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Aircraft Tax Audits – A Game Of Tomes

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Private aircraft owners and operators are well aware that aircraft are particular targets for federal and state tax audit, but that's OK. Knowing that the tax audit risk is there, and knowing what tax auditors are looking for, is an opportunity for proper aircraft ownership and operations planning to avoid many audit traps. If the trap has already been sprung, then it is important to know what the auditors are looking for and how to handle the situation. A business aircraft tax audit is a game of tomes – a fight between the IRS and the taxpayer involving the Internal Revenue Code, Treasury regulations, IRS rulings, court cases and the interpretation of these authorities. Here is what we are seeing these days in aircraft tax audits:

Passive Loss Rules

IRS tax auditors start with the passive loss rules for business aircraft tax audits, due to the complexity of the passive loss rules, and the significant tax losses typically generated by business aircraft from tax deductions for depreciation.

Under the passive loss rules, individual taxpayers must generally aggregate the taxable income and loss from their "passive activities" each year to determine their net passive income or loss. "Passive activity" means (a) any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate; and (b) any rental activity. A net passive loss for the year is generally nondeductible for that year.

The IRS will often argue that the activity relating to a business aircraft is passive activity in an attempt to limit the tax depreciation taken on a business aircraft. The IRS will argue that the aircraft is a "rental activity" and/or that the taxpayer does not "materially participate" in the conduct of a trade or business to which the aircraft relates.

Business aircraft are frequently owned by special purpose entities that own no assets other than the aircraft, which is then leased or otherwise made available to other companies within the taxpayer's control. Such operating structures can be the basis for defeating an IRS passive activity claim. The Treasury regulations provide that one or more trade or business activities or rental activities may be treated as a "single activity" for the passive activity rules if the activities constitute an "appropriate economic unit" for the measurement of gain or loss. Whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends upon all the relevant facts and circumstances, but the IRS looks at the following factors heavily: (a) similarities and differences in types of trades or business; (b) the extent of common control; (c) the extent of common ownership; (d) geographical location; and (e) interdependencies between or among the activities.

In anticipation of an IRS audit and their passive activity claims, taxpayers should structure their affairs to be properly "grouped" for passive loss purposes. To that end, taxpayers will need to file a written statement grouping together their aircraft and other business activity in the original year in which the activities were grouped as a single activity.

There is also a new passive activity trap developing. For those aircraft owned by limited liability companies, the Treasury Department proposed new regulations requiring that LLC members be classified as "limited partners" for passive loss purposes, unless such members have management authority and the LLC's operating agreement states that those members have the right to manage the LLC. Without LLC management authority, these proposed regulations could prevent "grouping" and require that an LLC's aircraft leasing activity be treated as a separate activity for passive loss purposes, thus suspending the LLC's aircraft depreciation losses.

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Hobby Loss

When a business aircraft is used for some personal purposes, an IRS auditor will sometimes seek to disallow all tax deductions relating to the aircraft because they consider the aircraft to be a "hobby." Under the "hobby loss" rules, no deductions are allowed when an activity is "not engaged in for profit." Whether an activity is a trade/business, or whether it is an activity not engaged in for profit is a facts and circumstances test, and the IRS auditor will look at nine factors to make this determination, such as (a) the manner in which the taxpayer carries on the activity; (b) the history of income or losses with respect to the activity; and (c) the personal pleasure or recreation of the activity for the taxpayer.

A taxpayer should certainly structure its business aircraft activity so as not to run afoul of the hobby loss rules, but even so, an aggressive tax auditor can still find a way to claim that the hobby loss rules apply. For example, a business aircraft can be the sole asset of an LLC owned by a taxpayer that controls several other business entities using the aircraft. In that situation, an IRS auditor may focus solely on the LLC in an effort to claim that the hobby loss rules apply. However, such a narrow reading of the law would need to be corrected, because where the taxpayer is engaged in several undertakings, each of these activities may constitute a separate activity or the several activities may constitute one activity, based upon the facts and circumstances. To group its activity, the taxpayer will need to show the IRS auditor that there are organizational and economic interrelationships between the various undertakings, the business purposes served by carrying on the various undertakings, and the similarities of the various undertakings.

At-Risk Rules

Although less discussed than the passive loss and hobby loss rules, IRS auditors are keenly aware that a taxpayer's loss deductions are limited to amounts "at-risk" in a trade or business or income-producing activity.

A taxpayer is considered at-risk for an activity with respect to the amount of money (and the adjusted basis of other property) contributed by the taxpayer to the activity. A taxpayer is also considered at-risk for an activity with respect to amounts borrowed for such activity to the extent the taxpayer (a) is personally liable for repayment of such amounts; or (b) has pledged property, other than property used in such activity, as security for such borrowed amounts. However, IRS auditors will not treat a taxpayer as being at-risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements or other similar arrangements. Also, if a taxpayer guarantees a loan for the purchase of an aircraft, an IRS auditor may not consider such guarantee as putting the taxpayer at-risk. In those situations, it would be better for the taxpayer to be the primary obligor on the loan, instead of the guarantor, even though this will complicate the loan transaction with the lender.

IRS auditors may also attempt to treat each activity that a taxpayer engages in as a separate activity for purposes of the at-risk rules. Losses generated by one activity generally may not be deducted against income generated by a separate activity, and this separation of activities can limit a taxpayer's ability to deduct losses even if the taxpayer's total amount at-risk exceeds the taxpayer's overall losses. However, two business activities may be treated as a single business activity for purposes of the at-risk rules if aircraft activity can be aggregated with other related trade or business activity by showing that (a) taxpayer actively participates in the management of the trade or business; or (b) with S corporations, 65 percent or more of S corporation losses for the taxable year are allocable to persons who actively participate in the management of the S corporation's trade or business. Factors that tend to show "active participation" in a trade or business include (a) making decisions relevant to the day-to-day operation and management of the business; (b) performing services within the business; and (c) hiring and discharging employees.

Predominant Business Use Under IRC § 280F

Heard of IRC § 280F? The IRS auditors have. Generally, aircraft are eligible for tax depreciation deductions over five or seven years, depending upon use. However, if an aircraft is not predominantly used for qualified business use (i.e., used more than 50 percent in the trade or business of the taxpayer) for any taxable year (the "Predominant Use Test"), a longer depreciation deduction period is imposed and any first-year bonus depreciation taken must be recaptured as ordinary income in the tax year that the Predominant Use Test is not satisfied.

Determining whether a taxpayer meets the Predominant Use Test is a two-step process. First, at least 25 percent of the total use of an aircraft during the taxable year must consist of qualified business use that does not involve 5 percent owners or related persons (the "25 percent Threshold"). If this first requirement is met, then the aircraft business use of such persons may count towards meeting the requirement that the aircraft be used predominantly (more that 50 percent) for qualified business use. However, the IRS interprets the 25 percent Threshold narrowly. Even if a 5 percent owner or related person is using the aircraft for business purposes, the IRS will not treat such business use as "qualified business use" of the aircraft for purposes of determining whether the aircraft's owner has satisfied the 25 percent Threshold. Therefore, satisfying an IRS auditor that the Predominant Use Test is met requires year-by-year oversight on a flight-by-flight and passenger-by-passenger basis.

Bonus Depreciation

What the law giveth, the IRS taketh away. Some IRS auditors have a particular dislike for "bonus depreciation" on business aircraft based purely on the tax deduction amount permitted ("That's a large deduction!"), and aggressively look for ways to directly or indirectly disallow bonus depreciation deductions.

Depending upon the year, taxpayers can take a 100 percent or 50 percent "bonus" or "accelerated" depreciation deduction for new aircraft purchased. The purpose of this law was to help stimulate the economy and preserve manufacturing jobs. However, the reality is that even when a taxpayer qualifies for bonus depreciation, the IRS is auditing business aircraft owners and aggressively trying to disallow bonus depreciation through various techniques. The "direct" method is to scrutinize the taxpayer's transaction under the bonus depreciation rules to find missteps.

For example, under the bonus depreciation rules, the "original use" of the aircraft must begin with the taxpayer – that is, it cannot be a used aircraft (other than certain sale/leaseback situations occurring within 3 months of the aircraft's original use). The taxpayer must also have a "written binding contract" signed at the right time. A contract is binding only if it is enforceable under state law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). However, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. Therefore, a contract to purchase an aircraft that has a liquidated damages provision of at least 5 percent may be considered a binding contract and the aircraft could still be eligible for bonus depreciation.

The lesson here on avoiding IRS audit disallowance of bonus depreciation is that the bonus depreciation rules, and future aircraft operations, must both be considered before signing the contract to purchase a new aircraft.

Air Transportation Excise Taxes

At one time, IRS audits for federal excise taxes ("FET") on air transportation services were generally limited to aircraft charter operators and commercial airlines. Those days are gone. Now, private aircraft operations and charter brokers are being aggressively audited for FET.

The Tax Code imposes a 7.5 percent FET on the amount paid for taxable transportation of any person by air, which is generally transportation by air that begins and ends in the United States. To determine the tax base on which FET is imposed, the tax is measured by the total amount paid for transportation, but when a payment covers charges for non-transportation services (such as meals and hotel accommodations) as well as for transportation of a person, the charges for the non-transportation services may be excluded in computing the FET. However, the non-transportation charges must be separately stated from the taxable transportation charges, otherwise an IRS auditor will seek to impose FET on otherwise non-taxable non-transportation services.

The IRS's latest invention is to claim that management fees paid by an aircraft owner to its aircraft management company are subject to FET, even when the aircraft is operated by the owner under FAR Part 91. In recent IRS chief counsel advice, the IRS examined a situation where an aircraft owner hired a management company to oversee aircraft operations, paid the management company a monthly management fee and reimbursed pilot employment and training costs. The IRS Office of Chief Counsel determined that the management company provided taxable transportation to the aircraft's owner, and that FET was due on the monthly management fees and pilot reimbursements, neither of which (according to the IRS) were non-transportation services. Business aircraft owners using management companies need to review and reconsider these relationships in light of the IRS's latest effort to expand the FET, with an eye towards clearly establishing that the aircraft owner has possession, command and control over the aircraft and that the management company is an agent of the owner. In addition to challenging the IRS's new position during the audit and through litigation, aircraft owners should consider (a) directly employing the pilots, or (b) creating their own corporate flight department.

Responsible Person Tax For Uncollected FET

If it turns out that the company required to collect and remit FET on air transportation services to the IRS does not actually have the money to pay, that is not a problem – for the IRS. The IRS can seek to collect a trust fund recovery penalty equal to 100 percent of the unpaid FET from a "responsible person," which is a person who (a) is responsible for collecting, accounting for, and paying over the FET; and (b) willfully fails to perform this responsibility. Typically, these are high-ranking company officers who control the payment of FET to the IRS.

If the IRS auditor seeks to assert this trust fund recovery penalty, a taxpayer needs to show that any failure to remit was not "willful." The IRS treats a responsible person as being "willful" if he (a) pays other creditors after he knows of the employer's failure to pay the withheld funds to the IRS; or (b) recklessly disregarded a known risk that the taxes were not being paid over. If a responsible person is made aware that FET has not been remitted to the IRS, that person's investigation or correction of the mismanagement can help prove that the responsible person was not "willful" and thus not liable for the trust fund recovery penalty.

Recordkeeping!

Instead of fighting over deductions, the IRS has an easier time winning audits when the taxpayer has bad recordkeeping and fails to substantiate its business aircraft use. Tax deductions are considered to be a "legislative grace" and taxpayers are required to substantiate their business use of aircraft by adequate records or by sufficient evidence corroborating the taxpayers' own statements for (a) the amount of such expense; (b) the time, date, distance traveled and place of the travel, entertainment, amusement, recreation, or use of the aircraft; (c) the business purpose of the expense; and (d) the business relationship to the taxpayer of persons entertained that used the aircraft. The Treasury regulations provide more details regarding the business aircraft recordkeeping requirements, but the point here is to maintain adequate business aircraft records so as to prevent an IRS auditor from disallowing tax deductions based upon a business aircraft owner's bad recordkeeping.

Conclusion – Don't Panic

The best IRS audit defense occurs before the audit letter comes. Pre-plan business aircraft use and ownership, and keep good records. When the audit examination letter comes, don't panic. There is usually adequate time to manage the audit process and work through the issues with the IRS auditor. If the IRS audit does not have a satisfying result, there are other opportunities to resolve the tax issues, such as the IRS Appeals Division and, if needed, the courts, both of which are impartial and will give the taxpayer a fair chance to resolve its tax problems.