

IRS COMPLIANCE

Taxes and Business Aircraft

Avoiding pitfalls when filing your annual return.

By Victor Anvick
Enrolled Agent
Private-SE-Inst. Cessna 182



Smart presentation of your tax return and the use of an extension, if necessary, are often good insurance against an IRS audit.

As this article is scheduled for publication during the time when many corporations, partnerships and individuals will be in the process of accumulating data for their tax returns for 2002, I thought that it might be appropriate to discuss a number of randomly selected topics that usually surface during tax season.

Filing for an extension

Many taxpayers are under the impression that filing for an extension of time to file a tax return will increase the likelihood of an audit. This is not true. Factors influencing tax return audit selection include items such as type of industry, income, assets and location, as indicated by the content of return attachments and a host of other items.

Theoretically, a corporate tax return due on Mar 15 should contain the same income and deductions as the one filed on Sep 15—the extended due date. However, many times all of the data necessary to file a complete and accurate tax return is not available by the first due date. That is precisely when an extension request should be made.

After all, it is much better to file an extension request and pay the projected tax, than to risk filing an incomplete or inaccurate return and having to amend the tax return later. Amended tax returns nearly always receive greater scrutiny than the original because amended returns often claim additional aircraft depreciation or operating expenses that were inadvertently omitted from the original return.

Over the past 30 years I have seen and heard of several cases where an IRS agent indicated that the items that caused the entire return to be selected for audit were the item(s) on the amended tax return.

Planning point

I have often advised clients to file for an extension of time to file a return in order to give them additional time to review their aviation business diaries, calendars and contracts signed after year end, the foundation of which may have been laid during the year. A review of such documentation may provide the keys to claiming very significant additional valid deductions on corporate, partnership or individual tax returns.

Presentation issues

As stated previously, sometimes the issues contained on the face of the return can trigger an audit. For example, describing an aircraft as a "Cessna Citation X aircraft" on a depreciation schedule is likely to attract much more attention from the IRS than the description "Trans Equip C-750 S/N 1234."

In the second example you have properly identified the aircraft and even included the specific serial number, so meeting all the disclosure requirements. I believe, and experience has shown, that the second description can provide a lower profile.

Some tax returns I have reviewed make repeated use of the term "aircraft" or "airplane," as in aircraft fuel, airplane hangar rent, airplane property taxes, aircraft repairs and interest on airplane loan. Why not consider using simpler terminology such as fuel, rent, property taxes, repairs and interest? Why wave a red flag in front of a bull?

30% bonus depreciation

As soon as the 30% bonus depreciation provisions were promulgated as part of the Job Creation and Worker Assistance Act of 2002, it became clear that those provisions would not have the desired effect on our industry, or the economy as a whole, for a number of reasons—from corporate accounting scandals to the pitfalls of the new tax law itself. (See Professional Pilot, Sep 2002, Personal use of business aircraft and corporate responsibility.)

Approximately 65% of US states have still not passed conformity legislation that allows use of the 30% bonus depreciation for state income tax purposes. This has resulted in many 2001 state tax returns being filed in error. Amended tax returns will be necessary for these taxpayers. Because of the cooperation between the IRS and state taxing authorities, any time a state changes its tax liability on a return, the IRS is also notified.

For this reason, a number of IRS audits will be triggered as a result of errors on state income tax returns. Even though the 30% bonus depreciation may be perfectly legal for a particular taxpayer on a federal return, the state's notification to the IRS is likely to prompt a second look at the federal tax return.

With more than 40 states in a budget deficit position for this next fiscal year, I doubt whether any of those states will be eager to pass the required conformity legislation.

For those aircraft owners who are eligible for the additional depreciation in 2002, please check with your tax advisor to determine if your state has approved the 30% bonus depreciation before you sign and file the last year's tax return.

Increased audits for LLCs

With restructuring of the IRS nearly complete, the agency has selected a sample of 50,000 individual tax returns for audit. One purpose of this project is to collect data to update its audit selection criteria for future years.

During the audit of these individual returns, many limited liability corporation (LLC) and subchapter "S" corporate returns could be selected for examination as the passthrough entities often produce large depreciation and operating expense deductions for aircraft owners.

The IRS has announced plans to begin increased audit activity in 2004 and 2005 for LLCs, partnerships and subchapter "S" entities. In fact, the current proposed federal budget for the year beginning Oct 1, 2003 includes an allocation of \$133 million for the audit of businesses and high-income individuals.

Flight department entities

Over the past several years it has become increasingly popular to set up an LLC (partnership or single member) or a subchapter "S" corporation for the sole purpose of purchasing and operating an airplane, largely for liability reasons.

Unfortunately, many of these entities are only single-purpose entities and have no business plan or model, no other assets and/or ascertainable business activity, and would find it very difficult to meet the active trade or business requirements of the Internal Revenue Code (IRC). Yet these flight department entities have been used to spin off large depreciation and other deductions to the LLC members or subchapter "S" corporate shareholders.

Remember that it is a requirement of the depreciation sections of the IRC, sections 167 or 168, that the property must be used in connection with an active trade or business before one dollar of depreciation can lawfully be claimed.

Another potential problem that may exist with many of these flight department entities is that in the eyes of FAA the "carriage of company officials, employees and guests on a company aircraft must be incidental to the company's business," per FAA Chief Counsel Interpretation 1989-22 dated Aug 8, 1989.



If claiming your aircraft operations as a business expense, it's a good idea to create a business plan around the aircraft's use.

In this case the term "incidental" means an activity secondary to the company's main business, which could be any legal activity such as manufacturing, wholesaling, consulting or marketing.

If the "carriage is in fact a major enterprise in itself, it may not be conducted by any person unless he holds an operating certificate under Part 121 or 135 applicable," per preamble to Amendment 91-101, as cited in FAA Chief Counsel Opinion 1989-22.

Obviously, if you or your company are trying to operate an aircraft under FAR Part 91 when it should be operating under a certificate issued pursuant to FAR Part 135 or 121, you have a lot of exposure with FAA and your insurance broker that goes well beyond the purpose of this tax article.

As a tax advisor, I believe that many flight department companies run a very real risk of being classified as a hobby. For example, consider the possible outcome if the business was not set up properly and operated like a legal business.

If the proper operating certificates were not obtained and there was no other ascertainable active trade or business activity conducted by the flight department company other than rendering and charging for air transportation services, an IRS agent could be in a strong position to argue for a "hobby loss" classification pursuant to the provisions of IRC Section 183.

If the IRS is successful in classifying the flight department company as a hobby, then all aircraft deductions including depreciation are lost forever. The additional taxes, penalties and interest could easily surpass 50% of the cost of an aircraft.

Possible solutions

1 Meet with a seasoned aviation attorney to determine if your operation is in violation of the FARs.

2 Develop a business plan for the aircraft entity. In Mar 2002 the US Tax Court in

Parker v Commr, TC Memo 2002-76 ruled that a taxpayer who had been active in aviation for more than 34 years was operating a hobby. One of the main factors influencing the US Tax Court's opinion was the lack of a business plan.

Keep in mind that for aviation business plan purposes it is not necessary to pay someone an exorbitant amount to develop a valid business plan. A basic business plan that addresses the following points will suffice regardless of whether you operate a small single-engine aircraft or the world's most expensive intercontinental business jet.

- xxxxa objectives of the business
- xxxxb mission statement
- xxxxc break-even analysis
- xxxxd description of products or services
- xxxxe market definition and analysis
- xxxxf income forecasts
- xxxxg marketing plans
- xxxxh plan of implementation
- xxxxi procedures for monitoring performance
- xxxxj provisions for updating or amending the plan.

3 Consider changing the single-purpose flight department company into an active trade or a business multipurpose entity.

For example, if I owned a manufacturing or wholesale operation I might consider using the aircraft entity as a marketing or management company. Rather than charging for the use of the aircraft, I would charge marketing or management fees based upon the new business that the marketing company helped to generate. I might even consider transferring some employees and business equipment to the marketing/management firm.

4 Have contracts drawn up between the LLC and the entity that it services stipulating the nature of the services to be performed along with a fee schedule.

Long experience in tax controversies has shown that the best evidence of a bona fide business activity is performance by both parties to a valid, enforceable contract combined with actual consideration exchanged between the parties for goods or services.

End result

By performing the above steps, you will have taken considerable measures to help ensure that:

- 1** you are in compliance with the appropriate FARs.
- 2** you have a bona fide, multi-purpose active trade or business, rather than a single-purpose flight department company, because any transportation use of the aircraft will be incidental or secondary to the marketing or management services, since mere use of the aircraft will not generate any revenue.
- 3** you will have greatly reduced the possibility of a successful hobby loss challenge.
- 4** you will also have reduced the risk of a successful passive activity allegation by the IRS because you are not charging for use of personal property, namely the airplane.
- 5** payments for marketing or management fees will not be subject to federal excise/air transportation taxes.
- 6** you will be in a position to generate more revenues and strengthen your case on the

above points by offering marketing or management services to other businesses.

Taking a practical approach

If you cannot obtain all the information necessary to file a complete and accurate tax return, pay the projected tax and file an extension request. Obtaining an extension will not increase your chance of an audit and you may uncover additional deductions by taking the time to do a thorough documentation review.

Ask your tax preparer to be mindful about return presentation and terminology used on the official forms and on workpaper attachments. Observe federal and state tax differences to avoid a second look at the return.

Make sure that you are operating your aircraft in accordance with applicable FARs, as many unwary aircraft owners have not only been faced with violations of these regulations, but have also helped to build the IRS case against them concerning tax issues.

If you have your aircraft in a separate entity, make sure that it is a multipurpose entity and that you develop a basic business plan. A well-crafted business plan can only add weight to your case with FAA and the IRS.



Victor Anvick holds a master of science in taxation and is an enrolled agent who specializes in aviation taxation. His practice is located in Acton CA. He may be reached at www.atisgroup.com.

