

Charting a Course Through the IRS's Business Aircraft Campaign

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In this installment of *Practically Speaking: Tax Controversy*, the authors examine the IRS's new enforcement initiative targeting aircraft use by large corporations, large partnerships, and high-income individuals, and they offer insights on how best to prepare for possible audits.

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On February 21 the IRS announced plans to begin auditing the personal use of business aircraft with its business aircraft campaign.¹ The campaign is part of the IRS's ongoing efforts to improve tax compliance and will use funding from the Inflation Reduction Act. This article focuses on the IRS's initiatives in this area.

I. Overview of the Business Aircraft Campaign

The IRS's scrutiny of tax return positions relating to aircraft is not a recent phenomenon.

Historically, the number and scope of these audits were limited because of resource constraints. However, a group of senators has prompted the IRS to increase scrutiny on private jet users and to use its regulatory authority to close the so-called standard industry fare level, an air travel expense calculation that values the price of a flight significantly lower than the same flight on a chartered jet.² So, a significant shift is underway in the landscape of business aircraft audits.

¹ IR-2024-46.

² See letter by six senators encouraging Treasury and the IRS to close standard industry fare level loophole (Mar. 10, 2024).

In announcing the campaign, IRS Commissioner Daniel Werfel said:

Personal use of corporate jets and other aircraft by executives and others have tax implications, and it's a complex area where IRS work has been stretched thin. With expanded resources, IRS work in this area will take off. These aircraft audits will help ensure high-income groups aren't flying under the radar with their tax responsibilities.³

This announcement aligns with the IRS's renewed scrutiny of high-income and high-wealth individuals.⁴ In a subsequent interview, Werfel said that the IRS is not unfairly reaching into individual bank accounts; it's relying on publicly available data and will be operating within the authorities granted by Congress.⁵ In the case of corporate aircraft, there are various public databases with information on private jets from which the IRS intends to gather data. The agency will then use advanced data science and analytics to select returns for examination. Notably, the IRS will use artificial intelligence to help guide its decisions on which taxpayers to audit, which will hopefully lower the risk of the IRS selecting compliant taxpayers.⁶

The IRS has not specified a revenue generation amount for the campaign but views it as a potentially significant revenue source because of the activity's material nature.⁷ Based on recent data reported in the press, there are approximately 15,000 business jets in the United

States⁸ and in 2022, S&P 500 companies spent approximately \$65 million on corporate jets.⁹

II. Potential Focus Areas

Some of the main areas that the business aircraft campaign is expected to scrutinize include imputed income, deduction disallowance, bonus depreciation, deduction restrictions, excise tax, and passive activities. New audits may encompass 2021 and future years based on statute of limitations considerations.

A. Imputed Income From Personal Use of Corporate Jet

Section 61(a) says that any fringe benefit provided by an employer should be included in the recipient service provider's income unless specifically excluded by law. As a result, and with limited exception, the personal use of business aircraft by an organization's service providers — including use by any spouses, family members, or other personal guests of those service providers — will result in imputed income to the service providers. Reg. section 1.61-21(b)(6) provides that the value of a flight on an employer-provided piloted aircraft is determined under the general valuation rules (the charter rate) unless the special valuation rule (the standard industry fare level) applies.

Given the complex rules for determining the value to be included in employee compensation and whether the value of an employee's flight (and any other passenger's flight) will be taxable to the employee, returns reporting corporate jet use are particularly susceptible to audit.

B. Disallowance of Expenses Incurred for Entertainment Use of Corporate Jet

In addition to the aforementioned effect on the individual, section 274(a) denies the company a deduction for entertainment expenses. Reg. section 1.274-10 provides special rules for aircraft used for entertainment purposes. In part, reg. section 1.274-10(e) provides the permissible

³ IR-2024-46.

⁴ See Andrew R. Roberson, Michelle Marion, and Garrett J. Hahn, "IRS Refocuses on Enforcement of High-Income and High-Wealth Individuals," *Tax Notes Federal*, Dec. 4, 2023, p. 1801. The IRS has launched several initiatives targeting high-net-worth taxpayers, large partnerships, and large corporations, including: the balance sheet discrepancy initiative, audits of 76 of the largest partnerships using AI, the large foreign-owned corporations transfer pricing initiative, the large corporate compliance program, and the partnership self-employment tax initiative. IR-2024-09.

⁵ Robert Frank, "Tax Evasion by Wealthiest Americans Tops \$150 Billion a Year, Says IRS Chief," CNBC (Feb. 22, 2024).

⁶ *Id.*

⁷ IR-2024-46.

⁸ Justin Surette, "Here's How Many Private Jets There Are in the USA," Simple Flying (Aug. 24, 2023).

⁹ Theo Francis and Stephanie Stamm, "The \$65 Million Perk for CEOs: Personal Use of the Corporate Jet Has Soared," *The Wall Street Journal*, Jan. 16, 2024.

methods for determining the aircraft operating expenses allocable to entertainment air travel.

Even before the launch of the business aircraft campaign, the IRS had shown significant interest in both the personal and entertainment use of corporate aircraft. In *DiDonato*,¹⁰ the IRS audited the taxpayers' use of a corporate jet. It underscored the requirement that for corporate jets used for entertainment, the allocation of aircraft expenses must be determined on a per-person, per-flight basis, according to the types of use under reg. section 1.274-10, effective in 2012.¹¹

Like the income imputation rules, the rules for determining any deduction disallowance under section 274 are quite nuanced. The calculation relies heavily on details included in the company's flight log since it requires insight into whether the flight for each passenger was for business non-entertainment, business entertainment, personal non-entertainment, personal entertainment, or commuting purposes.

C. Adherence to Depreciation Rules for Aircraft

Depreciation of corporate aircraft is also an area of interest. In 2017 section 168(k)(2)(B) allowed companies to deduct the full price of "transportation property," which includes corporate aircraft "used in the trade or business of transporting persons or property,"¹² from their returns in the year purchased, between 2018 and 2022. The bonus depreciation is being phased out for aircraft purchased in 2023 or later, but the House-backed bipartisan tax package would restore 100-percent bonus depreciation through 2025.¹³ Further, under section 280F(b)(1), each flight must be a qualified business use of at least 50.1 percent to qualify for bonus depreciation, and 25 percent of the business use has to be use that is not just renting the plane to oneself or another related party. Because a company can receive bonus depreciation in the first year, the

deductions for the cost of the aircraft rather than upkeep will be the highest-dollar area for the IRS to target in an audit.¹⁴

Taxpayers should also keep in mind the recapture rules that might affect them in the year they sell a corporate jet. If a corporate jet is sold for a gain, the amount exceeding the adjusted basis is treated as ordinary income under section 1245. This is particularly important to consider if the taxpayer claimed bonus depreciation on its corporate jet.

D. Compliance With Additional Deduction Allowance and Limitations Rules

A taxpayer may not deduct expenses if the activities generating the expenses are not engaged in for profit.¹⁵ Although section 183 was initially designed to prevent the deduction of losses from hobby farms, it has since been extended to include aircraft leasing.¹⁶ Section 183(c) specifies that "the term 'activity not engaged in for profit' means any activity other than one with respect to which deductions are allowable for the taxable year under IRC 162 or under paragraph (1) or (2) of section 212." Sections 162 and 212 define activities that are considered a trade or business, or production of income or investment, respectively. For instance, if taxpayers form a limited liability company exclusively to purchase an aircraft and lease it back to themselves, that would be subject to section 183.

The IRS's suspicion that a corporate jet is being used more for personal enjoyment rather than legitimate business purposes could trigger an audit. The challenge is proving the intent behind the use of the jet. Moreover, if the aircraft is used for both personal and business purposes, expenses must be allocated between these uses. The IRS may audit if it believes the allocation is not accurate or fair.

E. Adherence to Federal Excise Tax Rules

Section 4721 imposes an excise tax on the amounts paid for transportation of people or

¹⁰ *DiDonato v. Commissioner*, T.C. Memo. 2013-11.

¹¹ In *DiDonato*, the majority of the taxpayers' trips were personal entertainment based on the fact that their children were on the flights and the destinations were amusement parks and family members' locations. The taxpayers failed to produce evidence to support a business purpose for these trips.

¹² Section 168(k)(2)(B)(iii).

¹³ Tax Cuts and Jobs Act, section 13201; Tax Relief for American Families and Workers Act of 2024, section 203.

¹⁴ Section 179.

¹⁵ Section 183(a).

¹⁶ See IRS Audit Technique Guide, "Activities Not Engaged in for Profit" (Sept. 2021).

property by air.¹⁷ The person making the payment is liable for tax and usually, the person receiving the payment is responsible for collecting the tax and remitting it to the IRS. Tax generally applies to amounts paid to scheduled airlines and companies that provide charter aircraft; tax may apply to amounts paid to operators of noncommercial aircraft for transporting others. Failure to pay or collect excise tax could result in an audit of the return. Moreover, the suspected misclassification of flights to avoid excise tax could also result in the return being selected for audit.

F. Aircraft Leasing as a Passive Activity

Lastly, an audit risk may arise when an aircraft is owned by one entity and leased to another because leasing is inherently considered a passive activity. It is crucial to clarify that this is deemed a passive activity only when an aircraft is leased without a pilot, a practice often called “dry leasing.” This differs from a charter or “wet lease,” when both the aircraft and a pilot are provided by the lessor. To circumvent passive activity regulations, a taxpayer can choose a passive activity grouping election per Rev. Proc. 2010-13, 2010-4 IRB 349, before a return is selected for audit.

III. Audit Readiness

A. Recordkeeping

As the saying goes, the best defense is a good offense. In the realm of taxation, this translates into maintaining comprehensive records to keep each tax year audit ready. Having contemporaneous data to support business use is critical. Taxpayers often assume a business purpose is clear and thus do not contemporaneously substantiate a position. But having the documentation prepared contemporaneously will, at a minimum, save taxpayers time and effort on an audit. This approach will also reduce any operational risk associated with employees with institutional knowledge leaving the company or being unable

to locate records requested by the IRS. In fact, in addressing concerns about corporate jet audits, the IRS has suggested taxpayers focus on their recordkeeping systems.¹⁸ So taxpayers now have even more reason to invest in recordkeeping systems after the announcement of the business aircraft campaign.

B. Practical Approaches

Since corporate jet audits typically occur a few years after returns are filed, it is crucial that taxpayers retain their records for a reasonable period, which may cover several years. The delayed timing of these audits, years after return filing, can pose challenges for taxpayers to retrieve documentation if not already preserved in their records. It is therefore essential to implement proper recordkeeping methods from the outset.

Taxpayers can stay audit ready by keeping detailed aircraft records including:

- aircraft purchase documents or lease and charter documents;
- aircraft tail numbers, aircraft registration numbers, manufacturer’s serial numbers, and aircraft types and models;
- aircraft maintenance logs; and
- aircraft usage policies.

The following practices will also help ensure audit readiness:

- flight records for every flight leg should clearly and contemporaneously document the date of the flight, aircraft used, all passengers, trip purpose on a per-passenger basis, origin airport and destination airport, flight hours, statute miles, pilot and copilot, and information about the expenses incurred to operate the flight;
- for any flights designated as business flights, the log should specify the business purpose for each business passenger and include any supplemental documentation to substantiate the business purpose of the trip;
- for any flight designated as a mixed-use flight for one or more passengers, the log

¹⁷ See IRS Audit Technique Guide, “Excise Tax — Air Transportation” (Apr. 2008).

¹⁸ IR-2024-46.

should provide sufficient details to substantiate (for each passenger) whether the trip was primarily for personal purposes or business purposes;

- for any flights with nonemployee personal guests, the log should identify which service provider invited those guests;
- for personal flights, any amounts included in wages, fringe benefit computations, and the calculation of disallowed aircraft expenses;
- the flight log should include any deadhead flights (flights with no passengers, often done for repositioning purposes) if the taxpayer incurred expenses for them; and
- the log should be as detailed as possible about a taxpayer's business purpose and should include a review of the taxpayer's calendar or timesheets for the most accuracy.

IV. Conclusion

Effectively resolving an IRS examination often comes down to substantiation. Overall, the IRS's business aircraft campaign represents a significant shift in its enforcement efforts, particularly toward high-net-worth individuals. The campaign's focus on comprehensive recordkeeping, adherence to depreciation rules, compliance with deduction allowances and limitations, and the observance of federal excise tax rules, among others, underscores the need for taxpayers to be vigilant and proactive. The use of advanced analytics and the additional funding available to the IRS are expected to enhance the agency's ability to identify audit targets and ensure compliance. Although the campaign may pose challenges, it also provides an opportunity for taxpayers to review and improve their current tax practices, ensuring they are audit ready at all times. As the landscape of corporate jet audits evolves, staying informed and prepared will be key to navigating this complex area of tax law. ■

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