A Practical Guide to Private Aircraft for Private Clients
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David P. DeYoe, McDermott Will & Emery LLP (ddeyoe@mwe.com)
Richard A. Lang, McDermott Will & Emery LLP (rlang@mwe.com)
Thomas P. Ward, McDermott Will & Emery LLP (tward@mwe.com)

Agenda

- FAA Considerations
  - Ownership and the FAA
  - Common FAA Problems
- Federal Income Tax Considerations
  - Imputed Income for Aircraft Use (Code Section 61)
  - Deduction Disallowance for Aircraft Use (Code Section 274)
  - Depreciation (Code Section 280F)
  - Bonus Depreciation (Code Section 168(k))
- Other Tax Considerations
  - State Sales and Use Tax
  - Federal Excise Tax
- Estate Planning Considerations
What to Buy

- Whole Aircraft
  - Need crew or management company
  - Tax benefits and tax costs
- Fractional share (NetJets, Flexjet, Flight Options)
  - Size of share determines availability of hours (50 to 800 hours possible based on 1/16th to 100% share)
  - Management provided by fractional program administrator
- Jet Card
  - Essentially a prepaid charter arrangement, available in increments of 25 hours (and perhaps less) – like a Starbucks card – but more expensive
  - All management provided by jet card company
  - No ownership interest or benefits

Ownership and the FAA

- FAA Regulations (14 CFR) require registration of aircraft and owner
  - Must be US citizen, resident alien, or foreign corporation qualified to transact business in the US, but aircraft must be primarily used in US
  - Partnership can qualify, but all partners must be individuals and US citizens
  - US corporations are US citizens if president and 2/3rds of board are US citizens and 75% of voting interests are owned or controlled by US citizens
  - Owner trust or voting trust can be used if owner would otherwise fail citizenship test
Ownership and the FAA (cntd)

- FAA Regulations create 2 sets of rules with respect to private aircraft
  1. Part 91 (14 CFR 91)
     - Strictly private operation – not charter and no reimbursement permitted (except in limited circumstances)
     - Airworthiness and operational rules are less strict than under charter rules
     - Philosophy of rule: less public interest in regulatory oversight when owner is flying himself and guests – owner’s self-interest sufficient incentive to fly in a safe manner
     - Generally, an owner would prefer to fly under the Part 91 rules

Ownership and the FAA (cntd)

2. Part 135 (14 CFR 135)
   - Charter operations
   - Much stricter rules and reporting requirements that limit duty time for crew members, mandate better weather equipment at airports
   - Must be certificated (up to 12 month long process) or added to another operator’s certificate
   - Full reimbursement permitted
   - Philosophy of rule: FAA needs to protect passenger from operators who may sacrifice safety for profits
Ownership and the FAA (cntd)

- Permitted reimbursement arrangements under Part 91
  1. Time Share (also known as a “wet lease”)
     - Owner leases aircraft – with crew – to another
     - Lessee can reimburse but only for amount up to the incidental costs of flight plus 2x the cost of the fuel
     - Owner remains in operational control of the aircraft and bears liability risk

Ownership and the FAA (cntd)

2. Interchange Agreement
   - Owner leases aircraft to another in exchange for equal time on the other person’s aircraft
   - No reimbursement – except charge can be made for difference in costs of owning, operating, and maintaining the two aircraft
   - Time each aircraft is used should be close – cannot pay to make up difference in hours used
Ownership and the FAA (cntd)

3. Joint Ownership Agreement
   - Each owner must be registered owner with FAA
   - One owner arranges for crew and management
   - Each owner pays share (usually based on usage) of cost of owning, operating, and maintaining

Ownership and the FAA (cntd)

4. Intra-corporate group
   - Intra-corporate exemption permits full reimbursement among limited group of affiliated companies
   - Applies to aircraft owner, its corporate parent, its first tier subsidiaries, and its brother/sister entities

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Parent Corp
   Owner Sub
   Sub
   Sub
   Sub
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Common FAA Problems

- Single Purpose Entities (a/k/a Flight department companies)
  - Common structure intended to provide limited liability - for example, special purpose limited liability company
  - To comply with Part 91, FAA requires that ownership be “incidental” to the business (other than ownership of the aircraft) of the owner – which special purpose entity does not have

Common FAA Problems (cntd)

- To FAA even periodic infusion of capital by the members or the sole member to cover the costs of owning and operating the aircraft will cause the special purpose entity to be in the business of providing air transportation for hire – and subject to the rules of Part 135
Common FAA Problems (cntd)

- Charging/Reimbursement for flights under part 91
  - Except for exemptions, no charging or reimbursement is permitted
  - Reimbursement in kind – “I'll pay for the hotel” – is a violation

Common FAA Problems (cntd)

- Consequences of violating FAA regulations
  - Fines (up to $11,000 per day per violation)
  - Grounding of aircraft or crew or both
  - Possible invalidation of insurance
  - Basis for a piercing of the corporate veil argument
Common FAA Problems (cntd)

- Solutions
  - Individual ownership – not single member LLC
  - Place ownership in management entity that has business purpose for owning aircraft
    - No hard assets at risk in the event of an accident
  - In both instances insurance is available to protect owner from liability

Imputed Income: Business Use of Aircraft

- No imputed income to employee for business flight
  - Must be ordinary and necessary expense under Code Section 162
  - Straight business costs not subject to entertainment disallowance under Code Section 274(a) – cf., business entertainment use
  - Business use does not generally include commuting from employee residence to employee’s principal place of business
Imputed Income: Personal Use of an Aircraft

- If flight is personal, then the value of aircraft use is imputed as gross income to the employee
- If an employee traveling on business is accompanied by a spouse, another family member or a guest, the value of that person’s flight is taxable to the employee
  - Exception if presence of spouse, other family member or guest was dictated by business reasons – scrutinized on audit
- 50% Seating Capacity Rule: If 50% or more of regular passenger aircraft seating capacity on a flight is used by individuals on business, no income imputation for accompanying spouse and dependent children traveling for personal purposes

Imputed Income: Personal and Business Use of an Aircraft

- If flight is part business and part personal, need to determine the primary purpose of the flight based on facts and circumstances. Relevant considerations may include:
  - Relative time spent on personal activities v. business activities
  - Agenda
  - Location
  - Characterization of trip by the company
  - Presence of spouse or personal guests
- Contemporaneous recordkeeping is critical
Imputed Income: Business Entertainment

- If primary activity is entertainment and expenses otherwise deductible under Code Section 162, need to consider entertainment disallowance rules under Code Section 274(a).
- Entertainment is determined on an objective basis – personal enjoyment is not relevant.
  - Is entertainment activity directly related to business – is “principal character” of mixed business and entertainment the active conduct of a trade or business (no imputed income) or the creation of goodwill (imputation generally required)?
  - Is entertainment activity associated with active conduct of trade or business?
    - Must generally occur directly preceding or following a “substantial and bona fide business discussion”

Imputed Income: Security Concerns

- If “bona fide business–oriented security concern” exists and employer requires employee travel on company plane for personal trips, then employer can exclude from employee’s gross income the excess value of the flight over the “safe harbor airfare”
- Covers spouse and dependents who travel with employee, but not if they travel apart from the employee unless the security concern applies separately to spouse and dependents.
- Employer must have a specific basis for concern and must establish:
  - Overall security program (24-hr); or
  - Independent security study
Imputed Income: Valuing Personal Flights

- Fair market value of a comparable charter flight, or
- Standard industry fare level (SIFL) rate
  - The value is determined by (1) the applicable SIFL rate and (2) the applicable aircraft multiple
  - SIFL rates are set every six months and depend on the distance flown
  - The aircraft multiple depends on the weight of the aircraft and whether or not the employee is a "control employee"
- Employer must consistently use same SIFL rate method for year. However, Notice 2005-45 and Prop. Treas. Reg. 1.61-21(g)(14)(iii) permit charter rate method for entertainment flights of all "specified individuals" and SIFL for everyone else
- If SIFL rules applied incorrectly, then charter rate method applies
- Forms: W-2, Form 1099 or Schedule K-1

Deduction Disallowance: Brief History

- Code Section 274(a) generally disallows entertainment expenses unless "directly related to" or "associated with" the active conduct of a trade or business
- Exception if recipient is imputed gross income (e.g., charter rate or SIFL rate)
- In *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 255 F.3d 495 (8th Cir. 2001), the Eighth Circuit held that a corporate taxpayer could deduct all expenses incurred in providing an aircraft to an employee for personal use if the employee included the value of the flight as wages
- Since income reported under the SIFL method is generally less than the cost of the flight to the company, this approach created a disparity ("SIFL Arbitrage")
Deduction Disallowance: Brief History

- As amended, entertainment expenses for flights of "specified individuals" are deductible only to the extent they are treated as income by the "specified individual".
- Subsequent guidance:
  - Notice 2005-45 issued on May 27, 2005
  - Proposed Treasury Regulations under Code Section 61 and 274 issued on June 15, 2007

Deduction Disallowance: Classifying Use of Aircraft

- Assume costs would otherwise satisfy Code 162.
- Four categories of employer-provided use:
  - Business Use
  - Business Entertainment Use
  - Personal Non-Entertainment Use
  - Personal Entertainment Use
- Lease for full and adequate consideration.
**Deduction Disallowance: Business Use**

- Not changed by 2004 JOBS Act
- Generally deductible by the employer
- No income imputation to employee

**Deduction Disallowance: Business Entertainment Use**

- Not changed by 2004 JOBS Act
- Business entertainment use is travel to engage in entertainment activity if entertainment activity is either
  - “directly related” to business; or
  - “associated with” business and occurs immediately preceding or following a substantial business discussion
- If satisfied, then employer can fully deduct and no income imputation for employee
**Personal Non-Entertainment Use**

- Continues to be treated in the same manner as personal corporate flights prior to the 2004 JOBS Act
- Distinguish personal non-entertainment from personal entertainment
  - Objective determination – what activities take place at destination
  - Examples of personal non-entertainment (medical care, attend funeral, charitable)
- Employer can fully deduct if income imputed to employee
- Employee must report income attributable to the value of the personal non-entertainment flight as well as the value of any flights provided to family members

**Personal Entertainment Use**

- Non-specified individual personal entertainment use treated in the same manner as prior to 2004 JOBS Act
  - Employee imputed gross income
  - Employer deduct all expenses for flight
- For "specified individual" personal entertainment use, deductions disallowed:
  - Except to extent the amount is treated as compensation to individual or to the extent that specified individual reimburses for flight – (but note FAA implications)
  - Applies to costs of leased or chartered aircraft as well
Specified Individuals

- Specified individuals are defined to include the following:
  - Officer, director or any direct or indirect beneficial owner of more than 10% of any class of equity of a corporation
  - Partner holding a greater than 10% equity interest in the partnership
  - A general partner, officer or managing partner of a partnership (covers the equivalent in a LLC taxed as a partnership)
  - Director or officer of a tax-exempt entity
- Applies to spouse or family member or another individual because of relationship to the specified individual
- Applies to use of an aircraft by a specified individual of a party related to the aircraft-owning entity (e.g. corporate subsidiaries)

Calculating Entertainment Use

- Historically costs allocated among flights in proportion to number of miles or hours based on primary purpose of the flight
- Notice 2005-45 and Proposed Treasury Regulations require a passenger-by-passenger allocation based on one of the following:
  - Occupied Seat Hours
  - Occupied Seat Miles
  - Flight-by-Flight Method
- Costs include operating and fixed costs (such as depreciation), but arguably do not include some costs, like corporate overhead or interest expense
- One method must be applied consistently for all usage during the taxable year
- Costs may be calculated separately for each individual aircraft or may aggregated across aircrafts with “similar cost profiles” (e.g., cannot aggregate turboprop aircraft with jet aircraft)
Leasing and Chartering

- No loss disallowance under Code Section 274(e)(8) if company leasing or chartering plane is receiving adequate and full consideration (i.e., arm's length rates and terms)
- Preamble to Proposed Treasury Regulations only discussed leases to unrelated party
- If aircraft leased to a related party, exception should still apply but one can expect greater IRS scrutiny

280F: Depreciation Deductions

- To claim depreciation the aircraft must be used primarily in the United States in a trade or business or for the production of income
- Aircraft are defined as “listed property” and subject to limitations on depreciation under Code Section 280F
- Aircraft which are used greater than 50% in a “qualified business use” may be depreciated under MACRS; if not, the aircraft must be depreciated under the alternative depreciation system (“ADS”)
  - Part 135 aircraft are depreciable under MACRS over a recovery period of seven years or under ADS over a recovery period of twelve years
  - Part 91 aircraft are depreciable under MACRS over a period of five years or under ADS over a period of six years
- If an aircraft which is depreciated under MACRS falls below the 50% qualified business use threshold, the aircraft must switch to the alternative system and any “excess depreciation” must be recaptured in income
280F: Business Use Requirement

- Special Treatment of Certain Usage
  - The following uses do not qualify as “business use” unless at least 25% of the total usage of the aircraft otherwise qualifies as business use
    - Leasing to a person who owns 5% or more of the company that owns the aircraft (or someone related to such person)
    - Use treated as compensation by such 5% owner or related person
    - Use treated as compensation for any other person unless an amount is included in the gross income of such person and there was withholding if required

Bonus Depreciation: 168(k)

- To be eligible for bonus depreciation, the aircraft must be:
  - Eligible for MACRS
    - Must be used 50% for business purpose
    - Must be used predominantly in the U.S.
  - “new”
- If eligible, 50% of the cost of the eligible property may be deducted in the year the property is acquired
- Remaining 50% of the cost or “basis” remains eligible for depreciation in future years
- Must be recaptured and taken into income if the qualified business use of an aircraft falls below 50% in a given year
State Sales and Use Taxes

- Sales Tax
  - Several states (some with aircraft manufacturing or servicing facilities) have no sales tax and delivery in one of those states will avoid sales tax (which can be a significant amount)

State Sales and Use Taxes (cntd)

- Use Tax
  - Applies when aircraft is brought into a state
  - Tax is usually the difference between state’s sales/use tax and the amount paid in sales tax to the state where the sale occurred
Sales and Use Taxes (cntd)

- Many states have become more aggressive and strategies to reduce tax are limited --- but alternatives still exist
  - acquire and then contribute the aircraft to another entity
  - Keep aircraft out of state for extended period
  - Use aircraft in commerce
- Dollars involved demand careful planning

Excise Taxes

- Code Sections 4261 and 4271 impose 7.5% excise tax on the amount paid for taxable transportation of persons and property
  - Taxable transportation begins and ends in US or in that area of Canada or Mexico that is within 225 miles of US
Excise Taxes

- What is an “amount paid” for taxable transportation?
  - Payments by an owner to a management company to oversee maintenance and operations = not taxable
  - Payments by joint owners to pay pro rata share of expenses = not taxable

Excise Taxes (cntd)

- In affiliated group (corporations connected by common ownership of 80% or more, measured by value and voting — not the same as FAA Part 91 intra-company exemption), if aircraft is not available for hire by non-members of the affiliated group = not taxable
- Lease payments under time share/"wet lease" = taxable
- Amounts paid by partner to partnership for use of aircraft = taxable
Excise Taxes (cntd)

- Amounts paid to equalize costs under interchange agreement = taxable
- Beginning January 1, 2008, amount paid by member/shareholder of disregarded entity, even if payments are for maintenance = taxable
- Hourly fee payments to fractional program manager (and, in view of IRS, management fees) = taxable

Estate Planning Considerations

- Little has been written on estate planning for aircraft. And there is nothing from the courts or IRS specifically addressing the estate and gift tax ramifications of the transfer of aircraft
- Aircraft are generally depreciating assets, expensive to use and maintain, so they are not commonly candidates for lifetime wealth transfer
- As assets worth millions or tens of millions, private aircraft can have a significant impact on the estate plan in a number of ways
Estate Planning Considerations

– Does your client want to leave the Global Express to the kids?

Estate Planning Considerations

– Or even to the spouse? Even the spouse’s needs may be different – for instance, if the client uses the aircraft for business, post-death it may be better to provide for the spouse’s air travel needs in some other manner than through the client’s current aircraft

– So the testamentary plan may be to direct the sale of the client’s aircraft, and provide elsewhere in the estate plan for funds for private air travel by the spouse and children
Estate Planning Considerations

- The valuation of aircraft for estate and gift tax purposes is governed by Reg. §20.2031-1(b). Like an automobile, an aircraft is valued at its retail price, rather than the price at which a dealer would purchase it.
- **Beware** – sale of plane to fund residuary marital gift may cause partial disqualification of marital deduction due to difference between retail valuation for estate tax purposes and **wholesale** proceeds for marital deduction funding purposes. Solution – fund in-kind and sell after funding.
- **Planning Possibility** -- In situation where the plane might otherwise be sold and estate plan otherwise calls for a large charitable contribution, consider in-kind or fractional formula allocation of plane to charity to avoid estate tax on “mismatch” between retail valuation and wholesale proceeds.

Estate Planning Considerations

- If the plan is to leave the aircraft in a transfer subject to estate tax, then consider the mechanics under the estate plan for making that transfer.
  - Think about a typical tangible personal property clause – if it’s a catch-all – it might sweep up the aircraft and leave it with mom’s china in equal shares to the kids. Like what reputedly happened in the Jackie O. estate – that might wreck havoc on the intended estate plan because the estate taxes on the aircraft charged to the residue might diminish the residuary bequests.
Estate Planning Considerations

- Consider alternatively what might occur if the plane is held in or under a business entity. What if client’s death triggers a buy-sell? The plane may be sold unintentionally along with the business interest
  - If your client owns an interest in a private plane -- add to your planning checklist –
    - Does it make sense to pass this particular aircraft on the client’s beneficiaries at death?
    - Is the plane “accessible” for transfer or is it buried under entities bundled with other assets?
    - And what are the estate tax considerations to passing along that interest?
    - Should the client consider asset protection planning because of increased exposure attributable to aircraft ownership?

Estate Planning Considerations

- Some post-death scenarios for private aircraft ownership
  - Aircraft as part of an ongoing business probably involves the fewest issues because
    - The transfer is imbedded in the general business succession
    - No re-registration required
    - Aircraft one of many assets to be valued in valuing the business for estate tax purposes
Estate Planning Considerations

- Aircraft for personal travel – Mom and Dad’s plane to be used by the kids – same dilemma as the vacation home – who owns it and how are expenses shared?
  - Potentially easier to share a fractional interest program interest than an entire aircraft. (And may be a better solution to switch to fractional – two sibling families can’t fly one plane to different locations at the same time!)
  - Coming up with a formula for sharing fixed and variable costs

- Ownership options
  - Endowed trust – exclusively designed to hold and fund family private aircraft travel – doesn’t have the same feel as family compound trust but perhaps a fit for some families
  - Family “pot trust” for multiple family lines
  - Co-ownership by family line trusts
  - Co-owned by individuals
Estate Planning Considerations

- Ownership structure
  - Own directly – easier to comply with FAA regulations to fly part 91 but arguably greater liability exposure for owner’s other assets
  - Own through a special purpose entity – better liability protection (?) but may disqualify for part 91 travel
  - Federal excise tax may apply where indirect ownership

Estate Planning Considerations

- Other important structuring considerations
  - Ownership structure should be influenced by where the money in the family is – private aircraft is a consumption – e.g. where possible use personal assets potentially subject to estate tax rather than GST exempt trusts
  - Be aware of arcane FAA registration qualification rules. So called “owner” trust may be best bet for trust ownership in order to avoid need to file underlying trust with FAA. “Owner trust” is similar to an Illinois “land trust”
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