

## IRS Notice 2005-45 and its likely impact on aircraft tax deduction

### Introducing an end-run tax increase for business aircraft, with the potential for taxpayer perjury.

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**IRS Notice 2005-45 principally affects personal use of business aircraft for recreational or entertainment purposes by “specified individuals,” occurring on or after Oct 22, 2004**

In a continuing effort to keep Pro Pilot readers current with developments concerning tax treatment of personal use of business aircraft, this article examines the effects of Internal Revenue Service (IRS) Notice 2005-45 on aircraft tax deductions. Earlier related articles in Pro Pilot include “Separating business and pleasure for tax purposes” (Oct 2004) and “One-year extension of bonus depreciation—the implications” (Feb 2005).

In May 2005 IRS issued Notice 2005-45 in an attempt to clarify certain provisions of the American Jobs Creation Act of 2004 relating to recreational, amusement or entertainment use of business aircraft.

The author’s opinion is that this notice is harsh, punitive and naive in its treatment of entertainment use of business aircraft and that it will affect our industry adversely for years to come if it is not modified through future legislative action.

Officials at IRS have shown that they have very little knowledge as to how bona fide businesses integrate aircraft into their day-to-day operations.

#### Background

Generally, for personal flights that took place prior to Oct 22, 2004, there was no reduction in depreciation and other aircraft-related expenses for personal use, as long as the individuals using the aircraft imputed the correct standard industry fare level (SIFL) rate value for those personal flights as additional income on their respective tax returns.

The American Jobs Creation Act of 2004 (AJCA) changed that favorable treatment for “specified individuals” (defined below). It also repealed a long string of taxpayer-favorable US Tax Court (and other) cases, pronouncements, etc, that had existed for the preceding 4 years.

Repealing all these cases was seen as a way to “pay for” the one additional year of bonus depreciation eligibility for a limited number of aircraft purchased in 2004 and placed in service in 2005.

The AJCA left many issues unresolved as to the tax treatment of personal/recreational use of business aircraft. The industry, taxpayers and their advisors demanded clarification and additional guidance on many open items.

On May 27, 2005 IRS responded by issuing Notice 2005-45.

#### IRS Notice 2005-45

This notice primarily affects personal use—classified as recreation, amusement or entertainment—by specified individuals. The notice disallows deductions for all expenses that relate to maintaining and operating the aircraft.

These expenses include, but are not limited to, fuel, pilot salaries, maintenance and other personnel assigned to the aircraft, flightcrew meals and lodging, takeoff and landing fees, maintenance and maintenance flights, onboard refreshments, amenities, gifts, all hangar and parking costs, management fees, depreciation and special expensing amounts under Internal Revenue Code (IRC) section 179.

If you charter an airplane, all costs billed for charter trips, as well as lease payments on leased aircraft, are subject to the same disallowance provisions of the notice.

## Specified individuals



**Under IRS Notice 2005-45, taxpayers may choose either the occupied seat-miles method or the occupied seat-hours method when allocating business and entertainment use of an aircraft.**

These are:

1 Individuals subject to section 16(a) of the Securities Exchange Act of 1934

2 Every person who is a direct or indirect owner of more than 10% of any class of any registered equity security issued by the taxpayer

3 Officers, directors or more than 10% owners of subchapter “C” and “S” corporations

4 Any partner who holds more than a 10% equity interest in the partnership, any general partner, officer, managing member of a partnership

5 Directors or officers of tax-exempt entities

Notice 2005-45 may also class spouses of specified individuals, as well as other related business entities, as specified individuals.

## Calculating disallowed expenses

The notice provides 2 methods of allocating business and entertainment use—the occupied seat-miles method and the occupied seat-hours method. Taxpayers are free to use whichever method produces the more favorable result—but the same method must be used for “all usage for the taxable year.”

1 The occupied seat-miles method calculates a cost per occupied passenger seat-mile for all miles flown by the aircraft during the taxable year. Total aircraft costs are divided by total passenger miles flown during the year.

2 The occupied seat-hours method calculates a cost per occupied passenger seat-hour for the year. For this method, all aircraft costs are divided by total occupied passenger seat-hours during the year.

The disallowed deductions would be the per-seat-mile or per-seat-hour cost multiplied by the number of miles or hours allocated to recreation, entertainment or amusement usage by specified individuals, less any amounts added to the individuals’ income or reimbursed to the employer. See the following examples.

Example 1: Assume that an aircraft owner elects to use the per-seat-hours method. The company has incurred aircraft costs and depreciation for the year in the amount of \$10 million. Total occupied passenger seat-hours for the year are 2000 hours. Cost per occupied seat-hour is \$5000. If 400 occupied seat hours were allocated to recreation use by specified individuals, then \$2 million of depreciation and other deductions would be disallowed if none of the specified individuals reimbursed the company or had any portion of the \$2 million added to their W2s (in the case of a corporate employee) or as a guaranteed payment (in the case of a partner in a partnership).

Example 2: Assume that a company flies 10 business trips and 4 entertainment trips during the year, and that all passengers are specified individuals. Each business round trip is 4 hours long, with 3 passengers on each trip, for a total of 120 occupied business seat hours for the year. Each of the 4 entertainment round trips is also 4 hours long, with 8 passengers per trip, for a total of 128 entertainment occupied seat hours. Thus, the total occupied seat hours for the year is 248 hours. However, since 128 hours is allocated to entertainment use, 51.6% of all deductions, including depreciation, will be disallowed for the year if the executives do not reimburse the company or have the \$2 million of entertainment seat value added to their W2s as additional tax income. In the event that \$500,000 of additional income were reported by the executives, the company would lose \$1.5 million in aircraft deductions providing those executives were not also classified as “covered employees” subject to IRC section 162(m). (Covered employees are those of publicly-held companies—generally the highest-paid 4 employees with salaries in excess of \$1 million.)

While example 2 may be an extreme case using lower than average total hours for a business aircraft, it does illustrate that a few fully-loaded entertainment flights could deplete the tax deductions for many bona fide business trips with relatively few passengers. Clearly, trips with children, nannies etc, could be particularly expensive and troublesome for the business which needs maximum tax benefits from aircraft expenditures.

## Deadhead flights



**For some taxpayers, it may be worth considering the purchase of a less expensive aircraft or the use of a charter aircraft for entertainment purposes. Loss of the deduction for a particular charter trip may be preferable to the possible loss of millions in depreciation and other items on a new aircraft.**

Notice 2005-45 states that “an aircraft returning empty from a flight after discharging 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.”

One interpretation of this kind of logic is that IRS is saying it would rather have the aircraft remain idle as opposed to having the airplane return home to pick up passengers for a business trip. The fact is that operating costs are the same whether the airplane is full or empty. No other type of business asset is treated this way.

## Multipurpose flights

In the case of a mixed-use trip, the notice requires an allocation for business segments and entertainment segments. The entertainment cost or disallowance is the number of entertainment occupied seat miles or seat hours multiplied by the occupied seat per-mile/per-hour cost, as determined at the end of the taxable year.

## Open issues and questions

1 Despite its frequent use of the terms “entertainment,” “recreation” and “amusement,” Notice 2005-45 does not define any of those terms.

2 The notice does not include crew seats in the occupied seat miles or hours. Should they be included? One school of thought indicates a negative because the flightcrew is always there for a business purpose, in that they are being paid to get the aircraft safely from point to point regardless of the number of passengers or their individual reasons for being aboard. Preflight, takeoff, cruise, landing and other procedures and functions are the same for a business trip or entertainment trip.

3 Since the notice requires segregation of costs for each class of aircraft (eg, twin-engine jets, 3-engine jets, 4-engine jets, single-engine turboprops), what is a fractional share owner supposed to do if he owns a share in a Citation but ends up taking a King Air for a particular trip?

4 If we extend the faulty logic of the notice to disallowing a building lease payment deduction, we would have to calculate the hourly cost of the building based on a hourly census allowing for employees who are out of the building for vacations, sick leave, business meetings, etc. We would also have to account for employees who were in the building but were taking a break, at lunch, making personal calls and otherwise engaged in nonbusiness activities such as office birthday and holiday parties. In fact, IRS might as well propose the same treatment for employee vans in the van pool fleet, as well as for the extra passengers in a car who may or may not be in a car for business reasons.

5 The notice creates a separate class of “other personal use.” How should we classify bereavement flights or any other flight that does not constitute entertainment, recreation or amusement? Obviously, since the notice doesn’t cover these other personal-use flights, they are not subject to the same occupied per-seat-mile/hour costs for disallowance purposes.

6 Even though Notice 2005-45 makes frequent mention of reimbursement of disallowed expenses by employees as a way to increase or restore aircraft deductions, it fails to mention that such reimbursement would also be subject to federal excise taxes for air transportation and sets up the aircraft owner for a potential FAR violation if the subject flight was conducted under Part 91.

7 While the notice is applicable to all “entertainment” flights by specified individuals occurring on or after Oct 22, 2004, IRS recognizes that it issued the notice after many taxpayers had already filed their calendar year 2004 tax returns. While IRS doesn’t want taxpayers to amend their 2004 returns, it is permitting them to use any reasonable method to account for entertainment flights which took place between Oct 22, 2004 and Jun 30, 2005. The 2004 adjustments can be made on the 2005 tax return. For flights occurring on or after Jul 1, 2005, the seat-miles or seat-hours method must be used.

8 If tax preparation software providers do not address the return preparation issues presented by Notice 2005-45, preparation of a complete and accurate tax return will be impossible. At present, I know of no tax return preparation software being offered to tax professionals that is capable of making the required calculations or adjustments to depreciation based upon the notice’s requirements. Obviously, any adjustments to a tax return will have to be fully supported by spreadsheets, detailed records listing the reason why each passenger was aboard the aircraft for each

segment, flight logs etc.

9 Note that, in Example 2 above, the disallowance of the depreciation and other deductions was 51.6%. In the past, whenever business use fell to 50% or less in any year, that triggered an immediate recapture of bonus depreciation, amounts claimed as a section 179 expensing election, and the excess of accelerated depreciation over straight-line depreciation. None of the Treasury officials I spoke to could give a positive assurance that recapture would not occur if the depreciation disallowance was 50% or more in any one taxable year as a result of Notice 2005-45.

10 In order to avoid any potential depreciation recapture, taxpayers may want to consider purchasing a less expensive aircraft or using a charter aircraft for entertainment purposes. It would certainly be better to lose a deduction for a particular charter trip than risk losing millions in depreciation and other items on the new Challenger, Falcon, Gulfstream etc. (I have made this suggestion in many past articles—now may be an opportune time to implement that strategy.)

### Summary and planning opportunities

The purpose of this article is not to provide an exhaustive, all-inclusive, law review analysis of IRS Notice 2005-45, but simply to raise Pro Pilot readers' levels of awareness.



**US-operated Bombardier Global Express visits HKT (Phuket, Thailand). While most overseas corporate trips may be for business, a certain proportion are for entertainment and pleasure. New IRS legislation changes the way companies and individuals claim non-business trips.**

In order to minimize the impact of this notice on aircraft deductions, I suggest that each business entity that owns, leases or charters aircraft for business and entertainment purposes take the following actions:

- 1 Take the time to define what constitutes "business" for your enterprise. Analyze your own facts and circumstances.
- 2 Give equal thought to defining what constitutes entertainment, recreation or amusement for your business. What may be entertainment for businesses and employees engaged in the manufacturing of construction equipment may constitute a business activity for a sporting goods manufacturer sending their employees to a sporting event.
- 3 Revise your business plans, corporate minutes etc, to state that the objective of every investment or asset purchased by your business is made with the intent of producing a profit. This includes the purchase of everything from paper clips to aircraft.
- 4 Include an additional statement that any individual who has access to, and uses, any assets belonging to your business is expected to use the asset for business purposes, is a current customer or client, or is expected to become a referral source for future business.
- 5 By being creative and narrowing the scope of the language in Notice 2005-45 for your business, you may be able to minimize greatly the notice's impact on your business. Remember that tax returns and the application of the tax laws are based on all the facts and circumstances for each particular taxpayer.
- 6 Perhaps the main incentive IRS has for revising this notice or withdrawing it altogether is the fact that, because of its extreme complexity and lack of logic, it will be impossible to prepare a complete and accurate return for 2004 and later years. Collecting all the data necessary to comply with Notice 2005-45 will be extremely challenging for even the most conscientious organization. Anyone who knowingly prepares a return based on incomplete data could, theoretically, be subject to preparer penalties. Would anyone who knows of the inaccuracies inherent in the return, and signs it, be guilty of perjury?

Before you sign and date your next tax return, read the fine print in the signature block..



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