How Flight Cards Can Minimize The Impact of The Personal Use Disallowance Rules

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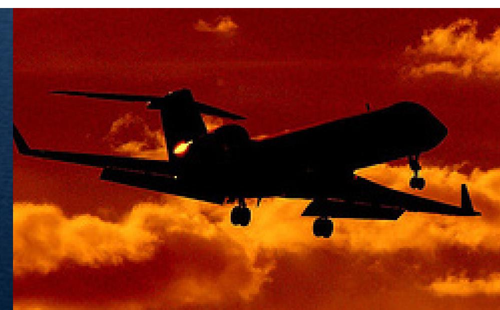
A company that owns an aircraft is generally able to capitalize on the deductions that make ownership advantageous. Many times the company will determine it appropriate that key employees travel on the company aircraft for personal purposes. Under current law businesses are limited in the amount they can deduct for personal recreational use of the corporate aircraft. This article focuses on the limitations on the deductibility of expenses related to recreational flights on a company aircraft, and how flight cards can minimize these adverse tax results.

A landmark decision by the Tax Court in Sutherland Lumber-Southwest, Inc. v. Commissioner codified prior law, and clearly provided that a corporate taxpayer may deduct the full cost of a non-business (recreational) flight on the company's aircraft, even over the amount the recipient (i.e. the officer / employee using the aircraft) included as income for the use of the aircraft. However, soon after this landmark decision Congress overturned Sutherland.

The American Jobs Creation Act of 2004 (AJCA), amended the Internal Revenue Code (Section 274) limitation on the deductible amount of trade or business expenses for use of business aircraft for recreational. The IRS subsequently issued Notice 2005-45, providing interim guidance on the AJCA, which sets out how the IRS will apply Code Section 274 to deductions for recreational use of business aircraft. Proposed Regulations were then issued and somewhat provide relief, however, they do not substantially modify the harsh effect of the AJCA and the Notice provisions.

Under the new rules, to the extent a business aircraft is used for recreational purposes, the expenses will be disallowed as a deduction, including any allocable depreciation. For example, if the aircraft was flown for 100 hours, 30% of which was for recreational purposes, the company would be forced to disallow 30% of its deductions, including, most significantly, depreciation deductions. The amount treated as compensation to an individual (i.e. the recipient includes the value in their income), may serve to reduce the disallowed



portion (this is a small offset, providing little benefit). For a company with a high tax basis aircraft, the loss of depreciation entitlements related to this disallowance can push the lost tax deduction in excess of $20,000 or $30,000 per flight hour (or more in the case of bonus depreciation eligible aircraft, or aircraft purchased late in the tax year).

To exemplify, assume a new $12,000,000 Learjet acquired by a business on September 1, 2009. If the aircraft is bonus eligible, and 5 year MACRS eligible, then the first year depreciation entitlement is $7,200,000. Assume further that the aircraft flies 150 hours during the last 4 months of the year, 50 hours of which are recreational travel due to the high number of holidays during the end of the year. Assume further an operating budget of $300,000 for those 4 months. In this example, the lost deduction is $2,400,000 of depreciation and $100,000 of operating expenses before netting any deminimis compensation income to the employee. On a per flight hour basis, the company's lost deduction is $50,000 per flight hour!!!

The disallowance plays a further role with "deadhead" flights. This may happen, for example, if the company needs to use its corporate aircraft for a business trip in the middle of another employee's vacation trip and brings the aircraft back home after dropping off the employee. The rules provide that deadhead flights also factor into the calculation of the disallowance and even though no passengers are on board, the company will experience further loss of deductions.

So, what is the magic bullet to reduce the harsh effects of these rules? The way is the use of a flight card. With card programs, you don't own any share of the aircraft. Instead, you are really "chartering" an aircraft from the card provider on a block hour basis, purchasing a block of hours such as 25 or 50 on the card. When the entire amount on the card is used, you may purchase another card, or not.

Several conveniences come from the use of a card. Card providers may have their own fleet of aircraft that they manage, and are also able to draw from a wide array of charter operators. Generally, your account is deducted only for occupied flight hours, not for time spent positioning your plane before or after the flight, as most card programs offer "one-way" pricing. Thus, typically deadheads do not count towards your flight time, unlike the conventional method of using the company aircraft.

Additionally, when a flight card is used, there is usually a guarantee of flight availability provided minimal notice given. It may even be possible to obtain a discounted rate or elongated time frame on which to use your card hours. Also, you can choose the best possible aircraft solution based on the purpose of your trip – either light, mid, large cabin, or extended range aircraft (as opposed to the one size cabin option with your company aircraft).

Most importantly, when you use a flight card, the disallowance rules relate only to the amount paid for the card; tax depreciation is not a cost factored into the card. As a result, the after tax cost of using a card will likely be lower than use of a company aircraft (with a high tax basis).

Consider the previous example, whereby the company's lost deduction was $50,000 per flight hour. If the company had purchased a 50 hour card for the last 4 months of Calendar year 2009 instead of using its new aircraft, the cost of a card for an equivalent aircraft would have been roughly $400,000. So, the company would have had to spend $400,000 of non-deductible dollars. By not using its own aircraft for these flights, the company might have saved $75,000 of the operating expenses (direct operating costs, not fixed costs), so the net cost of the card is $325,000. But, by using the card instead of its own aircraft, the company saved taxes on $2,500,000 of additional tax deductions, which assuming a conservative 35% federal and state rate, equals $875,000 in tax savings.

As icing on the cake, your company aircraft will always be available for business needs, and even when your business aircraft is in use, you will still have access to aircraft with the flight card.

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