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Business Expenses

INSIGHT: Aircraft Business Tax Deductions: Top Ten for 2018 and Beyond

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The 2017 Tax Cuts and Jobs Act (2017 tax act) made several changes to business deduction rules that directly or indirectly affect the permitted tax deductions for aircraft used in a taxpayer's trade or business or for investment purposes. Many of the changes are actually quite favorable. There has been much written on each of these "Top Ten" topics in general, but the purpose of this article is to provide an analysis and strategy to make the most of the changed business tax environment specifically with respect to aircraft.

The "Top Ten for 2018 and Beyond" for business aircraft tax deduction presupposes a very good technical knowledge of the prior tax rules for aircraft business deductions. Please note that future guidance published by the Internal Revenue Service on the new statutory provisions may well be contrary to the interpretation suggested as reasonable in this article.

1. BONUS DEPRECIATION Most remarkably, a new or used aircraft used in a trade or business (not an investment activity), **acquired and placed in service after Sept. 27, 2017**, is eligible for 100 percent bonus depreciation, which means the entire purchase price of the aircraft can be deducted in the first year the taxpayer operates the aircraft for a business flight. Absent bonus depreciation, the cost of an aircraft is deductible over periods ranging from 5 to 12 years.

Taxpayers taking advantage of the new bonus depreciation rules should exercise extreme caution in the use of the aircraft in the first year with respect to either business entertainment or commuting because the percentage of use for those purposes could reduce, even to zero, the depreciation commensurately pursuant to Code Section 274(a) and Section 274(l) as amended by the 2017 tax act.

Example 1: A $48 million aircraft acquired in 2018 and placed in service in December of 2018 used for one entertainment business flight and one commuting flight by a non-owner executive could result in a "0" depreciation deduction. In contrast, if the only flights on the aircraft in 2018 were for non-entertainment, non-commuting business flights, the depreciation deduction in 2018 would be the full $48 million, absent application of the new messy excess business loss and NOL rules as described in No. 8 below.

Another word of caution with respect to keeping the benefit of the new 100 percent bonus depreciation is to "pass" Section 280F use in that year and in the ensuing years even after the bonus depreciation has been taken in order to avoid recapture of the bonus depreciation on a go-forward basis. To pass Section 280F, the aircraft generally cannot either be used 75 percent or more for personal purposes by a 5 percent owner, or be leased to a related entity where it is then used by a 5 percent owner for business or personal purposes more than 75 percent.

Bonus depreciation is phased out in 20 percent increments beginning in 2023. Favorably, certain "longer production period property" and "certain aircraft,"

definitions that cover most aircraft used in business, are eligible for one-year extensions of the bonus depreciation rules.

2. ELIMINATION OF TAX-FREE SECTION1031 EXCHANGES Section 1031 is the popular means by which aircraft owners can upgrade an aircraft without recognizing gain because Section 1031 provides for income recognition deferral through like-kind exchanges, e.g., an aircraft used in business for another aircraft to be used in business. However, under the 2017 tax act, absent a safe harbor for already partially completed exchanges, aircraft are no longer eligible for tax deferred like-kind exchange treatment after 2017. The elimination of Section 1031 for personal property such as aircraft is permanent. Due to the bonus depreciation rule discussed above and the inability to continue to use like-kind exchanges, taxpayers should be aware of the depreciation recapture rules that could come into play should the rules for accelerated depreciation such as Section 280F not be met on an ongoing basis. Additional factors that should be considered in light of the elimination of the like-kind exchange treatment include whether the state tax follows the federal bonus depreciation rules, whether the buy and sell are in the same year, and whether the aircraft is used in a trade or business or conversely in an investment activity.

Example 2: In 2018, a company owns a fully depreciated aircraft worth $18 million and exchanges it, plus $22 million cash, for a $40 million aircraft, used only for non-entertainment business. Company realizes gain of $18 million because tax-free exchange treatment is no longer available. If the Section 280F rules are met and bonus depreciation is taken, then the company can take a $40 million deduction that would completely offset the gain on the aircraft. If however, the company used the aircraft 76 percent for compensatory personal purposes of a 5 percent owner, the company would have the same $18 million of gain, but offset only by depreciation under the straight-line schedule, of less than $8 million, which would offset the gain recognized only to no less than $10 million rather than eliminate it.

3. BUSINESS ENTERTAINMENT DISALLOWANCE The personal entertainment disallowance rules of Section 274(e)(2) and Section 274(e)(9) have been around for a while and most aircraft owners are familiar with the Section 1.274-10 regulations applicable to vacation and other personal entertainment flights provided to employees, partners, directors, and independent contractors. Beginning in 2018, Section 274 was amended permanently to deny the deduction of ''business entertainment'' flights as well as personal entertainment flights. Previously, Section 274(a) generally provided an exemption from the 100 percent disallowance for entertainment if it was directly associated with or related to the active conduct of business, such as where business discussions with customers or clients took place before, during, or after the entertainment. With the 2017 tax act, now the expenses related to air travel that are determined to be for business entertainment are no longer deductible at all in contrast to the previous completely deductible treatment. The challenge here is determining when and how much of air travel is in fact related to business entertainment. Until guidance is issued, it is reasonable to take a ''primary purpose of the trip'' approach, which means that if the main driver for the trip was to entertain in a business context than the disallowance applies, and likely applies to all fully loaded expenses including depreciation. Furthermore, it is likely most reasonable to use the methodologies for allocating the disallowance set forth in Treas. Reg. 1.274-10 related to compensatory personal entertainment expenses—seat hours or miles, or flight hours or miles—based on the primary purpose of the flight per passenger.

Example 3: CEO travels in the company jet to take a potential client golfing where a potential business partnership discussion takes place. The CEO's spouse is the only other passenger on the aircraft and she is accompanying her spouse for a non-entertainment purpose, such as attending a funeral. If the full allocable expenses for the flight were $40,000 based on total flights and expenses during the year, then $20,000 would be non-deductible with respect to the CEO because he was flying for business entertainment purposes, if the Treas. Reg. 1.274-10 flight hour or mile type allocation rules are used for the business entertainment portion of the trip. In addition, there would be a small amount of Form W-2 income inclusion for the spouse's travel, but a full deduction to the company with respect to her travel because her travel is not entertainment, either business or personal.

4. COMMUTING DISALLOWANCE Like the new denial of deduction for business entertainment, the new Section 274(l) rules related to ''commuting'' do not specifically relate to aircraft travel. Section 274(l) provides that ''In General—no deduction shall be allowed under this chapter for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee.'' Note that the new provision applies to **employees**, and thus presumably partners, directors, other self-employed individuals, and possibly 2 percent or greater S corporation owners, would not be subject to the disallowance.

An easy way to avoid application of the disallowance is to meet the ''ensuring the safety'' of the employee statutory exemption. Of course, there is not yet guidance on what this means, but it is reasonable to conclude that it falls under the exemption if the individual is flying pursuant to an ''independent security program'' or other overall 24-hour security program as defined in Treas. Reg. 1.132-5(m). Furthermore, it is reasonable that outside of Treas. Reg. 1.132-5(m), the determination is based on all the facts and circumstances, for example, recent death threats directed at the executive.

Example 4: CEO and spouse are covered by an independent security study that provides for travel in the employer aircraft for all domestic and foreign travel. CEO and spouse fly on a weekly basis from their home in Boca Raton, Fla., to New York, the CEO's primary place of work. No expenses would be disallowed under the new Section 274(l) provisions because the travel in the employer aircraft is to ensure the CEO's safety.

The new statutory language does not specify whether it means travel between **any** residence and **any** place of employment, or just the primary residence and primary place of employment. The better, or at least reasonable, interpretation is that it is only the primary residence and the primary place of employment.

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Example 5: CEO's primary residence is in New York and primary office is in New York. CEO's flight from New York to second employer office in Chicago for work purposes is not commuting because that flight would be a business trip, not taxable to the employee under the working condition fringe rules of Section 132, and should be fully deductible to the employer as a business trip, not commuting. However, if the CEO's primary office is in New York and primary residence is in West Palm Beach, Fla., then travel from Florida when there for non-business purposes to New York for work at the primary office is commuting, taxable income to the CEO reported on Form W-2, and not deductible to the employer company pursuant to Section 274(l).

Like the business entertainment issue, there is no guidance regarding the actual dollar amount that is nondeductible under the new commuting rules. There are at least three possible interpretations: (1) no expenses are deductible, not even the amount included in income; (2) only the amount included in income is deductible; or (3) all expenses are deductible where there is any income exclusion because the flight would now be deductible as wages, not commuting.

Example 6: Expenses related to New York to Florida commuting flights are $1 million, and wage-imputed income using the IRS Standard Industry Fare Level (SIFL) rates is $100,000. Under the alternative interpretations:

(1) Full $1 million is nondeductible despite the fact that $100,000 was included in income.

(2) $900,000 is nondeductible as attributable to the excess over the amount included in income.

(3) $1 million is completely deductible because not considered commuting.

What if there are non-employee commuting passengers on the same trip? Would the full expenses be allocable and deductible in accordance with the number and nature of the flight per passenger, or would the entire flight be ''tainted'' as a commuting flight? Again, like the new business entertainment disallowance, the most reasonable interpretation may be to follow the allocation method in Treas. Reg. 1.274-10 that applies to personal entertainment flights.

5. ELIMINATION OF MISCELLANEOUS ITEMIZED DEDUCTIONS–GENERAL Section 162 governs the expense deduction for those activities that are a ''trade or business.'' Section 212 governs the expense deductions for investment activities that, until the 2017 tax act, had been at least partially deductible as miscellaneous itemized deductions. In the more traditional aircraft ownership structure where the aircraft is owned or used by an actual operating company, the elimination of miscellaneous itemized deductions will not have an impact because the aircraft activity expenses are deductible by the business entity owner under the Section 162 trade or business expense rules.

However, for those non-traditional aircraft ownership structures, such as where the aircraft is owned by a family office or directly by an individual and Section 212 is the means by which a deduction is obtained, this new tax deduction cutback can be a problem to the extent the taxpayer was previously recognizing a deduction under Schedule A for aircraft expenses. Similarly, if an executive owned the aircraft and had related excess expenses related to travel for an employer company, a miscellaneous itemized deduction was available as an unreimbursed employee business expense. Under prior law, Section 212 and employee business expense miscellaneous itemized deductions were allowed subject to 2 percent of adjusted gross income as well as an overall limitation, and were preference items for alternative minimum tax. Now such investment or unreimbursed employee business expense deductions are completely disallowed.

There are several alternatives to get a deduction or a better tax result for these lost itemized deductions.

One alternative is where the individual that would like to use an aircraft for his own investment purposes is working at a company that has an aircraft. That company could be a public company or even a closely held company partnership or S corporation majority owned by the individual. If the individual flies for his own investment purposes on the company aircraft, there would be compensatory income inclusion because the flight would not be excluded as a working condition fringe by the company as the individual's investments are not related to the business purpose of the company. However, the income inclusion would be minor if the SIFL rules are used, and the entire fully loaded costs of the flight would be deductible to the company.

Another alternative is if the aircraft is set up as a leasing business, intended to make a profit over the life of the aircraft, and leased even to related parties. Then the expenses with respect to that aircraft rental business may be deductible to the extent of the rental income, and even beyond that to the extent of other passive income or if the passive activity rules under Section 469 do not create an issue.

Example 7: An individual owns an aircraft used in the management of the individual's investment activities or related to business travel for the individual's employer's company, with aircraft-related expenses including depreciation of $1 million per year and adjusted gross income of $1 million. Prior to 2018, $980,000 was deductible subject to the other limits on miscellaneous itemized deductions, but beginning in 2018, ''0'' would be deductible. If the aircraft ownership is restructured so that it is leased at full fair market rates to the employer company or to a management company, entities owned by the individual for investment activities, and/or unrelated third parties, then the expenses such as depreciation related to the leasing activities would generally be deductible subject to the passive activity limitations (if applicable). The lease payments made by the lessees would be deductible as dictated by the use of the aircraft. If the lessee is a family office management company as described in *Lender Mgmt., LLC v. Commissioner* (discussed below), the lease payments would be deductible as a Section 162 business expense.

6. ELIMINATION OF MISCELLANEOUS ITEMIZED DEDUCTIONS–LENDER CASE As described above, Section 212 investment expenses are no longer permitted as an itemized deduction, but Section 162 still remains to provide a deduction for expenses related to the production of income that is part of a trade or business rather than an investment activity.

Thus, the obvious solution is to create a situation where the expenses are related to a Section 162 activity rather than a Section 212 activity. Management expenses of one's owns investments are no longer deductible under Section 212 and thus many typically structured family offices cannot deduct the various ex-

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penses, including that related to an aircraft, in managing the investments of the family office. *Lender* is a breakthrough case. In this case, the Tax Court decided that certain expenses on behalf of three investment funds owned by related family members should be analyzed as deductions under Section 162, as opposed to Section 212, despite the fact the services were provided by the related financially savvy family member owner of Lender Management.

Lender Management employed its own full-time employees and was deemed to be in the ''business'' of providing investment advisory and financial planning services, and managing the investments for each of its three fund clients. Lender Management received both a management fee and carried interest for managing different investments at fair market value rates. Likely important to the Section 162 determination was the fact that there was not a high degree of ownership overlap between Lender Management and the three funds, and the Tax Court refused to apply ownership attribution between the related parties to find a higher degree of common ownership. Thus, this case provides a roadmap for family offices to obtain current deductions, including for travel on a leased or owned aircraft, despite the fact that the end result is investment management.

7. FEDERAL EXCISE TAX ON MANAGED AIRCRAFT A substantial excise tax at the rate of 7.5 percent of the amount paid applies to ''air transportation'' under Section 4261, sometimes referred to as the ''ticket tax.'' The Section 4261 tax is a type of sales tax that applies to situations where a customer is purchasing a flight on a commercial aircraft. However, the IRS has been very aggressive at applying the tax whenever there is a payment or reimbursement for a flight on an aircraft with crew, extending the tax to situations far beyond regular charter or commercial flights. For example, the IRS claims that when aircraft owners use an unrelated third-party management company to provide crew and other aircraft management services to the owner that the owner's payment for these management services is subject to the Section 4261 excise tax. Providing much needed relief, the 2017 tax act amended Section 4261 to exclude from the tax payments made to a management company by an aircraft owner or qualified lessee for support services for owner flights. Now, generally, an aircraft owner would not be paying the ''ticket tax'' for use of the owner's aircraft.

Despite this welcome exemption from the hefty excise tax, there are some very basic questions. First and foremost, does the exemption apply in the typical situation where the aircraft is owned (or leased) by an LLC that in turn allows the LLC's individual or entity owner to use the aircraft including related parties? In addition, does the exemption apply equally to Part 135 flights (an FAA designation for a commercial flight) where it is an aircraft owner using its own airplane?

8. LIMITATION ON EXCESS BUSINESS LOSSES AND NET OPERATING LOSS LIMITATION Prior to the 2017 tax act, taxpayers tracked three types of income: passive business, active business, and investments. Passive losses were not deductible against investment income or active business income. Now pursuant to Section 461(l) there are also new limitations on active business losses referred to as ''excess business losses.'' Excess business losses ($500,000 on a joint return) are not allowed for the taxable year, but are instead carried forward and treated as a Section 172 net operating loss carry-forward in subsequent taxable years. The rule applies to individuals, trusts, and estates individually, and to partnership or S corporations at the partner or shareholder level. Another 2017 tax act change is that net operating losses arising in tax years beginning after 2017 may only be carried forward and can do so indefinitely, but not back, and may only be used to offset up to 80 percent of regular taxable income.

The new excess business loss rules make tax planning significantly more complicated and increase the burden of tracking the various types of income, including that accruing pre- and post-2018. Issues remain as to how the new 20 percent deduction permitted by Section 199A (discussed below) interacts with the new Section 461(l) and Section 172 rules. It should be noted that if an excess business loss situation occurs, then no Section 199A deduction is available because there would not be qualified business income and the aggregate net operating loss will also reduce the future taxable income. There remains the question of the ordering rules for years in which there are both current excess business loss and net operating loss carry forward. Amongst other issues, the 100 percent bonus depreciation deduction on an aircraft may not be usable against investment income due to the new limit on excess business losses.

9. BUSINESS INTEREST LIMITATION Unlike the new Section 199A qualified business income 20 percent deduction, the new Section 163(j) interest expense limitations apply to all businesses whether pass-through or not, so C corporations are subject to the entity level disallowance as well. The deduction of business interest is now generally limited to the addition of (1) business interest income, and (2) 30 percent of the business's ''adjusted taxable income,'' which does not take into account net operating loss deductions under Section 172 and the Section 199A deduction, and floor plan financing interest, defined in Section 163(j)(9) related to the acquisition of motor vehicles, including boats and farm equipment, for sale or lease. The new rule specifically exempts depreciation, amortization, and depletion for years beginning prior to January 1, 2022, from the definition of adjusted taxable income, and investment interest and income from the calculations. Any deductions disallowed can be carried forward indefinitely by the taxpayer.

Important exceptions apply to the new Section 163(j) business interest expense limitation for businesses with gross receipts of $25 million or less, and certain utilities, farming, and real property trades or businesses.

With respect to aircraft specifically, an issue arises on how to apply the new limitations applies because of the pre-existing Section 274 entertainment limitations: does the new limit apply before or after application of the Section 274 limitation?

Example 8: Business owns an aircraft with interest expense of $1.4 million in 2018, and adjusted taxable income is $1.5 million. Interest expense that is nondeductible under Section 274 is $1 million. If it can be assumed that the Section 163(j) limit applies **after** the Section 274 disallowance, then the full remaining $.4 million should be deductible.

10. QUALIFIED BUSINESS INCOME DEDUCTION The 2017 tax act provides for a brand new tax code section that is intended to equalize or give advantage to entre-

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preneurs with ''pass-through'' businesses such as sole proprietorships, S corporations, and entities taxable as partnerships. Section 199A allows a 20 percent deduction for net ''qualified business income,'' which does **not** include specified service income such as law or accounting for higher income taxpayers. Qualified business income does not include investment-related income, gain, deduction, or loss such as capital gain, dividends, or interest expense. The amount of the new deduction also has as a limitation for higher income taxpayers equal to the greater of 50 percent of wages or 25 percent of wages plus 2.5 percent of the unadjusted basis of ''qualified property.''

If there was actual income for an aircraft leasing activity, it should constitute qualified business income and thus potentially be eligible for the new Section 199A 20 percent deduction. The problem with aircraft leasing is that it typically does not show a profit on an ongoing basis because the depreciation deduction against the rental revenue is so high. However, in those instances where there is a profit, the 20 percent deduction is very beneficial.

Separately, there may be opportunities to treat the aircraft activity as part of a larger trade or business where the aircraft activity relates to a trade or business. The new law requires that the wage/asset limitation applies separately with respect to each trade or business, but does not define exactly what is a trade or business. Likely if the aircraft is owned directly or leased to and used by an operating company, it can be viewed as one trade or business.

Example 9: S Corporation or LLC has a non-specified service trade or business and owns in a disregarded entity an aircraft used in the trade or business for business purposes of the S Corporation or LLC, leased from the disregarded entity to its owner. The aircraft is fully depreciated. The aircraft basis for Section 199A purposes is $40 million and therefor the asset limitation is $1 million ($40 million x 2.5%). The S Corporation or LLC has profit of $10.5 million and wages of $1 million. If the aircraft is part of the operating company trade or business, the Section 199A potential deduction of $2.1 million is limited to $1.25 million, and if not, then the Section 199A deduction is limited to only $.5 million (50% x $1 million).

CONCLUSION Aircraft owners should review their aircraft ownership and use structure in light of the new rules effective now. Bonus depreciation, elimination of the Section 4261 excise tax, and the *Lender* case may be a boost to reducing taxes. Careful documentation and analysis can minimize the impact of unfavorable new provisions such as the commuting and business entertainment deduction takeaway, elimination of miscellaneous itemized deductions, and excess business losses. Aircraft owners will want to review all activities of related entities that could constitute a ''trade of business'' in order to fully utilize the favorable 20 percent Section 199A deduction.

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