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The $11.2 Million Conference Table: Business Aircraft Upgrade Creates A Large Tax Bill

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The U.S. Tax Court denied an aircraft owner the "bonus" tax depreciation available for business aircraft because it did not have a conference table. Despite the adverse result, the case offers valuable lessons on how to use, and substantiate the use of, business aircraft for tax purposes and how the IRS and courts approach cases involving private aircraft.

Have Jet – Will Travel

The relevant facts are simple. On December 30, 2003, Michael Brown, an insurance salesman who sold $10 million to $300 million life insurance policies to wealthy individuals for estate planning purposes, purchased a $22 million business aircraft in Portland, Oregon. On the same day, Mr. Brown flew his newly acquired aircraft to both Seattle and Chicago for business meetings. These flights allowed Mr. Brown to claim a bonus tax depreciation deduction on the aircraft of approximately $11.2 million in 2003. In early 2004, a conference table and larger televisions were installed on the aircraft. The Internal Revenue Service (IRS) audited Mr. Brown, and ultimately denied the bonus tax depreciation deduction that Mr. Brown claimed for the aircraft, on the theory that the aircraft was not "placed in service" because the conference table was not installed until 2004. The Tax Court agreed with the IRS and imposed a 20 percent accuracy-related penalty.

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A Really Expensive Conference Table

Mr. Brown's aircraft had a typical interior seating configuration, but he wanted a conference table in the aircraft that he could "use [ ] for business," and that he "needed it for his mission." Accordingly, the Tax Court determined that "The conference table was now a necessity." Mr. Brown also wanted the standard 17-inch display screens replaced with 20-inch screens so that he could make better PowerPoint presentations to potential clients and other insurance agents. Mr. Brown contracted for these interior modifications in December 2003, and the work was performed in early January 2004.

Mr. Brown claimed bonus tax depreciation of almost $11.2 million on the aircraft as an expense for his insurance business for 2003. Upon audit, the IRS disallowed that deduction, and the Tax Court agreed that Mr. Brown could not properly claim bonus depreciation on the aircraft for 2003 because the aircraft was not "placed in service" that year since the conference table was missing and the larger display screens had not yet been installed.

The "Placed-In-Service" Requirement For Bonus Depreciation

The bonus depreciation sought by Mr. Brown would have allowed him to deduct 50 percent of the aircraft's purchase price, but only if the aircraft was acquired and "placed-in-service" in 2003. The Treasury Regulations state that "[p]roperty is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function." The IRS argued that the aircraft was not in a condition or state of readiness and availability for a "specifically assigned function," which was to operate as Mr. Brown deemed necessary for his insurance business, because the conference table and larger display screens were not installed until 2004.

Mr. Brown testified at trial that the conference table and larger display screens were "needed" and "required." The Tax Court found that the aircraft was not available for its intended use until those modifications were made because Mr. Brown "needed" these "seemingly minor touches." In post-trial briefs, Mr. Brown downplayed the significance of the improvements and argued that they had "nothing to do with the [aircraft's] assigned function of transporting him for his business." The Tax Court treated this argument as "post-trial framing [that] just doesn't square with the trial testimony" and determined that the aircraft was not "placed in service" in 2003, and imposed hefty penalties and interest.

Tax Penalties

Surprisingly, the Tax Court imposed a 20 percent accuracy-related penalty. Mr. Brown argued that the tax penalty should not apply because he relied on "substantial authority," which was the "express language of the Internal Revenue Code," and that he told others "that he needed to use the [aircraft] in his business before the end of the year to claim bonus depreciation."

The Tax Court was unpersuaded, in part because Mr. Brown did not offer Treasury Regulations or pertinent case law to support his "substantial authority" position until late in the case. The Tax Court ruled that Mr. Brown's subjective belief that he relied upon "substantial authority" was irrelevant because whether "substantial authority" exists is an objective standard involving an analysis of the law and its application to the relevant facts. Therefore, the Court found that Mr. Brown did not establish "substantial authority" to claim the bonus depreciation deduction for 2003 and upheld the accuracy-related penalty.

Lessons Learned

The teachable moments from this case are many:

- Private aircraft are a "suspect" class of business asset. Judge Holmes's legal opinion, which is readable and entertaining, is sprinkled with populist commentary. Mr. Brown wanted to "upgrade [his] ride" which would "entitle him to a 'giant' bonus depreciation allowance" and "the very rich *** are different from you and me." Tax auditors and judges tend to view private aircraft as an unnecessary luxury, but a business jet is a business tool and a taxpayer's representative needs to educate a taxing authority on the business value of private aircraft. Judge Holmes's legal opinion recognized that a private aircraft gave Mr. Brown a huge advantage over his competitors and that Mr. Brown lost a business opportunity (and $8 million commission) because of Mr. Brown's inability to immediately fly to a potential client. However, this understanding did not tangibly remove the private jet "stigma" that colored the case. The "giant" bonus depreciation allowance for the aircraft was poorly received by the Court, even though Congress wanted Mr. Brown to buy a new business asset to stimulate the economy and encouraged Mr. Brown to do so by allowing accelerated tax deduction. It is ironic that Mr. Brown bought the aircraft for bonus depreciation, which Congress wanted him to do, but the Tax Court denied it.
- For purposes of the "placed-in-service" requirement, a business aircraft is a travel tool, not a conference room. However, the Tax Court determined that the "specifically assigned function" of Mr. Brown's aircraft was not transportation, but flying conference room. The Tax Court reached this conclusion because of Mr. Brown's own testimony. The Tax Court's decision was wrong because the aircraft's primary business purpose was passenger transportation, which it could do in 2003, and therefore the aircraft could perform its specifically assigned function. As a secondary matter, the aircraft could itself serve as a location for meetings, but the aircraft's failure to fully satisfy this secondary (or dual) purpose did not mean that the aircraft was not "placed-in-service" when it was fully functional for passenger air transportation services.
- Be careful what you say. Mr. Brown's testimony in this case did him in. He narrowly defined the "specifically assigned function" of his business aircraft as a meeting place and a conference table was a "necessity." As such, the Tax Court could find that the aircraft was not "placed in service" in 2003 because there was no conference table, which was "necessary" to the aircraft's "specifically assigned function" as a conference room.
- Vigorously defend against penalties. The Tax Court imposed a 20 percent accuracy-related penalty on Mr. Brown for his failed claim that the aircraft was "placed-in-service" in 2003. In Mr. Brown's opening written brief to the Court, he did not aggressively argue "substantial authority" for his bonus depreciation deduction by citing the Code and Treasury Regulations, and referring the Tax Court to favorable, applicable case law. Mr. Brown may have avoided the tax penalty if he strongly argued that he acted with "reasonable cause and in good faith" by showing the Court that he relied on his tax advisor's advice or provided some credible proof that he was aware of relevant, supporting case law when he filed his 2003 income tax return.
- Substantiate business use of aircraft with records. In order to deduct business aircraft expenses, the aircraft's business use needs to be documented with adequate records showing (1) the expense amounts, (2) the time, date, distance traveled and place of travel, (3) the business purposes of the expense, and (4) the business relationship to the taxpayer of persons using the aircraft or for whom the aircraft was used. Mr. Brown's records for his business aircraft use were inadequate. The Court wrote that "something doesn't quite smell right" with Mr. Brown's records, and questioned whether the 2003 flights at the end of December were real business trips.
- Tax Court decisions happen within a context. On its own, this adverse decision and the penalties are a stretch by the Tax Court. However, this was only one of many tax problems that Mr. Brown had. The IRS also determined that Mr. Brown underpaid his taxes by over $30 million (for 2001 through 2006), and the IRS sought an additional $10 million in penalties. These other tax issues were settled between the IRS and Mr. Brown, and only the bonus depreciation issue remained for the Tax Court to decide. Those other tax issues – in which the IRS alleged that Mr. Brown claimed fraudulent consulting-fee deductions, used nominees to conceal ownership and control of entities from the IRS, and created false documents in an attempt to support illegitimate deductions – most likely influenced the decision against Mr. Brown on the bonus depreciation, even though those issues were resolved and not directly related to the aircraft.
- Tax cases move slowly, while interest accrues. The tax year at issue in this case was 2003, but the Tax Court's decision was not issued until 2013. Contentious tax disputes with the IRS can take years to resolve, during which time interest can accrue against the taxpayer if the taxpayer loses and did not deposit money with the IRS equal to the amount of tax that the IRS claimed is due.

Conclusion

This case is a cautionary tale for business aircraft owners taking delivery at the end of the tax year. Prior to year-end, the aircraft should be used for documented, legitimate business flights. If there are any desired improvements for the aircraft that have not been completed prior to the delivery, hold off on contracting for, or making, those improvements until after the aircraft is in a condition or state of readiness and availability for its specifically assigned function of passenger flight services (not flying conference room).