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IRS Income Tax Audits Are Increasing: What Should You Do When You Receive an Audit Notice?

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Perhaps you recently received an IRS audit letter involving your aircraft purchase, and a tax period in which you deducted aircraft related expenses from your taxable income. Your first thought cannot be printed here, but you know that you have an issue that you need to address quickly.

In this article, we will summarize the key steps you should take when you are confronted with an audit of federal income tax returns containing deductions and other reported positions relating to the ownership and operation of an aircraft.

Federal Income Tax Audits

Once you receive an audit letter from the IRS, your first impulse may be to bury it as deeply as possible in the piles of paper on your desk and forget about it until the due date. Unfortunately, this is one of the biggest mistakes that businesses can make.

The better approach is to begin to address the items raised in the audit letter immediately. First, you should contact your attorney to discuss the request and to analyze your tax returns for the year(s) in question. This allows you to recognize potential issues that the IRS may spot during its audit and develop a strategy so those issues can be properly addressed prior to the audit. This can reduce your possible tax exposure, and help avoid the stereotypical negative resolution that ends up costing you a substantial amount of time and, more importantly, a large amount of money.

In its simplest form, a tax audit is like a chess game. It requires proper planning, analysis and implementation to win. A thorough understanding of IRS Practice and Procedure - the rules of engagement - are of utmost importance and often makes a significant difference when dealing with the IRS or

other taxing authorities.

During an income tax audit, an IRS agent will look for several key items when he or she reviews your tax returns and related documentation. If your deductions relate to the business use of an aircraft, the IRS will typically look at several requirements that need to be met in order to substantiate those deductions:

Ordinary, Necessary and Reasonable...

To start, the IRS will analyze the type of business in which the aircraft was used, and the structure of the aircraft ownership and operation. This review will assist the IRS in making a determination as to whether the use of the aircraft qualified as an ordinary, necessary and reasonable business expense. There are a large number of court cases, IRS rulings and other guidance relating to this requirement because it is, by its nature, almost purely subjective.

Ideally, it is most helpful if you have substantiated the use of the aircraft in the business context ahead of time. Examples of ordinary, necessary and reasonable use of an aircraft in a business can be the need to efficiently move executive level personnel between offices or to and from sales calls, or perhaps the need to comply with corporate security procedures with respect to a particular executive.

It is also helpful if you have a business plan that sets forth various reasons for the necessity of owning and operating the corporate aircraft. Your attorneys can help you prepare documentation that will provide you with the maximum support for your position that the expenses relating to the use of a business aircraft were and continue to be ordinary, necessary and reasonable.

Passive Activity and Hobby Loss Limitations

Another section of the federal income tax laws contains an important, but complex, set of limitations on a taxpayer's ability to take deductions relating to activities which are considered "passive" by the IRS.

In many instances, the ownership and/or operating structure implemented in connection with the acquisition of an aircraft may cause the activity to be deemed "passive" by the IRS and, therefore, "not deductible" against ordinary income. This creates a timing issue, since the loss is "suspended" until the taxpayer has "passive income" or disposes of the aircraft.

This type of reclassification may generate significant tax liability for the taxpayer especially when bonus depreciation has helped increase the amount of the loss. Furthermore, the IRS can assert, based on the specific facts presented, that the

aircraft ownership and operating activity was a "hobby" and that the losses relating to that "hobby" are not merely suspended but are completely non-deductible.

Limitations Relating to Personal Recreational Use

In the Jobs Creation Act of 2004, Congress severely limited a corporation's ability to deduct the full cost of operating a business aircraft that is used by individual employees for personal recreational purposes. The IRS has subsequently issued a set of proposed regulations to implement this restriction. These proposed regulations are complex and the methods for calculating the disallowed amounts as set forth therein are not yet fully settled. Here too, there is a substantial risk that deducted amounts could be disallowed unless the purpose of each flight is properly documented and the amount of costs relating thereto is correctly calculated. Thus, it is imperative that your attorney review your aircraft flight logs and related records at the outset to determine your potential exposure and ways to mitigate it.

At-Risk Loss Limitation Rules

Complex IRS rules restrict the deduction of losses relating to a particular activity such that the amount deductible is limited by the extent that the taxpayer taking such deduction is "at-risk" with respect to such asset.

The specific rules relating to this "at-risk" loss limitation are beyond the scope of this article. However, your attorney should review the aircraft ownership and operating structure as well as the structure relating to any aircraft loans made pursuant thereto to ensure that the limitation does not apply to reduce or eliminate any deductions that you plan to take, or have taken.

Intangibles

Probably the biggest intangible, which is often overlooked, is the ability of the attorney who represents you to cultivate a positive relationship with the IRS agent and his or her manager. Ultimately, these are people just like you, with feelings and emotions. They may be more inclined to act one way or another depending on how they feel about you. Their perception of you will be affected by the relationship they develop with your representative, the lawyer you have hired for that purpose.

For this reason, it is equally imperative that you hire a lawyer who has a deep pool of experiences with IRS employees and who understands their perspective and motivations. The IRS agent may then be more inclined to see the issues from your point of view, and to understand that your position is reasonable in light of all the facts and circumstances.

Conclusion

As is evident from the preceding discussion, the area of aviation related tax deductions and the limitations on such deductions is a complex and highly specialized field. It is therefore in your best interest if you are faced with an audit relating to the operation or ownership of an aircraft or the sale or purchase thereof to retain qualified aviation tax counsel to assist you with respect to such an audit.

An experienced aviation tax attorney can help you develop a strategy, negotiate deadlines and prepare supporting documentation for the IRS.

Perhaps most importantly, however, aviation tax attorneys have deep and extensive relationships with IRS agents at all levels. Their relationships, and knowledge of how the agency operates, are key elements in making sure the audit process runs smoothly and has the least impact on their client's bottom line.

If you are lucky enough that you are not yet involved in such an audit, you have a window of opportunity that allows you to work with your aviation tax attorney to review your aircraft ownership and operating structure.

The performance of such a "pre-audit" review can provide you with protection from the foregoing risks and a myriad of other potential pitfalls you could encounter in the event that the IRS audits you and/or your business. If such a review reveals a need to restructure your aircraft ownership and operating structure to fit within the tax requirements described above, the minimal expense you incur now will enable you to avoid what could ultimately be a huge cost to you in terms of additional taxes, interest and penalties that could be assessed as a result of your tax audit.

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Ober|Kaler's Aviation Tax and Transactions group provides full-service tax and regulatory planning and counseling services to corporate aircraft owners, operators and managers. The group's services include Code Section 1031 tax-free exchanges, federal tax and regulatory planning, state sales and use tax planning, and preparation and negotiation of transactional documents commonly used in the business aviation industry, including aircraft purchase agreements, leases, joint-ownership and joint-use agreements, management and charter agreements, and fractional program documents.

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