Chartering your Company Aircraft:
Have you considered the Tax Issues?

What should owners know about placing their business aircraft on a management company's charter certificate? Keith Swirsky opens a three-part discussion series…

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In an arrangement that can offer mutual benefits, many company aircraft are managed by charter operators that are certified by the Federal Aviation Administration to offer flights for hire. The aircraft owner receives income from the management company, which in turn has access to an additional aircraft for its charter service. What appears to be a relatively straight forward business arrangement is in fact a sophisticated contract with considerable tax implications.

Frequently, the management company will present the owner with financial projections in a simple equation indicating that, if the owner allows the management company to charter the aircraft to third parties, the owner will net a substantial profit over its direct operating costs. Whether or not such a profit is likely to be realized is not the subject matter of this article. Rather, this article will address the various tax implications associated with the decision to allow the management company to charter the aircraft to third-parties.

The tax considerations fall into two primary areas:

- State sales and use tax, and
- Federal income tax.

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The decision to add an aircraft to a management company's charter certificate implicates certain limited federal excise considerations that we will also address in this series of articles.

State Sales & Use Taxes

When purchasing an aircraft it is a common misconception that one must focus solely on either the state of formation of the entity acquiring the aircraft, or the physical location of the aircraft on the date of delivery, to determine potential sales and use tax liability associated with the aircraft.

Although it is true that the state of formation of the entity owning the aircraft and/or the physical location of the aircraft on the date of closing may have sales tax consequences, ultimately state use tax considerations (meaning where the aircraft will be 'used and consumed') drive the aircraft planning and structuring. The most likely state where the aircraft will be used and consumed is the state where the aircraft is hangared. In other words, if the aircraft is acquired in State 'X' and qualifies for a State X exemption from sales tax, such as a flyaway exemption, but the aircraft is thereafter moved to State 'Y', where it is hangared, State Y's use tax laws will drive the aircraft ownership and operations planning.

When an aircraft is externally managed and placed on a management company's charter certificate, the mechanism for transferring possession of the aircraft to the management company for its use in third party charter activities is known as a lease. The title of the document should be irrelevant, as it is necessary to transfer possessory rights in the aircraft to the management company in order to allow the aircraft to be chartered to the public.

However, problems arise when the document provided by the management company is not referred to as a 'Lease Agreement' because many states may not treat the transaction as a lease of the aircraft from the owner to the management company if the document does not clearly appear to be a lease agreement. It is generally true that titling the document as a lease agreement and providing traditional lease terms (such as, most importantly, an hourly rent) will have the most desirable result from a state use tax perspective.

In connection with entering into a lease agreement, the entity owning the aircraft should obtain a state sales and use tax permit (i.e., a sales tax vendor registration). This permit allows the aircraft owning entity to acquire the aircraft and assert that its acquisition is solely for the purpose of 'resale'.

Buying to Sell/Lease

A purchase for the purpose of resale is generally an exempt purchase. In other words, if the aircraft owning entity is acquiring an aircraft solely for the purpose of resale, it is generally entitled to claim a use tax exemption in the state where it is hangaring the aircraft, and therefore avoid tax on the purchase price of the aircraft.

This result, of course, requires that the aircraft owning entity make no other use of the aircraft for its own purposes other than to hold the aircraft solely for leasing purposes. This is a critical provision because in many states, any use that is inconsistent with holding the aircraft for leasing purposes (such as a single flight for personal use) can void the exemption and cause the full value of the aircraft to be subject to state use tax.

Of significant importance in this regard, if the aircraft owning entity enters into a 'management services agreement' with the external management company, that document would imply that the

entity owning the aircraft is 'using' the aircraft for its own purposes, thereby undermining the use tax exemption on the purchase price of the aircraft.

To further illustrate this concept, in most states, when an aircraft is acquired for lease to a management company for use in third party charter, the rent paid by the management company is exempt from use tax. There are notable exceptions to this general rule, such as in Florida, where rent paid by a charter operator is generally not exempt from sales and use tax. However, Florida and other states, such as Texas, may reach a conclusion that the transaction between the aircraft owner and the management company is not a lease transaction, when the document is not referred to as a lease agreement and when an hourly 'rent' is not paid by the management company to the owner.

More specifically, when the lease agreement provides that the management company will credit the owner with all of the charter revenue, less a sales commission, and debit the owner with all the various operating expenses associated with the charter flight, states such as Florida and Texas may reach a conclusion that the transaction is not a lease transaction and is in essence a 'joint venture' with a common profit objective. Such an interpretation would lead a state to conclude that the aircraft owning entity 'used' its own aircraft in connection with the joint venture activities, thereby causing the full value of the aircraft to be subject to state use tax (the full value, in these circumstances, would either be the original purchase price or the fair market value, depending on the law of the state and the specific facts and circumstances).

> "It is paramount that the relevant contracting parties enter into the management company documentation."

In circumstances where a 'lease agreement' is prepared, with a specific hourly or monthly net rental payment, the state is more likely to reach the conclusion that the parties entered into an actual lease of the aircraft to the charter company instead of a joint venture.

It is paramount that the relevant contracting parties enter into the management company documentation, as the sales and use tax consequences are directly driven by the identity of such parties and by the terms and provisions as well as the titles, of such documents.

It is also clear that there is significant opportunity for sales and use tax minimization with properly planned and documented agreements with an external management company. Additionally, there is a huge potential for creating unnecessary sales and use tax liability with improperly prepared documentation. ▌

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