

Aviation Regulatory Bulletin

December 2006

Business Aircraft Operations and Regulatory Concerns

Business aircraft use is a practical, cost-effective alternative to commercial air travel. When used wisely, business aircraft offer significant benefits over commercial air travel, such as increased productivity, security, convenience, and lower travel costs. However, before a company decides to purchase or lease an aircraft, the company should conduct considerable planning and assess all of the various ownership and use options, including performing a thorough analysis of the regulatory framework in which commercial aircraft operate.

As an initial matter, a company must determine which ownership or use option—i.e., buy, lease or charter—is right for its unique needs, and whether the company can take advantage of the tax benefits associated with aircraft use. Some companies desire a great deal of control and management of their aircraft while others simply want a turnkey operation in which they out-source the management responsibilities. In determining how to proceed, companies must be mindful that the Federal government regulates aircraft use heavily and improper use may result in a civil penalty and denial of insurance coverage in the event of an accident.

In sum, the first step involved with aircraft use is for a company to assess its needs and potential use of the aircraft and verify that its intended uses are consistent with the applicable regulatory requirements. The creation of a comprehensive Aircraft Use Policy is perhaps the best way to ensure regulatory compliance.

SEC Issues

The Sarbanes-Oxley Act of 2002 (the “Act”) affected business aviation in three important ways. First, public companies are now required to certify the value of the business aircraft use perquisites granted to executives as “other annual compensation” in their annual reports and proxy statements. This raises the vexing issue of how to estimate the value of such use, especially as the penalties for failing to account properly for such use are real. See *In the Matter of General Electric Company*, Administrative Proceeding File No. 3-11677 (Sept. 23, 2004); *SEC v. Kozlowski, et al.*, 02 Civ. 7312 (S.D.N.Y. 2002); *SEC v. Adelpia Communications Corporation, et al.*, 02 Civ. 5776 (S.D.N.Y. 2002). Unlike the Internal Revenue Service’s (IRS) Standard Industry Fare Level (SIFL) and Fair Market Value (FMV) valuation methods for imputed income, the Securities and Exchange Commission (SEC) requires companies to determine the value of the perquisite “on the basis of the aggregate incremental cost to the registrant and its subsidiaries.”

Second, the Act requires a company to “disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships” that “may have a material current or future effect” on its financial condition. Until recently, off-balance-sheet transactions, commonly referred to as

synthetic leases, were a popular way to account for business aircraft. Now, in view of the negative perceptions associated with off-balance-sheet transactions, companies might want to reconsider their use.

Third, the Act prohibits personal loans to executives. Company loans were a common method for an executive to purchase an aircraft and often they served a mutually beneficial purpose in situations in which an executive's personal use of the aircraft might have been significant, yet the company did not want to purchase an aircraft. However, given the potential for abuse, the Act now prohibits this practice.

Also, on September 8, 2006, the SEC published its final rule (Final Rule) regarding executive compensation and related personal disclosure. Specifically, the SEC explained in the Final Rule that "business purpose or convenience does not affect the characterization of an item as a perquisite or personal benefit where it is not integrally and directly related to the performance by the executive of his or her job." Specifically, a company's decision to make its aircraft available for executive personal use for security purposes does not affect the characterization of the aircraft use as a perquisite or personal benefit. The presence of a company security policy requiring an executive (or an executive and his or her family) to use company aircraft for personal travel does not affect the conclusion that such use is a perquisite or personal benefit.

The Final Rule also made clear that the amount attributed to perquisites and other personal benefits for IRS purposes is not the aggregate incremental cost for SEC disclosure purposes. The cost of aircraft travel attributed to an executive for IRS purposes is not generally the incremental cost of such a perquisite or personal benefit for purposes of SEC disclosure rules.

Personal Use Should Be Handled Very Carefully

Personal use of business aircraft is an extremely desirable perquisite for executives, but such use is heavily regulated. Most companies, for example, do not realize that the Federal Aviation Administration (FAA) and the IRS have inconsistent positions on reimbursements for personal aircraft use, which makes personal use very difficult to handle properly. FAA requirements effectively bar reimbursements except in very limited circumstances. While IRS regulations allow reimbursements, the Service requires companies to impute income to an employee that equals the value of the aircraft personal use less reimbursements. Companies must also use the same valuation method (i.e., SIFL or FMV) during the entire tax period.

Unfortunately, the personal use of business aircraft may also have a negative impact on whether a company may take full advantage of an aircraft's depreciation allowance. Moreover, as a result of the American Jobs Creation Act of 2004, a company's tax deduction associated with personal use of an employer-provided aircraft is limited to the amount that the company imputes as income to the one using the aircraft.

The FAA will allow personal use reimbursements when operating under a time sharing agreement. A time sharing agreement is "an arrangement whereby a person leases his airplane with flight crew to another person, and no charge is made for the flights conducted under that arrangement other than" the direct operating costs plus 100% of the fuel costs. However, time sharing agreements are subject to federal excise tax since the IRS considers such agreements commercial in nature.

Thus, a company would be wise to develop a comprehensive personal use reimbursement policy to address the various regulatory concerns prior to being stuck in a regulatory quagmire.

Creating A Special Purpose Entity To Operate An Aircraft Likely Violates FAA Regulations

In an effort to limit liability, many companies often make the mistake of creating a special purpose entity (SPE) with its sole business function the ownership and operation of aircraft. Typically, the subsidiary owns the aircraft, employs pilots, operates the aircraft under Part 91 of the Federal Aviation Regulations for other entities within the corporate family, and seeks reimbursement.

However, the FAA would likely view the SPE's "major enterprise" or "primary business" as transportation by air for compensation or hire and, therefore, would require the SPE to possess an air carrier operating certificate. *Failure to obtain an operating certificate has serious consequences. For example, the FAA assessed a \$3 million civil penalty against a company for performing 49 flights without an air carrier certificate.* Obtaining such an air carrier certificate is time consuming and expensive, and imposes taxes and numerous restrictions not applicable when flight operations are merely "incidental" to the primary business of the operator.

Accordingly, instead of an SPE, companies may want to consider creating a flight department division within a parent or subsidiary. As a practical matter, any potential reduced liability sought by creating a flight department SPE must be weighed against the cost and expense of obtaining a Part 121 or Part 135 operating certificate or the risk of whether an insurance company would honor a policy in the event of an accident since a policyholder operating without the certificate may have violated Federal Aviation Regulations.

For more information, please contact David M. Hernandez at 202-312-3340 (office); 202-403-1678 (mobile); or e-mail at dhernandez@vedderprice.com.

David M. Hernandez is a Shareholder with the law firm Vedder, Price, Kaufman & Kammholz, P.C., one of the nation's leading aviation and finance law firms. Mr. Hernandez is a member of the Aircraft and Equipment Finance Practice Groups and adds a valuable skill set well suited for a wide range of aviation and regulatory issues. A graduate of the U.S. Air Force Academy and Northwestern University School of Law, Mr. Hernandez is a former U.S. Department of Transportation Honors Attorney and a former FAA Trial Attorney/Prosecutor. Mr. Hernandez also earned a master's degree in Business Administration from Monmouth University while serving on active duty as an Aircraft Maintenance Officer in the U.S. Air Force.

VEDDER, PRICE, KAUFMAN & KAMMHOLZ, P.C.

Copyright © 2006 Vedder, Price, Kaufman & Kammholz, P.C. *Aviation Regulatory Bulletin* is a periodic publication of Vedder, Price, Kaufman & Kammholz, P.C. and should not be construed as legal advice, tax advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your lawyer concerning your specific situation and any legal questions you may have.

If you have any questions regarding material in this issue of the *Aviation Regulatory Bulletin* or suggestions for a specific topic you would like addressed in a future issue, please contact Dean Gerber, the group's chair at 312-609-7638 or at dgerber@vedderprice.com, Ronald Scheinberg at 212-407-7730 or at rscheinberg@vedderprice.com or Jon Bogaard at 312-609-7651 or at jbogaard@vedderprice.com.

About Vedder Price

Vedder, Price, Kaufman & Kammholz, P.C. is a national full-service law firm with approximately 230 attorneys in Chicago, New York, Washington, D.C. and in Roseland, New Jersey. The attorneys in the firm's Aircraft and Equipment Finance Groups represent lessees, lessors, financiers and related parties, both domestic and international, in a broad range of equipment finance transactions, including those involving aircraft, railcars, locomotives, vessels, computers, medical equipment, industrial production equipment, satellites, cars and trucks.

Principal Members of the Equipment Finance and Aircraft Finance Groups:

Chicago:

Jonathan H. Bogaard
Dean N. Gerber
Timothy W. O'Donnell
Geoffrey R. Kass
Joshua D. Gentner
John T. Bycraft
Ronald J. Rapp
Jordan R. Labkon
James P. Lambe
Milos V. Kovacevic
Nirav A. Patel
Patrick J. Stoklas
Ryan J. Opeka
Kiran S. Advani
Robert J. Hanks
Imran M. Rahman

New York:

John I. Karesh
Francis X. Nolan III
Donald A. Wassall
Denise L. Blau
John E. Bradley
Ronald Scheinberg
Jeffrey T. Veber
Jay S. Zwerling
Amy S. Berns
Christine L. Carver
Cameron A. Gee
Ji W. Kim
Daniel Barlin
Justin M. Patrick

Washington, D.C.:

Edward K. Gross
Theresa Mary Peyton
David M. Hernandez
Philip M. Livingston

Related Disciplines:

Douglas J. Lipke (Insolvency)
Thomas P. Desmond (ERISA)
John T. Blatchford (Securities)
Ernest W. Torain, Jr. (Securities)

Chicago

222 North LaSalle Street
Chicago, Illinois 60601
312-609-7500
Fax: 312-609-5005
Contact: Dean N. Gerber

New York

805 Third Avenue
New York, New York 10022
212-407-7700
Fax: 212-407-7799
Contact: Ronald Scheinberg

Washington, D.C.

888 16th Street, N.W., Suite 800
Washington, D.C. 20006
202-355-1395
Fax: 202-355-1394
Contact: Edward K. Gross

New Jersey

Five Becker Farm Road
Roseland, New Jersey 07068
973-597-1100
Fax: 973-597-9607
Contact: John E. Bradley