

# From the Washington Counsel

by JOHN S. YODICE



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## Checklist of Tax Savings: Part Two

Last month we talked about an aircraft owner's business-related federal income tax credits and deductions. This month we will review deductions and credits that are available to an aircraft owner whether or not his aircraft is used in a trade or business.

As we said in the January issue, these comments are necessarily general and deal with the more typical situations. You should consult your attorney or tax advisor about any questions on your particular situation.

### Sales Tax

Any retail sales tax on the purchase of an aircraft or any aircraft equipment, whether imposed by a state or a city, is deductible.

Taxpayers who itemize their deductions may utilize the published schedule of standard sales tax deductions contained in the official instructions for Form 1040. These schedules are graduated according to income and family size. A deduction based on the schedule will normally be accepted without question. A taxpayer who claims a deduction in excess of the amount indicated in the schedule may be required to substantiate his entire deduction.

If you purchase an airplane or any expensive aeronautical equipment during the year, chances are your total sales tax payments exceed the amount allowed in the schedule. The question is, can you add the sales tax on these expensive items to the amount allowed in the schedule?

The purchase of an automobile has for some years been one item that can be added to the schedule amount without triggering the necessity of substantiating all of your sales tax payments for the year—only the tax on the automobile need be substantiated. The same rule now applies for aircraft. The aircraft must have been taxed at

the general sales tax rate, and the seller must have stated the tax separately and included it in the total amount paid.

Of course, you don't have to use the schedule. You can always deduct the actual total sales tax you paid during the year. But, if you don't use the schedule, you must be able to substantiate the amount of sales tax paid.

### Interest

The interest you pay on your aircraft or equipment loan is deductible, as is any other interest you pay. In fact, taxpayers sometimes fail to take full advantage of this deduction. If you have prepaid your aircraft loan during the taxable year, chances are you had to pay a penalty. These penalty payments are also deductible as interest.

A common problem is determining the amount of the interest deduction. Most of us make monthly payments that do not vary in amount from month to month. So the amount of interest paid each month varies from month to month because the unpaid balance is continually declining. Unless your bank or finance company advises you how much you paid in interest during the taxable year, you must compute the amount.

One simple method is to determine the total interest payable on the note, then divide that amount by the total number of monthly payments. This gives you an average monthly interest payment. Your deduction would be this amount times the number of monthly payments paid (or, if you are an accrual basis taxpayer, accrued) during the taxable year.

This method does not determine exactly what you paid in interest during the year, but if you use the method consistently over the life of the loan, you will get all of the interest deduction to which you are entitled. There are more precise, and more complicated, methods for computing your interest deduction. Your tax advisor can assist you in determining which to use.

One caveat on the interest deduction. Under certain circumstances, you can be deemed to have bought your aircraft for investment, and your interest deduction will be limited. For example, you may have purchased an aircraft, and then leased it back to the FBO who sold it, or leased it to a company you control. This has the advantage of giving you, the aircraft owner, the depreciation deduction, the investment credit, and, hopefully, a cash flow large enough to amortize the indebtedness generated by purchasing the aircraft. Some lease-backs, how-

ever, are considered to be "net leases." If yours is, your annual interest deduction cannot exceed \$10,000.

The aircraft is subject to a net lease in either of two circumstances. First, a net lease exists if you as the lessor are guaranteed a specific return, or are guaranteed against loss of income. Second, if expenses deductible solely as trade or business expenses (excluding rent paid and reimbursed expenses) are less than 15% of the rental income, the arrangement is a net lease.

### Personal Property Tax and Aircraft Licensing Fees

Some states and localities impose a personal property tax on aircraft. All property taxes are deductible by the person against whom imposed—that is, the person against whom assessed. So, an aircraft property tax is deductible.

State aircraft licensing fees create a more complicated situation, particularly in those states where the fees are imposed in lieu of the personal property tax. If an aircraft is used in a trade or business, or for the production of income, such fees should be deductible as trade or business expenses. But if the aircraft is used for personal purposes, a licensing fee, as such, is not deductible unless it can be considered a personal property tax.

In order for it to be considered a personal property tax, the fee must be *ad valorem*, that is, the fee must be substantially in proportion to the value of the aircraft. A fee based on aircraft weight or horsepower or passenger seats will probably not be considered *ad valorem*, but a fee based on the value of the aircraft should be deductible. If there is a minimum flat fee and then an additional fee based on the aircraft's value, the amount of the fee in excess of the minimum flat fee is deductible.<sup>1</sup>

It is my personal view that an aircraft licensing fee that is in lieu of personal property tax should be deductible as a personal property tax, but so far we haven't had an IRS ruling on it.

Some of our members have raised a question about the deductibility of the federal use tax (\$25 plus 2¢ per pound over 2,500 pounds for piston aircraft and 3½¢ per pound for turbine-powered aircraft). Unfortunately, it is clear that the federal use tax on aircraft is not deductible.

### Federal Gas and Oil Taxes

For some years, an aircraft owner was able to take a credit on his federal income tax return of 2¢ for each gal-



lon of gasoline used in his aircraft during the taxable year. Unfortunately, this tax credit was eliminated as of July 1, 1970, by the Airport and Airway Revenue Act of 1970. This is the so-called "user-charge" legislation, which imposed a 7¢ per gallon gasoline tax on noncommercial aviation.

However, the legislation did not eliminate the tax credit for aviation lubricating oil. You are still allowed a credit of 6¢ per gallon. In order to claim the oil tax credit, Internal Revenue requires that you complete and attach Form 4136 to your return to support the credit taken.

## State Fuel Tax

In addition to the federal fuel taxes, many states and localities also impose aviation fuel taxes. To the extent that these taxes are not refunded to you, you can deduct them. Notice that the state fuel taxes are a deduction, not a credit. The state or local fuel tax deduction would be taken on the line "State and local gasoline" on Schedule A of Form 1040.

## Casualty Losses

If you itemize your deductions, you can deduct your losses that are not compensated for by insurance or otherwise, and that arise from "fire, storm, shipwreck, or other casualty, or from theft." The terms "fire," "storm," "shipwreck" and "theft" are specific enough not to raise many questions. The questions presented usually involve the meaning of the term "other casualty." But, any unreimbursed property damage arising from an aircraft accident is almost certainly deductible. If it is not specifically a "shipwreck," certainly it is of a sufficiently similar character to be classified as an "other casualty." Similar losses occasioned by natural or other external forces in an event due to some sudden, unexpected or unusual cause are deductible.

Note, however, that IRS draws the line at losses reflecting a steady deterioration, or caused by other than external causes. Rusting, corrosion or other natural deterioration of an aircraft is not a casualty loss, nor is engine damage or failure due to normal wear and tear.

The amount of the deduction depends on how the property was used. If the property was not used in a trade or business, or to produce income, there are two basic limitations. First, there is a \$100 "floor" on the deduction. That is, the first \$100 of loss is not deductible. This limitation is applied on a casualty-by-casualty basis.

Second, the deduction is limited to the lesser of (1) the difference between the fair market value of the aircraft before the casualty and after, and (2) the aircraft's adjusted basis (essentially your cost). For example, assume that, before the loss, an aircraft had a fair market value of \$25,000 and an adjusted basis of \$15,000, and that the aircraft is totally destroyed. The deduction would be limited to \$14,900

(\$15,000 minus \$100).

If the aircraft was used in a trade or business and is totally destroyed, the rule is somewhat more liberal. The taxpayer can always deduct an amount equal to the aircraft's adjusted basis (essentially your cost less depreciation), even if the fair market value at the time of the casualty was less than the adjusted basis.

### Charitable Contributions

Individuals may deduct certain contributions to civil defense organizations set up under federal, state or local law. To be deductible, an expense must be directly connected with, and solely attributable to, the volunteer service you render. To illustrate, you should have no problem deducting the direct cost of operating your aircraft on a CAP mission. But you cannot deduct the general overhead of operating the aircraft. This type of expense isn't considered solely attributable to your volunteer service.<sup>2</sup>

Equipment donated to the CAP for its use should also be deductible. To deduct the full cost of the equipment, however, you should be prepared to convince IRS that you are not making personal use of it. One taxpayer lost part of his deduction for the cost of donated radio equipment because he retained control of the equipment and was able, by minor changes, to convert it back for his personal use.<sup>3</sup>

CAP uniforms, and the cost of cleaning them, may also be deducted. Other unreimbursed out-of-pocket expenses such as travel and mailing expenses can be deducted if they satisfy the charitable contribution test set forth above.

### Veterans Benefits

Finally, a word concerning the amounts the Veterans Administration (VA) pays for certain flight instruction. As discussed in the last article, flight instruction is sometimes deductible as an educational expense. Amounts reimbursed by the VA for flight instruction are however, tax-free. So, members often ask whether VA reimbursement prevents their taking an otherwise allowable deduction for instructional expenses. The answer, happily, is no. Even though the amounts you receive from the VA aren't taxed, you can still take an otherwise-allowable deduction.<sup>4</sup> This is one of the rare instances where IRS allows you what is in effect a double benefit. □

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### Notes

1. Rev. Rul. 71-471, 1971-2 Cum. Bull. 122.
2. Rev. Rul. 58-279, 1958-1 Cum. Bull. 145.
3. *Larry Miller*, 34 T.C.M. 1207 (1975).
4. Rev. Rul. 62-213, 1962-2 Cum. Bull. 59.