Chartering your Company Aircraft:

Have you considered the Tax Issues? (Part 3 of 3)

What should owners know about placing their business aircraft on a management company's charter certificate? Keith Swirsky concludes his three-part discussion series...

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The determination to charter an aircraft to third parties impacts eligibility for accelerated and bonus depreciation, the length of the depreciation schedule, and depreciation recapture.

With respect to accelerated depreciation under Internal Revenue Code (IRC) Section 280F, it is generally assumed that use of an aircraft to charter to unrelated third parties (i.e., the public) constitutes "qualified business use". To be eligible for accelerated depreciation, an aircraft must be used more than 50% of the time in qualified business use. So, in the situation where an aircraft may not be used more than 50% of the time in a trade or business activity, and therefore is ineligible for accelerated depreciation, adding charter hours to the aircraft's usage profile may result in the aircraft's aggregate "qualified business use" exceeding 50%.

While it is not significantly valuable from a tax perspective for an aircraft to be eligible for Modified Accelerated Cost Recovery System (MACRS) depreciation versus straight-line depreciation, MACRS nonetheless provides an accelerated write-off schedule. If an aircraft is new and the owner desires to take advantage of bonus depreciation, however, the aircraft must be eligible for accelerated depreciation (i.e., one of the

requirements for claiming bonus depreciation is eligibility for accelerated depreciation). Accordingly, under the proper circumstances, placing an aircraft on a charter certificate (making it available for charter to unrelated third parties) may allow an aircraft to qualify for MACRS depreciation when it otherwise would not.

Conversely, when an aircraft is chartered to the public more than 50% of the time in commercial (FAR Part 135) operations, the aircraft is no longer eligible for the 5-year MACRS/6-year straight-line depreciation schedule and converts to the 7-year MACRS/12-year straight-line schedule. If the 50% commercial use threshold is met in the first year that the aircraft is placed in service by the owner, then the aircraft will remain on the 7-year MACRS/12-year straight-line schedule during the entire time such owner owns the aircraft.

Caution

There is a trap here for the unwary; if the aircraft's depreciation schedule commences using a 5-year MACRS/6-year straight-line schedule in the first year the aircraft is placed in service (or even continuing in the second, third, etc. years) and subsequently in any tax year, while the aircraft is still being depreciated, charter hours to the public exceeds 50% of the total use of the aircraft, then the owner must convert tax depreciation to a 7-year MACRS/12-year straight-line schedule.

Also, the owner must recapture that portion of the depreciation deductions previously claimed under the 5-year MACRS/6-year straight-line schedule that are in excess of those deductions that the owner would have been entitled to had the aircraft always been on the 7-year MACRS/12-year straight-line schedule.

Many tax deductions related to the owner's aircraft are also limited under the so-called "personal entertainment rules" of IRC Section 274(e). Under these rules, if an aircraft is used in a trade or business activity in a manner that allows for tax deductions, those deductions will be limited to the extent of any personal entertainment use of the aircraft. Personal entertainment use is tracked on a passenger-by-passenger, flight-by-flight basis. The rules for calculating the disallowance amount are beyond the scope of this article, but assume for purposes of this article that the lost deductions are roughly comparable to the percentage of the use of the aircraft for personal entertainment purposes.

Example

Recall the case presented last month in Part 2 where the aircraft owner uses its aircraft solely in its trade or business. The owner computes its personal entertainment disallowance and, in this example, determines that 40% of the use of the aircraft was for personal entertainment, and therefore 40% of its deductions are disallowed.

Assume the total annual usage of the aircraft is 200 hours for combined business use and personal entertainment use (meaning that personal entertainment use was 80 hours for the year). Now, let's assume that the same 80 hours of personal entertainment use and 120 of trade or business use continues, but the owner also places its aircraft on a charter certificate and adds 200 hours of third-party charter use.

By adding the 200 hours of third party charter use, the total annual use of the aircraft is 400 hours in the aggregate, and accordingly only 20% of the aggregate hours are now personal entertainment hours, resulting in only 20% loss of tax

deductions relating to the personal entertainment disallowance rules. So, in this example, by adding charter hours to the aircraft, the personal entertainment use disallowance is diluted, resulting in enhanced tax deductions.

Important Additional Consideration

Another issue that arises in the context of charter operations of an aircraft relates to the imposition of federal air transportation excise taxes under IRC Section 4261 et al. It's common knowledge that when an aircraft is chartered to unrelated third parties, the charter operator must collect federal air transportation excise taxes (hereinafter FET) on the amounts it charges for charter flights. In the past several years, however, the IRS has been challenging whether or not too much control of the aircraft is ceded by an aircraft owner to the aircraft management company by virtue of the aircraft being placed on the management company's charter certificate.

More specifically, while it is not the "official" position of the IRS, as a practical matter in an IRS audit, if an owner's aircraft is solely operated in FAR Part 91 operations for the trade or business of the company, it is unlikely (assuming the aircraft ownership is properly structured) that the IRS will assess an FET on payments made by the owner to the management company relating the owner's use of its aircraft. The prior statement is again a gross generalization and does require significant planning to ensure that the Part 91 aircraft operations are correctly structured to avoid having "transportation services" provided, for compensation, by one party to another party.

If an aircraft is placed on a management company's charter certificate, so that aircraft operations are conducted under both FAR Part 91 and FAR Part 135, the IRS may assert that an FET is applicable to the Part 91 operations (as well as the Part 135 operations) because "possession, command and control" of the aircraft have been ceded to the management company with respect to all flights of the aircraft. This is a hotly contested issue, but it is nonetheless a topic of concern for aircraft owners.

The potential additional tax liability for a 7.5% FET due on all payments relating to Part 91 operations would substantially impair the economic benefits of chartering.

With respect to IRC Section 4261, sophisticated planning will include relevant considerations with respect to management company documentation. And, while the aviation industry has responded to the IRS' misguided efforts with respect to this issue generally, by not collecting FET on an aircraft owner's Part 91 operations, an aircraft owner may be liable for such taxes if they are assessed against the management company depending on the terms and conditions of the owner's agreement with its management company. Stay tuned. ▮

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