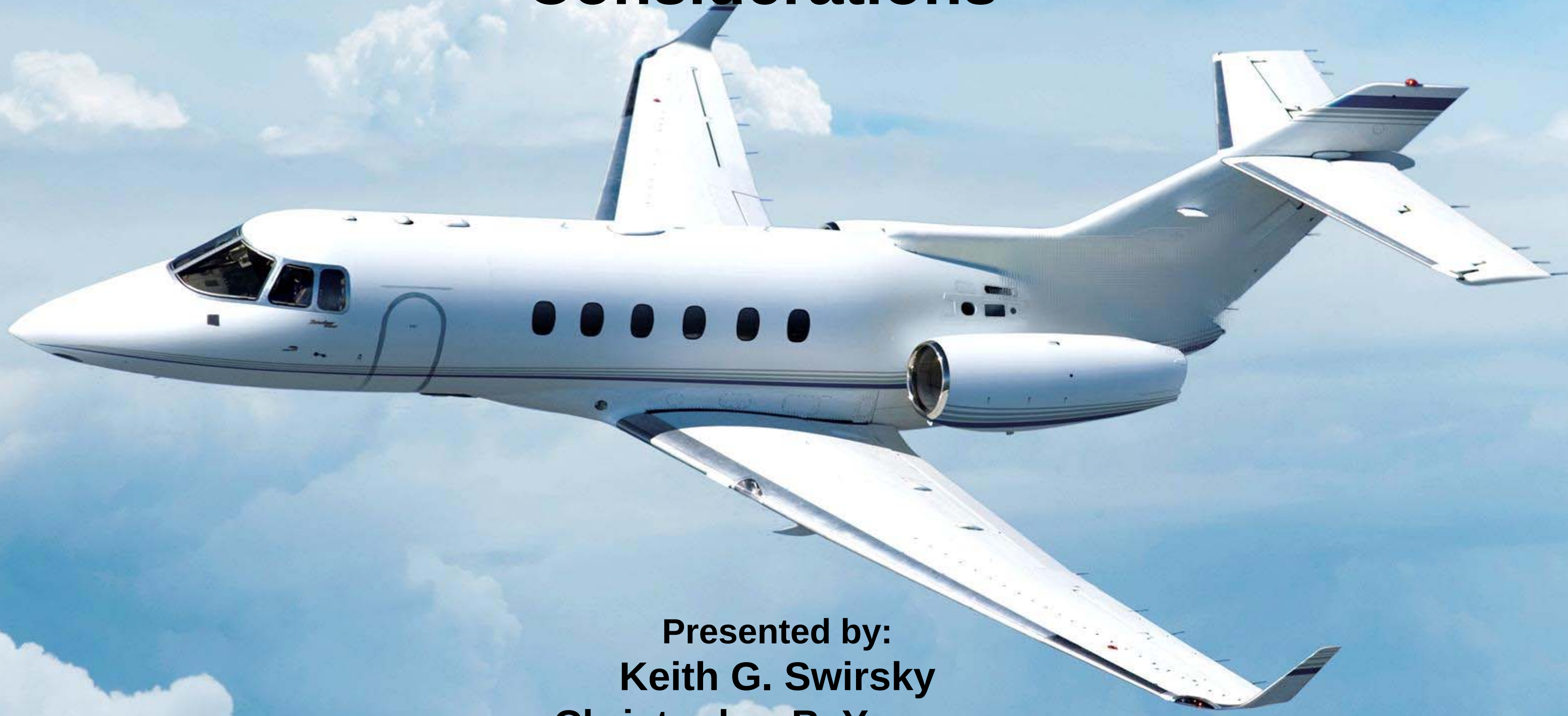
Aviation Tax Law Webinar – January 9, 2018

Options for Allowing Third Parties to Use Your Aircraft - Income Tax, Excise Tax and Sales Tax Considerations



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Upcoming GKG Law Webinar

- **February 13, 2018, 1:00PM EST**
  "Defending a Federal (IRS) Income Tax or Excise Tax Audit or a State Sales and Use Tax Audit/Federal Excise Tax Update."

  Presented by: Keith Swirsky and Christopher Younger.

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Overview of Webinar

- ✈ During today's webinar we will summarize the basic requirements of the following options for allowing a third party to pay compensation for the use of your aircraft and discuss the Federal income tax, Federal excise tax and state sales and use tax ramifications associated with the utilization of each option:
  - Part 135 Charter
  - Part 91 Dry Lease
  - Time Sharing under FAR Part 91.501
  - FAA "Nichols" Rule

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Tax Issues That Will Be Covered

- **Federal income tax - deducting expenses**
  - Trade or business (Code Sec. 162)
  - Depreciation schedule – 5/7 Year MACRS (Code Sec. 168(c))
  - Qualified Business Use (Code Sec. 280F)
  - Depreciation limitations – Personal entertainment use (Code Sec. 274)
  - Passive activity loss limitations (Code Sec. 469)
- **Federal air transportation excise taxes**
  - Federal fuel excise tax credits
- **State sales and use tax**
  - Sale for resale exemption
  - Common carrier/commercial aircraft/interstate commerce exemption
  - Sales tax on rent payments
  - Joint venture versus leasing issue

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Part 135 Charter

- You lease your aircraft to an on demand air taxi (charter) operator.
- The charter operator operates the aircraft to provide transportation service to third parties.
- Those third parties are customers of the charter operator and pay the charter operator fees for the transportation provided to them by the charter operator.
- The charter operator pays you a percentage or fixed amount of fees billed to its third party customers.

Non-Tax Advantages and Disadvantages of Part 135 Charter

✈ **Non-Tax Advantages**:

- The charter operator may charge third parties at any rate (in contrast to complex cost sharing allocations in Part 91 leasing structures and limitations on payment amounts in a time sharing arrangement).
- Simpler method for allowing larger numbers of third parties to use an aircraft.
- Enhanced liability protection planning by having third party operations conducted by the charter operator.
- Stricter operating and safety requirements imposed on charter operator.

✈ **Non-Tax Disadvantages**:

- The charter operator will generally earn a commission for its services.
- Added start-up expense to conform aircraft and aircraft documents for charter operations and ongoing additional crew training expense.
- Limited airport options available for aircraft operated under Part 135.
- Weather restrictions.
- Crew flight and duty time period rules/rest requirements.

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Tax Considerations Part 135 Charter

- **Federal income tax - deducting expenses**
  - May enhance deductibility of Code Sec. 162 trade or business expenses relating to aircraft.
  - May extend aircraft depreciation schedule – 5 v. 7 Yr. MACRS / 6 v. 12 Yr. ADS.

    Risk of Code Sec. 1245 recapture if depreciation schedule is extended.
  - Application of Code Sec. 469 passive activity loss limitation rules must be considered and analyzed.
  - Does not solve Code Sec. 274(e) personal entertainment use deduction limitation issues, but will modify calculations, reducing disallowed amount.
  - May resolve Code Sec. 280F "qualified business use" requirements.
- **Federal air transportation excise taxes**
  - Will apply to payments made by charter customer.
- **State sales and use tax**
  - Common carrier, commercial aircraft, interstate commerce exemption may apply.
  - Need to consider impact on sale for resale exemption - joint venture versus leasing issue.

Part 91 Aircraft Dry Lease

- You lease your aircraft without flight crew to a third party.
- The third party lessee pays you rent for its use of your aircraft.
- The third party lessee, by virtue of the dry lease, becomes the operator of the aircraft when it uses the aircraft.
- The third party lessee must hire its own pilots from a source unrelated to you.
- You and the third party lessee must agree how to allocate fixed and variable costs relating to the use of the aircraft by each of you.
- You and the third party lessee must have insurance coverage for each of your and the third party lessee's aircraft operations.

Non-Tax Advantages and Disadvantages of Part 91 Dry Leases

- **Non-Tax Advantages:**
  - Greater operational flexibility for Part 91 lessee – more airports available, fewer weather restrictions, no FAA imposed crew duty limits.
  - Less additional start-up expense because no need to conform aircraft and aircraft documents for charter operations and ongoing additional crew training expense.
- **Non-Tax Disadvantages:**
  - Aircraft operations by each party must be incidental to and within the scope of another business conducted by such party.
  - Number of Part 91 dry lessees is limited (usually no more than 3-4 is recommended depending on relationship of lessor and lessees) to avoid issues relating to unauthorized provision of common carriage.
  - Increased liability exposure for Part 91 lessee (and, potentially, for you).
  - Need to design, implement and maintain a cost sharing relationship between all aircraft operators and ensure that costs are paid by everyone.

Tax Considerations Part 91 Dry Lease

- **Federal income tax - deducting expenses**
  - Need to utilize arm's-length pricing/rent to support deductibility of business expenses under Code Sec. 162.
  - Depreciation schedule should remain at 5/6 year non-commercial.
  - Does not solve Code Sec. 274(e) personal entertainment use deduction limitation issues, but will modify calculation, reducing disallowed amount.
  - Application of Code Sec. 469 passive activity loss limitation rules must be considered and analyzed.
  - May resolve Code Sec. 280F "qualified business use" requirements if you have an unrelated third party as the Part 91 lessee.
- **Federal air transportation excise taxes**
  - Amounts paid by Part 91 lessee should not be subject to FET.
- **State sales and use tax**
  - Sales tax may apply to aircraft dry lease rent.

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Aircraft Time Sharing

- Authorized under FAR 91.501(c)(1).
- You lease your aircraft with flight crew to a third party.
- The third party lessee pays you rent for its use of your aircraft.
- You operate your aircraft to transport the third party time share lessee and/or its employees/guests.
- You charge the lessee for the flights conducted under the time sharing arrangement as specified in FAR 91.501(d).

Aircraft Time Sharing (Cont.)

- FAR 91.501(d) - charges cannot exceed (but may be less than) two times the cost of fuel, oil, lubricants, and other additives used during the flight, plus all of out of pocket expenses for:
  - travel expenses of the crew, including food, lodging and ground transportation;
  - hangar and tie down costs away from the aircraft's operating base;
  - insurance obtained for the specific flight;
  - landing fees, airport taxes and similar assessments;
  - customs, foreign permit, and similar fees directly related to the flight;
  - in-flight food and beverages;
  - passenger ground transportation;
  - flight planning and weather contract services.

Non-Tax Advantages and Disadvantages of Time Sharing

- **Non-Tax Advantages**:
  - Simplicity – ease of billing, no need to allocate costs.
  - Same operational flexibility as with Part 91 dry lease – more airports available, fewer weather restrictions, no FAA imposed crew duty limits.
  - Less additional start-up expense because no need to conform aircraft and aircraft documents for charter operations and ongoing additional crew training expense.
- **Non-Tax Disadvantages**:
  - Number of Time Sharing lessees is limited (usually no more than 3-4 is recommended depending on relationship of lessor and lessees) to avoid issues with common carriage.
  - Reimbursement amount is typically less than charter and dry lease options.

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Tax Considerations Time Sharing

- **Federal income tax - deducting expenses**
  - May affect deductibility of Code Sec. 162 trade or business expenses relating to aircraft – may trigger hobby loss analysis if Code Sec. 183 applicable.
  - May extend aircraft depreciation schedule – 5 v. 7 Yr. MACRS / 6 v. 12 Yr. ADS.

    Risk of Code Sec. 1245 recapture if depreciation schedule is extended
  - Does not solve Code Sec. 274(e) personal entertainment use deduction limitation issues, but will modify calculation, reducing disallowed amount.
  - Can be useful to avoid Code Sec. 469 passive activity issues that arise with the use of an aircraft dry lease.
- **Federal air transportation excise taxes**
  - Will apply to payments but may be offset in part by fuel excise tax credits.
- **State sales and use tax**
  - Payments should not be subject to state sales and use taxes.

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FAA "Nichols" Rule

- 1999, FAA Chief Counsel held in the "Schwab Opinion" that, when an employee travels for personal purposes, the employee is a "guest" and the transportation is not incidental to and within the scope of the business of the company. Hence employee could not be charged for the flight per FAR 91.501(b)(5) requirements.
- 2012, FAA Chief Counsel's "Nichols Opinion" modified the "Schwab Opinion" to permit charging a pro-rata share of the costs of owning, operating and maintaining the aircraft for certain employees whose position with the company merits a high level of company interference in the employees' personal travel plans (e.g., senior executive who may need to be recalled early from vacation).
- Company retains operational control of the aircraft.
- Payments subject to federal excise taxes on commercial transportation
- Company must create and update a list of individuals whose position with the company require him or her to routinely change travel plans quickly

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Non-Tax Advantages and Disadvantages of "Nichols" Rule

- **Non-Tax Advantages**:
  - Simplicity – no need for lease documentation, ease of billing.
  - Same operational flexibility as with Part 91 dry lease – more airports available, fewer weather restrictions, no FAA imposed crew duty limits.
  - Less additional start-up expense because no need to conform aircraft and aircraft documents for charter operations and ongoing additional crew training expense.
- **Non-Tax Disadvantages**:
  - Need to allocate costs.
  - Limited to only highest level executives listed by company.
  - Regulatory uncertainty because use is based on FAA Chief Counsel opinion, not language of FARs.
  - Limited ability to charge – only for flights for which executive may be recalled

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Tax Considerations "Nichols" Rule

- **Federal income tax - deducting expenses**
  - Should not affect business expense deductibility under Code Sec. 162.
  - Depreciation schedule should remain at 5/6 year non-commercial.
  - Does not solve Code Sec. 274(e) personal entertainment use deduction limitation issues.
  - Can be useful to avoid Code Sec. 469 passive activity issues that arise with the use of an aircraft dry lease.
- **Federal air transportation excise taxes**
  - Will apply to payments.
- **State sales and use tax**
  - Payments should not be subject to state sales and use taxes.

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Closing Remarks

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