Defensive Oversight: (Part 1)

Preparing for federal tax challenges

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Boards are well advised to structure aircraft acquisition and operations with a sharp eye toward what tax auditors want to see, cautions attorney Chris Younger.

As those of you who have hiked on rugged mountain trails can appreciate, a clearly marked, well-constructed and unobstructed path makes your trek easier and more enjoyable. Similarly, it is essential for companies that own and operate business aircraft to create a clear and unambiguous path that will lead a tax auditor to the simple conclusion that all tax consequences of such aircraft ownership and operation have been accurately addressed.

Board Members must recognize the need to construct such a path at the inception of (and throughout) the business aircraft acquisition process, and to maintain that path during the entire time the aircraft is owned and operated.

CREATING YOUR TRAIL

First, a Board must ensure that aircraft ownership and operations are structured in a manner such that any losses relating to the aircraft are currently deductible for Federal income tax purposes. Additionally, such a structure should be designed to eliminate or minimize the risk of any Federal Excise Tax liability with respect to such operations. The path to be followed must be clear and unambiguous.

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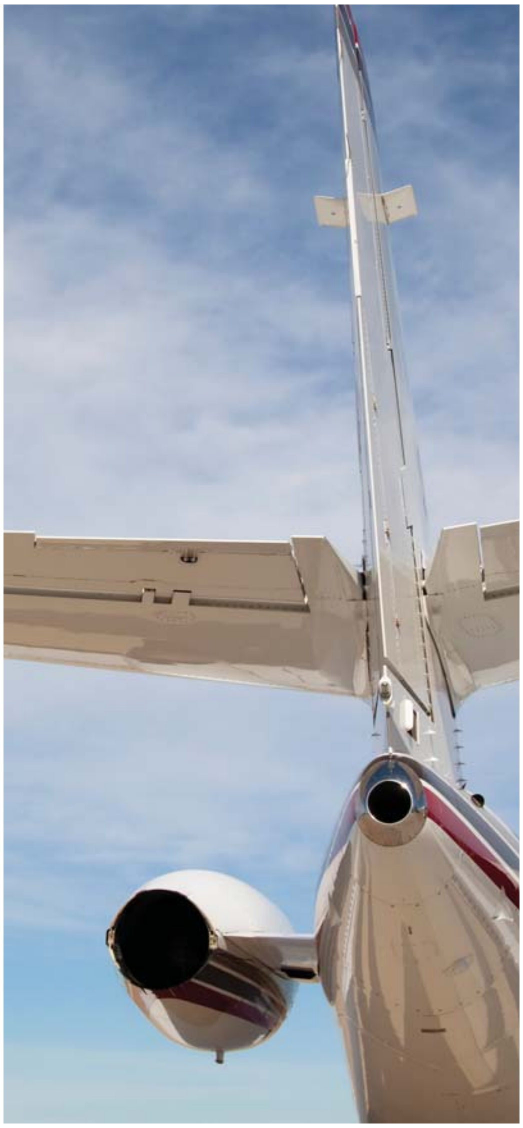
Next, Board Members should require a detailed business plan setting forth the purpose for acquiring a business aircraft and the business goals to be accomplished. Such a plan should be carefully written and well thought out, taking into account any tax objectives relating to aircraft ownership and use.

Following these two steps, the Board should work with its expert professional advisors to create a tax-efficient structure in which the aircraft will be owned and operated. This part of the process is completed by preparing a comprehensive set of documents relating to the ownership and operation, such as an aircraft usage policy, aircraft dry leases, charter and administrative services agreements, and agreements relating to joint aircraft ownership and usage. ›



Documents relating to financing must also be drafted with care and analyzed to ensure that they take into account all Federal Income Tax objectives and do not create any impediments to the realization of those objectives.

CLEARING AND SIGNPOSTING YOUR TRAIL

In an IRS tax audit, the Board wants an IRS agent to be able to see the desired objectives as clearly as possible. The structure described must document that all costs are ordinary, necessary and reasonable and show that all cost-related activities are pursued to generate profit.

Furthermore, the Board should ensure that the structure addresses all potential limitations on the deduction of any losses from the aircraft activity such as "passive activity" and "at-risk" loss limitations, and also limitations due to personal entertainment use or non-qualified business use of aircraft. In this way, the path that is designed and built by the Board will serve its intended purpose.

Another key component in this process is the continued maintenance of the path so that an IRS agent has no trouble following its trajectory. In the context of an aircraft, the Board must ensure that detailed records are maintained. These records should clearly identify the purpose for each flight and the reason why each passenger is on board the aircraft.

The path must be clear of all obstructions so that it is easily traversed. The Board should ensure that no extraneous and possibly distracting information is created or preserved. In this way, the Board can help an IRS agent or anyone else who needs to follow the path stay on course and not be led inadvertently to an unknown or unintended destination.

For example, if aircraft related depreciation shows up as a line item on a tax return, the Board should have very clear and easily retrieved records supporting the allowance. Again, this relates to maintaining a clearly marked path, free of obstructions, that is very easy to follow.

The use of the concepts described above can enable a Board to support the validity of any tax deductions relating to a business aircraft and to avoid the possibility of unwanted liability for income and excise taxes emanating from such ownership and operations.

The need for the Board to assemble a team of expert professional advisors to assist cannot be understated. Such a team can be an invaluable resource that enables a Board to proactively anticipate and oversee a review of tax effects emanating from the ownership and operation of a business aircraft.

THE BOARD CAN HELP AN IRS AGENT WHO NEEDS TO FOLLOW THE PATH TO STAY ON COURSE TO A CORRECT CONCLUSION

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Aircraft Index see Page 4