Income Tax Implications of the Revisions to Op Spec A008
Did the FAA Raise Your Taxes?

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In last month's issue of World Aircraft Sales, Craig Weller discussed the FAA's revisions to its standard operations specification paragraph A008 ("Op Spec A008") (see Charter Management and the FAA: An Update, pg. ___), and the impact that the revisions to Op Spec A008 and the FAA's accompanying guidance materials will have on business aircraft charter management agreements. This month, we will take a look at how the revisions to Op Spec A008 may affect your income tax planning.

Prospective purchasers of business jet aircraft must consider many factors in making a decision to purchase an aircraft. Two factors most commonly considered when purchasing an aircraft for business use are income tax efficiencies, and the potential for cash flow from third-party charter operations to offset fixed costs. In considering income tax efficiencies, prospective purchasers often ask: "Will I be able to fully depreciate the aircraft and use tax losses from depreciation and operating expense deductions to offset income from other sources?" In considering cash flow factors, prospective purchasers often ask: "Will I be able generate revenue from chartering my aircraft to offset fixed costs and thereby reduce my overall budget for my own use?" Unfortunately, these seemingly harmonious objectives pit the IRS rules against the FAA rules.

Prior to the issuance by the FAA of the revised Op Spec A008 and the FAA's accompanying guidance, with careful tax and FAA planning, and involvement of the owner in the day-to-day aircraft operations, both questions could have been answered in the affirmative. The revised Op Spec A008 and the FAA's accompanying guidance has, however, made it more difficult to plan an aircraft ownership and operations structure that meets both objectives. And, regardless of guidance from the national office of the FAA, as a practical matter, FAA Regional Counsel and Inspectors are applying their own provincial interpretations of Op Spec A008.

Based upon our experiences in advising well over 1,000 aircraft owners, and talking with aircraft manufacturers, brokers, dealers and management companies, we routinely hear the common belief that the more chartering that occurs, the better the tax benefits to the aircraft owner -- nothing could be further from the truth. This is true because the provision of an aircraft by the owner to the charter company is basically a lease; which the IRS may

deem to be a rental activity with respect to the owner.

The problem of classifying use of the owner's aircraft for third-party charter as a rental activity is that, in general, rental activities are "passive activities." Tax losses (i.e. depreciation) generated from passive activities may only be used to shelter passive income. Most of our clients (and everyone else reading this article) have very little, or no, passive income. Passive income is commonly earned from rental real estate activities where the taxpayer does not materially participate. Absent passive income, the tax depreciation from the aircraft will be worthless, as it will not shelter any taxable income.

This "rental activity" classification may be avoided, however. IRS regulations provide seven "exceptions" to the rental activity classification. The one that is most commonly relied upon in the industry provides that an activity is not a rental activity if "extraordinary personal services" are provided by or on behalf of the owner of the property in connection with making the property available to customers. In the context of a business aircraft, the phrase "extraordinary personal services" is generally considered to mean the provision of pilot services. Thus, where a business aircraft owner employs his or her own pilots, and provides both the aircraft, and the pilots to fly the aircraft, to the Part 135 charter operator, the aircraft owner may be able to avoid a rental activity characterization of the activity on the basis that the owner provided the aircraft to the Part 135 charter operator together with "extraordinary personal services." Conversely, IRS field auditors' internal guidelines recommend denial of the "extraordinary personal services" exception in cases where the aircraft owner does not employ the pilots.

Of course, providing both an aircraft, and pilots to fly the aircraft, to a Part 135 charter operator, is not enough to avoid a "passive activity" characterization of tax losses. It is also necessary for the aircraft owner to "materially participate" in the chartering activity; generally this means at least 10 hours per week of active involvement in the day-to-day aircraft operations. As a practical matter, many aircraft owners will not want to devote this substantial amount of time, and most charter companies will not welcome their involvement. What about the FAA? Well, it goes without saying that the FAA certainly does not welcome their involvement.

So how has Op Spec A008 impacted the ability of business jet aircraft owners to structure operations under the "extraordinary personal services" exception? Well, as mentioned last month, revised Op Spec A008 requires that all pilots on Part 135 charter flights be either direct employees or agents of the Part 135 charter operator, and the FAA guidance with respect to revised Op Spec A008 indicates that if pilots flying a Part 135 charter flight receive monetary compensation from the owner of the aircraft instead of the Part 135 charter operator, the Part 135 charter operator may be considered to have relinquished operational control of the flight. Consequently, it will be difficult to comply with both revised A008 and the "extraordinary personal services" exception at the same time.

Stay tuned for more updates. As mentioned in Craig Weller's article, the NBAA has been working to persuade the FAA to rescind that portion of the

guidance materials that indicate that a Part 135 charter operator may be considered to have relinquished operational control of the flight if the pilots receive compensation for the flight from the aircraft owner. If the NBAA is successful, the door to the "extraordinary personal services" exception may again be open, at least by a crack. Even so, we will still have to work with the FAA Regional Counsel and Inspectors who apply their own interpretation to the "direct employee or agent" language of revised Op Spec A008. Artful drafting of agreements submitted to the FAA will become paramount. Regardless of whether the NBAA is successful in its endeavor, there is likely to be a substantial amount of confusion on this issue in the industry for the foreseeable future.

Despite these problems, we remain optimistic. Creative and thoughtful (and perhaps aggressive) tax and FAA planning is still possible to achieve the desired objectives. This type of planning should not be taken lightly, and requires the expertise of experienced tax and FAA professional advisors.

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