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CLIENT ALERT

Entertainment Use of Aircraft – Final Regulations on Aircraft Disallowance Provisions

by
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The IRS recently published final regulations governing the implementation of the provisions of the American Jobs Creation Act of 2004 (the “2004 Act”) disallowing depreciation and operating expense deductions associated with use of corporate aircraft by company owners and executives for entertainment, recreation and amusement purposes. The final regulations will be effective for tax years beginning after August 1, 2012.

The 2004 Act limits a taxpayer’s ability to deduct aircraft depreciation and operating expenses when the aircraft is used to provide transportation to certain “Specified Individuals” for entertainment, amusement, or recreational purposes. In 2005, the IRS issued Notice 2005-45 providing interim guidance for implementation of the 2004 Act. In 2007, the IRS published proposed regulations for implementation of the 2004 Act. The final regulations incorporate substantially all of the provisions of Notice 2005-45 and the proposed regulations without modification, with the exception of some clarifications and added computational examples. This Client Alert will focus on provisions of the final regulations that were not contained in Notice 2005-45 or the proposed regulations, as GKG Law has previously published various alerts and articles discussing the 2004 Act, Notice 2005-45 and the proposed regulations.

The final regulations contain the following new provisions:

- The proposed regulations purported to allow a taxpayer to use straight line ADS 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 MACRS accelerated depreciation for all other tax purposes. However, the proposed regulations did not provide much detail concerning the mechanics of properly accounting for the use of ADS for one purpose and MACRS for other purposes for the same asset. The final regulations provide more examples illustrating such mechanics. In addition, the final regulations provide that disallowed depreciation cannot exceed the amount of tax depreciation of an aircraft in any tax year. This is particularly relevant

where a taxpayer utilizes ADS for purposes of calculating disallowed depreciation under the 2004 Act but utilizes MACRS for other purposes. In such cases, there would be no disallowed depreciation under the 2004 Act in any year after the aircraft has been fully depreciated for tax purposes using MACRS (although the taxpayer was utilizing ADS for purposes of calculating disallowed depreciation and the taxpayer will not have reached the final year(s) of the ADS depreciation schedule) since depreciation schedules under ADS tend to be longer than the depreciation schedules under MACRS.

This provision in the final regulations has the effect of allowing a taxpayer to cause less than 100% of its depreciable basis in the aircraft to be subject to disallowance provisions. For example, an aircraft depreciable under a 7-year MACRS schedule (which would include all or part of eight different tax years, assuming a half-year or mid-quarter convention), would be depreciable under the ADS system over a 12-year (13 tax-year) straight line schedule. Under the provisions of the final regulations, after the conclusion of the eighth tax year (reflecting depreciation deductions under the 7-year MACRS schedule), there would be no further disallowance associated with depreciation deductions, and only eight out of the 13 years reflected on the 12-year straight line schedule would have been factored into the disallowance deductions. In the first eight years on a 12 year straight line schedule, the aggregate percentage subject to disallowance is 62.5%. The total aggregate amount of depreciation disallowed over such eight year period would therefore be, on average, 62.5% of the amount that would have been disallowed if the taxpayer had not elected to utilize ADS for purposes of calculating the disallowance.

- The proposed regulations did not list interest expense as an aircraft cost subject to disallowance. Not surprisingly, the final regulations clarify that interest expense is a cost subject to disallowance. To make matters more complicated, the final regulations provide that interest “properly allocable” to an aircraft, under the interest tracing rules, is subject to disallowance. This means that interest expense does not have to be incurred in connection with aircraft specific financing. Instead, for example, if an aircraft owner has borrowed funds pursuant to a business line of credit that is properly allocable to the aircraft, a portion of interest paid on the funds borrowed under the line of credit would be allocable to the purchase of the aircraft and subject to disallowance under the 2004 Act.
- The final regulations clarify that the aggregate disallowed deductions are allocated pro rata across all aircraft costs, including fixed costs, direct costs, interest expense and depreciation.
- The final regulations provide several examples of how to allocate the cost of deadhead flights.
- The proposed regulations requested comments from the public regarding whether the IRS should adopt some sort of charter rate safe harbor to minimize or eliminate the impact of the disallowance provisions of the 2004 Act where aircraft

are chartered to specified individuals at fair market charter rates for entertainment flights, or where income is imputed to specified individuals at fair market rates for use of the company aircraft for entertainment purposes. The National Business Aviation Association and other commentators submitted comments to the IRS in connection with the issuance of the final regulations supporting the inclusion of some form of charter rate safe harbor in the regulations. However, the IRS elected to not include any form of charter rate safe harbor in the final regulations. The IRS nevertheless did leave the door open to adopt charter rate or other safe harbors in future published guidance.

If you have any questions concerning the final regulations or application of the disallowance rules generally, please do not hesitate to contact us.

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