The New Rules for Personal Use of Business Aircraft: What You Need to Know and Do

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In recent years, the media, Internal Revenue Service and Securities and Exchange Commission have taken a dim and skeptical view of private aircraft use by businesses. There is a general perception that personal use of business aircraft is extravagant and difficult to justify (despite long-standing and numerous FAA, IRS and corporate rules governing such use). Just last month, a prominent student loan company was reported to be under IRS audit for allowing company officers and their family to use its private jet for personal purposes.

This environment has spawned laws and rules that are designed to identify and prevent perceived abuses, but some of these rules go beyond preventing abuse and are quite complicated. The new IRS Tax Regulations for personal use of business aircraft are perhaps an example of needless complexity, but the new rules do offer a number of ways to plan personal flights using business aircraft. Knowing how these rules apply to you and how you can make them work to your advantage will keep you from paying more taxes than necessary.

Entertainment Use of Business Aircraft
Generally, a company can deduct all ordinary and necessary expenses paid or incurred during a tax year in carrying on any trade or business. However, no deduction is allowed for an activity generally considered to be entertainment. If a company allows its officers, directors and more-than-10% owners (a group defined by the IRS as "specified individuals") to use the company's aircraft for entertainment purposes, the company could lose a substantial amount of tax deductions relating to the aircraft and greatly increase the net cost of owning and operating the aircraft.

The IRS considers "entertainment" use of business aircraft to be any activity that is generally and objectively treated as entertainment, amusement or recreation. "Entertainment" does not include travel for the company's business purposes and for reasons such as medical purposes, attending funerals, participating in charitable activities and attending to other business activity. The IRS would probably consider any other personal use of a business aircraft to be "entertainment" and the related aircraft expenses subject to disallowance (except to the extent included as compensation by a specified individual).

When aircraft use is "entertainment," the company loses its ability to deduct (by disallowance) some aircraft ownership and use costs. As you might imagine, the disallowance calculation can be complex. How do you treat a flight that has one leg pure business and another leg entertainment? What if some passengers are making a business trip and others are taking a pleasure trip? Do you allocate deduction disallowances by seats, miles or both? The IRS tackled these issues with new Tax Regulations that are predictably complex, but which actually give useful direction.

New Relaxed Tax Rules

Although complicated, the new IRS Regulations include a number of rules that provide planning opportunities that can ease a company's tax burdens.

Generally, the cost of entertainment use of a business aircraft (in terms of disallowed tax deductions) can be much higher than an individual commercial flight's cost. To determine aircraft entertainment use expenses, a company must take into account all of the operating costs of maintaining and operating the aircraft. Industry use of the term "operating costs" generally refers to all costs, fixed and variable, including fuel, crew salaries, take-off, landing and hangar fees, maintenance, management fees, insurance and depreciation claimed on the taxpayer's tax return. Therefore, the IRS requires that all such variable and fixed costs be included when calculating aircraft entertainment use expenses.

This calculation method can be particularly painful for taxpayers that are depreciating their aircraft on an accelerated basis under the modified accelerated cost recovery system (MACRS), since disallowed accelerated depreciation results in large amounts being disallowed in the early years of aircraft ownership. However, the IRS did not want unintended, excessive, deduction disallowances for entertainment use of aircraft for taxpayers using accelerated depreciation, since this is inconsistent with Congressional intent to allow accelerated depreciation on aircraft as an incentive to purchase aircraft. Therefore, the Regulations permit a taxpayer to depreciate an aircraft on a straight-line basis (instead of MACRS) over an aircraft's class life when calculating disallowed deductions for entertainment use. As you can see, this becomes complicated because now the taxpayer is generally using accelerated depreciation on the aircraft under MACRS, but for purposes of calculating deduction disallowances for entertainment use of business aircraft, the taxpayer can use a straight-line method of depreciation. This complexity is, however, a benefit to the taxpayer since it will reduce the amount of aircraft expenses subject to deduction disallowance.

In addition, under the new Tax Regulations a taxpayer's investment or "basis" in its aircraft is not reduced for tax purposes by any depreciation disallowed due to entertainment use by specified individuals. Without this rule, a taxpayer would suffer both depreciation disallowances and a reduction in its basis in the aircraft, even though the taxpayer was unable to deduct the depreciation (i.e., heads I win, tails you lose). The benefit of preserving the taxpayer's basis is that when the aircraft is eventually sold, the taxpayer will have less depreciation "recapture" and so less taxes when the aircraft is sold.

Another planning opportunity exists if you are willing to lease or charter your aircraft to unrelated third parties. Under the new Tax Regulations, expenses allocable to an aircraft's charter or lease to an unrelated third party in a bona-fide business transaction for adequate and full consideration are not subject to disallowance for such periods. If properly structured, certain fixed costs can be passed on to the unrelated third party, thereby reducing your total aircraft expenses and deduction disallowances.

Under the new Tax Regulations, you will also want to avoid having deadhead flights after entertainment flights. An aircraft returning without passengers after discharging passengers or flying without passengers to pick up passengers (deadheading) is treated as having the same number and character of passengers as the leg of the trip on which passengers are aboard for purposes of determining deduction disallowances for an aircraft's entertainment use. Whenever possible, arrange to schedule a deadhead flight as a business flight, or possibly a chartered flight, so as to prevent additional deduction disallowances that will otherwise apply to that flight.

Finally, the new Tax Regulations relax the fringe benefit "consistency rule" and allow a company to allocate more compensation to specified individuals on entertainment flights, thereby further reducing any deduction disallowances to the company for the entertainment use of its aircraft. The deduction disallowance for entertainment use of a business aircraft does not apply to the extent that a company treats the flight as compensation to a specified individual. Therefore, the more compensation realized by a specified individual for an entertainment flight, the less deduction disallowance suffered by the company. The new Tax Regulations permit a company to value the entertainment use of aircraft by specified individuals under the general fair market value (charter rate) rule, but continue to value flights for other employees and for specified individuals that are not using the aircraft for entertainment purposes under either the lower SIFL formula or the charter rate rule.

Three Ways to Skin a Cat
In order to determine the amount of disallowed deductions caused by entertainment use of a business aircraft, the IRS Tax Regulations allow you to choose one of three different methods. Three different methods seems unduly complicated, but it gives you the opportunity to apply the method that gives you the best tax result because you can choose the preferred method after the tax year's end.

In general, it appears that the "flight-by-flight" method will give the most accurate results. Under the "flight-by-flight" method, a company will first add up its total aircraft expenses for the year and divide that amount by the total number of flight hours or miles for the year to determine the "cost per hour" or "cost per mile." So, for example, if all aircraft expenses for the taxable year are $3 million, and there are 300 flight hours and 120,000 miles, then the "cost per hour" is $10,000 and the "cost per mile" is $25. Second, the company will look at each flight and multiply the number of miles or hours for each flight by the above determined "cost per hour" or "cost per mile." So, if a flight is five hours and the aircraft traveled 2,000 miles, then the flight's cost was $50,000 using either "cost per hour" or "cost per mile." Finally, the company will allocate each flight's expense to each passenger to determine the disallowed amount. For example, if the total expense allocated to a flight is $50,000, and there are five passengers, then the expense allocated to each passenger is $10,000. If two of these passengers are specified individuals traveling for entertainment purposes, then the company is generally subject to a $20,000 deduction disallowance.

Although the above method may be administratively burdensome, the financial results will probably be better for the company than using the alternative, broad-brush methods that the IRS allows for calculating the deduction disallowance. Under the "occupied seat hour" or "occupied seat mile" formulas, the deduction disallowance is based upon the number of occupied-seat hours or miles used for personal entertainment flights of specified individuals. However, these methods tend to create distortions that artificially inflate the deduction disallowances for entertainment flights, especially when the aircraft is flown infrequently for entertainment purposes, but with a higher number of entertainment flight passengers.

To assist clients with deciding upon the best method to choose, and to help them keep track of the personal and business use of their aircraft, we provide our clients with an aircraft tax logbook that includes a form that can be used to track business and personal aircraft use for tax purposes.

Alternative Options

Given the tax complexities involved with using a business aircraft for entertainment purposes, there are a number of alternatives to consider. The new Tax Regulations only apply when you use your business aircraft for entertainment purposes, so one solution is to not directly permit use of your aircraft for such purposes. Instead, arrange for leases or charters of your aircraft when it is used for entertainment. Another option is to require your entertainment passengers to include in income that amount of compensation equal to the amount of the potential disallowed deduction since, under the tax laws, the potential deduction disallowance is reduced by the amount of compensation included in your specified individual's income.

Conclusion

Whether you take advantage of the relaxed Tax Regulations or structure your aircraft operations to avoid them entirely, consider carefully the tax consequences of using your business aircraft for entertainment purposes before the wheels go up.

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