Tax Savings For Flyers

PART I

Owners or operators of general aviation planes may be entitled to certain Federal income tax deductions. Business expenses, depreciation, aircraft damage, etc., offer possibilities

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EDITOR'S NOTE: This is the first part of a two-part series on the Federal income tax as it applies to general aviation aircraft ownership and operation. The second part will appear in the March issue of The PILOT. Messrs. Kopp and Molod, authors of this article on tax savings for aircraft owners and operators, are Associates of the Philadelphia law firm of Wolf, Block, Schorr and Solis-Cohen, of which AOPA's General Counsel, Alfred L. Wolf (AOPA 5), is a partner. This discussion of Federal income taxes continues a service to AOPA members started several years ago. (See The PILOT for March 1958, March 1959, February 1961, March 1963, March 1964 and March 1965.)

No area of the law is as complex and confusing to the layman as Federal tax law. Nor is any area of the law so fluid and subject to continual modification. For example, it may be recalled that in last year's article we discussed the case of *Noel's Estate v. Commissioner*, decided June 17, 1964, by the Court of Appeals for the Third Circuit, in which it was held that accidental death proceeds from flight insurance policies were not includable in the decedent's gross estate. We noted at that time that certiorari to the Supreme Court had been granted and that "it is quite possible that the Supreme Court will reverse the Court of Appeals." On April 29, 1965, the Supreme Court did reverse the Court of Appeals, and held that the decedent did possess the incidents of ownership of the policy and that the proceeds of the flight insurance in issue in that case were includable in the decedent's gross estate.

This article shall not offer an exhaustive study of the Federal tax laws but rather simply will touch upon some of the more significant avenues which may be followed in order to obtain legitimate tax savings, as intelligent tax planning and reporting may lead to substantial tax savings.

There is no dispute that morally questionable practices cannot be condoned. Nothing is wrong, however, either ethically or legally, with taking all of the deductions to which you are entitled as an aircraft owner or operator. Particular attention should be paid to the regulations concerning the keeping of accurate and detailed records of expenses, since legitimate expenses may be denied deductibility if they cannot be substantiated by properly kept records.

Because of the growing complexity of Federal tax law, particularly in recent years, it is imperative for nearly every taxpayer to consult with his lawyer or accountant for purposes of tax planning and reporting.

Although Federal rather than state taxes are generally of prime interest, state corporate income and franchise taxes are also of serious concern to businessmen. Virtually every state with a corporate income or franchise tax has established a formula for taxing the income of a corporation doing business in several states. The formulas are generally variations of one sort or another on a three-factor formula based on sales, payroll and value of property.

In addition to variations in the taxing formulas to be applied to corporate income, virtually every state differs from its sister states in the manner of arriving at the actual corporate income figure, there being no uniformity of treatment of items such as, to name a few, interest on governmental obligations, expenses related to exempt income, depreciation, investment credit, depletion, research and experimentation expenses, intercorporate dividends, capital gains and losses, loss carryovers, charitable contributions, etc.

Returning to the taxing formula, one of the more murky questions for purposes of valuing the property of a corporation doing business in several states is the proper treatment of transportation equipment. Only 11 states have specific provisions governing the attribution of transportation equipment. Seven of these 11 states generally attribute the value of movable property on the basis of miles traveled in the taxing state to total miles traveled. The other four states use the ratio of time spent in the taxing state to total time.

Because of the confusion and lack of conformity among the states, the Committee on the Judiciary of the United States House of Representatives formed a Special Subcommittee on State Taxation of Interstate Commerce to investigate and prepare an exhaustive report on the problem. The Subcommittee recently issued its report on the state taxing schemes.

On Oct. 22, 1965, based on the Subcommittee Report, a bill was introduced in Congress which would regulate and foster commerce among the states by providing a system for the taxation of interstate commerce. This bill, H.R. 11798, provides that corporate income taxes on corporations doing business in several states be based on Federal taxable income. Jurisdiction to tax would be based on ownership of realty or having an employee located in the state, and income would be apportioned on the basis of property and payroll. Of particular interest is the provision fixing the location of property for purposes of valuation. The general rule, of course, is that property is considered to be located in the state where it is physically present. However, "personal property which is not rented out and which is characteristically moving property, such as motor vehicles, rolling stock, aircraft, vessels, mobile equipment, and the like, shall be considered to be located in a State if (1) the operation of the property is localized in that State or (2) the operation of the property is not localized in any State but the principal base of operations from which the property is regularly sent out is in that State. If the operation of the property is not localized in any State and there is no principal base of operations in any State from which the property is regularly sent out, the property shall not be considered to be located in any State."

As for personal property which is rented out by a corporation to another person, it "shall be considered to be located in a State if the last base of operations at or from which the property was delivered to a lessee is in that State. If there is no base of operations in any State at which the corporation regularly maintains property of the same general kind for rental purposes, such personal property shall not be considered to be located in any State."

Property is "localized" in a particular state if during the taxable year it is operated entirely within that state, "or it is operated both within and without that State but the operation without the State is (A) occasional, or (B) incidental to its use in the tranportation of property or passengers from points within the State to other points within the State, or (C) incidental to its use in the production, construction,

(Continued on page 77)

or maintenance of other property located within the State."

The term "base of operations," with respect to a corporation's rented-out property or moving property which is not rented out, means "the premises at which any such property is regularly maintained by the corporation when (A) in the case of rented-out property, it is not in the possession of the lessee or (B) in the case of moving property which is not rented out, it is not in operation, regardless of whether such premises are maintained by the corporation or by some other person; except that if the premises are maintained by an employee of a corporation primarily as a dwelling place that shall not be considered to constitute a base of operations."

Whatever legislative action grows out of this bill will of course be called to your attention.

Looking now to Federal taxes, most AOPA members are probably most concerned with two principal sorts of deductions: business expenses and charitable contributions. The question may have arisen in the minds of some AOPA members as to the possibility of tax benefits when their airplanes are used *in part* for the benefit of a charitable organization. In the recent case of *Orr v. United States*, decided March 29, 1965, the Court of Appeals for the Fifth Circuit held that only a limited charitable deduction was allowable. John Orr, the taxpayer, served on numerous boards and committees of the Methodist Church. In carrying out these duties he used his own automobile and airplane, but also used the vehicles for noncharitable purposes. He claimed a charitable deduction for a proportionate share of his gasoline and oil, insurance, depreciation, repair and other expenses. The Commissioner allowed the charitable deduction for unreimbursed out-of-pocket expenses for gasoline and oil, pilot fees and license registration fees, but disallowed the deduction for depreciation, insurance, and repair expenses. The district court upheld the Commissioner's determination, and the Court of Appeals affirmed.

The taxpayer also sought a charitable deduction on the theory that he should be allowed to deduct the fair rental value of the vehicles for the length of time he used them for charitable purposes. This approach was also rejected by the Court, although the Court did note that under certain circumstances, where a taxpayer makes a gift of the use of property to a charitable organization by actually transferring *possession and exclusive control* of the property to the organization, a deduction of the fair rental value may be allowed.

As singularly dynamic and changing as the Federal tax law is, of equal vitality are many of the AOPA members who spend considerable time in transit from one place to another both here in the United States and abroad. It is, therefore, of particular interest to examine the tax treatment of travel expenses.

Although not generally realized by taxpayers, it should be specifically noted that by taking a standard deduction rather than itemizing deductions, travel and transportation business expense deductions are not lost. On the contrary, whether the individual taxpayer is an employer or an employee, allowable travel and transportation expenses, as well as various other items such as losses from the sale or exchange of certain property, are deductible from gross income in order to yield "adjusted gross income;" it is from this adjusted figure that the standard deduction is subtracted.

Even for those taxpayers who do itemize their deductions, it is important to bear in mind that their deductible travel and transportation expenses should not be lumped together with other deductions, but should be deducted from gross income first to arrive at adjusted gross income. A consequence of so doing, for example, is that the deduction for medical expenses (which is based on the *excess* of allowable medical expenses over 3% of adjusted gross income) is increased, though the allowable maximum deduction for charitable contributions (based on a percentage of adjusted gross income) is decreased.

The Revenue Act of 1964 repeals the travel allocation rule for travel within the United States, and reinstates the pre-1963 policy which permits deduction of the full amount of travel expenses incurred on trips within the United States which are primarily for business purposes. However, the allocation rule is still applicable to foreign travel, that is, for travel outside the United States away from home which exceeds one week and where the time outside of the United States away from home attributable to nonbusiness activities constitutes 25% or more of the total time on such travel. When these circumstances are present, the travel expenses (including meals and lodging), otherwise deductible, of a combined business-personal trip have to be allocated, with only the business portion, of course, being deductible.

The most important development in the Federal tax law in recent years, as far as aircraft owners and pilots are concerned, has been the development of fixed rules and regulations for determining the deductibility of expenses incurred with respect to an aircraft used in connection with "business entertainment." The expenses referred to here are expenses such as depreciation, operating costs, maintenance, repairs, insurance, painting, rentals, etc. Prior to 1963, if a taxpayer used an aircraft for purposes of promoting the good will of customers, the taxpayer could deduct some or all of the expenses incurred in operating the aircraft where such expenses were found to be ordinary and necessary business expenses. Under Section 274 of the Code and the Regulations thereunder, however, the taxpayer must satisfy two new requirements, in addition to the "ordinary and necessary" test, in order to deduct the expenses incurred in using an aircraft for entertaining business customers.

The taxpayer must establish (1) that the aircraft was used primarily for the furtherance of the taxpayer's trade or business and (2) that the expenses were directly related to the active conduct of the taxpayer's trade or business.

What do these two new tests mean? First, what constitutes using an aircraft primarily for the furtherance of the taxpayer's trade or business? Generally, an "entertainment" facility shall be considered as used primarily for the furtherance of the taxpayer's trade or business if it is established that the primary use of the facility during the taxable year was for purposes considered "ordinary and necessary" under Sections 162 and 212 of the Internal Revenue Code of 1954. In the case of aircraft, the regulations state specifically that an aircraft shall be deemed to be used primarily for the furtherance of the taxpayer's trade or business if the taxpayer establishes that more than 50% of the hours flown during the taxable year were hours flown in connection with travel considered to be ordinary and necessary within the meaning of Section 162 or 212 of the Internal Revenue Code of 1954. However, a taxpayer is not precluded from satisfying the "primary use" requirement according to a different measure, if reasonable. The second question is what are expenses "directly related" to the active conduct of the trade or business? Generally, expenses are considered directly related to the active conduct of the taxpayer's trade or business if it is established that they meet each of the following requirements set forth in the Regulations:

"(i) At the time the taxpayer made the entertainment expenditure (or committed himself to make the expenditure), the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure. A taxpayer, however, shall not be required to show that income or other business benefit actually resulted from each and every expenditure for which a deduction is claimed.

"(ii) During the entertainment period to which the expenditu[illegible]lated, the taxpayer actively engaged [illegible] a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining such income or other specific trade or business benefit (or, at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that he would have done so, although such was not the case solely for reasons beyond the taxpayer's control).

"(iii) In light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer's trade or business (or at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer's control). It is not necessary that more time be devoted to business than to entertainment to meet this requirement.

A taxpayer must substantiate each of the above elements of an expenditure by adequate records or by sufficient evidence corroborating his own statement. A record of the elements of an expenditure made at or near the time of the expenditure, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequently when generally there is a lack of accurate recall. To meet the "adequate records" requirement, a taxpayer should maintain an account book, diary, statement of expenses or similar record, and documentary evidence which, in combination, are sufficient to establish each element of the expenditure. Documentary evidence, such as receipts, paid bills, or similar evidence to support an expenditure are required for (1) any expenditure for lodging while traveling away from home and (2) any other expenditure of $25 or more. In general, each separate payment by the taxpayer shall ordinarily be considered to constitute a separate expenditure. However, concurrent or repetitious expenses of a similar nature occurring during the course of a single event shall be considered a single expenditure.

"(iv) The expenditure was allocable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment or with whom the taxpayer establishes he would have engaged in such active conduct of trade or business if it were not for circumstances beyond the taxpayer's control."

The two new tests discussed above operate in the following fashion. If an aircraft is not used primarily for the furtherance of the taxpayer's trade or business (e.g., less than 50% of the flying hours during the taxable year are in connection with travel considered ordinary and necessary under Section 162 and 212 of the Internal Revenue Code of 1954), *no deduction* whatsoever will be allowed for any expenses incurred in connection with using the aircraft for business entertainment purposes. On the other hand, if it is found that the aircraft is used primarily for the furtherance of the taxpayer's trade or business, the taxpayer will be allowed to deduct the expenses incurred in operating the aircraft to the extent that the aircraft was used for entertainment directly related to the active conduct of the taxpayer's trade or business.

It is important to remember that good will entertainment is counted in determining whether an aircraft is used primarily for the furtherance of the taxpayer's trade or business (first test) but is *not* counted in determining the extent of entertainment "directly related" to the taxpayer's trade or business (second test). For example, if a taxpayer establishes that 40% of his flying hours during the taxable year were for "directly related entertainment" and 25% of his flying hours during the taxable year were for "good will" entertainment, the taxpayer will be able to deduct only 40% of the expenses incurred in operating his aircraft. The limitations prescribed by Section 274 of the Code and the Regulations thereunder severely restrict the deductibility of expenses incurred in operating an aircraft for "business entertainment" purposes. It is indeed important for the aircraft owner and operator to be aware of these restrictions; otherwise, he will be counting on tax deductions where none in fact exist.

The above-described limitations on deducting the operating costs of an aircraft used for business entertainment purposes, of course, do not apply where the aircraft is used for pure business transportation. All "ordinary and necessary" expenses are deductible for pure business transportation without regard to the special entertainment limitations described above. In this area, the Internal Revenue Service has now generally accepted the premise that expenses incident to the use of an airplane for business transportation should not be any less deductible than the costs of an automobile for the same purpose.

In addition to the deductible items connected with your personal flying, you should give careful attention to all of your claimed deductions for travel, entertainment, etc. In recent years, "business expense" deductions of this type have become a prime target for IRS agents. Now, Section 274 of the Code requires the keeping of accurate and detailed records of these expenses, and the failure to do so will result in loss of the claimed deduction.

The Regulations provide that no deduction shall be allowed for any expenditure or item with respect to (1) traveling away from home (including meals and lodging) deductible under Section 162 or Section 212, or (2) any activity which is of the type generally considered to constitute entertainment, amusement, recreation, or with respect to a facility (e.g., an airplane) used in connection with such activity, unless the taxpayer substantiates each *element* of such expenditure. The elements of an expenditure are (1) amount, (2) time and place of traveling or entertainment or use of a facility with respect to entertainment, (3) business purpose, and (4) business relationship to the taxpayer of each person entertained, or using an entertainment facility.

A taxpayer must substantiate each of the above elements of an expenditure by adequate records or by sufficient evidence corroborating his own statement. These substantiation requirements, as well as the tax rules relating to casualty losses, depreciation and various other items, will be dealt with in the second part of this article, which will appear in next month's issue of The PILOT. ●