BY BRADFORD S. COHEN AND JAMES W. CHAPMAN

New Tax Rules Governing the Use of Private Aircraft

TAX AUTHORITIES HAVE RECENTLY TAKEN ACTION to clip the wings of two popular strategies that previously produced significant tax savings for owners and users of private aircraft. The first was sanctioned by *Sutherland Lumber-Southwest, Inc.* v. *Commissioner*.[1] That ruling permitted an employer to obtain a business deduction for all expenses attributable to the personal use of the employer's aircraft while requiring the recipient of the personal flight to include as taxable income only the Standard Industry Fare Level attributable to the flight.[2] (The SIFL is the range of commercial airfares, which are typically much lower than the actual cost of a flight on a private aircraft.) The *Sutherland Lumber-Southwest* rule was amended as part of the American Jobs Creation Act of 2004 (AJCA).[3]

The second strategy was the avoidance of California sales and use taxes on the purchase of an aircraft by a California resident. This was accomplished by purchasing the aircraft outside California, keeping the aircraft outside the state for 90 days following the purchase, and conducting the aircraft's first functional flight outside California. The California State Board of Equalization, however, recently issued revised use tax regulations for out-of-state purchases of aircraft.

While these two changes will have a substantial effect on the entertainment industry's use of private aircraft—by media companies and talent loan-out corporations alike—tax planning opportunities still exist under the modified tax rules, despite the effort of federal and state tax authorities to reduce their benefits.

Sutherland Lumber-Southwest Loses Altitude

The AJCA amended Internal Revenue Code Section 274(e) to modify the rules for the deductibility of trade or business expenses attributable to the entertainment-, amusement-, or recreation-related use (i.e., personal use) of "facilities" in certain circumstances. Within the meaning of Section 274(e), an airplane is considered a facility.[4] Airplane expenses subject to the deduction limitation of Section 274 include all expenses of maintaining and operating the airplane, including all fixed and operating costs, such as hanger fees, lease payments, charter fees, depreciation, and fuel, regardless of whether the airplane is owned, leased, or chartered.[5] The amendments to Section 274(e) are effective for aircraft expenses that are incurred after October 22, 2004.

Under the new law, deductions for expenses attributable to the personal use of an airplane by a "specified individual"[6] are limited to the amount that is actually included in the specified individual's taxable income.[7] If the specified individual is an employee, the income must also be treated as wages subject to withholding.[8]

The term "specified individual" is defined as any individual who is either subject to the requirements of Section 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer or who would be subject to those requirements if the taxpayer were an issuer of the equity securities referred to in Section 16(a).[9] Based on that definition the term "specified individual" includes, for both private and publicly held companies:

1) Officers, as defined by Section 16(a): the president, principal financial officer, principal accounting officer (or, if there is no accounting officer, the controller); any vice-president in charge of a principal business unit, division, or function (such as sales, administration, or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions.
2) Directors.
3) Direct or indirect beneficial owners of more than 10 percent of any class of equity securities.

For example, a specified individual with respect to a corporation (regardless of whether it is an S, C, or personal service corporation) will generally include any officer, director, and any stockholder with more than 10 percent of any class of the corporation's stock. As applied to a partnership or limited liability company, a specified individual will generally include any officer, managing member, or general partner, and will also include any limited partner or nonmanaging member with more than a 10 percent equity interest.

Use of an airplane by a specified individual's spouse or family member or by any other person because of the person's relationship to the specified individual is considered use by a specified individual for purposes of the deduction limitation of Section 274.[10] For example, use of an airplane for a vacation by a specified individual and his or her spouse and two children is treated as personal use of the airplane by four specified individuals. The "directly related to or associated with" standard of Section 274(a)(1)(A) must be satisfied—and in the case of a spouse and children, the additional requirement of Section 274(m)(3) must be satisfied—in order to avoid the requirements of Section 274(e) and for the associated expenses to be deductible under Section 274(a)(1)(A).

In order to claim a business deduction for expenses attributable to an airplane, the use of the airplane to which the expenses relate generally must fall within one of four categories. First, airplane expenses attributable to its use for entirely business-related purposes and that have no element of entertainment, amusement, or recreation are deductible if the expenses are reasonable and "ordinary and necessary" within the meaning of I.R.C. Sections 162 or 212.

Second, Section 274(a) provides a higher hurdle for the deductibility of airplane expenses attributable to its use for entertainment, amusement, or recreation purposes. In order to be deductible under Section 274(a), such use must meet two requirements. First, it must be "directly related to or associated with" the active conduct of the taxpayer's trade or business, which generally requires that the principal character of the trip must be the conduct of the taxpayer's business, and the actual conduct of business with an expectation of income must occur during the trip.[11] In addition, the expenses must be reasonable and "ordinary and necessary" within the meaning of

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Sections 162 or 212.

Third, if the use of the airplane is for entertainment, amusement, or recreation without a sufficient business purpose for the trip to qualify under Section 274(a)(1)(A), taxable compensation must be recognized. Effective October 22, 2004, expenses that are attributable to the personal use of an aircraft by specified individuals are deductible only to the extent that the specified individuals using the airplane are treated as receiving taxable compensation income from the flight.[12]

Finally, if the airplane is used for entertainment, amusement, or recreation and there is not a sufficient business purpose for the trip to qualify under Section 274(a)(1)(A), expenses attributable to the use by a specified individual before October 22, 2004, or at any time before or after October 22, 2004, by a nonspecified individual, are deductible in full if the persons using the airplane are treated as receiving taxable compensation income equal to the SIFL value of the personal use airplane flights. That is, the deduction is *not* limited to the amount treated as compensation by the persons using the airplane and is governed by the rule under the *Sutherland Lumber-Southwest* case.[13]

Thus, the rule of *Sutherland Lumber-Southwest* continues to be the standard with respect to the personal use of aircraft by nonspecified individuals. Because the SIFL value of an airplane flight is typically far lower than the expenses attributable to the flight, the *Sutherland Lumber-Southwest* rules provides a significant nontaxable fringe benefit to a nonspecified individual using the airplane for personal use, while permitting the taxpayer a full deduction for the associated airplane expenses.

Section 274(e) in Practice

The rules for deductibility of airplane expenses can be illustrated by the following example: An entertainer's loan-out company owns an airplane. The entertainer's use of the airplane owned by the loan-out company (of which the entertainer is the sole shareholder) for vacation travel constitutes an "entertainment facility"[14] subject to the deduction limitation rules of Section 274. Because the entertainer is a specified individual with respect to the loan-out company, the new rules of Section 274(e) will apply to his or her personal use of the airplane after October 22, 2004, unless the trip has sufficient business elements to allow expenses to be deducted under Section 274(a)(1)(A). Assuming that is not the case, the loan-out company's deduction for expenses attributable to the use of the airplane for the personal trips will be disallowed under Section 274(e)(2)(B) unless the entertainer recognizes additional compensation income attributable to the personal airplane trips.

Taxpayers should proceed with caution in the manner in which a specified individual recognizes additional compensation income in order to permit the taxpayer a full deduction for all expenses attributable to the personal use of an airplane. While Treasury Regulation Section 1.61-21(g) provides for the inclusion of the SIFL rate for the personal use of an aircraft as income and Treasury Regulation Section 1.61-21(b) provides for the inclusion into income of the fair market value of a fringe benefit, the regulations under Section 1.61-21 do not permit the inclusion of a separate amount into income for a fringe benefit, whether representing the amount of the employer's expenses attributable to a personal flight or otherwise. However, the Section 1.61-21 regulations and Section 274(e) should be satisfied—and the employer permitted a full deduction for the expenses attributable to the personal use of an aircraft by a specified individual—if the specified individual pays the employer an amount equal to the expenses attributable to the flight (assuming the expenses exceed the SIFL rate, as will almost always be the case) and the employer in turn pays additional taxable compensation to the specified individual in the same amount. This should leave both the employer and the specified individual in roughly the same after-tax position with respect to the personal use of the airplane as if the employer had been permitted to merely include an amount equal to the flight's expenses on the specified individual's Form W-2 .

This example can also illustrate the tax consequences of Section 274(e): The loan-out corporation allows its owner/entertainer to use the corporation's aircraft to fly the entertainer and his or her family to a vacation destination, a flight valued under the SIFL at $1,000. The corporation's expenses attributable to the flight are $10,000. If the corporation treats only $1,000 as wage compensation (subject to withholding) to the entertainer, the corporation may deduct no more than $1,000 of the cost of the flight provided to the entertainer and his or her family (unless the corporation can establish that the flight was for business reasons). However, if the aircraft is used for vacation travel by a personal assistant of the entertainer (assuming the personal assistant is not a specified individual), the loan-out corporation will be able to deduct the full $10,000 of expenses attributable to the personal trip while treating the personal assistant as having received only $1,000 of wage compensation income.

As a result of the new rules under Section 274(e), taxpayers will have three basic choices in the future. First, if the airplane will be used for personal purposes by specified individuals, the taxpayer will need to treat the full amount of all expenses allocable to the personal use of the airplane by the specified individuals as wages of the specified individuals in order to obtain a full deduction for the expenses attributed to their use. This can be accomplished by the specified individual paying to the taxpayer an amount equal to the taxpayer's expenses for the personal flights, followed by the taxpayer's payment of additional compensation to the specified individual of the same amount. If the taxpayer and the specified individual operate on different tax years, care should be taken to ensure that the payments are made prior to the close of the tax year in which the personal aircraft use occurs of either the specified individual or the taxpayer.

This may not be an appealing option due to the potentially large amount of additional income that must be included in the income of specified individuals. However, the taxpayer could eliminate the financial impact on the specified individual by making a grossed-up tax payment to the specified individual in an amount sufficient to pay the added tax liability (much as employers frequently agree to compensate employees for the tax liability associated with parachute payments under Section 280G). For example, if $10,000 is included in the income of a specified individual in order for his or her employer to obtain a $10,000 deduction for the specified individual's personal use of the employer's airplane, the employer could make an additional payment of $5,385 to cover the specified individual's additional tax liability (assuming the specified individual's effective tax rate is 35 percent).

Under the second option, the taxpayer could elect to forego or limit its income tax deduction by not treating all expenses allocable to the personal use of the aircraft as compensation to specified individuals. Finally, the taxpayer could limit the use of the employer's aircraft to activities that qualify as business use under Section 274(a)(1)(A). That would allow the taxpayer to deduct all expenses of the aircraft without allocating any additional income to specified individuals.

IRS Notice 2005-45

Last May, the IRS issued Notice 2005-45,[15] which provides detailed rules for allocating airplane expenses between personal and business use of the airplane for the deduction limitation of Section 274(e) attributable to personal use of the airplane by specified individuals. All the expenses of maintaining and operating the airplane (including all fixed and operating costs) must be taken into account in applying the allocation rules. Under Notice 2005-45, the total deductible expenses attributable to the airplane must

be allocated between 1) expenses for personal use of the airplane by specified individuals and 2) expenses for all other uses. Expenses for each tax year must then be allocated between personal and business use of the aircraft by reference to the number of either "occupied seat hours" or "occupied seat miles" flown by the aircraft during the tax year. (The taxpayer must choose one method, which must be used consistently for the tax year.) Occupied seat hours or occupied seat miles represent the sum of the hours or miles flown, respectively, by an aircraft multiplied by the number of seats occupied by any person (not just specified individuals) for each hour or mile. For example, a flight of 6 hours with three passengers results in 18 occupied seat hours.

The aggregate amount of expenses for the aircraft over the year (both fixed and variable) are then divided by the aircraft's total number of occupied seat hours or miles in order to obtain the average cost per single occupied seat hour or mile (which, when computed in terms of seat hours, is referred to as the hourly cost). Each aircraft trip must be independently analyzed to determine the number of hours or miles that each specified individual used the plane for personal purposes, and that number is multiplied by the hourly cost to determine the amount of the taxpayer's deductions that are subject to limitation by Section 274(e).

The allocation rules of Notice 2005-45 can be illustrated by the following example: A loan-out corporation's total expenses for its aircraft for the year were $3,600, and the aircraft had 18 occupied seat hours for the year, resulting in an hourly cost of $200 per seat hour. If one flight consisted of a six-hour vacation plane trip by three passengers, but only one of the three passengers was a specified individual (assume the other two are rank-and-file employees of the loan-out company), the cost of the flight allocable to the specified individual when applying Section 274(e) would be $1,200 (the six-hour flight multiplied by the $200 hourly cost). The loan-out company would be entitled to deduct $1,200 of expenses allocable to the specified individual's personal use of the aircraft only if that amount is attributed as income to the specified individual. If the value of the flight under the applicable SIFL valuation rules is $200 per person, and the specified individual includes only $200 in income, then the loan-out company may claim only a $200 deduction for the specified individual's use of the plane, and the company would be denied a deduction for the remaining $1,000. For the nonspecified individuals, the company would need to treat each of them as having $200 of income attributable to the flight in order to deduct the full expenses of $1,200 per nonspecified individual.

The allocation rules of Notice 2005-45 must be used for the deduction of aircraft expenses incurred after June 30, 2005. The notice also provides that taxpayers may elect to apply its provisions to aircraft expenses incurred after October 22, 2004 (the effective date of amended Section 274(e)), and before July 1, 2005 (the effective date of the notice).

Notice 2005-45 also provides that it applies to both regularly scheduled flights and to flights on private airplanes that are necessitated by security concerns, as provided in Treasury Regulations Section 1.132-5(m). In general, if an employee travels on a personal trip in an employer-provided aircraft for bona fide security concerns, the employee may exclude from income the employer's actual costs of the transportation beyond the amount the employee would have paid for the same mode of transportation absent the security concerns. The additional expense for security reasons is excluded from the income of the employee as a working condition fringe benefit.[16]

In order to qualify as an excludable working condition fringe benefit under Treasury Regulations Section 1.132-5(m), the employer must establish a specific basis for the concern for the safety of the employee, such as a death threat, kidnapping threat, threat of bodily harm, or terrorist activity in the region. A generalized and theoretical concern for the safety of the individual is not sufficient.[17] An independent security study conducted to establish an overall security program is typically required.[18]

Because Notice 2005-45 provides that it applies to the personal use of aircraft irrespective of security concerns, airplane expenses attributable to personal use remain subject to the deduction limitations of Section 274(e), even if the costs are otherwise excludable from the specified individual's compensation as a security-related fringe benefit. Therefore, if the purpose of the trip is personal, classifying an airplane trip by a specified individual as necessary due to security concerns will not avoid the deduction limitations of Section 274(e). In order for the employer to deduct the expenses of the airplane travel for personal trips (whether required by security concerns or not), an amount equal to the airplane expenses will need to be treated as the compensation of the specified individual under Section 274(e).

Rough Landing in California

Generally, California sales tax applies to the sale in California of tangible personal property. If title to the personal property occurs outside of California, California sales tax does not apply.[19] However, California use tax applies to the use of any property purchased for storage, use, or other consumption and use in California, if the sale of the property was not subject to California sales taxes.[20] California's use tax serves as a backstop to the sales tax, and exemptions from California's use tax frequently have onerous requirements. For example, California taxpayers sometimes attempt to purchase an airplane outside of California in order to avoid the imposition of California sales tax. However, if the airplane is immediately brought into California, the California use tax will nonetheless be imposed on the airplane.

To avoid the imposition of California use tax on an airplane that is purchased outside California but will ultimately be brought into California, California taxpayers need to comply with the "first functional use" exception unless another exemption from use tax is applicable.[21] However, the first functional use exception was revised by Senate Bill 1100[22] and by the California State Board of Equalization pursuant to revised use tax regulations issued on March 3, 2005, extending the period an aircraft generally must remain outside of California from 90 days to 12 months.

The revised first functional use test is applicable to aircraft purchased on or after October 2, 2004, and on or before June 30, 2006. However, the California Legislative Analyst's Office has been instructed to conduct a study of the revenue raised from this change and to report its finding to the legislature no later than June 30, 2006. The legislature will presumably consult this report in determining whether to extend the sunset date or to enact other changes.

The first functional use exception, as revised, provides that an airplane is not subject to California use tax if its first functional use occurs outside of California and the airplane is not brought into California within 12 months after the airplane is purchased.[23] For the purposes of this rule, "functional use" means use for the purposes for which the property was designed.[24] If an airplane is brought into California within 12 months after purchase and assuming the aircraft's first functional use occurred outside of California, the airplane may still avoid California use tax if it has very limited other contacts with California. California use tax will be avoided if all the following requirements are met: 1) The aircraft was not purchased by a California resident, 2) the aircraft was not subject to California property tax during the first 12 months of ownership, and 3) the aircraft was not used or stored in California more than half the time during the first 12 months of ownership.[25]

For aircraft purchased prior to October 2, 2004 (the effective date of the March 3, 2005, revisions to the first functional use excep-

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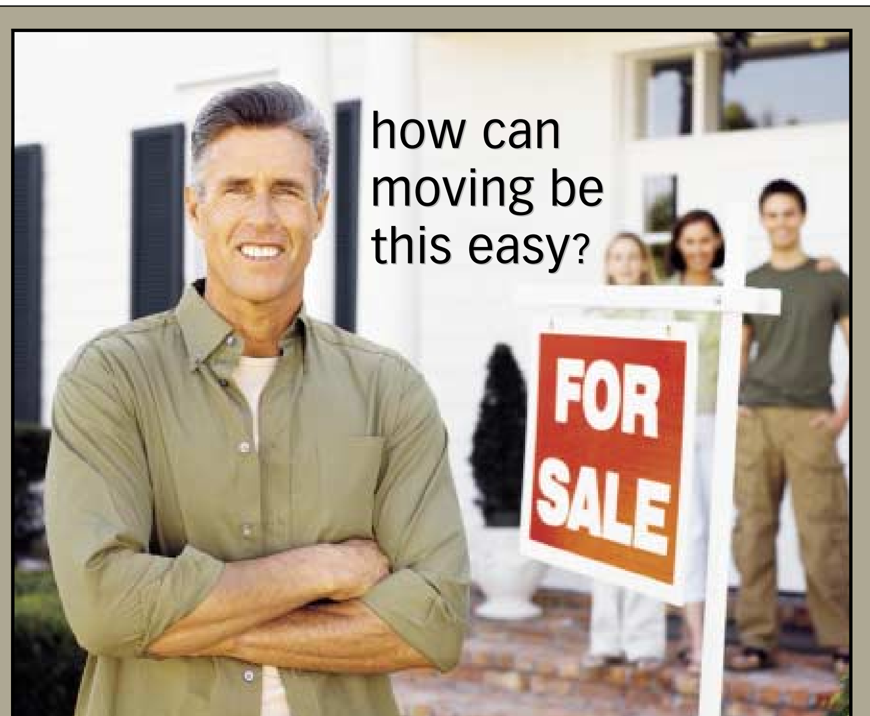
tion), and after June 30, 2006, an airplane needs to remain outside California for only 90 days following purchase in order to avoid California use tax.[26] If the aircraft is brought into California within 90 days after its purchase, the aircraft will be subject to California use tax unless the aircraft is used or stored outside California half or more of the time during the six-month period immediately following its entry into California.[27] If the first functional use of an aircraft is within California, even if the aircraft was purchased outside California, the aircraft will be treated as having been purchased for use in California and will be subject to California use tax.[28]

Regardless of when an aircraft is purchased or brought into California (assuming the first functional use of the aircraft is outside California), California use tax will not apply to the aircraft if half or more of the flight time traveled by the aircraft during the six-month period immediately following its entry into California is commercial flight time in interstate or foreign commerce.[29] For this purpose, commercial flight time includes business use of the aircraft but does not include personal use.

Despite the restrictions on tax savings imposed by the modified rules on the deductibility of airplane expenses under IRC Section 274(e) and on the first functional use exception from California use tax, with proper planning taxpayers may be able to structure their activities to avoid the impact of the new rules. For example, a specified individual can avoid the new rules under Section 274(e) by conducting sufficient business during a trip in order for the flight to be characterized as business and not personal under Section 274(a)(1)(A). Additionally, California residents purchasing aircraft outside California may do well to investigate 12-month leases for aircraft hangers in other states, such as a location near an out-of-state home owned by the taxpayer—depending, of course, on the foreign state's own domestic sales and use tax rules. ■

[1] Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000), *aff'd* 255 F. 3d 495 (8th Cir. 2001), *acq*. 2002-1 C.B. XVII, Action On Decision 2002-002 (Feb. 19, 2002).
[2] Treas. Reg. §1.61-21(g).
[3] American Jobs Creation Act of 2004, P.L. 108-357, §907(a).
[4] Treas. Reg. §1.274-2(e)(2)(i).
[5] *See* I.R.S. Notice 2005-45, 2005-24 IRB 1228 (May 27, 2005).
[6] The term "specified individual" is defined in I.R.C. §274(e)(2)(B)(ii). All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
[7] I.R.C. §274(e)(2)(B)(i).
[8] I.R.C. §274(2)(2)(A).
[9] I.R.C. §274(e)(2)(B)(ii); CONG. CONF. REPT. NO. 108-755, at 784 (2004).
[10] *See* I.R.S. Notice 2005-45, 2005-24 IRB 1228 (May 27, 2005).
[11] Treas. Reg. §1.274-2(c)(3).
[12] I.R.C. §§274(e)(2) and 274(e)(9).
[13] I.R.C. §§274(e)(2) and 274(e)(9); Sutherland Lumber-Southwest, Inc. v. Commissioner, 114 T.C. 197 (2000), *aff'd* 255 F. 3d 495 (8th Cir. 2001), *acq*. 2002-1 C.B. XVII, Action On Decision 2002-002 (Feb. 19, 2002); Chief Council Advisory 200344008. However, a bill currently under consideration in a House-Senate conference committee would set the value of *any* employee's personal use as the greater of the fair market value of such use or its actual cost, less amounts paid by or on behalf of such employee for such use.
[14] Treas. Reg. §1.274-2(b)(1).
[15] I.R.S. Notice 2005-45, 2005-24 IRB 1228 (May 27, 2005).
[16] Treas. Reg. §1.132-5(m).
[17] Treas. Reg. §1.132-5(m)(2)(i).
[18] Treas. Reg. §1.132-5(m)(2)(iii)-(iv).
[19] CAL. SALES & USE TAX REGS. §1620(a)(1).
[20] CAL. SALES & USE TAX REGS. §1620(b)(1).
[21] In addition to the first functional use exception, California's use tax does not apply to the use of property, including aircraft, purchased for use and used in interstate or foreign commerce prior to entry into California and thereafter used continuously in interstate or foreign commerce both within and without California and not exclusively in California. CAL. SALES & USE TAX REGS. §1620(b)(2)(B)(1).
[22] SB 1100 (enacted Aug. 16, 2004).
[23] CAL. SALES & USE TAX REGS. §1620(b)(5).
[24] CAL. SALES & USE TAX REGS. §1620(b)(3).
[25] CAL. SALES & USE TAX REGS. §1620(b)(5)(A)(1)–(4).
[26] CAL. SALES & USE TAX REGS. §1620(b)(4).
[27] CAL. SALES & USE TAX REGS. §1620(b)(4)(A).
[28] CAL. SALES & USE TAX REGS. §§1620(b)(4) and (5).
[29] CAL. SALES & USE TAX REGS. §§1620(b)(4)(B)(3) and 1620(b)(5)(C)(3).



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