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**AIRCRAFT RELATED DEPRECIATION
AND
OPERATING EXPENSE DEDUCTIONS**

By

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1. Tax Depreciation of Corporate Aircraft: Generally

Aircraft used for qualified business purposes or for the production of income and not held as inventory or stock in trade are listed property¹ and usually may be depreciated under the modified accelerated cost recovery system² over a recovery period of five years.³ Aircraft used for purposes not constituting qualified business use or for the production of income may not be depreciated. The MACRS system permits a taxpayer to claim a greater percentage of the depreciation deductions attributable to an asset during the first few years of the applicable recovery period than would be possible using a straight-line depreciation method. Of course, the tradeoff is that less depreciation will be available to offset income in later years.

As a general rule, a qualified business use is any use in a trade or business for which a deduction would be allowed under I.R.C. § 162.⁴ 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 corporate aircraft falling within any one of the three categories set forth below will not be treated as a qualified business use for depreciation purposes unless all qualified business uses, excluding any use falling within one of the three categories set forth below, comprise at least 25% of the total utilization of the aircraft during the applicable taxable year. The three categories of uses that will not qualify as qualified business uses under the conditions described above are as follows:

- a.* The leasing of the aircraft to any person who owns 5% or more of the company, or to any

¹ I.R.C. § 280F(d)(4)(A)(ii).

² Hereinafter "MACRS". *See, generally*, I.R.C. § 168(b).

³ Asset Class 00.21. Rev. Proc. 87-56, 1987-2 CB 671.

⁴ Treas. Reg. § 1.280F-6T(d)(2)(i).

person who is related (within the meaning of I.R.C. § 267(b)) to a person who owns 5% or more of the company.⁵

b. Use of the aircraft to provide compensation to any person who owns 5% or more of the company, or to any person who is related (within the meaning of I.R.C. § 267(b)) to a person who owns 5% or more of the company.⁶

c. 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.⁷

Example: During taxable year 2000, ABC Corporation used its corporate aircraft 40% of the time for qualified business purposes other than those listed in I.R.C. § 280F(d)(6)(C)(i), and 60% of the time for a purpose specified in I.R.C. § 280F(d)(6)(C)(i)(II), which use specifically constituted the provision of personal, nonbusiness-related transportation to various employees of ABC Corporation, each of whom owned 5% or more of the stock of ABC Corporation. ABC Corporation imputed income to the employees using the Noncommercial Flight Valuation Rule⁸ for all personal, nonbusiness-related use of the aircraft.

Because ABC Corporation imputed income to the employees using the Noncommercial Flight Valuation Rule for all personal, nonbusiness-related use of the aircraft, such use constituted use of the aircraft to provide compensation to employees,

⁵ I.R.C. § 280F(d)(6)(C)(i)(I).

⁶ I.R.C. § 280F(d)(6)(C)(i)(II).

⁷ I.R.C. § 280F(d)(6)(C)(i)(III).

⁸ Discussed at IV.B.3, below.

and the expenses incurred by ABC Corporation to provide such compensation should, therefore, be deductible under I.R.C. §162 as a qualified business use of the aircraft *vis-a-vis* ABC Corporation. However, because the employees to whom income was imputed were persons who each owned 5% or more of the stock of ABC Corporation, I.R.C. § 280F(d)(6)(C)(i)(II) provides that personal, nonbusiness-related use of the aircraft by such persons will constitute a qualified business use only if the 25% test of I.R.C. § 280F(d)(6)(C)(ii) is satisfied.

In this case, the 25% test of I.R.C. § 280F(d)(6)(C)(ii) is indeed satisfied because the aircraft was used 40% of the time for qualified business purposes other than those listed in I.R.C. § 280F(d)(6)(C)(i). Consequently, the use of the aircraft 60% of the time to provide transportation to employees who each owned 5% or more of the stock of ABC Corporation, for the personal, nonbusiness-related purposes of the employees, also constitutes qualified business use. Hence, the aircraft is considered to be used 100% of the time for qualified business purposes.

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

If an aircraft is used during a taxable year part of the time for a qualified business purpose, and part of the time for personal, nonbusiness purposes (except in the context of use of an aircraft by an employer to provide compensation to an employee, as discussed above), the depreciation deduction allowable for the taxable year will be limited to a portion of the depreciation deduction that would have been allowed for the taxable year if the aircraft had been used solely for qualified business purposes or for the production of income, that bears the same ratio as the qualified business use of the aircraft during the taxable year bears to all the use of the aircraft during the taxable year, and that portion of a depreciation deduction that is disallowed in a given taxable year as a result of personal, nonbusiness use

may not be deducted in any subsequent year.⁹

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 alternative depreciation system¹⁰ will depend on whether the qualified business use or the personal, nonbusiness use of the aircraft predominates. If the aircraft is used more than 50% of the time for qualified business purposes, the Predominant Business Use Test is satisfied and the depreciable portion of the cost basis of the aircraft generally may be depreciated under MACRS.¹¹ However, if the aircraft is used predominantly for personal, nonbusiness purposes and 50% or less of the time for qualified business purposes, the Predominant Business Use Test is not satisfied.¹² In such event, the aircraft generally may still be depreciated to the extent of the qualified business use, but that portion of the basis of the aircraft that may be depreciated must be depreciated using the straight line ADS system.¹³ Business use aircraft depreciable under the ADS system must be depreciated on a straight-line basis over a six year recovery period.¹⁴

The Predominant Business Use Test must be met during each taxable year that the aircraft is in service.¹⁵ If the aircraft is used less than 50% of the time for qualified business purposes or for the production of income during any taxable year, the aircraft must be depreciated under the ADS system

⁹ I.R.C. § 280F(d)(2).

¹⁰ I.R.C. § 168(g). Hereinafter "ADS".

¹¹ I.R.C. § 280F(b)(3).

¹² *Id.*

¹³ I.R.C. § 280F(b)(1).

¹⁴ Asset Class 00.21. Rev. Proc. 87-56, *supra* note 4.

¹⁵ *Id.*

during such taxable year and all subsequent taxable years.¹⁶ 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.¹⁷

Example: X, an individual, owns and operates a private aircraft with a \$10,000 depreciable basis remaining after taking into account depreciation deductions in prior taxable years. During taxable year 2000, X used her aircraft 75% of the time for qualified business purposes, and 25% for personal, nonbusiness purposes. X would have been entitled to \$10,000 depreciation deduction under MACRS for 2000 had she used the aircraft solely for qualified business purposes or for the production of income during 2000.

Because X used her aircraft only 75% of the time during taxable year 2000 for qualified business purposes, X is only entitled to a \$7,500 (75% of \$10,000) depreciation deduction under MACRS for 2000. The remaining \$2,500 (25% of \$10,000) may not be depreciated in subsequent taxable years.

3. Effect of Commercial Charter Operations on Depreciation

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,

¹⁶ *Id.*

¹⁷ I.R.C. § 280F(b)(2).

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 depreciation schedule applicable to the aircraft. For example, if an aircraft is used predominantly in commercial and contract carrying of passengers and freight by air, the aircraft may still be depreciated under MACRS, or ADS if otherwise required. However, the recovery period will be increased to seven years under MACRS, or twelve years under ADS.¹⁸

4. Aircraft Predominantly Used Outside the United States

If an aircraft is used predominantly outside the United States during a taxable year, the aircraft owner will not be entitled to a depreciation deduction under the MACRS methodology for that taxable year, but rather must determine a depreciation deduction for the aircraft under the ADS methodology.¹⁹

An aircraft will not be deemed to be used predominantly outside the United States if either of the following two tests is met.

a. Simple Arithmetic Test

The first test involves merely comparing the number of days during the applicable taxable year that the aircraft is physically present within the United States against the number of days the aircraft is physically outside the United States. If the number of days the aircraft is inside the United States exceeds the number of days the aircraft is outside the United States, the aircraft will not be deemed to be used predominantly outside the United States.²⁰

¹⁸ Asset Class 45.0. Rev. Proc. 87-56, supra note 4.

¹⁹ I.R.C. § 168(g)(1)(A).

²⁰ Prop. Treas. Reg. § 1.168-2(g)(5)(i).

b. "Some Degree of Frequency" Test

If the aircraft fails the simple arithmetic test because it is outside the United States more days than it is inside the United States, it still may not be deemed to be used predominantly outside the United States if it is operated to and from the United States "with some degree of frequency" on a scheduled or unscheduled basis.²¹

The question as to precisely what constitutes "some degree of frequency" has never been fully answered. The IRS held in Rev. Rul. 73-367²² that a commercial airline met the "some degree of frequency" standard with respect to an aircraft operated on a regular schedule that included a single stop in the United States approximately once every two weeks. Subsequent private letter rulings have cited Rev. Rul. 73-367 for the proposition that an aircraft making one flight to the United States approximately every two weeks is sufficient to meet the standard.²³ However, those letter rulings addressed scheduled commercial airline operations, and consequently, how those letter rulings would apply in the context of unscheduled operations of business aircraft is unknown.

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²¹ Prop. Treas. Reg. § 1.168-2(g)(5)(iii)(A).

²² 1973-2 C.B. 8.

²³ *See, e.g.*, Priv. Ltr. Rul. 9008031; Priv. Ltr. Rul. 9008033; Priv. Ltr. Rul. 8622033.