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- EDITOR'S NOTE
- NONQUALIFIED DEFERRED COMPENSATION PLANS OF TAX-EXEMPT EMPLOYERS: NEW AND OLD RULES—HOW DO YOU COPE?
  Joseph D. Olivieri, Birgit Anne Waidmann, and Matthew I. Whitehorn
- CONSIDERATIONS IN APPLYING FOR THE MEDICARE PART D EMPLOYER SUBSIDY
  Yi-Ling Lin
- EQUITY PLANS UNDER NEW DEFERRED COMPENSATION RULES
  Linda Zong
- INTERNATIONAL EMPLOYEE BENEFITS
  Bruce J. McNeil
- EXECUTIVE COMPENSATION: HOW DOES SECTION 409A AFFECT MY COMPANY? A SELF-DIAGNOSTIC GUIDE FOR EMPLOYERS
  Ethan Lipsig
- AIRPLANES—AIR "PAINS": DEDUCTION DISALLOWANCE UNDER NOTICE 2005-45
  Ruth Wimer

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Airplanes—Air "Pains": Deduction Disallowance Under Notice 2005-45

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Companies that own, lease, or charter airplanes gave a collective sigh of dismay when the IRS issued Notice 2005-45[1] (the Notice) earlier this year. The Notice provides a simple but harsh interpretation of the new rules for determining the amount of deduction disallowance under Section 274 of the Internal Revenue Code (IRC or Code) for the entertainment, amusement, or recreational (Entertainment) use of company-provided aircraft by certain company employees.[2] Clarifying changes enacted by Section 907 of the American Jobs Creation Act of 2004[3] (the Jobs Act), the Notice details the IRS's response to the taxpayer's victory in *Sutherland Lumber-Southwest v. Commissioner*[4] years before. This article explains the inflexible new rules set forth in Notice 2005-45 and provides an analysis of the various ways that companies are coping—right or wrong.

OVERVIEW OF THE PROBLEM

In short, the new deduction disallowance is all about the math. Prior to the Jobs Act, a company could deduct not only the costs related to business travel but in addition, all costs attributable to Entertainment travel if proper income inclusion for such travel was made. Under current law, however, the deduction for Entertainment travel generally is limited to the *actual dollar amount included in income*, which may be little or nothing. As an illustration, prior to the Jobs Act, a company that provided an airplane used solely for transporting executives to vacation destinations, for which flights the proper amount of income inclusion was $200,000 and with annual total costs of $1 million, could deduct the full $1 million. Under current law, the deduction would be limited to $200,000 (the amount included in the executives' income), resulting in a deduction disallowance of $800,000.

The reason for the difference between the expenses associated with a company-provided aircraft and the amount included in income is due, in

part, to the favorable rules for imputing income to employees and independent contractors[5] for personal flights provided by an employer. The income inclusion rules for personal flights by an employee or by an employee's guest generally allow the company to include in the employee's Form W-2 an amount equal to the value of the flights as calculated using the Standard Industry Fare (SIFL) rates, but only to the extent such amount exceeds the amount, if any, reimbursed by the employee. Although the SIFL rates are comparable, they are not the same as first-class airfare. The value of flights determined under the SIFL rates for "control" employees is higher than the value of flights for "non-control" employees, but regardless of whether the employee is control or not, the value of flights calculated using SIFL rates are quite low when compared to the cost of chartered flights. The IRS's income inclusion rules require that a comparable piloted charter value be included in the employee's income if the SIFL rates are not chosen to be used or if the SIFL rates were used incorrectly. Like the SIFL rates, the charter rates can be far less than the otherwise deductible expenses incurred by the employer providing the personal flights where the employer owns the airplane and has significant depreciation deductions.

The costs attributable to flights by employees either for business or for personal purposes that are *not* Entertainment are generally allowable in full as a deduction.[6] Under Section 274 prior to its amendment by the Jobs Act, a company could deduct all costs of personal flights by specified employees that were Entertainment flights taken prior to October 22, 2004, if the correct inclusion in income occurred. For Entertainment flights taken after October 22, 2004, and before July 1, 2005, the transition rule contained within Notice 2005-45 provides that the company may use any reasonable method to determine disallowed expenses limiting the deduction to the extent the dollar amount exceeds the amount either included in income or reimbursed by the employee.[7]

For Entertainment flights taken on or after July 1, 2005, the company is required to follow the specific rules set forth in the Jobs Act and Notice 2005-45 for allocating the costs of Entertainment flights. The Notice provides that all such costs are disallowed as a deduction to the extent the amount exceeds the amount included in income or reimbursed by the employee, thereby requiring costs to be determined under the following formula:

[All costs of maintaining and operating the aircraft for the year]

multiplied by

[Entertainment flight seat hours or miles of specified individuals for the year / all occupied seat hours or miles of all passengers for the year]

Less

Greater of the amount included in income or reimbursed expenses for Entertainment flights by specified individuals

As noted previously, the Jobs Act changed the math of calculating the deduction for Entertainment flights by requiring deductible expenses to correspond with the amount actually included in the employees' income. However, the approach for crunching the numbers for this rule taken by Notice 2005-45 is harsh in the sense that *all* fixed and variable costs are included. Furthermore, *all seat*s count for this purpose without an analysis of whether the seat being occupied resulted in the occurring of an expense by the employer.

Notice 2005-45[8] provides this simple, key example to illustrate the IRS's new position:

> **Example 1.** During the taxpayer's taxable year, a taxpayer's aircraft is used for Flights 1, 2, and 3. The duration of these flights is five hours, five hours, and four hours, respectively. 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 x five hours or 20 occupied seat hours for Flight 1, plus four passengers x five hours or 20 occupied seat hours for Flight 2, plus four passengers x four 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 five hours each on Flight 2 and four passengers for four hours each on Flight 3), and the total cost subject to disallowance is $26,000 (26 occupied seat hours x $1,000). For the purpose of determining the amount disallowed (to the extent not treated as compensation or reimbursed), $5,000 ($1,000 x five hours) is allocable to each A and B for Flight 2, and $4,000 ($1,000 x four hours) is allocable to each 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; 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) as compensation to each A, B, E, and F. The taxpayer may deduct $5,200 of the cost of Flight 3. The deduction for the remaining costs of $10,800 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).

Example 1 illustrates the strict mathematical approach taken by the IRS in that all occupied seat hours or miles for the year are added for the period and are given equal weight despite the fact that it would be more reasonable to calculate the *cost per flight* and then divide by the number of passengers on the flights. Conveniently, the inequities that could result from the IRS's position are not readily apparent in Example 1 because all flights in the example have the same number of passengers. However, in real life where the same airplane may fly with one passenger or with 20 passengers on a given day, wildly favorable or unfavorable results may occur.

Example 2 illustrates the principles of the Notice that unduly *favor* the taxpayer.

> **Example 2.** Assume flights are taken to and from the same location on the same company-provided aircraft, each with an associated cost of $5,000. One flight is a vacation flight taken by a specified individual and his spouse, and the other flight carries 20 executives on a business trip. The expense disallowance under Notice 2005-45 would be $909 (2/22 x $10,000),[9] rather than $5,000, the true cost of the Entertainment flight when calculated on a flight by flight basis.

In contrast, depending on the company's particular facts regarding the number of passengers on each flight, coupled with the purpose for each flight, the Notice could have very unfavorable and seemingly inequitable results. In addition to allocating all flight costs for the year to all occupied seat hours or miles rather than allocating the costs per flight to the Entertainment travel, the Notice's methodology clearly requires allocation of costs to Entertainment seats on flights flying primarily for business.

Flight 2 in Example 1 above could be a flight for business for two employee passengers accompanied by their spouses for Entertainment. Although in this instance it would be reasonable to presume that there were *no costs* for the Entertainment passengers—after all, the employer incurred the costs to send its employees for business—the Notice's methodology requires a significant deduction disallowance based on its strict mathematical approach using occupied seat miles or hours.

ELABORATION OF COMPONENTS OF DEDUCTION DISALOWANCE

Income Inclusion Rules

Companies that own, lease, or charter aircraft must now, and always have had to, be intimately familiar with the income inclusion rules applicable to personal flights.[10] Proper reporting of income for personal flight has long been a legal requirement, and now that information is also necessary for calculation of the exact deduction disallowance under Code Section 274.

To begin with, gross income for employees is defined as "all income from whatever source derived, including . . . fringe benefits."[11] In general, the amount of income imputed for an employee fringe benefit is the value of the benefit received from the use of corporate property less any reimbursement by the employee for such use.[12] Therefore, any property or service of value provided to an employee by an employer is taxable income unless a specific statutory provision authorizes an exclusion from income. The Code contains numerous exclusions but not nearly as many as the typical employer presumes. The Code section most frequently relied upon for exclusion from income for travel on company aircraft is Section 132(d), which excludes certain fringe benefits from income as a "working condition fringe."[13] A working condition fringe is that which would be deductible by the employee under Code Section 162 if the employee had paid the expense.[14] With respect to flights on employer-provided aircraft, the trip must be *primarily* for business purposes in order to be excludable under the working condition fringe rules.[15] If the trip is primarily for personal reasons, the value of the flight is a non-deductible personal expense and therefore included in the employee's income under the specific rules set forth under Treasury Regulations Section 1.61-21(g).

No bright-line test exists to determine whether a flight is primarily for business purposes; the specific facts and circumstances of the flight must be examined. Factors to evaluate include the following:

- Amount of time spent on personal activities compared to business activities;

- Business agenda of the trip;
- Location/destination of the flight;
- Characterization of the trip; and
- Presence of a spouse or non-employee guest.

From a practical perspective, because of IRS scrutiny, it is strongly recommended that the above criteria be carefully considered, referenced, and documented when deciding whether the flight is primarily for business purposes as this has understandably been an area of great disagreement between the IRS and the taxpayer. In recently issued audit guidelines, the IRS has indicated that it will specifically target executives' use of company-provided aircraft and examine flight logs in addition to other documentation to determine if further income inclusion for personal, as opposed to business, use is warranted.[16]

The rule for determining the amount that is includible in an employee's income is to determine the *fair market value* of a flight on the employer-provided piloted aircraft. The general rule for determining fair market value is to determine the amount equal to that which the individual would have had to pay in an arm's-length transaction to charter the same or a comparable piloted aircraft for that period for the same or a comparable flight.[17] The value of the flight cannot be determined using the value of a commercial, non-charter aircraft for a comparable flight, and the value of the flight is to be allocated among all employees on the flight.[18]

The major and most often used exception to the general valuation rule where an employee is provided with a personal flight on an employer-provided aircraft is to value the flight using the SIFL rules.[19] The SIFL rules generally produce taxable compensation that is significantly lower than the cost of the flight to the employer[20] and often lower than the amount that results under the general valuation rule referenced above. Under the SIFL rules, the value of each flight for each passenger is determined separately (*e.g.*, a round-trip flight consists of two one-way flights), and therefore, two separate valuations per passenger are required.[21] Also, the value of the flight under the SIFL rules is required to be calculated on a passenger-by-passenger basis for all employees, control and non-control (see below for the definitions of these terms), and the employee's personal guests.[22] The income inclusion rules require that if an employer allows an employee to use the company aircraft for personal purposes and to invite a guest, then the employee has received compensation equal to the value of the employee's and the guest's flights, and the guest has received a nontaxable gift. For example, if a spouse accompanies an employee on a business trip on

an employer-provided aircraft, the value of the spouse's flight, if taken for personal purposes, is includible in the employee's income unless the seating capacity rule is met (see discussion below). The SIFL rate(s) applicable to an employee's personal guests[23] is the same SIFL rate(s) that would be applicable to the employee if the employee were on a personal trip. In addition, if an employer uses the SIFL rules to value any flight provided to an employee in a calendar year, IRS regulations provide that the SIFL rules must be used to value all flights provided to all employees in the calendar year.[24]

The IRS and the Department of Treasury indicated in the Notice that they plan to amend the income inclusion regulations to permit companies to value the Entertainment use of aircraft by specified individuals under the charter fair market value rule but continue to value flights for other employees and for specified individuals not traveling for Entertainment using the SIFL formula.[25] The Notice states that until the regulations are published, taxpayers may rely on the Notice to allow this inconsistency in the treatment of specified individual entertainment flights and all other flights for income inclusion purposes.[26] This loosening of the consistency rule still does not make it completely easy for an employer to know whether it is best to use the charter fair market value rule or the SIFL rates for income inclusion as such can only be known after all the personal flights by employees and their guests have occurred making it possible to determine which results in the least overall imputed income and loss of deduction. For example, a CEO taking a personal trip with his wife, in-laws, five children, and a couple of friends would certainly find that the charter fair market value rule results in less income than the SIFL rate for the trip multiplied by 11.

In addition, Notice 2005-45 makes clear that if the amount treated as compensation on account of a personal flight (*i.e.*, the value of the flight calculated either as the charter fair market value of the flight or by applying the SIFL rules) is *greater* than the amount of the company's costs for the flight, the company's deduction is limited to actual costs.[27]

> **Example 3.** A company owning a six-year-old, fully depreciated airplane with costs per flight seat hour for the year of $200, transports an employee, spouse, and their three children to a vacation destination, resulting in income inclusion in the amount of $12,000 to the employee. If the duration of the flight was two hours, the company may only deduct $2,000 ($200 x 10 flight hours (five passengers x two hours) = $2,000).

Under the SIFL aircraft valuation formula provided for in the regulations that have not changed due to the Jobs Act, the value of a flight is determined using a three-step process.[28]

Step 1: First, on a per individual basis, the number of statute (not

nautical) miles flown on the personal flight is multiplied by the SIFL cents-per-mile charge in effect for the period during which the flight occurred. The Department of Transportation sets the SIFL cents-per-mile charge and updates the rates semi-annually. Figure 1 shows the SIFL cents-per-mile rates for flights taken between January 1, 2005, and June 30, 2005.[29]

Figure 1. Mileage Rates Table

Flight Miles	Cents per Mile
First 500 miles	$ 0.1942 /mile
501–1,500 miles	$ 0.1480 /mile
Miles over 1,500 miles	$ 0.1423 /mile

Step 2: Second, the result from Step 1 is multiplied by the appropriate aircraft multiple from Figure 2, taking into account whether the employee in question is a control or non-control employee (see below for definitions).

Figure 2. Aircraft Multiple Table

Maximum Certified Take-Off Weight of the Aircraft	Aircraft Multiple for a "Control Employee"	Aircraft Multiple for a "Non-Control Employee"
6,000 lbs. or less	62.5%	15.6%
6,001–10,000 lbs.	125%	23.4%
10,001–25,000 lbs.	300%	31.3%
25,001 lbs. or more	400%	31.3%

Step 3: Finally, the terminal charge in effect for the period during which the flight was taken is added to the product determined in Step 2. The Department of Transportation also sets the terminal charge rate and reviews the rate semi-annually. The terminal charge rate is $35.49 for flights taken between January 1, 2005, and June 30, 2005.

> **Example 4.** A CEO (control employee) uses the company airplane for a personal trip of 1,800 statute miles in April 2005. The airplane weighs 15,000 pounds.
>
> *Income Inclusion:*
>
> [Aircraft Multiple x (SIFL rate(s) x Miles)] + Terminal Charge

[300% x ((.1942 x 500 miles) + (.1480 x 1,000 miles) + (.1423 x 300 miles))] + $35.49 = $1,190.16

As noted above, the SIFL formula takes into account whether or not the employee taking the flight is a control employee. It is important to note that the definition of control employee has nothing to do with whether the employee actually has control of determining the destination of the flight. Treasury Regulations Section 1.61-21(g)(8)(i) defines control employee, for non-government employees, as any of the following:

- Officers, whether appointed, elected, or confirmed by the board or shareholders, limited to the lesser of:
- 1 percent of all employees; or
- 10 employees;
- The top 1 percent of the most highly compensated employees, limited to a maximum of 50 employees;
- 5 percent or greater owners of equity, capital, or profits interest in the employer; or
- A director of the employer.

Any employee who is a family member or guest of a control employee is also a control employee.[30] The term "employee" does not include any individual unless such individual is a common-law employee, partner, or 1 percent or greater shareholder of the employer.[31] At the same time, any employee whose salary is less than $50,000 per year cannot be a control employee.[32] Generally, a company's top management personnel are control employees. Unfortunately, the definition for control employee is not the same as for specified employee, the relevant term for those employees whose flights result in a deduction disallowance under the new section 274 rules. This inconsistency results in an increased administrative burden on the employer, requiring it to track the classification of the employee using a company-provided airplane for at least two different purposes.

In addition to the SIFL rules, the income inclusion regulations provide that a personal flight will not be taxable if 50 percent or more of the regular seating capacity of the aircraft is occupied by employees, including partners in a partnership, whose flights are primarily for business.[33] If this so-called "seating capacity rule" is satisfied, the flight value of employees, spouse, and dependent children of employees is excludable from income.[34] Under

the seating capacity rule, the definition of employee *excludes* independent contractors and directors.[35] For flights with multiple legs, the 50 percent threshold must be met when the individual boards the aircraft and when the individual deplanes in order to meet the seating capacity rule.[36] In other words, if an employee and the employee's guests continue on a personal flight after 50 percent or more of the business passengers have deplaned, then the value of the personal flight is not excluded from income. The seating capacity rule is so favorable--resulting in zero income inclusion--that the IRS has made it clear that seats cannot be removed temporarily from the plan to meet the rule.[37] Thus, an airplane with ten seats must have five seats occupied for business in order to exclude from income the value of any of the other occupied seats.

Because the IRS allowed for zero income inclusion if the seating capacity rule was met, it was commonly believed that the rules for deduction disallowance would permit full deduction for such flights. Unfortunately, Notice 2005-45 fully counts those seats for purposes of calculating the deduction disallowance. In other words, such seats fully count in the "occupied seat hours or miles" calculation. Thus, where the seating capacity rule is met, any Entertainment seat hours result in an even larger deduction disallowance because there is *no* offsetting income inclusion.

Similarly, Notice 2005-45 did not provide any special deduction treatment for the value of personal flights excluded from income under the special security program rules. The special income inclusion rules provide that if the employer has either an overall 24 hour security program or has obtained an independent security study, then the excess of the value of the flight over a lower SIFL rate may be excluded from the employee's income as a working condition fringe.[38] It would have been logical for the Notice to not have subjected this value which has been labeled by the income inclusion rules as work related to the deduction disallowance for Entertainment use; but alas, such was not the case. Example 5 illustrates this.

> **Example 5.** Assume that the costs and a regular SIFL value for a vacation flight on a heavy airplane is $7,000 and $4,000 respectively. If the employer has a qualifying security program, the employee can exclude from income the value of the flight in excess of $2,000 as a working condition fringe and is only taxed on the remaining $2,000 to approximate the cost the employee would have paid to go on vacation had the employer not had concerns for her safety. However, the employer will have a deduction disallowance of $5,000, the full difference between its costs and the reduced amount included in income.

Of utmost importance to publicly traded companies is the treatment

of income inclusion for Section 162(m) purposes, which disallows deductions for certain compensation over $1 million during any given year. 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"[39] is subject to Section 162(m). Thus, to the extent the covered employee's "applicable employee remuneration," including remuneration related to Entertainment, exceeds $1 million, the taxpayer's deduction is disallowed for any amount greater than $1 million.[40] This can be viewed as a favorable result because it indicates that it is the *income inclusion*, and not the *costs*, that is subject to the Section 162(m) disallowance. Thus, a non-Entertainment personal flight by a covered employee with more than $1 million of compensation during a year, where costs for the flight were $30,000 and income inclusion was $4,000, would presumably result in a deduction disallowance of only $4,000 under Section 162(m).

Spousal Travel

The income inclusion rules that apply to travel by spouses who are guests are far more complicated than those applicable to other guests. The Code and the regulations provide multiple, interacting provisions that address travel by a spouse of an employee. To begin with, Code Section 162 provides for a deduction for the ordinary and necessary expenses paid or incurred in carrying on any trade or business, including traveling expenses incurred in the pursuit of a trade or business.[41] Section 274 of the Code similarly disallows a deduction for expenses that are generally considered to constitute entertainment, amusement, or recreation "unless the taxpayer establishes that the item was directly related to . . . the active conduct of the taxpayer's trade or business."[42] Treasury Regulations Section 1.162-2(c) provides that where a taxpayer's spouse accompanies the taxpayer on a business trip, the expenses attributable to the spouse's travel are not deductible unless it can be adequately shown that the spouse's presence on the trip has a *bona fide* business purpose. The spouse's performance of some incidental service does not cause the spouse's expense to qualify as deductible business expenses.[43] In contrast, travel by a spouse who accompanies her husband to an out-of-town, *bona fide* business meeting for the purpose of actually performing services for her husband's employer while on the business trip (*e.g.*, performing administrative and secretarial services for her husband's employer during the meeting, serving as a translator during the meeting,[44] attending business sessions specifically directed at non-employee spouses,[45] or the presence seen as essential in protecting and promoting the company's image[46]) could be considered a deductible business expense.

In addition to the preceding general "business purpose" requirement, Code Section 274(m)(3) Code disallows a deduction for travel expenses paid or incurred with respect to an accompanying spouse unless the follow-

ing *three* conditions are satisfied:

- The spouse is an employee of the taxpayer;
- The travel is for a *bona fide* business purpose; and
- The expenses would otherwise be deductible by the spouse.

However, for both Code Sections 274(m)(3) and 274(a), if, as an alternative to meeting all the Section 162 and Section 274(m)(3) requirements listed above, the proper amount for the spousal travel is included in the employee's income, the costs are potentially deductible but subject to the *new* limit of Section 274. Thus, if the spousal travel constitutes *Entertainment* with respect to a specified individual, then the deduction is still limited to the dollar amount actually included in income.

The income inclusion rules surprisingly[47] would permit an exclusion from income for spousal travel, even where the Section 274(m)(3) rules are not met, if the non-employee spouse's travel meets the business requirements of Section 162, and the employer did not treat the travel as compensation to the employee spouse. If the spousal travel is not clearly for business, proper income inclusion *must* be made. Even if the spousal travel is clearly for business, if income inclusion is *not* made, the employer will not be able to deduct *any* expenses unless the spouse is also actually employed by the employer.[48] Thus, it is safe to say that where the costs of providing a flight on company aircraft are significant, the employer will likely be motivated to include the value of the flight in the employee's income despite the fact that the non-employee spouse was there for business purposes.

> **Example 6.** Assume a non-employee spouse accompanies an employee spouse on a business trip. If the value of a non-employee spouse's flight applying the SIFL formula is $1,000, and the costs associated with the flight are $5,000, then including the $1,000 in the employee spouse's income potentially allows for deduction in the amount of $5,000 if it can be substantiated that the trip by the non-employee spouse was not for "entertainment, amusement, or recreation."

Personal Versus Entertainment

The most significant issue left unresolved by Notice 2005-45 is the distinction between non-business personal travel and travel which is entertainment, amusement, or recreation. However, there are some clues. In *Sutherland Lumber*, the flights in question for deduction disallowance were flights solely and exclusively for vacation by employees and family

members. With respect to that which is *not* considered Entertainment, the regulations indicate that commuting would not be considered subject to the disallowance, although clearly personal and requiring income inclusion.[49]

It may be assumed that in addition to travel for commuting purposes, other types of travel that would fall into the category of non-Entertainment personal travel include travel to check on personal investments, for charitable purposes, to attend a funeral, or due to a family emergency. Furthermore, although certain personal travel by a non-employee spouse may not meet the stringent business-related requirements set forth in Code Section 162 and would therefore not be deductible as a business expense under Section 162, such travel may not meet the "entertainment, amusement, or recreation" trigger for a denial of deduction under Section 274(a)(1) either.

As an illustration of a very common problem area, assume a non-employee spouse accompanies her husband to an out-of-town ceremony where he will be awarded for his contributions to the company. The purpose for the non-employee spouse's travel to the meeting is to support her husband in his receipt of this award and to show her support for his efforts and contributions to the company. It may be reasonable to conclude that the non-employee spouse's presence at the company-sponsored ceremony would not be considered time spent for her "entertainment, amusement, or recreation," as little or no time would be spent furthering any type of "Entertainment" goals. In this situation, where the non-employee spouse is not actually working, the non-employee spouse's travel is not directly related to the business of the husband's employer and, therefore, would not be deductible by the employer as a business expense under Section 162 of the Code unless treated as compensation to the employee. However, the non-employee spouse's travel in many cases would not rise to the definition of an entertainment, amusement, or recreation expense. Other examples might include situations in which the spouse's presence at dinners and social gatherings promotes employee moral and fosters networking and business relations, yet not at a level sufficient to meet the Section 162 business expense threshold. A concern is that absent specific guidance, the IRS would view travel by a spouse, accompanying a specified employee spouse traveling on business, as always being travel which is either entertainment, amusement, or recreation and thus subject to the new disallowance rules.

Expenses Subject to the Disallowance

Under the Jobs Act[50] and Notice 2005-45, the employer's deduction disallowance is generally equal to the difference between the actual cost of the flight and the compensation amount included in the executive's income under the SIFL rules, as well as the amount reimbursed to the employer. This deduction disallowance for goods, services, and facilities relate only to flights of those individuals who meet the definition of "specified indi-

viduals" as defined under Section 16(a) of the Securities and Exchange Act of 1934[51] (the Securities Act)[52] or that would if the employer were subject to the exchange act. (Note: The term "specified individuals" is discussed below in additional detail.) In the case where the "specified individual" is an employee, the employer excludes such expenses from the deduction disallowance to the extent that the expenses do not exceed the amount treated as compensation to the "specified individual" employee[53] or which are reimbursed. If the "specified individual" is a non-employee, the employer excludes such expenses from the deduction disallowance only to the extent that the expenses do not exceed the amount of the expenses which are includible in the gross income of the non-employee, the amount that must be reported on Form 1099, or the amount reimbursed.[54]

Notice 2005-45 states that for purposes of calculating the amount of expenses for entertainment use of an aircraft that are disallowed, taxpayers must take into account all of the expenses of maintaining and operating the aircraft (all fixed and operating costs).[55] The Notice states that 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 (including amounts deductible under Section 179); in the case of chartered aircraft, all costs billed for the charter; and in the case of leased aircraft or other leased equipment, lease payments.[56] Interest expense related to the purchase of a company-provided aircraft would also appear to be subject to the disallowance, but overhead costs in general should not be.

Depreciation and Section 280F Implications

By far the biggest disappointment with Notice 2005-45 of employers owning aircraft was the position that depreciation is subject to the Section 274 disallowance. Before Notice 2005-45 was issued, there was the belief that depreciation would not be subject to the disallowance as it is a fixed cost and therefore not an expense directly related to the provision of a particular Entertainment flight where the purchase and use of the airplane was primarily for business. Because Notice 2005-45 clearly limits the deduction of all costs including depreciation in years where there is Entertainment use, some employers are rethinking the use of accelerated depreciation.

The new Section 274 rules should not impact the requirements for favorable depreciation under Section 280F, which like Section 274 treats some personal use negatively, because the type of use sought to be limited by Section 280F is almost completely different than that described in Section 274(a).

Code Section 280F limits depreciation for listed property not used

predominantly in a trade or business; similarly, Treasury Regulations Section 1.280F-7(b) limits lease deductions. If an aircraft that is leased by a taxpayer is not used "predominantly in a qualified business use" in any year, the lessee must add an inclusion amount to gross income in the first year in which the aircraft is not so used.[57] For purposes of Section 280F, property is treated as predominantly used in a qualified business use for any taxable year if the business use percentage for such taxable year exceeds 50 percent.[58] Qualified business use does *not* include:

1. Leasing property to any 5 percent owner or related person;

2. Use of the property provided as compensation for the performance of service by a 5 percent owner or related person; or

3. Use of property provided as compensation for the performance of services by any person who is not a 5 percent owner or related person unless an amount is included in the gross income of such person with respect to such use and, where required, taxes are withheld.[59]

These exclusions from qualified business use do not apply with respect to any aircraft for which at least 25 percent of the total use of such aircraft during the taxable year consists of other qualified business use.[60] The definition of qualified business use is confusing because of the use of two negatives with respect to non-5 percent owner employee use. Note that purely personal, even Entertainment use, other than by 5 percent owners, may count for the special 25 percent rule if it has been properly included in income.

"Specified Individuals"

The amended provisions of the new tax law apply to individuals who, with respect to an employer or other service recipient, are subject to the requirements of Section 16(a) of the Securities Act or would be subject to such requirements if the employer or service recipient were an issuer of equity securities referred to in Section 16(a) of the Securities Act.[61]

Generally, a "specified individual" is defined as any of the following:

- Officers (as defined by Section 16(a) of the Securities Act);

- Directors; or

- More than 10 percent-or-greater owners of private and publicly held companies (includes subchapter C or subchapter S or a personal service corporation);

- For partnership purposes, any partner that holds a more than 10 percent equity interest in the partnership, general partner, officer, or managing member of a partnership; or

- Director or officer of a tax-exempt entity.[62]

An officer is defined under Section 16(a) of the Securities Act as any of the following:

- President;

- Principal financial officer;

- Principal accounting officer (or, if there is no such accounting officer, the controller);

- Any vice-president in charge of a principal business unit, division, or function (such as sales, administration, or finance);

- Any other officer who performs a policy-making function,;or

- Any other person who performs similar policy-making functions.[63]

The guests of a guest of a "specified individual" would also be considered a "specified individual."[64] Generally, members of an employer's management team would all be "specified individuals."

Method of Allocating Expenses to Flights

Notice 2005-45 states that the total deductible expenses attributable to an aircraft must be allocated to expenses for use of the aircraft for Entertainment of specified individuals and expenses for all other uses.[65] A taxpayer must allocate expenses for each taxable year using either the occupied seat hours or the occupied seat miles flown by the aircraft and must apply the chosen method consistently for all usage for the taxable year.[66] Occupied seat hours or miles is the sum of the hours or miles flown by the aircraft multiplied by the number of seats occupied for each hour or mile. For example, a flight with a duration of six hours with three passengers results in 18 occupied seat hours. Companies 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 mile.[67] Noteworthy is the provision in the Notice that allows companies to either calculate the cost per occupied seat hour or occupied seat mile separately for each aircraft or to aggregate the

costs of aircraft of similar cost profiles. As an example, the Notice states that the costs for a turboprop aircraft and a jet aircraft must be calculated separately.[68] Accordingly, the Notice provides an opportunity for strategy for companies with multiple aircraft.

> **Example 7.** Assume a company has several aircraft including two twin engine aircrafts, each with annual costs of $1 million. The company provides one aircraft to the CEO and her family exclusively for Entertainment purposes, and the other aircraft is reserved for the exclusive use of the CEO and all other company employees for business purposes or personal flights that are not Entertainment. Assume further that the airplane used for Entertainment has 100 seat hours for the year, and the other airplane has 300 seat hours for the year. Combining the aircraft as permitted by the Notice would result in a potential $500,000 in costs being attributed to the deduction disallowance (prior to reduction for income inclusion to the CEO), rather than $1 million in costs had the airplanes been accounted for separately.

The amount disallowed 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 by each specified individual for each flight.[69] 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 or reimbursed by the specified individual for that flight.

Note that in any given year, if all flights are for business or for personal reasons that are not Entertainment, or all flights are not taken by any specified individual, no costs are subject to the new Section 274(a) deduction disallowance. That is, the taxpayer is generally permitted to deduct the total cost of maintaining and operating the aircraft, assuming that for Entertainment flights for non-specified individuals proper income inclusion occurred.

Under Notice 2005-45, an aircraft returning empty from a flight after discharging passengers or traveling empty to pick up passengers (situations referred to as "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.

The costs of a flight provided to a specified individual that includes a segment or segments for business and Entertainment must be allocated to the business and Entertainment uses.[70] 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(s).[71]

Example 8 illustrates the allocation for trips for both business and Entertainment.

> **Example 8.** 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 flight has resulted in nine occupied seat hours. If G had returned directly to City A from City B, the flight hours would have resulted in four occupied seat hours. The taxpayer's cost per occupied seat hour is $1,000.
>
> The total amount subject to deduction disallowance is $5,000. This is computed by taking the total occupied seat hours (nine) less business occupied seat hours (four) multiplied by the cost per seat hour ($1,000) [nine hours minus four hours multiplied by $1,000 = $5,000].

Figure 3 provides an overview of the general taxation consequences that arise upon the use of an company-provided aircraft by a CEO who is a specified individual, other employees who are not specified individuals, and non-employee guests of both (*e.g.*, spouse).

SOLUTIONS TO THE AIR "PAINS"

The most obvious solution to the "air pains" caused by the Jobs Act and Notice 2005-45 is to limit or eliminate Entertainment use by specified individuals, as the new Section 274 deduction disallowance is based only on the expenses allocated to Entertainment miles or hours by specified individuals. A company's executive travel policy could either prohibit Entertainment travel for employees or guests or ration the amount permitted per year per employee. Note that other personal travel for specified individuals, such as commuting, investment related, or personal or family emergency, could still be freely permitted without any deduction disallowance.

Increasing reimbursements by specified individuals focusing only on Entertainment flights is another possible solution. However, reimbursements may result in increased Federal Aviation Administration (FAA) requirements, as well as application of the 7.5 percent excise tax imposed by Section 4261. In addition, reimbursements reduce dollar-for-dollar the disallowance otherwise imposed on the employer company, but at the cost

Figure 3. General Taxation Consequences of Company-Provided Aircraft

Event	Income Inclusion	Disallowance Before July 1, 2005	Disallowance After July 1, 2005
Vacation flight by CEO and spouse; 1 hour	Yes. SIFL value x 2 (employee and spouse) in CEO's W-2	Yes. Possibly only incremental costs	Yes. 2 seat hours
Vacation flight by employee and spouse; 1 hour	Yes. SIFL value x 2 (employee and spouse) in employee's W-2	No	No
Business flight by CEO, 2 hours; spouse accompanies for personal but not for entertainment	Yes. SIFL value x 1 (spouse only) in CEO's W-2	No	No
Business flight by CEO, 2 hours; spouse accompanies for entertainment; deadhead flight returns	Same	Possibly no	Yes. 4 seats hours
Commute by CEO	Yes. SIFL value x 1 (employee) in CEO's W-2	No	No
Commute by employee	Yes. SIFL value x 1 (employee) in employee's W-2	No	No
10-seat plane occupied by CEO and 4 employees on business, and 5 spouses for entertainment; 1 hour	No	No	Yes. 1 seat hour
10-seat plane occupied by CEO and 3 employees on business, and 4 guests of CEO for entertainment; 1 hour	Yes. SILF value x 4 (four guests) in CEO's' W-2	No	Yes. 4 seat hours
Vacation flight by CEO, spouse, and 3 children (1 of whom is 19 months old); 5 hours	Yes. SIFL value x 4 in CEO's W-2	Yes. Possibly only incremental costs	Yes. 20–25 seat hours

dollar-for-dollar to the paying executive. Accordingly, in this case, the economic burden of paying for the airplane is borne by the employee.[72]

As a separate matter, rumors abound that if employees reimburse the employer an amount equal to a charter cost for the same flight, the flights no longer are classified as flights subject to the Section 274 disallowance. Proponents of this position argue that the flight in this case is not "provided by the employer" and therefore is not an Entertainment cost subject to Section 274. Thus, no disallowance occurs no matter how high the costs associated with the flight. There is some support for this position in Section 274(e)(8) which exempts from the general Section 274 disallowance "entertainment sold to customers." Specifically, Section 274(e)(8) exempts from the disallowance expenses for goods or services that are sold by the taxpayer in a *bona fide* transaction for an adequate and full consideration in money or money's worth. However, it its not clear exactly how Section 274(e)(8) will apply to employers who engage in charters or lease to unrelated third parties under Notice 2005-45, and it is likely that it may not provide relief to employers who do not charter or lease their airplanes at all to unrelated third parties.

Increasing the amount included in income using the fair market value charter rule focusing only on Entertainment flights by specified individuals is a solution that, thanks to Notice 2005-45, is technically permitted under current income tax rules. As mentioned previously, actual employer costs may *not* be used as a basis for income inclusion, but the Section 61 regulation "charter" costs may be used for the specified individual's Entertainment flights, while the generally lower SIFL costs could be used for all other personal flights. However, like reimbursements, this simply shifts the burden, in this case the tax burden, to the specified individual who now must pay income tax on the larger amount reported on the Form W-2. Compounding the problem is the fact that the increased inclusion in income also increases the employment tax burden on the employer and employee[73] and may be subject to the new withholding rules for bonus compensation in excess of one million dollars. Most importantly, if the executive's compensation is subject to disallowance under Section 162(m), amounts included in the executive's compensation in excess of that which is mandatory (*e.g.*, amounts determined applying the applicable SIFL rates) would generally not be recommended. This is because although the Section 274 disallowance is decreased, the amount is disallowed in any regard under Section 162(m) if total compensation for the employer's year then exceeds $1 million.[74]

Recordkeeping for Airplanes

Notice 2005-45 clearly states that after July 1, 2005, the deduction disallowance must be calculated based on the basis of seat hours or miles compiled on a yearly basis.[75] Accordingly, a company that permits any

Entertainment use by specified individuals or their guests must maintain records for the total seat hours or miles for each aircraft or grouping of aircraft of similar cost profiles for the year.[76] Also with respect to keeping records for purposes of the deduction disallowance, the employer must carefully substantiate which seats were actually entertainment, amusement, or recreation, as contrasted to other types of personal travel. The company is also required to keep records during the calendar year of all personal flights by all employees, independent contractors, and their related guests in order to comply with proper Forms W-2 and 1099 reporting requirements. For this purpose, the employer must ensure that careful records are maintained as to which employee or independent contractor that a no service provider passenger's flight is attributable, if any.[77] If the employer intends to use the SIFL rules for this purpose, it may find it easier to use seat miles rather than seat hours for purposes of calculating the disallowance so as to more easily match the proper income inclusion with the flight subject to the disallowance. Companies that are subject to Securities and Exchange Commission (SEC) reporting requirements must also maintain records as to the incremental costs incurred due to any personal flights for the executives subject to SEC reporting.[78] Presumably, for aircraft that are chartered exclusively for the flight, the incremental costs would be the entire costs of the charter; however, for flights on aircraft owned by the employer, the incremental costs may only include fuel and other miscellaneous incremental expenses.[79] Finally, for Code Section 280F purposes, the company must track leasing to 5 percent owners and related parties and use for compensatory purposes by 5 percent owners[80] as a percentage of all use during the year in order to determine whether the 25 percent and 50 percent thresholds necessary for favorable depreciation have been met.

CONCLUSION

Notice 2005-45 provides rules that are simple to understand, even if the results are not what employers were wanting or expecting as the IRS's interpretation of the new disallowance rules under Code Section 274. It would appear that the major remaining "unknown" with respect to the new provisions under Section 274(a) is where to draw the line between flights for entertainment, amusement, or recreation and all other personal flights—a critical issue as the latter is not subject to the new disallowance. In addition, employers attracted to owning their own aircraft for purposes of efficiency may find that the recordkeeping and calculations added by Notice 2005-45 to current IRS, SEC, and FAA burdens may tip the scales in the direction of flying commercially.

NOTES

1. Notice 2005-45, 2005 IRB LEXIS 210, 2005-24 I.R.B. 1228.
2. Note that an amendment to a recent bill (Highway Reauthorization and Excise Tax Simplification Tax Act of 2005 (H.R. 3)) proposed to expand the deduction disallowance for Entertainment use to all employees regardless of status as a specified individual. *See* Section 5516 of the Senate amendment to H.R. 3.
3. Pub. L. No. 108-357.
4. 114 T.C. 197 (2000), *aff'd* 255 F.3d 495, 2001 U.S. App. LEXIS 14998 (8th Cir. 2001).
5. Later references to "employee" in this article also will generally include reference to independent contractors.
6. It may be an over generalization to claim all costs of business travel are always deductible given the IRS position in FSA 200137002 wherein an amount equal to first class airfare was concluded to be the only amount deductible rather than the actual higher costs of owning and operating a company aircraft. The IRS relied on *Kurzet*, TCM 1997-54, *aff'd* in part and *rev'd* in part 222 F.3d 830, 86 AFTR2d 2000-5655 (CA-10,2000) where the Tax Court found costs "extraordinary" for the taxpayer's few uses in its business. In addition, Section 274(n) generally provides for a 50 percent deduction disallowance for entertainment expenses even where in connection with business.
7. "Reasonable" method is not defined for this purpose other than that the new rules set forth in the notice will be determined to be reasonable. Accordingly, subjecting only incremental costs for entertainment flights may be reasonable if the majority of flights for the year on the aircraft was for business. Furthermore, where a single flight was for business but included a guest flying for entertainment, it may be reasonable to have no deduction disallowance on the basis that no costs were incurred for the entertainment usage.
8. Notice 2005-45, Section (B)(6).
9. Two entertainment passengers divided by 20 total occupied seat hours multiplied by $10,000 total costs (two flights multiplied by costs of $5,000 each).
10. One of the more common misconceptions concerning the Jobs Act is that companies may no longer use the SIFL rules for imputing income. These rules have not changed, and in fact, currently it is not permissible to use *cost* as a basis for imputing income.
11 IRC § 61.
12. Treas. Reg. § 1.61-21(b)(1).
13. *See* IRC § 132(d) and Treas. Reg. § 1.132-5.
14. *Id.*
15. Treas. Reg. § 1.132-5(k).
16. *See* IRS Market Segment Specialization Program Audit Guidelines.
17. Treas. Reg. § 1.61-21(b)(6)(ii).
18. *Id.*
19. Treas. Reg. § 1.61-21(g)(5).
20. Depreciation, including bonus depreciation, in the early years of owning an aircraft would typically result in the total employer costs being higher than a charter-based income inclusion.
21. Treas. Reg. § 1.61-21(g)(3)(ii).
22. *Id.* Note also that the value of the flight provided to a child less than two years old is deemed to be zero. Treas. Reg. § 1.61-21(g)(1).
23. *See* Treas. Reg. § 1.61-21(5). Not answered in the regulations is how to determine if a passenger is a "guest." It would appear that such determination is subjective, based on facts and services, and is a matter of "attitude" of the employee in whose income the passenger in question's flight would be included.
24. Treas. Reg. § 1.61-21(g)(14).
25. Notice 2005-45, Section (B)(8).
26. *Id.*
27. *Id*.
28. *See* Treas. Reg. §§ 1.61-21(g)(5) and 1.61-21(g)(7).
29. Rev. Rul. 2005-14. The SIFL rates are typically published after the beginning of the time period to which they relate.
30 Treas. Reg. § 1.61-21(g)(8)(ii)(A).
31. *Id.*
32. Treas. Reg. § 1.61-21(g)(8)(ii)(B).

33. Treas. Reg. § 1.61-21(g)(12)(i)(A).
34. *Id.*
35. Treas. Reg. § 1.61-21(g)(12)(i)(B)(1).
36 . Treas. Reg. § 1.61-21(g)(12)(ii).
37. Treas. Reg. § 1.61-21(g)(12)(iii)(B).
38. Treas. Reg. § 1.132-5T(m)
39. As defined in IRC § 162(m)(3).
40. IRC § 162(m)(1).
41. *See* IRC § 162(a)(2).
42. IRC § 274(a)(1)(A).
43. *See Kerr v. Commissioner, T.C. Memo 1990-155*.
44. *Id.*
45. *See Anchor National Life Insurance Co. v. Commissioner, 93 T.C. 382 (1989)*.
46. *See Disney v. United States, 267 F. Supp. 1 (1967)*.
47. IRC § 132 regulations generally allow for an exclusion from income as a working condition fringe only if the recipient could deduct the value as a business expense on his or her personal income tax return. An employee spouse flying for business with a non-employee spouse also flying for business purposes could *not* deduct the non-employee spouse's cost of travel because of the Section 274(m)(3) limitation.
48. IRC § 274(m)(3).
49. Treas. Reg. § 1.274-2(b)(1)(i).
50. *See* Section 907 of the Jobs Act.
51. 15 USCS § 78p(a)
52. IRC § 274(e)(2)(B)(ii).
53. IRC § 274(e)(2)(B).
54. *See* IRC § 274(e)(9).
55. Notice 2005-45, Section (B)(4).
56. *Id.*
57. Treas. Reg. § 1.280F-7(b)(1) and IRC § 280F(b)(1).
58. IRC § 280F(b)(3).
59. IRC § 280F(d)(6)(C).
60. IRC § 280F(d)(6)(C)(ii).
61. Notice 2005-45, Section (B)(3).
62. *Id.*
63. 15 U.S.C. § 78p(a).
64. *Id.*
65. Notice 2005-45, Section (B)(5).
66. *Id.*
67. *Id.*
68. *Id.*
69. *See Id*. at Section (B)(1).
70. *Id.* at Section (B)(7).
71. *Id.*
72. In contrast, owners of companies taxable as partnerships may find reimbursements to be the appropriate approach where Entertainment usage by the different owners varies. For example, three equal partners using one partner's airplane, with usage resulting in $600,000, would find it more equitable to have the "flying" partner reimburse the $600,000 so that the other two partners do not pay tax on an additional $200,000 deduction disallowance reported on their individual Schedule K-1s.
73. Applicable taxes include Social Security taxes of 7.5 percent on the first $90,000 for 2005 and Medicare taxes of 1.45 percent on all additional compensation.
74. IRC § 162(m)(1).
75. Notice 2005-45, Sections (B)(5) and (D).
76. If records are kept separately for each aircraft, the company may calculate the deduction disallowance for each aircraft separately or when aggregated and determine which method provides the least disallowance.
77. It is possible that a passenger is not a guest of any specific employee or independent contractor on the flight and, therefore, there would be no income inclusion for the employee or independent contactor attributable to the flight.

78. *See* 17 C.F.R. § 229.402(b).
79. For employer-owned aircraft, incremental costs might include ground transportation, per trip related maintenance, foreign permit, and similar fees directly related to the flight; parts and external labor per hour of flight; insurance obtained for the specified flight; away from home base hangar fees and tie down costs; in-flight food and beverage; crew travel expenses; flight planning and weather contract services; landing fees; airport taxes; and similar assessments.
80. It is assumed that the company would not have any use in the third category listed under Section 280F (personal use by other than a 5 percent owner for which W-2 inclusion was not made).