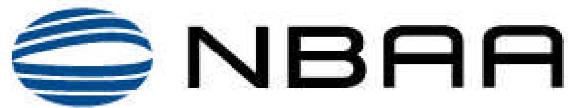

National Business Aviation Association's Tax Committee
Federal Tax Working Group - Regulatory Initiatives
Meeting with IRS
June 7, 2011
Iselin, NJ

Federal Tax Issue #1: Tax Penalty for Use of Business Aircraft for Charitable Purposes

Owners and operators of business aircraft regularly contribute the use of their airplanes for charitable purposes, often in support of national safety and relief efforts. Examples include the contribution of relief flights in the days and months following Hurricane Katrina. Countless business aircraft flew medical and food supplies and relief workers to the hurricane-stricken areas and transported hurricane victims to safe grounds in new communities throughout the U.S. The same thing happened when a hurricane devastated Haiti and during the recent disasters in Mississippi and Louisiana. Surprisingly, the income tax regulations impose a tax *penalty* on the use of a business aircraft for charitable purposes.

NBAA submitted comments to Treasury on September 13, 2007, explaining this problem and presenting a regulatory solution. (A copy of these comments is attached.)

Under current tax law, a charitable deduction is limited to certain variable costs of transportation for charitable purposes. Only those expenditures incurred for operation, maintenance, and repair, which are directly attributable to the use of such aircraft on a charitable flight can qualify as charitable deductions. Examples of costs that could be "directly attributable" to a charitable flight include the cost of fuel and oil for the flight, pilot fees incurred solely for the flight, rental charges for an aircraft used only for the flight, and extra liability insurance incurred only for the flight. In other words, this is a "but for" test: the expenditure is deductible only if it would not have been incurred but for the charitable flight.

Charitable deductions are not permitted for a proportionate share of fixed costs that would have been incurred even if the charitable flight had not occurred. Examples of such fixed costs include depreciation, general maintenance and repairs, and insurance. Similarly, pilot salaries and aircraft rents that do not vary with the number of flights would appear to be fixed costs that would not be "directly attributable" to a charitable flight. Accordingly, taxpayers generally cannot take a charitable deduction for fixed aircraft operating and maintenance costs attributable to charitable flights.

Since fixed expenses often comprise most of the operating and maintenance costs of an aircraft, a charitable flight can result in a substantial disallowance of expenses that might otherwise be deductible. For example, if a company aircraft is used 100% for business flights, then all of its fixed costs, including depreciation, ordinarily would be deductible. However, if the same aircraft is used 90% for business flights and 10% for charitable flights, then 10% of the fixed costs apparently would be nondeductible. In other words, charitable flights can result in the disallowance of otherwise deductible business expenses,

because a charitable deduction is not allowed for fixed costs attributable to charitable flights, and there is no provision in the law allowing the deduction of such costs as business expenses (assuming the primary purpose of the flight was for charitable rather than business purposes).

This rule is contrary to the Congressional policy behind the enactment of the charitable contribution deduction. It also is contrary to the Congressional policy to encourage investment by businesses in capital goods, most recently a 100% bonus depreciation deduction in the year the asset is placed in service. Depending on the amount of charitable use in the initial year, doing a good deed and responding to Congressional incentives could cost the owner many millions of dollars in lost depreciation deductions.

Instead of rewarding companies that conduct charitable flights with a tax benefit, this rule imposes an additional tax liability on such companies. Congress could not have intended that flights for charitable purposes would result in a tax *penalty*. Accordingly, we request an amendment to the business use regulations (Treas. Reg. § 1.274-5T(b)(6)(i)(B)) to provide that the out-of-pocket costs of charitable flights would not be taken into account in allocating costs between business and personal flights and the charitable flights would be disregarded in determining the business and personal percentage of the flights.

Federal Tax Issue #2: Capitalization and Repair Rules

Treasury has issued Proposed Regulations that address several areas that would affect previous guidance and how the general aviation industry has treated certain repair and inspection expenditures for many years. These Proposed Regulations would partly overturn existing case law applicable to general aviation and we feel that they go beyond the authority of the Secretary in regard to the law. We believe that if adopted, the Proposed Regulations would actually provide less clear guidance for general aviation and would increase tension and disagreements between taxpayers and the IRS on audit.

NBAA submitted comments on these Proposed Regulations on June 9, 2008. (A copy of these comments is attached.)

The current repair regulations provide simple tests driven by facts and circumstances.[1] Over the years, a significant body of case law and IRS guidance has been developed for taxpayers to rely upon. NBAA understands that the current proposed regulations do not clearly address all issues of whether expenditures should be deducted currently or capitalized. However, there are several areas that NBAA believes are unduly punitive to the general aviation industry. We would like to identify several of these areas and propose workable alternatives.

Routine Maintenance Safe Harbor

The proposed regulations provide a safe harbor under which routine maintenance is treated as an expense item.[2] Under the Proposed Regulations, maintenance is routine only if at the time the aircraft is placed in service, "the taxpayer reasonably expects to perform the [maintenance] activities more than once during the class life." While this safe harbor may apply to the high use and frequent maintenance

[1] Treas. Reg. § 1.263(a)-1(b) specifies that capital expenditures include amounts paid or incurred to 1) add to the value, or substantially prolong the useful life, of property, or 2) adapt property to a new or different use.
[2] Prop. Reg. § 1.263(a)-3(e)(1).

cycles of commercial airline aircraft, it would produce nonsensical results for general aviation aircraft on which routine maintenance and inspections would not occur more than once over the aircraft's class life. The reason for this difference is that commercial aircraft have a class life of 12 years and general aviation aircraft have a class life of 6 years.[3] Therefore, the same repairs and inspections when performed on commercial aircraft would be expensed under the safe harbor, but when performed on general aviation aircraft would not qualify for the safe harbor and would be subject to the new qualitative factors set forth in the Proposed Regulations.[4] We propose that the final regulations adopt a rule that treats all aircraft as having a 12 year class life for purposes of the safe harbor. Furthermore, we ask that an additional safe harbor be added to permit taxpayers to deduct the costs of "inspections."

Modification of the *Plainfield Union* Definition of Repairs

The court in the *Plainfield Union* case explained that—

An expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."[5]

The Proposed Regulations essentially adopt this test, except for an unfortunate modification added to the end of the discussion of normal wear and tear.[6] Due to this modification, expenditures to repair normal wear and tear that occurred prior to the taxpayer's acquisition of a used aircraft must be capitalized as "a betterment" to the aircraft. This rule needlessly imposes an extraordinary and impractical burden on purchasers of used aircraft, because they must track the condition of each part of the aircraft as of the date of purchase to determine whether future repairs or replacements of parts must be capitalized as betterments. Since aircraft have thousands of parts and numerous subsystems that are subject to routine maintenance and inspection, this modification to the *Plainfield-Union* definition of repairs is totally unworkable. We believe that the *Plainfield-Union* test should be retained in the regulations without the unfortunate modification at the end of the discussion of normal wear and tear.

The 50% Rule for Deemed Restorations

The Proposed Regulations add a bright line test to identify a deemed "replacement of a major component or structural part" that must be capitalized as a "restoration."[7] Under that test, if 50% of the replacement cost[8] or 50% of the property's structure[9] are replaced, than a deemed restoration has occurred. If a taxpayer happens to schedule his aircraft for a heavy maintenance visit (HMV)[10] and an

[3] Rev. Proc. 87-56 Asset Class 45.0 (commercial aircraft and assets) and Asset Class 0.21 (noncommercial aircraft and all helicopters).
[4] Prop. Reg. § 1.263(a)-3(f)(1).
[5] *Plainfield-Union Water Co. v. Comm'r*, 39 T.C. 333 (1962).
[6] Prop. Reg. § 1.263(a)-3(f)(2)(iii)(B). The modification at the end of the discussion of normal wear and tear adds the phrase: "or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer."
[7] Prop. Reg. § 1.263(a)-3(g)(1)(vi).
[8] Prop. Reg. § 1.263(a)-3(g)(3)(i)(1).
[9] Prop. Reg. § 1.263(a)-3(g)(3)(i)(2).
[10] Rev. Rul. 2001-4, Situation 1, 2001-1 C.B. 295.

engine shop visit (ESV)[11] at the same time, the taxpayer could easily incur costs in excess of 50% of the total replacement cost of an older aircraft even though the aircraft is not at the end of its useful life and is not in a state of disrepair. We believe that this bright line test is arbitrary and not within the scope of Treasury's authority. We request that this test be deleted from the final regulations.

Federal Tax Issue #3: Entertainment Use Disallowance Proposed Regulations

On June 15, 2007, Treasury issued Proposed Regulations on Deductions for Entertainment Use of Business Aircraft. The Proposed Regulations followed amendments to IRC Section 274 contained in the American Jobs Creation Act of 2004. NBAA submitted comments on the Proposed Regulations on September 13, 2007, and provided comments at the public meeting on October 25, 2007. (Copies of these comments are attached.) In 2007 and 2008, the NBAA Tax Committee met with Treasury and the IRS to provide additional information and discuss particular issues. No further guidance has been issued to date. NBAA urges the IRS and Treasury to renew efforts to work toward final regulations.

Federal Tax Issue #4: Why Business Aviation Often Relies on Leases

Owners of business aircraft often engage in aircraft leasing to limit aircraft related liability, comply with Federal Aviation Administration (FAA) rules, facilitate state sales and use tax planning and to maximize utilization of the aircraft.

The most common type of aircraft lease, a "dry lease," is the transfer of possession and control of an aircraft without any pilots to a lessee. Under a dry lease, FAA rules provide that the lessee is responsible for operational control and safety of the aircraft. Dry leases are used for lessees to use the aircraft in noncommercial operations, for which the FAA generally prohibits compensation for air transportation, and are also use for lessees who are certificated air carriers providing commercial air transportation to others. An aircraft may be subject to a single, exclusive dry lease, such as from a special purpose entity that owns an aircraft to a company that will operate the aircraft. Alternatively, an aircraft may be dry leased to one or more noncommercial lessees for such lessees' use and/or to an air carrier lessee to provide commercial air transportation to others.

Another type of aircraft lease, a "wet lease," is an arrangement whereby a person agrees to provide an entire aircraft and at least one crewmember to the user. Under FAA rules, wet leases are available on a limited basis to noncommercial operators as a way to obtain compensation on a limited basis for flights such as demonstration flights, time sharing flights, interchange flights and for flights carrying candidates in elections.

[11] *FedEx Corp. v. United States*, 291 F. Supp. 2d 699 (D. Tenn.), *aff'd*, 412 F.3d 617 (6th Cir. 2005).

Federal Tax Issue #4a: Passive Loss – LLC/LP Issue

Treasury is considering issuing guidance that might treat LLC members as limited partners for passive loss purposes. This could preclude grouping an individual's LLC member interest in a leasing activity with the individual's other business activities for passive loss purposes. Such a rule could arbitrarily limit the deductibility of aircraft expenses when an aircraft is owned by an LLC that leases the aircraft to another pass-through entity.

NBAA submitted comments on this issue on April 16, 2010. (A copy of these comments is attached.)

When the passive loss rules were enacted as part of the 1986 Tax Reform Act, Congress understood that State law generally prohibited limited partners from actively participating in the business of their limited partnerships. In recognition of this understanding, I.R.C. § 469(h)(2) effectively presumes that limited partners do not materially participate in their limited partnerships for passive loss purposes, except as provided in regulations. The Regulations provide that limited partners can overcome this effective presumption by showing material participation under 3 of the 7 material participation tests or by also being general partners. Since there is a different material participation rule for limited partners, the Regulations generally prohibit limited partners from grouping certain activities such as equipment leasing conducted by their limited partnerssship with their other business activities.

Subsequent to the 1986 Tax Reform Act, State partnership acts were revised in all but four states to eliminate the limitation on limited partners' active participation in their limited partnerships. Therefore, there is no reason for the special participation and grouping rules for limited partners under § 469(h)(2) to continue to exist, except with respect to limited partnerships in four states. Unfortunately, rather than pare these special rules back to apply only to limited partners in four states, the IRS sought to expand them to apply to LLC members. Following numerous losses in court, the IRS informally announced that it will provide guidance on how LLC members are to be treated under § 469(h)(2).

NBAA's comments explain that the IRS should modify the regulations to clarify that the special rules for limited partners should not apply to LLC members because no State limits LLC members' participation in LLCs. These rules should apply only to limited partners in the four states that continue to prohibit limited partners from actively participating in limited partnerships. Furthermore, it would be arbitrary to apply these special rules to LLC members, and not to stockholders in S corporations or general partners in general partnerships. In addition, it would be unnecessary to apply this additional layer of material participation and grouping test to LLC members in view of the otherwise applicable material participation and grouping rules.

Federal Tax Issue #4b: Passive Loss Grouping (Rev. Proc. 2010-13)

Pursuant to Rev. Proc. 2010-13, taxpayers must file passive loss grouping statements with their returns for tax years beginning after January 25, 2010, to avoid the default grouping rule under which each of the taxpayer's activities is deemed to be a separate activity for passive loss purposes. This requirement is an unnecessary trap for the unwary. This unnecessary trap is a concern for aircraft owners, because they may be unaware of this filing requirement and they cannot know whether their aircraft is potentially a separate activity subject to this new requirement to file a grouping statement.

NBAA filed comments with the IRS on November 4, 2008, regarding the IRS proposal in Notice 2008-64 to issue this guidance. (A copy of these comments is attached.)

The grouping statement provides a trap for the unwary, because many taxpayers will be unaware of this required filing. Rev. Proc. 2010-13 attempts to address the trap for the unwary problem by allowing taxpayers to file late grouping statements, except that when the taxpayer is being audited, the taxpayer can only file the grouping statement if the taxpayer has reasonable cause for the previous failure to file the grouping statement. This remedy does not address the trap for the unwary problem, because the "reasonable cause" standard is a high standard which may not apply to taxpayers who are unaware of the requirement to file the grouping statements. See United States v. Boyle, 469 U.S. 241 (1985) ("The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' . . . .").

The grouping statement is also a trap for the unwary, because taxpayers cannot know whether they need to file the grouping statements due to the absence of a definition of "activity" under the passive loss rules. As discussed in NBAA's comments, Treasury abandoned its previous attempt to define the term "activity" and instead issued Treas. Reg. § 1.469-4 stating that what constitutes an activity is within the taxpayer's reasonable discretion. By requiring grouping statements with a default rule that treats each activity as a separate activity for passive loss purposes, the IRS is requiring taxpayers to somehow determine whether they potentially have multiple activities, even though Treasury has deliberately decided as a policy matter not to define "activity." Accordingly, this grouping election requirement directly contradicts Treasury's policy decision to not define "activity;" it is so vague that it is unreasonable to impose it on taxpayers; and it continues to pose an unnecessary trap for the unwary.

Federal Tax Issue #4c: Leasing Company Trap – Depreciation and Passive Loss

The "Leasing Company Trap" consists of two issues: (a) the different rule for measuring qualified business use for aircraft leased to 5% owners and related parties under I.R.C. § 280F (the "Depreciation Issue"), and (b) the prohibition on grouping leasing activities with C corporation businesses for passive loss purposes (the "Passive Loss Issue").

(i) Depreciation Issue: In the case of an aircraft that is used by the company that owns it, § 280F generally permits the company to use bonus and MACRS depreciation (rather than the Alternative Depreciation System), if the company uses the aircraft at least 25% for business purposes with the personal flights treated as fringe benefits provided to employees. In the case of an aircraft that is leased to a 5% owner or related party, § 280F generally permits the lessor to use bonus and MACRS depreciation (rather than ADS), if the aircraft is used at least 25% by passengers unrelated to 5% owners or related parties. If such a leased aircraft fails this 25% unrelated passengers test, the IRS has held in Tech. Adv. Mem. 2009-45-037 (Jul. 29, 2009) that the lessor cannot meet the 50% qualified business use test in § 280F based on the lessee's business use of the aircraft.

There is no logical reason for aircraft leased to 5% owners or related parties to be precluded from meeting the 50% qualified business use test based on the lessee's qualified business use. That interpretation by the IRS in TAM 2009-45-037 is not required by the statute or regulations. The IRS should issue guidance permitting qualified business use for leased aircraft to be measured by the lessee's percentage of business use.

(A memorandum explaining this problem in more detail is attached.)

(ii) Passive Loss Issue – An individual can group non-leasing activities conducted in pass-through entities with activities conducted in closely-held C corporations for the purpose of determining material participation. However, grouping is not allowed if the pass-through entity is leasing an asset to a C corporation. This arbitrary distinction creates artificial suspended passive losses for aircraft leased to C corporations, even when the owner of the aircraft also owns the C corporation and materially participates in its business.

There is no logical reason for this difference in the grouping rules for leasing and non-leasing activities. The passive loss Regulations (under Treas. Reg. § 1.469-4(d)(5)(ii)) should be amended or other guidance should be issued to clarify that a leasing activity in a pass-through entity can be grouped with a business activity in a closely-held C corporation.

(A memorandum explaining this arbitrary distinction in more detail is attached.)

Federal Tax Issue #5a: Federal Transportation Excise Tax - Audit Technique Guide

In 2008, the IRS completed and published its Excise Tax – Air Transportation Audit Techniques Guide (ATG) covering taxes on amounts paid for certain transportation of persons and property by air, and on fuels used in aviation. Business aircraft operators generally pay fuel taxes, and on certain operations such as air charter transportation, collect and remit air transportation taxes, determined on a flight-by-flight basis and subject to exceptions. However, the ATG raised a number of questions for business aircraft operators, including what factors determine when the air transportation tax applies and whether the tax applies to certain common business aviation operations arrangements.

NBAA sent its preliminary questions to the IRS, and met with then chief of excise tax, policy managers, policy analysts, coordinators and counsel in February 2009. At the meeting, the IRS proposed an industry director's directive project, similar to the Sportfishing Association Excise Tax Initiative. In 2009, NBAA and the National Air Transportation Association (NATA) assembled a group of industry participants to meet with the IRS on the issues. Two meetings were held in early 2010, with industry participants meeting with Jody Angelo, Senior Excise Tax Policy Analyst, Air Transportation, Foreign Insurance, ODCs & International Issues with the IRS. No further meetings have been held due to IRS travel restrictions, lack of involvement by IRS counsel's office, and concerns the FAA Reauthorization could make sweeping changes in the Excise Tax.

At this point, it does not appear that FAA Reauthorization will alter the basic principle that air transportation is subject to excise tax. The areas of uncertainty remain, but in the meantime the business aviation industry has experienced an increase in federal excise tax audits. NBAA urges the IRS to resume the meetings and work toward updated and relevant guidance on federal excise taxes.

Federal Tax Issue #5b: Federal Transportation Excise Tax – SMLLC Issue

The check-the-box regulations under the entity classification rules were amended as of January 1, 2008, to provide that single member LLCs ("SMLLCs") are respected entities for Federal Transportation Excise Tax ("FET") purposes. Treasury viewed this as a purely administrative change, but it has significant unanticipated substantive effects. This unintended change in the substantive law can impose substantial and unexpected FET liabilities on individuals and companies that structured their aircraft arrangements in SMLLCs in reliance on the disregarded treatment of SMLLCs. Since there was no intent to change substantive law regarding the application of FET to aircraft held in SMLLCs, we request that the change in the check-the-box regulations with respect to FET be repealed retroactively.

NBAA submitted comments on this issue on December 14, 2009, with a revision on December 18, 2009. (A copy of the revised version of these comments is attached.)