Meritas Capability Webinar

Avoiding Common Mistakes Companies Make When Operating Business Aircraft

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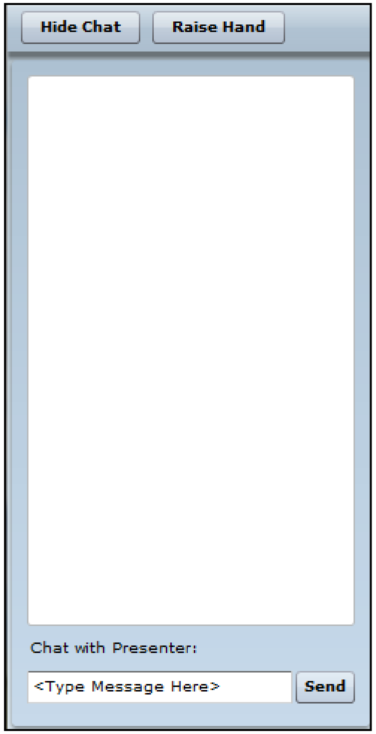

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Common Mistakes in Operating Business Aircraft

- Business aircraft operations are not only highly regulated they are regulated by several different agencies with different agendas
  - What may comply with the rules of one agency may violate the regulations of another agency
- Business aircraft operators have to structure their operations to comply with these requirements
  - Requires careful balancing and knowledge of regulatory environment

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Scenario

- President of Bigco, Inc. calls you and says that he's decided that the company needs to purchase a business jet
  - Bigco will use aircraft to transport employees between the company's facilities in 6 states and entertain clients
  - Bigco will also let wholly owned subsidiary, Littleco, LLC, use the aircraft

Scenario

- President asks you to create Planeco LLC
  - President is worried about liability issues and hopes to shield Bigco's assets from the operation of the aircraft
  - Bigco will be the sole member of the LLC
  - Planeco will own and register the aircraft and employ the pilots
  - Bigco will make necessary capital contributions to Planeco to purchase and operate the aircraft
  - Littleco will reimburse Bigco for their use of the aircraft

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Mistake #1 – The Flight Department Company

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Flight Department Company Trap

- This structure creates a Flight Department Company that violates the Federal Aviation Regulations (FARs)
  - Planeco's was established solely for the purpose of providing air transportation to a parent corporation, its subsidiaries, and its officers for compensation
  - Planeco's operations require it to obtain an air charter certificate

Flight Department Company Trap

The FAA's worldview is black and white

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Flight Department Company Trap

- Most non-commercial business aviation operates under Part 91 of the FARs
  - No FAA Certification/Licensing
  - Less restrictive operational requirements
- Most commercial business aviation operates under Part 135 of the FARs
  - Requires an air charter certificate
  - Compliance with stricter operational requirements
  - Federal tax on commercial transportation

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Flight Department Company Trap

- A commercial operator is "a person who, for compensation or hire, engages in the carriage by aircraft in air commerce of persons or property." FAR 1.1
  - "Compensation" has been defined by the FAA very broadly to include capital contributions, reimbursement, and even goodwill and exchange of services
  - "[A] company whose sole purpose is transportation by air and receives . . . amounts paid by [parent company] needed to pay the costs of owning and operating the aircraft must obtain certification. . . ." FAA Chief Counsel Opinion Letter, 3/9/2007

Intra-Corporate Family Arrangements

- Carriage of officials, employees, guests, and property of a company on an [aircraft] operated by that company or a subsidiary of the parent, when the carriage is within the scope of, or incidental to, the business of the company (other than transportation by air) and no charge . . . is made for the carriage in excess of the cost of owning, operating, and maintaining the aircraft . . .” FAR 91.501(b)(5)

Intra-Corporate Family Arrangements

- Key phrases:
  - "within the scope of or incidental to, the business of the company"
  - "other than transportation by air"
- Planeco has no other business except to provide transportation by air
- FAR 91.501(b)(2), therefore, doesn't allow Bigco to escape the Flight Department Company Trap

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Mistake # 2 – "But everyone does it this way…."

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Flight Department Company Trap

- Why care?
  - A Flight Department Company violates the FARs
  - Its operations may violate any "compliance with laws" covenants in loan agreements or insurance policies
  - FAA may fine the operator
  - The FAA may revoke the certificates of pilots that operated flights improperly under Part 91
  - IRS may attempt to collect the transportation excise tax on the theory that the flights should have been commercial

Flight Department Company Solutions

- Legally operate under Part 135
  - Obtain a Part 135 certificate (a lengthy and expensive process)
  - Find an existing Part 135 certificate holder to operate and manage aircraft under Part 135 (more expensive and restrictive than operating under Part 91)
- Have Bigco (or perhaps Littleco) own and operate the aircraft
  - Doesn’t provide the desired liability shield
- Transfer business to Planeco (Remembering that the flights must be within the scope of or incidental to the business of the company)
- Consult with aviation attorney for other “creative” solutions

Scenario

- President of Bigco agrees (finally) that the aircraft will be registered by Bigco
- He doesn't want Bigco to operate the aircraft
- He's found a local Part 135 charter company that will manage the aircraft and operate it for Bigco
  - "That way, all the risk will be on them."

Mistake #3 – Not understanding "operational control"

Operational Control

- Operational control means "the exercise of authority over initiating, conducting or terminating a flight." FAR 1.1
- "Exercise of authority" is crucial factor in this context
  - to "use, cause to use or authorize to use aircraft, for the purpose of air navigation…"

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Operational Control

- Operator accountable for safety and all other aspects of the aircraft operation
  - Must have full knowledge of flight operations
  - Airworthiness, eligibility of flightcrew, identity of passengers
  - Flightcrew must determine on operator's behalf whether flight can be conducted safely and in accordance with regulations, etc.
  - O/C responsibility and accountability cannot be transferred

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Operational Control

- Part 91 operator may outsource aircraft management to a third party
  - Management company may provide crewmembers, conduct aircraft maintenance, arrange flight planning services, etc.
- Aircraft owner retains operational control
- Management agreement must clearly establish legal and regulatory liability continues to be vested in aircraft owner

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Operational Control

- Many Part 91 operators rely on crew provided by the management company
  - Must have agreement in place with management company defining the role of pilots vis-à-vis operational control, etc.
  - In addition, crewmember agency agreements – If pilots are direct employees of the aircraft owner/operator, such agency agreements may not be necessary
- Management company may also arrange for or provide maintenance services
  - Part 91 operator maintains ultimate responsibility and accountability for determining airworthiness prior to each flight

Mistake #4 – Not understanding personal use and reimbursement rules

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Scenario

- Bigco's President intends to use the aircraft to travel to his summer home, ski lodge, and to visit his grandkids across the country
- You suspect that this personal use may become the primary use of the aircraft

Personal Use and Reimbursement

- FAA doesn’t have a problem with personal use of a company’s aircraft by executives
- The IRS on the other hand….
  - Personal or entertainment use of the aircraft may have potentially large tax consequences for Bigco, e.g. disallowance of expenses or changed depreciation
  - Important to plan in advance; you can’t “unfly” flights
  - Consultation with aviation-experienced accountants a must

Personal Use and Reimbursement

- Personal use of the business aircraft also has personal income tax implications
- Personal use of an employer provided aircraft is a fringe benefit and is included in the employee's gross income
- Fringe benefit is taxable to the employee even if the employee is not the recipient (e.g. spouse, children, guests)

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Personal Use and Reimbursement

- Valuation of amount fringe benefit can be based on either fair market value or the SIFL (Standard Industry Fare Level) Rates
  - SIFL rates are published every 6 months by the IRS and are adjusted (modified) by an aircraft multiple (based on maximum certified gross take-off weight of the aircraft)
  - Different rates "control employee" for “non-control” employees
  - Also a terminal charge that changes every six months.

Personal Use and Reimbursement

- Sample SIFL calculations for control employee from Chicago to Naples, FL (1,145 statute miles) on a light business jet

First 500 Statute Miles	X 24.9¢	= $ 124.50
Next 645 Statute Miles	X 18.98¢	= $ 122.42
Subtotal		= $246.92
Aircraft Multiple	X 300%	= $740.76
Terminal Charge	+ $45.52	= $786.28

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Personal Use and Reimbursement

- Generally, an executive cannot reimburse the company for personal use of an aircraft operated by the company
- Reimbursement = compensation Both scenarios are unacceptable to the FAA
  - Providing compensation for transportation by air is a "commercial" operation requiring a Part 135 charter certificate

Partial Reimbursement

- Time Sharing Agreement (FAR 91.501(c)(1) allows a wet lease (aircraft and crew) and allows for reimbursement of limited costs
  - Basically 200% of fuel plus crew travel expenses, landing fees, and hangar costs, etc
- Only applies to large and turbine powered multiengine aircraft
  - But… There are exceptions for members of the National Business Aviation Association

Full Reimbursement

- In 2010, the FAA agreed to allow full reimbursements for certain high-level employees whose position merits a high level of corporate interference into his or her travel plans
- FAA requires specific corporate steps and findings
- Company must have a need to immediately recall the employee at any time
- <u>FAA has emphasized that this is a very limited exception that not every company will be allowed to use</u>

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Scenario

- Bigco's President calls
  - Aircraft broker has found an airplane, but we've got to act fast
  - Broker knows the seller and trusts them so there's no reason for an inspection
  - Broker has "standard" contract that she has used with the seller before

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Mistake #5 – Not Planning

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Planning

- Business aircraft are expensive assets that must operate in a heavily regulated environment
- In addition to the issues discussed today, Capetown registrations, sales/use tax, disallowances for entertainment use, passive activity, depreciation, and other issues need to be considered
- It's not also possible to easily (or cheaply) undue the business structure or operations after the fact

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