Monday, March 17, 2014

Once a business attains a certain level of success, an aircraft often becomes a valued asset. Public and closely held private companies alike find that the use of a **private aircraft**—whether possessed via whole or fractional shares, and whether owned, leased or chartered—fosters secure and efficient transportation for owners and executives. However, this benefit does not come without a price, and it is not unusual for the **tax deductions** with respect to the typical flight department to run in the $20 to $30 million range. These significant amounts, and the fact that the deduction and other tax rules are so complex and often subjective, have caused company aircraft to catch the attention of the **Internal Revenue Service** (IRS). A new **Information Document Request** (IDR), IRS Form 4564, has recently been employed on audits of companies with business aircraft, providing a roadmap for how to prepare for an IRS audit.

**Overview**

In order for a business to deduct substantial aircraft-related costs, several complicated tax issues must be vetted, including: (1) the proper depreciation schedule for the aircraft and equipment; (2) the new Internal Revenue Code (Code) Section 274 entertainment disallowance rules; and (3) the passive activity rules. Any actual or deemed payments for use of the plane also may be subject to a 7.5 percent excise tax. Finally, the executives flying may have more imputed income for flights not properly documented as being primarily in the interests of the business rather than an individual benefit. The new IDR requests information that would allow the IRS to determine whether these tax requirements are satisfied.

**The Business Deduction**

In preparing the business tax return, taxpayers historically simply deducted all the expenses of the business aircraft on the basis that the aircraft was used within the scope of the company’s business and thus met the deduction rules of Code Section 162. However, since October 22, 2004, there has been a “take away” from that deduction under Code Section 274 for any use that is considered personal “entertainment, amusement, or recreation.” Unfortunately, many businesses are unaware of this rule, or if they are aware of it, they do not follow the now-final Treasury Regulations promulgated pursuant to Code Section 274 regarding how to properly calculate the “take away.”

In short, under these rules, if a business has $20 million of aircraft expenses, and 25 percent of the aircraft usage was for personal entertainment travel, $5 million of the expenses are not deductible on the business tax return.

The IRS is aware of some easy adjustments vis-à-vis the Code Section 274 deduction disallowance that applies to virtually all companies owning aircraft. The new IDR asks for the Code Section 274 calculation performed by the company. The IDR separately asks for the total expenses of the aircraft, including the following:

- Catering fees
- Depreciation
- Interest expense
- Lease payments
- Charter payments
- Management fees
- Other costs
- Crew and maintenance salaries
- Crew meal and lodging expenses
- Takeoff and landing fees
- Maintenance flights
- Hanger fees
- Fuel
- Tires
- Insurance
- Registration

The IDR also asks for all information that would be on the flight logs, and requires the name of each passenger and specification of whether each passenger was travelling for business, personal reasons or personal entertainment.

On audit, the IRS is making significant adjustments based on the information obtained in response to the IDR for a variety of reasons, including that the business was not able to show it did the Code Section 274 calculations, or did them incorrectly, or did not substantiate the specific use by each passenger.

**Depreciation**

The cost of purchasing an aircraft can be taken as a tax deduction surprisingly rapidly, typically over five years. Although the Obama administration raised the specter of lengthening the period for depreciation, at the same time it enacted “bonus” depreciation that allowed for 50 percent to 100 percent of the entire cost deduction to be taken in the year a new aircraft is placed in service, rather than in later years over the normal five-year period.

A threshold test for using bonus depreciation for closely held companies is satisfying Code Section 280F, which requires a complicated two-step 25 percent and a 50 percent business use test in order to qualify. Code Section 280F is a “when,” not a “how much,” test and is often misinterpreted by taxpayers. The IRS is taking a hardline approach where an aircraft is leased to a related company, arguing that even business use by an owner will not allow the Code Section 280F test to be satisfied, commonly referred to as the “leasing company trap.” See IRS Tech. Adv. Mem. 200945037.

On an alternative basis, bonus depreciation in the amount of $11.25 million for an aircraft purchased and actually flown in 2003 was attacked by the IRS in the recent case of Brown v. Commissioner, T.C. Memo. 2013-275. There, the issue was that the aircraft was not being placed in service in 2003 for the specific purpose intended, when the taxpayer indicated that a conference table and big screen TV were integral to his specific intended business use. In response to the taxpayer’s substantiation of the business use, the Tax Court stated, “this is just not believable” and assessed a 20 percent understatement penalty pursuant to Code Section 6662. Of interest in the case is the Tax Court’s reference to Ernest Hemingway’s reply to F. Scott Fitzgerald: “the very rich are different from you and me . . . [T]hey have more money.” This statement is indicative of the general attitude of the IRS and the courts with respect to audits of aircraft.

**Passive Activity**

Passive activities as defined in Code Section 469 are endeavors with insufficient “material participation” conducted by an individual or by flow-through businesses, such as subchapter S corporations or partnerships, and are generally not of concern in the C corporation context. The problem with passive activity historically was that passive activity losses could only be offset by passive activity income, and therefore passive activity income itself was not in any way a problem. However, the interest in avoiding passive activity characterization has
increased with the new Code Section 1411 that applies a 3.8 percent tax to “net investment income” generated from passive activities.

The typical context in which passive activity issues arise is where an aircraft is held in one entity and leased to a second entity. Leasing is per se a passive activity. Note that passive activity leasing refers to a so-called “dry lease” of the aircraft (that is, without a pilot), not the “wet lease” or charter that refers to use of the aircraft with a pilot provided by the lessor.

There is a solution around the application of the passive activity rules where an aircraft is dry leased and used by a second business that is related to the lessor business. To avoid the passive activity rules, the taxpayer can do a passive activity grouping election before the auditor comes knocking. The mechanics of the election are provided by Revenue Procedure 2010-13, 2010-1 C.B. 349, and the timeframe to make the election has been extended at a minimum through 2014.

Federal Excise Tax

Just as many businesses that own aircraft are not aware of the new entertainment deduction disallowance, many also are unaware of the Federal Excise Tax imposed by Code Section 4261 that can apply to payments received or deemed to be received for use of their piloted aircraft, even where the aircraft operates under Part 91, the Federal Aviation Administration authority for non-commercial use. It is simplest to think of this tax as a type of sales tax. Code Section 4261(a) imposes a 7.5 percent tax, plus a small leg tax, on the amount paid for taxable transportation that begins and ends in the United States. Therefore, if a U.S. business accepts a cash reimbursement for domestic travel on its “corporate jet,” it may be obligated to collect and pay over the excise tax, a tax normally associated only with commercial air travel.

There has been a tremendous amount of audit activity related to this little-known excise tax. For example, the battle over the Federal Excise Tax as applied to fractional ownership resulted in congressional action to change the rules. Where a taxpayer owned a partial interest (referred to as a “fractional” share in the world of air travel) and a company provided management services, the IRS’s position was that the taxpayer was actually leasing the aircraft to the management company, which then chartered the aircraft. In effect, the IRS claimed that the owner was chartering its own aircraft to itself and owed the 7.5 percent excise tax on those payments. Billions of dollars were involved, and Code Section 4261 was amended to exempt fractional interests. To make up the tax gap, Congress increased the fuel tax.

After the fractional interest debacle, the IRS did not give up. In virtually all audits of aircraft across the United States, the excise tax was asserted in instances where the taxpayer owned its own whole aircraft but, instead of having a flight department and its own pilots, employed a commercial aircraft management company to provide those services. On April 19, 2013, the National Business Aviation Association (NBAA) referenced prior favorable guidance on the issue, stating the following in a letter to the IRS:

Finally, the Chief Counsel Advice (CCA) memorandum (Number: 2012100026, released March 9, 2012) ignored this conflicting guidance and took the approach that virtually all amounts paid by an aircraft owner to a management company are subject to FET. Since the publication of the CCA, NBAA and NATA have observed that virtually any business aviation company engaged in providing aircraft management services is subject to audit. The expense incurred by the Service to undertake these audits, and by the taxpayer to defend the audits, is significant and clearly not the best use of resources by either party.

Code Section 4282(a) provides that the tax imposed does not apply to amounts paid by one member of an affiliated group to another member of that group for air transportation. In Private Letter Ruling 200123002 (January 2, 2001), the IRS declared that the exemption did not apply where the group members were not corporations. Thus, where an affiliated group of companies share an aircraft, the Code Section 4261 7.5 percent tax will apply on the fair market value of the aircraft use even where a cash payment is not made, unless the usage is corporation to corporation.

The new IDR seeks information pertaining to any payments made for use of the aircraft by individuals. The IRS is seeking ammunition to apply the excise tax to reimbursements made by executives, typically in public company situations where the executive reimburses so as not to have the value reported on the proxy statement, e.g., PLR 200705010 (the IRS ruled that where a former CEO reimbursed the employer for use of the aircraft, the employer was obligated to collect the Code Section 4261 excise tax from the CEO).

Imputed Income

It is safe to say that everyone wants to avoid “imputed income,” which refers to a situation where the taxpayer did not actually receive cash, but his tax return must show income expressed in dollars for the accretion in wealth he was deemed to experience. Usage of company aircraft is rife with imputed income opportunities that
employment tax auditors eagerly pursue. Owners of partnerships receive imputed income as a guaranteed payment on their Form K-1. Independent contractors, such as directors, will see it on the Form 1099, and employees, including Subchapter S owners, will receive it on their Form W-2 subject to typical employment tax withholdings.

A flight that is primarily for the business of the entity providing the aircraft will not result in imputed income. This would seem to be an easy determination, but it is not. In *Flowers v. Commissioner*, 326 U.S. 465 (1946), the Supreme Court of the United States held that the taxpayer must be away from the tax home to deduct travel expenses. The “tax home” must be identified and has nothing to do with state tax residency, but is a federal income tax determination of the location where the individual performs most of his work, makes most of his money, and where the most important work is performed, based on all the facts and circumstances. This determination is becoming more difficult with the advent of telecommuting and the fact that the sophisticated executive may not spend the bulk of his time in any one location. The concept of a tax home is still developing, and the IRS challenges it frequently on audit. The determination of tax home was favorably decided, for example, in *Snellman v. Commissioner*, T.C. Summ. Op. 2014-10; No. 13186 125. In that case, an unemployed individual living in Florida obtained a job in Missouri for less than one year, and the Tax Court determined that all his travel, lodging and meals in the job location were excluded from income as travel away from home.

The general rule for imputed income for personal travel is to refer to the arms-length charter rate for the same flight, but the regulations under Treasury Regulations Section 1.61-21(g) allow for use of the Standard Industrial Fare Level (SIFL) rates, which are only approximately $1 per mile for the highest paid employees, officers and owners. If an auditor catches the taxpayer not imputing income for a flight that the auditor determines is personal, the far higher charter rate amount will be used.

In addition to commuting trips that do not start from the tax home, the IRS examines two other areas: spousal travel and business entertainment. In short, gone are the days when the cost to bring a spouse along on a business trip qualified as a deductible ordinary and necessary business expense. Not only will the IRS impute income for the “tag-along” spouse, there is a very real danger that the spouse’s presence will cause the entire trip to be viewed as personal rather than business, resulting in imputed income for the employed spouse as well.

Business entertainment is a favorite for the IRS auditor to reverse treatment, impute income, and impose penalties and interest. Unless the entertainment is in a clear business setting, such as a gala to celebrate an office opening, the entertainment must be associated with or directly related to the active conduct of the taxpayer’s business. Generally, this means that the taxpayer and its potential customers or clients cannot simply enjoy one another’s company while engaging in an entertainment activity, such as golf, skiing, fishing, dining or sightseeing. Rather, there must be actual business conducted that can be substantiated by focused and documented business discussions of specific, not general, topics, recorded for later IRS review.

**Summary**

The IRS has refined its audits of business-owned aircraft and is expressing tenacity in getting the maximum federal tax dollars from miscalculated tax deductions, incorrect imputed income and nonpayment of excise tax. Companies that own aircraft should know the rules and document, document, document.

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