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TAX PLANNING FOR THE OWNERSHIP AND OPERATION OF GENERAL AVIATION AIRCRAFT

WILLIAM P. STRENG* and S. LEE HANCOCK**

I. SCOPE AND PURPOSE OF THIS ARTICLE

Air travel has become an essential mode of transportation in the fast-paced environment in which we live and work. A significant portion of the demand for such air travel is satisfied by the use of aircraft engaged in general aviation. Over 180,000 aircraft are currently utilized in general aviation, boarding more than ninety million passengers each year.1 The Federal Aviation Administration predicts that more than 267,000 general aviation aircraft will be in use by 1988.2 Commercial airlines, the more noticeable counterpart of general aviation, currently employ the use of only about 2,500 aircraft.3

The increasing use of air travel, when coupled with the flexibility and convenience derived from aircraft ownership, has prompted a great many businesses and individuals to consider private aircraft ownership and operation.4 Inherent in any such business decision is an analysis of the resulting federal, state, and local tax effects. For example, assuming the acquisition for business purposes of a $40,000 aircraft for $4,000 cash and the assumption of a seven-year, ten percent note for $36,000 to be paid in seven equal annual installments. The present value5 of total capital out-

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2 Id.
3 Accelerating the Momentum of Success, at 2 (available from Beech Aircraft Corporation, Wichita, Kansas, 67201).
5 All future cash outlays and savings have been discounted at 8% to reflect the time value of money. Assuming that the taxpayer could invest funds at 8% interest, the net present value represents the amount of capital which, when supplemented with the earnings thereon and the taxpayer's tax savings from aircraft ownership, would be sufficient to cover all future cash payments.
lays, after federal income tax savings derived from depreciation deductions, interest expense deductions, and the investment tax credit could be less than fifty percent of the stated acquisition price of the aircraft. Stated differently, after a current use-of-funds and assumed return analysis, the net-after-tax capital cost of the $40,000 aircraft could be less than $20,000.

This article provides an analysis of the various tax effects of aircraft acquisition, operation, and disposition. Although the most significant considerations involve the federal income tax consequences, federal excise taxes on aircraft use and fuels, state property taxes, and state sales taxes also affect the cost of aircraft ownership. As will be seen, the majority of tax benefits derived from the operation of an aircraft are limited to aircraft used for business purposes. A discussion of precisely what quality of aircraft utilization satisfies a business purpose is imperative in analyzing these tax effects. A complete discussion of the effects of aircraft ownership could, of course, become a discussion of taxation.

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* Assuming that the taxpayer paid 10% down and $7,395 a year to retire the $36,000 debt, the present value of the note payments (including interest) and the down payment is approximately $42,000.

* Assuming a 20% salvage value, total depreciation over the life of the aircraft would be $32,000. Additional first year depreciation and accelerated depreciation allow the majority of the depreciation in the early years. Therefore, the tax saved from depreciation by a taxpayer in the 50% marginal tax bracket, discounted to present value at 8%, is approximately $13,690.

* The total interest paid on the loan would be $15,761. Again, assuming a 50% marginal bracket taxpayer and discounting to present value at 8%, the tax savings derived from the interest deduction total approximately $6,245.

* The 10% investment tax credit would be $4,000. Although it is not dependent upon the individual’s tax bracket, the benefit would be reduced to approximately $3,700 when discounted to account for the one year delay in receiving the benefit of the credit on the tax return.

* The present value of cash disbursements and tax savings are summarized below:

<table>
<thead>
<tr>
<th>CASH OUTLAYS</th>
<th>TAX SAVINGS</th>
<th>NET PRESENT VALUE CAPITAL COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Down Payment</td>
<td>$13,690</td>
<td>$4,000</td>
</tr>
<tr>
<td>Annual Payments</td>
<td>6,245</td>
<td>3,700</td>
</tr>
<tr>
<td>TOTAL OUTLAYS</td>
<td>$38,500</td>
<td>$18,865</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$42,500</td>
<td>($23,635)</td>
</tr>
<tr>
<td>Interest Deductions</td>
<td>3,700</td>
<td>8,245</td>
</tr>
<tr>
<td>Investment Tax Credit</td>
<td>3,700</td>
<td>8,245</td>
</tr>
</tbody>
</table>
in general, since aircraft ownership and operation can effect the owner's or user's tax situation in virtually any context. The scope of this article is limited to those situations and effects which are most likely to appear frequently and, particularly, where peculiar results occur due to the ownership of aircraft rather than of other types of properties.

II. AIRCRAFT ACQUISITION AND BUSINESS USE

The majority of tax benefits associated with aircraft ownership are dependent upon the use of that aircraft for business purposes. The determination of the business or personal nature of the use of an aircraft can be a quite subjective process, as discussed more fully below. The following discussion of the tax aspects of the business use of aircraft necessarily assumes that the aircraft is owned and operated in pursuit of a trade or business or for the production of income.

A. Acquisition

1. Investment Tax Credit

Probably the most significant tax incentive for the purchase of an aircraft for business use is the availability of the investment tax credit. Congress enacted the investment credit provisions to reduce the after tax cost of machinery and equipment and, thereby, "bolster the economy and create additional jobs." Unlike operating expenses and depreciation, the tax savings derived from the credit are unaffected by the taxpayer's marginal tax bracket, as a tax credit is offset dollar for dollar against the actual tax liability. The credit is currently equal to ten percent of the qualified investment. Thus, by the acquisition of a business aircraft, the taxpayer can obtain a direct reduction in his current year's tax liability.

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11 See notes 173-218 infra, and accompanying text.
12 I.R.C. §§ 38 and 46.
15 The taxpayer is also allowed to carryback and carryforward the credit three and seven years respectively. I.R.C. § 46(b). Treas. Reg. § 1.46-2 (1973).
bility of ten percent of the aircraft’s cost.\textsuperscript{16}

The effective benefit from the credit is that, assuming no limitation problems, through the federal income tax process the aircraft purchaser receives a rebate for ten percent of the cost of the aircraft. The credit is unaffected by any future disposition assuming the taxpayer does not dispose of the aircraft prior to the expiration of its useful life.\textsuperscript{17} This credit is in addition to allowable depreciation on the aircraft.\textsuperscript{18}

Several limitations exist on the available credit amount. Although property which is predominantly used outside of the United States generally does not qualify for the credit,\textsuperscript{19} an aircraft which (i) is registered with the FAA and (ii) is operated to and from the United States does qualify for the investment tax credit.\textsuperscript{20} Thus, foreign registered aircraft used significantly in the U.S. (even assuming federal and local law so permits) will not be eligible for the investment tax credit. Only $100,000 of used property will qualify for the investment credit in any tax year.\textsuperscript{21}

An aircraft is

\textsuperscript{16} I.R.C. § 46(a)(2)(A).

\textsuperscript{17} The useful life of the aircraft for investment credit purposes is the same as the useful life used in the depreciation deduction computations. I.R.C. § 46(c)(2). See notes 63-66 infra, and accompanying text for a discussion of choosing an appropriate useful life.

\textsuperscript{18} Unlike additional first year depreciation, the investment tax credit does not reduce the depreciable basis of investment property placed into service after December 31, 1963. I.R.C. § 48(g) had provided for a reduction in the basis for the amount of the credit, but it was repealed by Pub. L. No. 88-272, I.R.C. § 203(a)(1) (effective 1-1-64). See generally J. CHOMMIE, FEDERAL INCOME TAXATION § 71 at 199 (2d ed. 1973). Compare with, 3 AICPA PROFESSIONAL STANDARDS § 4094 which, although allowing financial statement presentation of the investment tax credit as merely a reduction in taxes for that year, recommends that any applicable investment credit reduce the depreciable basis of the asset so as to be “reflected in net income over the productive life of the acquired property and not in the year in which it is placed in service.” Id. at § 4094.11.

\textsuperscript{19} I.R.C. § 48(a)(2)(A). Generally, the determination of predominant use outside the United States requires that the aircraft be outside the United States for at least 50% of the year. Treas. Reg. § 1.48-1(g) (1964). See Rev. Rul. 71-178, 1971-1 C.B. 6 where daily analysis of aircraft use was required to determine whether the aircraft had been located in United States for 50% of year. See also Rev. Rul. 73-367, 1973-2 C.B. 8.

\textsuperscript{20} I.R.C. § 48 (a)(2)(B)(i) provides the exception for “any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated to and from the United States or is operated under contract with the United States.”

\textsuperscript{21} I.R.C. § 48(c)(2)(A). In the case of a husband and wife filing separate returns the limitation will be $50,000 per return. I.R.C. § 48(c)(2)(B). See Treas. Reg. § 1.48-3 (1972).
not, however, considered "used" for purposes of the investment tax credit and accelerated depreciation merely because the aircraft was used as demonstrator or for FAA certification testing prior to the taxpayer's acquisition of the aircraft. In order for the entire cost of the aircraft (new and used) to qualify, the useful life of the aircraft must not be less than seven years. If the useful life is less than seven but not less than five years, two-thirds of the aircraft cost would qualify for the ten percent credit, in effect making the investment tax credit equal to six and two-thirds of the acquisition cost. Similarly, if the useful life is less than five but not less than three years, only one-third of the aircraft cost will qualify, making the credit equal to three and one-third percent of the aircraft's cost.

In addition to the restrictions on the type of property qualifying for the credit, the total credit is limited according to the tax liability of the taxpayer. If the taxpayer's tax liability is less than $25,000, the credit cannot exceed the amount of tax liability for that year. If the taxpayer's liability exceeds $25,000 for any year in which a credit is claimed (including carryback and carryover years), the total credit is limited to $25,000 plus a percentage of the tax liability in excess of $25,000. The taxpayer may carryback or carryforward the credit for three and seven years, respectively, if the eligible credit is not fully allowed because of an insufficient current tax liability. Thus, the taxpayer will be allowed to claim the credit if he has sufficient tax liability in prior, current, or future tax years. Obviously, considering the value of the use of money, the taxpayer would prefer to utilize the credit currently rather than to postpone its availability through the carryover mechanism.

2. State Sales and Use Taxes

Upon the acquisition or disposition of an aircraft, the buyer or
seller will, in most states, incur liability for taxes imposed on the sale. Ultimately the tax cost for this transfer will be absorbed by the purchaser. Due to the mobility of an aircraft and the relatively large sales price, sales tax planning may become important. Most states exempt certain casual sales made by sellers that normally do not sell similar items. Other states restrict the casual sales concept to sellers who do not have any taxable sales in the ordinary course of business. Although a state may not impose sales taxes on sales made in the course of interstate commerce, (e.g., where an out-of-state buyer takes delivery outside of the seller's state), most states have circumvented this constitutional limitation by imposing a use tax upon the use of property within the state.


See, e.g., Texas Comptroller of Public Accounts Administrative Decision No. 8036, November 7, 1978, where the Comptroller held that the taxpayer's purchase of the aircraft from an out-of-state resident was not a casual sale within the meaning of the Texas statute because the Kentucky seller would have been required to hold a sales and use tax permit had it operated in Texas. See also Texas Comptroller of Public Accounts Administrative Decision No. 10193 (cited at 16 Texas Lawyer's Weekly Digest, No. 18, May 2, 1979, p. 18-6). There, an aircraft that was leased from an out-of-state seller, delivered to the lessee in Texas, hangared in Texas at its home base, used for 17 maintenance flights, 3 intrastate flights and 100 interstate flights was deemed leased for use in Texas. Accordingly, the lessee was liable for payment of Texas use tax on the lease payments.


See, e.g., United Airlines, Inc. v. Mahin, 410 U.S. 623 (1973) where the Court upheld an Illinois use tax on fuels stored in Illinois but used in the course of interstate flights. Temporary use within the state can also be sufficient to allow the state to tax such use. For example, in Skelton v. Federal Express Corp., 531 S.W.2d 941 (Ark. 1976) the application of the state use tax was upheld where the taxpayer transported 18 new jet aircraft into Arkansas where they remained approximately 50 days for modifications. The court held that, in accordance with the Arkansas statute, the aircraft "left the stream of commerce and 'finally came to rest' in Arkansas and consequently were subject to taxation." 531 S.W.2d at 944. See also Federal Express Corp. v. Woods, 569 S.W.2d 408 (Tenn. 1978) where the Tennessee Supreme Court held that the state use tax applied to in-state inventory of aircraft parts used to service the carrier's aircraft fleet, used only nominally in intrastate services. The court construed the statutory exemption applying to carriers "who perform no intrastate carrier services," Tenn. Code Ann. § 67-3012(8) (Supp. 1977), to not apply because Federal Express received approximately $6,000 or .06% of total revenue, from shipments originating from, and delivered to points within Tennessee. The result of this $6,000 of intrastate oriented income was the assessment of approximately $117,000 in Tennessee use taxes.
Thus, the incentive to purchase an aircraft in a low sales tax state or outside the United States is reduced if the aircraft will be used in a state which has an effective enforcement use tax. The use tax can normally be effectively enforced through aircraft registration requirements and through local property tax assessment procedures.

The planning advice in this context is to complete the sale outside the high sales tax jurisdiction where the aircraft will be used in a low use tax jurisdiction. The parties should particularly avoid being subject to both a sales tax in the seller's jurisdiction and a use tax in the buyer's jurisdiction. In transnational transactions tax savings might be achieved through causing title to pass while aircraft is over international waters.

B. Operating Expenses

1. Cash Expenses

If an aircraft constitutes a business asset, expenses incurred in the operation of the aircraft will generally be deductible under Code Section 162. For an expenditure to be deductible under that section, three general requirements must be satisfied. The expenditure must be (i) "ordinary and necessary", (ii) a current expense and not a capital outlay, and (iii) incurred for business and not personal reasons. An expenditure will be a capital outlay and not a current expense if the usefulness of the acquired asset will last longer than one year. This normally does not present any unique problems in the context of aircraft expenses.

Whether or not the expenditure is "ordinary and necessary" within the meaning of Code Section 162(a) is not easily determined. Although most normal expenditures incurred in a trade

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33 Although there are several practical difficulties in enforcing a state use tax, aircraft, like automobiles, are often required to be registered within the state and many states require proof of use tax payment to accompany registration. See generally Hellerstein supra note 28, at 691. Generally a state cannot require out-of-state sellers to collect its use tax. Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954). But cf. Scripto, Inc. v. Carson, 362 U.S. 207 (1960) (Florida could require out-of-state retailer to collect use taxes without violating the Commerce Clause or the Due Process Clause of the Federal Constitution).


35 This determination presents problems in any context. See Welch v. Helvering, 290 U.S. 111 (1933) where Mr. Justice Cardozo, in analyzing the "ordinary
or business will meet this test, some will not. Expenses which are in excess of "the prevailing rate in the locality for which a plane with a pilot could be chartered" have been held not deductible, although this does not appear to be the general rule.

While generally the expenses incurred by one taxpayer for another are not deductible, where such payments are made under a binding obligation the payments will generally be deductible by the taxpayer making them. Accordingly, a taxpayer has been allowed to deduct expenses incurred in the operation of an aircraft, even where that taxpayer loaned the aircraft to another corporation under a binding reciprocal lending arrangement.

The variety of expenses deductible under Code Section 162 would appear to be quite broad. Virtually all expenses associated with the business use of the aircraft have been held to be deductible. These include maintenance expenses, a pilot's salary, and the cost of fuel. As discussed more fully below, expenses of an aircraft used for both personal and business purposes can be deducted to the extent of business use. The taxpayer will be required to substantiate any business allocation. One case, however, allowed the taxpayer to allocate unidentified hours based on the hours he could identify.

Several courts have rejected attempts at deducting the costs allocable to maintaining the proficiency of a pilot, even though the piloting skills are used solely for business purposes and such training is required under FAA regulations. These expenses were

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and necessary requirement," stated:

One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

_Id._ at 115.

38 Palo Alto Town & Country Village, Inc., 32 T.C.M. (CCH) 1048, 1053 (1973). The court held that the record did not show a sufficient need of immediate use nor was safety increased by the use of the business' own plane.

37 See generally Chommie, supra note 18 at § 46.

36 Hitchcock v. United States, 63-2 USTC (CCH) § 9756 (E.D. Wash. 1963).

35 Marshall v. Comm'r, 240 F.2d 185 (5th Cir. 1957).


held to be personal and, therefore, not deductible. Similarly, the costs of training the corporate president to fly were also denied deductibility. These training expenses have been held not to qualify as educational expenses, at least where the taxpayer merely intends to open a charter service in the future and does not currently have a trade or business.

2. Depreciation

In addition to the deductibility of cash expenses incurred in the operation of the aircraft, the taxpayer is entitled to claim depreciation of the aircraft over its useful life. Because depreciation is premised upon the recovery of cost basis (cash paid and liability assumed), depreciation deductions available in the early years may exceed the cash outlay in those early years. Of course, this variance will adjust itself, either by a reduction in subsequent depreciation or upon the sale of the aircraft. Nevertheless, the current deductibility produces both an immediate tax savings and a reduction in the net present value of any capital expenditures for a business aircraft.

By the use of an accelerated method of depreciation (whereby the depreciation deduction is greater in the earlier years), the present value of the tax savings can be significantly increased.

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45 For example, if a $40,000 aircraft was purchased by paying $4,000 down and assuming a $36,000 note payable annually for seven years at 10% interest, the first year loan payment would be $7,395. Therefore the total cash outlay in the first year would be $11,395. If the taxpayer used a seven year life to calculate depreciation based upon the double-declining balance method, the depreciation in the first year would be $11,428. The use of additional first year depreciation could increase total depreciation in the first year to $14,286 ($4,000 + 2/7 (40,000 − 4,000)). See note 59 infra. However, deductions may be limited by the applicability of the "at-risk" provision. See notes 277-280 supra and accompanying text.

46 However, the Code provides for a reduction in salvage value of an asset up to 10% of the cost thereto. Therefore, the taxpayer may disregard any salvage value less than 10% of the aircraft's acquisition cost. I.R.C. § 167(f), Treas. Reg. § 1.167(f)-1(a) (1964). Treas. Reg. § 1.167(b)-0(a) (1956) states: "Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the uncovered cost or other basis less salvage during the remaining useful life of the property."

47 This results from the consideration that due to the time value of money, a tax savings in earlier years is worth more than the same amount of savings in future years.
The total amount of depreciation over the useful life of the aircraft will be the same, however, under any method. Thus, the major difference between depreciation methods is the timing of the deduction.

The largest tax savings from the depreciation deduction results from use of one of the various accelerated methods, the most advantageous being the double declining balance (DDB) method. This method would allow, for example, forty percent of an aircraft's cost to be deducted in the first year if a five year life is used. The double declining balance method is only available for new aircraft. A used aircraft, however, will qualify for the 150% declining balance method, which still provides substantial accelerated tax savings. If an individual is expecting greater income in future years, or if he has no other current income which can be absorbed by the accelerated aircraft depreciation deductions, the straight line method of depreciation would be the most beneficial because the taxpayer would receive no immediate tax benefit from excess depreciation in the earlier years. If accelerated depreciation is actually claimed, this benefit would be available for loss carryover purposes. The carryover period, however, may be too short to enable full utilization during the carryover period.

Because of the diminishing benefit of the declining balance method, at some subsequent point in time the DDB computed deduction becomes less than would be allowed under the straight-

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48 Under the declining balance methods of depreciation, a constant depreciation rate is applied to a reducing balance, and thus the depreciation is greater in the earlier years. See Treas. Reg. § 1.167(b)-2(a) (1956). Under the double-declining balance method the constant rate is twice the rate which would apply if the asset was depreciated equally over its useful life.

49 Based on a five year life, the straight line rate is 20% and the double declining balance rate is 40% (2 X 20%).

50 I.R.C. § 167(c)(2).

51 Treas. Reg. § 1.167(b)-0(b) (1956); see Buddy Schoellkopf Prods., Inc. v. Comm'r, 65 T.C. 640, 652 n. 15 (1975).

52 There is currently no recognized method of depreciation which will delay depreciation deductions the same way as the accelerated methods encourage them. However, if the aircraft was subject to little use, the taxpayer might depreciate the engine and the airframe separately based upon the ratio of the number of hours the aircraft was used to the total expected useful hours of the engine and airframe, respectively. If the taxpayer used a method based upon the hours of use, the taxpayer would have the burden of demonstrating that the depreciation was "both reasonable and consistent". Treas. Reg. § 1.167(b)-4(b) (1956).
line method. At this crossover point a switch to the straight-line method should usually be made, and the Code specifically provides that a taxpayer may implement such a change without obtaining the permission of the Commissioner, as is required in other types of depreciation method changes.

In addition to the accelerated method of depreciation the Code allows additional first year depreciation in the amount of twenty percent of the cost of qualified personal property, including an aircraft. The amount of property qualified for this purpose is limited, which in turn limits the total annual additional first year depreciation deduction to a $4,000 amount. This special first year depreciation deduction allowance is in addition to any other depreciation deduction allowed in the first year, including the double declining balance method.

The depreciation deduction is based upon the acquisition cost of the plane, i.e., the "cost basis." This cost basis consists of those costs incurred in acquiring the aircraft which must ordinarily be capitalized instead of deducted currently. The breakdown of the aircraft components into separate depreciation accounts is not required. Even though depreciation on the engine is usually faster than depreciation on the airframe, only one useful life need be used for this purpose.

Although the shorter the useful life the earlier the tax benefits obtained through depreciation, reducing the useful life of the aircraft may also reduce the percentage of the cost which qualifies

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53 After the change to the straight line method, depreciation is based upon the adjusted basis of the asset at the time of the change and the remaining useful life.

54 I.R.C. § 167(e)(2); Buddy Schoellkopf Prods., Inc. v. Comm'r, 65 T.C. 640, 652 n. 16 (1975).

55 The additional first year depreciation applies only to property with a useful life of six years or more, and of a character which is normally subject to depreciation under I.R.C. § 167. I.R.C. § 179(d)(1).

56 The amount of qualified property is limited to $10,000 and $20,000 per year for an individual and a joint return, respectively. I.R.C. § 179(b).

57 Twenty percent of $20,000.

58 Treas. Reg. § 1.179-1(a) (1960). However, the basis of the aircraft is first reduced by the amount of the additional first year depreciation prior to computing regular section 167 depreciation for the first year.

59 Hitchcock v. United States, 63-2 USTC (CCH) § 9756 (E.D. Wash. 1963).

60 Gardner, Multiple Ownership, FLYING, March 1976, at 64.
for the investment tax credit. No less than a seven year life should be chosen to enable eligibility for the maximum investment tax credit, even though this seven year life will delay the depreciation deduction for the aircraft.

Several cases have allowed a useful life of five years for aircraft, and some, a four-year useful life. The Service, in its Class Life Asset Depreciation Range System (the ADR system) provides for a useful life of six years for all aircraft except helicopters and those aircraft used by air transport companies. Additionally, the ADR system provides for a five year lower and a seven year upper limit on an aircraft’s useful life. The ADR system basically provides that the Service will not challenge the useful life of assets covered by the system. It does not preclude the use of another life, but the taxpayer will have to show that the period chosen is reasonable. The ADR system must be elected for all assets placed into service during the year, and this may provide an obstacle to its election for a newly acquired aircraft. Nevertheless, the Guidelines, although not binding on the Service, should be supportive of any chosen life between five and seven years, especially in view of the decided cases allowing a five year life and a four year life.

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61 See note 24 supra and accompanying text. Some members of the 96th Congress particularly concerned with the problem of adequate capital funds have suggested that the useful lives for investment tax credit and depreciation purposes be permitted to be different so as to enable maximization of the tax benefits. Information from author’s personal knowledge.


64 Rev. Proc. 77-10, 1977-1 C.B. 548. Assets used in commercial and contract carrying of passengers and freight by air have an asset guideline period of 12 years with an ADR lower and upper limit of 9.5 and 14.5 years. Id. at 563.

65 Id. at 550.


68 Id.

69 If the taxpayer has acquired other assets during the year of the aircraft acquisition, in order to elect the ADR system for the aircraft he will have to elect the ADR system for those other assets. Treas. Reg. § 1.167(a)-11(a)(1) (1974). This may not be the most advantageous depreciation life for those other assets, and it may consequently be appropriate for the taxpayer not to elect the ADR system for that year.
3. Timing Considerations

Expenses incurred in the operation of an aircraft used for business purposes are deductible.\textsuperscript{30} If the taxpayer uses the cash method of accounting, the deduction is allowed in the year in which the disbursement is made.\textsuperscript{71} An accrual basis taxpayer is entitled to the deduction in the year in which the expense is incurred, irrespective of when the resulting cash disbursement is made.\textsuperscript{72} Although both methods of accounting are specifically authorized, the cash method presents the taxpayer with greater flexibility in timing the deductibility of expenses incurred. For example, it is possible for the taxpayer to pay expenses for January, 1979 in December, 1978 and deduct the amount in computing his 1978 taxable income. The flexibility of the cash method does not, however, give the taxpayer unlimited control over the timing of his deductions. The Secretary is authorized to compel a taxpayer to change to a different method of accounting if the method used does not clearly reflect income.\textsuperscript{73}

A substantial number of court decisions deal with various prepayments, and the Secretary's attempted disallowance of a deduction for such prepayment.\textsuperscript{74} Of particular importance with respect to aircraft ownership and operation are prepayments of interest paid on borrowings to finance the aircraft acquisition and prepayments of casualty insurance premiums. Interest prepayments made after 1975 are not deductible by the cash basis taxpayer until the year in which the interest is actually incurred.\textsuperscript{75} Although insurance prepaid for a three-year period is not deductible in the year paid, but ratably over the term of the period insured,\textsuperscript{76} insurance for a one-

\textsuperscript{30} I.R.C. § 162(a). See the discussion accompanying note 33 supra.

\textsuperscript{71} Treas. Reg. § 1.446-1(c)(1)(i) (1974).

\textsuperscript{72} Treas. Reg. § 1.446-1(c)(1)(ii) (1974).

\textsuperscript{73} I.R.C. § 446(b).

\textsuperscript{74} The Secretary usually argues one or all of the following four theories in disallowing the deductibility of a prepayment: (1) the prepayment results in the creation of an asset with a useful life in excess of one year; (2) the prepayment lacks a suitable business purpose; (3) the prepayment was a mere deposit; or (4) the prepayment materially distorts the taxpayer's income. See, e.g., Clement v. United States, 580 F.2d 422 (Cl. Ct. 1978).

\textsuperscript{75} I.R.C. § 461(g).

\textsuperscript{76} See Rev. Rul. 70-413, 1970-2 C.B. 104.
year period is normally deductible in the year paid even though the coverage extends to a subsequent year. This latter result would probably be applicable with respect to other reasonable pre-payments made, even though the benefit extends into the subsequent year. This would occur, for example, where aircraft supplies are purchased which will not be exhausted by the end of the year of purchase.

4. Capitalized Costs

Expenditures incurred in the operation and maintenance of an aircraft used to transport materials or people in connection with the production of inventory, may be required to be included in the cost of the inventory at the end of the year, thus denying the deductibility of such expenditures and delaying the resulting tax benefit until such inventory is sold. Similarly, the allocable portion of aircraft costs (including depreciation) must be capitalized when used in conjunction with the construction of a physical plant or a similar long-lived asset.

Certain expenditures for repairs and maintenance are not deductible, but rather must be capitalized and deducted ratably over the period of their benefit due to the magnitude of the cost. With respect to an aircraft for which the taxpayer has elected the Class Life ADR systems, repairs which are not obviously to be capitalized are deductible currently to the extent that they do not exceed 14 percent of the unadjusted basis of the aircraft.

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79 Treas. Reg. § 1.471-11 (1973). For example, freight costs incurred in connection with inventoriable items are not current expenses, but must be added to the cost of inventory acquired. Loveman & Son Export Corp. v. Comm'r., 296 F.2d 732 (6th Cir. 1961), cert. denied, 369 U.S. 860 (1962) (6th Cir. adopting decision at 34 T.C. 776 (1960)).
82 See note 65 supra, and accompanying text.
83 Treas. Reg. § 1.167(a)-11(d)(2)(iv) (1971) denies the deductibility under the ADR system for certain excluded additions. Generally, excluded additions are expenditures, in excess of $100, which substantially increase the asset's capacity or productivity, or are a substantial modification thereof.
5. Ownership by Related Corporation

For purposes of limiting liability, the aircraft might be owned by a separate corporation, e.g., a service corporation. In such event the various operating expenses and depreciation will be for the benefit of the service corporation. The aircraft would then be leased by the service corporation to the related user corporation.

If these several corporations file a consolidated return, the tax results of the several corporations will be essentially irrelevant. If the related corporations file separately, however, the rental payments received by the service corporation will need to be reflective of an arm’s length standard. This will be partially true where the corporation receiving a rental amount in excess of a fair market value amount is a corporation having tax-preferred status. This status can derive, for example, from being a foreign corporation. Code Section 482 authorizes the Commissioner to allocate income and deductions to appropriately reflect income. For example, the Commissioner might deny the user corporation a deduction for any rent paid to the Service corporation in excess of fair rental value, in which case he is compelled to make a corresponding reduction in the rent income of the service corporation. Regulation § 1.482-2 provides definitive rules for ascertaining the amount of such allocation.

6. Federal Excise Taxes

Federal excise taxes are imposed upon (i) fuels sold for aviation purposes and (ii) the amounts paid for transportation of persons and property by air. The two taxes are intended to be mutually exclusive, and care must be taken to avoid payments for both types of excise tax with respect to the same use of the aircraft. In addition, excise taxes are imposed upon international passenger departures and for the use of civil aircraft.

Of course, in many instances insurance coverage can similarly eliminate these risks.

The existence of several corporations does not generate availability of several reduced rate structures below the $100,000 taxable income level. I.R.C. §§ 1551, 1561.

As indicated in the Appendix to the Budget of the United States Government for the Fiscal Year 1980, at 707, receipts from these several excise taxes
a) Fuels Tax

An excise tax is imposed on fuels used in noncommercial aviation, except for farming purposes, at the rate of seven cents per gallon. For gasoline which is already subject to a manufacturers' tax at the rate of four cents per gallon, the tax imposed for noncommercial aviation use is three cents per gallon, resulting in a total excise tax of seven cents per gallon. Although the manufacturer's or importer's tax of four cents per gallon is normally refundable when the fuel is not used for highway purposes, that credit is unavailable when the fuel is used in noncommercial aviation. Thus, the total tax paid for fuels used for noncommercial

<table>
<thead>
<tr>
<th></th>
<th>1978 Actual</th>
<th>1979 Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Passenger ticket tax</td>
<td>1,109,324</td>
<td>1,197,900</td>
</tr>
<tr>
<td>Waybill tax</td>
<td>64,887</td>
<td>66,600</td>
</tr>
<tr>
<td>Fuel tax</td>
<td>49,807</td>
<td>71,000</td>
</tr>
<tr>
<td>International passenger tax</td>
<td>76,527</td>
<td>72,000</td>
</tr>
<tr>
<td>Aircraft use tax</td>
<td>26,424</td>
<td>29,100</td>
</tr>
<tr>
<td>Aircraft tires and tubes tax</td>
<td>990</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Most of these tax amounts would be reduced if various proposed bills were to be adopted. However, other taxes proposed would increase the overall excise tax revenue from air related taxes.

“Noncommercial aviation” means any use of an aircraft, other than use in a business of transporting persons or property for compensation or hire by air. I.R.C. § 4041(c)(4). “In general, the dividing line between noncommercial aviation (subject to the fuel taxes) and commercial aviation (subject to the taxes on passenger and air freight transportation) is use of a business of transporting persons or property for compensation or hire. If for a flight an aircraft is subject to the passenger or cargo tax, then it is, for that flight, used 'in a business of transporting persons or property for compensation or hire by air' and is therefore for that flight not subject to the fuel taxes.” Senate Finance Comm. Report on Pub. L. No. 91-258 [1979] FED. EX. TAX REP. (CCH) § 300.11.

I.R.C. § 4041(f)(2).

I.R.C. § 4041(c). The tax imposed upon any liquid sold to an owner or other operator of an aircraft for use in noncommercial aviation or used as a fuel in an aircraft used in noncommercial aviation, unless there was a prior taxable sale of such liquid.

The general manufacturer's or importer's tax on gasoline is imposed by I.R.C. § 4081.

I.R.C. § 4041(c)(3). Under I.R.C. § 4041(c)(5) this tax is scheduled to be terminated on July 1, 1980.

The total tax on noncommercial aviation fuels will be seven cents per gallon before and after September 30, 1977, due to the reduction in the tax on special fuels and diesel fuels. See House Committee Report on Pub. L. No. 91-605 [1979] FED. EX. TAX REP. (CCH) § 300.10.

I.R.C. § 6421.

I.R.C. § 642(e)(3) states that “[t]his section shall not apply in respect of gasoline which is used . . . in noncommercial aviation. (as defined in section 4041(c)(4)).” (emphasis added).
aviation is seven cents per gallon. In contrast, no tax is imposed on the sale of aviation fuels to be used in commercial aviation, and the general manufacturer's tax credit provision is fully operable. This enables fuels purchased for commercial aviation to escape the fuels tax.

This tax is due to expire on July 1, 1980. The budget of the United States Government for the fiscal year 1980 includes a proposal to change the current seven cents per gallon tax on aviation fuel to an ad valorem tax of 10 percent of the price of aviation fuel. The effect of such a change will be to insert an automatic ratchet effect whereby the tax receipts increase as fuel prices increase.

b) Transportation Tax

A tax is imposed of eight or five percent on amounts paid for the taxable transportation of persons or property, re-


Commercial aircraft use of gasoline is to result in a full refund or credit of 4 cents a gallon, and no tax is to be imposed on the commercial use of 'special fuels' (2 cents a gallon at present, if used for non-highway purposes). On the other hand, the present 2-cents-a-gallon refund available for noncommercial aircraft use of gasoline and the present reduction in the retailers' tax on special fuels to 2 cents a gallon from 4 cents a gallon for aviation use is to be eliminated.

97 See I.R.C. § 4041(c)(5).

98 I.R.C. § 4261.

99 I.R.C. § 4271.

100 The "amount paid" includes the value of any payments in kind in addition to money paid. See Rev. Rul. 76-394, 1976-2 C.B. 355; Rev. Rul. 74-123, 1974-1 C.B. 319. In addition, reallocations made by the Service pursuant to I.R.C. § 482 have been held by the Service to constitute amounts paid for transportation and therefore subject to the 8% tax. [1979] IRS Letter Rulings Rep. (CCH) Ltr. 7849002 (August, 1978) revoked by Ltr. 7908010 (September, 1978). See also Id., Ltr. 7822026 (March, 1978). In a National Office Technical Advice Memorandum the Service ruled that a state's sales tax and airport landing and parking fees assessed against an air transportation charter company and passed on by the charterer to its customers must be included in the "amount paid" for an air travel for purposes of computing the tax imposed by Code § 4261 on the transportation of persons by air. Id. Ltr. 7919008 (no date given).

101 Generally, taxable transportation includes all travel which begins and ends within United States or within the 225-mile zone. I.R.C. § 4262(a). The 225-mile zone includes areas of Canada and Mexico which are within 25 miles of the nearest point in the Continental United States. I.R.C. § 4262(c)(2).

102 I.R.C. § 4261.

103 I.R.C. § 4271.
spectively. The tax on transportation of persons and property is not limited to amounts paid to commercial airlines. Generally, amounts paid to lease an aircraft are taxable where the lessor does not transfer possession, command, and control of the aircraft. Whether certain lease and other payments are amounts paid for transportation of persons or property cannot be easily determined. The Service has looked primarily to such factors as whether the lease was dry or wet and whether the lessor or lessee furnished the pilot. This latter element would often appear to be the controlling factor. The tax does not apply to amounts paid to a company to maintain and operate an aircraft owned by the taxpayer.

Two statutory exceptions exist to the general rules dividing non-commercial and commercial aviation, both of which require that the aircraft used is deemed noncommercial and, therefore, the tax on fuels is imposed rather than the transportation tax. The first

105 It generally makes no difference whether the amounts are paid on an hourly, daily, or monthly basis, or are variable in accordance with the use of the aircraft. See, e.g., [1979] IRS LETTER RULINGS REP. (CCH), Ltr. 7835009 (May 25, 1978), and Rev. Rul. 60-311, 1960-2 C.B. 341, Rev. Rul. 76-556, 1976-2 C.B. 354 where items furnished by the corporate customer (e.g., fuel, insurance) were considered amounts paid for taxable transportation.


107 See, e.g., Rev. Rul. 68-256, 1968-1 C.B. 489, where the Service held that a wet lease was taxable and a dry lease was not taxable. The Service, although referring to the dry and wet lease distinction, based this distinction not only upon whether fuels were supplied by the lessor, but also upon whether the lessor provided the flight crews which were responsible for the flights.

108 In Private Letter Ruling 7835009, the Service held that the payments for flights where the lessor provided the pilots were taxable whereas nontaxable when the lessee furnished the pilots (where, in either case, the lessor provided fuel and insurance). [1979] IRS LETTER RULINGS REP. (CCH) Ltr. 7835009 (May 25, 1978).


Exceptions from the rules applicable to commercial aircraft are provided under both versions of the bill in the case of certain small aircraft and not on established lines and aircraft used by affiliated corporations under certain circumstances. In order to avoid the need for detailed recordkeeping, the use of such aircraft is not to be subject to the taxes on passenger and air freight transportation but is to be subject to the fuels taxes. These exceptions are designated to assure that the taxpayer is not subject to both sets of taxes for the same flight but on the other hand also to assure that the taxpayer is subjected to one set of taxes.
exception is for aircraft with a certificated take-off weight of 6,000 pounds or less and not operated on an established line. The other exception provides that amounts paid by or charged to one member of an affiliated group for the use of an aircraft owned and operated by another member of that group are considered paid in connection with noncommercial aviation, provided that the aircraft is not rented to outsiders. The position of the Service is that the exemption is available only if the aircraft is not available for hire to outside parties and that the exemption becomes available only as of the date availability of the aircraft to outside parties ceases. A question might arise as to who is a member of an “affiliated group” for purposes of this exemption. It is understood that the position of the Service is, for example, that a pension fund which owns and leases an aircraft to the corporation making the pension fund contributions is not considered to be an affiliate. The “payment” for purposes of establishing this tax liability may occur inadvertently. For example, an allocation made pursuant to Code Section 482 may constitute an amount paid for transportation and subject to the tax on transportation of

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111 Certificated take-off weight is defined at I.R.C. § 4492(b).
112 I.R.C. § 4281. In holding that a leased aircraft was not operated on established lines where the lessee controlled the directions, routes, times, and cargo carried, the Service explained the crux of the established line requirement: It does not necessarily mean that strict regularity of schedule is maintained; that the full run is always made; that a particular route is followed; or that intermediate stops are restricted. The term implies that the person rendering the service maintains and exercised control over the direction route, time, number of passengers carried, etc.

[1979] I.R.S. LETTER RULINGS REP. (CCH) Ltr. 7835008 (May 25, 1978). See also Rev. Rul. 72-617, 1972-2 C.B. 580 (no established line where aircraft used for overnight mail services did not make the same flights prior to the mail contract and postal service maintained control of the flight schedule and had exclusive use of the aircraft); but see Rev. Rul 72-219, 1972-1 C.B. 350 (scheduled flights constituted an established line even though other non-scheduled flights were operated between the same two cities).

113 As defined by I.R.C. § 1504(a) without respect to the exclusions of I.R.C. § 1504(b). I.R.C. § 4282(b). See Rev. Rul. 76-394, 1976-2 C.B. superseding Rev. Rul. 68-343, 1968-1 C.B. 491 holding, prior to the enactment of 4282(b) that amounts paid to members of an ownership group for the use of the aircraft by other members of the group were subject to the transportation tax. See also Rev. Rul. 68-660, 1968-2 C.B. 517 (amounts paid for transportation by members of non-profit flying club were taxable).
114 I.R.C. § 4282.
c) Use Tax on Civil Aircraft

In addition to the excise taxes on aircraft fuels and transportation, a federal use tax is imposed on civil aircraft used in the navigable airspace of the United States. The Supreme Court agrees that this tax is a "user charge." The tax is imposed upon the owner of the aircraft, although a lessee may agree with a lessor to pay the tax. If the aircraft is used for transportation in foreign air commerce, the taxpayer is entitled to a refund of a portion of the use taxes paid in connection with that aircraft which are allocable to the international use. On several occasions the Administration has proposed increasing this tax, arguing that non-commercial aircraft users are bearing less than a proportionate cost of the airways facilities. After rejection of those proposals such an increase has apparently now been abandoned by the Administration.

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117 I.R.C. § 4492(a) defines "taxable civil aircraft" as any engine driven aircraft required to be registered under the Federal Aviation Act of 1958, or any aircraft owned by or for a United States person, I.R.C. § 4492(a), excluding those aircraft owned by an aircraft museum (as defined at I.R.C. § 4041(h)(2)).

119 Mere possession does not constitute use, nor does use by a manufacturer, dealer, wholesaler, retailer, exporter or importer solely for demonstration, testing, or delivery purposes. Treas. Reg. § 154.3-1 (1972).

120 As defined at 49 U.S.C. § 1301(24), except that the term does not include navigable airspace of the Commonwealth of Puerto Rico or any possession of the United States. 26 C.F.R. § 154.3-1(6) (1978).

121 The tax is a flat $25 annually, with additional taxes imposed of 3-1/2 cents per pound for all turbine-powered aircraft and 2 cents per pound for other aircraft with a certificated take-off weight of over 2,500 pounds. I.R.C. § 4491. Form 4638, Federal Use Tax Returns on Civil Aircraft, is used to report the aircraft weight and pay the tax. 26 C.F.R. § 154.3(e)-1(e) (1978).

122 See Commonwealth of Massachusetts v. United States, ___ U.S. ___, 98 S. Ct. 153 (1978), where the Supreme Court rejected a constitutional challenge in upholding a registration tax on civil aircraft as the tax applied to a helicopter owned by the state and used exclusively for state police work. The court concluded the tax was a user charge. See also Note, 43 J. Air L. & Com. 612 (1977) (discussion of the issue prior to recent Supreme Court decision).

123 26 C.F.R. § 154.3-1(d)(1) (1978). If the aircraft changes ownership during the year, the second owner is not liable for the tax if it was paid by the prior owner. Id. at § 154.3-1(d)(2).

124 I.R.C. § 4493. Presumably, the value of the tax payment will be taken into account in negotiating the price of the transaction.

125 I.R.C. § 6426. See also 26 C.F.R. § 154.3-1(e) (1978).
d) Proposed Tax on New Aircraft and Avionics

The Budget of the United States Government for 1980 indicates that a new 6 percent tax on new aircraft and avionics is being proposed, to become effective on October 1, 1980.\(^2\)\(^{125}\) Probably to be a retail rather than a manufacturer’s tax,\(^2\)\(^{126}\) this tax will be applicable to planes sold for use in non-commercial aviation situations. The objective is to obtain more revenue from general aviation.

Consistent with other similar taxes, probable exemptions will be provided for (i) exports and (ii) military sales. If a manufacturer’s tax is enacted, the spectre of constructive sales problems will be raised when the manufacturer sells at retail. Rules will have to be implemented to cover leasing transactions, whether the tax is imposed at the retail or the manufacturer’s level.

C. Disposition

1. Investment Credit Recapture

The advantages of the investment tax credit and accelerated depreciation may be mitigated, as earlier noted, by the early disposition of the aircraft. Although the investment tax credit taken upon the acquisition of the aircraft does not affect the depreciation on the aircraft or the gain or the loss on the disposition of the aircraft, if the aircraft is disposed of\(^2\)\(^{127}\) prior to the useful life used in computing the amount of qualified investment, the taxpayer is essentially required to repay that amount of credit taken which would not have been available had the actual holding period of the property been used in determining the original credit.\(^2\)\(^{128}\) For example, assume an aircraft having an anticipated useful life of seven years and a cost of $50,000 is disposed of after four years. Irrespective of the gain or loss recognized, the taxpayer will have to recapture a portion of the credit taken, that portion being equal to the difference between the original credit\(^2\)\(^{129}\) based upon a seven

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\(^{125}\) Budget of the United States Government, Fiscal Year 1980, at 72.

\(^{126}\) The Budget does not appear to indicate the type of tax (whether retailers or manufacturers) to be imposed.


\(^{128}\) I.R.C. § 47.

\(^{129}\) The original credit taken would have been $5,000 ($50,000 cost \times 10\%) if the property was acquired after January 21, 1975.
year life and the credit that would have been allowed had the actual holding period of four years been used to compute the credit. Thus, a taxpayer is not allowed to create investment credit in excess of the actual use period of the aircraft by arbitrarily choosing a useful life of seven years. That recapture is reflected on the return for the year of disposition. Even though the credit is ultimately recaptured, the taxpayer will have had the benefit of the credit amount for the period the asset is held.

2. Depreciation Recapture

In addition to the recapture of the investment tax credit, the disposition of the aircraft will constitute a taxable event upon which gain will be recognized to the extent that the proceeds received on the disposition exceed the adjusted basis of the aircraft. In general, any gain recognized will be subject to capital gain rates. If, however, an overall net loss occurs from trade or business property disposition for a particular year, then all of the losses for such year will be deductible as ordinary losses.

An important exception to the treatment of gain as capital gain is the depreciation recapture provision, which requires that the gain from the sale of personal property (i.e., an aircraft) be treated as ordinary gain to the extent of post-December 31, 1962 depreciation.

The depreciation recapture provisions, including Code section 1245, bar an individual from taking an excessive depreciation deduction against ordinary income and then realizing capital gain upon the sale of the property. The recapture provisions

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130 If the credit had been computed based upon the four year life, the credit would have been $1,667 ($50,000 cost X 1/3 X 10%) if the property was acquired after January 21, 1975. Thus, the credit recaptured is $3,333 ($5,500 - 1,667).

131 "The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received." Treas. Reg. § 1.1001-1(a) (1972).

132 Generally, the adjustment bases of the aircraft will be its original cost, increased by capitalized expenditures and reduced by depreciation. I.R.C. § 1016.

133 I.R.C. § 1231 requires that the taxpayer net all gains and losses from disposition of property used in the trade or business as capital gains and losses. If there is a net gain, all gains and losses are treated as capital gains and losses. If however, there is a net loss, then generally, all gains and losses are treated as ordinary losses. I.R.C. § 1231.

134 I.R.C. § 1245.
do not, however, require that gain in excess of depreciation previously claimed on the aircraft be treated as ordinary gain. Thus, to the extent that gain is in excess of the depreciation taken, that gain will be capital gain.\(^{126}\)

A portion\(^{126}\) of the capital gain recognized upon the disposition of the aircraft will be deductible in determining taxable income. For individuals this deduction, in effect, reduces the maximum tax rate on the gain from 70 percent to 28 percent.\(^{127}\) Similar treatment is available to corporate sellers. Prior to 1979, the non-taxable portion of the capital gain was an item of tax preference,\(^{128}\) and subject to a 15 percent tax in most instances.\(^{129}\) The Revenue Act of 1978, however, eliminates such excluded capital gains with respect to the 15 percent tax.\(^{130}\) The excluded gain is included in the tax base for purposes of the new alternative minimum tax provisions.\(^{141}\)

### 3. Gain Postponement

An important method of avoiding the recognition of gain and, particularly, the resulting recapture of depreciation on the disposition of an aircraft is to structure the disposition as a trade-in, or an exchange of like-kind\(^{142}\) property. The result of such a trans-

\(^{126}\) For example, assume that an aircraft has a 30,000 adjusted basis. (50,000 cost less 20,000 post 12/31/62 depreciation). If the aircraft is sold for 20,000, a 10,000 loss is recognized and there is no depreciation recapture. If, however, the aircraft is sold for 40,000, the 10,000 gain (40,000 less 30,000 adjusted basis) is treated as ordinary income. Furthermore, if the aircraft is sold for 60,000, the taxpayer realizes a 30,000 gain (60,000 less 30,000 adjusted basis) 20,000 of which is ordinary income (the amount of depreciation taken on the aircraft). The remainder of the gain, 10,000, is treated as section 1231 capital gain.

\(^{127}\) For sales prior to October, 1978 one-half of the long term gain is excluded. 26 U.S.C. § 1202 (1976). Subsequent to September, 1978 long term capital gains will be subject to a 60% exclusion due to section 402 of the Revenue Act of 1978, I.R.C. § 1202 (as amended).

\(^{128}\) Assuming a taxpayer in the 70% bracket, the 70% tax on the 40% of non-excluded gains results in a net tax of 28%.


\(^{130}\) I.R.C. § 56(a). The 15% is only assessed on amounts in excess of $10,000 or the regular tax deduction.

\(^{131}\) I.R.C. § 57(a).

\(^{132}\) I.R.C. § 55.

\(^{142}\) "Like kind" refers "to the nature or character of the property and not to its grade or quality," Treas. Reg. § 1.1031(a)-1(b) (1956). Thus, the exchange of an aircraft for new aircraft would qualify as a like kind exchange. See Treas. Reg. § 1.1031(a)-1(c)(1) (1956).
action is nonrecognition of any realized gain on the disposition of the aircraft. Unlike an involuntary conversion, the like-kind exchange provisions only apply to true exchanges. The taxpayer cannot sell the aircraft and then reinvest the proceeds in similar property within a limited time period so as to avoid income recognition on the disposition of the aircraft. A prospective cash purchaser might be located, with that purchaser acquiring the aircraft desired to be acquired, with a tax-free exchange then being arranged with the cash buyer. The buyer would, presumably, not recognize any gain on the purchase and exchange of the aircraft received by the seller, and the seller would be entitled to dispose of his original aircraft in a tax postponement transaction.

Since the like-kind exchange provisions are non-elective, if the disposition of the aircraft will result in the recognition of a loss, the taxpayer will desire to avoid a trade-in. This can be accomplished by the sale of the original aircraft outright, followed by the cash purchase of the new aircraft. In such cases, the rules applicable to the taxable disposition of an aircraft would apply as fully described above.

4. Charitable Contribution

The aircraft may be disposed of by gift to a charitable entity. The contribution of the aircraft to a charitable organization will generally provide the taxpayer with a deduction for the fair market value of the property contributed. If the aircraft has a fair market

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143 The nonrecognition of gain provided for in I.R.C. § 1031 does not apply to the extent that the taxpayer receives non-like-kind property. I.R.C. § 1031(b). A loss is not, however, recognizable merely because the taxpayer receives both qualifying and non-qualifying like-kind property. I.R.C. § 1031(c).

144 Property which is compulsorily or involuntarily converted (as the result of its destruction, theft, seizure, etc.) may be replaced within two years after the close of the tax year in which the property is converted and the taxpayer may elect to not recognize any gain on the conversion. I.R.C. § 1033.


146 The buyers would purchase the aircraft for its fair market value. Thus, even if gain were to be recognized it would be zero.

147 Care must be taken to maintain the distinction between the sale and subsequent purchase of the desired aircraft in that the Service may assert that a sale-purchase was, in reality, a like-kind exchange and disallow any loss realized by the taxpayer.

148 "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any com-
value in excess of its basis, however, the amount of the contribution may be reduced in this situation. The amount of the charitable contribution is first reduced by the amount of any gain which would have been ordinary income, i.e., depreciation recapture, if the aircraft had been sold for its fair market value at the time of the contribution. Additionally, if the use by the charitable organization is unrelated to the purpose or function of the organization, the contribution is reduced by the unexcluded portion of long term gain which would have been recognized had the taxpayer sold the contributed property at its fair market value. If the aircraft is sold to the charitable organization at less than its fair market value, the taxpayer's basis is apportioned under the bargain sale rules between the portion deemed sold and contributed. Further, the taxpayer can recognize no loss in such situations.

III. OWNERSHIP FORM

Although the aircraft can be acquired and owned in many different forms, certain modes of ownership result in different tax advantages and disadvantages. If the aircraft is owned individually, the tax benefits, e.g., investment tax credit and depreciation, will be realized directly by the taxpayer. Similarly, if the aircraft is owned and operated by a partnership, the incidents of ownership will generally flow through directly to the individual partners of the partnership.
If the aircraft is acquired by, or contributed\textsuperscript{155} to the capital of a corporation, the individual shareholder will, in most instances, be able to limit any potential liability with respect to the operation of the aircraft.\textsuperscript{156} The corporate form of ownership is not, however, necessarily the best form of ownership. First, although the individual shareholder is generally sheltered from personal liability, all assets of the corporation are subject to any potential liability. Second, the individual owner can normally attain virtually the same limited liability afforded by corporate ownership by simply obtaining the proper amount of liability insurance.\textsuperscript{157} Finally, corporate ownership necessitates a much greater deal of administration, with respect to both state and federal regulation and taxation.

A significant disadvantage of corporate ownership is the absence of any direct benefit to the shareholders of the incidents of ownership. If the corporation is formed merely for the purpose of owning and operating the aircraft, the expenses incurred will only offset income received by the corporation.\textsuperscript{158} The corporate entity will shelter income derived from the operation of the aircraft, for example, where the aircraft is to be profitably leased and the individual taxpayer is in a high tax-bracket.\textsuperscript{159} If a corporation meets the income\textsuperscript{160} and ownership\textsuperscript{161} requirements of a personal holding

\footnotesize
\textsuperscript{155} The taxpayer would generally not recognize any gain on the exchange of appreciated property to a corporation controlled by the taxpayer to the extent that stock and securities are received. I.R.C. § 351. See generally, B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ch. 4 (1971).

\textsuperscript{156} There are situations in which the courts will disregard the corporate entity and consequently destroy the shareholders limited liability. See Hamilton, The Corporate Entity, 49 Tex. L. Rev. 979 (1971).

\textsuperscript{157} Although extended liability insurance will obviously cost the taxpayer, such costs are deductible currently as an ordinary and necessary expense. Conversely, the costs of incorporation are not deductible currently but must be amortized over a 60 month period. I.R.C. § 248.

\textsuperscript{158} "[C]orporate losses are reflected on the shareholders individual income tax return only when, as, if his investment in the corporation becomes worthless, at which time the loss is almost always a capital loss rather than a deduction from ordinary income." Bittker & Eustice, note 155 supra at 6-25.

\textsuperscript{159} Although the earnings will usually be subject to double taxation, once when earned at rates ranging from 17 to 46\% for tax years beginning after 1978, and again upon distribution to the individual shareholder, the lower taxes in the initial year of income may generate enough income to exceed the additional tax paid upon distribution to the shareholder.

\textsuperscript{160} Generally, a corporation must have at least 60\% of its adjusted ordinary gross income as personal holding company income. I.R.C. § 542(a)(1).

\textsuperscript{161} Five or less individuals must own, directly or indirectly, more than 50\%
company, however, the personal holding company tax effectively mandates that personal holding company income, e.g., certain rental income, be distributed and taxed annually to the corporation's shareholders.

Where the corporation is a mere title-holder and all management functions are carried out by the individual shareholders, a distinct possibility exists that the corporate entity will be disregarded for tax purposes. Although such a disregard of the corporate entity is usually upon the assertion of the Service, the taxpayer has, occasionally, successfully argued that the corporate entity was a mere shell. In either case, the result of finding a "dummy" corporation and disregarding the corporate entity for tax purposes requires the shareholder to include the items of income and expense directly in the computation of his taxable income.

The taxpayer may, upon a valid Subchapter S election, choose to have the corporate form of ownership in order to attain the limitation of liability advantages, and still retain the flow-through characterization of individual or partnership ownership. Although this Subchapter S election is often summarily described as a corporation taxed as a partnership, such is not the case. Generally, the Subchapter S corporation will provide for the flow-through of investment credit and losses, but the Subchapter S provisions are extremely technical and difficult in their applicability of the value of the corporation's outstanding stock at some point during the last half of the corporation's taxable year. I.R.C. § 542(a)(2).

Personal Holding Company Income is defined by I.R.C. § 543. See also Treas. Reg. § 1.543-1 (1973).

Personal holding company income is subject to a 70% tax imposed in addition to the tax imposed at ordinary corporate rates. I.R.C. § 541.

See generally B. BITTKER & J. EUSTICE, note 155 supra, at 2-22.

See, e.g., Paymer v. Comm'r, 150 F.2d 334 (2d Cir. 1945).


See generally B. BITTKER & J. EUSTICE, supra note 155, ¶ 6.01; S. SURREY, W. WARREN, P. MCDANIEL, & H. AULT, FEDERAL INCOME TAXATION 555-74 (1973) [hereinafter cited as SURREY].

"While the section is sometimes loosely described as permitting a corporation to elect partnership tax treatment, the technical structure of the Subchapter S provisions make his statement quite inaccurate, except as respects the overall generalization that the shareholders of a Subchapter S corporation are subject to tax on undistributed corporate income, as are the partners with respect to undistributed partnership income." SURREY, note 167 supra, at 555.
The taxpayer may be able to attain the limited liability available through corporate ownership, along with the flow through of losses, with the formation of a limited partnership. This would provide the taxpayer with the desired results without the technical pitfalls prevalent with the Subchapter S election. This may also be accomplished through the use of "trust" which does not constitute a trust or a corporation for federal income tax purposes but, rather, constitutes a partnership.

IV. BUSINESS V. PERSONAL USE PROBLEMS

A. Business Use

1. Profit Motive

The crucial question with respect to the determination of the business related uses of aircraft is the existence of a genuine profit motive. Generally, this relates specifically to whether the expenses are incurred in the pursuit of a trade or business or for the production of income. For such a pursuit to be a trade or business the existence of a true profit motive must be shown. "The expectation of profit need not be a reasonable one, but it must at least be shown that the taxpayer in good faith intends that his enterprise shall yield a profit." The determination of a profit motive is a question of fact, and the burden of proof is on the taxpayer to show that an aircraft and its related expenses are incurred in the conduct of a trade or

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169 "Subchapter S is quite complicated and a business getting along without much legal or accounting advice will certainly need more if it operates under Subchapter S." Surrey, note 167 supra, at 557.
170 See generally W. McKee, W. Nelson, & R. Whitmire, note 154 supra, at ch. 2.
172 Robert E. Hecathorn, 41 T.C.M. (P-H) 337, 338 (1972); See also Lamont v. Comm'r, 339 F.2d 377 (2d Cir. 1964); Hirsch v. Comm'r, 315 F.2d 731 (9th Cir. 1963).
173 I.R.C. § 162(a).
174 I.R.C. § 212.
175 Bullock's Dep't Store, Inc. v. Comm'r, 42 T.C.M. (P-H) 1122, 1136 (1973).
business and not for social or personal use. The Service will review any alleged business expenses with great detail, and any assumptions made will probably be unfavorable to the taxpayer. The Service’s determination of business and personal use will not be rejected by the Tax Court unless the taxpayer produces adequate contrary evidence.

2. Allocation Rules

Travel expenses incurred in connection with a trip with both personal and business activities “are deductible only if the trip is related primarily to the taxpayer’s trade or business.” The regulations are somewhat more specific in this regard, generally requiring that the taxpayer spend more time on the business rather than the personal activities.

No allocation between business and personal travel expenses incurred while traveling solely within the United States is required. The travel costs will either be deductible in toto or not at all, depending upon the primary purpose of the trip. In determining whether a flying expense within the United States is primarily related to a trade or business, excessive travel time in relation to the length of stay at the destination as well as the number and location of stops have been considered by the courts.

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177 Johnston v. Comm'r, 45 T.C.M. (P-H) 73 (1976) (Petitioner failed to produce sufficient evidence to support the deductibility of aircraft expenses.)


179 Id. at 237; e.g., Zeagler v. Comm'r, 27 T.C.M. (P-H) 391 (1958); see rule 142(a) of the Tax Court rules of practice and procedure, 26 U.S.C. § 7453 (1976).


182 Travel outside the United States is defined by Treas. Reg. § 1.274-4(e)(1), T.D. 6758, 1964-2 C.B. 78, as “travel which is not from one point in the United States to another point in the United States. . . .” Treas. Reg. § 1.274-4(e)(iii), T.D. 6758, 1964-2 C.B. 78, states: “In the case of travel by private airplane, any flight, whether or not constituting the entire trip, where both the takeoff and the landing are within the United States shall be considered travel from one point in the United States to another point in the United States.”

183 Treas. Reg. § 1.162-2(b)(2) (1958). “The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer’s trade or business is an important factor in determining whether the trip is primarily personal.” Id.

184 Cowing v. Comm'r, 38 T.C.M. (P-H) 745, 785 (1969) (The taxpayer traveled fifteen days for a three day convention and had stopovers in Las Vegas and other suspect cities.)
The relation must be to a current trade or business, as the courts will not allow a purported business motive where the venture is either unrelated to the taxpayer's current trade or business or to a new expansion of the current trade or business. In this context, too, the burden of the taxpayer is substantial.

With respect to travel expenses incurred for travel outside the United States, Code section 274 will limit the deductible expenses in certain situations. The limitation applies only if the travel outside the United States exceeds one week, and if more than twenty-five percent of the days spent outside the United States are non-business days. The regulations provide special rules in determining whether a given day is personal or business. In general, the determination is based on the time spent during the day on business and personal activities. Where a taxpayer's presence is required "for a specific and bona fide business purpose" that day will be considered a business day even if, because of the length of the meeting, more time was spent during the normal working hours on non-business activities.

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186 See generally Hoffman & Thompson, Here's What an IRS Agent Looks For When Auditing T & E Expense Deductions, 16 TAX. FOR ACCOUNTANTS 24 (1976). See also Osborn, Careful Planning Can Increase Professionals' Deductions for Travel and Entertainment, 17 TAX. FOR ACCOUNTANTS 74 (1976).
187 "Travel which is not from one point in the United States to another point in the United States shall be considered travel outside the United States." Treas. Reg. § 1.274-4(e)(1), T.D. 6758, 1964-2 C.B. 78.
190 The taxpayer may allocate business and personal time other than on a daily basis if the taxpayer "establishes that a different method of allocation more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity." Treas. Reg. § 1.274-4(d)(2), T.D. 6758, 1964-2 C.B. 78.
195 Id.
3. Entertainment Facility

In addition to limiting the deductibility of certain aircraft expenses for travel outside the United States, Code section 274 limits certain expenditures for aircraft used not for travel but as an entertaining facility. The regulations provide that any expenditure with respect to the use of an entertainment facility shall not be allowed as a deduction unless the facility is used primarily for the furtherance of the taxpayer's trade or business, and the expenses incurred were directly related to the taxpayer's trade or business. The entertainment limitation applies only to the extent that the aircraft is used as an entertainment facility.

In *Beckley v. Commissioner* the Service asserted that because the aircraft involved was not used more than fifty percent for business purposes, Treasury Regulation Section 1.274-3(e)(4)(ii)(b) denied any reduction related to the use of the aircraft. The Tax Court rejected the Service's position, holding that to the extent that the aircraft was used for transportation it did not fall within the limitations set forth in section 274. The Tax Court relied on a

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107 Treas. Reg. § 1.274-2(e)(2) (1969) provides that “[a]ny item of personal or real property owned, rented, or used by a taxpayer shall (unless otherwise provided . . .) be considered to constitute a facility used in connection with entertainment if it is used during the taxable year for, or in connection with, entertainment.”

108 Entertainment is defined by the regulations as “any activity which is of a type generally considered to constitute entertainment, amusement, or recreation.” Treas. Reg. § 1.274-2(b)(1)(i) (1969). The regulations further provide that an objective test shall control the determination of whether a given activity is entertainment. Treas. Reg. § 1.274-2(b)(1)(ii) (1969).

109 The regulations provide that an aircraft shall be deemed to be primarily used in furtherance of his trade or business if “the taxpayer establishes that more than 50 percent of hours flown during the taxable year was in connection with travel considered to be ordinary and necessary within section 162 or 212 and the regulations thereunder.” Treas. Reg. § 1.274-2(e)-4(ii)(b) (1969).

110 In general, directly related entertainment requires the taxpayer establish the expenditure was “directly related to the active conduct of [his] trade or business.” Treas. Reg. § 1.274-2(a)(1) (1969). For specific requirements of the directly related test, see Treas. Reg. § 1.274-2(C) (1969).


202 34 T.C.M. (CCH) 235 (1975).

203 Id. at 239.
specific regulation which provides that even though an entertainment facility is used on some occasions for entertainment purposes, the deductibility of expenses incurred for travel is controlled by rules ordinarily applicable to travel expenses. "We believe the regulations make it clear that the expenses of non-entertainment use of a transportation type facility [i.e., for business transportation] are not affected by the entertainment facilities rule." The court went on to hold that "in such situations only the regular business expense rules apply [without application of the entertainment facility deductions test]" Thus, it appears that entertainment facility rules of Code section 274 are not applicable to expenditures incurred as the result of business transportation, even though the aircraft is also used as an entertainment facility.

4. Substantiation Requirements

Both the subjective nature of the business-personal distinction and the irrebuttable presumption in favor of the Service combine to place a heavy burden on the taxpayer to maintain adequate records and documentation, not only of the use of the aircraft, but also of the surrounding business transactions for which the aircraft was used. The Federal Aviation Regulations require certain operating information to be maintained in an aircraft log, but as a general rule this information alone is insufficient. The Tax Court has, however, enumerated with implied approval the contents of such logbooks to the effect that they may be used to support the taxpayer's position. In one case, the Tax Court con-

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An expenditure [which might be deemed either travel or entertainment] shall be deemed for travel to which this section does not apply if it is:
(1) With respect to a transportation type facility (such as an automobile or an airplane), even though used on other occasions in connection with an activity of a type generally considered to constitute entertainment, to the extent the facility is used in pursuit of a trade or business for purposes of transportation not in connection with entertainment.


207 See note 180 supra.


209 The items included in such logbooks relied upon by the court have in-
sidered, but did not accept the taxpayer's own contemporaneous notation of the business or personal nature of his flights.\textsuperscript{210}

The cases are replete with estimates of the percentage of time which the aircraft was used for business or personal travel. Generally, the taxpayer makes a high allocation of business travel, the Service a low allocation, and the court finds the correct allocation to be somewhere in between.\textsuperscript{211} In a few cases, the courts have based their determination on the Cohan rule,\textsuperscript{212} whereby the court can attribute a reasonable amount of expenses to business related motives even if the taxpayer does not fully establish that the specific activities were business related.\textsuperscript{213} In the more usual situation, however, the courts require substantial evidence to support the business motive, and the taxpayer's testimony alone will probably be insufficient.

In \textit{Johnston v. Commissioner}\textsuperscript{214} the Tax Court held that the taxpayer did not sufficiently substantiate the business nature of his flights. The taxpayer had made several trips to various cities purportedly to discuss franchising arrangements with various investors and to "discern the character of various sections of the cities and . . . select a site which would enhance the possibility of a

\footnotesize{\textit{\textsuperscript{210} Cowing v. Comm'r, 28 T.C.M. (CCH) 696, 699, 706-07 (1969); Fairburn v. Comm'r, 28 T.C.M. (CCH) 438, 440 (1969).}}

\footnotesize{\textit{\textsuperscript{211} Although it is difficult to have the court accept a taxpayer's own notation, courts will more readily accept a record made at the time of the aircraft's use rather than after the fact based upon the user's memory. \textit{See Internal Revenue Manual} § 774.82(3) which states, "The account book, dairy, statement of expense, or similar record should be prepared or maintained in such a manner that the recording of the elements of an expenditure is made at or near the time the expenditure is made."}}

\footnotesize{\textit{\textsuperscript{212} The Cohan rule is the result of the Second Circuit's decision in Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930) that "absolute certainty in such matters is usually impossible and is not necessary; the Board [now the Tax Court] should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making." \textit{Id.} at 543-44. The applicability of the Cohan rule has been severely limited by the enactment of I.R.C. § 274.}}

\footnotesize{\textit{\textsuperscript{213} See \textit{Cowden v. Comm'r, 9 T.C.M. (CCH) 1148, 1151, vacated and remanded, 202 F.2d 748 (5th Cir., 1953); Gibson Prods. Co., 8 T.C. 654 (1947); Leonard v. Comm'r, 11 T.C.M. (CCH) 12 (1952), aff'd, 203 F.2d 566 (6th Cir. 1953) (per curiam).}}

\footnotesize{\textit{\textsuperscript{214} 35 T.C.M. (CCH) 74 (1976).}}
The Tax Court held that the aircraft use was not pursuant to the taxpayer's trade or business, referring specifically to the lack of documentation and objective results from the trips. In other cases, the Tax Court has also looked to the nature of the business in which the aircraft is used, continuity of the business, time devoted to the business by the taxpayer, and whether the taxpayer is engaged in the business for the purpose of earning a livelihood or merely as an avocation.

A taxpayer's lack of knowledge concerning the nature and extent of an aircraft's use has also been found by the courts to support a denial of a business motive. The essential ingredient here is that the taxpayer must keep complete and accurate records in order to increase the verifiable business use of the aircraft and, ultimately, the tax benefits associated therewith.

Although expenses incurred in the operation of the aircraft for transportation purposes in connection with a business will normally be deductible, most expenses incurred in connection with travel from the taxpayer's home to his place of work will be nondeductible commuting expenses. It makes no difference that the taxpayer's home is his principal place of business. The Service takes the position that a taxpayer's home is the place he is away from home while there even though his family may reside at his non-principal place of business. See Rev. Rul. 71-247, 1971-1 C.B. 54 where a construction worker was allowed to treat his city of residence as his home. Generally, a taxpayer may have more than one trade or business and it is not grounds for disallowance of a deduction that the expenses were incurred in the pursuit of a non-primary trade or business.

There is no convincing way to distinguish the expenses here from those of suburban commuters. Petitioner's hardships are no different.
of work, if such place of work is not temporary. Thus, the use of an aircraft to travel to work will not generate deductible business expense. Although a taxpayer cannot deduct commuting expenses, he does not have to include in income amounts paid by fellow commuters for rides, unless he is in the business of furnishing rides for co-employees. If, however, a taxpayer has two different places of work, he may be able to deduct the expenses incurred in commuting to that which is not his principal place of work. Each place of work must have some substantial independent significance, rather than one place merely being an “office in the home.”

C. Hobby Losses

Where the taxpayer acquires an aircraft and operates or rents the aircraft for an alleged business purpose, the taxpayer may have trouble sustaining the deduction of expenses in excess of income over an objection by the Service that the activities are

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than those confronting the many taxpayers who cannot find suitable housing close to their urban place of employment and must daily commute to work. We see no reason why petitioners in the case at bar should receive more favored tax treatment than their urban counterparts who also cannot live near their worksites. Id. at 299 (quoting 52 T.C. 964).


213 See note 219 supra.
a mere hobby. The Service may attempt to disallow deductions claimed by a corporation based upon the lack of the ordinary and necessary requirement of section 162.224 With respect to individuals and Subchapter S corporations,225 special rules apply to the deductibility of expenses incurred in the absence of a genuine profit motive.226 An activity227 is presumed to be an activity engaged in for profit, however, if the gross income exceeds the deductions applicable to such activity for two years in a period of five consecutive years,228 unless the Secretary establishes to the contrary.229 Prior to the enactment of section 183, some courts required demonstration of a reasonable expectation of a profit,230 in addition to the requirement that the taxpayer subjectively intended to make a profit.231 The "reasonable expectation" test has been eliminated232 and an objective test is to be used in determining the existence of a genuine profit motive.233

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225 I.R.C. § 183(a) specifically applies to individuals and electing small business corporations. See Curran v. Comm'r, 29 T.C.M. (CCH) 696 (1970), where the Tax Court held that the Subchapter S provisions could not be used to allow deductibility of the taxpayers' flying expenses which otherwise lacked a profit motive.
226 The rules are somewhat circular, providing that an "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212." I.R.C. § 183(c). See also Treas. Reg. § 1.183-1(a) and Treas. Reg. § 1.183-2 (1972).
227 An activity is defined in Treas. Reg. § 1.183-1(d) (1) (1972).
228 I.R.C. § 183(d); Treas. Reg. § 1.183-1(c) (1972). The taxpayer may elect to postpone the determination of whether an activity is engaged in for profit via the presumption until the taxpayer has engaged in the activity for the five-year period. Treas. Reg. § 1.183-1(a) (1972).
229 I.R.C. § 183(d).
231 The pre-Section 183 cases looked primarily at the specific intent of the taxpayer in determining whether the activity was engaged in for profit. See, e.g., Smith v. Comm'r, 9 T.C. 1150 (1947). But see Bullock's Dep't Store, Inc., 32 T.C.M. (CCH) 1168, 1182 (1973).
233 Id. Treas. Reg. § 1.183-2(b) (1972) lists nine factors to be taken into account in determining the existence of a genuine profit motive:
   1. Manner in which the taxpayer carries on the activity.
   2. The expertise of the taxpayer or his advisors.
   3. The time and effort expended by the taxpayer in carrying on
The treatment of any losses incurred in connection with the operation of the aircraft depends, in part, upon the use of the aircraft and the form of ownership. With respect to an individual, losses are allowed only if they are incurred in a trade or business, a transaction entered into for profit, or are the result of a casualty loss incurred with respect to property not connected with a trade or business. Although the above limitations are not statutorily applicable to corporations, cases have arisen where a corporation has been denied deductions based upon the fact that the losses were incurred upon property held for the convenience of the corporation's shareholders. In addition, such disallowed charges are sometimes treated as constructive distributions to the shareholder benefitted. A recent case, however, holds that the absence of a statutory bar to losses so incurred precludes a disallowance of those losses.

D. Corporate Ownership—Personal Use

While the personal use of an aircraft owned by an individual will

the activity.

(4) Expectation that assets used in activity may appreciate in value.

(5) The success of the taxpayer in carrying on other similar or dissimilar activities.

(6) The taxpayer's history of income or losses with respect to the activity.

(7) The amount of occasional profits, if any, which are earned.

(8) The financial status of the taxpayer.

(9) Elements of personal pleasure or recreation.

A casualty loss is statutorily defined as one that arises "from fire, storm, shipwreck, or other casualty, or from theft." I.R.C. § 165(c)(3). Generally, a casualty loss is the result of an identifiable event of a sudden, unexpected, or unusual nature. Rev. Rul. 54-85, 1954-1 C.B.; see W. Bittker and L. Stone, supra note 155, at 22.

See Riss v. Comm'r, 57 T.C. 469 (1971); Greenspon v. Comm'r, 229 F.2d 947 (8th Cir. 1956).

See generally W. Bittker and J. Eustice, note 155 supra at 7-30 n. 60.

International Trading Co. v. Comm'r, 484 F.2d 707 (7th Cir. 1973). When I.R.C. § 280A was enacted to limit the vacation home deduction for individuals, trusts, estates, partnerships and Subchapter S corporations, the Congress determined not to include regular corporations within the limitation. "However, no inference should be drawn from this section in the case of a corporation, as to whether or not expenses incurred for the maintenance of a residence are connected with its trade or business for purposes of the tax laws." Staff of the Joint Comm. on Taxation, 94th Cong., 2d Sess. at 144, General Explanation of the Tax Reform Act of 1976 (1976).
simply result in the non-deductibility of any associated expenses, the personal use of a corporately owned aircraft can result in income to the individual user. This income will normally be characterized as salary or dividend income, the latter being particularly unfavorable since the individual involved is charged with additional income but the corporation is not allowed to deduct the constructive payments because they have been characterized as a dividend. The personal use of a corporate yacht, auto, supplies and materials, and a lake house have all resulted in constructive dividends. Business aircraft are by no means excluded from the list, and the personal use of a corporate aircraft has resulted in a constructive dividend to the individual.

The amount of income can be unreasonably high, as the general rule is that the individual receives income in an amount equal to the fair rental value of the aircraft used. Another rule used by the Service appears to result in a more reasonable income determination. Under this latter rule the Service will impute income based upon the portion of aircraft expenses allocable to the personal use. Additionally, any use by the taxpayer's family or friends will generally be imputed to the taxpayer and the taxpayer will be charged with the income attributable to such use.

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243 Estate of Law, 23 T.C.M. (CCH) 1554 (1964).


246 Beckley v. Comm'r, 34 T.C.M. (CCH) 235, 240; Report, note 240, supra at 162.

247 Report, note 240, supra at 162.

248 See Rev. Rul. 69-104, 1969-1 C.B. 33. The apparent theory is analogous to the doctrine of constructive receipt in that the taxpayer has dominion or control over the travel and thus receives income therefrom. However, the constructive receipt doctrine traditionally deals with when income is realized rather than to whom it is attributable. Report, note 240, supra at 160.
In reviewing the federal income tax returns of former President Nixon, the Joint Committee Staff attempted to determine the proper treatment of his personal trips as well as trips taken by his family and friends in government aircraft. The Staff's report indicated that, because of the unique nature of the President's duties requiring him to be on constant call, income would not be imputed for the President's personal flights. With respect to the use of government aircraft by Nixon's family and friends, the Staff concluded that normally the President would be charged with the fair rental value of the aircraft used. Since special security precautions were necessary for his family members, however, the Staff recommended that the income attributable to the President should be limited to the comparable first class airfare which would have been incurred had his family flown on commercial airlines. The Staff rejected the argument that no income should be imputed to the President where his family and friends accompanied him because no additional expenses were incurred as the result of the additional passengers.

E. Employee Reimbursement

Somewhat analogous to the business-personal use problem is the situation where an individual owns an aircraft and uses it in connection with his activities as an employee. Such expenses would seem to be deductible if truly related to a business motive. Indeed, technically this appears to be the result reached by the courts. Courts, however, have held that such expenses are prima facie personal where the employee incurs those expenses knowing that his employer will not reimburse him for those expenses. Thus, if an individual flies his own plane instead of commercial airlines, knowing that his employer will not reimburse him for the expenses incurred, those expenses will not be deductible by the individual. Obviously, a reimbursement arrangement should be established in advance between the employee and his employer.

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349 Report, note 240 supra.
350 Id.
353 Id. See also Bratton & Malloy, Unreimbursed expenses—A problem area, 55 Taxes 257 (1977).
V. THE OWNER AS LESSOR OF THE AIRCRAFT

A. Objectives of Leasing

The use of leases in the ownership and operation of an aircraft may prove beneficial to both the owner-lessee and the lessee. Although the lessor will report rental payments received as income, the lessor is also entitled to all of the usual incidents of ownership of business property, e.g., investment tax credit, depreciation, etc.254 Because most of the benefits attributable to aircraft ownership are significantly affected by the taxpayer's margin tax bracket, a high bracket taxpayer might beneficially purchase the aircraft and lease it to a lower bracket operator. The lessee can deduct rental payments made, providing that he has not taken title to the property nor has any equity interest therein.255 If the lessee is in a net operating loss carryover position the use of a lease arrangement may be particularly beneficial, since rental payments expense deductions in the early years will probably be less than ownership benefits such as accelerated depreciation and the investment tax credit.

In the usual situation, a fixed base operator desiring to acquire an aircraft for his operations may arrange with a third party to acquire the aircraft and lease it to the fixed base operator, rather than borrowing the funds to purchase the aircraft.256 This arrangement allows the third party to deduct depreciation and interest, thereby indirectly reducing the total lease payments necessary for the third party to liquidate any debt service obligation.257 The purchase will probably have been made on financed leases or "leveraged leases" to the lessee. The Service may challenge the existence of a lease and, thereby deny the lessor's deduction for interest and

256 In general these leases are net leases, the lease term covers a substantial part of the useful life of the leased property, and the lessee's payments to the lessor are sufficient to discharge the lessor's payments to the lender." Rev. Proc. 75-21, 1975-1 C.B. 715.
257 The lease payments are generally computed to at least cover the owner-lesser's mortgage payments. However, since the owner-lessee will obtain a reduction in his tax liability due to depreciation, interest, and other deductions the rental payments necessary to sustain a positive cash flow for the owner-lessee are substantially reduced.
depreciation. Although not determinative of the existence of a lease, the Service has promulgated various guidelines which it will apply in determining the existence of a lease. In addition, the Service in several letter rulings has addressed the issue of the existence of a true aircraft lease for tax purposes.

If the lessor is deemed to have entered into a "net lease," he may be liable for the minimum tax of 15 percent on depreciation taken in excess of that which would have been taken under the straight line method. The net lease qualification is determined on an annual basis, and the lease will qualify if (i) the sum of the lessor's business expense deductions are less than 15 percent of the total rental income produced from the lease or (ii) the lease provides that the lessor will receive a guaranteed rate of return or if it provides that the lessor is guaranteed against a loss of income. If the individual taxpayer leases an aircraft under a lease which meets the net lease requirements and deducts accelerated depreciation on the aircraft, then the excess depreciation taken over the amount that would be allowed under the straight line method is an item of tax preference and may be


259 Rev. Proc. 75-21, 1975-1 C.B. 715. Generally, the Service will look to the lessor's investment determined to be "at risk", lease term and renewal options, purchase and sale rights, investment, loans, or guarantees by the lessee, the lessor's profit motive. Id. Rev. Proc. 75-28, 1975-1 C.B. 752 enumerates the information required to be submitted to the Service to obtain a ruling.

260 See, e.g., IRS LETTER RULINGS REP., Ltr. 7848033 (Aug. 30, 1978); Id. Ltr. 7845025 (Aug. 9, 1978); Id. Ltr. 7836029 (June 8, 1978).

261 See Proposed Treas. Reg. § 1.57-3.


263 The expenses includable in the 15% determination include only those deducted under I.R.C. § 162. Thus, deductions for taxes, interest, and depreciation do not qualify. Proposed Treas. Reg. § 1.57-3(b)(2).


265 I.R.C. § 57(c)(1)(B). See also Proposed Treas. Reg. § 1.57-3(c).

266 Accelerated depreciation on leased personal property is not an item of tax preference for a corporation other than an electing small business corporation. Proposed Treas. Reg. § 1.57-1(c)(8).

267 The Code requires that the useful life for this purpose be determined without the provision allowing the Commissioner to prescribe a variance in useful life by 20%. I.R.C. § 57(a). See I.R.C. § 167(m). The results is that the useful life is that prescribed by the ADR system without the minimum allowance. See Rev. Proc. 73-10.
taxed at 15 percent depending on the taxpayer's other tax preference items.

Certain individuals who lease personal property are excluded from taking the investment tax credit. The credit will be allowed to the individual lessor only if: (i) the property has been manufactured or produced by the lessor or (ii) the term of the lease is for less than 50 percent of the useful life of the property and during the first year in which the property was leased the deductions under section 162 exceeded 15 percent of the rental income produced from such property. As with the minimum tax on accelerated depreciation subject to a net lease, the tax benefits are reduced primarily to limit the potential for shifting the benefits to a high marginal tax bracket individual taxpayer.

If the acquisition of leased aircraft is financed, the interest payments to retire the debt may not be entirely deductible. The rental income derived from an aircraft lease would cause any interest expense associated therewith to be considered "investment interest" and, accordingly, would be limited to the taxpayer's net investment income plus $10,000. This provision would have only a limited effect on the taxpayer to the extent he has no other sources of investment interest in excess of the statutory $10,000 limit.

Although depreciation, interest, etc., will be deductible by the owner-lessee subject to the above limitations, the Tax Reform Act of 1976 limits the amount of deductible expenses to the amount which the taxpayer had "at risk." Generally, this limits

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269 I.R.C. § 46(e)(3). In this situation an investment tax credit will not be allowed to an electing Subchapter S corporation. Treas. Reg. § 1.46-4(d)(1)(ii) (1972).
274 Investment income means the excess of investment income (as defined in I.R.C. § 163(d)(3)(B)) over investment expenses (defined at I.R.C. § 163(d)(3)(C), I.R.C. § 163(d)(3)(4)).
275 In the case of a married taxpayer filing separately, the limitation is $5,000. I.R.C. § 163(d)(1).
the taxpayer's deductions to his capital investment\textsuperscript{277} plus liabilities incurred for which the taxpayer is personally liable.\textsuperscript{278} The "at risk" provisions specifically apply to the leasing of personal property, although the Revenue Act of 1978 modified the rules to apply to all activities except those relating to real estate.\textsuperscript{279}

B. Sale—Leasebacks

The use of leases in connection with financing the acquisition of newly-acquired aircraft and the sale of an aircraft to a third party coupled with a leaseback of the aircraft from the third party may provide financial benefits. This generally provides the seller-lessee with additional working capital and may increase his deduction with respect to the aircraft.\textsuperscript{280} The taxpayer must be very careful, however, in structuring the sale-leaseback so as to assure retention of the tax benefits. The Service may restructure the transaction in terms of a like-kind exchange, thereby disallowing depreciation to the buyer-lessee, and the deductibility of the rental payment by the seller-lessee.

C. Trust Gift or Sale and Leaseback

Similar problems arise in connection with the gift or sale of the aircraft to a trust created for and benefit of the taxpayer's children. The formalities of the gift-leaseback or sale-leaseback in this context may be disregarded because the transfer and subsequent rental payments were not "necessary."\textsuperscript{281} Various other factors have been considered by the courts,\textsuperscript{282} and the most recent

\textsuperscript{277} I.R.C. § 465(b)(1) provides that the taxpayer is considered at risk to the extent of "money and the adjusted basis of other property contributed by the taxpayer to the activity." I.R.C. § 465(b)(1)(A).

\textsuperscript{278} I.R.C. § 465(b)(2) provides that liabilities of the taxpayer are considered at risk if the taxpayer is personally liable or to the extent of the fair market value of pledged property (other than the property used in the activity in question). In addition, amounts borrowed from persons who have an interest in the activity or are related to the taxpayer are excluded from the amount which the taxpayer is at risk.


\textsuperscript{280} See generally, J. Morris, note 254 supra, at 25.

\textsuperscript{281} See, e.g., Van Zandt v. Comm'r, 341 F.2d 440 (5th Cir. 1965); Mathews v. Comm'r, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976).

\textsuperscript{282} See Wiles v. Comm'r, 59 T.C. 289 (1972), aff'd per curiam, 491 F.2d 1406 (5th Cir. 1974), where the Tax Court denied rental deductions despite
Supreme Court decision provides authority for the allowance of
the transaction where the parties have the true incidents of owner-
ship, even though the practicalities of the transaction negate any
possible detriment to the lessors resulting therefrom.\textsuperscript{223}

VI. **Conclusions**

Although many tax considerations must be weighed in connec-
tion with the acquisition, operation, and disposition of aircraft,
the vast majority of these considerations are not unique to aircraft
as aircraft. The tax benefits derived from the business use of an
aircraft can, however, substantially reduce the taxpayer’s net cost
thereof. Although certain tax benefits may be obtained through
the ownership of the aircraft by a corporation, a Subchapter S
corporation, or a partnership, the additional administrative bur-
dens with respect thereto may outweigh the tax advantages. Simi-
larly, the benefits obtainable from the careful use of leases are
accompanied by substantial restrictions and, in most cases, will re-
quire the advice of an experienced tax practitioner. Perhaps the
most significant question for the majority of aircraft owners is the
distinction between business and personal use of the aircraft. The
enlightened owner should be able, with proper record-keeping, to
adequately support the business use of the aircraft more readily
and, consequently, to increase the associated deductible expenses.

the fact that there were other tenants in the same building, the grantor had no
reversionary interest, and where there was no independent trustee. In Yanow v.
Comm’r, 44 T.C. 444 (1965), aff’d, 358 F.2d 743 (3d Cir. 1966), the Tax Court
denied depreciation deductions to the owner-lessee due to the lack of a profit
motive. But see Oakes v. Comm’r, 44 T.C. 427 (1965) and Mathews v. Comm’r,
61 T.C. 12 (1973), rev’d, 520 F.2d 323 (5th Cir. 1975), cert. denied, 424 U.S. 967
(1976), where the lease status was upheld.