Fundamentals of Aviation Law

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Whether you are a pilot, an air traffic controller, an aircraft maintenance specialist, or a management executive, you will likely work for, or work with, business entities of all different types and sizes. It is important that you gain an appreciation of the basics of business entity law and the pros and cons of each type of entity.

In this chapter, we will review the fundamentals of business entities under U.S. law. Our approach will include a description of each of the more prominent types of business entities. Specifically, we will take a look at the following entity forms:

- Sole proprietorship
- Partnership
- Limited partnership
- Limited liability company
- Corporation

Beyond the legal basics, this chapter will also allow you to take a look at how each of these entities is affected by current tax laws in the United States. Understanding how the tax code impacts an entity is often a critical step in making business decisions and/or deciding what type of entity will best suit your business plan.

THE SOLE PROPRIETORSHIP

One of the most common forms of operating a business in the United States is the sole proprietorship. Although this form of business is often associated with small business enterprises, a substantial number of large businesses are also sole proprietorships.

In the sole proprietorship, the owner is the business enterprise. There is no distinction between the owner and the business. The business is not a separate entity from the owner.

There are advantages to a sole proprietorship, including the following:

- There is no additional cost to starting a sole proprietorship.
- The owner calls all the shots in the business, including the hiring and firing of employees.
- It is a simple process to transfer ownership of a sole proprietorship with no approvals from partners or shareholders required.
- All profits inure to the benefit of the sole proprietor.

Establishing a sole proprietorship

The sole proprietorship is probably the simplest of all business entities to create. There are no government approvals required, and no legal formalities are necessary. Although some local and state governments may require a business license, this is likely to be required of any business. In many cases, a sole proprietorship is looked upon as being the default form of business. If no other form of business has been established, the law will look to the sole proprietorship as the most likely form of business.

In selecting a name for a sole proprietorship, the owner can use her own name or select a trade name that appeals most. A budding aviation entrepreneur named Arnold Tuddle may wish to name his new flight school "Arnie's Future Aces" or Arnold Tuddle d/b/a (doing business as) "Arnie's Future Aces." In many states, any trade names must be registered with the state under fictitious name statutes. The statutes allow consumers and vendors to be able to track down the owner of a business that uses a trade name who might be otherwise difficult to identify by name.

Liability issues for sole proprietors

Perhaps the most significant disadvantage of the sole proprietorship is the unlimited personal liability borne by the owner. Unlimited personal liability means that creditors of the sole proprietorship may recover on their claims by pursuing the sole proprietor's business or personal assets. This disadvantage is arguably magnified in the context of the aviation industry where liability exposure is a constant hazard.

For example, let us assume that Ray wants to establish an air charter business. He names it Ray's Air Services. If anyone is injured while the business operates an aircraft, or if the business cannot pay its creditors in a timely manner, those with claims related to the business can go directly after Ray's personal assets. See Fig. 7-1 for a depiction of how liability to business creditors works in the context of a sole proprietorship.

Because of pervasive concerns regarding liability exposure in the world of aviation, you will seldom find an aviation business that is operated as a sole proprietorship. One alternative to the sole proprietorship model that is discussed below is the one-member limited liability company (LLC) or corporation. For a fuller discussion of these forms of doing business, see the discussion below.

Taxation of sole proprietorships

The sole proprietorship is not taxed as an entity separate from its owner. The profits of the company are treated directly as the profits of the entity's owner. Federal and Internal Revenue Service (IRS) rules require that sole proprietors prepare an income statement for their businesses on a form called a Schedule C. Schedule C includes a summary of all the corporation's revenue and expenses. Any net income or net loss is then filtered through to the sole proprietor's individual income tax return (IRS Form 1040) and in turn taxed at the sole proprietor's individual tax rate. See Fig. 7-2 for a flowchart depicting the approach to taxation for sole proprietorships, assuming an effective tax rate for the owner (Ray) of 20 percent, revenues of $100,000, and expenses of $40,000.

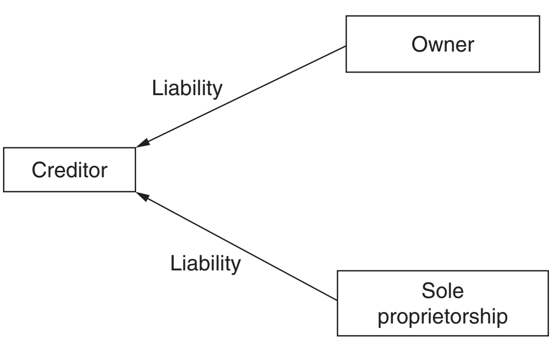

Figure 7-1 Sole proprietorship liability.

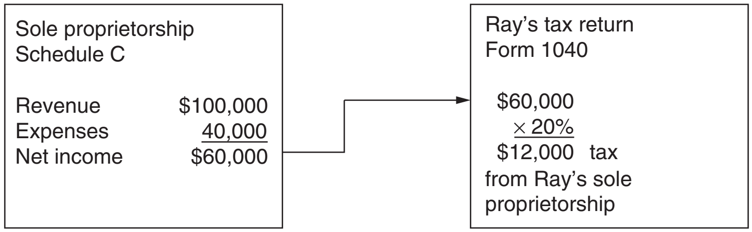

Figure 7-2
Sole proprietorship taxation.

PARTNERSHIPS

Partnerships are a voluntary combination of two or more individuals or entities for the purposes of engaging in a trade or business for profit. Partnerships are also referred to as general partnerships to distinguish them from limited partnerships (discussed below).

Establishing a partnership

A partnership can be created with very little formality or effort. All that needs to be present are two or more persons or entities that voluntarily agree to coown a business with the intention of making and sharing profits. No formal documents or agreements are required for a partnership to be legally established. Interestingly, there is no requirement that partners be active participants in the management of the partnership business. The day-to-day operations of a partnership can be delegated to employees and hired managers without any impact on the legality of the partnership's existence.

Similar to a sole proprietorship, a partnership can function using the name of its partners. A partnership can also use a fictitious trade name, in which case it will be subject to registering the trade name under state law.

One important note is that a partnership is not the same as a coownership. A coownership is evidenced by two or more persons owning an asset. A coownership does not require that the parties have any intention of coowning a trade or business with the intention of making a profit (as is required for a partnership). The terms *coownership* and *partnership* are often confused in the aviation industry. It is important to make the distinction correctly because aircraft can be registered to either a partnership or a coownership. See Chap. 8 for further discussion.

Operation of a partnership

Unlike a sole proprietorship, a partnership has more than one owner. Therefore, there is a bit more complication in the way the partnership will be operated. With a sole proprietorship, there is one person calling the shots, and that person's way of doing things is generally not subject to challenge. With the introduction of two or more owners, a partnership requires greater attention to the rights and duties of each partner in the functioning of the business enterprise.

Unless there is an agreement that states differently, all partners have a right to share in the management of the partnership. This means that each partner will have a single vote, no matter how large or small his or her contribution of capital to the partnership unless an agreement indicates something different. Partners also have the flexibility to designate management of the partnership to one or more partners.

Although it is not required, a well-drafted partnership agreement is strongly recommended for any partnership. In a partnership agreement, the partners can address issues such as capital contributions, management of the partnership, and termination or sale of the partnership.

As indicated above, perhaps the strongest indicator of a partnership is the sharing of profits from the partnership business. The general rule for partnerships is that, unless expressly stated differently, all partners have an equal right to sharing in the partnership's profits. However, most partnership agreements indicate that partners will share in profits in proportion to capital contributions to the partnership by each partner. The same rules also apply to partnership losses. It is assumed, unless expressly stated otherwise, that partnership losses are to be applied equally. Again, most partnership agreements will call for sharing losses in proportion to capital contributions made by partners to the partnership.

Liability issues for partnerships

Just as with a sole proprietorship, partners share exposure to unlimited personal liability to creditors of the partnership. In addition, there is the added complexity of whether liability can attach to one partner when it was another partner who created the liability in question.

With respect to torts, a partner will generally be held liable for the torts of another partner or an employee of the partnership. This means that a partner can be held liable for the negligence or intentional tort(s) of one or more of the other partners. For example, Ray (from the previous example) now wants to expand his business. He takes on a partner and friend named Bob. Bob and Ray form a 50-50 partnership for the purpose of providing on-demand air charter service (B&R Air Services). Both Bob and Ray share duties managing the partnership and piloting the aircraft for charters. One day Ray gets into a landing accident owing to his negligence in providing for proper crosswind corrections, and two passengers are seriously injured. Naturally, Ray is personally liable for the injuries to the passengers. However, Bob will also be liable to the passengers. The passengers may even collect all their damages from Bob, who would then have to pursue Ray for an appropriate contribution of his share of the loss.

Similarly, a partner is liable for the contractual obligations entered into by the other partners on behalf of the partnership. Therefore, all partners are jointly liable for the debt created by the contract. If one partner is required to pay more than her fair share on a judgment, she may be able to seek contributions from other partners to equalize the loss from the judgment. Let's say B&R Air Services also entered into a contract to purchase new Global Positioning System (GPS) equipment for their aircraft. They financed the transaction by taking a note and promising to pay the bank that underwrote the transaction in monthly installments. If Bob and Ray default on the note, the bank can recover damages from either or both of them. Again, if one of them pays an unequal amount of the damages to the bank, that partner can pursue the other partner for contribution to equalize the liability borne by each partner.

See Fig. 7-3 for a chart depicting how partnerships and individual partners share liability in a general partnership.

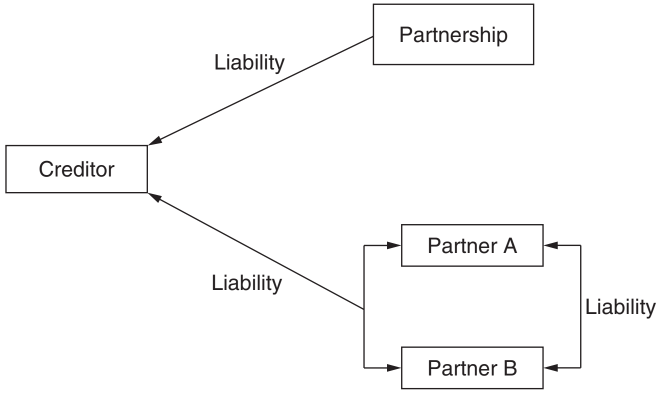

Figure 7-3 Partnership liability.

Just as with sole proprietorships, the issue of legal liability, especially in the aviation industry, has greatly diminished the number of pure partnerships that run aviation-related enterprises. Alternatives such as limited liability companies and corporations have become the more likely form of doing business in the aviation environment. These forms of doing business are discussed in greater detail below.

Ownership of assets

Another interesting issue with partnerships is the question of whether individual partners own specific partnership assets. Put another way, this question asks, What do the partners in a partnership actually own? With a sole proprietorship, the question is easily answered. All assets belong to the sole proprietors. However, with a partnership, the answer is a bit more complex. Partners own a right to only their share of the partnership's profits. They do not own any rights to specific partnership assets. Therefore, upon the death of a partner, a deceased partner's heirs cannot seek to recover specific assets such as buildings, aircraft, and computers. Instead, the heirs would be entitled to the deceased partner's share of the partnership profit.

Let's go back to the example of B&R Air Services to further explore this issue. Suppose that B&R Air Services owns two aircraft (both Cessna 310s) of equal fair market value. The partnership owns no other assets (all office space and equipment are leased). If Bob dies, his heirs cannot stake a claim on one of the Cessna 310s based on the fact that Bob was a 50 percent owner of the partnership and is thus entitled to one-half of the partnership's assets. Instead, Bob's heirs can only make a claim to an interest in 50 percent of the profits of B&R Air Services. Further, Bob's heirs do not have any rights to the management of the partnership.

Taxation of partnerships

For taxation purposes, a partnership files a separate information tax return as a business entity on IRS Form 1065. The tax return requires the partnership to report all revenue less expenses. However, the profit is not taxed at the partnership level. Instead, it flows (based on partnership arrangements for sharing profits) to each partner individually. It is at the individual level that partnership profits are taxed at the individual partner's tax rate.

For example, assume that B&R Air Services had revenue of $100,000 and expenses of $40,000 in tax year 2006. The resulting profit of $60,000 would not be taxable at the

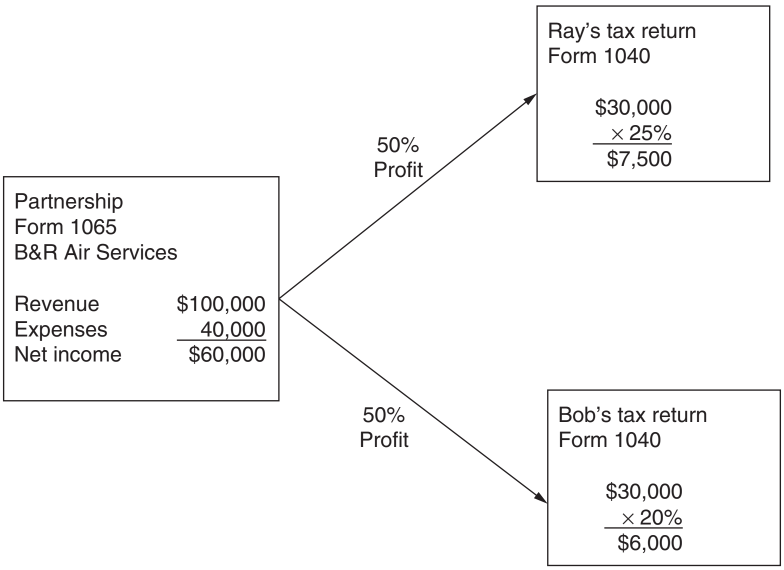

Figure 7-4 Partnership taxation.

partnership level, meaning that B&R Air Services would not be taxed on the $60,000 profit. However, the profit of $60,000 would flow to each partner individually and then be taxed at that partner's individual tax rate. Therefore both Bob and Ray would have to report $30,000 (50 percent of $60,000) as income, and they would be taxed at their respective personal income tax rates (which increase with greater personal income). Figure 7-4 depicts the flow of income from a partnership to its individual partners, assuming an effective tax rate of 20 percent for Bob and 25 percent for Ray.

Termination of a partnership

A partnership is terminated upon the death of a partner or the withdrawal of a partner from the partnership. The termination of a partnership is often referred to as dissolution of the partnership.

However, the remaining partners may still proceed with the business of the dissolved partnership, albeit in a different business form. If Ray decided to withdraw from B&R Air Services, the partnership between Bob and Ray would be dissolved. However, that would not necessarily stop Bob from continuing the business as a sole proprietor or taking on a new partner and starting a new partnership. Of course, it would be best for all parties to have a carefully drafted agreement outlining the procedures to be followed to buy out a withdrawing or deceased partner and continue the business. Such an agreement lessens the possibility of confusion and disputes upon the death or withdrawal of a partner.

LIMITED PARTNERSHIPS

One special type of partnership is the limited partnership. A limited partnership consists of two types of partners: general partners and limited partners. General partners manage the partnership and invest capital in the partnership. Limited partners invest only capital in the partnership and do not participate in the management of the partnership.