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## **IRS ENTERTAINMENT RULES LIMIT DEDUCTIONS FOR AIRCRAFT OWNERS AND USERS**

### **DEDUCTING AIRCRAFT EXPENSES? DETAILED TAX CALCULATIONS REQUIRED**

IRS regulations require taxpayers claiming deductions for aircraft to undertake detailed calculations to determine what fraction of total expenses may be rendered non-deductible due to personal entertainment use of the plane. These calculations are necessary not only for aircraft owners, but also for lessees and charter customers; they apply to any company seeking deduction of expenses for use or ownership of business aircraft. Described in greater detail below, these required calculations involve evaluating the purpose-for-travel of all passengers carried on the aircraft, and assessing what fraction of the total aircraft occupancy during the year was comprised of travelers with an entertainment purpose.

### **COMPLIANCE CHALLENGES – A REALISTIC EXAMPLE**

Because of their terrific usefulness, aircraft are often shared among a variety of businesses. In some cases, this takes the form of genuine co-ownership, while in others the aircraft owner may sell usage to other companies, either through leasing of aircraft without crew, or by selling air transportation through an FAA authorized charter or “timesharing” arrangement. Such transactions occur both between unrelated parties, and between companies that are under the common control.

In this example, company O owns the aircraft. Endeavoring to receive maximum value from its costly asset, O leases the aircraft to lessee companies L1 and L2 (which are related companies under common control with O), and also enters into an agreement with charter company C for C to sell charter usage to the public. Individuals II own O, L1, and L2.

L1 and L2 have costs of leasing the aircraft, and O has costs of owning it. Each of the three has a different set (or “bucket”) of flights that are relevant to it in the year. L1 and L2’s buckets include, respectively, only the flights that each leased from O. O’s bucket, on the other hand, includes all of the flights—collectively, O’s flights, L1’s flights, L2’s flights, and the charter flights. A single given flight may have disparate effects on multiple buckets. (Each charter customer has its own “bucket,” but, for this example, we will assume those customers to be unrelated and, thus, not II’s problem.) The new regulations require II to establish compliance procedures that can identify the appropriate usage “bucket” for each company seeking to deduct expenses related to the aircraft. That company must then calculate the percentage of deductible expenses based on the usage, and apply that percentage to its aircraft expenses—whether those expenses are for ownership, leasing, chartering, or otherwise.



## CONCENTRATING AIRCRAFT EXPENSES IS NOT AN OPTION

One might suggest, in response to the above example, that the need for L1 and L2's calculations would be eliminated if O were to simply pay all of the aircraft expenses. Because the three companies have the same owners, those owners may not care which company pays the expenses so long as the net amount is the same. In this plan, O will operate the aircraft itself, pay all bills, and provide flights *gratis* to L1 and L2. Unfortunately, this approach runs into problems with both the IRS and the FAA.

The IRS would challenge O's payment of expenses for other companies, based on the concept that O is entitled to deductions only for expenses that are in furtherance of its trade or business. If L1 and L2 are other enterprises, then O lacks the ability to deduct payments made for their benefit.

The FAA, also, would take issue with the approach, arguing that O is providing L1 and L2 with illegal charter service. The FAA applies great scrutiny to situations where one party provides a aircraft, along with crew, to another party—irrespective of whether those parties are related. Even where no money is paid for the use of the aircraft, the FAA has held that the flow of money between entities and their owners (e.g., through capital contributions or distributions) is sufficient to constitute compensation for air-travel provided. This precedent would give the FAA ample basis to find that hidden compensation exists for O's provision of air travel and, thus, that an illegal charter is taking place.

Although, the three, distinct calculations in the above example cannot be avoided, there are compliance steps that can be taken to minimize the challenges, once the requirements are recognized and understood.

## UNDERSTANDING THE CALCULATION

In a nutshell, the new regulation (Reg. §1.274-10) prevents the taxpayer from deducting a portion of aircraft expenses equal to the portion of aircraft use in the year that consisted of "specified individuals" traveling for entertainment purposes. Offset is available for fringe-benefit income recognized by the travelers, and for amounts paid for the entertainment use (subject to FAA limits on when payment can be made). The term "specified individual" is defined very broadly, and generally includes anyone who holds a high-ranking position with the taxpayer, or with any related taxpayer, as well as anyone who owns, directly or indirectly, more than 10 percent of the taxpayer or of any related taxpayer.

Once the specified individuals traveling for entertainment have been identified, the regulations allow the taxpayer to choose among four different methodologies to determine what percentage of aircraft use those travelers represented. A taxpayer may change methods from year to year. The best practice is to perform the calculation in each of the four ways, so that the method that yields the greatest tax deduction can be selected. Taxpayers who have deductions in a single year related to more than one aircraft must apply the same method to all the aircraft for that year.

The four options are comprised of a two-by-two matrix of choices. The taxpayer may choose to measure aircraft use by flight miles, or flight hours; and may choose to measure by passenger trip, or by aircraft trip. As examples: under the "flight hours" / "aircraft trip" method each hour flown by the aircraft in the year is deemed to have the same cost; under the "flight miles" / "passenger trip" method, each mile flown by a passenger is deemed to have the same cost. To illustrate the distinction, under the "aircraft trip" method, a flight with one passenger is deemed to have the same cost as an identical flight with two passengers; under the "passenger trip" method a flight with two passengers is deemed to cost twice as much as an identical flight with one passenger. Taxpayers must aggregate all aircraft costs throughout the year, and allocate them across the usage, based on the chosen method of measuring. Once the cost of each unit

of usage has been thus determined, the regulations prevent deduction of the portion of occupancy consisting of specified individuals traveling for entertainment purposes.

## CONCLUSION

The regulatory framework does not change the fact that the tax law permits companies making use of general aviation aircraft as ordinary and necessary business assets to deduct those costs. It does, however, enhance the compliance burden. Each passenger's purpose must be identified, as it may have an effect on the business's tax outcomes. All it requires is a single entertainment passenger, on a single trip in the year, to trigger the need for an extensive calculation that looks not just at the trip where that passenger was present, but at the total usage in the year. The need for systematic and consistent keeping of aircraft usage records has never been greater. Each passenger's presence and travel purpose must be documented, as it will likely have an effect on tax deductions. Companies that understand the new requirements have approaches available to meet them with minimum burden and inconvenience, while companies that ignore them may find their deductions challenged in the event of an audit. This article is intended as a brief introduction to a complex area; it is not comprehensive, and may not address other related issues that have a bearing on outcomes. Taxpayers are advised to consult a professional versed in this specialized area.

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This article provides an introduction to a complex, and often ambiguous, area of law. Knowledgeable people may disagree as to outcomes in particular cases. Always consult with your advisor.

