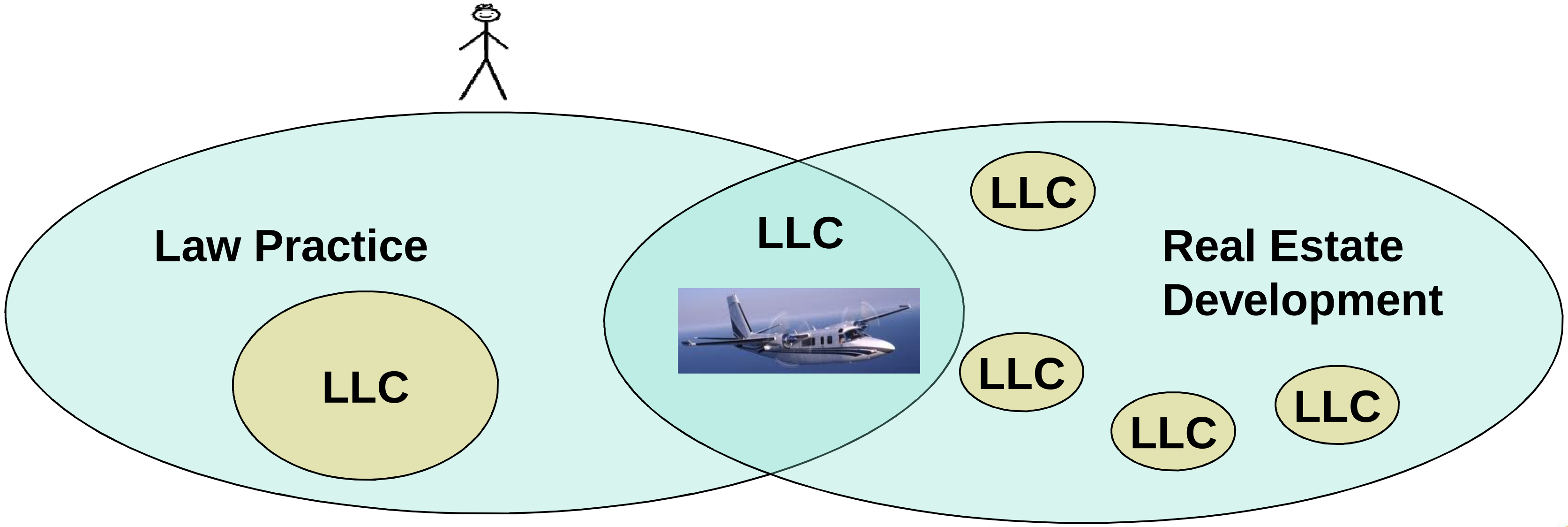
Related-Party Leasing

Passive Activity – Grouping*



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Related-Party Leasing

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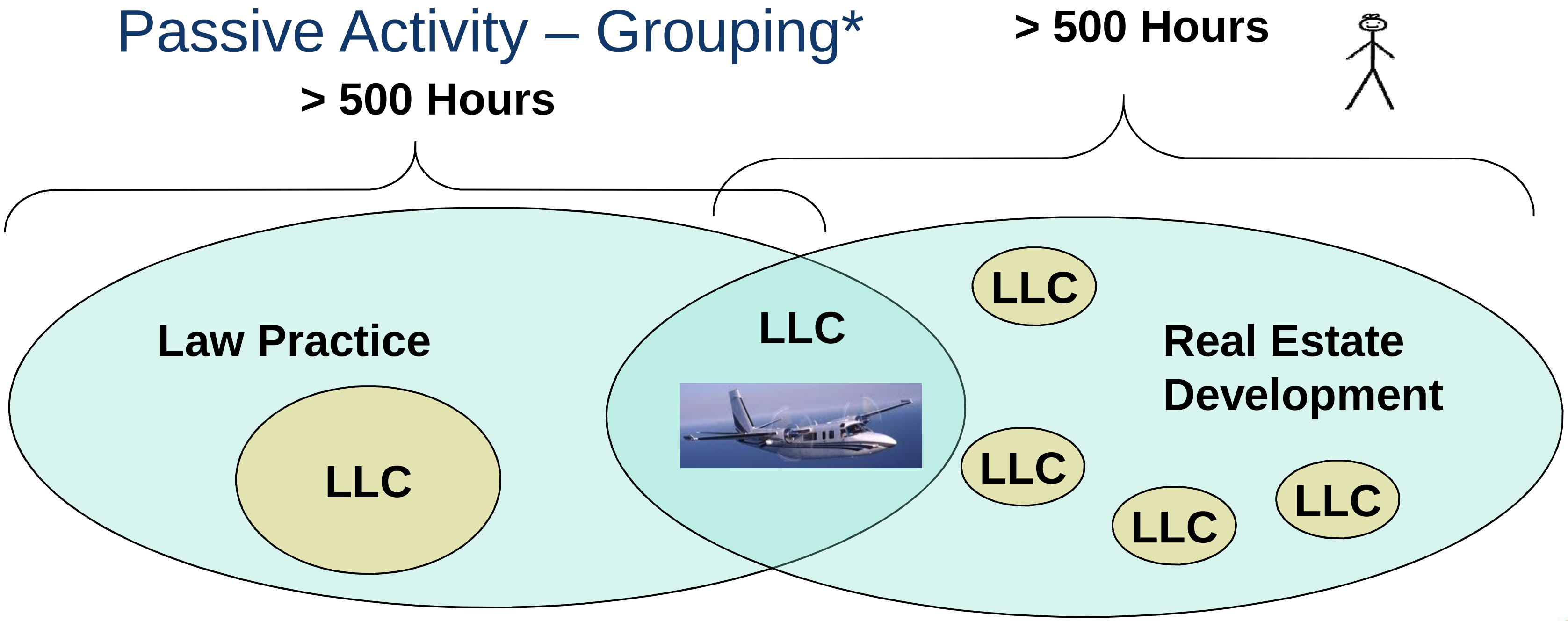

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Related-Party Leasing

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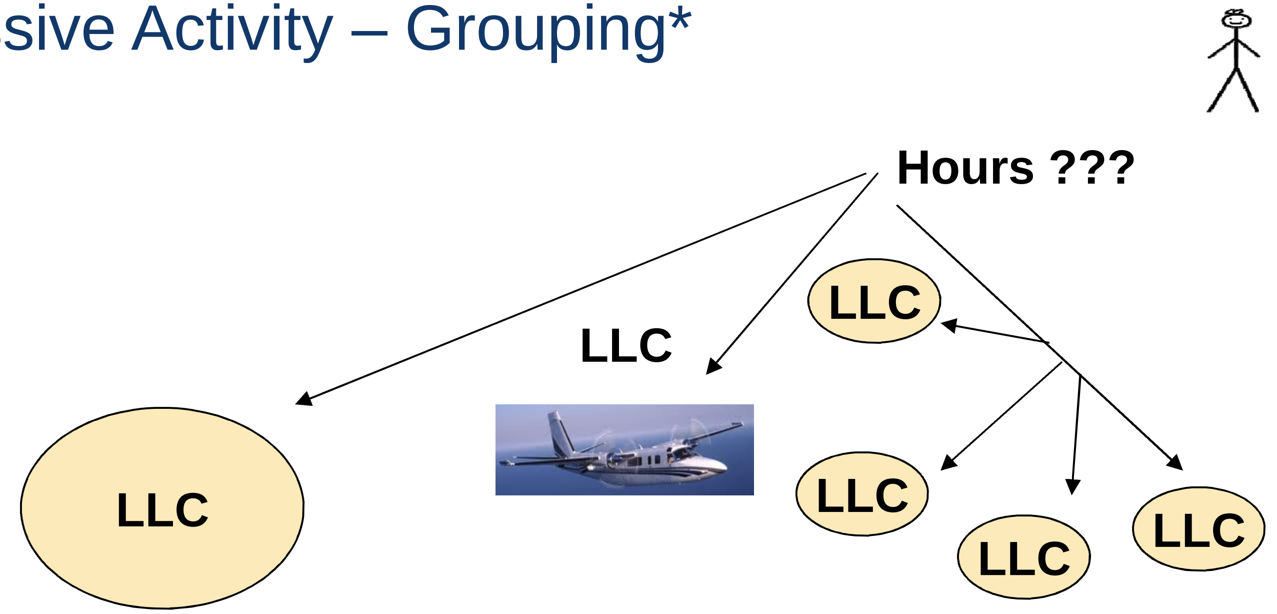


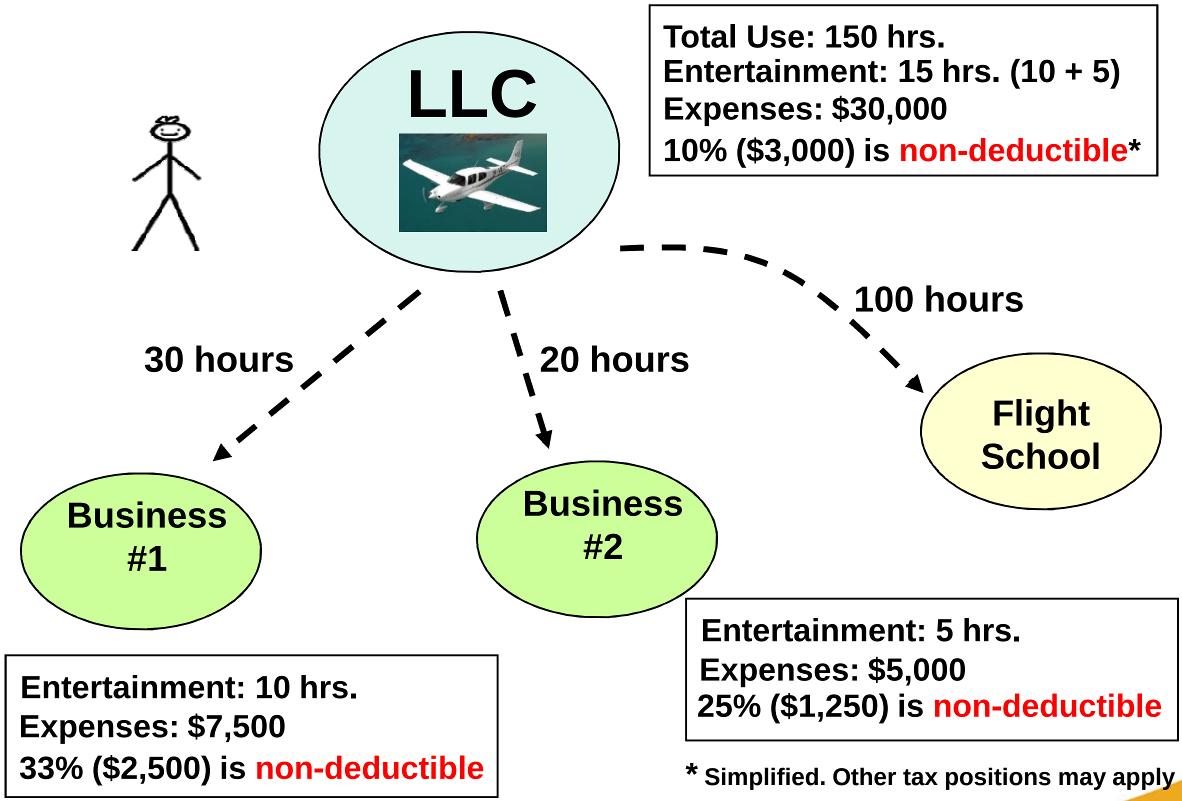
*Grouping is complex; this is a conceptual overview.

Related-Party Leasing

Costs and Use Per Lessee

- Each lessee taxpayer has a distinct **collection** of **costs** and **usage.**
- **Aircraft** flight log must be decomposed into hierarchical virtual flight logs: a log for each lessee, and each lessor (with the lessor's log also encompassing that of its lessees).

Example



* Simplified. Other tax positions may apply

Hobby Loss Rules (Sec.183)
Ordinary and Necessary (Sec. 162)

- What is it?
- Why is it important?
- How does that apply to your employer / client?

Internal Revenue Code Section 183, 162

Hobby Loss Rules

- In general, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business. An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business. A necessary expense is one that is appropriate for the business. Generally, an activity qualifies as a business if it is carried on with the reasonable expectation of earning a profit. (Definition from IRS website)

Internal Revenue Code Section 183

Hobby Loss Rules

- In general, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business.
  - Targets activities that the taxpayer derives pleasure and personal enjoyment
  - Horse, yachts, aircraft
  - A plumbing business is not likely to be challenged as a hobby

Internal Revenue Code Section 183

Hobby Loss Rules

- An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business.
  – A subjective test
  – Depends on the taxpayer's facts and circumstances
  – It is probably not ordinary for a local diner to operate an aircraft
  – But it can be ordinary for a regional chain of restaurant operator to operate an aircraft to visit various locations

Internal Revenue Code Section 183

Hobby Loss Rules

- A necessary expense is one that is appropriate for the business.
  - Again, very subjective
  - Is it necessary for a taxpayer to own an aircraft for two business trips per year?
  - While an aircraft can accomplish the mission, it does not mean it is “necessary”
  - Ordinary and necessary does not mean the least expensive way to travel

Internal Revenue Code Section 183

Hobby Loss Rules

Generally

- An activity qualifies as a business if it is carried on with the reasonable expectation of earning a profit.
  - This applies when the aircraft is considered a stand alone operating business
  - However, for most taxpayers, this test can be applied along with another active trade of business – law firm, medical practice, construction company, etc.
  - "Expectation of earning a profit" – does not mean a business has to be "profitable"
  - The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year
  - A taxpayer won a case despite showing continuous tax losses for many years

Internal Revenue Code Section 183

Hobby Loss Rules

Importance of this rule

- If an activity is not for profit, losses from that activity may not be used to offset other income. An activity produces a loss when related expenses exceed income.
- To avoid running afoul of this rule:
  - Make profits!
  - Consider if a grouping election is appropriate
  - Owning an aircraft within the operating business
- Passive loss limitation results in a deferral of deductions
- Hobby loss can result in total disallowance of deductions

Internal Revenue Code Section 183

Hobby Loss Rules / Ordinary and Necessary

Factors to consider if a business has a profit motive

- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity?
- If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the start-up phase of the business?
- Has the taxpayer changed methods of operation to improve profitability?
- Does the taxpayer or his/her advisors have the knowledge needed to carry on the activity as a successful business?
- Has the taxpayer made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

Internal Revenue Code Section 183, 162

Hobby Loss Rules / Ordinary and Necessary

Factors to consider if a business has a profit motive

- These tests are a guideline only
- Documentation is very important
- Consider a business plan
- Run it like a business

Internal Revenue Code Section 183, 162

Depreciation

- Overview
- Methods
- 50% business use threshold and IRC §280F
- Financial impact of lost deductions
- Flight department involvement

Depreciation

Overview

- Assets used in a business must be depreciated
  - A portion of the cost is expensed over a defined period of time
  - The amount of deduction is dependent upon use
- Depreciation deduction for an aircraft is **HUGE**
  - Typically depreciation is the single largest deduction of aircraft ownership
  - We want to protect it!

Depreciation

Overview

- The amount of time you can depreciate the asset is based on the type of use
  - Charter operations – 7 years
  - Business operations – 5 years
  - If mixed use, predominant use will prevail
- Personal use of the aircraft will also affect the amount of the deduction
  - Other business use
  - Entertainment use
- Method
  - Accelerated depreciation can be used if business use > 50%
  - Straight-line depreciation (ADS) has to be used if business use < 50%

Depreciation

Accelerated Depreciation - MACRS

Year	5 Year Half-Year Convention	7 Year Half-Year Convention	5 Year Mid-Quarter Convention	7 Year Mid-Quarter Convention
1	20.00%	14.29%	5.00%	3.57%
2	32.00%	24.49%	38.00%	27.55%
3	19.20%	17.49%	22.80%	19.68%
4	11.52%	12.49%	13.98%	14.06%
5	11.52%	8.93%	10.94%	10.04%
6	5.76%	8.92%	9.58%	8.73%
7		8.93%		8.73
8		4.46%		7.64%

Depreciation

Alternative Depreciation System - ADS

Year	6 Year Half-Year Convention*	12 Year Half-Year Convention*	6 Year Mid-Quarter Convention*	12 Year Mid-Quarter Convention*
1	8.33%	4.17%	2.08%	1.04%
2 - 6	16.67%	8.33%	16.67%	8.33%
7	8.33%	8.34%	14.58%	8.33%
8 - 12		8.33%		8.34%
13		4.17%		7.29%

*Small Rounding Error

Depreciation

Method

- Advantages to MACRS
  - You can claim the a large portion of the deduction in first 2 years of ownership
  - More deduction sooner, means less tax sooner
- Straight Line (ADS)
  - Evenly taken through the life the aircraft
  - Predictable
  - If business use of aircraft is not expected to be high, this is the method you will use

Depreciation

Method

- Bonus!
  - If an aircraft is purchased new, the company could be eligible for *Bonus Depreciation*
  - From now until the end of 2019, 50% of the cost can be depreciated immediately
  - MACRS can be claimed on the remaining 50% of cost in the current year
- Quick Example
  - New G280 purchased for $ 23,000,000
  - Bonus depreciation claimed = $11,500,000
  - MACRS depreciation = $ 2,300,000
  - First year depreciation totals $ 13,800,000 = 60% of the cost

BONUS!

Depreciation

IRC § 280F

- Aircraft are labeled as “listed property” by the IRS
  - Visibility on tax return is prominent
  - Extra rules must be followed in order to claim deduction
- Most companies prefer MACRS – more deduction sooner
  - 50% business use is a milestone to keep in mind
  - If business use falls below 50%, the company will be forced to use ADS (straight-line) depreciation
  - If business use falls below 50%, the company will have to *recapture* (take back as income) the “extra” depreciation already taken using MACRS

Depreciation

IRC § 280F

- Further complications
  - Leasing to a 5% or greater owner
  - What is considered to be business use of the aircraft?
- Timing is everything
  - In the end, depreciation will be taken, but it’s a question of when
    - MACRS vs ADS
    - Bonus
    - Recapture “extra” depreciation
  - We’d *prefer* to have deductions sooner rather than later

Depreciation

Audit

- IRS knows an audit target when it sees it
  - Depreciation prominent on return
    - Separately stated, large number
    - Listed property
    - Typically losses on tax return
      - Partnership tax return
      - S-Corporation tax return
  - Visibility could lead to being chosen for audit

Depreciation

Audit

- IRS is looking for
  - Aircraft placed in use during the 4th quarter especially
    - Was there adequate business use?
  - Business use of the aircraft
    - Someone needs to know the details
    - Is the flight for business vs. personal purposes?
    - If it's personal, is it personal non-business or is it personal entertainment?

Depreciation

Audit

- Documentation of passengers
  - The purpose of each passenger on the aircraft needs to be classified
    - Business
    - Non-business/non-entertainment
    - Entertainment
- What information can you assist with?
  - Flight records
  - Support of the flight records – who has this?

Depreciation

Audit

- Listed property document requirements mandated in IRC § 274(d)4
  - Time and place of the travel – in the flight logs already
  - The business purpose of the travel
    - Citing a trip as “business” is not enough
    - No amount of documentation and substantiation is too much
  - The business relationship to the taxpayer
    - Employees - easy
    - Contractors – more difficult

Depreciation

Audit

- How can you be proactive?
  - Work with the people who prepare the tax return or make the calculations
    - Your objectives are really the same - how can you support the deductions being taken?
  - Look ahead and see what the percentages of business use will be for the year
    - Do you know if there will be a lot of entertainment flights?
    - Project the business use of the aircraft in order to advise management
      - More business flights are needed
      - Put the entertainment flights on another airplane

Handling an IRS Audit

Initiation of the Audit

- Taxpayer or Taxpayer Representative Receives IRS Audit Notification via a mailed letter (often stems from audit of another company).
- The letter will indicate the contact information of the Revenue Agent, and request a call-by date, approximately 10 days away.
- The Taxpayer should reach out to a tax professional to serve as a Power of Attorney (POA), and with their assistance complete a Form 4562 (a form that allows a representative to speak on their behalf BEFORE) contacting the Revenue Agent.
- The POA should reach out to the Agent by the response date to discuss the scope of the exam and the procedure that will be followed

Handling an IRS Audit

Why Use a Representative

- IRS examiners tend to know very little about aircraft, outside of the fact that they may generate large losses on a tax return. This can make disallowing aircraft deductions an easy target.
- The initial contact sets the tone for the scope and tenor of the exam. Professionals may be able to avoid a fishing expedition and narrow the scope.

Handling an IRS Audit

Why Use a Representative

- A Power of Attorney well versed in aircraft exams will be familiar with the common areas of inquiry and “trick questions.” You can avoid a lot of later heartache by allowing them to navigate potential examination areas that are hard to spot.
- Many Taxpayers feel that because they are confident that they followed the law, they should be open and comprehensive with answering all IRS questions expansively and quickly, and that having a lawyer indicates that they are guilty. This is simply not the way the examination process works.

Handling an IRS Audit

The Examination Process

- The initial interview is either preceded by, or followed with, written requests for Information called Information Document Requests (IDRs)
- Information provided to the IRS should be **narrowly limited** to responding to specific requests.
- Common Information required for responding to IDRs
  - Accounting Records and Bank Statements
  - Tax Return and Workpapers
  - Complete Aircraft Flight Logs
  - Expense substantiation
  - Fringe Benefit and PE Disallowance Computations

Handling an IRS Audit

The Examination Process

- Key Audit Issues:
  - Code 469 - Passive Activity Loss Limitation
  - Code 183 - Hobby Loss Limitation
  - Code 162 - Ordinary & Necessary
  - Propriety of Grouping for Code 469 and/or 183 Purposes
  - Code 274 - Substantiation (Flight Logs and Expenses)

Handling an IRS Audit

The Examination Process

- Key Audit Issues, continued:
  - Treatment of Personal Use (Disallowance and Fringe Benefit Income)
  - Code 280F - Qualified Business Use for MACRS Depreciation
  - Depreciation
  - Unique Issues - Flight Schools and Consulting Structures

- Extension of the Statute of Limitations

Handling an IRS Audit

Conclusion of the Examination

- Preliminary Report
  - Opportunity for Rebuttal, Meeting w/ Manager, Fast Track Mediation
- "No Change" Letter
- Agreed Adjustments
- Final Report (“30-Day Letter”)
- Notice of Deficiency (“90-Day Letter”)

Handling an IRS Audit

Unagreed Examination

- IRS Appeals
- Tax Court
  - **No** Pre-Payment Required
- District Court or Court of Federal Claims
  - Pre-Payment Required

NBAA

Questions and Answers

Contact Information:

Daniel Cheung: daniel@aviationtaxconsultants.com
Jonathan Levy: jonl@advocatetax.com
Sue Folkringa: suef@aviation-cpa.com