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Leasing Structures & Associated Risks: The Looming Issue of “Illegal Charter”

Friday, May 3, 2019 11:30 AM to 12:30 PM

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MAY 02 2019 → MAY 03 2019 | MARINA DEL REY, CA

BUSINESS AVIATION TAXES SEMINAR

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Outline

- Pre-Flight Planning: Basic Concepts and Definitions
- Initiating the Flight: Staying on the Appropriate Side of the Regulatory Divide
- Safely Completing the Flight: What Happens When its Operated Incorrectly?
- Touch-Down, Parting Thoughts and Conclusion
- Questions

The Key Question Here:

- FAA: Is the flight a “commercial operation”?
- IRS: Is the flight an “air transportation service”?

Asked Another Way:

- FAA: “Is the **operator** of the aircraft carrying **persons** or **property** for compensation or **hire**?”
- IRS: “Is the party with possession, command and control of the airplane receiving remuneration for the flight?”

Breaking it Down – Key Definitions re the Key Question:

→ “**Operator**” and/or “**Operational Control**”

- “*Operate*, with respect to aircraft, means use, cause to use or authorize to use aircraft, for the purpose . . . of air navigation including the piloting of aircraft, with or without the right of legal control (as owner, lessee, or otherwise).”
- “*Operational control*, with respect to a flight, means the exercise of authority over initiating, conducting or terminating a flight.”
 - General Presumption: Registered Owner is the Operator
 - If You Want Another “Person” to be the Operator:
 - Lease or “Operating” Agreement
 - Over 12,500 MGTOW – Must Be Written and 14 C.F.R § 91.23 Applies
 - Very Important: No Such Thing as a “Disregarded Entity” in the FAA’s World

Breaking it Down – Key Definitions re the Key Question:

- “**Person**” – Basically Any Warm Body Other Than Required Crewmember
- “**Property**” – Basically Anything of Value Belonging to Somebody Other Than a Required Crewmember
- “**or hire**” – The Big Problem:
 - What most people think of as “commercial”
 - This is the “holding out” or “common carrier” concept – from the railroad days

Breaking it Down – Key Definitions re the Key Question:

- “**Compensation**” – The Bigger Problem:
 - This element makes the test much broader than commonly understood
 - **Any value** in **any amount** across **any boundaries** paid for the flight
 - Profit motive not required!
 - Can simply include the sharing of costs – more on that below!
 - Beware “**Flight Department Companies**”
 - From Commercial Operator Definition: “Where it is doubtful that an operation is for "compensation or hire", the test applied is whether the carriage by air is merely incidental to the person's other business or is, in itself, a major enterprise for profit.”

Breaking it Down – Key Definitions re the Key Question:

- The Other Key Definitions – *Leasing*:
 - A “lease” is a state-law concept – generally means the transfer of possession and use in exchange for some consideration
 - Once a state-law lease exists, FAA recognizes 2 types of leases:
 - Specifically Defined: “**Wet Lease**” – the lease of an aircraft plus any one crewmember
 - Not Specifically Defined: “**Dry Lease**” – generally a “mere” equipment lease (i.e., the lessee gets its own crewmembers – key: the pilots)

Breaking it Down – Key Definitions re the Key Question:

- Significance in the Difference?
 - FAA presumes the lessor has retained operational control under a wet lease, i.e., it is a commercial operator
 - Operational control is transferred to lessee under a dry lease – simply pushes the Key Question one rung down the ladder: Is the lessee then acting as a commercial operator?

Breaking it Down – Key Definitions re the Key Question:

- When is a “Dry Lease” Not Really a Dry Lease?
 - Aircraft “***without crewmember***” is the only specifically defined element, ***but***
 - FAA looks to other “***indicia of operational control***” – such as:
 - Who is maintaining the airplane?
 - Who is paying for what (such as insurance, hangar, etc.)?
 - Who is bearing the regulatory and civil liability?
 - Beware the “***Sham Dry Lease***”

Polling Question

A “dry” lease is a lease without:

- A. Fuel
- B. Pilots
- C. Food service

Polling Question

Answer B: Pilots

Run this Pre-Flight Checklist Every Time the Wheels are Going to Roll:

- Is it a commercial operation?**
 - Who is the Operator?
 - Carrying persons or property?
 - Is compensation occurring?

If an element is missing (e.g., no persons are being carried or no compensation is being received) – you “break the chain” and are not a “commercial operator”:

- May conduct flight under 14 C.F.R. Part 91
 - But what does that mean?!
 - No additional certification required
 - More flexibility (pilots duty days, weather, etc.)
 - Less cost?
- Will (probably) pay the non-commercial fuel tax

If *it is* a “commercial operation” – next question: Do any exemptions apply?

→ 14 C.F.R. § 91.321 – Carriage of Candidates

If *it is* a “commercial operation” – next question: Do any exemptions apply?

→ 14 C.F.R. § 91.501 – Key Business Use Exemptions (When Commercial Rules are not Required)

If *it is* a “commercial operation” – next question: Do any exemptions apply?

- 14 C.F.R. § 91.501 – Key Business Use Exemptions
 - **Demonstration Flights**
 - Capped compensation (see slide below on §91.501(d))
 - Written agreement not required
 - IRC § 4261 federal excise tax (FET) may apply

If *it is* a “commercial operation” – next question: Do any exemptions apply?

- 14 C.F.R. § 91.501 – Key Business Use Exemptions
 - **Affiliated Group Flights**
 - Pro rata compensation
 - Written agreement not required
 - Very narrow and tricky: Who is an affiliate? Beware **FDC's!**
 - FET may apply

If *it is* a “commercial operation” – next question: Do any exemptions apply?

- 14 C.F.R. § 91.501 – Key Business Use Exemptions
 - **Interchange Flights**
 - Pro rata compensation
 - Written agreement required
 - both parties must be companies
 - Very narrow and tricky: No “***True-Ups***”!
 - FET may apply

If *it is* a “commercial operation” – next question: Do any exemptions apply?

- 14 C.F.R. § 91.501 – Key Business Use Exemptions
 - **Joint Registered Ownership**
 - Pro rata compensation
 - Written agreement required
 - both parties must be companies – and **registered owners** (i.e., not simply co-owners of the registered owner)
 - FET may apply

If *it is* a “commercial operation” – next question: Do any exemptions apply?

- 14 C.F.R. § 91.501 – Key Business Use Exemptions
 - **Time Sharing Flights**
 - Capped compensation
 - Written agreement required
 - “Lessor” must be a company
 - FET may apply

Initiating the Flight: Staying on the Appropriate Side of the Regulatory Divide



If *it is* a “commercial operation” – next question: Do any exemptions apply?

- Time Sharing/ Demonstration Flight Compensation Cap - no charge can be made except for 91.501(d) expenses:
 - Fuel, oil, lubricants, and other additives
 - Travel expenses of the crew, including food, lodging, and ground transportation;
 - Hangar and tie-down costs away from the aircraft’s base of operation.
 - 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.
 - An additional charge equal to 100 percent of the expenses listed item 1 (fuel, oil, lubricants, and other additives)

Initiating the Flight: Staying on the Appropriate Side of the Regulatory Divide



What if an exemption does not apply?

- **Must** comply with applicable commercial rules – most likely 14 C.F.R. Part 135
 - What does that mean?!
 - Side note: Part 125 and DOT / Air Charter Rules
- Will most likely have to pay the Federal Excise Tax
 - See IRC § 4261
 - Generally 7.5% plus segment fees
 - Covered in more detail in other presentations

Polling Question

Charges under a Time Sharing Agreement are limited to actual aircraft expenses as determined by the operator. True or false?

Polling Question

False: Charges are limited to those described in § 91.501(d)

Safely Completing the Flight: What Happens When its Operated Incorrectly?



So, if you are complying with the right set of rules:

→ Go “fly safe” and have fun!

Safely Completing the Flight: What Happens When its Operated Incorrectly?



And if you are not complying with the right set of rules:

- Potential civil penalties – now potentially starting at over \$33K per violation
- Potential certificate actions – not good for pilots or air carrier certificate holders!
- Potential insurance implications – operations may be excluded from coverage
- Potential criminal actions – not good for anyone!

Safely Completing the Flight: What Happens When its Operated Incorrectly?



Three Current Common Issues – The FAA and IRS are Cracking Down!

- Inappropriate cost sharing – Examples:
 - iPhone/Android apps that allow for “flight sharing”
 - Faulty “aircraft dry leasing programs”
- Inappropriate use of commercial exemptions
 - Charging in excess of amounts permissible under § 91.501(d) for demonstration flight or time sharing flight
 - Passenger is led to believe it is a charter flight

Safely Completing the Flight: What Happens When its Operated Incorrectly?



What Does an Enforcement Action Look Like

- FAA enforcement powers are not unfettered; such powers are limited by statute, regulation, and its own policy guidance
 - Example: United States District Courts have exclusive jurisdiction if the sanction amount is more than \$400,000 (\$50,000 if the violation was committed by an individual or small business concern)
 - Cannot simply select the maximum sanction available- must consider the following:
 - the nature, circumstances, extent, and gravity of the violation;
 - with respect to the violator, the degree of culpability, any history of prior violations, the ability to pay, and any effect on the ability to continue doing business; and
 - other matters that justice requires

Safely Completing the Flight: What Happens When its Operated Incorrectly?



What Does an Enforcement Action Look Like

→ FAA's policy guidance is found in FAA Order 2150.3C:

→ *This order contains policies, procedures, and guidelines for the Federal Aviation Administration's compliance and enforcement program. The order also articulates the FAA's philosophy for using various remedies, including education, corrective action, informal action, remedial training, administrative action, and legal enforcement action, to address noncompliance with statutory and regulatory requirements enforced by the FAA. **It provides for the public a written statement of the Administrator's policy guidance for imposing sanctions for violations of such requirements.***

*The order is used at all levels by agency personnel who are engaged in the investigation, reporting, and processing of enforcement actions. **It applies to all offices with regulatory responsibilities***

Safely Completing the Flight: What Happens When its Operated Incorrectly?



What Does an Enforcement Action Look Like?

- Could start with a phone call or a ramp check
- Letter of Investigation (LOI) – notifies alleged violator and provides an opportunity to tell their “side of the story”
 - Generally only ten days to reply to an LOI
- The LOI will be placed in the Enforcement Investigative Report (EIR)
 - Under FAA Order 2150.3C, that Report is required to include all evidence, even if that evidence is not favorable to the FAA’s case
 - Anything you say can and will be used against you
- Civil Penalty Letter
- Press Release
- Complaint in United States District Court

Safely Completing the Flight: What Happens When its Operated Incorrectly?



What Does an Enforcement Action Look Like

→ Does Intent Matter?

→ As to the amount of the sanction, absolutely; the FAA is required to look at the following factors when determining sanctions (in addition to the limitations under US Statute):

→ *how safety was affected; **whether the violation was inadvertent and not deliberate**; the certificate holder's level of experience; attitude of the violator; degree of hazard; action taken by employer or other authority; the use of the certificate; violation history; decisional law; ability to absorb sanction; consistency of sanction; whether the violation was reported voluntarily; and corrective action.*

→ Bottom Line: These are not factors you want the FAA considering

Polling Question

What is the airspeed velocity of an unleaden European swallow?

1. 25 miles per hour
2. 50 miles per hour
3. I don't know that



**Safely Completing the Flight:
What Happens When its Operated Incorrectly?**



Polling Question

Answer: 25 miles per hour

So what is one to do to make sure you are staying on the right side of the regulations?

- **When setting up your ownership and operating structure – run the checklist!**
- **Every time you go fly – run the checklist!**
- **Every once in a while – run the checklist!**

“Aviation in itself is not inherently dangerous. But to an even greater degree than the sea, it is terribly unforgiving of any carelessness, incapacity or neglect.”

**Captain A.G. Lamplugh,
British Aviation Insurance Group,
London, circa 1930**

Questions?



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