

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: Associate Area Counsel – Jacksonville, CC:LB&I:RFPH:JAX  
(Large Business & International)

from: Chief, Branch 7  
Associate Chief Counsel  
(Income Tax & Accounting)

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subject: Change in Use of Airplane

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayers =  
A =  
B =  
C =  
D =  
E =  
F =  
G =  
H =  
I =  
J =  
K =  
L =  
M =  
N =  
O =  
P =  
Q =  
R =

S =  
T =  
U =

### ISSUE

Whether Taxpayers' leasing of an airplane to J for the commercial and contract carrying of passengers during the P taxable year constitutes a change in use of the airplane under section 168 of the Internal Revenue Code.

### CONCLUSION

Yes. The primary use of the airplane during the P taxable year was the leasing of the airplane to J for use in its charter business and, therefore, the classification of the airplane for the P taxable year changes from 5-year property to 7-year property.

### FACTS

Taxpayers, who are individuals, A and B, own 100 percent of C, which is taxed as a partnership for federal income tax purposes.

A also is the sole shareholder of several S corporations that own automobile dealerships located in D, E, F, and G. Through C, A provided management services to these dealerships.

During H, C purchased an airplane for business travel to the automobile dealerships and began to depreciate this airplane under section 168(a) as 5-year property.

In the years after H, the airplane became less necessary and less affordable, but A was unable to sell the airplane due to its depressed value. Therefore, in I (which is during the taxable year subsequent to H), C entered into a dry lease agreement with J, to offset the cost of maintaining the airplane.<sup>1</sup> The key provisions of this dry lease agreement are as follows:

1. J is a certified air carrier in the business of chartering aircraft.
2. C wishes to dry lease the airplane to J when C is not using the airplane.
3. J shall pay to C, per flight hour, \$K less \$L per assigned crew member provided by C.
4. C agrees to pay J \$M per month to keep the airplane on J's charter certificate.
5. J agrees to solicit charter business appropriate to the airplane and to dry lease the airplane from C when not in use by C.
6. C will pay all reasonable and necessary costs or expenses relating to maintenance, repair, and servicing of the airplane.

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<sup>1</sup> As used here, the term "dry lease" means K, the lessee, will put the airplane on its 14 C.F.R. Part 135 charter certificate and operate the airplane under K's name and charter.

7. At the end of the lease term, J shall return the airplane to C.

In a letter dated N, O, Taxpayers' attorney, provided information concerning the employment histories of the airplane's pilots, the pilots' W-2s, the airplane's flight tracker information, and the purpose of each trip for P and Q. Based upon the information provided, the airplane was used for more hours by J's charter business than by C for A's business travel to various automobile dealerships.

Specifically, during P (which is two taxable years after H), the airplane was used as follows: R flight hours for leasing (charter) use, S flight hours for business use (for A's business travel to various automobile dealerships), and T flight hours for Taxpayers' personal use. These flight hours total U hours.

Prior to the P taxable year, C depreciated the airplane under section 168(a) as 5-year property.

### LAW AND ANALYSIS

Section 167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in a trade or business or of property held for the production of income.

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in section 168(a); and (2) the alternative depreciation system in section 168(g). Under either depreciation system, a taxpayer computes the depreciation deduction by using a prescribed depreciation method, recovery period, and convention.

The applicable recovery period for purposes of either section 168(a) or 168(g) is determined by reference to class life or by statute. Section 168(i)(1) defines the term "class life" as meaning the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under section 167(m) (determined without regard to section 167(m)(4) and as if the taxpayer had made an election under section 167(m)) as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990. Former section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range (ADR) system of depreciation, the depreciation allowance was based on the class life prescribed by the Secretary that reasonably reflected the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations provides rules for classifying property under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Further, property

is classified according to primary use even though the activity in which such property is primarily used is insubstantial in relation to all the taxpayer's activities.

Section 1.167(b)-11(e)(3)(iii) further provides that in the case of a lessor of property, unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for the property is determined as if the property were owned by the lessee. However, in the case of an asset guideline class based upon the type of property (for example, trucks or railroad cars) as distinguished from the activity in which used, the property is classified without regard to the activity of the lessee.

Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under section 168. The revenue procedure establishes two broad categories of depreciable assets: 1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and 2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The same item of depreciable property can be described in both an asset category (asset classes 00.11 through 00.4) and an activity class (asset classes 01.1 through 80.0), in which case the item is classified in the asset category. See *Norwest Corp. & Subs. v. Commissioner*, 111 T.C. 105 (1998) (item described in both an asset and an activity category should be placed in the asset category).

Asset class 00.21 of Rev. Proc. 87-56 includes airplanes, except those used in commercial or contract carrying of passengers or freight, and all helicopters. Airplanes described in asset class 00.21 have a class life of 6 years and, consequently, are classified as 5-year property under section 168(e)(1). Accordingly, these airplanes have a recovery period of 5 years for purposes of section 168(a) and 6 years for purposes of section 168(g).

Asset class 45.0, Air Transport, of Rev. Proc. 87-56 includes assets (except helicopters) used in commercial and contract carrying of passengers and freight by air. Airplanes described in asset class 45.0 have a class life of 12 years and, consequently, are classified as 7-year property under section 168(e)(1). Accordingly, these airplanes have a recovery period of 7 years for purposes of section 168(a) and 12 years for purposes of section 168(g).

Section 168(i)(5) provides that the Secretary shall, by regulations, provide for the method of determining the deduction allowable under section 167(a) with respect to any tangible property for any taxable year (and the succeeding taxable years) during which such property changes status under section 168 but continues to be held by the same person.

Section 1.168(i)-4 provides the rules under section 168(i)(5). For purposes of section 1.168(i)-4, section 1.168(i)-4(a) provides that the year of change is the taxable year in which a change in the use occurs.

Section 1.168(i)-4(d)(1) provides that section 1.168(i)-4(d) applies to a change in the use of MACRS property (as defined in section 1.168(b)-1(a)(2)) during a taxable year subsequent to the placed-in-service year, if the property continues to be MACRS property owned by the same taxpayer and, as a result of the change in use, has a different recovery period, a different depreciation method, or both. For example, section 1.168(i)-4(d) applies to MACRS property that results in a reclassification of the property under section 168(e) due to a change in the use of the property.

Section 1.168(i)-4(d)(2)(i) provides that a change in the use of MACRS property occurs when the primary use of the MACRS property in the taxable year is different from its primary use in the immediately preceding taxable year. The primary use of MACRS property may be determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property.

Section 1.168(i)-4(d)(4)(i) provides that, if a change in the use results in a longer recovery period for the MACRS property before the change in the use, the depreciation allowances beginning with the year of change are determined as though the MACRS property had been originally placed in service by the taxpayer with the longer recovery period. MACRS property affected by section 1.168(i)-4(d)(4) is not eligible in the year of change for the election provided under section 168(f)(1), 179, or 1400L(f), or for the additional first year depreciation deduction provided in section 168(k) or 1400L(b). See section 1.168(i)-4(d)(4)(ii) or section 1.168(i)-4(d)(5)(ii)(B), as applicable, for determining depreciation for this property beginning with the year of change.

In the present case, the airplane was used in two business activities during the P taxable year -- used for A's business travel to automobile dealerships, and leased by C to J for use in its charter aircraft business. A's business use of the airplane is described in asset class 00.21 of Rev. Proc. 87-56. Because C leased the airplane to J who used the airplane in its charter business, the leasing use of the airplane is described in asset class 45.0 of Rev. Proc. 87-56. Section 1.167(b)-11(e)(3)(iii). The cost of the airplane is not allocated between these two activities. Instead, the total cost of the airplane is classified, for depreciation purposes, according to the activity in which the airplane is primarily used during the P taxable year. Section 1.167(a)-11(b)(4)(iii)(b). This determination may be made in any reasonable manner. Section 1.168(i)-4(d)(2)(i).

Several appellate decisions discuss the "primary use" standard for asset classification under section 1.167(a)-11(b)(4)(ii)(b). See, e.g., Clajon Gas Co, L.P. v. Commissioner, 354 F. 3d 786 (8<sup>th</sup> Cir. 2004). Courts have concluded that the actual purpose and function of an asset determines its asset class (a use-driven functional standard) rather than the terminology used to describe an asset by its owners or others.

Generally, the use of an asset used for transportation is measured in miles. For an airplane, another appropriate measurement of use is flight hours. In this case, the IRS examiner provided information about the airplane's flight hours during the P taxable year. No information about the airplane's mileage was provided. Accordingly, we will

determine the primary use of the airplane during the P taxable year based on the airplane's flight hours during that year.

Based on the information provided about the airplane's flight hours during the P taxable year, the airplane was used 83 percent (R / U) for the leasing (charter) activity, 15 percent (S / U) for A's business travel to automobile dealerships, and 2 percent (T / U) for Taxpayers' personal use. Applying the use-driven functional standard, the airplane was primarily used in the leasing (charter) activity during the P taxable year. Accordingly, for the P taxable year, the airplane is described in asset class 45.0 of Rev. Proc. 87-56 and is classified as 7-year property under § 168(e)(1).

The airplane was classified as 5-year property for the taxable year immediately preceding the P taxable year. Consequently, for the P taxable year, the classification of the airplane under section 168(e)(1) changes from 5-year property to 7-year property. Accordingly, such a reclassification constitutes a change in the use of the airplane for purposes of section 168(i)(5) and section 1.168(i)-4(d).

#### CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS



We note that we are not opining on the application of section 280F to the airplane.

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Please call (202) 622-4930 if you have any further questions.