MISSION POSSIBLE !!!

PROPERLY STRUCTURING THE ACQUISITION AND OPERATION OF BUSINESS AIRCRAFT

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"Good Morning. Your mission is to acquire an aircraft that provides senior management with efficient, safe and secure transportation. Assemble your team carefully and get started - but should you fail, the Agency will disavow any knowledge of your existence. Good Luck. This tape will self-destruct in 5 seconds………."

Just as it takes planning and teamwork to save the world from evildoers, properly structuring the acquisition and operation of business aircraft requires planning, communication and an experienced business aviation team. Your team needs to handle Federal Aviation Administration (FAA) regulations, sales and use taxes, federal income and excise taxes and liability protection issues. Getting your team to work together could be tricky, because when it comes to business aircraft acquisition and operation, solving one problem could unintentionally create another. So, let's pull your team together and get this Mission started.

1. The FAA Expert: Skilled in Preventing a Flight Department Company Problem

At the mention of acquiring an aircraft, corporate counsel and risk managers will become concerned about liability. If there is an accident, the company will be at risk for a lawsuit and its assets will be exposed to cover any such liability if there is inadequate insurance or if the insurance company refuses to cover the claim. The company's shareholders will also be concerned about liability and may inquire as to why the company has put itself in this position.

To avoid these problems, corporate counsel might think to create a special purpose "flight department" entity with no assets other than the aircraft and no purpose other than operating the aircraft for the parent company, and perhaps affiliated entities. Problem solved? Is the parent company protected from liability relating to the aircraft? Not likely, and this is where your first Mission team member, the FAA Expert, jumps in to prevent a major FAA violation.

You will probably want the aircraft to operate under the FAA's noncommercial Part 91 regulations, as compared to the more stringent Part 135 regulations that apply to the commercial use of aircraft. Part 91 generally applies to aircraft with less than 20 passenger seats and less than 6,000 pounds of maximum payload capacity that are operated, without compensation, by and for the owner with its own flight crew. FAA rules permit a subsidiary company to fly an aircraft carrying executives from its parent company or other subsidiaries of the parent under Part 91 without an FAA air carrier certificate. However, except in the parent-subsidiary context, if any "compensation" is received by the aircraft's operator, the FAA could claim that Part 91 does not apply, and try to require the operator to obtain a commercial certificate and comply with the Part 135 regulations. Furthermore, the FAA may bring an enforcement action against both the company, with fines of up to $11,000 per violation, and its pilots, who could lose their licenses.

So, how does this affect our "flight department company?" After all, it will only fly for its parent company and affiliates, receive no cash for flying, and is never expected to make a profit. According to the FAA, anything of value can represent compensation, including remuneration for operating expenses, accounting chargebacks between affiliated entities, furthering the economic interests of the affiliate, any provable quid pro quo between the companies, or obtaining a tax deduction for carrying persons or property of the affiliate. The FAA may take the position that a flight department company is receiving compensation even if the company can prove that it does not operate for profit.

Your FAA Expert should also inform you that Part 91 flying must be "incidental to and within the scope of" some business other than transportation by air. Unfortunately, our "flight department" subsidiary in this case has no business except transportation by air. FAA Chief Counsel interpretations provide that a company without business other than a flight department may not fly under Part 91, but must instead obtain an FAA certificate and comply with Part 135.

So, what to do? There are a number of different ways around this Mission problem. One solution that your FAA Expert may suggest is for your special purpose entity to "dry lease" the aircraft to the ultimate user of the aircraft. A dry lease is a lease of an aircraft without the flight crew. In the case of a dry lease, the lessee generally has operational control of the aircraft for FAA purposes, and so the aircraft owning company structure can still qualify under Part 91. By contrast, a "wet lease" is a lease of an aircraft with at least one crew member, the lessor generally has operational control of the aircraft and the FAA rules generally treat a wet lease as a charter operation, which must be conducted under Part 135.

If the ultimate user of the aircraft is the parent company, the parent company will still be at risk for liability relating to the aircraft's operations. FAA compliance and liability protection are usually at odds, but FAA compliance is the starting point for proper aircraft acquisition and operation. A significant amount of aircraft liability insurance is always prudent. By complying with FAA regulations, there is less chance that the insurance carrier will attempt to deny coverage in the event of an accident where it is discovered that the aircraft's use was not in compliance with FAA rules.

Since complete liability protection and FAA compliance is a difficult "balancing act", is a special purpose entity owning the aircraft still necessary? Your Sales and Use Tax (SUT) Expert has something to say.

2. The Sales and Use Tax Expert: Saving You A Million Dollars

Most states impose a sales tax or a use tax of between 3% and 10% of the value of an aircraft at the time that the aircraft is purchased. On a $20 million aircraft, a 5% sales tax means a $1 million tax liability….. but your SUT Expert will have some planning ideas that can lawfully reduce this tax hit.

By way of background, a state may impose a "sales tax" on the purchase or lease of an aircraft within its borders. On the purchase of an aircraft, the sales tax only applies in the state where the aircraft is delivered. However, on the lease of an aircraft, multiple states could claim that its sales tax applies to the transaction, including the state where the aircraft is delivered at the beginning of the lease, the hangar location of the aircraft, or any other state that has jurisdiction to tax the aircraft.

In addition to sales tax, a state may impose a "use tax" on the use, storage, or consumption in the state of an aircraft acquired outside the state and subsequently brought into the state. The sales tax and the use tax work together. The use tax is basically a "backstop" tax that applies to the use of property when the sales tax did not apply to the purchase of that property. Because the sales tax and the use tax work together, a taxpayer will normally not be subject to both the full sales and use tax. For example, if a company pays sales tax in one state on an aircraft, but lands the aircraft in a second state, the second state may be able to impose a use tax, but may also give the company a tax credit that reduces its use tax to the extent sales tax was paid on the aircraft in the first state.

As a practical matter, most states will not attempt to assess a use tax against an aircraft owned by a nonresident who occasionally operates the aircraft in their state. However, aircraft purchasers and owners should be familiar with the use tax provisions of the state where the aircraft will be hangared, the state in which the company has its principal place of business, and any other state where the aircraft may be frequently used or stored.

Back to our Mission. You are acquiring an aircraft and your FAA Expert has suggested that you "dry lease" the aircraft to the ultimate user of the aircraft in order to comply with the FAA's noncommercial Part 91 regulations. However, you do not want to needlessly pay state sales and use tax.

Your SUT Expert will tell you that several types of exemptions may be available to permit you to purchase an aircraft tax-free, but for this Mission, the statutory "sale-for-resale" exemption to sales and use tax should be the way to go.

In many states, a company or an individual can use a separate business entity to purchase an aircraft tax-free if its sole use of the aircraft will be to hold the aircraft for arm's length leasing to other parties. Under this structure, there is no sales tax on the purchase of the aircraft, although the lease payments would be subject to sales tax since, under most states' laws, leasing is treated as a taxable sale subject to sales tax. However, this can be an economically beneficial trade-off because, instead of paying up-front sales tax on the purchase price of the aircraft, sales tax can instead be deferred and paid out over the lease term on the lease payments. Therefore, the ultimate total sales tax on a lease may be less than the sales tax on the purchase of the aircraft, depending upon the number of years that the aircraft is owned and leased. Under "time value of money" principles, it will also cost you less money to pay taxes over time compared to paying them up-front in one lump sum.

THE CLIFFHANGAR

Our Mission to acquire a business aircraft is moving forward thanks to your FAA Expert and SUT Expert, but what about depreciation? Deductibility of operating expenses? Personal use limits and Federal Excise Tax? Will experts in these areas agree with what the FAA and SUT Experts are doing? Stay tuned………………