

# WHEN THE INTERNAL REVENUE CODE AND THE FAA REGULATIONS COLLIDE – WHAT RESULTS?

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# When the Internal Revenue Code and the FAA Regulations Collide – What Results?

*By Sanford Millar of MillarLaw A Professional Corporation – 8/8/16*

The Federal Aviation Administration (FAA) categorizes aircraft owners and operators into different categories. In general, the FAA grants an owner of an aircraft who operates the aircraft for personal use and enjoyment a certificate under Part 91 of the FAA Regulations. On the other hand, Part 135 of the FAA regulations governs the operation of charter aircrafts. A charter company is generally granted a Part 135 certificate holder.

A private aircraft owner who is granted a Part 91 certificate may be a flight enthusiast, an ex-pilot, or a businessman. In certain instances a Part 91 certificate holder does more than merely invest large sums of capital in an aircraft solely for personal or business purposes. It is common practice for Part 91 certificate holders to lease the aircraft for use in charter flights by charter companies. Generally, owners of small airplanes also invest time in building a business centered on leasing out the aircrafts when not used for personal purposes. The certificate holder may at times invest time in maintaining the aircraft, managing pilots and flight crew, and providing services to the lessee in connection with making the aircraft available for use.

The FAA has aimed to ensure the safety of charter flights by implementing specific, and sometimes complex, operational control requirements for aircrafts leased by Part 135 certificate holders for use in providing charter flights. Equally as complex as the FAA operational control requirements are the tax laws related to determining the character of the income/losses resulting from the leasing activity by a Part 91 certificate holder.

Certain expenses incurred by the owner of the aircraft in connection with leasing the aircraft out may be in direct conflict with FAA regulations depending on the type of certificate an aircraft owner holds. In recent audits, state tax authorities have disallowed losses generated from rental of a privately owned aircraft because the transaction between the owner and the charter company violated the operational control requirements of the FAA.

A person who owns or operates the aircraft must comply with the FAA regulations under Title 14 of the United States Code. In addition, an aircraft owner who operates an aircraft for any purpose other than personal travel must comply with the Internal Revenue Code under Title 26.

This article delves into the issues faced by Part 91 certificate holders when determining tax liability from activities related to leasing of the aircraft to Part 135 certificate holders. Particular focus is potential areas of conflict between the FAA and the tax code when an aircraft owner provides services in connection with leasing out an aircraft for charter.

## **FAA Overview – Part 91 vs. 135**

The Federal Aviation Administration (FAA), a branch of the U.S. Department of Transportation, is charged with the duty of issuing aircraft owners certification for operation of the aircraft. FAA regulations require registration of an aircraft and owner. In addition to registration, the aircraft must be granted certificate authorizing the aircraft for flights. The FAA issues authorization to operate an aircraft by issuing an airworthiness certificate. Registered owners or owner's agents of an aircraft may apply for an airworthiness certificate.

In general, the FAA categorizes an aircraft as either private, charter, or airline aircraft. The ownership and operational structure of an aircraft determines which FAA regulations apply. Private aircrafts generally are operated under Part 91 of the Federal Aviation Regulations. On the other hand, Part 135 governs the operation of charter aircrafts.

### **Part 91**

FAA Regulation's Part 91 is the general operating and flight rules for strictly private air transportation. Part 91 aircrafts are generally operated by the owner for personal and business use. These aircrafts are not made available for hire or compensation to transport others. Part 91 provides that operation of a civil aircraft requires an airworthiness certificate issued by the FAA. Under Part 91 the pilot in command of the aircraft is responsible for determining whether that aircraft is in condition for safe flight, in other words whether the aircraft is in an airworthy condition.

Part 91 rules regarding operational control of the aircraft are less strict and less costly to comply with than under Part 135. However, if an owner of a private owned aircraft operated under Part 91 leases the aircraft to a charter company for charter flights, the aircraft is no longer under Part 91 but must comply with Part 135 regulations.

### **Part 135**

Part 135 provides operating requirements for commuter and on demand operations and rules governing persons on board the aircraft. Part 135 subjects the certificate holder to stringent operational and maintenance requirements. The reason for the higher standard of care placed on charter flight operators is to ensure the safety of the passengers. An aircraft with a Part 91 certificate that is leased by a Part 135 certificate holder, that is a

charter company operating charter flights, must comply with operations control requirements set forth in Operational Specification A008.

### **Operational Control requirements under Part 135**

Under Part 91, the owner/user of the aircraft is responsible for operational control of the aircraft. Operational control means the user exercises full control over the operations of the aircraft and bears full responsibility for the airworthiness. Part 91, also allows for the owner of the aircraft to hire a management company to manage the aircraft, including provide for pilots, as long as the owner of the aircraft retains operational control.

On the other hand, a Part 135 certificate holder must retain operational control of all aircraft operations. A charter flight operating under Part 135 must comply with the operational control requirements of OpSpec A008. OpSpec A008 provides guidance to charter operations on maintaining operational control over charter flights conducted under Part 135. The purpose of OpSpec A008 is to ensure charter operators are not delegating responsibilities to owners of the aircrafts for charter flights.

An aircraft leased by a Part 135 certificate holder is listed on the certificate holder's operations specification and must therefore comply with the operational control requirements under OpSpec A008. Under OpSpec A008 Part 135 certificate holder retains all responsibility for the operational control of aircraft operations. Under OpSpec A008 essential elements of operational control, that is non-delegable by a Part 135 certificate holder, require that crewmembers be direct employee or agent of a certificate holder during every aspect of the part 135 operations. In addition, the certificate holder is accountable for actions and inactions of crewmembers during all aircraft operations, including any pre-flight and post-flight duties. OpSpec A008 also requires that a leased aircraft used in its Part 135 to remain in the certificate holder's exclusive possession or custody during at all times of the 135 flight.

In addition, OpSpec A008 sets forth specific requirements for operational control when the aircraft is used under Part 91 and Part 135, say for example a privately owned aircraft is operated by the owner under Part 91 and also leased to charter operations under Part 135. OpSpec A008 requires a Part 135 certificate holder to ensure that the maintenance of a leased aircraft continues to adhere to the certificate holder's maintenance program at all times even when in use by Part 91 certificate holder, OR, that the aircraft undergoes an appropriate airworthiness conformity validation check when the aircraft is returned to the certificate holder but before the aircraft is operated under Part 135 again by the certificate holder.

Lastly, A008 prohibits a Part 135 certificate holder to engage in a wet lease with any person that is not granted a Part 135 or Part 121 certificate. The next section explains what a wet lease is and how this last requirement is of



major concern for Part 91 certificate holders leasing aircrafts for charter operations.

### **Dry Lease vs. Wet Lease**

The leasing of an aircraft may be a dry lease or a wet lease. A dry lease is a term that identifies when an aircraft is leased without any crew or fuel.

Under a dry lease, the charter company provides the crew to operate the aircraft, and therefore the lessee has operational control.

On the other hand, a wet lease is a lease where the lessor provides the crew to operate the aircraft, and in some instances also the fuel. Under OpSpec A008 a lease is considered a wet lease if any of the following conditions exist:

- A certificate holder (that conducts operations under part 135) is required to use the aircraft owner's pilot in part 135 operations,-
- The aircraft owner is obligated to provide pilots to the part 135 certificate holder to operate the aircraft or
- The aircraft owner has the power to veto who the part 135 certificate holder may use as to pilot the 135 operations.

Part 135 operational controls prohibit a certificate holder from engaging in a wet lease with any person not authorized by the FAA to engage in common carriage operations under Part 121 or 135. The reason for this is because an essential element of operational control requires that crewmembers of a Part 135 flight must be direct employees or agents of the certificate holder.

However, in a wet lease the crewmembers are not the direct employees or agents of a Part 135 certificate holder because the crewmembers remain under the direction of the lessor.

### **How does Operation Specifications A008 apply to private aircraft owners?**

Often times private owners place time in maintaining the aircraft for private use. However, under A008 when the aircraft is operated under Part 91 and Part 135, for example in a leasing arrangement, the aircraft must be maintained at all times on the FAA approved Part 135 maintenance program. Either the owner must implement the maintenance program, or, the charter operator must inspect the aircraft after it is returned from Part 91 operations to assure the aircraft meets the FAA Part 135 maintenance program. In some instances significant additional expenses in maintaining the aircraft for use by charter operations will fall on the owners of the aircraft.

In addition, OpSpec A008 prohibits a private owner from wet leasing an aircraft for charter operations – that is where the lease is not independent from the accompanying services. The crewmembers contracted for services

during charter flights must be the direct agent during all aspects of the charter operations.

### **Leasing an Aircraft for IRS purposes**

The tax code provides specific rules and regulations regarding when a loss from an activity may be taken as a deduction. An aircraft owner who leases out his private plane for use by charter companies must be mindful of whether any loss resulting from the activity will be disallowed as a passive activity loss.

A passive activity is an activity where the taxpayer does not materially participate. Rental activities, including the leasing of an airplane, are per se a passive activity regardless of whether the taxpayer materially participates in the activity. Rental activities are those activities where the taxpayer receives payments from customers in exchange for use of a tangible personal property. The leasing of an airplane to charter companies for use in flights fits squarely within the definition of rental activity.

With regards to leasing of an aircraft the IRS in Revenue Ruling 68-256 adopts the same meaning as the Aviation industry. Under the IRS's interpretation a dry lease is when a company leases an aircraft for a lump sum and operates the aircraft with its own crew. A wet lease results when a company leases an aircraft and the lease includes the use of the crew supplied.

For tax purposes, the issue of whether the activity is a passive rental activity or non-passive activity in connection with leasing the aircraft out generally turns on whether the activity is a dry lease or a wet lease.

### **Rental activity as a Passive Activity**

Section 469 disallows a deduction for passive activity losses. Passive activity is any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate in. However, rental activity is a per se passive activity regardless of whether the taxpayer materially participates in the activity.

Rental activity, as defined as "any activity where payments are principally for the use of tangible property." Specifically, rental activity is any activity involving the use of tangible property by customers, and, where the gross income attributable to the conduct of the activity represents amounts paid principally for the use of such property is rental activity.

The issue of whether losses from the leasing of an aircraft resulted in rental activity was raised in *Frank v. Commissioner*<sup>[1]</sup>. In *Frank* petitioner leased an aircraft to two customers, approximately for a period of six months to each customer. The customers paid for fuel, oil, maintenance, inspection

fees, insurance, and parts. Petitioner changed the airplane's oil, removed screws from the inspection plates, and tied down and washed the airplane, however Petitioner did not provide records to show how often he performed these tasks. The Service disallowed the losses incurred by petitioner as passive losses. The Court held that petitioner's losses resulted from rental activity because petitioner leased the aircraft to customers and customers paid petitioner for use of the airplane. In this case, the Court found that services were not the dominant element of the relationship between Petitioner and Customer.

### **Exceptions to Rental activity – Extraordinary Personal Services as the dominant element of the relationship**

The leasing of a privately owned aircraft to a charter company is not considered to be rental activity if the private owner can demonstrate that the lease is accompanied by extraordinary personal services provided in making the aircraft available for use. And, under *Frank* the dominant purpose of the lease must be for the purpose of receiving services provided by the owner and not for the use of the aircraft. If payments made are principally for services provided, and not for use of the property then the activity is not a rental activity.

Extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services.

Rev. Rul. 2005-64, set forth an example of what qualifies as extraordinary personal services with regards to leasing of an aircraft. The ruling included two situations where the taxpayer leased an aircraft to a customer.

- Situation 1: the taxpayer leased the aircraft without supplying pilot or crew to maintain the airplane. The activity was determined to be a rental activity because no extraordinary personal services were provided in connection with making the aircraft available for use by the lessee. Furthermore, the Service reasoned that the activity is rental activity because the use of the aircraft, rather the provision of services was the dominant element of the relationship between lessor and lessee.

- Situation 2: Taxpayer provided a pilot and crew to operate and maintain the airplane, along with fuel for plane and drink and food for passengers. The activity in this situation came under the exception of non-rental activity because extraordinary services were provided in connection with use of the aircraft. The Service reasoned that the services provided by the pilot, crew, and transportation staff is the dominant relationship and the use of a seat on the aircraft is incidental to receipt of such services.



Therefore, the Service allows a Part 91 aircraft owner to classify the lease of an aircraft as non-rental activity if the owner can demonstrate the lease was akin to a wet lease where the dominant motivation was to receive the services of the crew member. However, to classify the lease as a wet lease for non-passive activity purposes would be in direct violation of the FAA regulations prohibiting a Part 135 certificate holder from engaging in a wet lease with a Part 91 certificate holder.

### **What Results?**

In general, a Part 91 certificate holder is prohibited from engaging in a wet lease with charter companies operating under a Part 135 certificate. And generally, a Part 91 aircraft owner may class the activity as a non-rental activity if it engages in wet lease with a Part 135 charter operator. However, a wet lease would be in direct violation of OpSpec A008. Therefore, the activity of leasing of the airplane by a Part 91 certificate holder to a Party 135 certificate holder is per se a passive rental activity.

A few exceptions may allow a Part 91 taxpayer to meet the exception of extraordinary services. Where extraordinary services provided by the Part 91 certificate holder, other than providing crewmembers, and the services are not in violation of OpSpecA008 then the taxpayer may argue the dominant relationship is for the receipt of the services. For example, extraordinary services may include services that are not in violation of OpSpec A008 such as maintaining the aircraft at all times on the FAA approved Part 135 maintenance program.

Additionally, a taxpayer with a private airplane may be able to engage in a lease of the aircraft and supply crewmembers under a narrow exception. The FAA released a Frequently Asked Questions on February 11, 2008, addressing the concerns of Part 135 operations and aircraft owners. In Question 3, the FAA responded that a Part 135 certificate holder may use crewmembers of an aircraft owner provided that the agents report to the carrier on operational and maintenance issues and both agents, adhere to the direction and instructions and other commands of the carrier; and if the carrier maintains operational control over the crewmembers.

In some situations the parties to the lease may contract separately for flight crew and services independent from the lease. In this type of setup the FAA distinguishes between a dry lease or a wet lease based on whether the aircraft and flight crew are obtained separately, or provided together in a package. A letter issued by the FAA on October 24, 2012, considered the question of operational control involving the leasing of an aircraft which included a separate contract for crewmembers. The situation involved an aircraft operated under Part 91 that was leased without a crew to a part 135 certificate holder. In addition, the part 135 certificate holder contracted for

pilots from the lessor to fly the aircraft on flights under the operational control of the lessee. Under the FAA's legal interpretation operational control in leasing of an aircraft turns on whether the lease is a dry lease or a wet lease. The FAA found the dry lease accompanied by a separate agreement for pilot services to be a dry lease so long as the arrangement for pilot services is truly independent from the lease of the aircraft.

If the Service adopts the FAA's legal interpretation then a taxpayer may be able to lease an aircraft without any crewmembers and also provide crewmembers in a separate contract. In providing crewmembers the lessor must relinquish all operational control over the crewmembers to the charter certificate holder to be in compliance with OpSpec A008. Here, even though the crewmember services are independent from leasing the aircraft for FAA purposes, when taken together for tax purposes it is the dominant element of the relationship.

### **Material participation:**

If taxpayer can establish that the leasing of an aircraft comes within extraordinary personal services exception, then the activity will be non-rental activity. As a non-rental activity, taxpayer may then take a loss deduction for the activity only if the activity is a (1) trade or business, and (2) the taxpayer materially participates.

Trade or business activities are activities, other than rental activities, that involve the conduct of a trade or business or are conducted in anticipation of the commencement of a trade or business .

Taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a regular, continues, and substantial basis.

Materially participation is generally established if the individual participates in the activity for more than 500 hours during the year.[2] However, certain limitations for what qualifies as participation are provided for in the Treasury Regulations, including:

- ***Certain work not customarily done by owners:*** Work performed by the individual owners is not considered to be participation where the type of work performed is not the type of work that is customarily done by an owner of such activity, and the principal purposes of performing such work is for the purpose of avoiding the passive activity limitations.

- ***Participation as an investor:*** Work done by an individual in the individual's capacity as an investor in an activity is not treated as participation in the activity unless the individual is directly involved in the day-to-day management or operations of the activity. Work done by an individual in the individual's capacity as an investor in an activity includes-

- i. Studying and reviewing financial statements or reports on operations of the activity;
- ii. Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and
- iii. Monitoring the finances or operations of the activity in a non-managerial capacity.

The case of *Est. of Roger E. Stangeland*<sup>[3]</sup> demonstrates material participation by a taxpayer/owner. In *Stangeland* the taxpayer was the owner of an entity formed, to own and lease out airplanes. A third party was hired to manage the aircrafts but the third party consulted with taxpayer when maintenance was required on the airplanes. Particularly, taxpayer would review all maintenance bids submitted to the third party. Taxpayer was also involved in negotiations for sale and purchase of the airplanes. The Court held that the taxpayer's involvement was not that of an investor/owner but direct involvement in the day-to-day management because taxpayer participated in the sale and purchase of the aircrafts, and was involved in the decision making for maintaining and renovating the aircrafts.

### **Material Participation and OpSpec A008:**

Material participation generally requires the owner of the airplane to participate in the activity for a minimum of 500 hours during the year. Neither the tax Code nor the Treasury Regulations provide for what type of services constitute participation, only what is prohibited from being allocated to participation.

Additionally, OpSpec A008 only prohibits certain operational control activities from being delegated by a Part 135 lessee to a Part 91 lessor. However, OpSpec A008 does not prohibit all activities from being delegated to or performed by the owner of the aircraft. For example, a Part 91 certificate holder may choose to maintain the aircraft at all time on the FAA approved Part 135 maintenance program even during the time that the aircraft is used for Part 91 operations.

Therefore a taxpayer may materially participate in an activity without being in violation of OpSpec A008. For example, the owner of the aircraft in *Stangeland* was involved in the everyday decision negotiation of selling and purchasing the aircraft, the leasing of the aircraft to third parties, and the day-to-day decision making. These activities do not automatically violate the operational control requirements of A008 per se.

The FAA released FAQ Question 5 provides that aircraft owners may coordinate selection of maintenance facility with the air carries and provide mechanic's to perform maintenance on the aircraft. Similar to *Stangeland*, the



participation by the owner in the decision making for maintenance of the aircraft qualifies for material participation and also would not be in violation of OpSpec A008. Therefore, a taxpayer may materially participate in the leasing of the airplane without being in violation of OpSpec A008.

In addition, the day-to-day operations of running a business with as maintaining employees, managerial decision making, and accounting functions allows the taxpayer to meet the material participation test without even having to consider the limitation of OpSpec A008.

## **Conclusion**

Taxpayers who choose lease out their private airplanes to charter companies must be mindful of both the tax laws that govern the activity and the limitations in place by the FAA. An owner/lessor may structure the lease for tax planning purposes only to face conflicting laws by the FAA. Particularly, when a Part 91 certificate holder wishes to lease out the private airplane for use in charter operations they must consider all operational control limitations in place by the OpSpec A008 and determine if the lease can be structured to be in compliance with the FAA regulations and at the same time provide tax benefits. Therefore, private airplane owners should seek professional advice prior to structuring any lease with a charter operation with a Part 135 certificate.

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[1] *Frank v. Commissioner*, TC Memo 1996-177.

[2] Material participation may also be established by either of the following: (1) the individual's participation for the year constitutes substantially all of the participation in the activity for the year; (2) the individual participates in the activity for more than 100 hours, and that participation is not less than that of any other individual (including individuals who are not owners of interests in the activity); (3) the individual's aggregate participation in "significant participation activities" for the year exceeds 500 hours; (4) if the individual materially participated in that activity (without regard to this test) for any five of the ten tax years that immediately precede the tax year; (5) an individual is treated as materially participating in a personal service activity for a tax year if the individual materially participated in the activity for any three tax years that precede the tax year; and (6) an individual may be treated as materially participating in an activity for a tax year based on all facts and circumstances involved. Certain participation is deemed insufficient to constitute material participation, or is not taken into account, under this test.

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