The passage of two years since the issuance of Notice 2005-45 has not significantly dampened the enthusiasm of the Internal Revenue Service in its mission to stamp out executives’ entertainment use of company aircraft. The newest tool in the IRS’s arsenal is the deduction limitation set forth in amended section 274(e)(2) of the Internal Revenue Code. That limitation, which the IRS interprets as conditioning a company’s deductions for aircraft expenses on each executive’s reason for being on the flight, rather than the primary purpose of the flight, arises out of legislative changes to section 274(e)(2) by the American Jobs Creation Act of 2004.

Taxpayers who have been struggling with the 2005 Notice’s preliminary guidance, which took effect on July 1, 2005, now have additional guidance in the form of Proposed Regulations published on June 15, 2007. Whether or not this latest guidance can be characterized as helpful to taxpayers is in doubt, because the IRS has not only been unrelenting in rejecting the primary purpose test, but, in doing so, has cherry-picked among the historical statutory and regulatory principles applicable to entertainment expenses since 1962.

The IRS’s reaffirmation of its decision to classify aircraft expenses based on a passenger’s reason for being on a flight is particularly open to question. The IRS has rejected taxpayers’ pleas, based on existing law, for primary purpose or incremental cost approaches in determining both the trigger for the entertainment deduction disallowance of section 274(e)(2) and the amount of expenses that should be disallowed. Indeed, the Proposed Regulations reflect a continuing vigorous effort by the IRS to penalize taxpayers for the entertainment use of aircraft by their executives (and others also deemed to be “specified individuals”), rather than implementing workable disallowance rules designed to address the primary purpose for using the aircraft, the costs fairly allocable to entertainment use, and the discrepancy between the income reported for personal flights (when valued under the standard industry fair market use, and the discrepancy between the income reported for business purposes, or for recreation, unless the expense is directly related to or, in certain cases, associated with the taxpayer’s trade or business, or (ii) a facility used in connection with such entertainment activity. Section 274(e)(2) operates as an exception to the general entertainment deduction disallowance rule of section 274(a).

The Proposed Regulations also attempt to have it both ways regarding the interplay between sections 274(e)(2) and 162(m) (the $1 million deduction limitation applicable to certain executive compensation). They side-step difficult issues such as how section 274(e)(2) relates to such matters as the rules pertaining to entertainment facilities under section 274(a)(1)(B) and the other disallowance provisions within section 274, as well as the valuation of fringe benefits. In the end, the Proposed Regulations represent a reiteration of the IRS’s position that section 274(e)(2), which structurally is merely a limitation on an exception to the disallowance of entertainment expenses and facilities, is a stand-alone disallowance provision in its own right.

Nevertheless, the Proposed Regulations do contain some helpful clarifications and changes, including a flight-by-flight alternative for calculating allocable costs, as opposed to the occupied seat method announced in the 2005 Notice.

Under special transition rules, taxpayers may rely on the Proposed Regulations or the 2005 Notice pending issuance of the final regulations and may themselves even cherry pick between the rules. The Preamble to the Proposed Regulations also invites taxpayer comment on various issues, such as the issue of aircraft as entertainment facilities, the criteria for aggregating aircraft with similar cost profiles, and the viability of a charter rate safe harbor rule for establishing costs.

This article describes the main points of the Proposed Regulations and highlights the differences from the 2005 Notice. It also summarizes several areas where additional guidance is badly needed. In drafting the final regulations, Treasury and the IRS will optimally heed taxpayers’ comments on operational problems with the rules and will provide more examples of how the rules actually apply to common fact patterns.

**Background**

**A. Amendment of Section 274(e)(2)—Intended to Stop Perceived Abuses**

Section 274(a) is a limitation on expenses otherwise deductible under section 162 of the Code. It bars the deduction of expenses for (i) an activity generally considered to be entertainment, amusement, or recreation, unless the expense is directly related to or, in certain cases, associated with the taxpayer’s trade or business, or (ii) a facility used in connection with such entertainment activity. Section 274(e)(2) operates as an exception to the general entertainment deduction disallowance rule of section 274(a). Prior to amendment by the 2004 tax law, section 274(e)(2) allowed the taxpayer to deduct all the expenses related to its executives’ personal (including entertainment) use of its aircraft, even though the value of the personal trips reported as income to the executives was less than the cost of providing the trips. Specifically, in Sutherland Lumber-
Southwest, Inc. v. Commissioner, the Tax Court held that if an aircraft is used for entertainment and thus is potentially subject to disallowance under section 274(a), section 274(e)(2) operates as a complete exception to the disallowance as long as the value of the personal use of the aircraft is properly imputed to the employee and reported as compensation on the taxpayer’s return. In that case, the taxpayer had used the special SIFL valuation rules applicable to flights on noncommercial aircraft under Treas. Reg. § 1.61-21(g) to determine the value of the executives’ personal trips — the result being that the expenses deducted by the company far exceeded the income imputed to the executives.

In reaction to the taxpayer’s victory in Sutherland Lumber and media reports of excessive use of corporate aircraft for personal purposes, Congress amended section 274(e)(2) to stanch the perceived abuse. Consequently, effective for expenses incurred after October 22, 2004, section 274(e)(2) limits the taxpayer’s deduction of expenses for entertainment goods, services, and facilities (including airplanes used for entertainment) provided to “specified individuals” to the amount that the taxpayer treats as compensation to the recipient. In other words, in the case of a “specified individual,” the amount of the taxpayer’s deduction for entertainment cannot exceed the amount treated as wages for income tax withholding purposes with respect to the employee receiving the entertainment goods, services, or facilities or, in the case of a director or other independent contractor, the amount reported as compensation income on a Form 1099-MISC. Moreover, these amounts must be reported on the taxpayer’s income tax return as compensation. The excess of the taxpayer’s allocable costs is disallowed under section 274(a). Although the 2004 amendment was “intended to overturn Sutherland Lumber . . . with respect to covered employers,” the restriction on deductibility in section 274(e)(2) is not limited by its terms to expenses attributable to corporate aircraft, and has a much broader reach, including potentially the personal use of automobiles.

B. Issuance of Notice 2005-45 — The IRS Takes Aim

Notice 2005-45 was published on May 27, 2005, and became effective July 1, 2005, to provide guidance to taxpayers on how the deduction disallowance rules should apply pending the issuance of final regulations. In contrast to the conference report’s single example of vacation use of a company aircraft by a specified individual, the 2005 Notice adopted an “occupied seat” analysis, which effectively pro-rates the cost of maintaining and operating the aircraft for the year among all aircraft passengers on all passenger-occupied flights in order to determine the costs associated with specified individuals’ entertainment use.

The IRS’s speedy issuance of the 2005 Notice was matched by a prompt and vigorous taxpayer response. Commentators expressed surprise at the IRS’s rejection of the centerpiece of existing longstanding law applicable to transportation facilities capable of being used for entertainment purposes — namely, the primary purpose test. Quite simply, the 2005 Notice’s per-passenger, per-seat approach created many new issues for taxpayers, some of which are addressed in the Proposed Regulations but regrettably not in a manner consistent with existing law.

Analysis of the Proposed Regulations

A. “Specified Individuals” — Apparently Still the Many, Not the Few

The definition of “specified individual” in section 274(e)(2)(B)(ii) is any individual who is subject to the reporting requirements of section 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer or a related party, or who would be subject to those requirements if the provider of the benefit were publicly traded. In other words, the statutory definition is aimed at a fairly small group of individuals with policy-making authority over the taxpayer. The Proposed Regulations, however, expand the statutory definition to include every person who:

(a) is the direct or indirect beneficial owner of more than 10 percent of any class of any registered equity security (other than an exempted security),
(b) is a director or officer of the issuer of the security,
(c) would be the direct or indirect beneficial owner of more than 10 percent of any class of a registered equity security if the taxpayer were an issuer of equity securities, or
(d) is comparable to an officer or director of an issuer of equity securities.

The Proposed Regulations explain that a specified individual is an officer, director, or more than 10-percent owner of a corporation taxed under subchapter C or subchapter S of the Code, or a personal service corporation. For partnership purposes, a specified individual includes any partner holding more than a 10-percent equity interest, general partner, officer, or managing member of a partnership. The definition also includes a director or officer of a tax-exempt entity. Moreover, a specified individual is the recipient of the entertainment provided to a spouse, family member or another person because of the person’s relationship to the specified individual, and all entertainment costs for those persons are allocable to that specified individual.

Under the “related party” rule, the disallowance provisions apply to the use of an aircraft for the entertainment of a specified individual of a party related to the taxpayer within the meaning of section 267(b) or 707(b). Thus, if Corporations A and B are commonly owned and Corporation A provides an entertainment flight to B’s employee, S, who is a specified individual, A’s costs will be disallowed, except to the extent the benefit is treated as compensation to S by B or is reimbursed to B by S. Thus, presumably A will get “credit” for the treatment of the benefit provided to S, and B will have to inform A of that treatment so that A can compute the amount, if any, to be disallowed.

In the case of a large publicly held company with many affiliates, it would be logical to identify the specified individuals simply by reference to the individuals covered in the company’s SEC filings under section 16(a) of the Securities Exchange Act of 1934, but the IRS seemingly interprets the term to include officers of lower-tiered subsidiaries, even though these individuals are not covered by section 16(a). The IRS’s interpretation is apparently based both on the related-party rule, as clarified in the technical amendments included in the Gulf Opportunity Zone Act, and the as-if language of section...
274(e)(2)(B)(iii), *i.e.*, as if the lower-tier subsidiary were itself a reporting entity under section 16(a). The IRS may also believe that any officer within the corporate structure could effectively “control” the use of an aircraft — a questionable proposition as best. Thus, if such a person takes a personal trip, the portion of the expenses attributable to the person’s flight are subject to the limitations of section 274(e)(2). In other words, the expansive definition may apply mechanically, based solely on job titles, to each corporate affiliate’s officer contingent, without the threshold of a minimum compensation level. Such an interpretation has the potential for expanding significantly the administrative burden of applying the provision as well as the size of the disallowance. For companies that allow employees to hitchhike on corporate aircraft with open seats, this interpretation will likely significantly increase the cost of continuing such a policy.

Interestingly, the Proposed Regulations do not expand the definition of specified individual to include former service providers, who would have been specified individuals when they performed services (e.g., a former officer or a director). Therefore, it does not appear that former executives will be treated as specified individuals unless they are deemed to be such by virtue of their relationship with a current specified individual, for example, flying as a personal guest of that specified individual.16

The Proposed Regulations do not except flights provided to children who are younger than two years old, even though, for fringe benefits purposes, the value of their flights is deemed to be zero under the SIFL rule.17 One must assume from the IRS’s silence on this issue that the taxpayer must allocate a full passenger share of disallowed expenses to an infant who is accompanying a specified individual on an entertainment flight.

### B. Definition of “Aircraft” — Use, Not Ownership, Is the Key

Under the 2005 Notice and the Proposed Regulations, the disallowance applies to any aircraft owned by, leased to, or chartered to the taxpayer or any party related to the taxpayer within the meaning of section 267(b) or 707(b).18

### C. Definition of “Entertainment” — No New Definition, But Some Clarity Around the Edges

1. Focus on entertainment activities. The Proposed Regulations leave undisturbed the longstanding definition of entertainment set forth in existing regulations19 and, consistent with that definition, acknowledge that not all personal travel by executives on company aircraft constitutes entertainment for purposes of the specified individual’s entertainment disallowance.20 Although the Proposed Regulations list only travel to a family member’s funeral as an example of such personal nonentertainment travel, examples of such travel listed in the Preamble include travel for other businesses, medical purposes, funerals, and charitable activities. The Preamble expressly eschews offering additional guidance regarding the definition of entertainment,21 which suggests that the final regulations may likewise offer little additional guidance.

Nevertheless, the IRS’s acknowledgement that there can be personal nonentertainment flights and that the existing definition of “entertainment” should be followed are promising developments. Many taxpayers were concerned that the Proposed Regulations might impose a more expansive definition of entertainment to limit taxpayers’ ability to classify as entertainment those personal flights undertaken for purposes that do not rise to the level of entertainment.

To the contrary, the Proposed Regulations give taxpayers the ability to determine the entertainment or nonentertainment nature of flights based on the existing definition of entertainment. Therefore, if a flight is not for a purpose that is ordinarily considered entertainment, amusement or recreation,22 it should not be subject to the entertainment disallowance of section 274(e)(2). In addition to the examples in the Preamble, personal nonentertainment travel includes routine personal activities, such as commuting to and from work.23 Revenue Ruling 63-144 indicates that routine personal travel also includes driving to the grocery store and visiting a hospitalized relative.24 Based on this guidance, the treatment of a specified individual’s flights as personal but not entertainment will depend on the types of activities undertaken at the destination. For example, travel to a second home (which is conceptually similar to commuting) and travel to any location (including possibly a vacation destination) may not be entertainment if the primary purpose and activity is to work in a relaxed atmosphere.25 Similarly, a spouse and other family members traveling with an executive on a business trip will ordinarily not be traveling for business purposes,26 but whether their travel is for entertainment will depend on whether they engage in entertainment activities like sightseeing.

Company personnel tasked with classifying flights with respect to specified individuals will be confronted by several unresolved issues in the Proposed Regulations. One threshold issue is the identification of possible categories of flights. Based on the reference in the Proposed Regulations to personal nonentertainment travel, there appear to be three general classifications of flights: business nonentertainment, personal nonentertainment, and personal entertainment. Mixing and matching these terms suggests a fourth category: business entertainment. The Proposed Regulations, however, make this fourth category confusing. They define “business entertainment air travel” as flights that are either “directly related” to business or are “associated with” business and directly preceding or following a substantial business discussion.27 Under this definition, business entertainment air travel is a subset of the deductible business flights classification. In contrast, a flight to entertain customers merely to promote goodwill (that is not immediately preceding or following substantial business discussions) will likely be a company business flight under the ordinary and necessary business expense test in section 162, but it will be subject to the entertainment disallowance rules in section 274(a).28 As a flight for company business purposes rather than for any individual’s personal purposes, any flight in this fourth category will be separate from the “personal entertainment” category. Since the Proposed Regulations already use the term “business entertainment,” it may be appropriate to refer to such flights as “nondeductible business entertainment.”

These four categories of flights for specified individuals may be illustrated by the following diagram:
The definition of entertainment in the existing regulations requires the application of an objective standard to determine whether an activity is ordinarily considered to constitute entertainment, amusement or recreation. The regulations further provide, however, that in distinguishing entertainment from business travel, the taxpayer’s business should be taken into consideration. It follows that to distinguish personal entertainment from personal nonentertainment travel, the objective standard should be applied based on a similarly-situated individual.

The current definition of entertainment is written in terms of whether a single activity is classified as entertainment. In fact, individuals often engage in a variety of activities at their travel destinations. Although the existing regulations do not purport to define the standard for considering various activities collectively, it seems proper to make that determination for each passenger based on the passenger’s primary purpose for making the trip.

Most taxpayers welcome the ability to classify certain flights as personal nonentertainment, because this classification reduces the amounts disallowed. Supporting this classification, however, may require an unwelcome level of analysis by the taxpayer (with supporting documentation in the taxpayer’s business records) of the personal activities of the company executives, board members, and their guests traveling on company aircraft. This level of inquiry may raise problems when personnel responsible for ensuring compliance while maximizing deductions must obtain personal travel information from executives and their families who may not be interested in sharing such information.

2. Entertainment facilities. The Preamble requests comments on whether guidance should be issued regarding the use of aircraft as “entertainment facilities” under section 274(a)(1)(B). While the Preamble states that the Proposed Regulations do not address circumstances in which aircraft may be considered entertainment facilities, there is already authority that an aircraft used for a single minute for entertainment purposes during the year is classified as an entertainment facility. The question is whether the exception for transportation facilities should be interpreted to treat nonentertainment flights (and business entertainment flights) in the same way.

Optimally, the IRS should apply the entertainment expense disallowance and the entertainment facility disallowance to aircraft in the same manner.

D. Expenses Subject to Deduction Disallowance — Everything, Including the Galley Sink

1. All-inclusive costs. Notice 2005-45 provides that taxpayers must include “all of the expenses of maintaining and operating the aircraft,” interpreted as including “all fixed and operating costs,” in determining the year-end allocation of allowable and disallowed expenses under the occupied seat method. The Proposed Regulations reject comments arguing that references in the legislative history to “aircraft operating costs” and “actual costs” indicate a legislative intent to limit the allocation to variable costs. Moreover, although the Proposed Regulations give taxpayers a choice between the occupied seat method and a flight-by-flight method (as discussed below), they require the same broad array of costs to be allocated under both methods.

The Proposed Regulations specifically provide that the annual aircraft expenses to be taken into account include, but are not limited to, all of the expenses of operating the aircraft, including all fixed and variable expenses the taxpayer deducts in the year. This is essentially the same formulation of expenses reflected in the 2005 Notice and includes:

- 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, or gifts;
- hangar fees (at home and away);
- management fees;
- costs of fuel, tires, maintenance, insurance, registration, certificate of title, inspection, and depreciation; and
- all costs paid or incurred for aircraft leased, or chartered, to or by the taxpayer.

Defining includible expenses broadly has the collateral effect of implicitly bolstering the IRS’s rejection of an incremental cost
allocation approach (except where a trip includes both business and personal segments). That is to say, by using all expenses for the year as the same starting point for the mechanical application of the occupied seat method or the new flight-by-flight method, the IRS avoids such questions as whether a full-cost allocation should apply to such situations as a specified individual “hitchhiking” on what is otherwise a business flight with a majority of business passengers, or a spouse accompanying a specified individual for entertainment on a business flight of the specified individual. This approach exacerbates the disconnection between the fringe benefits rules and the expense disallowance rules.

The omission of interest expense (and financing costs generally) from this list suggests that the IRS has not decided whether interest is within the scope of expenses covered by the entertainment disallowance. The exception in section 274(f) for items deductible by an individual irrespective of his or her connection with the taxpayer’s business does not appear to apply to interest.41 Nevertheless, it is not absolutely clear that the scope of expenses subject to the disallowance should include interest in the first place.42 Existing rulings do not mention interest,43 and there is no indication that the expenses subject to the entertainment disallowance reach beyond those directly relating to the aircraft, such as corporate overhead, payroll, purchasing, information technology, etc., in a manner similar to the inventory capitalization rules under section 263A.44 If interest expense is to be subject to the entertainment disallowance, the IRS should issue further guidance governing the allocation of debt to aircraft.45

2. The adequate-and-full-consideration exception

a. Exception for third-party charters. The Proposed Regulations carve out expenses allocable to a lease or charter of the taxpayer’s aircraft to an unrelated third party in a bona fide business transaction for adequate and full consideration.46 Only the expenses attributable to the “charter period” are excluded. This regulation represents a very sensible solution to a common problem. Taxpayers that engage charter operators to charter excess capacity on their aircraft to third parties often find that they do not receive detailed information (such as passenger lists) with respect to the charter flights. Without this information, it is impossible to calculate accurately the occupied seat or flight-by-flight allocations.

To address this problem, the Proposed Regulations allow taxpayers to first allocate costs to the “charter period,” but leave this initial allocation open to reasonable interpretation. Accordingly, even if the taxpayer is using the occupied seat method for the year, it could first allocate expenses to the charter period based on the ratio of total charter hours (or miles) to total flight hours (or miles) for the year. Furthermore, it should also be able to allocate directly to the “charter period” any additional costs incurred solely due to the charter operations, such as the costs associated with placing the aircraft on a charter certificate and purchasing additional insurance.

Although the exception for third-party charters represents a practical solution to a practical problem, the regulations are carefully worded to match the adequate-and-full-consideration exception in section 274(e)(8), which applies to “goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money’s worth.” This suggests that the legal justification for the carve-out in the Proposed Regulations for third-party charter flights is the exception in section 274(e)(8).

b. No specific exception for related parties. The Preamble explains, however, that the Proposed Regulations do not address the adequate-and-full-consideration exception in section 274(e)(8), since it is addressed in Treas. Reg. § 1.274-2(f)(2)(ix).47 Unfortunately, the Preamble then misstates the existing regulations, stating that existing regulations provide that the adequate-and-full-consideration exception only applies to taxpayers “in the trade or business of providing entertainment to customers.” Although the existing regulations refer to customers, it does not require the taxpayer to be in the “trade or business of providing entertainment.” Query whether the IRS’s misstatement of the existing regulations is an attempt to narrow the adequate-and-full-consideration exception without having to amend the applicable regulation.48

On balance, a sensible response is to accept the statement in the Preamble that the proposed regulations do not address the adequate-and-full-consideration exception. This means that the section 274(e)(8) exception should apply to the lease or charter of an aircraft at fair market value, even between related parties.49 Nevertheless, a higher level of scrutiny is applied to the adequacy of the terms and rates charged between related parties.50

3. Fair market charter rates as a potential safe harbor for determining the expenses of an entertainment flight. The Preamble states that the IRS is considering the option of allowing companies to determine the amount of their expenses for entertainment flights by reference to undiscounted charter rates instead of using actual costs.51 Taxpayers may not use this method now, but the IRS is requesting comments on how this approach could work. With appropriate input from taxpayers, including comments on how such a cost rule should mesh with valuation rules (including the consistency rule discussed below), one might reasonably expect guidance on this approach in the final regulations.

The hypothetical undiscounted charter cost will be used to determine the potential amount of the disallowance by applying the taxpayer’s allocation method to that hypothetical cost. The resulting net amounts subject to disallowance as allocable to entertainment use of the aircraft by specified individuals (after reduction for imputed compensation and reimbursements) will be subtracted from the taxpayer’s actual expenses in determining the taxpayer’s net deductions for the aircraft. For example, an undiscounted charter rate for a comparable flight will be allocated to the individuals on a flight in lieu of the occupied seat or flight-by-flight methods. This rule (if adopted) would allow the deduction of all costs in excess of charter rates. Indeed, this was the net tax effect of the rules before the introduction of the SIFL rates in 1985. Therefore, it is interesting, and helpful, that the IRS is revisiting the past and looking for ways to minimize the administrative problems created by the new expense disallowance provisions.52

If this safe harbor is adopted in the final regulations, the fringe benefit regulations should also be amended to permit companies to impute income based on the safe harbor cost allocated to the specified individuals for entertainment use of the aircraft. In that way, the potential entertainment disallowance could be eliminated.53
4. Election to use straight-line depreciation for purposes of the entertainment disallowance
   
   a. Straight-line depreciation election. The Proposed Regulations, like the 2005 Notice, require taxpayers to treat depreciation as an operating expense in computing the disallowed amount for the year. In doing so, the Proposed Regulations disregarded public comments asking that “operating expenses” include only the incremental costs incurred by reason of entertainment uses of the aircraft and exclude fixed costs such as depreciation.54 As the Preamble notes, public comments also raised a concern that, because of the effects of accelerated depreciation methods and so-called bonus depreciation during the early years of an aircraft’s depreciable life, treating the year’s depreciation allowance as an operating cost for purposes of section 274 could overstate the actual economic costs of operating the aircraft and unfairly inflate the disallowance.

   Treasury and the IRS have responded to this latter concern by providing an elective straight-line method for determining the amount of depreciation to be treated as an operating expense for this limited purpose. Prop. Reg. § 1.274-10(d)(3) permits the taxpayer to compute depreciation for purposes of section 274 using a straight-line method over the aircraft’s class life (generally either 6 or 12 years)55. The bonus depreciation rules of section 168(k) are disregarded for this purpose, as are special provisions for New York Liberty Zone property and qualified Gulf Opportunity Zone property, so that the straight-line computation is based on the aircraft’s unadjusted depreciable basis.

   This elective straight-line method is used only in computing the amount of depreciation to be included in the aircraft’s operating costs for purposes of determining the entertainment disallowance and has no effect in computing the amount of depreciation otherwise allowable under section 168. Indirectly, however, using this elective method will affect the amount of depreciation that may be deducted with respect to the aircraft for the year. Under a two-step process, the taxpayer first computes the depreciation expense that is treated as an operating expense for purposes of section 274. Because the straight-line method generally will result in a smaller depreciation expense than would an accelerated depreciation method (at least in the early years of the recovery period), the aircraft’s pool of operating expenses for purposes of section 274 allocations (and thus the potential disallowance) is smaller than it would be absent this election.

   b. The straight-line depreciation election is easy to make but difficult to revoke. Making the election is straightforward. The taxpayer simply files an income tax return using the straight-line method to compute the amount of depreciation included in the aircraft’s operating expenses for purposes of section 274. Upon making this election, however, the taxpayer must use the straight-line method for all of its “taxpayer-provided” aircraft and must continue to use the method for the entire period in which it uses any such aircraft. This “all in” rule applies to any aircraft owned by the taxpayer as of the date of the election, as well as any subsequently acquired aircraft. The prefatory language of Prop. Reg. § 1.274-10(d)(3)(ii) should be clarified, however, to avoid confusion.56

   Once elected, the taxpayer must use this methodology unless and until it receives a private letter ruling from the IRS permitting its revocation.57 Consent to revoke the election will be granted only upon a showing of “compelling circumstances.” In addition to the cost, delay, and administrative burden frequently encountered in seeking a private letter ruling, the “compelling circumstances” standard typically is a difficult procedural hurdle to overcome. As a result, as attractive as this alternative method is (and its use is likely to be widespread), it should not be adopted lightly.

   c. The straight-line depreciation election can be a trap for the unwary if not made in the year of acquisition. With respect to aircraft that the taxpayer placed in service in earlier years, depreciation is determined by applying the straight-line method to the aircraft’s original cost basis over its class life, as if the taxpayer had used that methodology from the year the aircraft was placed in service. If the aircraft was acquired in a section 1031 exchange, the same approach is applied using the basis determined under section 1031(d).58 The class life of aircraft depreciated using 5-year MACRS is 6 years,59 and the class life of aircraft depreciated using 7-year MACRS is 12 years.60 Therefore, using the original cost to determine straight-line depreciation for aircraft placed in service in prior years will result in depreciation dollars that were previously subjected to (or pre-dated) the entertainment disallowance, being subjected to the disallowance a second time.61 In view of this double counting problem, companies with aircraft already in service should carefully consider whether the straight-line election is beneficial.

   Presumably, the IRS did not intend to produce the double counting of depreciation expense for taxpayers who likely believe that they are making a taxpayer-friendly election. The solution to the double-counting problem is for the final regulations to provide that the switch to the straight-line method is prospective using the aircraft’s adjusted basis at the beginning of the year of the election.

   d. Effect of the election to use straight-line depreciation on tax basis in the aircraft. After applying one of the prescribed methodologies for computing the portion of the pool of operating expenses that is allocable to entertainment flights and thus disallowed under section 274, the Proposed Regulations next require the taxpayer to allocate the disallowed amount on a pro rata basis “to all of the expenses disallowed by this section.”62 This pro rata allocation in turn determines the amount of depreciation otherwise deductible under section 168 (computed using the generally applicable depreciation conventions, including accelerated depreciation and bonus depreciation) that instead relates to entertainment flights and is disallowed by reason of section 274.

   The Proposed Regulations are unclear, however, whether this pro rata allocation of the disallowed amount between depreciation and other operating expenses (including meal and entertainment expenses) is to be made based on the aircraft’s depreciation allowance for the year computed under the accelerated methods of section 168 or, instead, is allocated based on the depreciation determined under the straight-line method of Prop. Reg. § 1.274-10(d)(3) and included in the pool of operating expenses subject to disallowance. The language of Prop. Reg. § 1.274-10(f)(2) supports both interpretations.

   This difference is significant because a special rule preserves the aircraft’s tax basis to the extent depreciation is disallowed by reason of its entertainment use.63 Under this rule, Treas. Reg. § 1.274-7 will apply to any depreciation that is disallowed by reason of being...
allocated to an entertainment flight. The Proposed Regulations also provide that, “In that case, the basis of an aircraft is not reduced for the amount of depreciation disallowed” under the Proposed Regulations. Taxpayers, however, should not read too much into this sentence.

Treas. Reg. § 1.274-7 applies to “facilities” that are used for both business and non-business purposes. Essentially, that provision bifurcates the facility into two assets, one used for business and one used for personal purposes. To the extent deductions are disallowed under section 274, the facility’s basis is adjusted for purposes of computing depreciation deductions and for determining gain or loss on the sale of the facility in the same manner as other property (such as a residence) that is used partly for business and partly for personal purposes.

The Proposed Regulations’ incorporation of Treas. Reg. § 1.274-7 is curious, because that rule specifically applies only to entertainment “facilities” rather than entertainment “activities,” but the Treasury and IRS have made clear that the Proposed Regulations are not intended to address issues arising from entertainment facilities. In addition, even though Treas. Reg. § 1.274-7 was promulgated more than 40 years ago, there is relatively little guidance on the mechanics of the basis adjustments it requires, and the Proposed Regulations provide no explanation or examples of its intended application in this context. Optimally, the final regulations will include more detail (including examples) on how the “facilities” rule is to apply in the context of entertainment “activities.”

In the meantime, the drafters of the Proposed Regulations have indicated informally that the special rule of Prop. Reg. § 1.274-10(f)(1) is intended to be a relatively simple mechanism for preserving the aircraft’s basis to the extent that depreciation is disallowed. During informal discussions, they posited the following example: Assume that an aircraft is purchased for $100x, has a recovery period of five years, and the taxpayer elects to depreciate the aircraft on a straight-line basis for all purposes. But for the application of section 274, the taxpayer would claim a depreciation allowance of $20x each year and would reduce the aircraft’s tax basis in the same amount. If under the Proposed Regulations, however, $5x of depreciation is disallowed each year by reason of entertainment flights, then the taxpayer instead is entitled to a depreciation allowance of $20x each year and would reduce the aircraft’s tax basis in the same amount.

If under the Proposed Regulations, however, $5x of depreciation is disallowed each year by reason of entertainment flights, then the taxpayer instead is entitled to a depreciation allowance under section 168 of only $15x in each of the five years. At the end of the five-year recovery period, if the taxpayer sells the fully depreciated aircraft in a taxable sale, it will have a tax basis of $25x in the aircraft (rather than zero) for purposes of computing gain or loss on the sale, reflecting the $5x basis preserved each year under Prop. Reg. § 1.274-10(f)(1). Presumably, the same basis will be available if the taxpayer instead disposes of the aircraft in a section 1031 exchange. The government did not intend for the preservation of the $5x basis each year, however, to affect the total amount of depreciation to which the taxpayer is otherwise entitled (i.e., the depreciable basis at the beginning of year 2 is $80x, rather than $85x).

5. 50-percent deduction limitation on meals and business entertainment. Curiously, one question left unanswered by the Proposed Regulations is how the 50-percent deduction limitation for meal and entertainment expenses set forth in section 274(n) dovetails with the section 274(e)(2) methodology. It appears that the 50-percent deduction limitation applicable to meals served on the aircraft will be applied first to avoid a double disallowance. This reading is consistent with the language of the Proposed Regulations to the effect that the expenses potentially subject to entertainment disallowance are “the fixed and variable expenses the taxpayer deducts in the taxable year.”

The 50-deduction limitation on entertainment is irrelevant to costs that are disallowed under section 274(a)(1) and does not apply to costs that qualify for the compensation exception in section 274(e)(2). Accordingly, the 50-percent deduction limitation is only relevant to otherwise deductible business entertainment. Fortunately, the legislative history to the Tax Reform Act of 1986 states that the 50-percent deduction limitation is not intended to apply to transportation costs. Nevertheless, since there do not appear to be any cases or rulings confirming this transportation exception, there is some risk that the 50-percent deduction limitation could apply to costs attributable to business entertainment air travel.

6. Expenses attributable to providing security. The Proposed Regulations provide that the presence of a bona fide business-oriented security concern as defined in Treas. Reg. § 1.132-5(m) will not convert an otherwise entertainment flight into a business flight. The Preamble notes that Treas. Reg. § 1.132-5(m) reduces, but does not eliminate, the imputed income at SIFL rates to a passenger traveling on a private aircraft for security reasons. In other words, the IRS believes that a bona fide business-oriented security concern will not preclude the application of the disallowance with respect to an entertainment flight.

Nevertheless, the Proposed Regulations do not discuss whether the presence of a bona fide business-oriented security concern will permit that taxpayer to treat the additional expenses associated with providing security on an entertainment flight as expenses falling beyond the reach of the entertainment disallowance. While the reference in the Preamble to Treas. Reg. § 1.132-5(m) suggests that such treatment of additional security-related expenses may not be barred, caution is dictated here since section 274(e)(2) addresses the taxpayer’s expense disallowance for entertainment rather than the imputation of income to the specified individual who is being protected.

E. Allocation of Expenses to Entertainment Use — Still Mechanical, But Taxpayers Can Now Take “Flight”

The Proposed Regulations remain loyal to the occupied seat allocation method that taxpayers have been struggling with since the issuance of the 2005 Notice. In response to comments that the method creates illogical results in allocating airplane costs to passengers on an equal basis no matter how many passengers are on a given flight, however, the Proposed Regulations do offer taxpayers a choice between the occupied seat method and a new flight-by-flight allocation method, which takes into account the number of passengers (and their reasons for flying) on each flight.

1. Details of the allocation methods. Under the flight-by-flight method, costs are first allocated among flights in proportion to the hours or miles of each flight. Then, the costs for each flight are allocated proportionately among each passenger. This eliminates the distortion under the occupied seat method, which allocates a proportionately greater amount of costs to flights with a greater
number of passengers (even though the flights are the same in hours or miles). The flight-by-flight method is a more logical method for apportioning costs with respect to a company’s use of an aircraft, particularly since the number of passengers on a given flight will not materially change the operating costs of the aircraft. Depending on the facts surrounding the entertainment use of the aircraft during the year, however, it will prove beneficial to have the choice between the two methods, since it may be difficult to predict which method will give rise to a lower deduction disallowance.

The taxpayer may elect for a given taxable year which of the two allocation methods to use for the year. The Proposed Regulations provide, however, that the choice must be consistently followed in that the taxpayer must use either the occupied seat method or the flight-by-flight method for all usage of all aircraft for the taxable year. Thus, the taxpayer may not use one method for one aircraft or group of aircraft with “similar cost profiles” and another method for another aircraft or other aircraft with their own “similar cost profiles.”

It appears that the choice of method — the Proposed Regulations do not call it an “election” — can be made on the taxpayer’s return (or perhaps on an amended return). As the choice does not affect timing, it is not a method of accounting and presumably can be changed from year to year.

Both methods start with the determination of the total direct and indirect aircraft costs for the entire year. Both methods then proceed with the steps leading to the determination of the costs attributable to entertainment use of the company’s aircraft for the year by specified individuals and thus subject to disallowance (after reduction for amounts treated as compensation to specified individuals and any amounts reimbursed to the company by specified individuals). Finally, under both methods the same amount of compensation imputed to (or reimbursed by) specified individuals for entertainment flights is subtracted from the tentative amount of the disallowed expenses with respect to each aircraft to determine the final amount of the disallowance for that aircraft.

The key difference between the two methods is the allocation procedure used to reach the amount of the tentative disallowance for entertainment use by specified individuals. Under the occupied seat method, the total costs for the year for the aircraft are first divided by occupied seat hours (or miles) flown by the aircraft for the year in order to come up with an average cost per occupied seat hour (or mile) for the entire year. Once the average occupied seat hour (or mile) cost is determined, that cost is multiplied by the number of specified individuals’ entertainment occupied seat hours (or miles) for the year.

In contrast, under the flight-by-flight method, total costs for the year for the aircraft are first divided by the total number of flight hours (or miles) of the aircraft for the year in order to derive the average cost of each flight hour (or mile) for the entire year. Once the average flight hour (or mile) cost is determined, that cost is multiplied by the number of hours (or miles) of each flight to determine the total cost of that flight. The resulting cost for the flight is allocated to the passengers on the flight on a per capita basis, including specified individuals flying for entertainment purposes.

The results under the two methods, depending on the facts, can be dramatically different. To illustrate, assume that a company’s aircraft is used for five round-trips during the year, all of equal length. On four of the round-trips, the single passenger is a specified individual flying for business purposes. The fifth round-trip consists of a specified individual, his spouse and two children flying to and from their vacation destination. Under the occupied seat method, 50 percent of the total costs of the aircraft for the year will be disallowed (less imputed compensation and any reimbursements for the vacation trip), because each occupied seat hour or mile is weighted equally. In contrast, under the flight-by-flight method only 20 percent of the total costs of the aircraft for the year will be disallowed.

The similarities and differences between the two methods can be further illustrated by another example. Assume that an aircraft with $20,000 in allocable expenses is used for two flights consisting of two hours each during the taxable year. Assume that on Flight A, there are four passengers — two specified individuals flying for entertainment purposes and the other two individuals, either non-specified individuals (flying for any purpose) or specified individuals flying for non-entertainment purposes. Assume also that on Flight B, there are two passengers, who are either non-specified individuals (flying for any purpose) or specified individuals flying for non-entertainment purposes.

Under the occupied seat method, the total costs of $20,000 are divided by the 12 total occupied seat hours (4 passengers x 2 hours for Flight A + 2 passengers x 2 hours for Flight B) resulting in an average cost per occupied seat hour of $1,667. This amount is then multiplied by 4, the number of occupied seat hours of specified individuals flying for entertainment (2 specified individuals on Flight A), resulting in a tentative expense disallowance to the taxpayer of $6,668. From this amount, the taxpayer subtracts any compensation reported for the specified individuals and any reimbursements from them to determine the final amount of the disallowance.

If the occupancy configuration of the two flights were that the two specified individuals flying for entertainment purposes were the only passengers on Flight A and the two other passengers from Flight A flew instead on Flight B, the result would be the same under the occupied seat method since the method does not take the number of passengers on the flights into account — every occupied seat is weighted equally irrespective of the flight profile.

Under the flight-by-flight method, the example will produce better or worse results than the occupied seat method, depending upon the two different flight configurations. Under this alternative, the total costs of $20,000 are divided by the four total flight hours for the year (two hours for Flight A and two hours for Flight B) resulting in an average cost per-flight hour of $5,000. The cost of each flight, therefore, is $10,000, which is allocated per capita among the passengers. This will result in $2,500 being allocated to each of the two specified individuals flying for entertainment purposes on Flight A since there are four passengers on that flight. Thus the taxpayer’s tentative disallowance will be $5,000, as compared with $6,668 under the occupied seat method. If the occupancy configuration of the two flights were different — the two specified individuals flying for entertainment were the only passengers on Flight A and the two other passengers from Flight A flew instead on Flight B — the result would be worse under the flight-by-flight method.
The Proposed Regulations allow
Although the IRS rejected an incre
Proposed Regulations direct the taxpayer to determine the excess
of the expenses for the entertainment segment are disallowed.
must allocate the expenses of a trip that involves at least one seg
vided individuals. Since the Proposed Regulations do not make clear
the excess occupied seat hours or miles is the amount disallowed, less
any amounts treated as compensation or reimbursed by the speci
ified individual to the taxpayer.75

An example in the Proposed Regulations illustrates this compu
ration in the case of a specified individual who flies as the only
passenger on a two-hour business flight from City A to City B, then
on a three-hour entertainment flight from City B to City C, and fi
nally on a four-hour return flight from City C to City A.76 Under
example, the entertainment cost allocation in this situation will be
determined by subtracting from the nine total occupied seat hours
the four occupied seat hours the specified individual would have
flown if he or she had flown solely from City A to City B and back
for business, resulting in an incremental five hours of deemed ent
ertainment occupied seat hours.

Obviously, this is a simplified example, and in reality multi-leg
trips involving business and entertainment legs may prove more
complicated to address.

Interestingly, the special incremental rule for mixed-purpose
flights in the Proposed Regulations relates only to the occupied
seat method, even though there is a need for a comparable rule
for the flight-by-flight method. Consider the above example. How
is the four-hour return flight from City C to City A to be accounted
for under that method? Counting it in full as an entertainment flight
because it is a return from the most recent entertainment leg seems
just as unfair as under the occupied seat method. (It does not appear
the flight could be excluded entirely as a non-entertainment flight.)
Clarification is needed in the final regulations on this issue.77

3. Aggregation of aircraft. The Proposed Regulations allow
taxpayers to aggregate the expenses of aircraft with “similar cost
profiles” for purposes of applying the rules.78 Aircraft are of similar
cost profiles if their operating costs per mile or hour are compara-
have the same engine type (jet or propeller), and have the
same number of engines. Other facts to be considered include, but
are not limited to payload, passenger capacity, fuel consumption
rate, age, maintenance costs, and depreciable basis. This is one area
where the IRS provided more specifics, though the rules are more
restrictive than those in the 2005 Notice, in that the guidance ap-
ppears to limit aggregation to situations where the aircraft are virtu-
ally identical.

4. “Deadhead” flights. Under the Proposed Regulations, a dead-
head flight is a flight on an aircraft returning without passengers
after discharging passengers or flying without passengers to pick
up passengers.79 Thus, in the simple case of a deadhead flight asso-
ciated with a single flight with passengers aboard, the regulations
provide that the deadhead leg will be treated as “having the same
number and character of passengers as the leg of the trip on which
passengers are aboard.” In effect, this deadhead rule counts the oc
cupied leg twice, giving it a double weighting compared with the
weighting of flights not associated with deadheading. This princi
ple applies for both the occupied seat method and the flight-by-
flight method.80 So far, so good.
The Proposed Regulations do not provide clear guidance, however, for the more complex situation where the deadhead flight occurs between two unrelated flights involving more than two destinations, such as an occupied flight from City A to City B, followed by a deadhead flight from City B to City C and then an occupied flight from City C to City A. In this situation, the Proposed Regulations provide that the allocation of expenses to the deadhead leg (under whichever of the two methods is being used) is “based on” the number, entertainment/nonentertainment purposes, and hours or distance traveled by the passengers on the occupied legs. The term “based on” arguably permits taxpayers to use any reasonable allocation method. For example, the taxpayer might classify the deadhead leg as one of the occupied legs, possibly based on the primary purpose of the occupied leg or the relative lengths of the occupied legs. The ambiguity in the term “based on” may also permit taxpayers to apply the principle that in multi-leg flights the entertainment portion of the flight is only the excess of the total hours (or miles) flown over the nonentertainment hours (or miles), analogous to the mixed-use analysis discussed above.

5. Aircraft owned by individuals; nondeductible business entertainment. Suppose an individual owns (or is lessee of) an aircraft and the individual operates the aircraft for business and personal purposes. In that case, the compensation exception in section 274(e)(2) will not apply, because the individual will not be receiving the flights as compensation from an employer. Instead, the costs of all personal flights will be disallowed simply because such flights will not qualify as business flights. Consistent with the existing regulations, the disallowance of costs with respect to personal flights will be determined under the primary purpose method. At the same time, if any of the flights (either business or personal) include passengers traveling for entertainment purposes, the possible effect of the entertainment disallowance will need to be considered.

The Proposed Regulations are not clear on whether they apply to all entertainment flights or only to entertainment flights provided as compensation. If the Proposed Regulations applied to all flights, then the sole proprietor would have to apply the per-passenger allocation rules with respect to any passengers (including the individual) traveling for entertainment purposes. If the Proposed Regulations, however, only applied to flights provided as compensation, then the sole proprietor will apparently be free to apply the primary purpose method in determining the entertainment disallowance under section 274(a)(1).

The first sentence of the Preamble characterizes the Proposed Regulations as applicable only to section 274(e)(2), and the first sentence of Prop. Reg. § 1.274-9(a) seems to closely track section 274(e)(2). Accordingly, these provisions suggest that the Proposed Regulations do not apply to an aircraft operated by an individual. On the other hand, Prop. Reg. § 1.274-10(a)(1) asserts the application of the entertainment disallowance rule with respect to all flights. Presumably, the final regulations will clear up this ambiguity. In the meantime, individuals operating aircraft bear some risk if they ignore the allocation rules.

The ambiguity similarly arises with respect to company aircraft used for nondeductible business entertainment flights. To the extent that such flights are not provided as compensation to anyone, the entertainment disallowance will apply under section 274(a)(1) and the compensation exception in section 274(e)(2) will not apply.

Until further classification is provided on whether the Proposed Regulations apply only to flights provided as compensation under section 274(e)(2), it is unclear whether nondeductible business entertainment flights are subject to the per-passenger allocation rules.

F. Status of the Primary Purpose Method

The Preamble explains that the IRS considered and rejected comments suggesting that entertainment or nonentertainment classification should be made for each flight as a whole undertaken primarily for business purposes, with the presence of passengers traveling for entertainment purposes not resulting in any entertainment disallowance because there would be no marginal cost of carrying those additional passengers. The primary purpose method typically minimizes the entertainment disallowance because, when there are both business and entertainment passengers, the primary purpose of the flight will ordinarily be a business purpose. Consistent with the Preamble, the Proposed Regulations provide that taxpayers can only use the occupied seat method or the flight-by-flight method to allocate expenses for purposes of the disallowance.

The rejection of the primary purpose method in the Proposed Regulations raises the question whether companies have a valid tax return reporting position to support the use of the primary purpose method. Once final regulations are promulgated, they will have the force of law of legislative regulations authorized by statute. The effective date of final regulations will be the date that final regulations are published. In the meantime, the 2005 Notice and the Proposed Regulations will apply. Presumably, final regulations will not be issued before the end of 2007.

Unlike final regulations, proposed regulations “carry no more weight than a position advanced on brief” by the Commissioner. It is therefore necessary to evaluate the merit of the IRS’s position that the disallowance of entertainment expenses should be calculated on a per-passenger basis rather than on a per-flight primary purpose basis. The Preamble states that Congress intended to use a per-passenger allocation method because section 274(e)(2)(B) “focuses on the recipient . . . not the purpose of the employer.” This inference is one possible interpretation, but its merit is not compelling.

The only function of section 274(e)(2)(B) is to limit the exception in section 274(e)(2) to the “expenses which do not exceed the amount of the expenses” included in the specified individual’s compensation. The entertainment disallowance of expenses is imposed by section 274(a)(1), which applies to the disallowance to “deduction[s] otherwise allowable” for entertainment activities. Under the plain wording of the statute, the entertainment disallowance can only apply to deductions otherwise allowable. Since no deductions would otherwise be allowable (as ordinary and necessary business expenses under section 162) with respect to a passenger traveling for personal entertainment purposes on a flight that is primarily for business purposes, there are no expenses that could potentially be subject to the entertainment disallowance with respect to such passenger. Accordingly, the interpretation of the statute presented in the Preamble directly conflicts with the plain language of the statute.
In addition, the Proposed Regulations’ allocation methods conflict with current law. The existing regulations under section 274 provide for the allocation of expenses among flights in proportion to miles traveled with no reference to a per-passenger allocation.\textsuperscript{98} In addition, courts have allowed costs to be allocated among flights based on flight hours, again with no per-passenger allocation.\textsuperscript{98} In fact, the extant regulations require that expenses be allocated based on the primary purpose of each flight.\textsuperscript{98} Likewise, the courts and at least one IRS revenue ruling and IRS publication hold that when a flight is primarily for business purposes, there is no per-passenger disallowance of costs for other passengers traveling for entertainment purposes.\textsuperscript{96}

Absent from the Preamble is any reference to published legislative history supporting the per-passenger allocation methods. In fact, the expressed intent of Congress has consistently supported the primary purpose method. The Conference Report to the 2004 tax law confirms that Congress carefully considered the Sutherland Lumber decision,\textsuperscript{97} in which aircraft costs were allocated among each flight, with no per-passenger allocation of costs.\textsuperscript{98} That Congress refrained from changing the established method of allocating costs among flights supports the proposition that Congress accepted the primary purpose method. In addition, in considering the 1962 and 1978 Acts, Congress confirmed its intention to have an exception to the entertainment disallowance for transportation facilities that does not diminish taxpayers’ existing ability to deduct the costs of ordinary business travel.\textsuperscript{99} Alas, the proposed per-passenger allocation methods, unless changed, would diminish those deductions.

Accordingly, the plain language of the statute, existing law, and legislative history consistently favor the primary purpose method. Nevertheless, taxpayers who use the primary purpose method in applying the entertainment disallowance of section 274(e)(2) should be prepared for IRS challenge on that point.

**G. Clarification of the Consistency Rules when Applying the SIFL Valuation Rules — Still a “Lose/Lose” Situation**

The 2005 Notice permits taxpayers who have elected to use their employees’ personal flights using the SIFL rules to value the entertainment use of the aircraft by specified individuals using general valuation principles,\textsuperscript{100} without violating the requirement to use only the special valuation rules once elected. In other words, the consistency requirement of the noncommercial flight valuation rule,\textsuperscript{101} which a taxpayer electing to use the SIFL rules must use to value all flights provided to employees during the year, will not be violated if the taxpayer values the specified individuals’ entertainment use of the aircraft by reference to fair market value, but continues to value flights for other employees and for specified individuals not traveling for entertainment using the SIFL formula. The Proposed Regulations continue the relief from the consistency requirement but remind taxpayers that consistency among groups is required. For example, if a company values the entertainment use of aircraft by one specified individual under the general valuation rule, it may not value the entertainment use of aircraft for any other specified individual under the SIFL rules. Moreover, the existing consistency rules continue to apply for valuing the entertainment use of aircraft for other employees (non-specified individuals) and for valuing the personal use of aircraft by specified individuals not traveling for entertainment purposes.\textsuperscript{102}

This relief from the consistency requirement permits taxpayers to minimize the effect of the deduction disallowance by applying fair market valuation to determine the amount to be treated and reported as compensation paid to the specified individual or the amount that the specified individual may reimburse. It may have the effect, however, of requiring more compensation treatment than the amount of the taxpayer’s costs allocable to the flight, in which event the taxpayer’s deduction is limited to the costs.\textsuperscript{103}

The Proposed Regulations ignore requests that taxpayers be permitted to determine compensation with respect to entertainment flights of specified individuals by reference to an amount (between the calculated SIFL value and fair market value) that would equal or approximate costs allocated to the entertainment use under the 2005 Notice’s occupied seat methodology. In other words, taxpayers are still in a “lose/lose” situation. For entertainment flights by specified individuals, taxpayers are limited to a deduction based on allocable costs of the entertainment flight if the fair market value imputed (or reimbursed) is greater than costs, and limited to a deduction equal to the imputed (or reimbursed) amounts if the allocable costs of operating the aircraft are greater than the SIFL value imputed (or reimbursed) amounts.

**H. Section 274(e)(2)’s Interplay with Section 162(m) — Having It Both Ways**

Having It Both Ways

The Preamble takes the position that any amount for the entertainment use of an aircraft that is treated as compensation to a specified individual who is also a “covered employee” as defined by section 162(m)(3) is subject to the deduction disallowance of section 162(m). Thus, to the extent the covered employee’s “applicable employee remuneration” for section 162(m) purposes exceeds $1 million, the taxpayer’s deduction is disallowed under section 162(m). In other words, the Preamble ignores the conceptual distinction between deductions based on aircraft cost and employee income based on the value of aircraft use, by applying the compensation deduction disallowance rules of section 162(m) to amounts that are treated as compensation because of entertainment use of corporate aircraft, even thought corporate deductions are otherwise based on the cost of the aircraft, rather than the value imputed to the employee.

**I. Automobiles**

Section 274(e)(2), as amended in 2004, and the definitions of “entertainment facility” and “entertainment” in the existing regulations apply to automobiles,\textsuperscript{104} even though the amendment was designed to address the disparity between aircraft operating costs and the SIFL rates.\textsuperscript{105}

The Proposed Regulations do not discuss automobiles. Applying the entertainment disallowance to employer-provided automobiles, particularly using a per-passenger allocation method, would impose an extraordinary administrative burden particularly on small companies. It is difficult to believe that Congress intended for individuals to document the names and number of passengers in their automobiles for every mile driven, and to further document which trips and which passengers are traveling for personal entertainment and personal nonentertainment purposes. The complexity of the entertainment disallowance calculation for an ordinary automo-
bile driven for 15,000 miles in a year would be burdensome in the extreme. Particularly, in view of the dollar amounts involved for an automobile, imposing such a requirement with respect to automobiles would be plainly unworkable. Therefore, the IRS should exempt automobiles from the entertainment disallowance rules.

**Transition Rule**

Until final regulations are promulgated, the taxpayer may rely on the rules in the Proposed Regulations or the 2005 Notice. Thus, if a particular issue is addressed in both the Proposed Regulations and the 2005 Notice, the taxpayer may rely on either set of rules, essentially cherry picking the more favorable rule. Where the Proposed Regulations include a rule on an issue that was not included in the 2005 Notice, however, the taxpayer may not rely on the absence of a rule in the 2005 Notice to apply a rule contrary to the Proposed Regulations.

**Conclusion**

The Proposed Regulations, like Notice 2005-45, penalize any entertainment use of company aircraft by a specified individual, regardless of the business reasons necessitating the flight. In spite of the IRS’s efforts to provide more guidance on how the entertainment disallowance should be determined under the two per-passenger allocation methods, the fundamental flaw in rejecting the primary purpose principle as the starting point remains. The Preamble encourages comments on specific issues by September 13, but taxpayers should not limit their comments to the mechanics of the rules set forth in the Proposed Regulations. Indeed, taxpayers should consider challenging the implementation of the per-passenger allocation methods on the grounds these methods are ultimately administratively unworkable and burdensome.

**Marianna G. Dyson** is a member of the Washington law firm of Miller & Chevalier Chartered, whose executive committee she currently chairs. She received her B.A. and J.D. degrees from the University of Louisville, and her LL.M. degree in Taxation from the Georgetown University Law Center. She served as Special Assistant for Fringe Benefits in the Office of IRS Associate Chief Counsel (Employee Benefits and Exempt Organizations). Ms. Dyson writes and speaks frequently about issues relating to executive compensation and fringe benefits. She may be reached at mdyson@milchev.com. **John B. Hoover** is an attorney with Dow Lohnes PLLC in Washington, DC. He received his B.S. degree from the University of Virginia, his J.D. and M.B.A. degrees from the University of Georgia, and his LL.M. degree in Taxation from Georgetown University Law Center. His is also a certified public accountant. Mr. Hoover is a frequent writer and speaker on tax issues involving company aircraft; this is his first article for The Tax Executive. He may be reached at jhoover@dowllohnes.com. The authors gratefully acknowledge the assistance of Lee H. Spence, of counsel for Miller & Chevalier Chartered, in preparing this article.

2. Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.
4. 72 Federal Register 33169 (June 15, 2007).
8. Section 274(e)(2) also includes a cross-reference to section 274(e)(9), which pertains to non-employees, the result being that the same deduction disallowance occurs with respect to entertainment flights provided to independent contractors who happen to be specified individuals or deemed specified individuals. I.R.C. § 274(e)(2)(B)(i).
9. See I.R.C. § 274(e)(2)(A). See also Prop. Reg. § 1.274-9. Section 274(e)(2) also requires the taxpayer to report the compensation on its tax return. In accordance with Temp. Reg. § 1.162-25T, the taxpayer arguably meets this requirement merely by deducting the operating costs of the aircraft on its return.
13. Id.
15. Although the Proposed Regulations are silent on who is responsible for treating the personal trip as compensation, presumably B, the common law employer of S, would be treated as the provider of the benefit for fringe benefits purposes even though A actually provided the benefit. Treas. Reg. § 1.61-21(a)(5) states that “[t]he ‘provider’ of a fringe benefit is that person for whom the services are performed, regardless of whether that person actually provides the fringe benefit to the recipient.” This is in contrast to the fringe benefit rules, which provide that retirees who became “control employees” after reaching age 55, or within three years before their retirement, must always be treated as control employees for valuation purposes. Treas. Reg. § 1.61-21(g)(11).
19. Id.
21. Id.
22. 1963-2 C.B. 129, Q&As 10 and 76.
23. Travel to another location to work (but not attend business meetings) would typically not qualify as business travel. Beckley v. Commissioner, 34 T.C.M. (CCH) 235, 238 (1975). That does not automatically mean, however, that the purpose of the trip is entertainment. See Ireland v. Commissioner, 89 T.C. 978, 983 (1987) (meetings at beachfront property were classified as business); Townsend Industries, Inc. v. United States, 342 F.3d 890, 894-96 (8th Cir. 2003) (fishing trip was “directly related” to business).
26. Since such flights are for company business, it should not be necessary to impute income to any company specified
individual for the customers’ travel. Because the flight would be subject to the entertainment disallowance, however, a company employee on the plane could not exclude it from income as a working condition fringe benefit. Nevertheless, where the customer flying for entertainment is flying for a company entertainment purpose rather than for entertainment as a personal guest of a specified individual who is also on the flight, there should be no attribution of the customer’s travel to the specified individual. This distinction becomes clearer in the case of a flight with multiple specified individuals and multiple company customers. Indeed, the Proposed Regulations do not spell out the rules for attribution of guests to specified individuals and invite comments on this issue. Preamble, 72 Fed. Reg. at 33172-33173.

32. 72 Fed. Reg. at 33171-33172.
33. Treas. Reg. § 1.274-2(e)(2)(i); Mediatworks, Inc. v. Commissioner, 88 T.C.M. (CCH) 73 (2004) (“The slightest use of a facility in connection with an activity which is of a type generally considered to constitute entertainment, amusement, or recreation operates under the text of section 274(a)(1)(B) to disallow any deduction as to that facility.”).
35. Treas. Reg. §§ 1.274-2(e)(3)(i) and (iii)(a) explain that expenses “with respect to” an entertainment facility are governed by the entertainment facility rules under section 274(a)(1)(B), while the “out-of-pocket” costs are governed by the entertainment expense rules under section 274(a)(1)(A).
36. A detailed analysis of the transportation facility exception to the entertainment facility disallowance is provided in an article published shortly before the issuance of the proposed regulations. John B. Hoover, Personal Use of Corporate Aircraft — Entertainment Versus Routine Personal Travel, 48 Tax Mgmt’t Memorandum (BNA) 195 (May 28, 2007).
37. 72 Fed. Reg. at 33171. The Preamble notes, in justification, that industry use of the term “operating costs” generally refers to all costs, including fixed costs such as depreciation and that the term “aircraft operating costs” was used in Sutherland Lumber to denote both fixed and variable costs for purposes of section 274(e)(2). The reference to industry use of the term “industry costs” is likely to be challenged by many in the aircraft industry.
41. Helwig v. Commissioner, 78 T.C.M. (CCH) 838 (1999). Arguably, the exception in section 274(f) could apply to an aircraft held for investment purposes, but corporate aircraft typically would not fit that characterization.
42. Id. (the Tax Court in Helwig merely accepted the litigants’ apparent consensus that interest expense is within the scope of expenses subject to disallowance).
43. See Treas. Reg. § 1.274-2(e)(3)(i). See also Rev. Rul. 63-144, 1963-2 C.B. 129, Q&A 45 (“The facility expenditure limitations cover depreciation and general operating costs such as rent, utility charges, repairs, insurance, salaries of watchmen, etc.”); TAM 9608004 (Feb. 23, 1996) (entertainment facility disallowance applied to “fuel and oil, insurance, pilot’s salary, repairs, hangar rental, and depreciation” with respect to an aircraft).
44. Even under the broad scope of the capitalization rules in section 263A, interest is not included in the general capitalization rules but is subject to a separate set of rules in section 263A(f).
45. In the absence of rules regarding the allocation of debt, the interest tracing rules under Temp. Reg. § 1.163-8T may be useful to companies seeking to take the position that their interest expense is not allocable to their aircraft.
47. Preamble, 72 Fed. Reg. at 33173.
48. In reaching this position, the IRS may have considered TAM 200214007 (Apr. 5, 2002), which discusses legislative history indicating that the exception applies “if that facility is legitimately involved in selling entertainment.” The TAM concludes that the exception applies when one S corporation provides a facility to a commonly owned S corporation for entertainment events. Accordingly, it would appear that, to the extent that there is a requirement to be in the business of selling entertainment, this requirement is met simply by engaging in the business of providing a facility used in entertainment. Although the Preamble should not have misstated the regulation, the misstatement should not ultimately restrict the scope of the adequate-and-full-consideration exception.
49. See TAM 200214007 (section 274(e)(8) applied to company that provided use of facility to related company, based in part on fact that company was paid fair value for the use of the facility); Rev. Rul. 63-144, Q&A 52, 53 (lessor not subject to entertainment facility disallowance on lease to related party with fair market rental rate and terms); Catalano v. Commissioner, 79 T.C.M. (CCH) 1632 (2000), aff’d 240 F.3d 842 (9th Cir. 2001) (IRS did not assert entertainment facility disallowance with respect to lessor’s expenses, even though related lessee was subject to entertainment facility disallowance due to its entertainment use of boat).
52. Currently, in order to obtain the net tax result under the adequate-and-full-consideration exception of having only a charter rate disallowed, it is necessary to obtain an FAA charter certificate or hire a charter operation. 14 C.F.R. part 135. Either way, the charter fees incur the 7.5-percent federal excise tax. See I.R.C. §§ 4261, et seq. Permitting the disallowance to be calculated at charter rates will be easier to administer.
56. That provision begins by stating, “If the taxpayer elects to use this paragraph (d)(3) with respect to aircraft placed in service in taxable years before the current year . . . .” This language could be interpreted to mean that the taxpayer may elect to apply the straight-line method only to aircraft purchased after the date of the election rather than to all taxpayer-provided aircraft. This does not appear to be the intent of the Proposed Regulations.
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57. Prop. Reg. § 1.274-10(d)(3)(iii). Although the use of either straight-line or accelerated depreciation methods generally affects only the timing of the recovery of the taxpayer’s basis in the aircraft, section 274 results in a permanent disallowance of a portion of the deduction for operating expenses (including depreciation) to which the taxpayer is otherwise entitled. Thus, the election to use the straight-line method to compute the amount of operating expenses potentially subject to permanent disallowance in a given year will affect the taxpayer’s lifetime income. As a result, while choosing between straight-line and accelerated depreciation methods generally is a method of accounting in the context of sections 167 and 168, the straight-line election is not a method of accounting in the context of the Proposed Regulations, as is reflected in the inability to use the traditional accounting method change procedures to alter the election.

59. Rev. Proc. 87-56 (asset class 00.21).
60. Rev. Proc. 87-56 (asset class 45.0).
61. For example, an aircraft depreciated using 5-year MACRS with a half-year convention would be depreciated by approximately 52 percent in the first two years (20% + 32%). If the company elects to use straight-line depreciation beginning in the third year for purposes of the entertainment disallowance, the aircraft will be depreciated using the straight-line method over the remaining 4.5 years of its 6 year class life, thereby subjecting another 75 percent (4.5/6) of its original cost to the entertainment disallowance. Therefore the straight-line election in this situation would cause a total of 127 percent (52% + 75%) of the aircraft’s cost to be subject to the disallowance.

64. T.D. 6659 (June 24, 1963).
67. Joint Committee on Taxation, 99th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 64 (1987). The Blue Book explains that certain ancillary costs would be subject to the disallowance, but “the cost of transportation . . . is not reduced pursuant to this rule.” Based on this legislative history, which also appears in the Senate and House Reports, one commentator has explained that “travel and transportation costs are not themselves subject to the cut-back, and therefore, if incurred in the context of providing entertainment and meals, remain deductible in full.” Ira B. Stechel, Entertainment, Meals, Gifts and Lodging – Deduction and Recordkeeping Requirements, 520 Tax Mgmt’t. (BNA) § I.E.2.a(1), at A-71 to A-72 (2003) (explaining that travel and transportation costs are not subject to the 50-percent deduction disallowance).

68. Prop. Reg. § 1.274-10(b)(3) explains that “business entertainment air travel” is entertainment air travel that meets the “directly related” or “associated with” business tests under section 274(a)(1)(A).
70. Preamble, 72 Fed. Reg. at 33171.
71. In addition to requiring taxpayers to choose between the occupied seat and flight-by-flight methods, the consistency requirement also requires taxpayers to choose between basing the calculation on seat hours or seat miles. Prop. Reg. §§ 1.274-10(e)(1), -e(2)(i), and -e(3)(iii).
72. For purposes of this discussion, all references to “aircraft” include a group of aircraft whose costs have been aggregated because of similar cost profiles.

73. For example, a flight of two hours occupied by two passengers would result in two occupied seat hours for that flight.
74. Prop. Reg. § 1.274-10(e)(2)(iii). Presumably, the IRS is referring to entertainment legs not involving specified individuals, because it is otherwise unclear how an entertainment leg would not otherwise result in a disallowance.
75. This comparison approach is similar to the rule available for determining the value of the personal portion of a trip under the SIIFL rules of Treas. Reg. § 1.61-21(g)(4)(iii) when the trip is primarily for business purposes.
77. Indeed, one gets the impression that flight-by-flight may have been a late addition to the Proposed Regulations and that all issues arising from the addition have not been fully thought through.
79. Prop. Reg. § 1.274-10(f)(3)(i). The 2005 Notice had inartfully referred to a deadhead flight as involving “an aircraft returning empty from a flight after discharging passengers or traveling empty to pick up passengers.” IRS Notice 2005-45, § B.6 (emphasis added)
80. Id.
82. The individual could operate the aircraft by piloting it himself or by personally hiring a pilot. The same analysis would apply to an aircraft owned (or leased by) an individual’s disregarded limited liability company.
84. 72 Fed. Reg. at 33170.
85. Ordinarily, operating an aircraft in an individual capacity is not a prudent tax strategy. While the per-passenger allocation rules might not apply, the unavailability of the compensation exception in section 274(e)(2) means that the costs of personal flights are completely disallowed even if they are for nonentertainment purposes. In the case of an aircraft in a single member limited liability company, new members could be added to shed disregarded status and trigger the section 274(e)(2) exception.
86. “Nondeductible business entertainment” flights are defined to mean flights for entertainment purposes that (a) meet the ordinary and necessary business expense test under section 162, but (b) fail the “directly related” and “associated with” business tests under section 274(a)(1)(A). An example would be flying a group of customers to a resort location to play golf when no business is discussed and the trip does not meet the requirement under section 274(a)(1)(A) that it be immediately preceding or following a substantial business discussion. Such flights may fall within the section 274(e)(2) exception to the extent that company employees are on board.
87. There could be insignificant marginal costs attributable to additional passengers, such as catering. The costs are ignored for purposes of this discussion.
92. The individual could operate the aircraft by piloting it himself or by personally hiring a pilot. The same analysis would apply to an aircraft owned (or leased by) an individual’s disregarded limited liability company.
94. 72 Fed. Reg. at 33170.
95. 95 T.C. 495 (1990), aff’d, 12 F.3d 1005 (10th Cir. 1993).
96. Temp. Reg. § 1.274-5T(b)(6)(i)(B) provides that a taxpayer’s business
use of an aircraft is determined based on mileage for purposes of the substantiation requirements in section 274(d). These substantiation rules apply to any deduction with respect to travel, entertainment (including entertainment falling within an exception in section 274(e)) and listed property. Temp. Reg. § 1.274-5T(a).


98. 114 T.C. at 198.

99. The Joint Committee’s general explanation of the 1978 Revenue Act states that “[e]xpenses of an automobile or an airplane used on business trips will continue to be allowed.” Staff of J. Comm. on Taxation, 95th Cong., 1st Sess., General Explanation of the Revenue Act of 1978, 208 (J. Comm. Print 1978). The court in Beckley v. Commissioner, 34 T.C.M. (CCH) 235, 240 (1975), commented as follows that the entertainment facility rules were not to affect ordinary business travel:

We believe the regulations make it clear that the expenses of nonentertainment use of a transportation type facility (i.e., for business transportation) are not affected by the entertainment facilities rule. In such situations only the regular business expense rules apply (without the application of the entertainment facility deduction test).

100. See Treas. Reg. § 1.61-21(b)(6) (fair market value of employer-provided piloted flight is equal to the amount that an individual would have to pay in an arm’s-length transaction to charter the same or a comparable piloted aircraft for that period for the same or comparable flight).

101. Treas. Reg. § 1.61-21(g)(14).


103. Of course, if the charter safe harbor is adopted by the final regulations and taxpayers are permitted to base compensation on the safe harbor amount, this discrepancy between compensation and cost is potentially eliminated.


105. H.R. Rep. No. 108-755, at 783-4 (2004). The amendment to section 274(e)(2) was initially proposed as an amendment only with respect to aircraft. Corporate Jet Tax Shelter Reform Act of 2004, H.R. 4352, 108th Cong., 1st Sess. § 2 (2004). That the amendment to section 274(e)(2)(B) was broadened to include all forms of entertainment demonstrates that it is not restricted to aircraft.


107. For example, taxpayers may continue to rely on the less stringent rules of the Notice for aggregating aircraft in lieu of the stricter rules of the Proposed Regulations, since both the Notice and the Proposed Regulations address the issue.