'Ordinary and necessary' are key words in determining whether business travel in private planes is allowable by IRS. Tax aspects of depreciation, business entertainment and educational expenses, are other areas examined

Tax Savings For Flyers: Part II

■■ Last month we talked about usual Federal income tax credits and deductions which are available to aircraft owners whether or not these credits and deductions are business-related. This month we will review some of the business-related tax deductions.

As we said in the February issue, these comments are necessarily general and deal with the more typical situations. You should consult your attorney or tax adviser about any questions on your particular situation. The footnotes giving the citations to the cases discussed are included for their information.

Travel Expenses

The usual form of deducting all or part of the cost of operating a private aircraft is as a business travel deduction. The general rule is that a taxpayer is allowed to deduct all of his ordinary and necessary trade or business expenses, including the cost of travel in private aircraft. As this general rule implies, there are two basic requirements that must be met. The expense must be incurred in a *trade or business* carried on by the taxpayer, and the expense must be *ordinary and necessary.* The problem with deducting aircraft operating expenses usually revolves around whether such costs are *ordinary and necessary.* The *trade or business* requirement has not proved to be a major stumbling block.

Years ago, AOPA went to the Commissioner of Internal Revenue to determine "whether the deductibility of traveling expenses as business expenses for Federal income tax purposes is affected by the fact that the travel is by nonscheduled air carrier, private or personal plane, in lieu of the older types of transportation such as automobile, bus or railroad." In 1949, and again in 1956, the Commissioner assured AOPA that travel expenses meeting the two tests are deductible "irrespective of the mode of travel." And this is still true. But, as we said earlier, the problem has been to meet the *ordinary and necessary* requirement.

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

The typical problem of the employee is that the cost to him of operating his aircraft on business trips exceeds the reimbursement made to him by his employer. He would like to deduct the excess. Employees have not fared too well in their battles with IRS to accomplish this.

In last year's tax article (March 1970 PILOT, by William A. Rosoff) two cases were cited where an employee's costs of operating an aircraft were disallowed as not *ordinary and necessary* expenses.

The first [1] involved a sales representative whose responsibilities occasionally required him to travel to different parts of this country. In 1964, he flew his *Apache* approximately 100 hours, of which 75 hours were attributable to business trips for his employer, and 20 hours were attributable to trips to look after his investment properties. His reimbursement from his employer was limited to standard commercial airline rates. He claimed a deduction of 95% of his aircraft operating expenses less reimbursements. This deduction was disallowed by IRS. On appeal, the Tax Court agreed with IRS, relying heavily on the fact that the employer refused to reimburse beyond the commercial airline rates. "In other words, in the judgment of his employer the additional expense was not considered to have been appropriately incurred." The Court disallowed the portion of the deduction relating to the investment properties because it was not "ordinary and necessary" to the management, conservation or maintenance of the properties.

The other case [2] involved an employee who at first was a consultant and later chief executive officer and chairman of the board of a company in the molded paper pulp products business. He flew his own airplane on company business but did not seek reimbursement from his company for his costs of maintaining and operating the plane. IRS disallowed the deduction of the aircraft operating costs attributable to business use, and the Tax Court agreed. The Tax Court held that if a corporation which reimburses its officers and employees for expenses does not reimburse for a particular expense (cost of business travel in personally owned plane), "that expense *prima facie* is personal either because it was voluntarily assumed or because it did not arise directly out of the exigencies of the business of the corporation." This case is on appeal.

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

The most recent case [3] in this area denied a medical doctor a business expense deduction for unreimbursed expenses incurred in using his plane on trips benefiting the pharmaceutical firm which employed him. At first, the doctor was reimbursed by his employer based upon first-class air fare. Thereafter, the company discontinued any reimbursement for costs associated with the business use of privately owned airplanes. The doctor continued using his airplane on business trips. In holding that IRS properly disallowed the expenditures, the Tax Court said, "Where an employee, knowing that reimbursement will not be forthcoming, voluntarily undertakes a course of action on behalf of his employer, any expenses arising from such an undertaking are normally viewed as being *prima facie* personal."

These cases are major stumbling blocks to the deduction of an employee's cost of business travel in his own aircraft. But a recent revenue ruling may indicate some softening in the IRS position.[4] This ruling allowed a government employee to deduct his expenses, including depreciation, of operating his own aircraft on government business. The facts are sketchy. "During 1969, the taxpayer was required to travel extensively in connection with his employment. Although he was not required to use his privately owned airplane for business travel, due to the urgency of his trips he was permitted to do so. He was issued overall travel authorizations which provided authority for travel by 'privately owned auto or aircraft' among other possible means of transportation. The taxpayer was reimbursed for his travel at a standard rate based on the total miles traveled on official business. *Held*, the travel expenses incurred by the taxpayer in excess of his reimbursement are deductible as ordinary and necessary business expenses."

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

This was confirmed in a 1963 case which held that a partnership's expenses of owning and operating aircraft used roughly one-half for business and one-half for personal use are deductible in proportion to the expenses for business use.[5] One interesting sidelight in this case is that there was some flying time that was neither attributable to business use nor personal use. Presumably this unaccounted time included proficiency time. This time was "allocated between the business and personal use on a percentage basis." This suggests that when an aircraft is used for business flying a substantial part of the time, proficiency flying is deductible in the same proportion as the business flying. If the aircraft is used exclusively for business, and the pilot flies only on business, the proficiency time should be fully deductible.

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

Depreciation

Where all or a portion of the costs of operating a private aircraft are deductible, these costs (such as gas, oil, maintenance, inspection, hangar rent, insurance, etc.) are fairly simple to compute. The one exception is depreciation. The aircraft depreciation deduction is the amount allowed each year for the usual wear and tear on an aircraft used in a trade or business.

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

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

It is beyond the scope of this article to explain in detail the other methods. Suffice it to say that the declining balance method and the sum of the years' digits method allow the larger depreciation in the first year and a lesser depreciation in each succeeding year. If you use the declining balance method, you can use a rate up to double the straight line rate on new property, and up to 150% of the straight line rate on used property.

Bonus Depreciation

In addition to regular depreciation, any taxpayer (except a trust) may elect to write off up to 20% of the cost of a new or used aircraft for the first taxable year for which a depreciation deduction is allowable to the taxpayer. This "bonus" depreciation is computed on the cost of the aircraft without reduction for salvage value. The remaining cost, after reduction for bonus depreciation and salvage value, is depreciable as already explained above. The bonus depreciation applies only to aircraft with a useful life of at least six years. It is allowable to the extent of $10,000 of cost ($20,000 on a joint return).

New Business Depreciation Rules

In order to stimulate the economy, the Treasury Department announced on Jan. 11, 1971, new business depreciation rules which relax the existing rules in certain limited areas. The new rules (1) allow greater flexibility in determining useful life, (2) terminate the complex "reserve ratio test", and (3) liberalize the practice of determining how much deduction can be taken in the first year for an asset put in service during the year. These rules are rather complex, and beyond the scope of this article. You should check with your tax adviser to determine if, and how, your particular operation can benefit from the new rules.

Business Entertainment

The costs of operating an aircraft may be deducted if the aircraft is used for business entertainment. The taxpayer must establish (1) that the aircraft was used *primarily* for furtherance of the taxpayer's trade or business, and (2) that the expenses were directly related to the active conduct of the taxpayer's trade or business. According to the regulations, an aircraft is deemed to meet the primary test if more than 50% of hours flown during the taxable year was in connection with travel considered to be ordinary and necessary. However, a taxpayer is not precluded from satisfying the primary use requirement according to a different measure, if reasonable. What are expenses "directly related" to the active conduct of the trade or business in the second requirement? The IRS has a very complicated test. But simplified, or rather oversimplified, the test is that some *bona fide* business actually be transacted during the entertainment period with some real expectation of a business benefit.

Educational Expenses

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

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

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

In a recent Tax Court case, an FAA medical examiner (a private medical doctor designated to give flight medical exams) was allowed to deduct his flying expenses because his flying served as training to maintain and improve his skills as a medical examiner.[6]

However, educational expenses are not deductible if incurred to meet the *minimum* educational requirements for qualification in taxpayer's present employment, trade or business, or if taken to qualify the individual for a *new* trade or business. Thus, if a person obtains a pilot's license to fly on business, the cost of obtaining it would probably not be deductible. A deduction of this sort is not allowed any more than the cost of learning to drive an automobile. By the same token, the costs of education leading to an instructor's rating would not be deductible to an instructor. This is no more deductible than the cost of law school is to a lawyer.

A recent case is illustrative of the problem. An accountant sought to deduct the cost of acquiring his private pilot's license. He occasionally traveled out of town on business and his firm permitted him to travel by private plane, reimbursing him at commercial air travel rates. IRS denied the deduction and the Tax Court agreed. The Court said, "on this record we cannot find a sufficient connection between the expenditures (for learning to fly) and the business of an employee to allow the deduction."[7] A corporation which paid for the flight training of its president ran into the same problem—the expenses of flight training were disallowed as a business deduction.[8]

Record Keeping

One of the secrets to the deductibility of the expenses we have discussed is complete and detailed records. In our experience, those who have been most successful in persuading IRS of the propriety of their deductions have been those who had carefully kept logbooks fully substantiating the deductions. □

FOOTNOTES

[1] *John T. Harley, Jr.*, 28 T.C.M. 1186, P-H Memo T.C. ¶69,225 (1969).
[2] *Robert G. Fairburn*, 28 T.C.M. 438, P-H Memo T.C. ¶69,077 (1969).
[3] *Richard L. Westerman*, 55 T.C. No. 48, ¶55.47 P-H T.C. (1970).
[4] Rev. Rul. 70-558, 1970 Int. Rev. Bul. No. 45, at 8.
[5] *Hitchcock v. U.S.*, 8 Av. Cas. 17953 (E.D. Wash. 1963).
[6] *Keith W. Shaw*, 28 T.C.M. 1359, P-H Memo T.C. ¶69,120 (1969).
[7] *Paul Katz*, 29 T.C.M. 511, P-H Memo T.C. ¶68,016 (1968).
[8] *Gibson Products Company*, 8 T.C. 654 (1947).

Notes From The Washington Counsel

by JOHN S. YODICE/ AOPA 199738