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TAX DEDUCTIONS FOR NON-BUSINESS USE OF A BUSINESS AIRPLANE

NEW PROPOSED REGULATIONS PROVIDE SOME ANSWERS AND MORE QUESTIONS

The deductibility of personal use of a business aircraft was greatly impacted by a change in the law in 2004. The change was ambiguous at best, but now Treasury has issued proposed regulations on how they intend to interpret it. These new regulations provide certain reasonable guidance and hint that there may be more to come.

The purpose of the legislation was to limit the deductibility of personal entertainment use of business aircraft by officers and shareholders. Although the potential abuse highlighted in the committee reports dealt with publicly-held companies, the law as ultimately drafted applied to closely-held entities as well. Congress sought to remedy the situation by disallowing a portion of the corporate deductions that were attributable to personal entertainment use of a business aircraft provided to an employee.

Not all personal use of business aircraft is subject to the legislation. Flights must be for the benefit of officers or 10% stockholders, and the nature of the use must be entertainment. Therefore, if the employee uses the aircraft for non-entertainment reasons, or the employee is neither an officer nor a shareholder, the changes in the law do not apply. Although the entertainment classification is pivotal in determining the applicability of the disallowance, the regulations provide no guidance in defining it. Obviously, family vacations, attending sporting events with personal friends, and the like, are entertainment; but what about commuting, or visiting family members?

The regulation is clear that the disallowance could occur when a guest travels for personal entertainment purposes on a business trip. The mere fact that there is no incremental cost incurred on the trip does not preserve the deduction. Of course this disallowance would seem to apply only when the guest was traveling for entertainment reasons; a guest traveling merely to be with their spouse may be fully deductible.

Although the proposed regulations do not allow the use of a primary purpose test as an escape for a non-business guest; that test is applicable when determining whether a trip is primarily for business or for personal use. The regulations use an example of an extended business trip involving negotiation of a contract

followed by a game of golf. Because the primary purpose of the trip was the negotiation of the contract, it is not reclassified as entertainment subject to disallowance. However, to the extent that there is a personal entertainment deviation to a business trip, the incremental cost of this deviation would be subject to disallowance.

The regulations contain some surprising elections designed to both simplify and potentially reduce any disallowance for shareholder entertainment. The first of these elections allows a computation of potential disallowance under an occupied seat rule that is calculated on either an annual basis or a per-flight basis. A second election allows the taxpayer to depreciate the aircraft slower for purposes of determining disallowance under the new entertainment rules.

Perhaps the most important, and most surprising, provision of the new proposed regulations alluded to the potential use of charter rates rather than actual cost to determine disallowed expenses. Although the proposed regulations do not approve this methodology at this time, they state that Treasury is considering adopting a charter rule when the regulations are released in final form.

Regardless of the ambiguity in the proposed regulations relating to potential disallowance for entertainment, there is no question in the law about the duty to keep contemporaneous records. Existing law requires that logs be maintained for all aircraft use. The contemporaneous recordkeeping requirement mandates that information be retained as to the business purpose of the trip, who traveled on the aircraft, and any person visited during the trip. Taxpayers may choose to rely on the proposed regulations prior to them becoming final; however, they may differ significantly when finally released.

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