

# Aviation Tax Law Webinar

## Federal Income Tax Treatment of Business Aircraft for Entertainment, Recreation or Amusement Purposes Update on Final Regulations



**Troy A. Rolf, Esq.**

### Washington, DC Office

1054 31st St., N.W.  
Suite 200

Washington, DC 20007

Telephone: (202) 342-5251

Facsimile: (202) 965-5725

Email: [kswirsky@gkglaw.com](mailto:kswirsky@gkglaw.com)



### Minnesota Office

700 Twelve Oaks Center Dr  
Suite 700

Wayzata, Minnesota 55391

Telephone: (952) 449-8817

Facsimile: (952)449-0614

Email: [trolf@gkglaw.com](mailto:trolf@gkglaw.com)

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# American Jobs Creation Act of 2004

- Section 274 of the tax code limits deductions for expenses of facilities (including aircraft) used for entertainment, amusement or recreational purposes
- A business aircraft is considered to be such a facility
- The American Jobs Creation Act of 2004 (the “Act”) amended Section 274 to overrule the Sutherland Lumber decision for aircraft expenses incurred after October 22, 2004



# American Jobs Creation Act of 2004

- Old Law: Expenses for employees' personal, non-business flights were fully deductible under Sutherland Lumber if income was imputed to the employee for the value of the flight (e.g., *SIFL*)
- New Law: Expenses for entertainment, amusement, and recreational flights of "Specified Individuals" are now deductible only UP TO the amount of income imputed to (or reimbursement received from) the Specified Individuals



# Who is a Specified Individual?

- ➔ The term “Specified Individuals” includes all officers, directors and persons directly or indirectly owning more than 10% of any equity class of the taxpayer, or any related party (within the meaning of IRC §§ 267(b) or 707(b))
  - Applies to private companies, publicly-held companies, partnerships, and tax-exempt entities
  - Includes spouse, family members or guests of the specified individual



# American Jobs Creation Act of 2004

- ➔ New law does not alter deductibility of expenses attributable to travel of Specified Individuals for business purposes, or for personal flights for other than entertainment, recreational, amusement purposes
- ➔ New Law does not alter deductibility of expenses attributable to travel of Non-Specified Individuals for any purposes, including entertainment, recreational, amusement purposes



# American Jobs Creation Act of 2004

- The IRS issued Notice 2005-45 in 2005, followed by proposed regulations in 2007, to answer many open questions
- Notice 2005-45 provided interim guidance for calculating the disallowance based on passenger seat miles/hours method
- The Proposed Regulations add the “flight by flight” method



# American Jobs Creation Act of 2004

- The IRS published final regulations Aug. 1 2012, superseding Notice 2005-45 and the proposed regulations for all flights on and after such date
- The final regulations largely adopt the rules contained in Notice 2005-45 and the proposed regulations



# What is Entertainment?

- Sports events
- Hunting
- Fishing
- Golfing
- Travel to Country Clubs
- Skiing
- Resort Destinations



# What Activities are Personal, but do not Constitute Entertainment?

- Commuting
- Travel to a funeral
- Travel to for medical purposes
- Travel for charity work
- Travel for business other than that of the employer providing the flight
- Travel to meetings with personal advisors
- Transportation between homes not associated with entertainment



# Strategies for Avoiding/Minimizing Disallowance of Aircraft Expense Deductions

- Carefully analyze the purpose of all “personal” flights taken by each Specified Individual
- Not all “personal” flights need to, or should, be characterized as “entertainment, recreation or amusement”
- NOTE: The purpose of all business flights, and all “personal” flights that are NOT classified as “entertainment, recreation or amusement” must be documented



## Strategies for Avoiding/Minimizing Disallowance of Aircraft Expense Deductions

- Under the final regulations, expenses allocable to leases or charters to unrelated third-parties in bona-fide transactions for full and adequate consideration may be excluded
- Accordingly, increase use by unrelated third-parties under dry leases, and/or Part 135 charter at arms-length rates
- Caution: adverse Passive Loss (IRC 469) impact could outweigh benefits



# Strategies for Avoiding/Minimizing Disallowance of Aircraft Expense Deductions

## Charter/Dry Lease to Specified Individuals:

- ➔ The final regulations do not address expenses allocable to leases or charters of the employer's aircraft to Specified Individuals at arm's length rates. The IRS has stated, however, that the exception in the preceding slide does not apply to such transactions



## Strategies for Avoiding/Minimizing Disallowance of Aircraft Expense Deductions

- Notice 2005-45: When an aircraft is flown empty to pick up or to drop off one or more passengers, the empty flight is treated as having the same number and character (i.e., business vs. entertainment) of passengers as the flight for which passengers are on board
- Accordingly, plan ahead to minimize deadheading related to entertainment flights



# Strategies for Avoiding/Minimizing Disallowance of Aircraft Expense Deductions

- ➔ Plan ahead to combine business trips with entertainment trips
  - Business and entertainment at a single destination
  - Business and entertainment at separate destinations



# Travel for Both Business and Recreational Purposes

## Single Destination

- ➔ The final regulations do not address how to determine whether a Specified Individual's trip to a particular destination should be categorized as business or entertainment when both activities are conducted
- ➔ Other regulations governing the imputation of fringe benefits provide that income must be imputed to an employee only if the personal purpose of the employee in traveling to a particular destination is primary
- ➔ In light of the absence of guidance in the Notice and the Proposed Regulations, it should be reasonable to assume that a similar methodology may be used



# Travel for Both Business and Recreational Purposes Multiple Destinations

- ➔ When a flight provided to a Specified Individual includes one or more destinations for business purposes, and one or more other destinations for entertainment purposes, the flight hours/miles allocated to entertainment use will be the excess of the total flight hours/miles flown during the trip over the number of flight hours/miles that would have been flown if the flights to the entertainment destinations had not occurred



## Multiple Aircraft Available

- If more than one private aircraft is available for use, the following three-part strategy may help reduce your disallowance:
1. Use higher-basis (typically newer) aircraft solely for business and personal non-entertainment flights
  2. Calculate disallowance for each aircraft separately (i.e., do not aggregate expenses)
  3. Aggregate expenses only if newer, higher basis aircraft will be used for entertainment (Note: to be eligible to aggregate expenses, aircraft must have similar cost profiles, by reference to payload, seating capacity, fuel consumption rate, maintenance costs, number of engines, etc.)



## Strategies for Avoiding/Minimizing Disallowance of Aircraft Expense Deductions

- Use less expensive alternatives for all entertainment flights, such as
  - Older, lower basis aircraft in fleet
  - Jet Cards
  - Charter
  - Time Share of Third Party Aircraft, Dry Lease, Interchange



# What Expenses are Subject to Disallowance?

- Taxpayers must include all expenses of operating and maintaining the aircraft during the taxable year, including, for example:
- fuel
  - landing fees
  - overnight hangar fees
  - catering
  - meal and lodging expenses of the flight crew
  - management fees
  - hangar rent
  - salaries of pilots
  - maintenance personnel and other personnel assigned to the aircraft maintenance costs
  - lease payments (if aircraft is leased rather than owned)
  - charter fees (if aircraft is chartered rather than owned)



# What Expenses are Subject to Disallowance?

- While not normally considered an “expense” from a financial accounting point of view, taxpayers must also include tax depreciation when calculating expenses
- Final regulations also provide that interest “properly allocable” to an aircraft, under the interest tracing rules, is an expense subject to disallowance
- Under the interest tracing rules, interest does not have to be incurred in connection with aircraft specific financing, but rather may include general borrowing, for example, pursuant to a corporate line of credit, when a portion of the line of credit interest is utilized for the purchase of the aircraft
- Interest was not mentioned or specifically listed as an includable expense in Notice 2005-45 or the proposed regulations



# Special Rules Regarding Depreciation Expense

- ➔ Taxpayers may elect to calculate depreciation using the ADS straight-line method over the class life of the aircraft solely for purposes of calculating the amount of the disallowed expense, even if another method is used for tax or book purposes
- ➔ The election may be made for aircraft placed in service in prior years. In such cases, apply straight line to original basis as if the election had been in effect since the aircraft was placed in service
- ➔ If taxpayer elects to use the straight-line method for one aircraft, it must use the method for all aircraft it owns



# Special Rules Regarding Depreciation Expense

- Final Regulations also clarify that where a taxpayer elects to use ADS for purposes of calculating the disallowance attributable to entertainment flights, the amount disallowed is any given year as a result of the election to utilize ADS may not exceed the amount of depreciation otherwise allowable for that tax year
- This may result in less than 100% of the basis in the aircraft being subject to disallowance over time



# Special Rules Regarding Depreciation Expense

Example of \$1m basis in aircraft depreciable under MACRS over 5 years or ADS over six (half-year convention):

	Normal	274	Normal	274
	MACRS	Disallowance	ADS	Disallowance
Year	Deduction	(No ADS Election)	Deduction	(ADS Election)
1	200,000	100,000	83,333	41,667
2	320,000	160,000	166,667	83,334
3	192,000	96,000	166,667	83,334
4	115,200	57,600	166,667	83,334
5	115,200	57,600	166,667	83,334
6	57,600	28,800	166,667	57,600
7	0	0	83,333	0
<b>Total:</b>	<b>1,000,000</b>	<b>500,000</b>	<b>1,000,001</b>	<b>432,601</b>



# Special Rules Regarding Depreciation Expense

- ➔ Election may only be revoked for compelling reasons with IRS consent
- ➔ The expense disallowance provisions are applied on a pro-rata basis to all of the disallowed expenses
- ➔ Tax basis is only reduced by the amount of depreciation actually allowed after application of the disallowance rules
- ➔ Disallowed depreciation is suspended basis, which will be treated as basis in an asset which is used for personal, living and family purposes, in accordance with IRS Reg. 1.274-7



# Methodologies for Calculating Disallowance of Aircraft Expense Deductions

- Calculate disallowance using all available methods, and use method that provides the best result
- Passenger by passenger method by seat hours
  - Passenger by passenger method by seat miles
  - Flight by flight method by seat hours
  - Flight by flight method by seat miles



# Record Keeping and Calculations under Passenger Seat Hour/ Seat Mile Methods

The taxpayer must maintain records of all aircraft expenses, and either the total number of flight hours or miles flown by each individual passenger on each flight of the aircraft, and then must categorize the hours or miles flown by each individual on each flight in one of 3 buckets: business non-entertainment, entertainment or personal non-entertainment

Business Non-Entertainment



Entertainment



Personal Non-Entertainment



# Record Keeping and Calculations under Passenger Seat Hour/ Seat Mile Methods

Assume 5 passengers on board (all Specified Individuals), 3 of whom are traveling on business, 1 is traveling for personal entertainment, and 1 is traveling for personal non-entertainment. The trip is 1,000 miles, and the seat miles methodology is used:

	<u>Passengers</u>	<u>Miles</u>	<u>Total Seat Miles</u>
Business	3	1,000	3,000
Personal Entertainment	1	1,000	1,000
Personal Non-Entertainment	1	1,000	1,000



## Record Keeping and Calculations under Passenger Seat Hour/ Seat Mile Methods

- At the end of the tax year, all occupied seat miles (or hours) in all three buckets are totaled
- The sum of all expenses subject to disallowance is divided by the total sum of occupied seat miles (or hours) in all 3 buckets
- The average cost per occupied seat mile (or hour) for the taxable year is determined



# Allocating Expenses to Business and Entertainment Uses under Passenger Seat Hour/ Seat Mile Methods

- The average cost per occupied seat mile (or hour) is multiplied by the total number of occupied seat miles (or hours) for a given entertainment flight to determine the expenses associated with the entertainment flight



## Allocating Expenses to Business and Entertainment Uses under Passenger Seat Hour/ Seat Mile Methods

- The total amount imputed as income to, or reimbursed by, the Specified Individual for each individual entertainment flight (not to exceed the entertainment expenses associated with the flight) is subtracted from the entertainment expenses associated with the flight to determine the amount disallowed



## Methodologies for Calculating Disallowance of Aircraft Expense Deductions

- Determine total costs for the year
- Determine total flight hours/miles for the year
- Calculate costs per flight hour/mile
- Review all flight legs that have passengers travelling for entertainment purposes
- Multiply hour/mile cost times hours/miles of flight to determine cost of the flight
- Prorate costs of flight on a per passenger basis, and net against SIFL income for such passengers



## Strategies for Avoiding/Minimizing Disallowance of Aircraft Expense Deductions

- ➔ Use Tax Deferred Exchanges (IRC 1031) to avoid taxation of depreciation recapture on sale of an aircraft and minimize depreciable basis of newly acquired aircraft to reduce amount potentially subject to disallowance on future entertainment flights



# Closing Remarks



**Keith G. Swirsky**  
**GKG Law, P.C.**

1054 31<sup>st</sup> St. NW, Suite 200  
Washington, D.C. 20007

Tel: (202) 342-5251

Fax: (202) 965-5725

E-mail: [Kswirsky@gkglaw.com](mailto:Kswirsky@gkglaw.com)

[www.gkglaw.com](http://www.gkglaw.com)

