



MISSION POSSIBLE !!!

PROPERLY STRUCTURING THE ACQUISITION AND OPERATION OF BUSINESS AIRCRAFT

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This Article is Part 2 of a 2 Part Series

When last we left you, our intrepid hero and busy executive, you were halfway through your Mission to acquire an aircraft for your company to provide senior management with efficient, safe and secure transportation. As you quickly realized, finding the right aircraft was just the beginning.

The acquisition and operation of business aircraft requires planning, communication and an experienced business aviation team that can handle Federal Aviation Administration (FAA) regulations, sales and use taxes, Federal income and excise taxes and liability protection issues. Equally important is getting your team to work together to smoothly manage your aircraft's acquisition and operation, and not create unanticipated problems.

In Part 1 of this 2 Part Series, you met two experts who helped you through some thorny aircraft acquisition problems. First, your FAA expert suggested that, in order to avoid costly FAA trouble, your aircraft should be owned by a special purpose entity (SPE) and your company should maintain operational control of the aircraft for

FAA purposes through a "dry lease" arrangement. Second, your Sales and Use Tax (SUT) Expert was able to save you \$1 million in state sales and use tax on the purchase of your aircraft under a state law (called a "sale-for-resale" exemption) that allows a company to purchase an aircraft tax-free if it leases the aircraft at arm's length to other parties. This Article will focus on your Federal Tax Expert, whom you also need to speak with when acquiring your aircraft because there are important Federal tax issues affecting both the acquisition and operation of your aircraft.

The Federal Tax Expert: Structuring Your Aircraft Acquisition and Operations to Maximize Tax Benefits and Minimize IRS Tax Audit Risks

As you might expect two Federal Tax Experts to suggest, it is best to talk with your Federal Tax Expert at the beginning of your Mission. IRS tax audits can be exceptionally time consuming, expensive and invasive. Tax audits are a fact of business life, but when an aircraft's acquisition and operation has been properly structured by a Federal

Tax Expert, your IRS audit can be reduced in scale from a screaming nightmare to a mere inconvenience. There are several Federal tax issues affecting aircraft acquisition and operation that you need to plan for.

1. Tax Free Exchanges: Legally Paying No Federal Income Tax

Your company could be acquiring an aircraft for the first time, or as is often the case, your company already owns an aircraft and is selling that aircraft. In those circumstances where you are both selling an aircraft and purchasing a new one, you have an opportunity to avoid Federal income taxes on the sale of the old aircraft by combining both transactions into a tax-free “like-kind exchange” (LKE).

On the sale of an aircraft, there is the potential for you to incur significant Federal income taxes. Your old aircraft has probably been “depreciated” for tax purposes, and so when you sell that aircraft you may need to pay Federal tax on the amount of depreciation taken (called “depreciation recapture”) at ordinary income tax rates. In addition, you could sell your old aircraft for even more than what you bought it for, which is economically good, but would be additional gain subject to Federal income tax at capital gains rates. Instead of paying Federal income tax now, however, you can defer the Federal tax otherwise due on the sale of your old aircraft.

Under Internal Revenue Code (Code) Section 1031, business and investment property may be exchanged tax-free for other like-kind business and investment property. In our case, an LKE would defer the tax on the gain from your old

aircraft until your new aircraft is sold. As an additional benefit, your new aircraft could itself later be disposed of in an LKE, thereby again deferring the gain from the old aircraft. The LKE is a powerful tax-planning tool, but one that requires careful attention to many specific and technical requirements under the Code and IRS Treasury Regulations. For example, the purchase and sale documentation will need to evidence your intent to conduct an LKE. Arrangements for payment of proceeds from the sale of your relinquished aircraft must be made prior to closing; ordinarily, simply having proceeds held in “escrow” with a title and escrow company will be insufficient. Also, coordination with your SUT Expert, who might want to use a state “trade-in” credit, is critical due to the potential inconsistencies between state law and Federal law requirements. Therefore, you need the expertise of your Federal Tax Expert to properly implement the LKE.

2. Federal Excise Taxes: Take the Lesser of Two Evils

Under the Code, the IRS imposes either a Federal Excise Tax (FET) of 7.5% on amounts paid for receiving taxable transportation or an FET on fuel. When your company is operating an aircraft under FAA Part 91, you will want the FET on fuel to apply because it can be much less than the FET on amounts paid for taxable transportation. The IRS can, however, impose on your company the FET on FAA Part 91 operations if you are not careful.

Typically, a company will not use its aircraft all the time, so instead of leaving the aircraft on the ground unused while paying fixed costs, a company will enter

into an agreement with an aircraft management company in which the management company will pay your company a fee to charter the aircraft to other companies or individuals. When your company is using the aircraft for non-commercial purposes under FAA Part 91, you will want to ensure that you are treated by the IRS as remaining in “possession, command and control” of the aircraft during such use. If not, it is possible for the IRS to assert that your company’s Part 91 flight is really being conducted pursuant to the management company’s possession, command and control. For example, you may have given up possession of your aircraft if you have allowed a charter flight to be placed on the schedule that cannot be reasonably canceled. In such an event, all of the costs and expenses that are paid in connection with such flights would be subject to the 7.5% FET, instead of the lower FET on fuel. Also, aircraft management agreements are commonly put into the aircraft owning entity’s name, but often this entity is an SPE, so this will cause the amounts funded into this entity as “capital contributions” or “reimbursements” to be subject to the 7.5% FET.

3. Tax Depreciation and Tax Deductions for Aircraft Operations: Don’t Lose It!

The biggest Federal tax benefit of owning a business aircraft is your ability to “depreciate” that asset and deduct aircraft operating expenses for Federal tax purposes.

“Accelerated depreciation” is a tax deduction intended to encourage businesses to acquire assets and use them in their trade or business. Therefore, your \$20 million aircraft

acquisition can generate a \$20 million tax deduction for your company over a five-year accelerated cost recovery period, even though the aircraft itself may still be worth \$20 million or more at the end of such period. In addition, the expenses of operating the aircraft (i.e., fuel, pilots, storage) can also be deductible.

Here’s the catch: the IRS has a number of tools for disallowing and limiting aircraft depreciation and expense deductions. Without bogging you down in the details that your Federal Tax Experts know and love, you need to be aware of a couple of things.

First, the IRS must agree that your company is a “trade or business” and that your aircraft expenses are “ordinary and necessary” for your business activity. These are subjective standards that the IRS and taxpayers frequently disagree upon. Therefore, the facts in each situation must be fully understood so that the best presentation of your company’s business activity can be made to the IRS. If you place your aircraft in an SPE and run all of your expenses through this SPE, even though you may use the aircraft in another business activity in which you are engaged, it is likely that the IRS will assert that the aircraft owning entity is not engaged in a “for profit” activity and therefore expenses in excess of revenue are not deductible (in addition to the 7.5% FET problem discussed above).

Second, if the entity owning the aircraft is a “passthrough entity” such as a partnership, S corporation and most limited liability companies, aircraft deductions may be further limited. For example, under the “passive loss” rules, tax losses caused by depreciation and

expense deductions can be suspended if the owner of the passthrough entity does not “materially participate” in the business or if the business is treated as engaging in a rental activity (such as leasing to a charter company). Also, under the “at-risk” rules, owners of passthrough entities could be prevented from deducting losses greater than the amount of cash or property they contributed to the entity, or company indebtedness beyond which they are personally indebted (in most cases, a personal guaranty will not qualify).

4. Personal Use of Aircraft: How Can You Say No to the CEO?

Your company is using the aircraft for business purposes, but the company’s CEO and majority shareholder wants to use the aircraft to fly him and his family to a vacation destination. Are you going to say no? Before answering the question, you need to be alerted to a couple of things that could potentially put a damper on that vacation.

First, you probably do not want to charge the CEO for the cost of the flight, regardless of whether the CEO is willing to pay because such payment could inadvertently cause FAA problems. Instead, the value of the CEO’s personal use of the aircraft should be imputed as a taxable fringe benefit to the CEO. The IRS permits you to determine the “value” of the flight in two different ways. Under the “Fair Market Value” rule, the CEO is imputed with a taxable fringe benefit equal to the cost of chartering a similar aircraft for a similar flight on an arm’s length basis. The other method, called the “Standard Industry Fare Level” (SIFL) rule is less expensive for the CEO (and so probably preferred by him). Under SIFL, the

CEO’s flight is valued based on a cents per mile formula which will normally be lower than the “Fair Market Value” rule. However, this comes at a cost to your company because of a relatively new tax law.

Congress recently enacted the American Jobs Creation Act of 2004, amending the Code (again) to prohibit taxpayers from deducting the full cost of their aircraft in the event of recreational use. It may be possible to avoid this result through revised ownership and operational planning, which currently is “aggressive” due to the lack of sufficient guidance in this area. A discussion of such planning opportunities is beyond the scope of this article. Ultimately, the point is to keep in mind that recreational use of the company’s aircraft by an individual on board any flight (even a flight operated primarily for business purposes) can adversely affect your company’s Federal tax deductions.

Mission Accomplished

Congratulations! By reading through this article, you have completed your true Mission: you have learned that when it comes to the acquisition and operation of business aircraft, some up-front planning, and a capable team of professionals, can help you maximize your business aircraft ownership experience. We’re expecting your call!