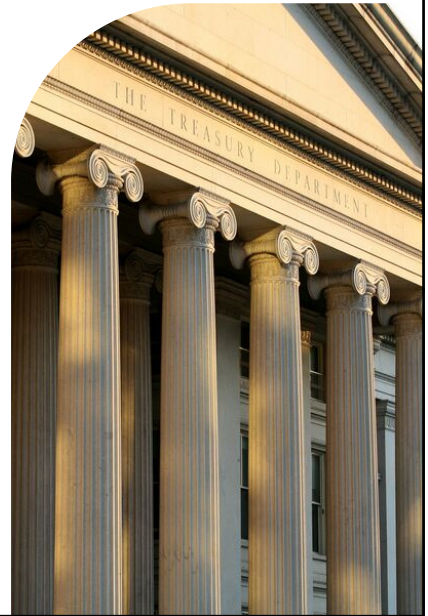


# Welcome

36<sup>th</sup> Annual Managing Tax Audits and Appeals Seminar  
October 6, 2022



# 36<sup>th</sup> Annual Managing Tax Audits and Appeals Seminar

## LB&I Update

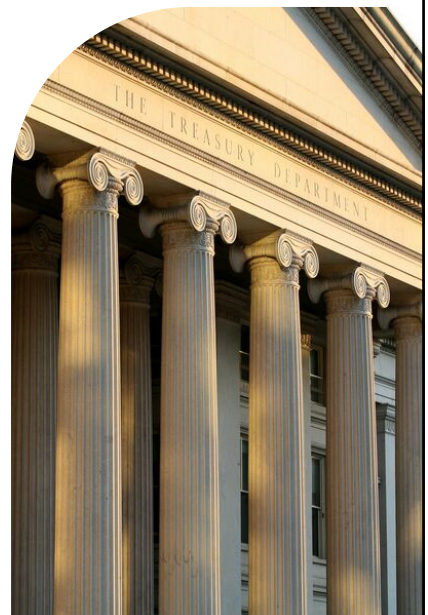
Nikole Flax, Commissioner, LB&I

David B. Blair, Crowell & Moring LLP

Carina Federico, Crowell & Moring LLP

Washington, D.C.

October 6, 2022



## Agenda

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- Inflation Reduction Act
- Taxpayer First Act
- Revenue Procedure 94-69
- Large Corporate Compliance (LCC)
- LB&I Campaigns
- Research Credit Audits
- Compliance Assurance Process (CAP)
- Large Partnership Compliance Program



## Inflation Reduction Act

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- Provides \$80 billion in funding to the IRS over 10 years
  - \$45 billion for enforcement activities
  - Over \$25 billion for operations support
  - \$3 billion for taxpayer services
  - \$4 billion for maintaining and modernizing the IRS's business systems
- Secretary Yellen's September 15, 2022 remarks
  - Additional 5,000 new call center employees
  - Plans to hire new IRS employees
- IRS's plans for implementation, guidance projects, updates to IT



## Taxpayer First Act

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- Three major components: Comprehensive Customer Service Strategy, Organizational Structure and Training Strategy.
- Efforts currently underway to develop redesign of the examination function.
- How will this affect LB&I?



## Revenue Procedure 94-69 Update

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- Rev. Proc. 94-69 was applied to taxpayers under the Coordinate Examination Program (eliminated in 2000), and then the Coordinated Industry Case Programs, which was replaced by the Large Corporate Compliance Program in 2019
- Taxpayers under the Large Corporate Compliance Program generally are not under continuous examination, but instead examined based on risk profile
- Temporary procedure in place
- Guidance on a new process is forthcoming



## Large Corporate Compliance (LCC)

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- Covers compliance oversight for LB&I's largest corporate taxpayers.
- IRS continues a shift toward increased focus on data analytics as LCC employs automatic application of the large case pointing criteria to determine the LCC population
- Factors are used to determine which large and complex corporate taxpayers to audit. For example, pointing criteria include such items as gross assets and gross receipts and other variables. In the past, this was done on a manual, localized basis. Automated pointing allows a more objective determination of the taxpayers that should be part of the population



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## LB&I Campaigns

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- Syndicated Conservation Easements & Micro-Captive Insurance Arrangements
- Virtual Currency
- Research Credit Campaigns
- Tax Cuts and Jobs Act-related Campaigns:
  - Section 965 campaign – Covers corporations, partnerships and individuals
  - Section 199 claims risk review campaign
  - Life Insurance Reserves Campaign



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## Research Credit updates

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- Requirements for administrative claim for refund or credit under Section 41, requiring specific information
  - Chief Counsel Memorandum and FAQs (Feb. 2022)
- Transition period until January 10, 2024 whereby IRS will notify a claimant of any perceived deficiency and taxpayer will have 45 days to provide the missing information
- After January 10, 2024, claims will be rejected based on missing information without the opportunity to cure.



## Compliance Assurance Program (CAP)

---

- As of September 15, 2022, the IRS is accepting applications for the 2023 CAP year
- For 2023 CAP year, the IRS is returning to the regular one open return eligibility criteria for returning applicants
- For new applicant currently under examination to be eligible for participation in the CAP Program, the applicant can have no more than three tax years open for examination on the first day of the applicant's CAP year, and the examination team determines (with concurrence from the applicant) that these open years will close from the examination group no later than 12 months after the first day of the applicant's CAP year if accepted
- Only new CAP applicants are required to provide the TCF Questionnaire with the application
- For returning CAP taxpayers, there will be a discussion at the opening conference regarding internal controls over the tax function



## Large Partnership Compliance Program

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- Several partnership campaigns are underway; the TCJA and 965 campaigns also include partnerships
  - New campaign in 2022 for Partnership Losses in Excess of Partner's Basis.
- Audits are underway



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Thank you

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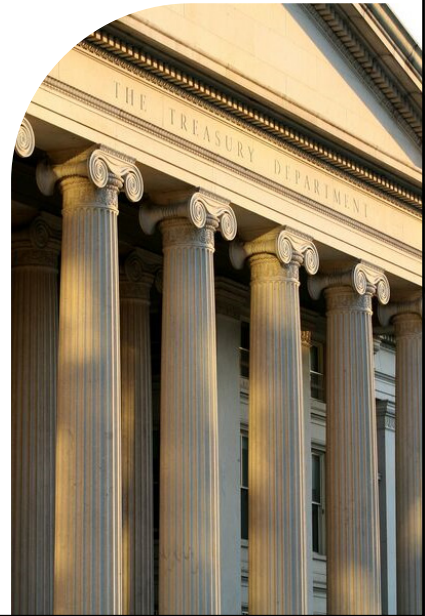
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## APMA and MAP Update

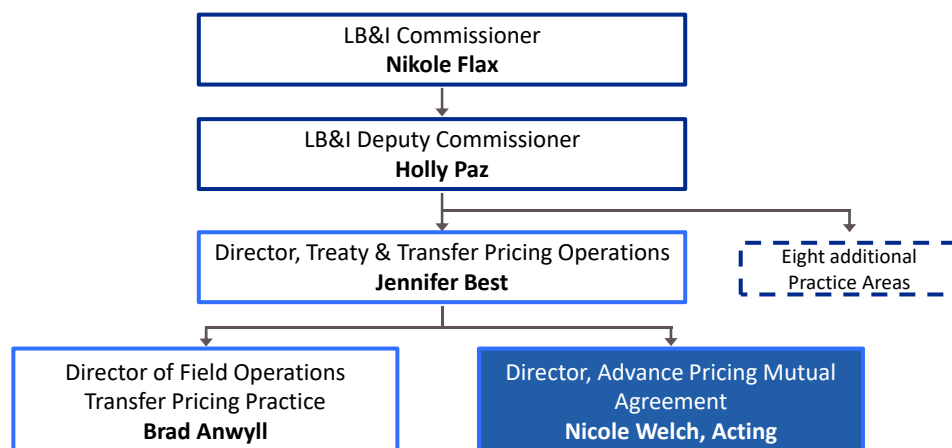
Nicole Welch, Acting Director  
Advance Pricing and Mutual Agreement Program

David Fischer  
Crowell & Moring LLP

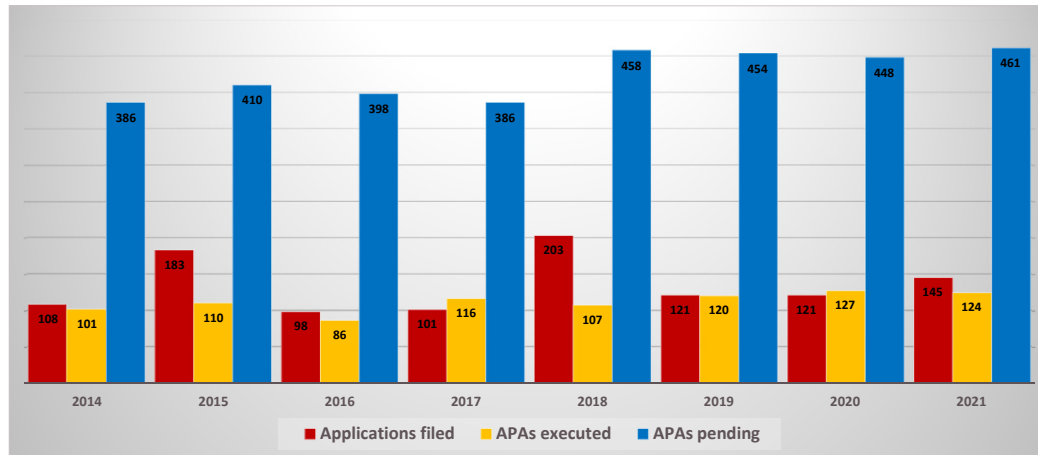
October 6, 2022



## IRS Transfer Pricing Organization



## APMA Annual Inventory

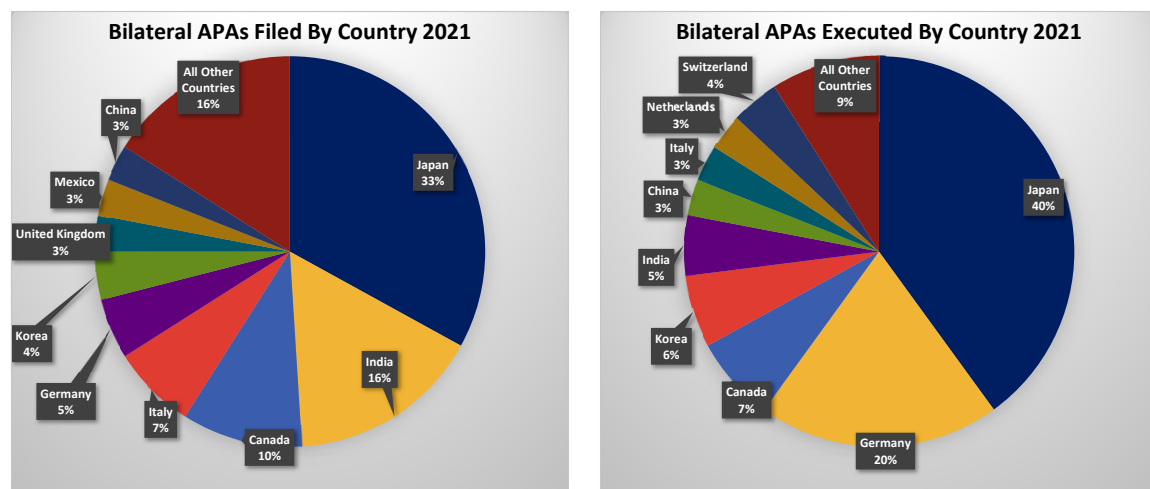


Source: APMA Annual Reports 2014-2021



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## APMA Statistics: Countries



APAs Filed: 145    APAs Executed: 124 (78 renewals)    APAs Pending: 461 (185 renewals)

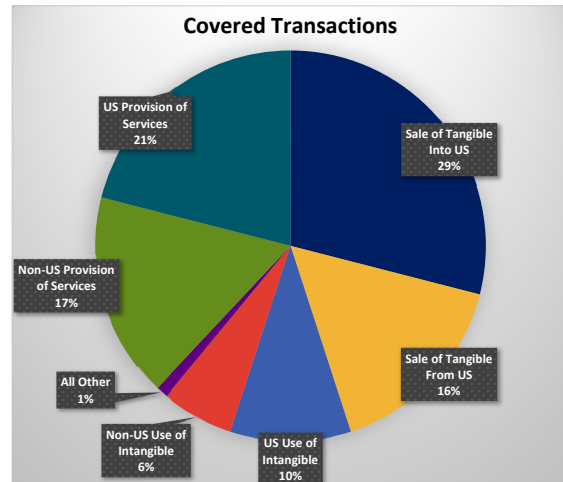
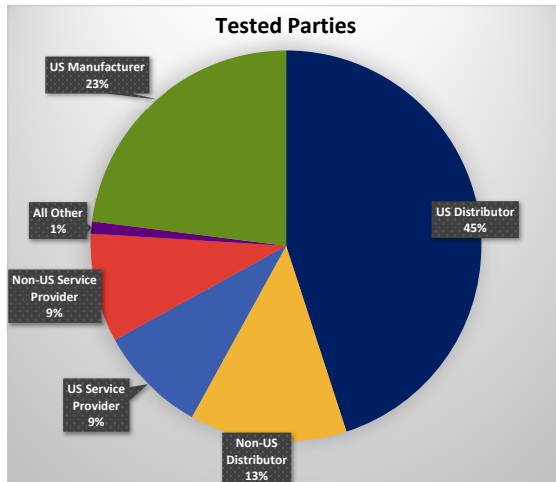


Source: APMA Annual Report 2021

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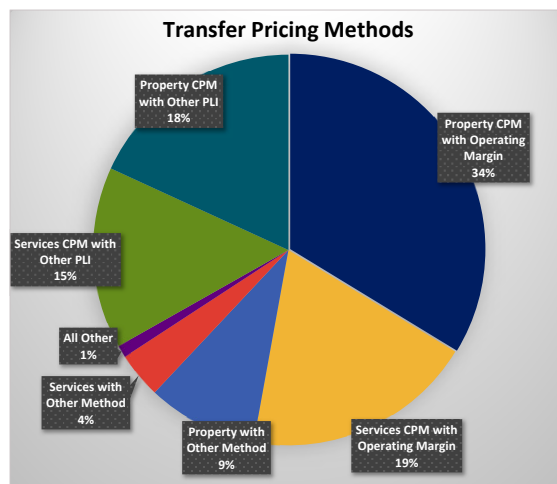
## APMA Statistics: Parties and Transactions



Source: APMA Annual Report 2021

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## APMA Statistics: Methods



CPM with Operating Margin PLI: 53%

CPM with Other PLI: 33%

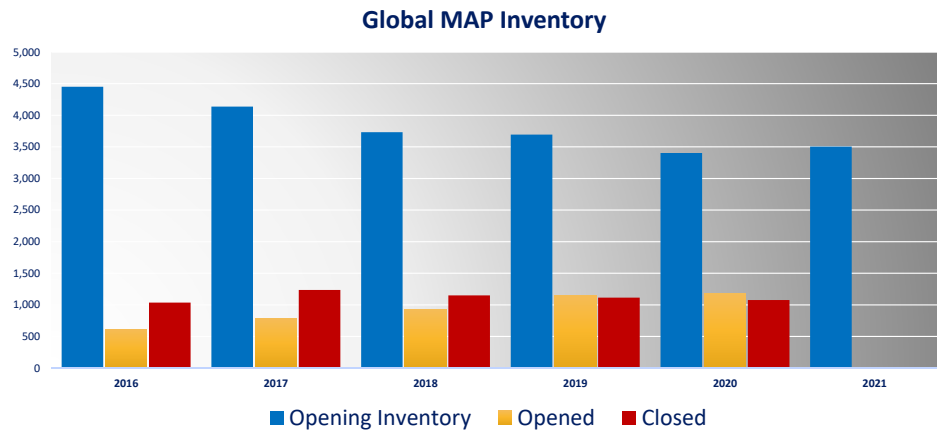
Other Methods: 14%



Source: APMA Annual Report 2021

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## Global MAP Statistics

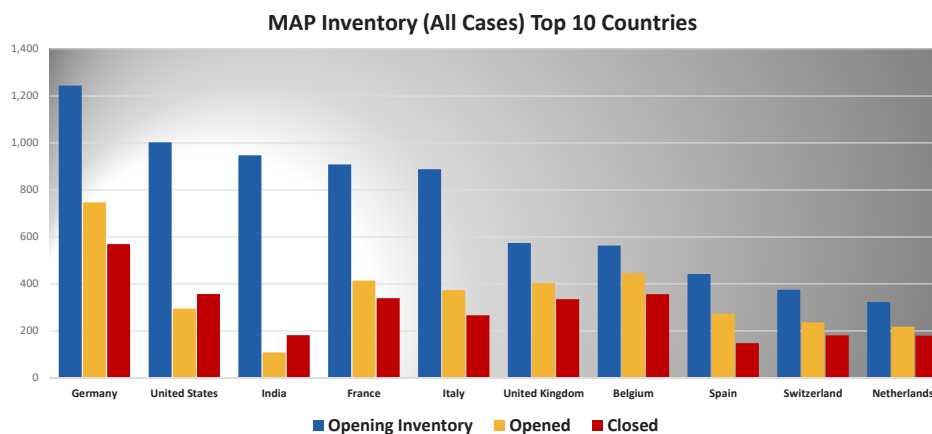


Source: [https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-\[2016-2020\].htm](https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-[2016-2020].htm)



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## Global MAP Statistics

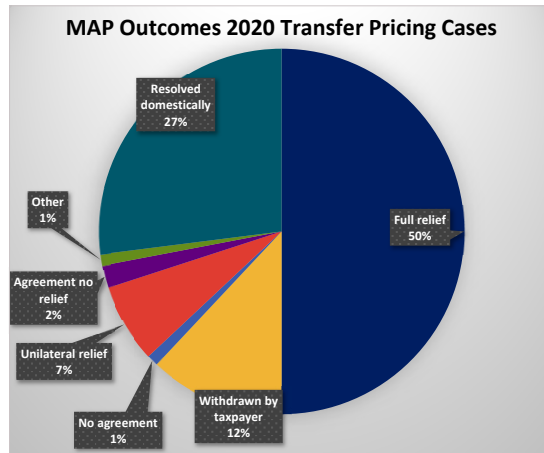


Source: [https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-\[2016-2020\].htm](https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-[2016-2020].htm)



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## US MAP Statistics



209 cases resolved

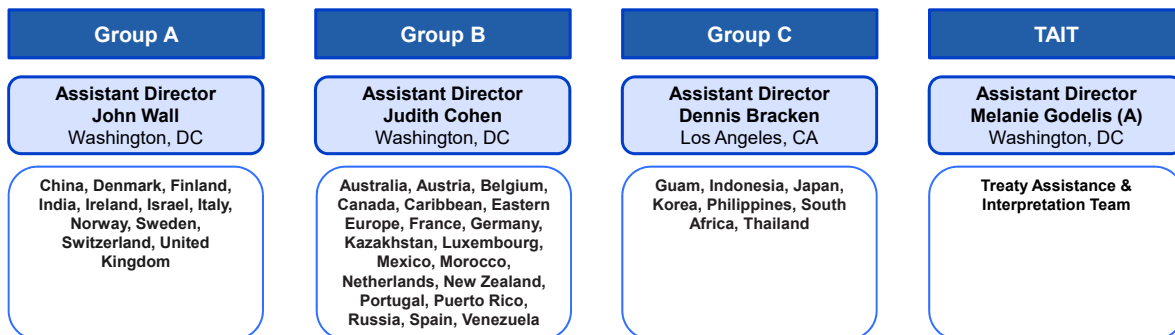
Source: <https://www.oecd.org/tax/dispute/2020-map-statistics-united-states.pdf>



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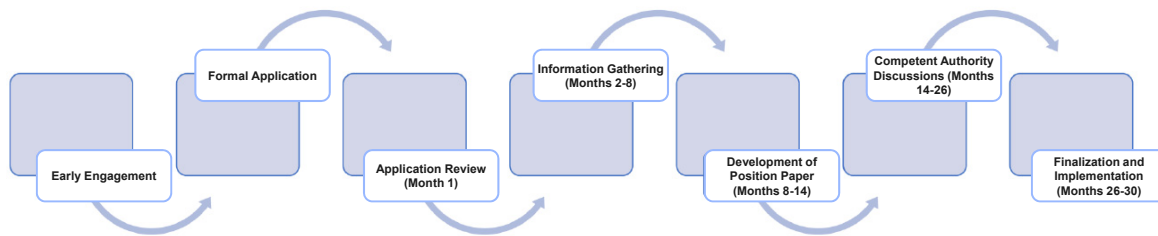
## APMA Organization

**Director, Advance Pricing Mutual Agreement**  
**Nicole Welch, Acting**



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## Sample Bilateral APA Process and Timeline

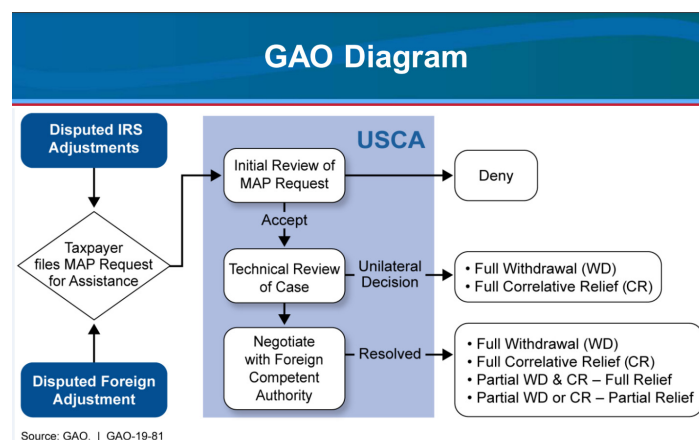


Source: Bilateral Advance Pricing Arrangement Manual @ OECD 2022



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## Overview of MAP Process



Source: GAO. | GAO-19-81



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## OECD Bilateral Advance Pricing Arrangement Manual

OECD FORUM ON TAX ADMINISTRATION

### **Bilateral Advance Pricing Arrangement Manual**



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## ICAP

FORUM ON TAX ADMINISTRATION

### **International Compliance Assurance Programme**

Handbook for tax administrations  
and MNE groups



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# Questions?

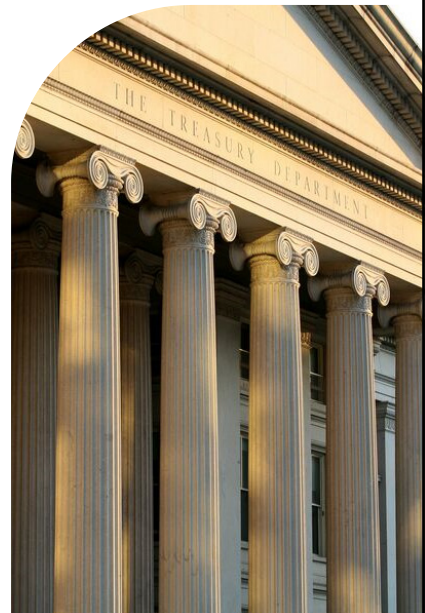
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## Recent Cases Answer Important Tax Accounting Questions

Dwight Mersereau  
Sami Skabelund  
October 6, 2022



## Agenda

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- “Clear Reflection of Income”
- Capitalization of Litigation Costs



## “Clear Reflection of Income”

*Continuing Life Communities Thousand Oaks LLC v. Commissioner, T.C. Memo. 2022-31*



## Statutory Provisions

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- Section 446(b)

“[I]f the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.”



## Statutory Provisions

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## Statutory Provisions

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## Statutory Provisions

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- Section 446(b)

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## Statutory Provisions

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- Section 446(b)

“[I]f, ~~in the opinion of the Secretary,~~ the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, **in the opinion of the Secretary,** does clearly reflect income.”



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## Regulatory Provisions

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- Treas. Reg. § 1.446-1(a)(2)

“[N]o method of accounting is acceptable unless, **in the opinion of the Commissioner,** it clearly reflects income. A method of accounting which reflects consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expenses are treated consistently from year to year.”



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## Regulatory Provisions

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- Treas. Reg. § 1.446-1(a)(2)

“[N]o method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects **consistent application of generally accepted accounting principles** in a particular trade or business **in accordance with accepted conditions or practices** in that trade or business will **ordinarily** be regarded as clearly reflecting income, provided all items of gross income and expenses are treated **consistently from year to year.**”



## Regulatory Provisions

---

- Treas. Reg. § 1.446-1(a)(2)

“[N]o method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects **consistent application of generally accepted accounting principles** in a particular trade or business **in accordance with accepted conditions or practices** in that trade or business will **ordinarily** be regarded as clearly reflecting income, provided all items of gross income and expenses are treated **consistently from year to year.**”



## IRS Litigating Position

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- The **Commissioner decides** whether a taxpayer's method of accounting clearly reflects income, and
- The Commissioner's determination can only be set aside if the taxpayer proves there was an **abuse of discretion**.



## Supreme Court Holding

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- *Thor Power Tool Co. v. Commissioner*
  - Taxpayer's method was contrary to a valid, binding regulation.
  - There is no presumption that following GAAP accounting results in clear reflection of income.
  - The Commissioner's determination that a method does not clearly reflect income is rebuttable only upon a showing that there was an abuse of discretion.



## Tax Court's Analysis

---

- **First**, did the taxpayer's use of GAAP take it out of the "ordinarily" will "clearly reflect income"?
  - Did the taxpayer consistently follow GAAP?
  - Did the taxpayer follow industry practice?
  - Did the taxpayer use its method consistently from year to year?
  - **Did the taxpayer match its income and expenses on an annual basis?**
  - Is the item material?
    - The Court considered whether the taxpayer did not follow its overall method for a material item, not whether the item, in isolation, was material.
    - For example, a cash method taxpayer uses an accrual method for a material/immaterial expense.



## Tax Court's Analysis

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- **Second**, was the method of accounting contrary to a statute or regulation?
  - In this case the Court found that the taxpayer had not earned the deferred fees, and
  - Earning the fees was a condition precedent, not a condition subsequent, to recognizing the income.
  - Therefore, the taxpayer complied with the "all events test."



## Tax Court's Analysis

---

- **Third**, did the taxpayer have the ability to pay the taxes?
  - The Court held that the taxpayer's deferral was not inconsistent with the purpose of tax accounting.
  - The Court also noted that the taxpayer's compliance with GAAP prevented the taxpayer from manipulating income recognition.



## Tax Court's Analysis

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- **Fourth**, is the taxpayer's method consistent with caselaw?
  - The Court distinguished cases in which advance payments were includible in income when received because, in this case the, fees paid upfront were held by a trustee.
  - Thus, the taxpayer did not have "dominion" over the fees (and did not receive them) until the trustee paid them to the taxpayer.
  - Therefore, the taxpayer's method of including nonrefundable fees as it provided services was consistent with caselaw.



## Tax Court's Analysis

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- **Finally**, did the Commissioner abuse his discretion?
  - The Commissioner's opinion was that the taxpayer's method did not clearly reflect income.
  - Under the plain meaning of the regulation, the taxpayer would lose.
  - However, the Commissioner exercises discretion in reaching his opinion.
  - The exercise of discretion is not unlimited.



## Tax Court's Analysis

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- Abuse of discretion (cont'd)
  - Courts have held that an "abuse of discretion" is a finding of fact, a conclusion of law, or a mixed question of law and fact.
  - The Court found that the Commissioner's power of discretion was weakened by its history.
  - The Court held that the Commissioner abuses his discretion where the taxpayer's method is: (1) consistent with the clear reflection standard in the regulations ("ordinarily"); (2) is not contrary to a statute or regulations; (3) consistent with the purpose of tax accounting (ability to pay); and (4) consistent with caselaw.



## Lesson of *Continuing Life*

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- Where a taxpayer's method of accounting satisfies the four part test articulated in *Continuing Life*, the Commissioner should find the taxpayer's method clearly reflects income.
- If the Commissioner does not, the taxpayer has a strong case that the Commissioner abused his discretion, and the taxpayer should consider challenging the Commissioner's determination.



## Capitalization of Litigation Costs

*Mylan, Inc. v. Commissioner*, 156 T.C. 137 (2021)

*Actavis Laboratories, FL, Inc. v. United States*, 130 AFTR 2d 2022-5601 (Ct. Fed. Cl.)





## Statutory Provisions

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- Section 162(a)

“There shall be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...”

- Section 263(a)

“No deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”



## Case Law

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- Courts have held that an expenditure generally must be capitalized where it is determined that the expenditure either:
  - Creates or enhances a separate and distinct asset, or
  - Otherwise generates **significant future benefits** for the taxpayer.



## Regulatory Provisions

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- Because of difficulties in administering the “**significant future benefits**” standard for intangible assets, the IRS issued regulations that define the exclusive scope of the significant future benefit test with specific categories of intangible assets for which capitalization is required.



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## Regulatory Provisions

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- Treas. Reg. § 1.263(a)-4(b)(1) requires capitalization of amounts paid:
  - To acquire an existing intangible;
  - To create or enhance various “separate and distinct” intangibles;
  - To create or enhance a “future benefit” identified in subsequent guidance published by the IRS; and
  - **To create certain types of intangibles identified in § 1.263(a)-4(d).**



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## Regulatory Provisions

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- Treas. Reg. § 1.263(a)-4(d)(5) and (9) enumerate certain “created intangibles,” including amounts paid to another to **defend or perfect title to intangible property** and **rights obtained from a governmental agency**.
- With respect to rights obtained from a governmental agency, Treas. Reg. §1.263(a)-4(d)(5)(I) specifies:
  - A taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.



## Regulatory Provisions

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- Treas. Reg. §1.263(a)-4(d)(9)(I)
  - A taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer’s title to the intangible property.
- However, the preamble to the proposed regulations—
  - This not intended to require capitalization of amounts paid to protect the property against infringement and to recover profits and damages as a result of infringement.
  - As under current law, these costs are generally deductible.



## Regulatory Provisions

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- Under Treas. Reg. §1.263(a)-4 taxpayers must not only capitalize the direct costs of creating intangibles, but they also must capitalize any amounts paid to **facilitate** an acquisition or creation of, among other things, an intangible described in paragraph (d).
- An amount is paid to **facilitate** the acquisition or creation of an intangible if the amount is paid in the process of investigating or otherwise pursuing the transaction.



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## Litigation Expenses

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- The deductibility of a legal expense generally depends upon the **origin and character of the claim** with respect to which the expense was incurred.
  - Legal expenses directly connected with or pertaining to the taxpayer's trade or business are deductible as ordinary and necessary business expenses.
  - While expenses arising out of the acquisition, improvement, or ownership of property are capital expenditures.



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## Litigation Expenses

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- Patent law distinguishes suits for the defense of title to intellectual property from patent infringement litigation.
  - The former involves the disposition or acquisition of a capital asset, and expenses in litigating such a suit are capital expenditures.
  - On the other hand, an award of damages in patent infringement litigation is ordinarily an award of compensation for gains or profits lost by the patent owner and hence is taxable as ordinary income in the year received.



## Review

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- Taxpayers must capitalize costs of creating certain intangible assets, including a right obtained from a governmental agency.
- Taxpayers must capitalize not only the direct costs of obtaining the right, but also any amounts paid in the process of investigating or otherwise pursuing the right.
- Taxpayers must capitalize legal costs of lawsuits for the defense of title to intellectual property, but both parties may deduct the cost of patent infringement litigation.



## Facts

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- TPs produced generic drugs and are required to obtain FDA approval to market them.
- As part of obtaining FDA approval, TPs were required to notify the branded drugs' patent holders that the patents were invalid or that TPs generic drugs would not infringe the patents.
- This usually resulted in patent infringement lawsuits against TPs, triggering a 30-month stay in which any FDA approval TPs received was not "effective."



## Facts

---

- The FDA may grant TPs tentative or final approval regardless of the patent infringement suits.
  - The FDA granted approval if TPs demonstrated certain scientific and technical requirements.
- Such FDA approval, however, was not "effective" until one of three events happened.
  - First, TPs won the infringement lawsuits during the 30-month stay, in which case the FDA approval was effective immediately.
  - Second, TPs lost the infringement lawsuit during the 30-month stay, in which case the FDA approval was effective when the patent expired.
  - Third, the lawsuits were pending after the 30-month stay, in which case approval was effective immediately and TPs could market the drug "at risk."



## Issue

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- TPs deducted the costs they incurred to defend against the patent infringement lawsuits.
- The IRS treated the costs as capital expenditures.



## Legal Fees for the Patent Litigation

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- All parties agreed the intangible is the FDA approval for the drug.
- The Courts found the costs of patent infringement litigation was not a step in obtaining effective FDA approval.
- The Courts held that, although filing an application for FDA approval triggers patent litigation as well as the FDA review process, this does not transform patent litigation into a step in the FDA approval process.
- The Courts, therefore, found that the patent litigation expenses did not facilitate TPs' obtaining FDA approval, and consequently, the litigation expenses were currently deductible.



## Legal Fees for the Patent Litigation

---

- The Tax Court provided the following reasons for its holding:
  - The FDA continues its review process during the patent infringement suit and may issue an approval before the lawsuit is resolved.
  - The FDA does not analyze patent issues in its review, and neither the statute nor regulations suggest that patent issues might block approval.
  - Winning the lawsuit does not ensure that the TPs will receive FDA approval because the FDA can disapprove applications for not meeting the scientific and technical requirements.



## Legal Fees for the Patent Litigation

---

- The Tax Court also explained its rationale as follows:
  - “Absent the filing of such a suit by a patent holder, the generic drug manufacturer is under no obligation to demonstrate that a patent is invalid or not infringed to obtain FDA approval. In other words, a patent on a brand name drug presents no impediment to FDA approval of a generic version unless the patent holder decides to take advantage of the mechanism Congress provided for an early adjudication of the patent holder’s rights. We cannot conclude that such litigation—controlled by and primarily benefiting patent holders—is a step in the FDA approval process for the generic drug.”





## Legal Fees for the Patent Litigation

---

- With regard to the “**origin of the claim**,” the Courts concluded that the litigation expenses that TPs incurred in defending the patent infringement lawsuits arose out of the ordinary and necessary activities of their generic drug businesses and accordingly were deductible.
- The Courts stated that, although TPs must assert in their applications to the FDA that the listed patents covering the brand name drugs were invalid or not infringed by the generic versions, TPs were not required to undertake affirmative litigation to establish that point as a condition of entering its generic on the market.



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## Lesson of *Mylan & Actavis*

---

- Determining whether litigation expenses must be capitalized is a two-step process.
  - First, a taxpayer must determine the origin of its claim, and whether the origin is a capital transaction.
  - Second the taxpayer must determine whether the regulations under §263(a) require capitalization.
  - *Mylan* and *Actavis* provide a good analytical roadmap for making those determinations.



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Questions?



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## Tax Policy and Election Forecast

Jim Flood

Scott Douglas

Crowell & Moring LLP

October 6, 2022



## Agenda

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- Introductions
- Inflation Reduction Act Tax Provisions – IRS Guidance process
- Tax Extenders in the Lane Duck
- The Mid-Term Congressional Elections
- Questions and Answers
- Conclusion



## Inflation Reduction Act (IRA) Tax Provisions – IRS Guidance



## Treasury/IRS Guidance

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- Guidance is necessary to implement Inflation Reduction Act, including:
  - Book income AMT
  - Green energy tax credits
  - Credit enhancements for Labor, Buy America, Energy Communities
- IRS to issue Notices requesting comments on areas for guidance
- Opportunity for taxpayers to:
  - Identify priority areas
  - Weigh in on substance of new regulations and other guidance



## Tax Extenders in the Lane Duck



## Tax Extenders Overview

- In recent years, tax extenders contained a number of green-energy provisions, but most of those were already addressed in the recently-passed IRA.
- A retroactive extension of 2021 expirations could be done, but expired COVID-era tax provisions will be met with skepticism.
- This year's package is expected to be smaller in scope compared to previous years.
- Congress will have roughly 5 weeks during the lame duck session to pass an extenders package before the end of the year.
- What is in or out is still to be determined, but expect Democrats to insist on an extension of the expanded CTC (\$85B) in trade for GOP priorities.



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## Tax and Non-Tax Extenders – Notable Items on the Table

Policy	First-Year Cost	Ten-Year Cost
Extend 100 percent bonus depreciation	\$15 billion*	\$250 billion
Reinstate R&E expensing	\$60 billion*	\$155 billion
Restore pre-2022 net interest deduction limit	\$20 billion	\$200 billion
Revive remaining 2021 tax extenders	\$2 billion	\$20 billion
Extend 3 percent physician payment bonuses	\$2 billion	\$25 billion
Extend increased Medicaid funding for territories	<\$1 billion	\$5 billion
<b>Subtotal, Policies</b>	<b>\$100 billion</b>	<b>\$650 billion</b>
Repeal/delay PAYGO sequester	\$120 billion	~\$1.2 trillion
<b>Total</b>	<b>\$220 billion</b>	<b>\$1,850 billion</b>

*Memo: Cost of one-year extension of all policies above\**

\$150 billion

Sources: Congressional Budget Office and Committee for a Responsible Federal Budget.

\*Expensing of equipment and R&E will have very little ten-year cost if enacted for only one year, since timing of tax payments would just be shifted. However, this low cost of largely a mirage, given the likelihood of further extensions.



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## 2022 Mid-Term Elections



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### The Current Political Dynamic in Washington, D.C.

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- President – Biden – Democrat
- Senate – Schumer – Democratic Majority (50 + VP)
- House – Pelosi – Democratic Majority (222-213)
  
- Senate – 35 Seats Up for Election – 21 R, 14 D (6 open seats)
- Senate – Democratic net loss of 1 seat = Republican Senate
  
- House – all 435 seats up for election
- House – Dem loss of 5 seats = Republican House



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## The Historical Mid-Term Election Year Trends

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- The Party in Power – Democrats – Loses seats
- The Party in the WH – Lose Congressional Seats - 1934 to 2018 – President's party avg loss of 28 House seats and 4 Senate seats
- The President's party – has gained seats in H and S only twice – under George W. Bush and FDR
- Two Correlations to Mid-Term Outcomes – Presidential approval rating and Number of Congressional seats controlled by President's Party (more seats, greater probability of loss)
- Presidents defending the same approximate number of House seats as President Biden – have gone from losing 8 House seats (Eisenhower) to winning 18 House seats (GW Bush)
- The Bottom Line – the trends favor Republicans



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## Recent Election Trends – U.S. House

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- 2018 House Election – President Trump – Dems won 235 seats (now 222) & had majority in 116<sup>th</sup> Congress - **235 - 200**
- 2020 House Election – President Trump – Dems won 222 seats (But Republicans picked up 13 seats) and Democratic majority in 117<sup>th</sup> Congress was reduced to **222 - 213**
- 2020 House Election – Some key swing Democrats won by smaller margins than was predicted in the polls
- The Bottom Line – Loss of 5 Democrats = Republican House



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## Recent Election Trends - U.S. Senate

- Democrats – defending 14 seats in the Senate
- Presidents defending approximately the same number of Senate seats as Biden – have ranged from losing 3 Senate seats (Reagan) to gaining 8 seats (FDR)
- 1934-2018 – the incumbent party has on average defended 17 seats in the Senate
- The Bottom Line – the trends favor Republicans in the Senate, but the number of open seats, the nature of some Republican candidates and some energizing issues for Democrats could neutralize that advantage



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## The Presidential Factor - Recent History of 1<sup>st</sup> Term Mid-Terms

Year	President's Approval		Mid-Term Election Results	
	10/2	Election Day	House	Senate
1994	43.0%	46.0%	-54	-9
2002	65.6%	64.4%	8	1
2010	45.4%	45.6%	-64	-6
2018	43.9%	43.6%	-42	2
2022	42.1%	?	?	?

\* - Real Clear Politics averages, except 1994 (Gallup)



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## President Biden's Approval Rating\*

- President Biden's approval rating of 42.1% as of 10/2/22 is a concern for Democrats hoping to maintain Congressional majorities.
- Biden's approval is underwater in all but one job performance categories:
  - Handling of the Economy: 37.7%/59.2% (-21.5%)
  - Inflation: 31.7%/65.0% (-33.3%)
  - Coronavirus: 48.7%/47.0% (+1.7%; latest data: 9/8)
  - Foreign Policy: 40.8%/53.6% (-12.8%)
  - Immigration: 34.3%/59.3% (-25.0%)
  - Crime: 36.3%/57.3% (-21.0%)
  - Direction of Country: 26.8% right track/65.9% wrong track (-39.1%)
- Generic Congressional Ballot: Dem – 45.1%/GOP – 46.1% (GOP +1.0%)

\* - Real Clear Politics averages



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## The 2022 Midterm Elections: The Top Line Preview

- The House majority is very likely to swing to the GOP
  - Current split: 222 D – 213 R (+5 to take majority)
- The Senate outcome is less certain
  - Currently, 11 states are being watched closely:
    - Most Vulnerable – GA, NV, WI, PA
    - Tier 2 (less likely to flip) – AZ, NH, NC, FL
    - Tier 3 (unlikely to flip) – CO, WA, OH
- 🗳️🗳️ All but 2 incumbents (NH & WA) in these 11 are under 50% 🗳️🗳️
- Current polling compared to 2020 Presidential result:

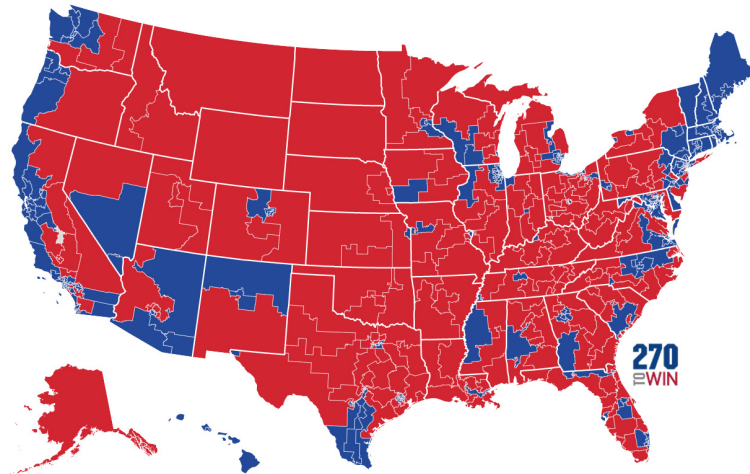
Most Vulnerable			Tier 2 (less likely)			Tier 3 (unlikely)		
	RCP	2020		RCP	2020		RCP	2020
Georgia	D +2.2	D +0.3	Arizona	D +3.9	D +0.4	Colorado	D +9	D +13.5
Nevada	R +2.2	D +2.4	New Hampshire	D +6.6	D +7.3	Washington	D +8.7	D +19.2
Wisconsin	R +3.0	D +0.6	North Carolina	R +1.5	R +1.3	Ohio	R +1.2	R +8.1
Pennsylvania	D +4.3	D +1.2	Florida	R +4.0	R +3.3			



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## Update on the 2020 Election

U.S. House – the Map – Democrats 222; 213 Republicans



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## Update on the 2022 Midterm Elections

Senate Race Ratings as of September 22, 2022

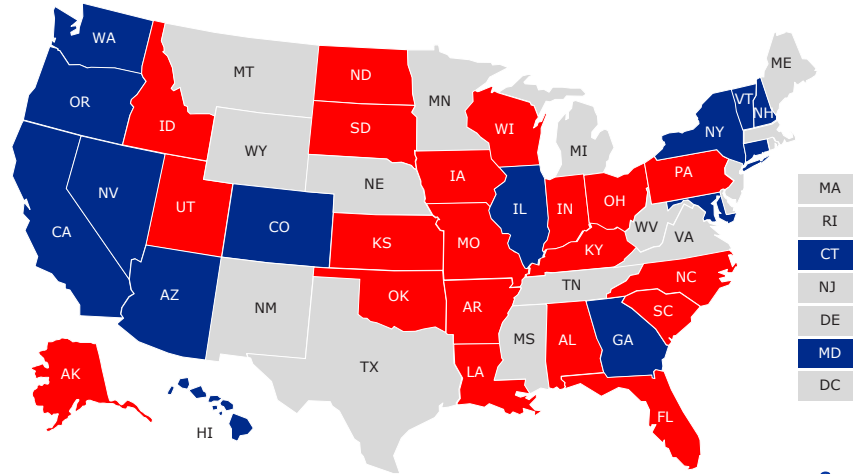
Solid D (9)	Likely D	Lean D	Toss Up	Lean R	Likely R	Solid R (15)
CA-Padilla CT-Blumenthal HI-Schatz IL-Duckworth MD-Van Hollen NY-Schumer OR-Wyden VT-Open WA-Murray		AZ-Kelly CO-Bennet NH-Hassan	GA-Warnock NV-Cortez Masto PA-Open WI-Johnson	FL-Rubio NC-Open OH-Open	UT-Lee	AK-Murkowski AL-Open AR-Boozman IA-Grassley ID-Crapo IN-Young KS-Moran KY-Paul LA-Kennedy MO-Open ND-Hoeven OK-Lankford OK-Open SC-Scott SD-Thune

Source: The Cook Political Report

## Update on the 2022 Midterm Elections

### Senate 2022 Elections Map

■ Democratic-held seat ■ Republican-held seat



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## Update on the 2022 Midterm Elections

### House Race Ratings as of October 5, 2022

Likely D (15)	Lean D (17)	Toss Up D (20)	Toss Up R (10)	Lean R (11)	Likely R (11)
AZ-04 Stanton CA-09 Harder CO-07 Open CT-02 Courtney GA-02 Bishop IL-06 Casten IL-11 Foster IL-14 Underwood MD-06 Trone NC-06 Manning NJ-03 Kim NJ-05 Gottheimer NM-03 Leger Fernandez NY-04 Open PA-12 Open	CA-47 Porter CA-49 Levin CT-05 Hayes IL-13 Open MI-03 Open MI-08 Kildee NC-01 Open NH-02 Kuster NV-04 Horsford NY-03 Open NY-17 Maloney NY-18 Ryan OH-09 Kaptur OR-04 Open OR-06 New Seat TX-28 Cuellar VA-07 Spanberger	AK-AL Peltola CA-13 Open IL-17 Open IN-01 Mrvan KS-03 Davids ME-02 Golden MI-07 Slotkin MN-02 Craig NH-01 Pappas NV-01 Titus NV-03 Lee NY-19 Open OH-13 Open OR-05 Open PA-07 Wild PA-08 Cartwright PA-17 Open RI-02 Open VA-02 Luria WA-08 Schrier	AZ-01 Schweikert CA-22 Valadao CA-27 Garcia CO-08 New Seat NC-13 Open NE-02 Bacon NM-02 Herrell NY-22 Open OH-01 Chabot TX-34 Merged Seat	AZ-02 O'Halleran AZ-06 Open CA-41 Calvert CA-45 Steel FL-27 Salazar IA-01 Miller-Meeks IA-03 Axne NJ-07 Malinowski NY-01 Open WA-03 Open WI-03 Open	CA-03 Open CA-40 Kim FL-13 Vacant FL-15 New Seat IA-02 Hinson MI-10 Open MN-01 Finstad MT-01 New Seat NY-02 Garbarino NY-11 Malliotakis TX-15 Open

Source: The Cook Political Report

## 2022 Midterm Election

### Predictions

- **Jim Flood**

- House: GOP picks up a net of 12-17 seats
- Senate: 51-49 Dem majority
- Bonus Question: Georgia Runoff?

- **Scott Douglas**

- House: GOP picks up a net of 20-25 seats
- Senate: Either 50-50 (swapping NV & PA) or 51-49 GOP majority (holding PA)
- Bonus Question: Georgia Runoff? Yes

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Questions?



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## Crowell Team

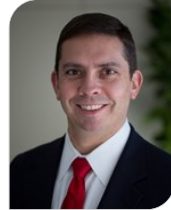
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# Thank You!



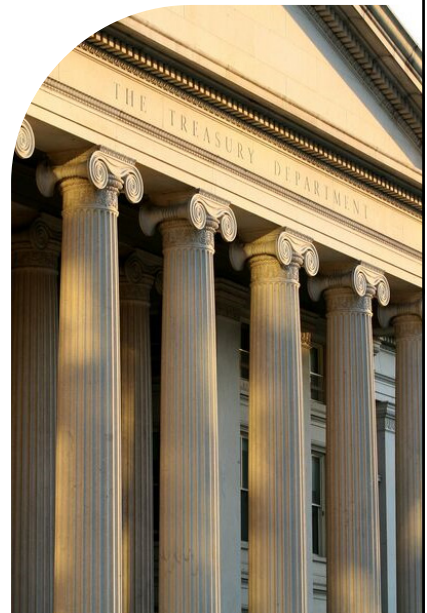
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## Cui Bono: Hot Topics in Employee Benefits for Tax Departments

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Anthony Provenzano  
Hillary Webb  
Kristy Wrigley-Durer

Washington, D.C.  
October 6, 2022



## Agenda

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- Deductions under Section 404(b)
- Managing IRS Exams of Tax-Qualified Plans
- Health Care Issues
- NQDC and FICA
- Taxation of Emerging Fringe Benefits
- Tax Issues for Retiring Executives
- Understanding Controlled Group in Private Equity Context



## Deducting Deferred Compensation and Reach of Section 404(b)

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- General deduction rules:
  - Section 461(a): Proper taxable year under method of accounting
  - Treas. Reg. 1.461-4(d): Look to Section 404 for timing of deduction.
  - Section 404(a)(5): For a nonqualified, unfunded plan, deductible in year in which employee includes amount as income (also in Treas. Reg. sec. 1.404(a)-12(b))



## Deducting NQDC and Reach of Section 404(b)

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- Deferred compensation defined in Treas. Reg. sec. 1.404(b)-1T:
  - Compensation paid “more than a brief period of time” after end of employee’s taxable year
  - Compensation paid after 2 ½ months following year in which the related services are rendered are presumed to be deferred
- Section 404(b)(2): Deferred comp determination made without regard to exclusions from income.
  - Could apply to nontaxable fringe benefits promised in future years
  - Examples could include prizes and trips



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## Managing IRS Exams of Qualified Plans

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- Routine exam: Exam of Form 5500
  - Review of plan amendments
  - Distribution reporting
    - Loans (likely biggest issue)
    - Form 1099-R reporting (matched with trust statements)
    - Review of distribution forms
  - Identification of possible prohibited transactions
  - Contributions and deductions
- Review of recent transactions:
  - Annuity purchases
  - Terminations
  - Mergers



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## Managing IRS Exams of Qualified Plans

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- Interviews with internal administrators:
  - Seek written questions before hand
  - Have counsel present
  - Limit scope of questions
- Understanding plan governance:
  - Administrative and investment committees
  - Identifying payment procedures
- Recent focus on missing participants:
  - Concern over payments being made
  - Required beginning date compliance



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## Health and Welfare Considerations

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- Post-termination Nondiscrimination Issues
  - Section 105(h) nondiscrimination rules apply to self-funded plans
  - ACA extended “similar” rules to nongrandfathered insured plans (PHSA section 2716)
  - IRS delayed enforcement (Notice 2011-1), but still some uncertainty
  - Consider taxation of premiums so section 104 applies instead
- Surplus VEBA Assets
  - IRS no longer ruling on reallocation of surplus assets (Rev. Proc. 2020-3)
  - But is ruling on expansion of VEBA membership (PLR 202236004)
- IRS Form 1095-C Audits
  - Activity continues
  - Best practices



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## Special FICA Timing Rule Applicable to NQDC

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- Under § 3121(a), wages are subjected to FICA taxation when constructively or actually received. This is known as the “general timing rule” and it coincides with the application of income tax withholding
- § 3121(v)(2) mandates that amounts deferred under a nonqualified deferred compensation plan must be subjected to FICA taxation as of the later of the date the services were performed or the date on which there is no substantial risk of forfeiture
- The application of § 3121(v)(2) is not elective!



## Special FICA Timing Rule Applicable to NQDC

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- If properly applied, the deferred comp and subsequent increases in its present value escape FICA taxation at distribution under the “nonduplication rule”
  - Application of § 3121(v)(2) often viewed as favorable, because FICA taxation occurs in a year when employee’s other wages exceed OASDI wage base
- Employer may retroactively correct open years and IRS may assess FICA taxes for those years. Otherwise, FICA taxation occurs at distribution under general timing rule.
- Regs do not permit employer to correct closed years’ failures.



## Special FICA Timing Rule Applicable to NQDC

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### When to collect:

- Rule of administrative convenience: Allows employer to select any date during the year after the “vesting date” to select value and collect and deposit taxes
  - Often used for practical purposes
  - Timing of collection must be linked to value at time
- Lag method: Allows employer to select date and deposit within 90 days following date amount otherwise required to be taken into account
  - Allows amount to shift into following year.
  - Deferral must be adjusted for interest



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### *Davidson v. Henkel* (January 6, 2015)

#### Private Cause of Action Under ERISA for Failing to FICA Tax Properly

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- Henkel maintained a SERP, which is a “nonaccount balance” plan under § 3121(v)(2) regulations
- FICA taxes are usually applied to the present value of the SERP benefits when the employee retires, i.e., when all events are known that allow the value of the lifetime retirement benefit to be reasonably ascertainable
- An outside advisor told Henkel that it had failed to subject the present value of the SERP benefits to FICA taxation at retirement. Henkel also was not FICA taxing the distributions



*Davidson v. Henkel* (January 6, 2015)

Three Ill-Advised Actions That Led Retirees to Seek a Remedy Under ERISA

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- Henkel settled with the IRS without the retirees' knowledge and began withholding FICA taxes at distribution under the general timing rule (with no gross up)
- In addition, Henkel withheld from distributions the employees' shares of FICA taxes that it had paid to the IRS under the settlement
- Henkel admitted to Davidson in writing, "yes, at the time you commenced receipt of this benefit, Henkel should have applied FICA tax to the present value of your nonqualified pension benefit"



*Davidson v. Henkel* (January 6, 2015)

Private Cause of Action Under ERISA for Failing to FICA Tax Properly

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- 2012: U.S. district court certified a class of 49 retirees; case was allowed to move forward on the premise that the Henkel SERP was governed by ERISA
- Earlier this year, the court held that an employer's promise under a "top hat" plan to provide a stated benefit carried with it an obligation to administer the plan in a manner that essentially guaranteed the "proper" tax treatment of benefits under FICA
- Henkel paid the benefits required by the plan formula, but, by its own admission, failed to withhold FICA taxes under the "special timing rule" of § 3121(v)(2)



### *Davidson v. Henkel*

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- The court held Henkel liable under ERISA, because its failure to apply FICA taxes at the time of each employee's retirement required the application of FICA taxation at payment, which diminished the retirees' net benefits
- Indemnification protection under § 3102(b) does not help when employer failed to apply § 3121(v)(2)
- Because the application of the special timing rule of § 3121(v)(2) is exceedingly complex, it is not uncommon for employers to make mistakes in the application of this rule



### *Davidson v. Henkel (cont'd)*

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- The decision in *Henkel* may open the door to employees who feel aggrieved by their employer's mistakes to sue under ERISA for recovery of their lost tax benefits
- Thus, the decision highlights a very real threat facing a sponsoring employer of a "top-hat" plan if it fails to administer the plan in a manner that results in the most beneficial tax treatment
- Takeaway for employers: Review the FICA tax procedures being applied to your nonqualified deferred comp arrangements



## FICA Tax Exam Activity and Issues

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- Exam activity with FICA taxes within executive compensation has not slowed
- Supplemental pension benefits remains an easy target for exam
  - Timing of FICA tax withholding and deposit
  - Calculation of benefits
  - Focus on when benefit becomes reasonably ascertainable
- Defined contribution arrangements (salary and bonus deferral)
  - Far more common than pension arrangements
  - Often complex vesting schedules
  - Review of earnings and permissible investments
- RSU and equity compensation
  - Retirement vesting
  - Valuation issues



## Tax Issues Raised by Retiring Executives

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- Worker classification: Employee v. independent contractor
  - Rev. Rul. 87-41: 20 factor test
  - IRS Training Manuals point to 3 factor test:
    - Financial control
    - Behavioral control
    - Relationship of the parties
- Tax implications:
  - FIT and FICA withholding
  - State/local tax withholdings
  - Improper reporting



## Tax Issues Raised by Retiring Executives

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- When does Executive “retire”?
  - Nonqualified plans: Upon “separation from service”
    - Not dependent on classification.
    - Based on all facts and circumstances.
    - Expected at time of separation that no further or no more than 20% of historic level of services will be performed.
    - If 50% or more services, presumption is that there is no separation.
    - Many open questions about calculation.
  - Qualified Plans (401(k) and pension)
    - Entitlement to payment: “When can I get payment?”
    - Commencement of minimum required distributions: “I don’t want payment.”
    - Must be substantive change in relationship
    - IRS may look to section 409A standards.



## Tax Issues Raised by Retiring Executives

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- Welfare Plan Issues:
  - Look to terms of Plans
  - Executive retiree health may be taxable to executive under Section 105(h).
    - Section 105(h) generally prohibits discrimination in pre-tax self-funded health coverage
    - Many employers consider post-tax health coverage.
- Taxing NQDC payments:
  - General rule: Most states consider amounts taxable where income was earned.
  - Federal blocker applies to:
    - Qualified plans
    - Certain excess benefit plans
    - Payments of NQDC if paid over life or over period of 10 years or more.



## Tax Treatment of Emerging Fringe Benefits

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- Fringe benefits are generally taxable unless they fall under one of the IRS exclusions.
- Accident and health benefits are one of the exclusions.
- Under Code section 105, amounts received as reimbursements under an accident or medical insurance plan are generally excluded from the income of employees.



## Fringe Benefits: Lactation Expenses

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- In 2010, the IRS excluded lactation expenses from medical care expenses.
- On November 23, 2010, members of Congress signed a letter to the Commissioner stating that expenses related to breastfeeding should qualify as a medical care expense.
  - The letter stated that the American Academy of Pediatrics encourages mothers to breastfeed their infants for at least the first year of a child's life.
- The IRS then published Announcement 2011-14 (Lactation Expenses as Medical Expenses)
  - The IRS reversed course and allowed lactation expenses as medical care expenses. Amounts reimbursed by employers are not considered income to the taxpayer.



## Fringe Benefits: Shipping and Handling

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- Shipping and handling fees for an eligible medical expense are generally excludable.
- This applies to the shipping and handling fees associated with drugs/medications.
- The 2010 Letter to the Commissioner indicated that breast milk is more than just food. The properties associated with breast milk may be similar to that of medication for infant children.



## Fringe Benefits: Milk Stork

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- Milk Stork allows traveling mothers to send back breast milk for their infant children while they are on business trips.
  - Although the specific expense referenced in the 2010 Letter to the Commissioner was related to breast pumps, the intent of the letter was to allow for expenses related to breastfeeding generally to be considered medical care expenses.
    - The members of Congress indicated that expenses related to breastfeeding (not just lactation pumps) should be considered medical care expenses because “breast milk goes beyond nutrition and contains antibodies, anti-infective agents, and immunoglobins that prevent disease.”
- Milk Stork, like lactation pumps, is an expense related to breastfeeding.
- Additionally, Milk Stork fees for shipping breast milk can be equated to the shipping and handling fees associated with other eligible expenses.





## Tax Treatment of Emerging Fringe Benefits – Trends/Examples

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- We have helped companies navigate the tax issues of a range of fringe benefits, including inquiries about the tax implications of offering:
  - Corporate-wide yoga classes or other wellness benefits
  - Gym memberships
  - Carbon offset passes
  - Citi Bikes
  - Organic food deliveries



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## Other Emerging Medical Benefits

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- Gene Testing – The market for DNA testing has exploded over the last five years.
- Is this a medical benefit?
- Private Letter Ruling 201933005 states that only the health information portion could be reimbursed from the Health FSA.... “[T]he taxpayer had to allocate the total cost of the test between the health services and the ancestry services ... [using] 'a reasonable method' to value the health information services.”



## Understanding Controlled Group in Private Equity Context

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- A plan subject to Code Section 401(k) must satisfy certain nondiscrimination tests outlined in sections 401(k) and 401(m).
- These tests compare the benefits received by highly compensated employees to the benefits received by all other employees, taking into account all employees of the “employer.”
- The term employer is defined to include all employees of organizations under common control with the plan sponsor under section 414(c), or within the same “controlled group” under section 414(b).
- Entities are considered part of the same 414(c) controlled group if they are in a “parent-subsidary group,” a “brother-sister group” or a “combined group.”



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## Understanding Controlled Group in Private Equity Context

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- A parent-subsidary group includes one or more chains of organizations conducting trades or businesses connected through ownership of a controlling interest (80%) with a common parent.
- A brother-sister group includes trades or businesses if the same 5 or fewer individuals have a controlling interest in each organization.
  - For brother-sister groups, the regulations also provide that the controlling interest determination reflects only the ownership of each such person to the extent such ownership is identical with respect to each such organization
- A combined group includes all entities combined through both parent-subsidary and brother-sister groups.



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## Understanding Controlled Group in Private Equity Context

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- There is limited legal guidance on whether an entity within a private equity structure would constitute a trade or business for purposes of Code section 414(c).
- A recent line of cases referred to as “*Sun Capital*” in the First Circuit addressed whether a fund constituted a trade or business for purposes of a different law concerning pension liability.
  - These cases generally support the position that private equity funds that are not actively involved in the management or operations of a company fall outside the definition of “trade or business.”
  - The cases are also consistent with several cases in the tax field that noted the difference between investing and running a trade or business.



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## Understanding Controlled Group in Private Equity Context

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- The position that a private equity fund is not a trade or business appears common within the private equity industry, based on:
  - The technical language of section 414(c), which requires a trade or business for a parent-subsidary group; and
  - Prior caselaw describing that mere investment activity does not constitute a trade or business.
- However, given the growing profile of the private equity industry, it is likely that either Congress or the IRS will seek to provide clarity with respect to controlled group determination



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## Questions?

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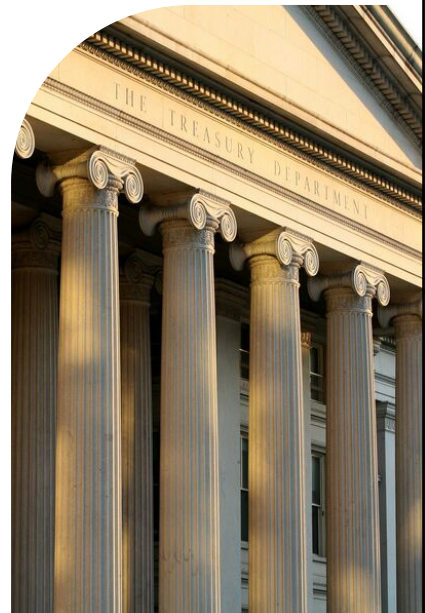
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## Penalty Defense

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Senior Judge Marvel, U.S. Tax Court  
Ashton "Hap" Trice, Deputy Associate Chief Counsel, IRS Procedure and  
Administration  
Carina Federico, Crowell & Moring LLP  
Sami Skabelund, Crowell & Moring LLP

October 6, 2022



## Types of Penalties

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### **Delinquency (§6651)**

- Non-fraudulent failure to file: 5% of net tax due per month, up to 25%
- Fraudulent failure to file: 15% of net tax due per month, up to 75%
- Failure to pay: 0.5% of net tax due per month, up to 25%

### **Accuracy-Related (§6662): 20% of underpayment attributable to the following:**

- Negligence or disregard of rules or regulations
- Substantial understatement of income tax
- Noneconomic substance transactions



## Types of Penalties

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- **Reportable Transaction Understatement (§6662A): 30% of understatement of tax resulting from undisclosed reportable transaction**
- **Civil fraud (§6663): 75% of any portion of an underpayment attributable to fraud**
- **Foreign-related penalties**
  - FinCEN Form 114: Report of foreign bank and financial accounts (*Bittner*, No. 21-1195 (U.S. 6/21/22) (petition for cert. granted))
  - Form 5471: Information Return of U.S. Persons with Respect to Certain Foreign Corporations
  - Form 5472: Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business



## Section 6676 Erroneous Refund

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- If a claim for refund or credit is made for an “excessive amount,” a 20% penalty applies to that claim
- No “stacking” of penalties- does not apply to any portion of the excessive amount that is subject to the accuracy-related or fraud penalties (§§6662, 6662A and 6663)
- Immediately assessable
- Not subject to deficiency procedures
- *Exxon* case
- Strict liability if excessive amount attributable to noneconomic substance transaction (§6676(c))



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## Strict Liability Penalties

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- **Strict Liability Penalties**
  - Failure to disclose reportable transactions (§6707A)
  - Noneconomic substance transaction penalty (§§6662(b)(6); 7701(o))
  - Gross valuation overstatement of charitable deduction property (§6664(c)(3))



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## Defenses to Penalties

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- **Administrative waiver:** IRS may provide administrative relief from penalties, for example, in the event of delay by the IRS in preparing forms or publishing guidance
  - First Time Abatement: IRS may provide administrative relief the first time a taxpayer is subject to penalties for failure to file, failure to pay, and failure to deposit
- **Procedural Challenges**
- **Reasonable Cause Defense**
- **Strict Liability**
- **Adequate Disclosure Exception**
- **Qualified Amended Returns**
- **Statute of Limitations**
- **Proper Calculation**
- **Constitutional Defenses**



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## Procedural Challenges

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### Did the IRS properly assert the penalty?

- **Section 6751(b)**
  - “No penalty under this title shall be **assessed** unless the **initial determination** of such **assessment** is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.”
  - *Graev and Chai Saga*
    - *Graev v. Commissioner*, 147 T.C. 460 (2016); *Graev v. Commissioner*, 149 T.C. 485 (2017); *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017)
  - **Breaking News: *Kroner v. Commissioner***, 2022 WL 4140340 (11th Cir. 9/13/2022)
  - CCA202204008



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## Reasonable Cause

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- **Reasonable Cause**

- The exercise of “reasonable cause and good faith” can be a complete defense to penalties (§6664)
- Factors considered include the extent of the taxpayer’s effort to assess the correct tax liability and taxpayer’s education, sophistication, and business experience (Reg. §1.6664-4)

- **Litigation pitfalls**

- Reliance
  - Privilege issues: Tax practitioner as planner and advisor

- **Merit cases where penalty determined**

- **Heightened standard under Section 6662A**



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## Ways to Make a Reasonable Cause Defense

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- Written requests
- Deficiency procedures/appeals
- Claim for refund
- Collection due process proceedings



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## Adequate Disclosure Exception

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- Except to the penalty attributable to disregard of rules or regulations
- Section 6662(b)(1) penalty not imposed if position was adequately disclosed
- Section 1.6662-4(f) sets forth the method of making adequate disclosure:
  - Disclosure made on properly completed form attached to return or qualified amended return
  - Disclosure made on Form 8275 if position is not contrary to a regulation
  - Disclosure made on Form 8275-R if position is contrary to a regulation
  - For recurring items, must be made for each taxable year



## Adequate Disclosure Exception (Continued)

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- Good faith challenge to validity of regulation requires that taxpayer conducted a careful analysis of reasonably available authorities (i.e. statute, legislative history, underlying Treasury Decision, relevant case law)
- Does not apply if position with respect to rule or regulation does not have a reasonable basis, if the taxpayer fails to keep adequate books and records, or if the taxpayer fails to substantiate records properly



## Rev. Proc. 94-69

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- LB&I considering obsoleting Rev. Proc. 94-96
- Currently, treated as filing “qualified amended returns” after commencement of IRS exam
- Requires taxpayers to submit, within 15 days of the IRS’s first written information request, a written statement describing all items that would result in adjustments if the taxpayer had filed a properly completed amended return
- If Rev. Proc. 94-69 becomes unavailable, taxpayers may wish to file qualified amended return



## Qualified Amended Returns

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- **Qualified Amended Returns**
  - Disclosures can be made on a qualified amended return
  - Amounts of tax reported on a qualified amended return will be treated as if they had been reported on the original return for purposes of computing the amount of the tax “underpayment” unless the original return reported a fraudulent position
- **To be “qualified,” the amended return must be filed before:**
  - The date the taxpayer is first contacted concerning an IRS exam
  - In the case of a promoted transaction, the date the shelter promoter is first contacted concerning an IRS exam
  - In the case of a pass-through item, the date the pass-through entity is first contacted concerning an IRS exam
  - The date a John Doe summons is served on a third party with respect to an activity of the taxpayer for which the taxpayer claimed a tax benefit
  - The date on which the IRS announced a settlement initiative for a listed transaction



## SOL, Calculations, Constitutional Defenses

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- **Statute of Limitations Defense**
- **Proper calculation of penalty amount**
- **Constitutional Defenses**
  - 8th Amendment
    - *United States v. Toth*, 33 F.4th 1 (1st Cir. 2022)
  - 5th Amendment



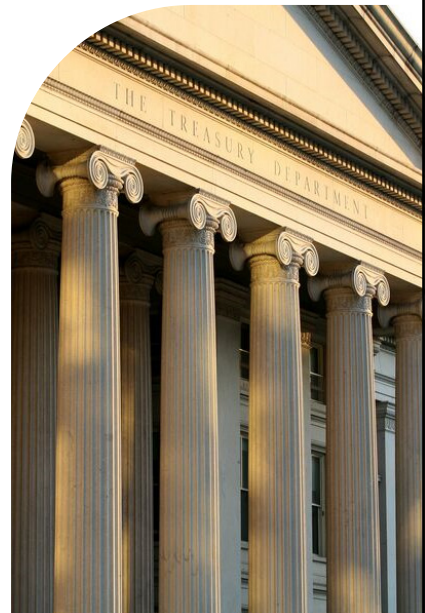
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## 36th Annual Managing Tax Audits and Appeals Seminar

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Income Tax Audits Involving Aircraft and Air Transportation Issues

Chris Younger and Eric Homsí | Washington, DC | October 6, 2022



# Income Tax Audits Involving Aircraft and Air Transportation Issues

## DISCLAIMER

This presentation is being provided for general information and should not be construed as legal advice or as a legal opinion regarding any specific facts or circumstances. You are urged to consult your attorney or other advisor concerning your specific situation and for any specific legal or financial questions you may have.



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## Income Tax Audits Involving Aircraft and Air Transportation Issues

### Outline

- During today's presentation, we will discuss key issues that are typically analyzed in federal income tax audits of business aircraft owners and operators.
- We will focus our discussion by reviewing Information Document Requests provided to taxpayers during IRS audits involving these issues. We will highlight the information being requested and the IRS's purpose for requesting that information. We will then explain best practices for compliance and recordkeeping relating to these issues.
- We will focus on the following key income tax issues that arise during audits of aircraft related deductions:
  - Limitations on depreciation of aircraft imposed by the "listed property" rules – focus on accelerated depreciation (including "bonus" depreciation) deductions.
  - Effects of personal and entertainment use of business aircraft:
    - Requirements for imputation of fringe benefit income to employees for personal flights; and
    - Disallowance of aircraft related expense deductions resulting from personal entertainment, business entertainment and commuting use of business aircraft.



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## Federal Income Tax Issues

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- Trade or Business – Ordinary, Necessary and Reasonable Requirement – IRC § 162
- Activity Not Engaged In for Profit – IRC § 183
- Depreciation/Bonus Depreciation – IRC § 167/168
- Qualified Business Use Requirements – IRC § 280F
- Business Entertainment – IRC § 274(a)
- Personal Use and Imputation of Fringe Benefit Income – IRC § 61
- Entertainment Use By Specified Individual – IRC § 274(e)
- Commuting Disallowance – IRC § 274(l)
- At-Risk Loss Limitation Rules – IRC § 465
- Passive Loss Rules – IRC § 469



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## Depreciation

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### Example of IDR Focusing on Issues Related to Aircraft Depreciation Deductions

In order to determine the proper tax treatment of expenses claimed for the company owned aircraft for the 2017 tax year period ending 06-30-2018, the following items are being requested.

1. Aircraft purchase documents
2. Aircraft insurance policy
3. [FBO] contract
4. [Legal consulting] contract
5. [Charter operator] contract
6. Flight log data
7. Per the Exhibit E Revised Flight Log Report: Please provide the flight schedule and a detailed narrative describing the nature of the visits, specifics, particular reason, what was conducted, and include documentation to support the business visits for the following selected flights:
  - a. [sample of flights]
8. For the selected flights (7A) above, provide the passenger manifest (although the taxpayer may not be required under Part 91 of the FAA rules to keep a passenger manifest, the taxpayer is required pursuant to IRC Section 162 and 274(d) to keep such information to substantiate business use) or provide documentation to support the passenger(s) on board for each flight leg of each trip. Include an explanation of the purpose for the passenger to be at the location. Please be specific.
9. [Charter operator] invoices for all the October 2017 flights
10. Aircraft registration



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## Depreciation

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- Depreciation is allowed on assets like aircraft which are used in a “trade or business” and subject to “exhaustion, wear and tear, and obsolescence” over time (IRC §167).
- Depreciation is taken on costs that must be capitalized, the most significant being the cost of purchasing a business aircraft and some major repair costs.
- Depreciation, like deductions for operating expenses, is affected by hobby loss, entertainment use, and passive loss limitations and by “listed property” rules.



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## Depreciation Method

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- IRC §168(b) allows for two depreciation methods:
  - Modified Accelerated Cost Recovery System, generally referred to as MACRS, and
  - Alternative Depreciation System, generally referred to as ADS or straight-line depreciation.
- Generally MACRS is preferable because recovery period is shorter and deductions are weighted more heavily in the earlier years.
- Under either method, the tax basis in the aircraft is reduced annually by the amount of the depreciation deduction, with the result that there is taxable gain equal to the difference between the tax basis and the sales price when the aircraft is eventually sold.



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## Depreciation Qualifying for MACRS

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- Two tests:
  - Aircraft must be predominantly used (more than 50%) for a “qualified business use”
    - Use in a trade or business of the taxpayer
    - See next slide regarding significant exclusions!
  - Aircraft must be predominantly used (more than 50%) in U.S.
- If predominant use tests are not satisfied in any year during the depreciation period, MACRS no longer applies and any prior deductions that exceed the amounts allowed under straight-line depreciation must be “recaptured” and included in income.



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## Depreciation: IRC § 280F Qualified Business Use

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- Three categories of uses qualify as “Qualified Business Use” only if all other Qualified Business Uses comprise at least 25% of total use
- Three Excluded Uses:
  - Leasing to any person who owns 5% or more of the taxpayer, or to any related person (within the meaning of Section 267(b) of the IRC);
    - Use is excluded regardless of whether flight is for business or pleasure
    - a/k/a the “leasing company trap”
  - Use as compensation to any person who owns 5% or more of the company, or to any related person;
  - Use as compensation to any other person, unless an amount is included in the gross income of such person with respect to such use of the aircraft, and any required income tax was withheld (e.g., SIFL).



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## Depreciation: Recovery Periods

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- MACRS Depreciation
- One of two MACRS schedules can apply to business aircraft:
  - 5-year MACRS: Fixed wing aircraft (except those used for commercial or contract carrying of passengers or freight) and all helicopters
  - 7-year MACRS: All aircraft used for commercial or contract carrying of passengers or freight except helicopters
- Straight line depreciation
- One of two straight line schedules can apply to business aircraft:
  - 6-year straight line: Fixed wing aircraft (except those used for commercial or contract carrying of passengers or freight) and all helicopters
  - 12-year straight line: All aircraft used for commercial or contract carrying of passengers or freight except helicopters



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## Depreciation: Recovery Periods

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- If the aircraft use falls partially in two categories, the schedule for the predominant use (more than 50%) applies.
- The categories of uses applied by the IRS for depreciation purposes do not exactly mirror the categories used by the FAA for regulatory purposes.
  - Example: A fixed wing aircraft used predominantly in Part 135 operations is 7-year MACRS property, but a helicopter used in Part 135 operations is 5-year MACRS property.



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## Depreciation: Conventions

- Conventions are used to determine the amount of depreciation that can be taken the first year, which also affects depreciation amounts in subsequent years.
- Half Year Convention: an aircraft purchased anytime before the end of the taxpayer's 3rd quarter will be treated as if it had been purchased in the middle of the year.
- Mid-Quarter Convention: an aircraft purchased anytime during the taxpayer's 4th quarter will be treated as if it had been purchased in the middle of the quarter, assuming that 40% or more of all MACRS property purchased by the taxpayer was acquired in the 4th quarter.



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## Depreciation Schedules

**5/7 Year MACRS  
Half-Year Convention**

Year	5-Year	7-Year
1	20.00%	14.29%
2	32.00	24.49
3	19.20	17.49
4	11.52	12.49
5	11.52	8.93
6	5.76	8.92
7		8.93
8		4.46

**5/7 MACRS Mid-Quarter  
Convention  
Placed in Service in Q4**

Year	5-Year	7-Year
1	5.00%	3.57%
2	38.00	27.55
3	22.80	19.68
4	13.68	14.06
5	10.94	10.04
6	9.58	8.73
7		8.73
8		7.64



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## Depreciation Schedules

**Straight Line Method  
Half Year Convention**

Year	6	12
1	8.33%	4.17%
2	16.67	8.33
3	16.67	8.33
4	16.67	8.33
5	16.67	8.33
6	16.67	8.33
7	8.33	8.34
8		8.33
9		8.34
10		8.33
11		8.34
12		8.33
13		4.17

**Straight Line Method  
Mid-Quarter Convention  
Placed in Service in Q4**

Year	6	12
1	2.08%	1.04%
2	16.67	8.33
3	16.67	8.33
4	16.67	8.33
5	16.66	8.33
6	16.67	8.34
7	14.58	8.33
8		8.34
9		8.33
10		8.34
11		8.33
12		8.34
13		7.29



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## Bonus Depreciation Tax Cuts and Jobs Act of 2017 (“TCJA” or “2017 Act”)

- Expanded the scope of “Qualified Property” that is eligible for bonus depreciation to include used property;
- Increased the portion of the basis of Qualified Property that may be immediately expensed to 100% for Qualified Property placed in service after September 27, 2017, and before January 1, 2023;
- Authorizes expensing of 80% of the basis of Qualified Property placed in service after December 31, 2022, and before January 1, 2024;
- Authorizes expensing of 60% of the basis of Qualified Property placed in service after December 31, 2023 and before January 1, 2025;
- Authorizes expensing of 40% of the basis of Qualified Property placed in service after December 31, 2024, and before January 1, 2026;
- Authorizes expensing of 20% of the basis of Qualified Property placed in service after December 31, 2025, and before January 1, 2027; and
- Extends all of the above placed in service deadlines by an additional year for Certain Aircraft and Property having Long Production Times – not discussed in today’s presentation).



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## Personal/Entertainment Use - Aviation Expense IDR

This IDR is being issued to request supporting documentation for Aviation expenses claimed on return.

Please provide the following:

1. Copies of any contracts or agreements for the management, leasing, fractional ownership and Charter of any aircraft. In addition please provide the following documents:
  - a. aircraft purchase agreements,
  - b. any lease documents,
  - c. charter agreements,
  - d. aircraft management contracts
2. The FAA charter under which each aircraft is operated.
3. FAA Flight Logs, Flight Manifests and any other flight diaries, logs, notes or records for each flight taken. Flight Log should include:
  - a. Flight Date
  - b. Origin City
  - c. Destination City
  - d. Flight Time (Hobbs Meter Reading)
  - e. Number of Passengers
  - f. Pilot in Command (PIC)
  - g. Co-Pilot (SIC)
4. Aircraft Maintenance Flight Log



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## Personal/Entertainment Use - Aviation Expense IDR (cont'd)

5. Passenger Manifest with relationship of passengers to Owner.
6. Tail Number of Aircraft; Aircraft Registration Number; Manufacturer's Serial Number; Make and Model of the Aircraft; and Number of Passenger seats on the Aircraft.
7. Federal Excise Tax returns filed, if any.
8. Describe the method used in identifying the business and non-business use of each aircraft and how you arrived at a business use percentage. Provide any work papers used to prepare the aircraft expense deductions for the tax return. Be prepared to explain how the deductions on the tax return reconcile to the books and records.
9. For each Flight:
  - a. Documents establishing the business purpose of each trip
  - b. For each person transported, business relationship to any member of the Consolidated Group
  - c. All other documentation required by IRC 274 for each trip
  - d. Minutes/Documents indicating the Business purpose of the Aircraft
10. Provide the Corporate policy for the use of aircraft.
11. If any amounts were paid by or to any member of the consolidated Group reimbursing the group for their personal use, provide the canceled check or wire transfer evidencing payment. Likewise, if any amount was charged or accrued on the books of company for personal use, provide documentation for these items. In addition, provide W-2s showing any income inclusion on the Employee's W-2 and the documents computing the inclusion.



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## Personal/Entertainment Use

Form <b>4564</b> (Rev. September 2009)	Department of the Treasury — Internal Revenue Service <b>Information Document Request</b>	Request Number <b>1</b>
To: (Name of Taxpayer and Company Division or Branch)		Subject
		SAIN Number
		Submitted To:
		Dates of Previous Requests

Please return Part 2 with listed documents to requester identified below

Description of documents requested

1. Did the company provide air transportation to or for employees other than regularly scheduled commercial carriers during calendar year 2012 or 2011?

2. If the company provided employees air transportation utilizing "Business Aircraft", then please:

a. Describe the circumstances and employees involved. For example, was the aircraft chartered, leased, or owned by the company or a related entity. If the aircraft was chartered or leased, please provide a copy of the contract/agreement.

b. Provide a listing of each flight on Business Aircraft showing the:

- i. Flight date
- ii. Origin of flight
- iii. Destination of flight
- iv. Mileage of each flight leg
- v. Number of seats available on aircraft
- vi. Name of each passenger, and
- vii. Whether the passenger was traveling for company business, personal, or personal entertainment purposes.

c. If the passenger was traveling for company business purposes, also provide:

- i. Business relationship of each passenger to taxpayer, and
- ii. Business purpose for each passenger's trip.



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## Personal/Entertainment Use

Form <b>4564</b> (Rev. September 2009)	Department of the Treasury — Internal Revenue Service <b>Information Document Request</b>	Request Number <b>1</b>
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d. If the passenger was traveling for personal purposes, provide:

i. Whether the passenger was a "specified individual", guest or relative of a "specified individual" under IRC 274(e)(2)(B);

ii. Whether the passenger was a "control employee", guest or relative of a "control employee" as defined in 1.61-21(g)(8)

iii. What amount, if any, the employee (officer, shareholder, partner) reimbursed in expenses or paid the taxpayer for the personal flight.

3. Please provide all computations made under IRC 274(e), Notice 2005-45 or proposed regulations related to the amount deductible under IRC 274(e)(2) or (9) for personal entertainment flight's aircraft expenses incurred for "specified individuals." Please make sure the information provided reflects the:

a. Type of Aircraft expense (fuel, interest, depreciation, flight crews, etc.) considered in the IRC 274(e) calculation, and

b. Flight by Flight computations.

4. Please provide detailed "Fair Market Value" or "Standard Industry Fare Level (SIFL)" computations where the taxpayer has calculated taxable compensation of wages for Personal Use of Business Aircraft for employees or independent contractors. Additionally, provide the related Form W-2 or Form 1099 along with a computation showing how much of the compensation on the Form is related to personal use of aircraft.

5. Copy of each aircraft purchase contract and invoice.

6. Copy of each aircraft's tax depreciation schedule from date first placed in service through 2012. Be sure this information includes any depreciation disallowed as a result of application of IRC 274(e)(2) or (9) limitations.

7. Each aircraft registration number, manufacturer's serial number, type and model of aircraft, and number of passenger seats on the aircraft.



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## Personal/Entertainment Use

Form <b>4564</b> (Rev. September 2006)	Department of the Treasury — Internal Revenue Service <b>Information Document Request</b>	Request Number <b>1</b>
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8. Copy of your company's policy/guidelines regarding use of the business aircraft. Please include information regarding who may use the aircraft; purposes for which the aircraft may be used; if there are multiple requests to use the aircraft at the same time, how is the determination made on which request is granted.

9. Please provide comprehensive list detailing amounts of all expenses associated with each aircraft in 2011 and 2012. These expenses include, but are not limited to-

- Catering fees
- Depreciation;
- Interest expense (clarified in 1.274-10);
- Lease payments;
- Charter payments;
- Management Fees;
- Other costs.
- Crew and maintenance salaries;
- Crew meal and lodging expenses;
- Takeoff and landing fees;
- Maintenance flights;
- Hanger fees;
- Fuel, tires, insurance, registration



## Personal/Entertainment Use

- IRC Section 61 provides rules governing the tax implications for employees (including family members and guests of employees) of utilizing an employer-provided aircraft for personal, non-business transportation.
- Business use is use in furtherance of the business of the employer.
- Non-business use is any other use, including predominantly:
  - Personal travel by an employee
  - Travel in furtherance of another business of an employee (e.g. another business that the employee or his/her family members own; brother-sister companies; affiliated entities)
  - Commuting



## Effect of Personal Use of Aircraft

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- Business Travel
  - No income imputed to the employee
  - Expenses generally deductible by the company if not business entertainment
- Personal Use
  - Income imputed to the employee
  - Depending on purpose of travel the deduction of the expenses for the flight(s) may disallowed in whole or in part
- Is it Business or is it Personal?
  - What is the passenger's "primary purpose" for traveling?
  - How is it determined?
  - Time spent on each activity is an "important factor"



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## Personal Use

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- What is Personal Use?
  - The primary purpose of the trip is not within the scope of the company's business
    - Although the passenger may have a business purpose for travel, if it is not for the company's business it is considered personal
    - Routine personal travel, commuting, entertainment
  - On any aircraft provided by the company
    - Owned (or leased) aircraft, chartered aircraft, fractional aircraft
  - "Employee" includes:
    - Anyone who provides service to the company – e.g., employees, partners, directors, independent contractors, certain former employees



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## Impact of Personal Use on Employee

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- Treas. Reg § 1.61-21(g)
  - The IRS views personal flights on the company aircraft as a taxable fringe benefit (exception for 50% seating capacity rule)
  - Employee pays payroll tax and income tax on the value of the flight
  - The value of the flight is calculated under one of two methods as specified in the Treasury Regulations:
    - Standard Industry Fare Level (SIFL)
    - Fair Market Value (charter rate)



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## Deduction Disallowance Provisions

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- IRC Section 274 limits deductions for expenses of facilities used for entertainment, amusement or recreational purposes & commuting (except as necessary to ensure the safety of the employee).
- A business aircraft is considered to be such a facility; the law applies to such use of an aircraft by "Specified Individuals."
- Requires that expenses and depreciation be allocated to business travel and entertainment/commuting travel on a pro rata basis and denies or limits deductions for expenses and depreciation allocated to entertainment/commuting.



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## Impact of Personal Use on Company

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- Commuting is a subset of personal travel
  - Covers flights between any of the employees' residences and his/her primary business location
    - Income is imputed to the employee but
    - The company cannot deduct any costs incurred relating to commuting (IRC §274(l))
- Travel to/from second homes
  - Is this commuting and totally disallowed?
    - Travel to/from secondary residences is sometimes treated as personal non-entertainment flights
      - IRS may challenge such treatment and attempt to reclassify as personal entertainment use or as commuting use
  - Taxpayers should document contemporaneously if no entertainment activities took place on a particular trip



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## Impact of Personal Use on Company

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- Personal entertainment travel is a subset of personal travel
  - Income is imputed to the employee, but
  - The company's ability to deduct the cost of such flights for "specified individuals" is limited
    - The costs and expenses included in the calculation of the disallowance are not limited to Direct Operating Costs
    - The calculation is based on formulae set forth in IRS regulations
- The disallowance relating to personal entertainment use applies only to entertainment travel for "specified individuals" which generally includes:
  - Principal financial officer, principal accounting officer or controller, vice presidents in charge of a principal business unit, division or function and any other officer who performs a similar policy-making function;
  - Directors; and
  - Owners of 10% or more of the company
- Need contemporaneous documentation for flights taken for personal non-entertainment purposes so they are not presumed to be entertainment



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## Business Entertainment

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- Business Entertainment travel is a subset of Business travel
  - No income is imputed to the employee, but
  - The company's ability to deduct the cost of such flights for any individual is limited.
  - Not clear whether the Business Entertainment disallowance is limited to all costs or exactly how calculated.
- **EXAMPLE:** CEO travels for a weekend of golf with business associates where proposed business venture is discussed while playing golf. The Business Entertainment disallowance will apply.
- Reasonable approach is to judge Business Entertainment passenger by passenger based on the primary purpose test and allocate costs similar to the Personal Entertainment disallowance.
- Advisable to have contemporaneous documentation for flights taken for business non-entertainment purposes so they are not presumed to be entertainment.



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## General Tax Considerations - Documentation

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- Document use (for **each passenger** on each flight)
  - Dates of departure/return, number of days spent on business
  - Destination (not just airport name)
  - Brief written explanation of business reason for travel or nature of business benefit expected
  - Document any entertainment activities or lack thereof
  - Maintained contemporaneously – at or near the time of the use
  - Log, trip sheet, etc. generally sufficient to establish each element
  - For guests – identify hosting employee
- Maintain records of:
  - expenses for the aircraft, and
  - the identity of:
    - every passenger,
    - his/her relationship to the company,
    - why he/she is on board, and
    - how much (if anything) he/she paid for the flight (note FAA restrictions on payments for non-commercial flights).
- Records should be created contemporaneously with the flight



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## Potential Limitations on Deductibility—IRC § 274

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- Business Entertainment & Recreational Use by a Specified Individual
  - Limits owner's/operator's rights to deduct expenses attributable to business entertainment and to entertainment, amusement and recreational flights for "Specified Individuals"
    - Includes flights to resort destinations or sporting events or to go hunting, fishing, golfing, skiing, etc.
    - Specified Individual = officer, director or owner of more than 10% of any equity class of the aircraft owner or a related party, plus their families and guests
  - Does not limit deductibility of expenses for entertainment, amusement and recreational flights for anyone who is not a Specified Individual
  - Does not limit deductibility of expenses for flights by Specified Individuals that are not for entertainment, amusement or recreation
    - Examples: travel to attend funeral or for medical reasons



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## Potential Limitations on Deductibility—IRC § 274(l)

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- Commuting Flights
  - TCJA disallows deduction of expenses of providing transportation to an employee in connection with travel between the employee's residence and place of employment
    - Place of Employment is the employee's regular or principal place of business
    - Employee's residence is any permanent or temporary residence, including second homes and vacation homes
    - Safety Exception: Disallowance does not apply if employer-provided transportation is necessary to ensure the safety of the employee
    - Compensation exception under IRC § 274(e) does not apply – no reduction in disallowance to the extent of imputed income



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## Methods for Calculating Disallowance

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- Calculate disallowance using all available methods, and use method that provides the best result
  - Passenger by passenger method by seat hours
  - Passenger by passenger method by seat miles
  - Flight by flight method by seat hours
  - Flight by flight method by seat miles



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## Methods for Calculating Disallowance

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- The taxpayer must maintain records of all aircraft expenses, and either the total number of flight hours or miles flown by each individual passenger on each flight of the aircraft, and then must categorize the hours or miles flown by each individual on each flight in one of three buckets.



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## Methods for Calculating Disallowance

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- At the end of the tax year, all occupied seat miles (or hours) in all three buckets are totaled.
- The sum of all expenses subject to disallowance is divided by the total sum of occupied seat miles (or hours) in all three buckets.
- The average cost per occupied seat mile (or hour) for the taxable year is determined.
- The average cost per occupied seat mile (or hour) is multiplied by the total number of occupied seat miles (or hours) for a given entertainment/commuting flight to determine the expenses associated with such flight.
- The total amount imputed as income to, or reimbursed by, the Specified Individual for each individual entertainment flight (not to exceed the entertainment expenses associated with the flight) is subtracted from the entertainment expenses associated with the flight to determine the amount disallowed.
- At audit, IRS may assume ALL aircraft use is personal AND entertainment, unless taxpayer proves otherwise.



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# Questions?



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## Speakers

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