Part III - Administrative, Procedural, and Miscellaneous

Deductions for Entertainment Use of Business Aircraft

Notice 2005-45

This notice provides interim guidance to taxpayers on the limitation under § 274(e) of the Internal Revenue Code on the deductible amount of trade or business expenses for use of a business aircraft for entertainment. Section 274(e) was amended by § 907 of the American Jobs Creation Act of 2004 (AJCA), effective for amounts incurred after October 22, 2004. The rules provided in this notice apply until regulations are effective.

A. BACKGROUND

Under § 274(a)(1)(A), no deduction is allowed for an activity generally considered to be entertainment, amusement, or recreation, unless the taxpayer establishes that the activity is directly related to or (in certain cases) associated with the active conduct of the taxpayer's trade or business. Section 274(a)(1)(B) disallows deductions for facilities used in connection with entertainment, amusement, or recreational activity, regardless of connection to the taxpayer's trade or business.

Section 1.274-2(b)(1) of the Income Tax Regulations provides that entertainment means any activity of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing,

vacation and similar trips. Similar activities relating solely to the taxpayer's family also may constitute entertainment. Entertainment may include an activity that satisfies the personal, living, or family needs of an individual, such as providing food and beverages or a hotel suite to a business customer or the customer's family. Entertainment does not include activities, however, that are clearly not regarded as constituting entertainment, such as the provision of supper money by an employer to an employee working overtime, the maintenance of a hotel room by an employer for lodging of employees while in business travel status, or the use of an automobile in the active conduct of a trade or business even though also used for routine personal purposes such as commuting to and from work. Under § 1.274-2(b)(1)(ii), an objective test is used to determine whether an activity is of a type generally considered to constitute entertainment.

Section 274(e) provides exceptions to the general disallowance provisions of § 274(a). Prior to amendment by the AJCA, § 274(e)(2) excepted expenses from § 274(a) "to the extent that the expenses are treated by the taxpayer" as compensation to the employee/recipient of the entertainment activity. Section 274(e)(9) similarly excepted expenses to the extent that the expenses are treated by the taxpayer as income to persons who are not employees.

Section 274(o) provides that the Secretary shall prescribe regulations necessary to carry out the purposes of the section.

Generally, § 1.61-21(b) requires an employee to include in gross income the fair market value of a fringe benefit, such as an entertainment flight (reduced by any

reimbursement or statutory exclusion). For employee flights on employer-provided noncommercial aircraft, § 1.61-21(g) provides that an employer may value such flights using the Standard Industry Fare Level (SIFL) formula. Under § 1.61-21(g)(14)(i), an employer that uses the SIFL formula in a calendar year to value any flight provided to an employee during a calendar year must use the SIFL formula to value all flights provided to employees during that calendar year. The fringe benefit rules under § 1.61-21(g) generally apply to all service providers, including employees, independent contractors, partners, and directors. The regulations do not permit valuation of a flight by reference to the employer's costs.

Ann. 85-113, 1985-31 IRB 31, allows an employer to elect the frequency at which in-kind fringe benefits are treated as paid. The benefits must be treated as paid no later than the end of each calendar year, but in-kind fringe benefits provided during the last two months of a calendar year may be treated as paid during the subsequent calendar year. See Ann. 85-113, sections 1 and 5(a).

In *Sutherland Lumber-Southwest, Inc. v. Comm'r*, 114 T.C. 197 (2000), *aff'd* 255 F.3d 495 (8th Cir. 2001), *acq.* AOD 2002-02 (Feb. 11, 2002), the Tax Court held that the amount a taxpayer may deduct for the cost of entertainment-related flights under the § 274(e)(2) exception is not limited to the amount included in the income of the employees and corporate officers who took the flights. Rather, the court held that a taxpayer may deduct the full cost of an employee's or officer's non-business flight on the taxpayer's aircraft if the taxpayer includes in the recipient's income the value of the flights computed under the rules of § 1.61-21. As a result, a deduction greater than the

amount included in the recipient's income was allowable.

The ACJA amendment to § 274(e)(2) and (9) is intended to overturn *Sutherland Lumber-Southwest, Inc. v. Comm'r*. H.R. Conf. Rep. No. 108-755, at 798 (2004). Specifically, as amended by § 907 of the AJCA, the § 274(e)(2) and (9) exceptions to the § 274(a) disallowance apply in the case of a "specified individual" only "to the extent that the expenses do not exceed the amount of expenses" that are treated as compensation to the specified individual. A specified individual is any individual who is subject to the requirements of § 16(a) of the Securities Exchange Act of 1934 (15 U.S.C. § 78p(a)) with respect to the taxpayer, or who would be subject to those requirements if the taxpayer were an issuer of equity securities referred to in that section. Section 274(e)(2)(B).

Thus, in the case of a specified individual, the § 274(e)(2) and (9) exceptions apply only to the extent that a taxpayer treats as compensation to the specified individual an amount equal to or greater than the amount of deductible entertainment expenses allocable to entertainment provided to the specified individual. Expenses allocable to entertainment provided to the specified individual that are not treated as compensation to the specified individual are disallowed.

This notice specifically addresses expenses paid or incurred in connection with the use of aircraft as entertainment. Section 274 (e)(2) and (9), however, apply to all expenses subject to § 274(a). Taxpayers may apply the principles of this notice to expenses paid or incurred in connection with other entertainment activities.

B. APPLICATION

(1) In general

In general, the use of an aircraft for an employee's or other recipient's entertainment, amusement, or recreation is subject to § 274(a) unless excepted by § 274(e). Expenses for entertainment use of an aircraft by a specified individual are disallowed except to the extent of the amount treated as compensation to the specified individual, as provided in this notice. The amount disallowed with regard to a specific flight also is reduced by any amount that a specified individual reimburses the taxpayer for that flight.

(2) Use of aircraft for entertainment

Whether an aircraft is used for entertainment of a specified individual is determined without regard to the ownership of the aircraft. Therefore, the costs of leased or chartered aircraft are subject to disallowance under § 274(a) (unless excepted by § 274(e)) and this notice. Furthermore, § 274(a) and (e) and this notice apply to the costs of aircraft operated on a regular schedule or used for bona fide security concerns (as provided in § 1.132-5(m)).

(3) Specified individuals

A "specified individual" is either an individual who is subject to § 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer, or an individual who would be subject to § 16(a) if the taxpayer were an issuer of equity securities referred to in that section. "Specified individual" includes 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. Thus, a “specified individual” is an officer, director, or more than 10% owner of a corporation taxed under subchapter C or subchapter S, or a personal service corporation. For partnership purposes, “specified individual” includes any partner that holds a more than 10% equity interest in the partnership, general partner, officer, or managing member of a partnership. "Specified individual" also includes a director or officer of a tax-exempt entity.

The provisions of this notice 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 § 267(b) or § 707(b). Thus, if X and Y are related corporations within the meaning of § 267(b) and Y provides entertainment use of an aircraft to A, who is a specified individual as to X, Y’s costs are disallowed (except to the extent treated as compensation to A or reimbursed by A) under § 274(e)(2)(B).

For purposes of this notice, a specified individual is the recipient of entertainment provided to a spouse or family member of the specified individual or to another person because of the person’s relationship to the specified individual. See § 1.61-21(a)(4). Thus, costs allocable to entertainment provided to a spouse, family member, or other person are attributed to the specified individual for purposes of determining the amount of disallowed costs. As used hereafter in this notice, the term “specified individual” includes any person to whom a taxpayer has provided entertainment that is attributable

to a specified individual under this paragraph.

(4) Expenses of aircraft subject to disallowance

For purposes of calculating the amount of expenses for entertainment use of an aircraft that are disallowed (except to the extent treated as compensation to or reimbursed by a specified individual) under § 274(e)(2)(B) or (9), taxpayers must take into account all of the expenses of maintaining and operating the aircraft (all fixed and operating costs). These expenses include, but are not limited to, fuel costs; 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 and maintenance flights; costs of on board refreshments, amenities, or gifts**;** hangar fees (at home or away); management fees; depreciation; amounts deductible under § 179 ; in the case of chartered aircraft, all costs billed for the charter (including amounts for flight time, waiting time, fuel, and overnight expenses); and, in the case of leased aircraft or other leased equipment, lease payments.

(5) Method of allocating expenses to flights

For purposes of § 274(e)(2)(B) and (9), the total deductible expenses attributable to the aircraft must be allocated to expenses for use of the aircraft for entertainment of specified individuals and expenses for all other uses. A taxpayer must allocate expenses for each taxable year using either occupied seat hours or occupied seat miles flown by the aircraft and must apply the chosen method consistently for all usage for the taxable year. Occupied seat hours or miles is the sum of the hours or miles flown by an aircraft multiplied by the number of seats occupied for each hour or mile. For example,

a flight of 6 hours with three passengers aboard results in 18 occupied seat hours. See the special rule for "deadhead" flights, below.

Taxpayers must aggregate all fixed and variable expenses to determine the total expenses paid or incurred during the taxable year and divide the amount of total expenses by total occupied seat hours or occupied seat miles flown to determine the cost per occupied seat hour or occupied seat mile. Taxpayers may calculate the cost per occupied seat hour or occupied seat mile separately for each aircraft or may aggregate the costs of aircraft of similar cost profiles. For example, the costs of a turboprop aircraft may not be aggregated with the costs of a jet aircraft and the costs of a two-engine jet aircraft may not be aggregated with the costs of a four-engine jet aircraft.

The amount disallowed under § 274 is the sum of (a) the cost of each occupied seat hour (or mile) flown by a specified individual for entertainment purposes, less (b) the sum of the amount treated as compensation and the amount reimbursed for each specified individual and each flight. Therefore, to determine the amount subject to disallowance, taxpayers must allocate the costs to the specific entertainment flight provided to a specified individual and compare the cost of each flight to the amount treated as compensation to or reimbursed by the specified individual for that flight.

Example

A taxpayer's aircraft is used for Flights 1, 2, and 3, of 5 hours, 5 hours, and 4 hours, respectively, during the taxpayer's taxable year. On Flight 1, there are four passengers, none of whom are specified individuals or traveling for entertainment. On

Flight 2, passengers A and B are specified individuals traveling for entertainment and passengers C and D are not specified individuals or are not traveling for entertainment. On Flight 3, all four passengers (A, B, E, and F) are specified individuals traveling for entertainment. The taxpayer incurs $56,000 in expenses for the operation of the aircraft for the taxable year.

The aircraft is operated for a total of 56 occupied seat hours for the period (four passengers times 5 hours or 20 occupied seat hours for Flight 1, plus four passengers times 5 hours or 20 occupied seat hours for Flight 2, plus four passengers times 4 hours or 16 occupied seat hours for Flight 3). The cost per occupied seat hour is $1,000 ($56,000/56 hours). The total entertainment usage of the aircraft for specified individuals subject to disallowance is 26 occupied seat hours (two passengers for 5 hours each on Flight 2 and four passengers for 4 hours each on Flight 3) and the total cost subject to disallowance is $26,000 (26 occupied seat hours X $1,000).

For purposes of determining the amount disallowed (to the extent not treated as compensation or reimbursed), $5,000 ($1,000 X 5 hours) each is allocable to A and B for Flight 2, and $4,000 ($1,000 X 4 hours) each is allocable to A, B, E, and F for Flight 3.

For Flight 2, the taxpayer treats $1,200 (the fair market value of the flight) as compensation to A, and B reimburses the taxpayer $500. The taxpayer may deduct $1,700 of the cost of Flight 2 allocable to A and B. The deduction for the remaining $8,300 cost allocable to entertainment provided to A and B on Flight 2 is disallowed (with respect to A, $5,000 less the $1,200 treated as compensation, and with respect to

B, $5,000 less the $500 reimbursed). For Flight 3, the taxpayer treats $1,300 (the fair market value of the flight) each as compensation to A, B, E, and F. The taxpayer may deduct $5,200 of the cost of Flight 3. The deduction for the remaining $10,800 cost allocable to entertainment provided to A, B, E, and F on Flight 3 is disallowed ($4,000 less the $1,300 treated as compensation to each specified individual).

(6) Special rule for "deadhead" flights

For purposes of this notice, an aircraft returning empty from a flight after discharging passengers or traveling empty to pick up passengers (deadheading) is treated as having the same number and character of occupied seat miles or hours as the leg or legs of the trip on which passengers are aboard.

(7) Allocation of expenses on trips of a specified individual involving both business and entertainment

The costs of a flight provided to a specified individual that includes a segment or segments for business and for entertainment must be allocated to the business and entertainment use. The entertainment cost is the excess of the total cost of the flights (by occupied seat hours or miles) over the cost of the flights that would have been taken without the entertainment segment or segments.

Example. G, a specified individual, is the sole passenger on an aircraft on a two-hour flight from City A to City B. The flight from City A to City B is for business. G then travels on a three-hour flight from City B to City C for entertainment purposes, and returns from City C to City A on a four-hour flight. G's flights have resulted in nine occupied seat hours (two for the first segment, plus three for the second segment, plus

four for the third segment). If G had returned directly to City A from City B, the flights would have resulted in four occupied seat hours. Five occupied seat hours are allocable to G's entertainment use of the aircraft (nine total occupied seat hours less four occupied seat hours). If the taxpayer's cost per occupied seat hour is $1,000, $5,000 must be allocated to G's entertainment use of the aircraft ($1,000 X five occupied seat hours). The amount disallowed is $5,000 less any amount the taxpayer treats as compensation to G or G reimburses the taxpayer for this flight.

(8) Non-commercial flight valuation consistency rule

Under § 1.61-21(g)(14)(i), a taxpayer who uses the SIFL formula in a calendar year to value any flight provided to an employee must use the SIFL formula to value all flights provided to employees during that calendar year. The Internal Revenue Service and the Treasury Department plan to amend these regulations to permit taxpayers to value the entertainment use of aircraft by specified individuals under the fair market value rules of § 1.61-21(b), but continue to value flights for other employees and for specified individuals not traveling for entertainment using the SIFL formula. Until regulations are published, taxpayers may rely on this notice to allow this inconsistency in the treatment of specified and non-specified individuals for income inclusion purposes. If the amount treated as compensation is greater than the amount of the taxpayer's costs (as determined under this notice) for a flight, however, the taxpayer's deduction is limited to the taxpayer's costs.

(9) Interaction with § 162(m)

Any amount for the entertainment use of an aircraft that is treated by the taxpayer as compensation to a specified individual who is also a "covered employee" (as defined in § 162(m)(3)) is subject to § 162(m). Thus, to the extent the covered employee's "applicable employee remuneration" (as defined in § 162(m)(4)), including remuneration related to entertainment, exceeds $1,000,000, the taxpayer's deduction is disallowed under § 162(m).

(10) Costs treated as compensation

The amount of costs to which this notice applies is reduced by an amount treated as compensation to a specified individual who is an employee of the taxpayer if the amount is treated as compensation for the flight on the taxpayer's income tax return as originally filed and as wages for purposes of chapter 24 (relating to withholding of income tax at the source on wages). See § 1.274-2(f)(2)(iii)(A) and Ann. 85-113. For a specified individual who is not the taxpayer's employee, costs are treated as compensation if the amount for the flight is included in an information return under Part III of subchapter A of chapter 61 (unless not required to be reported under those provisions). See § 1.274-2(f)(2)(iii)(B).

C. REQUEST FOR COMMENTS

The Service and the Treasury Department request comments on issues arising under this notice. Comments should be submitted in writing on or before August 1, 2005, and should include a reference to Notice 2005-45. Comments may be submitted to CC:PA:LPD:PR (Notice 2005-45), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, comments may be

submitted electronically via the following e-mail address: Notice.Comments@irscounsel.treas.gov. Please include "Notice 2005-45" in the subject line of any electronic communications.

Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2005-45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. All comments are available for public inspection and copying.

D. EFFECTIVE DATE

This notice applies to expenses incurred after June 30, 2005. The Service will not challenge a reasonable method of determining disallowed expenses incurred after October 22, 2004, and before July 1, 2005. Application of this notice to determine disallowed expenses is a reasonable method.

E. TRANSITION RULE FOR REPORTING DISALLOWED EXPENSES

A taxpayer that incurs expenses to which § 274(e), as amended by the AJCA, applies in a taxable year ending after October 22, 2004, but on or before May 27, 2005, may apply the disallowance of expenses for that taxable year against expenses incurred in the taxpayer's first taxable year ending after May 27, 2005. Thus, for example, a calendar year taxpayer may choose to adjust its taxable income either (a) for its 2005 taxable year to reflect the disallowance of expenses to which this notice applies that are incurred after October 22, 2004, and before January 1, 2006, or (b) for its 2004 taxable year to reflect the disallowance of the portion of the expenses incurred after October 22, 2004, and before January 1, 2005, and for its 2005 taxable year to reflect the

disallowance of the portion of the expenses incurred after December 31, 2004, and before January 1, 2006.

DRAFTING INFORMATION

The principal author of this notice is Michael A. Nixon of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Mr. Nixon or Christian Wood at (202) 622-4930 (not a toll-free call).