DEPRECIATING CORPORATE AIRCRAFT

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Overview.

Many aircraft owned and operated by businesses today are depreciable for income tax purposes under the Modified Accelerated Cost Recovery System ("MACRS") of Section 168(b) of the Internal Revenue Code. The MACRS statute is often considered to be very pro-taxpayer because it permits taxpayers with depreciable assets to accelerate the tax depreciation of the assets by allowing a greater percentage of the depreciation deductions produced by the assets to be takenduring the first few years of the applicable recovery period than would result using a straight-line depreciation method. Of course, the tradeoff is that less depreciation will be available to offset income in later years.

In some cases, aircraft are depreciable for income tax purposes, but do not qualify for accelerated depreciation under the MACRS system. In such cases, the aircraft must be depreciated under the generally less favorable Alternative Depreciation System ("ADS") of Section 168(g) of the Internal Revenue Code. Depreciation under ADS is based on a straight-line method and thus results in equal depreciation deductions each year during the applicable recovery period. Recovery periods under the ADS system tend to be longer than recovery periods under MACRS for the same property.

Whether or not a taxpayer may depreciate an aircraft, and if so, the appropriate depreciation method and recovery period to be used, depends on several factors. Chief among these are the category of aircraft (e.g., airplane or helicopter), and the type of use to which the aircraft is put (e.g., personal, business, or commercial). Based on these factors, all aircraft may be placed in one of the following asset classes:

1. Aircraft, other than helicopters, used in commercial or contract carrying of passengers and freight by air (i.e., typical Part 135 operations). Aircraft in this category generally may be depreciated under MACRS over a recovery period of seven years, or under ADS over a recovery period of twelve years.

2. Aircraft used for qualified business purposes or for the production of income (i.e., typical business-use Part 91 operations), and helicopters used in commercial or contract carrying of passengers and freight by air . Aircraft in this category generally may be depreciated under MACRS over a recovery period of five years, or under ADS over a recovery period of six years.

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3. Aircraft held as inventory or stock in trade, and aircraft used for purposes not constituting either qualified business use, use for the production of income, or use in the commercial or contract carrying of passengers or freight (i.e., typical personal-use Part 91 operations). Aircraft in this category generally may not be depreciated.

Qualified Business Uses.

As a general rule, a qualified business use is any use in a trade or business for which a deduction would be allowed under Section 162 of the Internal Revenue Code. Section 162 is the statutory provision that defines deductible trade or business expenses. Certain uses of an aircraft by a business entity that arguably may be considered qualified business uses will not qualify as qualified business uses under certain circumstances. Specifically, any use of a business-owned aircraft falling within any one of the following three categories will not be treated as a qualified business use for depreciation purposes <u>unless</u> all qualified business uses, excluding any use falling within one of the three categories, comprises at least 25% of the total utilization of the aircraft during the applicable taxable year:

1. The leasing of the aircraft by a company to any person who owns 5% or more of the company, or to any person who is related (within the meaning of Section 267(b) of the Internal Revenue Code) to a person who owns 5% or more of the company.

2. Use of the aircraft to provide compensation (i.e., to provide personal, non business-use flights without reimbursement at fair market rates) to any person who owns 5% or more of the company, or to any person who is related (within the meaning of Section 267(b) of the Internal Revenue Code) to a person who owns 5% or more of the company.

3. Use of the aircraft to provide compensation to any other person unless an amount is included in the gross income of such person with respect to such use of the aircraft, and any required income tax was withheld (e.g., income is imputed under the Standard Industry Fare Level ("SIFL") formula).

Mixed Qualified Business Use and Commercial Use: The Primary Use Test.

Many companies that own and operate business aircraft attempt to offset some of the costs of owning and operating the aircraft by holding the aircraft out, either to the public or to a few select clients, as being available for charter at times when the aircraft is not otherwise being utilized by the owner. Such cross utilization of aircraft can affect the asset class, and hence the depreciation schedule, applicable to the aircraft.

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As discussed above, aircraft, other than helicopters, used in commercial or contract carrying of passengers and freight by air generally may be depreciated under MACRS over a recovery period of seven years, and aircraft used for qualified business purposes or for the production of income and helicopters used in commercial or contract carrying of passengers and freight by air generally may be depreciated under MACRS over a recovery period of five years. Consequently, when an aircraft other than a helicopter is used part of the time in commercial or contract carrying of passengers and freight by air, and part of the time for other qualified business purposes or for the production of income, questions concerning the appropriate MACRS recovery period are likely to arise.

Treasury regulations specify that when property is used for different purposes at various times in such a manner that the property could potentially be classified into more than one asset class, the property shall be included in the asset class for the activity in which the property is primarily used. Property is to be classified according to the primary use to which the property is put, even though the activity in which the property is used is insubstantial in relation to all of the activities of the taxpayer. In addition, the asset class of an aircraft that is subject to a lease is determined as if the aircraft were owned by the lessee.

Although not further defined in the regulations, the "primarily used" standard appears to suggest that an aircraft other than a helicopter will be depreciated under MACRS over a seven year recovery period if the proportion of the time it is used in commercial or contract carrying of passengers and freight by air exceeds the proportion of time that it is used for other qualified business purposes or for the production of income, and conversely that the same aircraft will be depreciated under MACRS over a five year recovery period if the proportion of the time it is used for other qualified business purposes or for the production of of the production of income exceeds the proportion of time that it is used in commercial or contract carrying of passengers and freight by air. The regulations do not specify a method (e.g., total flights, total flight hours, total days of use) of measuring various types of use.

For purposes of determining the appropriate asset class for a mixed-use aircraft, it is only necessary to determine the primary use of the aircraft during the first taxable year during which the aircraft is in service. Treasury regulations provide that no change in the classification of property shall be made because of a change in the primary use of the property after the taxable year in which the property was first placed in service.

Effect of Personal, Nonbusiness Use on Depreciation: The Predominantly Business Use Test.

If an aircraft is used during a taxable year part of the time for a qualified business and/or commercial purpose or for the production of income (collectively "Business Uses"), and part of the time for personal, nonbusiness purposes (collectively "Personal Uses"), the depreciation

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deduction allowable for the taxable year will be limited to a fraction of the depreciation deduction that would have been allowed for the taxable year had the aircraft been used solely for Business Uses. The allowable depreciation deduction for such taxable year will be the fraction of the otherwise allowable deduction that bears the same ratio as the Business Uses of the aircraft during the taxable year bears to all the use of the aircraft during the taxable year. The depreciable basis of the aircraft will nevertheless be reduced by the entire amount of depreciation that would have been allowed had all the use of the aircraft during the year constituted Business Use, with the result that the portion of the depreciation deduction that is disallowed in a given taxable year as a result of Personal Use may not be deducted in any subsequent year and is therefore lost forever.

In addition, whether the depreciable portion of the aircraft may be depreciated under MACRS, or will be required to be depreciated under the generally less favorable ADS will depend on whether the Business Use or the Personal Use of the aircraft predominates. If more than 50% of the use of the aircraft during each taxable year constitutes Business Use, the predominantly business use test is satisfied and the depreciable portion of the cost basis of the aircraft during each taxable year constitutes or less of the use of the aircraft during each taxable portion of the cost basis of the aircraft during each taxable year constitutes business use test is not satisfied. In such event, the aircraft generally may still be depreciated to the extent of the Business Use, but that portion of the basis of the aircraft that may be depreciated must be depreciated using the straight line ADS system.

The predominantly business use test must be met during every taxable year that the aircraft is in service. The consequences of failing the test in even a single taxable year can be severe. If the test is failed during any taxable year that the aircraft is in service, the aircraft must be depreciated under the ADS system during such taxable year and all subsequent taxable years. In addition, if the aircraft had been depreciated under MACRS during any prior taxable year, the taxpayer must recapture prior depreciation to the extent that depreciation deductions taken during prior years exceed the deductions that would have been allowed under the ADS system. In other words, the allowable deprecation must be recalculated retroactively to the date the aircraft was first placed in service, and any excess depreciation in prior years resulting from the recalculation must be recaptured and taken into income in the first taxable year in which the test was not satisfied.

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