Cessna Pilots Association

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# CESSNA PILOTS ASSOCIATION


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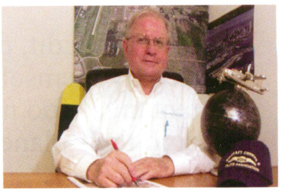
# Tax Risks



*By Jim Baloun*

***HOW DO THEY TAX THEE?***
***Let's NOT Count the Ways***

The "direct route" to peaceful enjoyment of your aircraft starts with properly planning for tax savings before the purchase. Begin with selecting the right type of entity to minimize legal risks, and to maximize tax benefits. Then go on to consider the tax aspects of financial issues that present several options for tax reporting based on your selection of entity type, and type of use.

S-Corporations and Partnerships flow income and losses to the individual return(s) of the owner(s) in similar fashion, but with some subtle nuances. "Basis" and "at-Risk Limitations" must be considered. If you think you might be using either of the above forms, it would be a great idea to get a thorough briefing from an aviation tax advisor who has experience dealing with audits of aircraft entities. Failure to get a thorough briefing will be like taking off into a thunderstorm.

In the May issue we discussed Entity Selection, July put that into a "risk" perspective. Today, we are going to take a look at the risk of TAXES that arise from that choice.

Before you depart on your flying honeymoon, you must ante-up.

Sales tax is paid at delivery, or Use Tax must be paid within 30 days.

Fuel taxes come in the form of Federal Excise Tax or Sales Tax (or both) - depending on how you get it and where. Municipalities, airport authorities and even library districts get a piece of these taxes, along with some annual personal property taxes or registration fees in some states. Go to your State's Department of Revenue and do your homework.

In the eyes of persons outside the pilot community, aviation is the epitome of physical risk. Our family members are jealous of the money spent on our planes, and our trusted advisors are leery of them as well, because they will eventually be blamed for Tax Surprises if they do not scare you away from buying the plane.

We need to assess financial risks of taxes and audits to protect our trusted advisors from allowing us to take monetary risks, just as we learn to protect ourselves in flight from the physical risks.

The fact remains - what really keeps an aircraft aloft is money. You need to be sure to have enough "fuel" in the tank before takeoff, or your flight may be shorter than you had wished.

Any penalties and interest on top of delinquent taxes is like ice on our wing. Not needed, not appreciated; and hard to prevent.

We were encouraged by our flight school to run "full-rich" to avoid risk of damaging the engine. Mike Busch has sage advice on risk/reward and hidden costs of learning. Not getting good advice from an aviation accountant is like aggressively learning without a multi-probe engine analyzer.

Just as Flight Service briefings provided good information to make a "go or no-go" decision, You should not hesitate to consult an Aviation CPA before launching into a purchase, even if you do not plan to use your plane for business.

Some of us have dealt with tax audits; the rest of us are looking forward to one. Audits get started in many ways, not just because we have an aircraft.

We know pilots hear hangar stories about bad experiences with the IRS or state tax authorities, but we cannot really know all the circumstances of how our friends were selected for audit, or how badly it was handled by themselves or their non-aviation accountants. Too many pilots have bailed out and sold their plane without putting up a good fight.

As an aircraft owner/operator, you have three "partners" flying everywhere you go. Beside the FAA, both State and Federal agencies want to exercise increasing control over how we operate our aircraft and our businesses and all these "partners" view us as ATM's. Our local state now has its hand out looking for Use Tax, which we will address in a future article.

It is important to note there are two types of tax risk, with the first being from the type of event we cannot do anything about. That is the risk of being randomly selected for an audit.

The other tax risks can be avoided or mitigated with careful planning, but not shared.

In today's tax money hungry environment, rest assured you will be a scrutinized by your local state, as well as the IRS. There are tax exposures related to operation of any aircraft and pilot, co-pilot or person who owns the aircraft. The documentation requirements must be on the mind of the flight crew, passengers and maintenance staff as well as the company accounting staff.

The chances of your business being a target of a random audit are less than five percent.

Just because you or your entity owns an aircraft, and the auditor happens to see your Cessna, you are virtually assured that the auditor will want to take a look at your aircraft records, including logbooks.

You cannot avoid having an auditor look at your use of the plane, regardless of how many layers of corporations and limited liability companies you put in place. You will be hunted down by every state where the plane appears to operate, and you will be receiving exploratory letters asking why the agency can't seem to find your tax form. So unless you actually live in Delaware, you can forget about having the mythical magical shield from sales and use taxes. However, you can plan to pay the lowest tax possible if you employ a good strategy before making an offer to purchase.

There is always the reality of being subject to sales or Use Tax, and you cannot wish them away by thinking that someone other than you should have demanded them at the closing, or forever forget about collecting them. Ignorance of Use Tax is no excuse, same as not knowing about a TFR.

There are some exemptions from Sales and Use Taxes which can be utilized by your entity which might save you some money. If your aircraft is going to be operated under Part 135, or for interstate commerce, it can be exempt. Every state has exceptions and grand fathering provisions, but they are going away. Do you pre-purchase planning, and go to the states website. Then call us.

The next category of risk relates to tax treatment of your use of the aircraft. This is where planning can have a tremendous return on investment.

The IRS has rules for businesses which every business owner, CPA, and Tax Preparer deals with on a daily basis. How many of us are aware of the special IRS rules for aviation? Unless you have dealt with a variety of Audits, you can't be expected to anticipate auditor's positions.

What are these rules? The IRS special rules for aircraft owners are contradictory to the business rules you probably know, and few tax professionals have time to focus on the 1% of their practice that aviation represents. Thus, most professional tax preparers and accountants are handicapped in their ability to recognize the traps before being caught up in them. Many of the most punitive rules are as apparent as clear-air-turbulence (that is, they're not clear at all!).

Entertainment rules take half of the fun out of business expenses, but can totally destroy deductions for aircraft usage. Businesses and Secret Service agents can spend money on wine and sporting events, but God forbid you might use your aircraft to take a customer or top-performing employee for a round of golf in your aircraft!

The IRS requires use of a logbook to track each passenger on each leg of every flight.

Passengers get to ride in company vehicles every day, but some company employees get 1099's or bigger W-2's if they go on a personal trip in a company owned aircraft.

As much as your tax advisor is probably not familiar with the IRS rules for aircraft, the Agent auditing your return probably doesn't know much about aviation audits, either. To make matters worse, the agents generally have no idea that there are different rules for different categories of aircraft and operations by different entity types. The IRS knows this, and has prepared a "Cliff's Notes" handbook on how to challenge deductions and documentation.

Here's a strong recommendation: Never go to an audit without consulting a CPA who has successfully done battle with the IRS on similar aviation issues. Do not go to an audit alone. Let your CPA isolate you and keep you from saying anything damaging. Once you've said something, you can't take it back. Do not respond to the IRS yourself either in writing or verbally. Let a professional handle it. Reach out for help the same day you get the first notice.

Address business tax consequences and personal taxes with your TEAM of legal and tax advisors before making an offer to purchase. Your trusted professionals who have been around you for a long time should be willing to invite specialists to the table. To minimize your risks, you must do your planning exercises with AVIATION specialists before making a decision on entity selection and structure, or tax savings may not be realized.

For example, before CPAaviation.com offers a tax solution to a purchaser, we perform a series of surveys. We need to know how the aircraft will be operated. We confirm the client has a clear understanding of tax documentation requirements. We address how the aircraft fits into the life of the new owner and his existing or intended business or employment situation. We may verify the tax savings - and risks of deviation from your plans. We strive to include all stakeholders and advisors whose lives will change when you take delivery of your new aircraft.

Do not go into a purchase without the right co-pilot and discussion with your TEAM. Be sure that your AVIATION TEAM is qualified to work with your ground crew. Start "planning" early!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