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## PROTECTING FLIGHT SCHOOL AIRCRAFT FROM PASSIVE ACTIVITY LIMITATIONS

A taxpayer who incurs a loss in a business designated as a “passive activity” is only allowed to deduct the loss to the extent of net passive activity income derived from other sources. Your activity will be passive as to you if either: (1) it is a long-term rental of tangible property, or (2) it is a business in which you do not materially participate. The principle useful exception available to flight school aircraft owners to avoid passive treatment under prong (1) is an exclusion where property is rented with an average period of customer use of seven days or less. Any agreement with a fixed based operation should not be structured as a lease, but rather as a marketing agreement, with the end users briefly renting the aircraft from the owner company. No end user should have a continuous or recurring right to use the aircraft but, instead, should rent the plane on a flight-by-flight basis for short periods.

### **A PROPERLY CONSTRUCTED AGREEMENT STILL REQUIRES MATERIAL PARTICIPATION**

Although short-term rental to the public will likely allow a taxpayer to avoid the per se classification of the aircraft operation as a passive rental activity, it is still necessary that he/she materially participate in the business activity in order to avoid passive characterization. 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 per 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. This test must be met each year of the activity. The 100-hour threshold is measured based on your taxable year (typically January to December). In the first year, work hours in anticipation of starting the business may be counted. It is likely that a taxpayer who makes a significant investment in an aircraft, who has responsibility for establishing the maintenance, profitability, and general management of the aircraft, will spend more than 2 hours per week in this activity. If both members of a married couple participate, their hours are added together in evaluating the thresholds, regardless of whether or not they file a joint tax return. Of course, it is important not only that the taxpayer invest the time in the activity, but also that he properly documents it.

It is important to maintain records to reflect your participation in the activity. Many aircraft owners find that the following items require a significant investment of their time:

1. Evaluation and inspection of aircraft acquired, as well as evaluation of alternative aircraft ultimately rejected.
2. Preparation of a detailed business plan that reflects the owner’s “honest expectation of economic profit.”
3. Analyzing actual versus projected results and developing alternate strategies where appropriate.
4. Reviewing maintenance squawks proposed by pilots and mechanics.



5. Visual inspections of the aircraft.
6. Flight inspections of the aircraft.
7. Approval of billing invoices.
8. Preparation of financial reports for use by others in the business.
9. Preparation of tax and regulatory reports.
10. Evaluation of insurance coverage, including evaluation of rejected alternative insurance.
11. Meetings with professionals regarding concerns for the business.
12. Meetings with representatives at flight schools or fixed based operators.
13. Review of pricing alternatives and preparation of a market analysis of other aircraft on the field or in the area.
14. Evaluation of avionics, airframe, or engine upgrades.

In certain cases, hours worked will not count towards the total. Work not customarily done by an owner does not count if a principal purpose of doing the work was to meet the material participation requirement. In some cases, courts have also excluded travel time, recordkeeping and tax preparation, dealing with bank deposits, and post office trips. Further, you should understand that “investor” hours by individuals not directly involved in the day-to-day management or operations of the activity do not count, although “trade-or-business” hours do. Examples of “investor” hours include: studying and reviewing financial statements or reports on operations of the activity; preparing or compiling summaries or analyses of the finances or operations of the activity for the individual’s own use; and monitoring the finances or operations of the activity in a non-managerial capacity.

We recommend that you make a brief diary outlining your time investment. Should you be examined by taxing authorities, they will ask you to provide this type of analysis. Although contemporaneous records are not required, they are obviously easier to construct at the time the services are performed, and contemporaneous records have increased evidentiary value. It is safest to have a cushion of hours in case the IRS seeks to challenge some.

## CONCLUSION

The passive activity classification rules are technical and involved. Bright-line distinctions (such as the difference between 99 annual hours versus 100) have the ability to disproportionately affect tax outcomes. Careful planning and understanding of the applicable legal rules is essential to sustaining the expected tax consequence upon audit by the IRS. This memorandum is not intended, and should not be read, as a comprehensive treatment of its subject matter, nor does it necessarily address all topics of import in the area. Always consult a qualified professional.

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