November 24, 2014

Via email (Teresa.bostick@cpa.state.tx.us) and FedEx

Teresa G. Bostick
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P.O. Box 13528, Capitol Station
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RE: Response to Comptroller Invitation for Comments Regarding Draft Comptroller Rule 3.280 Relating to Aircraft and Sales for Resale

Dear Ms. Bostick:

On behalf of the National Business Aviation ("NBAA"), thank you for allowing us the opportunity to comment on draft Comptroller Rule 3.280, published in the *Texas Register* on October 31, 2014 (*39 Tex.Reg. 8503, et seq*), as well as certain modifications to other existing rules that impact the ownership and operation of aircraft in Texas (collectively the "Proposed Rule"). NBAA represents more than 10,000 member companies, 1,112 of which are located in Texas, and is the leading organization for companies that own or operate general aviation aircraft to make their businesses more efficient, productive and successful.

General aviation is a major driver of the Texas economy, supporting more than 56,000 jobs and generating $14.6 billion in economic activity annually according to the Texas Department of Transportation. Due to the large size of Texas, the 392 public use airports in the state allow business to get done in small cities and towns that are not served by the 25 airports with commercial airline service.

With the importance of general aviation to the Texas economy, NBAA carefully analyzed the Proposed Rule and our comments focus on the modification and/or addition of draft Rule provisions that set the circumstances under which a purchase (in this case, of an aircraft) may qualify for the sale for resale exemption. In our view, the Proposed Rule will negatively impact the general aviation industry in Texas as it will limit the ability to conduct the leasing of aircraft, which is done for many legitimate business and regulatory compliance purposes. Instead of taxpayers paying the appropriate tax actually called for under the Texas Tax Code (the "Code") related to that leasing, the Proposed Rule would implement a new regime that essentially amounts to a double tax.

Business and Regulatory Compliance Reasons for Aircraft Leasing

There are a number of significant agencies or bodies of law – in addition to Texas state tax law – that have an enormous impact on decisions related to ownership and operation an aircraft, including:

- The Federal Aviation Administration ("FAA") – arguably the agency that has the most to say, and has the biggest impact on, the ownership and operation of aircraft in the U.S.;
- The Internal Revenue Service ("IRS"), imposes significant taxation on aircraft ownership and operations; and

- General risk management law – how to structure aircraft ownership and operations to provide appropriate liability protection depending on the nature of operation the parties wish to conduct.

While direct ownership is possible in certain situations, many companies are structured in ways that make such ownership extremely restrictive due to FAA regulations surrounding cost sharing and use of the aircraft by subsidiaries. Direct ownership also results in the highest possible risk for any use of the aircraft on that person or business that is the direct owner and operator.

FAA Compliance Reasons for Leasing

Leasing is a common method used by aircraft owners to comply with FAA rules. FAA operational rules make leasing necessary for certain types of aircraft uses. The general aviation rules in Part 91 of the FAA Regulations ("FAR") generally permits aircraft operations that involve no compensation or hire. Therefore, in order for an aircraft owner limited by the rules of FAR Part 91 to provide use of the aircraft, even to related parties, in compliance with the rules, leasing is necessary. Leasing an aircraft allows the lessee to operate the aircraft for the lessee's own use, generally also under the rules of FAR Part 91.

Aircraft owners may also lease to avoid the FAR Part 91 issue of the "flight department company." This term refers to a company that is set up solely for the purpose of owning and operating aircraft to provide air transportation. The FAA takes the position that a "flight department company" cannot operate an aircraft under FAR Part 91 because the carriage of persons would not be "incidental to" the business of that company. Nevertheless, a separate entity is permitted to own an aircraft and lease it to another company that operates the aircraft under FAR Part 91.

Leasing is also a common method to place an aircraft in commercial operations. An aircraft owner may lease an aircraft to a certificated air carrier so that the aircraft can be used to provide transportation of passengers or property for compensation or hire. For general aviation aircraft, such operations are generally conducted under FAR Part 135, which generally applies to air charter operations. In that case, the lessee must hold an air carrier certificate that authorizes the operator to conduct aircraft charter operations under FAR Part 135. In addition, the aircraft must meet the outfitting, equipment, and maintenance requirements of that Part.

The FAA also has complex citizenship rules for aircraft registration that may prevent a limited partnership or other entity from registering an aircraft with the FAA Aircraft Registry. In such instances, it is common practice for a separate company to register the aircraft with the FAA and lease it to such an entity for its business use.

Limiting Liability Exposure

Generally under common law, each person who owns, operates, pilots, or maintains an aircraft is responsible for damages arising from that person's negligence or willful misconduct with respect to the aircraft. An aircraft owner may also be strictly liable for damages arising out of aircraft ownership under a products liability theory or a particular state statute. Leasing the aircraft allows aircraft ownership

liability to be borne by the company that owns the aircraft and aircraft operational liability to be borne by the company responsible for the pilots and operating the aircraft for its particular flights.
Likewise, the owners of a business frequently place ownership of an aircraft in a separate entity that leases the aircraft to the business to protect the aircraft from liability exposure arising from other operations of the business.

Details on Leasing Structures within the Normal Course of Aircraft Ownership and Operation

Within the normal course of business with respect to the ownership and operation of aircraft, including leasing, aircraft owners and operators must create structures that comply with federal aviation regulations, federal tax law, general risk management law, and state tax law. This Proposed Rule essentially seeks to impose significant new burdens on Texas tax payers that go well beyond the plain meaning of the Code, relying on assumptions that directly conflict with every other area of the law that applies to aircraft ownership and operation. This has created a situation where a significant number of aircraft owners must pay sales or use tax in excess of what they actually owe in order to utilize ownership and operating structure that are required in the normal course of business.

The following structures involving leasing are designed to demonstrate how the limitations on aircraft ownership and operations imposed by various regulatory agencies can have a significant business impact.

Ownership in a leasing company that then leases to different parties for non-commercial use

This structure does provide a method for allowing some cost sharing, but it can create significant issues under the IRS rules, and it still leaves each individual lessee with the highest possible risk allocation with respect that lessee's own use of the aircraft. Moreover, by far the normal course of business with respect to this type of leasing is leasing on an hourly basis with hourly rates that can fluctuate widely depending on what is being provided with the lease (for example, whether the fuel cost is a component of the rental) – very rarely is this type of leasing done on a monthly or longer basis with fixed monthly rental payments made under the lease.

Ownership in a leasing company that then leases to a commercial operator

This structure creates the most opportunity for cost sharing as provided under the FARs and/or cost mitigation with respect to the aircraft, and is the best possible risk transferring mechanism because it shifts civil liability risk to the commercial operator (for flights operated under FAR Part 135). However, this structure also creates a significant additional tax burden on all use of the aircraft because the IRS 7.5% transportation of persons tax applies to amounts paid for commercial air transportation services.

Moreover, by far the normal course of business with respect to this type of leasing in the industry is a lease under which the lessor remains ultimately responsible for making sure all costs of ownership and operation are met, but in exchange for carrying this burden, the lessor receives anywhere between 80% and 95% (if not 100%) of all charter revenue derived from the use of the aircraft. This charter revenue is then applied as credits against the underlying amounts owed by the lessor (and which then creates enormous incentive – for both the lessor and the charter operator – to use the aircraft in commercial

service). Due to the nature of charter revenues, this type of leasing is very rarely done on a monthly or longer basis and does not normally involve fixed monthly rental payments made under the lease.

Challenges with Application of Proposed Rule to General Aviation Leasing Structures

With the specific nature of general aviation aircraft ownership and operating structures described above, the Proposed Rule seeks to impose sales and use taxes on aircraft owners that is not consistent with the Code or the Comptroller's own previous guidance in this area. The Proposed Rule will drastically change the normal course of general aviation aircraft ownership in Texas and have a detrimental effect on the industry.

For example, the Comptroller apparently wishes to only recognize one form of leasing – basic finance leasing from a bank or other entity that establishes a fixed monthly rental payments – as if that is the only kind of leasing that exists. This completely ignores the actual, and very logical and well-established, normal course of business in the industry. For example, under the FARs, a "dry" lease of an aircraft (i.e., the lease of the aircraft without any crew members being provided) from the registered owner to a separate person such as a commercial operator is in fact a true "lease" made in the normal course of business. A dry lease is a lease as a matter of law, and it doesn't matter if the lessee is somehow related to the underlying registered owner, or if a person related to the registered owner then flies on the aircraft as a passenger – as far as the FAA is concerned (and the IRS with respect to the significant federal fuel or excise taxes imposed on aircraft), these are all separate persons. Moreover, such a lease has significant ramifications on which parties have regulatory obligations with respect to the operation of the aircraft, and what type of penalties might apply to those parties in the event of an incident or accident arising out of the use of that aircraft.

In summary, and as described in further detail below, through the Proposed Rule, the Comptroller effectively seeks to enforce arbitrary, vague, and subjective standards, rules, and definitions against an industry that the Comptroller has not engaged during the rulemaking process to understand normal business practices. As such, the Rule should not be implemented – in any form – because the Rule attempts to engraft extra-statutory requirements that are not present in the underlying statutes in the Texas Tax Code. Such attempts clearly and directly exceed the authority of the Comptroller and have previously been rejected by the Texas Supreme Court (*See, e.g., Combs v. Roark Amusement & Vending, L.P.*, 22 S.W.3d 632 (*Tex*. 2013)).

Detailed Analysis of Selected Provisions of the Proposed Rule

These comments provide a detailed review and analysis of specific selected sections of the Code and the Proposed Rule, including specific examples of the how the Proposed Rule differs from the actual normal course of business, standard leasing practices, and so forth, with respect to the aviation industry in Texas.

- **Key statutory provisions:**
    - §151.005 of the Code defines a sale or purchase, in the context of aircraft, as the sale or lease (i.e., transfer of possession) of an aircraft for consideration. Notably, the statute

does not require "exclusive" transfer of possession; the statute does not qualify, limit, or otherwise condition what constitutes a "lease" for the purpose of §151.005 of the Code, nor does the statute qualify, limit, or otherwise condition what constitutes "consideration" for the purpose of §151.005 of the Code.

- §151.006 of the Code defines a sale for resale, in the context of aircraft, as the sale of an aircraft (i.e., tangible personal property) to a purchaser for the sole purpose of purchaser's leasing or renting the aircraft to another person in the normal course of business. Notably, the Code does not qualify, limit, or otherwise condition the definition of a "purchaser" for the purpose of §151.006 of the Code; in other words, §151.006 does not preclude an affiliated or related party from being qualified purchaser for the purpose of §151.006. Further, this section of the Code does not qualify, limit, or otherwise condition what constitutes the normal course of business for the purpose of §151.006 of the Code.

- **Proposed Rule §3.285(a)(8):**

  - In this Section the Comptroller purports to broadly define the normal course of business, as, in pertinent part for the purpose of this memorandum, "the ***usual or customary activities undertaken in furtherance of an enterprise*** or endeavor involving the sale, ***lease***, rental, or trade of tangible personal property… ***at fair market value*** for the purpose of attempting to derive a ***gain, benefit, advantage***, income, or profit..." [***Emphasis added***]. By its own terms, however, Proposed Rule §3.280(j)(4) ignores usual and customary business practices with respect to aircraft leasing which have been commonplace in the industry for quite some time by further limiting what may constitute normal course of business. In lieu of respecting the actual usual and customary business practices, described at some length above, the Proposed Rule effectively serves to reject many common leasing structures by virtue of improperly imposing vague and subjective standards that appear to be both new and unique to aircraft.

  - For example, and as noted above, when an aircraft is leased to a commercial charter operator (i.e., a certificated air carrier) who operates the aircraft under Part 135 of the FARs it is common in the industry that the consideration paid by the lessee charter operator under the lease is defined as a portion (typically a substantial portion, up to 85% - 90%) of the charter revenues derived from the charter operator's commercial use of the aircraft. This consideration typically covers the lessor's fixed and some variable costs, and comprises a significant portion of a lessor's revenue with respect to the Aircraft. This type of lease structure readily meets satisfies the normal course of business standard, when the standard is judged by what is usual and customarily accepted in the industry (i.e., under the plain language of Proposed Rule §3.285(a)(8)described immediately above). In contrast, while the Rule purports to require aircraft leases to contain a fixed minimum monthly payment, §151.005 of the Code – the actual statute – merely requires a transfer of possession for consideration.

- **Proposed Rule §3.280(c)(3):** Use Tax imposed if an aircraft is "used" more than 50% in Texas; time in Texas calculation now purports to include time the aircraft spends on the ground; this proposed rule:

    - Directly conflicts with current rule §3.297(c)(3)(A), which states: "In determining whether an aircraft is used more than 50% outside this state, the comptroller will consider all flight time in this state, including the portion of interstate flights in Texas airspace";

    - Is inconsistent with Texas ad valorem tax law – which by statute looks solely at location of aircraft departures as a proxy for "use" in the state (*See Texas Property Tax Code §§21.05 and 21.055*);

    - On its face further fails to account for material reasons why an aircraft might involuntarily be on the ground (i.e., crew is grounded, unplanned maintenance, accidents / incidents, FAA grounding, acts of God, etc.);

    - Fails to recognize that aircraft owners do not in the normal course of business keep any record of an aircraft's time spent on the ground or the reasons why an aircraft may be on the ground at a particular location. Further, while non-commercial aircraft operators (i.e., aircraft operating under Part 91 of the FARs) generally do keep flight logs, this is not specifically required by the FARs. Accordingly, Proposed Rule §3.280(c)(3) may be fundamentally unenforceable against certain aircraft owners; and

    - Fails to acknowledge that, while Comptroller response letter (Oct. 28, 2014) to comments from the State Bar of Texas Tax Section in their letter dated August 15, 2014 on this issue declines to "create a unique rule for aircraft" with respect to "use", multiple portions of the code and rules do just that*; See, e.g.*, Proposed Rule §3.280(j)(4) vis-à-vis draft rule §3.285(a)(8), with respect to the definition of normal course of business.

- **Proposed Rule §3.280(j)(3):** Purports to define "Sole Purpose of Leasing;" however, this definition conflicts with federal tax law; the Code, and federal aviation law, all of which combine to create the actual normal course of business with respect to what constitutes a lease and the purpose of that leasing in this industry:

    - Purpose of resale exemption is to prevent double tax – *See Sharp v. Clearview Cable TV*, *960 S.W.2d 424, 427 (Tex. App. Austin 1998);*

        - Federal excise tax is paid on all commercial / 135 operations; application of the Rule for leases to FAR Part 135 operators potentially results in double tax;

    - Extra-statutory requirements imposed upon resale exemption - contrary to *Roark 422 S.W.3d at 637*:

- Amounts to an end-around attempt to define what constitutes a lease for Texas sales tax purposes, without regard to usual and customary business practices;

- Application of the extra-statutory requirements of the Proposed Rule would invalidate many other forms of lease structures and lease agreements that the general aviation industry and FAA have long recognized as valid leases that serve legitimate business purposes, without regard to profit motive;

    - For example, the Proposed Rule's requirement for a fixed monthly lease payment contradicts the charter revenue apportionment structure described in detail above, regarding aircraft leases to FAR Part 135 charter operators. In other words, the Proposed Rule would, *ab initio*, purport to invalidate a lease structure that has existed and has been accepted in the industry, and is a lease as a matter of law under the FAA's rules, for decades;

- Sale for resale of taxable items is exempt under § 151.302(a) of the Code;

- Sale for resale includes sale of tangible personal property to a purchaser for sole purpose of purchaser's leasing or renting in normal course of business under § 151.006(2) of the Code;

- Lease definition is straightforward; *See*, current rule §3.294(a)(2)

    - Typical agreements with commercial operators (i.e., FAR Part 135 certificate holders), meet the Comptroller's the definition of lease under §3.294, as do typical non-commercial dry lease agreements governing operations under FAR Part 91;

    - Plain language of Proposed Rule §3.280(j)(3) attempts to reject an aircraft lease where the lessor remains responsible for maintenance, storage, or insurance. This is contrary to normal and customary practices in many leases. For example, the Comptroller does not dispute validity of a Hertz car rental for resale purposes, even though Hertz reserves all maintenance responsibilities. This indicates that the Comptroller is attempting to create a different standard for the general aviation industry.

    - Comptroller's rejection of a lessor's responsibility to maintain, store, or insure an aircraft bears no rational relationship to what occurs in the normal course of business in the industry

    - Notably, Texas courts have stated, in rejecting a similarly-situated attempt by the Comptroller to such enact extra-statutory requirements, that "[r]equiring a complete divestiture of 'care and control' over [a

> lessor's] equipment would write the exemption out of the statute and is **not reflective of the realities of the marketplace**" (*Clearview Cable TV*, 960 S.W.2d at 428) [**emphasis added**].

- FAA Operational Control Requirements:
  - An aircraft operator's responsibility for operational control of aircraft supersedes any agreement, contract or arrangement. For example, these requirements take precedence over any reservations made by Lessor. The Comptroller's extra-statutory requirement in the Proposed Rule of exclusive possession during the entire lease term is not found in the Code or required by the FAA, so long as exclusive operational control is transferred during a lessee's actual use of an aircraft;
  - Reading Proposed Rule §3.280(j)(3) (i.e., exclusive transfer of possession and control for duration of lease term) together with proposed §3.280(j)(5) (i.e., presumed 1% per month lease rate presumption) purports to only recognize lease terms with fixed monthly rental payments. This conflicts with normal and customary business practices by failing to recognize alternative lease terms and structures that exist in the industry as described above.

- **Proposed Rule §3.280(j)(4)-** Normal Course of Business:
  - As discussed above, while the term "normal course of business" has not been previously defined by Code or Rules, there is most definitely a "normal course of business" within the aviation industry, and the definition the Comptroller seeks to impose applies too narrowly here. Reading all of the Proposed Rule together with the new normal course of business definition in §3.285(a)(8), and further based on recent Comptroller actions, it appears that the only "normal" course of business Comptroller will recognize with respect to aircraft leasing are bank and financing leases with a single exclusive lessee for a fixed multi-year term. This disregards other legitimate and normal course of business structures commonly used in the industry.
  - Extra-statutory requirements – contrary to *Roark*:
    - Fair market value is just one component of normal course of business analysis; For example, risk management and FAA regulatory compliance are legitimate business purposes that in some cases require a leasing structure in the normal course of business;
    - Existing statutes and rules contain no prohibition, special conditions, heightened scrutiny, or other unique treatment concerning leasing to related parties;
    - Requires that "lessor ***must show*** that a similar transaction would take place between unrelated entities." [***emphasis added***]. In practice, all four examples of

evidence provided in proposed §§(j)(4)(A)-(D) may easily be refuted; accordingly, this requirement is vague and subjective;

- Ignores separate corporate entity theory.

- **Proposed Rule §3.280(j)(5):** Establishes presumptive lease rate of 1% of an aircraft's purchase price per month; however:

  - 1% presumption is, in effect, an extra-statutory imposition of an economic substance test; economic substance is not a tax code requirement;

  - 1% is not representative of actual fair market value in the industry;

  - Fixed monthly rental payments, regardless of the amount of the lease rate, are generally not reflective of usual and customary industry practices except for the bank and finance leasing segment of the industry;

  - The Proposed Rules state an aircraft owner "may rebut" the 1% presumption with contemporaneous evidence that another rate is fair market value; however, the Comptroller has no obligation to consider or give any weight to such evidence. This is in contrast to the imbalanced standard set forth in proposed §3.280(j)(4) described above, where lessor "*must show*" evidence; and

  - The Proposed Rules effectively fail to recognize lease structures other than fixed term, exclusive leases with single lessees;

- **Proposed Rule §3.280(d)(4)(c):** Purports to define acceptable standards of evidence for a non-resident aircraft purchaser to qualify for the "fly-away exemption." Proposed Rule §3.280(d)(4)(c) illustrates the point that Comptroller does not fully understand important aspects of the industry, including important FAA regulations. Proposed Rule §3.280(d)(4)(c) states that "filing of a fixed term lease" with the FAA aircraft registration branch under FAR 91.23 "constitutes registration" for purposes of evidencing qualification for the fly-away exemption; however:

  - Submitting a lease to the FAA registry's technical branch for FAR 91.23 compliance is not a "registration" and such leases are not recorded with the FAA registry;

  - FAR 91.23 applies to other types of operating and use agreements that are not leases, including without limitation aircraft operating /use agreements put in place between an aircraft owner trustee and an underlying beneficial owner/operator of an aircraft under such a trust;

  - Whether a lease term is "fixed" is immaterial to whether FAR 91.23 applies; and

- FAR 91.23 only applies to "large aircraft" with a maximum gross takeoff weights of over 12,500lbs (as defined in the FAR), thus the pain language of Proposed §3.280(d)(4)(c) ignores an entire class of aircraft, i.e., those aircraft that are not "large aircraft" under the FAR.

Conclusion

While NBAA applauds the Comptroller for its efforts to develop this Proposed Rule, it unfortunately applies arbitrary, vague and subjective standards, rules and definitions to the general aviation industry. The many regulations applying to general aviation aircraft are complex and the Proposed Rule as drafted will significantly harm the industry as it applies extra-statutory requirements that are in direct conflict with how the industry operates in the normal course of business.

On behalf of NBAA's 1,112 member companies located in Texas, we formally request that the Comptroller not promulgate the Proposed Rule in any form until the general aviation industry has further opportunities to directly engage with the Comptroller's office in developing an effective rule that aids in tax administration while not harming a critical segment of the Texas economy. Finally, due to the significant concerns expressed by our members, NBAA is also evaluating filing a lawsuit challenging the validity of the Proposed Rule under the Texas Administrative Procedures Act.

Should you have any questions I may be reached at (202) 783-9451 or sobrien@nbaa.org. Thank you for your consideration.

Sincerely,

Scott O'Brien
Senior Manager, Finance and Tax Policy