IRS ISSUES PROPOSED REGULATIONS ON ENTERTAINMENT USE OF BUSINESS AIRCRAFT

By Keith G. Swirsky

On June 14th, 2007, the IRS released the long awaited Proposed Regulations relating to entertainment use of business aircraft. These Proposed Regulations affect taxpayers that deduct expenses for entertainment provided to Specified Individuals, and reflect amendments under the American Jobs Creation Act of 2004 (the "Jobs Act") and the interim guidance provided in Notice 2005-45 (the "Notice").

The Proposed Regulations apply to any taxable year beginning on or after the date of publication of a Treasury decision adopting Final Regulations in the Federal Register. However, taxpayers may rely on the rules in the Proposed Regulations or those provided in the Notice for taxable years beginning before the publication of a Treasury decision adopting the Final Regulations. Because public hearings on the Proposed Regulations are scheduled for October 25th, 2007, it is not clear whether publication of the Treasury decision adopting Final Regulations will occur in 2007 or 2008.

The National Business Aircraft Association (NBAA), and many other industry interest groups have lobbied for significant modification to the provisions of the Jobs Act and the guidance of the Notice. While the Proposed Regulations do not adopt the majority of the comments made to the IRS they at least do not make matters worse. In fact, the IRS has provided some relief, resulting in increased tax deductions for such entertainment use. Rather than discuss all of the comments that the IRS declined to adopt, this article will focus on those areas where the IRS relaxed the rules, providing for enhanced tax deductions.

Depreciation

Most taxpayers depreciate their aircraft using either a five-year or seven-year MACRS depreciation methodology. Because depreciation is included in the definition of expenses, aircraft with a high adjusted tax basis have a high occupied seat mile or hour value. The Proposed Regulations relax the requirement to use actual depreciation in the expense calculation and now permit a taxpayer to elect to use a hypothetical straight line approach over the class life of the aircraft. For purposes of calculating the expense disallowance, if a taxpayer elects to use the straight line method and the class life for any aircraft it operates, it must use that same method for all aircraft that it operates, and must continue to use the same method for the entire period the taxpayer uses aircraft for entertainment use. If the taxpayer elects to use this methodology with respect to aircraft placed in service in taxable years before the current taxable year, the amount of depreciation is determined by applying the straight line method of depreciation to the original cost of the aircraft (or, for property acquired in a tax-free exchange, the basis of the aircraft as determined under Section 1031(d)) and over the class life of the aircraft as though the taxpayer used that methodology from the year the aircraft was placed in service.

Clearly the Proposed Regulations will decrease the expense disallowance for aircraft with high tax basis and those recently placed in service.

The Proposed Regulations clarify that if an amount disallowed is allocated to depreciation, Internal Revenue Regulation 1.274-7 applies and the basis of the aircraft is not reduced for the amount of the depreciation disallowed. In other words, the disallowed amount is treated as an asset which is used for personal purposes, and not an

asset used in a trade or business, and gain or loss on the sale of the aircraft is calculated in the same manner as other property which is used partly for business and partly for personal purposes. In order to determine the allocable amount of depreciation subject to disallowance, the Proposed Regulations provide that the expense disallowance provisions apply to all expenses on a pro-rata basis.

Occupied Seat Hour and Occupied Seat Mile Formula

The Notice provided an occupied seat hour (or mile) formula to allocate expenses to entertainment flights provided to Specified Individuals. The formula multiplies the hours and miles flown by an aircraft by the number of occupied seats to determine the cost per occupied seat or mile.

The Proposed Regulations provide the option of allocating expenses on a flight-by-flight basis as an alternative to using the occupied seat hour (or mile) formula. Under the flight-by-flight method, a taxpayer may aggregate all expenses for the taxable year and divide the amount of the total expenses by the number of flight hours (or miles) for the taxable year to determine the cost per hour (or mile). The taxpayer allocates expenses to each flight by multiplying the number of hours (or miles) for the flight by the expense per hour (or mile) and allocates expenses for the flight to the passengers on the flight per capita.

The benefit of this provision may not be obvious, so an example would be helpful. Assume a taxpayer conducts ten flights during the year between the same two city pairs. On the first nine flights, the taxpayer has one executive flying for business purposes, and on the tenth flight the company has nine individuals all flying for recreational purposes. In this example, pursuant to the Notice, fifty percent (50%) of the total expenses for the

year would be subject to disallowance, whereas, under the flight-by-flight methodology only ten percent (10%) of the expenses for the year would be subject to disallowance. Whether the new flight-by-flight approach will benefit any given taxpayer will be difficult to determine until the tax year is over and a calculation can be made under both methodologies to determine which methodology produces the smaller disallowance of expenses for the year.

Charter Rate Safe Harbor

Perhaps the most significant provision of the Proposed Regulations is the Charter Rate Safe Harbor. As an alternative to determining actual expenses for the year, the IRS is considering whether the Final Regulations should permit taxpayers to determine the amount of their expenses paid or incurred for entertainment flights by reference to charter rates. Under such a Safe Harbor, taxpayers could elect to treat as the amount of expenses for entertainment flights, an undiscounted charter rate for each flight, in lieu of calculating the actual expenses attributable to each entertainment flight provided to Specified Individuals. Under the Safe Harbor, the undiscounted charter rate for the flight would be allocated to the individuals on the flight in lieu of the occupied seat hour or mile, or flight-by-flight, allocation methods. It is important to understand that the Proposed Regulations do not include the Safe Harbor at this time, but instead, the IRS has requested comments on whether such a Safe Harbor, or other Safe Harbors, should be adopted.

The Charter Rate Safe Harbor is a ***significant*** relaxation of the current set of rules. To clarify, the Proposed Regulations are not requiring or suggesting that the Specified Individual must pay the charter rate and, in fact, under the Rules of FAR Part

91, in general, an individual may not pay for aircraft transportation received from the employer. Instead, the Charter Rate Safe Harbor would allow a taxpayer to reference a market charter rate to determine the expense subject to disallowance on a given flight. Use of the charter rate to determine the expense is particularly advantageous when there is a high per-seat hour or per-seat mile, or even a flight-hour cost, such as when the aircraft has a high adjusted tax basis or when fixed costs are amortized over a small number of occupied seat miles or seat hours. Further, when the Charter Rate Safe Harbor is paired up with the rule in Internal Revenue Regulation 1.61-21(g) that allows a company to **impute** income to the Specified Individual utilizing the charter rates, it is possible to realize no net disallowance on the company's tax return.

The IRS will likely require a variety of mechanical/administrative procedures in order to utilize the Charter Rate Safe Harbor. In particular, it would be important for the taxpayer to prove what the market charter rate would have been for the flight in question, and to maintain written evidence in their files, as backup, for tax return preparation purposes. Because of the significance of the Charter Rate Safe Harbor, the industry should heavily weigh in that this Charter Rate Safe Harbor should be adopted in the Final Regulations.

There are numerous provisions in the Proposed Regulations which the NBAA and other industry interest groups will comment on to present corporate aircraft owners' perspective on the Jobs Act provisions. We will provide updates as more information is available, to assist aircraft owners in their continued tax planning. For the time being, at least, use of the flight-by-flight rule and straight line depreciation, will certainly improve tax planning. Stay tuned for further developments.