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At approximately the same time that this article was published, Jack Welch, former CEO of General Electric Company, decided to forgo his use of company aircraft, a part of his retirement package. By some estimates, this will save General Electric Company in excess of \$2.0 million per year.

PERSONAL USE OF BUSINESS AIRCRAFT AND CORPORATE RESPONSIBILITY

**Victor C. Anvick holds a Master of Science in Taxation,
and is an Enrolled Agent.**

**He is a pilot, author and lecturer and
specializes in aviation taxation.**

**His practice is located in Acton, California
and may be contacted at 661/269-9441 or
v.anvick@worldnet.att.net
Website www.atisgroup.com**

The purpose of this article is to explore federal income tax treatment of personal use of business aircraft in light of three U.S. Tax Court cases, one Appellate Court case, an IRS Action on Decision and the Job Creation and Worker Assistance Act of 2002.

SUTHERLAND LUMBER - SOUTHWEST, INC. v. COMMISSIONER, 114 T.C. 197 (MARCH 28, 2000):

Sutherland Lumber's principal place of business is located in Kansas City, Missouri with retail lumber outlets located in eight Texas locations. The company also owned a Lear 25 which was used for travel related to its lumber business and for air charter operated out of Kansas City.

Aircraft Business Use:

The usage of the aircraft in 1992 consisted of 30% charter flights, 23% director's flights, 18% non-vacation flights, 24% vacation flights and 5% other purpose flights. In 1993 the aircraft was used for 16% charter flights, 16% director's flights, 32% non-vacation flights, 24% vacation flights and 11% other purpose flights. Thus, for the years under audit, the aircraft was used 71% for business in 1992 and 64% in 1993.

Accordingly, the Internal Revenue Service conceded that Sutherland was entitled to deduct aircraft expenses and depreciation for “the expenses for operating the aircraft for flights attributable to the lumber business, the air charter business, the non-vacation flights and the director’s flights.”

Aircraft Personal Use Dispute:

Sutherland used the standard industry fare level rates (S.I.F.L.) to impute compensation to the W-2s of top management who used the aircraft for personal use of 29% in 1992 and 36% in 1993. The company deducted 100% of the operating expenses and depreciation for both years. The I.R.S. only allowed deductions for actual business use and limit the remaining deductions for personal use to the amounts added to the W-2s for fringe benefit compensation.

The Tax Court agreed with the taxpayer and allowed the deduction of the business-related expenses and depreciation in addition to the aircraft expenses and depreciation attributable to the personal use.

I.R.S. Appeal:

The I.R.S. appealed the decision to the U.S. Court of Appeals 8th Circuit. Unfortunately for the government, the 8th Circuit Court of Appeals agreed with the U.S. Tax Court and reaffirmed the deductions claimed.

Additional I.R.S. Challenges:

In *National Bancorp of Alaska, Inc. v. Commissioner*, T.C. Memo 2001-202, a Gulfstream G11B was used partly in pursuit of “NBA’s trade or business for transportation purposes and partly for personal entertainment use by certain employees.”

The business usage in 1996 was 71.2% with 28.8% attributed to personal entertainment use.

Once again, the I.R.S. argued that the deduction for personal entertainment use should be limited to the amounts treated as fringe benefit compensation on the employees’ W-2s. The U.S. Tax Court ruled in favor of the taxpayer.

In *Midland Financial Co. and Subsidiaries v. Commissioner*, T.C. Memo 2001-203, this financial services company, located in Oklahoma City, primarily used its Falcon 2000 to service retail bank locations throughout Oklahoma and to manage its loan portfolio for commercial, consumer and residential loans throughout the country.

The facts of the case that were stipulated to by the I.R.S. and Midland, were:

1. “During the years in issue, petitioner used the Falcon predominantly for business travel, but it was occasionally used for personal travel by George and Jeff Records (the “Recordses”), two corporate officers of the petitioner.

Petitioner kept accurate records that indicate the nature of the flights of the Falcon.”

2. “The personal use of the Falcon served to compensate the Recordses for their services as employees of petitioner and did not constitute constructive dividends to them. The amounts of compensation paid to the Recordses during the years in issue, including the value of the personal use of the Falcon were reasonable.”

The I.R.S. argument was the same in this case as in Sutherland and National Bancorp of Alaska, i.e., the personal use deductions of operating expenses and depreciation should be limited to the amounts included as fringe benefit compensation. The personal use during the years at issue ranged from 20% to 32%.

The U.S. Tax Court ruled, in applying the doctrine of *stare decisis*, again in favor of the taxpayer. The doctrine of *stare decisis* generally requires that the Tax Court follow the holding of a previously decided case absent any special justification. See *Sec. State Bank v. Commissioner*, (Dec. 52,859) 111 T.C. 210, 213 1998, *aff'd*. (2000-2 USTC ¶ 50549) 214 F.3d 1254 (10th Cir. 2000).

In the National Bancorp and Midland cases, there were no special justifications that would have permitted a decision different than the one in Sutherland. In all three cases the aircraft were predominantly used for business. The business usage factors ranged from 68% to 80% and the personal was 20% to 32%.

Having lost on the same issues in a series of cases, the Internal Revenue Service issued an Action on Decision on February 11, 2002 wherein it acquiesced to the decision in *Sutherland Lumber-Southwest Inc. v Commissioner*, 255 F.3d 495 (8th Cir. 2001).

When it comes to relying on an Action on Decision, the I.R.S. states: “Generally, an Action on Decision is issued where its guidance would be helpful to Service personnel working with the same or similar issues. Unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent.

Actions on Decisions shall be relied upon within the Service only as conclusions applying the law to the facts in the particular case at the time the Action on Decision is issued. Caution should be exercised in extending the recommendation of the Action on Decision to similar cases where the facts are different. Moreover, the recommendation in the Action on Decision may be superseded by new legislation, regulations, rulings, cases or Actions on Decisions.”

Business Use Advised:

Note that the airplanes, in all of the cases cited above, were primarily used for business purposes, i.e., from 64% to 80% business use. Thus, the strategy of permitting a business aircraft to be used for personal fringe benefit compensation purposes must be done in a judicious manner.

For example, attempting to use an aircraft for 20% business use and 80% personal fringe benefit compensation, while attempting to claim 100% deductions for aircraft expenses and depreciation, is not supported by the opinions of any of the above cases. Consequently, the U.S. Tax Court may not be bound by the doctrine of *stare decisis* and could render a much different opinion. Therefore, any aircraft owner or advisor that departs from a business use factor much below 64% may be asking for a very expensive controversy while trying to apply Sutherland and its companion cases.

Another problem presented by low business use is that in addition to being required by the Internal Revenue Code to use straight-line depreciation as opposed to accelerated MACRS (modified accelerated cost recovery system), low business use of 50% or less could also result in opening up unreasonable compensation arguments by the I.R.S. Any IRS agent could argue that the personal use fringe benefit compensation, when added to an employee's W-2 salary, may constitute unreasonable, nondeductible compensation. This could be an especially strong argument against public or private companies that have never declared a dividend. The more expensive the aircraft, the stronger the government's argument could be for disallowing unreasonable compensation. If that were to happen, additional taxes, penalties and interest could represent a significant portion of the purchase price of the aircraft.

Observation:

Remember that in the Midland case, "the amounts of compensation paid . . . including the value of the personal use of the Falcon, were reasonable." We will never know if a personal use factor of 50% or more would have still been regarded as "reasonable" by the examining agent. I suggest that the possibility of losing deductions for aircraft costs and depreciation because of excessive personal use of a multi-million dollar aircraft may be too much of a gamble for executives and shareholders in a post-Enron, MCI/Worldcom environment.

Furthermore, with the spotlight on corporate responsibility, I suspect that many independent directors, executive compensation committees, shareholders and lenders may do more to limit personal use of business aircraft than the I.R.S. and U.S. Tax Court combined.

New Bonus Depreciation:

On March 9, 2002 the Job Creation and Worker Assistance Act of 2002 was signed into law. It grants tax relief to buyers of high end capital goods, including aircraft. Qualifying new aircraft or improvements to used aircraft enjoy a 30% first year bonus depreciation on the cost or adjusted basis of the airplane or the improvements.

Among the various requirements that an airplane must meet in order to qualify for this favorable tax treatment is a business use of more than 50% during the first taxable year. If business use during the first taxable year is 50% or less, the airplane will not qualify for the 30% bonus depreciation or the MACRS method of depreciation per I.R.C. § 168(k)(2)(C)(i)(II).

Furthermore, in any subsequent tax year that the aircraft's qualified business use falls to 50% or less, the 30% bonus depreciation must be immediately recaptured as ordinary income per I.R.C. § 168(k)(2)(E)(ii). Thus, aircraft tax advisors and their clients have a great incentive to see that qualified business use remains well above 50%.

Neither the 30% bonus depreciation, nor the regular accelerated MACRS depreciation will trigger alternative minimum tax for qualifying expenditures.

Finally, one little known fact about the 30% bonus depreciation is that it is also subject to the general expense rules regarding whether an item is deductible under the ordinary, necessary and reasonableness tests.

Example: Your company just purchased a new \$10 million aircraft near the end of last year and flew only three trips. Two out of the three trips were business trips and the third trip was to fly the CEO and his family home for the holidays. The CEO properly imputed the S.I.F.L. rate income on his 2001 W-2 as fringe benefit compensation. The company claimed 100% deduction on its 2001 corporate tax return for aircraft expenses and depreciation pursuant to the Court cases mentioned above.

Do you think any competent IRS agent would pass up the opportunity to challenge the "reasonableness" of taking a \$3 million bonus depreciation deduction for two business trips?

Will agents be in a stronger position to challenge the "reasonableness of compensation" in cases where the 30% bonus depreciation was claimed notwithstanding the acquiescence of Action on Decision in Sutherland?

Summary:

When the Sutherland case and its subsequent appellate opinions were issued, some advisors and aircraft owners immediately seized the opportunity to craft aggressive tax strategies which seemed to place more of an importance on the personal use of aircraft rather than qualified business use. The Internal Revenue Code, Internal Revenue Service and the U.S. Tax Court, Circuit Courts of Appeal, District Courts, Court of Claims and the U.S. Supreme Court have historically given

preference to business use over personal use of any kind of plant, property or equipment for these taxpayers seeking to have their business expenses and depreciation approved as valid deductions.

The Sutherland and its companion cases once again bare this out with qualified aircraft business usage factors ranging from 64% to 80%. The obvious lesson to be gained from the above cases, the doctrine of *stare decisis* and the Action on Decision for Sutherland, is that limited personal use of business aircraft if properly treated and taxed as fringe benefit compensation, using the SIFL rates, may have its place for taxpayers with similar fact patterns.

However, a word of caution may be in order to those business who have decided to claim the new 30% bonus depreciation on aircraft that are also used for fringe benefit purposes. The new law is still unsettled and untried in this area. With the I.R.S. increasing its audit activity, I suspect that some aircraft owners and their advisors may have already laid the ground work for cases that will provide additional guidance in this area.

Planning Suggestion:

Why not consider using the sales discount usually offered on most new business class aircraft to purchase a used aircraft or a fractional share to use as the fringe benefit aircraft rather than using the most expensive aircraft in the fleet? Take whatever deductions are legally allowable and don't even risk tainting the more expensive aircraft with any personal use. Such a strategy may be more palatable to directors, shareholders and others. I am sure that our industry has enough qualified sales professionals who would greatly appreciate the opportunity to discuss such a strategy.