A TAXING SITUATION

PRESERVING AIRCRAFT TAX DEDUCTIONS AND PROTECTING YOUR JOB

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Over the past 12 years I have received many urgent calls from chief pilots whose flight departments were in imminent danger of being shutdown.

The most common reason given by the chief pilots was the disallowance of all the aircraft-related tax deductions by the Internal Revenue Service. In some cases, during the acquisition process, the need for the aircraft was not adequately addressed. In other cases, the aircraft usage, expenses and other critical information were not properly documented during the ownership and operations period. The improper treatment of the expenses produced inaccurate tax returns, internal reports and other items. Since the owner/employer was not going to be able to retain an acceptable level of tax benefits, the aircraft was listed for sale with a broker. All positions in the flight department would be terminated as soon as the aircraft was sold.

Unfortunately, for general aviation, variations of the above scenarios are repeated far too often. In addition to needless job losses is the fact that individuals and entities suffer financial and tax losses that are difficult, if not impossible, to recoup. More than likely, these former owners will never return to aircraft ownership and will lose the incalculable benefits of private business air transportation and ownership.

The purpose of this article is to briefly discuss some of the steps that should be taken to properly document the need for the aircraft during the acquisition phase; and to provide a review of the type of information required by the Internal Revenue Service to substantiate aircraft business usage and tax deductions.

AIRCRAFT ACQUISITION

The first issue that needs to be addressed and documented when you feel that your business should purchase its first airplane, or when you think that you need to make an addition to a pre-existing fleet is, "Why do you need the airplane?"

If you cannot currently supply a well-reasoned response to this question, chances are that your tax advisor will not be able to answer this question to the satisfaction of an IRS agent in the event of an audit.

First time buyers, whether they are a sole proprietorship or a Fortune 100 conglomerate, should document factors such as incompatible airline schedules, lack of scheduled service to desired and/or needed locations, canceled or late flights, lost baggage, or any other transportation problem that has interfered with your company's ability to conduct business on a day-to-day basis, serve its current customers, or open new markets.

Examples of adequate documentation should include memos, minutes of Board of Directors meetings, copies of airline schedules at the time of acquisition, receipts for the replacement of lost luggage or other property, and particularly the loss of any business opportunity that occurred because of a commercial flight cancellation or other problem.

Aircraft owners looking to add to their fleets or upgrade equipment should consult with their chief pilot to accurately assess the capabilities of the present aircraft in view of anticipated needs.

I recommend that pilots identify particular flights within the past two or three years that could have been conducted more efficiently if the current aircraft would have had the capabilities of the new equipment. For example, how many fuel stops, ground handling charges and layovers could have been eliminated? How much baggage and personnel were left behind to take alternative transportation? If 15%-20%, or more, of the prior flights could have been conducted more efficiently, you have a foundation for a persuasive argument to be made to an examining agent or shareholders in support of an equipment upgrade.

However, before you can prevail, you have to have the substantiation. All of the above data, copies of purchase agreements, loan documents, flight logs, maintenance records, operating and non-operating expenses, insurance policies, etc., should be maintained and kept in the flight department. If they are not, those documents are simply in the wrong place, and flight department record keeping and document retention procedures are in need of an operations review or a major overhaul.

AIRCRAFT TAX DEDUCTIONS

We should all realize that tax deductions are a matter of legislative grace. Experience has taught me that IRS agents demand more information to substantiate aircraft tax deductions than other basic types of deductions such as computers, furniture, fixtures, etc. Therefore, from an IRS substantiation point of reference, the record keeping function of the flight department needs to be more complete and accurate than almost any other department or division in the company.

The basic standards of deductibility required of any "active trade or business" by Internal Revenue Code § 162 and the regulations thereunder, is concerned with the business expenditure being classified as an "ordinary and necessary" expense of the business.

Having information in the flight department files concerning travel difficulties involving commercial transportation or inefficient flights because of limitations of current equipment would seem to meet the "ordinary" test of Internal Revenue Code § 162. Being able to point to new customers or contracts signed as a result of obtaining your first company airplane or equipment upgrade would constitute ***prima facie*** evidence that the business aircraft was "appropriate and helpful" to business development. Thus, the "necessary" test of I.R.C. § 162 would also have been met.

The U.S. Tax Court in Commissioner v. Tellier, 66-1 USTC 9319, 383 U.S. 687, 689 (1966) has defined "ordinary" as a "normal and natural response" to the specific conditions under which the taxpayer conducts his business. In the same case, "necessary" was defined as "appropriate and helpful" to the development of the taxpayer's business.

Many other U.S. Tax Court cases have enunciated similar positions, although I have seen some field agents erroneously try to interpret "ordinary and necessary" as meaning "mandatory to the survival of the business." Aircraft owners do not have to meet artificial criteria that are not supported by the Internal Revenue Code, regulations, rulings, U.S. Tax Court cases or other recognized or citable sources of authority.

The next requirement for deductibility of transportation expenses concerns the nature and purpose of the trip, dates, amounts, names of individuals or companies visited and the relationship of the individuals and entities to the business claiming the deduction. Additionally, I prefer clients to document the amount of any new business or contracts that were secured as a result of a meeting or series of meetings.

(During appeals negotiations, I once offered to surrender all deductions and depreciation on a $5 million corporate jet if the Appeals Officer would remove $30 million of taxable income resulting from a contract that was received and serviced as a direct result of the usage of the corporate jet. The Appeals Officer declined my offer and accepted the return as filed.)

Keeping a record of additional business generated by the aircraft may also be very persuasive when it comes to asking for a larger flight department budget, new equipment, or proving that the flight department is not a cost center, but in reality one of the most profitable operations of the company.

SUMMARY

At today's prices, professional pilots are entrusted with the proper care, feeding and control of multi-million dollar assets. Being a competent pilot with good cockpit organizational skills and habits is no longer adequate. Some of those organizational skills need to encompass business documentation, record keeping, managerial skills and effective communication. Many pilots are also finding themselves included in managerial meetings along side upper management, attorneys, CPAs, etc., as part of the aircraft management advisory team. Having the proper documentation available at the right time may end up saving millions of dollars in taxes along with the flight department.

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