

Aircraft Ownership Tax & Legal Considerations



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Guidance Issued

- Notice 2005-45 issued on 5/27/05
- Effective for expenses incurred after 6/30/05
- Provides interim guidance for deducting expenses for the entertainment use of corporate aircraft by specified individuals
- Principles of notice apply to the use of other entertainment facilities by specified individuals

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Proposed Regulations Issued

- Proposed Regulation §§ 1.274-9 and 1.274-10 issued 6/15/07
- Effective for expenses incurred after 6/30/05
- Apply to any taxable year beginning on or after the date of publication of a Treasury decision adopting the rules as final regulations

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Proposed Regs v. Notice 2005-45

- The proposed regulations may be relied upon for taxable years beginning before the publication of the Treasury decision
- If Notice 2005-45 and the proposed regulations include different rules for the same particular issue, then the taxpayer may rely on either the rule set forth in Notice 2005-45 or the rule set forth in the proposed regulations
- However, if the proposed regulations include a rule that was not included in Notice 2005-45, taxpayers may not rely on the absence of a rule in Notice 2005-45 to apply a rule contrary to the proposed regulations

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Statutory Disallowance Rule

- § 274(a) – General disallowance rule
 - No deduction for entertainment activities and facilities
- Exception to General Rule
 - § 274(e)(2) – Deduction allowed to the extent expenses are treated as compensation to the employee
 - § 274(e)(9) – Deduction allowed to the extent expenses are includible in gross income of nonemployee (S corp shareholders, partners, nonemployee directors)

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Case Law

- *Sutherland Lumber v. Comm’r*, 114 T.C. 197 (2000), *aff’d* 255 F3d 495 (8th Cir. 2001), acq. AOD 2002-02(Feb. 11, 2002)
 - Employer may deduct all expenses related to personal use of aircraft by executives without regard to amount included as compensation by the executives
 - Result: Employer deduction many times larger than the required income inclusion
- Tax Court reaffirmed Sutherland holding in:
 - *National Bankcorp of Alaska v. Comm’r*, 82 TCM 369 (2001)
 - *Midland Financial Co. v. Comm’r*, 82 TCM 371 (2001)

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§ 907 of AJCA

- § 907 of AJCA overturns *Sutherland*
 - Effective for expenses incurred after 10/22/04
- In the case of **specified individuals** only,
- Expenses for **entertainment** are disallowed to the extent the expenses exceed
- The **amount treated as compensation** to the specified individual

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What is Entertainment?

- Neither Notice 2005-45 nor the proposed regulations define entertainment other than to refer to the current regulations

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Entertainment § 1.274-2(b)

- Any activity of a type generally considered to be entertainment, amusement or recreation
- Entertaining at night clubs, theaters, golf and athletic clubs, sporting events
- Includes the cost of an activity that is claimed as a business expense, which satisfies the personal, living or family needs of an individual
- Bona fide security costs are not a per se business expense, so one must look to the underlying activity for which security costs are incurred to determine value of flight

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What is Entertainment?

- Excludes:
 - Commuting expenses
 - Trip for funeral
 - Trip to visit sick relatives
 - Trip for charity work
 - Trip for business other than that of the employer
 - Transportation between homes not associated with entertainment

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Personal v. Entertainment?

- Executive and wife attend a wedding of a customer's daughter using company aircraft for customer relations. How is this viewed?

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Personal v. Entertainment?

- If Executive's attendance at the wedding is in furtherance of the employer's trade or business then such flight is classified as business entertainment.
 - For business entertainment the taxpayer must establish that the expenses are directly related to or associated with the active conduct of the taxpayer's trade or business. The entertainment expense which is "directly related" or "associated with" the taxpayer's trade or business is deductible, subject to the 50% limitation of section 274(n).
- If the executive's attendance relates to his own personal affairs, then the flight is classified as personal entertainment.
 - For personal entertainment, the executive must include the value in income and the amount in excess of the executive's income inclusion is disallowed (assuming the executive is a specified individual).
- For the spouse, deductions for expenses related to the spouse's seat would be allowed to the extent included in the executive's income.

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Spousal Travel

- How is spouse travel categorized where a spouse is required to accompany an employee on a business trip?

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Spousal Travel

- Despite the benefits to corporate image and morale that often flow from traveling with spouses, both the courts and the IRS have been hostile to taxpayer arguments for deduction of spousal travel expenses.
- While some companies have been able to deduct the expense of spousal travel as a business expenses, these decisions have been rare and the findings are highly fact-specific. In the view of the IRS, there are almost no instances where a spouse is "required" to accompany an employee on a business trip. Under 274(m)(3), spousal travel is routinely disallowed on audit.
- However, the executive must include the value of the spouse's flight in income. Accordingly, the deductions would be allowed to the extent the executive includes the value of the spouse's flight in income.

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Primary Purpose Test

- Many commentators requested the Treasury to adopt a test for the primary purpose of a flight. Thus, if the primary purpose of the flight is business no amount would be disallowed for entertainment provided to any specified individuals who are traveling for entertainment
- The proposed regulations do **not** adopt a primary purpose test
- Each person's purpose on the flight must be determined

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Predominance Test

- If entertainment use is contemplated at the same time as legitimate business use, can the total cost be prorated between business use passengers and personal use passengers?

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Predominance Test

- Use the predominate use test to determine if the flight is business or entertainment related.
- Where the flight is primarily related to the employer's trade or business or primarily personal in nature depends on the **facts and circumstances in each case**.
- Pursuant to section 1.162-2(b)(2) of the Regulations, the amount of time during the period of the trip which is spent on personal activities compared to the amount of time spent on activities directly related to the employer's trade or business is an important factor in determining whether the trip is primarily personal or primarily business.

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Specified Individuals

- Officers and Directors
- More than 10% owners of any equity class
- Individuals of private and publicly-held companies, partnerships, tax-exempt entity
- Spouse and family members of specified individual
- Officer (Defined by §16(a) of the SEC Act of 1934)
 - president
 - principal financial officer
 - principal accounting officer/controller
 - any VP in charge of a principal business unit, division or function
 - any other officer who performs policy-making functions
 - any other person who performs similar policy-making functions

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Specified Individuals

- Notice applies to entertainment of a specified individual of a party related to the taxpayer within the meaning of §§ 267(b) or 707(b) (the proposed regulations do not modify the notice as to specified individuals)
- If Corp. Y provides entertainment use of its aircraft to A, who is a specified individual or related to Corp. X, Y's costs are subject to disallowance
- If Corp. X leased the plane from Corp. Y, the lease payments by X would be subject to disallowance and income to Y. Corp. Y aircraft expenses would not be affected by the disallowance rules

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Amount Treated as Compensation

- Valuation methods
 - Fair market value in arms length transaction [§ 1.61-21(b)], or
 - Cost incurred by employer is not determinative of fair market value
 - Non-commercial flight valuation (SIFL) [§ 1.61-21(g)]
 - Consistency Rule – If used to value 1 flight, it must be used for all flights during the year provided to employees
 - Notice notes that tax consistency rule will be amended to permit employers to use fair market value method to value flights for specified individuals traveling for entertainment and SIFL for all others [§ 1.61-21(g)(14)(i)].

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Amount Treated as Compensation

- Consistency Rule
 - The proposed regulations relax the consistency rule to permit taxpayers to value entertainment use by specified individuals under the fair market value rules of § 1.61-21(b) but continue to value flights for other employees and for specified individuals not traveling for entertainment using either the SIFL formula or the fair market value
 - The proposed regulations preserve the consistency rule of section 1.61-21(g)(14)(i) with respect to particular groups of employees (specified and non-specified individuals) and with respect to non-entertainment flights.
 - Thus, if an employer values the entertainment use of aircraft by one specified individual under the fair market value rules of section 1.61-21(b) in a calendar year, the employer must use the fair market value rules to value the entertainment use of aircraft by all specified individuals during that calendar year.

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Amount Treated as Compensation

- Treatment as Compensation to Non-Specified Individuals
 - Proposed regulations clarify that in order for a taxpayer to meet the requirements of §274(e)(2) for expense treated as compensation, the taxpayer must include the proper amount as compensation to an employee on an employee's tax return
- Section 162(m)
 - Proposed regulations did not modify Notice 2005-45. Income treated as compensation to the employee and an expense to the taxpayer for purposes of §274(e)(2) shall be subject to §162(m)

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Announcement 85-113

- Provides special employment tax and income tax withholding rules for non-cash taxable fringe benefits
- Value of benefits provided during last 2 months of the current calendar year may be deemed paid in the next year
- However, deduction disallowance will be for the current year

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Expenses Subject to Disallowance

- Salaries (pilots, maintenance, other personnel)
- Depreciation & 179 deductions
- Fuel Costs
- Meal & lodging expenses of flight personnel
- Take-off and landing fees
- Hangar fees (at home and away)
- Maintenance costs & management fees
- On-board refreshments, amenities
- Costs billed for chartered flight
- Costs of leased planes

Note: Expenses determined without regard to plane ownership

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Special Rules

- Under § 1.274-6, the disallowance rules do not apply to any deduction allowable to an individual taxpayer without regard to the connection to the taxpayer's trade or business (e.g., property taxes)
- The personal entertainment portion of the aircraft results in that portion of the aircraft being treated as a personal asset (§1.274-7)
 - The asset's basis will be adjusted for purposes of computing depreciation and gain or loss on sale or exchange

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Determining Disallowed Expenses

- For purposes of determining the expenses allocated to entertainment air travel of a specified individual, a taxpayer must use either
 - the occupied seat hours or miles (Notice 2005-45), or
 - the flight-by-flight method of paragraph (Prop. Reg §1.274-10)
- A taxpayer must use the chosen method for all flights of all aircraft for the taxable year.

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Occupied Seat Hour Method - Example

1. Total annual expenses of the aircraft
2. Total annual occupied seat hours (miles) for the aircraft
3. Cost of each occupied seat hour (mile) for the aircraft*
(1 ÷ 2)
4. Occupied seat hours (miles) used for personal entertainment purposes by each specified individual
5. Cost of personal entertainment usage for each specified individual for each flight
(3 x 4)
6. Amount included in income for each specified individual for each flight
7. Disallowed amount (5 – 6)
8. Amount allowed (1 - 7)

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* Costs can be calculated separately for each aircraft or aggregated for aircraft with similar cost profiles

Occupied Seat Hour Method - Example

Taxpayer's aircraft is used for flights 1, 2, and 3 that take 5, 5 and 4 hours, respectively.

Flight 1 has four passengers none of which are specified individuals.

Flight 2 has specified individuals A and B both traveling for entertainment purposes and non-specified individuals C and D. Taxpayer treats \$1,200 as compensation to A, and B reimburses taxpayer \$500

Flight 3 has specified individuals A and B both traveling for entertainment purposes. The taxpayer treats \$1,300 as compensation to A and B.

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Occupied Seat Hour Method - Example

- The aircraft is operated for 48 occupied seat hours:
 - Flight 1 - 4 passengers times 5 hours (20)
 - Flight 2 – 4 passengers times 5 hours (20)
 - Flight 3 – 2 passengers times 4 hours (8)
- The taxpayer incurs \$48,000 in expenses for operating the aircraft in the taxable year.
- Total cost per occupied seat hours is \$1,000 (\$48,000 / 48)

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Example – Occupied Seat Hours (miles)

Flight	Hours	Passengers			Total Occ'd Seat Hrs (bxf)	Occ Seat Hrs (Business) (bxc)	Occ Seat Hrs (Entertain) (bxd)
		Business	Entertain	Total (d+e)			
1	5	W,X,Y,Z		4	20	20	-
2	5	C,D	A,B	4	20	10	10
3	4		A,B	2	8	-	8
TOTAL					48	30	18

Entertainment Flight	Passenger on Flight	Total Personal Entertainment Cost Per Passenger	Amount Included in Income/ Reimbursed	Disallowed Deduction
2	A	5,000	1,200	3,800
	B	5,000	500	4,500
3	A	4,000	1,300	2,700
	B	4,000	1,300	2,700
TOTAL		18,000	4,300	13,700

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Flight-by-Flight Method

1. Total annual expenses of the aircraft
2. Total annual flight hours (miles) for the aircraft
3. Cost of each flight hour (mile) for the aircraft* (1 ÷ 2)
4. Expenses for each flight are allocated to each flight multiplying cost per hour (mile) by the number of hours or miles for that flight
5. The expenses for each flight are then allocated to the passengers per capita
6. Amount included in income for each specified individual for each flight
7. Disallowed amount (5 – 6)
8. Amount allowed (1 - 7)

* Costs can be calculated separately for each aircraft or aggregated for aircraft with similar cost profiles

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Flight-by-Flight Method - Example

Taxpayer's aircraft is used for flights 1, 2, and 3 that take 5, 5 and 4 hours, respectively.

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Flight 3 has specified individuals A and B both traveling for entertainment purposes. The taxpayer treats \$1,300 as compensation to A and B.

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Flight-by-Flight Method - Example

- The aircraft is operated for 14 hours.
- The taxpayer incurs \$48,000 in expenses for operating the aircraft in the taxable year.
- Total Costs per hour is \$3,429
- Total Cost per flight:
 - Flight 1 - \$3,429 x 5 = \$17,145
 - Flight 2 - \$3,429 x 5 = \$17,145
 - Flight 3 - \$3,429 x 4 = \$13,710

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Example – Flight-by-Flight Method

Flight	Cost per Flight	Passengers		Business	Entertain
		Business	Entertain		
1	\$17,145	W,X,Y,Z		17,145	-
2	\$17,145	C,D	A,B	8,573	8,573
3	\$13,710		A,B	-	13,710
TOTAL				25,718	22,283

Entertainment Flight	Passenger on Flight	Total Personal Entertainment Cost Per Passenger	Amount Included in Income/ Reimbursed	Disallowed Deduction
2	A	4,287	1,200	3,087
	B	4,287	500	3,787
3	A	6,855	1,300	5,555
	B	6,855	1,300	5,555
TOTAL		22,283	4,300	17,983

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Deadhead Flights

- An aircraft returning empty from a flight after discharging passengers or traveling empty to pick up passengers
- Treated as having the same number and character of occupied seat hours (or miles) as the leg(s) of the trip on which passengers are aboard.

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Example 2 – Deadhead Flight

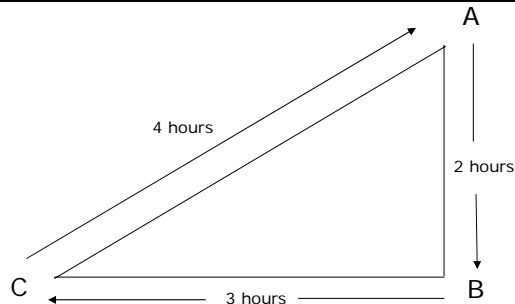
Flight	Hours	Passengers			Total Occ'd Seat Hrs	Occ Seat Hrs (Business)	Occ Seat Hrs (Entertain)
		Business	Entertain	Total			
1	5	2	-	2	10	10	-
2	5	1	1	2	10	5	5
3	3	-	2	2	6	-	6
4	3	-	2	2	6	-	6
TOTAL					32	15	17

With deadhead flights, costs increase, but cost per occupied seat hour decrease to \$1,875

Entertainment Flight	Passenger on Flight	Total Personal Entertainment Cost Per Passenger	Amount Included in Income	Disallowed Deduction
2	B	9,375	1,100	8,275
3	A	5,625	1,100	4,525
	B	5,625	1,100	4,525
4	A	5,625	-	5,625
	B	5,625	-	5,625
TOTAL		31,875	3,300	28,575

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Example 3 Business & Entertainment Trips



Flight Route	Nature	Total Hours	Deemed Business	Deemed SI Entertain
A - B	Business	2	4	
B - C	Entertain	3		
C - A	Return	4		
Total OSH		9	4	5

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FAA Rules

Overview of FAA Rules on Aircraft Operation

- **Part 135 operations vs. Part 91 operations**
 - Part 135 of the Federal Aviation Regulations (FARs) governs commercial aircraft operations
 - Includes commercial aircraft transportation and charter operations
 - Part 91 of the FARs governs non-commercial or “private” aircraft operations
- **Generally aircraft owner cannot charge (or be reimbursed by) people to fly aircraft without Part 135 Certificate issued by the FAA (“No Compensation Rule”)**
 - Very expensive and time-consuming to obtain Part 135 Certificate; would only do so if truly creating a charter company

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FAA Rules

Exceptions to No Compensation Rule

■ Exceptions to the No Compensation Rule include:

- Time-sharing arrangements - where user of aircraft can reimburse for certain expenses of flight (but never equates to 100% of costs)
- Intra-corporate family operations - parent and subsidiary corporations can charge each other for use of aircraft, but does not work for brother-sister corporations, individuals, LLCs, partnerships, etc.
- Joint ownership of aircraft - if two different people or entities own aircraft, then can divide expenses however desired (not limited to ownership percentage)

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FAA Rules

Restrictions on Operations of Aircraft

- Even when not trying to charge people for use of aircraft, there are still significant restrictions on what entities can operate aircraft
- “Flight Department Company rules” provide that an entity can only operate an aircraft under Part 91 if the operations of the aircraft are “incidental and related to” the business operations of the entity
 - Cannot have single-purpose entity operate an aircraft - that would be considered a “flight department company” and would require a Part 135 certificate, even if owned by an individual
 - Many people try to insulate the potential liability of an aircraft from their personal or business assets by putting aircraft in an entity, but must consider the flight department company rules

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FAA Rules

Structuring Around the Flight Department Company Rules

- One structuring technique commonly employed to avoid being a Flight Department Company is to have a single purpose entity own the aircraft and dry lease (meaning a lease without a pilot) the aircraft to an individual or operating entity
 - Liability not totally alleviated, because lessee is operating aircraft and could have liability related to operations
 - Must consider tax consequences to dry lease (sales tax, passive activity, etc.)
- Another structuring technique is to create a new business, such as a consulting business, within the new entity owning the aircraft
 - If the business of the new entity is to make the principal available to consult with his various business entities and to the business of the entity
 - Liability for the aircraft should be insulated within the new entity under this scenario

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FAA Rules

Penalties for Violation of the FARs

- The FAA does not go around auditing individuals and companies that operate aircraft very often, but if there is a crash of an airplane the FAA does audit to determine if the flight was in violation of the FARs
- The statutory penalties for violation of the FARs are significant, including fines of up to \$11,000 per flight and loss of pilots' licenses
- However, the far more important downside to violating the FARs would be potential loss of insurance coverage for such flights
 - Many aircraft insurance policies have specific language stating that coverage can be denied if flights are in violation of the FARs
 - Even for policies that do not have such language, most of the policies cover only operations under Part 91; most violations occur when people are actually operating under Part 135 (within a single purpose entity or charging for use of the plane), without a Part 135 certificate, so coverage could be denied
 - Denial of coverage does not occur very often, because not that many flights crash, but we have seen coverage denied for these types of violations

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FAA Rules

Charter Companies, Fractional Ownership and Jet Cards

- Many of these rules and restrictions can be avoided if privately owned aircraft are put with a charter company to manage and operate the aircraft (because the charter company has a Part 135 certificate)
- The Part 91 restrictions generally do not apply to fractional ownership of aircraft or to jet cards (purchase of specific hours in a certain class of aircraft) because most of these fractional owner and jet card companies have Part 135 certificates for the aircraft in their fleet

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