

restrictions on described articles of cultural property of State Parties is amended in the entry for Cyprus by, in the column headed "Cultural Property," removing the entry and adding in its place the following entry:

"Archaeological material of pre-Classical and Classical periods ranging approximately from the 8th millennium B.C. to 330 A.D. and ecclesiastical and ritual ethnological material representing the Byzantine and Post-Byzantine periods ranging from approximately the 4th century A.D. to 1850 A.D."

Dated: July 26, 2012.

**Harold M. Singer,**

*Director, Regulations and Disclosure Law Division, U.S. Customs and Border Protection.*

**Heidi Cohen,**

*Senior Counsel for Regulatory Affairs, Office of the Assistant General Counsel for General Law, Ethics & Regulation, Department of the Treasury.*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[TD 9597]

RIN 1545-BF34

#### Deductions for Entertainment Use of Business Aircraft

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations relating to the use of business aircraft for entertainment.

These final regulations affect taxpayers that deduct expenses for entertainment, amusement, or recreation provided to specified individuals. The final regulations reflect statutory amendments under the American Jobs Creation Act of 2004 (AJCA) and the Gulf Opportunity Zone Act of 2005 (GOZA).

**DATES:** *Effective Date:* These regulations are effective August 1, 2012.

*Applicability Date:* For dates of applicability, see §§ 1.61-21(g)(14)(iii), 1.274-9(e), and 1.274-10(h).

**FOR FURTHER INFORMATION CONTACT:**

Michael Nixon (section 274), (202) 622-4930; or Lynne A. Camillo (section 61), (202) 622-6040 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

#### Background

This document contains final amendments to the Income Tax

Regulations, 26 CFR part 1, relating to the disallowance under section 274 of the Internal Revenue Code (Code) of deductions for the use of business aircraft for entertainment.

On June 15, 2007, a notice of proposed rulemaking (REG-147171-05) regarding the use of business aircraft for entertainment was published in the **Federal Register** (72 FR 33169). Written and electronic comments responding to the notice of proposed rulemaking were received. A public hearing on the proposed regulations was held on October 25, 2007. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The comments and revisions are discussed in the preamble.

#### Explanation of Provisions and Summary of Comments

##### 1. Determination of Costs

###### a. Application of Disallowance to Fixed Costs

The proposed regulations provide that expenses subject to disallowance under section 274(a) include variable costs such as fuel and landing fees, and fixed costs such as depreciation, hangar fees, pilot salaries, and other items not directly related to an individual flight. Commentators suggested that the final regulations should limit expenses subject to disallowance to the direct or variable costs of a flight and exclude fixed costs. The final regulations do not adopt this comment because section 274(e)(2) does not explicitly differentiate between fixed and variable expenses and because such an interpretation is contrary to Congressional intent.

###### b. Charter Rate Safe Harbor

The proposed regulations requested comments on whether, as an alternative to determining actual expenses, the final regulations should allow taxpayers to determine the amount of expenses paid or incurred for entertainment flights by reference to charter rates. The proposed regulations asked for specific comments on the availability of substantiated actual, published, undiscounted charter rates charged to the general public by companies that meet certain requirements.

Commentators generally endorsed the inclusion of a charter rate safe harbor in the final regulations. They suggested that the IRS establish rates either by conducting a survey of average charter rates by region or by authorizing representatives of the industry to create a charter rate reporting system. One commentator suggested that if the IRS

does not establish charter rates, individual taxpayers should be allowed to determine charter rates.

Commentators also stated that a charter rate safe harbor should include rates for rentals of small piston aircraft, which taxpayers use extensively for business but normally are not chartered.

The difficulty of determining accurate and reliable charter rates continues to be an impediment to establishing a charter rate safe harbor. Accordingly, the final regulations do not include these rules. However, the final regulations authorize the IRS to adopt charter rate or other safe harbors in future published guidance, see § 601.601(d).

###### c. Depreciation

The proposed regulations permit a taxpayer to elect to compute depreciation expenses on a straight-line basis for all of the taxpayer's aircraft and all taxable years for purposes of calculating expenses subject to disallowance, even if the taxpayer uses another method to compute depreciation for other purposes. The proposed regulations provide a transition rule for applying the straight-line election to aircraft placed in service in taxable years preceding the election, which requires the taxpayer to apply the straight-line method as if it had been applied from the year the aircraft was placed in service.

A commentator requested that the final regulations allow a separate election for each aircraft. The final regulations do not allow an aircraft-by-aircraft election. Requiring taxpayers to make the election for all aircraft appropriately balances the policies of promoting business investment through the allowance of additional first-year depreciation and denying a tax benefit for entertainment use of business aircraft.

The commentator also suggested that changing depreciation methods under the transition rule may result in disallowing more than 100 percent of the cost of the aircraft. In response to the comment, the final regulations clarify that, in any taxable year, the depreciation disallowance does not exceed the amount of otherwise allowable depreciation. Thus, the sum of the allowable depreciation and the depreciation disallowed will not exceed 100 percent of basis, regardless of the taxable year a taxpayer makes the straight-line election.

The final regulations provide examples illustrating how taxpayers determine depreciation and basis under the election.

#### d. Interest Expense

A commentator asked for clarification on whether interest is an expense that is subject to disallowance. In response to this comment, the final regulations clarify that interest is subject to disallowance if the underlying debt is secured by or properly allocable to an aircraft used for entertainment.

#### e. Aircraft Aggregation

The proposed regulations provide that a taxpayer may aggregate expenses for aircraft of similar cost profiles to calculate expenses subject to disallowance. The proposed regulations require that aircraft have the same engine type and number and suggest other factors relevant to whether aircraft are of a similar cost profile.

A commentator requested that the final regulations make the aircraft aggregation rules less restrictive. The commentator opined that taxpayers should be allowed to aggregate the expenses of all aircraft to alleviate the administrative burden of computing and allocating expenses to entertainment use of the aircraft. The commentator stated that, alternatively, the rules inappropriately require similar cost profiles to include the same number of engines and require an unduly detailed analysis of the aircraft characteristics.

The final regulations retain the aircraft aggregation rules. Aggregating the expenses of all aircraft regardless of cost characteristics would create unacceptable distortions in the amount of expenses allocated to the use of each aircraft. The rules are sufficiently broad and flexible for taxpayers to easily apply them.

### 2. Allocation of Costs to Flights

#### a. Primary Purpose Test

The proposed regulations provide two alternative methods for allocating the costs associated with the use of an aircraft to provide entertainment to specified individuals. The occupied seat hours or miles allocation method divides the total expenses for the year by the number of occupied seat hours or occupied seat miles to determine a per seat or per mile rate, and it applies the rate to the number of hours or miles of entertainment use. The flight-by-flight method allocates expenses to a flight and then to the passengers on the flight according to the entertainment or nonentertainment character of the travel.

Commentators suggested that the final regulations adopt a primary purpose test for identifying disallowed expenses. Under a primary purpose test, the primary purpose of a flight would

determine whether any costs associated with specified individuals traveling for entertainment on that flight are disallowed. Generally, if the primary purpose of a flight is business, no more than the additional or incidental costs associated with specified individuals traveling for entertainment aboard that flight would be disallowed. Some commentators suggested that if the primary purpose of a flight is business, no costs should be allocated to entertainment. One commentator advocated that the final regulations include a primary purpose test as a safe harbor for smaller aircraft.

The final regulations do not adopt a primary purpose test. Section 274(e)(2) applies if a taxpayer provides entertainment, amusement, or recreation to a specified individual and does not depend on either the reason the taxpayer provides the entertainment or the overall use of the aircraft. Disregarding entertainment use by a specified individual is contrary to Congressional intent in amending section 274(e)(2) to disallow expenses allocable to entertainment use of aircraft by specified individuals.

#### b. Effect of Allocation Rules

Commentators suggested the passenger-by-passenger allocation of costs in the proposed regulations imposes an undue administrative burden on taxpayers. One commentator stated that the regulations result in excess disallowance and are unworkable due to their inconsistency with the primary purpose test. Another commentator said that determination of the character of each passenger's use could be difficult and asked for more examples illustrating when a use is entertainment.

The final regulations retain the occupied seat hours or miles and flight-by-flight allocation rules. Before the amendment of section 274(e)(2), taxpayers were required to maintain records of the character of the use of aircraft by employees to comply with the income inclusion rules of section 61 and § 1.61–21. Any additional administrative burden resulting from the requirement to identify, and allocate expenses to, entertainment use of aircraft is limited and is inherent in the statutory requirement to allocate expenses to entertainment use. The final regulations do not include additional examples of entertainment use because entertainment use is defined for purposes of section 274 in § 1.274–2(b)(1) and is therefore beyond the scope of this regulation.

### 3. Allocation of Disallowance to Expenses

The proposed regulations provide that the disallowance provisions are applied on a pro rata basis to all disallowed expenses. A commentator requested clarification of how an amount that is treated as compensation to or reimbursed by a specified individual is allocated to disallowed expenses. The commentator noted that it is necessary to determine the amount of disallowed expenses that represents depreciation to properly adjust an aircraft's basis.

In response to this comment, the final regulations clarify that any amounts disallowed and any amounts reimbursed or treated as compensation are applied to total expenses subject to disallowance on a pro rata basis. The final regulations include an example illustrating this rule.

### 4. Bona Fide Security Concerns

The proposed regulations do not exempt expenses for entertainment travel from disallowance under section 274 when there is a business need to use the aircraft to provide security pursuant to § 1.132–5(m). A commentator argued that the final regulations should provide that the excess cost of using a private aircraft for bona fide security concerns should not be subject to disallowance. Section 1.132–5(m) reduces the amount of income inclusion for the fringe benefit under circumstances in which a bona fide security concern exists, but does not convert an entertainment flight into a business flight. Because section 274(e) does not provide an exception to disallowance for expenses related to the use of a private aircraft for bona fide security concerns, the final regulations do not adopt this comment.

### 5. Aircraft as Entertainment Facilities

The proposed regulations do not address the use of aircraft as entertainment facilities, but requested comments on whether additional guidance on this question should be issued. Commentators suggested that the same rules in the proposed regulations should apply to the use of aircraft as entertainment facilities and requested that the final regulations clarify when and how the rules apply to entertainment facilities.

These regulations interpret section 274(e)(2). Section 274(e)(2) is an exception to the disallowance provisions of section 274(a). Expenses for entertainment facilities are disallowed under section 274(a)(1)(B). Therefore, the final regulations clarify that section 274(e)(2) and the associated regulations apply to expenses for

entertainment facilities as well as entertainment activities. However, the final regulations do not include specific rules for the use of aircraft as entertainment facilities, which are addressed elsewhere in the section 274 regulations.

#### 6. *Deadhead Flights*

The proposed regulations provide that an aircraft flying without passengers en route to pick up, or after having discharged, passengers (deadhead flight) is generally treated as having the same number and character of passengers as the leg of the trip on which passengers are on board. A commentator suggested that the final regulations allow any reasonable method to determine expenses related to deadhead flights. The final regulations do not adopt this rule because it would be difficult to administer.

Another commentator asked that the final regulations provide examples including mathematical computations for expenses for deadhead flights. In response to this comment, the final regulations include examples illustrating the computation of expenses for a deadhead flight.

#### 7. *Leases to Third Parties*

The proposed regulations provide that expenses allocable to a lease or charter of an aircraft to an unrelated third party in a bona-fide business transaction for the charter period are not subject to the expense disallowance. A commentator suggested that the rules for leases and charters to third parties should clarify that “charter period” includes “lease period,” that not only expenses but also flight hours or miles attributable to a charter period are removed from the seat/hour or seat/mile calculation, and that a taxpayer may use any reasonable method to allocate expenses to a charter period.

The seat hour or seat mile calculation is a method of allocating expenses to entertainment use. If expenses are not subject to the expense disallowance, then no allocation is required, and seat hours or miles attributable to a charter period are not included in that calculation. The final regulations change the term *charter period* to the term *lease or charter period*. The final regulations also clarify that whether a third party is unrelated to the taxpayer is determined under section 267(b) or 707(b).

#### 8. *Section 274(e)(8) Exception*

A commentator asked for clarification on whether the proposed regulations modify the section 274(e)(8) exception for “entertainment sold to customers.”

Another commentator asked for clarification on what constitutes “adequate and full consideration” for purposes of the section 274(e)(8) exception.

The proposed and final regulations, which provide guidance on the section 274(e)(2) exception, state that the section 274(a) disallowance for the use of a taxpayer-provided aircraft for entertainment does not apply to expenses that meet the exceptions of section 274(e). As 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, and only to entertainment sold to customers. However, the final regulations do not provide additional rules on the section 274(e)(8) exception, which is outside the scope of the regulations.

#### 9. *Travel on Regularly Scheduled Commercial Airlines*

A commentator requested that the final regulations include an exception for entertainment flights by employees of commercial passenger or cargo airlines on flights operated by their employers. The commentator also noted that identifying entertainment use by specified individuals on these flights and allocating expenses to this use would be extremely burdensome. While the final regulations do not provide a general exception to the disallowance rules for taxpayers that are commercial passenger or cargo airlines because a general exception is not supported by the statute, the final regulations provide a special rule for specified individuals on regularly scheduled flights of taxpayers that are commercial passenger airlines. This rule treats expenses of entertainment flights by specified individuals in the same manner as expenses of entertainment flights by non-specified individuals under certain circumstances.

#### 10. *Charitable Contribution Deduction*

A commentator suggested that the final regulations should include rules on charitable contribution deductions for the fixed costs of using aircraft for charitable purposes. These rules are outside the scope of the regulations; therefore, the final regulations do not adopt this comment.

#### 11. *Income Inclusion and Compensation*

Section 274(e)(2) and the proposed regulations provide, in general, that expenses are not disallowed to the extent of the amount a taxpayer treats as compensation to, or includes in the income of, a specified individual. A commentator requested that the final

regulations include a “safe harbor deduction” of the amount of compensation claimed for the specified individual. The final regulations do not adopt this comment because section 274(e)(2) already operates as a safe harbor deduction to the extent of amounts treated as compensation and income, up to the amount of expenses properly allocable to that entertainment use.

The proposed regulations additionally provide, in effect, that expenses are not disallowed to the extent of the amount a specified individual reimburses the taxpayer. A commentator asked that the final regulations include examples of how these rules apply when an employee pays for a flight and that the regulations specify that the taxpayer has income in that circumstance. The final regulations retain examples from the proposed regulations that illustrate the amount of expenses disallowed when amounts are treated as compensation or when an employee reimburses the taxpayer. The circumstances under which the taxpayer has income from reimbursements is beyond the scope of these regulations.

#### **Effective/Applicability Date**

The final regulations apply to taxable years beginning after August 1, 2012.

#### **Effect on Other Documents**

Notice 2005–45 (2005–1 CB 1228) is obsolete as of August 1, 2012.

#### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

#### **Drafting Information**

The principal authors of these regulations are Michael Nixon of the Office of Associate Chief Counsel (Income Tax and Accounting) and Lynne A. Camillo of the Office of

Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

#### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

**Authority:** 26 U.S.C. 7805\* \* \*  
Section 1.274–9 also issued under 26 U.S.C. 274(o).\* \* \*  
Section 1.274–10 also issued under 26 U.S.C. 274(o).\* \* \*

■ **Par. 2.** Section 1.61–21 is amended by revising paragraphs (g)(14)(i) and (ii) and adding paragraph (g)(14)(iii) to read as follows:

#### § 1.61–21 Taxation of fringe benefits.

\* \* \* \* \*

(g) \* \* \*  
(14) \* \* \*

(i) *Use by employer.* Except as otherwise provided in paragraph (g)(13) or paragraph (g)(14)(iii) of this section or in § 1.132–5(m)(4), if the non-commercial flight valuation rule of this paragraph (g) is used by an employer to value any flight provided in a calendar year, the rule must be used to value all flights provided to all employees in the calendar year.

(ii) *Use by employee.* Except as otherwise provided in paragraph (g)(13) or (g)(14)(iii) of this section or in § 1.132–5(m)(4), if the non-commercial flight valuation rule of this paragraph (g) is used by an employee to value a flight provided by an employer in a calendar year, the rule must be used to value all flights provided to the employee by that employer in the calendar year.

(iii) *Exception for entertainment flights provided to specified individuals after October 22, 2004.* Notwithstanding the provisions of paragraph (g)(14)(i) of this section, an employer may use the general valuation rules of paragraph (b) of this section to value the entertainment use of an aircraft provided after October 22, 2004, to a specified individual. An employer who uses the general valuation rules of paragraph (b) of this section to value any entertainment use of an aircraft by a specified individual in a calendar year

must use the general valuation rules of paragraph (b) of this section to value all entertainment use of aircraft provided to all specified individuals during that calendar year.

(A) *Specified individuals defined.* For purposes of paragraph (g)(14)(iii) of this section, *specified individual* is defined in section 274(e)(2)(B) and § 1.274–9(b).

(B) *Entertainment defined.* For purposes of paragraph (g)(14)(iii) of this section, *entertainment* is defined in § 1.274–2(b)(1).

\* \* \* \* \*

■ **Par. 3.** Section 1.274–9 is added to read as follows:

#### § 1.274–9 Entertainment provided to specified individuals.

(a) *In general.* Paragraphs (e)(2) and (e)(9) of section 274 provide exceptions to the disallowance of section 274(a) for expenses for entertainment, amusement, or recreation activities, or for an entertainment facility. In the case of a specified individual (as defined in paragraph (b) of this section), the exceptions of paragraphs (e)(2) and (e)(9) of section 274 apply only to the extent that the expenses do not exceed the amount of the expenses treated as compensation (under section 274(e)(2)) or as income (under section 274(e)(9)) to the specified individual. The amount disallowed is reduced by any amount that the specified individual reimburses a taxpayer for the entertainment.

(b) *Specified individual defined.* (1) A specified individual is an individual who is subject to section 16(a) of the Securities Act of 1934 in relation to the taxpayer, or an individual who would be subject to section 16(a) if the taxpayer were an issuer of equity securities referred to in that section.

Thus, for example, a specified individual is an officer, director, or more than 10 percent owner of a corporation taxed under subchapter C or subchapter S or a personal service corporation. A specified individual includes every individual who—

(i) Is the direct or indirect beneficial owner of more than 10 percent of any class of any registered equity (other than an exempted security);

(ii) Is a director or officer of the issuer of the security;

(iii) Would be the direct or indirect beneficial owner of more than 10 percent of any class of a registered security if the taxpayer were an issuer of equity securities; or

(iv) Is comparable to an officer or director of an issuer of equity securities.

(2) For partnership purposes, a specified individual includes any partner that holds more than a 10 percent equity interest in the

partnership, or any general partner, officer, or managing partner of a partnership.

(3) For purposes of this section, *officer* has the same meaning as in 17 CFR § 240.16a–1(f).

(4) A specified individual includes a director or officer of a tax-exempt entity.

(5) A specified individual of a taxpayer includes a specified individual of a party related to the taxpayer within the meaning of section 267(b) or section 707(b).

(c) *Specified individual treated as recipient of entertainment provided to others.* For purposes of section 274(a), a specified individual is treated as the recipient of entertainment provided to another individual because of the relationship of the other individual to the specified individual if the entertainment is a fringe benefit to the specified individual under section 61(a)(1) (without regard to any exclusions from gross income). Thus, expenses allocable to entertainment provided to the other individual are attributed to the specified individual for purposes of determining the amount of disallowed expenses.

(d) *Entertainment use of aircraft by specified individuals.* For rules relating to entertainment use of aircraft by specified individuals, see § 1.274–10.

(e) *Effective/applicability date.* This section applies to taxable years beginning after August 1, 2012.

■ **Par. 4.** Section 1.274–10 is added to read as follows:

#### § 1.274–10 Special rules for aircraft used for entertainment.

(a) *Use of an aircraft for entertainment—(1) In general.* Section 274(a) disallows a deduction for certain expenses for entertainment, amusement, or recreation activities, or for an entertainment facility. Under section 274(a) and this section, no deduction otherwise allowable under chapter 1 is allowed for expenses for the use of a taxpayer-provided aircraft for entertainment, except as provided in paragraph (a)(2) of this section.

(2) *Exceptions—(i) In general.* Paragraph (a)(1) of this section does not apply to deductions for expenses for business entertainment air travel or to deductions for expenses that meet the exceptions of section 274(e), § 1.274–2(f), and this section. Section 274(e)(2) and (e)(9) provides certain exceptions to the disallowance of section 274(a) for expenses for goods, services, and facilities for entertainment, recreation, or amusement.

(ii) *Expenses treated as compensation—(A) Employees who are not specified individuals.* Section

274(a), § 1.274–2(a) through (d), and paragraph (a)(1) of this section, in accordance with section 274(e)(2)(A), do not apply to expenses for entertainment air travel provided to an employee who is not a specified individual to the extent that a taxpayer—

(1) Properly treats the expenses relating to the recipient of entertainment as compensation to an employee under chapter 1 and as wages to the employee for purposes of chapter 24; and

(2) Treats the proper amount as compensation to the employee under § 1.61–21.

(B) *Persons who are not employees and are not specified individuals.*

Section 274(a), § 1.274–2(a) through (d), and paragraph (a)(1) of this section, in accordance with section 274(e)(9), do not apply to expenses for entertainment air travel provided to a person who is not an employee and is not a specified individual to the extent that the expenses are includible in the income of that person. This exception does not apply to any amount paid or incurred by the taxpayer that is required to be included in any information return filed by the taxpayer under part III of subchapter A of chapter 61 and is not so included.

(C) *Specified individuals.* Section 274(a), § 1.274–2(a) through (d), and paragraph (a)(1) of this section, in accordance with section 274(e)(2)(B), do not apply to expenses for entertainment air travel of a specified individual to the extent that the amount of the expenses do not exceed the sum of—

(1) The amount treated as compensation to or included in the income of the specified individual in the manner specified under paragraph (a)(2)(ii)(A)(1) of this section (if the specified individual is an employee) or under paragraph (a)(2)(ii)(B) of this section (if the specified individual is not an employee); and

(2) Any amount the specified individual reimburses the taxpayer.

(iii) *Travel on regularly scheduled commercial airlines.* Section 274(a), § 1.274–2(a) through (d), and paragraph (a)(1) of this section do not apply to expenses for entertainment air travel that a taxpayer that is a commercial passenger airline provides to specified individuals of the taxpayer on the taxpayer's regularly scheduled flights on which at least 90 percent of the seats are available for sale to the public to the extent the expenses are includible in the income of the recipient of the entertainment in the manner specified under paragraph (a)(2)(ii)(A)(1) of this section (if the specified individual is an employee) or under paragraph (a)(2)(ii)(B) of this section (if the

specified individual is not an employee).

(b) *Definitions.* The definitions in this paragraph (b) apply for purposes of this section.

(1) *Entertainment.* For the definition of *entertainment* for purposes of this section, see § 1.274–2(b)(1).

Entertainment does not include personal travel that is not for entertainment purposes. For example, travel to attend a family member's funeral is not entertainment.

(2) *Entertainment air travel.*

*Entertainment air travel* is any travel aboard a taxpayer-provided aircraft for entertainment purposes.

(3) *Business entertainment air travel.* *Business entertainment air travel* is any entertainment air travel aboard a taxpayer-provided aircraft that is directly related to the active conduct of the taxpayer's trade or business or related to an expenditure directly preceding or following a substantial and bona fide business discussion and associated with the active conduct of the taxpayer's trade or business. See § 1.274–2(a)(1)(i) and (ii). 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 § 1.132–5(m).

(4) *Taxpayer-provided aircraft.* A *taxpayer-provided aircraft* is any aircraft owned by, leased to, or chartered to, a taxpayer or any party related to the taxpayer (within the meaning of section 267(b) or section 707(b)).

(5) *Specified individual.* For rules relating to the definition of a specified individual, see § 1.274–9.

(c) *Amount disallowed.* Except as otherwise provided, the amount disallowed under this section for an entertainment flight by a specified individual is the amount of expenses allocable to the entertainment flight of the specified individual under paragraph (e)(2), (e)(3), or (f)(3) of this section, reduced (but not below zero) by the amount the taxpayer treats as compensation or reports as income under paragraph (a)(2)(ii)(C)(1) of this section to the specified individual, plus any amount the specified individual reimburses the taxpayer.

(d) *Expenses subject to disallowance under this section—(1) Definition of expenses.* In determining the amount of expenses subject to disallowance under this section, a taxpayer must include all of the expenses of operating the aircraft, including all fixed and variable expenses the taxpayer deducts in the taxable year. These expenses include, but are not limited to, 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 flights; costs of on-board refreshments, amenities and gifts; hangar fees (at home or away); management fees; costs of fuel, tires, maintenance, insurance, registration, certificate of title, inspection, and depreciation; interest on debt secured by or properly allocated (within the meaning of § 1.163–8T) to an aircraft; and all costs paid or incurred for aircraft leased or chartered to the taxpayer.

(2) *Leases or charters to third parties.* Expenses allocable to a lease or charter of a taxpayer's aircraft to an unrelated (as determined under section 267(b) or 707(b)) third-party in a bona-fide business transaction for adequate and full consideration are excluded from the definition of expenses in paragraph (d)(1) of this section. Only expenses allocable to the lease or charter period are excluded under this paragraph (d)(2).

(3) *Straight-line method permitted for determining depreciation disallowance under this section—(i) In general.* In lieu of the amount of depreciation deducted in the taxable year, solely for purposes of paragraph (d)(1) of this section, a taxpayer may elect to treat as its depreciation deduction the amount that would result from using the straight-line method of depreciation over the class life (as defined by section 168(i)(1) and using the applicable convention under section 168(d)) of an aircraft, even if the taxpayer uses a different methodology to calculate depreciation for the aircraft under other sections of the Internal Revenue Code (for example, section 168). If the property qualifies for the additional first-year depreciation deduction provided by, for example, section 168(k), 168(n), 1400L(b), or 1400N(d), depreciation for purposes of this straight-line election is determined on the unadjusted depreciable basis (as defined in § 1.168(b)–1(a)(3)) of the property. However, the amount of depreciation disallowed as a result of this paragraph (d)(3) for any taxable year cannot exceed a taxpayer's allowable depreciation for that taxable year. For purposes of this section, a taxpayer that elects to use the straight-line method and class life under this paragraph (d)(3) for any aircraft it operates must use that methodology for all depreciable aircraft it operates and must continue to use the methodology for the entire period the taxpayer uses any depreciable aircraft.

(ii) *Aircraft placed in service in earlier taxable years.* The amount of depreciation for purposes of this paragraph (d)(3) for aircraft placed in service in taxable years before the

taxable year of the election is determined by applying the straight-line method of depreciation to the unadjusted depreciable basis (or, for property acquired in an exchange to which section 1031 applies, the basis of the aircraft as determined under section 1031(d)) and over the class life (using the applicable convention under section 168(d)) of the aircraft as though the taxpayer used that methodology from the year the aircraft was placed in service.

(iii) *Manner of making and revoking election.* A taxpayer makes the election under this paragraph (d)(3) by filing an income tax return for the taxable year that determines the taxpayer's expenses for purposes of paragraph (d)(1) of this section by computing depreciation under this paragraph (d)(3). A taxpayer may revoke an election only for compelling circumstances upon consent of the Commissioner by private letter ruling.

(4) *Aggregation of aircraft—(i) In general.* A taxpayer may aggregate the expenses of aircraft of similar cost profiles for purposes of calculating disallowed expenses under paragraph (c) of this section.

(ii) *Similar cost profiles.* Aircraft are of similar cost profiles if their operating costs per mile or per hour of flight are comparable. Aircraft must have the same engine type (jet or propeller) and the same number of engines to have similar cost profiles. Other factors to be considered in determining whether aircraft have similar cost profiles include, but are not limited to, maximum take-off weight, payload, passenger capacity, fuel consumption rate, age, maintenance costs, and depreciable basis.

(5) *Authority for establishing safe harbors for determining expenses.* The Commissioner may establish in published guidance, see § 601.601(d)(2) of this chapter, one or more safe harbor methods under which a taxpayer may determine the amount of expenses paid or incurred for entertainment flights.

(e) *Allocation of expenses—(1) General rule.* For purposes of determining the expenses allocated to entertainment air travel of a specified individual under paragraph (a)(2)(ii)(C) of this section, a taxpayer must use either the occupied seat hours or miles method of paragraph (e)(2) of this section or the flight-by-flight method of paragraph (e)(3) of this section. A taxpayer must use the chosen method for all flights of all aircraft for the taxable year.

(2) *Occupied seat hours or miles method—(i) In general.* The occupied seat hours or miles method determines

the amount of expenses allocated to a particular entertainment flight of a specified individual based on the occupied seat hours or miles for an aircraft for the taxable year. Under this method, a taxpayer may choose to use either occupied seat hours or miles for the taxable year to determine the amount of expenses allocated to entertainment flights of specified individuals, but must use occupied seat hours or miles consistently for all flights of all aircraft for the taxable year.

(ii) *Computation under the occupied seat hours or miles method.* The amount of expenses allocated to an entertainment flight taken by a specified individual is computed under the occupied seat hours or miles method by determining—

(A) The total expenses for the year under paragraph (d) of this section for the aircraft or group of aircraft (if aggregated under paragraph (d)(4) of this section), as applicable;

(B) The number of occupied seat hours or miles for the taxable year for the aircraft or group of aircraft by totaling the occupied seat hours or miles of all flights in the taxable year flown by the aircraft or group of aircraft, as applicable. The occupied seat hours or miles for a flight is the number of hours or miles flown for the flight multiplied by the number of seats occupied on that flight. For example, a flight of 6 hours with three passengers results in 18 occupied seat hours;

(C) The cost per occupied seat hour or mile for the aircraft or group of aircraft, as applicable, by dividing the total expenses under paragraph (e)(2)(ii)(A) of this section by the total number of occupied seat hours or miles under paragraph (e)(2)(ii)(B) of this section; and

(D) The amount of expenses allocated to an entertainment flight taken by a specified individual by multiplying the number of hours or miles of the flight by the cost per occupied hour or mile for that aircraft or group of aircraft, as applicable, as determined under paragraph (e)(2)(ii)(C) of this section.

(iii) *Allocation of expenses of multi-leg trips involving both business and entertainment legs.* A taxpayer that uses the occupied seat hours or miles allocation method must allocate the expenses of a trip by a specified individual that involves at least one segment for business and one segment for entertainment between the business travel and the entertainment travel unless none of the expenses for the entertainment segment are disallowed. The entertainment cost of a multi-leg trip is the total cost of the flights (by occupied seat hours or miles) minus the

cost of the flights that would have been taken without the entertainment segment or segments.

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (e)(2):

*Example 1.* (i) A taxpayer-provided aircraft is used for Flights 1, 2, and 3, of 5 hours, 5 hours, and 4 hours, respectively, during the Taxpayer's taxable year. Each flight carries four passengers. On Flight 1, none of the passengers is a specified individual. On Flight 2, passengers A and B are specified individuals traveling for entertainment purposes and passengers C and D are not specified individuals. For Flight 2, Taxpayer treats \$1,200 as compensation to A, and B reimburses Taxpayer \$500. On Flight 3, all four passengers (A, B, E, and F) are specified individuals traveling for entertainment purposes. For Flight 3, Taxpayer treats \$1,300 each as compensation to A, B, E, and F. Taxpayer incurs \$56,000 in expenses for the operation of the aircraft for the taxable year. The aircraft is operated for 56 occupied seat hours for the period (four passengers times 5 hours (20 occupied seat hours) for Flight 1, plus four passengers times 5 hours (20 occupied seat hours) for Flight 2, plus four passengers times 4 hours (16 occupied seat hours) for Flight 3. The cost per occupied seat hour is \$1,000 (\$56,000/56 hours).

(ii) For purposes of determining the amount disallowed (to the extent not treated as compensation or reimbursed) for entertainment provided to specified individuals, \$5,000 ( $\$1,000 \times 5$  hours) each is allocable to A and B for Flight 2, and \$4,000 ( $\$1,000 \times 4$  hours) each is allocable to A, B, E, and F for Flight 3.

(iii) For Flight 2, because Taxpayer treats \$1,200 as compensation to A, and B reimburses Taxpayer \$500, 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 (for A, \$5,000 less the \$1,200 treated as compensation, and for B, \$5,000 less the \$500 reimbursed).

(iv) For Flight 3, because Taxpayer treats \$1,300 each as compensation to A, B, E, and F, Taxpayer may deduct \$5,200 of the cost of Flight 3. The deduction for the remaining \$10,800 cost 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 2.* (i) G, a specified individual, is the sole passenger on an aircraft that makes three flights. First, G travels on a two-hour flight from City A to City B for business purposes. 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 flights have resulted in nine occupied seat hours (two for the first segment, plus three for the second segment, plus four for the third segment). If G had returned directly to City A from City B, the flights would have resulted in four occupied seat hours.

(ii) Under paragraph (e)(2)(iii) of this section, five occupied seat hours are

allocable to G's entertainment (nine total occupied seat hours minus the four occupied seat hours that would have resulted if the travel had been a roundtrip business trip without the entertainment segment). If Taxpayer's cost per occupied seat hour for the year is \$1,000, \$5,000 is allocated to G's entertainment use of the aircraft (\$1,000 × five occupied seat hours). The amount disallowed is \$5,000 minus the total of any amount the Taxpayer treats as compensation to G plus any amount that G reimburses Taxpayer.

(3) *Flight-by-flight method*—(i) *In general.* The flight-by-flight method determines the amount of expenses allocated to a particular entertainment flight of a specified individual on a flight-by-flight basis by allocating expenses to individual flights and then to a specified individual traveling for entertainment purposes on that flight.

(ii) *Allocation of expenses.* A taxpayer using the flight-by-flight method must combine all expenses (as defined in paragraph (d)(1) of this section) for the taxable year for the aircraft or group of aircraft (if aggregated under paragraph

(d)(4) of this section), as applicable, and divide the total amount of expenses by the number of flight hours or miles for the taxable year for that aircraft or group of aircraft, as applicable, to determine the cost per hour or mile. Expenses are allocated to each flight by multiplying the number of miles for the flight by the cost per mile or the number of hours for the flight by the cost per hour. The expenses for the flight then are allocated to the passengers on the flight per capita. Thus, if five passengers are traveling on a flight, and the total expense allocated to the flight is \$10,000, the expense allocable to each passenger is \$2,000.

(f) *Special rules*—(1) *Determination of basis.* (i) If any deduction for depreciation is disallowed under this section, the rules of § 1.274-7 apply. In that case, the basis of an aircraft is not reduced for the amount of depreciation disallowed under this section.

(ii) The provisions of this paragraph (f)(1) are illustrated by the following examples:

*Example 1.* (i) B Co. is a calendar-year taxpayer that owns an aircraft not used in commercial or contract carrying of passengers or freight. The aircraft is placed in service on July 1 of Year 1 and has an unadjusted depreciable basis of \$1,000,000. The class life of the aircraft for depreciation purposes is 6 years. For determining depreciation under section 168, B Co. uses the optional depreciation table that corresponds with the general depreciation system, the 200 percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. For determining the depreciation disallowance for each year under paragraph (d)(3) of this section, B Co. elects to use the straight-line method of depreciation and the class life of 6 years and, therefore, uses the optional depreciation table for purposes of section 168 that corresponds with the straight-line method of depreciation, a recovery period of 6 years, and the half-year convention. In each year, the aircraft entertainment use subject to disallowance under this section is 10 percent of the total use.

(ii) B Co. calculates the depreciation and basis of the aircraft as follows:

	200 Percent declining balance depreciation amount	Straight line depreciation amount	Depreciation disallowance under section 274	Depreciation deduction	§ 1.274-7 Basis of aircraft	Suspended basis.
Year 1 .....	200,000	83,300	8,330. (.10 × 83,300)	191,670 (200,000 minus 8,330).	808,330 (1,000,000 minus 191,670).	8,330.
Year 2 .....	320,000	166,700	16,670 (.10 × 166,700).	303,330 (320,000 minus 16,670).	505,000 (808,330 minus 303,330).	25,000 (8,300 plus 16,670).
Year 3 .....	192,000	166,700	16,670 (.10 × 166,700).	175,330 (192,000 minus 16,670).	329,670 (505,000 minus 175,330).	41,670 (25,000 plus 16,670).
Year 4 .....	115,200	166,700	16,670 (.10 × 166,700).	98,530 (115,200 minus 16,670).	231,140 (329,670 minus 98,530).	58,340 (41,670 plus 16,670).
Year 5 .....	115,200	166,600	16,660 (.10 × 166,600).	98,540 (115,200 minus 16,660).	132,600 (231,140 minus 98,540).	75,000 (58,340 plus 16,660).
Year 6 .....	57,600	166,700	16,670 (.10 × 166,700).	40,930 (57,600 minus 16,670).	91,670 (132,600 minus 40,930).	91,670 (75,000 plus 16,670).
Year 7 .....	.....	83,300	8,330 (.10 × 83,300) ..	.....	91,670 .....	91,670.

(iii) In Year 7, there is no further deduction for depreciation of the aircraft, therefore, under paragraph (d)(3) of this section, no depreciation expense is disallowed. Under § 1.274-7 and this paragraph (f)(1), basis is not reduced for disallowed depreciation. Therefore, at the end of Year 7, the basis of

the aircraft for purposes of § 1.274-7 is \$91,670, which is the total amount of disallowed depreciation in Years 1 through 6. B Co.'s deductions for depreciation total \$908,330, which added to \$91,670 equals \$1,000,000.

*Example 2.* (i) The facts are the same as in *Example 1*, except that B Co. does not elect to use the straight-line method of depreciation under paragraph (d)(3) of this section until Year 3.

(ii) B Co. calculates the depreciation and basis of the aircraft as follows:

	200 Percent declining balance depreciation amount	Straight line depreciation amount	Depreciation disallowance under section 274	Depreciation deduction	§ 1.274 Basis of aircraft	Suspended basis.
Year 1 .....	200,000	.....	20,000 (.10 × 200,000).	180,000 .....	820,000 (1,000,000 minus 180,000).	20,000.
Year 2 .....	320,000	.....	32,000 (.10 × 320,000).	288,000 (320,000 minus 32,000).	532,000 (820,000 minus 288,000).	52,000 (20,000 plus 32,000).
Year 3 .....	192,000	166,700	16,670 (.10 × 166,700).	175,330 (192,000 minus 16,670).	356,670 (532,000 minus 175,330).	68,670 (52,000 plus 16,670).
Year 4 .....	115,200	166,700	16,670 (.10 × 166,700).	98,530 (115,200 minus 16,670).	258,140 (356,670 minus 98,530).	85,340 (68,670 plus 16,670).
Year 5 .....	115,200	166,600	16,660 (.10 × 166,600).	98,540 (115,200 minus 16,660).	159,600 (258,140 minus 98,540).	102,000 (85,340 plus 16,660).

	200 Percent declining balance depreciation amount	Straight line depreciation amount	Depreciation disallowance under section 274	Depreciation deduction	§ 1.274 Basis of aircraft	Suspended basis.
Year 6 .....	57,600	166,700	16,670 (.10 × 166,700).	40,930 (57,600 minus 16,670).	118,670 (159,600 minus 40,930).	118,670 (102,000 plus 16,670).
Year 7 .....	.....	83,300	8,330 (.10 × 83,300) ..	0 .....	118,670 .....	118,670.

(iii) In Year 7, there is no further deduction for depreciation of the aircraft, therefore, under paragraph (d)(3) of this section, no depreciation expense is disallowed. Under § 1.274-7 and this paragraph (f)(1), basis is not reduced for disallowed depreciation. Therefore, at the end of Year 7, the basis of the aircraft for purposes of § 1.274-7 is \$118,670, which is the total amount of disallowed depreciation in Years 1 through 6. B Co.'s deductions for depreciation total \$881,330, which added to \$118,670 equals \$1,000,000.

(2) *Pro rata disallowance.* (i) The amount of disallowed expenses, and any amounts reimbursed or treated as compensation, under this section are applied on a pro rata basis to all of the categories of expenses subject to disallowance under this section.

(ii) The provisions of this paragraph (f)(2) are illustrated by the following example:

*Example.* (i) C Co. owns an aircraft that it uses for business and other purposes. The expenses of operating the aircraft in the current year total \$1,000,000. This amount includes \$250,000 for depreciation (25 percent of total expenses).

(ii) In the same year, the aircraft entertainment use subject to disallowance under this section is 20 percent of the total use and C Co. treats \$80,000 as compensation to specified individuals. Thus, the amount of the disallowance under this section is \$120,000 (\$1,000,000 × 20 percent (\$200,000) less \$80,000).

(iii) Under paragraph (f)(2) of this section, C Co. may calculate the amount by which a category of expense, such as depreciation, is disallowed by multiplying the total disallowance of \$120,000 by the ratio of the amount of the expense to total expenses. Thus, \$30,000 of the \$120,000 total disallowed expenses is depreciation (\$250,000/\$1,000,000 (25 percent) × \$120,000).

(iv) The result is the same if C Co. separately calculates the amount of depreciation in total disallowed expenses and in the amount treated as compensation and nets the result. Depreciation is 25 percent of total expenses, thus, the amount of depreciation in disallowed expenses is \$50,000 (25 percent × \$200,000 total disallowed expenses) and the amount of depreciation treated as compensation is \$20,000 (25 percent × \$80,000). Disallowed depreciation is \$50,000 less \$20,000, or \$30,000.

(3) *Deadhead flights.* (i) For purposes of this section, an aircraft returning without passengers after discharging passengers or flying without passengers to pick up passengers (deadheading) is treated as having the same number and character of passengers as the leg of the trip on which passengers are aboard for purposes of allocating expenses under paragraphs (e)(2) or (e)(3) of this section. For example, when an aircraft travels from point A to point B and then back to point A, and one of the legs is a deadhead flight, for determination of disallowed expenses, the aircraft is treated as having made both legs of the trip with the same passengers aboard for the same purposes.

(ii) When a deadhead flight does not occur within a roundtrip flight, but occurs between two unrelated flights involving more than two destinations (such as an occupied flight from point A to point B, followed by a deadhead flight from point B to point C, and then an occupied flight from point C to point A), the allocation of passengers and expenses to the deadhead flight occurring between the two occupied trips must be based solely on the number of passengers on board for the two occupied legs of the flight, the character of the travel of the passengers on board (entertainment or nonentertainment) and the length in hours or miles of the two occupied legs of the flight.

(iii) The provisions of this paragraph (f)(3) are illustrated by the following examples:

*Example 1.* (i) Aircraft flies from City A to City B, a 6-hour trip, with 12 passengers aboard. Eight of the passengers are traveling for business and four of the passengers are specified individuals traveling for entertainment purposes. The aircraft flies empty (deadheads) from City B to City C, a 4-hour trip. At City C it picks up 12 passengers, six of whom are traveling for business and six of whom are specified individuals traveling for entertainment purposes, for a 2-hour trip to City A. The taxpayer uses the occupied seat hour method of allocating expenses.

(ii) The two legs of the trip on which the aircraft is occupied comprise 96 occupied seat hours (12 passengers × 6 hours (72) for the first leg plus 12 passengers × 2 hours (24)

for the third leg). Sixty occupied seat hours are for business (8 passengers × 6 hours (48) for the first leg plus 6 passengers × 2 (12) hours for the third leg) and 36 occupied seat hours are for entertainment purposes (4 passengers × 6 hours (24) for the first leg plus 6 passengers × 2 (12) hours for the third leg). Dividing the 36 occupied seat entertainment hours by 96 total occupied seat hours, 37.5 percent of the total occupied seat hours of the two occupied flights are for entertainment.

(iii) The 4-hour deadhead leg comprises one-third of the total flight time of 12 hours. Therefore, the deadhead flight is deemed to have provided one-third of the total 96 occupied seat hours, or 32 occupied seat hours (96 × 1/3 = 32). Of the 32 deemed occupied seat hours, 37.5 percent, or 12 deemed occupied seat hours, are treated as entertainment under paragraph (f)(3)(ii) of this section. The 32 deemed occupied seat hours for the deadhead flight are included in the calculation under paragraph (e)(2)(ii)(B) of this section and expenses are allocated under paragraph (e)(2)(ii)(D) of this section to the 12 deemed occupied seat hours treated as entertainment.

*Example 2.* (i) The facts are the same as for *Example 1*, but the taxpayer uses the flight-by-flight method of allocation.

(ii) Of the 24 passengers on the occupied flights, 10 passengers, or 41.7 percent, are traveling for entertainment purposes. If the annual cost per flight hour calculated under paragraph (e)(3)(ii) of this section is \$1,000, \$4,000 is allocated to the 4-hour deadhead leg. Under paragraph (f)(3)(ii) of this section, 41.7 percent of the \$4,000, or \$1,667, is treated as an expense for entertainment. The calculation of the cost per mile or hour for the year under paragraph (e)(3)(ii) of this section includes the expenses and number of miles or hours flown for the deadhead leg.

(g) *Effective/applicability date.* This section applies to taxable years beginning after August 1, 2012.

**Steven T. Miller,**

*Deputy Commissioner for Services and Enforcement.*

Approved: July 25, 2012.

**Emily S. McMahan,**

*Acting Assistant Secretary of the Treasury (Tax Policy).*

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