POTENTIAL ADVERSE TAX CONSEQUENCES OF THE TRADITIONAL AIRCRAFT LEASEBACK

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A U.S. Tax Court case, Kelly v. Commissioner, T.C. Memo 2000-32, 79 TCM 1427, published earlier this year, may have adverse tax consequences for aircraft operated in a leaseback under FAR Part 91 or FAR Part 135. Prior to analyzing the Kelly case, a few background comments are in order.

BACKGROUND

Many current lease agreements used by FBOs and charter operators throughout the United States contain terms and conditions that may result in the leaseback being treated as a passive activity for the aircraft owner in the event of an IRS audit.

If a short-term rental/charter activity is ultimately deemed to be a passive activity, then all of the deductions for depreciation and operating and non-operating expenses, in excess of the charter income, would only be available to offset passive income from other sources or be carried forward as a suspended loss until the aircraft was sold. At that time, the aircraft deductions would become available to offset non-passive income such as salary, interest or most dividends.

Code section 469, Passive Activity Losses and Credits Limited, and the regulations thereunder, apply to all non-corporate taxpayers, personal service corporations, closely held "C" corporations and subchapter "S" corporations. This code section was enacted as part of the Tax Reform Act of 1986.

DEFINITION AND APPLICATION OF THE RULE

The general definition of a passive activity includes any rental activity or any active trade or business in which the taxpayer does not materially participate. Material participation requires much more than a general managerial oversight in the "operations" of the aircraft. The regulations require a regular, continuous and substantial involvement in the day-to-day operations of the activity.

Most traditional leaseback agreements provide little opportunity for the aircraft owner to participate in any meaningful way in the day-to-day operations of the charter business. Furthermore, the payment of a monthly "management fee," by definition, indicates that a full time manager may be on site to handle the day-to-day business operations. Full service management agreements have proven to be a major hurdle that some taxpayers, under audit, have been unable to overcome. Those taxpayers have had their tax deductions suspended until the aircraft was sold.

U.S. TAX COURT DECISIONS

The U.S. Tax Court has rendered several opinions since 1986 that have classified many taxpayer business endeavors as passive activities.

In Frank v. Commissioner, T.C. Memo 1996-177, the Court ruled that Mr. Frank's business of renting his aircraft to student pilots through two different flight schools, GAPA and SAFT, was a passive activity because the Court viewed the aircraft activity as a rental activity and, therefore, a passive activity. In this case, the U.S. Tax Court did not even bother to take the time or expend the effort to analyze the numerous regulations under Code section 469 that provide exceptions to the rental activity rule. For example: when tangible personal property is rented under circumstances where the average rental period is seven days or less, the activity is **not** a rental activity. Regs. section 1.469-1T(e)(3)(ii)(A). In all fairness to the Court, Mr. Frank was a tax protester and was also challenging the constitutionality of the U.S. Tax laws. He had no professional representation before the Court. He was his own attorney. Usually the Court spends little of its resources on tax protesters.

The Court's opinion stated, "petitioners leased the plane to GAPA and SAFT. GAPA and SAFT rented the plane to customers who were learning to fly. The airplane was held by GAPA and SAFT for use by customers. The amounts to be paid to petitioners by GAPA and SAFT were for the use of the airplane. Services were not the dominant element of the relationship. This is a rental activity for purposes of section 469. Rental activity is passive whether or not the taxpayer materially participates in it. Section 469(c)(4)".

As you can see from the quote in the Frank case, the Court was not interested in thoroughly analyzing any exceptions to the general rule which might have benefited this tax protester.

The Kelly case on the other hand, involved an individual who was an equipment operator and mechanic for a lumber company. Mr. Kelly owned six aircraft that were rented to pilots through various flight schools in Eugene, Oregon. The Internal Revenue Service agreed that Mr. Kelly spent "at least 500 hours each year in conjunction with the activity." Here, there was no argument that Mr. Kelly did not materially participate in the activity. In fact he participated more than what was required under the regulations. Mr. Kelly's problem was that the Internal Revenue Service viewed his lease with the FBO, Friendly Air, as a long-term lease. Friendly Air, in effect, was considered as the one and only customer. Under this line of logic, long-term leases are considered to be rental activities. "A rental activity is passive whether or not the taxpayer materially participates." IRC section 469(a)(4).

Mr. Kelly also acted as his own attorney. Obviously, he should not have used a traditional lease agreement. Furthermore, it is apparent that his agreement did not define who was a customer and who was not a customer. This oversight left an opportunity for the IRS and the U.S. Tax Court to draw their own conclusions on this pivotal issue. The case opinion stated, "The lessee is Friendly Air, and the leases were on a yearly basis. Even if the petitioner satisfied the other requirements, the exceptions, (pertaining to the average length of rental period etc.), in the regulations would not apply."

PLANNING OPPORTUNITIES

At this point, the industry has two U.S. Tax Court memorandum opinions to be concerned about. Taken as a whole, both cases say to me, if you want to stand a chance of having your aircraft activity classified as a non passive activity:

1. Don't use a long-term standard leaseback agreement. For FAR Part 135 operations, consider using an operational control agreement that would also satisfy the Federal Aviation Administration.
2. Don't use terms such as lessee/lessor. Consider using terms such as owner/operator.
3. For FAR Part 91, consider using an agency or a marketing agreement.
4. Don't use management agreements for FAR Part 135 or FAR Part 91 unless you are sure you want passive treatment. Administrative services maintenance and pilot services agreements should be considered as an alternative.
5. Leave room in your agreements for meaningful owner participation.
6. Identify who is a customer or user of the aircraft. If you don't the IRS or Tax Court may make that determination for you.

7. Don't use a minimum hours per month guarantee. Under prior audits, that condition has helped the IRS build their case that the FBO is the ultimate user of the aircraft because the owner would be in a position to receive income regardless of whether the aircraft flew or not.
8. Usage periods should be stipulated to be 7 days or less. If the FBO or any customer violates that condition, there should be a penalty provision.
9. The FBO/charter operator should provide a letter to the aircraft owner to the effect that they are only interested in the aircraft as long as the aircraft/owner provides services along with the aircraft. Without this, the Frank case could be problematic.
10. Be sure to maintain copious records of material participation time and efforts spent in the activity. Without this substantiation, you will not be in a position to prove the requisite amount of material participation.
11. If you receive an audit notice from any local, state or federal taxing authority, use some common sense and call your tax advisor. Only experienced tax litigators belong in tax court.

PERSPECTIVE

While these two U.S. Tax Court memorandum decisions do not have the force and effect of U.S. Appellate Court or a U.S. Supreme Court decision, they should not be ignored. In view of the unfavorable results for Messrs. Frank and Kelly, these cases do not need to bring about an end to short-term aircraft rental/charter operations for those taxpayers who abide by the regulations and are willing to document their efforts. At the same time, this industry cannot continue to do business as usual by continuing to use essentially the same form of contracts that have been with us since the days of the Wright brothers.

Astute charter operators and flight school owners should consider developing two separate programs each bundled with its own distinctive level of services. One program should be set up for those owners who desire a passive activity treatment. Another program could be established for aircraft owners who can genuinely offer value added services in conjunction with their aircraft, participate in a documented, meaningful way and could demonstrate a regular, continuous and substantial involvement in all phases of the aircraft operation.

As I have advised some aircraft manufacturers over the past few years, short-term aircraft rentals/charters are not for everyone. The primary candidate is the business professional or business entity who uses the aircraft in their trade or business and wants to generate some income to help offset operating or non-operating expenses while they are not using the aircraft for their own business pursuits. Some individuals who are full time, non-owner employees, will have a more difficult time with the current passive activity regulations.

The above list of items is by no means all inclusive nor is a guarantee of any particular tax result. I am only providing it as an indication of the kinds of issues that may be used as a starting point from which to develop a credible, defensive position in the event of a regulatory challenge. There is certainly a lot more work that could be done by aircraft manufacturers, owners, charter operators and other interested parties in the way of fostering cooperation between the FAA, IRS, congress and industry organizations such as NATA, NBAA and AOPA. Additional extensive tax research, expanded case analysis, different types of agreements and documentation procedures could be developed that would strengthen any particular technical position.

I feel that if these efforts are not undertaken in the near future, on an industry-wide basis, then we could see the day when we will have a negative Appellate Court case or even a U.S. Supreme Court case.

This industry possesses all the resources necessary to arrive at a workable solution for all concerned, or it can engineer its own demise by merely doing nothing and failing to stay current with a different set of regulations.