PCS Tax Insight

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Recent tax developments involving business aircraft may present both challenges and opportunities

Failure to consider recent IRS guidance regarding business aircraft may result in compliance problems or missed opportunities.

In brief

Taxpayers should ensure that they understand the unique federal income tax issues associated with owning business aircraft, especially in light of recent IRS guidance relating to entertainment use of employer-provided aircraft, changes in use of business aircraft, bonus depreciation on business aircraft, and routine maintenance performed on aircraft engines. Failure to consider this guidance may result in compliance problems or missed opportunities.

Editor's note: While this article discusses selected federal income tax issues associated with owning business aircraft, it does not discuss certain other issues, like federal excise taxes. It also does not discuss state tax issues, like sales and use tax and property tax.

Entertainment use of employer-provided aircraft may result in disallowed deductions

On July 31, 2012, the IRS issued final regulations addressing the tax treatment of an employer with respect to certain personal use of employer-provided aircraft. The final regulations adopt the 2007 proposed regulations with some notable changes, and explain in some detail how to apply the amendments enacted as part of the American Jobs Creation Act of 2004 and the Gulf Opportunity Zone Act of 2005 that limit the costs that a taxpayer may deduct when a 'specified individual' uses employer-provided aircraft for personal entertainment travel.

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Who is a 'specified individual'?

The final regulations provide that expenses for the 'entertainment' use (as defined in Reg. Sec. 1.274-2(b)(1)) of an employer-provided aircraft by a specified individual are disallowed to the employer except to the extent of the amount treated as compensation or income to the specified individual, or to the extent that a specified individual reimburses the taxpayer for that flight.

The regulations generally define a specified individual as an officer, director, or a direct or indirect beneficial owner of more than 10% of any class of registered security (if the taxpayer were an issuer of equity securities) of a corporation taxed under subchapter C or subchapter S, or a personal service corporation. The term also includes a person who is comparable to a director or officer. For partnership purposes, a specified individual includes any partner that holds a more-than-10% equity interest in the partnership, a general partner, an officer, or a managing partner of a partnership. Furthermore, a specified individual includes a director or officer of a tax-exempt entity. The final regulations also apply to a specified individual with respect to a party related to a taxpayer under either Section 267(b) or Section 707(b).

The final regulations also apply to use of the aircraft by other individuals, if:

- the specified individual is treated as the recipient of entertainment provided to the other individual because of the relationship of the other individual to the specified individual, and
- the entertainment is a fringe benefit to the specified individual under Section 61(a)(1) (without regard to any exclusions from gross income).

Observation: The rule above represents a slight change from the proposed regulations, which simply referred to a spouse, family member, or other individual being treated as a specified individual due to the relationship to the actual specified individual.

What expenses are taken into account?

The final regulations provide that in calculating the amount of expenses for personal entertainment use of an aircraft that is disallowed, the taxpayer must take into account all the expenses of operating the aircraft (including all fixed and variable costs). These expenses include 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 (at home or away); management fees; cost of fuel, tires, maintenance, insurance, registration, certificate of title, inspection, and depreciation; interest on debt secured by or properly allocated (within the meaning of Reg. Sec. 1.163-8T) to an aircraft; and all costs paid or incurred for aircraft leased or chartered.

Observation: The proposed regulations did not specify interest as an example of an expense that would be subject to the disallowance. Based upon a request from a commentator for clarification, the IRS included it within the final regulations as an example. Requiring an allocation of interest expense to an aircraft within the

meaning of Reg. Sec. 1.163-8T likely will create an administrative burden for some taxpayers.

Observation: The final regulations permit a taxpayer to elect to calculate depreciation on a straight-line basis over the class life of an aircraft for all of the taxpayer's aircraft for the current year and all future years when calculating the amount of disallowed expenses. For aircraft placed in service in tax years prior to the tax year of the election, the amount of depreciation is determined by applying the straight-line method to the unadjusted depreciable basis over the class life of the aircraft as though the taxpayer had used that method from the year the aircraft was placed in service.

Observation: The taxpayer may calculate expenses separately for each aircraft or may aggregate expenses of aircraft with similar cost profiles. The final regulations provide that aircraft must have the same engine type and the same number of engines to have similar cost profiles. Other factors to be considered include maximum take-off weight, payload, passenger capacity, fuel consumption rate, age, maintenance costs, and depreciable basis.

How are expenses allocated?

The final regulations provide two methods to allocate expenses to personal entertainment flights provided to specified individuals. Whichever method is chosen, the taxpayer must use the chosen method for all flights of all aircraft for the tax year.

Occupied-seat method

A taxpayer may allocate expenses for each tax year using either occupied seat hours or occupied seat miles flown by the aircraft. The chosen method must be applied consistently throughout the tax year. In general, taxpayers must aggregate all fixed and variable expenses to determine the total expenses paid or incurred during the tax year and divide the total expenses by total occupied seat hours or occupied seat miles flown to determine the cost per occupied seat hour or occupied seat mile.

The expenses of a flight provided to a specified individual that includes legs for both business and entertainment purposes must be allocated to the business use and entertainment use. The entertainment expense subject to the disallowance is the excess of the total expenses of the flights (by occupied seat hours or miles) less the expenses of the flights that would have been taken without the entertainment leg(s), less the sum of the amount treated as compensation or income and the amount reimbursed for the specified individual.

Examples of the occupied-seat method are provided in the final regulations.

Flight-by-flight method

The final regulations allow the taxpayer to allocate expenses on a flight-by-flight basis. Under this method, a taxpayer may aggregate all expenses for the tax year and divide the amount of total expenses by the number of flight hours or miles for the taxable year to determine the cost per hour or mile. The taxpayer then allocates expenses to each flight by multiplying the number of miles or hours for the flight by

the cost per hour or mile and allocates expenses for the flight to the passengers on the flight per capita.

Whichever method of allocating expenses is used (i.e., occupied-seat method or flight-by-flight method), the final regulations provide that the expense disallowance is to be applied on a pro rata basis to all disallowed expenses. Also, the final regulations provide that any amounts reimbursed or treated as compensation are to be applied on a pro rata basis. An example is provided in the final regulations to illustrate this rule.

What amount is disallowed?

In summary, the amount disallowed under Section 274 for a personal entertainment flight by a specified individual is the amount of the expenses allocable to the entertainment flight of the specified individual (using either the occupied-seat hour or mile method or the flight-by-flight method), reduced (but not below zero) by the amount the taxpayer treats as compensation or income to the specified individual. Any amount the specified individual reimburses the taxpayer also reduces the amount of disallowance.

Change in use of business aircraft may cause a change in asset class

In CCA 201228036 (released July 13, 2012), the taxpayer's subsequent use of company aircraft (after the year the aircraft was placed in service) caused a change in asset class, resulting in a longer recovery period for depreciation purposes. Initially, the taxpayer purchased the aircraft for business travel to various automobile dealerships. Shortly thereafter, use of the aircraft declined, and it became less affordable. Due to its depressed value, the taxpayer was unable to sell the airplane. In order to offset the cost of maintaining the airplane, the taxpayer entered into a lease arrangement with another party pursuant to which the lessee would use the airplane in its charter operations. Because the airplane was used for more flight hours by the lessee in its charter operations than by the taxpayer for travel to various automobile dealerships, the airplane was reclassified under Rev. Proc. 87-56 from asset class 00.21 (5-year MACRS property) to asset class 45.0 (7-year MACRS property). This reclassification constituted a change in use under Section 168(i)(5), and resulted in a longer recovery period.

Observation: In this context, the IRS Office of Chief Counsel explained that the cost of the airplane should not be allocated between the two asset classes. Rather, the cost of the airplane should be allocated entirely to one asset class or the other based on the 'primary use' standard (which in this case was based on flight hours).

Extended placed-in-service deadline for 50% bonus depreciation may be available to taxpayers with qualifying aircraft

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended 50% bonus depreciation through December 31, 2012. It had previously been set to expire after December 31, 2010. In general, under these rules, property must be placed in service before January 1, 2013, in order to qualify for 50%

bonus depreciation. However, an extended placed-in-service deadline of January 1, 2014, may be available to taxpayers with qualifying aircraft (see Section 168(k)(2)(C)). To qualify for the extended placed-in-service deadline, the following requirements must be met (in addition to the placed-in-service requirement):

(1) the original use of the aircraft must commence with the taxpayer after December 31, 2007 (see Section 168(k)(2)(A)(ii)),

(2) the aircraft must be acquired by the taxpayer after December 31, 2007, and before January 1, 2013 (see Section 168(k)(2)(A)(iii) for additional details),

(3) the aircraft must not be 'transportation property,' (i.e., tangible personal property used in the trade or business of transporting persons or property) (see Section 168(k)(2)(C)(ii)),

(4) the taxpayer purchasing the aircraft must have (at the time of the contract for purchase) made a nonrefundable deposit of the lesser of 10% of the cost or $100,000 (see Section 168(k)(2)(C)(iii)),

(5) the aircraft must have an estimated production period exceeding four months (see Section 168(k)(2)(C)(iv)(I)), and

(6) the aircraft must have a cost exceeding $200,000 (see Section 168(k)(2)(C)(iv)(II)).

Based on these requirements, a company that uses its non-commercial aircraft to provide business-related transportation to employees and their business associates may be able to benefit from the extended placed-in-service deadline. As such, a qualifying taxpayer could potentially purchase its aircraft as late as December 31, 2012, and then place it in service as late as December 31, 2013.

Routine maintenance performed on aircraft engines may result in an immediate deduction

On December 23, 2011, the IRS issued temporary regulations under Section 263(a), relating to the capitalization of tangible property. Among other things, these temporary regulations outline a safe harbor providing that routine maintenance performed on a unit of property other than a building or a structural component of a building is deemed not to improve that unit of property (see Reg. Sec. 1.263(a)-3T(g)). Accordingly, routine maintenance performed on tangible personal property, such as aircraft engines, may result in an immediate deduction, instead of capitalization.

This safe harbor defines routine maintenance as the recurring activities a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. In this regard, routine maintenance activities may include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of parts of the unit of property with comparable and commercially available and reasonable replacement parts.

Activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life of the unit of property. Factors to consider in determining

whether a taxpayer is performing routine maintenance include: the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statement.

More detailed examples of qualifying routine maintenance are provided in the temporary regulations.

What actions should be considered?

Taxpayers should ensure that they understand the unique federal income tax issues associated with owning business aircraft, especially in light of recent IRS guidance. Where employer-provided aircraft will be used by specified individuals for entertainment purposes, taxpayers should consider the new regulations under Section 274, and make sure they have adequate documentation to substantiate the amount of any disallowed deductions, to the extent the related expenses are not reimbursed or treated as compensation or income to the specified individuals. Taxpayers should also carefully consider how the aircraft will be used -- even for non-entertainment business purposes -- because certain activities may adversely affect the aircraft's classification and recovery period for depreciation purposes. Lastly, taxpayers that own business aircraft, or those that are contemplating the purchase of business aircraft, should make sure they consider the benefits of the bonus depreciation rules under Section 168(k) and the routine maintenance safe harbor under the temporary regulations associated with Section 263(a).

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