

## CLIENT ALERT

### Aircraft Expenses: IRS Clarifies Position on Deductions by Sole-Proprietors

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The IRS recently issued a legal memorandum addressing how a sole proprietorship determines whether it may deduct aircraft related expenses it incurs. In the memorandum, the IRS took the position that a sole proprietor should apply Code Section 162's primary purpose test instead of using the expense allocation rules set forth in Treas. Reg. 1.274-10 to determine whether such expenses are deductible. However, in a likely to be disputed move, the IRS also said that taxpayers still need to use a reasonable method other than the primary purpose test for allocating expenses for flights containing passengers being flown for entertainment purposes.

#### Overview of relevant code sections: Section 162 and Section 274

Taxpayers are generally allowed to deduct all the ordinary, necessary and reasonable expenses paid or incurred in carrying on their trade or business. However, the Internal Revenue Code and Treasury Regulations contain special rules relating to the deduction of travel and entertainment expenses that are designed, in part, to prevent taxpayers from engaging in potentially abusive transactions that enable the deduction of otherwise personal expenses as business expenses.

One key issue for business aircraft owners and operators is the income tax treatment of expenses relating to flights on board aircraft operated for both business and personal reasons. Under Treas. Reg. § 1.162-2(b)(1), a taxpayer can deduct the expense of such trips only if the trip is related primarily to the taxpayer's trade or business (the "primary purpose test"). If the trip is primarily personal, the traveling expenses are not deductible. Of course, the taxpayer can still deduct the expenses at the destination that are properly allocable to the taxpayer's business (i.e., the taxpayer cannot deduct the cost of flying to a family wedding but he can deduct the business meal he had with a client the night before).

Another key issue is the income tax treatment of entertainment related expenses incurred by a taxpayer. The Code generally bars taxpayers from deducting expenses related to entertainment activities. This restriction also prohibits deduction of costs pertaining to the use of an entertainment facility, including aircraft.

However, there are some exceptions to the general rule prohibiting deduction of entertainment related expenses. For example, if a taxpayer provides an entertainment related fringe benefit to its employee or other recipient and includes the value of the fringe benefit in the recipient's gross income or receives from the recipient a reimbursement of such costs, the taxpayer incurring the entertainment expense may be able to deduct all or a portion of such expense.

Under Section 274(e)(2)(A), a taxpayer may deduct entertainment expenses if the taxpayer treats the expense as compensation to its employee (e.g., a taxpayer spends \$1,000 flying an employee to a sporting event but reports the \$1,000 as wages to the employee). Under Section 274(e)(9), a taxpayer can deduct entertainment expenses if the recipient is not an employee and the entertainment expense is treated as compensation for services rendered or as a prize or award (e.g., in exchange for painting his office, the taxpayer flies the painter on his plane but treats the value of the flight as compensation to the painter). Treas. Reg. § 1.274-10(e) provides the permitted methodologies for allocating expenses between the various individuals present on flights

and creates a disallowance methodology that accounts for mixed use flights provided by an employer to its employees and independent contractors.

Another critical issue for aircraft owners involves travel expenses of family members accompanying a sole proprietor on a trip. Under Section 274(m), a taxpayer generally cannot deduct the expenses of a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel. Such expenses are deductible only if (1) the spouse, dependent, or other individual is an employee of the taxpayer or (2) their travel is for a bona fide business purpose and such expense would otherwise be deductible by the spouse, dependent, or other individual.

### **IRS Memo: Sole Proprietors and Aircraft Related Expenses**

The IRS memo addresses how a sole proprietor determines the deductibility of expenses relating to the sole proprietor's ownership and operation of aircraft. The memorandum addresses sole proprietors who report their business activity on Schedule C to an IRS Form 1040 and who wholly own and operate a business in either (1) their own capacity or (2) through a single-member LLC which is disregarded as an entity separate from its owner for federal income tax purposes.

In the memo, the IRS states that entertainment compensation exceptions in Section 274(e)(2) and (9) do not apply to sole proprietors because a sole proprietor is not an employee of the sole proprietorship and does not receive compensation and wages from the sole proprietorship. Instead, the IRS said a sole proprietor should use Section 162's primary purpose test to determine whether its aircraft related expenses are deductible. Accordingly, if the sole proprietor's primary purpose for the trip is business, the aircraft expense is deductible under Section 162 even if there are passengers on the aircraft who are traveling for personal reasons.

However, the IRS also noted that Section 274's general disallowance on deducting entertainment expenses may still apply even if the primary purpose for the trip is related to the sole proprietor's business. The IRS explicitly states that taxpayers cannot use the primary purpose test to allocate expenses between entertainment and non-entertainment passengers and that the use of such a method is not reasonable. Instead, the IRS states that the sole proprietor must use a reasonable method other than the primary purpose test to allocate expenses relating to each flight between business and entertainment uses when entertainment passengers are on board the aircraft.

### **Conclusion**

The memo is helpful since it confirms that sole proprietors should use the primary purpose test described above when making the threshold determination as to whether aircraft related expenses, including depreciation, are deductible. However, the IRS's statement that the primary purpose test is not a reasonable method for determining the amount of any disallowed expenses without providing another methodology for making such a determination leaves open the question of what methodologies the IRS will accept as reasonable.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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