Reconciling Federal Tax Planning with State Sales and Use Tax and FAA Considerations

by

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There are many traps for the unwary in reconciling the FAA, state tax, and federal tax considerations involved in structuring aircraft transactions. For example, one of the first instincts of attorneys inexperienced in corporate aircraft structuring is to place the newly acquired aircraft, together with pilots, crew, and administrative staff, in a separate company (Newco) to isolate its liabilities. Newco will provide transportation services to Newco's shareholders and/or companies owned or controlled by Newco's shareholders and seek reimbursement to cover its costs. What may seem to be effective liability planning, however, is often the worst possible plan from the Federal Aviation Administration's (FAA) point of view, as well as from a federal tax and possibly state tax perspective as well.

Because Newco, in this structure, is providing aircraft and crew, the FAA views Newco as a transportation service provider, even if its only customers are Newco's shareholders and the related companies. Newco will be ineligible for the favorable rules under which most corporate aircraft are operated: Federal Aviation Regulation (FAR) Part 91, and, if it does not obtain an FAR Part 135 certificate or operate the aircraft under a third party's FAR Part 135 certificate with respect to all such flights, Newco and its pilots will be subject to substantial civil fines and disciplinary action. Furthermore,

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ironically, the liability protection planning for aircraft operations will also not be effectively achieved because Newco's shareholders and the related companies may have "operational control" of the aircraft on all flights conducted under FAR Part 91, and consequently all responsibility for decisions concerning conduct of the flight (other than safety related decisions retained by the Pilot in Command) will have shifted to Newco's shareholders and the related companies. Indeed, the only liability protection that is likely afforded in this structure is related to Newco's creditors (e.g., for borrowed funds and vendor purchases).

Additionally, the IRS has issued numerous Revenue Rulings and Private Letter Rulings under Code Section 4261 (Federal Transportation Excise Tax), stating that the transportation provided to Newco's shareholders and the related companies in this structure is "taxable transportation," and all amounts paid (constructively or actually and whether or not characterized as payments, reimbursements, or equity or debt capitalization) are taxable and subject to applicable Federal Transportation Excise Tax. Finally, any state sales and use tax planning which relies on a "sale for resale" exemption under applicable state law, will be undermined; the sate would likely view Newco's activities as service oriented, rather than leasing of property.

The solution is a simple restructuring. Typically, sufficient liability protection can be achieved in concert with FAR compliance by having Newco *dry lease* the aircraft to the related companies and cause the related companies to obtain pilots and crew from an unrelated third party.

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Once the FAA issue is solved through a dry lease structure, or other solution, the focus often shifts to federal tax planning. Assuming one of the objectives of the planning is to allow Newco's individual owners to benefit from depreciation related losses, the lease structure has a major flaw. Under federal tax rules governing passthrough entities, such as Newco, any losses derived from a passive activity are suspended until the owner of the passthrough entity receives passive income or liquidates his or her investment. Normally, the owner can avoid passive loss characterization by devoting enough time to the business of the passthrough entity to exceed the "material participation" threshold, but losses derived from a "rental activity" are almost always passive. A dry lease, in particular, is passive under IRS precedent. A wet lease - - aircraft with pilots and crew - - is not passive.

As is often the case, the aspect of the planning designed to address concerns of one authority creates problems for the planning from the perspective of another. In this case, the planning to utilize losses from tax depreciation would favor the original structure, where Newco provided pilots and crew, but this planning is in tension with other federal tax considerations, and FAA and state sales and use tax concerns. The structure must be modified to fit within one of the exceptions to the "rental activity" rule, and still comply with FAA rules. The means for accomplishing this vary widely from case to case, but one technique is to restructure the organization so that the owner of Newco owns the same percentage of the lessee entities.

Under this exception to the "rental activity" rule, the owner of one entity may lease to another entity of which he owns an identical proportion without adverse effect. For example, a wholly owned S corporation (S1), owning an aircraft, can dry lease the

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aircraft to another wholly owned S corporation (S2) for use in S2's business, and losses derived from aircraft depreciation will not be characterized as losses from a passive rental activity. However, S1's owner's losses *would* be characterized as passive if S1 leased the aircraft to a limited partnership of which the owner owns only fifty percent (50%). This is an all-or-nothing exception, the owner does not, unfortunately, get the opportunity to characterize 50% of the losses as active losses.

Frequently, one of the owner's objectives is to offset the cost of aircraft ownership to some degree by making the aircraft available for public charter. This objective fits well with federal tax planning goals, because it gives Newco substance and can improve Newco's bottom line profitability, even if it does not make Newco profitable. For reasons that are obvious, the FAA will not allow Newco to charter the aircraft to the public directly, and, if the aircraft is chartered, it must, at all times during charter, be under the operational control of a Part 135 operator. Accordingly, Newco must enter into an agreement with a charter operator that transfers complete operational control of the aircraft to the operator for the purposes of charter.

The problem with this approach is that the typical agreement provided to Newco for signing by the charter operator resembles a dry lease. As discussed above, a dry lease results in passive income or loss characterization, and the IRS will apportion Newco's basis in the aircraft. Any loss derived from the part of Newco's activities related to charter will be a passive loss.

One possible solution to the *per se* characterization of charter related receipts as passive rental income is to adjust the terms of the agreement between Newco and the charter operator so that the charter operator bears certain aircraft related costs (which are

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covered by the gross charter receipts) during the term of the agreement. Assuming this is done correctly, and the payments owed by the charter operator to Newco are substantially reduced, Newco may be able fit within a narrow regulatory exception for rental income that is less than two percent (2%) of the lesser of the unadjusted basis (cost basis) or the fair market value of the aircraft which allows Newco to disregard the rental activity as a *per se* passive separate activity. This approach adds the complexity, however, of creating an extra sets of records to account for Newco's charter and non-charter activities separately.

Another potential issue that dry leases create relates to the state sales tax treatment of the structure. Ordinarily, a dry lease is beneficial, because it allows Newco to benefit from the sale for resale exemption. Tax is assessed not against the entire purchase price, but against individual lease payments. At other times, however, the need to have a dry lease in place between Newco and affiliates or between Newco and the charter operator can complicate state tax planning. First, where the state has a casual sale exemption, the exemption is sometimes inapplicable where the buyer intends to use the purchased property in a taxable transaction. States ordinarily consider leases to be taxable transactions, and, therefore, the casual sale exemption may be inapplicable because of a dry lease.

Second, where the state has a "trade-in" credit, and Newco or one of its affiliates owns a trade-in aircraft, the tax can sometimes be limited to the difference in value between the trade-in aircraft and the new aircraft. This can result in a dramatic reduction in tax, but the strategy can rendered ineffective as a result of a dry lease. Although it may benefit from the exemption originally, Newco's subsequent lease of the aircraft will often

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be viewed as a second taxable transaction. Tax will be due on lease receipts. The dry lease, therefore, undermines Newco's ability to benefit from the trade-in credit.

The process of reconciling the objectives of the aircraft buyer with the conflicting rules of the FAA, the IRS, and state tax authorities is challenging to the most experienced of practitioners. Often the ideal planning for one regulatory regime will completely defeat the owner's objectives, because of its effect in another forum. Successful planning requires a thorough understanding of the pitfalls that are likely to arise, and techniques for avoiding them. The best structure is the one that causes the owner to compromise least on the owner's objectives, minimizes risk, and does not generate unanticipated consequences.

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