



IRS Publishes Guidance for Calculating Disallowance of Expense Deductions for Recreational Use of Corporate Aircraft -By Keith G. Swirsky & Troy A. Rolf-



If you use your company's business aircraft for recreational travel, the American Jobs Creation Act of 2004 (the "Act"), signed into law by President Bush on October 22, 2004, 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 certain "Specified Individuals" for entertainment, amusement, or recreational purposes. The law is intended to produce additional tax revenues and is, in effect, a back-door tax increase on companies that operate business aircraft.

The Act created a great deal of confusion in the business aviation community because, while the Act clearly limits the deduction permitted to taxpayers for the expenses associated with the provision of flights to Specified Individuals for entertainment, amusement, or recreational purposes (hereinafter "recreational"), the Act does not provide a method for calculating the limitation, or any guidance concerning how to allocate costs for flights in many situations. In order to address these and other questions raised by the Act, the IRS published Notice 2005-45 on May 27, 2005 ("Notice 2005-45").

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 disallowing deductions for expenses paid or incurred with respect to any facility, including aircraft, which is used in connection with recreation.

Prior to enactment of the Act, the Eighth Circuit Court of Appeals 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 all the expenses associated with such flights. The *Sutherland Lumber* case was heavily publicized, given its pro-taxpayer result, on a newsworthy topic.

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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”.

Overview of Notice 2005-45

Notice 2005-45 provides interim guidance for calculating the deductible portion of expenses associated with aircraft operations, where the aircraft is used for both business and recreational purposes. The Notice requires that all expenses of operating the aircraft be aggregated, and that a percentage of the sum of all such expenses be allocated to costs associated with recreational use. After that portion of the sum of all expenses allocated to costs associated with recreational use is determined, the taxpayer may subtract from such amount all or a portion of any amounts that are either imputed as fringe benefit income to Specified Individuals for the value of the recreational flights, or reimbursed by Specified Individuals to the taxpayer.

Aggregating Expenses

In aggregating the sum of all expenses of operating the aircraft, taxpayers must include all depreciation, as well as all expenses of operating and maintaining the aircraft over a period of time (e.g., a taxable year), including, without limitation, all fixed, variable, direct and incidental operating costs (e.g. fuel, landing fees, overnight hangar fees, catering, meal and lodging expenses of the flight crew, management fees, hangar rent, salaries of pilots, maintenance personnel and other personnel assigned to the aircraft, maintenance costs, etc). Further, if the aircraft is leased or chartered, lease payments and all amounts billed to charter the aircraft must be included. The Notice does not address how to allocate costs to third party charter usage of the company aircraft.

Allocating Expenses to Business and Recreational Uses

The method of allocating expenses to business and recreational uses established by Notice 2005-45 requires that the taxpayer maintain records of either the total number of flight hours flown by each individual passenger on each flight of the aircraft or the total number of miles flown by each individual passenger on each flight of the aircraft, and to categorize the hours or miles flown by each individual on any given flight either as business hours/miles, or recreational hours/miles. For example, assuming a taxpayer elects the “miles” method of record keeping, if 3 passengers travel on a 1,000 mile flight, and 2 of the passengers are traveling for business and 1 of the passengers is a Specified Individual traveling for recreational purposes, the taxpayer would be considered to have operated the aircraft for 3,000 miles (i.e., 3 passengers multiplied by 1,000 miles), of which 2,000 miles would be considered business miles (i.e., 2 passengers traveling for business, multiplied by 1,000 miles), and 1,000 miles would be considered recreational miles (i.e., 1 passenger traveling for recreational purposes, multiplied by 1,000 miles).



The taxpayer in this example would be required to aggregate these miles with all other business and recreational miles flown over a period of time (e.g., a taxable year), and then calculate the total number of recreational miles flown over said period as a percentage of the total number of all miles (business and recreational) flown over such period. The resulting percentage would then be applied to the sum of all expenses of operating the aircraft over the same period of time to determine the gross amount of the expenses subject to disallowance under the Act (hereinafter referred to as the “Gross Recreational Use Expenses”).

After the Gross Recreational Use Expenses has been determined, the taxpayer may subtract from such amount any amounts that are either imputed as fringe benefit income to Specified Individuals for the value of the recreational flights, or reimbursed by Specified Individuals to the taxpayer, subject to the limitation that the amount that may be subtracted from the Gross Recreational Use Expenses for any given flight may not exceed the expenses allocable to those Specified Individuals traveling on such flight for recreational purposes.

The ability to subtract from the Gross Recreational Use Expenses amounts imputed as income to Specified Individuals is further limited in that amounts that would otherwise be subtracted from Gross Recreational Use Expenses under the preceding paragraph may not be subtracted if the employee is a “Covered Employee” (within the meaning of Section 162(m)(3) of the Internal Revenue Code), and receives compensation (excluding certain commission-based and performance-based compensation) in excess of \$1,000,000. A “Covered Employee” is the CEO of a publicly traded company, or any other employee of a publicly traded company whose income must be reported to the SEC by reasons of such employee being among the 4 highest compensated employees (other than the CEO) of the company.

Travel for Both Business and Recreational Purposes

Single destination

It is unclear from the text of the Act and the Notice how to determine whether a trip to a particular destination should be categorized as business or recreational when a Specified Individual spends time in both business and recreational activities at the same destination. Treasury regulations governing the imputation of fringe benefits for personal air travel 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. In light of the absence of guidance in the Act or the Notice, it should be reasonable to assume that a similar methodology may be used to determine whether flight hours or miles flown by a Specified Individual should be categorized as recreational or business in situations where the Specified Individual travels to a single destination for both business and recreational purposes.

Multiple destinations

In the context of travel to multiple destinations on a single trip, Notice 2005-45 provides that when a flight provided to a Specified Individual includes one or more destinations for business purposes, and one or more other destinations for recreational purposes, the flight hours or miles allocated to recreational use will be the excess of the total flight hours or miles flown during the trip over the number of flight hours or miles that would have been flown if the flights to the recreational destinations had not occurred.



Note that this rule differs somewhat from the rule governing imputation of fringe benefit income under the Standard Industry Fare Level (a.k.a. “SIFL”) rule. Under the SIFL rule, one must determine, based on all the facts and circumstances, whether the entire trip taken as a whole was primarily for business or personal purposes. If the trip is primarily business, a rule similar to that described above would apply. However, if the trip was primarily personal, the business destinations are ignored, and income is imputed based on a hypothetical trip that includes only the recreational destinations.

Special Rule for Deadhead Flights

According to Notice 2005-45, when an aircraft is flown empty to pick up one or more passengers or to drop off one or more passengers, the empty flight is treated as having the same number and character (i.e., business vs. recreational) of passengers as the flight for which passengers are on board. For example, if 5 passengers all of whom are traveling for recreational purposes are on board a 2 hour flight from A to B, and the passengers disembark at B and the aircraft is flown empty for 2 hours to return to A, the taxpayer will be considered to have used the aircraft for 20 recreational flight hours (i.e., 5 passengers, multiplied by 4 flight hours for the round-trip from A to B and back to A, even though the passengers were not actually on the return flight from B to A).

Note, that this special rule for deadhead flights appears to apply only for purposes of calculating the amount of the deduction to be disallowed under Section 274, and differs from the rules governing imputation of fringe benefit income. There does not appear to be a requirement under current regulations to impute income to individuals for the value of an empty flight leg that is required to ferry an aircraft to or from a location where passengers traveling for recreational purposes are picked up or dropped off.

Flight Valuation Consistency Rule

Treasury regulations governing imputation of fringe benefit income provide that an employer may value flights using either the SIFL method, or the fair charter value method, but requires that if any flight is valued using the SIFL method, all flights in that taxable year must be valued under the SIFL method. Notice 2005-45 modifies the consistency requirement and allows employers to value travel for Specified Individuals traveling for recreational purposes under the fair charter value method while continuing to value other travel, including recreational travel by non-Specified Individuals, under the SIFL method.

