86-SBE-188

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATS OF CALIFORNIA

In the Matter of the Appeal of) No. 84A-642-AJ
JAMES P. LENNANE)

Appearances:

For Appellant: James P. Lennane, in pro. per.

For Respondent: Alison Clark Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest, of James P. Lennane against a proposed assessment of additional personal income tax in the amount of $26,268 for the year 1981.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue,

The issues in this appeal are (1) whether for depreciation purposes, respondent properly increased the useful life of appellant's Learjet from 6 to 12 years and (2) whether the excess accelerated depreciation appellant claimed on the Learjet constitutes an item of tax preference income,.

In April 1981, appellant purchased. an eight passenger, two engine, Learjet Model 35A for use in his business. The Learjet was used commercially to carry passengers and as a medical air ambulance to transport organs for transplant operations. On his 1981 personal income tax return, appellant elected to depreciate the jet using the 150 percent declining balance method and elected the Class Asset Depreciation Range System. He applied a six-year useful life to the jet following the period listed for the Asset Guideline Class 00.21. Respondent determined t-hat the aircraft fell within class 45.0, which applies a 12-year useful life and therefore determined that part of appellant's claimed depreciation should be disallowed. Respondent also determined that appellant had erred in calculating his preference-tax, in that he did not include as an item of tax preference the amount by which depreciation claimed on the jet exceeded the amount which would be allowable using straight-line depreciation. Respondent determined that the jet was personal property subject to a lease and, therefore, that. the excess accelerated depreciation taken on it should have been included as an item of tax preference income. Respondent issued a proposed assessment reflecting its determinations which it affirmed after considering appellant's protest. This timely appeal followed.

The first issue is the amount of depreciation appellant is entitled to deduct in 1981.

Section 17208 allowed as a depreciation deduction a reasonable allowance for the exhaustion, and wear and tear of property held for the production of income. The property must be depreciated over its useful life. (Rev. & Tax Code, § 17208.) California regulations give the taxpayer the option of determining a property's useful life by referring to the federal class life Asset Depreciation Range (ADR) system and adopt, with certain exceptions not relevant to this appeal, Treasury Regulation section 1.167(a)-11. (Cal. Admin. Code, tit. 18, reg. 17208.) The class life system was designed to minimize disputes between taxpayers and the taxing agency as to the correct useful life of property. Use of the system is optional with the taxpayer who makes an annual election to use the system,

Once an election is made for the taxable year, it nay not be revoked. (Treas. Reg. 4 1.167(a).) Under the ADR system, the Commissioner of the Internal Revenue Service is authorized to prescribe class lives on an industry-by-industry or other basis. (Fort Howard Paper Company v. Commissioner, ¶ 77,422 T.C.M. (P-II) (1977).)

The class lives prescribed by the Commissioner are found in Revenue Procedure 77-10 which contains two asset guideline classes for aircraft. (Rev. Proc. 77-10, 1977-1 C.B. 548.1 Asset guideline class 00.21 includes airplanes used in all business activities, "except those used in commercial or contract carrying of passengers Of freight," and is assigned an asset guideline period of six years, (Rev. Proc. 77-10, supra, at 550.) Asset guideline class 45.0, applicable to assets used in air transport, "[i]ncludes assets , . . used in commercial and contract carrying of passengers and freight by air, ..." and is assigned a guideline period of twelve years. (Rev. Proc. 77-10, supra, at 563.) At issue in this appeal is in which of these two classes appellant's aircraft'belongs. Respondent contends that since the aircraft was used commercially to transport passengers and as a medical air ambulance to transport freight, it clearly falls within guideline class 45.0. Although appellant agrees that the aircraft was used as respondent claims., he argues that the twelve-year life assigned to class 45.0 is inapplicable to his aircraft. He contends that. for various reasons his aircraft has a shorter useful life than airplanes which are normally used in air transport and concludes. that his aircraft should be assigned the six-year life applicable to class 00.21. For the reasons expressed below, we agree with respondent.

Under the ADR system, property is classified according to its use. Treasury Regulation section 1.167(a)-11(b)(4)(b)(iii)(b) provides that "[f]or purposes of this section, property shall be included in the asset guideline class for the activity in which the- property is primarily used." As the court noted in Tennessee Natural Gas Lines v. Commissioner, 72 T.C. 74, 94, (1978), "this. regulation does not refer to the nature of the equipment or the manner in which it operates: rather, this regulation emphasizes the use to which the equipment is put." In the case before us, appellant's aircraft is used in the commercial carrying of freight and passengers, placing it squarely within class 45.0. Despite this,. appellant requests that we place his aircraft in class 00.21, a class which specifically excludes aircraft used as. his is used.. To do so would clearly be a misapplication of the ADR

system. The use of the AD2 system is optional-with the taxpayer, but once it is elected, the taxpayer is bound by the requirements of that system. Since appellant elected the AD2 system, and the use to which he puts his jet is within class 45.0 we must conclude that respondent correctly assigned it a twelve-year useful Life.

The second issue is whether excess accelerated depreciation claimed in connection with the airplane is an item of tax preference.

In addition to other taxes imposed under the Personal Income Tax Law (Rev. & Tax. Code §§17001-19452), section 17062 imposes a tax on the amount by which the taxpayer's items of tax preference exceed his net business loss. Included among the items of tax preference is the amount by which the deduction allowable for depreciation of personal property subject to a lease exceeds tne amount of depreciation allowable had the taxpayer used straight-line depreciation. (Rev. & Tax. Code §§ 17062, 17063, subd. (c), and 18211, subd. (a)(3).)

Respondent determined that the excess depreciation appellant claimed in connection with the jet is an item of tax preference. Appellant contends that it is not, because the jet was not subject to a lease-, For the 'reasons expressed below, we agree with. appellant.

Since the California statutes in question are substantially similar to section 57 of the Internai Revenue Code, federal interpretations of that section are relevant to our inquiry. (Holmes v. McColgan, 17 Cal.2d 426, 430 [110 P.2d 428], cert. den., 314 U.S. 636 (86 L.Ed. 510] (1941).) Federal regulations proposed under section 57 define a Lease for purposes of the minimum tax as "any arrangement or agreement, formal or informal, written Or oral, by which the owner of property (the "lessor") receives consideration in any form for the use of his property by another party." (Prop, Treas. Reg. § 1.57-3(d)(1), 35 Fed. Reg. 19768, 59769, (1970).) We believe that appellant's arrangements with his customers do not fall within this definition because he is providing his customers with a service, air transportation, rather than merely allowing them to use his aircraft. Although the use of the aircraft is necessary to the providing of the services, appellant's customers do not themselves use the equipment, since appellant maintains possession and control of the aircraft at all times. Appellant's aircraft was hired by various customers, on a short-term basis, with Payment either by the mile or the hour,. Appellant always

provided the pilot; in fact-he was required to do so by the Federal Aviation Administration. In addition, he provided ail fuel used and was soleiy responsible for maintaining the aircraft. Since appellant maintained control of the aircraft and did not give his customers direct use of it, we conclude that the aircraft is not subject to a lease. This conclusion is supported by the Intern-al Revenue Service's interpretation of a similar provision under section 48 of the Internal Revenue Code, (Rev. Rul. 71-397, 1971-2 C.B. 63; Rev. Rul. 68-109, 1968-T C.B. 10.) in addition, the Franchise Tax Board has cited no authority and no argument in support of their position, Therefore, we conclude that this property is not subject to a lease and that the excess accelerated depreciation claimed by appellant is not an item of tax preference. Respondent's action, therefore, must be modified,

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of James P. Lennane against a proposed' assessment of additional personal income tax in the amount of $26,268 for the year 1981, be and the same is hereby modified in accordance with the foregoing opinion. In all other respects, respondent's action is sustained.

Done at Sacramento, California, this 19th day of November, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9