

# Game Over: Private Aircraft Expense Deductions Disallowed Under Hobby Loss Rules

---

December 2013

Ed Heinbockel, one of the creators of the classic “Leisure Suit Larry” video game series, had a case in the U.S. Tax Court. Like the title character Larry, Ed did not prevail, as the Tax Court determined that he engaged in private aircraft activity “not entered into for profit” under the “hobby loss” rules, resulting in the denial of aircraft tax deductions, plus penalties and interest.

## “Love for Flying”

Ed owned and ran a company, Visual Purple, LLC, (VP) that developed 3-D training simulations for the U.S. Department of Homeland Security (DHS) and other government agencies. When VP won a contract with DHS in 2004, Ed, a pilot since the age of 17, saw an opportunity to combine his professed “love for flying” with VP’s business. Ed purchased an aircraft for the claimed business purpose of providing transportation services to VP. Ed reported his aircraft expenses on his Internal Revenue Service Form 1040, Schedule C, and called the aircraft business “Collective Flight,” but the activity never really got off the ground.

Ed occasionally flew the aircraft to transport himself for VP-related trips, but often did not seek reimbursement from VP because of VP’s cash flow problems. Collective Flight had no other revenue sources, and it generated net losses every year. The IRS disallowed all of the losses from Collective Flight for 2005 through 2007 because the activity was “not entered into for profit.”

## Hobby Loss Rules – No “Love for Flying”

Under Internal Revenue Code Section 183 “hobby loss” rules, tax deductions are generally disallowed when an activity is “not engaged in for profit.” Whether an activity is “not engaged in for profit” is a facts and circumstances test, and the IRS auditor will generally look at nine factors to determine whether a taxpayer has a profit objective: (1) the manner in which the taxpayer carried on the activity, (2) the expertise of the taxpayer or his advisors, (3) the time and effort expended by the taxpayer in carrying on the activity, (4) the expectation that assets used in the activity may appreciate in value, (5) the success of the taxpayer in carrying on other similar or dissimilar activities, (6) the taxpayer’s history of income or losses with respect to the activity, (7) the amount of occasional profits, if any, that are earned, (8) the financial status of the taxpayer,

and (9) the presence of personal pleasure or recreation. Based on these factors, the Tax Court easily concluded that Ed did not engage in the Collective Flight activity for profit, and denied the tax deductions in excess of Collective Flight's income. As determined by the Tax Court:

- Ed did not conduct Collective Flight in a businesslike manner. When Ed bought the aircraft, the loan documents specifically stated that he was going to use it for "personal" purposes;
- Ed failed to keep complete records. There were no written contracts between Collective Flight and VP—his only alleged customer;
- Ed did not institute changes in an effort to earn a profit, after realizing that Collective Flight could not make a profit from servicing VP;
- Ed did not seek guidance from industry experts. Ed relied on "intuition" and his casual conversations with some pilots and aircraft brokers;
- Ed did not devote significant time to the aircraft activity. Ed claimed he spent 10 hours per week with Collective Flight, but had no records to support his administrative hours;
- The aircraft was not expected to appreciate in value, and ultimately was sold at a loss;
- Ed's history of income and losses with respect to Collective Flight did not come close to generating a profit during any year at issue. Ed admitted that he knew he had a dying business model; and
- The presence of Ed's personal passion to pilot planes weighed heavily against him. As Ed testified, "I love to fly. I'll be real up-front about that. Flying's always been a passion of mine."

Based on these factors, the Tax Court denied Ed's tax deductions for his aircraft activity, and upheld the IRS imposed 20% accuracy-related penalty for tax underpayment.

### Lessons Learned

Unfortunately for Ed Heinbockel, his case is a study on what not to do with private aircraft and taxes. The main lessons are:

- If you are going to take tax deductions on an aircraft, you need to consult with a tax advisor. The Tax Court looked unfavorably at the fact that there was no evidence that Ed had any discussions with lawyers, accountants, or any other aircraft experts or advisors about the potential profitability of the aircraft.
- The details are important. If you buy an aircraft for business use, your loan documents should not state that the aircraft was purchased for personal purposes. If you are leasing an aircraft, there should be a written lease and invoices or other evidence of billing, adequate books and records, and you should charge arm's-length rates to charter customers. Collective Flight's records were too spotty for the Tax Court to determine that it carried on in a businesslike manner. Ed also used the aircraft for personal purposes, and should have made an attempt to allocate the aircraft expenses between his personal and business use of the aircraft.

- Don't talk so much (but be cooperative). Through the course of the audit, Ed told the IRS revenue agent everything that the Agent needed to deny Ed's aircraft-related tax deductions under the "hobby loss" rules. If you are going to talk, be consistent. Ed testified that he "built spreadsheets," but the Tax Court found this to be inconsistent with the evidence of only a one-page "pro-forma" spreadsheet that Ed admitted he had done in a "stream of conscious[ness]." Notwithstanding Ed's loquaciousness, the Tax Court determined that Ed was not sufficiently cooperative during the audit, and had refused to provide documents to the IRS revenue agent.

At the end of the day, however, Ed is not someone to worry about. Ed took a large tax deduction for the aircraft in 2004, and it appears that the IRS could not challenge that tax deduction because of the statute of limitations. Also, Ed and his wife are, in the words of the U.S. Tax Court, "a happy couple possessed by entrepreneurial spirit." However, better tax planning and recordkeeping would have served the Heinbockels well.

For more information, please contact Gary I. Horowitz at 703.905.2845 or [ghorowitz@wiley.law](mailto:ghorowitz@wiley.law).