Tax Treatment Of Corporate Aircraft Use:

Entertainment, Amusement and Recreational Purposes (Part 2)

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With a focus on rules for Specified Individuals, attorney Troy Rolf concludes his two-part series dealing with the tax implications of personal and recreational use of company aircraft.

Last month we assessed the IRS's Notice 2005-45 which seeks to provide a way for owners of business jets to calculate the number of 'recreational' hours flown aboard a company's aircraft versus the number of 'business' hours flown in order to obtain the right amount of tax depreciation for business use of the aircraft. We established that this method had attracted a large amount of criticism by taxpayers.

To illustrate, assume that a corporation operates only two flights in an entire year, and each of the two flights is five hours in duration. Assume that on the first of these flights there was only a single passenger, and this passenger was traveling solely for business, non-entertainment purposes. On the second flight there were nine passengers, all of whom were Specified Individuals (or were traveling as family members or guests of a Specified Individual) traveling for entertainment purposes.

In this admittedly extreme example, each of the two flights was five hours in duration, and so the costs actually incurred by the company to operate each of the two flights would likely be similar (with the second flight perhaps using a small amount of additional fuel due to the extra weight of the additional passengers). However, under the Notice 2005-45 methodology we explored in last month's edition, the company would be required to allocate its operating expenses and depreciation 10% to the first flight and 90% to the second flight due to the fact that business, non-entertainment hours flown (1 passenger x 5 hours = 5) constituted 10% of the total number of passenger-hours flown while entertainment hours flown (9 passengers x 5 hours = 45) constituted 90% of the total number of passenger-hours flown.

Thus, on these facts, 90% of all operating expense and depreciation deductions would be subject to the Recreational Flight disallowance even though only half of the actual aircraft hours flown related to the Recreational Flight.

EFFORTS TO SIMPLIFY

In 2007, the IRS proposed a new set of regulations to implement the Jobs Act. These adopted the methodology dictated by Notice 2005-45. However, in order to address the criticisms of the methodology, the proposed regulations also recommended allowing ›

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taxpayers the option of using an alternative methodology whereby costs could be allocated initially on a flight-by-flight basis rather than on a passenger-by-passenger basis.

Returning to the previous example, under the alternative methodology, since each of the two flights accounted for exactly one-half of the total flying time for the year, all operating expenses and depreciation would initially be allocated one-half to each of the two flights, thus resolving the potential distortion highlighted. Under the alternative methodology, after expenses and depreciation are initially allocated on a flight-by-flight basis, the expenses and depreciation attributable to any specific flight may then be subdivided and re-allocated on a passenger-by-passenger basis where the flight carries more than one passenger, some of whom are traveling for entertainment purposes and some for non-entertainment purposes. The proposed regulations provide that companies may use either miles or hours as the basis for the calculations.

The proposed regulations also suggest allowing a taxpayer to use Alternative Depreciation System (ADS) straight line depreciation for purposes of calculating the portion of the taxpayer's depreciation deduction that will be disallowed due to use of the aircraft for entertainment purposes, even though the taxpayer uses Modified Accelerated Cost-Recovery System (MACRS) accelerated depreciation for all other tax purposes. However, the proposed regulations did not provide much detail concerning the mechanics of how using ADS for one purpose and MACRS for other purposes for the same asset would work.

CHOICE OF METHODOLOGY

On August 1 of this year, the IRS published final regulations implementing the Jobs Act. The final regulations adopted both the methodology dictated by Notice 2005-45, and the optional alternative methodology set forth in the proposed regulations. Taxpayers therefore have a choice as to which methodology to use.

The final regulations also adopted the provisions of the proposed regulations that allow a taxpayer to use straight line ADS depreciation for purposes of calculating the amount that will be disallowed due to entertainment use, even though the taxpayer uses MACRS for all other tax purposes. The final regulations clarify that disallowed depreciation cannot exceed the amount of tax depreciation otherwise allowable with respect to the aircraft in any year, and provide examples illustrating the math and mechanics of how to use ADS for calculating the disallowance while using MACRS for all other purposes.

This briefing provides only an outline introduction to the aircraft operating expense and depreciation disallowance under Section 274 of the Internal Revenue Code related to use of corporate aircraft for entertainment, recreation and amusement purposes. The tax rules governing such entertainment, recreation and amusement use are too complex to be fully explored in this article, which is designed to alert readers to this convoluted issue. Boards of Directors should consult experienced aviation tax counsel for a more thorough explanation of the rules and the tax consequences of such use.

"Taxpayers therefore have a choice as to which methodology to use."

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