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September 13, 2007

**VIA Hand Delivery**

CC:PA:LPD:PR (REG-147171-05)  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, D.C.

RE: Comments on Proposed Treasury Regulations Relating to the Use of Business Aircraft for Entertainment (Prop. Treas. Reg. §§ 1.274-9, -10 and 1.61-21)

This letter is respectfully submitted by the National Business Aviation Association (“NBAA”) to provide comments regarding Proposed Treasury Regulations relating to the use of business aircraft for entertainment. These regulations interpret amendments to I.R.C. § 274(e)(2) and (e)(9) made by the American Jobs Creation Act of 2004 (the “Jobs Act”). NBAA represents more than 8,000 Member Companies, and is the leading organization for companies that own or operate general aviation aircraft to help make their businesses more efficient, productive and successful. Set forth below are NBAA’s specific comments presented in the order that they appear in the preamble and the proposed regulations.

**1. Additional guidance is needed to alleviate the tax problem that companies face when using their aircraft for charitable flights.**

The discussion of the definition of entertainment in section 1(a) of the Preamble explains that flights to participate in charitable activities are not subject to the entertainment expense limitation. However, excluding charitable flights from the entertainment disallowance does not alleviate the tax problem that companies face when using their aircraft for charitable purposes. Owners and operators of business aircraft regularly contribute the use of their airplanes for charitable purposes, often in support of national safety and relief efforts. One such example was the contribution of relief flights in the days and months following Hurricane Katrina. Countless business aircraft flew medical and food supplies and relief workers to the hurricane-stricken areas and transported hurricane victims to safe grounds in new communities throughout the U.S.

Under current tax law, a charitable deduction is limited to certain variable costs of transportation for charitable purposes. Treas. Reg. § 1.170A-1(g) (charitable deduction allowed for “out-of-pocket transportation expenses”); *Orr v. United States*, 343 F.2d 553, 557 (5th Cir. 1965), *aff’d* 226 F. Supp. 809 (M.D. Ala. 1963) (charitable deduction is not allowed for “payments which the taxpayer would have made for non-charitable reasons”); Rev. Rul. 58-279, 1958-1 C.B. 145, *modified*, Rev. Rul. 84-61, 1984-1 C.B. 39 (charitable deduction allowed for “out-of-pocket expenses directly attributable to the performance of such volunteer services”). “Only those expenditures incurred for operation, maintenance, and repair, which are directly attributable to the use of such aircraft” on a charitable flight can qualify as charitable deductions. Rev. Rul. 58-279. Examples of costs that could be “directly attributable” to a charitable flight include (a) the cost of fuel and oil for the flight, (b) pilot fees incurred solely for the flight, (c) rental charges for an aircraft used only for the flight, and (d) extra liability insurance incurred only for the flight. *See Orr*, 343 F.2d at 555; Rev. Rul. 58-279; Priv. Ltr. Rul. 92-43-043 (July 29, 1992).

In contrast, charitable deductions are not permitted for a proportionate share of fixed costs that would have been incurred even if the charitable flight had not occurred. *Orr*, 343 F.2d at 556-8; Rev. Rul. 58-279. Examples of such fixed costs include depreciation, general maintenance and repairs, and insurance. *Orr*, 343 F.2d at 556-8; *Mitchell v. Comm’r*, 42 T.C. 953, 973-4 (1964), *acq.* 1965-2 C.B. 6 (no charitable deduction for depreciation); Rev. Rul. 58-279. Similarly, pilot salaries and aircraft rents that do not vary with the number of flights would appear to be fixed costs that would not be “directly attributable” to a charitable flight. Accordingly, taxpayers generally cannot take a charitable deduction for fixed aircraft operating and maintenance costs attributable to charitable flights.

Since a taxpayer is only entitled to a business expense deduction for the portion of its aircraft expenses attributable to the business use of the aircraft, it is not permissible for a taxpayer to deduct costs attributable to a charitable flight as business expenses (assuming the charitable flight is not primarily for business purposes). Applicable tax regulations provide that the business use percentage is determined based on business miles divided by total miles, and do not provide for the treatment of charitable miles as business miles. *See* Treas. Reg. § 1.274-5T(b)(6)(i)(B). In *Orr*, all of the fixed expenses attributable to the charitable use of the aircraft were disallowed even though the aircraft was used for charitable, business and personal use. *See Orr*, 226 F. Supp. at 810 (In 1957, the aircraft was used approximately 80% for charity, 13% for business and 7% for personal use. In 1958, it was used approximately 15% for charity, 49% for business and 36% for personal use.); *see also Davidson v. Comm’r*, 82 T.C. 434, 440 (1984) (“[c]haritable uses are personal”).

Since fixed expenses often comprise most of the operating and maintenance costs of an aircraft, a charitable flight can result in a substantial disallowance of expenses that might otherwise be deductible. For example, if a company aircraft is used 100% for business flights, then all of its maintenance and operating expenses ordinarily would be deductible. However, if the same aircraft is used 90% for business flights and 10% for charitable flights, then 10% of the fixed costs apparently would be nondeductible. In other words, charitable flights can result in the disallowance of otherwise deductible business expenses, because a charitable deduction is

not allowed for fixed costs attributable to charitable flights, and there is no provision in the law allowing the deduction of such costs as business expenses (assuming the primary purpose of the flight was for charitable rather than business purposes).

Instead of rewarding companies that conduct charitable flights with a tax benefit, this rule imposes an additional tax liability on such companies. It is inconceivable that Congress intended that flights for charitable purposes would result in an increase in the aircraft operator's taxes. The appropriate remedy would be to amend the regulations to correct this problem. For example, the problem could be resolved by amending Treas. Reg. § 1.274-5T(b)(6)(i)(B) to provide that costs to operate and maintain an aircraft are to be allocated only among non-charitable flights, and that costs qualifying for an out-of-pocket charitable contribution deduction are excluded from the total costs allocated between business and personal flights. For example, suppose that 80% of the flight miles (or hours) are for business flights, 10% are for charitable flights and 10% are for personal flights. Under this suggested regulatory structure, the "out-of-pocket" costs attributable to the charitable flights would be deductible as a charitable contribution. The out-of-pocket costs would then be subtracted from the total operating costs, and the remaining operating costs (including the fixed costs otherwise attributable to the charitable flights) would be allocated 8/9ths to the business flights and 1/9th to the personal flights.

**2. The flight-by-flight allocation method is an improvement; however, NBAA urges the IRS and Treasury to reconsider their decision to reject the primary purpose method.**

Prop. Treas. Reg. § 1.274-10(e)(3) allows taxpayers to use the flight-by-flight method of allocating expenses. This represents a much needed improvement over the occupied seat method since it removes the obvious distortion under that method that resulted from allocating costs among flights in proportion to the numbers of passengers on each flight. Nevertheless, as explained below, the passenger-by-passenger cost allocation methods (occupied seat method and flight-by-flight method) are inconsistent with existing statutes and legislative history, which require that costs be allocated based on the primary purpose of each flight taken as a whole. Furthermore, they impose an excessive administrative burden on taxpayers.

**A. The "primary purpose" method would effectuate Congressional intent.**

The Preamble explains in section 1(b) that the IRS considered and rejected comments suggesting that entertainment or nonentertainment classification should be made for each flight as a whole, rather than for each passenger on each flight. Under the primary purpose method, if a flight is undertaken primarily for business purposes and there are additional passengers traveling for entertainment purposes, the entertainment disallowance would apply to only the marginal cost (e.g. additional catering charges) of carrying those additional passengers. Consistent with the Preamble, Prop. Treas. Reg. § 1.274-10(e)(1) prohibits the use of the primary purpose method by requiring that taxpayers only use the occupied seat method or the flight-by-flight method to allocate expenses for purposes of the entertainment disallowance.

The IRS and Treasury should reconsider their decision to reject the primary purpose method, because the passenger-by-passenger methods (i.e. the occupied seat method and the flight-by-flight method) conflict with the plain language of the statute, are inconsistent with Congress' intent and impose an excessive administrative burden for taxpayers.

I.R.C. § 274(a)(1) applies the entertainment disallowance to “deduction[s] otherwise allowable” “with respect to” entertainment activities. (The compensation exception in I.R.C. § 274(e)(2) merely sets forth an exception to this disallowance.) The provision under which deductions would otherwise be allowable is I.R.C. § 162, which permits the deduction of ordinary and necessary business expenses. Under § 162, the deductibility of expenses for a trip is determined based on the primary purpose of the trip. Treas. Reg. § 1.162-2(b)(1); Temp. Treas. Reg. § 1.274-5T(b)(6)(iii). The courts and IRS have made it clear that under § 162, when a flight is primarily for business purposes, the costs of the flight are deductible under § 162 as business expenses and the only costs allocable to passengers traveling for personal purposes are the marginal costs attributable to such passengers. See *French v. Comm’r*, 59 T.C.M. (CCH) 966 (1990) (family members accompanied taxpayer on private aircraft); *Pohl v. Comm’r*, 59 T.C.M. (CCH) 887 (1990) (spouse accompanied taxpayer traveling by car); *Marlin v. Comm’r*, 54 T.C. 560 (1970), *acq.* 1970-2 C.B. xx (spouse accompanied taxpayer on trip to Europe); Rev. Rul. 56-168, 1956-1 C.B. 93; IRS Pub. 463, at 5 (2006). In contrast, the passenger-by-passenger allocation methods would disallow costs otherwise deductible with respect to business travel, by reallocating them to the passengers traveling for entertainment purposes. Since the passenger-by-passenger allocation methods would disallow costs that are not otherwise allowable with respect to entertainment activities, these methods directly conflict with the plain language of the statute.

The only justification offered in section 1(b) of the Preamble for the passenger-by-passenger allocation methods is the observation that § 274(e)(2)(B) “focuses on the recipient . . . not the purpose of the employer.” The relevance of this observation is tenuous. Absent from the Preamble is any reference to published legislative history supporting the passenger-by-passenger allocation methods.

In fact, Congress has consistently supported the primary purpose method. Congress made clear its intent with respect to both the 1962 and 1978 Acts to have an exception to the entertainment disallowance for transportation facilities that would not diminish taxpayers' existing ability to deduct the costs of ordinary business travel. The Joint Committee Report with respect to the 1978 Revenue Act stated that “[e]xpenses of an automobile or an airplane used on business trips will continue to be allowed.” Staff of J. Comm. on Tax’n, 95th Cong., *General Explanation of the Revenue Act of 1978*, at 208 (J. Comm. Print 1978). The court in *Beckley v. Commissioner*, 34 T.C.M. (CCH) 235, 240 (1975) commented as follows that the entertainment facility rules were not to affect ordinary business travel:

We believe the regulations make it clear that the expenses of nonentertainment use of a transportation type facility (i.e., for business transportation) are not affected by the entertainment facilities rule. In such situations only the regular

business expense rules apply (without the application of the entertainment facility deduction test).

The existing regulations under the substantiation rules in I.R.C. § 274(d) require the allocation of expenses among flights in proportion to miles traveled with no reference to a passenger-by-passenger allocation. Temp. Reg. § 1.274-5T(b)(6)(i)(B) provides that a taxpayer's business use of an aircraft is determined based on mileage for purposes of the substantiation requirements in § 274(d). These substantiation rules apply to any deduction with respect to travel, entertainment (including entertainment falling within an exception in § 274(e)) and listed property. Temp. Reg. § 1.274-5T(a). In addition, courts have allowed costs to be allocated among flights based on flight hours, again with no passenger-by-passenger allocation. *Noyce v. Comm'r*, 97 T.C. 670 (1991). In other contexts, the regulations consistently apply the primary purpose test. *See, e.g.*, Treas. Reg. § 1.280F-6(e)(2) (business use percentage to be eligible to use accelerated depreciation). In accordance with existing law, in *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 197, 198 (2000), *aff'd*, 255 F.3d 495 (8th Cir. 2001), *acq.* 2002-1 C.B. xvii, the aircraft costs were allocated among each flight, with no passenger-by-passenger allocation of costs. The Conference Report to the Jobs Act makes it clear that Congress carefully considered the *Sutherland* decision. H.R. Rep. No. 108-755, at 784 (2004). The fact that Congress refrained from changing the established method of allocating costs among flights indicates that Congress adopted the primary purpose method when it amended § 274 in 2004.

**B. The passenger-by-passenger methods (particularly the occupied seat method) create unnecessary administrative burdens.**

In addition to the fact that the plain language of the statute, existing law and the legislative history require the primary purpose method, the passenger-by-passenger methods (particularly the occupied seat method) create an unnecessary administrative burden simply by being different from the primary purpose method which applies for purposes of the ordinary and necessary business expense deduction under I.R.C. § 162. Under Prop. Treas. Reg. § 1.274-10(e), the passenger-by-passenger allocation methods apply only to flights provided as compensation to specified individuals, due to the cross-reference to Prop. Treas. Reg. § 1.274-10(a)(2)(ii)(C), which deals with flights provided as compensation to specified individuals. The regulations do not discuss the allocation method to be used for a company's nondeductible entertainment air travel that is not provided as compensation to employees. For example, suppose a company flies several of its customers to a destination for entertainment purposes and the trip meets the ordinary and necessary business expense requirements, but it does not meet the "directly related" and "associated with" standards in I.R.C. § 274(a)(1)(A). In view of the absence of a regulation requiring that the company use a passenger-by-passenger allocation method for such nondeductible business entertainment flights, the company presumably would use the primary purpose method for such flights in accordance with existing law as explained above.

Particularly in the case of the occupied seat method, this inconsistency in the applicable methods creates a serious administrative problem. Suppose a company owns an aircraft and has three one-hour flights during the year. On the first flight, one employee travels alone for

business purposes; on the second flight, two customers travel for entertainment purposes (and the “directly related” and “associated with” tests are not met); and on the third flight a specified individual employee travels with two friends for personal entertainment purposes. (Assume that all taxable fringe benefits are properly reported, and that all three flights meet the ordinary and necessary business expense requirement under § 162.) The second flight would be nondeductible as an entertainment flight under § 274(a), but it would not be a compensatory fringe benefit subject to § 274(e)(2). The third flight would be nondeductible as an entertainment expense, and it would be a compensatory fringe benefit subject to § 274(e)(2). Accordingly, if the occupied seat method is to apply only to flights subject to § 274(e)(2), one-third of the operating costs would be disallowed with respect to the second flight under the primary purpose method, and one-half of the total operating costs would be disallowed with respect to the third flight under the occupied seat method. Accordingly, if the final regulations are to retain the passenger-by-passenger allocation methods, it will be necessary for them to address this inconsistency, presumably in a manner that prevents the disallowance of the same costs twice due to these inconsistent allocation methods. As explained above, the better solution would be for the final regulations to drop the passenger-by-passenger allocation methods entirely.

In addition, it has become clear from recent experience that the passenger-by-passenger allocation methods impose an inordinate burden on taxpayers. While the primary purpose method only requires taxpayers to determine whether each flight is primarily for entertainment or nonentertainment purposes, the passenger-by-passenger methods require this determination for each passenger. In view of the legal complexity of distinguishing between entertainment purposes and nonentertainment purposes such as routine personal purposes, this requirement dramatically increases the amount of legal analysis needed to even begin the calculations. In addition, this analysis requires an intrusive inquiry by company accounting personnel into the details regarding the personal activities of each passenger traveling for personal reasons. Once each passenger’s entertainment or nonentertainment purpose has been identified, the process of calculating the disallowance is significantly more complex than under the primary purpose method. For example, the determinations and calculations with respect to deadhead flights, discussed below, become far more complex under the passenger-by-passenger methods than under the primary purpose method.

The administrative burden imposed by these rules is further highlighted by their potential application to automobiles. The entertainment disallowance applies with respect to automobiles as well as aircraft, since the definitions of “entertainment facility” and “entertainment” in the existing regulations both refer to automobiles. Treas. Reg. § 1.274-2(e)(2)(i), (b)(1)(i). While Congress’ intent in amending section 274(e)(2) in the Jobs Act was to address the disparity between aircraft operating costs and the SIFL rates, the entertainment disallowance in § 274 and the limitation on the compensation in § 274(e)(2)(B) are not restricted to aircraft. H.R. Rep. No. 108-755, at 783-4 (2004). Similarly, while the proposed regulations only discuss aircraft, the IRS in Notice 2005-45, 2005-24 I.R.B. 228, stated that these rules may be allocable to other entertainment activities. Applying the entertainment disallowance to employer-provided automobiles, particularly using a passenger-by-passenger allocation method, would impose an

extraordinary administrative burden, particularly on small companies. On the other hand, nothing in the statute supports applying the disallowance differently to aircraft and automobiles.

**3. Additional costs to provide security on entertainment travel should not be subject to disallowance.**

The Preamble explains in section 1(c) that the IRS considered and rejected comments suggesting that entertainment use by a specified individual of an aircraft should not be treated as entertainment within the meaning of § 274 or subject to § 274(e)(2)(B) merely because there is a business need to use the aircraft to provide security, pursuant to Treas. Reg. § 1.132-5(m). Consistent with the Preamble, Prop. Treas. Reg. § 1.274-10(b)(3) states that air travel is not business entertainment air travel merely because a taxpayer-provided aircraft is used for the travel as a result of a bona fide security concern under Treas. Reg. § 1.132-5(m). Since business entertainment air travel is defined under Prop. Treas. Reg. § 1.274-10(b)(3) to mean entertainment air travel that meets the “directly related” or associated with” tests in § 274(a)(1)(A), it appears that the regulation is merely stating that when the purpose of a flight is entertainment and a private aircraft is used for security reasons, the security considerations do not convert the purpose of the flight into a business purpose.

This regulation does not address the issue of whether in the case of employer-provided travel for entertainment purposes, the *additional* costs incurred to provide security will be included in the costs subject to the entertainment disallowance. While this issue is not addressed by the proposed regulations, NBAA is concerned that taxpayers will incorrectly interpret this regulation to mean that the additional costs to provide security are subject to the entertainment disallowance. Accordingly, the regulations should be clarified to state that additional costs incurred to provide security on entertainment travel are not subject to disallowance.

Excluding additional costs to provide security from the entertainment disallowance is consistent both with existing law and good policy.

Present law regarding additional costs to provide security on travel for personal purposes is summarized in Treas. Reg. § 1.132-5(m)(1), which explains that a deduction is allowed for “the excess of the amount actually paid for the transportation over the amount the employee would have paid for the same mode of transportation absent the bona fide business-oriented security concerns.” The regulation further explains that the additional security costs that would be deductible include the costs of a specially designed vehicle over the cost of a vehicle that the employee would otherwise use and the costs of a private aircraft over the cost that the employee would otherwise incur to fly. Based on this principle, these regulations provide that if the requirements of the regulation are met, the imputed income to an employee will be reduced for transportation provided in a specially designed employer-provided automobile or in an employer-provided aircraft.

Just as the additional costs to provide security on personal travel qualify as business expenses under § 162 and are not included in taxable fringe benefits to employees under § 132, such security costs also should be excluded from the costs subject to the entertainment

disallowance. In this regard, the Joint Committee Report to the 1978 amendment to § 274 explains that if a “portion” of a facility is not used for entertainment purposes, the expenses with respect to that portion of the facility will not be subject to the entertainment facility disallowance. *See General Explanation of the Revenue Act of 1978*, at 208 (J. Comm. Print 1979). This concept should apply to the security features on a specially-designed automobile (e.g. bullet-proof glass) and to the additional costs to provide private aircraft over commercial flights.

Excluding from the entertainment disallowance the additional costs of providing transportation-related security when there are bona fide business-oriented security concerns properly recognizes the nonentertainment aspect of travel when a specified individual’s personal safety is jeopardized because of his or her employment status with the taxpayer or his or her location in a dangerous geographic location for the taxpayer’s purposes. NBAA suggests that meeting the requirements for a “bona fide business-oriented security concern” under the fringe benefit rules should be sufficient to qualify for the exception, and the cost of the private air travel necessitated by such concerns in excess of the cost of a first class ticket for such travel should be treated as a security expense, with only the cost of the first class ticket treated as an entertainment expense.

The policy reasons for allowing employers to deduct the additional costs of providing security to their employees are obvious. Suppose an employee of an engineering firm is working in a dangerous area (e.g., for a contractor working on reconstruction efforts in Iraq, an oil company in a troubled country in Africa, or a manufacturer in a violence-prone area in South America). By precluding the engineering firm’s deduction of the cost of safely transporting an employee from a dangerous geographic area to a safer location for rest and relaxation, the regulations provide an incentive for the engineering firm to refrain from providing such security. The foreseeable result is an increased risk of kidnapping or other harm to the employee. Particularly in view of the serious security risks for Americans in many parts of the world, our Government should take steps to protect American travelers, rather than use the tax laws to create disincentives for employers to provide security for their employees.

**4. The industry standard for the term “aircraft operating expenses” equates to direct operating costs, not “all costs, fixed and variable”.**

Section 2(a) of the Preamble states that industry use of the term “operating costs” generally refers to all costs, fixed and variable, including depreciation, claimed on the taxpayers tax return. NBAA believes this statement is incorrect and, in fact, the business aviation industry standard term for the words “operating expenses” is Direct Operating Costs (DOCs), which equates to variable costs incurred for a flight. The entire industry -- NBAA, aircraft manufacturers and dealers, and industry publications such as *Business & Commercial Aviation* magazine -- all equate operating expenses with DOCs and exclude the fixed costs associated with aircraft ownership from these calculations. DOCs are those expenses incurred when operating the aircraft; examples include: fuel, additives, lubricants, landing fees, catering, crew lodging/meal expenses, and certain engine/propeller/airframe maintenance required on an hourly utilization basis.



**5. The entertainment facility rules apply to transportation facilities such as aircraft (and automobiles) in the same manner as the entertainment expense limitation.**

Section 5(e) of the Preamble explains that the proposed regulations deal with only the expense disallowance rules under I.R.C. § 274(a)(1)(A) and invites comments regarding the application of the entertainment facility rules under I.R.C. § 274(a)(1)(B). It is not clear from Prop. Treas. Reg. § 1.274-9(a) or -10(a) that these regulations in fact apply only with respect to the entertainment expense limitation in § 274(a)(1)(A), rather than the entertainment facility limitation under § 274(a)(1)(B). Nevertheless, the statement in the Preamble regarding the scope of the regulations raises the concern that taxpayers will go through the process of establishing recordkeeping and accounting systems to implement the complex determinations and calculations mandated by the regulations only to confront a new set of regulations under the entertainment facility disallowance in § 274(a)(1)(B).

The final regulations should cover both the entertainment expense disallowance and the entertainment facility disallowance. Releasing these rules in two stages creates unnecessary uncertainty, complexity, confusion and administrative burden. Moreover, there is no reason to delay releasing entertainment facility rules, because the most reasonable interpretation of the entertainment facility rules is that they apply to transportation facilities such as aircraft (and automobiles) in the same manner as the entertainment expense limitation.

The costs subject to the entertainment facility disallowance under I.R.C. § 274(a)(1)(B) are only those “with respect to” a facility, and generally include depreciation and operating costs such as utilities, maintenance and insurance. Treas. Reg. § 1.274-2(e)(3)(i). In contrast, the entertainment expense disallowance under I.R.C. § 274(a)(1)(A) applies to out-of-pocket costs incurred in the use of the facility, such as fuel and catering. Treas. Reg. § 1.274-2(e)(3)(iii)(a). In the legislative history to the 1978 Tax Act, Congress explained that in the case of transportation facilities such as automobiles and aircraft, the entertainment facility disallowance was only intended to apply to travel for entertainment purposes. In this regard, the Joint Committee Report to the 1978 Act provided:

[E]xpenses attributable to a nonentertainment use of a facility were not treated as being expenses with respect to an “entertainment facility,” e.g. the use of an automobile or airplane for business travel purposes.

*General Explanation of the Revenue Act of 1978*, at 206 (J. Comm. Print 1978). This exception for transportation facilities also applied under the entertainment facility limitations in the Revenue Act of 1962. See *Beckley v. Comm’r*, 34 T.C.M. (CCH) 235, 240 (1975); Rev. Rul. 63-144, 1963-2 C.B. 129, Q&A 51-53.

In addition to the legislative history, the transportation facility exception appears in the regulations. Treas. Reg. § 1.274-2(b)(1)(iii)(c)(I) presents the exception for travel in transportation facilities “in pursuant of a trade or business . . . not in connection with

entertainment.” That regulation includes a cross reference regarding “non-entertainment expenditures with respect to such facilities” to Treas. Reg. § 1.274-2(e)(3)(iii)(b). Treas. Reg. § 1.274-2(e)(3)(iii)(b) provides that “[e]xpenses or items attributable to the use of a facility for other than entertainment purposes such as expenses for an automobile when not used for entertainment” are not considered expenses with respect to an entertainment facility. Similarly, the Tax Court in *Beckley v. Commissioner*, 34 T.C.M. (CCH) at 240, explained as follows:

We believe the regulations make it clear that the expenses of nonentertainment use of a transportation type facility (i.e., for business transportation) are not affected by the entertainment facilities rule. In such situations only the regular business expense rules apply (without the application of the entertainment facility deduction test).

Accordingly, the entertainment facility rules should not apply to the nonentertainment use of an aircraft. The most practical and reasonable approach is to further apply the entertainment facility disallowance rule to aircraft in the same manner as the entertainment expense disallowance. The alternative would be to require taxpayers to divide expenses between (1) out-of-pocket expenses (e.g., fuel costs) subject only to the entertainment expense disallowance § 274(a)(1)(A), and (2) costs “with respect to” an aircraft (e.g. depreciation, maintenance and insurance) subject to the transportation facility exception under the entertainment facility disallowance in § 274(a)(1)(B). These rules are already far too complex. There is no reason for the IRS and Treasury to arbitrarily interpret the transportation facility exception to the entertainment facility disallowance in a manner that requires a different set of allocation rules from those applicable to aircraft under the entertainment expense disallowance rules.

**6. The language in the preamble regarding the “adequate and full consideration exception” in I.R.C. § 274(e)(8) should be clarified to make clear that the preamble does not modify existing law regarding the scope of this exception.**

The Preamble states in section 5(i) that the proposed regulations do not provide guidance regarding the adequate and full consideration exception in I.R.C. § 274(e)(8), because existing regulations at Treas. Reg. § 1.274-2(f)(2)(ix) address that exception. Consistent with this statement, the proposed regulations do not discuss this exception. After noting that the proposed regulations do not discuss this exception, the Preamble incorrectly asserts that “[A]s stated in § 1.274-2(f)(2)(ix), section 274(e)(8) applies only to taxpayers that are in the trade or business of providing entertainment to customers...”. NBAA is concerned that this incorrect statement regarding that regulation will cause confusion.

Existing cases and rulings support the conclusion that the adequate and full consideration exception applies to lessors of aircraft and to taxpayers providing air charter service irrespective of their line of business. *See* Tech. Adv. Mem. 2002-14-007 (Apr. 5, 2002) (§ 274(e)(8) applied to company that provided use of facility to related company, based in part on fact that company was paid fair value for the use of the facility); Rev. Rul. 63-144, Q&A 52, 53 (lessor not subject to entertainment facility disallowance on lease to related party with fair market rental rate and terms); *Catalano v. Comm’r*, 79 T.C.M. (CCH) 1632 (2000), *aff’d*, 240 F.3d 842 (9th Cir. 2001)

(IRS did not assert entertainment facility disallowance with respect to lessor's expenses, even though related lessee was subject to entertainment facility disallowance due to its entertainment use of boat). Moreover, the expense allocation rule for leases and charters in Prop. Treas. Reg. § 1.274-10(d)(2) is based on the adequate and full consideration exception, and its application is not limited to lessors and taxpayers that provide air charter service who are in the business of providing entertainment to customers. Accordingly, the Preamble to the final regulations should withdraw this incorrect statement and clarify that the Preamble does not modify existing law regarding the scope of the adequate and full consideration exception.

**7. NBAA would like to work with the Treasury Department/IRS to develop a Charter Rate Method Safe Harbor.**

The Preamble in section 5(j) states that a charter rate method safe harbor is being considered to value flights for purposes of the entertainment disallowance. This approach represents a reasonable alternative to determining actual expenses, and would alleviate some of the administrative burdens that these complex rules place on taxpayers, as well as provide greater certainty to taxpayers and specified individuals as to the cost to the company of an entertainment flight. Accordingly, NBAA supports the adoption of this safe harbor and would like to work with the IRS and Treasury to further develop such a safe harbor method.

**A. Safe harbor rates published semi-annually by the IRS based on industry data would be preferable.**

The Preamble requests comments regarding the availability of published charter rates. Both for administrative efficiency and fairness among taxpayers, it would be desirable to use a standard set of published charter rates. In this regard, workable models are provided by the systems currently employed to publish Standard Industry Fare Level (SIFL) rates pursuant to Treas. Reg. § 1.61-21(g) or standard mileage rates used to calculate the deductible costs of operating an automobile for business, charitable, medical or moving purposes substantiated under Treas. Reg. § 1.274-5. National and regional charter rates are tracked by companies such as CharterX/Wyvern, an established online information resource to the charter industry ([www.CharterX.com](http://www.CharterX.com)), which is the largest repository of air charter supply and demand data in the world. The company handles more than 3,000 charter quote requests daily and over 1 million flight requests and quotes each year. As such, the company maintains an extensive database of published and actual charter rates and business activity. Other companies which handle charter quote request include NBAA has spoken with officials at CharterX and both NBAA and CharterX would be willing to work with the IRS to establish safe harbor charter rates and an acceptable charter rate tracking and reporting mechanism. The IRS could use this information to publish semi-annual safe harbor charter rates per hour (or per mile) based on relatively few variables such as the aircraft's maximum certified takeoff weight.

The Preamble suggests that taxpayers could establish safe harbor charter rates based on rates charged to the general public for a comparable aircraft on a comparable flight within 10 days of the taxpayer's flight by unrelated charter companies that charter 10 or more aircraft to the general public but not to the taxpayer. As the vast majority of charter operators in the U.S.

have fewer than 10 aircraft on their charter certificate, and aircraft move on/off charter certificates regularly so a charter operator could have 10 aircraft one day and 9 the next, this constraint causes NBAA concern. This restrictive rule would make it difficult for taxpayers to establish a fair market charter rate, which is inconsistent with the purpose of establishing a safe harbor for administrative efficiency. To minimize these complexities, safe harbor rates published semi-annually by the IRS based on industry data would be preferable.

In recognition of the fact that published safe harbors may not reflect fair market charter rates in all situations, taxpayers should have the alternative of establishing fair market charter rates. To apply this alternative, the following modifications to the proposed rule are suggested: (a) the 10 day limit should be expanded to six months, since charter rates ordinarily do not fluctuate dramatically; (b) the reference to comparable flights should be deleted, since charter rates for a given aircraft are generally the same per hour irrespective of the route; (c) the 10 aircraft threshold for charter companies should be eliminated, since the industry is comprised of many charter companies operating only a few aircraft; and (d) the ban on using rates charged by charter companies otherwise hired by the taxpayer should be eliminated, since the requirements that the charter company be unrelated and the rate be available to the general public are sufficient safeguards.

One aspect of the administrative efficiency provided by a charter rate method safe harbor would be the ability of taxpayers to impute income to employees at charter rates under Treas. Reg. § 1.61-21(b)(6), so that the taxpayer providing the flight to its employees would not have to incur any expense disallowance. To implement this approach, it would be necessary to synchronize the provisions in the safe harbor with the rules governing imputed income at charter rates. For example, the imputed income rules provide that the charter rate is to be allocated only among the control employees on a flight, while the proposed regulations contain no similar limitation.

**B. A separate Safe Harbor should be included for “Piston Powered Aircraft” because these aircraft generally are not available for charter.**

Many aircraft operated for business purposes are piston-powered single or multi-engine airplanes. These airplanes could also be used by specified individuals for entertainment purposes, and the specified individual often acts as the pilot of the aircraft. However, the full gamut of piston airplanes operated in the U.S. generally is not available for charter. Nor is there an on-line resource easily identifying a national average cost for these aircraft.

NBAA urges the IRS and Treasury to include a safe harbor for piston powered aircraft leased without pilot services similar to the charter rate method safe harbor. For piston aircraft, NBAA suggests that the “wet” rental rate for the same or comparable aircraft would be the appropriate proxy for determining the safe harbor rate. (NOTE: For the purpose of piston aircraft rental, the wet rate generally includes the cost of fuel in the rental price, but not the pilot). This wet rental rate is readily available from a Fixed Based Operator (FBO) or flight school usually located in the same geographical area as the taxpayers.

Because not all piston airplanes are available in the rental market, NBAA recommends the service include guidelines in this safe harbor instructing taxpayers to look at the same or comparable aircraft available for rent. For example, the taxpayer may operate a Grumman Tiger, which is a 4-seat, fixed landing gear, 180 horsepower single-engine piston aircraft. A comparable aircraft would be a Cessna 172, Piper Archer, or Diamond DA-42, all of which are four-seat single-engine piston airplanes that are readily available in the rental market.

If the taxpayer's aircraft is involved a lease-back or other arrangement with an FBO or flight school, whereby the taxpayer's aircraft is available to third parties in an arm's length rental transaction, NBAA recommends that third party wet rental rate be used for the safe harbor calculation. Similar to the Charter Rate Method Safe Harbor, the taxpayer would maintain a record documenting the wet rental rate for the same or comparable aircraft.

**8. The final regulations should clarify that interest expense is not subject to the entertainment disallowance.**

Interest expense is absent from the lists of expenses subject to the entertainment disallowance in Treas. Reg. § 1.274-2(e)(3)(i), Prop. Treas. Reg. § 1.274-10(d) and Notice 2004-45. Similarly, existing rulings do not list interest expense among the expenses subject to the disallowance. Rev. Rul. 63-144, Q&A 45 ("The facility expenditure limitations cover depreciation and general operating costs such as rent, utility charges, repairs, insurance, salaries of watchmen, etc."); Tech. Adv. Mem. 96-08-004 (Feb. 23, 1996) (entertainment facility disallowance applied to "fuel and oil, insurance, pilot's salary, repairs, hangar rental, and depreciation" with respect to an aircraft). The omission of interest expense from these lists of expenses is clearly intentional, since the existing regulations and proposed regulations also omit any discussion of the debt allocation method that taxpayers would use to determine which interest expense would be subject to the disallowance. Furthermore, the omission of interest is appropriate since interest expense, financing costs and general corporate overhead should not be included in the disallowance with operating expenses that are directly related to the aircraft such as fuel and landing fees. To eliminate any confusion on this issue, the final regulations should clarify that interest expense is not subject to the entertainment disallowance.

**9. The proposed rules for leases or charters to third parties should be simplified and clarified.**

Prop. Treas. Reg. § 1.274-10(d)(2) states that companies that lease aircraft or provide charter flights to unrelated third parties in bona-fide business transactions for adequate and full consideration can eliminate costs allocable to the "charter period" from the costs subject to the entertainment disallowance. This provision clearly follows the requirements of the adequate and full consideration exception in § 274(e)(8), and provides a useful example of that provision's application in the case of leases and charters to third-parties. This rule quite sensibly relieves companies from having to obtain passenger data from unrelated lessees and charter customers to apply the cost allocation rules.

It is apparently intended that when the expenses attributable to the charter period are removed from the entertainment disallowance calculation, the flight miles or hours attributable to that period should also be removed from the calculation. In addition the term “charter period” is apparently intended to include the period during which the aircraft is *leased* to third parties. The final regulations should clarify these points.

The term “charter period” appears to provide flexibility to companies to determine the method of allocating costs to the charter period. This makes sense because companies often do not have access to the passenger information during periods of use by third parties under leases or charters. For example, if the “charter period” is three months, it would seem appropriate to exclude one-fourth of the year’s depreciation expense from the disallowance calculations. The final regulations should more clearly state that companies can use any reasonable method to determine the costs allocable to the charter period.

## **10. The depreciation rules/straight line election.**

### **A. Depreciation Consistency Rule**

Prop. Treas. Reg. § 1.274-10(d)(3)(i) permits taxpayers to elect to calculate the disallowance using straight-line depreciation over the alternative depreciation life of the aircraft even if they actually deduct accelerated depreciation. This approach is intended to enable the accelerated depreciation rules to have their intended effect of encouraging investment.

However, NBAA is concerned that the election contains an overly strict consistency rule that essentially locks a taxpayer into the straight line rule for all planes forever. This rule is even more strict than the election under I.R.C. § 168(g)(7) to use straight line depreciation for tax purposes. (Under § 168(g)(7), the straight line method can be elected separately for each depreciation class placed in service in each year.) Since there is no apparent reason to require taxpayers to use the same method for all aircraft forever, the election should be modified to allow taxpayers to elect, or not elect, the straight line method separately for each aircraft in the year of acquisition of the aircraft.

When an aircraft is acquired in a like kind exchange, it would be overly complex to require the carryover basis in the replacement aircraft to continue to be depreciated under (or not under) the straight line method election, while the additional basis in the replacement property is subject to an independent election under this rule. A more workable approach would be to allow the taxpayer to elect (or not elect) the straight line depreciation rule for the entire basis in the replacement aircraft at the time of the exchange. Precedent for this approach is provided by Treas. Reg. § 1.168(k)-1(f)(5)(iii), which permits bonus depreciation to be elected for the entire basis of the replacement aircraft.

### **B. Depreciation Transition Rule**

Prop. Treas. Reg. § 1.274-10(d)(3)(ii) states that when the straight line election is made for an aircraft placed in service in a prior year, the straight line depreciation amount is calculated

for future years as if the aircraft had been depreciated on the straight line basis from the time it was originally placed in service. This rule results in more than 100% of the cost of the aircraft being included in depreciation for purposes of the entertainment expense disallowance. For example, if an aircraft is depreciated using 7 year MACRS for the first 3 years (assuming a half-year convention), the depreciation during those three years would total 56% (14.29% + 24.49% + 17.40%). Switching to straight line would mean that over the remaining 9.5 years of its 12 year alternative life another 79% ( $9.5 / 12$ ) of the original cost would be included in depreciation subject to the entertainment disallowance. The result would be that a total of 135% (56% + 79%) of the original cost would be included in the entertainment disallowance calculation.

There is no possible policy reason to support double counting depreciation in this manner, and NBAA assumes that this trap for the unwary was merely an oversight in drafting the proposed regulations. The more sensible transition rule is to calculate straight line depreciation prospectively beginning with the adjusted basis in the year of the election. More generally, a prospective change in the depreciation calculation is the approach commonly used for tax and financial accounting purposes.

**11. The rules for aggregation of aircraft can be simplified greatly, to avoid imposing undue administrative burdens.**

Prop. Treas. Reg. § 1.274-10(d)(4) provides that aircraft with similar cost profiles can be aggregated in the calculation of disallowed entertainment expense. The regulation further states that to have similar cost profiles the aircraft must have the same engine type (jet or propeller) and the same number of engines. The regulation further states that other factors to be considered include payload, passenger capacity, fuel consumption rate, age, maintenance costs, and depreciable basis. Section 2(c) of the Preamble requests comments regarding these criteria.

In general, these criteria should be less restrictive in the interest of administrative efficiency. The calculations required under these rules impose a great administrative burden on companies. It takes many hours to accumulate, analyze and document information regarding passengers' purposes for travel, perform the complex calculations required to determine the entertainment disallowance for each flight, and compare those amounts with the imputed income or reimbursements with respect to each employee on each flight. By unnecessarily limiting taxpayers' ability to aggregate aircraft, the regulations would require that companies perform these calculations multiple times, rather than in an aggregate calculation. Furthermore, it will require taxpayers to track expenses separately for each aircraft, and, when the costs are not readily identifiable with respect to a specific aircraft, it will require companies to go through complex analysis to allocate costs among separate aircraft. Just a few examples of costs that may be troublesome to allocate among aircraft include hangar rental, salaries to maintenance employees and pilots, umbrella insurance costs and management company fees. In view of the great administrative burden otherwise imposed by these regulations on taxpayers, NBAA requests that the final regulations not take a restrictive approach to aggregation of aircraft.

In view of the administrative burdens imposed by the complex calculations, the final regulations should permit taxpayers to aggregate all aircraft. Nevertheless, the following are specific comments regarding the aggregation criteria listed in the proposed regulation:

The requirement that aircraft can only be aggregated if they have the same number of engines should be deleted. Some aircraft cost more to own and operate than other aircraft with a greater number of engines. The number of engines is simply not a litmus test for an aircraft's cost profile. This criterion should be moved to the list of criteria that should be considered.

Among the factors to be considered is the aircraft's depreciable basis. Presumably the term "depreciable basis" refers to the unadjusted basis. In view of the 5 year MACRS depreciation applicable to noncommercial aircraft, a comparison of depreciated basis amounts would not make much sense.

The other factors listed seem to require an unnecessarily detailed analysis of the various characteristics of each aircraft. This level of analysis is entirely unnecessary. A reasonable analysis based on the original cost should be sufficient.

In any case, the IRS should allow aggregation of all aircraft operated under a fractional ownership program. (An aircraft fractional ownership program is one where a company or individual buys a share of an aircraft, is a registered owner of that aircraft, and has access to the owned aircraft, or a different and comparable aircraft in the fractional program under a dry lease exchange agreement. A fractional program manager will perform aviation services (e.g., aircraft scheduling, maintenance management, pilot hiring and crew scheduling). Since aircraft are constantly exchanged under fractional programs, it would be nearly impossible to undertake the analysis suggested for the aircraft provided to a taxpayer under those programs and then segregate the costs among those aircraft.

**12. The final regulations should allow taxpayers to use any reasonable method to account for deadhead flights.**

Prop. Treas. Reg. § 1.274-10(f)(3)(i) explains that in the case of a roundtrip flight from point A to point B and back to point A, a deadhead leg such as the return trip from point B to point A is treated as having the same number of passengers traveling for the same purposes as the occupied leg. This rule is relatively straightforward and easy to apply.

Prop. Treas. Reg. § 1.274-10(f)(3)(ii) addresses the issue of how to characterize a deadhead leg in a multi-leg flight, such as a flight from point A to point B, followed by a flight from point B to point C, and then back to point A. The regulation explains that the deemed number and purposes of passengers with respect to the deadhead leg will be "based on" the number and purposes of the passengers on the occupied legs and the length in hours or miles of the occupied legs.

The term "based on" does not prescribe a particular method of performing this calculation, but only requires that the determination be "based on" the listed information.



Accordingly, this rule appears to leave room for any reasonable method of determining the deemed number and purposes of passengers with respect to the deadhead leg. The final regulation should more clearly state that any reasonable method may be used for this determination.

The final regulation should not attempt to prescribe a specific method to make this determination, due to the administrative complexity involved and the variety of potential factual situations. There are several reasonable methods of making this determination. The deemed number and purposes of passengers for a deadhead flight could be determined by reference to one of the occupied legs. For instance, if point C is midway between points A and B, it would seem sensible to characterize a deadhead leg from point B to point C entirely by reference to the occupied flight from point A to point B. Another possible method is to view a deadhead leg from point B to point C as a detour on the trip from point B back to point A. Under this approach, if the flight from point A to point B is for business and the flight from point C to point A is for entertainment, only the excess of the miles traveled on the flights from point B to point C and from point C to point A over the number of miles between points A and B would be entertainment miles. This approach is reasonable, and it follows the detour approach to multi-leg trips in Prop. Treas. Reg. § 1.274-10(e)(2)(iii). A third possible approach is to make the determination for the deadhead flight using some sort of weighted average based on the number and purposes of the passengers on the occupied legs. There may well be other reasonable methods for making this determination in other fact situations. For example, if there is a long occupied leg from point A to point B and a series of much shorter occupied legs in the general area of point B followed by a long deadhead leg to return to point A, it may make the most sense to determine the character of the long deadhead flight to return to point A by reference to the number and character of the passengers on the flight from point A to point B.

Each of these methods is reasonable and each may seem more appropriate in certain circumstances. However, attempting to prepare regulations that would dictate how each of these methods must work and exactly when each method must be used would create an overly complex set of rules. On the other hand, picking one rule to apply in all cases would produce an unnecessarily complex rule that would likely produce nonsensical and potentially skewed results in many situations.

From an administrative perspective, it is easiest to make the determination solely by reference to one of the other legs on the flight. This is the case because in computerized flight accounting systems, it is typically easier to repeat the number and purposes of the passengers on an occupied flight for a deadhead flight. The other methods tend to require some sort of side calculation, which would then need to be specially documented. Particularly in view of the complexities of matching up imputed income or reimbursements for passengers with entertainment flights, the administrative burden associated with accounting for deadhead flights can be particularly challenging. Taxpayers should have the flexibility to use this approach based on a cost-benefit analysis. The importance of providing this level of flexibility to taxpayers is heightened in the context of the passenger-by-passenger allocation methods, since the deadhead flight calculations discussed above imposed a particularly onerous administrative burden in that

context. (Of course, this undue complexity is another reason for scrapping the passenger-by-passenger allocation methods entirely.)

On the other hand, the most logical approach in many circumstances will be the detour approach based on the rules for multi-leg trips in Prop. Treas. Reg. § 1.274-10(e)(2)(iii). Taxpayers willing to go to the trouble to work through this analysis should be free to do so. Similarly, taxpayers should be able to apply the other methods in appropriate circumstances.

In clarifying that taxpayers can use any reasonable method to account for deadhead flights, the final regulations should not require taxpayers to elect a particular method. In the first place, the tax laws do not impose any strict consistency requirement, since the calculations involved in the entertainment disallowance are not “methods of accounting” for tax purposes. (“Methods of accounting” relate to the timing of deductions rather than the disallowance of deductions. *See* Treas. Reg. § 1.446-1(e)(2)(ii)(a), (b); Rev. Proc. 2002-18, 2002-1 C.B. 678, § 2.01; *North Carolina Granite Corp. v. Comm’r*, 43 T.C. 149 (1964) (discussing changes in the taxpayer’s calculation of percentage depletion).) Furthermore, as explained above, no one method will be most appropriate in all situations. Deadhead flights are a situation in which less restrictive regulatory guidance is better.

We appreciate the opportunity to provide comments with respect to these proposed regulations and look forward to testifying at the hearing on October 25, 2007.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ed Bolen', with a horizontal line extending to the right.

Ed Bolen  
President and CEO