Will your Record Keeping Survive an Audit?

Wednesday, October 22, 2014 | 1:30 p.m. – 2:30 p.m.

PRESENTED BY:

Phil Crowther, Jackson & Wade, LLC
Doug Stewart, Aircraftlogs
Jed Wolcott, Wolcott & Associates
Introductions

• Jed R. Wolcott, CPA
  Wolcott & Associates PA

• Doug Stewart, CPA
  AircraftLogs

• Phil Crowther, JD, CPA, MBA
  Jackson & Wade LLC
What We’ll Explain Today:

• Overview of the Rules in Plain English
• Why It’s Difficult
• Tips for Your Record Keeping System
• Common Problems Encountered in Audits or Reviews
The Plain English for Aviation Deductions

You Must Comply with....

• General rules regarding deduction of “ordinary and necessary” business expenses

• Specific rules regarding:
  – Substantiation of aircraft deductions
  – Personal use of company aircraft
  – Entertainment use of company aircraft by “specified individual”
  – “Commercial” use of the aircraft.

• IRS definition of “commercial” is broader than FAA’s definition.
Summary of Personal Use Implications

What the IRS and SEC Expect You to Do...

- **IRS**: Increase Taxable Income of Employees - When an employer provides personal use of a corporate aircraft to an employee, the IRS expects the employer to “impute income” to employee as a fringe benefit.

- **IRS**: Disallow Some of Your Tax Deductions - When a corporate aircraft is used for “personal entertainment” of company owners or executives, the company must disallow a portion of the costs of owning and operating the aircraft.

- **SEC**: Disclose Personal Use by Executives - When a company provides personal use (of most any kind) to the executives of an SEC registrant, the company should disclose the incremental cost which it incurred by providing that personal use.

- **SIFL**
- Control Employees & Guests
- W-2’s

- Entertainment
- Seat Hours & Seat Miles
- Specified Individuals & Guests
- Empty Seats & Deadhead

- Proxy Statement
- Named Executive Officers
- Incremental Costs & Direct Operating Costs
Why this is Difficult?

Just Some of the legal Code and Regulations....

- Internal Revenue Code of 1986 (“IRC”)
  - Including amendments by the American Jobs Creation Act of 2004
- IRC § 168 - Accelerated cost recovery system
- IRC § 274 [travel and entertainment deductions and substantiation]
- IRC § 469 [passive activity loss limitations]
- Treas. Reg. § 1.61-21(g) [fringe benefit rules for aircraft]
- Exchange Act Rule 16a-1(f).
- And more...
The Raw Data You Need:

Tips for Your Record Keeping System
Maintaining Tax and Other Documentation

IRS Record-Keeping Rules

• IRC § 6001 gives the IRS the authority to require taxpayers to keep such records as the IRS may prescribe.
• Treas. Reg. § 6001-1(a) provides that taxpayers “shall keep such permanent books of account or records, … as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information”
• IRS auditors will claim that the records must be contemporaneous.
• Despite the mandatory “shall”, these rules are prescriptive
  – They do not require taxpayers to keep specific records
  – No court has denied deductions simply because the taxpayer did not keep written records.
Maintaining Tax and Other Documentation

Burden of Proof

• A taxpayer claiming a deduction has the burden of proving that he or she is entitled to claim that deduction
• This is known as the “Burden of Proof”
• Do not have to prove “beyond a reasonable doubt”
• Merely have to prove that “more likely than not”
• Have to prove the proper elements
• IRC § 274(d) lists the required elements for aircraft deductions.
• Contemporary written records have the highest probative value
• Testimony has the least
Maintaining Tax and Other Documentation

Elements

• Treas. Reg. § 1.274-5T(b)(6) lists the required elements.
• With regard to expenditures, the taxpayer must substantiate:
  – Amount
  – Date
  – Business purpose
• With regard to aircraft use, the taxpayer must substantiate
  – Amount of use
  – Date of the use
  – Business purpose
• In case of aircraft, business purpose may related to trip or flight
Maintaining Tax and Other Documentation

Substantiation

• Substantiating the amounts and dates is not difficult
  – Accounting records substantiate expenses
  – Aircraft flight log substantiates aircraft use
• Substantiating business purpose requires more work
• Amount of substantiation will vary
• In some cases, the business purpose is self-evident
• In other cases, additional explanation is required
• The nicer the destination, the more documentation is required
• Documentation can include evidence of business relationship
Maintaining Tax and Other Documentation

Recommendations - Flight Information

• Aircraft Flight Log should include:
  – Dates of departure and return.
  – Destinations, described by name
  – Passenger names and relationship to the company
  – Primary reason for flight

• Supplemental Information:
  – If mixed business/personal trip, days spent on business
  – If passengers traveling for personal reasons, need additional information to compute fringe benefit income and (if applicable) disallowance of deductions
Maintaining Tax and Other Documentation

Recommendations - Accounting Information

• Keep separate accounts for aircraft costs, including:
  – Fuel costs
  – Repairs and maintenance
  – Insurance
  – Hangar
  – Pilot salaries and training costs
  – Trip costs, including catering costs and landing fees
  – Office expense for flight department

• Don’t need to allocate overhead costs to flight department
  – Doing so could make those expenses subject to disallowance
Key Items To Support Business Flights
More is better, fewer is worse

1. Flight log and passenger manifest (examples follow)
2. Documentation of the business purpose for each passenger
3. Emails & correspondence supporting the purpose of a flight
4. Planning materials, presentations, agendas & minutes for business meetings
5. An aircraft use policy, and this flight complies
6. SIFL and Personal Use Calculations for non-business flights
7. A business plan for the purchase and use of the aircraft
Sample #1 – Tax-Focused

<table>
<thead>
<tr>
<th>Line</th>
<th>Trip Ref</th>
<th>Date of Flight</th>
<th>ID</th>
<th>Destination</th>
<th>Airframe Hours</th>
<th>Flight Hours</th>
<th>Tax Information</th>
</tr>
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<tbody>
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</tbody>
</table>

**TOTAL HOURS**

Total Flights

In Trip Ref, use x.y format where x represents the trip and y represents the flight, or any segment where passengers emplane or deplane.

In Tax Category, enter the number of passengers travelling for the following purposes:

- **bus**: Business use which is nontaxable and deductible.
- **ent**: Entertainment use which is nontaxable and nontaxable (e.g., customer entertainment and company-sponsored employee entertainment).
- **epu**: Employee personal use which is taxable and deductible.
- **spe**: Specified employee personal entertainment use which is taxable and nondeductible.

NBAA 2014 Business Aviation Convention & Exhibition October 21, 22, 23 | Orlando, FL
# Aircraft Flight Log:

<table>
<thead>
<tr>
<th>Flight ID</th>
<th>Airport</th>
<th>Date</th>
<th>Block Time H.H-MM</th>
<th>Flight Time H.H-MM</th>
<th>Crew Hours</th>
<th>Cycles</th>
<th>Landings</th>
<th>Inaug. Apprs</th>
<th>FTA</th>
<th>Aprts</th>
<th>Holds</th>
<th>Out</th>
<th>In</th>
<th>Burn</th>
<th>QTY</th>
<th>Invoice#</th>
<th>Goal</th>
<th>Total FPL</th>
<th>FLN</th>
<th>Person Meeting with and Tel. No.</th>
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<tbody>
<tr>
<td>PWO</td>
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| P = PIC | S = SIC | CIRCLE for Pilot Flying on each leg

<table>
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<tr>
<th>Crew Members</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
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<th>Error</th>
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<th>Gallons to Liters</th>
<th>Liters to Gallons</th>
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<td>1.0</td>
<td>3.785</td>
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<tr>
<th>Minutes to Tutina</th>
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<th>13-18</th>
<th>19-24</th>
<th>25-30</th>
<th>31-36</th>
<th>37-42</th>
<th>43-48</th>
<th>49-54</th>
<th>55-60</th>
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<th>Passenger Manifest</th>
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<tr>
<th>Remarks</th>
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<tbody>
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</tbody>
</table>

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Sample #2 – Detailed, Crew Use
### Aircraft Flight Records - N300J

<table>
<thead>
<tr>
<th>Leg</th>
<th>Flight #</th>
<th>Airport</th>
<th>Block Out</th>
<th>Trip Times</th>
<th>Block In</th>
<th>Flight</th>
<th>Land Day</th>
<th>Land Night</th>
<th>Fit Details</th>
<th>Distance (Kilometers)</th>
<th>Fuel Burn</th>
<th>Total Expense</th>
<th>Category</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>KCMH</td>
<td>--</td>
<td>09/15/14</td>
<td>09/15/14</td>
<td>0.8</td>
<td>0.5</td>
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<td>Show</td>
<td>$0.00</td>
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<tr>
<td>2</td>
<td></td>
<td>KPTK</td>
<td>08:00</td>
<td>09/15/14</td>
<td>08:45</td>
<td>1</td>
<td>1</td>
<td>--</td>
<td>Show</td>
<td>299.8</td>
<td>--</td>
<td>Show</td>
<td>$0.00</td>
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<tr>
<td>3</td>
<td></td>
<td>KCOS</td>
<td>10:10</td>
<td>09/15/14</td>
<td>11:50</td>
<td>2.0</td>
<td>1.7</td>
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<td>Show</td>
<td>1837.2</td>
<td>--</td>
<td>Show</td>
<td>$0.00</td>
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<td>4</td>
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<td>09/15/14</td>
<td>09/15/14</td>
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<td>Show</td>
<td>2137.0</td>
<td>0.0</td>
<td>None Selected</td>
<td>$0.00</td>
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<tr>
<td>Total Ending</td>
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<td>Show</td>
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<td></td>
<td>None Selected</td>
<td>$0.00</td>
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### Crew Member

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<tr>
<th></th>
<th>Duty Start</th>
<th>Leg 1</th>
<th>Leg 2</th>
<th>Leg 3</th>
<th>Leg 4</th>
<th>Duty End</th>
<th>Total Duty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Riddle, Robert</td>
<td>09/15/14</td>
<td>PIC</td>
<td>PIC</td>
<td>PIC</td>
<td>PIC</td>
<td>12:30</td>
<td>5.0</td>
</tr>
<tr>
<td>Gee, Conan</td>
<td>09/15/14</td>
<td>PIC</td>
<td>PIC</td>
<td>PIC</td>
<td>PIC</td>
<td>12:30</td>
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</tbody>
</table>

Aircraft N300J is equipped with 10 passenger seats.

### Passenger List

<table>
<thead>
<tr>
<th>Passenger Name (Last Name, First)</th>
<th>Leg 1 KCMH - KPTK # Pax: 4</th>
<th>Leg 2 KPTK - KCOS # Pax: 4</th>
<th>Leg 3 KCOS - # Pax: 0</th>
<th>Leg 4 # Pax: 0</th>
<th>Prelim SIFL</th>
<th>Prelim SIFL</th>
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</thead>
<tbody>
<tr>
<td>Smith CEO, Roger (C)</td>
<td>BUS</td>
<td>PNE</td>
<td>X</td>
<td>X</td>
<td>$1047.29</td>
<td></td>
</tr>
<tr>
<td>Smith, Timothy (TG)</td>
<td>BUS</td>
<td>PNE</td>
<td>X</td>
<td>X</td>
<td>$1047.29</td>
<td></td>
</tr>
<tr>
<td>Jackson, Frederick (C)</td>
<td>BUS</td>
<td>BUS</td>
<td>X</td>
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<td>$0.00</td>
<td></td>
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<tr>
<td>Fletcher, Ray (C)</td>
<td>BUS</td>
<td>BUS</td>
<td>X</td>
<td>X</td>
<td>$0.00</td>
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</tbody>
</table>
Other Helpful Info

• Planning materials & agendas for business meetings
• Program summaries and/or presentations used
• Emails & correspondence supporting the purpose of a flight
• Third-party documentation is the strongest
Your Document Inventory

• On the Aircraft
  – Time Sharing Agreement
  – Dry Lease Agreement
  – Bank Lease Documents
  – Aircraft Registration & Certificate of Airworthiness
  – Certificate of Insurance & Emergency Contacts
  – Importation Paperwork (relevant to country requirements)

• In the office
  – Flight Logs and Passenger Manifests
  – Passport Copies
  – Invoices, Receipts & Expenses
  – Emails & similar correspondence to substantiate trip purposes & expenses
  – Relevant accounting & tax treatment policies approved by the company
  – Corporate Aircraft Use Policy
Frequent Gray Areas in Business Aviation

Consistency is important

• Business flights which originate or terminate near a second home
• Mixed use flights involving both personal and business destinations
• Business flights to vacation destinations
• Flights involving related companies

NBAA 2014
Common Problems Encountered During Audits
What To Expect from an IRS Audit

Have a jet? Expect an audit at some time.

- What happens first?
- What will be requested?
- What should you do?
- What is IRS Appeals?

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Form 4664
Department of the Treasury — Internal Revenue Service
Information Document Request

To: (Name of Taxpayer and Company Division or Branch)

Please return Part 2 with listed documents to requester identified below.

**Description of documents requested**

1. Did the company provide air transportation to or for employees during calendar year 2012 or 2011?

2. If the company provided employees air transportation:
   a. Describe the circumstances and employees involved. Include the one time agreement.
   b. Provide a listing of each flight on Business Aircraft:
      i. Flight date
      ii. Origin of flight
      iii. Destination of flight
      iv. Mileage of each flight leg
      v. Number of seats available on aircraft
      vi. Name of each passenger, and
      vii. Whether the passenger was traveling for company business purposes.
   c. If the passenger was traveling for company business purposes, provide:
      i. Business relationship of each passenger to taxpayer, and
      ii. Business purpose for each passenger’s trip.

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   c. If the passenger was traveling for company business purposes, provide:
      i. Business relationship of each passenger to taxpayer, and
      ii. Business purpose for each passenger’s trip.
Five Signs that Your Audit will Go South...

1. Lack of documentation for business flights
2. No SIFL calculations for company employees
3. No disallowance calculations
4. Family members aboard your aircraft
5. Frequent business trips to Orlando.
What’s the Difference: SIFL and Disallowance?

**SIFL**

- SIFL affects employees!
- Fringe benefit income to employee resulting from inviting non-business passengers or spouses on the flight
- Viewed as compensation by the IRS
- Included in their W-2 or 1099
- “Standard Industry Fare Level” -- mileage rates & terminal charges
- Charter rate calculation using market prices is an alternative to SIFL, but is not as popular

**Expense Disallowance**

- Disallowance affects the company!
- Makes a percentage of your aircraft costs non-deductible
- Proportional to the personal entertainment use of your aircraft
- This can be a significant dollar impact, especially when a new airplane is being depreciated
- This IRS issue is often overlooked by companies with aircraft.
Entertaining Clients?

- Entertainment of clients is always generates questions
- Taking clients to football game or other sporting events
- Consult with your tax advisor
- Generally must have bona fide business discussion
- Documentation is critical
Flights you can win, fights you will lose

Winners

???

Losers

1. You need a $20 million jet to visit a $100,000 rental property.
2. Hunting trips are deductible
3. All flights are business because the boss is always working
4. Trips to Orlando with family are 100% business
Questions & Answers

- Jed R. Wolcott, CPA
  Wolcott & Associates PA

- Doug Stewart, CPA
  AircraftLogs

- Phil Crowther, JD, CPA, MBA
  Jackson & Wade LLC
Thank You