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Aircraft Leasing and Predominant Business Use: The IRS Adds A Few New Wrinkles

The When is an aircraft leasing business not a business? When is business use of an aircraft not business use? When the IRS says so, at least according to a recent IRS ruling where the IRS determined that taxpayers were neither regularly engaged in the business of leasing nor predominantly using their aircraft for business, thereby subjecting their aircraft to unexpected tax depreciation limitations. This ruling has serious implications for any aircraft owner that took first-year "bonus" depreciation on the purchase of a new aircraft, since the IRS will use this ruling to require bonus depreciation recapture on certain leased aircraft.

Background

In Technical Advice Memorandum (TAM) 200945037, two limited liability companies (LLCs) were formed to acquire and lease aircraft. The LLCs primarily leased aircraft to a related, operating business entity (Lessee). The LLCs and the Lessee had similar, overlapping ownership. The aircraft were used for a combination of purposes; qualified business use, personal travel, entertainment flights, flights to influence legislation and maintenance flights. Over time, "LLC One" purchased and leased four different aircraft to related companies, and took depreciation deductions for the aircraft. "LLC Two" claimed the additional first-year "bonus" depreciation allowance on its aircraft, and depreciated its remaining basis in the aircraft.

Generally, aircraft are eligible for tax depreciation deductions over 5 or 7 years under the modified accelerated cost recovery system ("MACRS"), depending upon its use. However, under IRC § 280F, if an aircraft is not predominantly used for qualified business use (i.e., used more than 50% in the trade or business of the taxpayer) for any taxable year (the "Predominant Use Test"), then MACRS is not available, and instead the aircraft must be depreciated under the slower straight line method of the alternative depreciation system ("ADS"), and any first-year "bonus" depreciation taken must be "recaptured" as ordinary income in the tax year that the Predominant Use Test is not met.

Leasing Exception

The Predominant Use Test and the IRC § 280F depreciation limitation rules can be entirely avoided if the aircraft is leased or held for leasing by any person "regularly engaged" in the business of leasing aircraft (the "Leasing

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Exception”). The principal issue in the TAM was whether the aircraft leased by LLC One and LLC Two to related entities were exempt from depreciation deductions limitations by virtue of the Leasing Exception.

In order to qualify for the Leasing Exception, LLC One and LLC Two needed to be “regularly engaged” in the business of leasing aircraft. A person is considered regularly engaged in the business of leasing property only if contracts to lease such property are entered into with some frequency over a continuous period of time. This determination is made on the basis of the facts and circumstances in each case, taking into account the nature of the person’s business in its entirety, but occasional or incidental leasing activity is insufficient. For example, a person leasing only one passenger automobile during a taxable year is not regularly engaged in the business of leasing automobiles.

The IRS ruled that LLC One and LLC Two were not regularly engaged in the business of leasing because:

- LLC One and LLC Two never leased aircraft to persons other than related parties.
- Multi-year leases were entered into with related parties without competition.
- Multi-year leases “arguably” violated the requirement that leases be entered into “with some frequency”.
- LLC One leased only two aircraft at any time and used a joint lease to lease two aircraft to Lessee.
- LLC Two leased only one aircraft at any time.
- The commonality of ownership between LLC One, LLC Two and Lessee, combined with the “considerable degree” of personal use of aircraft by the entities’ owners, lead the IRS to conclude that the individual owners retained a significant degree of personal control over the use of aircraft despite the ownership and leasing arrangements.
- The predominant use of certain aircraft was personal use by the entities’ owners “without regard to the leases,” suggested to the IRS that the aircraft were the personal property of the individual owners, and only occasionally or incidentally used in the taxpayers’ business.

Based on the totality of these factors, the IRS concluded that the taxpayers were not regularly engaged in the business of leasing aircraft, and, as such, needed to meet the Predominant Use Test (which they failed, as discussed below).

In determining that the Leasing Exception did not apply, the IRS analogized the aircraft leases to an example in the Treasury Regulations where a taxpayer leasing only one automobile during a taxable year was not regularly engaged in the business of leasing automobiles. However, this is a difficult analogy for the IRS to support, given the vast differences between aircraft and cars. A single aircraft can cost the same or more than a fleet of automobiles, and generate significant revenue for the lessor. Furthermore, the complicated logistics involved with the ownership and operation of a single aircraft can require an entire flight department, at the additional cost of millions of dollars a year, in addition to the cost of the aircraft.

<u>Predominant Use Test</u>

Determining whether a taxpayer meets Predominant Use Test is a two-step process. First, at least 25% of the total use of an aircraft during the taxable year must consist of qualified business use that does not involve 5% owners or related persons (the “25% Threshold”). If this first requirement is met, then the business use of such persons of the aircraft may count towards meeting the requirement that the aircraft be used predominantly (more than 50%) for qualified business use.

However, the IRS interprets the 25% Threshold narrowly. Even if a 5% owner or related person is using the aircraft for business purposes, the IRS will not treat such business use as "qualified business use" of the aircraft for purposes of determining whether the aircraft's owner has satisfied the 25% Threshold. The taxpayers in the TAM argued that the qualified business use of aircraft is all business use of the aircraft, without regard to whether that business use was by a 5-percent owner or related person. This is a reasonable argument, given that the purpose of the Predominant Use Test is to prevent property that is predominantly used for personal purposes from qualifying for MACRS, and so the business use of aircraft should be treated as qualified business use for purposes of the 25% Threshold. However, the IRS expressly rejected the taxpayers' argument, and asserted its position that all 5% owner or related person use, including business use, is excluded as non-qualified business use in applying the 25% Threshold. The aircraft thus failed the Predominant Use Test and the taxpayers were subject to the depreciation deduction limitations, including first-year "bonus" depreciation recapture.

All is Not Lost

Despite the IRS's severe determinations regarding the Leasing Exception and 25% Threshold, which one day may be put to the test in court, the IRS did offer a helpful hand in at least one regard.

In order to determine whether an aircraft is being used predominantly for qualified business use, a "reasonable allocation" must be performed when an aircraft flight transports both (1) a 5-percent (or greater) owner or related person, and (2) one or more other persons. The IRS will accept as a reasonable allocation an allocation made on the basis of the occupied seat hours or miles method pursuant to Proposed Reg. § 1.274-10(e) and Notice 2005-45. This is good news, since it means that the mere presence of a 5% owner or related person on a flight will not automatically transform the entire flight into a 5% owner/related person flight, but instead preserves the character of the flight as qualified business use as it may pertain to the other passengers.

It's Complicated

The rules relating to the Predominant Use Test and the depreciation deduction limitation rules are particularly complicated and difficult to apply, yet need to be understood and carefully administered in order to avoid depreciation limitations and first-year "bonus" depreciation recapture.

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