Passive Activity Loss

Can you afford to overlook it? by Edward Kammerer & Katie Ahern

In challenging economic times such as these, aircraft owners are constantly looking for ways to make their operations more efficient. In order to defray expenses and to generate income, owners may enter into leases, timesharing arrangements or charter agreements.

In certain states, utilizing a lease structure for aircraft operations may result in sales tax savings for the owner. However, even amidst otherwise careful planning, one tax issue is frequently overlooked, often resulting in a substantial and surprising tax liability – the passive activity limitation.

The passive activity limitation disallows the deduction of losses from passive activities. Since deductions for the depreciation of an aircraft are often a substantial contributor to an overall loss of the business, this limitation typically means that an aircraft owner is not able to deduct the depreciation of the aircraft.

This limitation may affect individuals, estates, trusts, partners, LLC members, and certain closely-held C corporations. The passive activity limitation typically limits losses (1) whenever the person seeking to deduct a loss from an activity does not "materially participate" in that activity, or (2) whenever the activity at issue is a leasing activity.

So, for example, let's say John Smith, a real estate developer, is the sole member of Up, LLC. John makes $400,000 per year as a developer. Let's say Up, LLC owns an airplane, which it leases to Sky, Inc. Now let's further assume Up, LLC experiences a $400,000 loss for the taxable year, due primarily to the large depreciation deductions for the airplane.

John expects that the loss will flow through to his individual tax return, offsetting the $400,000 he earned as a developer. Unfortunately, John may be in for an unpleasant surprise, as passive losses may not generally be used to offset income from other sources.

MATERIAL PARTICIPATION

If John does not materially participate in the business of Up, LLC, his ability to deduct Up's losses are limited. In order to materially participate, John must be regularly, continuously and substantially involved in Up's activities.

John may have difficulty showing that he materially participates in Up's activities, because he has a separate career as a developer, and Up is not his principal business. Fortunately, regulations offer a series of specific rules to identify what generally constitutes material participation. For example, John may not be subject to the passive › activity limitation in any of the following situations:

- John participates in Up's activities for over 500 hours during the year.
- John is the only person who participates in Up's activities.
- John participates for over 100 hours during the year and no one else participates more than John.
- John did materially participate in the activity for five out of the last ten years.

Additional material participation standards are available under the rules. John may need to analyze his situation under those standards if he cannot meet any of the above.

Aircraft owners frequently face challenges in meeting the material participation standards for several reasons. Like John, aircraft owners often have other businesses on which they focus their attention. As a result, their participation in the aircraft-related activity may be lower than other individuals. Also, not all participation is considered in the owner's material participation total.

For example, the following efforts of an owner may not count toward material participation:

- Approving proposed charter customers or trips;
- Work not customarily performed by an owner;
- Studying and reviewing financial statements or reports on operations;
- Preparing or compiling summaries or analyses of finances or operations for the owner's own use; or
- Monitoring finances or operations in a non-managerial capacity.

Finally, an airplane may be used by someone other than the owner, such as under a charter or timeshare arrangement. In other words, when an aircraft owner relinquishes control of the aircraft, they may also sacrifice the tax benefits of the airplane's depreciation.

Therefore, it is important that aircraft owners understand the material participation rules, which provide predictability by enabling an owner to determine whether his or her involvement in an activity for an upcoming year will constitute material participation. Such an understanding allows an owner to conduct his or her tax planning accordingly and to more accurately evaluate the bottom-line financial result of a proposed use of the airplane.

LEASING

Leasing activity is generally treated as passive activity, regardless of whether the material participation tests are met. Let's assume John participates in Up's activities for ten hours per week, for a total of 520 hours during the year. John has participated for over 500 hours during the year, and therefore, he may meet the first material participation standard above. However, since Up's only activity is leasing, John may still be subject to the passive activity limitation.

Fortunately, with careful planning, airplane owners may take advantage of exceptions to this general leasing rule. For example, leasing exceptions may be available in the following situations:

- Certain short-term leases;
- Personal services, such as pilot services, are provided with the airplane;
- Lease of the airplane is incidental to a non-lease activity;
- The aircraft is customarily made available during defined business hours for non-exclusive use, such as a company airplane made available for personal flights when not in use by the company.

Like many of the passive activity rules, the leasing exceptions are relatively complex and their potential application must be carefully analyzed in each situation.

EFFECT OF PASSIVE ACTIVITY LIMITATION

Again, the passive activity limitation disallows the deduction of losses from passive activities. Instead, any loss resulting from a passive activity may only be used to offset income from other passive activities.

Such offsetting passive income may include certain rental income, or income from other activities where material participation is lacking. The disallowed passive losses may not be used to offset income from sources such as interest, dividends, annuities and certain royalties. The practical result is often an airplane owner who is unable to make use of depreciation deductions for the aircraft.

Passive activity losses in excess of offsetting passive income may not be deducted. The excess passive activity losses are instead carried forward to the next taxable year. In other words, if there is no passive activity income to offset the passive activity loss in one year, the loss is carried forward until there is passive income in another year or until the entire interest in the activity is sold.

When an individual disposes of his or her entire interest in the activity and recognizes a corresponding gain or loss, any previously disallowed losses that are carried over from ›

previous years are generally allowable at that time. So, for example, if John is unable to deduct his share of the losses, he may need to wait until he sells his membership interest in Up, LLC to deduct those losses.

GROUPING ACTIVITIES

At this point, John is presumably rather unhappy but need not give up hope just yet. John may yet be saved by the so-called grouping rules.

Let's assume John does materially participate in Development, Inc., his real estate development practice. John participates in real estate projects worldwide. Assume further that the airplane is used solely to transport John to his various project sites. In this scenario, we can put aside John's leasing problems for now and assume that John's passive activity problem results solely from his lack of material participation in Up, LLC.

John may assert that, because the airplane supports the activities of Development, his real estate development business and the ownership and operation of the airplane are really all one activity.

More importantly, that one activity is an activity in which John materially participates, and therefore, he should be allowed to deduct any losses of Up, LLC. In some cases, leasing activities may also be grouped with other activities.

To determine whether the grouping approach is appropriate, the airplane owner should consider the following factors:

- How are the applicable businesses similar?
- How are they different?
- Are they under common control?
- Are they under common ownership?
- Are they located in the same place?
- Does the activity of one business depend on the activity of the other(s)?
- Do they buy and sell goods among themselves?
- Do they have the same customers?
- Do they involve services that are normally provided together?
- Do they have the same employees?
- Do they share books and records?

Airplane owners should also be aware of new reporting obligations that apply to the grouping rules. The Internal Revenue Service now requires that taxpayers report certain groupings of activities, regroupings of activities, and the addition or disposition of activities within existing groups. The required written statements must generally accompany the taxpayer's original income tax return for the year in which activities are grouped, added, regrouped, etc.

Special rules apply for groupings by partnerships and S corporations. If the grouped activities are not properly and timely reported, the activities will typically be treated as separate activities. In other words, if the reporting rules are not followed, the taxpayer may lose the opportunity to deduct losses.

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A WORD OF CAUTION…

It should be noted that this article is limited to a description of certain general rules regarding the passive activity loss limitation. However the rules surrounding these issues are fairly complex and each situation must be carefully analyzed in order to plan an effective solution. Additionally, a host of other tax and regulatory rules apply to the ownership and operation of aircraft.

Aircraft owners should take caution because an effective planning solution with regard to one issue, such as the passive income limitation, may trigger other tax or regulatory issues. For example, an aircraft placed in a special purpose entity may be an effective solution to certain tax and business challenges, however, this structure may create a risk of violating myriad FAA rules.

Similarly, providing pilot services along with an airplane may remove an activity from the definition of leasing, and therefore, from the passive activity limitation. However, that arrangement may trigger other federal taxes and FAA rules.

Such intersections of government regulations, federal tax rules, state tax rules, and business concerns highlight the importance of building a team of advisors that are educated in the unique issues implicated by aircraft ownership and operation.

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› Edward Kammerer is a Partner, and Katie Ahern an Associate at Hinckley, Allen & Snyder LLP. Edward can be contacted via telephone: +1 401 274 2000; or email: ekammerer@haslaw.com. Alternatively, email Katie at kahern@haslaw.com.

More information from www.haslaw.com

ED KAMMERER

KATIE AHERN

Aircraft Index see Page 4