

# A CRITICAL KEY TO IRS **AUDIT** SURVIVAL

It is a well-known fact among the professional tax and aviation communities that there has been a significant increase in federal, state and local tax audits involving the acquisition, operation and disposition of aircraft within the last 3 - 5 years.

This article will provide some of my “battle tested” record keeping techniques that have been developed over 30 years as an aviation tax specialist and explore the consequences of failure to keep copious and contemporaneous aircraft expense and usage records.

The cost of not having proper documentation for an IRS audit involving a plethora of aircraft issues surrounding the

in dispute because the parties have presented conflicting evidence as to the business or personal nature of many of Plaintiff’s trips.”

The IRS contested the classifications of many of the “business trips” because the taxpayer’s children, girlfriends and others traveled with Mr. Morton to vacation destinations throughout the world and stayed with him at his vacation homes. Flight logs were maintained which identified the date and time of the trip, the number of passengers, arrival and departure airports and the flight crew. However, there was no attempt to keep systematic records as to the identity of the passengers or the reasons why any of the passengers



business use of a G-III and a G-IV aircraft was very clearly demonstrated on April 27, 2011 by *Morton v. U.S.* 107 AFTR 2D 1963.

Peter Morton, one of the co-founders of the Hard Rock Café chain and creator and developer of the Hard Rock brand, filed a refund suit in the U.S. Court of Federal Claims in order to recoup nearly \$9.8 million in taxes assessed by the Internal Revenue Service. He claimed that he should be entitled to deductions for aircraft depreciation, operating and non-operating expenses. Before the court would allow the deductions, it had to determine ... “whether Plaintiff has substantiated those business deductions he is attempting to deduct.” The court observed, ... “there are material facts

were aboard a particular flight. The court stated ... “the lack of information about people included on the trip makes it difficult to say at this point definitively that the flights were or were not for business purposes.”

In arriving at the business or personal classification of the various trips, Mr. Morton would meet with his accountant sometime after the trips were concluded. But the court was unable to say whether or not these meetings were sufficiently contemporaneous enough to provide credibility as to the business or personal nature of the flights.

Judge Baskir opined, ... “the court cannot allow a refund until plaintiff convinces the court that the aircraft are actually used for “productive use in a trade or business”,

and ... “that the Plaintiff has not sufficiently substantiated the business or personal nature of the individual trips”.

The court gave the taxpayer approximately 60 days to present further evidence as to the nature of the business use of the aircraft. The taxpayer was unable to prove his aircraft business usage for the years under audit so the government kept the \$9.8 million.



### **OBSERVATIONS AND RECOMMENDATIONS:**

1: Contemporaneous records, are those that are maintained at or near the time of the event by a person with knowledge of the event and must be kept not only to show an overall purpose for the business trip but also the reason each passenger was aboard for each flight segment. For at least the last 5 years, IRS agents have been requiring aircraft owners to prove that each person was not aboard the flight segment for recreation, entertainment or amusement purposes.

2: Occasional meetings during the year or at the end of the year with your tax preparer to try to determine which flights may have been for business or personal reasons will not be enough to make a credible case.

3: Examples of the types of documentation that I use are; emails both before and after the trip that identify the trip objectives, a brief meeting agenda, participants and contact information for all passengers. Advance trip requests, approved by the appropriate corporate officer, seem to work especially well for public entities. We also include a post trip evaluation to indicate if the objective was met along with future follow- up action items. Copies of purchase orders for

new equipment, purchase contracts for real estate, etc are also inserted in the trip file where appropriate. Obviously, receipts for all trip expenses are maintained in the trip file.

4: All of these records can either be kept in paper format or as part of an online aviation documentation storage vault that has been designed exclusively for the analysis and preservation of permanent aircraft records or both. Whatever system you elect to use, the records need to be available when you need them. If you get a computer virus or suffer a natural disaster and cannot obtain your records, the taxing authority will make an assessment.

5: Those who claim bonus or accelerated depreciation have to make sure that their annual business usage is more than 50% for every year during the 6 and 12 year exposure periods for Part 91 and Part 135 aircraft respectively. If your business use falls to 50% or less, then bonus or accelerated depreciation in excess of straight line is required to be recaptured on your tax return per Internal Revenue Code sections §179 and 280F(b) (2). Although few IRS agents may admit it, we have seen a number of cases where I and other advisors strongly believe that bonus depreciation was an audit trigger.

6: Finally, verify your tax deductions before the return is signed and filed. That means, make sure you have copies of receipts or other records that prove the total value of all the deductions you are claiming. If you think that all tax preparers do that....you're wrong! ■

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