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Business Aircraft Liabilities In Mergers, Acquisitions And Reorganizations

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Many large corporations own private aircraft for business purposes and to provide senior executives with efficient, fast, safe and secure transportation. However, aircraft-related liabilities can affect both the seller and acquirer during the acquisition, sale, merger or reorganization of a business enterprise in many areas, including civil aviation, federal income and excise taxes, state sales, use and personal property taxes, and general contracting with third parties, such as aircraft management companies and charter operators. Accordingly, some important questions need to be asked during corporate transactions that involve aircraft.

How is the Company's aircraft owned and operated?

The Company's aircraft is likely owned and operated in a separate entity, ostensibly to minimize liability exposure from aircraft operations. This special purpose "flight department" entity generally has no assets other than the aircraft and no purpose other than

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operating the aircraft through cost-sharing arrangements with the parent company and affiliates so as to cover operating and finance costs. This structure (called an "illegal flight department company") violates FAA rules and can actually increase the risk of insurance claim denial and corporate veil-piercing.

Is the acquirer a U.S. citizen?

If the acquirer is a foreign person or entity and the aircraft was registered in the U.S., the foreign acquirer may not be able to maintain the U.S. registration due to unique FAA and Department of Transportation citizenship requirements. In such circumstances, there are options available such as transferring legal ownership of the aircraft to a trust that qualifies as a U.S. citizen.

Did the Company allow any non-business use of the aircraft?

Generally, the Company can deduct all ordinary and necessary business expenses paid or incurred during a tax year relating to its aircraft. This can include aircraft operating costs such as fuel, crew salaries, hangar fees, maintenance, management fees, insurance and depreciation claimed on the Company's tax return. The acquirer should determine whether the Company's officers, directors or owners were allowed to use the aircraft for non-business, entertainment purposes because tax deduction disallowance rules can create liabilities for the acquirer upon an IRS audit of the Company. The Company can also lose tax deductions if it fails to maintain detailed records on the aircraft's use.

Is the aircraft being depreciated?

While the answer to this question is almost certainly "yes," the Company's acquirer should be aware of its potential liability for income taxes on depreciation "recapture" if it acquires the aircraft as part of the overall transaction. In a reorganization, depreciation recapture is normally not triggered; however, the acquirer (through its subsequent ownership of the Company) could have a tax liability for depreciation recapture on the future disposition of the aircraft unless such disposition qualifies for an exception from depreciation recapture or is structured as an IRC § 1031 tax-deferred like-kind exchange.

Does the Company own the aircraft with title free and clear of all liens?

Liens are generally filed with the FAA Aircraft Registration Branch in Okla-

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homa City, Oklahoma, but aircraft liens can be filed in several other places, including the International Aircraft Registry in Ireland (pursuant to the Cape Town Treaty Implementation Act of 2004). Federal tax liens are governed solely by the Internal Revenue Code, therefore a valid notice of federal tax lien can be filed against the Company with the circuit court clerk in the county where the aircraft is located, even without filing such notice with the FAA. UCC-1 Financing Statements can also be filed on the Company's aircraft with the secretary of state and/or the county clerk's office(s) where the Company or aircraft is located.

Is the Company collecting and/or paying all required federal excise taxes?

Common mistakes with business aircraft ownership and use can unexpectedly trigger federal excise taxes, such as chargebacks between affiliated entities within a corporate structure, and capital contributions or loans to the entity within the Company that operates the aircraft. Normally, the Company is not even aware of this potential liability, so acquirers need to explore the Company's history of aircraft operations and the funding sources for flight activity.

Aircraft operators providing "taxable transportation" are required to collect a federal excise tax (FET) of 7.5 percent of the amounts paid for such services, plus a flat rate per each domestic flight segment. FET applies to private aircraft transportation services if the Company is in "possession, command and control" of the aircraft. If the same entity owns the aircraft, controls the aircraft's pilots, pays aircraft operating expenses, and maintains liability and hull risk insurance for the aircraft, then FET liability can exist and apply to the funding sources for the aircraft's operation if the aircraft is used for persons or entities other than the aircraft owning entity and no exemption, such as the "affiliated group" exemption, applies. The responsible persons for both the Company and its acquirer can become personally liable for uncollected FET through the "trust fund recovery penalties" law regardless of the limited liability protection normally associated with business entities.

Did the Company pay state sales tax on the purchase of the aircraft or state use

tax?

Most states impose a sales tax of between 2 percent and 10 percent on the purchase price (or value) of an aircraft when it is purchased. The sales tax applies in the state where the aircraft is delivered. Some states, such as Oregon, do not impose a sales tax and other states, such as South Carolina, have very low sales taxes (i.e., \$300). It is not uncommon to have an aircraft delivered in one of these states and then operated in another, with the aircraft owner assuming that its state sales tax obligations have been satisfied. If sales tax was not paid on the aircraft's purchase, a state may impose a "use tax" on the use, storage, or consumption of an aircraft acquired outside the state and subsequently brought into the state.

Are personal property taxes on the aircraft owed annually and have they been paid?

Aircraft are treated as tangible personal property. Depending upon where the aircraft is hangared, there can be annual state, county or local personal property taxes imposed upon the Company based upon the value of the aircraft.

Does the Company have a management company for the aircraft?

Aircraft operations may be managed by the Company or through a management company. A management company oversees all aircraft activity, including pilot services, fuel and lubricants, maintenance, inspections, repairs, insurance, storage, flight planning, catering, ground transport and vendors. If the Company has a management agreement with the management company, this contract needs to be carefully reviewed since the rights and obligations under management agreements can vary greatly, including with regard to the Company's indemnification obligations to the management company and management company fees.

Does the Company have an aircraft lease agreement with a charter operator?

Since business aircraft are expensive, the Company may put the aircraft into charter service to defray costs during the times when the aircraft would otherwise sit idle, but the charter must be operated by an FAR Part 135 certificated charter

operator. Putting an aircraft into charter requires that the aircraft meet certain technical requirements, operational restrictions, and have a lease agreement with the charter operator. The lease agreement should clearly show that the charter operator has "operational control" over the aircraft on all chartered flights, otherwise the Company is at risk for having an illegal flight department under the Federal Aviation Regulations.

Does the Company own a fractional interest in the aircraft or co-own the aircraft with other parties?

If the Company co-owns the aircraft, or owns a fractional interest in an aircraft operated by a fractional jet ownership program, the agreements controlling and affecting those relationships need to be reviewed since the Company may not be able to have a change in ownership or transfer the aircraft without such other parties' consent. In a fractional program, the program's operator may also be entitled to receive a fee for its consent. There can also be rights of first refusal that allow the fractional program operator or other co-owners to buy back the aircraft from the Company, often at a discount.

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Conclusion

As part of proper due diligence, it is essential to identify, evaluate and address the potential liabilities that can arise in corporate transactions that involve aircraft. This vigilance will help ensure that the transaction proceeds as intended and without incurring unexpected liabilities.