

## **IRS Issues Final Regulations Regarding Deductions for Entertainment Use of Business Aircraft**

The Internal Revenue Service (“IRS”) recently issued final regulations (the “Final Regulations”) regarding deduction limits for the entertainment use of corporate aircraft by “specified individuals” (*e.g.*, officers, directors and more-than-10% owners).<sup>1</sup> Specifically, the Final Regulations identify the airplane-related expenses subject to disallowance under section 274(a) of the Internal Revenue Code of 1986, as amended (the “Code”). The Final Regulations adopt, with only minimal modifications, controversial proposed regulations to Code section 274 that were issued in 2007 (the “Proposed Regulations”).<sup>2</sup> The Final Regulations will be applicable for tax years beginning after August 1, 2012.<sup>3</sup>

Code section 274(a) generally disallows tax deductions for items constituting entertainment, amusement or recreation activities and facilities (including the use of business aircraft for entertainment purposes), unless the taxpayer establishes that the activity was directly related to or associated with the active conduct of its trade or business. Code section 274(e)(2), however, provides an exception to the disallowance of Code section 274(a) and allows companies to deduct entertainment expenses relating to employees, so long as the expenses are properly treated by the company as compensation to the employee on its corporate tax return and as wages to the employee for income tax withholding purposes. In the case of entertainment, including the use of business aircraft, provided to “specified individuals,” however, the deduction is allowed only up to the amount that a company treats as compensation to, or includes in the income of, a specified individual.<sup>4</sup> Under the applicable Code and regulatory provisions, the amount includable in income by employees for personal airplane use is typically much less than the company’s costs allocable to the flight.

The Final Regulations apply with respect to entertainment use of aircraft owned by, leased to or chartered to a taxpayer or any party related to the taxpayer. The Final Regulations make clear, however, that “entertainment” does not include personal travel that is not for entertainment purposes, such as travel to attend a family member’s funeral. And, notably, while the Final Regulations explain that the disallowance of Code section 274(a) does not apply to deductions for “business entertainment air travel” (*i.e.*, entertainment air travel aboard a taxpayer-provided aircraft that is directly related to the active conduct of the taxpayer’s trade or business or related to an expenditure directly preceding or following a substantial and bona fide business discussion and associated with the active conduct of a taxpayer’s trade or business), they also make clear that air travel does not constitute “business entertainment air travel” merely because a taxpayer-provided aircraft is used for the travel as a result of a bona fide security concern.

As alluded to above, in devising the Final Regulations, the IRS rejected many of the comments it received on the Proposed Regulations. The Final Regulations are therefore likely to draw criticism from stakeholders. For

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<sup>1</sup> Available at <http://www.gpo.gov/fdsys/pkg/FR-2012-08-01/pdf/2012-18693.pdf>. The Final Regulations define a “specified individual” consistently with Code section 274(e)(2)(B) as “an individual who is subject to section 16(a) of the Securities Act of 1934 in relation to the taxpayer, or an individual who would be subject to section 16(a) if the taxpayer were an issuer of equity securities referred to in that section.”

<sup>2</sup> Available at <http://www.gpo.gov/fdsys/pkg/FR-2007-06-15/pdf/E7-11445.pdf>. The 2007 proposed rules were generally based on principles first expressed in the IRS guidance set forth in Notice 2005-45, but with several significant modifications. IRS Notice 2005-45 became obsolete as of August 1, 2012. For reference purposes, however, IRS Notice 2005-45 is available at [http://www.irs.gov/irb/2005-24\\_IRB/ar11.html](http://www.irs.gov/irb/2005-24_IRB/ar11.html).

<sup>3</sup> August 1, 2012 is the date that the Final Regulations were published in the Federal Register.

<sup>4</sup> Under the Final Regulations, the amount disallowed is also reduced by any amount that a specified individual reimburses the company.

example, despite general endorsement by commentators to the contrary, the IRS refused to allow companies to determine the amount of expenses paid or incurred for entertainment flights by reference to charter rates.<sup>5</sup> Rather, companies must continue to determine actual expenses.

In addition, the IRS denied commentators' requests to limit disallowed expenses to direct or variable costs of a flight and exclude the fixed costs. Rather, the Final Regulations provide that expenses subject to disallowance include all fixed and variable expenses of operating the aircraft that the company deducts in the taxable year. These expenses include, but are not limited to, salaries for pilots, maintenance personnel and other personnel assigned to the aircraft; meal and lodging expenses of flight personnel; take-off and landing fees; costs for maintenance flights; costs of on-board refreshments, amenities and gifts; hangar fees; management fees; costs of fuel, tires, maintenance, insurance, registration, certificate of title, inspection and depreciation; interest on debt secured by or properly allocated to an aircraft; and all costs paid or incurred for aircraft leased or chartered to the company. The Final Regulations allow companies to compute depreciation deductions for this purpose under a straight-line method for all corporate aircraft and all taxable years (even if the company uses another method to compute depreciation for other federal income tax purposes).

The IRS also refused to allow companies to aggregate the expenses of all aircraft when calculating expenses subject to disallowance, instead only permitting companies the ability to aggregate expenses for aircraft of similar cost profiles. In determining whether aircraft are of a similar cost profile, the Final Regulations require that aircraft have the same engine type and number and suggest several other relevant factors.<sup>6</sup> As a consequence, companies will be required to conduct a detailed analysis of aircraft characteristics, which some may find administratively burdensome.

With respect to identifying disallowed expenses when allocating the costs associated with the use of business aircraft for entertainment, the IRS refused commentators' requests to adopt a primary purpose test.<sup>7</sup> Rather, the Final Regulations provide two other alternative methods that companies should use for allocating costs: 1) the occupied seat hours or miles allocation method, which divides the total expenses for the year by the number of occupied seat hours or occupied seat miles to determine a per seat or per mile rate, and which applies the rate to the number of hours or miles of entertainment use; or 2) the flight-by-flight method, which allocates expenses to a flight and then to the passengers on the flight according to the entertainment or non-entertainment character of the travel.

The Final Regulations also address how to properly allocate expenses in the case of "deadhead flights" (*i.e.*, flights without passengers, either en route to pick up passengers or returning after having discharged passengers). The IRS refused a request to allow companies to use "any reasonable method" to determine expenses related to such flights. Rather, the Final Regulations require that deadhead flights be treated as having the same number and character of passengers as the leg of the trip on which passengers are on board for purposes of allocating expenses related to the flights.

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<sup>5</sup> The Final Regulations do, however, authorize the IRS to adopt charter rates or other safe harbors in future published guidance.

<sup>6</sup> The other relevant factors include, but are not limited to, maximum take-off weight, payload, passenger capacity, fuel consumption rate, age, maintenance costs and depreciable basis.

<sup>7</sup> A primary purpose test would look at the primary purpose of a flight to determine whether any costs associated with specified individuals traveling for entertainment on that flight would be disallowed. If the primary purpose were business, no more than the additional or incidental costs associated with specified individuals traveling for entertainment aboard that flight would be disallowed.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); Glenn Waldrip at 212-701-3110 or [gwaldrip@cahill.com](mailto:gwaldrip@cahill.com); or Abigail Darwin at 212.701.3240 or [adarwin@cahill.com](mailto:adarwin@cahill.com).

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