A Detailed Analysis of § 280F Depreciation Recapture for Business Aircraft

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To be eligible to use accelerated or bonus depreciation on a business aircraft, § 280F of the Internal Revenue Code (I.R.C.) generally requires that the aircraft be used at least 50 Percent for business purposes (the "**50 Percent Test**"). Passing the 50 Percent Test is particularly important for taxpayers seeking to deduct 100 percent bonus depreciation under the Tax Cuts and Jobs Act of 2017. While this test may seem straightforward, it is actually complex and subject to interpretation. As a result of efforts by the National Business Aviation Association (NBAA), the Treasury Department has opened a regulations project to address one of these issues.

In Section I, this article explains (i) the implications of passing or failing the 50 Percent Test, (ii) the basic mechanics of the 50 Percent Test, and (iii) several issues arising under this test. In Section II, the article explains the recapture calculation which applies if the 50 Percent Test is failed. Section III discusses the exception in § 280F(c) for lessors in the business of leasing. Finally, Section IV discusses the corresponding income inclusion calculation for lessees when the 50 Percent Test is failed.

I. 50 Percent Test Under § 280F(b)

A. Implications of the 50 Percent Test

1. Aircraft Depreciation - General Rules

In general, aircraft are depreciated under either an accelerated depreciation method (referred to as "**MACRS**") or the straight line method (under the "**Alternative Depreciation System**"). Aircraft used in "commercial or contract carrying of passengers or freight" are generally depreciated under MACRS over seven years or under the Alternative Depreciation System over 12 years.[2] Aircraft not used in "commercial or contract carrying of passengers or freight" are generally depreciated under MACRS over five years or under the Alternative Depreciation System over six years.[3]

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2 Rev. Proc. 87-56, 1987-2 C.B. 674 (Asset Class 45.0).

3 Rev. Proc. 87-56 (Asset Class 00.21).

The determination of the appropriate depreciation life (five-year or seven-year) is based on the "primary" use of the aircraft.[4] In the case of leased aircraft, that determination is made based on the lessee's use of the aircraft.[5] The primary use may be determined in any reasonable manner.[6] In the case of an aircraft, the primary use is generally determined based on flight miles or flight hours.[7]

Thus, a company that uses its own aircraft primarily for company business purposes would generally depreciate the aircraft using five-year MACRS (with an Alternative Depreciation System life and method of six-year straight line). A company that uses its aircraft primarily to lease it to a charter company for charter service would generally depreciate the aircraft using seven-year MACRS (with an Alternative Depreciation System life and method of 12-year straight line).

If an aircraft qualified for bonus depreciation in a year in which bonus depreciation was available, then depending on the relevant year either 50 percent or 100 percent of the cost of the aircraft could be depreciated in the year in which the aircraft was placed in service.[8] 50 percent bonus depreciation is generally available for new aircraft acquired and/or placed in service on or before Sept. 27, 2017. New or used aircraft acquired and placed in service after Sept. 27, 2017 may qualify for 100 percent bonus depreciation.[9] 100 percent bonus depreciation was generally available for new aircraft placed in service after Sept. 8, 2010, and before the end of 2011.[10] Under both 50 percent and 100 percent bonus depreciation, a one-year extension of the respective placed in service dates was permitted under certain circumstances.[11]

2. Aircraft That Fail the 50 Percent Test Must Use the Alternative Depreciation System

Under § 280F(b), an aircraft that fails the 50 Percent Test (explained below) in any year is required to use the Alternative Depreciation System in that year and all future years, and it may not use MACRS or bonus depreciation.[12]

If the aircraft initially passes the 50 Percent Test, but fails the test in a subsequent year, then the owner must recognize income (i.e., recapture income) equal to the amount of accelerated or bonus depreciation deducted in prior years in excess of the amount that would have been deducted using the Alternative Depreciation System from the year the aircraft was placed in service.[13] If a portion of the depreciation deductions in prior years were reduced due to entertainment use of the aircraft, then the depreciation deductions subject to recapture should be limited to the portion of the depreciation deductions that were allowable in the prior years.[14] These concepts are discussed in more detail in Section II.

While failing the 50 Percent Test can have a dramatic effect on taxable income due to the difference between accelerated depreciation and the Alternative Depreciation System, failing the test does not directly cause depreciation to be nondeductible. Occasionally, taxpayers or IRS Agents mistakenly assume that the adjustments to calculate qualified business use for purposes of the 50 Percent Test are to be treated as adjustments to allowable deductions. In fact, § 280F(b) only directly affects the timing of depreciation due to its effect on depreciation life and methods. The adjustments to calculate qualified business use (discussed below) for purposes of the 50 Percent Test only relate to the test, and they do not directly result in the nondeductibility of depreciation. However, Section II below explains that when there are different expense disallowance

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4 Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b). If the primary use of the aircraft changes in a year after the year in which it was initially placed in service, the depreciation deductions must be recalculated prospectively based on the new primary use. Treas. Reg. § 1.168(i)-4(d).

5 Treas. Reg. § 1.167(a)-11(e)(3)(iii).

6 Treas. Reg. § 1.168(i)-4(d)(2).

7 Chief Coun. Adv. 2012-28-036 (July 13, 2012).

8 I.R.C. § 168(k). The requirements to qualify for bonus depreciation are beyond the scope of this article.

9 The Tax Cuts and Jobs Act of 2017, § 13201 amended the bonus depreciation provisions in I.R.C. § 168(k).

10 former § 168(k)(5).

11 § 168(k)(2)(B), (C).

12 I.R.C. § 168(k)(2)(D)(i) provides that bonus depreciation is not available for property that is required to be depreciated under the Alternative Depreciation System pursuant to § 280F(b).

13 § 280F(b)(2).

14 § 280F(b)(2)(B).

percentages in different depreciation years, the depreciation recapture adjustment resulting from failing the 50 Percent Test can result in a net depreciation deduction disallowance.

B. The 50 Percent Test

This section describes the two steps to the 50 Percent Test and then explains how the test works in the case of three different ownership structures: "**Sole Proprietorship Structure**," "**Employer-Provided Aircraft Structure**," and "**Related Party Leasing Structure**."

1. Two Steps to the 50 Percent Test

To pass the 50 Percent Test, the aircraft must be "predominantly" used in a "qualified business use" ("**QBU**").[15] The aircraft will be treated as predominantly used in a QBU if the "business use percentage" exceeds 50 percent.[16] The "business use percentage" is the percentage of total use that is QBU.[17]

In general, QBU is any use in a "trade or business."[18] This would include use in a trade or business for which ordinary and necessary expenses would be deductible under I.R.C. § 162(a). However, it would not include use of the aircraft for the "production of income" for purposes of I.R.C. § 212.[19] Fortunately, the level of business activity needed for a rental operation to qualify as a trade or business under § 162(a) is minimal.[20]

This definition of QBU is subject to "**Compensation Exceptions**" and a "**Related Party Leasing Exception**," as well as a special rule for aircraft. Under the first Compensation Exception, QBU does not include flights provided as compensation to a five-percent owner or related person.[21] (For convenience, this article uses the term "**Five-Percent Owners**" to refer to both "five-percent owners" and "related persons.") Under the second Compensation Exception, QBU also does not include flights provided as compensation to other service providers, unless the flights were included in such person's gross income and such income was subjected to the appropriate income tax withholdings.[22] Under the Compensation Exceptions, personal flights provided by the company to Five-Percent Owners of the company cannot be classified as QBU on the grounds that using the aircraft to compensate employees is a business use. (These three structures are further discussed below.)

Under the Related Party Leasing Exception, QBU does not include leasing to a Five-Percent Owner.[23] This exception only applies to the extent that the individual passenger is a Five-Percent Owner with respect to the owner or lessee of the aircraft.[24] Therefore, if the aircraft is leased to a company that is related to the Five-Percent Owner, a flight by the lessee company will be treated as QBU in the course of the aircraft owner's leasing business, except to the extent that individual passengers are Five-Percent Owners.[25] (However, see Section I.C.2 below which discusses the regulations project to treat

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15 § 280F(b)(1).

16 § 280F(b)(3).

17 § 280F(d)(6)(A).

18 § 280F(d)(6)(B).

19 Treas. Reg. § 1.280F-6(d)(2).

20 In general the rental of a single property is ordinarily considered to be a trade or business activity. See *Higgins v. Comm'r*, 312 U.S. 212, 214 (1941) ("the Commissioner also conceded before the Board of Tax Appeals that the real estate activities of the petitioner in renting buildings constituted a business"); *Curphey v. Comm'r*, 73 T.C. 766, 774 (1980) ("This court has held repeatedly in cases subsequent to the Supreme Court decision in Higgins that the rental of even a single piece of real property for production of income constitutes a trade or business."); *Elek v. Comm'r*, 30 T.C. 731 (1958) ("The rental and management of an apartment building or residential property amounts to a trade or business of the owner, and this is true where an agent acts for the owner.").

21 § 280F(d)(6)(C)(i)(II). Treas. Reg. § 1.280F-6(d)(ii)(C) provides that the term "five-percent owner" is defined in I.R.C. § 416(i)(1)(B), and "related person" is defined in I.R.C. § 267(b).

22 § 280F(d)(6)(C)(i)(III).

23 § 280F(d)(6)(C)(i)(I).

24 Treas. Reg. § 1.280F-6(d)(2)(ii)(A).

25 It is assumed for purposes of this article that, if the Related Party Leasing Exception does not apply, the aircraft owner's lease of the aircraft to a related party will be QBU in the course of its rental business under I.R.C. § 162. See note 20 above.

the Five-Percent Owner's flights for business purposes as QBU.)

Under the special rule for aircraft, if at least 25 percent of the use of the aircraft is QBU after the above exceptions are applied, then the exceptions will not apply for purposes of the 50 Percent Test.[26] This means that for an aircraft, there is a 25 percent test taking into account the exceptions (the "**25 Percent Test**"), and, if the 25 Percent Test is passed, then the 50 Percent Test is applied without the exceptions.[27] Typically, the 50 Percent Test without the exceptions will be passed, so the special rule effectively lowers the bar to 25 percent.

2. <u>Three Ownership Structures</u>

There are of course many possible ownership structures for aircraft. The following explains the above two step test under the three common ownership structures referred to herein as the "**Sole Proprietorship Structure**," the "**Employer-Provided Aircraft Structure**," and the "**Related Party Leasing Structure**."

a. <u>Sole Proprietorship Structure</u>

Under the Sole Proprietorship Structure, the aircraft is owned by an individual and used by the individual in the course of a business he or she operates as a sole proprietor. Since a limited liability company ("**LLC**") owned entirely by the individual may be treated as a disregarded entity,[28] a Sole Proprietorship Structure would include situations in which the individual owns the aircraft and the business through one or more disregarded single-member LLCs.

Under a Sole Proprietorship Structure, the individual obviously cannot provide personal flights to himself as compensation for his own services. Therefore, with respect to the owner's travel, the Compensation Exceptions have no application. Likewise, since the aircraft is not leased, the Related Party Leasing Exception does not apply. Since neither of the exceptions is relevant, there is ordinarily no difference between applying the 25 Percent Test with the exceptions and applying the 50 Percent Test without the exceptions.[29] Accordingly, the 25 Percent Test is irrelevant, and the 50 Percent Test is applied without first going through the 25 Percent Test.

For example, suppose that under a Sole Proprietorship Structure an individual owner is the only passenger on the aircraft, and the aircraft is flown 100 hours during the year, consisting of 40 flight hours for business purposes and 60 flight hours for the individual's personal purposes.[30] In that case the QBU of 40 percent would fail the 50 Percent Test, and the aircraft would not qualify for accelerated or bonus depreciation, but instead would have to be depreciated under the Alternative Depreciation System (six-year straight line).

The 50 Percent Test would be as follows:

50 Percent Test	
QBU – flight hours for business	40 hours
Total use	100 hours
QBU percentage	40 percent
<u>50 Percent Test failed</u>	

26 § 280F(d)(6)(C)(ii).

27 This two-step test is explained in Tech. Adv. Mem. 2009-45-037 (July 29, 2009) and *DiDonato v. Commissioner*, T.C. Memo. 2013-11, *119.

28 Treas. Reg. § 301.7701-2(a), -3(a).

29 However, there may be a difference between the 25 Percent Test and the 50 Percent Test if the sole proprietorship provides compensation flights to employees of the sole proprietorship. This situation is discussed in Section I.C.5 below.

30 For simplicity, the examples in this article refer only to flight hours and not flight miles. Section III.A. below discusses the methods to calculate the QBU percentages in more detail.

b. Employer-Provided Aircraft Structure

Under an Employer-Provided Aircraft Structure, the company owns the aircraft and uses it to transport its executives. An executive's personal flights are reported as compensation, typically at SIFL rates[31] on the executive's Form W-2.[32]

Under this structure, the 25 Percent Test would first be applied with the business flights classified as QBU, and due to the Compensation Exceptions the personal flights would not be QBU. If the 25 Percent Test is passed, the 50 Percent Test is applied without the Compensation Exceptions, which means that the personal flights would be treated as QBU due to their business purpose of compensating service providers.

As an example, suppose that under an Employer-Provided Aircraft Structure the company owns an aircraft and uses it to transport only the executive, who is a Five-Percent Owner. During the year, there are 30 flight hours for company business and 70 flight hours for the executive's personal purposes, which are reported as compensation on the executive's Form W-2.

The 70 flight hours for the executive's personal purposes would be excluded from QBU under the Compensation Exceptions. The result would be that the QBU percentage for the 25 Percent Test would be 30 percent. Since this would pass the 25 Percent Test, the 50 Percent Test would be applied without the exceptions. Without the Compensation Exceptions, the 70 flight hours for personal purposes would be included in QBU for the 50 Percent Test. They would be included in QBU, because compensating employees is a business purpose for the company. Thus, for purposes of the 50 Percent Test, all 100 flight hours would be QBU, which would result in a QBU percentage of 100 percent. Thus, the aircraft would pass the 50 Percent Test and would be eligible for accelerated or bonus depreciation.

The 25 Percent and 50 Percent Tests would be as follows:

25 Percent Test

QBU – flight hours for business	30 hours
Total use	100 hours
QBU percentage	30 percent

25 Percent Test passed; so proceed to 50 Percent Test

50 Percent Test

QBU – flight hours for business	30 hours
QBU – flight hours for personal purposes	70 hours
QBU	100 hours
Total use	100 hours
QBU percentage	100 percent

50 Percent Test passed

31 The taxable compensation reported to an executive for personal flights on company aircraft is typically calculated at Standard Industry Fare Level (SIFL) rates provided in Treas. Reg. § 1.61-21(g).

32 If the company is a partnership and the executive is a partner, the personal flights would ordinarily be reported as guaranteed payments on the executive's Schedule K-1 from the company.

c. Related Party Leasing Structure

Under the Related Party Leasing Structure, one company (the lessor) owns the aircraft and leases it to a related company (the lessee). The lessee uses the aircraft in its business and to provide personal flights to its executives

Under the IRS' view as expressed in Technical Advice Memorandum ("**TAM**") 2009-45-037, flights conducted by the lessee to transport Five-Percent Owners are excluded from QBU for purposes of the 25 Percent Test due to the Related Party Leasing Exception. Under this view, this exclusion would apply irrespective of whether the executive is traveling for the lessee's business purposes or for the executive's personal purposes.

As an example, suppose that under a Related Party Leasing Structure a company owns an aircraft and leases it exclusively to a commonly-owned company. The lessee company uses the aircraft to transport the majority stockholder for 60 flight hours on company business flights and 30 hours on personal flights. In addition, the lessee uses the aircraft for another 10 flight hours to transport for company business purposes another employee who is not a Five-Percent Owner.

The 90 flight hours to transport the Five-Percent Owner would be excluded from QBU under the Related Party Leasing Exception. (This interpretation is the IRS' view in TAM 2009-45-037, but see the discussion of the regulations project in Section I.C.2 below.) Since the other 10 flight hours are to transport a non-Five-Percent Owner, those 10 hours would not be excluded under the Related Party Leasing Exception, and they would count as QBU in the lessor's aircraft leasing business activity. Therefore, the QBU percentage would be 10 percent. Since this would fail the 25 Percent Test, the 50 Percent Test would not be applied without the exceptions. Applying the 50 Percent Test with the exceptions, the QBU percentage would still be the same 10 percent, which is less than 50 percent and fails the 50 Percent Test. Accordingly, the aircraft would not be eligible for accelerated or bonus depreciation.

The 25 Percent and 50 Percent Tests would be as follows:

25 Percent Test

QBU – 10 hours for non-Five-Percent Owner	10 hours
Total use	100 hours
QBU percentage	10 percent

25 Percent Test failed; so 50 Percent Test applies with exceptions

50 Percent Test

QBU – 10 hours for non-Five-Percent Owner	10 hours
Total use	100 hours
QBU percentage	10 percent

50 Percent Test failed

C. Issues Arising Under the 25 Percent and 50 Percent Tests

1. Multiple Passengers on a Flight

The IRS stated in TAM 2009-45-037 that, when there are multiple passengers on a flight, there should be a reasonable allocation between Five-Percent Owners and other passengers. This seems consistent with the fact that the statute and regulations focus on whether the passenger is a Five-Percent Owner.[33] In the TAM, the IRS stated that to allocate between

33 § 280F(d)(6)(C); Treas. Reg. § 1.280F-6(d)(2)(ii)(A).

use by Five-Percent Owners and other passengers, it would accept the occupied seat method that is used for entertainment disallowance purposes.[34] Presumably, the IRS would also accept the flight-by-flight method which is also provided under the entertainment disallowance regulations. Furthermore, it would appear reasonable to base the calculation on either hours or miles as is permitted under the entertainment disallowance regulations.[35]

The occupied seat method and the flight-by-flight method are explained in the *NBAA Personal Use of Business Aircraft Handbook* in Section III.B.2. [**https://www.nbaa.org/admin/taxes/personal-use/**] Under the occupied seat method based on miles, each mile traveled by each passenger is an occupied seat mile. If two passengers travel on a flight for 100 miles, then there is a total of 200 occupied seat miles. In contrast, under the flight-by-flight method based on miles, the number of miles traveled is divided among the passengers. If two passengers travel on a flight for 100 miles, then each passenger is considered to have traveled for 50 miles.

The TAM does not prescribe any consistency rules such as whether the same method must be used for all aircraft in a given year, or from one year to the next, or whether the method must be the same as the method used for the entertainment disallowance.

The TAM addressed the allocation between Five-Percent Owners and other passengers, which is relevant under the Employer-Provided Aircraft Structure and the Related Party Leasing Structure. It would seem reasonable to expect the IRS to accept these allocation methods for allocations among passengers traveling for business and personal purposes in a Sole Proprietorship Structure. However, there does not appear to be a compelling reason to require these allocation methods under a Sole Proprietorship Structure, since the allocation is between business and personal uses of the aircraft rather than between Five-Percent Owner passengers and other passengers. Accordingly, it would also seem reasonable to expect that the allocation between business and personal uses could be determined based on the primary purpose for the flight, which is the method generally used to allocate costs in a Sole Proprietorship Structure as explained in the *NBAA Personal Use of Business Aircraft Handbook* in Section III.A. [**https://www.nbaa.org/admin/taxes/personal-use/**]

For example, suppose that under an Employer-Provided Aircraft Structure the aircraft is flown 60 hours with four passengers: a Five-Percent Owner traveling for business purposes and his three personal guests traveling for personal purposes. Assume further that the aircraft is flown for another 40 hours with one passenger: the Five-Percent Owner traveling for business purposes.

The company should count hours using a reasonable method, which would include either the occupied seat method or the flight-by-flight method based on either hours or miles. Under the occupied seat method (hours), the 60 flight hours with four passengers would count as 60 occupied seat hours for business and 180 occupied seat hours for personal purposes. The other 40 flight hours would count as 40 occupied seat hours for business purposes. Thus, the QBU percentage for the 25 Percent Test would be 35.7 percent ((60 + 40)/(60 + 180 + 40)), and therefore the 25 Percent Test is passed. As demonstrated above, once the 25 Percent Test is passed, the 50 Percent Test is applied without the Compensation Exceptions which results in a QBU percentage of 100 percent.

The 25 Percent Test under the occupied seat hour ("OSH") method would be as follows (see next page):

34 TAM 2009-45-037 cites Prop. Treas. Reg. § 1.274-10(e) and IRS Notice 2005-45, 2005-1 C.B. 1228, for the occupied seat method for purposes of the entertainment disallowance. *See also* Treas. Reg. § 1.274-10(e) (final regulations issued in T.D. 9597 (July 31, 2012)).

35 Treas. Reg. § 1.280F-6(e)(2) provides that the QBU percentage is to be calculated using miles. In Priv. Ltr. Rul. 92-17-006 (Jan. 2, 1992), the IRS stated that, based on this regulation, the calculation must be based on miles. However, in TAM 2009-45-037 the IRS more recently stated that the calculation may be performed based on hours or miles.

25 Percent Test

One Five-Percent Owner traveling 60 OSH for business	60 OSH
One Five-Percent Owner traveling 40 OSH for business	40 OSH
Total QBU	100 OSH
Total use (60 + 180 + 40 OSH)	280 OSH
QBU percentage	35.74 percent

<u>25 Percent Test passed</u>

Alternatively, under the flight-by-flight (hours) method, the 60 flight hours would count as 15 business hours (60 / 4 x 1) and 45 personal hours (60 / 4 x 3), while the 40 flight hours would count as 40 business hours. Thus the QBU percentage for the 25 Percent Test would be 55 percent ((15 + 40)/(60 + 40)), and the 25 Percent Test is passed. As demonstrated above, once the 25 Percent Test is passed, the 50 Percent Test is also passed.

The 25 Percent Test under the flight-by-flight method would be as follows:

25 Percent Test

One Five-Percent Owner allocated ¼ of 60 hours	15 hours
One Five-Percent Owner traveling 40 hours	40 hours
QBU	55 OSH
Total use	100 OSH
QBU percentage	55 percent

<u>25 Percent Test passed</u>

2. <u>Business Flights by Five-Percent Owner in Aircraft Leased Between Related Parties</u>

Sometimes referred to as the "Leasing Company Trap," this issue is whether business flights by Five-Percent Owners on aircraft leased between related parties should be classified as QBU. The issue is currently the subject of a regulations project at Treasury. The regulations project was initiated at the request of NBAA, in a letter to the IRS, dated March 25, 2013, [**https://www.nbaa.org/member/admin/taxes/federal/fet/management-fees/20130401-rev-rul-74-123-response.pdf**] which supplemented NBAA's letter to Treasury dated Feb. 11, 2013, [**https://www.nbaa.org/admin/taxes/federal/20130222-nbaa-tax-policy-meeting.pdf**] on the subject. These letters provide a more complete analysis of the issue. However, the need for a regulatory change to address this issue can be summarized as follows:

The Related Party Leasing Exception is designed to address the potential overstatement of the QBU percentage for the 25 Percent Test when an aircraft is leased to a related party. If there were no Related Party Leasing Exception and the aircraft was used mainly for personal purposes, a lease of the aircraft to a related company would result in the lessor claiming 100 percent business use, based on the fact that the aircraft is used in the lessor's leasing business 100 percent of the time. Thus, a related party lease would disguise the real extent of the actual personal use of the aircraft (by the lessee).

The Related Party Leasing Exception addresses this problem by stating that leasing to a related party will not count as QBU to the extent that the passengers are Five-Percent Owners. If this exception is interpreted to mean that all such flights by a Five-Percent Owner are deemed nonbusiness, then the exception would err in the opposite direction by understating the QBU percentage.

In connection with the request for regulations to correct this problem, NBAA explained that the Related Party Leasing Exception only requires that the activity of leasing to a related party not be counted as QBU. The statute does not actually provide instructions as to how QBU should then be determined. It only states how it should not be determined (i.e., by not counting leasing to a related party as qualifying as QBU). In the letters requesting the change in regulations, NBAA argues that to the extent that the Related Party Leasing Exception applies, QBU should be determined for purposes of the 25 Percent Test by looking through to the lessee and including business flights by Five-Percent Owners as QBU.

This argument was previously rejected in TAM 2009-45-037 which held that all leasing to a related party failed to qualify as QBU to the extent of the Five-Percent Owner passengers irrespective of the purposes for their flights.[36] Accordingly, NBAA has asked Treasury to review the issue and provide guidance to reverse the IRS' position on this issue. At this time, Treasury and IRS officials have advised that such regulations have been drafted and are expected to be issued with prospective application. IRS officials have also advised that prior to the effective date of such regulations, it is the IRS' view that business flights by a Five-Percent Owner under a Related Party Leasing Structure are not included in QBU for purposes of the 25 Percent Test.

For example, suppose that in a Related Party Leasing Structure, one Five-Percent Owner flies 50 hours for the business of the lessee and 30 hours for personal nonentertainment purposes, and one non-Five-Percent Owner travels 20 hours for lessee business. Under the IRS' view of current law as expressed in TAM 2009-45-037, the aircraft would fail the 25 Percent Test, because all travel by a Five-Percent Owner under a Related Party Leasing Structure would fail to qualify as QBU for the 25 Percent Test. Under the approach expected in future regulations, the lessor would look through to the lessee with respect to flights to which the Related Party Leasing Exception applies so that the Five-Percent Owner's business flights would count as QBU for the 25 Percent Test. Once the 25 Percent Test is met, all flights should count as QBU for the 50 Percent Test, since the Related Party Leasing Exception would not apply for the 50 Percent Test.

In this case, the 25 Percent Test would be as follows:

25 Percent Test	**IRS View of Current Law: All Five-Percent-Owner Flights Are Not QBU**	**Expected Regulations: All Five-Percent-Owner Business Flights Are QBU**
One Five-Percent Owner - business	0 hours	50 hours
One non-Five-Percent Owner - business	20 hours	20 hours
QBU	20 hours	70 hours
Total use	100 hours	100 hours
QBU percentage	20 percent	70 percent

<u>25 Percent Test failed, without Five-Percent Owner's business hours</u>

<u>25 Percent Test passed, if look through to the lessee and count Five-Percent Owner's business hours</u>

3. <u>Passengers Traveling for Entertainment Purposes</u>

Another issue that arises is whether the use of the aircraft to transport passengers for entertainment purposes (as defined under the entertainment disallowance rules in § 274(a)) is precluded from qualifying as QBU for

36 The Tax Court in *DiDonato v. Comm'r*, T.C. Memo. 2013-11, *119, cited TAM 2009-45-037 and followed its reasoning in treating leasing to a related party as not QBU, irrespective of whether the flight was for business purposes. Likewise, in TAM 92-17-006, the IRS ruled that the 25 Percent Test was met in the case of an aircraft leased to a related party, when non-Five-Percent Owners were the passengers for more than 25 Percent of the total use of the aircraft.

purposes of the 25 Percent and 50 Percent Tests. This issue mostly affects whether a Five-Percent Owner's entertainment travel, which is treated as compensation or as a related party leasing use, would count as QBU for the 50 Percent Test.

The issue arises primarily in the 50 Percent Test for Five-Percent Owners under the Compensation Exceptions (or the Related Party Leasing Exception). Under the Employer-Provided Aircraft Structure (or the Related Party Leasing Structure), once the 25 Percent Test is passed, the 50 Percent Test is applied without the exceptions. If a Five-Percent Owner is traveling for entertainment purposes, his travel (without the exceptions) would be treated as compensation expense by the employer (or rental by the related party lessor), and therefore it would ordinarily count as QBU for purposes of the 50 Percent Test. However, if the entertainment disallowance precludes qualification of an entertainment flight as QBU, then this travel would not count as QBU for the 50 Percent Test.[37]

Under these circumstances, the IRS occasionally takes the position in tax audits that, since the costs allocated to passengers traveling for entertainment purposes are not deductible pursuant to the entertainment disallowance in I.R.C. § 274(a), the use of the aircraft for such travel should not be considered use in a trade or business for purposes of the QBU tests.

As noted above, the basic requirement (before applying the exceptions) for a use of an aircraft to be QBU is that the use must be in a trade or business.[38] Also as discussed above, providing compensation to employees constitutes use in an employer's trade or business, and leasing the aircraft constitutes use in the lessor's rental business. Therefore, entertainment flights provided by an employer that owns the aircraft or by a lessee to its employees would nevertheless appear to meet the requirement to be QBU. The entertainment disallowance in § 274(a) precludes a deduction for entertainment travel, but it does not contradict the fact that the entertainment flight is in furtherance of the owner's trade or business (by compensating employees or by leasing to a lessee). Moreover, § 280F and the related regulations do not provide any special rule stating that flights classified as entertainment flights under § 274(a) are precluded from being QBU. Accordingly, it is difficult to understand the legal basis for the occasional assertion by IRS agents that entertainment travel is excluded from QBU for the 50 Percent Test.

With respect to this issue, it may be relevant that the definition of business use percentage in Treas. Reg. § 1.280F-6(d)(2) does not state that the business use percentage is to be determined after application of the entertainment disallowance in § 274. In contrast, the definition of "business/investment use" in the immediately following paragraph provides that business/investment use is determined "after application of section 274."[39] Accordingly, the most reasonable reading of the regulations would appear to be that business use percentage is determined based on the extent of use in a trade or business *before* applying the entertainment disallowance in § 274.

Even if application of the entertainment disallowance to a flight would preclude that flight from qualifying as QBU, there are exceptions to the entertainment disallowance that may be relevant. In situations involving non-Five-Percent Owners, it would often be the case that the non-Five-Percent Owner is not a "specified individual" for purposes of the compensation exception to the entertainment disallowance.[40] Accordingly, if the non-Five-Percent Owner is a service provider (e.g., an employee) but is not a specified individual, then the compensation exception in § 274(e)(2) may be available. In that case, it would seem extremely unlikely that the IRS would

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37 The issue can also arise in the relatively rare case of Non-Five-Percent Owners who are Specified Individuals. For both the 25 Percent and 50 Percent Tests under the Employer-Provided Aircraft Structure (or the Related Party Leasing Structure), if a non-Five-Percent Owner is traveling for entertainment purposes, the QBU treatment of his travel would not be affected by the exceptions. It would be treated as compensation expense by the employer (or rental by the related party lessor), which would ordinarily count as QBU for purposes of both the 25 Percent and 50 Percent Tests. However, if the entertainment disallowance precludes qualification of an entertainment flight as QBU, then the entertainment travel by a non-Five-Percent Owner who is a Specified Individual would not count as QBU for either the 25 Percent Test or the 50 Percent Test.

38 § 280F(d)(6)(B).

39 Treas. Reg. § 1.280F-6(d)(3)(ii). In general, the "business/investment use" of listed property divided by total use is the deductible portion of expenses. It includes use in a trade or business under § 162 and in production of income under § 212. The distinction in the § 280F regulations between "qualified business use" and "business/investment use" is discussed in Priv. Ltr. Rul. 91-06-018 (Nov. 8, 1990).

40 "Specified individuals" are generally directors, officers, and owners of 10 percent or more of the company. § 274(e)(2)(B); Treas. Reg. § 1.274-9(b).

assert that the non-Five-Percent Owner's entertainment travel would be excluded from QBU. Alternatively, in situations involving related party leases, the lessor may charge fair market rent at arm's length terms, and accordingly the lease could qualify for the exception in § 274(e)(8) for bona fide transactions for adequate and full consideration. If either of these exceptions applies, then the entertainment flights would not appear to be precluded from qualification as QBU.

For example, suppose that in an Employer-Provided Aircraft Structure, one Five-Percent Owner is the only passenger, and he flies 30 hours for business purposes, 10 hours for personal non-entertainment purposes, and 60 hours for personal entertainment purposes. The aircraft would meet the 25 Percent Test, because after applying the Compensation Exceptions, the QBU for the 25 Percent Test would be 30 percent (30 hours / 100 hours). For the 50 Percent Test, all of the personal flight hours should be business flights since they are to provide compensation to the Five-Percent Owner. Therefore, the QBU percentage for the 50 Percent Test should be 100 percent. However, under the approach sometimes asserted by the IRS, the 60 flight hours for personal entertainment travel would be excluded from QBU for purposes of the 50 Percent Test, even without asserting the Compensation Exceptions. Under this alternative interpretation, the QBU percentage for the 50 Percent Test would be 40 percent ((30 + 10) / 100), and the aircraft would fail the 50 Percent Test.

In this case, the 50 Percent Test would be as follows:

50 Percent Test	**Entertainment Flights Excluded From QBU**	**All Personal Flights Included in QBU**
One Five-Percent Owner - business	30 hours	30 hours
One non-Five-Percent Owner - personal non-entertainment	10 hours	10 hours
One Five-Percent Owner - entertainment	0 hours	60 hours
QBU	40 hours	100 hours
Total use	100 hours	100 hours
QBU percentage	40 percent	100 percent

<u>50 Percent Test failed, if entertainment travel cannot count as QBU</u>

<u>50 Percent Test passed, if all personal travel counts as QBU for 50 Percent Test</u>

4. <u>Lease to Charter Company</u>

One question that frequently arises is how to treat a lease to an unrelated charter company. Since the lease is not between related parties, there is no reason to apply the Related Party Leasing Exception. Assuming the lease to the charter company is an arms-length transaction, it ought to be treated as rental business activity which would ordinarily be a trade or business activity of the lessor. This would mean that the lease would be respected as a business activity of the lessor irrespective of whether the lessee's passengers are Five-Percent Owners traveling for personal or business purposes. Therefore, the lease to the charter company ought to be QBU for both the 25 Percent and 50 Percent Tests.

5. <u>Employees of Sole Proprietorship</u>

If a sole proprietorship has employees, then it is necessary to treat the arrangement as both a Sole Proprietorship Structure and an Employer-Provided Aircraft Structure.

The presence of passengers in addition to the sole proprietor raises the question of whether to perform the QBU tests based on the primary purpose of each flight or on a passenger-by-passenger basis. TAM 2009-45-037 states that to apply the Related Party Leasing Exception on flights with both Five-Percent Owners and other passengers, a reasonable allocation must be made between the passengers. In other words, since the Related Party Leasing Exception (and the Compensation Exceptions) are based on the identity of each passenger, it is necessary to use a passenger-by-passenger allocation method to apply those exceptions. However, when the exceptions do not apply, the classification of flights as QBU is determined by the general rule in § 280F(d)(6)(B) that QBU is travel in the course of a "trade or business." The general rule for determining whether a flight is conducted in furtherance of a trade or business is to perform the allocation based on the primary purpose of the flight.[41]

This apparent mixing of primary purpose method and passenger-by-passenger methods for sole proprietors could be handled by applying a passenger-by-passenger allocation method to all flights, since the IRS is unlikely to object. Alternatively, it would seem consistent with the rules to apply the primary purpose method to flights on which all passengers are Five-Percent Owners, but apply a passenger-by-passenger analysis to flights on which there is a mix of Five-Percent Owners and non-Five-Percent Owners. To apply this concept, personal guests of Five-Percent Owners would be treated as Five-Percent Owners.[42] This mixed approach would be workable under the flight-by-flight allocation methods, but it would not work under the occupied seat method.

Under this mixed approach, there are several combinations of passengers to consider. First, suppose that the sole proprietor is traveling for business purposes, and his or her guests (e.g., family, friends or employees) are traveling for personal entertainment purposes. In this case, the sole proprietor would be treated as using all of the occupied seats, and the primary purpose of the flight (presumably business) would determine the QBU status of the flight.

Second, suppose that the sole proprietor is traveling for business, and his or her employees are also traveling on company business. In that case, the entire flight would be for business and would be QBU under either the primary purpose method or the flight-by-flight method. Therefore, the question of which method to use would be moot.

Third, suppose the sole proprietor is traveling for business purposes, and his or her unrelated employee is traveling for personal entertainment purposes. Assume further that this is the unusual case in which the employee is receiving the personal flight as compensation for services rather than as a personal guest of the sole proprietor. Since the employee is not a Five-Percent Owner, the personal flight would not trigger the Compensation Exceptions. For that reason, the employee's travel would be QBU, and therefore the whole flight would be QBU under either the primary purpose or flight-by-flight methods.

Fourth, suppose the sole proprietor is traveling on a flight for personal purposes. Suppose further that his or her employee is traveling either for business purposes or for personal purposes (but not as a personal guest of the sole proprietor). Either way, the employee's travel would be QBU, while the sole proprietor's travel would not be QBU. Accordingly, in either case, since there would be travel by a Five-Percent Owner and a non-Five-Percent Owner, the passenger-by-passenger method (i.e., the flight-by-flight method) would need to be applied for the flight.

As an example with only one passenger on each flight, suppose that under a Sole Proprietorship Structure, the sole proprietor is the only passenger on 80 flight hours consisting of 20 flight hours for business purposes and 60 flight hours for personal purposes. Assume further that an unrelated employee (who is not a Five-Percent Owner) is the only passenger and is traveling for personal purposes for 20 flight hours.

If the employee's personal travel is viewed as travel as a personal guest of the owner, then only the owner's 20 business hours would count as QBU. However, if the employee's travel is provided as compensation for services, then, because the employee is not a Five-Percent Owner, the Compensation Exceptions would not apply. With no flights subject to the Compensation Exceptions, there would be no reason to apply the 25 Percent Test. Under the 50 Percent Test, the owner's 20 flight hours of business travel and the employee's 20 hours would be the only QBU hours. The 40 Percent QBU percentage would fail the 50 Percent Test, and the aircraft would not be eligible for accelerated depreciation.

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41 Treas. Reg. § 1.162-2.

42 See the discussion of the classification of guests in section I.C.6 below.

The 50 Percent Test would be as follows:

50 Percent Test

Owner's business travel	20 hours
Employee's personal travel, reported as compensation	20 hours
QBU	40 hours
Total use	100 hours
QBU percentage	40 percent

<u>50 Percent Test failed</u>

As a contrasting example with multiple passengers, suppose again that under a Sole Proprietorship Structure, the sole proprietor and the family members who are not employees are the only passengers on 60 flight hours consisting of 20 flight hours for business purposes and 40 flight hours for personal purposes. Assume further the sole proprietor and a related employee (who therefore is a Five-Percent Owner) travel together on 40 flight hours, with the sole proprietor traveling for business purposes and the related employee traveling for personal purposes. Assume that on those flights the related employee is not regarded as a personal guest of the sole proprietor, and therefore the sole proprietorship imputes income at SIFL rates to the related employee.

The 20 flight hours in which the sole proprietor travels with family members as personal guests would count as business travel based on the primary purpose of these flights. Since the family members traveling as guests are not receiving the flights as compensation for services as employees, the Compensation Exception would not apply. The allocation suggested in TAM 2009-45-037 between Five-Percent Owners and non-Five-Percent Owners is not necessary for these flights, because they do not involve the Compensation Exceptions (or the Related Party Leasing Exception), both of which are based on the identity of the passengers. Instead, they are based on whether the flight is in furtherance of a "trade or business" which is generally determined under the primary purpose method.

In contrast, the 40 flight hours with the sole proprietor and a related employee would trigger the Compensation Exception for the related employee. For these flights, the reasonable allocation suggested in TAM 2009-45-037 would be necessary. Therefore, under the flight-by-flight method, these 40 hours would be considered as 20 flight hours for business purposes and 20 flight hours excluded from QBU for the 25 Percent Test under the Compensation Exception.

The Total QBU hours for the 25 Percent Test would be 40 hours. Since the 25 Percent Test is passed, the 20 flight hours for the related employee would count as QBU for the 50 Percent Test. This would total 60 hours of QBU for the 50 Percent Test, and the 50 Percent Test would be passed.

The 25 Percent Test would be as follows:

25 Percent Test

Owner's business travel with personal guests (primary purpose method)	20 hours
Owner's business travel with related employee (flight-by-flight method)	20 hours
QBU	40 hours
Total use	100 hours
QBU percentage	40 percent

<u>25 Percent Test passed</u>

The 50 Percent Test would be as follows:

50 Percent Test	
Owner's business travel with personal guests (primary purpose method)	20 hours
Owner's business travel with related employee (flight-by-flight method)	20 hours
Related employee's personal travel, reported as compensation	20 hours
QBU	60 hours
Total use	100 hours
QBU percentage	60 percent

50 Percent Test passed

6. Personal Guests of Five-Percent Owner

Another issue that arises from time to time is whether guests, who are not service providers to the company and are traveling for non-business purposes, should be classified as Five-Percent Owners or as non-Five-Percent Owners. Presumably, the travel by a guest in connection with company business would be classified as QBU in all cases. However, when the guest is traveling for nonbusiness purposes, it would appear necessary to determine whether the guest is a guest of the company or is a personal guest of a particular executive. This distinction is supported by the analysis at the end of TAM 2009-45-037 captioned "Other flights not directly related to the business of Lessee One or Lessee Two."

A personal guest of a particular executive would be viewed as another seat used by the executive. If the executive is a Five-Percent Owner, then the guest would be viewed as another Five-Percent Owner. In contrast, a guest traveling for the guest's personal purposes might be considered a guest of the company (rather than a personal guest of a particular executive), when providing the flight to the guest furthers the company's business interests (in contrast to a flight provided to a friend of the executive). An example might include providing a nonbusiness flight to an executive at another company that does business with the taxpayer company.

Under a Sole Proprietorship Structure, providing a nonbusiness flight to a company guest may, or may not, qualify as a trade or business flight, depending on the business purposes served by providing the flight to the guest. If the flight is for entertainment purposes, the deduction would be disallowed under the entertainment disallowance in § 274(a), but as discussed in Section I.C.3 above, that ought not preclude the guest's flight from being QBU.

Similarly, under an Employer-Provided Aircraft Structure, providing a nonbusiness flight to a company guest would likewise appear to qualify as QBU, if providing the flight serves the company's business purposes. There is no reason to expect that the Compensation Exceptions would apply to a flight provided to a guest who does not provide services to the company.

Under a Related Party Leasing Structure, if the lessee provides a nonbusiness flight to a guest of the lessee (again, not a personal guest of a particular executive), the flight would not be considered as a flight provided to a Five-Percent Owner. Therefore, it would not be excluded from treatment by the lessor as a flight in furtherance of the lessor's business of leasing. For this reason, it ought to be included in QBU.

7. Maintenance and Training Flights

Another issue is whether maintenance flights should be (i) classified as business flights and included in both the numerator and the denominator of the 25 Percent and 50 Percent Tests, or (ii) excluded from both the numerator and denominator. If the occupied seat method is used, then maintenance flights would be excluded from the numerator and denominator, because the occupied seat method is based on the number of passengers on the flight. However, if the flight-by-flight method or the primary purpose method is used, the issue is present.

In TAM 2009-45-037, the IRS asserted that it was unreasonable to classify maintenance flights as business, because maintenance flights pertain to all of the other flights. Therefore, the IRS position is that maintenance flights should be simultaneously classified for different purposes in proportion to the purposes of the occupied flights. Mathematically, the result can be achieved by excluding maintenance flights from both the numerator and the denominator of the QBU tests.

Nevertheless, a reasonable argument can be made that maintenance flights should be classified as business for purposes of the QBU tests under the flight-by-flight or the primary purpose method. First, it appears that the conclusion in the TAM that maintenance flights are included in total flights in the denominator is consistent with other guidance. In general under the listed property regulations, the denominator includes "total use" of the property.[43] Similarly, the regulations explaining the flight-by-flight method define the denominator as "flight hours or miles for the taxable year" with no provision for the reduction in this total to exclude maintenance flights.[44] In addition, in *Noyce v. Commissioner*,[45] the Tax Court found that the denominator for purposes of determining business versus personal use was the total flight hours which included the maintenance flights. In view of these authorities, it appears that maintenance flights should be included in the denominator.

Repairs and maintenance of business assets are generally regarded as business expenses which supports treating the maintenance flights as business flights.[46] Furthermore, the regulations governing the classification of flights for purposes of the entertainment disallowance generally classify the purpose of each person's flight according to its primary purpose, or principal character, rather than by dividing it up in proportion to the various purposes for which the person may be traveling.[47] Therefore, it may be reasonable to classify maintenance flights as entirely for business and include them in the numerator based on their principal purpose of maintaining a business asset.

A similar analysis would apply to training flights. However, in some cases an aircraft is used for training an executive who only pilots the aircraft for his own entertainment purposes.[48] In that case, the training flights would be classified as personal flights.

For example, suppose that in an Employer-Provided Aircraft Structure, one Five-Percent Owner is the only passenger, and he flies 20 hours for business purposes and 70 hours for personal purposes. In addition, the aircraft flies 10 hours for maintenance purposes. Under the approach typically advocated by the IRS under the flight-by-flight method, the 10 flight hours for maintenance would be allocated proportionately between the business and personal flight hours, with the result that the QBU percentage for the 25 Percent Test would be 22.2 percent (20 / (70 + 20)), and the aircraft would fail the 25 Percent Test. In contrast, if the 10 flight hours for maintenance were treated as business travel, the QBU percentage would be 30 percent ((20 + 10) / (20 + 70 + 10)), and the aircraft would pass the 25 Percent Test.

In this case, the 25 Percent Test would be as follows (see next page):

43 Treas. Reg. § 1.274-5T(b)(6)(i)(B).

44 Treas. Reg. § 1.274-10(e)(3)(ii).

45 97 T.C. 670 (1991) (Maintenance flight hours were excluded from the numerator, because they were nondeductible start-up expenses incurred prior to use of the aircraft in charter service; however, the maintenance flight hours were included in the denominator.).

46 Treas. Reg. § 1.263(a).

47 Treas. Reg. §§ 1.162-2(b), 1.274-2(c)(3)(iii).

48 See, e.g., *Noyce v. Comm'r*, 97 T.C. 670 (1991).

25 Percent Test	Allocate Maintenance	Maintenance As Business
One Five-Percent Owner traveling for business	20 hours	20 hours
Maintenance flights		10 hours
QBU	20 hours	30 hours
Total use	90 hours	100 hours
QBU percentage	22.2 percent	30 percent

25 Percent Test failed if allocate maintenance in proportion to other flights

25 Percent Test passed if treat maintenance flights as business flights

8. Political or Lobbying Flights

Classifying flights for political or lobbying purposes as QBU raises unique issues. TAM 2009-45-037 focuses on whether such flights are in furtherance of the company's business (and therefore classified as company business flights), or constitute personal uses of the aircraft by an employee (typically a Five-Percent Owner).

In the case of political or lobbying flights in furtherance of company business, it would appear reasonable to classify such flights as QBU. As discussed above, with respect to entertainment flights, the basic requirement for qualification as QBU is that the flight must be "in a trade or business of the taxpayer."[49] The fact that flights for political or lobbying purposes may be disallowed under a separate provision[50] should not change the analysis of whether the flights are in furtherance of the taxpayer's trade or business.

In contrast, when the flights are in furtherance of the personal interests of a Five-Percent Owner, then they would appear to be properly classified as personal flights of that Five-Percent Owner. In that case, for the 25 Percent Test, either the Compensation Exceptions would apply in an Employer-Provided Aircraft Structure, or the Related Party Leasing Exception would apply in the case of a Related Party Leasing Structure. For the 50 Percent Test (which applies without the exceptions), the flights should be included in QBU as compensation flights in the case of Employer-Provided Aircraft Structure or as rental use in the case of a Related Party Leasing Structure.

II. Depreciation Recapture When the 50 Percent Test Is Failed

If the 50 Percent Test is failed in any year, then "Excess Depreciation" must be recaptured.[51] Excess Depreciation is defined as the (a) allowable depreciation under the accelerated method used in prior years, minus (b) the allowable depreciation if the Alternative Depreciation System had been used from the time it was placed in service.[52] The calculation of "allowable" depreciation is made taking into account the nondeductible percentage in previous years.[53] More generally, the recapture adjustment is the recapture amount needed to adjust the cumulative depreciation to what it would have been if the Alternative Depreciation System had been used from the time the property was placed in service.[54]

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49 I.R.C. § 280F(d)(6)(B).

50 I.R.C. § 162(e).

51 § 280F(b)(2); Field Service Adv. 0292 (Oct. 7, 1992) ("the language of the Code is clear in providing for recapture in any subsequent year").

52 § 280F(b)(2); Treas. Reg. § 1.280F-3T(d)(2).

53 The definition of "allowable" depreciation in Treas. Reg. § 1.1016-3(b) does not discuss whether "allowable" depreciation takes a business use percentage into account. However, the court in *CBS Corp. & Subs v. United States*, 105 Fed. Cl. 74 (2012), clearly ruled that "allowable" depreciation means depreciation after any disallowance.

54 Treas. Reg. § 1.280F-3T(f), Example (7)(iv).

The following example of this calculation of Excess Depreciation is based on Treas. Reg. § 1.280F-3T(f), *Example (7)*. The recapture calculation from that example is simplified and adapted below to the depreciable life and method applicable to aircraft. This example illustrates the calculation of excess depreciation taking into account the business use percentages each year.

Suppose the following facts:

Aircraft purchased in 2014	$7,000,000
Business use percent in 2014	60 percent
Business use percent in 2015	40 percent
Business use percent in 2016	40 percent

Depreciation for 2014 would be as follows (assuming a half-year convention):

Cost	7,000,000
Depreciation percentage (five-year MACRS)	20%
Total depreciation – MACRS	1,400,000
Business use percent	60%
Depreciation deduction	840,000
Excess depreciation as of 1-1-15:	
Allowable depreciation in 2014 – MACRS	840,000
Allowable depreciation in 2014 if ADS:[55]	
Cost	7,000,000
Depreciation percent (ADS six-year straight line)	1/12
Total depreciation – ADS	583,333
Business use percent	60%
Allowable depreciation in 2014 – ADS	350,000
Recapture	490,000

One observation from this example is that when the entertainment use percentage varies from year to year, the Excess Depreciation calculation can reduce the total deductible depreciation by moving depreciation deductions from years with high business use to years with low business use. Accordingly, failing the 50 Percent Test even after the asset is fully depreciated can result in depreciation recapture.[56]

However, the depreciation recapture calculation does not create an opportunity for the IRS to increase the amount of recapture by redetermining the personal use (or entertainment use) percentage in prior years. As noted above, the definition of Excess Depreciation compares "allowable" depreciation under accelerated methods with "allowable" depreciation under ADS. Since the "allowable" depreciation is the same business use (or nonentertainment) percentage under MACRS as under ADS, the depreciation recapture calculation does not create an opportunity for the IRS to simply determine a high personal use percentage in prior years and recapture that increased percentage of depreciation.

Depreciation should be calculated over the remainder of the life of the asset as if ADS had been used from the time it was placed in service.[57] Accordingly, the recaptured amount is added to the adjusted basis for purposes of calculating future depreciation over its remaining depreciable life.[58] In view of the adjustments to suspended

55 "**ADS**" refers to Alternative Depreciation System.

56 *See* Field Service Adv. 0292 (depreciation recapture must be calculated for any year that the taxpayers fails the 50 Percent Test).

57 Temp. Treas. Reg. § 1.280F-3T(c)(2).

58 Temp. Treas. Reg. § 1.280F-3T(d)(1), (f), *Example (7)*(iv).

basis described in the entertainment disallowance regulations,[59] it would appear necessary to adjust the suspended basis as well.

Under that principle, and taking into account the suspended basis concept from the entertainment disallowance regulations, it would follow that in the above example depreciation and suspended basis through the time of a sale in 2016 would be calculated as follows:

	Business Depreciation	Suspended Basis	Total Depreciation
2014: MACRS depreciation (60 percent business)	840,000	560,000	1,400,000
2015: Recapture (60 percent business)	(490,000)	(326,667)	(816,667)
Accumulated depreciation 1-1-15	350,000	233,333	583,333
ADS depreciation (1/6) and Business use (40 percent)	466,667	700,000	1,166,667
Accumulated depreciation 12-31-15	816,667	933,333	1,750,000
2016: ADS depreciation (1/2 year)[60] and Business use (40 percent)	233,333	350,000	583,333
Accumulated depreciation through Date of sale in 2016	1,050,000	1,283,333	2,333,333

This allocation between allowable deductions and suspended basis would appear to apply for purposes of calculating gain on sale with the sale bifurcated between business and nonbusiness (or entertainment and nonentertainment) portions of the aircraft.[61] The following is an example of such a bifurcation calculation based on the above allowable and suspended basis amounts, assuming a sale for $5 million in 2016 (table continued on next page):

Average Business Percentage:

2014: 60% for ½ year = 30%	
2015: 40% for 1 year = 40%	
2016: 40% for ½ year = 20%	
Total	90%
Number of years	2
Average Percentage	45%

59 Treas. Reg. § 1.274-10(f).

60 I.R.C. § 168(d)(4) provides that the half-year convention applies in the year of sale.

61 § 274(g); Treas. Reg. § 1.274-7, -10(f); *Snyder v. Comm'r*, T.C. Memo. 1975-221; *Sharp v. United States*, 99 F. Supp. 743 (D. Del. 1961), *aff'd per curiam*, 303 F.2d 783 (3d Cir. 1962); Rev. Rul. 72-111, 1972 C.B. 56.

	Business Portion	Suspended Basis	Total
Sale price (45 percent business)	2,250,000	2,750,000	5,000,000
Cost (45 percent business)	3,150,000	3,850,000	7,000,000
Accumulated depreciation (above)	(1,050,000)		(1,050,000)
Adjusted Basis	2,100,000	3,850,000	5,950,000
Gain (Loss)	150,000	(1,100,000)	(950,000)

In the above gain calculation, the gain of $150,000 on the business portion of the aircraft would be taxable gain. However, the loss of $1,100,000 on the nonbusiness portion of the aircraft would be a nondeductible personal (or entertainment) loss.

III. The Business of Leasing Exception in § 280F(c)

I.R.C. § 280F(c)(1) provides that the depreciation limitations in § 280F are not applicable to listed property leased "by any person regularly engaged in the business of leasing such property." Temp. Treas. Reg. § 1.280F-5T(c) explains that this exception for companies in the business of leasing applies—

> if contracts to lease such property are entered into with some frequency over a continuous period of time. The determination shall be 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.

In TAM 2009-45-037, the IRS determined that the business of leasing exception in § 280F(c) did not apply to related party leasing activity when an entity leased two aircraft to related parties and another entity leased one aircraft to related parties. In the TAM, the IRS determined, based on the example in Temp. Treas. Reg. § 1.280F-5T(c) of a lease of one automobile, that the lease of one or two aircraft was merely an "occasional or incidental" activity.

The comparison in the TAM of leasing one or two aircraft to leasing one automobile is suspect. One aircraft is far more complex and expensive than one automobile. It does not make sense to conclude that owning and leasing one aircraft is an occasional and incidental activity simply because owning and leasing one automobile is occasional and incidental.

The example of leasing one automobile is based on the assumption that when a company is engaged in a business, its lease of one automobile to an employee is a minor, insubstantial activity that is merely incidental to its primary business operations. In contrast, it is often the case that a taxpayer will lease an aircraft from one entity whose only business is aircraft leasing to an operating company. Such aircraft leasing activities often involve large amount of money and are operationally complex. Unlike the lease of a single automobile that would be incidental to a company's business, many taxpayers' aircraft leasing activities are large and complex and are not minor, insubstantial activities incidental to other business activities.

Despite the flaws in the analysis in TAM 2009-45-037, the IRS typically follows that ruling and concludes that taxpayers leasing aircraft between related entities do not meet the business of leasing exception in § 280F(c).

On the other hand, this regulation was interpreted by the IRS in TAM 2008-41-037 (Oct. 10, 2008) to apply the business of leasing exception to a company that leased automobiles to its employees solely for their personal use at below market rates. The ruling explains the applicable standard from the regulation as follows:

> [S]ection 1.280F-5T(c) of the regulations provides a clear definition of "regularly engaged in the business of leasing" for purposes of section 280F(c)(1) of the Code that does not require a separate trade or business of leasing automobiles, and does not require a determinable profit motive for the activity. Instead,

> for purposes of section 280F(c)(1), the clear definition of "regularly engaged in the business of leasing" under section 1.280F-5T(c) requires that the contracts to lease listed property be entered into with some frequency over a continuous period of time and that the nature of the taxpayer's business in its entirety be taken into account in making this factual determination in each case. Therefore, for purposes of section 280F(c)(1), it is sufficient that the leasing activity is substantial with a reasonable connection to the overall business activities of the taxpayer.

The IRS then discussed the substantial nature of the taxpayer's leasing activity and the reasonable connection to the overall business activities of the taxpayer as follows:

> In the instant case, the Taxpayer's business operations obtain a number of benefits from the leasing activity, including moving automobiles out of inventory and advertising its brand through putting additional Brand A and Brand B vehicles on the road. These benefits are reasonably and clearly related to the operation of the Taxpayer's primary business of selling Brand A and Brand B automobiles, and support the position that Taxpayer is engaged in the business of leasing automobiles.

The taxpayers in TAM 2008-41-037 used the leased automobiles solely for their personal use, but the leasing activity was connected to the taxpayer's business by moving automobiles out of inventory and advertising the brand by putting the vehicles on the road. Many taxpayers' aircraft leasing activities will have a stronger connection with the taxpayer's overall business, if the leased aircraft are actually used directly in the taxpayer's business. Accordingly, such taxpayers' leasing activities would meet the requirement stated in this ruling that the leasing activity must be substantial and have a reasonable connection to the company's overall business.

Thus, under TAM 2008-41-037, it appears that many aircraft lessors are "regularly engaged in the business of leasing" aircraft within the meaning of § 280F(c)(1), and the depreciation limitation in § 280F(b) ought not apply. However, in view of the IRS's consistent reliance on the analysis in TAM 2009-45-037, taxpayers should be cautious in relying on the reasoning in TAM 2008-41-037.

Note that the "business of leasing" exception under § 280F(c) is a specific test for purposes of § 280F. In contrast, under the Supreme Court's decision in *Higgins v. Commissioner*,[62] and the many cases that have followed *Higgins*, only a minimal level of business activity is necessary for a rental activity to qualify as a trade or business activity under § 162(a).[63] Under *Higgins*, a typical aircraft lease from a special purpose entity to a related business ought to qualify as a trade or business activity under § 162, rather than an activity for the production of income under § 212, irrespective of whether such leasing activity is found to meet the business of leasing exception in § 280F(c).

IV. Depreciation Recapture Adjustment for the *Lessee*

Pursuant to § 280F(c)(2) through (5), Treas. Reg. § 1.280F-7(b) requires that if the *lessee's* QBU with respect to the property is 50 Percent or less in any taxable year, the *lessee* shall report an amount of income determined by a formula set forth in the regulation. The plain language and the example in Treas. Reg. § 1.280F-7(b)(3) makes it clear that the QBU calculation is performed for the lessee (not for the lessor).[64] Since the lessor and lessee are two different taxpayers, the lessee's QBU percentage would not be determined based on the lessor's use.

The 25 Percent and 50 Percent Tests apply to the lessee in essentially the same way as they apply to the lessor. However, since the lessor and the lessee are situated differently, they may well have different QBU percentages. For example, in the case of a Related Party Leasing Structure, under the 25 Percent Test, the lessee would not be required to exclude any flights under the exclusion in § 280F(d)(6)(C)(i)(I) for "leasing property to any 5-percent owner or related person" (assuming the lessee is not subleasing the aircraft to another person). Once this difference is taken into account, the lessee typically has a much better chance of passing the 50 Percent Test.

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62 312 U.S. 212 (1941).

63 See discussion of this issue at note 20 above.

64 Treas. Reg. § 1.280F-7(b)(3) provides, "If listed property . . . is not used predominantly in a qualified business use in any taxable year in which such property is leased, the lessee must add an income inclusion amount."

If the lessor fails the 50 Percent Test and is required to use the Alternative Depreciation System, then it would seem inequitable to also require the lessee to report an income inclusion under this rule. While it may well be that such a double-taxation argument has merit, it should be noted that Temp. Treas. Reg. § 1.280F-5T(a) states that "The special rules for lessees set out in this section apply with respect to all lessees of listed property, even those whose lessors are not regularly engaged in the business of leasing listed property." Since this statement is not repeated in Treas. Reg. § 1.280F-7, it is possible that it only applies to the superseded lessee income inclusion rules under Temp. Treas. Reg. § 1.280F-5T. Furthermore, the regulation was intended "to provide for amounts to be included in the income of lessees . . . [that are] . . . intended to approximate the present value of the economic detriment imposed by sections 280F(a) and 280F(b) on similarly situated owners of listed property."[65] Therefore, it would appear inconsistent with the purposes behind § 280F to require the adjustment to be made twice – once for the lessor under § 280F(b) and again for the lessee under § 280F(c).

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The 50 Percent Test under § 280F is surprisingly complex. Understanding the relationship between the 25 Percent Test and the 50 Percent Test is key to applying this test to business aircraft. These calculations are frequently misapplied by taxpayers as well as IRS examiners, resulting in unnecessary controversy and confusion. Furthermore, IRS examiners tend to be reluctant to allow the § 280F(c) "business of leasing" exception. Hopefully, relief will be provided soon in the form of Treasury Regulations permitting a look-through election by which lessors can count as QBU the business use by Five-Percent Owner passengers on lessee flights.

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65 T.D. 8218, 1988-2 C.B. 40