SURVIVING THE AUDIT

Victor C. Anvick holds a Master of Science in Taxation
and is enrolled to practice before the I.R.S.
He is a pilot, author and lecturer and specializes in aviation taxation.
His practice is located in Acton, California
v.anvick@worldnet.att.net
(661)269-9441
Airplane: 2001 Cessna Turbo Skylane

Note to reader: This article was originally published in December 1997
Professional Pilot. This article is still valid under current tax law.

Very few pieces of correspondence can raise the recipient’s blood pressure, and create such a feeling of general malaise as a letter from the Internal Revenue Service stating that your tax return has been selected for audit. If you or your business receives one of these initial taxpayer contact letters -- sit down, take a few deep breaths and CALL YOUR TAX ADVISOR. Don’t call the agent whose name and number is on the contact letter. Your tax advisor can do that after both of you have signed form 2848, Power of Attorney and Declaration of Representative. Without this form, the Internal Revenue Service cannot discuss the case with anyone other than the taxpayer or entity being examined.

Most contact letters usually give a 10-30 day response time. I like to respond with a Power of Attorney and a phone call near the end of the response time in order to make an appointment with the agent, as far in advance as possible, to have time to assess the client’s position.

Before your advisor meets with the I.R.S. or responds to the initial contact letter, you should meet with your advisor to discuss the contents of the letter. The letter will indicate many general areas to be examined. Assuming aircraft deductions are listed in the letter, you should take the following steps:

1. Review the aircraft business logbook to make certain that you have a valid business purpose for all flights classified as business flights.
2. For personal trips, make sure that records showing additions to wages were properly calculated using the S.I.F.L. rates in effect at the time of the flight.

3. For operating and non-operating expenses claimed on the returns, make sure that you have copies of vendor invoices attached to photocopies of both sides of the canceled check or a copy of a credit card receipt.

4. Locate the purchase order and other documents that may have been used to determine the tax basis for aircraft depreciation.

5. Make an assessment of your overall substantiation strength to determine areas of exposure. This will provide an early warning so that your advisor can begin developing a strategy as to how to handle the rough spots. However, a better solution is to have your tax advisor perform a flight department documentation review (simulated audit) every 12-24 months to determine where your weaknesses are prior to receiving the I.R.S. notice.

6. Do a tax projection to determine the potential tax liability, penalties and interest if 100%, 75%, 50%, or 25% of the deductions were disallowed for the years in question.

The benefit of doing a tax projection is that it can prepare you for a 100% disallowance of all aircraft deductions, no matter how strong your case is. A full disallowance is not that uncommon at the agent level. It usually occurs for a combination of reasons, including lack of knowledge concerning the role business aircraft play in corporate America, lack of substantiation and documentation, no knowledge concerning the FARs, poor working knowledge of the Internal Revenue Code, and with some agent’s, a deep-seated bias against aircraft. I have also encountered some agents who have had difficulty accepting high operating and non-operating expenses generated by turbine equipment.
The above procedures only constitute a minimum of steps that should be well underway, or preferably completed, prior to the initial interview with the agent. This is why it is so important to contact your tax advisor immediately upon receipt of the initial contact letter.

THE INITIAL I.R.S. INTERVIEW

The Internal Revenue Service Audit Manual states that the initial interview can be one of the most productive interviews of the examination process. It also reminds agents that they are not only auditing a tax return, but they are also examining an individual or entity and all of its sources of revenue and deductions.

Obviously, individuals and business entities should be professionally represented at the initial interview, as well as all other meetings or conversations with the agent. (Clients should have as little contact with IRS personnel as possible.)

It is during this initial, get acquainted, interview that astute advisors will also ask several questions about the agent assigned to the audit. Questions relating to education, experience, inside and outside of the I.R.S., any knowledge about aviation, prior business experience, etc., may provide valuable insight for strategic planning later on. During this time, it is also a good idea to ask the agent directly if he or she has a bias against individuals or entities who use aircraft for bona fide business purposes.

The initial interview is also a good time to lay a foundation for open and honest communications. Your advisor should indicate that positions taken by I.R.S. personnel, based upon groundless assumptions regarding aircraft usage, amount of expenses, etc., will not be tolerated. If the agent has any questions or needs information, a sincere effort will be made to get the answers or information.

If, based upon comments made by the agent during your initial interview, you or your advisor determine that the agent has insufficient knowledge concerning aviation, you may wish to talk to his or her supervisor and request a substitution of agent.

The role of the examining agent is to make a fair and accurate determination of the tax. If your advisor feels that a fair and accurate determination will not be possible
because of a negative attitude or biased opinions, the sooner a formal objection is raised, the better. In some cases a letter to the local I.R.S. District Director or your local U.S. Congressman may not be out of order. Requests for a new agent should be sent via certified mail so that the request will be made a part of your case file.

There are many factors that determine if your tax return will be examined. Your tax return may be selected for audit based upon your industry, income level, I.R.S. district, or how the tax return was prepared. Descriptions used on the tax return for operating, non-operating expenses and depreciation have been known to trigger audits. If your tax return is examined, and the agent discovers aircraft deductions on the return, that area of the return is often subjected to much closer scrutiny than all other parts of the return combined.

Several years ago I worked on a case where the audit team spent so much of their time budget trying to disallow aircraft tax deductions on the corporate jet that many of the really sensitive, non-aircraft areas on the return received very little attention. The airplane deductions were well substantiated and the aircraft usage, as a business tool, was well documented. As a result, no adjustments were made to the aircraft deductions, and only minor adjustments were made to other non-aviation-related issues. Although we will never know, I have always wondered what kind of assessment the audit team may have secured if they had not been so determined to disallow perfectly valid aircraft tax deductions.

**CONDUCT OF THE AUDIT**

While the I.R.S. Audit Manual encourages the agent to maintain control of the audit, your business is the entity being inconvenienced by the examination. The taxpayer should exercise control over the kind of information provided to the agent. It is not required to give the agent trade secrets, etc.

During the audit, the agent will likely issue Document Information Requests called DIRs. Items requested on the DIRs can range from aircraft purchase agreements to
canceled checks and the like. It is usually good policy to respond to reasonable requests in a timely manner. Doing so can increase your credibility.

If the request is unreasonable, either in the time allotted for a response or in terms of the quantity of information requested, ask if alternative information can be provided, if you can have more time or perhaps talk to the agent’s supervisor.

Once information is provided to the agent, make them initial their document request. Much time has been wasted in audits by agents asking for the same items two or three times. Repetitive requests for the same information would be grounds for a meeting with their supervisor, as your time and money and the government’s resources are being wasted.

COMPLETION OF THE AUDIT

After all of the items on the DIRs are furnished to the agent and the field work is completed, a Revenue Agents Report (RAR) will be prepared by the agent that will list all of the adjustments to the tax liability shown on the return that have not been addressed to the agent’s satisfaction.

The RAR, also called a 30-day letter, gives the taxpayer basically two choices:

1. Sign the assessment and agree to pay any additional tax, plus interest and penalties; or
2. File an Appellate Conference Protest and request an Appeals Conference with an Appeals Officer. (Your tax advisor should be familiar with appeals office procedures.)

If you do not respond within 30 days, a final notice of deficiency, the 90-day letter, will be sent to you. At that point, the only recourse is to pay the tax and sue for a refund in federal district court or the U.S. Court of Claims, or not pay the tax and file a petition with the U.S. Tax Court within 90 days from the date shown on the notice of deficiency.

Even though the agent may have completed his examination, your examination of his work is just beginning. Assuming a partial disallowance of operating and non-
operating expenses, audit adjustments on multi-million dollar turbine equipment can often reach several million dollars, especially after the imposition of penalties and interest.

Don’t overlook state income tax adjustments, interest and penalties that will be assessed, in addition to the I.R.S. adjustments, pursuant to information sharing agreements between federal and state taxing authorities. The state adjustment, in a high tax state, could be as much as 25% or more of the I.R.S. adjustment. Furthermore, many states have statutes of limitations in excess of the normal three (3) year federal status. Therefore, a state may be able to make a four (4) year assessment and still be within the statute of limitations for that state. At this point your advisor needs to obtain a copy of the I.R.S. agent’s case file and make use of the Freedom of Information Act (FOIA).

FREEDOM OF INFORMATION ACT

The Freedom of Information Act provides an opportunity for taxpayers to receive a copy of the agent’s case file. By filing a Freedom of Information Act Request with the District Disclosure Officer, you will be able to review the agent’s notes, work papers and other documents. This will give you and your advisor an opportunity to make a better determination as to the strength of the government’s case, quality and amount of research, notes about the administration of the case and other valuable information.

The FOIA request can be filed after the completion of field work. The FOIA file should be in your tax advisor’s hands and have been thoroughly reviewed prior to going to an appeals conference.

APPEALS CONFERENCE

The purpose of the appeals conference is to provide the taxpayer a chance to reduce the adjustments proposed by the agent and to give the government a chance to assess the hazards of litigation in order to save the time and expense of going to court.
Appeals officers try to conduct the conference in a quasi-judicial manner by evaluating the facts, law and litigating prospects of the case.

I have found most appeals officers to be much more objective and impartial than the examining agent. At an Appeals Conference you have more of an opportunity to expand upon any favorable merits of the case that may have been ignored by the agent in his report. This is why it is so important to get a copy of the case file before your advisor goes to the Appeals Conference.

Furthermore, appeals officers are usually more receptive to listening to new facts and may openly discuss weaknesses of the government’s position. Appeals officers do not report to nor are they reviewed by the examination division. Appeals officers are under the jurisdiction of the Regional Director of Appeals, rather than the Regional Director of Examinations. Appeals officers are evaluated by how many cases they settle and keep from going to trial.

If the appeals officer feels the government has less than a 10%-20% chance of winning the case in court, they are instructed to concede the case. Strong taxpayer cases often settle in the 60%-80% range. (EXAMPLE: A strong taxpayer case settling in the 60%-80% range would reverse 60%-80% of the examining agent’s proposed tax adjustment, a corresponding reduction in interest and a more than likely waiver of all penalties.) I have seen weak taxpayer cases settle in the 25%-50% range. As part of the settlement process, most penalties may be waived in a significant number of cases, even those that are very weak for the taxpayer.

SUMMARY

I.R.S. examinations involving aircraft issues present an additional set of challenges for both the taxpayer and the I.R.S. agent.

Aircraft owners have to make sure that their documentation is in order because of the additional scrutiny aircraft expenditures receive from the agent. Accordingly, every opportunity must be taken to learn as much as possible about the examining
agent, his opinions about business aircraft and knowledge of our industry to ensure a fair and accurate determination of the tax.

If you are unhappy with the result of an audit, make use of the appeals conference. Many times, I have seen multi-million dollar adjustments completely reversed for very strong cases or reduced by a substantial amount for marginal or weak cases.

Lastly, don’t overlook the importance of the Federal Aviation Regulations in a tax audit. As strange as it may seem, they can carry a good deal of weight. After all, as pilots and operators, we are bound by them and we are all subject to their full force and effect. Regulations covering currency, proficiency, test flights after maintenance procedures and other areas can be used to increase the overall business usage percentage, resulting in additional deductions. By combining the FARs with the provisions of the Internal Revenue Code, competent tax advisors can present a very formidable case.