acquisition vehicle that raises pools of cash from public investors through an IPO in order to seek acquisition candidates within a specified time frame, usually two years. In 2007, SPACs represented almost a quarter of all IPO activity, and the popularity of SPACs is continuing in the first quarter of 2008. Whereas early SPAC offerings generally targeted capital raises of $100 million or less, in recent months SPACs have gotten significantly larger, with the first billion-dollar SPAC now successfully raised and the NYSE recently announcing that it will allow SPAC listings. With more than $15 billion of SPAC capital now in search of M&A deals, we can expect a surge of M&A activity in this segment. The recently announced decision by long-established hedge fund manager Halcyon to go public via a SPAC acquisition may be a good example of significant deals to come.

Private companies, including portfolio companies of private equity firms, seeking to access the public markets may benefit from a SPAC reverse acquisition, in large part because the structure is an efficient way to raise capital without the time, expense and risk of doing a traditional IPO in an uncertain market. As the number of SPACs looking to do acquisitions increases, targets may also obtain negotiation leverage, especially when dealing with a SPAC nearing its liquidation deadline. As compared to a strategic deal or a reverse merger with an existing company, a SPAC deal may offer the further advantage of merging into a pristine shell company with no operations. Because SPAC sponsors generally have expertise both in private equity and in the industries in which the target operates, the parties have maximum flexibility to make use of sponsor management skills as much or as little as they want.

But SPAC deals also pose some unique deal risks and challenges. Unlike most public company acquirors, SPACs typically require that any acquisition be submitted to a shareholder vote, thus adding a measure of deal consummation risk that may not exist with other structures. Furthermore, SPACs usually provide shareholders who oppose a deal with an easy exit mechanism that permits conversion of shares into a pro rata portion of the cash pool held by the SPAC, which can significantly reduce the cash available for acquisition at closing. If more than a fixed percentage of IPO shares (typically between 20% and 40%) exercise these rights, the acquisition is terminated. Other issues that need to be addressed include questions of recourse and expense reimbursement in the event of a breach or shareholder turndown.

As a cross between an IPO and a reverse merger, the SPAC structure presents meaningful opportunities to companies looking to access the public markets. As the SPAC market continues to evolve, so will the deal technology needed to get such deals done.

# *Aircraft Due Diligence in Mergers, Acquisitions and Reorganizations*: Protecting Against Contingent and Unknown Liabilities

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Many large corporations own private aircraft to provide senior executives with efficient, fast, safe and secure transportation. A business aircraft can cost anywhere from $5 million to $65 million with annual operating expenses equal to 10% of the aircraft's purchase price. Corporations expect that a business aircraft will increase company leaders' productivity and create sufficient additional business opportunities so as to justify and offset the costs of owning and operating a private jet.

The ownership and operation (these are separate events) of a business aircraft comes in a variety of forms. The aircraft can be owned by the operating company, a holding company, subsidiary or an affiliate (collectively for this article, "Company"). Likewise, the aircraft can be directly operated by the Company for the benefit of other entities within the corporate structure, or the aircraft can be leased to a charter operator, which in turn charters the aircraft back to the Company as needed.

Accordingly, the use and ownership of a business aircraft involves a shifting number of legal issues in the areas of: (1) civil aviation, (2) federal income tax, (3) federal excise tax, (4) state sales, use and personal property taxes, and (5) contractual rights and obligations with third parties, such as aircraft management companies and charter operators.

As part of the acquisition, sale, merger or reorganization of a business enterprise, M&A lawyers need to consider the Company's current and past private aircraft activity in order to protect against contingent and unknown liabilities that can accrue from the ownership and use of the aircraft. These liabilities can affect both the seller and the acquirer, depending on the form of the corporate transaction and whether or not the aircraft is transferred as part of the deal. Potential aircraft liabilities can be identified through the Due Diligence Request. This article provides suggested due diligence questions intended to alert transacting parties to potential aircraft related issues.

## Threshold Due Diligence Questions

*Does the Company own, lease or use an aircraft or fractional interest in an aircraft? Has the Company ever owned, leased or used an aircraft or fractional interest in an aircraft?* Since some aircraft related liabilities can follow the acquired business, whether or not the aircraft conveys, acquirers need to be concerned about assuming contingent and unknown liabilities of the acquired Company. Business aircraft operations are often erroneously structured, and so if there is an IRS audit, the Company can be liable for federal excise taxes on "air transportation services," plus penalties and interest, even though the Company was unaware that it was providing such services.[1] If the Company was not filing federal excise tax returns (IRS Form 720), the statute of limitations on this tax liability never expires. In the event of an IRS audit after the Company is acquired, such unpaid federal excise taxes may become the acquirer's responsibility, even if the Company's acquirer does not obtain the aircraft.

A seller should also be concerned about contingent and unknown aircraft liabilities if the seller is subject to indemnification provisions in the transaction agreement. The seller needs to carefully review the indemnification provisions and consider the implications of any indemnification provisions in the transaction agreement on the seller in light of its pre-closing aircraft ownership and operations. The seller should conduct internal due diligence in making this assessment, whether or not the aircraft is being transferred to the acquirer, to confirm continued legal and regulatory compliance.

## Civil Aviation Due Diligence

*How is the Company's aircraft owned and operated?* The Company's aircraft may be owned and operated in a separate limited liability company, ostensibly to minimize the Company's liability exposure from aircraft operations. This special purpose "flight department" entity would have no assets other than the aircraft and no purpose other than operating the aircraft for the Company. The parent company and affiliates of this "flight department" entity may have cost sharing arrangements in place to pay the aircraft owning entity amounts sufficient 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.

Most business aircraft are regulated under FAR Part 91, which applies to aircraft that are operated by and for the aircraft's owner with its own flight crew. Part 91 aircraft operations must be "incidental to and within the scope of" some business other than transportation by air, but a "flight department" subsidiary has no other business activity.[2] FAA Chief Counsel interpretations state that a company without business other than a flight department may not fly under Part 91, but must instead obtain an FAA operating certificate and comply with FAR Part 135.[3]

*Has the aircraft owning entity accepted cost reimbursements from affiliates, employees or clients using the aircraft?* Assuming the above requirement is met, FAA rules permit a subsidiary to fly passengers from its parent company or other parent company subsidiaries under FAR Part 91. However, except for the parent-subsidiary dynamic,[4] if any "compensation" is received by the aircraft's operator, the FAA can claim that FAR Part 91 does not apply and that the aircraft owning entity needed an FAA operating certificate for FAR Part 135 commercial flight operations, thereby subjecting the Company to fines of up to $11,000 per violation (with the pilots losing their licenses). The FAA takes the position that anything of value can represent "compensation," including operating expense reimbursements, accounting chargebacks between affiliated entities, furthering the economic interests of the affiliate, any provable quid pro quo, or a tax deduction for the affiliate's flight.[5]

*Is the acquirer a U.S. citizen?* While not strictly a due diligence question, 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 complex U.S. citizenship requirements that are unique to the FAA and Department of Transportation (DOT).[6] In such circumstances, there are other options available, such as transferring legal ownership of the aircraft to a trust that qualifies as a U.S. citizen.

## Federal Income Tax Due Diligence

*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.[7] 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. This basic rule is subject to a number of limitations generally beyond the scope of this article (*e.g.*, "for profit" requirements, passive loss, hobby loss and at-risk rules). However, the acquirer should determine whether the Company's officers, directors or owners were allowed to use the aircraft for non-business purposes. Complex deduction disallowance rules exist under the Internal Revenue Code of 1986, as amended (Code) that, upon an audit of the Company, can create liabilities for the acquirer.[8]

No tax deduction is allowed for an activity generally considered to be "entertainment."[9] If a company allows its officers, directors and more-than-10% owners to use the Company's aircraft for entertainment purposes, the Company could lose substantial tax deductions. The IRS considers "entertainment" use of business aircraft to be any activity that is generally and objectively treated as entertainment, amusement or recreation.[10] When aircraft use is "entertainment," the company loses its ability to deduct (by disallowance) some aircraft ownership and use costs. The IRS has promulgated new Tax Regulations to address these issues.[11] The Company can also lose tax deductions if it fails to maintain detailed records on the aircraft's use.[12]

*Has the aircraft been depreciated?* While the answer to this question is almost certainly "yes," the acquirer of the Company should be aware of its potential liability for income taxes on depreciation "recapture" if it acquires the aircraft as part of the overall transaction.

Most business aircraft are depreciated for federal income tax purposes over five years and there may also be additional "bonus" depreciation.[13] Essentially, these depreciation rules allow the Company to deduct the purchase price of its aircraft for tax purposes. However, on the sale of an aircraft, the depreciation deduction generally needs to be "recaptured" at ordinary income tax rates.[14] In a reorganization, depreciation recapture is normally not triggered (except to the extent that gain is otherwise recognized on the transfer of the property).[15] Therefore, when an acquirer obtains the Company, depreciation recapture may not occur. 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 a 1031 tax deferred like-kind exchange.

*Did the Company acquire the aircraft in a 1031 tax deferred like-kind exchange?* If the Company's current aircraft was obtained pursuant to a Section 1031 tax deferred like-kind exchange in which the Company disposed of a prior aircraft, an acquirer of the Company needs to make sure that the 1031 exchange was done correctly. Under Section 1031, business and investment property may be exchanged tax-free for other like-kind business and investment property. A like-kind exchange would defer the tax on the gain from the sale of the old aircraft until the new aircraft is sold.

In a recent report, the Treasury Inspector General for Tax Administration found there to be little IRS oversight of the capital gains (or losses) deferred through like-kind exchanges and suggested that the IRS increase oversight to ensure compliance.[16] It is anticipated that the IRS will increase audits of 1031 exchanges. Therefore, the acquirer of the Company could potentially be financially responsible for a defective 1031 exchange. Tax deferred exchanges require careful attention to many specific and technical requirements under the Code and IRS Treasury Regulations. For example, the purchase and sale documentation for the relinquished aircraft need to evidence an intent to conduct a tax deferred exchange and arrangements for payment of proceeds from the sale of the relinquished aircraft must be made prior to closing (ordinarily, simply having proceeds held in "escrow" with a title and escrow company will be insufficient).

*Does the Company own the aircraft with title free and clear of all liens and encumbrances?* The Company registered its ownership of the aircraft with the FAA Aircraft Registration Branch in Oklahoma City, Oklahoma. Aircrafts are frequently purchased with borrowed funds, and are encumbered by liens and security instruments. Liens on the aircraft, however, can be filed in several places. Liens are generally filed with the FAA Aircraft Registration Branch in Oklahoma City, Oklahoma. The United States has also adopted the Cape Town Treaty Implementation Act of 2004, which provides that interests in U.S. registered aircraft, including security instruments, are also filed in the International Aircraft Registry in Ireland. Federal tax liens are governed solely by the Code, thus the IRS is not subject to the FAA's requirements for filing liens against civil aircraft in Oklahoma City, Oklahoma.[17] Therefore, a valid notice of federal tax lien can be filed against the Company with the clerk of the circuit court in the county in which the aircraft is located, even without filing such notice with the FAA in Oklahoma City, Oklahoma. Finally, UCC-1 Financing Statements can 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.

## Federal Excise Tax Due Diligence

*Is the Company collecting and/or paying all required federal excise taxes?* There are common mistakes with business aircraft ownership and use that 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% of the amounts paid for such services, plus a flat rate per each domestic flight segment.[18] FET applies to private aircraft transportation services if the Company is in "possession, command and control" of the aircraft.[19] 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.[20]

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.[21] Any person required to collect, truthfully account for, and pay over the FET to the IRS that willfully fails to do so, or willfully attempts in any manner to evade or defeat such tax, is liable for a penalty equal to the total amount of the tax evaded, not collected, or not accounted for and paid over. There are aircraft related cases where the IRS has sought to recover uncollected FET from the persons that control a company.[22] When the Company is acquired and FET is subsequently asserted, the IRS can collect the FET from the Company or the Company's responsible persons at the time that the FET liability arose. However, the amount collected by the IRS does not exceed the amount of FET due, regardless of whether it is collected from the Company (as FET) or from the responsible persons (as trust fund recovery penalties). Therefore, if the Company's former responsible persons pay the trust fund recovery penalties, the Company can be absolved of the FET liability (although the Company could still be liable for additional penalties and interest on the uncollected FET).

*Is the aircraft owned by a single member limited liability company?* The Company's aircraft may be owned by a single member limited liability company (LLC) wholly owned by the Company. Prior to January 1, 2008, a single member LLC was "disregarded" for federal tax purposes. Therefore, the LLC and the parent Company were the same entity for tax purposes and FET did not apply to any transactions between the LLC and the Company. However, beginning January 1, 2008, single member LLC's are no longer treated as disregarded entities for purposes of FET.[23] Therefore, a single member LLC cannot be ignored as a "disregarded" entity for all federal tax purposes and instead the LLC's aircraft ownership and operations on behalf of the Company must be evaluated for potential FET liabilities.

## State Sales, Use and Personal Property Tax Due Diligence

*Did the Company pay state sales tax on the purchase of the aircraft?* Most states impose a sales tax of between 2% and 10% 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.

*Where has the aircraft been operated and was state use tax(es) paid to those states?* If sales tax has not been paid on the purchase of an aircraft, a state may impose a "use tax" on the use, storage, or consumption in the state of an aircraft acquired outside the state and subsequently brought into the state. The use tax is a "backstop" tax that applies to the use of tangible personal property when the sales tax did not apply to the purchase of that property.

*If sales tax was paid on the purchase of the aircraft, how much was paid?* Because the sales tax and the use tax work together, a taxpayer will normally not be subject to both the full sales and use tax. However, if an aircraft is delivered in one state where sales tax is paid, but the aircraft is based in a different state, the second state may still be able to impose a use tax. For example, if a 4% sales tax is paid in the state where the aircraft is delivered, but there is a 7% use tax in the state where the aircraft is based, the Company will still need to pay the 7% use tax, but may take a tax credit for the sales tax paid on the aircraft in the first state, effectively reducing its use tax liability to 3%. However, sometimes the Company neglects to pay the use tax.

*If sales and/or use tax was not paid when the aircraft was purchased, why not?* Through tax planning, private aircraft are often acquired without sales tax liability. In certain states, sales taxes on aircraft purchases can be avoided in different ways, such as through statutory casual sale exemptions, commercial operator exemptions, or be greatly reduced by trade-in credits on an aircraft sold by the Company at the same time that the Company is purchasing another aircraft.

*Is the aircraft being leased, and if so, are sales taxes being collected on the lease payments?* In many states, a company can use a separate business entity to purchase an aircraft tax-free if its sole use of the aircraft will be to hold the aircraft for arm's length leasing to other parties. In this case, there is no sales tax on the purchase of the aircraft, although the lease payments are generally subject to sales tax because leasing is treated by many states as a taxable sale subject to sales tax that must be collected from the lessee and remitted to the taxing authority. On the lease of an aircraft, multiple states can claim that its sales tax applies, including the state where the aircraft is delivered at lease inception, the aircraft's base of operations, or any other state that has nexus with the aircraft.

*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.

*Is the aircraft properly registered under state law?* In addition to federal (FAA) and international (Cape

Town Convention) aircraft registration, some states also require aircraft located in its state to be locally registered. This serves the purposes of allowing a state to charge registration fees and locate aircraft so as to levy sales and use taxes.

## Contract Due Diligence

*Does the Company have a management company for the aircraft? Is there a management agreement?* 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 a hangar lease agreement?* If there is a hangar lease agreement, the acquirer of the Company should look closely at the provisions relating to the Company's responsibilities for hazardous and regulated materials where the aircraft is stored, including proper disposal. The scope of the Company's indemnification of the hangar owner for environmental matters should also be reviewed.

*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.

*If the Company owns a fractional interest in the aircraft or co-owns the aircraft with other parties, are there related documents or agreements?* 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 for a number of reasons. 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. Also, there can 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. These contracts also usually control aircraft scheduling among the co-owners, responsibilities for splitting aircraft related fixed costs, and provide particular remedy provisions in the event of disputes.

## Conclusion

The suggested due diligence questions in this article will help lawyers identify and address many of the potential liabilities that can arise in transactions where aircraft are involved. For additional guidance, our firm frequently assists other law firms as special counsel on their M&A transactions to help resolve aircraft issues and prevent potential liabilities from becoming real.

**NOTES**

1. I.R.C. § 4261.
2. 14 C.F.R. § 91.501(b)(5).
3. Letter from Rebecca B. MacPherson, Assistant Chief Counsel, FAA, to James Dymond, Esq., Moore & Van Allen PLLC (Mar. 9, 2007).
4. 14 C.F.R. § 91.501(b)(5).
5. Letter from Rebecca B. MacPherson, Assistant Chief Counsel, FAA, to Michael Goldman, Silverberg, Goldman & Bikoff, LLP (June 14, 2006).
6. 14 C.F.R. § 204.2(c).
7. I.R.C. § 162.
8. I.R.C. § 274.
9. *Id.*
10. Prop. Treas. Reg. § 1.274-10(b)(1); Treas. Reg. § 1.274-2 (b)(1).
11. Prop. Treas. Reg. §§ 1.61-21; 1.274-9; 1.274-10.
12. I.R.C. § 274(d)(4); Treas. Reg. §1.274-5T (b)(6).

13. I.R.C. §§ 167; 168.
14. I.R.C. § 1245.
15. I.R.C. § 1245(b)(3); Treas. Reg. § 1.1245-4(c).
16. Treasury Inspector General for Tax Administration, Rpt. No. 2007-30-172 (Sept. 17, 2007).
17. I.R.C. § 6323(f), Treas. Reg. § 301.6323(f)-1(e), Ex (5).
18. I.R.C. § 4261.
19. Rev. Rul. 76-394, 1976-2 C.B. 355.
20. I.R.C. § 4282.
21. I.R.C. § 6672.
22. *Ferguson v U.S.*, 99 AFTR 2d 2007-2486 (2007).
23. Treas. Reg. § 301.7701-2(c)(2)(v).