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Tax Treatment of the Use of Employer-Provided Aircraft for Entertainment: Current Law and Issues for Congress

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Summary

In general, business taxpayers are permitted to deduct all the ordinary and necessary expenses they incur in earning gross income, such as employee compensation (including fringe benefits). By contrast, expenses incurred by business taxpayers that are personal in nature or primarily for the entertainment, amusement, or recreation of employees (including senior executives) are generally not deductible.

Section 274(e)(2) of the Internal Revenue Code offers an exception to the rule denying deductions for expenses associated with the entertainment of employees. Specifically, business taxpayers may claim a deduction for the cost of goods, services, and facilities used in connection with the entertainment of employees and independent contractors, provided they treat the expenses as compensation in the case of employees or compensation for services rendered in the case of non-employees. Among the facilities covered by this rule are business aircraft. For most employees, the deduction cannot exceed the actual cost of using the facilities for entertainment. But in the case of certain senior executives, the deduction cannot exceed the total amount that business taxpayers report on their federal income tax returns as compensation for the executives' use of the facilities.

This report examines the current tax treatment of the personal use of employer-provided aircraft, describes proposed changes in this treatment being considered in the 109th Congress, and discusses policy issues raised by these proposals. It will not be updated.

The Senate-passed version of a tax reconciliation bill (H.R. 4297) contains two provisions that would modify the tax treatment of the use of employer-provided aircraft for the entertainment of employees and their friends and families. Section 455 of the measure would expand the current limitation on the deduction for expenses associated with the personal use of these aircraft to cover all employees and independent contractors; section 463 would require individuals who travel for their own entertainment on employer-provided aircraft to value those trips for tax purposes as the greater of the actual cost of the travel or its fair market value. These provisions are not included in the House-passed version of H.R. 4297.

Interest groups that would be affected by these proposed changes, led by the National Business Aviation Association, are concerned that the changes would act like a luxury tax on purchases of business aircraft and dampen demand for such planes and related services. They are pressing Congress to exclude them from any conference agreement over H.R. 4297 that may emerge.

Unlike the federal tax imposed on domestic purchases of expensive boats in the early 1990s, however, the proposed changes would not operate like a luxury tax on purchases of business aircraft, though they could raise the tax burden on individuals who travel for entertainment on employer-provided aircraft. In addition, trends in the demand for and use of such aircraft appear to be unaffected by the tax treatment of the use of employer-provided aircraft by employees for their own entertainment.

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Tax Treatment of the Use of Employer-Provided Aircraft for Entertainment: Current Law and Issues for Congress

Under section 162(a) of the Internal Revenue Code (IRC), business taxpayers (e.g., subchapter C corporations, general partners, sole proprietors, and subchapter S-corporation owners) are allowed to deduct all “ordinary and necessary” expenses they incur in earning gross income. In general, a business expense is considered ordinary if it is common or usual and widely accepted in the taxpayer’s business; an expense is considered necessary if it is both appropriate and helpful to the taxpayer’s business. A common example of an ordinary and necessary business expense is reasonable compensation (including fringe benefits) paid to employees.

By contrast, expenses incurred by business taxpayers that are personal in nature (e.g., personal use of a motor vehicle owned by a company) or primarily for the entertainment, amusement, or recreation of employees generally are not deductible.

The Senate-passed version of a tax reconciliation bill (H.R. 4297) contains two provisions that would significantly alter the tax treatment of a fringe benefit offered by numerous firms: personal travel for entertainment on employer-provided aircraft by employees (including senior executives) and independent contractors. Similar provisions are not included in the House-passed version of the bill. One provision (section 455 of the Senate-passed version of H.R. 4297) would expand the existing limitation on the deductibility of costs associated with the personal use of such aircraft so that it covers all employees. The other provision (section 463 of the Senate-passed version of H.R. 4297) would modify the formula for valuing the personal use of employer-provided aircraft so that individuals receiving such a benefit would be required to report the actual cost of this travel as taxable compensation.

Interest groups that have a stake in the matters addressed by these proposed changes (including makers of business aircraft) have raised a variety of concerns about their likely effects. They are especially concerned about the implications of the proposed changes for the cost of taxpayer compliance and the demand for and use of business aircraft and related services. Fearing that the proposals pose too great a threat to their interests, these groups, led by the National Business Aviation Association (NBAA), have launched a lobbying campaign aimed at persuading Congress to exclude the changes from any conference agreement on H.R. 4297 approved by the House and Senate.

This report examines the current treatment under federal tax law of the personal use of employer-provided aircraft, describes the proposed changes in this treatment

under the Senate-passed version of H.R. 4297, and discusses policy issues raised by these changes. It will not be updated.

Current Law

In general, the federal tax code allows firms to deduct all ordinary and necessary expenses they incur in producing their gross income. Thus, it comes as no surprise that under IRC section 274(a), business taxpayers may claim no deduction for expenses they incur in providing entertainment, amusement, or recreation, unless they can demonstrate that such an activity is directly related to or associated with the active conduct of any trade or business they are engaged in. This denial of a deduction also applies to expenses incurred for facilities used to provide entertainment, amusement, or recreation, such as yachts, hunting lodges, swimming pools, tennis courts, cars, and aircraft. The main intent of this rule is to prevent business taxpayers from treating personal expenses as ordinary and necessary business expenses.

Nonetheless, there are several exceptions to this rule. Under one exception, which resides in IRC section 274(e)(2), business taxpayers may claim a deduction for the cost of goods, services, and facilities used in connection with entertainment, amusement, or recreation they offer to employees (including senior executives) or independent contractors (including directors of a company who are not employees), **provided** the expenses are treated on the business taxpayers' federal income tax returns as compensation paid in the case of employees or as compensation for services rendered (or an award or a prize) in the case of non-employees. The deduction cannot exceed the actual cost of the goods and services, or the actual cost of using the facilities. No deduction may be claimed for the use of employer-provided aircraft for the entertainment of employees to the extent that the cost is reimbursed by those individuals.

Under current federal tax law, all individual taxpayers must include compensation for services rendered — such as fees, commissions, and fringe benefits — in their taxable income. IRC section 61 requires individual taxpayers to include in their taxable income the amount by which the fair market value of a fringe benefit exceeds any amount they pay for it. One such benefit is flights taken for personal reasons on employer-provided aircraft.

By now it should be clear that a consequential tax consideration for business taxpayers that own or lease aircraft and employees who travel for entertainment on such aircraft is the valuation of the personal use of this aircraft. Making such a valuation can involve a complicated set of calculations. Under IRS regulation §1.61-21(g), the value of personal flights on employer-provided aircraft typically is determined under a formula known as the Standard Industry Fare Level (SIFL). This formula takes into account flight mileage rates (which vary by the total distance flown), a terminal charge, and the weight of the aircraft.¹ The SIFL formula does not

¹ See IRS Revenue Ruling 2005-61 for the SIFL mileage rates and terminal charges for the
(continued...)

apply in all cases. When it does not apply, the value of a personal flight is considered its fair market value, which is measured as the amount an individual would have to pay to charter the same or a comparable aircraft for the same period and the same, or a comparable, flight. But other considerations may affect the valuation of personal travel on employer-provided aircraft for entertainment. For example, if a trip that is made primarily for business purposes involves a combination of business and personal flights, the excess of the value of all the flights taken over the value of the flights that would have been taken if none of the flights were personal is included in the gross income of employees traveling for personal reasons. But if a trip is primarily personal, the value of all personal flights that would have been taken if there were no business flights is included in income. No amount is included in income if an employee takes a personal trip on an employer-provided aircraft and at least one-half of the aircraft's seats are occupied by employees who are traveling primarily for business purposes and are not required to include the value of the flight in their income.

It is possible under current federal tax law for business taxpayers to claim a deduction for the personal use of employer-provided aircraft by employees (with certain exceptions that are discussed below) or independent contractors that exceeds the amounts they are required to report as compensation on their tax returns. Such a situation is likely to arise when a business taxpayer deducts the actual cost of personal flights by certain individuals but includes in their reported compensation the value of the flights as computed under the SIFL formula. The actual cost of such a flight takes into account all the expenses of maintaining and operating an aircraft (including depreciation allowances) and can amount to thousands of dollars. By contrast, the value of a personal flight on employer-provided aircraft using the formula is comparable to the cost of a first-class ticket for a senior company executive and a coach ticket for other employees.²

The legitimacy of such a deduction was a central issue in a lawsuit involving the IRS and a retail lumber company called Sutherland Lumber-Southwest, Inc.³ Sutherland Lumber owned and operated an airplane that its executives used for business and personal travel. The company deducted the actual cost of using the aircraft for this personal travel, and the IRS challenged the practice on the grounds that it violated IRC section 274(e)(2), which limited an employer's deduction for the personal use of employer-provided aircraft to the amount treated as employee compensation on its federal income tax return. In its ruling in the case, the Tax Court held that Sutherland Lumber was allowed to deduct the actual cost of personal flights taken by employees only if those flights were treated for tax purposes as a fringe benefit and properly included in the employees' compensation. The court also ruled that such a deduction was allowable even if it exceeded the amounts treated as

¹ (...continued)
second half of 2005.

² Kerry Lynch, "So Long Sutherland. Sorry to See You Go," *Business and Commercial Aviation*, Jan. 1, 2005, vol. 96, no. 1, p. 70.

³ *Sutherland Lumber-Southwest Inc. V. Commissioner*, 114 T.C. 197 (2000), affd 255 F.3d 495 (8th Cir. 2001), acq., AOD 2002-02 (Feb. 11, 2002).

compensation to the employees. In 2001, the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court's ruling.

Some Members of Congress and the IRS were displeased with the Tax Court's decision in the Southwest Lumber case. Eventually, they found a legislative remedy for what they deemed an unjustified tax benefit for some business executives. Under a provision (section 907) in the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357), business taxpayers may not deduct the actual cost of using employer-provided aircraft for personal trips by "specified individuals" if that cost is greater than the fair market value of those trips. Rather, any deduction for such travel is limited to the amount that is included in the income of these individuals. Specified individuals are defined as employees or independent contractors who are subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934, or who would be subject to such requirements if their employer were an issuer of the equity securities referred to in section 16(a). Generally, those individuals are officers (as specified in section 16(a)), directors, and owners of publicly and privately held companies holding an equity interest of 10% or greater. Officers are defined as the president; principal financial officer; principal accounting officer; a vice-president in charge of a primary business unit, division, or function; or any other person engaged in policymaking at a firm. The provision applied to all goods, services, and facilities used for the entertainment of the specified individuals, but it was specifically targeted at the use of employer-provided aircraft for that purpose.

The provision served three purposes: (1) to overturn the Tax Court's ruling in the Sutherland Lumber case as it applied to senior company executives, (2) to raise revenue to offset part of the revenue cost of the act, and (3) to deny certain small business owners a net deduction for the personal use of aircraft owned by their firms.⁴ Before the enactment of AJCA, such a deduction was possible when owners of non-corporate firms (so-called passthrough entities such as partnerships and S corporations) traveled for personal reasons on company aircraft and claimed a business deduction for such trips based on the actual cost of operating the aircraft but reported the total value of those trips as compensation under the SIFL formula.

In late May 2005, the IRS issued temporary guidance (IRS Notice 2005-45) to business taxpayers on how they should apply the limitation on the deduction for the use of employer-provided aircraft for the entertainment of specified individuals that was enacted as part of AJCA.⁵ The guidance is to remain in effect until the agency issues final regulations on the topic. A central issue addressed by the notice concerned the allocation of a business taxpayer's flight expenses between the personal use of "specified individuals" and all other uses. For the time being,

⁴ The congressional Joint Committee on Taxation estimated that the provision would lead to a revenue gain of \$1.023 billion between FY2005 and FY2009. See U.S. Congress, Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 4520, the "American Jobs Creation Act of 2004,"* JCX-69-04 (Washington: Oct. 7, 2004), p. 10.

⁵ For a summary of the temporary guidance, see Jason Greene, "IRS Provides Guidance on Deduction for Personal Use of Aircraft by Specified Individuals," *Mondaq Business Briefing*, June 8, 2005.

business taxpayers are required to allocate these expenses for each tax year on the basis of either “occupied seat hours or occupied seat miles flown” by aircraft they own or lease and to be consistent in applying either method. To determine the amount of flight expenses that cannot be deducted under IRC section 274(e)(2), a business taxpayer must allocate the expenses to specific flights involving personal travel by the specified individuals and compare the cost of each flight with the amount treated as compensation or reimbursed by the individuals for those flights. In the case of flights involving a combination of employees flying on business and specified individuals flying for their own entertainment, the cost of the flights must be allocated between business and entertainment use.

Proposed Changes in the Tax Treatment of the Use of Employer-Provided Aircraft for Entertainment in the 109th Congress

The FY2006 budget resolution adopted by Congress contained instructions for three different reconciliation measures, including a bill to reduce revenues by a total of \$70 billion from FY2006 to FY2010. In November 2005, the Senate passed a revenue reconciliation bill (S. 2020) that would reduce revenues by \$57.7 billion over that period. In early December 2005, the House passed a revenue reconciliation bill (H.R. 4297) that would lower revenues by \$56.1 billion in the same period and differed in significant ways from the Senate-passed version. In early February 2006, the Senate approved its own version of H.R. 4297 by substituting an amended version of S. 2020 for the language of the House-passed version. Before a final revenue reconciliation bill can be cleared for the President’s signature, the House and Senate must resolve differences between the two bills in a conference committee, and any conference agreement reached by the committee must be approved by the House and Senate.

While the House-passed version of H.R. 4297 would make no changes in the tax treatment of the personal use of employer-provided aircraft, the Senate-passed version would further modify the rules for deducting and valuing expenses associated with such use. Specifically, section 455 of the Senate bill would extend the limitation on the deduction for expenses related to the personal use of such aircraft by specified individuals to all employees and independent contractors; section 463 would require employees and independent contractors who travel on employer-provided aircraft for their entertainment to value this use for tax purposes according to the greater of the fair market value of flights taken or their actual cost — which takes into account both fixed and variable expenses — less any amount paid to employers by employees and contractors for the personal use of the aircraft. The two provisions are intended to raise revenue and to eliminate what some Members of Congress consider an unwarranted tax break for personal travel by business executives on company aircraft.⁶

⁶ The Joint Committee on Taxation estimates that the two provisions in S. 2020 would raise a total of \$4 million in FY2006 and \$32 million in FY2006 to FY2010. See U. S. Congress, (continued...)

Policy Issues Raised by the Proposed Changes

Some are concerned that the proposed changes in the Senate-passed version of H.R. 4297 would harm the flight departments of U.S. owners of business aircraft and domestic manufacturers of business aircraft, leading to revenue declines, plant closures, and job losses. These critics charge that the proposed changes are equivalent to imposing a luxury tax on purchases of business aircraft.⁷ In their view, the adoption of the changes would do more than discourage the personal use of business aircraft: it would make the use of such aircraft less desirable, eventually reducing domestic sales of general aviation airplanes and the demand for aviation services.⁸ The interest group leading the opposition to the changes, the NBAA, contends in a policy brief that the “proposed tax increases” would have the same effect on the domestic general aviation aircraft manufacturing industry that the federal luxury tax on boats in the early 1990s had on domestic boatbuilders: the brief claims (without supplying supporting evidence) that the tax “nearly halted domestic production and sales (of expensive boats) until it was repealed.”⁹

How valid is such a concern? Not enough information about the role played by the personal use of business aircraft in domestic demand for the aircraft and related aviation services is available from public sources to offer a definitive answer to this question. Nevertheless, there is reason to doubt that the concern has much validity.

First, the proposed changes in the tax treatment of the personal use of employer-provided aircraft would not operate like a luxury tax on purchases of business aircraft. A luxury tax is an excise tax on an item that tends to raise the prices paid for it by buyers, who may end up bearing the brunt of the tax. By contrast, the provisions in the Senate-passed version of H.R. 4297 would affect the amount employers could deduct for the personal use of aircraft they make available to employees and independent contractors and the amount that individuals traveling for their own entertainment on employer-provided aircraft are required to report as taxable income for those trips, which are considered a fringe benefit. If both provisions were enacted, business taxpayers could deduct no more than the amounts reported as taxable income by employees and contractors for the personal use of employer-provided aircraft, and employees and contractors traveling for personal reasons on such aircraft would be required to report as taxable income the greater of the fair market value of those trips or their actual cost.

⁶ (...continued)

Joint Committee on Taxation, *Estimated Revenue Effects of the Tax Provisions Contained in S. 2020, the “Tax Relief Act of 2005,” as Passed by the Senate on November 18, 2005*, JCX-82-05 R (Washington: Nov. 29, 2005), pp. 6-7.

⁷ Kerry Lynch, “Senate Moves to Increase Tax on Personal Use of Business Jets,” *The Weekly of Business Aviation*, vol. 81, no. 23, Dec. 5, 2005, p. 259.

⁸ *Ibid.*, p. 259.

⁹ NBAA, *The Tax Reconciliation Conferees Should Not Accept the Two Senate Tax Increases on Businesses that Rely upon General Aviation*, updated Jan. 20, 2006; available at [<http://www.nbaa.org/public/govt/issues>]; last visited on Jan. 30, 2006.

As one might expect, these changes would have implications for the tax liabilities of eligible employers and employees. On the one hand, because the actual cost of personal travel on business aircraft tends to be much greater than its fair market value as determined under existing IRS regulations, firms with aircraft operations conceivably could claim larger deductions for the personal travel of so-called specified individuals than they are allowed under current law, perhaps lowering the firms' tax liabilities. On the other hand, employees (including senior company executives) and independent contractors would have to report more as compensation for their personal travel for entertainment on employer-provided aircraft than they are required under current tax law, perhaps increasing their tax liabilities. For owners of non-corporate or passthrough firms that own or lease aircraft, the combined effect of the provisions on the tax treatment of their personal travel on such aircraft may be no net increase in their tax liabilities: they would be required to report higher amounts as compensation for such travel — potentially increasing their tax liabilities — but they would be allowed to claim larger deductions for the expenses associated with such travel, reflecting the higher amounts reported as compensation, potentially offsetting the addition to their taxable incomes.

Second, even if the provisions were to raise the tax liabilities faced by most individuals who travel on employer-provided aircraft for their own entertainment, it appears unlikely that such an increase would have a significant effect on domestic demand for business aircraft. Domestic sales and use of these aircraft seem to be influenced more by the competitive advantages of having ready access to such aircraft for business travel, advances in aviation technology, and current and expected trends in business profits than by relatively minor tax considerations, such as the deductibility and valuation of personal travel on employer-provided aircraft by employees, independent contractors, and senior executives.¹⁰ Recent trends in orders for and shipments of business aircraft offer some empirical support for this view. Worldwide shipments of business jets in 2005 were 27% above the level for 2004.¹¹ And from late 2004 to late 2005, worldwide order backlogs for these planes expanded by an estimated 25%.¹² The United States accounted for about 60% of worldwide sales of these aircraft in 2005. This expansion occurred during a period when the limitation on deductions for personal travel on employer-provided aircraft by specified individuals imposed by AJCA was in effect. Moreover, the estimated revenue cost of the provisions from FY2006 through FY2010 (\$32 million) is unlikely to make a dent in the profits that domestic companies that own and operate aircraft will earn over that period. In 2003, according to the NBAA, 376 of the companies comprising the *Fortune 500* operated business aircraft, and their

¹⁰ These advantages include employee time savings, improved productivity while traveling, improved customer and employee retention rates, supply chain improvement, employee safety and security, travel expense savings, the pursuit of charitable missions, and revenues from charter service. See Andersen, *Business Aviation in Today's Economy*, white paper series no. 4, Spring 2001, pp. 6-8; available at [<http://www.nbaa.org>].

¹¹ General Aviation Manufacturers Association, *GAMA Annual Industry Review & 2006 Market Outlook Briefing* (Washington: 2006), p. 4.

¹² Joseph C. Anselmo, "Soaring Again: Business Jet Market Is Poised for Record Year; U.S. Economy Will Determine the Full Extent," *Aviation Week and Space Technology*, vol. 163, no. 18, Nov. 7, 2005, p. 43.

combined net income totaled \$88 billion.¹³ These firms represented about 5% of the NBAA total membership in 2003.

¹³National Business Aviation Association, *NBAA 2004 Fact Book: NBAA Members and the Fortune 500*, available at [<http://www.nbaa.org/public/news/stats/factbook/2004>].