

June 20, 2007

MEMORANDUM TO CLIENTS

RE: Proposed IRS Regulations on Entertainment Use of Business Aircraft

The IRS recently issued proposed regulations under Code section 274(e)(2) (and 274(e)(9)) on deducting entertainment use of an employer's aircraft by specified individuals – officers, directors, more than 10% owners and their family members. 72 Fed. Reg. 33169 (June 15, 2007). We summarize the IRS proposal below and highlight a number of issues.

In general, entertainment expenses are not deductible unless they are directly related to (or associated with) the active conduct of the employer's trade or business. Code section 274(e)(2) provides an exception for amounts treated as compensation to the employee, but (since the law changed effective October 22, 2004) the maximum deduction of employer's expenses cannot exceed the compensation imputed for a specified individual. To calculate this imputed compensation for entertainment flights, employers can either use the general or special valuation rules. Under the general approach, a taxpayer uses the fair market value of the flight based on an arms-length charter of same or comparable aircraft for the same or comparable flight (or if no pilot, rental of comparable aircraft). Under the special rule, a taxpayer uses the "SIFL" rate under Treas. Reg. § 1.61-21(g). To calculate the employer's deductible entertainment expenses for specified individuals, Notice 2005-45 clarifies who is covered and the relevant costs, and illustrates the allocation of costs for an entertainment flight.

Despite commentators request for relief in various areas, the proposed regulations largely track the interim guidance in Notice 2005-45, described below, taking a hard line on most issues. However, a few provisions would give employers additional flexibility – including the new flight-by-flight allocation approach and depreciation method, and floating a possible charter safe harbor rule.

- **Use of Aircraft for Entertainment:** The Notice applies without regard to ownership of the aircraft, or whether used on regular schedule or for bona fide security concerns. The proposed regulations follow this same approach.
- **Specified Individuals:** The Notice clarifies that this term includes an officer, director, more than 10% owner, and any spouse or family member (or other relationship) thereof. The proposed regulations follow the same approach (referencing SEC regulations under 17 CFR 240.16a-1(f) for definition of officer), but request comments on how the regulations could define those with a relationship to a specified individual.

- Expenses of Aircraft Subject to Disallowance: The Notice provides that all of the expenses of maintaining and operating the aircraft, including all fixed and operating costs, must be taken into account. Despite comments to the contrary, the proposed regulations follow this same approach (including guidance on leasing expenses), but permit use of a special straight-line depreciation basis over the class life of an aircraft for all of the employer's aircraft for the current and future years. Also, the regulations explain that expense disallowance applies to expenses on a pro rata basis; if a disallowed amount is allocable to depreciation, the basis of the aircraft is not reduced for the amount of depreciation disallowed.
- Method of Allocating Expenses to Flights: The Notice provides an occupied seat hour or mile formula to allocate expenses to entertainment flights provided to specified individuals. The formula multiplies the hours or miles flown by an aircraft by the number of occupied seats. Then the employer aggregates all expenses to determine the total expenses paid or incurred during the year with respect to an aircraft (or aggregated aircraft based on similar cost profiles) and divides the total expenses by total occupied seats hours or miles to determine the cost per hour/mile. The proposed regulations retain this formula (with additional information on appropriate cost profile aggregation), but also provide an option of allocating expenses on a flight-by-flight basis. Under this new method, an employer aggregates all expenses for a taxable year and divides by the number of flight hours or miles for the year to determine the cost per hour/mile. Then the employer allocates expenses to each flight by multiplying the number of miles/hours for the flight by the expense per hour/mile, and allocates expenses for the flight to the passengers on the flight per capita (e.g., (total year expenses/# flight hours or miles) x (# miles or hours for the flight) / (number of passengers)).
- "Deadhead" Flights: The Notice provides that an empty flight is treated the same as the occupied flight. The proposed regulations provide additional clarification on deadhead flights. An aircraft returning without passengers or flying without passengers to pick-up passengers is treated as having the same number and character of passengers as the leg of the trip with passengers. When a deadhead flight does not occur as part of a roundtrip flight, but occurs between two unrelated flights involving more than 2 destinations, the allocation of passengers and expenses to the deadhead flight between the occupied trips is based on the number of passengers on board for the two occupied legs of the flight, the character of the passengers on board (entertainment or non-entertainment) and the length in hours or miles of the two occupied legs of the flight. The preamble references a safe harbor approach for treating the empty flight as if it had the same composition as either the prior or subsequent flight, but it is unclear if the proposed regulations permit such an approach.
- Allocation of Expenses Involving Business and Entertainment: The Notice provides that the entertainment cost is the excess of the total cost of the flights (by occupied seat hours or miles) over the cost of the flights that would have been taken without the entertainment segment(s). The proposed regulations retain this rule for allocation based on seat hours or miles.

- Consistency Rule: The Notice provides an exception to the general SIFL consistency rules that permit employers to use the fair market value rules for entertainment use of specified individuals while continuing to use the SIFL rate for other employees and for specified individuals on non-entertainment business travel. The proposed regulations adopt this same exception.
- Section 162(m): The Notice provides that any amount for the entertainment use of an aircraft that is treated by the employer as compensation to a specified individual who is also a "covered employee" is subject to section 162(m). Despite comments to the contrary, the IRS has retained this position in the proposed regulations.
- Costs Must be Treated as Compensation: The Notice states that affected amounts must be treated as compensation on the employer's income tax return as originally filed and as wages for purposes of income tax withholding (or, for non-employees, reported on Form 1099). The proposed rules adopt these positions.
- Possible Charter Rate Safe Harbor: The preamble to the proposed regulations states that the IRS and Treasury are considering whether to provide a charter rate safe harbor. Under this approach, employers could elect to treat – as the amount of expenses for entertainment flights – an undiscounted charter rate for each flight in lieu of calculating the actual expenses of each entertainment flight provided to specified individuals. This approach would replace the occupied seat or flight-by-flight approach. The amount would be based on an undiscounted charter rate that a person would pay in an arms-length transaction to charter the same or comparable aircraft for the same or comparable flight – using published rates charged to the general public within 10 days before or after the actual flight by an unrelated qualified chartering company (e.g., charters at least 10 aircrafts during the year). Also, if elected, the safe harbor approach would apply to all entertainment flights until revoked.

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Comments are requested on the proposed regulations by September 13 (with a public hearing scheduled for October 25), including comments on the charter rate safe harbor or other safe harbors, and whether guidance should be issued on treating an aircraft itself as an "entertainment facility" (which the proposed regulations do not address). Employers may rely on the Notice (but not the lack of a rule to apply a rule contrary to the proposed regs) or the proposed regulations for taxable years beginning before the final regulations are issued.

We hope this summary is helpful. Please contact Liz Dold (202-861-5406) or Lou Mazawey (202-861-6608) if you have questions or would like to discuss possible comments on the proposal.