

CLIENT ALERT

IRS Issues Final Regulations Governing Entertainment Use of Aircraft

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On July 31, 2012, the IRS released final regulations disallowing deductions for certain entertainment use of aircraft. With a few exceptions and clarifications, the final regulations continue the rules set forth in the proposed regulations, which were released on June 14, 2007. Business aircraft operators need to be aware not only of the punitive tax consequences of these rules with respect to flights provided to officers, directors, and similar individuals, but also the onerous recordkeeping and calculations required by the regulations.

General rule

Section 274(a) disallows deductions with respect to an aircraft used for entertainment purposes, unless the expense is directly related to the active conduct of the taxpayer's trade or business.

An exception is provided under section 274(e)(2)(A). If an employee (other than a "specified individual") uses an aircraft for entertainment purposes, expenses related to that trip are not disallowed as long as the trip is properly reported as compensation to the employee. Under the fringe benefit rules, entertainment use is generally reported to employees based on "SIFL" or charter rates. A similar exception is provided for entertainment use by an independent contractor (other than a "specified individual"), as long as amounts are properly reported to the independent contractor.

Disallowance for specified individuals

The section 274(e)(2)(A) exception, however, is limited in the case of "specified individuals." Where a specified individual uses an aircraft for entertainment purposes, expenses with respect to that entertainment use are allowed only to the extent of the amount included in that individual's income under the fringe benefit rules (either SIFL or charter rates) plus the amount reimbursed to the company. Those amounts are usually much lower than the all-in costs of owning and operating the aircraft. The result is a significant expense disallowance where specified individuals use the aircraft for entertainment purposes.

Under the final regulations, a specified individual includes an officer or director of a corporation; a general partner, officer, or managing partner of a partnership; and any person that owns more than 10% of the equity of a corporation or partnership. It is not clear how equity ownership in a partnership would be calculated for this purpose, and whether a holder of "profits interests" could be considered to be a specified individual. A specified individual can also be considered the recipient of an entertainment flight in certain other circumstances, including where such flight is provided, for example, to the person's spouse.

Amount disallowed

The regulations disallow the amount of expenses "allocable" to the entertainment flight of the specified individual. For this purpose, all fixed and variable expenses must be included in the calculation. The final regulations specifically include in the list

maintenance, insurance, depreciation, and, in a change from the proposed regulations, interest on debt secured by or "properly allocable" to the aircraft. As noted above, these costs per flight will be significantly higher than the SIFL or charter rates imputed to the specified individual under the fringe benefit rules, and thus this disallowance can be significant. Moreover, compliance with these rules requires complicated and detailed recordkeeping.

The final regulations have two important "clarifications," one positive with respect to depreciation and one negative with respect to interest, from the proposed regulations. While the regulations are effective as of August 1, 2012, the preamble's description of these points as clarifications may indicate the IRS's position under the proposed regulations for periods before August 1, 2012.

Depreciation

First, like the proposed regulations, the final regulations allow a taxpayer to compute depreciation expenses on a straight-line basis for purposes of calculating the entertainment disallowance. The taxpayer can make this election even if it uses a different method of calculating depreciation for other purposes. Once the election is made, the taxpayer must use this computation method for all depreciable aircraft that it owns. Under the proposed regulations, it was not clear whether this election benefited the taxpayer. Since it requires an additional set of calculations, some taxpayers may not have elected to use the straight-line method for this purpose.

The final regulations "clarify" that the amount of depreciation disallowed under section 274(a) in a particular taxable year can never exceed the actual depreciation otherwise allowed. Thus, the straight-line method will almost always be very favorable for the taxpayer. In an extreme example, if a taxpayer were able to take 100% bonus depreciation in the first year of ownership, it would not be otherwise allowed any depreciation for that aircraft for any future year. If the aircraft was used for entertainment flights the first year, some amount of the first year depreciation would be disallowed but only a portion of the amount calculated using the straight-line convention. No depreciation would be disallowed under section 274(a) in future years, even if the taxpayer used the aircraft for entertainment flights in those years.

Interest

Second, the final regulations "clarify" that interest can be subject to disallowance if the underlying debt is secured by or properly allocable to an aircraft used for entertainment. The determination of whether interest is "properly allocable" to an aircraft requires analysis under regulations providing for allocation of interest expense for purposes of applying the passive loss rules and certain non-business interest limitations. Taxpayers that do not otherwise allocate interest under these regulations will be required to make additional calculations to comply with this rule.

Method of allocation

As in the proposed regulations, the final regulations require that expenses be allocated to an entertainment flight either on the basis of occupied seat hours or the flight-by-flight method. Both of these methods require allocation based on passengers. Comments to the proposed regulations requested that the IRS also allow taxpayers to allocate expenses on a per-flight basis, based on the primary purpose of the flight. Such a method would have decreased the administrative burden of these regulations. The IRS rejected that suggestion.

Like the proposed regulations, the final regulations provide special rules for deadhead flights, and the final regulations include examples to illustrate the operation of the rules. Specifically, the examples use a weighted average method for calculating the portion of a deadhead flight deemed to be for entertainment when another leg in the trip includes an entertainment flight.

Open questions

The final regulations leave open several important questions, including the exact scope of the entertainment facility disallowance, and when an aircraft is considered to be an entertainment facility. The preamble to the final regulations also creates additional confusion regarding the section 274(e)(8) exception, which provides that there is no section 274(a) disallowance for expenses for goods or services sold by the taxpayer in a bona fide transaction for an adequate and full consideration. The preamble incorrectly states that this exception is only available to taxpayers in the trade or business of providing entertainment to customers, a requirement neither in the statute nor set forth in the final regulations.

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