

# TAX MATTERS

*A newsletter dedicated to informing California Aircraft and Vessel owners about taxes*

*Prepared and distributed by Aero & Marine Tax Professionals*

## FAA CRACKS DOWN ON PART 135 CHARTER OPERATORS

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If you're an aircraft owner, or are thinking about becoming one, you may have heard complaints that the FAA is making it more difficult for owners to make their aircraft available for charters under Part 135 of the Federal Aviation Regulations (FARs). But you might not have heard the details on what the FAA is doing, why this is happening and what it means to aircraft owners.

### What is "A008"?

On December 29, 2006, the FAA released Notice 8000.347. This notice makes specific changes to the standard operations specifications for charter operators, specifically Operations Specification A008, and provides extensive guidance on how to comply with these changes. Although the FAA insists that A008 merely restates existing law, A008 stands to have a substantial impact on aircraft owners that want to make their aircraft available for charter.

A008 provides new rules and guidance for ensuring that charter operators maintain "operational control" over charter flights conducted under Part 135 of the FARs. The upshot of these new rules is that the days of "piggybacking" your aircraft onto a charter certificate or "partnering with" a charter operator and having minimal interference from the charter operator are gone. As an aircraft owner, your control over your aircraft, and the people chartering it out, has significantly diminished.

The FAA is currently revisiting some of the A008 guidance, but aircraft owners should follow the current version for now and monitor the status of A008 closely until the dust settles.

### Why is This Happening?

The genesis of the FAA's increased enforcement efforts can be traced to a relatively recent accident. On February 2, 2005, a Challenger 600 aircraft, operated by Platinum Jet Management under the charter certificate of Darby Aviation, crashed on takeoff from Teterboro Airport in New Jersey. During a failed takeoff attempt, the aircraft ran off the runway, crashing through the airport perimeter fence, colliding with an automobile traveling on a six-lane highway, and finally demolishing a nearby building. The two pilots and two people on the ground were seriously injured.

The National Transportation Safety Board determined that the probable cause of the accident was improper loading of the aircraft, resulting in a center of gravity that was too far forward to allow a safe takeoff. However, the NTSB also took the highly unusual step of concluding that the FAA's improper oversight of Darby Aviation, the charter operator, was a contributing factor in the accident. In a very public and embarrassing rebuke, the NTSB specifically blamed the FAA for its lax enforcement of operational control rules, which resulted in an unlicensed party, Platinum, illegally operating a charter flight under Darby's charter certificate.

In response to the NTSB's criticism, the FAA stepped up its enforcement of the operational control rules to address what the FAA believes is a widespread problem in corporate aviation—the illegal "renting out" of charter certificates to aircraft owners by charter companies.

### How Does A008 Affect Aircraft Owners?

A008 is intended to prevent charter operators from improperly delegating their responsibilities to aircraft owners for the operation of Part 135 charter flights. However, A008 is not just an issue for charter

operators. If an aircraft owner is found to be illegally exercising operational control over charter flights in violation of A008, the consequences to an aircraft owner could be severe, including FAA enforcement action or invalidation of aircraft insurance as a result of operating the aircraft in violation of the FARs. Here's a look at just a few changes imposed under the new A008 and how they will affect aircraft owners.

### **Lease to the Charter Operator**

A008 requires that an aircraft used in charter operations must be leased by the owner to the charter operator, or if there is no lease, the aircraft must be in the legal custody of the charter certificate holder. FAA inspectors may consider the lack of a formal lease agreement between the aircraft owner and the charter operator as a “red flag” requiring further investigation of operational control.

### **“Wet Leasing” v. “Dry Leasing”**

In aviation parlance, a “dry lease” is an aircraft lease where the lessor does not provide any pilots to the lessee along with the aircraft. In contrast, a “wet lease” is an aircraft lease where the lessor provides the lessee with at least one pilot in addition to the aircraft. This is an important distinction because Part 135 of the FARs prohibits a charter operator from wet leasing an aircraft from a party that is not itself a certificated charter operator.

Historically, pilots employed by aircraft owners for the owner's Part 91 flights have also flown charter flights. Some owners took this a step further, specifically requiring the charter operator to use their crew on their aircraft. In other words, the aircraft owner has wet leased its aircraft to the charter operator.

Until the Platinum/Darby crash, the FAA often overlooked this violation of the FARs. But under the new A008, the FAA now prevents owners from wet leasing their aircraft to charter operators. The FAA reasons that if the pilots flying charters are employed by the aircraft owner rather than the charter operator, they will be loyal to the owner and less inclined to follow the instructions of the charter operator, who is required to exercise complete authority and operational control over charter flights.

### **Pilots**

In addition to prohibiting wet leasing, A008 now requires that pilots of charter flights must be employees or agents of the charter operator. A008

now imposes various restrictions on using the aircraft owner's pilots for charter flights, including:

- The aircraft owner cannot require the charter operator to use the owner's pilots for charter flights.
- The aircraft owner can't be required to provide pilots to the charter operator for charter flights.
- The aircraft owner cannot veto the charter operator's use of any particular pilot on a charter flight.
- Each pilot flying a charter flight has to be directly and separately compensated by the charter operator for a charter flight, as either an employee or direct agent of the charter operator.

### **Flight Operations**

Under A008, the FAA has clarified that the charter operator must know and determine in advance whether a Part 135 charter flight will be conducted and whether it can be safely operated in accordance with the FARs. The charter operator must ensure that the aircraft crew is trained and qualified under Part 135 and whether they meet the applicable duty-time and rest requirements before a charter flight takes place. The charter operator must also determine that the aircraft is airworthy. Finally, the charter operator must schedule and dispatch each charter flight after determining that it can be safely conducted, and must be responsible for making appropriate decisions if a charter flight cannot be safely or legally conducted under the prevailing conditions. The charter operator cannot delegate these responsibilities to the aircraft owner.

### **Aircraft Maintenance Requirements**

Most aircraft are not used exclusively for charter operations. When the planes are not generating charter revenue, they are operated by the aircraft owner under Part 91 of the FARs. Under A008, the charter operator must ensure that the aircraft is maintained at all times on the FAA-approved Part 135 maintenance program, even during the time that the aircraft is operated under Part 91.

If the charter operator does not have a system for ensuring that the aircraft owner will maintain the aircraft on the approved Part 135 maintenance program even during Part 91 operations, the charter operator must perform an appropriate inspection to assure that the aircraft still complies with its FAA approved Part 135 maintenance program when the aircraft is

returned from a Part 91 flight. This inspection could result in significant additional expenses to charter operators and owners.

### **Insurance and Indemnification**

If an aircraft owner provides the insurance for charter flights, this can be viewed by the FAA as a "red flag" that the owner actually has operational control. Even more significant, the FAA will not permit an aircraft owner to indemnify the charter operator for any accidents or liability in connection with charter operations under the charter certificate. The charter operator must bear accountability and financial responsibility for accidents or liability arising from charter operations.

### **Possible Tax Issues**

Putting an aircraft out for charter will now result in the aircraft owner giving up many rights to determine how its aircraft may be operated and by whom. Some FAA inspectors have even taken the position that the aircraft owner no longer has the right to decline charter trips that are requested by the charter operator. As a result, aircraft owners may now face the risk that Part 91 flights conducted by their own pilots could be categorized by the IRS as taxable transportation subject to federal excise tax. The new rules may also lead the FAA to take the position that Part 91 flights are really charter flights in disguise, and to take enforcement action for not operating under Part 135.

In addition, if the FAA requires a formal lease of the aircraft from the owner to the charter operator, this leasing arrangement may result in additional sales or use tax to the owner or charter operator, depending on the state involved. (Be sure to consult an Aero & Marine Tax professional!)

Worse yet, because A008 requires charter operators to exercise considerable control over aircraft used for charters to the exclusion of the owner and may also require a formal lease of the aircraft to the charter operator, it may now be a near certainty that the IRS will consider chartering aircraft to the public through a charter operator to be a passive activity, subject to limitations on deductions (including depreciation) produced by passive activities. Passive activity treatment for charter operations is very likely to have been the rule even before the new A008, but the new A008 may be the last straw in an uphill battle to avoid passive treatment.

### **What's the Bottom Line?**

The changes brought about by A008 may cause significant headaches for aircraft owners and charter operators, not the least of which will be inconsistent enforcement practices as FAA investigators get up to speed on the rules. If you own an aircraft that is already being chartered, or are considering making your aircraft available for charter, you should contact a qualified professional to help you comply with and limit your potential liability from A008, and to address the tax issues that it raises.

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