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Salesman Penalized for 'Placed in Service' Interpretation

By David Burton

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In this article, Burton discusses *Brown v. Commissioner*, a Tax Court case addressing whether an aircraft was placed in service when the taxpayer took delivery of it or when amenities requested by the taxpayer were added.

The month of December often brings with it a spate of questions about when an asset is placed in service (that is, eligible for tax benefits). As bonus depreciation expired for most assets placed in service after 2013, the issue was particularly pervasive last December. Conveniently, the Tax Court published an opinion the same month that cautions taxpayers against being too innovative in their interpretation of this term of art.

Aircraft Without Amenities Not in Service

In *Brown v. Commissioner*,[1] the Tax Court was given the opportunity to evaluate the tax planning of a salesman who specializes in selling insurance for estate planning purposes. The court noted that the insurance salesman regularly earned commissions of $10 million or more from the sale of a single policy, and according to *The New York Times*, was purported to have been the co-creator of split-dollar life insurance arrangements to avoid estate taxes.

Brown had an exceptionally good year in 2003, and Congress increased the bonus depreciation percentage from 30 to 50 percent for equipment placed in service after May 5, 2003. These two factors propelled Brown to upgrade his Hawker aircraft with a Bombardier Challenger that could fly across the country without refueling.

The Bombardier could be ready to fly by the end of 2003 but would lack two upgrades that Brown felt were important for his insurance sales business: a conference table and 20-inch video screens for PowerPoint presentations. Brown did not, however, see the missing features as obstacles to a 2003 bonus depreciation deduction. He picked the plane up on December 30, 2003, and flew it to two business meetings and to his vacation home in Cabo San Lucas. Afterward, the Challenger returned to the outfitter for the upgrades, which were started on January 5 and finished on January 30, 2004.

Brown and his spouse claimed almost $11.2 million in bonus depreciation deductions for the aircraft on their 2003 tax return. The IRS audited their tax return and challenged this deduction, as well as several others. The Browns and the IRS settled all the issues except the bonus depreciation.

The Tax Court held that Brown's aircraft was not placed in service in 2003 because the conference table and larger video screens were not installed until 2004. The court's holding is not so broad as to imply that an aircraft must be outfitted with each amenity that ultimately will be installed; however, the court relied on Brown's own testimony to reach its conclusion, which is summarized in the following excerpt:

> Brown . . . argues that his plane was "fully functional for air transportation" . . . when placed in service in 2003. The 2004 modifications, Brown says, "merely provided enhancing features that did not involve improvements necessary to allow the Challenger to serve its specific function of providing air transportation in connection with Brown's insurance business."
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> We agree with Brown that the Challenger "was fully functional for air transportation." But that's not quite the right question. The regulation tells us to decide when the plane was ready and available for a "specifically assigned function." Reg. section 1.167(a)-11(e)(1)(i).
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> What exactly was the specifically assigned function of Brown's new plane? . . . According to [Brown's] testimony, his insurance business required that the airplane have a conference table and the larger screens so he could make his Power Point presentations to clients and other agents — and those presentations were not a peripheral part of his business. Without those two requirements, the Challenger wasn't

[1]T.C. Memo. 2013-275.

fully functional for the very specific needs of Brown's insurance business.

Tax Court Relies on Power Plant Cases

The court's analysis in *Brown* was based on several cases, but two decisions involving a wind farm and a hydroelectric plant are of particular note. In the wind farm case, a taxpayer acquired two wind turbines in 1985 but they lacked monitoring and control equipment and were fitted with helicopter blades.[2] If the wind conditions were favorable, the turbines could produce electricity through manual operation; however, such electricity was generated on the regular, ongoing basis necessary for sale to a utility. Thus, the Tax Court found the wind turbines were not in service until some point after 1985.

In the hydroelectric case, the plant started generating electricity in November 1972 that was sold to customers; however, on December 7, 1972, ''a disruption in the unit's electrical power caused damage that led to a temporary shutdown for repairs. Preoperational testing didn't resume until early 1973.''[3] In the *Brown* decision, the Tax Court summarized its holding in the hydroelectric case: ''We found . . . that the plant wasn't available for use until it had completed all preoperational testing in January 1973. Only after the unit . . . was available for service on a regular basis was the unit in a state of readiness and availability for its specifically assigned function'' (internal quotations omitted).

Finally, the court in *Brown* summarized the two decisions and other placed-in-service opinions: ''These cases teach us that not just any use of an asset will satisfy the placed-in-service standard. An asset must instead be available for *its intended use on a regular, ongoing basis* before we can find it 'placed in service' in the tax year in question'' (emphasis in original).

What if the Tax Planning Was Reversed?

The court's holding invites the following questions: What if bonus depreciation was instead only available for equipment placed in service after December 31, 2003? Would the court have reached the same conclusion? Let's suppose that Congress had made bonus depreciation effective for equipment placed in service *after* December 31, 2003, and that Brown really wanted to fly his new plane in 2003 and show it off to his business associates. In that scenario, would the Tax Court have accepted the argument that the lack of the conference table and 20-inch video monitors in 2003 resulted in the aircraft being placed in service in 2004? I believe the Tax Court in that instance still would have decided against the Browns. The court would have likely characterized the *intended use* of the aircraft as business transportation and found that it was ready and available for that purpose in 2003, despite the lack of the conference table and 20-inch screens. Thus, placed-in-service issues require particular care because the court may interpret the facts related to the asset's *intended use* in a manner least advantageous to the taxpayer.

Tax Court Imposes Penalties

As demonstrated by the preceding hypothetical, the placed-in-service standard is viewed by many as a gray area in which the lack of clear tests would make a court hesitant to impose penalties. Nonetheless, the Tax Court imposed a 20 percent ''substantial understatement'' penalty on the Browns. The Browns had two avenues for avoiding the penalty: (1) they could have demonstrated that there was ''substantial authority'' for reporting that the Challenger was placed in service in 2003, or (2) they could have shown they ''acted with reasonable cause and in good faith.'' Reg. section 1.6664-4(b)(1).

It appears that counsel for the Browns did a poor job of briefing the first issue: ''Not until their reply brief did the Browns even discuss the key regulation. . . . We cannot say that they have established substantial authority by providing a well-reasoned construction of the applicable statutory provision'' (citations and internal quotations omitted).

Regarding whether the Browns acted with reasonable cause and in good faith, the court found that ''the Browns don't bring forth any evidence — for example, reliance on their CPA's tax advice or some credible proof that they were aware of *Hellings* and the other cases when they filed their returns — showing how they did so.''

A fundamental lesson of *Brown* appears to be the importance of professional tax advice. Had the Browns requested a tax opinion regarding the placed-in-service position, they either would have been counseled not to take the position or they would have at least had proof that they relied in good faith on reasonable advice and thus would have likely avoided the understatement penalty.

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[2] *85 Gorgonio Wind Generating Co. v. Commissioner*, T.C. Memo. 1994-544.

[3] *Consumers Power Co. v. Commissioner*, 89 T.C. 710 (1987) (quotations are from *Brown v. Commissioner*).

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