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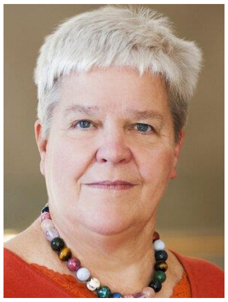
What To Know About IRS' New Jet Use Audit Campaign

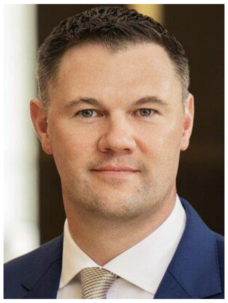
By **Mary Hevener, Steven Johnson and Jonathan Zimmerman** (March 29, 2024, 6:17 PM EDT)

The Internal Revenue Service recently launched a new audit campaign initiative that will focus on executives' personal travel on company-provided aircraft. Companies with high visibility or generous corporate aviation programs should prepare now.



Mary Hevener

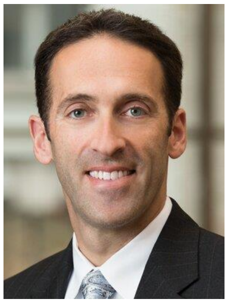
In his State of the Union address, President Joe Biden targeted tax breaks for corporations and wealthy individuals who use private jets as part of a broader goal to make big corporations and the wealthy pay "their fair share." Following the address, the White House highlighted a recently announced IRS audit initiative to "crack down on high-end tax evasion like deducting personal use of corporate jets as a business expense."[1]



Steven Johnson

The identity of entities that the IRS will audit is unknown, nor is it known whether the IRS will focus primarily on deduction rules, or on the special valuation methods for personal travel on corporate or partnership-provided aircraft. Under either approach, the IRS is expected to propose substantial tax assessments, to limit deductions for depreciation — especially accelerated depreciation — and to substitute so-called charter values for special valuation rules, where possible.

When responding to an audit, companies should be prepared to prove historic compliance with these complex rules, while also being aware of areas where guidance is limited.



Jonathan Zimmerman

IRS Announces Planned Audits

The IRS announced on Feb. 21 an intent to open approximately four dozen audits this spring relating to the use of personal jets owned or leased by multinational and domestic corporations and "complex partnerships" operating in several industries.[2] These audits may be prompted by the significant increase in private air travel during the COVID-19 pandemic, and we expect tax years 2021 and 2022 to be the periods the IRS analyzes for examination. The entities selected will be identified through advanced analytics, applied to a database of corporate jet activity that the IRS is developing. It is possible that these entity audits may lead to audits of high-income taxpayers using these jets.

IRS Commissioner Daniel Werfel explained during a press call that the IRS is concerned that deductions have been overstated, and that passengers' personal travel has not been correctly reported as taxable income. Such reporting would require wage withholding, in the case of any employees' travel, and we assume this will be another focus of the IRS aircraft-use audits.

The IRS has never before issued clear guidance on various aspects of the rules governing personal use of corporate aircraft, including explaining how the Tax Cuts and Jobs Act's 2017 changes to the deductibility of entertainment expenses and entertainment facilities would affect the deductibility of travel on company-provided aircraft.

All business-entertainment expenses are specifically excluded from the regulations that since 2007 have limited aircraft deductions by top executives, and the IRS did not amend those regulations when it issued guidance on the TCJA changes. Indeed, the IRS also has never issued any update to its pre-1979 definition of an airplane as a "transportation facility" — not an "entertainment facility."

Aircraft Deduction Disallowance Rules and Exemptions

In 2004, Congress enacted special deduction limitations affecting private aircraft, for the specific purpose of overriding cases — including the U.S. Tax Court's 2000 Sutherland Lumber v. Commissioner decision, that had allowed deductions even when aircraft were used for personal purposes. These statutory changes in Section 274(e)(2) applied to personal entertainment flights by top executives, and limited aircraft deductions to the amount imputed as income to the executives.

The 2007 regulations implementing these changes completely exempted business entertainment flights, as well as various types of personal flights, that were not considered "entertainment." These regulations — like the preceding case law — never specified that airplanes were "entertainment facilities," but instead simply limited deductions for both fixed and operating costs of aircraft, allocated across all flights and on a per-passenger basis, affecting deductions only for passengers on "personal entertainment flights."

This regulatory exemption for business entertainment flights made sense, because it had never been clear that the cost of transportation to entertainment was necessarily considered part of any entertainment expense.

Congress addressed this point by enacting the 50% disallowance rule under Code Section 274(n), applicable to both entertainment and food and beverage expenses from 1987 through 2017.

Congress specifically exempted from the disallowance for entertainment expenses any transportation — for example, transportation to restaurants — and the IRS never countermanded that exemption.

In 2017, in the TCJA, Congress moved the disallowance for "entertainment expenses" from Code Section 274(n) to Section 274(a), again with no indication that "transportation to entertainment" should be considered part of any entertainment expense — much less that an airplane might be considered to be a transportation facility.

In implementing the TCJA changes, the IRS also never indicated that "transportation expenses" were part of "entertainment expenses," and it also made no changes to the longstanding rules in Section1.274-10 of the Treasury Regulations, which since 2007 have provided special disallowance rules applicable only to top executives' personal entertainment travel on airplanes.

Absent any such clarification, it is difficult to see how the IRS could disallow even the incremental costs, much less the fixed costs, of aircraft operation simply because some passengers may be on business entertainment flights.

Despite these rules that provide exemptions from the deduction disallowance for both the business — and the business entertainment — use of aircraft, it is still possible that the IRS, in audits, will try to allege that the disallowance rules apply to top executives' travel, either by disregarding these prior exemptions, or by trying to apply deduction disallowance rules under Section 162(m) — which disallows compensation expenses in excess of $1 million per year for top executives of public companies.

Avoiding Violations of Section 280F

This new round of IRS aircraft audits may focus on potential violations of Section 280F, the provision limiting claims for accelerated depreciation under Section 168 for airplanes — and other specified listed property — when there is excessive personal use by business owners and their employees. Under Section 280F(b)(1), the depreciation deduction allowed for any listed property used less than 50% in a "qualified business use" during a tax year is limited to straight-line depreciation.

Section 280F(d)(6)(C)(i) provides that qualified business use does not include use of property by a 5% owner or related person, whether the property is leased to such a person, or is provided as compensation for services.

For aircraft, Section 280F(d)(6)(C)(ii) provides that the 5% owner rule does not apply if at least 25% of the total use of the aircraft during the tax year consists of a qualified business use that is not excluded under Section 280F(d)(6)(C)(i).

However, under a controversial 2009 technical advice memorandum, the IRS concluded that, even if the owner's use is for the owner's business purposes, such use still counts as owner use — which, if it exceeds 75%, results in denial of accelerated depreciation.[3] For this reason, companies with 5% owners should expect that the IRS will be looking for instances where this 25% test is not met.

SIFL Valuation Rules for Taxing Personal Travel

The safe harbor valuation rules applicable to personal flights on employer-provided aircraft, are based upon the standard industry fare level, or SIFL, statistics published by the U.S. Department of Transportation. The values determined using these rules must be imputed for any personal trips by employees, independent contractors and their guests.

For top employees, these imputed values serve as caps for the maximum deductible amount for any "personal entertainment flights." When the SIFL valuation method was designed, the basic rate applicable to a flight by a top executive or guest was believed to approximate two times first class fares. However, these SIFL valuations have declined over the years, and special valuation exceptions have also been provided.

Most companies are careful to apply the rules correctly. However, particularly in payroll tax audits, the IRS is likely to look for mistakes because, if the IRS corrects an SIFL valuation in an audit after the statute of limitations has expired on correcting information returns, it can apply the charter values in Section 1.61-21(g)(13) of the Treasury regulations to the misvalued flights, and then propose to collect payroll tax withholding from this substantially increased value.

IRS Audits and Predicted Results

The deduction disallowance, valuation and withholding rules applicable to travel on company aircraft are extremely complicated. To be prepared for a potential audit, companies should retain their flight logs including for those for foreign travel, passenger manifests, notes on any business reasons for passenger flights, valuation calculations for flights where income was imputed and the deduction disallowance calculations for entertainment flights taken by top executives and their families and guests.

We believe that an IRS audit initiative may result in the IRS national office issuing informal guidance that addresses many unanswered questions. Ultimately, these audits may also lead to litigation that follows Sutherland Lumber and its related cases, all won by taxpayers insisting that transportation costs are not entertainment expenses, and that airplanes are not entertainment facilities.

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Disclosure: Hevener represented Sutherland Lumber in the case discussed in this article.

[1] https://www.whitehouse.gov/briefing-room/statements-releases/2024/03/07/fact-sheet-president-biden-is-fighting-to-reduce-the-deficit-cut-taxes-for-working-families-and-invest-in-america-by-making-big-corporations-and-the-wealthy-pay-their-fair-share/.

[2] IR-2024-46.

[3] TAM 200945037 (7/29/2009).