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## DEFENDING YOUR AIRCRAFT DEDUCTIONS BEFORE TAXING AUTHORITIES

Aircraft owners/operators seeking tax benefits are well-advised to undertake additional care and prudence, due to the high-scrutiny and high-exposure nature of the undertaking. In the event of an examination, you should anticipate and prepare for a review of the following items:

1. Is your aircraft undertaking a trade or business, or a non-deductible hobby?
2. Do you have an honest expectation of profit from the activity?
3. Do you have a business plan, and was it written before you were notified that you were being examined?
4. Have you made a valid election to group the aircraft undertaking with another trade or business undertaking for purposes of the “hobby loss” and/or “passive activity” rules?
5. Do you materially participate in the activity, and have you kept contemporaneous documentation of your time spent?
6. Have you documented personal use, and made proper adjustments to your tax returns as a result?
7. Have you kept a contemporaneous, per-flight record of the business purpose (including business benefit expected) of each passenger on the aircraft?
8. Have all charges for transportation services, including reimbursements from shareholders and related parties, been subjected to federal excise taxes and the tax remitted?
9. Are the expenses incurred ordinary, necessary, and reasonable in amount?
10. Have you properly included all use of the aircraft in your logs?
11. Do you have sufficient basis and resources at risk to be able to utilize loss deductions?
12. Is your qualified business use of the aircraft sufficient to support any accelerated forms of depreciation and/or expensing you have claimed?
13. For each passenger flying for personal non-entertainment reasons, have you retained contemporaneous documentation of the non-entertainment nature of the trip?

The first avenue of attack in an income-tax audit will generally be an attempt to reclassify the aircraft undertaking as a non-deductible hobby. Regulations outline nine non-exclusive factors designed to reflect the taxpayer’s intent. These include: the manner in which the taxpayer carries on the activity; the expertise of the taxpayer and/or his advisors; the time and effort expended by the taxpayer in carrying on the activity; the expectation that the assets used in the activity may appreciate in value; the success of the taxpayer in carrying on other similar or dissimilar activities; the taxpayer’s history of income or loss with respect to the



activity; the amount of occasional profits, if any; the financial status of the taxpayer; and the involvement of elements of personal pleasure or recreation. Important considerations include whether you treat the activity like a business, have separate books and records, undertake appropriate forecasting and budgeting, have made adjustments to make the activity profitable, and are working hard to achieve a profit.

In order to win the hobby-loss question, you should be able to show that you had an honest expectation of profit in the activity, and that pursuit of profit was your primary motivation. This does not necessarily require execution of a plan wherein you immediately create taxable income. It is possible to have an honest expectation of profit, even though the activity itself proves unsuccessful. In making this determination, the auditor will view objective facts as more persuasive than your subjective expressions of intent.

The auditor will request a copy of your business plan. They will also ask you if the plan was written independently of you receiving notice that you were being examined. The business plan should outline in general form the aircraft undertaking and any related businesses which it supports. It can provide a significant outline of your profit expectations on a stand-alone or combined basis.

Another likely area of attack upon audit is whether the aircraft undertaking is an active trade or business in which you materially participate, or is a passive activity. Any loss classified as a passive activity by individuals, partnerships, trusts, and small corporations will generally only be deductible to the extent of net passive income. Excess passive losses will be carried forward indefinitely until either (1) offset by income from the same activity or other passive activities, or (2) converted to active upon a qualifying disposition by you of the activity. A loss will be classified as passive if either the activity is a rental (as specifically defined in the passive activity regulations), or you do not materially participate. Material participation generally requires that you devote more than 500 hours each year to the undertaking, or more than 100 hours each year and more time than any other individual. The nature of the time invested is also relevant; investor-type hours do not count unless you are directly involved in the day-to-day management or operations of the activity.

The auditor will also be concerned as to what type of documentation you have relating the time devoted to the undertaking. Your records should contain sufficient detail to outline both the time invested, and the nature of the services rendered to the undertaking. This time record will be relevant for purposes of determining both material participation and possible classification as a hobby.

Many aircraft structures benefit from filing a grouping election to clarify the scope of your activities for purposes of the passive activity rules. There are detailed regulations governing the validity of such elections, and a strict procedure for filing the election. Often, the election must be included in your personal 1040, and handling it correctly will require coordination with your 1040 preparer.

The auditor will be concerned as to how personal use of the business aircraft is accounted for. Personal use of a business asset may result in a disallowance of deductions and/or result in a constructive dividend. Personal use that is given as a fringe benefit as part of a reasonable compensation package will generally be viewed as an ordinary and necessary business expense to the provider of the fringe benefit. However, if a passenger's flight is of a personal entertainment nature, unless an exception applies, a disallowance of deduction of aircraft expenses attributable to the passenger will result. The amount attributed to the passenger will generally be calculated by allocating aircraft costs on a per capita basis among the passengers. The most common exception to the disallowance rule would be for entertainment flights provided as a fringe benefit. However, if the passenger (or, if the passenger is a guest, the individual who invited the passenger, and to whom the passenger's flight represents a fringe benefit) meets the statutory definition of a "specified individual," the amount exempted from disallowance will be limited to the sum of the fringe-benefit income recognized, plus the amount, if any, reimbursed for the flight.

If you have collected fees for transportation services, those fees are most likely subject to the Federal Excise Tax on transportation of persons or property, a tax that requires filing and remittance quarterly (The issue of whether collection of such fees is permissible under Federal Aviation Administration rules also requires attention, but is beyond the scope of this article.)

Under audit, you may need to demonstrate that your aircraft is an ordinary and necessary expense of your business, and that any training (other than CFI or commercial, which will not be deductible) also has a direct and proximate relationship to skills needed in your business. There is no mechanical test for these issues; rather, the outcome will depend upon your ability to subjectively convince an auditor that the expenses were justified.

With proper planning, the trauma associated with an examination can be greatly diminished. There is a significant body of tax law, including an opportunity to make important elections, that can be more effective through proper planning. When operating a corporate aircraft, the time to plan for a tax examination is well in advance of receiving the notice.

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