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Documentation:

A Necessity when Claiming Deductions.

Careful implementation and thorough recordkeeping are essential when supporting tax deductions, notes attorney Chris Younger.

A recent United States Tax Court decision illustrates the need to carefully implement tax planning and thoroughly maintain business records when acquiring and operating a business aircraft. In that case (Williams v. Commissioner, T.C. Memo 2014-158 (2014)), the court analyzed an individual's ability to take income tax deductions relating to the purchase and use of an aircraft.

The court's conclusions regarding careful and complete documentation also apply to corporations owning a business aircraft for company travel while making it available part time to a third party (such as a charter operator) for generating income or offsetting expenses, or to employees for personal use.

The taxpayer, Scott Williams, was a pilot and a practicing lawyer who owned a telephone skills training business. His firm purchased the aircraft in question in December 2006 and leased it to two flight schools. In 2007, total use of the airplane was 384.3 hours, of which 58.4 hours where flown by Williams for his own use, 55.7 hours by his business for company travel, and the remaining 270.2 hours by the flight schools.

Agreements with the flight schools required them to provide virtually all management and other services relating to the aircraft. Furthermore, neither Williams nor his business was allowed to preempt flights scheduled by the schools. Williams abided by his agreements with the flight schools, and in testimony to the tax court he confirmed that on several occasions he chartered other aircraft when his aircraft was not available because of its use by the schools.

ACTIVITY DOCUMENTATION NOT COMPLETE

Williams estimated that he spent approximately 150 labor hours solely on activity related to his aircraft in 2007. He did not, however, provide a log of his time spent on this activity or any other documentation regarding maintenance performed on the aircraft. For example, Williams claimed that he spent over 25 hours on business dinners relating to the aircraft ownership and operations but failed to support this assertion with any business records. He also provided incomplete logs that listed only the trips flown by him for personal matters and for his business. He failed to produce any flight logs describing the flight schools' use of the aircraft.

Williams deducted depreciation and other expenses relating to the aircraft against income earned by his telephone training skills business. The IRS disallowed the deductions because the Service determined they were passive and could not be deducted from the non-passive income generated by William's telephone skills training firm. Williams appealed the IRS's decision to the Tax Court.

The passive loss rules of the IRS provide that net losses from a taxpayer's passive activities may not be used to offset net income from the taxpayer's non-passive activities. Two or more activities may be grouped together and considered a single activity but only if they constitute an appropriate economic unit for the measurement of gain or loss. Whether activities constitute an appropriate economic unit is a matter of facts and circumstances, with greatest weight being placed on the following factors: ›

(1) Similarities and differences in types of trades or businesses;
(2) Extent of common control;
(3) Extent of common ownership;
(4) Geographical location; and
(5) Interdependence between/among the undertakings (for example, the extent to which the activities sell goods/services to one another).

The Tax Court held that the aircraft activity could not be grouped with the activity of the telephone skills training firm because the two activities had no similarities and that common control and ownership and geographic location were not of any probative value (i.e., they were not pivotal in determining the case's outcome). Additionally, the court found that there was no meaningful interdependence between the activities because Williams utilized the aircraft only "to avoid pat downs, searches, baggage claim and lost baggage with the airlines" and would charter another aircraft if necessary.

DOCUMENTING PASSIVE VS. NON-PASSIVE ACTIVITY

The term "passive activity" includes any activity in which the taxpayer does not materially participate, as well as any rental activity regardless of whether the taxpayer does or does not materially participate in the activity. A "rental activity" is any activity where payments are principally for the use of tangible property, unless the activity falls within a regulatory exception. Notably, the activity is not deemed passive if the average period of use by customers is seven days or less, such as is typically the case in the car rental business.

There are seven tests for determining whether a taxpayer is treated as materially participating in an activity for any taxable year, including three that are particularly relevant to the Williams case. These three are as follows:

1. Taxpayer participates in the activity for more than 500 hours;
2. Taxpayer participates in the activity for more than 100 hours during the taxable year, and the taxpayer's participation in the activity is not less than the participation in the activity by any other individual; or
3. Taxpayer participates in the activity for more than 100 hours during the taxable year, and based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous and substantial basis.

The extent of an individual's participation in an activity may be established by any reasonable means including records such as appointment books, calendars or narrative summaries. Creating and maintaining records of participation in the activity, therefore, is critical.

Williams maintained that the activity was not a rental activity because the customers of the flight schools used the aircraft for less than seven days. The IRS argued that the flight schools were the customers that rented the aircraft so they did not fall within that seven-day exception. However, the Tax Court bypassed this issue altogether and held that regardless of whether the aircraft use by the flight schools was a rental activity, Williams had not produced sufficient records to show that he materially participated in the activity. The court stated that "a post-event 'ballpark' guesstimate" will not suffice.

Williams had provided too little written documentation to corroborate his testimony that he spent the required time working on the aircraft activity to meet the material participation tests. This simple failure to maintain and produce adequate records prevented Williams from deducting any of the aircraft-related losses against income generated by the Business.

This case provides a good illustration of the fact that carefully following the requirements of tax rules and maintaining thorough records to support tax positions are critically important.

Do you have any questions or opinions on the above topic? Get them answered/published in World Aircraft Sales Magazine. Email feedback to: Jack@avbuyer.com

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