BURNS & LEVINSON LLP

CLIENT UPDATE

What's Happening in Business Aviation?

May 2013

This edition of the Burns & Levinson Business Aviation Report covers new developments in the following areas of business aviation:

- Rentals from leasing aircraft may be subject to the new 3.8 percent tax on net investment income.
- Entertainment use regulations issued.
- Bonus depreciation is renewed at 50 percent for aircraft purchased in 2013 and for certain aircraft delivered in 2014.
- Owners must monitor personal use to ensure prior year bonus depreciation is not recaptured.
- FAA modifies "Schwab" rule to permit executives' reimbursement of employers for certain personal use of aircraft.
- Legislation generally exempts fractional interests from transportation excise tax, yet IRS continues to push for excise tax on aircraft management fees.

Business Aircraft and the New 3.8 Percent Tax on Net Investment Income

Closely held businesses that own or use aircraft through an intercompany lease arrangement should review their aviation legal structure to determine whether the new 3.8 percent tax on net investment income ("NII") applies to the company's intercompany rental income. The NII tax, enacted as part of the Health Care and Reconciliation Act, applies to investment income, which generally includes rental income, unless the rental income is earned in the ordinary course of a trade or business.

Pursuant to proposed regulations, the scope of a trade or business for purposes of the NII tax will be based on grouping rules applied by the taxpayer for purposes of the passive loss limitation rules (IRC section 469). The passive loss rules deny deductions for net losses from passive activities. In determining whether an activity is passive and whether a loss exists from an activity, passive loss rules permit taxpayers to group undertakings in appropriate economic units. The IRS normally requires groupings to remain the same from year to year.

The proposed NII regulations grant a one-time "fresh start" that allows taxpayers to select new groupings to take into account the new NII tax and existing passive loss restrictions.

Recommendation: Review your aircraft ownership structure and consider filing new passive loss groupings for 2013 or 2014.

Final Entertainment Use Regulations Issued

In July of 2012 the IRS issued final regulations relating to the use of aircraft for entertainment. The regulations adopt the IRS' position that aircraft costs must be allocated to all passengers. Entertainment disallowance is based on each passenger's principal purpose for travel, even if the principal purpose of the overall flight is not entertainment. The regulations also clarify that interest expense is subject to disallowance if the debt giving rise to the interest is secured by or properly allocable to an aircraft.

The IRS rejected several comments by taxpayers suggesting the disallowance be calculated by aggregating and averaging expenses from all aircraft owned by the taxpayer, or by reference to the cost of chartering similar aircraft. However, the final regulations authorize the IRS to adopt a charter rate or other safe harbor in the future.

The regulations retain the option for taxpayers to calculate the disallowance for depreciation allocable to entertainment on a straight line basis over the aircraft's class life (generally six or twelve years). The straight line election applies to all aircraft owned by a taxpayer, and is subject to a consistency rule so long as the taxpayer owns any of the aircraft. The final regulations provide that the amount of the disallowance in any year cannot be larger than the depreciation deduction. The election is not beneficial in all cases, and each taxpayer should carefully review its situation before making the election.

The final regulations follow the proposed regulations in regard to allocating the cost of deadhead flights to entertainment. Commentators requested that the IRS provide numerical examples applying the deadhead rules, and the IRS obliged, but the new examples may contain a subtle error. Whether the apparent error is helpful or harmful depends on specific facts, but with some caution, taxpayers may be able to use the anomaly to their benefit.

Recommendation: Review your entertainment use and related policies to ensure compliance with the final entertainment use regulations. Consider straight line depreciation for calculating the disallowance, and examine the deadhead rules for allocating costs to entertainment.

Bonus Depreciation Renewed

The American Taxpayer Relief Act of 2012 extended bonus depreciation for another year at a 50 percent rate. The revived 50 percent bonus depreciation applies to aircraft (including fractional interests) acquired in 2013 so long as the acquisition is not pursuant to a written binding contract that was in effect before January 1, 2007. An aircraft acquired pursuant to a written binding contract in effect before January 1, 2014 (but not in effect before January 1, 2007) is eligible for 50 percent bonus depreciation if placed in service before January 1, 2015, but only as to that portion of its adjusted basis attributable to manufacture or production before January 1, 2014.

Recommendation: Consider whether tax savings from bonus depreciation justifies the acquisition of a new aircraft for delivery in 2013 or 2014.

Bonus Depreciation Recapture

Taxpayers who claimed bonus depreciation in prior years should carefully monitor the level of personal use under the "listed property" rules. A portion of bonus depreciation may be recaptured if personal use exceeds 50 percent in any year during the depreciable life of the aircraft. The personal use rules overlap the entertainment

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rules, but differ in important ways.

Recommendation: Taxpayers should analyze personal use levels of aircraft on an ongoing basis, and should defer or rearrange personal flights that would cause depreciation recapture.

FAA Modifies Schwab Rule

In 1993 Charles Schwab & Co. requested that Mr. Schwab be permitted to reimburse the company for the full cost of his personal use of the company's aircraft. The FAA took the position that Federal Aviation Regulations did not permit the company to charge officials, employees, and guests who were carried on a company airplane for vacation, a pleasure trip, or similar purposes. The Schwab rule, as it came to be known, created an inconvenient inconsistency between FAA rules and other requirements, such as tax and SEC disclosure.

Many public companies prefer to have executives reimburse them for the incremental cost of personal use of company aircraft to avoid the need for public disclosure under SEC Regulation S-K. This practice was prevented in many cases by the Schwab rule.

On March 1, 2010, the FAA modified the Schwab rule to permit reimbursement by certain employees up to the full cost of personal flights operated under section 91.501(b)(5). The FAA justified the modification based on advances that allow executives to work on company business while traveling for personal reasons. Changes in communication technology now allow executives to be available 24/7, which wasn't the case when the Schwab rule was adopted.

The rule, which comes with new administrative compliance requirements and will apply to a limited number of executives in any company, is a welcome expansion of Part 91 options.

Recommendation: Consider taking advantage of the new flexibility in accepting reimbursement for certain personal flights by executives, but ensure reimbursement is pursuant to written policies that comply with the modified rule.

Federal Aviation Excise Tax: Fractional Interests and Management Companies

The federal transportation excise tax ("FET") applies to domestic commercial flights at a rate of 7.5% of the amount paid for the flight, plus $3.90 per person for each segment. The IRS continues to audit, assess, and litigate FET issues.

Fractional Interests. Despite the IRS' unrelenting approach to FET audits, Congress prospectively repealed the FET on flights by holders of at least a 1/16th share (1/32nd in the case of a helicopter). To partially offset the revenue loss caused by this repeal, Congress enacted a surtax on fuel used in fractional ownership programs. The repeal of the excise tax expires, by its terms, on September 30, 2015, whereas the imposition of the fuel tax sunsets on September 30, 2021. Supporters of the FET repeal will seek to have it extended past 2015 and ultimately made permanent.

Management Companies. Notwithstanding taxpayer favorable developments on the fractional interest front, the IRS continues to argue that FET applies to payments made by aircraft owners to management companies. FET applies only to transportation, yet the IRS argues that payments for a broad array of services are for transportation, even for owners who fly their managed aircraft under Part 91. Management companies, in contrast, have taken the position that fees for transportation encompass only direct costs related to a specific flight. At issue are monthly management fees and other reimbursements, which generally cover such costs as aircraft and engine maintenance, cleaning, recordkeeping, scheduling, flight planning, weather services, pilot and crew training, and similar items. Presently, managers are typically not collecting FET on management fees, yet that may change as the IRS presses its case. Our view is that the IRS has a weaker position than aircraft mangers, but it may take a court or legislation to resolve this issue.

Recommendation: An efficient aircraft ownership structure should take Federal transportation excise tax into account. Some structures may cause FET to apply, whereas other arrangements may avoid the imposition of FET. Taxpayers should ensure that FET risks and opportunities are properly considered.

Important 2013 Rates

FET. Federal excise taxes on commercial air transportation, effective January 1, 2013, are:

Percentage Tax: 7.5%
Domestic Segment Fee: $3.90
International Arrival/Departure Head Tax: $17.20
Hawaii/Alaska Flight Tax: $8.60

Standard Industry Fare Level Rates.
(January 1, 2013 through June 30, 2013)

Terminal Charge: $48.54
Mileage Rates: Up to 500 miles = 26.55¢ per mile
501 to 1500 miles = 20.24¢ per mile
Over 1500 miles = 19.46¢ per mile

US tax analysis and discussion contained in this communication is of a general nature and is not intended to address the circumstances of any particular person. We endeavor to provide complete, accurate, and timely informaiton, but we cannot guarantee that this information is accurate as of the date it is received or that it will continue to be accurate in the future. Taxpayers should seek advice from a tax advisor based on the taxpayer's particular circumstances.

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