From the Washington Counsel

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Checklist of Tax Savings: Part One

It's the time of year when many of us are beginning to think about our federal income tax returns. So, it's a good time to review the deductions and credits available under the tax law relating to the ownership and operation of a private aircraft. This month, we'll review the business-related tax savings. Next month, we'll look at credits and deductions that are available to an aircraft owner whether or not his aircraft is used in a business.

Travel Expenses

The usual form of deducting all or part of the cost of operating a private aircraft is as a business travel deduction. The general rule is that a taxpayer is allowed to deduct all of his ordinary and necessary trade or business expenses, including the cost of travel in private aircraft. In 1949, and again in 1956, the Internal Revenue Service assured AOPA that travel expenses meeting the general rule are deductible "irrespective of the mode of travel." And this is still true.

The deductions are allowable whether the taxpayer is an individual, partnership, corporation, estate or trust. And, important to many of our members, these deductions may be available to an employee. This is because the performance of services as an employee is considered in tax law to be a trade or business.

Business corporations, partnerships and self-employed individuals usually have an easier time than employees in deducting the cost of owning and operating a private aircraft for business travel. Their problems usually arise when the aircraft is used for both business and personal use. If the business portion meets the *ordinary and necessary* test, it is deductible.

This was confirmed in a 1963 case, which held that a partnership's expenses of owning and operating aircraft used roughly one-half for business and one-half for personal use are deductible in proportion to the expenses for business use.[1] One interesting sidelight in this case is that there was some flying time that was neither attributable to business use nor personal use. Presumably this unaccounted time included proficiency time. This time was "allocated between the business and personal use on a percentage basis."

This suggests that when an aircraft is used for business flying a substantial part of the time, proficiency flying is deductible in the same proportion as the business flying. If the aircraft is used exclusively for business, and the pilot flies only on business, the proficiency time should be fully deductible.

The typical problem of the employee is that the cost to him of operating his aircraft on business trips exceeds the reimbursement made to him by his employer. He would like to deduct the excess. Three unsuccessful Tax Court cases give us clues as to how to better prepare our own cases.

The first [2] involved a sales representative whose responsibilities occasionally required him to travel to different parts of this country. In 1964, he flew his Apache approximately 100 hours, of which 75 hours were attributable to business trips for his employer, and 20 hours were attributable to trips to look after his investment properties. His reimbursement from his employer was limited to standard commercial airline rates. He claimed a deduction of 95% of his aircraft operating expenses less reimbursements. This deduction was disallowed by IRS. On appeal, the Tax Court agreed with IRS, relying heavily on the employer's refusal to reimburse beyond the commercial airline rates. The Court disallowed the portion of the deduction relating to the investment properties because it was not "ordinary and necessary" to the management, conservation or maintenance of the properties.

The second case [3] involved an employee who at first was a consultant and later chief executive officer and chairman of the board of a company in the molded paper pulp products business. He flew his own airplane on company business but did not seek reimbursement from his company. IRS disallowed the deduction of the aircraft operating costs attributable to business use, and the Tax Court agreed. The Tax Court held that if a corporation that reimburses its officers and employees for expenses does not reimburse for a particular expense (cost of business travel in personally owned plane), "that expense *prima facie* is personal either because it was voluntarily assumed or because it did not arise directly out of the exigencies of the business of the corporation."

The Tax Court in each of these cases, emphasized that the taxpayer's trade or business was earning his salary, and it was neither necessary that he fly to retain his employment nor was there any advantage gained by flying his own plane.

The third case [4] in this area denied a medical doctor a business expense deduction for unreimbursed expenses incurred in using his plane on trips benefiting the pharmaceutical firm that employed him. At first, the doctor was reimbursed by his employer based upon first-class air fare. Thereafter, the company discontinued any reimbursement for the costs associated with the business use of privately owned airplanes. The Tax Court said, "Where an employee, knowing that reimbursement will not be forthcoming, voluntarily undertakes a course of action on behalf of his employer, any expenses arising from such an undertaking are normally viewed as being *prima facie* personal."

Fortunately, a later revenue ruling indicates some softening in the IRS position.[5] This ruling allowed a government employee to deduct his expenses, including depreciation, of operating his own aircraft on government business.

The facts are sketchy. "During 1969, the taxpayer was required to travel extensively in connection with his employment. Although he was not required to use his privately owned airplane for business travel, due to the urgency of his trips he was permitted to do so. He was issued overall travel authorizations which provided authority for travel by 'privately owned auto or aircraft' among other possible means of transportation. The taxpayer was reimbursed for his travel at a standard rate based on the total miles traveled on official business. *Held*, the travel expenses incurred by the taxpayer in excess of his reimbursement are deductible as ordinary and necessary business expenses."

These cases suggest the importance of documenting the advantages derived from the use of the private aircraft, especially the limitations of airline schedules and connections versus the time-saving flexibility of the private aircraft. They also show the danger of failing to obtain any reimbursement.

One additional point. Travel and transportation business expense deductions are not lost by taking a standard deduction rather than itemizing deductions. On the contrary, allowable travel and transportation expenses, as well as various other items, are deductible from gross income in order to yield "adjusted gross income." It is from this adjusted figure that the standard deduction is subtracted.

Depreciation

The depreciation provisions allow the aircraft owner an annual deduction for the usual wear and tear on an aircraft used in a trade or business. The actual depreciation computations can be fairly complex. We will only cover the high points here.

First, the deduction is allowed only to the extent that the aircraft is used in a trade or business. If the aircraft is used only for business purposes, 100% of the allowable depreciation can be deducted. But, where the aircraft is used for both business and personal purposes, depreciation is allowed only to the extent of the business use of the aircraft. So, if only one-third of total hours are business-related, only one-third of the allowable depreciation can be deducted.

Depreciation may be computed in several different ways—the straight line method, the declining balance method, the sum of the years' digits method and other "consistent methods." Whatever method is used, you must first determine the useful life of the aircraft, that is, the probable period of time it will be used in the taxpayer's trade or business. The depreciation guidelines provided by IRS (which are not mandatory) give six years as the useful life of an aircraft. Some aircraft owners have been permitted to use five years.[6] Then the salvage value of the aircraft—its fair market value at the end of its useful life—must be estimated. In no event may an aircraft, or any asset, be depreciated below its reasonable salvage value.

The straight line method of computing the depreciation deduction is the most common in use. It assumes that the depreciation sustained is uniform during the useful life of the property. The cost or other basis of the aircraft, less its estimated salvage value, is deductible in equal annual amounts over the estimated useful life of the property.

The declining balance method and the sum of the years' digits method provide so-called "accelerated depreciation" by allowing larger deductions during the initial years of an aircraft's useful life. A point to note is that the tax benefits of accelerated depreciation are subject to "recapture" when the aircraft is sold or disposed of. This can result in the gain from such a sale being classified as ordinary income, rather than as a capital gain.

In order to stimulate the economy, the Treasury Department announced in 1971 new business depreciation rules that relax the existing rules in certain limited areas. The new rules (1) allow greater flexibility in determining useful life, (2) terminate the complex "reserve ratio test," and (3) liberalize the practice of determining how much deduction can be taken in the first year for an asset put in service during the year. These rules are rather complex, and beyond the scope of this article. You should check with your tax advisor to determine if, and how, your particular operation can benefit from the new rules.

Bonus Depreciation

In addition to regular depreciation, any taxpayer (except a trust) may elect to write off "bonus" depreciation on a new or used aircraft for the first taxable year for which a depreciation deduction is allowable. "Bonus" depreciation is computed on the first $10,000 of the aircraft's cost. The maximum deduction is 20 percent of $10,000 ($2,000; $4,000 on a joint return). The remaining cost, after deduction for bonus depreciation and salvage value, is depreciable as already explained above. The bonus depreciation applies only to aircraft with a useful life of at least six years.

Business Entertainment

As a result of frequent attempts at "tax reform," the business entertainment deduction rules have become some of the most complex in the Internal Revenue Code. Basically, the taxpayer must establish (1) that the use of the aircraft was *primarily* to further the taxpayer's trade or business and (2) that the actual expenses were directly related to the active conduct of that trade or business.

More specifically, the taxpayer must establish three criteria. First, more than 50% of the aircraft's flight hours were business-related. Second, at the time the aircraft was used to entertain, the taxpayer had more than a general expectation of deriving a business benefit.

Third, the taxpayer held a *bona fide* business discussion for the purpose of obtaining income.

Educational Expenses

Members frequently ask whether they can deduct the costs of instructional flying as a business deduction.

The regulations provide that educational expenses are deductible if the education (1) maintains or improves skills required by the individual in his employment, trade or business, or (2) meets the express requirements of his employer, or the requirements of applicable law or regulations, imposed as a condition to the individual's retention of his salary, status or employment.

Under these regulations, the costs of maintaining proficiency (including instruction) required in an individual's employment, trade or business are deductible. For example, the cost of becoming revalidated would be deductible to an instructor—as maintaining and improving his professional skills, and also because required by regulation. Similarly, the cost of refresher courses such as AOPA offers would also be deductible for a person who flies on business.

In a recent Tax Court case, an FAA medical examiner (a private medical doctor designated to give flight medical exams) was allowed to deduct his flying expenses because his flying served as training to maintain and improve his skills as a medical examiner.[7]

However, educational expenses are not deductible if incurred to meet the *minimum* educational requirements for qualification in a taxpayer's present employment, trade or business, or if taken to qualify the individual for a *new* trade or business. Thus, if a person obtains a pilot's license to fly on business, the cost of obtaining it would probably not be deductible. A deduction of this sort is not allowed any more than the cost of learning to drive an automobile. By the same token, the costs of education leading to an instructor's rating would not be deductible to an instructor.

A case involving an accountant is illustrative of the problem. The accountant sought to deduct the cost of acquiring his private pilot's license. He occasionally traveled out of town on business and his firm permitted him to travel by private plane, reimbursing him at commercial air travel rates. IRS denied the deduction and the Tax Court agreed. The Court said, "on this record we cannot find a sufficient connection between the expenditures (for learning to fly) and the business of an employee to allow the deduction."[8] A corporation which paid for the flight training of its president ran into the same problem—the expenses of flight training were disallowed as a business deduction.[9] A photographer, on the other hand, was able to demonstrate that flying gave him the ability to take aerial photographs, and improve the marketability of his product.[10]

Investment Tax Credit

This is a credit of up to 10% of the cost of new aircraft and aviation equipment acquired and placed in service in a business before January 1, 1981. For used aircraft and equipment, the first $100,000 of cost is eligible. For the full credit, the property's useful life must be at least 7 years. The credit's available for the year the property's placed in service. It can be used to offset the first $25,000 of that year's tax liability, plus 50% of the tax liability over that amount. Carryovers and carrybacks are normally available.

One caution. Consult your tax advisor about any questions on your particular situation. □

Notes

1. *Hitchcock, v. U.S.* 12 AFTR2d 5801 (E.D. Wash. 1963).
2. *John T. Harley, Jr.*, 28 T.C.M. 1186 (1969).
3. *Robert G. Fairburn*, 28 T.C.M. 438 (1969), *appeal dismissed* 1971 P–H ¶61,000 (3rd Cir. 1971).
4. *Richard L. Westerman*. 55 T.C. 478 (1970).
5. Rev. Rul. 70–558, 1970–2 Cum. Bull. 35 (1970).
6. *Reginald Denny* 33 B.T.A. 738; *Gibson Products* Co. 8 T.C. 654 (1947); *R. B. Cowden*, 9 T.C.M. 1148 (1950), *vacated and remanded for entry of decision in accordance with agreement of parties*, 202 F.2d 748, 749 (5th Cir. 1953).
7. *Keith W. Shaw* 28 T.C.M. 626 (1969).
8. *Paul Katz* 27 T.C.M. 87 (1968).
9. *Gibson Products Co., supra; accord John C. Beckley* 34 T.C.M. 238 (1975) *appeal dismissed* (3rd Cir. May 26, 1976).
10. *Alan Aaronson*, 29 T.C.M. 786 (1970).