PERSONAL USE OF CORPORATE AIRCRAFT: LOSS OF TAX WRITE-OFF'S.

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If you use your company's business jet for vacation travel or other personal, non-business purposes from time to time, the American Jobs Creation Act of 2004 (the "Act") , signed into law by President Bush on October 22, 2004, has raised your taxes. The Act overrides the Sutherland Lumber decision by limiting a taxpayer's ability to deduct aircraft depreciation and operating expenses when the aircraft is used to provide transportation to owners, officers and employees for entertainment, amusement, or recreational purposes. This law is intended to produce additional tax revenues and is, in effect, a back-door tax increase on companies that operate business aircraft.

Overview and Prior Law

The Internal Revenue Code ("IRC") generally allows taxpayers to deduct from income all ordinary, necessary and reasonable expenses paid or incurred during a taxable year in carrying on the taxpayer's trade or business. IRC Section 274 modifies the foregoing general rule by prohibiting taxpayers from deducting expenses paid or incurred with respect to any facility, including aircraft, which is used in connection with entertainment, amusement, or recreation (hereinafter, "recreation").

Prior to enactment of the Act, the Eighth Circuit Court of Appeals had held in Sutherland Lumber v. Commissioner of Internal Revenue that the limitation contained in IRC Section 274(a) did not apply to flights provided by a taxpayer to the taxpayer's shareholders and employees on a company-operated aircraft for recreational purposes if the taxpayer imputed fringe benefit income to the shareholders and employees for the value of flights. Therefore, the company could deduct the expenses for such flights.

Effect of American Jobs Creation Act of 2004

The Act in effect overrules the Sutherland Lumber decision by limiting the deduction permitted to taxpayers for the expenses associated with the provision of flights to certain "Specified Individuals" for recreational purposes to the amount imputed to the Specified Individuals as fringe benefit income for such flights. The term "Specified Individuals" includes any person who is the direct or indirect owner of more than 10% of any class of equity security of the taxpayer, and any officer or director of the taxpayer. The Act does not limit the deduction permitted to companies for the expenses associated with operating flights for entertainment, amusement, or recreational purposes for employees who are not "Specified Individuals".

Open Questions

1. "Personal" Flights Might Not All Be Subject to IRC 274.

The Act raises more questions than it answers. For example, are all flights for which income must be imputed to the employee under the fringe benefits regulations subject to the IRC Section 274 limitation created by the Act? Presumably, the answer to that question is qualified "no".

When a taxpayer provides a flight to an employee for purposes unrelated to the taxpayer's trade or business, the fringe benefit regulations require that the taxpayer must impute income to (or charge) the employee for the value of the flight. However, not all flights provided to an employee under conditions requiring the imputation of fringe benefit income constitute flights for recreational purposes.

In various rulings, the IRS has recognized that routine personal uses by an employee of a company vehicle for purposes unrelated to the trade or business of the employer are not subject to IRC Section 274 if the use of the vehicle by the employee is for purposes other than recreation. In applying this concept to aircraft, the IRS agreed in the Sutherland Lumber case that IRC Section 274 does not apply to situations where a taxpayer provides a flight to an employee for purposes related to another business of the employee, or for charitable purposes. It is of course unclear what, if any, other types of situations where a taxpayer provides a flight to an employee for purposes unrelated to the trade or business of the taxpayer may be excluded from the scope of IRC Section 274, or whether the IRS will continue in the aftermath of the Act to recognize any such flights as being outside the scope of IRC Section 274.

2. Business Travelers and Recreation Travelers Sharing a Flight

It is also unclear from the text of the Act what effect, if any, the Act will have on taxpayers' ability to deduct expenses associated with operating mixed-use flights conducted primarily for business purposes, where some passengers are traveling primarily for business purposes, and other passengers are traveling primarily for recreational purposes. The passengers traveling for recreation could be either company employees or the spouse or guests of the business travelers.

In either situation, arguably the fact that the flights served primarily business purposes should allow full deductibility, with only the marginal costs, if any, incurred for those traveling for recreational purposes being subject to the limitation created by the Act. This interpretation is supported by legislative history underlying IRC Section 274 and various Tax Court and IRS rulings. Yet, currently, there is no guidance on point, and it is conceivable that the IRS could assert that the expenses incurred for such flights would have to be apportioned in some manner, thereby limiting full deductibility of such expenses.

3. Travel for Both Business and Recreational Purposes

Similarly, it is unclear from the text of the Act how to treat flights where an employee travels for both business and recreational purposes. Treasury regulations provide that when a taxpayer furnishes air transportation to an employee to a particular destination on a taxpayer-provided aircraft, and the purpose of the employee in traveling to the destination serves both a personal and a business purpose, income must be imputed to the employee only if the personal purpose of the flight is primary.

The determination of whether a flight is primarily for personal or business purposes is based on a facts and circumstances analysis. Factors to be considered in making such a determination include the amount of time spent on personal activities and the amount of time spent of activities relating to the taxpayer's trade or business. For example, according to treasury regulations, if a taxpayer spends one week at a destination on business activities, and an additional five weeks at the destination for recreational purposes, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary. Presumably, then, it should be reasonable to assert that if the business purpose of a flight is primary, IRC Section 274 should not apply.

4. Multi-City Trips for Both Business and Recreational Purposes

A more difficult case is presented in the context of a multi-city trip that includes two or more destinations other than the original point of departure, where at least one of the destinations is primarily for personal purposes, and at least one of the destinations is primarily for business purposes. In such situations, the "Standard Industry Fare Level" (a.k.a "SIFL") method of imputing income provides rules for apportioning the value of the flights into business and non-business components, with income being imputed for the personal-use component.

Applying the same or a similar methodology to multi-city trips where one or more destinations are primarily for business purposes, and one or more other destinations are primarily for recreational purposes, would appear to be a logical means of apportioning aircraft operating expenses for purposes of the amended IRC Section 274. However, in the absence of specific guidance from the IRS, it is possible that the IRS could require another methodology.

Further Guidance

Until guidance is provided by the IRS, it is only possible to apply a well reasoned, consistent methodology to resolving the issues discussed in this article. The NBAA Tax Committee has requested such guidance from the IRS, and industry representatives met with IRS and Treasury staff in February of this year to discuss the need for guidance. The IRS has not yet provided any indication of when they will issue such guidance, or the content of the guidance they will issue. Until the IRS issues its guidance, companies that permit their aircraft to be used by their "Specified Individuals" for recreational travel should consult with their aviation and tax advisors promptly to devise an appropriate approach for implementing these new rules.

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Effective planning for corporate aircraft ownership and operations requires a complete and in-depth understanding of applicable State and Federal tax issues, as well as the Federal Aviation Regulations. Keith G. Swirsky and Troy A. Rolf are shareholders in the law firm of Galland, Kharasch, Greenberg, Fellman & Swirsky, P.C. concentrating in the areas of corporate aircraft transactions and aviation taxation The firm's business aircraft practice group provides full-service tax and regulatory planning and counseling services to corporate aircraft owners, operators and managers. The group's services include Section 1031 tax-free exchanges, federal tax and regulatory planning, state sales and use tax planning, and negotiation and preparation of all manner of transactional documents commonly used in the business aviation industry, including aircraft purchase agreements, leases, joint-ownership and joint-use agreements, management and charter agreements, and fractional program documents. Mr. Swirsky can be reached at the firm's Washington, DC office, 1054 31st Street, NW, Suite 200, Washington, DC 20007, telephone: (202) 342-5251, facsimile (202) 965-57254, e-mail kswirsky@gkglaw.com. Mr. Rolf can be reached at the firm's Minnesota office, 700 Twelve Oaks Center Drive, Suite 204, Wayzata, MN, 55391, telephone: (952) 449-8817, facsimile (952) 449-0614, e-mail trolf@gkglaw.com.