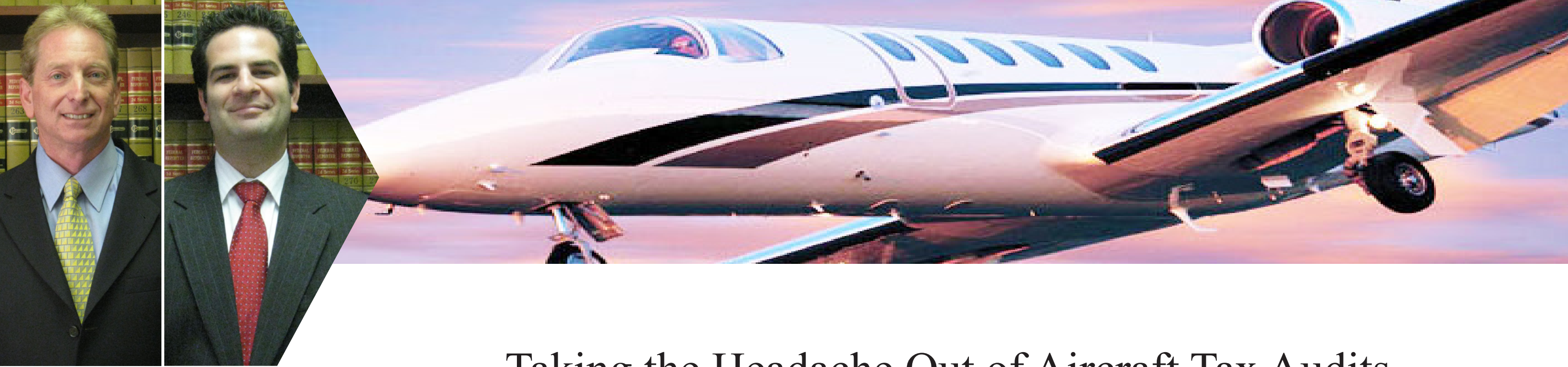

Taking the Headache Out of Aircraft Tax Audits

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Imagine this: you get back to your office after a trip on your corporate jet. You sit down at your desk ready to start your busy work week only to find that while you were gone you received an audit letter from the IRS. Immediately, your stress level begins to mount. Since you typically rely on your accounting department to handle your taxes or perhaps an outside accounting firm, you prepare to make the call everyone hopes to avoid. Before you pick up the phone, read this article. You may think twice about who assists you in an audit revolving around corporate aircraft.

Dealing with an IRS audit, in and of itself, can be quite a challenging and painstaking process. Further, an IRS audit dealing with the use of a corporate aircraft frequently involves the most convoluted provisions in the Internal Revenue Code. However, these rules also allow for a significant amount of interpretation and, in turn, a significant amount of planning when understood and applied correctly. So, if you don't want the IRS to assess a large tax deficiency, working with an aviation tax expert will bolster your chances of success. This article will highlight some of the more commonly challenged tax return positions involving corporate aircraft and highlight the issues involved.

<u>Reasonableness</u>:

The IRS may call into question whether utilization of a private aircraft was reasonable in the business under Internal Revenue Code ("IRC") § 162. One way corporations show that purchasing and using the corporate aircraft is reasonable is to have a business plan that incorporates the benefits of the aircraft into it.

<u>Personal Use</u>:

An area subject to substantial planning and interpretation is the personal use disallowance rules of IRC § 274. This code section and the current Proposed Regulations are complicated and can have various meanings and different applications to different types of aircraft uses.

By way of background, on October 22, 2004, Congress passed The American Jobs Creation Act (AJCA) which overturned the ruling in Sutherland Lumber-Southwest, Inc. v. Commissioner that a corporate taxpayer may deduct the full cost of a non-business (entertainment) flight on the company's aircraft. Subsequent to the AJCA, the IRS issued Notice 2005-45 and Proposed Regulations. Notice 2005-45, when combined with the Proposed Regulations, provides four different methodologies to calculate any disallowance.

Although IRC § 274 on its face may seem to disallow all deductions associated with personal / entertainment use of an aircraft, there are in fact several categories into which personal / entertainment use may be placed, only one of which causes complete disallowance of deductions. Thus, calculating the deduction under different methodologies, and correctly identifying which category the "use" should be placed in, may allow a taxpayer to realize a greater tax savings.

In addition to understanding the calculation methodologies, and the type of "use," it is also necessary to understand which expenses are subject to the personal use disallowance rules. There are numerous other "special rules" contained in the AJCA, the Notice and the Proposed Regulations and experts in the industry have taken and continue to take positions on the proper interpretation of these laws. Aviation tax specialists will be familiar with these developments and should require limited background research in order to understand all of the issues at play in a particular audit.

At-Risk Rules When Financing:

Sometimes the IRS will challenge deductions for being in excess of your amount at-risk. A taxpayer is generally considered at-risk under IRC § 465 for the amount of money and the adjusted basis of property he contributes to an activity. In addition, a taxpayer may also be at-risk for amounts borrowed for use in the activity, but only if the taxpayer is personally liable for repayment of the loan. The complications surrounding at-risk rules and financing were addressed in detail in an article by Kara Kraman, an attorney in GKG Law's Minneapolis office, in the January edition of World Aircraft Sales. When the IRS asserts that you are taking deductions and losses beyond the amount you actually have at-risk, there may be arguments available to you to prove that you are at-risk for a greater amount than the IRS claims. For example, if you have personally and unconditionally guaranteed the loan on the aircraft and you have no right of subrogation against anyone else, you will probably be considered at-risk for the amount of the loan. The at-risk rules are, again, complicated, and not typically dealt with on a day to day basis by the average tax professional.

Passive Activity Loss Rules:

The IRS may also argue that you have used the aircraft in a rental activity or that you have not materially participated in the active conduct of a trade or business, and thus all depreciation tax losses and operating losses should be treated as passive. If the losses are treated as passive, the taxpayer will only be able to utilize those losses and deductions to offset passive income.

Few taxpayers have any passive income. Aviation tax experts will know what will be considered normal in the aviation context for material participation, will have familiarity with what is considered a "rental activity," and will know how to argue that a rental activity should be classified as a "non-rental" activity. Further, assertions that an individual "materially participates" in an activity of chartering an aircraft to the general public have to be carefully weighed against potential violations of the FAA's regulations and the IRS's knowledge of what is "substantive" in the context of providing a transportation service (in terms of the respective roles of a third-party charter company and the aircraft owner). Documentation of such a transaction is also very relevant to any positions taken in an audit.

<u>Federal Excise Taxes</u>:

The IRS has become continuously and increasingly more aware of issues relating to the so-called flight department company. Are you using a special purpose entity ("SPE") that not only owns the aircraft, but also pays for the crew and other operating expenses? Has the SPE contracted directly with a management company? If you answer "yes" to either of these questions, you may find yourself subject to an excise tax audit. Coincidently, such an operating structure also violates the FAA's regulations. Ironically, having a "flight department company" may provide a defense to a "rental activity" passive activity claim by the IRS, but there must be a careful balancing between income tax benefits and excise tax liabilities when determining a tax strategy.

<u>Future Planning</u>:

As an overarching issue, it is more likely than not that prospective modifications will need to be made to the aircraft ownership and operating structure to address various federal income and excise tax concerns and federal aviation regulatory considerations. At this juncture, if not sooner, an aviation tax expert should be retained to address any pre-existing problems and to provide solutions for prospective aircraft operations.

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