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## Leaving No Stone Unturned: The IRS Targets High Net-Worth Individuals with Private Aircraft Operations

In response to declining tax revenue, the IRS has announced two separate, but high profile audit programs that will affect private aircraft owners and the people servicing private aircraft flight operations.

### **High Net-Worth Individual Audits**

The IRS has created a new tax enforcement unit that will target high net worth individuals for audit. Individuals with tens of millions of dollars in assets will have to answer questions from the IRS's Global High Wealth Industry group about their privately held companies, partnerships, trusts, offshore accounts, gifting techniques and, of course, private aircraft.

Before the IRS comes in, it would be wise to do an internal check-up and review of the high net worth individual's private aircraft ownership and use. The IRS aggressively reviews private aircraft related tax benefits, and tends to take the view that private aircraft ownership and operation is non-deductible until proven otherwise.

Therefore, as a threshold matter, detailed records should be maintained regarding the aircraft's use that can substantiate the taxpayer's deductions. Bad recordkeeping is enough for the IRS to justify tax deduction disallowances.

Beyond that, the IRS goes through a laundry list of tax rules, limitations, and disallowances during a private aircraft related audit, including: passive loss, hobby loss, at-risk rules, depreciation limits for aircraft not "predominantly" used for qualified business purposes, entertainment deduction disallowances, imputed income (i.e., "SIFL"), and 1031 tax-deferred exchange compliance. The IRS will also surprise taxpayers with additional tax assessments for unpaid federal excise taxes ("FET") if a taxpayer's private aircraft operations qualify as a taxable "air transportation service" as defined by the IRS. FET (which is a 7.5% tax, plus segment fees) can be unintentionally triggered in numerous ways, including owning and operating the aircraft in a special purpose entity. An internal review of private aircraft tax matters can allow for actions to be taken to correct issues and prevent more serious ones before an IRS audit.

### **Worker Classification Audits**

Starting February, 2010, the IRS will randomly audit 6,000 U.S. employers for proper worker classification and employment tax compliance under a National Research Program (NRP). The IRS is auditing large and small employers in a cross-section of industries. The purported

purpose of these audits is to save taxpayers' time by allowing the IRS to refine its audit selection techniques. This may save taxpayers' time in the future, but these NRP audits will cost taxpayers significant time now. The IRS also wants to try to "quantify" the tax gap between employment taxes owed and employment taxes actually paid due to misclassification of individuals as independent contractors instead of employees.

Generally, the IRS collects more money in employment taxes when a worker is classified as an employee, so the IRS is predisposed to classify workers as employees instead of independent contractors wherever possible. Private aviation is directly affected by this because many flight departments use pilots, maintenance personnel and flight attendants on a contract basis to avoid the tax, insurance and other responsibilities associated with employing these individuals. If an IRS agent determines that flight department personnel are improperly classified as independent contractors, the company can be liable for back taxes, interest and penalties.

Whether flight department personnel are employees or independent contractors depends primarily on who "controls" the worker. The IRS has a 20 Factor Test that it uses as an aid in making worker classification determinations, which includes such factors as (1) compensation payment method, (2) set hours of work, (3) payment of business and traveling expenses, (4) working for more than one company at a time, (5) training, and (6) a company's right to discharge the worker. There is no bright line test

for how many factors it takes to be classified as either an employee or an independent contractor, but instead each situation is individually examined and worker classification is based on the total facts and circumstances. A useful tool for evaluating whether a worker is an employee or an independent contractor is IRS Form SS-8 (Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding).

<http://www.irs.gov/pub/irs-pdf/fss8.pdf>.

Before the IRS comes in, flight departments should review their worker classifications in terms of written agreements, actual business practices and the relationship between the company and the workers. A written independent contractor agreement can strongly support a company's classification of a worker as an independent contractor. If there is an audit and the IRS disagrees with the company's worker classification, the company can still treat the worker as an independent contractor if it qualifies for "Section 530 Relief" by demonstrating to the IRS that there was a "reasonable basis" for not treating the worker as an employee, such as industry practice or legal precedent. Alternatively, instead of hiring employees or independent contractors, a flight department could contract with a professional staffing company that treats the workers as their own employees.

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