Special Purpose Entities: To Use or Not to Use?

-By Brian J. Heisman & Troy A. Rolf-

GKG Law, P.C.
1054 Thirty-First Street, N.W.
Washington, D.C. 20007
Phone: (202) 342-5200
Facsimile: (202) 965-5725

Aviation Group
Keith G. Swirsky
-kswirsky@gkglaw.com
Troy A. Rolf
-trolf@gkglaw.com
John Craig Weller
-cweller@gkglaw.com
Brian J. Heisman
-bheisman@gkglaw.com

Maybe you have been in this situation before. Your company is profitable, growing, and frequently charters aircraft to meet the business transportation needs of the company's executives. You have determined that your company requires the use of a corporate aircraft frequently enough to justify the purchase of a corporate aircraft. Of course, a corporate aircraft is a high value asset, and operating a corporate aircraft creates a potential for extensive liability exposure. You therefore conduct due diligence by discussing aircraft ownership and operations structuring options with your in-house general counsel and/or accountant. Your counsel or accountant (who is unfamiliar with the ins-and-outs of corporate aircraft operations) advises that your company form a subsidiary (a "special purpose entity" or "SPE") for the sole purpose of owning and operating the aircraft because he or she believes it will shelter the profitable parent company from any potential liability exposure arising from the operation of an aircraft. You follow your counsel's/accountant's advice. Your due diligence is now done, right? Well, maybe not.

The above scenario describes what is perhaps the most common error in structuring corporate aircraft ownership and operations. Before following such advice, you should make sure you understand all of the possible ramifications of purchasing and operating the aircraft when using a special purpose entity. For example, structuring aircraft ownership and operations as described above could result in a determination by the Federal Aviation Administration (FAA) that your SPE is operating a commercial charter business without the appropriate licenses and certificates. Further, depending on the specific details of the ownership structure, structuring aircraft ownership and operations as described above could also subject your flight operations to the federal excise taxes applicable to commercial air transportation and/or undermine effective state sales and use tax planning.

As a general rule, when an aircraft is being operated under Part 91 of the Federal Aviation Regulations (FARs), the aircraft operator cannot receive compensation of any kind for the provision of air transportation to any other party (FAR Part 91 provides the general operating rules applicable to all aircraft operations). The FAA interprets "compensation" very broadly, to include capital contributions, loans, etc. Effectively, any economic benefit provided to the aircraft operator could be deemed compensation, so there is essentially no legitimate way to fund the operations of an aircraft when it is operated by a SPE in such a

manner as to avoid a determination that the funds constituted "compensation" for air transportation services. The FAA has consistently held that a company that operates an aircraft principally for the purpose of providing air transportation services to another company may not fly under Part 91, and rather must obtain an FAA air carrier operating certificate and conduct operations under FAR Part 135 (FAR Part 135 provides an additional layer of regulation applicable to charter and on-demand operations for compensation or hire), even where the sole recipient of the air transportation services is the aircraft operator's own parent company or affiliates. Consequently, the use of an SPE to operate an aircraft on behalf of its parent operating business, as described above, would force aircraft operations to be conduced under FAR Part 135. In such an event, the failure of the SPE to obtain an FAA air carrier operating certificate and conduct operations under FAR Part 135 could undermine the very liability protection planning that the SPE was intended to provide, and could cause a variety of other problems, including FAA civil penalties, and cancellation of insurance or denial of insurance claims.

After reading the previous paragraphs, you may decide it is in the best interest of your company to abandon the idea of purchasing an aircraft with an SPE. However, you should bear in mind that the FAA rules described above prohibit an SPE from operating an aircraft under FAR Part 91, but do not prohibit an SPE from owning an aircraft. Thus, there are planning opportunities available in order to utilize an SPE to purchase the aircraft, but nonetheless operate it under FAR Part 91. One such planning opportunity is for the SPE to purchase an aircraft, and then enter into a dry lease (a lease where the lessor [in this case the SPE] provides only the aircraft and not a flight crew) of the aircraft with the parent operating business (a typical approach used for sales tax planning as well). Pursuant to the terms of the dry lease, the parent operating business must hire its own pilots, and generally manage the aircraft on its own behalf. Utilizing such a structure, if implemented properly, will not undermine the strict requirements for operating under FAR Part 91, as, by virtue of the dry lease, the lessee (i.e., the parent operating business) becomes the operator of the Aircraft. Further, if the aircraft is being operated by the parent business, so long as transportation is within the scope of, and incidental to the business of the parent company, then, under certain circumstances, the parent may also take advantage of an exception to the no-compensation-under-Part 91 general rule that would allow parent operating business to also use the aircraft to provide air transportation services to its own parent company, its own subsidiaries, and other subsidiaries of its own parent, all on a fully cost-reimbursable basis (but not a for-profit basis). But that is an issue for another article.

Provided you have decided to operate under FAR Part 91, and provided a complying dry lease structure is in place, it will be necessary to determine what type of SPE entity to use. Aircraft are assets that generate heavy losses (mainly through depreciation). SPEs are generally pass-through entities that allocate the tax losses generated by aircraft operations to the parent operating company. Depending on the tax classification of the losses, the parent company may be entitled to net the losses against income from other operations in the parent operating business.

In a March 2, 2009 letter to the Transportation Security Administration, the Chairman of the Committee on Homeland Security, U.S. Representative Bennie G. Thompson himself voiced "serious concerns… about several components in the NPRM" and urged postponement of final implementation of the new general aviation

One type of pass-through entity often used is an "S" corporation. Additionally, if the parent operating business is an "S" corporation, they will often utilize a qualified subchapter "S" subsidiary (also known as a QSUB or QSSS). A QSSS is disregarded for federal income tax purposes, and the assets of the QSSS are treated as being owned directly by the parent "S" corporation. While the regulations governing "S" corporations allow for losses to be passed to the corporation's shareholders, one possible disadvantage to the use of an "S" corporation is the limitations on the types and number of shareholders. For example, in order to qualify as an "S" corporation, the shareholders must be individuals or certain other pass-through entities, and in no circumstances can a shareholder be a "C" corporation. Because of these limitations, as well as others, in order for a parent operating company that is a "C" corporation to benefit from the net tax losses of a subsidiary SPE, the parent corporation must either file tax returns on a consolidated basis with the SPE (if the SPE is itself a corporation), or must form the SPE as a Limited Liability Company (LLC), a partnership, or some other "pass through" entity.

The freedoms afforded to LLCs often tip the scale for many parent operating businesses, and therefore, utilizing an LLC as the SPE is often the most common choice. Though, like corporations, an LLC is governed by state law, the Internal Revenue Code and Regulations promulgated thereunder by the IRS provide a multitude of planning opportunities when using an LLC. For example, an LLC which otherwise meets the requirements of an "S" corporation can elect to be treated and taxed as an "S" corporation. An LLC can also elect to be treated and taxed as a "C" corporation (though there is seldom a reason to do so). Additionally, an LLC with at least two members can elect to be taxed as a partnership. If no affirmative election is made by the LLC, the default prescribed by the Regulations is that an LLC with two or more members (LLC statutes use the term Members instead of Shareholders) will be taxed as a partnership. Similarly, an LLC with only a single member (SMLLC) is by default a disregarded entity, and the sole member of the SMLCC is treated as owning the assets of the LLC directly for income tax purposes.

Though this article highlighted some of the issues involved in using an SPE to purchase an aircraft, it by no means contains an exhaustive checklist. There are many traps for those unfamiliar with the intricacies of the Internal Revenue Code, state sales and use tax statutes, and FAA regulations. Aircraft acquisitions and operations planning is a complicated endeavor, fraught with traps for the unwary. It is therefore critical that your aircraft acquisition and operations planning team include an attorney, accountant or consultant who is well versed in corporate aircraft tax and regulatory issues.

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Brian J. Heisman is a tax specialist concentrating in the area of business aircraft transactions and operations and corporate reorganizations in the law firm of GKG Law, P.C.   The firm's business aircraft group provides full-service tax and regulatory planning and counseling services to corporate aircraft owners, operators and managers. The group's services include Section 1031 tax-free exchanges, federal tax and regulatory planning, state sales and use tax planning, and negotiation and preparation of all manner of transactional documents commonly used in the business aviation industry, including aircraft purchase agreements, leases, joint ownership and joint-use agreements, management and charter agreements, and fractional program documents. Brian may be reached at the firm's Washington, DC office at telephone (202) 342-6743, facsimile (202) 342-5219, E-mail: bheisman@gkglaw.com. Troy manages the firm's Minnesota office, at 700 Twelve Oaks Center Drive, Suite 700, Wayzata, MN, 55391, telephone: (952) 449-8817, facsimile (952) 449-0614, e-mail: trolf@gkglaw.com.

Troy A. Rolf is a business aviation and tax attorney concentrating in the areas of business aircraft transactions and operations in the law firm of GKG Law, P.C. TTroy manages the firm's Minnesota office, at 700 Twelve Oaks Center Drive, Suite 700, Wayzata, MN 55391, telephone: (952) 449-8817, facsimile (952) 449-0614, email: trolf@gkglaw.com or through the firm's Washington D.C. office.