Will the IRS Deny MACRS Depreciation for Your Aircraft Based on Your Business' Organizational Chart?

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In 1984, Congress enacted Section 280F of the Internal Revenue Code (the "IRC") to prohibit taxpayers from depreciating so-called "Listed Property" (which includes business aircraft) under the modified accelerated costs recovery system ("MACRS") when such aircraft are used predominantly for personal purposes. However, in Technical Advice Memorandum 200945037 ("TAM 200945037"), which the IRS released on November 6, 2009, the IRS interpreted a provision in Section 280F in a manner that could potentially cause some legitimate business flights to be treated as personal flights for purposes of determining whether the aircraft is eligible to be depreciated under MACRS. Perhaps even more troubling is the fact that, for the flights in question, it is not the legitimacy (or lack thereof) of the business purposes of the flights that would be determinative as to whether the flights would be treated as business or personal, but rather the organizational structure of aircraft ownership and operations. Based on TAM 200945037, in audits where eligibility of an aircraft for MACRS depreciation is at issue, IRS auditors may become more interested in your organizational chart than in your records substantiating the business purposes of your flights.

Overview of Section 280F

According to Section 280F, in order to depreciate a business aircraft under MACRS in any given tax year, more than 50% of the use of the aircraft during such tax year must be use in a trade or business of the taxpayer, which Section 280F defines as "Qualified Business Use". However, Section 280F carves out three categories (described in the following section of this article) of common trade or business uses that may not be counted for purposes of satisfying this 50% test unless all other trade or business uses comprise at least 25% of the total use of the aircraft during the tax year. Put another way, if Qualified Business Uses other than those uses falling within such three categories comprise at least 25% of the total utilization of the aircraft during the tax year, then uses falling within such three categories may also be counted for purposes of meeting the 50% test.

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The 25% and 50% use tests must be met during every taxable year that the aircraft is in service. The consequences of failing the tests in even a single taxable year is that the aircraft must be depreciated under the less favorable straight-line method (known as the "Alternative Depreciation System" or "ADS") 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.

The Three Categories of Excluded Uses

The three categories of business uses that may not be counted for purposes of meeting the 50% test unless the 25% test is first satisfied are the following:

1. the leasing of the aircraft to any person who owns 5% or more of the taxpayer, or to any related person (within the meaning of Section 267(b) of the IRC);

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 related person (e.g., a flight for which income is imputed to a 5% owner under the Standard Industry Fare Level ["SIFL"] formula); and

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., SIFL).

TAM 200945037

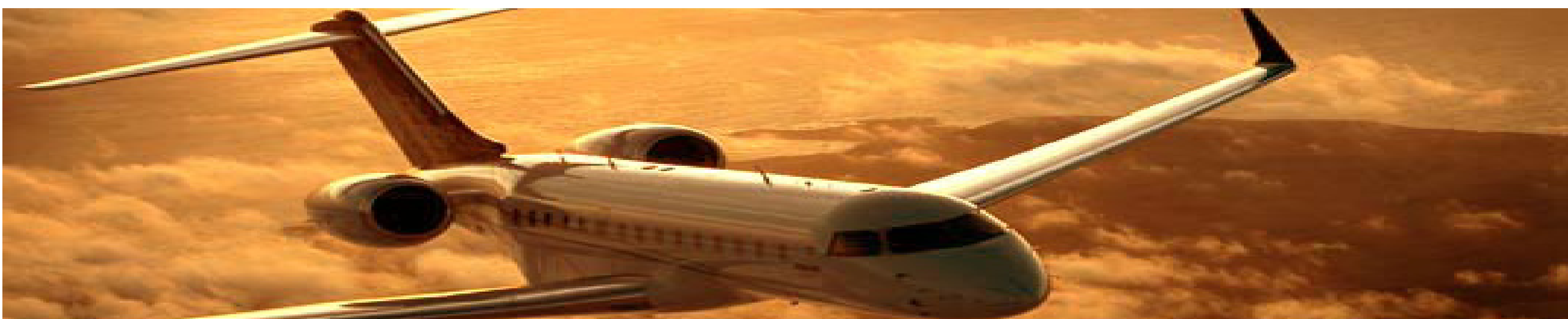
Of the three categories of excluded uses described above, only the first (i.e., the leasing of the aircraft to any person who owns 5% or more of the taxpayer, or to any related person) was at issue in the IRS' analysis in TAM 200945037. Specifically, the issue in TAM 200945037 involves a business aircraft that was owned by a special purpose entity, and dry leased to another entity, where both the lessor entity and the lessee entity were under common ownership and control. The lease of the aircraft to another entity that was under common ownership and control with the lessor constituted a lease to a "related person" within the meaning of Section 280F.

Section 267(b) provides a lengthy list of relationships that can cause two or more "persons" to be considered "related". The list includes obvious relationships such as spouses, ancestors, descendents and siblings. However, the list also includes less obvious relationships, such as those between natural persons (i.e., individuals) and legal persons (e.g., corporations, partnerships, trusts, etc.), as well as relationships between two or more legal persons. For example, Section 267(b) provides that an individual and a corporation are related persons if the individual directly or indirectly owns more than 50% of the value of the outstanding

stock of the corporation. Similarly, Section 267(b) provides that two "S" corporations are related persons if the same individual owns more than 50% of the value of the outstanding stock of each corporation. Further, any two corporations are related persons if they are part of a group of corporations connected to a common parent through more than 50% common ownership (by equity or voting power), or if 5 or fewer individuals, estates or trusts collectively own more than 50% of the equity or voting power of the two corporations. The relationship examples provided above are only a few of relationships listed in Section 267(b). A complete listing of the relationships mentioned in Section 267(b) is beyond the scope of this article, but for purposes of this article the list can be summarized generally to include any relationship where one person (whether an individual or legal entity) is a family member of, or directly or indirectly owns or controls more than 50% of, any other person.

The problem arises from the fact that the text of Section 280F appears to exclude all use of an aircraft that is leased to a related person from being used to meet the 25% test regardless of whether such use was for business or personal purposes. This, of course, makes no sense in light of the fact that the purpose of Section 280F is to restrict the applicability of MACRS depreciation when property is used predominantly for personal use, not business use. When the IRS published Section 1.280F-6(d)(2)(ii) of the Treasury Regulations implementing IRC Section 280F, the IRS appeared to recognize the incongruity in the statute in that such section states that the text concerning the leasing of property to a "related person" shall be applied "only to the extent that the use of the listed property is by an individual who is a related party or a 5-percent owner with respect to the owner or the lessee." Section 1.280F-6(d)(2)(ii) has long been interpreted by many in the business aviation community to mean that a lease of an aircraft to or for the benefit of an individual for the individual's own personal purposes would be disallowed, while a lease to a business entity for the business entity's business purposes would not be disallowed. This distinction is warranted in that in the context of a business flight by a business entity, the aircraft is being operated by and for the benefit of the business entity, not the individual passengers. In such situations, the passengers (be they 5% owners or rank-and-file employees) are traveling in their capacities as officers or employees of the company and not in their individual capacities.

Put in simpler terms, it was believed that where an aircraft is leased to an individual for the individual's own personal purposes, the individual was the "user" of the aircraft within the meaning of Section 1.280F-6(d)(2)(ii) of the Treasury Regulations, and therefore subject to the exclusion in IRC Section 280F, but if an aircraft is leased to a business entity for business purposes, the business entity, not by the individual passengers, would be the "user" of the aircraft within the meaning of Section 1.280F-6(d)(2)(ii) of the Treasury Regulations, and therefore would not subject to the exclusion in IRC Section 280F. This interpretation is consistent with the purpose of IRC Section 280F, as well as with the other two categories of uses that are excluded from counting as Qualified Business Uses (e.g., personal uses for which income is imputed under SIFL). However, in TAM 200945037, the IRS appears to be ignoring the purpose and context of Section 280F, and is instead interpreting Section 280F, as well as the Treasury Regulations, to disallow all flights under a lease between related parties if an individual who is a 5% owner or a related person is on board the aircraft regardless of whether such individual was traveling for business or personal purposes.



This interpretation can lead to some startling results where two similar business aircraft, both of which are used primarily, or even exclusively, for business purposes could be treated substantially differently for tax purposes based on how the ownership of the aircraft is structured. The following examples illustrate the problem:

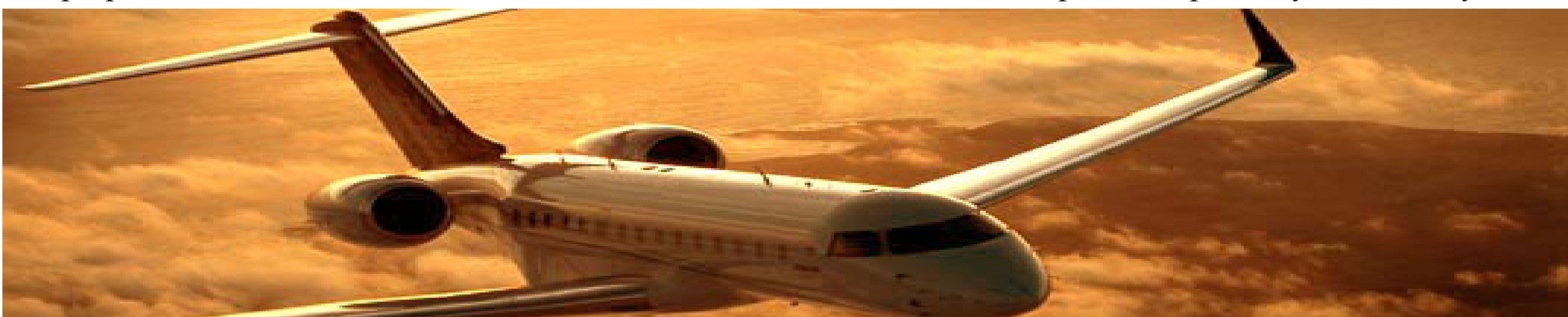
Example 1: Assume that Mr. Taxpayer is the CEO and sole shareholder of ABC Corp, and that ABC Corp is an "S" corporation in the trade or business of widget manufacturing. Assume also that ABC Corp has a headquarters and several manufacturing plants, distribution warehouses and sales offices, all of which are in different cities scattered around the world. Let's assume further that ABC Corp purchases a business aircraft, and the sole and exclusive use of the aircraft is to transport Mr. Taxpayer to and from ABC Corp's various offices and facilities for business purposes, and that the costs and expenses of operating and maintaining the aircraft qualify as ordinary, necessary and reasonable business expenses. Finally, let's assume that ABC Corp enforces a policy prohibiting any employee, including Mr. Taxpayer, from using the aircraft for any personal, non-business purposes.

Based on these facts, ABC Corp's use of the aircraft would almost certainly be "Qualified Business Use" within the meaning of Section 280F. Since such constituted 100% of all use of the aircraft, both the 25% and the 50% tests would be satisfied, and the aircraft would be eligible to be depreciated under MACRS.

Now let's change the hypothetical just a bit.

Example 2: Assume the same facts as in Example 1, except as follows: Instead of ABC Corp purchasing the aircraft, Mr. Taxpayer forms a special purpose entity, DEF Corp, to purchase and hold title to the aircraft. DEF Corp is also an "S" corporation, and Mr. Taxpayer is the sole shareholder of both ABC Corp and DEF Corp. DEF Corp leases the aircraft to ABC Corp, and ABC Corp then operates the aircraft in the exact same manner and for the exact same purpose as in Example 1. DEF Corp has no other business other than to hold title to the aircraft and to lease the aircraft to ABC Corp.

Applying the IRS' interpretation of Section 280F, as described in TAM 200945037, to these facts results in radically different tax consequences. Specifically, in light of the fact that ABC Corp and DEF Corp are clearly "related persons" within the meaning of Section 267(b), TAM 200945037 apparently would disallow all use pursuant to the lease from DEF Corp to ABC Corp (which of course comprises 100% of all use) for purposes of meeting the 25% test, thus making it impossible to meet the 25% test. Further, since the 25% test could not be satisfied, all such use pursuant to the lease from DEF Corp to ABC Corp would also be disallowed for purposes of meeting the 50%, thus likewise making it impossible to meet the 50% test. Since the 50% test could not be satisfied, the aircraft would not be eligible to be depreciated under MACRS. As mentioned above, the fact that the aircraft could not be depreciated under MACRS does not necessarily mean that the aircraft could not be depreciated at all; if the 50% test is not met, the aircraft might still be depreciable under ADS if the aircraft is used in a trade or business or for the production of income. It is not clear from TAM 200945037 whether the IRS would disqualify the use pursuant to the DEF Corp-ABC Corp lease solely for purposes of the 25% and 50% tests, in which case the aircraft in this example could probably still be fully



depreciated, albeit under ADS instead of MACRS, or whether the IRS might assert that such use is tainted for all depreciation purposes, in which case the aircraft in this example might not be depreciated at all.

Conclusion

Naturally, the above examples present extreme cases; many aircraft ownership and operating structures are far more complex, and business aircraft are often used for both business and personal purposes, rather than exclusively for business purposes. Nevertheless, these simplified examples highlight issues that may apply to many business aircraft owners and operators, and in this author's view, there is no valid tax policy reason to treat a taxpayer with facts similar to Example 2 differently from a taxpayer with facts similar to Example 1. Nor is it likely that Congress intended different results in the two fact patterns. Prior to the issuance of TAM 200945037, many business aviation professionals and advisors believed that the language in Section 280F disqualifying use under a lease to a related person was intended to disqualify only use under leases where the aircraft was leased to, or for use by, an individual for the individual's personal, non-business purposes. This belief was reinforced by the clarification provided by the IRS in the Treasury Regulations. Moving forward, however, it is clear that the IRS has a different view of the world. Whether, and to what extent, the IRS may push this issue in audits or in the courts remains to be seen. However, conservative tax planning requires that the issues raised by TAM 200945037 be addressed in connection with any planning or reviewing of any aircraft ownership and operations structure. Consequently, anyone who utilizes a lease in aircraft ownership and operations structure should consult with his or her aviation tax advisor as soon as possible to determine whether he or she has any audit risk under TAM 200945037.

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