

# **A Primer for the New Flight Department: The ABCs of Legal and Tax Planning**

By Joanne Barbera and Heidi Albers

Launching a company flight department should be a carefully planned, thoroughly researched process. To navigate the road leading to a successful and effective flight department, you first must know where the legal and tax potholes lie.

## **Scenario for Company ABC**

Dear Aviation Attorney:

I am the manager of Company ABC's new flight department. We are planning to acquire and operate an XYZ turbine aircraft. I expect that there are many legal and tax planning issues we should consider. Can you help?

Sincerely,  
Duly Diligent  
Flight Department Manager

## **Advice for Company ABC**

Dear Duly Diligent:

Thank you for your letter. We would be pleased to advise you and Company ABC on legal and tax planning issues. Here is a summary of typical company flight department issues to get us started.

### **1. FAA Issues**

The aircraft must be registered when it is purchased. Assuming that the aircraft will be registered in the United States, the new owner must meet the U.S. citizenship or alternate requirements for aircraft registration. If the company purchasing the aircraft is a limited liability company, the FAA Registry will require supporting citizenship and authority documents in addition to the aircraft bill of sale and the company's aircraft registration application. On March 1, 2006, a new international registry of interests in aircraft began operation. Assuming your new: 1) airframe is certificated to transport at least eight (8) persons (including crew) or goods in excess of 2,750 kilograms and/or 2) engines are jet propulsion engines having at least

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1,750 lbs. of thrust or are turbine/piston engines having at least 550 horsepower, then in order to protect its interest in its new airframe and/or engines, Company ABC must register as a Transactional User Entity (TUE) and register its interest in the airframe and/or engines with the international registry.

From an operating and maintenance standpoint, safety is the primary concern of the FAA. The company flight department is responsible for strict compliance with applicable operating and maintenance rules.

Most company flight departments operate their aircraft under the noncommercial operating rules of Part 91 of the Federal Aviation Regulations (FARs). FAR Part 91 does not allow operations in common carriage. Common carriage is defined as the holding out of a willingness to transport persons or property from place to place for compensation. FAR Part 91 also prohibits non-common carriage operations for compensation, with certain exceptions.

The exceptions most important for company flight operations are contained in FAR 91.501. This regulation applies to large and turbine-powered multiengine airplanes. "Large aircraft" means aircraft of more than 12,500 pounds maximum certified takeoff weight. U.S. registered small airplanes that are not turbine powered, multiengine airplanes and helicopters may operate under FAR 91.501 as well, using the NBAA Small Aircraft Exemption.

Under FAR 91.501, the following arrangements are typically used by company flight departments to provide limited transportation for compensation: 1) parent-subsidary; 2) time sharing; 3) interchange; and 4) joint ownership.

The parent-subsidary rule in FAR 91.501(b)(5) allows a company operator to charge for the carriage of officials, employees and guests of certain related companies the cost of owning, operating and maintaining the airplane, so long as the carriage is within the scope of and incidental to the business of that company. The aircraft, however, should not be operated by a "flight department company" set up solely to operate the aircraft for others.

FAR 91.501(b)(6) and (c)(1) permit time sharing, an arrangement whereby a person leases his airplane to another person and no charge is made except for those permitted under FAR 91.501(d). The permitted charges are basically two times the cost of fuel plus certain limited expenses.

FAR 91.501(b)(6) and (c)(2) permit interchange, where one person leases his aircraft to another person in exchange for equal time on that person's aircraft for a charge not to exceed the difference between the cost of owning, operating and maintaining the two aircraft.

FAR 91.501(b)(6) and (c)(3) permit joint owners, where one of the registered joint owners of an airplane employs and furnishes the flight crew for that airplane and each of the registered joint owners pays a share of the charge specified in the agreement.

In addition to the FAR Part 91.501 options, a Part 91 aircraft operator can "dry" lease an aircraft to another for compensation. A dry lease is a lease of the aircraft without crew.

Leases of large aircraft are generally subject to the Truth In Leasing requirements of FAR 91.23. This regulation would apply to the time sharing, interchange and dry lease arrangements described above.

Some flight departments desire to use their aircraft in commercial operations some or all of the time but do not desire to obtain and maintain their own commercial FAA operating certificates. An arrangement with an aircraft and charter certificate holder can accomplish these goals. The FAA has issued Notice 8000.347, which addresses such arrangements. Consult your aviation attorney to ensure compliance with all FAA safety and Department of Transportation (DOT) economic requirements.

## **2. Federal Transportation Excise Tax**

Section 4261 of the Internal Revenue Code imposes a 7.5 percent tax plus a per passenger segment fee on U.S. commercial air transportation and arrival and departure taxes for commercial international flights. Generally, any time an operator provides an aircraft with crew to and/or from the U.S., the transportation tax and/or fees may apply. Any flights that are taxable pursuant to Section 4261 are eligible for a partial refund of the fuel tax imposed under Section 4041 of the Internal Revenue Code. The fuel tax is paid at the pump whenever fuel is purchased. Operators of flights subject to the transportation tax may then seek a credit or refund for taxes paid on fuel.

The most important exemption from the federal transportation excise tax for company flight departments is the “affiliated group” exemption. Internal Revenue Code Section 4282 exempts from the tax transportation by air for other members of the aircraft operator’s affiliated group. An example of an affiliated group eligible for the exemption is a parent corporation that owns at least 80 percent of the stock in each of four subsidiary corporations, one of which owns an aircraft, employs pilots, and carries the employees of its parent and fellow subsidiaries for compensation. An organizational chart is helpful in determining how the exemption applies to a particular group of companies.

The transportation tax also does not apply to aircraft under 6,000 pounds MCTOW not operated on an established line.

The Internal Revenue Service (IRS) has decided that it is not bound to follow the FAA’s determination of what constitutes commercial air transportation. Therefore, even though most of the arrangements discussed above are noncommercial for FAA purposes, the federal transportation excise tax may apply. Specifically: the tax applies to parent-subsidary operations unless the affiliated group exemption applies; the tax generally applies to time sharing and interchange; and joint ownership operations are typically not subject to the tax. A dry lease is not subject to the tax. For the type of charter arrangement described above, the commercial customer’s flights are subject to the tax. The charter certificate holder typically takes care of collecting, reporting and remitting the tax to the IRS. Similarly, payments made for use of aircraft in a fractional ownership program are subject to the tax, which is typically collected, reported and remitted to the IRS by the fractional program manager.

### **3. Federal Income Tax Issues**

Federal income tax considerations are important in planning for and administering aircraft ownership and operations. In particular, business aircraft have the potential to give the relevant taxpayer substantial income tax deductions for depreciation and other expenses. Classification of the aircraft as property used in the trade or business, and characterization of the aircraft expenses as trade or business expenses, are important first steps. The aircraft tax depreciation schedule then depends on factors such as whether the aircraft is used for commercial or noncommercial operations, for primarily business or primarily personal purposes, and primarily within or primarily outside of the U.S. Aircraft maintenance must also be characterized to determine whether to capitalize or expense the costs involved. Entertainment use of business aircraft may limit deductibility of aircraft depreciation and related expenses. After determining the deductions possible, it is important to examine IRS limitations such as basis, at-risk, and passive activity loss limitations to determine the ability of the taxpayer to use the aircraft-related deductions. When the company is ready to replace its aircraft with another one, the like-kind exchange rules of Section 1031 of the Internal Revenue Code may provide important tax benefits. Company ABC should work closely with its income tax advisors to maximize its position with respect to possible deductions.

### **4. Personal and Entertainment Use of the Company Aircraft**

Personal use of company aircraft by employees, their spouses, family members and guests may result in taxable income to the employees. Under IRS income tax rules, if an employee does not reimburse the employer for the value of personal flights on board the company aircraft (as well as those involving a spouse, family member or guest), the value is imputed income to the employee. Beginning on October 22, 2004, entertainment use of company aircraft by officers, directors and more-than-10% shareholders also generally results in a partial disallowance of tax deductions relating to the aircraft.

As discussed above, however, the FARs governing noncommercial aircraft strictly limit the arrangements under which compensation may be accepted by the operator. Please note also that if Company ABC is a public company, personal use of the company aircraft may also have disclosure implications under the Securities and Exchange Commission rules.

Use of company aircraft by specified individuals (officers, directors and more than 10% owners) that is considered non-business entertainment use may also limit the company's aircraft related tax deductions. Again, you should consult with your company's tax and governance advisors regarding these issues.

### **5. Sales, Use and Property Tax and Aircraft Registration**

Most states tax the purchase of aircraft and fuel, aircraft leasing and the storage and use of aircraft. However, Montana, New Hampshire and Oregon have no sales or use tax. Massachusetts exempts aircraft from sales and use tax, and aircraft over 6,000 pounds certified takeoff weight are exempt from sales and use tax in Connecticut, and aircraft over 12,500 pounds certified takeoff weight are exempt from similar tax for sales in Delaware. Some states tax services such as aircraft modification, refurbishment and repair.

Some states impose personal property tax on aircraft. In addition, several states require their residents to register their aircraft and pay a fee based on factors such as value, weight, age and type of aircraft. Location of the aircraft and flight crew may also create nexus for the owner and/or operator for income, franchise and “doing business” taxes. Company ABC should determine where the aircraft will be purchased, used and stored and how it will be used for state and local tax planning purposes.

## **6. Pilot Qualifications and Employment**

The company flight department is generally responsible for locating and engaging pilots who meet the requirements to operate the aircraft for the flights involved under both the FAA regulations, applicable insurance policies and any applicable international rules. The company should also determine whether the pilots will be employees or independent contractors. The employment status of the pilots has important legal, tax, insurance and administrative implications.

## **7. Liability and Insurance**

The general rules of tort law apply to determine the liability of aircraft owners and operators. The standard of care is generally a negligence standard, but may vary from state to state and country to country. Aircraft owners and operators may be liable for injuries to persons and property arising out of aircraft operations if their conduct does not meet the appropriate standard of care.

Aircraft owners and operators must carefully assess their potential liability exposure and aviation insurance needs to plan for appropriate and adequate insurance coverage. Company ABC should work with an experienced aviation broker, identify all persons and operations for which coverage is desired, and pay close attention to any arrangements involving compensation for use of the aircraft.

We have provided the above information as an overview of possible issues and as a way to begin the planning discussion. We would also suggest the NBAA Management Guide as an excellent resource. We look forward to working on Company ABC’s issues with you.

Very truly yours,  
Aviation Attorneys

*Joanne Barbera is a partner in the Kansas City, Missouri, law firm of Cooling & Herbers, P.C., which practices extensively in aviation law. She holds a masters of law degree in taxation (L.L.M.) from the University of Missouri at Kansas City, is a 1993 graduate of the University of Michigan Law School and received her B.A. with honors from the University of Notre Dame. She is also a member of the NBAA Tax Committee. Heidi Albers is an associate with Cooling & Herbers, P.C. She is a 1999 graduate of the University of Missouri-Columbia Law School and received a dual degree in English and Business Administration, summa cum laude, from William Jewell College.*