Employer's Guide to
Fringe Benefit Rules

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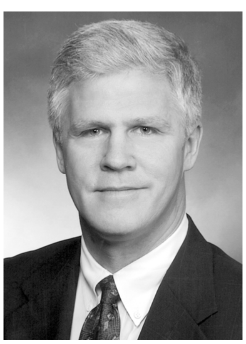

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Corporate Jets: How to Deal With the Tangle of FAA and IRS Rules

Private jet travel is addictive, despite compliance problems and formidable costs

by David DeYoe, Esq. and David R. Fuller, Esq.

With the airline experience as trying as it's ever been in the history of commercial aviation, perhaps travel by private aircraft has never seemed so attractive to executives flying on business — and those whose employers offer them the use of company aircraft for personal travel. (See Tab 900 of the *Guide* for more on flights using company aircraft.) Private jet travel's strengthened appeal is all the more reason to be aware of the pitfalls that go with flying on the "company" aircraft, for business or for pleasure.

Problems include the ownership and operational structure of the aircraft because the manner in which the aircraft is owned, operated, and funded can determine what regulations apply and many owners unknowingly fly under the wrong set of regulations.

When an employee flies on a company aircraft for business purposes, the value of the flight is not included in the employee's income because it is considered a working condition fringe benefit. (See Tab 400 for more on working condition fringe benefits.)

When an employee uses a company aircraft for personal or entertainment purposes and reimburses the company for the fair market value (FMV) of the flight, there is no income inclusion but the reimbursement can cause complications with government agencies like the Federal Aviation Administration (FAA). (See ¶912 for discussion on personal vs. business flights; also see the August and September 2007 issues of the newsletter for a two-part series on entertainment use of business aircraft.) Generally, Treas. Reg. §1.61-21(b) requires an employee to include in gross income the FMV of a fringe benefit, such as an entertainment flight (reduced by any reimbursement or statutory exclusion). For employee flights on employer-provided noncommercial aircraft, Treas. Reg. §1.161-21(g) provides that an employer may value such flights using the Standard Industry Fare Level (SIFL) formula (see ¶913).

Experts have estimated that as many as 75 percent of private jet aircraft owners do not fully comply with government regulations regarding ownership and operation of their aircraft. While private aircraft provide comfort, security and convenience, this failure to comply with the law threatens to ground the aircraft and subject the owner to serious legal and financial consequences.

The compliance problems are usually related to two sets of regulations: the FAA's complex and often conflicting rules known as the Federal Aviation Regulations (FARs), and the IRS' complex regulations under Code Sections 61 and 274. In combination, the FARs and the IRS regulations create a tangled array of rules and limitations, the sum and substance of which are often both inexplicable and inscrutable. As a result, many private aircraft owners have unknowingly created ownership arrangements that do not pass muster with the FAA. Usually this is the result of a conflict between owners' desire to limit liability and reduce taxes, the FAA's desire to promote safety and the IRS' desire to increase tax revenues. Clearly, many aircraft owners need to review their compliance status.

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Compliance Problems

Many employers maintaining corporate aircraft attempt to limit their liability by owning and operating their aircraft in a limited liability company (LLC) or corporation that has no assets or business other than the aircraft. Almost always this ownership arrangement violates the FARs because the FAA applies a different set of rules to strictly private air transportation (regulated under Part 91 of the FARs) than to commercial charter operations (regulated under Part 135). Under the FARs, an entity whose only asset is an aircraft is deemed to be in the business of providing air transportation service for compensation and, as a result, must operate under the stricter, commercial standards of Part 135. Even if the sole member of a single-asset LLC is the only person making use of the aircraft, the FAA views the LLC's operations as commercial, and therefore subject to Part 135, because funds are periodically infused into the LLC by the member to pay the costs of ownership and operation.

Because of the confusion about what constitutes private versus commercial operations, an owner must exercise care when purchasing an aircraft and organizing flight operations. Seemingly innocuous ownership or reimbursement decisions can result in violations of the Part 91 rules and may require that operations be conducted pursuant to the more restrictive and costly rules of Part 135 of the FARs. Violators are at risk for penalties that include significant fines that may accumulate on a daily basis and the possible grounding of the aircraft or crew, all of which make specialized, experienced assistance a necessity when purchasing an aircraft, structuring the ownership entity and dealing with reimbursements.

Reimbursements — 'For Compensation or Hire'?

To avoid or limit income inclusion and adverse tax consequences (including the disallowance of operating deductions), the IRS has historically advised employers to simply have their employees reimburse the employer for the value of the aircraft's use. Of course, it is not as simple as the IRS might suggest.

If an employee uses a corporate-owned airplane for personal use and reimburses the company — assuming the employer is the owner of the aircraft — the employee may unintentionally be creating a situation in which the operator of the aircraft would be considered a "commercial carrier" by the FAA. FAR Section 1.1 defines a commercial operator as a "person who, for compensation or hire, engages in the carriage by aircraft in air commerce of persons or property." The test historically applied to determine whether an operation is for "compensation or hire" is whether the operator receives direct or indirect payment, but it is not necessary that a flight be conducted for profit to meet the definition.

How Can Aircraft Owners Comply?

So how does an owner comply with the FARs? For a business owner the aircraft may be owned by the business or by an affiliate that has other assets and a real, operating business to which the aircraft ownership can be incidental. Under this arrangement, however, the assets of the owning entity, which may be substantial, are put at risk. So for the business owner, compliance means putting at least some of its business assets at risk while at the same time maintaining enough insurance to allow the business owner to sleep at night. An individual owner has only one option — buy enough insurance to cover the risks of ownership and protect the owner's assets.

If an operator is using an airplane for commercial purposes as defined by the FARs, insurance coverage may not apply if it was purchased for only non-commercial operations. If the owner accepts reimbursements for an employee's use of the aircraft, and does not have insurance for commercial uses, it may be flying without insurance, either for the hull or for the lives of the passengers and crew. Operators should carefully examine their insurance policies to ensure proper coverage.

Taxation

In addition to the FARs, aircraft owners must deal with multiple layers of taxation. State sales and use taxes (in most states) apply to aircraft. Sales tax may usually be avoided by taking delivery of the aircraft in a state that does not have a sales tax or does not impose it on aircraft sales. Use taxes, however, are much harder to avoid and vary from state to state, but can, in certain circumstances, be reduced. With many of the larger private jets priced at over $30 million, the sales or use tax on the purchase of a jet may exceed $2 million — so proper planning is a necessity.

For current owners, an aircraft, like a car, can be traded in and sales/use taxes can be reduced based on the trade-in value. In addition, Section 1031 allows aircraft to be exchanged (just like real estate), with income taxes on some or all of any gain deferred. Exchanges can be complicated so an experienced advisor is a must.

Tax depreciation rules for aircraft also vary depending on the characterization of the use — strictly private or commercial — and, again, the IRS and the FAA determinations are often at odds with one another. The two agencies clearly do not talk with one another or take a coordinated approach to aviation issues. This conflict adds yet another degree of complexity and tension for an

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employer trying to comply with the FARs while also trying to keep federal income taxes low. New rules dealing with expense deductions when personal use or entertainment is involved further complicate tax computations. Proper coordination of ownership structuring and tax planning is a crucial, but very often overlooked, aspect of private aircraft ownership and management.

Alternative Ownership Structures

New ownership and access programs make private flight increasingly available (see "Air Taxis Take Flight," August 2007 newsletter, page 8 for an example). Outright ownership is the traditional method. But it is not the only option. Several firms offer fractional shares in aircraft — akin to a tenancy in common real estate with many of the same benefits and burdens of ownership. For a price, an employer can purchase a share of an aircraft and obtain the concomitant right to use the aircraft for the number of hours associated with the share (usually with a 50-hour minimum).

Because 50 hours may be more than some employers desire to spend for the use of an aircraft, "jet card" programs were developed. These programs are much like owning a Starbucks card (just more expensive — a lot more expensive): The buyer pays a fee in advance and, instead of lattes and cappuccinos, receives the right to use an aircraft for as few as 25 hours a year. The jet card program does not provide any ownership benefits, but does allow for use of an aircraft at an expensive but, compared with whole or fractional ownership, more affordable price.

Fractional ownership and jet card programs eliminate most of the headaches of whole ownership because the fractional sponsor handles all of the management of the aircraft. The single-asset LLC or corporation can still be a problem, but the fractional programs deal with liability questions by maintaining substantial amounts of insurance coverage (usually between $200 million and $400 million or more) and by tailoring the insurance to cover most ownership arrangements.

Fractional Ownership

Fractional owners have the same tax benefits of ownerships as whole-interest owners. In addition, most fractional programs agree to repurchase the interest after some fixed period so the owner's risk of selling the interest is significantly reduced. Fractional owners have an additional advantage because the programs allow owners to switch between different aircraft in the program fleet, so an owner of a share of a Hawker 800 can switch to a larger Gulfstream G-550 or a smaller Hawker 400 to accommodate its needs on a particular flight. Fractional programs, however, are not cheap. A one-sixteenth interest in a midsize aircraft may cost more than $750,000, require monthly maintenance payments of $8,000 or more, and hourly flight time charges of $2,200 or more.

Jet card programs offer essentially the same operational advantages and disadvantages that the fractional programs offer — someone manages the aircraft and with proper scheduling the aircraft will be there to pick up the card-holder — all at a price from around $100,000 and up for 25 hours. There is no capital investment in the aircraft and no ownership interest — and the liability exposure of the owner is like that of a passenger on a commercial airliner. Jet card programs seem to work for executives and high-net worth individuals and employers that are "testing the market" — they like the idea of private air transportation but are not ready to invest as heavily as either whole or fractional ownership would require.

The benefits of owning an aircraft (even through fractional or jet card programs) can be addictive. Who wants to go to O'Hare two hours early, submit to scans and possible searches, and then potentially wait for hours as the flight is delayed — especially when the alternative is no lines, no scans, no waiting and one very comfortable, very private ride? The time saved and the privacy obtained can increase productivity significantly. So even though the costs are high and the FAA and IRS rules are tricky (and often conflicting), for a growing number of employers and executives the benefits of private air travel are well worth it. As with most regulatory issues, proper planning can overcome most hurdles of aircraft ownership and operation.