

Aviation Tax Law Webinar – November 5, 2013

# OPTIONS FOR LIMITED AIRCRAFT USAGE/ISSUES RELATING TO THE PURCHASE AND OWNERSHIP OF AN INTEREST IN A FRACTIONAL PROGRAM AIRCRAFT

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# Upcoming Webinar

## ➔ Federal Income Tax Treatment of Personal Use of Aircraft

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# Options for Limited Aircraft Usage

- Whole Aircraft Ownership
- Joint Ownership/Co-Ownership
- Operating Leases
- Fractional Aircraft Ownership
- Flight Cards and Block Charter Programs
- Ad Hoc Charter



# Fractional Aircraft Ownership

- Combines many of the advantages, while eliminating many of the disadvantages, of both whole ownership and joint ownership.
- In a traditional program, you purchase an undivided tenants in common interest in a particular aircraft.
- Each 1/16<sup>th</sup> interest in an aircraft typically entitles the owner to 50 flight hours per year.



# Fractional Aircraft Ownership

- Fractional owners have access to the entire fleet of aircraft managed by the program.
- This facilitates scheduling flexibility and aircraft type/size selection.
- Fractional owners can select the aircraft best suited to their mission on a flight-by-flight basis.



# Fractional Aircraft Ownership

- Fractional ownership is typically a viable solution for up to 200 flying hours per year.
- However, higher hours may be useful in situations where you need multiple cabin sizes/ range capabilities and/or “simultaneous usage” of multiple aircraft on a single day.
- The 200 hours metric is suggested because at this number the effective hourly cost of traditional whole ownership and the cost of fractional ownership will approximate each other, depending on a variety of assumptions made.



# Fractional Aircraft Ownership

- ➔ Fractional program aircraft accrue up to 1,300 hours per year.
- ➔ The only “buyer” of program aircraft is the fractional program itself.
- ➔ Therefore, market value of fractional program aircraft typically decline more rapidly than with whole aircraft ownership.
- ➔ However, offsetting this consideration is the fact that capital outlay is only a percentage of the capital outlay with whole aircraft ownership.





# Fractional Aircraft Ownership

## → Hypothetical example:

- Whole aircraft valued at \$20,000,000 with 3% annual decline in value, results in a loss of \$600,000 in capital in year one;
- A portion of the same aircraft is purchased in a fractional program – if the owner required 200 annual hours, then  $\frac{1}{4}$  share would be purchased, costing \$5,000,000.
- The fractional aircraft share would have to decline in value at least 12% in the first year in order for the owner to suffer a loss of \$600,000 in capital.



# Fractional Aircraft Ownership

- ➔ Currently two major programs with numerous aircraft of various makes and models, serving national and international markets.
- ➔ Customers of these larger programs can have an aircraft pick them up at any suitable airport in the U.S., and parts of the Caribbean, Canada, Mexico, Central America and Hawaii, and not be charged for deadhead time.
- ➔ Enhanced service parameters translate to increased fees.



# Fractional Aircraft Ownership

- ➔ Other fractional programs are smaller, utilize less program aircraft and serve a regional market, with aircraft based at only one or two airports.
- ➔ Smaller regional fractional programs typically have more restrictions on where they will pick you up or drop you off, and may charge for deadhead time if your trip does not begin or end at the home operating base of the aircraft.
- ➔ These smaller programs typically attract owners by offering lower fees.



# Fractional Aircraft Ownership

## ➔ Additional Advantages of Fractional Ownership:

- External “turn-key” management; high level “concierge” style services.
- Sharing fixed costs among multiple owners.
- Reduced capital outlay.
- No empty leg or repositioning fees, resulting in the ability to be picked up or dropped off in any city without added costs or inconvenience.
- Guaranteed buy back provisions (less a “remarketing” commission).
- Access to multiple aircraft with different cabin size and range abilities.



# Fractional Aircraft Ownership

## ➔ Additional Advantages (Continued)

- Fractional programs may offer a long term lease, instead of a purchase, providing essentially identical rights and privileges to the fractional owner, but with the added benefit of a pre-determined capital outlay for the “ownership cost” by virtue of the fixed lease payments.
- Flexible operating parameters under FAR Part 91, subpart K, or alternatively, less flexible operating parameters under FAR Part 135 however, with enhanced liability protection planning.
  - Fractional program aircraft may be operated under either the general operating rules of FAR Part 91 subpart K, or under the commercial charter rules of FAR Part 135. Larger programs operate aircraft under both sets of rules. Some fractional programs operate all program flights under Part 135. Some fractional programs may not be licensed to operate under Part 135 and therefore operate all flights under subpart K of Part 91.



# Fractional Aircraft Ownership

## → Some Disadvantages of Classic Fractional Ownership Include:

- Increased management and infrastructure costs. Generally, costs to manage a fractional share (those costs are reflected in both the monthly management fee and the occupied hourly rate) can approximate the costs to manage a whole aircraft for the larger share size purchases (e.g. a  $\frac{1}{4}$  share size).
- Increased market value depreciation due to high utilization of the aircraft (*i.e.*, some contracts permit as much as 1,700 hours of annual utilization compared to typical fleet utilization of approximately 400 hours per year).
- Increased federal taxes on operations.



# Flight Cards and Block Charter

- Flight card programs have made fractional ownership program fleets available to persons with aircraft utilization requirements of fewer than 50 hours per year.
- With a flight card program, a customer generally pre-pays for a certain number of flight hours (typically 25) on a certain make and model of aircraft, and thereby gains access to the fractional fleet of the fractional program affiliated with the flight card program.
- Whenever the customer flies, the total number of flight hours flown is debited from the card. When the flight hours are all used, the customer has no further obligation to buy another card.



# Flight Cards and Block Charter

- ➔ Block charter programs are similar to flight card programs.
- ➔ Usually provide for access to fleets of aircraft that are managed by charter operators rather than fractional fleets.
- ➔ Aircraft in charter fleets tend to be older, on average, and do not have standardized interiors and amenities like those in fractional fleets.
- ➔ With some block charter programs, you may have access to only the charter fleet of a single charter operator. Other cards provide access to aircraft offered by many charter operators.





# Flight Cards and Block Charter

- ➔ Flight card programs generally offer all of the conveniences normally associated with fractional ownership.
- ➔ With respect to flight cards tied to fractional ownership programs, there may be a slight cost premium associated with the lower annual aircraft utilization being purchased by the customer.
- ➔ Block charter programs, since they are tied to charter fleets, and therefore reflect charter fleet pricing, conveniences and inconveniences (e.g. older fleet averages), may generally reflect a price advantage vis-à-vis flight cards.



## Ad Hoc Charter

- ➔ If you fly fewer than 25 hours per year, a flight card or block charter program may be too costly, and require a commitment to more hours than needed.
- ➔ Ad hoc charter is likely your best option.
- ➔ The use of ad hoc charter for your business flights will give you greater flexibility as to when and where you can fly versus the use of scheduled air service.
- ➔ With ad hoc charter, you control the departure time for your flight and can into and out of a larger number of airports than those served by scheduled air carriers.



# Ad Hoc Charter

- ➔ Disadvantages to the use of ad hoc charter:
- You will not necessarily be guaranteed a flight on a specific aircraft (although you may request a specific aircraft and receive a confirmation prior to departure).
  - The aircraft that you charter could be of any vintage or layout and you may not know ahead of time all of the amenities it will contain.
  - You will not choose the flight crew assigned to operate the aircraft you charter.
  - You will not determine the amount or types of insurance coverage for the charter flight you schedule.



# Ad Hoc Charter

- Advantages to the use of ad hoc charter:
- No long-term commitment.
  - No capital outlay.
  - No requirement that you acquire aviation expertise.
  - Charter pricing is generally very competitive, as it ultimately represents pricing that is “subsidized” by the aircraft owner. This subsidy exists because the charter pricing in the United States does not reflect cost of capital, and further only reflects a small contribution towards the fixed cost overhead of the aircraft.



# Issues Relating to the Purchase and Ownership of an Interest in a Fractional Program Aircraft



## Fractional Aircraft Ownership Issues

- ➔ Recent developments in the fractional aircraft program marketplace make it imperative that program participants understand the risks inherent in purchasing/owning fractional aircraft interests.
- ➔ Many purchasers perceive the purchase of a fractional aircraft interest as a less risky alternative to owning/co-owning an aircraft.



## Fractional Aircraft Ownership Issues

- ➔ One of the key risks that a potential fractional interest purchaser must evaluate in connection with the acquisition or renewal of a fractional aircraft interest and participation in a fractional aircraft ownership program is the viability, strength and reputation of the fractional program operator.



# Fractional Aircraft Ownership Issues

- A fractional program operator typically:
- Sells the fractional aircraft interest to its customer and, at the end of the program term, repurchases that interest;
  - Agrees, for a fee, to manage all aspects of maintaining and operating program aircraft (and in many instances to operate those aircraft) on behalf of fractional owners;
  - Charges an owner an hourly fee for the use of program aircraft by the owner and requires that the owner pay a portion of those hourly fees in advance.





## Fractional Aircraft Ownership Issues

- ➔ Because the fractional program operator will repurchase the fractional aircraft interest at the end of the program term, it is important to choose an operator that has the financial wherewithal to honor its obligation to repurchase that interest.
  - Without assurance that the fractional program operator will meet its obligations, an owner may be left with an investment in an aircraft that it cannot use effectively and cannot easily liquidate.



# Fractional Aircraft Ownership Issues

- There are several ways to mitigate these risks:
- When evaluating the purchase of a fractional aircraft interest or the renewal of fractional program documents, obtain as much information as possible concerning the fractional program operator's business operations and financial condition.
  - The best time to request additional information is prior to purchasing a fractional interest or renewing program documents. This is the point at which you will have the most leverage to obtain the information needed to make an informed decision regarding both the efficacy and the desirability of making an investment in a fractional program operator's product and its aircraft.



# Fractional Aircraft Ownership Issues

- There are several ways to mitigate these risks:
- Ensure that the agreements with the fractional program operator contain maximum protection for you. Include terms that will allow you to liquidate your investment if a fractional program operator's solvency is questionable or if it fails to competently perform its obligations to its customers.
  - An example of such a provision is a requirement that the fractional program operator operate all program flights in accordance with the terms and conditions of the program documents and that the program operator will be in default of its obligations to an owner if an owner's scheduled flight is not operated as required due to the program operator's fault a certain number of times (usually two or three times) during a specified time period (usually 6 or 12 months).



# Fractional Aircraft Ownership Issues

→ What if things go wrong?

- Despite your best efforts in performing an evaluation of a fractional program operator and building into the program documents a comprehensive set of protections against a fractional program operator default, a fractional program operator may without advance warning cease operations or be forced into receivership or involuntary bankruptcy proceedings.



# Fractional Aircraft Ownership Issues

## → What if things go wrong?

- Work with other owners of your aircraft to ensure that it is properly maintained and insured on a going forward basis so that the value of the aircraft can be maintained for purposes of selling it at the earliest possible time.
- If the fractional program operator owns an interest in the same aircraft, this will make the process of liquidating the owners' investment in that aircraft more difficult.
- Even if the fractional program operator does not own such an interest, it is likely that vendors that provided services with respect to program aircraft may seek to assert mechanic's and similar liens against the aircraft for amounts owed to those vendors.



# Fractional Aircraft Ownership Issues

→ What if things go wrong?

**HIRE A GOOD ATTORNEY!**



# Closing Remarks



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