



## Tactics to Survive an IRS Audit

November 3, 2011

Sue Falkringo, CPA, MBA  
Commercial Pilot, AS/MEL, Instrument Airplane

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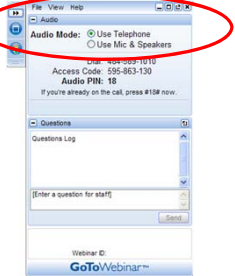
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## Today's Webinar:

- Today's webinar length will be approximately 1 hour and 30 minutes, in 2 sections:
  - Section 1 is 50 minutes + questions (1 hour CPE or CLE)
  - Optional section 2 is 30 minutes + questions
- If you need assistance with accessing the webinar or with the course materials

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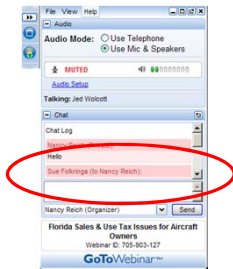
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## We get asked many questions during the webinar.....

- We try to answer all questions asked during the webinar
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- We may ask you to contact us after the webinar if your question is too complex to answer using the 'chat' feature

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## Reminders:



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## Wolcott & Associates, PA: What We Do

- We are an aviation-dedicated group of CPAs and accounting professionals
- Our clients are aircraft owners and operators, pilots, and owner-pilots
- We specialize in the preparation of aircraft income tax returns, state tax matters, IRS audits, structuring aircraft ownership, and related aviation tax and financial matters
- We identify, protect and preserve tax deductions for your aircraft!

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## Resources:

The image shows three resource cards. The first card is titled 'Income Tax Guide for Aircraft Used in Business' and features a 'NEW EDITION' badge. The second card is titled 'Personal Use of Company Aircraft' and also features a 'NEW EDITION' badge. The third card is titled 'Spreadsheet Guide for SIFL and Entertainment Cost Limitation Calculations' and features an image of a spreadsheet and a pen.

Order at [www.aviation-cpa.com/products/reports.cfm](http://www.aviation-cpa.com/products/reports.cfm)

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## Resource Lookup

The image is a screenshot of the Wolcott & Associates, P.A. website. The header includes the company name and 'Certified Public Accountants'. Below the header is a navigation menu with links for Home, Our Services, Resource Library, Our Location, Contact Us, and Employment. The main content area features a large image of an airplane and a 'Latest News' section with several articles. A red arrow points to a search bar in the bottom right corner of the page.

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## Resource Materials

- Copies of today's materials are available at our website at [www.aviation-cpa.com](http://www.aviation-cpa.com).
- This PowerPoint presentation – **S0101**
- IRS code and regulation references on each slide
- Look for green lookup bar on the homepage

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## Aircraft Audit Issues

# Passive Loss Limitations IRC § 469

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## Passive Loss Limitations (PAL) IRC §469

- IRS limits use of losses from:
  - Rental activities
  - Inadequate participation of owner
- Causes:
  - Lease to 135, rental company
  - Dry leases
  - Aircraft owner does not participate in activity
- Result: Passive losses can only be used to offset passive income and often can not be used by taxpayer



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## PAL Income

- PAL Income includes:
  - Rental income
  - Income from activities where owner does not have material participation
  - Gain on sale of property used in a passive activity
  - Passive income generator (PIG)
- PAL Income does NOT include:
  - Operating company income
  - Portfolio income (interest, dividends, annuities)
  - Income from working interests in oil and gas
  - Royalties from self-created intangibles

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## PAL Rules, Exceptions, and Grouping

- There are 6 exceptions to the PAL leasing rules. Treas. Reg. § 1.469-1T(e)(3)(ii)(A)-(F) 10601
- There are 7 “tests” in the PAL material participation rules. Treas. Reg. § 1.469-5T(a)(1)-(7) 10603
- PAL grouping rules provide a defense to the material participation rules. Treas. Reg. § 1.469-4 10604
  - Note, as of January 25, 2010, grouping election must be in writing, filed with each tax return in the group

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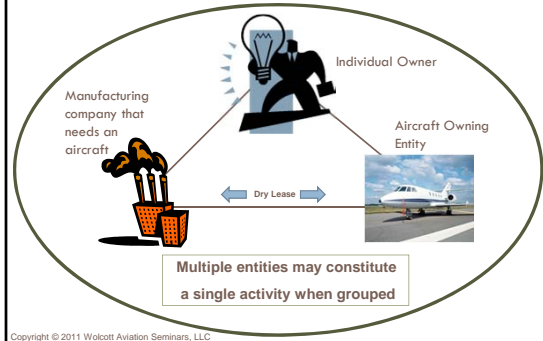
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## PAL – Grouping Provision



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## What to do Before the Audit

- Separate active and passive activities to limit passive effects
- Amend returns to include grouping election
- Restructure assignment of duties, prepare time logs
- Look for passive income opportunities
  - Rental real estate
  - Passive income generators (PIG)
- Document taxpayer’s intentions with leases and in corporate minute books with annual meetings

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## What to do During the Audit

- Claim grouping if circumstances permit (new rules after Jan 25, 2010)
- Prepare analysis of active and passive income and expenses and request auditor allow restating
- Test to see if insubstantial use criteria exists
  - 80/20 test Candelaria vs. United States 40101
  - Less than 2% aircraft FMV or other comparisons Treas. Reg. § 1.469-4(d) 11003
- Regulations give taxpayer substantial latitude to establish material participation
- Stress facts and circumstances

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## Aircraft Audit Issues

### Ordinary and Necessary Use - IRC §§ 162, 212

10103

10104



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## Ordinary and Necessary Business Expense - IRC §162

- The IRS ordinary and necessary business expense standard requires that an expense be:
  - Appropriate
  - Helpful in carrying on the taxpayer's business
  - A common and accepted practice
  - Reasonable in amount
  - Incidental to the business
  - Not "lavish" or "exorbitant"

I.R.C. § 162(a)(2): 10101

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## Ordinary and Necessary Business Expense - IRC §162

- Aircraft must be ordinary and necessary to the normal course of business
- Three hurdles must be overcome:
  - Air transportation is a business requirement
  - Air transportation need may only be met by private aircraft
  - The aircraft is appropriate for the company's use



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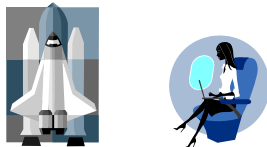
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## Ordinary and Necessary Business Expense - IRC §162

- IRS may try to limit deduction because aircraft was inappropriate for specific travel requirement
  - Could limit deduction to first class airfare equivalent
  - May substitute reduced hourly operating rate



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## Ordinary and Necessary Business - Defenses

- Little guidance in IRS regulations defining "Ordinary and Necessary" use for aircraft
- Arguments for and against "Ordinary and Necessary" use are often subjective and rely on facts and circumstances
- Court cases often helpful in defending taxpayer position
- No limitations on ordinary and necessary use cited in Sutherland §60119, Midland Financial §60111 or National Bankcorp §60112 cases

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## What to do Before the Audit

- Analyze company need for private air transportation
- Consider trading if current aircraft is inappropriate for company's use
- Document business use with corporate minutes approving purchase and explaining business purpose. Prepare business plan and adopt in minutes
- Maintain logs tracking business use, non-business use, training

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## What to do During the Audit

- Argue facts and circumstances
  - Need for air travel
  - Unique circumstances such as celebrity status, medical requirements, business in remote locations, middle-management travel requirements
- Cite cases:
  - Noyce v. Comm, 97 T.C. 670 (1991) <sup>60100</sup>
  - Marshall v. Comm, T.C. Memo (RIA) 1992-65 <sup>60104</sup>
  - Kurzet v. Comm, 222 F.3d 830 (10th Cir. 2000) <sup>60105</sup>
  - Richardson v. Comm, T.C. Memo (RIA) 1996-368 <sup>60106</sup>
- Reasonableness of travel expenditures is determined in comparison with the revenue from the activity
  - Depreciation is generally ignored (Noyce) <sup>60107</sup>

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## Aircraft Audit Issues

### Depreciation Issues IRC §§168, 167, 280F

<sup>10700</sup>

<sup>10708</sup>

<sup>10701</sup>



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## Depreciation Audit Issues:

- Non-compliance with *Listed Property* rules
- Incorrect application of depreciation rates
- Failure to follow §1031 tax free exchange regulations 11000
- Failure to follow bonus depreciation rules



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## Sec. 280F Listed Property Rules

- Aircraft are considered *Listed Property*; means more scrutiny Sec. 1.280F-7(b) 10701
- Leasing of aircraft to 5% owner (or related party) means you have an additional hurdle to overcome in meeting the 50% or greater business use to qualify for MACRS depreciation Sec. 1.280F-6(d)(ii)(A)(1) 10702
- Aircraft Exception: If all other use qualified business use by a 5% owner is greater than 25% then you can count the 5% owner use as qualified business use in meeting the 50% test 1.280F-6(d)(2)(ii)(B) 10702

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## Depreciation Rates for Aircraft

- Only two tax depreciation methods available for business aircraft:
  - +50% business use - taxpayer may use optional Modified Accelerated Cost Recovery System (MACRS)
  - - 50% business use - taxpayer must use Alternative (straight line) Depreciation System (ADS)
- Depreciation must be allocated according to mileage or other basis
  - Active vs. Passive
  - Business vs. Personal

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## Depreciation Rates for Aircraft - MACRS

- Modified Accelerated Cost Recovery System (MACRS)
  - 5 Year rate for Part-91 aircraft
  - 7 Year rate for Part-135 aircraft
    - Depreciation rate must reflect predominant use each year if use is split between Part-91 and Part-135
- **BIG GOTCHA:** If MACRS is adopted and business use falls below 50% taxpayer must recapture previous year's excess depreciation

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## Depreciation Rates for Aircraft - ADS

- Alternative Depreciation System (ADS) Straight Line Depreciation
  - 6 Year rate for Part-91 aircraft
  - 12 Year rate for Part-135 aircraft
- Once MACRS requirements are no longer met and ADS is required, taxpayer cannot change

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## Bonus Depreciation Issues

- Typical bonus depreciation audit issues:
  - Not meeting contract requirements
  - Not meeting deposit requirements
  - Incorrect application of 1<sup>st</sup> year business-use requirements
  - Purchasing existing contracts
  - Failure to meet +50% business use in all subsequent years
- If you claim bonus depreciation, **EXPECT TO BE AUDITED**



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### 1031 Tax-Free Exchange Regulations IRC §1031 11000

- Rules for “Forward” and “Reverse” exchanges are complex
- Completing the transactions within the specified deadlines is crucial
- Failure to meet stat deadlines will cause gain on the relinquished aircraft to be recognized in the year of sale
- Seller cannot receive proceeds from sale of relinquished aircraft until new aircraft is acquired
- Suggestion: Use exchange company



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### Single-Purpose Companies Have High Audit Exposure

- SPC's are companies formed to only own an aircraft
- Often used to shelter from potential liability, lease aircraft back to owner
- Typically S-Corps and multi-member LLC's
- Cash in equals cash out
- Depreciation expense remains very prominent
- Very high audit selection rate

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### What to do Before the Audit

- Consider restructuring SPC ownership to limit audit exposure
- Review 91 vs. 135 use to see if rate is appropriate
- If leasing, review use by 5% owners; amend if necessary
- Consider the “visibility” of bonus depreciation



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## What to do During the Audit

- Depreciation is governed by statute and regulations, leaving little “wobble room” during audit
- Facts and circumstances of little value
- Ordinary and necessary use rules prevail
- Auditor will determine if documentation exists to support business use
- Tax court cases won't help much



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## Upcoming Webinars

- Nov. 17, 2011: Tax Benefits from the Business Use of Your Aircraft. Introductory-level webinar on ownership structures, types of deductions, use of aircraft by W-2 employees, depreciation, other tax information for new and prospective owners. One hour CPE, CLE
- Dec. 01, 2011: 2011 Year-End Tax Strategies. Tax planning for individuals and companies; tips on last minute ideas for 2011, new regulations for 2012. Something for everyone. **Free! Free! Free!**
- 3 Webinars In January 2012: Passive Loss Limitations for Aircraft Owners, SIFL, Entertainment Cost Disallowance. One hour CPE, CLE each

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## Aircraft Audit Issues

### Hobby Losses IRC §183 10300



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## Hobby Loss Rules – IRC §183

- Restricts use of losses against other taxable income if activity is not “for profit”
- IRS presumes activity is not a hobby if company has profits in 3 out of 5 years
- If not 3 profitable years, IRS will allow taxpayer to apply facts and circumstances test
- Hobby Loss Rules are dangerous because they allow IRS to disallow all operating costs, ownership costs, and depreciation. Can be big win for IRS

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## Hobby Loss Rules

- IRS often cites Hobby Loss rules when aircraft is owned by a single-purpose company (SPC)
  - Includes S-corps, multi-member LLC's, and Schedule C's for individually-owned aircraft
  - Cash in often equals cash out, meaning no profit from day-to-day operations
  - SPC's often have consistent loss years due to depreciation

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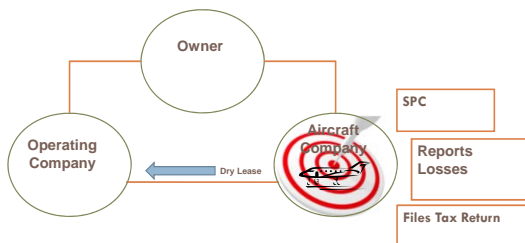
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## Single Purpose Companies – Audit Targets

### Example of Single-Purpose Company



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## Hobby Loss Rules Treas. Reg. §1.183-2(b)

10502

IRS regulations provide a list of nine factors to test if an activity is for profit, such as

1. Manner in which taxpayer carries on the activity
2. Expertise of the taxpayer or advisors
3. Time and effort expended
4. Expectation of future profits
5. Expectation that assets will appreciate in value

IRS also permits grouping of "hobby" activity with other profitable activity

Treas. Reg. § 1.469-4(d) 11003 and Candeleria vs. United States 40101

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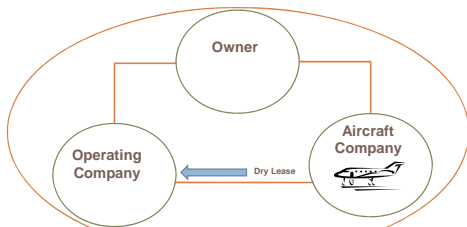
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## Hobby Loss Rules (Continued)

- Taxpayer might aggregate "hobby" activity with profitable activity, 1.183-1(d) 10501



NOTE: Include grouping decision reference in each tax return

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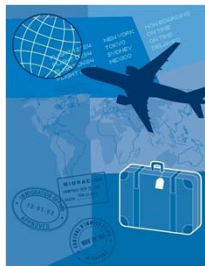
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## What to do Before the Audit

- Hobby Loss Rules:
  - Change ownership structure to place aircraft in a profitable operating company, or
  - Change ownership to make company a disregarded SM-LLC
  - Amend returns to include grouping election
  - Create business plan, record in Corporate Minute Book
  - Document, document, document



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## What to do During the Audit

- Review the nine factors IRS uses to test if activity is for profit
- Other arguments:
  - Positive cash flow
  - Do not include depreciation in calculation or determining IRC §183 loss test (see *Noyce v. Commissioner*) 60100
  - Aircraft tend not to lose value, make good investment
  - Rental or charter use of aircraft pays down loan, builds equity
  - Depreciation only defers taxes; gain or loss will result when aircraft is sold

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## Aircraft Audit Issues

Personal Use of  
Company Aircraft  
IRC § 274 10304  
Reg § 1.61 10400



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## Personal Use of Company Aircraft

- For individual-owned aircraft, including aircraft in a single-member LLC owned by an individual:
  - Apply primary purpose test, similar to how individual-owned autos are reported 10100
  - Deduct pro-rata portion of direct costs, ownership costs and depreciation for non-business flight use
  - No distinction between non-business and entertainment flights; use is either business or non-business

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## Personal Use of Company Aircraft

- For aircraft owned by a Corporation, S-Corp or Partnership and provided with pilot(s):
  - Employees must report SIFL<sup>1</sup> taxable income for non-business flights 10400
  - Cash reimbursements may satisfy this requirement
  - Company must apply American Jobs Creation Act of 2004 cost limitations for entertainment flights by "specified individuals" and guests 10300

<sup>1</sup>Standard Industry Fare Level rates published by DOT



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## Personal Use Of Company Aircraft – Defenses (continued)

- Entertainment Cost Limitations
  - No "safe harbor" rules
  - Follow Notice 2005-45 10307
  - Follow proposed Reg. 1.274-10 10300
  - Reg. 1.47171-05 contains the NPRM where this code came from 11006
- No cases yet (legislation is too recent)

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## What to do Before the Audit

- Personal Use of Company Aircraft:
  - Amend employee personal tax returns to include SIFL
  - Amend company returns to recognize the entertainment cost disallowance rules for aircraft-owning entity
  - Amend returns for non-business use deduction for individually-owned and flown aircraft
  - Document business flights; make sure flight logs support business and non-business use IRC § 274(d)(4) 10305



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## What to do During the Audit

- Expect the auditor to disallow all costs, expenses and depreciation until taxpayer proves business use
- If SIFL overlooked, request auditor permit amending the 1040 returns
- If entertainment cost disallowance deductions were overlooked, request auditor permit amending company returns
- Key strategy is to get business use of the aircraft deducted (think about the future aircraft use)

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## Aircraft Audit Issues

### Flight Department Company IRC §§4261, 4262

10800

10801



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## Flight Department Company Issue – IRC § 4261

10800

- Entity only owns and operates the aircraft
- Pays DOC's including pilots
- Only purpose is to provide air transportation
- Commercial says IRS!!!! – Excise tax owed:
  - 7.5% of all costs, plus
  - \$3.70 per passenger (2011)
  - 6.25% for freight
  - See Notice 2005-62 10804



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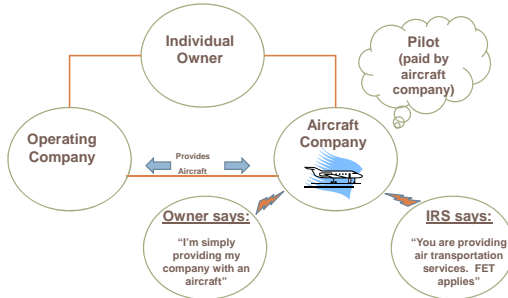
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## Typical Flight Department Company Structure



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## Flight Department Company – How to Restructure – Pros and Cons

- Convert “wet lease” to “dry lease”
- Create separate management company to employ pilots?
  - OK, providing the lessee pays the pilots
  - Note potential problem: This strategy could convert activity to passive
- Key issue – who controls the pilot?
- Caution: It is too late to restructure after the audit has commenced

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## Affiliated Group Exemption as a Flight Dept. Co. Audit Defense – IRC 4282 <sup>10802</sup>

- Allows large company with many subsidiaries to form an “aircraft operations” entity to operate the company aircraft without incurring FET liability
- Must be a common parent owning at least 80% of each includable subsidiary
- Certain entities are not includable, including S-corporations (IRC Sec. 1504) <sup>11001</sup>
- Exemption does not apply to flights provided to third parties outside of the affiliated group

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## What to do Before the Audit

- Convert wet leases to dry leases (can be as simple as changing which checkbook is used)
- Have written leases making clear who pays the pilots
- Hire (or create) a management company to provide pilots
- If claiming affiliated group exemption, be sure all entities using the aircraft qualify



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## What to do During the Audit

- Argue facts and circumstances
- Examine the flight logs for exempt flights
- Aircraft with MTOW < 6,000 lbs are exempt
- If the aircraft was operated between subsidiaries, see if the Affiliated Group Exemption applies
- Analyze all IRS findings and positions and consider a negotiated settlement
- If settling, depreciation is not included as expense; only cash amounts paid are subject to FET
- If required to pay FET, claim fuel tax 10803



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## Every Issue Won at Field Audit Level is a Victory!

- Consider the field auditor the "Traffic Cop"
- Easier to argue a ticket on the street than in Traffic Court
- Any issue eliminated at the audit level is gone

**THE FIELD EXAMINATION IS THE MOST CRUCIAL PORTION OF THE AUDIT**



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## At This Stage

### EVERYTHING IS NEGOTIABLE



If you can't settle the case at the audit level, then someone is being unreasonable

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## Final Points

- Be sure to incorporate all 3 foundation elements in your defense:
  - IRS Code and Regulations
  - Tax Court cases
  - Facts and circumstances
- Fight all IRS positions at the field-audit level; don't wait until later to begin to build your defense
- Cases become more expensive to fight at Appeals or Tax Court levels
- Don't be intimidated by Appeals or Tax Court options.

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## Flight Tax Systems, Inc. – Coming Soon

- Aviation software created to assist aircraft owners and operators in properly recording and documenting business flight use. Calculates:
  - Primary purpose flights
  - SIFL
  - Entertainment cost disallowance

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## Thank You Very Much!

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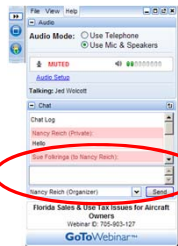
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## Reminder

- We are still taking questions using the GoToWebinar chat window
- If you have a question that hasn't been answered, we will remain connected to the webinar and will answer your question in the order in which it was received



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## Short Intermission



- We are going to pause for a moment and then continue with a review of tax cases which illustrate some of the points we've reviewed today
- Please stay connected to the webinar if you wish to participate

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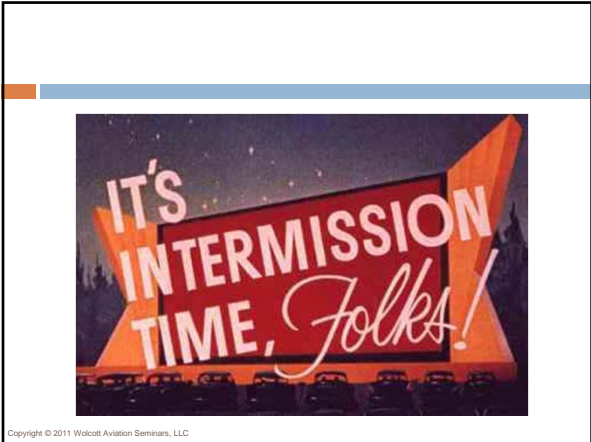
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### Passive Loss Limitations Cases - IRC§ 469

- Leroy Candelaria and Elena Candelaria, Plaintiffs vs. United States of America, Defendant U.S. District Court, West. Dist of Texas, El Paso Division, Civil Action No. EP-06-CV-0216-KC <sup>60101</sup>
- Eugene J. and Kathryn A. Schumacher vs. Commissioner Docket No. 18776-02S. 7/23/2003 <sup>60102</sup>
- Thomas Kenvill, Plaintiff v. U.S.A.: U.S. District Court, Dist. N.D., Northwestern Div., Civ. A3-96-135 11/06/97. <sup>60103</sup>



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### IRC§ 469 Cases

- Leroy Candelaria and Elena Candelaria, Plaintiffs vs. United States of America, Defendant U.S. District Court, West. Dist of Texas, El Paso Division, Civil Action No. EP-06-CV-0216-KC 10/05/2007. Taxpayer owned company created solely to lease property to a related partnership. Auditor said passive. Taxpayer claimed grouping based on "insubstantial" provision under 80/20 rule, in that leasing gross and net incomes were less than 20 percent of combined totals of both companies. Court agreed with taxpayer.

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## IRC § 469 Cases (Continued)

- **Eugene J. and Kathryn A. Schumacher vs. Commissioner**, Docket No. 18776-02S, 7/23/2003.

Taxpayer owned 90% of a flight training, rental, charter, and sales company. 10% owner was general manager. Taxpayer purchased equipment personally and leased it to the company. IRS auditor said Sch. C activity was passive due to leasing and insufficient participation. Taxpayer claimed grouping under "insubstantial" provision. Court agreed with taxpayer that activity was not passive.

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## IRC § 469 Cases (Continued)

- **Thomas Kenvill, Plaintiff v. U.S.A.**, U.S. District Court, Dist N.D., Northwestern Div., Civ. A3-96-135 11/06/97.

Taxpayer owned a twin engine aircraft that he made available on a non-exclusive basis to charter companies. The taxpayer piloted the aircraft for the charter flights. Taxpayer reported a loss from the aircraft business on his 1040 which the IRS disallowed as passive. Taxpayer challenged under the non-exclusive exception, and that charter flights were incidental to his non-aviation consulting business. Many facts and circumstances were presented. The Court rendered a split decision; upheld taxpayer's position on incidental, but agreed with IRS that non-exclusive provision did not apply.

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## Ordinary and Necessary Use Case Review IRC §162

- **Noyce v. Commissioner**, 97 T.C. 670 (1991) 60100
- **Kurzet v. Commissioner**, 222 F.3d 830 (10th Cir. 2000) 60105
- **Richardson v. Commissioner**, T.C. Memo (RIA) 1996-368 60106
- **Dunn v. Commissioner**, T.C. Memo. 2010-198 60118



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## Noyce v. Commissioner

**Robert N. Noyce and Ann S. Bowers Noyce v. Commissioner:** Docket No. 21094-88., 97 TC, No. 46, 97 TC 670, 12/6/1991. Taxpayer was cofounder and vice chairman of Intel. Taxpayer purchased and piloted a Citation which he used for Intel business. Intel would only reimburse a portion of the travel costs. Taxpayer deducted the balance of unreimbursed costs and depreciation. Auditor said use of private aircraft was not ordinary and necessary, and disallowed nearly all the deductions. Court concluded that taxpayer was entitled to deduct unreimbursed expenses and depreciation for business use of the plane.

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## E.W. Richardson v Commissioner

**E.W. Richardson v. Commissioner:** Docket No. 27308-92 TC Memo 1996-368, 72 TCM 348, Filed 8/12/1996. Taxpayer used aircraft for transportation between auto dealerships and other investments. IRS disallowed losses stating (1) aircraft primarily for benefit by taxpayer, (2) not ordinary and necessary, and (3) unreasonable in amount. Taxpayer argued benefits of private air transportation. Court agreed with taxpayer.

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## Ordinary and Necessary Use – Restaurant Company Audit Case

- Family-owned restaurant chain
- Owned 3 aircraft in a limited partnership
- Expenses of the aircraft allocated to restaurants
- All 3 restaurants located within a 25 mile radius of each other
- IRS challenged aircraft expenses to restaurants as not ordinary and necessary
- Owner took over case to negotiate settlement

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## Hobby Loss Case Review IRC § 183

- Bernard Cornfeld, Appellant, v. Commissioner, US Court of Appeals D.C. Circuit 85-1243, 8/12/86. 60108
- Louismet v. Commissioner Dec. 39.054 43 T.C.M. 1496 (1982) 60109
- Donald R. Campbell and Patricia A. Campbell v. Commissioner, US Court of Appeals, 6<sup>th</sup> Circuit 87-1892, 2/23/1989, 868 F2d 833 60107
- Morton, Peter v. U.S., (2011, Ct Fed Cl) 60114



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## Bernard Cornfeld v. Commissioner

Bernard Cornfeld, Appellant v. Commissioner: U.S. Court of Appeals, D.C. Circuit, 85-1243.

Taxpayer was President, Chairman and part owner of Investor Overseas Services, Ltd (IOS) one of the first international conglomerates. Taxpayer had a small fleet of aircraft for business and charter use and owned a 25% interest of an aircraft charter and management company.

In 1969 he purchased a BAC 1-11 to add to the fleet, which he initially leased to an airline. After lease terminated the aircraft entered a refurbishment facility to convert to executive interior. Soon after, Cornfeld was removed as President/Chairman of IOS. He defaulted on the renovations and lost deposits on the interior work. Taxpayer reported losses from charter activities and on the BAC 1-11.

IRS said that taxpayer did not have an honest profit motive for the leasing. In addition, IRS said the BAC 1-11 had never been placed in service. IRS and taxpayer settled on use of the other aircraft, but went to court on the BAC 1-11. The Tax Court found for the IRS.

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## Bernard Cornfeld v. Comm (con't)

Taxpayer appealed to U.S. Court of Appeals. Taxpayer said he was not a pilot or skydiver, and did not amuse himself with aircraft. Taxpayer was able to establish that the aircraft were not purchased for personal use.

Taxpayer also testified that the charter business generated revenue, and that he hired (and owned part of) a professional management and charter company. Taxpayer argued that there was a profit motive and court agreed.

As to entering service, the Court found that the lease to the airline was a business use, and therefore the BAC 1-11 had entered service. Court reversed the lower court's findings and found for Cornfeld on both counts.

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## Peter Morton v. Commissioner

**Peter Morton v. United States:** U.S. Court of Federal Claims, Case No. 08-804C (2011)

The taxpayer used an airplane owned by the real estate S-corp. He claimed his use of the aircraft was business-related, and supported his several S-Corporations. Claimed he could apply the aircraft expenses to other companies because his companies operated as a "unified business enterprise".

The Claims Court found that case law supported the taxpayer's theory and would allow him to take deductions for the aircraft, even though the entity owning the aircraft did not use it to further its particular profit motive.

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## Personal Use Case Review §274

- Use of SIFL valuation provides "safe harbor"
- Application and use of SIFL – Cases
  - **Sutherland Lumber-Southwest v. Commissioner:** US-CT-APP-8<sup>th</sup> Circuit 00-2827, 7/3/2001 60110
  - **Midland Financial Co. & Subs. v. Commissioner:** Docket Nos. 12302-99, 4574-00; TCM 371, 60111 8/1/2001
  - **National Bancorp of Alaska, Inc. v. Commissioner:** Docket No. 6388-00 TCM 369, 8/1/2001 60112



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## Midland Financial

- **Midland Financial Company and Subsidiaries v Commissioner of the Internal Revenue Service,** U.S. Tax Court, Docket Nos. 12302-99, 4574-00 4574-00 .
  - Principal business was selling financial services
  - Main offices in Oklahoma City, Oklahoma
  - Subsidiary Midland Aviation Company owned a Falcon 200
  - Aircraft used primarily for business with some personal use by corporate officers
  - Audit covered years ending July 31, 1995, 1996 and December 31, 1996 (short year)
  - IRS determined tax due of \$308,629

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## Midland Financial

### ■ IRS and Midland Agree

- Expenses for the use of the aircraft in the banking business were deductible
- Midland attributed income to officers for their personal use using SIFL valuation rules
- Midland used the appropriate SIFL rates for control employees and weight of aircraft

Year Ended	SIFL Income	Percent Personal Use
July 31, 1995	\$48,424	20 %
July 31, 1996	\$45,077	31%
December 31, 1996	\$14,916	32%

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## Midland Financial

### ■ The Issue

- IRS contends that regulations limit the deduction of aircraft costs and expenses to the extent claimed as compensation to officers
- Discussion (from the opinion): "...[IRS] argues that the amounts of [Midland's] deductions attributable to the personal use of the Falcon are limited to the amounts reported as wages to the [officers] for such use..."

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## Midland Financial

### ■ The Result

- Taxpayer wins
- Costs and expenses for personal use of the aircraft are deductible to the company



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## Midland Financial

"You have to be careful in evaluating this case, because there were a whole lot of compliance issues here. Fortunately our client had excellent documentation supporting his position, but without that, the outcome might have been far different."

- Steven T. Ledgerwood, Esq.



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## Flight Department Company – Cases

Petit Jean Air Service v. United States; U.S. District Court, East Ark. LR-71-6-216, 2/7/1974. Winthrop Rockefeller (former Governor of Arkansas) leased aircraft to corporation for liability purposes. Corporation employed pilots, operated aircraft for owner and others. IRS imputed FET per Sec. 4262 on all travel. Court reversed for owner use, held for FET on 3rd party use of aircraft. 60113



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## Audit Case

### ■ Facts:

- Four-member LLC operates medium jet aircraft
- LLC paid all the expenses, including the pilot

### ■ Issues:

- IRS cites commercial use (flight department company), i.e. FET
- Taxpayers recorded reimbursements as capital contributions (not income), but deducted all expenses
- Hobby loss rules; IRS wanted to disallow all deductions

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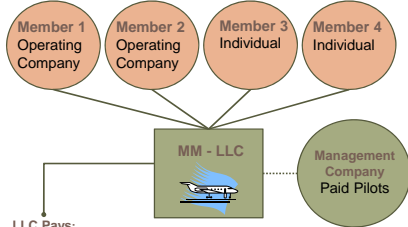
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## Audit Case



**LLC Pays:**  
•Direct Operating Costs (DOCs)  
•Deducted Depreciation  
•Distributed losses to members via K-1's

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## Audit Case

- **Taxpayer Response:**
  - Cited economic entity concept and other defenses to hobby loss rules
- **Outcome:**
  - Negotiated settlement
  - IRS agreed to drop hobby loss position
  - Taxpayer accepted commercial use finding (FET)
  - Taxpayer entitled to fuel tax credits
  - Taxpayer paid approx \$130,000 in FET and interest
  - IRS agreed to waive penalties

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## Thank You Very Much!

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