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New Personal Use of Corporate Aircraft Tax Rules: Notes for Tax and Executive Compensation Practitioners

On August 1, 2012, the Internal Revenue Service (the "IRS") published final regulations concerning the tax deductibility of corporate expenses associated with the personal use by employees of corporate aircraft.[1] As noted below, these rules may have implications for those involved with public-company executive compensation disclosure, as well as of course for tax practitioners who must apply the rules to prepare federal income tax returns.[2] Generally, the principal takeaways are as follows:

- The final regulations provide guidance on statutory rules that significantly limit the deduction a corporate taxpayer may take for expenses relating to the use by officers and directors, and other "specified individuals" (as defined below), of company aircraft for personal use. Generally, the deduction is limited to the amount taken into account as compensation income by the specified individual.[3]

- The final regulations set out a framework for the tax allocation of costs between business and personal users of an aircraft, and to so-called "dead-head" flights, for purposes of determining the deduction amount to be disallowed in respect of specified individuals. Those allocation rules may be of interest to those seeking to fashion "best-practices" methodologies for making such allocations for executive compensation disclosure purposes.

[1] The final regulations can be found at http://www.gpo.gov/fdsys/pkg/FR-2012-08-01/pdf/2012-18693.pdf. These regulations obviate IRS Notice 2005-45 and finalize regulations originally proposed on June 15, 2007 (72 Fed. Reg. 33169 (June 15, 2007)) and later corrected on July 12, 2007, and were required by amendments to the American Jobs Creation Act of 2004 ("AJCA") and the Gulf Opportunity Zone Act of 2005. The final rules are effective for tax years beginning after August 1, 2012.

[2] To be clear, the tax regulations do not impact the executive compensation disclosure rules of the Securities and Exchange Commission ("SEC").

[3] The rules for income inclusion by employees arising from personal use of corporate aircraft are beyond the scope of this note. Generally, employees may utilize the usually taxpayer friendly standard industry fare level (or "SIFL") rates for purposes of determining the amount of income inclusion. Because of the relatively small amounts required to be included in income, the import of the AJCA amendments to Section 274 and the final regulations is to significantly limit the employer's allowed deduction.

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- The final regulations define the class of persons subject to the special disallowance rules – i.e., "specified individuals" – by reference to the short-swing profit reporting rules under Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")[4]. We note that:
  - Because of the added tax consequences now resulting from being a reporting person, the cross-reference in the final regulations may cause some companies to rethink the methodology by which their executives are classified as reporting persons under Section 16; and
  - The final regulations appear to require companies to determine who would be reporting persons for each of their subsidiaries, as if the subsidiaries were subject to the Section 16 reporting rules. Because of the expansive definition of "specified individuals" in the final regulations, the tax rules would now apply to directors and officers of direct and indirect subsidiaries of parent companies, which could result in large numbers of relatively low-level employees being treated as "specified individuals." This may have the greatest practical implications where such employees are engaged in business travel but are permitted to bring spouses and family members along as guests, who would then be subject to the new rules, thus raising the possibility of substantially complicating compliance with the final regulations and increasing the loss of deduction.

Background

In *Sutherland Lumber-Southwest Inc. v. Commissioner*, 114 T.C. 197 (2000), the Tax Court held that so long as an employer treated the value of non-business flights as income to an employee under the fringe benefit rules of Section 61, the employer could deduct the entire cost of using corporate aircraft for non-business purposes, and that the amount of this deduction would not be limited to the amount actually includable in the employee's income. In response, in the AJCA, Congress amended the language of Sections 274(e)(2) (expenses treated as compensation) and 274(e)(9) (expenses includable in income of persons who are not employees), limiting the employer's deduction for personal use of goods, services and facilities (including the use of business aircraft) by "specified individuals" who are employees of the taxpayer, in the case of 274(e)(2), and non-employees of the taxpayer, in the case of 274(e)(9), to the amount includable in income by the employee or non-employee as compensation, as the case may be. The treatment of employees and non-employees who were not included in the definition of "specified individuals" was unaltered under the AJCA. Notice 2005-45, issued shortly after the AJCA amendment was enacted, provided guidance

[4] All section references herein are to the Internal Revenue Code of 1986, other than references to Section 16 of the Exchange Act.

on implementing the new statute, specifically addressing expenses paid or incurred in connection with the use of aircraft as entertainment, and, among other things, setting forth specific rules for calculating the expenses of aircraft use and allocating such expenses to specific flights. The final regulations largely maintain the rules established by Notice 2005-45, issued in response to the changes implemented by the AJCA and the subsequent proposed regulations.

Final Regulations

The final regulations address the treatment of "specified individuals" and persons who are not "specified individuals," and the calculation and allocation of the expenses of aircraft use. In the case of non-"specified individuals," the general statutory framework, interpreted by *Sutherland* as described above, continues to apply.

In the case of "specified individuals," the final regulations provide that the deduction of expenses incurred through personal use[5] of an employer-provided aircraft is disallowed except to the extent the amount does not exceed the amount which is includable in income, or reimbursed (in which case there is income to the employer in respect of the reimbursement, and an offsetting deduction for the expense), by the individual.[6]

"Specified individuals" are those individuals who are subject to reporting obligations under Section 16(a) of the Exchange Act (i.e., officers, directors and 10% shareholders of public companies) or who would be subject to reporting under Section 16(a) if the taxpayer had publicly traded equity securities.[7] We note that companies sometimes designate persons

[5] Expenses incurred for business entertainment air travel are not subject to disallowance under these rules. "Business entertainment air travel" is entertainment air travel "aboard a taxpayer provided aircraft that is directly related to the active conduct of the taxpayer's trade or business or related to an expenditure directly preceding or following a substantial business discussion and associated with the active conduct of the taxpayer's trade or business."

[6] The staff of the SEC's Division of Corporation Finance has issued guidance concerning the obligation to disclose the aggregate incremental cost and type of perquisites provided to "named executive officers" of public companies. The guidance provides that if the aggregate incremental cost to a company of personal use of corporate aircraft by an executive is fully reimbursed by the executive, the use of the aircraft does not have to be disclosed as a perquisite. Exchange Act Regulation S-K Compliance and Disclosure Interpretation 119.07 (July 3, 2008). While the determination of the "cost" in question differs, the effect of reimbursement is similar. We note, however, that reimbursement by employees for personal use of company aircraft may raise issues under the Federal Aviation Act.

[7] The definitional cross-reference calls to mind the issues arising from the Internal Revenue Code's definition of the term "covered employee" under Section 162(m) by reference to the group of "named executive officers" for whom compensation disclosure is required by the SEC's proxy disclosure rules. That cross-reference led to a surprising tax result more than a decade after the passage of Section 162(m), when the number of executives subject to the deductibility limitation of Section 162(m) was reduced from five persons to four because the SEC changed its proxy disclosure rules. See IRS Notice 2007-49 (June 5, 2007). In the current context, the cross reference to reporting persons under Section 16(a) raises the immediate question of whether a representative of an entity director (i.e., an entity deemed to be a director by deputization) would be regarded as a "specified individual" for purposes of the final regulations, and if so whether all employees of that entity travelling on corporate aircraft in their capacities as such would be required to be accounted for as "specified individuals." "Deputization" refers to an entity that is deemed to be a director of a company by reason of having

as subject to the reporting rules of Section 16(a) who may not need to be so designated.[8] Such companies may now wish to reconsider that approach in order to avoid the risk of expense disallowance. For partnership purposes, a "specified individual" includes any partner that holds more than a ten percent equity interest in the partnership, or any general partner, officer, or managing partner of a partnership. A taxpayer's "specified individuals" include "specified individuals" of those parties related to the taxpayer under Sections 267(b) or 707(b), such as companies sharing a common control group. As a result, as noted above, it appears that any person who would be a reporting person of a majority-owned subsidiary of a public company, if the private subsidiary were itself subject to the reporting rules, would be treated as a specified individual. Finally, a "specified individual" will be treated as having had personal use of company aircraft when it is provided to another individual because of his or her relationship to the specified individual, if the personal use is a fringe benefit to the specified individual under Section 61(a)(1) (without regard to any exclusions from gross income).

The principal other noteworthy aspects of the final regulations are summarized below:

- Expenses that are potentially subject to disallowance under the final regulations include all the expenses of operating the aircraft, whether fixed or variable, including costs relating to salaries (pilots, maintenance and other personnel), meal and lodging expenses of flight personnel, take-off and landing fees, maintenance flights, onboard refreshments, amenities and gifts, hangar fees, management fees, fuel, tires, maintenance, insurance, title, registration and inspection, depreciation, interest on debt secured by or properly allocated (in accordance with a tracing regime established in generally applicable Treasury regulations) to an aircraft, and all costs paid or incurred for aircraft leased or chartered to the taxpayer. The IRS rejected commentator requests to adopt a "charter rates" safe harbor as an alternative to determining actual expenses.

- In calculating expenses allocable to a "specified individual" that may be subject to disallowance:

    - Expenses allocable to a lease or charter of an employer's aircraft to an unrelated third party in an arms' length transaction are not subject to expense disallowance;

"deputized" a person to sit on the board of directors of the company to act on behalf of the entity. Blau v. Lehman, 368 U.S. 403 (1962).

[8] Typically, an over-inclusive approach may be adopted because of a desire to treat all executives with specified titles as having the status of being among the top group of senior executives, and there has been little if any potential negative impact of that approach.

- Multiple aircraft with similar cost profiles (determined in accordance with the final regulations) may be aggregated; and

- Taxpayers are permitted (but are not required) to elect to use straight-line depreciation for all of the taxpayer's aircraft over the class life of the aircraft (or aggregated group of aircraft) for determining the amount of depreciation expenses that are potentially subject to disallowance, even where the taxpayer uses a different methodology to calculate depreciation for other tax purposes. To avoid the possibility that making this election would cause a taxpayer to have disallowed depreciation expense in excess of the cost of the aircraft, the regulations clarify that the amount of depreciation permitted in determining the depreciation allowance in any taxable year cannot exceed the allowable depreciation for that year. Where a taxpayer uses the straight-line methodology and class life for any aircraft that it operates, the taxpayer must use the same methodology for all depreciable aircraft it operates for the entire period of operation.

- The disallowance rule applies to aircraft owned by or leased or chartered to a taxpayer but does not apply to travel on regularly scheduled commercial flights where at least 90% of the seats were available for sale to the general public.

- The regulations reference the definition of "entertainment" (i.e., personal use) provided in Treas. Reg. §1.274-2(b)(1)(ii) but add that travel to attend a family member's funeral is a specific example of personal travel that is not considered "entertainment."[9] The preamble reiterates that the existence of a "bona fide security concern" does not justify recharacterizing personal use of an aircraft as business use.

- For allocating expenses to personal use flights, taxpayers may use either the "occupied seat method" or the "flight-by-flight method." The IRS rejected commentator suggestions to adopt a "primary purpose" test, under which only the incremental expense of individuals engaging in personal travel would be disallowed if the flight's primary purpose was business-related. Appendix A of this note illustrates the two methodologies.

- Allocation of expenses to "deadhead flights" (i.e., flights having no passengers but en route to picking up or from dispatching passengers) is based on the number of passengers on board for all occupied legs of the entire trip, the character of the travel of the passengers on board (personal versus business) and

[9] To the extent an employee's use is not classified as entertainment, the final regulations would not limit the employer's deduction.

the length in hours or miles of the entire trip, including the deadhead flights. Appendix B of this note illustrates these rules.

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APPENDIX A

Occupied Seat Hour or Miles Method

The taxpayer may choose whether to use occupied seat hours or miles but must use the chosen method consistently for all flights of all aircraft for the taxable year. Computation of expenses allocated to entertainment flights under the occupied seat hours or miles method requires determination of four values:

A. The total expenses for the year;

B. The number of occupied seat hours or miles – the occupied seat hours or miles for a flight is equal to the product of the number of hours or miles flown and the number of seats occupied on that flight (e.g., a flight of 6 hours with 3 passengers results in 18 occupied seat hours);

C. The cost per occupied seat hour or mile (A divided by B); and

D. The number of hours or miles of entertainment by a specified individual.

Note that there is a special rule for allocating expenses of multi-leg trips involving both business and entertainment legs when using the occupied seat hours or miles method: the taxpayer must allocate expenses of a trip by a "specified individual" that involves at least one segment for business and one segment for entertainment between the business travel and the entertainment travel unless none of the expenses for the entertainment segment are disallowed. The entertainment cost of a multi-leg trip is the total cost of the flights (denominated in occupied seat hours or miles) minus the cost of the flights that would have been taken without the entertainment segment(s).

Flight by Flight Method

All expenses for the taxable year are totaled and then divided by the number of flight hours or miles for the taxable year to determine the cost per hour or mile. Expenses are allocated to each flight by multiplying the number of miles by the cost per mile or the number of hours by the cost per hour; the cost per flight is divided by the number of passengers to determine the cost per passenger.

APPENDIX B

Example of Determination of Disallowed Expenses for Deadhead Flights of Multi-Flight Trips

Assume a three-legged flight where the legs are as follows:

- Leg #1 (City A to City B): 6 hours, 12 passengers (8 for business, 4 specified individuals for entertainment)
- Leg #2 (City B to City C): 4 hours, no passengers
- Leg #3 (City C to City A): 2 hours, 12 passengers (6 for business, 6 specified individuals for entertainment)

Using the occupied seat or hour method:

- There are 96 occupied seat hours (i.e., 12 passengers × 6 hours (72) for Leg #1 plus 12 passengers × 2 hours (24) for Leg #3), of which:
    - 60 occupied seat hours are for business (i.e., 8 passengers × 6 hours (48) for Leg #1 plus 6 passengers × 2 (12) hours for Leg #3) and
    - 36 occupied seat hours are for entertainment (i.e., 4 passengers × 6 hours (24) for Leg #1 plus 6 passengers × 2 (12) hours for Leg #3).
- 36 occupied seat entertainment hours divided by 96 total occupied seat hours yields 37.5% percent of total occupied seat hours of the two occupied flights for entertainment.
- Leg #2 (the deadhead leg) equals 1/3 of the total flight time of 12 hours.
- Therefore, under the occupied seat or hour method, the deadhead leg is deemed to have provided one-third of the total 96 occupied seat hours, or 32 occupied seat hours (96 × 1⁄3 = 32). Of the 32 deemed occupied seat hours, 37.5 percent, or 12 deemed occupied seat hours, are treated as entertainment.

Using the flight by flight method, given the same facts:

- Of the 24 passengers on the occupied flights, 10 passengers, or 41.7 percent, are traveling for entertainment purposes.
- Assuming an annual cost per flight hour of $1,000, $4,000 is allocated to the 4-hour deadhead leg.
- Therefore, under the flight by flight method, 41.7 percent of the $4,000, or $1,667, is treated as an expense for entertainment.

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