

ARTHUR ANDERSEN & CO.

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December 6, 1989

Mr. Steven L. Kitchen
KPL Gas Service Company
818 Kansas Avenue
Topeka, Kansas 66601

Dear Steve:

In response to your questions related to use of KPL's airplane by employees and their spouses, I have attempted to summarize the key provisions applicable to situations where income will be imputed to the employee for use of a corporate aircraft.

There are four specific situations under which an employee may have imputed income due to employee use of a corporate aircraft. Those situations include (1) use of the aircraft with a business purpose, (2) use of the aircraft primarily for business purposes, (3) use of the aircraft primarily for personal reasons, and (4) use of the aircraft for personal reasons.

(1) Business Purpose

If the employer-provided aircraft is used for a trip taken for business reasons, no income will be imputed. If the employee's spouse accompanies the employee and also has a business purpose, no income will be imputed attributable to the spouse portion of the trip. If a corporate-provided aircraft is used where the employee has a bona fide business purpose but the spouse does not, then income will be imputed to the employee for the spouse's portion of the trip based on the fair market value method or the safe harbor method. The fair market value method is based on the value of a comparable commercial flight. The safe harbor method is based on the Standard Industry Fare Level formula, commonly referred to as the SIFL rates. Generally, election of the SIFL rates is beneficial.

(2) Primarily Business Purpose

If a corporate aircraft is used by an employee primarily for business purposes, income is imputed for the excess of the value of the flights that would have been taken had there been no personal flights. This value is determined by segregating that portion of the trip that relates to business as opposed to that portion of the trip that relates to personal use. If a spouse accompanies the employee on such a trip, income is also imputed to the spouse for the excess value of such flights. Again, the employer may use the fair market valuation method or the safe harbor method to impute income to the employee.

(3) Primarily Personal Purposes

If trips are taken primarily for personal purposes, income would be imputed for the value of the personal flights that would have been taken had there been no business flights. If the spouse accompanies the employee, income would also be imputed for the spouse's portion of the personal flights. The employer may use the fair market valuation method or the safe harbor method as indicated above. In this case, however, the fair market value method represents the cost of a charter flight. Electing the safe harbor valuation method will almost always be advantageous in this type of situation.

(4) Personal Purposes

If the employer-provided aircraft is used for a trip taken for personal reasons, income will be imputed to the employee (and spouse) under the fair market valuation rules or the safe harbor method. Again, in this case, the fair market value method represents the cost of a charter flight. Electing the safe harbor valuation method will probably be advantageous to the employee.

In applying the above rules to your specific facts, we understand that an employee has been traveling on the corporate aircraft, which we assume is for a valid business purpose. No income will be imputed to the employee for those trips. On occasion, an employee's spouse has also been accompanying an employee on a trip. If no business purpose is established for the spouse, the amount of income imputed for the trip attributable to the employee's spouse would be the fair market value of a comparable airline ticket or, if so elected, an amount calculated under the SIFL rates.

The attached memorandum discusses bona fide business purposes. It should be pointed out that a house-hunting trip does not qualify as a business purpose. However, if the purpose of the spouse's trip is house-hunting, a moving expense deduction, subject to the moving expense limitation, may be allowed to offset the imputed income.

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Specific rules and examples of how to compute the safe harbor method (SIFL) are also reflected in the attached memorandum. If you need additional information or have any questions, please give us a call.

Very truly yours,

ARTHUR ANDERSEN & CO.

By


A. C. Hagemann

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Enclosure

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TO OFFICE FROM KANSAS CITY OFFICE

File InstructionsFOR THE FILES FROM MICHAEL E. SCHUERING
CHERI MADSENDATE NOVEMBER 29, 1989 JOB OR
ACCOUNT NO.Acknowledgment Copy

By _____

SUBJECT KANSAS POWER & LIGHT (KPL) -- PERSONAL USE OF AN
EMPLOYER-PROVIDED AIRCRAFT

The purpose of this memorandum is to set forth current IRS guidelines regarding the treatment of the personal usage of an employer-provided aircraft. The topics contained in the following paragraphs address:

- (a) IRS general provisions regarding personal use of a corporate aircraft and resulting income imputation;
- (b) case law illustrating actual circumstances where income imputation either was or was not required;
- (c) the valuation procedures to be used if income is to be imputed; and
- (d) the election and consistency rules associated with certain valuation methods.

General Requirements - (Bona Fide Business Purpose)

In general, gross income includes compensation for services, including fees, commissions, fringe benefits and other similar items. Examples of fringe benefits include a flight on an employer-provided aircraft (Reg. Section 1.61-21(a)(1)). Therefore, under the above provisions, if an employee uses an employer-provided aircraft for a personal trip, income must be imputed to the employee under one of the valuation methods discussed below. The employer's payment of costs related to having a spouse or guest accompany an employee on an employer-provided aircraft also results in income to the employee. The fact that an employer incurs no additional cost in transporting an employee, spouse or guest on a business flight has no bearing on the amount of income imputed to the employee. If the employee's or spouse's use of the corporate aircraft has a bona fide business purpose, no income is imputed to the employee (Reg. Section 1.162-2(c)). If no bona fide business purpose exists, then income is imputed to the employee under either the noncommercial flight valuation procedures or fair market value rules. The same rules apply for other family members or guests of the taxpayer who accompany him on such trip.

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Two prominent cases address the issue of a bona fide business purpose. In Fenstermaker v. Commissioner, Columbus and Southern Ohio Electric Company executives and their wives attended annual trade association meetings (EEI) and pursuant to its policy, the company paid or reimbursed the executives for their wives' expenses. The Tax Court declared that the expenses paid by the utility company were taxable income to the employee. The Court asserted that the wives provided no business connected services and their attendance was not necessary for their husband's effectiveness at the conventions; therefore, no bona fide business purpose existed. Despite the presence of many social functions designed for couples, the primary business reason for the conventions was the technical business meetings and lectures; therefore, the husbands could have attended the meetings alone. The Court also stated a wife's performance of some incidental service at a convention does not cause her expenses to qualify as deductible business expenses (Fenstermaker v. Commissioner, 37 T.C.M. 898 (1978)).

A contrasting view was conveyed in Disney v. U.S.. In the Disney case, Roy Disney was accompanied by his wife on several trips abroad, and pursuant to its policy, the company (Walt Disney Productions) reimbursed Disney for his wife's expenses. The Tax Commissioner refused to allow Disney to exclude from gross income, or to deduct as ordinary and necessary business expenses, the expenses related to his wife that were reimbursed by the company. However, the U.S. Court of Appeals reversed the decision, allowing Disney to exclude these amounts from gross income. It based its decision on the existence of a bona fide business purpose. The wife's presence was necessary for the husband to fulfill his employment duties and was necessitated by a long-standing company policy, and virtual insistence, that the wives accompany their husbands. Even though Mrs. Disney only attended social functions and press conferences, her presence was necessary from a business standpoint because of the "family image" Walt Disney Productions projects (U.S. v. Disney, 412 F.2d 784 (9th Cir. 1969)).

As seen by the decisions³ in these two cases, the existence of a bona fide business purpose is subjective. This is an area which the IRS looks at carefully and the ultimate determination depends on the facts and circumstances in each case. Furthermore, the burden of proof regarding whether there is a bona fide business purpose lies with the taxpayer.

The following guidelines may be used when evaluating whether a bona fide business purposes has been established:

- (a) Spouse's expenses are directly attributable to the company's business, and
- (b) the incurrence of the expenses are necessary to the conduct of the company's business, and
- (c) the primary purpose of the spouse's travel is to serve the company's business, and

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- (d) the spouse spends a significant amount of time accomplishing the business purpose for the travel.

Valuation Procedures

Recently, the IRS issued Regulation 1.61-21 which affects the fringe benefit area and more specifically establishes a safe-harbor method for imputing income for certain fringes. The regulation replaces the previously temporary regulation under Section 61.

The IRS makes two methods available to an employer to impute income for the personal use of an employer-provided aircraft. The first method is based on fair market valuation rules while the second is a safe-harbor method known as the Standard Industry Fare Level (SIFL) formula. If the safe-harbor method is elected, Regulation 1.61-21(e)(2)(iii) requires the employer to use this method to value all eligible flights taken during the calendar year.

The regulations distinguish between flights taken primarily for personal purposes and those taken primarily for business purposes. Per Regulation 1.61-21(b)(6), the fair market value of a flight which is primarily personal and taken on an employer-provided aircraft is equal to the amount an individual would have to pay in an arm's-length transaction to charter the same or comparable aircraft for the same or comparable flight. However, the fair market value of a flight which is primarily business and taken on an employer-provided aircraft is equal to the cost of commercial airfare ticket for the same or comparable flight.

Regulation 1.61-21(g)(5) sets for the safe harbor SIFL rules for imputing income for personal use. As stated, the use of this safe harbor method as an elective method.

Under the SIFL method, the value of a personal flight is determined by multiplying the SIFL rate for the period during which the flight was taken by the appropriate aircraft multiple. The SIFL rate is based on a terminal charge plus a mileage charge. The sum of the terminal charge and the mileage is then multiplied by a percentage based on the size of the plane and whether the user is a control employee.

Regulation 1.61-21(g)(8) defines control employee as:

- an elected officer (limited to lesser of 1% of all employees or 10)
- an employee whose compensation in the top 1% (however compensation must be over \$50,000)
- an employer with at least a 5% equity interest
- a director

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The regulation sets forth the SIFL rates to be used over a six-month period of time. The rates in effect on June 30 of a particular year will apply to flights taken during the last six months of the calendar year. The rates in effect on December 31 of a particular year will apply to the first six months of the subsequent year. The most recently published applicable terminal charge and mileage rates for the last six months of 1989 are as follows (Reg. Section 1.61-21(g)(5)):

| | |
|------------------|----------------|
| Terminal Charge | \$ 26.48 |
| Mileage Rates: | |
| Up to 500 miles | .1449 per mile |
| 501-1,500 miles | .1105 per mile |
| Over 1,500 miles | .1062 per mile |

The aircraft multiples are based on the maximum certified take-off weight of the aircraft. The aircraft multiples are as follows:

| <u>Maximum Certified Takeoff Weight of the Aircraft</u> | <u>Aircraft Multiple for a Control Employee</u> | <u>Aircraft Multiple for a Non-Control Employee</u> |
|---|---|---|
| 6,000 lbs. or less | 62.5 percent | 15.6 percent |
| 6,001 - 10,000 lbs. | 125.0 percent | 23.4 percent |
| 10,001 - 25,000 lbs. | 300.0 percent | 31.3 percent |
| 25,001 lbs. or more | 400.0 percent | 31.3 percent |

The following example will demonstrate the above calculation:

| | |
|-------------------|---------------------------|
| Length of flight | 250 miles |
| Size of aircraft | 9,000 lbs. takeoff weight |
| Control employee: | Yes |

Calculations:

| | |
|------------------------------|------------------------|
| Terminal Charge | \$ 26.48 |
| Mileage Charge (250 x .1449) | 36.23 |
| Total | \$ 62.71 |
| Applicable Aircraft Multiple | x 125% |
| One-Way Charge | \$ 78.39 |
| Round Trip | x 2 |
| Total Imputed Income | <u><u>\$156.78</u></u> |

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Under the above rules, if an employee uses an employer-provided aircraft and the overall purpose of the employee's trip is the business of the employer, no income would be attributed to the employee. However, if the employee's spouse accompanies the employee and does not have a bona fide business purpose for the trip, the value imputed as income is the amount computed under either the SIFL rules or the fair market valuation rules.

For example, assume an employee flies from Kansas City to Dallas in a corporate aircraft to attend a business convention. The employee's spouse accompanies the employee but does so without a bona fide business purpose. The amount includable in income related to the spouse's travel would be the value as computed under the SIFL valuation rules (if properly elected), or the fair market value of a commercial ticket. The above rules also apply to other family members or guests of the employee.

Election and Consistency Rules

The noncommercial (SIFL) flight valuation rules may be used for income, unemployment tax, and reporting purposes. Both an employer and employee may use the SIFL valuation rules or fair market value rules. However, once a flight is valued using SIFL, all flights taken during the calendar year must be valued using SIFL. An employee may only use the SIFL valuation rule if the employer uses the rule. The value of the fringe benefit, under either method, is reduced by any amount reimbursed by the employer to the employee.

Once the noncommercial flight valuation rule is used, it is deemed to have been elected by the employer (and, if applicable, by the employee). Neither the employer nor the employee is required to notify the Internal Revenue Service of the election. An employer who elects to use the SIFL rules must notify the employee of the election by the later of October 31, 1989 or 30 days after the employer first provides the benefit to the employee, in accordance with Reg. Section 1.61-21(c)(3)(ii).

MICHAEL E. SCHUERING

CHERI MADSEN

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