

Final Aircraft Deduction Disallowance Regulations

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Introduction

Although expenses related to business aircraft are deductible under Section 162 of the Internal Revenue Code (Code), Code Sections 274(e)(2) and (9) were amended by the American Jobs Creation Act to deny any deduction with respect to expenses in excess of the compensation included in income for entertainment, amusement or recreation travel by specified employees, generally defined as owners, officers and directors along with their guests. For example, after 2004, if \$1 million of allocable airplane expense was incurred for entertainment travel, with only \$100,000 included in income for the travel by the specified individual, then the disallowance or “take away” would be \$900,000. Conceptually, the entertainment disallowance is similar to the 50 percent deduction disallowance for business meals and entertainment; although the expenses are recognized as legitimate business expenses, for policy reasons, a portion is disallowed.

Internal Revenue Service (IRS) Notice 2005-45 sets forth the basic framework for the allocation of the take-away under Code Sections 274(e)(2) and (9). The basic framework is that all expenses or costs related to an aircraft owned, leased or chartered by an employer must on an annual basis be totaled, and the percentage allocated to entertainment, amusement or recreation travel by specified employees that is not included as income to such specified employees is disallowed as deductible. IRS Notice 2005-45 provided very detailed rules for determining the percentage related to entertainment travel, referred to as the “seat-by-seat” method.

On June 15, 2007, proposed regulations were issued that followed the basic framework of IRS Notice 2005-45, but added some favorable provisions such as the ability to use a “flight-by-flight” method of allocating expenses. The proposed regulations also tantalized business aircraft owners by suggesting that a “charter rate” might be adopted as a safe harbor approach for calculating the amount of the deduction disallowance, rather than requiring the taxpayer to use actual costs, which generally are much higher than what a charter company charges. Now after a good five years, final regulations have been issued. Following are the major provisions of these final rules.

Costs Subject to the Disallowance: Interest and Charter Rate Method

The final regulations adopt the position in IRS Notice 2005-45 and the proposed regulations that requires the use of all costs allocable to the entertainment travel in calculating the disallowance, including both fixed and variable costs, even though this value is not used for the IRS income inclusion rules or for U.S. Securities and Exchange Commission reporting. In calculating all costs, the final regulations provide examples of includable fixed and variable costs similar to those in IRS Notice 2005-45, such as depreciation, fuel, pilot salaries, charter expenses and management fees. However, now the calculation of all costs is required to include “interest on debt secured by or properly allocated (within the meaning of Treas. Reg. Section 1.163-8T which are detailed interest tracing rules) to an aircraft.”

Example: A public company pays cash for a \$35 million aircraft used partially for entertainment purposes by specified individuals. The corporation has never followed the interest tracing rules under Treas. Reg. Section 1.163-8T in the past, but because of the new requirement under the final regulations, it does so and determines that interest on debt is properly allocated to the aircraft under Treas. Reg. Section 1.163-8T. In calculating the deduction disallowance, the allocable portion of this imputed interest expense must be included.

In addition, the final regulations do not adopt IRS Notice 2005-45’s proposed alternative method of using charter rates rather than actual expenses in calculating the disallowance. However, the regulations reserve authority for the Commissioner to establish one or more safe harbor methods under which a taxpayer may determine the amount of expenses paid or incurred for entertainment flights in future published guidance.

Depreciation

The proposed regulations had adopted favorable rules regarding depreciation, and the final regulations retain and improve these rules in at least three respects. First, the regulations permit a taxpayer to elect straight-line depreciation for purposes of calculating expenses subject to disallowance, and to continue to use accelerated depreciation for general deduction purposes. This election must be applied for all depreciable aircraft for all taxable years.

Example: A \$40 million aircraft is eligible to be depreciated over one year and is used 50 percent for entertainment by specified employees. If the taxpayer elects straight-line for purposes of the deduction disallowance, then the permitted depreciation deduction is \$38.334 million.¹ If the special straight-line depreciation rule was not elected, the deduction would be \$20 million.²

Second, the final regulations clarify the provision in the proposed regulations that requires that, in the year of the initial election, the straight-line depreciation be treated as if it was in place retroactively. The final regulations provide that in any given taxable year the depreciation disallowance does not exceed the amount of otherwise allowable depreciation. Examples under the final regulations illustrate the potential implications for the straight-line election by demonstrating that after the regular tax depreciation schedule is completed, the disallowance under the alternative straight-line schedule stops. Practically, this rule means that over the life of the aircraft the total disallowance would likely be less if the straight-line depreciation election is made.

Third, final regulations retain the favorable position in the proposed regulations that add back the disallowed “suspended” depreciation to the basis of the aircraft for purposes of calculating gain on disposition. This means that even fully depreciated aircraft will have basis for purposes of subsequent sale if there was entertainment use of the aircraft resulting in a disallowance of some portion of the depreciation expenses. Previously it was unclear as to how to allocate specified employees’ income inclusion or reimbursements to the amount of the disallowed depreciation. The final regulations now provide that for this purpose, any income inclusion or reimbursement by the specified individual will be allocated *pro rata* to the disallowed depreciation.

Example: A taxpayer owns a \$40 million dollar aircraft that is fully depreciated after seven years and is then sold for \$10 million. The entertainment disallowance every year was 30 percent. Only \$1 million of the expenses in connection with the entertainment travel was treated as taxable wages to the specified individual employees. Depreciation accounted for exactly one half of all disallowed expenses, as the total of the fuel, pilot’s salaries, hanger fees, etc., exactly equaled depreciation every year. Although the aircraft had been fully depreciated and was sold for \$10 million, the taxpayer has no depreciation recapture, because for this purpose the basis of the aircraft was \$11.5 million.³

Aircraft Aggregation Limited

Generally, the deduction disallowance is calculated on an aircraft-by-aircraft basis. An exception to this rule allows a taxpayer to aggregate expenses for its business aircraft if the aircraft are of similar cost profiles. To prove similar cost profiles, Notice 2005-45 and the proposed regulations required that the aircraft have the same number and type of engines (*e.g.*, propeller or jet) and suggested other relevant factors, such as aircraft age and depreciable basis. The final regulations retain the same language, thus greatly limiting the ability to aggregate aircraft for determining the total costs subject to the disallowance.

Example: The taxpayer owns a four-year-old Bombardier Challenger 604 and a two-year-old Challenger 605. Although the aircraft are very similar (in terms of size, number and type of engines, *etc.*) and are used interchangeably, the aircraft ages and corresponding depreciable bases differ significantly and likely disqualify the taxpayer from combining all use and expenses for the deduction disallowance calculations.

Allocation of Expenses

The proposed regulations provided that entertainment expenses could be allocated on an occupied seat mile or hour method, or on a flight hour or mile method. The final regulations provide the same alternative methods for allocating the costs associated with the use of an aircraft to provide entertainment to specified individuals. The occupied seat hours or miles allocation method divides the total expenses for the year by the number of occupied seat hours or occupied seat miles to determine a per seat or per mile rate, and then applies that rate to the number of hours or miles of entertainment use. The flight-by-flight mile or hour methods divide the total expenses for the year by the number of flight hours or miles, and then allocate the per hour or mile expenses to each flight and then to the passengers on the flight according to the entertainment or non-entertainment character of each passenger’s travel. Once the disallowance is calculated under the appropriate method, amounts included in income and any reimbursements are subtracted from that amount. In other words, the taxpayer is still able to deduct the amount included as

¹ \$40 million less (\$40 million * 8.33% * 50%)

² \$40 million less (\$40 million * 50%)

³ \$40 million * 30% = \$12 million less (\$1 million * 50%) = \$11.50 million

taxable compensation in an employee's IRS Form W-2 unless Code Section 162(m) separately limits that deduction because the \$1 million limit was exceeded.

The final regulations now provide a specific example for deadhead flights (an aircraft flying empty in order to pick up passengers) between two occupied flights, and make it clear that a very specific weighted-average calculation must be made.

Example: Aircraft flies from city A to city B, a six-hour trip, with 12 passengers aboard. Eight of the passengers are traveling for business, and four of the passengers are specified individuals traveling for entertainment purposes. The aircraft flies empty (deadhead) from city B to city C, a four-hour trip. At city C, it picks up 12 passengers, six of whom are traveling for business and six of whom are specified individuals traveling for entertainment purposes, for a two-hour trip to city A. The taxpayer uses the occupied seat hour method of allocating expenses. The four-hour deadhead leg comprises one-third of the total flight time of 12 hours. Therefore, the deadhead flight is deemed to have provided one-third of the total 96 occupied seat hours, or 32 occupied seat hours.⁴ Of the 32 deemed occupied seat hours, 37.5 percent, or 12 deemed occupied seat hours, are treated as entertainment.

The final regulations also provide that expenses related to leasing or chartering to unrelated third parties as determined by Code Section 267(b) or 707(b) are not part of the deduction disallowance calculation.

Exception to Deduction Limitation for Non-Specified Individuals May Require Tax Information Reporting and Withholding

The final regulations make clear that the expense of entertainment travel provided either to employees or consultants who are not specified individuals will not be subject to the deduction limitation rules. For non-specified employees, the Code and final regulations suggest that timely Form W-2 reporting and the withholding of federal income tax in connection with the entertainment travel is required to qualify for this exception to the deduction disallowance rules. The guidance suggests that an analogous Form 1099 reporting requirement applies to entertainment travel for non-specified consultants.

Security Travel

Treas. Reg. Section 1.132-5(m) reduces the amount required to be included as taxable compensation for personal travel on employer-provided aircraft under circumstances in which a *bona fide* business-oriented security concern exists. The IRS declined to provide an exception in the final regulations to the disallowance rules for entertainment flights on business aircraft related to a *bona fide* security concern.

Travel on Regularly Scheduled Commercial Airlines

The final regulations do not provide a general exception to the disallowance rules for taxpayers that are commercial passenger or cargo airlines, but instead provide a special rule for specified individuals on regularly scheduled flights of taxpayers that are commercial passenger airlines. This rule treats expenses of entertainment flights by specified individuals in the same manner as expenses of entertainment flights by non-specified individuals under certain circumstances. In short, the regulations now provide rules so that commercial airlines generally do not suffer a deduction disallowance.

Issues Not Addressed

CODE SECTION 274(E)(8) ALTERNATIVE TO THE ENTERTAINMENT DEDUCTION DISALLOWANCE

Code Section 274(e)(8) is a frequently used alternative exception to the general disallowance rules, and if it applies the taxpayer need not apply the "take away" of Code Sections 274(e)(2) and (9). For example, if a specified employee charters the aircraft from the employer, then Section 274(e)(8) allowing a full deduction may apply and not the disallowance rules of Sections 274(e)(2) and (9). The final regulations do not further define what might fit under Section 274(e)(8) "*bona fide* transactions" involving "adequate and full consideration," and in the preamble the IRS states that it is beyond the scope of the regulations. The

⁴ 96 * 1/3 = 32

IRS simply refers to regulation Section 1.274-2(f)(2)(ix) and states that Code Section 274(e)(8) only applies to taxpayers that are in the trade or business of providing entertainment to customers, and only to entertainment sold to customers.

CHARITABLE USE

The final regulations do not give relief with respect to charitable use of business aircraft as requested by commentators. The general rule for charitable use of an aircraft is that only the out-of-pocket expenses may be deducted, not fixed expenses such as depreciation, and accordingly the general rule has not been changed.

DEFINITION OF ENTERTAINMENT FACILITY

The final regulations do not define entertainment facility. However, and perhaps more importantly, the final regulations state that Code Section 274(e)(2) and (9) rules do apply to entertainment facilities. This may indicate that a complete disallowance of all personal travel would not result should the aircraft be considered an entertainment facility, as the Sections 274(e)(2) and (9) rules do allow the deduction of non-entertainment personal travel.

DEFINITION OF ENTERTAINMENT

Unfortunately, the most difficult aspect of applying Code Section 274(e)(2) and (4) disallowances is how to distinguish between entertainment flights and non-entertainment flights, because, as previously described, only entertainment flights are subject to the disallowance rules. The final regulations state only that the definition of entertainment is found in regulation Section 1.274-2(b)(1), which is a regulation so old that it refers to entertainment in “cocktail lounges” and does not help with respect to the majority of modern travel. The final regulations include a “family funeral” as not being entertainment. Presumably, travel to medical appointments, travel for personal financial matters, travel to colleges with children and other routine personal travel should not be considered entertainment, and therefore costs for such travel should be fully deductible. On the other hand, any vacations or trips primarily to engage in traditional entertainment activities, such as gambling, going to the theatre, sightseeing, fishing and golfing, would all be considered entertainment and subject to the disallowance. Unfortunately, a large gray area exists with respect to the definition of entertainment, especially, with respect to “companion travel,” *e.g.*, travel by a non-working spouse with the working executive on the executive’s business trip. Accordingly, employers must keep careful records with respect to the exact nature of all specified employee travel and then make a reasonable judgment as to whether it is entertainment, amusement or recreation that is not deductible, or either business or non-entertainment travel that is fully deductible.

Summary

The final entertainment deduction regulations retain the harsh and detailed allocation rules, and virtually all taxpayers will need to revise their system of performing the calculations in order to avoid sanctions upon audit. However, the “sleeper” in the final regulations is the provision that allows taxpayers to elect to calculate the amount of the deduction disallowance for depreciation expense related to entertainment flights using straight-line depreciation, even when the taxpayer may be using a more favorable, accelerated method of depreciation for regular purposes. In addition, this provision eliminates the deduction disallowance for depreciation expense once the aircraft has been fully depreciated under the taxpayer’s regular shorter method of depreciation. This could potentially lead to significant planning opportunities for both current and prior open tax years.

For more information, please contact your regular McDermott lawyer, or:

Ira B. Mirsky: +1 202 756 8165 imirsky@mwe.com

Ruth Wimer: +1 202 756 8614 rwimer@mwe.com

For more information about McDermott Will & Emery visit www.mwe.com

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