Wet versus Dry Leasing of Aircraft

For many years there has been significant attention paid to aircraft leases. This does not include finance leases. The type of leases we are talking about are wet and dry leases, who may have operational control of the aircraft, and the possibility of illegal charter.

The FAA defines a wet lease in the Truth-in-Leasing Advisory Circular 91-37B as "any leasing arrangement whereby a person agrees to provide an entire aircraft and at least one crewmember". Leasing of an aircraft without any crew is normally considered a dry lease. In the case of a dry lease, the lessee exercises operational control of the aircraft, whereby, in the case of a wet lease the lessor normally retains operational control.

From the perspective of the Internal Revenue Service ("IRS") the commercial Federal Excise Tax (FET) is imposed on wet leases, whereby the noncommercial Federal fuel tax applies to dry leases. This may sound relatively simple, but there are still some questions among operators as to where the lines may be drawn. In addition, an operation may pass the test for FAR Part 91 but still be considered a commercial activity for FET purposes.

Following are some of the common leasing arrangements and the Federal Excise Tax ramifications of each.

WET LEASES

- **Timesharing** – this operation is defined under FAR 91.501(c)(1) as an arrangement "…whereby a person leases his airplane with flightcrew to another person, and no charge is made for the flights conducted under that arrangement other than those specified in paragraph (d) of section 91.501." This is considered a wet lease because the aircraft is provided with crew.
    - However, even though this is considered Part 91 the IRS considers this a commercial activity and although no profit is made, because of the restriction on charging, the commercial FET is due on the amounts paid and a credit or refund is allowed for the tax paid on the fuel burned for that flight.

- **Interchange** – this operation is defined under FAR 91.501(c)(2) as an arrangement "…whereby a person leases his airplane to another person in exchange for equal time, when needed, on the other person's airplane and no charge, assessment or fee is made, except that a charge may be made not to exceed the difference between the cost of owning, operating and maintaining the two airplanes." This is also considered a wet lease as the aircraft and crew of one company is exchanged for the aircraft and crew of another.
    - Even though in some cases no money changes hands, this is still considered a commercial operation for FET purposes, and the commercial tax is due on the fair market value of the interchange and again a credit or refund is allowed for the tax paid on the fuel burned for that flight. Keep in mind that there are two fair market values to be considered, one is the IRSs and one is yours.

- **Charter** – this operation is conducted under FAR Part 135, and the operator must hold a commercial operating certificate. This is always considered a wet lease as the aircraft is provided with aircraft and crew to the end user.
    - This operation is considered commercial both for FAA and IRS purposes and the commercial FET is due on the amounts paid, less catering, flight phones, limousine services obtained for the customer and separated stated on the invoice. In addition, a credit or refund is allowed for the tax paid on the fuel burned for that flight.

DRY LEASES

- **"True" Dry Lease –** as was stated before, a dry lease is a lease of an aircraft without crew. Typically, in a dry lease the lessee is responsible for hiring the flight crew and has operational control of the aircraft. In these cases, the lease is considered to be noncommercial, and the lessee and the lessor are not required to hold an FAA-issued operator's certificate as long as the lessee is not carrying persons or property for compensation or hire.
    - The IRS agrees with the FAA on dry leases and the commercial FET is not due on the lease payments between the lessee and lessor.

- **"Sham" Dry Lease –** would be an example of someone trying to confuse the issue as to who has control of the aircraft. The typical case is where the lessor is providing the aircraft under a dry lease and is also providing the crew under a separate agreement. Another example would be where the lessor is leasing you the aircraft, but you have to get your crew from the lessor or a specified source. In both cases the plane and the crew are too closely connected. In the case of a "sham" dry lease or "damp" lease the FAA may take the position that the lessor should hold a commercial operating certificate.
    - The IRS would more than likely consider the lessor to have possession, command and control and the commercial FET would be due on the lease and pilot service payments.

The Truth-in-Leasing Advisory Circular AC 91-37B makes the following statement, "The determination in each situation as to whether the lessor or lessee exercises operational control requires consideration of all relevant factors present in each situation. The terms of the lease itself are important; however, since they may not reflect the true situation, the actual arrangements and responsibilities should be given very careful consideration."

As can be seen, it is in everyone's best interest to understand what type of lease arrangement you are entering and not be caught unaware by either the FAA or the IRS.

Disclaimer: This information is not intended to provide a complete analysis of this subject but is meant to provide the reader with an accurate synopsis of a complex issue.

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