Income Tax Considerations:
Family Offices & Business Aircraft

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Upcoming 2020 Webinars

Tax Matters for Airplane Purchases *The 30,000 foot view*	October 22 1 pm ET
Federal Income & Excise Tax Implications of Personal & Entertainment Use of Business Aircraft	November 19 1 pm ET
Sales & Use Taxes on Aircraft: Latest Developments & Key Planning Tools	December 17 1 pm ET

Disclaimer

This presentation is being provided for general information and should not be construed as legal advice or legal opinion on any specific facts or circumstances. You are urged to consult your attorney or other advisor concerning your specific situation and for any specific legal or financial questions you may have.

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About Us

- Aircraft Purchase & Sale Transactions
- Aircraft Ownership & Operating Structures
- Federal & State Tax Planning
- Aircraft Ownership Trusts
- IRS, State & FAA Audits & Enforcement Actions
- Personal Use Guidelines & Calculations

Income Tax Considerations: Family Offices & Business Aircraft
Federal Aviation Regulations

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Will the Aircraft be operated under 14 CFR Part 91 or 14 CFR Part 135?

Trick question. In the business aviation industry, this question is often posed as an "either/or," but in reality:

- 14 CFR Part 91 contains the general operating and flight rules applicable to <u>all</u> aircraft operations; and
- 14 CFR Part 135 provides an **additional layer** of regulation applicable to commuter and on-demand charter operations

Commuter and on-demand charter operations must comply with **both** Part 91 and Part 135, so not "either/or".

Income Tax Considerations: Family Offices & Business Aircraft
Operations Under 14 CFR Part 91

Advantages

- Greater Operational Flexibility
  (runway length, weather reporting, flight/duty time limits, etc.)
- Reduced Administrative Requirements
  (no mandated drug/alcohol testing, pilot record keeping/sharing requirements)

Disadvantages

- Limited ability to obtain compensation for services
- Liability exposure of operating company

Income Tax Considerations: Family Offices & Business Aircraft
Operations Under 14 CFR Part 135

Advantages

- Operations need not be incidental to, or within the scope of, another business
- Unfettered ability to charge for services
- Shift liability to air carrier
- Possible sales/use tax benefits (depending on state law)

Disadvantages

- Operator must possess air carrier operating certificate issued under 14 CFR Part 119
- Time consuming and expensive to obtain your own air carrier operating certificate (third-party usually required)
- Increased regulatory requirements
  (operational restrictions, pilot record keeping/sharing, drug/alcohol testing, etc.)
- Extends depreciation schedule

Income Tax Considerations: Family Offices & Business Aircraft

Part 91 v. Part 135

- Most business aircraft owners prefer to operate their aircraft under Part 91 for their own business and personal flights.

- Therefore, the remainder of this presentation will relate to Part 91 ownership and operations structures.

Income Tax Considerations: Family Offices & Business Aircraft
FAA Regulatory Considerations

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Planning an Aircraft Ownership and Operating Structure

- FAA Compliance and Liability Protection Planning
  - Corporate Attorneys, Risk Managers and CFOs who lack corporate aviation expertise often consider liability protection planning first and conclude (incorrectly) that a Flight Department Company is required to minimize risk.

Income Tax Considerations: Family Offices & Business Aircraft

Typical Illegal Flight Department Company Structure

Individual or Parent Company

Air Transportation Services

Special Purpose Entity

- Primary business operated by Parent Company
- Special Purpose Entity employs (or contracts for) pilots
- Aircraft owned (or leased) and operated by Special Purpose Entity
- Special Purpose Entity incurs all expenses for operations
- Parent company reimburses Special Purpose Entity for expenses in some manner
  - Reimbursement may be on a flight-by-flight basis, or through capital contributions, or some other mechanism
- Special Purpose Entity has no other business operations

Income Tax Considerations: Family Offices & Business Aircraft

Flight Department Requirements

- Aircraft operator (if it is a business entity) must have a primary purpose **other than** air transportation
- Aircraft operations must support the primary purpose (i.e., be *within the scope of, and incidental to* such primary purpose)
- Must look solely within the four walls of the company (operations by special-purpose subsidiaries prohibited)
- Flight department companies may subject transportation to FET, and may violate insurance/loan covenants

Income Tax Considerations: Family Offices & Business Aircraft
Flight Department Requirements

- The Flight Department Requirements listed on the previous slide apply to aircraft operations, not ownership.
- Special-purpose subsidiaries that do not meet the requirements **may own and lease** aircraft, but **may not operate** aircraft.
- Special-purpose subsidiaries are commonly formed to act solely as *owning and leasing vehicles,* which can provide sales and use tax benefits in most states.
- Special-purpose subsidiaries that act solely as *owning and leasing* vehicles may lease aircraft to any entity that meets the Flight Department Requirements, to an individual, or to a licensed on-demand charter operator for use under 14 CFR Part 135.

Income Tax Considerations: Family Offices & Business Aircraft
Family Office as Owner/Operator or Lessee/Operator – FAA

Aircraft operations must be *within the scope of and incidental to* a primary purpose of the family office. E.g.:

- Bill paying, document handling and processing, managing homes and other personal assets
- Investigate potential investments and charitable opportunities for client families
- Interface with client external advisors

Income Tax Considerations: Family Offices & Business Aircraft

Family Office as Owner/Operator or Lessee/Operator – Tax Issues

- IRC 162

- IRC Lender Management LLC v. Commissioner, T.C. Memo 2017-246

Income Tax Considerations: Family Offices & Business Aircraft
IRC 162

- Allows deductions for ordinary, necessary and reasonable expenses incurred in the conduct of an active *trade or business*
- “Ordinary” expense is one that is normally expected in the circumstances
- “Necessary” expense is one that is appropriate and helpful to the business
- “Reasonable” expense is one that is reasonable in amount in relation to its purpose
  - *Income to be produced by a family office should be sufficient to justify aircraft expense*
- The use of private aircraft has been found to be reasonable when it saved substantial time for executives traveling in connection with business and provided the flexibility to travel to the places and on the dates needed to meet the demands of business.

Income Tax Considerations: Family Offices & Business Aircraft
Lender Management LLC v. Commissioner

Facts

- Lender Management, LLC – created by two of the Lender family's trusts to operate as Lender family office and provide investment management and advisory services to family members and third party, non-family members
- Family office was compensated for its services, primarily through profits interests
- Family office employed five people, including its chief investment officer, for whom reviewing investments for the family office was a full-time job
- Investors generally made disparate investment choices
- Family office took the position that, as a trade or business, it could deduct as IRC § 162 business expenses various items, including salaries and wages, repairs and maintenance, rent, taxes and licenses, depreciation, retirement plans, employee benefits and investment management fees

Income Tax Considerations: Family Offices & Business Aircraft
Lender Management LLC v. Commissioner

Trade or business

- The *Lender* court's decision turned on whether the family office was operating as a *trade or business*
- "Trade or business" is not well defined in the Code nor in Treasury regulations, but case law has examined three factors in determining whether a taxpayer's activities qualify as a trade or business, looking at whether the taxpayer
  a) *Undertook the activity with the intent to make a profit,*
  b) *Was regularly and actively involved in a considerable activity (by scope and extent), and*
  c) *Had business operation that had actually commenced*
- The court found that the Lender family office had met these three criteria

Lender Management LLC v. Commissioner

Factors for a business-like arrangement

- A family office's status as a trade or business is bolstered by conducting operations in a continuous and business-like manner. Such formalities might include:
  - Engaging legal, accounting, investment advisory or other services
  - Having non-family, full-time employees
  - Payment of compensation to family members who are working at the family office
  - Holding regular meetings with clients
  - Having formal contracts for services
  - Having physical office space
  - Having detailed financial reporting to clients

Questions?

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