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Corporate Aircraft Operations: The Twilight Zone of Regulation

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CORPORATE AIRCRAFT OPERATIONS: THE TWILIGHT ZONE OF REGULATION*

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I. INTRODUCTION

MANY COMPANIES acquire corporate aircraft in order to increase the efficiency, comfort, and security of their top executives who travel. In addition, the acquisition of aircraft is often viewed by management as a method of reducing or eliminating the headaches frequently associated with airline travel, such as delayed flights, missed connections, lost baggage, and a lack of service. Unbeknownst to them, this business decision has caused them to enter the twilight zone of conflicting Federal Aviation Administration (FAA), Department of Transportation (DOT), and Internal Revenue Service (IRS) regulations and interpretations.

To successfully traverse this maze, logical business choices must often be tempered, and sometimes completely put aside, in order to satisfy arcane and complex requirements that fail to reflect real world considerations. From an FAA perspective, the first and perhaps most common mistake is the creation of a separate subsidiary to own, operate, and maintain the aircraft. Although this is a logical step toward insulating a company from the potential liability associated with the operation of aircraft, the FAA would require the subsidiary to obtain a charter license if any compensation is received by the operator. The fact that the subsidary will operate only for its parent and sister companies is irrelevant to the FAA. Another approach is to hire a management company to provide the services necessary to support the company's use of the aircraft. In these instances, it is possible that the IRS will view the operation as commercial, and, therefore, subject payments to the management company to the ten percent transportation excise tax or the six dollar international departure tax, depending on the itinerary. These basic

business decisions open a pandora's box of regulations that frequently have no relationship to the practical world of corporate transportation.

This Article will address issues that should be considered in connection with the acquisition and use of corporate aircraft. These issues fall into two primary categories: (1) FAA regulations and (2) IRS transportation excise tax and imputed income issues. The interplay of these issues creates a quagmire of regulation that requires careful navigation if increased corporate efficiency is to be achieved. This Article will also address the operating guidelines established by the FAA and the applicability of the transportation excise tax to each of the operating structures.[1]

II. FAA REGULATORY FRAMEWORK

A. Background

As a general rule, the FAA requires aircraft operators to hold a certificate before engaging in any form of transportation for compensation or hire. Keeping this basic premise in mind, the exceptions to the certification rule[2] that form the basis for the vast majority of self-operated business transportation are narrowly construed and frequently at odds with real life business decisions. The FAA has different regulations for "commercial" and "non-commercial" transportation. The fundamental difference between the two types of transportation is whether the operation involves carrying persons or property for "compensation or hire." Although exceptions to licensing are interpreted narrowly, compensation is given a very broad definition and does not require a profit or even a profit motive. Even if there is no profit motive and the payment only covers costs, compensation nevertheless exists.[3] Compensation may even exist without an "exchange of greenbacks or dollar bills or anything else [i]f there is a *quid pro quo* which benefits the . . . operator . . . ."[4]

Absent compensation, the operation will be classified as "non-commercial." This includes typical FAR Part 91 operations

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[1] The primary focus of this Article is on the aviation operating issues and excise and imputed tax issues related to the carriage of passengers on corporate aircraft.

[2] *See* Federal Aviation Regulations, 14 C.F.R. pt. 91, subpt. F (1996).

[3] Administrator v. Rountree, 2 NTSB 1712 (1975).

[4] Administrator v. Henderson, NTSB Order No. EA-3335 (1991) (Initial Decision, Administrative Law Judge Patrick G. Geraghty) (an exchange of services, among other things, can constitute compensation or hire).

where the aircraft is used for personal use by company employees or for guests without charge,[5] as well as certain demonstration flights and transportation of athletic groups, choral groups, and other common-purpose groups where no charge is made.[6] When compensation is involved, the operation is considered "commercial" and is further categorized as "common carriage" or "private carriage for hire/non-common carriage."

B. COMMERCIAL OPERATIONS—COMMON CARRIAGE AND PRIVATE CARRIAGE FOR HIRE

1. *Common Carriage*

The law of common carriage has a long history and has been pivotal in FAA and DOT evaluations of whether a particular operation requires a license. Nevertheless, a precise definition is difficult at best. Although there are key characteristics—namely, holding out to the public, or to a segment of the public, as willing to transport persons or property for compensation or hire[7]—the determination is fact driven. When the FAA adopted Part 119 of the FARs[8] in late 1995, it backed away from defining "common carrier." Instead, it noted that the "term has been discussed in numerous court cases."[9] The FAA did, however, define "non-common carriage" in section 119.3 as "an aircraft operation for compensation or hire that does not involve a holding out to others."[10]

Common carriers include U.S. air carriers, which must obtain an FAA Air Carrier Operating Certificate and operations specifications issued under FAR Part 121 or Part 135 (depending on

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[5] Despite this general rule, in certain circumstances a private pilot can share the expenses of a particular flight with his or her passenger without causing the flight to be "commercial." *See* 14 C.F.R. § 61.118(b) (1996).

[6] *See* 14 C.F.R. § 91.501(b) (1996).

[7] *See* FAA Advisory Circular 120-12A, *Private Carriage Versus Common Carriage of Persons or Property* (Apr. 24, 1986).

[8] *See* 14 C.F.R. pt. 119 (1996). Part 119 clarified and updated certain operating requirements applicable to various types of commercial transportation and provides the framework for determining which licensing provisions (that is, Part 121, 125, or 135) apply.

[9] 60 Fed. Reg. 65,832, at 65,880 (1995).

[10] 14 C.F.R. § 119.3 (1996). The FAA also distinguished common carriage from non-common or private carriage at the end of the definitional section of Part 119 as follows: "When common carriage is not involved or operations not involving common carriage means any of the following: (1) Noncommon carriage; (2) Operations in which persons or cargo are transported without compensation or hire; (3) Operations not involving the transportation of persons or cargo; (4) Private carriage." *Id.*

the size of the aircraft being operated).[11] Common carriers also include foreign carriers which must obtain operations specifications issued under Part 129 of the FARs.[12] Until the adoption of FAR Part 119 in late 1995, the line of demarcation between Part 121 and Part 135 certification was fairly bright and depended upon aircraft size. Aircraft configured for more than thirty seats or having a payload capacity of more than 7500 pounds were to be operated under FAR Part 121.[13] Aircraft configured for thirty seats or less and having a maximum payload of 7500 pounds or less were governed by FAR Part 135.[14]

The above aircraft size distinction continued in effect until March 20, 1997, for carriers certificated by the FAA prior to January 19, 1996.[15] After March 20, 1997 (for grandfathered carriers), and after January 19, 1996 (for new applicants), the applicability of either Part 121 or Part 135 is determined with reference to the size of the aircraft and the type of operations[16] as follows:

(1) Scheduled passenger operations with aircraft with ten or more seats and with turbojet-powered aircraft (regardless of the number of seats) are conducted under Part 121.[17] This reflects concerted Congressional, NTSB, and FAA efforts to establish a single safety standard, namely Part 121, for all scheduled passenger operations regardless of aircraft size.

(2) Passenger charter and all cargo operations with aircraft have more than thirty seats or 7500 pound payload are conducted under Part 121 as "supplemental operations."[18]

(3) Scheduled passenger operations with aircraft having nine seats or less (excluding jets) remain under Part 135 and retain the classification of "commuter operations." Similarly, charter passenger and all cargo operations with aircraft having thirty

[11] *See* 14 C.F.R. pt. 121 (1996); Special Federal Aviation Regulation 38-2 ¶¶ 2(a), 4 (1996) (superseded) [hereinafter SFAR 38-2]; *see also* 14 C.F.R. § 119.21 (1996); 14 C.F.R. pts. 121, 135 (1996).

[12] *See* 14 C.F.R. § 129.11 (1996).

[13] *See* SFAR 38-2, *supra* note 11, ¶ 4(a).

[14] *See id.* ¶ 4(b).

[15] *See* 14 C.F.R. § 119.2(a) (1996).

[16] *See id.* § 119.2(a), (b). "Kind of operation" is defined in § 119.3 to mean "[all] of the various operations a certificate holder is authorized to conduct, as specified in its operations specifications, *i.e.* domestic flag, supplemental, commuter, or on-demand operations." *Id.* § 119.3.

[17] Such operations include "domestic operations" and "flag operations," as defined in 14 C.F.R. § 119.3 (1996).

[18] See 14 C.F.R. § 119.3 (1996) for a definition of "supplemental operations."

seats or less (7500 pound payload or less) remain under Part 135 as "on demand operations."[19]

Regardless of the FAA classification, most carriers will continue to require authority from DOT, which again varies depending on the size of the aircraft.[20]

2. Non-Common Carriage

In addition to commercial operations which constitute common carriage, there are also commercial operations which constitute "private carriage for hire" or "non-common carriage." Included in this class are the Part 91, Subpart F operations which include intra-corporate family operations, time-sharing, demonstration flights, interchange, and joint-ownership arrangements.[21] The private carriage for hire and non-common carriage operations (as defined in Part 119) also include Part 121 and Part 135 commercial operations.[22] While Part 125 continues to cover operations with aircraft configured for twenty seats or more or having a maximum payload of 6000 pounds or more,[23] Part 135, which historically covered commercial operations with aircraft below that size,[24] now refers to Part 119 for the rules governing non-commercial operations with small aircraft.[25] Both Part 125 and Part 135 operators are issued FAA

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19 An "operation" is defined as a commuter operation if it has a frequency of operations of at least five round trips per week on at least one route between two or more points according to the published flight schedules. In general terms, an "on demand operation" is one in which the departure time, departure location, and arrival location are specifically negotiated with the customer. *See id.*

20 *See* 14 C.F.R. pt. 204 (1996) (U.S. air carriers operating large aircraft and commuter air carriers operating small aircraft); *id.* pt. 298 (U.S. air taxis operating small aircraft); *id.* pt. 211 (foreign air carriers); 49 U.S.C. §§ 41101, 41301 (1994). The related DOT licensing requirements for air carriers are: (1) a certificate of public convenience and necessity (PC&N certificate) for U.S. scheduled and charter carriers, operating "large aircraft," (2) registration under Part 298 of the DOT's Economic Regulations for U.S. air taxi operators operating "small aircraft" or determinations of fitness for commuter carriers operating small aircraft, and (3) a foreign air carrier permit for foreign air carriers. DOT licensing is still largely dependent upon aircraft size: aircraft with more than 60 seats or 18,000-pound payload are deemed "large" and must be operated pursuant to a PC&N certificate, while aircraft with 60 seats or less or 18,000-pound payload or less are deemed "small" and are generally governed by Part 298. *See* 14 C.F.R. § 298.3 (1996).

21 *See* 14 C.F.R. § 91.501 (1996).

22 *See id.* § 119.3.

23 *See id.* § 125.1(a).

24 *See id.* § 135.1(a)(3) (superseded).

25 *See id.* § 135.1(a).

Operating Certificates and operations specifications under either Part 125 or Part 135, as appropriate.[26] The major concern for these operators is avoiding a "holding out" that would transform them into a common carrier thereby subjecting the operator to DOT licensing and FAR Part 121 or Part 135 requirements.

III. OVERVIEW OF FAA REGULATION OF SPECIFIC PRIVATE CARRIAGE FOR HIRE OPERATIONS— TIME-SHARING, INTERCHANGE AND JOINT-OWNERSHIP AGREEMENTS

A. BACKGROUND

Operations conducted under Subpart F of Part 91, such as intra-corporate family operations,[27] time-sharing,[28] demonstration flights,[29] interchange[30] and joint-ownership arrangements,[31] are excepted from the certification requirements otherwise applicable to operations for compensation or hire.[32] Although there is an element of compensation in Subpart F operations, such compensation is limited to reimbursement of certain costs depending upon the type of operation involved. Furthermore, although Subpart F, on its face, applies only to "large" airplanes[33]—by FAA definition, those over 12,500 pounds maximum certificated takeoff weight[34]—and multi-engine, turbojet-powered airplanes,[35] the FAA has granted a broad exemption to the National Business Aircraft Association (NBAA) on behalf of its members to extend the benefits of Subpart F to "small" airplanes and helicopters as well as individual exemptions to specific operators.[36]

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26 *See* 14 C.F.R. § 119.23(b) (1996); *see also* SFAR 38-2, *supra* note 11, ¶¶ 2(b), 5(b). The advent of Part 119 has not substantively altered licensing requirements for Part 135 commercial operators. A DOT license is not required for either type of operation.

27 *See* 14 C.F.R. § 91.501(b)(5) (1996).

28 *See id.* § 91.501(b)(6), (c)(1).

29 *See id.* § 91.501(b)(3).

30 *See id.* § 91.501(b)(6), (c)(2).

31 *See id.* § 91.501(b)(6), (c)(3).

32 *See id.* § 91.501(b).

33 *See id.* § 1.1.

34 *Id.*

35 *See id.* § 91.501(a).

36 *See* Petition of Nat'l Business Aircraft Ass'n, FAA Exemption No. 1637S (Sept. 30, 1996). The FAA has referred to this exemption in numerous interpre-

In determining the applicability of Subpart F, primary emphasis is placed on paragraph (a) of section 91.501, which states in pertinent part that "[t]he operating rules in this subpart [F] do not apply to those airplanes when they are *required* to be operated under Parts 121, 125, 129, 135 and 137 . . . ." or when common carriage is involved.[37] Whether an aircraft is *required* to be operated under Parts 125 and 135 (other than as a common carrier) depends, in part, on whether the operator has been determined to be a commercial operator, which is defined as:

> [A] person who, for compensation or hire, engages in the carriage by aircraft in air commerce of persons or property, other than as an air carrier or foreign air carrier or under the authority of Part 375 of this title. Where it is doubtful that an operation is for "compensation or hire" the test applied is whether the carriage by air is merely incidental to the person's other business or is, in itself, a major enterprise for profit.[38]

If the company is deemed a "commercial operator" (that is, established solely to provide transportation by air for compensation or hire as a major enterprise for profit), none of the Subpart F options would be available because the airplane is *required* to be operated under Part 125 or 135.[39] If the company is engaged in operations for compensation or hire, but *not* as a "commercial operator," as defined—in other words, the opera-

tations of the rule. *See, e.g.*, Interpretation 1991-53, 3 Fed. Av. Dec. I-126 (Sept. 23, 1991) (members of the NBAA may operate small aircraft in accordance with Subpart D (recodified as Subpart F)); Interpretation 1990-18, 2 Fed. Av. Dec. I-305 (July 13, 1990) (exemption granted to NBAA to allow its members to operate small aircraft in accordance with Subpart D (recodified as Subpart F)). The FAA has also advised parties to apply for and has granted similar exemptions to permit the use of small and non-turbojet aircraft under the rule. *See, e.g.*, Interpretation 1977-31, 1 Fed. Av. Dec. I-196 (June 15, 1977) (to operate a helicopter under Subpart D (recodified as Subpart F), an application for an exemption must be filed and granted); Petition of American Express Co., FAA Exemption No. 3638 (Oct. 8, 1982) (exemption to operate helicopters); Petition of Johnson & Johnson, FAA Exemption No. 3604 (Aug. 17, 1982) (exemption to operate helicopters).

[37] *See* 14 C.F.R. § 91.501(a),(b) (1996) (emphasis added).

[38] 14 C.F.R. § 1.1 (1996).

[39] Even if the operation of the aircraft is incidental to another business purpose, certain large corporate jets (for example, some G-IV models, BAC-111s, and B727s) have always been "required" to be operated under Part 125 simply because of the higher number of passenger seats and greater payload capacity. Notwithstanding this requirement, most corporate operators of these airplanes apply for, and routinely obtain, letters of deviation from Part 125. *See* 14 C.F.R. § 125.3 (1996). With a deviation, operations under Part 125 are not *required*, and Subpart F alternatives are available.

tions for compensation are merely "incidental" to the person's business—then Subpart F would be available to the operator.

As in all areas of Part 91, however, the question of compensation is not always clear cut. If the aircraft is owned by a small company and is carrying that company's owners or officials on personal travel, the mere fact that the owners have not paid for the flight does not end the inquiry. The company obviously is paying for the operation of the aircraft. If the operation is not generating revenue, the question arises, how does the company pay the costs associated with the aircraft, including such things as management fees and operating expenses? Infusions of capital, as opposed to "payments" for the flight, may nevertheless be compensation subjecting the company to potential violations. More important, if the company is not operating in compliance with the FARs, it could have an adverse affect on insurance coverage. With respect to the operations for non-company related individuals, it must be determined whether there is a *quid pro quo* for the operation. If there is, compensation is received.

Given the broad interpretation of compensation, extra caution must be exercised when determining whether Subpart F operations are available. This stems from the fact that compensation may be paid under Subpart F only if the aircraft operations are merely incidental to the company's other business. While this limitation is specifically included only in section 91.501(b)(5), whereby companies engaged solely in "transportation by air" are excluded from intra-corporate family operations for which there will be chargebacks or reimbursement, the FAA, by interpretation, has applied the transportation-by-air exception to operations conducted under section 91.501(b)(6) as well.[40] As a result, a company organized solely for the purpose

[40] *See, e.g.*, Interpretation 1989-22, 2 Fed. Av. Dec. I-241 (Aug. 8, 1989) (Clark Boardman Callaghan) (company organized solely to provide transportation to affiliated companies may not operate under Subpart F); Interpretation 1982-1, 1 Fed. Av. Dec. I-583 (Feb. 4, 1982) (if only business is to own, operate, and maintain aircraft, payment for Part 91 operations are not permitted); Interpretation 1978-35, 1 Fed. Av. Dec. I-325 (Oct. 31, 1978) (operating for other company through time-sharing not authorized if such carriage is primary business of the company); Interpretation 1976-41, 1 Fed. Av. Dec. I-149 (Dec. 13, 1976) (operation for compensation cannot be conducted under Part 91 when the sole purpose of the corporation would be providing transportation); Interpretation 1976-22, 1 Fed. Av. Dec. I-120 (July 13, 1976) (certificate required because company's primary purpose is providing transportation as reflected by its name); Interpretation 1975-25, 1 Fed. Av. Dec. I-41 (Apr. 21, 1975) (if primary business of company is operating the airplane, neither time-sharing nor interchange operations may be conducted); *see also* Interpretation 1975-16, 1 Fed. Av. Dec. I-28 (subsection

of owning and operating an airplane is not eligible for such Subpart F operations.

The FAA's analysis of commercial operators does have certain flaws, albeit non-fatal, when examined in the context of SFAR 38-2[41] and Part 119[42] which, in this context, replaces SFAR 38-2.[43] Paragraph 5 of SFAR 38-2 required all "commercial operators" (which are not air carriers) to be certificated under Parts 125 and 135, depending upon aircraft size.[44] However, paragraph 6(c)(2) of SFAR 38-2 defined "commercial operator" more strictly by excluding the incidental business/major enterprise-for-profit test in the FAR section 1.1 definition of "commercial operator."[45] Since SFAR 38-2 overrode any inconsistent provisions of Parts 125 and 135, *all* operations for compensation and hire (other than as an air carrier) would have been *required* to be operated under Parts 125 and 135.[46] It would follow that no such operations would have been eligible to be operated under Subpart F, effectively ruling out time-sharing, interchange, joint ownership, and other Subpart F operations from the FARs. The FAA never advanced this position as it would have produced an onerous and absurd result.

The new Part 119 is also flawed, again not fatally, but for a different reason. Paragraph (b) of section 119.23 provides that non-common carrier operations for compensation and hire with Part 135-size airplanes (less than twenty seats/7500 pound payload) are *required* to be conducted under Part 135 without regard to whether the operator is a "commercial operator," as defined in FAR section 1.1, or whether such commercial operations are merely incidental to the operator's other business.[47] Accordingly, under the FAA's strict analysis of section 91.501(a), all such operations would be excluded from Subpart F—indeed,

(b)(6) operations must be incidental to the non-air transportation business of the company operating the aircraft). It should be noted that this interpretation also stated that such (b)(6) operations must be within the scope of the operating company's business although there is no other support for such an interpretation. *Id.* at I-30.

[41] *See* 14 C.F.R. pt. 121 (1996); SFAR 38-2, *supra* note 11.

[42] *See* 14 C.F.R. pt. 119 (1996).

[43] *See* 60 Fed. Reg. 65,832, at 65,879 (1995).

[44] *See* 14 C.F.R. pt. 121 (1996); SFAR 38-2, *supra* note 11, ¶ 5.

[45] *See* 14 C.F.R. pt. 121 (1996); SFAR 38-2, *supra* note 11, ¶ 6(c)(2) ("commercial operator means a person, other than an air carrier, who conducts operations in air commerce carrying persons or property for compensation or hire."); *supra* text accompanying notes 38-39.

[46] *See* 14 C.F.R. pt. 121 (1996); SFAR 38-2, *supra* note 11.

[47] *See* 14 C.F.R. § 119.23 (1996).

Subpart F would be read out of the FARs for this size of corporate jet. What appears to save the day here is that the applicability section of Part 119[48] is limited, *inter alia*, to "commercial operators," as defined in FAR section 1.1, which would exclude an operator whose commercial operations are merely incidental to its other business, thus making such operators eligible to operate under Subpart F of Part 91.

B. Types of Subpart F Operations

1. *Intra-Corporate Family Operations*

As noted earlier, Subpart F is frequently relied upon by corporate operators for intra-corporate family operations—that is, operations carrying officers, employees, and guests of companies within the same corporate family.[49] Under such an arrangement, the member of the corporate family that is furnishing and operating the aircraft is entitled to be reimbursed up to the cost of "owning, operating and maintaining the airplane"—that is, reimbursed on a fully allocated cost basis. This regulation is limited by its terms to transportation that is "within the scope of, and incidental to, the business of the company (other than transportation by air)."[50] As a result, if a company seeks to minimize the potential liability associated with aircraft operations by limiting exposure to the hard assets of a "flight department company," Subpart F would not apply because that company would have been established solely for the purpose of providing transportation by air. The fact that it would carry only its parent's or subsidiary's employees is irrelevant. If there is any compensation for such operations, the company must obtain an FAA Operating Certificate.[51] As noted above, the FAA interpreta-

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[48] *See id.* § 119.1(a)(1).

[49] See 14 C.F.R. § 91.501(b)(5), which authorizes the

> [c]arriage of officials, employees, guests, and property of a company on an airplane operated by that company, or the parent or a subsidiary of the company or a subsidiary of the parent, when the carriage is within the scope of, and incidental to, the business of the company (other than transportation by air) and no charge, assessment or fee is made for the carriage in excess of the cost of owning, operating, and maintaining the airplane, except that no charge of any kind may be made for the carriage of a guest of a company, when the carriage is not within the scope of, and incidental to, the business of that company.

[50] *Id.*

[51] *See, e.g.*, Interpretation 1989-22, 2 Fed. Av. Dec. I-241 (Aug. 8, 1989) (the language of § 91.501(b)(5) clearly requires that aviation activities be secondary

tions incorporate its analysis of Subpart F's applicability generally and rule out *any* operation for compensation under Subpart F, except as an incident to the operating company's business.[52]

While this subsection permits a fully allocated cost recovery when operating for the operating company, its officials, employees, and guests and property of the company, the parent or subsidiary of the company and subsidiaries of the parent, the regulation itself does not clearly specify the costs that may be recovered as part of "the cost of owning, operating, and maintaining the airplane."[53] The FAA has interpreted the provision to mean that the cost recovery may include a pro rata portion of all fixed and variable overhead expenses associated with the airplane[54] based on the "costs associated with the use of the aircraft as established by [the company's] accounting department in the conduct of the normal business of the company."[55]

The parties to be carried (that is, the company officials as well as those of the parent, subsidiary, and parent's subsidiaries) and the parent-subsidiary relationship, while seemingly broad, are strictly construed.[56] For example, a natural person cannot be a parent for purposes of this provision, nor does common ownership of sister companies qualify for carriage under this provision.[57] The FAA has made clear that this subsection will be strictly construed and that only when objective evidence establishes a parent-subsidiary relationship will compensated operations for affiliated companies be permitted under section 91.501(b)(5).[58]

to the overall business of the company—a requirement that is not satisfied by a "flight department company"); Interpretation 1975-15, 1 Fed. Av. Dec. I-27 (Apr. 4, 1975) (a subsidiary providing air transportation as its sole business may not avail itself of § 91.501(b)(5)).

[52] *See supra* note 40.

[53] *See* 14 C.F.R. § 91.501(b)(5) (1996).

[54] *See* Interpretation 1985-9, 2 Fed. Av. Dec. I-59 (May 31, 1985).

[55] Interpretation 1985-10, 2 Fed. Av. Dec. I-60 (June 5, 1985).

[56] *See, e.g.*, Interpretation 1985-10, 2 Fed. Av. Dec. I-60 (June 5, 1985) (parent-subsidiary relationships will be strictly construed); Interpretation 1975-13, 1 Fed. Av. Dec. I-24 (Apr. 1, 1975) (sister companies that are separately organized but share the same ownership and management are not covered by the literal language of § 91.501(b)(5)); *In re Sutherland Lumber & Material Co.*, Denial of Exemption at 2 (Dep't Transp. May 26, 1978) (the parent-subsidiary relationship is applied literally and does not cover a group of family-owned companies engaged in a common business).

[57] *See* Interpretation 1985-17, 2 Fed. Av. Dec. I-71 (July 16, 1985).

[58] *Id.*

Unlike the other provisions in section 91.501(b), this subsection also requires that the operation be *within the scope of the company's business.* Merely being incidental to the company's business is not enough. Although the wording of the regulation is, at best, not clear, the FAA has issued several interpretations which state that the scope of the business test must be determined with reference to the business of the company operating the aircraft.[59] In addition, the FAA has interpreted the regulation's mandate that guests not be charged to mean that company officials or employees who are carried for personal travel are guests and, therefore, no payment may be made for such transportation.[60]

If a company does not fit within the parameters of section 91.501(b)(5), it may still be able to avail itself of one of the alternatives in section 91.501(b)(6), provided, of course, that such operations are incidental to the business of the company other than transportation by air.

2. *Time-Sharing Agreements*

Another option that is available under Subpart F is time-sharing,[61] which is defined as "an arrangement whereby a person

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[59] *See, e.g.*, Interpretation 1990-18, 2 Fed. Av. Dec. I-305, I-306 (July 13, 1990) (the facts must reflect that the carriage is within the scope of, and incidental to, the business of the company operating the airplane); Interpretation 1990-11, 2 Fed. Av. Dec. I-288, I-289 (May 24, 1990) (regulation requires that the operation be "within the scope of and incidental to the business of the company operating the airplane"); Interpretation 1975-16, 1 Fed. Av. Dec. I-28, I-29 (Apr. 4, 1975) (the carriage must be within the scope of, and incidental to, the business of the operating company); *see also* Interpretation 1992-42, 3 Fed. Av. Dec. I-273 (June 10, 1992) (no compensation may be paid for the carriage of a guest who merely has a mutual interest or is going to the same destination as the operating company since carriage is not within the scope of the operating company). *But see* Interpretation 1985-9, 2 Fed. Av. Dec. I-59 (May 31, 1985) ("within the scope of, and incidental to the business of that company refers to the business of either an aircraft owner/operator, its parents, or its subsidiaries").

[60] *See, e.g.*, Interpretation 1993-17, 4 Fed. Av. Dec. I-41, I-42 (Aug. 2, 1993) ("no charge may be made when officials, employees, and guests are carried on a company airplane for vacation, pleasure trip, or similar purposes" because such transportation is not within the scope of, and incidental to, the company's business); Interpretation 1977-80, 1 Fed. Av. Dec. I-271 (Dec. 16, 1977) (when a passenger's presence on a flight is not within the scope of the operating company's business, the carriage falls within the guest exception to payment).

[61] In an early interpretation, the FAA stated that time-sharing covers different corporations and not arrangements between companies in a subsidiary relationship because such affiliated companies were intended to be covered by subsection (b)(5). *See* Interpretation 1975-16, 1 Fed. Av. Dec. I-28, I-30 (Apr. 4, 1975). There is nothing in the language of the regulation itself that prevents companies

leases his airplane with flight crew 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]."[62] The charges that may be recovered are essentially limited to the out-of-pocket expenses associated with the particular flight,[63] plus an additional charge equal to 100% of the cost of fuel, oil, and other additives.[64] Even with this add-on, the owner/operator[65] of a corporate jet will likely not recover the fully allocated cost of a particular flight (including crew salaries, capital costs, maintenance and overhaul reserves, and other costs not specifically enumerated in the regulation) unless they

in a subsidiary relationship from engaging in time-sharing under subsection (b)(6). *See* 14 C.F.R. § 91.501 (1996).

[62] *Id.* § 91.501(c)(1). *But see* Interpretation 1975-48, 1 Fed. Av. Dec. I-76 (Oct. 2, 1975) (notwithstanding the express wording of the regulation, the FAA in an early interpretation stated that § 91.181(b)(6) "contemplates that pursuant to a time-sharing agreement the operational control passes to the lessee"). In another early interpretation, the FAA stated that time-sharing envisions a contractual arrangement covering a series of flights and not a single round trip since the latter would cause the operator to be a commercial operator and, therefore, require a license. *See* Interpretation 1979-52, 1 Fed. Av. Dec. I-395 (Sept. 19, 1979). In that case, the FAA was examining the proposed carriage of amateur athletic teams, sports groups, and choral groups—groups that may be carried pursuant to § 91.501(b)(8) for no charge. No other interpretations have been found which require that time-sharing involve a series of flights. In fact, the FAA later issued an interpretation that clearly stated that a company could operate its aircraft on a one-time flight for another company under a time-sharing arrangement. *See* Interpretation 1984-9, 2 Fed. Av. Dec. I-12 (May 2, 1984).

[63] These charges cover fuel, crew travel expenses, hangar and tie-down costs away from the aircraft's base, insurance for the specific flight, landing fees, airport taxes, and similar assessments, customs, and foreign permits. They also cover similar fees relating to the flight, in-flight food and beverages, passenger ground transportation, and flight planning and weather contract services. *See* 14 C.F.R. § 91.501(d) (1996).

[64] *See id.* § 91.501(d)(10). The FAA will not permit a calculation based on an average fuel price, but instead requires that such charges be directly related to the specific flight. *See* Interpretation 1985-15, 2 Fed. Av. Dec. I-67 (July 11, 1985).

[65] The FAA has specifically stated that time-sharing is available not only for an owner of an aircraft, but also for the lessee of an aircraft. *See* Interpretation 1985-19, 2 Fed. Av. Dec. I-74 (Sept. 9, 1984). Although it allows lessees to engage in time-sharing, the FAA has taken the position that the party recovering the charges must be a corporation based on the reference in subsection (b)(6) to flights involving company officials, employees, and guests. *See* Interpretation 1980-32, 1 Fed. Av. Dec. I-470 (Oct. 29, 1980). Such an interpretation, however, ignores the definition of a time-sharing agreement which contemplates a "person" leasing his airplane and the definition of person which includes, among other things, individuals, firms, partnerships, corporations, companies, and associations. *See* 14 C.F.R. §§ 1.1, 91.501(c)(1) (1996).

fit within the additional 100% of the fuel, oil and other additives.[66]

The FAA has issued opinions relating to time-sharing which emphasize that while payments for time-sharing are permitted under Part 91, an operating certificate is required if the availability of time-sharing is advertised, since such advertising transforms the operation into common carriage.[67] As the FAA has emphasized, the regulation itself permits such operations only when "*common carriage is not involved.*"[68] Given the specific and limited amounts which may be collected under a time-sharing arrangement, the FAA has advised that the final charge for such flight cannot be specified until a flight has been completed.[69] Although not directly addressed, this interpretation is a strong indication that a flat fee for a time-sharing arrangement would create a presumption in the FAA's eyes that the time-sharing requirements were not met. Presumably this could be overcome with evidence that the flat fee collected was no more than the amount permitted under the regulation. In the alternative, a reconciliation whereby a refund is made to the passenger for the amount by which the flat fee exceeded the permitted amount should also satisfy the FAA's requirement.

3. Demonstration Agreements

Subpart F also authorizes an operator to be compensated in an amount no greater than that permitted for time-sharing in connection with an operation for a prospective customer.[70] The FAA has advised that such operations are permitted not only in connection with a prospective sale, but also in connection with a

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66 Although time-sharing does not by its terms permit the recovery of administrative and overhead costs, the FAA has stated that the 100% additional charge for fuel, oil and other additives may be used to cover any costs associated with the operation, even if the costs to be recovered do not fit within the categories specifically enumerated in 14 C.F.R. § 91.501(d)(1)-(9) (1996). *See* Administrator v. Bowen, NTSB Order No. EA-3351 (1991) (pilots' fees may be recovered as long as they do not exceed the additional 100% permitted under § 91.501(d)(10)). This concept would control notwithstanding FAA interpretations which state, in general terms, that charges for time-sharing may not include administrative and overhead costs. *See* Interpretation 1982-1, 1 Fed. Av. Dec. I-583 (Feb. 4, 1982) (administrative and overhead costs may not be charged if a time-sharing agreement is used).

67 *See* Interpretation 1979-20, 1 Fed. Av. Dec. I-353 (May 9, 1979).

68 *Id.* (quoting 14 C.F.R. § 91.181(b) (recodified as 14 C.F.R. § 91.501(b) (1996)) (emphasis added).

69 *See* Interpretation 1975-18, 1 Fed. Av. Dec. I-32 (Apr. 10, 1975).

70 *See* 14 C.F.R. § 91.501(b)(3) (1996).

prospective lease.[71] The FAA has again made clear, however, that compensation for demonstration flights is not acceptable if common carriage is involved.[72]

When the FAA added Subpart D (the predecessor to Subpart F) to Part 91 of the FARs, it acknowledged that it had previously determined that aircraft manufacturers and aircraft sales companies did not need a commercial operator certificate to demonstrate aircraft to prospective customers when that customer is charged a fee to defray the operating expenses. Based on the purpose of the demonstration flight, the FAA stated that "the authorization should be equally applicable to the owner of the aircraft regardless of whether he is a manufacturer or aircraft salesman."[73] As such, not only may manufacturers and aircraft sales companies conduct demonstration flights, owners of aircraft may also conduct such flights.[74] Because the primary business of manufacturers and aircraft sales companies is clearly aviation-related, the incidental business test may not be rigidly applied. At no point, however, has the FAA expressly stated that the incidental business test does not apply to demonstration flights.

4. *Interchange Arrangements*

Another way to spread costs or gain access to corporate jets without the significant financial obligation that accompanies the acquisition of additional aircraft is through an interchange. An interchange agreement is defined as:

> [A]n 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.[75]

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[71] *See* Interpretation 1976-4, 1 Fed. Av. Dec. I-96 (Feb. 13, 1976). In that interpretation, the FAA advised that the language of the regulation itself was "broad enough to include persons who may be interested in leasing instead of selling their aircraft." *Id.* at I-97.

[72] *See* Interpretation 1979-27, 1 Fed. Av. Dec. I-360 (May 22, 1979) (common carriage would be involved if a large number of persons are carried and the operator advertises for sales demonstration flights).

[73] 37 Fed. Reg. 14,758, at 14,760 (1972).

[74] *See id.*

[75] 14 C.F.R. § 91.501(c)(2) (1996).

In essence, an interchange is an agreement to swap time on one party's aircraft for *equal time* on another party's aircraft.[76] Under this arrangement, the operator of the more expensive aircraft can be reimbursed *for the difference* between the fully allocated costs attributable to both airplanes.[77] Unlike time-sharing, where the cost recovery is limited, there are no limits, other than a fully allocated cost limit, on the categories of costs that may be recovered by the owner of the more expensive airplane under an interchange agreement.

Also, the definition of interchange agreement speaks about recouping the difference between the costs of "the two airplanes." Based on trends in the corporate aircraft business, including fractional-ownership programs,[78] interchanges have also been structured for multiple aircraft.

5. *Joint-Ownership Agreements*

Another way of spreading costs under Subpart F without FAA certification is through joint ownership. A joint-ownership agreement is "an arrangement whereby one of the registered joint owners of an airplane employs and furnishes the flight crew for that airplane and each of the registered joint owners

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[76] An interchange does not contemplate the swapping of unequal time—for example, 150 hours of G-IV time in exchange for 200 hours of Lear 25 time with the 50-hour difference constituting the payment from the Lear owner to the Gulfstream owner. The only payment permitted under the interchange concept is the Lear owner's payment to the Gulfstream owner for the difference in operating costs of the equal time (150 hours) being swapped. *See, e.g.*, Interpretation 1993-12, 4 Fed. Av. Dec. I-31 (Apr. 19, 1993) (although the operating costs of each aircraft may differ, there must be an equal flight time exchange); Interpretation 1990-23, 2 Fed. Av. Dec. I-314 (Aug. 17, 1990) (the equal exchange of time on each aircraft must be based on hours and not dollars); Interpretation 1985-15, 2 Fed. Av. Dec. I-67, I-68 (July 11, 1985) (an exchange for equivalent time is not permitted as an interchange—the exchange must be for equal time). *Contra* Interpretation 1975-25, 1 Fed. Av. Dec. I-41 (Apr. 21, 1975) (an uneven exchange of hours to balance out cost is a legitimate interchange).

[77] While the definition of interchange refers to "his" airplane and equalizing payments not to exceed the cost of "owning, operating, and maintaining" the airplane, it does not appear that the interchange concept is available only to owners as opposed to lessees. Although there is no opinion directly on point, the definition of time-sharing, which includes the same reference to "his" airplane, has been interpreted specifically to include lessees. *See supra* note 65. In addition, while ownership costs are recoverable, the reference to ownership in this instance merely relates to cost, not operations, and does not exclude leased aircraft from interchanges. Presumably, lease costs would be recoverable as a cost of operating the aircraft.

[78] *See infra* text accompanying notes 90-91.

pays a share of the charge specified in the agreement."[79] As the definition states, the parties to this agreement must be *owners* of the airplane and must be listed as "registered owners" on the FAA Certificate of Registration.

Notwithstanding the absence of regulatory limits on the number of registered owners or percentage interests, the number of joint owners should be limited to avoid changing the nature of the agreement into a travel club that would require licensing. In addition, care should be taken to avoid a joint-ownership arrangement where the operating joint owner owns a disproportionate undivided interest in the corporate jet. While each joint owner need not have an equal percentage of ownership, there should be a reasonable relationship between percentage of ownership and use. For example, if a five-party, joint-ownership arrangement involves an operating joint owner with a ninety-six percent ownership interest and *each* of the four remaining joint owners has a one percent ownership interest, but uses the airplane twenty-four percent of the time, it is likely that this gross disparity between ownership and use (that is, the four non-operating joint owners collectively having four percent ownership and ninety-six percent usage) would cause FAA to view this transaction as a sham and subject the operating joint owner to Part 135 certification requirements.

As with the other alternatives under section 91.501(b), joint ownership requires that the operation of the aircraft be incidental to another business purpose. The FAA has also advised that neither of the joint owners may carry persons or property for compensation or hire.[80] In other words, no compensation may be provided to a joint owner that carries officials, employees, or guests of its subsidiary as would otherwise be permitted under subsection (b)(5), nor does it appear that a joint owner would be permitted to enter into a time-sharing agreement.

Joint ownership does offer a degree of flexibility that is not found in time-sharing and interchange agreements in that there

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[79] 14 C.F.R. § 91.501(c)(3) (1996).

[80] *See* Interpretation 1991-53, 3 Fed. Av. Dec. I-126 (Sept. 23, 1991). This interpretation also cautioned against one joint owner providing pilot services to the other co-owner "because the delineation of operational control can become very hazy." *Id.* at I-127. Although the provision of pilot services carries potential liability, there is nothing in the regulations that prohibits it under a joint-ownership arrangement. In fact, the definition of joint ownership contemplates one of the owners employing and furnishing the flight crew. *See* 14 C.F.R. § 91.501(c)(3) (1996).

is no limit on the type of charges that may be recovered by the owner-operator of the airplane within the confines of a fully allocated cost reimbursement. The joint owners are not required to have equal percentages of ownership or pay equal shares of the costs, and truth-in-leasing requirements do not apply.[81]

The tradeoff here is that more thought has to go into constructing and negotiating the terms of the joint ownership and drafting the agreement to ensure that all bases are covered: What is the percentage interest that each joint owner has in the airplane? What percentage of the costs will each party bear? Will fixed costs, such as hangaring, training, and overhaul be shared in accordance with a fixed percentage? Will the variable costs of a particular flight be paid by the owner that is utilizing the airplane for that flight? What about scheduling priorities? And what is the mechanism for terminating the agreement where one party wants to withdraw voluntarily or defaults?

Although attempts have been made to structure "joint-ownership" arrangements through stock ownership in the company which owns and operates the corporate jet on behalf of its owner-shareholders, these arrangements are not within the literal language of the regulation and, therefore, are unacceptable.[82] When one examines this structure, there is no practical difference between two or more persons or companies jointly registering an airplane and operating it under the joint-ownership provision of Subpart F and the same persons or companies forming a separate corporation to own and operate the airplane on their behalf. The only difference is that the former involves an agreement between *registered owners* and the latter involves an agreement between the same persons in their capacity as shareholders of the registered owner. While the shareholder agreement would provide for the operation of the airplane by one shareholder subject to reimbursement by the other shareholder, utilizing the airplane for a particular flight, and would otherwise contain essentially the same basic conditions as the typical joint-ownership agreement, the regulations simply ignore the similarity and approve one structure while disapproving the other. As

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[81] *See infra* text accompanying notes 92-95.

[82] *See* Interpretation 1984-3, 2 Fed. Av. Dec. I-4 (Mar. 15, 1984) (joint ownership requires that each owner be a registered owner); Interpretation 1982-12, 1 Fed. Av. Dec. I-602 (Nov. 1, 1982) (unless listed as a registered owner, corporate shareholders may not operate under the joint-ownership provisions); Interpretation 1982-1, 1 Fed. Av. Dec. I-583 (Feb. 4, 1982) (use of an aircraft by shareholders of a company that owns aircraft is not joint ownership).

long as the number of shareholders is limited and the "compensation" is limited to cost reimbursement, there are no *safety* considerations that support the FAA's prohibition of such a structure.

C. Related Issues

1. *Operation of Foreign Civil Aircraft*

Even if a particular operation fits within Subpart F, the ability to engage in such operations may nevertheless be restricted. Specifically, attention must be paid to whether the operation involves a "foreign civil aircraft" carrying passengers or cargo under circumstances *not* constituting common carriage. For purposes of these DOT regulations, the term "foreign civil aircraft" includes both foreign-registered aircraft *and* U.S.-registered aircraft that are "owned, controlled or operated" by non-U.S. citizens.[83] Despite the commercial nature of these operations, from a safety standpoint, they are regulated under FAR Part 91 and do not require an FAA operating certificate. From an economic regulatory standpoint, however, these operations may require a foreign aircraft permit issued under Part 375 of DOT's Special Regulations.[84] The peculiar definition of foreign civil aircraft and related DOT licensing requirement may limit joint ownership, intra-corporate family operations, time-sharing, demonstration flights, and interchange arrangements involving U.S.-registered foreign civil aircraft.

Based on DOT's emphasis on the economic aspects of transportation by air and its concern regarding forms of cabotage, DOT would likely view the cost reimbursement features of the Subpart F operations, albeit limited, as "remuneration or hire," resulting in such operations being "commercial air operations" within the meaning of Part 375. Such a position would require the operator to obtain a DOT license. If this position is taken, only international flights can be authorized.[85] This stems from the fact that the governing statute prohibits foreign civil aircraft from engaging in "cabotage," that is, taking on passengers at one point in the U.S. destined for another point in the U.S.[86]—

[83] *See* 14 C.F.R. § 375.1 (1996).

[84] *See* 14 C.F.R. pt. 375 (1996); *see also* 49 U.S.C. § 41703 (1994).

[85] *See* 14 C.F.R. § 375.42 (1996). As a general rule, international operations are limited to six passenger flights per year.

[86] *See* 49 U.S.C. § 41703 (1994).

a statutory prohibition that would preclude the issuance of a Part 375 permit for a purely domestic commercial operation.

In the case of demonstration flights, however, the regulatory history of Part 375 supports the position that the limited payments made for such flights do not cause the flights to be classified as commercial air operations for purposes of Part 375. Specifically, when the definition of "foreign civil aircraft" was expanded in 1986 to include U.S.-registered aircraft that are "owned, controlled, or operated" by non-U.S. citizens, the DOT, in the preamble to the rule, stated that sales demonstration flights under section 91.501(b)(3), which are subject to the same cost reimbursement limitations as time-sharing, would *not* be considered "commercial air operations" within the meaning of Part 375 of the DOT's Special Regulations.[87] Although time-sharing of foreign civil aircraft was not mentioned in the preamble, the fact that the reimbursement permitted for time-sharing is identical to the reimbursement permitted for demonstration flights should support the conclusion that time-sharing is not a "commercial air operation" subject to Part 375. This, however, has never been addressed by the DOT.

2. *Management Companies*

Regardless of the type of operation or whether an operation is conducted under Subpart F, management companies are frequently used to handle the administrative and other details relating to the operation of a company's aircraft. Despite the important role management companies play in the operation of corporate aircraft, there are no regulations that specifically address them.

In examining a management company's function, it is obvious that it serves a hybrid role. The typical management company may perform any or all of the following: arrange for the crew, arrange the insurance, perform or arrange all maintenance, prepare all reports and required documentation, and, in general, "manage" all aspects of the operation and maintenance of the aircraft for the owner-lessee of the aircraft. Despite the services provided by the management companies, these arrangements are designed to give the owner-lessee control and responsibility over the operation of the aircraft. Although certain regional offices have examined the role of management companies, FAA headquarters, to date, has not issued a formal ruling on the reg-

[87] *See* 41 Fed. Reg. 7,251, at 7,253 (1986).

ulatory status of management companies. Specifically, FAA headquarters has not ruled on whether the management services received by the owner-lessee vest operational control in the owner-lessee or whether such services are the equivalent of the management company operating for the owner-lessee.[88]

Given the hybrid nature of management companies, aircraft owners-lessees may wonder whether it is essential to contract with a management company that has a Part 135 certificate. The answer to this is "it depends." The distinction between the management company providing services to enable the aircraft owner-lessee to "operate" its aircraft and the management company operating the aircraft for the owner-lessee affects the responsibility for the operation. As noted above, the former is designed to vest operational control in the owner-lessee, which would then conduct its operations under Part 91. In the latter case, operational control would be vested in the management company whose operations for the owner-lessee would be conducted under Part 135.

If a company wishes to generate revenue with the aircraft when it would otherwise not be operating, a management company with a Part 135 certificate would be required to enable the aircraft to be chartered to third parties. Without a Part 135 certificated operator providing such service, the company's options would be limited to time-sharing, under which it may collect limited reimbursement, but generally not a fully allocated cost reimbursement, and certainly not a profit.

Some companies may desire that the aircraft be operated in accordance with Part 135 standards when a Part 135 certificate would not otherwise be required. In this case, the agreement must be carefully structured to reflect that Part 135 is merely the standard by which operations are to be conducted, and that charters are not in fact being conducted. With such a distinction, the owner-lessee may retain possession, command, and control, thereby avoiding excise taxes, notwithstanding the fact that the operator has voluntarily undertaken to operate under Part 135 standards rather than those contained in Part 91. Com-

[88] FAA headquarters has recently undertaken a review of fractional interest programs generally. Such a review, by necessity, will cause the FAA to examine the role of management companies and will likely lead to a formal interpretation by the FAA. The outcome of this review could also affect the applicability of the transportation tax. *See infra* text accompanying notes 90-91 for a discussion of fractional ownership programs and *infra* text accompanying notes 112-18 for a discussion of excise tax issues relating to management companies.

panies must keep in mind, however, that there is a trade-off for requiring operations to meet the standards of Part 135. Among other things, a Part 135 operation requires certain minimum runway lengths, possibly precluding the operation of the aircraft at airports that may be desired, and imposes flight time limits for the crew—limits which, depending on the outcome of a rulemaking proceeding at the FAA,[89] may become even more stringent.

Even though many management companies have Part 135 certificates, the aircraft will nevertheless be "operated" under Part 91 when the owner-lessee is traveling. The bottom line with management companies is that an aircraft owner-lessee must carefully consider, in advance, the manner in which it wants the aircraft to be operated. If this is not given due consideration, the owner-lessee may find itself either not achieving its objectives or having to change management companies to do so.

3. *Fractional-Ownership Programs*

Another area of corporate aircraft operations which is designed around Subpart F of the FARs is fractional-ownership programs. Under these programs, which have grown into a major segment of corporate aviation, an owner need not bear all of the costs and burdens associated with the ownership of an aircraft. Instead, an owner can obtain access to a corporate aircraft by purchasing an interest that is commensurate with its anticipated usage, thereby significantly reducing its costs while maintaining the flexibility provided by the ownership of a corporate aircraft.[90]

By purchasing an interest in an aircraft, an owner gains the right to use an aircraft for a specified period of hours. Although such a purchase involves joint ownership of an aircraft, it goes far beyond. Specifically, not only is an interest in an aircraft purchased, the owner also enters into a management agreement with the company offering the fractional interest program and an interchange agreement with all other fractional owners of the same and other aircraft. This structure enables an owner to have access to another aircraft if the aircraft in which it owns an interest is unavailable.

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89 *See* 60 Fed. Reg. 65,951 (1995). A final rule has yet to be issued.

90 *See* Howard Banks, *Flying in Style*, FORBES, Oct. 16, 1995, at 385; Perry Bradley, *Fractionals: Friend or Foe?*, BUS. & COM. AVIATION, Nov. 1996, at 76.

Although FAA regulations provide for joint ownership and interchanges, the regulations do not specifically address fractional-ownership programs which are based on a mixture of such concepts. Notwithstanding the interchange of multiple aircraft in fractional programs, the FAA has not provided guidance on the manner in which such interchanges should work.[91] For example, if there are four airplanes in the interchange pool, is the operator of Aircraft A limited to swapping five hours of time on A for five hours of time on Aircraft B? Or can the operator of A provide five hours of time to the operator of B in exchange for three hours on B and one hour each on Aircrafts C and D, which are also participating in the interchange agreement? In other words, is each pairing a different interchange or are all of the pairings collectively a single interchange?

Although fractional-interest programs have proliferated largely without specific FAA regulation, FAA regional offices have reviewed such programs prior to their implementation. While certain regions have blessed these programs, at least one region has recently questioned the interchange element of the programs, as well as the delineation of operational control. As a result, FAA headquarters has initiated a review of such programs. Such a review, by necessity, will include an examination of the role of management companies in fractional programs and in general. The results of this review could either formally sanction fractional-ownership programs and management companies in their present form or require a substantial change or modification to the manner in which fractionally owned and managed aircraft are operated.

4. *Truth-in-Leasing Requirements*

Although not specified in Subpart F, time-sharing and interchange agreements are leases and, as such, subject to truth-in-leasing requirements.[92] This requires a written lease agree-

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91 Although formal guidelines have not been issued by the FAA, the managers of the primary fractional interest programs submitted their agreements to the regional FAA office for review and reportedly received the necessary clearances to proceed. As noted below, a recent examination of fractional interest programs has been undertaken by FAA headquarters.

92 *See* Interpretation 1975-16, 1 Fed. Av. Dec. I-28 (Apr. 4, 1975); *see also* Advisory Circular AC91-37A, *Truth in Leasing* (Jan. 16, 1978). Demonstration flights also have the earmarks of a lease, but given the shorter notice typically associated with such flights, it does not appear that the truth-in-leasing requirements have been strictly applied to demonstration flights.

ment which, among other things, identifies the party having operational control.[93] The lease must be mailed to the FAA in Oklahoma City within twenty-four hours after execution, and a copy must be carried aboard the aircraft.[94] In addition, the local FAA Flight Standards District Office must be notified at least forty-eight hours in advance of the *first* flight of the aircraft under the agreement so that the FAA will have an opportunity to inspect the aircraft.[95]

With the FAA and operational issues in mind, the applicability of the transportation excise tax must be examined.

IV. CORPORATE AIRCRAFT TAX-RELATED ISSUES

A. Transportation Excise Tax

1. *Background*

Section 4261(a) of the Internal Revenue Code imposes a tax of ten percent on all amounts paid[96] in the United States[97] for

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[93] *See* 14 C.F.R. § 91.23 (1996). The truth-in-leasing provisions require the parties to a lease of a large aircraft to include a truth-in-leasing provision immediately before the signature block. This provision includes, among other things, an identification of the regulations under which the aircraft was maintained during the preceding 12 months and the name of the party with operational control. *Id.* § 91.23(a). Leases of large aircraft involving U.S. or foreign air carriers are not required to include this provision in the agreement. *Id.* § 91.23(b)(i), (ii).

[94] *See id.* § 91.23(c)(1), (2).

[95] *See id.* § 91.23(c)(3).

[96] In the case of imputed income, no excise tax would apply since such taxes are based on amounts paid and, in the case of imputed income, no amount is actually paid. *See* Rev. Rul. 72-245, 1972-1 C.B. 437; Priv. Ltr. Rul. 90-28-027 (Apr. 5, 1990). There are circumstances, however, where the IRS will assess the excise tax even when no amount has been paid. Specifically, in the case of intra-corporate family operations, where no charge is made for the carriage of a subsidiary's personnel on the parent's aircraft, the IRS has advised that it will allocate a payment from the subsidiary to the parent based on an arm's-length charge for the transportation and that the excise tax will apply to such reallocation. *See* Tech. Adv. Mem. 79-08-010 (Oct. 26, 1978) (citing Rev. Rul. 72-371, 1972-2 C.B. 438; Rev. Rul. 70-111, 1970-1 C.B. 184). According to the IRS, "[w]here a corporation furnishes air transportation services to its wholly owned subsidiary it has a choice of having the subsidiary make a cash payment for the services, or charging the subsidiary for the services by an adjustment of inter-corporate accounts (a bookkeeping transaction)." *See* Priv. Ltr. Rul. 79-08-010 (Oct. 26, 1978). A Private Letter Ruling by the IRS carries no precedential value. *See* I.R.C. § 6110(j)(3) (West Supp. 1996). Nevertheless, it does reflect the IRS's position regarding this situation—a position that is directly in conflict with the FAA and DOT rules which limit, and in some circumstances prohibit, payments for such air transportation.

[97] In determining whether amounts are paid within the United States, the IRS examines not simply where the passenger will be picked up, but rather where the

taxable transportation[98] between two points in the United States or in a 225-mile zone beyond the continental U.S. border.[99] The tax, however, does not apply to transportation performed by aircraft with a maximum certificated takeoff weight of 6000 pounds or less which are not operated on an established line.[100] For transportation between the United States and a point outside of the 225-mile zone, an international departure tax of six dollars is assessed for flights originating in the United States.[101] In determining whether a trip originates in the United States, the IRS does not simply rely upon the location at which

aircraft will originate. For example, if a U.S.-based aircraft picks up a passenger in Canada within the 225-mile zone, the IRS takes the position that the amount is paid within the United States, since the transportation service commences when the aircraft departs to the point where it will pick up the passenger outside the United States. As a result, the 10% tax would apply. *See* I.R.C. § 4262(d) (West Supp. 1996) (taxable transportation includes layover, waiting time, and deadhead service).

[98] *See* I.R.C. § 4261(a) (West Supp. 1996). In addition to the passenger excise tax, a 6.25% tax is imposed on amounts paid for the carriage of property to a person engaged in the business of transporting property by air for hire within the United States and the 225-mile zone. *See* I.R.C. § 4271(a) (West Supp. 1996). Unlike the passenger tax, the tax on cargo applies even if the transportation is purchased outside the United States. The transportation tax expired on December 31, 1996, and was not reinstated until March 7, 1997—seven days after the Airport and Airway Trust Fund Tax Reinstatement Act of 1997 was enacted. *See* Pub. L. No. 105-2, § 2(b), 111 Stat. 4, 5 (1997).

[99] Taxable transportation is defined as transportation by air, which begins and ends in the United States or in the 225-mile zone. The 225-mile zone includes only the portions of Canada and Mexico that are no more than 225 miles from the nearest point in the continental United States. *See* I.R.C. §§ 4262(a), (c)(2), 4272 (West Supp. 1996). Even if the transportation begins and ends at the same point, the tax will apply. *See* Treas. Reg. § 49.4261-1(c) (1996); *see also* Tech. Adv. Mem. 95-24-003 (Mar. 2, 1995). Although transportation between the continental United States and Alaska or Hawaii is transportation which begins and ends in the U.S., such transportation is treated differently for excise tax purposes. *See infra* text accompanying notes 151-158.

[100] *See* I.R.C. § 4281 (1994). Any operation with some degree of regularity between definite points is considered to be operated on an established line if the person rendering the service maintains *and* exercises some degree of control over the direction, route, time, and number of passengers even if service is not absolutely regular. *See, e.g.*, Treas. Reg. § 49.4263-5(c) (1959); Tech. Adv. Mem. 95-27-008 (Mar. 23, 1995) (scenic tours on small aircraft operating pursuant to oral schedules and which may or may not include a stop on certain trips are taxable transportation); Tech. Adv. Mem. 95-24-003 (Mar. 2, 1995) (scenic tours operated at approximately the same time each day, which originate and terminate at the same point and make no stops, are taxable transportation even with small aircraft). Such interpretations reflect the intent of Congress to limit exemptions from the transportation excise tax. *See* Tech. Adv. Mem. 94-32-003 (May 6, 1994).

[101] *See* I.R.C. § 4261(c) (West Supp. 1996).

the passenger originally embarks and the location at which the passenger disembarks at the conclusion of the entire trip. Instead, the IRS evaluates a round trip routing as consisting of a minimum of two separate trips.[102] As a result, a trip that originates outside the United States, which is destined for a point in the United States and will then return to the point outside the United States, will be viewed by the IRS as a trip to the United States and a trip from the United States. Under such an interpretation, the six dollar international departure tax will be applied to the return segment of the round trip.

If the trip includes both a stop within the United States and a destination outside the zone, the international departure tax will apply if the portion within the United States was part of an uninterrupted international journey—that is, the stopover between the segments does not exceed twelve hours.[103] If the U.S. domestic segment does not qualify as part of an uninterrupted international trip, the ten percent transportation tax will be due for the amount allocated to the segment within the United States.

A prerequisite for the application of either of the transportation taxes is that the operation be "commercial." If the operation is not commercial,[104] the transportation tax will not apply, but the fuel tax imposed on non-commercial aviation must be paid.[105] In no case will both taxes be paid.[106] Because the IRS distinguishes between "commercial" and "non-commercial" op-

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102 *See* I.R.C. § 4263(e) (1996). For purposes of applying the transportation tax, a "round trip [is] considered to consist of transportation from the point of departure to the destination, and of separate transportation thereafter." *Id. See also* Rev. Rul. 74-538, 1974-2 C.B. 368 (round trip consists of two separate trips—one from the point of departure to the destination and a second trip returning from the destination causing the return portion of a foreign originating round trip to trigger the international departure tax when the return portion originates in the United States); Rev. Rul. 86-137, 1986-2 C.B. 181 (citing Rev. Rul. 72-538, 1972-2 C.B. 577); Rev. Rul. 74-181, 1974-1 C.B. 319 (modifying Rev. Rul. 72-538, 1972-2 C.B. 577, to expand its coverage).

103 *See* I.R.C. § 4262 (c)(3) (1996). *See also* Treas. Reg. § 49.4262 (d), (e) (1996); *infra* text accompanying notes 136-50.

104 The IRS defines non-commercial aviation as "any use of an aircraft, other than use in a business of transporting persons or property for compensation or hire by air." I.R.C. § 4041(c)(2) (West Supp. 1997).

105 *See* I.R.C. §§ 4041, 4081, 4091 (West Supp. 1996). The tax also applies to commercial aviation which is otherwise exempt from the 10% transportation tax due to the size of the aircraft or the applicability of the affiliated group exemption. *See* I.R.C. § 4041(c) (West Supp. 1997). The affiliated group exemption contained in I.R.C. § 4282 (1989) was revised by Pub. L. No. 104-188, 110 Stat. 1755 (1996). *See infra* note 119.

erations, the appropriate tax to be paid is highly dependent on the specific facts surrounding an operation.

While it is obvious that the transportation tax applies when a ticket is purchased on an airline, many corporate aircraft operations fall into the category of commercial, even though the FAA does not treat it as a commercial operation for licensing purposes. In fact, the IRS has specifically stated that the FAA's decision as to whether to classify an aircraft operator as a "commercial operator" is not controlling for purposes of determining whether the transportation or fuel tax applies.[107]

2. Subpart F Operations

The IRS has addressed virtually all of the Part 91, Subpart F operations. In some cases the applicability of the tax is solely fact driven while in others, the type of operation is determinative regardless of the facts. The overriding concern, however, is whether the corporate aircraft operations is characterized by the IRS as commercial, regardless of its characterization by the FAA.[108] Although the FAA definition of a commercial operator as a "person who, for compensation or hire, engages in the carriage by aircraft in air commerce of persons or property"[109] is similar to the IRS definition, the emphasis by each of the agencies differs substantially, leading to what appear to be inconsistent determinations.

In making its determination, the IRS focuses on which party has "possession, command and control" of the aircraft. In the IRS's view, a party that leases an aircraft to another, but retains the elements of possession, command, and control, and performs all services in connection with the operation of the aircraft, is providing a taxable transportation service.[110] Even if

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[106] *See* Rev. Rul. 72-360, 1972-2 C.B. 542; Priv. Ltr. Rul. 90-22-011 (Feb. 27, 1990); Tech. Adv. Mem. 93-14-002 (Dec. 22, 1992) (quoting Senate Finance Committee Report to Accompany the Airport and Airway Revenue Act of 1970, S. REP. No. 706, 91st Cong., 2nd Sess. 36 (1970)).

[107] *See* Rev. Rul. 78-75, 1978-1 C.B. 340. *See also* Tech. Adv. Mem. 93-22-002 (Feb. 9, 1993).

[108] *See* Rev. Rul. 78-75, 1978-1 C.B. 340 (FAA's classification is not controlling for purposes of determining whether the transportation or fuel tax applies).

[109] 14 C.F.R. § 1.1. (1996). To determine whether a particular operation is for compensation or hire, the FAA states that one must determine whether the carriage by air is merely incidental to the person's other business or is, in itself, a major enterprise for profit. *Id.*

[110] *See* Rev. Rul. 60-311, 1960-2 C.B. 341 (if owner leases aircraft with pilots to others, performs all services in connection with the operation of the aircraft, and

flights are being provided free of charge as part of a package, the flights would still be considered taxable transportation and subject to the transportation excise tax.[111]

When an aircraft is operated only for the owner-lessor by an in-house flight department, possession, command, and control of the aircraft has clearly remained with the owner. As such, the transportation excise tax does not apply. If, however, the company uses the services of a management company to support the operation of its aircraft, the answer is not as clear. Because the management company assumes many of the tasks that would otherwise be performed by the company,[112] it is more difficult to determine whether the owner-lessee has transferred possession, command, and control of the aircraft to the management company. In making this determination, the IRS will examine factors including the identity of the crews' employer, the party responsible for paying the insurance, and numerous other factors relating to the operation of the aircraft.[113] The more control the owner retains over the aircraft and crew and the more responsibility the owner has for obtaining or reimbursing the management company for expenses associated with the aircraft (such costs as insurance, crew salaries, and fuel), the greater the likelihood that a management company would be viewed as an agent of the owner and, therefore, not the provider of taxable transportation.[114]

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retains possession, command, and control, taxable transportation is being provided).

[111] *See* Rev. Rul. 63-155, 1963-2 C.B. 566. A hotel that provided free round-trip transportation as part of a package tour was providing a taxable transportation. In this instance, the tax was due on that portion of the amount paid for the package that is reasonably attributable to the transportation. Operations of this nature, however, have been held to constitute common carriage. *See* Las Vegas Hacienda v. CAB, 298 F.2d 430 (9th Cir. 1962), *cert. denied*, 360 U.S. 851 (1962).

[112] *See supra* text accompanying note 88.

[113] *See, e.g.*, Rev. Rul. 74-123, 1974-1 C.B. 318 (tax applies where government agency pays management company which provides crews, fuel, maintenance, inspection, repairs, storage, and indemnifies the government agency for any claims resulting from the performance of its services); Rev. Rul. 58-215, 1958-1 C.B. 439 (no tax applies where management company furnishes pilots approved by the owner and bases the pilots at the owner's facility, and owner maintains insurance and pays an hourly fee to cover costs of fuel and other items since management company is merely an agent of owner). A close examination of these rulings will reflect the difficulty in determining when a management company is acting as an agent and when it is providing a taxable transportation service, since the distinctions appear to be no more than a matter of nuance and degree.

[114] In determining whether the management company is an agent for purposes of the transportation tax, the facts and circumstances are controlling, and

When the aircraft is available for third-party charters, the ability of the owner to retain possession, command, and control to the satisfaction of the IRS is more difficult. Although flights for the owner may not be commercial operations for FAA purposes, the availability of the aircraft for third-party charters may result in a transfer of possession, command, and control to the management company for IRS excise tax purposes. Based on such a transfer, an owner would be required to pay the ten percent tax on all amounts paid to the management company with respect to the management services for that aircraft.[115] If the same company manages another aircraft for the owner which is not made available for charters, the IRS has, on at least one occasion, determined that possession, command, and control of an aircraft remained with the owner and, therefore, the transportation tax did not apply to that aircraft. With the exception of the availability of the first aircraft for charter, there is no apparent distinction in the services provided by the management company with respect to each of the aircraft.[116]

Given the emphasis that the IRS seems to place on the management company's ability to charter the aircraft, great care must be taken if the aircraft is to be made available for charter by third parties. Although the IRS has not provided clear guidance regarding the circumstances under which the availability of the aircraft for third-party charters would not result in a transfer of possession, command, and control for all purposes, including the owner's use, there are some common factors to which the IRS refers in making such a determination. Where a management company: (i) has the exclusive right to rent, charter, and schedule the aircraft, (ii) has full operational control, (iii) maintains the aircraft, (iv) provides, at its expense, the flight crew and support personnel, (v) pays the costs and expenses associated with operating and maintaining the aircraft, with the owner paying all amounts that exceeded the revenue rental for a particular month, and (vi) receives, as its payment, a

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the characterization of the relationship by the parties is not the deciding factor. For example, even if a management company is described as an independent contractor, and, in fact, is by law an independent contractor, it may nevertheless be an agent of the owner for purposes of the transportation tax. Tech. Adv. Mem. 93-47-007 (Aug. 12, 1993) (where owner pays the operational expenses, retains and exercises substantial operational control, and assumes risk of loss for the aircraft, possession, command, and control remains with the owner).

115 *See* Tech. Adv. Mem. 93-22-002 (Feb. 9, 1993).

116 *Id.*

percentage of the gross charter revenue, the IRS would view possession, command, and control of the aircraft as having been relinquished by the owner, thereby subjecting the owner's payments to the management company to the excise tax.[117]

The IRS has examined numerous cases involving the use of management companies, each of which has focused on various aspects of the factors listed above.[118] While all of the cases discussed possession, command, and control, each of the cases varied in the emphasis placed on particular factual determinations. Under these circumstances, there is no clear line that ensures that possession, command, and control will be deemed to remain with the owner when any of the identified responsibilities are assumed by the management company.

As noted in more detail below, the applicability of the transportation tax to operations under Subpart F of the FARs varies depending on the type of operation. For example, an excise tax generally does not apply in the case of joint ownership, but it does apply in the cases of time-sharing, demonstration flights, and interchanges. With respect to intra-corporate family operations, the applicability of the tax depends on the affiliated group exemption.[119]

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[117] *See* Tech. Adv. Mem. 93-43-002 (June 30, 1993).

[118] *See, e.g.*, Rev. Rul. 60-311, 1960-2 C.B. 340 (tax applies to rental amount and fuel provided by lessee when lessor provides crew and maintenance for leased helicopter, even though helicopter is used exclusively by lessee and based at lessee's camp); Rev. Rul. 58-215, 1958-1 C.B. 439 (management company is agent and no tax applies when corporation owns the aircraft, has exclusive control over aircraft personnel, pays operating expenses of the aircraft, and maintains aircraft insurance); Rev. Rul. 57-545, 1957-2 C.B. 749 (when lessor maintains aircraft insurance and leases aircraft with crew to lessee for lessee's exclusive use, and all operating expenses including crew salaries are reimbursed by lessee, lessor is providing a taxable transportation service); Tech. Adv. Mem. 93-43-002 (June 30, 1993) (where company operates, maintains, and insures owner's aircraft for owner, subject to reimbursement by owner for all costs including crew salary, standby charges, fuel, insurance, and overnight fees, and company has right to charter the aircraft to third parties when owner is not using it, taxable transportation is not being provided to owner).

[119] *See* I.R.C. § 4282 (1996). The IRS defines an affiliated group as one or more chains of includible corporations connected with a common parent corporation which owns at least 80% of the voting stock. *See* I.R.C. § 1504 (West Supp. 1996). If one member of an affiliated group is the owner or lessee of an aircraft and such aircraft is not available for hire by persons who are not members of the affiliated group, the transportation tax would not apply to payments received from another member of the affiliated group for services furnished in connection with the use of the aircraft. Until the most recent amendment, if an aircraft were operated for parties outside the affiliated group at any time during the tax quarter, or if it simply were made available but not operated for such outsiders,

In the cases of time-sharing and demonstration flights, where payments are made to the aircraft operator, it is not surprising that the IRS has determined that such flights are taxable transportation and assessed the transportation tax on the amounts paid.[120] In the case of interchanges, where there is an hour-for-hour exchange of use on aircraft owned by different companies, the IRS has determined that the transportation tax applies notwithstanding the fact that there may be no payment of cash.[121] Although joint ownership often involves the operation of the aircraft by one joint owner,[122] with payments of the costs associated with the aircraft being paid by all joint owners (including the non-operators), the IRS has determined, as a general rule, that the transportation tax does not apply. The justification for this position is that the payment is not for the use of someone else's aircraft, but rather covers the cost of operating one's own aircraft that remains under one's possession, command, and control.[123]

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the affiliated group exemption would not apply, and the transportation tax would apply when one member of the affiliated group operated *that* aircraft for another member. With the enactment of the Small Business Job Protection Act of 1996, this exemption has been changed to permit the exemption to apply on a flight-by-flight basis instead of an aircraft-by-aircraft basis. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996). In other words, if, on the flight at issue, the aircraft is operated for anyone outside the affiliated group, the affiliated group exemption will apply.

[120] *See* Rev. Rul. 68-256, 1968-1 C.B. 489 (transportation tax applies to amounts paid by prospective purchasers for demonstration flights).

[121] *See* Priv. Ltr. Rul. 93-16-035 (Jan. 26, 1993) (equal flight time is compensation). Although a payment of cash may be made to the owner of the more expensive aircraft to cover the difference in the cost of operating each of the aircraft, this cash payment is frequently a relatively small amount. In determining the amount against which the transportation excise tax should be applied, the IRS stated, as a general matter, that it should be computed on the basis of the fair market value of the units of use of each of the aircraft and, in the case of affiliated companies, should be based on an arm's-length charge. *See, e.g.*, Priv. Ltr. Rul. 93-16-035 (Jan. 26, 1993); Priv. Ltr. Rul. 90-22-011 (Feb. 27, 1990); Tech. Adv. Mem. 95-02-004 (Sept. 6, 1994).

[122] Although the FAA uses its defined term "joint ownership" to describe the ownership of an aircraft by multiple parties where one party operates for the others, the IRS refers to such ownership arrangements as co-tenants or co-owners.

[123] *See, e.g.*, Priv. Ltr. Rul. 81-48-032 (Sept. 1, 1981) (where owners of undivided interests in aircraft have equal rights of possession and use, and will not rent or lease the aircraft to others, amounts paid to the operating co-owner are not subject to transportation tax since the payments are for use of own aircraft); Priv. Ltr. Rul. 80-52-082 (Sept. 30, 1980) (tax not applicable to co-tenants who have right to possession and use as an incident of ownership). This is to be distinguished from the use of an aircraft by the shareholders of the corporation, even

Despite the general rule applicable to co-owners, however, the transportation tax applies to amounts paid under fractional-ownership programs.[124] This stems from the nature of the program which, according to the IRS, is more in the nature of a transportation service than a co-tenancy. Specifically, the fractional owners, as part of the purchase of an interest, execute certain other agreements relating to the management and use of the aircraft. While the joint-ownership agreement governs the rights among the owners of the specific aircraft, each owner is required to execute a management agreement and an interchange agreement. Pursuant to these agreements, the aircraft in which the owner has an interest is part of an interchange arrangement involving all other aircraft participating in the fractional-ownership program. Under this program, each owner would be entitled to a certain number of hours of aircraft use based upon the percentage of its ownership interest and has access to other aircraft in the program if the aircraft in which it owns an interest is not available. The management company provides and assigns the crew, maintenance, insurance, and all other matters relating to the operation of the aircraft.

In examining the circumstances surrounding the use of the aircraft by the fractional owners, the IRS concluded that the owners had transferred possession, command, and control to the management company and were being provided with a taxable transportation service. Because the manager controlled all aspects of the operation of the aircraft, including whether the owner would travel on its own aircraft, the fractional interest was indistinguishable from all other aircraft in the program and effectively formed a charter fleet for the program manager.[125] As such, the fractional owner is required to pay the transportation tax on all amounts paid to the manager.[126]

Once a determination is made, the amounts to be included as part of the cost for taxable transportation must be identified.

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where the cost structure among the shareholders is similar to that used by the co-tenants. In the case of the shareholders, the corporation retains possession, command, and control, subjecting amounts paid by the shareholders to the transportation tax. *See* Rev. Rul. 76-431, 1976-2 C.B. 328.

124 *See* Tech. Adv. Mem. 93-14-002 (Dec. 22, 1992); *see also* Tech. Adv. Mem. 94-04-006 (Oct. 12, 1993).

125 *Id.*

126 *See* Tech. Adv. Mem. 94-04-006 (Oct. 12, 1993). Although the IRS never clearly identified the amounts against which the tax would apply, the IRS reaffirmed its earlier decision that taxes would apply to amounts paid for the transportation service.

The IRS has reiterated the statutory language that includes amounts paid for layover time and deadhead service in the definition of taxable transportation, even though the passenger is not on board.[127] In addition, any amount paid to guarantee availability of an aircraft would be subject to the tax.[128] Payments made for ancillary expenses such as crew expenses for hotels, rental cars, and meals are also included in the amount against which the tax will be calculated.[129] The IRS reasons that such expenses are an element of providing charter service to the passenger and, as such, are taxable. Although sightseeing by the crew in its spare time may appear to have no relationship to a transportation service, the IRS also considers such items as a form of entertainment that is incurred in connection with the provision of the transportation service.[130] Similarly, amounts paid for state sales tax are viewed as part of the cost of obtaining the transportation service and, therefore, included in calculating the transportation tax.[131]

The IRS, however, has determined that certain expenses for goods and services provided in connection with the transportation are not to be subject to the transportation tax. For example, amounts paid for standby time on an air ambulance are subject to the transportation tax, while the in-flight medical costs are not.[132] In addition, amounts stated separately for in-

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[127] *See* I.R.C. § 4262(d) (1994) (the term "transportation" includes layover, waiting time, and deadhead flights, including the return of the aircraft to its home base); Rev. Rul. 76-556, 1976-2 C.B. 354 (charges for layover time and deadhead service are subject to tax); Rev. Rul. 72-565, 1972-2 C.B. 578 (amounts paid in connection with aircraft layover time and crew expenses are subject to tax); Rev. Rul. 57-545, 1957-2 C.B. 749 (amounts included for maintenance are subject to tax, but non-transportation items separately itemized on the invoice and in the carrier's records are not); Tech. Adv. Mem. 95-28-003 (Mar. 27, 1995) (pilot overnight expenses and pilot per diem charges are included in the amount against which the tax is calculated); Tech. Adv. Mem. 92-40-002 (May 12, 1992) (the charge for an extra pilot is taxable even if that pilot is available only in the event of an emergency and is not required to operate the aircraft).

[128] *See* Shell Oil Co. v. United States, 607 F.2d 924 (Ct. Cl. 1979) (tax applies to actual hourly rate and monthly charge guaranteeing availability of service).

[129] *See* Priv. Ltr. Rul. 87-21-053 (Feb. 19, 1987).

[130] *Id.*; *see also* Rev. Rul. 72-565, 1972-2 C.B. 578.

[131] *See* Rev. Rul. 73-344, 1973-2 C.B. 365 (state sales tax charged to passengers is part of the amount paid for air transportation and is taxable); *see also* Tech. Adv. Mem. 93-22-002 (Feb. 9, 1993).

[132] *See* Rev. Rul. 77-75, 1977-1 C.B. 344; Rev. Rul. 75-535, 1975-2 C.B. 430; *see also* Priv. Ltr. Rul. 90-52-017 (Oct. 1, 1990) (medical costs are not taxed since they relate to patient care and not transportation).

flight catering and service charges for administrative expenses are not subject to the tax.[133]

In addition to amounts that are paid for the transportation service, the IRS has interpreted "amounts paid" to include income that it has allocated under its statutory authority to a parent company when it is not satisfied with the manner in which the company has allocated expenses relating to the use of the aircraft.[134] In such an instance, the IRS may allocate income to the parent and a deduction to the subsidiary to reflect an arm's-length charge for the subsidiary's use of the parent's aircraft, even though no money actually changed hands and no intercompany charges were actually recorded. The transportation excise tax would then be applied to such allocated income. The IRS, however, has advised that the excise tax does not apply to income imputed to an individual for personal transportation on company-provided aircraft because no amount is actually or constructively paid.[135]

3. *Domestic Versus International Travel*

Trips between the United States and points outside the 225-mile zone are not subject to the ten percent transportation tax. Rather, such trips are subject to a six dollar tax for the use of international travel facilities.[136] For international trips involving a stop or stops within the United States or the 225-mile zone, the nature of the stop(s) and the period of time between the end of

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[133] *See* Treas. Reg. § 49.4261-2(c) (1962) (if a payment covers charges for non-transportation services which are separable and shown in exact amounts in the records relating to the charge, no tax is due); *see also* DEP'T OF THE TREASURY, INTERNAL REV. SER., MARKET SEGMENT SPECIALIZATION PROGRAM, AIR CHARTERS, at 11 (May 1993).

[134] *See* Tech. Adv. Mem. 79-08-010 (Oct. 26, 1978). It is possible that such a position by the IRS could cause the FAA to assert that the imputation of income to the parent constitutes a chargeback in contravention of the FAA's rules. No opinions have been published by the FAA with respect to this issue. If such a position were successfully advanced, the operator would be placed in a precarious position since compliance with one agency's requirements could result in a violation of another agency's requirements. There is no justifiable reason for the FAA to take such a position. On the other hand, query whether the FAA's prohibition or limitation on the amount of chargebacks for intra-corporate family operations would be a successful defense to the IRS's assertion that such charges are not properly allocated among the companies.

[135] *See* Rev. Rul. 72-245, 1972-1 C.B. 347; Priv. Ltr. Rul. 90-28-027 (Apr. 5, 1990). For a discussion of imputed income, *see infra* text accompanying notes 159-201.

[136] *See* I.R.C. § 4261(c) (West Supp. 1996).

one segment and the beginning of the next segment must be evaluated to determine whether it is part of an uninterrupted international journey[137] and which tax applies, if any.[138]

In general terms, a stopover in the United States will be deemed part of an uninterrupted international journey if the time period between the international segment and the domestic segment is no more than twelve hours.[139] In determining whether the layover between the two segments exceeds twelve hours, the IRS, recognizing that delays do happen, focuses not on the actual time, but rather on the scheduled interval.[140] If the twelve-hour period is exceeded as a result of a delay, the trip will continue to be classified as an uninterrupted international journey, provided the passenger continues on the first available flight which offers substantially the same accommodations as originally purchased.[141] If, however, the twelve-hour period is exceeded simply because there is no service available within the twelve-hour window, the trip will no longer be classified as uninterrupted international air transportation.[142]

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137 An uninterrupted international journey is defined as air transportation (other than between two points in the United States) in which

> (A) the scheduled interval between (i) the beginning or end of the portion of such transportation which is directly or indirectly from one port or station in the United States to another port or station in the United States and (ii) the end or beginning of the other portion of such transportation is not more than 12 hours, and
>
> (B) the scheduled interval between the beginning of any two segments of the portion of such transportation referred to in subparagraph (A)(i) is not more than 12 hours.

I.R.C. § 4262(c)(3) (1994).

138 If a ticket is purchased outside the United States to Europe with a stopover in New York that is less than 12 hours, neither the 10% tax nor the $6 tax would apply since the entire flight is international and does not begin in the United States. Even if the ticket is purchased within the United States, it will be exempt from taxation as long as the New York stopover does not exceed 12 hours. *See* 26 FED. TAX COORDINATOR 2d (R.I.A.) ¶ W-5109 (1996). In the case of a trip between two points in the United States, the 10% tax applies regardless of where the ticket is purchased. *Id.* ¶ W-5110.

139 *See* I.R.C. § 4262(c)(3) (1994). Stopovers at points outside the United States and the 225-mile zone have no effect on the characterization of the transportation for excise tax purposes. *See* Rev. Rul. 74-538, 1974-2 C.B. 368.

140 *See* Treas. Reg. § 49.4262(c)-1(c)(2) (1962). Because the regulations have not been amended since 1962, the regulations refer to six hours as opposed to the 12 hours referred to in the statute. Nevertheless, the concept of "scheduled interval" would continue to apply.

141 *See* Rev. Rul. 63-278, 1963-2 C.B. 568.

142 *Id.*; *see also* Treas. Reg. § 49.4262(c)-1(c)(2) (1962); *supra* note 140.

Certain trips include numerous stopovers or outbound and inbound routings which do not match. In these cases of "open-jaw" or "circle" transportation,[143] the determination of which excise tax applies will be based on various factors. Generally, an open-jaw or circle trip will be treated the same as a round trip for purposes of determining which tax applies if the points of the open jaw are within the continental United States or the 225-mile zone, and the distance between the two points of the open jaw does not exceed the distance of the shorter segment traveled.[144] For example, a trip from New York to Edmonton, Canada, with a return from Toronto to New York would be subject to the six dollar international departure tax, and the return trip from Toronto would be subject to the ten percent excise tax.[145] If, however, the return trip originated in Edmonton and merely stopped in Toronto, only the six dollar international departure tax would apply.

Trips that involve multiple points require closer analysis when some of the points on the itinerary are outside the continental United States and the 225-mile zone. Specifically, the furthest point on the trip will be the destination.[146] Thus, if the furthest point is within the United States or the 225-mile zone, the amount paid for the entire trip will be subject to the ten percent transportation tax since the trip will be treated as beginning and ending in the United States or the 225-mile zone. If the furthest point is outside the United States and the 225-mile zone, the six dollar international departure tax will apply. The length of time for stopovers outside the United States and the 225-mile zone will not change the designation of a trip as an uninterrupted international journey or as a domestic trip to which the ten percent tax applies.[147]

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143 An open jaw involves a trip where the passenger travels from a point to a destination with a return trip from the destination to a point other than the originating point, or the passenger travels from a point to a destination and returns from a different point to the originating point (that is, New York to San Francisco with a return San Francisco to Washington D.C. or New York to San Francisco with a return Los Angeles to New York). A circle trip involves a round trip which takes different routings on the outbound and return flight (that is, New York-Chicago-San Francisco-Los Angeles-New York). *See* Treas. Reg. § 49.4264(e)-1(b) (1962); *see also* Rev. Rul. 74-538, 1974-2 C.B. 368.

144 *See* Rev. Rul. 74-538, 1974-2 C.B. 368.

145 *Id.*

146 *Id.*; Rev. Rul. 72-233, 1972-1 C.B. 346.

147 *See* Rev. Rul. 74-538, 1974-2 C.B. 368.

In addition to the requirement that the twelve-hour layover not be exceeded, the IRS requires that the non-international segment be booked prior to the departure of the international segment.[148] The fact that the ticket for the domestic segment may not be purchased prior to the international segment does not change the tax character of the transportation. The traveler must, however, present the international ticket at the time of purchasing the domestic ticket, and the tickets must be inscribed to reflect the international nature of the trip.[149] If the U.S. domestic segment meets these requirements, it will be considered part of the international trip and the only tax to be paid for the entire trip is the six dollar international departure tax. If not, the ten percent transportation tax will be due for the amount allocated to the segment within the United States.[150]

Although the cases decided by the IRS frequently involve transportation on airlines, the reasoning of these cases would apply equally to corporate aircraft operations. Obviously, the classification of a trip with a stopover in the United States as an uninterrupted international journey can result in tremendous financial savings since such a classification triggers a six dollar tax in lieu of a tax of ten percent of the cost allocated to the segment of the trip within the United States.

4. *Special Rules for Alaska and Hawaii*

In addition to flights between a point in the United States and a point beyond the 225-mile limit of the United States, which are exempt from the ten percent tax, flights over foreign countries or international waters may be subject to a partial exemption from such tax even though the flight is between points in the United States (for example, between Honolulu and San Francisco).[151]

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[148] *See* Rev. Rul. 74-537, 1974-2 C.B. 369; *see also* Rev. Rul. 63-278, 1963-2 C.B. 568.

[149] *Id.*

[150] *See* I.R.C. §§ 4262 (c)(3) (1994); I.R.C. § 4261(a) (West Supp. 1996).

[151] For such a trip, "taxable transportation" will not include the:

> [P]ortion of any transportation by air which meets all 4 of the following requirements:
>
> (1) such portion is outside the United States;
>
> (2) neither such portion nor any segment thereof is directly or indirectly—
>
> (A) between (i) a point where the route of the transportation leaves or enters the continental United States, or (ii) a port or station in the 225-mile zone, and

Based on the statutory requirements, the fact that a flight is between two points within Alaska or Hawaii is not determinative of whether it is entitled to the partial exemption from the ten percent transportation tax.[152] Instead, the controlling factor is whether the flight between the points within Alaska or Hawaii not only goes over a foreign country or international waters, but also whether the route is more than 225 miles from the United States, including Alaska and Hawaii.[153] In examining whether the flight is beyond 225 miles of the United States, the IRS determines the portion of the transportation that is excludable from tax as transportation over foreign territory or international waters, in part, by reference to the point where the route of transportation leaves or enters the United States.[154] As such, the amount of tax may be affected by the particular routing used on a flight—the earlier the flight enters the United States on a re-

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(B) a port or station in the 225-mile zone;

(3) such portion—

(A) begins at either (i) the point where the route of the transportation leaves the United States, or (ii) a port or station in the 225-mile zone, and

(B) ends at either (i) the point where the route of the transportation enters the United States, or (ii) a port or station in the 225-mile zone; and

(4) a direct line from the point (or port or station) specified in paragraph (3)(A), to the point (or the port or station) specified in paragraph (3)(B), passes through or over a point which is not within 225 miles of the United States.

I.R.C. § 4262(b) (1994). The calculations used to prorate the taxable amount based on the portion of the transportation over international waters or foreign countries are contained in the regulations. *See* Treas. Reg. § 49.4262(b)-1(a), 1(b) (1962).

152 It should be noted that the partial exemption from the 10% transportation tax does not negate the payment of all taxes. To the extent a portion of the trip is excludable from the 10% tax, the $6 tax will apply. *See* Rev. Rul. 75-166, 1975-1 C.B. 352.

153 *Id.*; *see also* Treas. Reg. § 49.4262(b)-1(b) (1962) (transportation between the continental United States and Alaska or Hawaii will be partially exempt if it meets the requirements of I.R.C. § 4262(b)). The exemption applies to the cost of the part of the trip which is outside both the continental United States *and* Alaska and Hawaii. *See* 26 FED. TAX COORDINATOR 2d (R.I.A.) ¶ W-5114 (1996).

154 *See* Rev. Rul. 75-277, 1975-2 C.B. 439. It is important to note that the definition of the 225-mile zone focuses on the continental United States while the 225-mile criteria which serves to exempt from taxation a portion of the transportation between two points in the United States focuses on the entire United States, including Alaska and Hawaii. *Compare* I.R.C. § 4262(c)(2) (1994) *with* I.R.C. § 4262(b)(4) (1994).

turn trip, the higher the tax.[155] While routing is important,[156] however, the mere fact that the flight traversed a point beyond 225 miles of the United States is not controlling. Instead, the determination is based on whether there is a point on the direct line of transportation between the origin and the destination that is more than 225 miles from the United States.[157] Such an approach enables the IRS to minimize the manipulation of a routing in an effort to lower the tax base.[158]

B. INCOME TAX CONSEQUENCES

Aside from the multitude of FAA, DOT, and excise tax issues, the use of corporate aircraft can have tax consequences for the companies that own and operate them, as well as the individuals that use them for personal transportation. Although the FAA regulations make clear that no charge may be made for personal travel in the case of intra-corporate operations,[159] and the amount of compensation that may be paid in other Part 91 operations is strictly limited,[160] the IRS requires that the value of personal transportation on company-provided aircraft[161] be in-

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155 The regulations provide that the aircraft has departed the United States when "it passes over (i) the international boundary line between any part of the United States and a contiguous foreign country, or (ii) a point three nautical miles (3.45 statute miles) from low tide on the coast line." *See* Rev. Rul. 75-166, 1975-1 C.B. 352; Treas. Reg. § 49.4262(b)-1(a)(4) (1962).

156 *See* Rev. Rul. 75-277, 1975-2 C.B. 439.

157 *See* Rev. Rul. 75-166, 1975-1 C.B. 352; *see also* SEN. REP. NO. 1607, 84th Cong., 2nd Sess. 4 (1956).

158 To prorate the amount paid for such a ticket, the tax is applied: (1) to the portion of the fare, which the mileage of the taxable part bears to the total mileage, or (2) on the local fare between the points in the taxable segment plus an amount equal to the portion of the remainder of the total amount paid, which the remaining taxable mileage bears to the remaining total mileage. *See* Treas. Reg. §§ 49.4261-3(c), 49.4262(b)-1(c) (1996).

159 The FAA explicitly prohibits any payments from guests not traveling within the scope of the company's business. *See* 14 C.F.R. § 91.501(b)(5) (1996); *see also supra* note 60 and accompanying text.

160 *See* 14 C.F.R. § 91.501(b)(3), (6) (1996); *see also supra* text accompanying notes 49-82.

161 Income will be imputed for company-provided aircraft even if the aircraft does not belong to the employer. For purposes of these rules, the provider of the fringe benefit is the "person for whom services are performed" by the employee. *See* Treas. Reg. § 1.61-21(a)(5) (1992). Similarly, even if the person receiving the benefit is not the employee, the employee may nevertheless be taxed since the fringe benefit is taxable to the "person performing the service in connection with which the fringe benefit is provided." *See* Treas. Reg. § 1.61-21(a)(4) (1992).

cluded in the employee's income.[162] As a general rule, the employee must include in income the fair market value of the flight less any amount paid by the employee for such flight.[163] In determining fair market value, reference must be made to the amount that would have been paid for the flight in an arm's-length transaction.[164] The employee's subjective view of the value, the cost to the employer of providing the flight, and the cost of comparable commercial airfare are not relevant for valuation purposes.[165]

In certain circumstances, however, special valuation rules may be used to reduce by a substantial margin the amount that must be included in the employee's income.[166] As a general matter, a special valuation rule may only be used if (1) the employer treats the value of the flight as wages for reporting purposes, (2) the employee includes the value of the benefit in income, (3) the employee is not a control employee,[167] *or* (4) the employer

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[162] *See* Treas. Reg. § 1.61-21(a)(1) (1992). Under these rules, partners, directors, and independent contractors would be considered employees. *See* Treas. Reg. § 1.61-21(a) (1992). If there is more than one employee on the aircraft, the cost will be allocated among all employees present unless one or more of the employees control the use of the aircraft (that is, determines the route, departure time, and destination), in which case, the value of the flight will be allocated solely among such controlling employees unless a written agreement exists allocating the value of the flight in a different fashion. *See* Treas. Reg. § 1.61-21(b)(6)(ii) (1992).

[163] *See* Treas. Reg. § 1.61-21(b)(1) (1992).

[164] *See* Treas. Reg. § 1.61-21(b)(2) (1992). Nor may the flight be valued by reference to commercial airfare. *See* 11 FED'L TAX COORDINATOR 2d (R.I.A.) ¶ H-2302 (1996).

[165] *Id.*

[166] When a special valuation rule is properly used, the IRS will accept the value calculated thereunder as the fair market value. *See* Treas. Reg. § 1.61-21(c)(5) (1992).

[167] For purposes of the conditions that must be present for the application of a special valuation rule, a non-government control employee is any employee (1) who is an officer appointed, confirmed, or elected by the board of directors or shareholders and whose compensation equals or exceeds $50,000, (2) who is a director of the employer, (3) whose compensation equals or exceeds $100,000, or (4) who owns a 1% or greater equity, capital, or profits interest in the employer. *See* Treas. Reg. § 1.61-21(f)(5) (1992). It should be noted that when applying the non-commercial flight valuation formula, the definition of a control employee is slightly different. Specifically, in the valuation context, a control employee is any employee (1) who is an officer appointed, confirmed, or elected by the board of directors or shareholders (up to the lesser of 10 employees or 1% of all employees), (2) who is among the top 1% most highly paid employees (up to 50 employees, but in no event including employees earning less than $50,000), (3) who owns a 5% or greater equity, capital, or profit interest in the employer, or (4) who is a director of an employer. *See* Treas. Reg. § 1.61-21(f)(8) (1992).

demonstrates a good faith effort to treat the benefit correctly for reporting purposes.[168] Assuming the conditions are met, two basic valuation rules are available.

1. *Seating Capacity Rule*

The seating capacity rule provides that if fifty percent or more of the regular passenger seating capacity of an aircraft is occupied by persons who are traveling primarily for the employer's business,[169] the value of the flight for any employee who is not traveling primarily for the employer's business is treated as zero.[170] In determining whether this valuation rule is available, the fifty-percent seating capacity requirement must be met both at the time the individual whose flight is being valued boards the aircraft and disembarks from the aircraft.[171]

For the purposes of this rule, the seating capacity of the aircraft is the maximum number of seats that have at any time prior to the date of the flight been installed on the aircraft (when owned or leased by the employer), even if some of the seats have been removed for the flight in question.[172] This would include seats that are occupied by flight crew who are not on such flight primarily to serve as flight crew.[173] It does not, however, include seats that could not and have not at any time been legally used during takeoff (such as jump seats).[174] If the employer permanently removes seats from the aircraft, the regular seating capacity will be deemed reduced, provided that such seats are not added within the following twenty-four months.[175]

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168 *See* Treas. Reg. § 1.61-21(c)(3)(ii) (1992).

169 Under this rule, only employees are considered. As a result, independent contractors and directors of the employer will not be counted toward the 50% of the seats being occupied for the employer's business. *See* Treas. Reg. § 1.61-21(g)(12)(i)(B) (1992). In this case, if a flight taken by an individual is not considered taken by an employee, but the seating capacity rule is otherwise satisfied, the value of that person's flight is the value of a flight provided to a non-control employee (even if that person would otherwise be taxed based on the value of the flight to a control employee). *Id.*; *see infra* note 178.

170 *See* Treas. Reg. § 1.61-21(g)(12)(i)(A), (iii)(A) (1992).

171 *See* Treas. Reg. § 1.61-21(g)(12)(ii) (1992).

172 *Id.*

173 *See* Treas. Reg. § 1.61-21(g)(12)(v) (1992). If a seat occupied by a member of the flight crew is not counted as a passenger seat, such member of the flight crew is also disregarded in applying the 50% test. *Id.*

174 *See* Treas. Reg. § 1.61-21(g)(12)(iii)(B) (1992).

175 *Id.*

2. *Aircraft Valuation Formula*

If the seating capacity rule does not apply, the value of the flight may also be calculated under the aircraft non-commercial flight valuation rule.[176] Under this rule, the value of the flight is determined using the base non-commercial flight aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL).[177] Specifically, the SIFL cents-per-mile rate applicable to the period in which the flight was taken is multiplied by the aircraft multiple,[178] and the applicable terminal charge is added to the total.[179] In calculating the value, a distinction is made between control and non-control employees,[180] with flights by control employees receiving a higher valuation. The calculation of the flight length is determined with reference to the distance in statute miles between the point where the individual at issue boards the aircraft and where that individual disembarks.[181] In order to perform this calculation, the "flight" is determined on a passenger-by-passenger basis. As a result, a round trip will consist of the number of segments in which the individual enplaned and deplaned.[182]

When a flight is taken both for personal and business reasons, the valuation is also dependent on whether the flight was pri-

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[176] *See* Treas. Reg. § 1.61-21(g)(5) (1992).

[177] The Standard Industry Fare Level is calculated by DOT as a cents-per-mile rate and is revised semi-annually. *Id.*

[178] The aircraft multiple is based on the maximum certificated takeoff weight of the aircraft and is set forth in the regulations, with higher multiples applying to heavier aircraft and control employees. *See* Treas. Reg. § 1.61-21(g)(7) (1992). Specifically, an aircraft with a maximum certificated takeoff weight of 25,001 or more has an aircraft multiple for a control employee of 400%, while it only has a multiple of 31.3% for non-control employees. Aircraft between 10,001 and 25,000 pounds have a multiple of 300% and 31.3% for control and non-control employees, respectively. Aircraft weighing 6000 pounds or less and those weighing between 6001 and 10,000 pounds have multiples of 62.5% and 125% for control employees, respectively, and 15.6% and 23.4%, respectively, for non-control employees. *Id.*

[179] As with the SIFL, the terminal charge is calculated on a semi-annual basis by DOT. *See* 11 FED'L TAX COORDINATOR 2d (R.I.A.) ¶ H-2306 (1996).

[180] See *supra* note 167 for a discussion of control employees.

[181] *See* Treas. Reg. § 1.61-21(g)(3)(i) (1992). The fact that a circuitous route is taken does not affect the calculation of the distance of a flight for purposes of the valuation rule. *See* 11 FED'L TAX COORDINATOR 2d (R.I.A.) ¶ H-2309 (1992).

[182] *See* Treas. Reg. § 1.61-21(g)(3)(ii) (1996). In the event there is an intermediate stop due to weather, an emergency, refueling or obtaining other services unrelated to the individual's purpose for traveling, the additional mileage resulting from the intermediate stop is not considered when determining the distance of the employee's flight. *See* Treas. Reg. § 1.61-21(g)(3)(iii) (1992).

marily for business purposes or primarily for personal purposes.[183] If the trip is primarily for the employer's business, the employee must include in income the excess of the value of all the flights over the value of the flights that would have been taken if there were no personal flights.[184] On the other hand, if the trip is primarily personal, the full amount of all of the flights is includible in the employee's income.[185]

In addition to income being imputed for the employee's flight, income may also be imputed for a non-employee accompanying the employee. Under this rule, a family member[186] of a control employee will be deemed a control employee for purposes of the valuation.[187] This also means, however, that if the value of the flight to the employee is zero based on the seating capacity rule, the value is also zero for the spouse and child. In addition, an individual who was a control employee after age fifty-five or within three years after leaving the company will continue to be treated as a control employee for purposes of flights taken on the former employer's aircraft.[188]

3. *Bona Fide Security Concerns*

Special valuation rules may also be used if, for a bona fide security reason, an employee is required to be carried on the employer's aircraft for business and personal travel as opposed to traveling on commercial flights.[189] If this rule applies, the value of personal flights on the employer's aircraft is based on the non-commercial valuation rules with the exception that the

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[183] *See* Treas. Reg. § 1.61-21(g)(4) (1992).

[184] *See* Treas. Reg. § 1.61-21(g)(4)(ii) (1992). For example, if an employee flies from New York to Chicago for personal reasons and then goes to Los Angeles for primarily business purposes, the amount that would be imputed to the employee as income would be the value by which a New York-Chicago-Los Angeles-New York trip exceeds the value of a New York-Los Angeles-New York trip. *Id.*

[185] *See* Treas. Reg. § 1.61-21(g)(4)(iii) (1992).

[186] For purposes of this regulation, a family member is any party covered by I.R.C. § 267 (c)(4), including brothers, sisters, spouse, ancestors, and lineal descendants. *See* Treas. Reg. § 1.61-21(g)(8)(ii) (1992); I.R.C. § 267(c)(4) (West Supp. 1996).

[187] *See* Treas. Reg. § 1.61-21(g)(8)(ii) (1996). For example, the spouse and children of a Chief Executive Officer would be treated as control employees. *See* Treas. Reg. § 1.61-21(g)(7)(ii) (1992). The one exception is that a child under the age of two will always receive a valuation of zero. *See* Treas. Reg. § 1.61-21(g)(1) (1992).

[188] *See* Treas. Reg. § 1.61-21(g)(11) (1992).

[189] *See* Treas. Reg. § 1.132-5(m) (1997).

aircraft multiple is reduced to 200%, even if the employer does not otherwise use the special valuation rules.[190]

In order to be covered under this safe harbor valuation rule, the facts and circumstances must establish a specific basis for concern regarding the safety of the employee.[191] Types of concerns that would support the use of this valuation rule include threats of death or kidnapping; serious bodily harm either to that employee or other similarly situated employees because of the status of the employee as an employee of that employer; or a recent history of violent terrorist activity (such as bombings) in the geographic area in which the transportation is provided unless such activity is focused on a group that does not include the employee.[192]

Even if such circumstances exist, the IRS will not consider it to be a bona fide security concern unless the employer has an overall security program acceptable to the IRS for that employee.[193] Such a program must provide security to the employee on a twenty-four-hour basis at the employee's residence and workplace, while traveling, whether for business or personal reasons, and include the use of a bodyguard-chauffeur who is trained in evasive driving techniques, an automobile specially equipped for security, and guards, metal detectors, alarms, or similar methods of controlling access to the employee's workplace or residence.[194] In certain circumstances, a less comprehensive security program will be accepted for purposes of determining eligibility for this valuation. Specifically, if a program is implemented on a consistent basis by the employer, based on the reasonable recommendation of an independent security consultant following his/her security study for that employee, the comprehensive security program set forth in the regulations need not be rigidly followed.[195] Otherwise, unless the comprehensive security program described in the regulations is in place, the IRS will not permit the use of the special valuation rule for flights

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190 *See* Treas. Reg. § 1.132-5(m)(4) (1997). The regulations appear to assume that the aircraft multiple would typically be 400% or 300%. If the aircraft, however, was a light aircraft, the multiple of 200% would exceed the standard multiple. Under such circumstances, the standard multiple could be used. *See supra* note 178.

191 *See* Treas. Reg. § 1.132-5(m)(2) (1997).

192 *See* Treas. Reg. § 1.132-5(m)(2)(i)(A), (B) (1997).

193 *See* Treas. Reg. § 1.132-5(m)(2)(ii) (1997).

194 *See* Treas. Reg. § 1.132-5(m)(2)(iii)(A) (1997).

195 *See* Treas. Reg. § 1.132-5(m)(2)(iv) (1997).

taken on security grounds.[196] Once it is determined that a bona fide security concern exists for the employee, it is also deemed to exist for the employee's spouse and children, and the special valuation rule is applied when they accompany the employee.[197]

With the limited exception of the security valuation rule, which may be used if all of the conditions are satisfied, the special valuation rules must be used on a consistent basis. In other words, if the special valuation rules are used by an employer for any employee, they must be used for all employees during the calendar year. Similarly, if the employee uses a special valuation rule for any flight, special valuation rules must be used for all flights.[198] Due to the significant reduction in the amount of income imputed to an employee under the special valuation rules, failure to comply with the rules is a ground for the IRS to disallow the application of the rule.[199] For example, if a valuation is made for a control employee based on the non-control employee value, if the seating capacity rule is improperly applied, or if the aircraft multiple used is the multiple for a lighter aircraft, the special valuation rules will not be available to value the flight taken by the control employee or the persons taking the erroneous position.[200]

In any case, imputed income not only raises tax issues for the employee, it also imposes certain obligations on the company.[201] If these obligations are not met and the IRS requirements not satisfied, the ramifications for the company and its employees can be substantial. As such, if corporate aircraft are going to be used for personal travel, it is imperative that the IRS requirements be navigated correctly. Otherwise, a fair market value will be used, subjecting the employee to a level of imputed income

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196 *See* Treas. Reg. § 1.132-5(m)(2)(iii)(B) (1997). For example, if security is provided at the workplace but not at the residence, or a specially equipped automobile is used, but the remaining aspects of a security program are not included, the requirement for a security program will not be satisfied. *Id.*

197 *See* Treas. Reg. § 1.132-5(m)(3) (1997).

198 *See* Treas. Reg. § 1.61-21(g)(14)(i), (ii) (1992). An employee, however, may elect to use the general fair market value rule, even if the employer uses the special valuation rule, although there does not appear to be any reason for an employee to do so.

199 *See* Treas. Reg. § 1.61-21(g)(13)(i)(A) (1992).

200 *See* Treas. Reg. § 1.61-21(g)(13)(i)(B) (1992).

201 Although the income is imputed, the company must nevertheless comply with all requirements relating to payroll taxes and withholding and reporting requirements. *See* Stephen D. Halliday, *Tax Issues Arising from the Use of Non-Commercial Aircraft*, 46 TAX EXECUTIVE 190, 191 (1994).

that likely far exceeds anything that was contemplated by the employee when it used the aircraft for personal travel.

To date, the FAA has not expanded, nor does it appear that it will expand, the concept of compensation to include imputed income to the recipient of the transportation. Excluding situations involving imputed income from the classification of compensation is logical given that the operator derives no benefit from such imputed income. In the case of a reallocation of income by the IRS to the operator of the aircraft, a similar result should be reached. Although income is reallocated to the operator, such reallocation results solely from the application of law by the IRS. To decide otherwise would place the operator in the position of being unable to satisfy the two masters at once. This is simply no reason for such an extreme position.

V. CONCLUSION

As is apparent, the operation of corporate aircraft is a mine field resulting from the interplay of often conflicting FAA, DOT, and IRS rules. Perhaps one of the most significant problems with these regulations, as they have been interpreted by the respective agencies, arises from the fact that the regulations do not seem to account for day-to-day business realities. Effectively, the regulations have impeded companies that attempt to reduce the potential liability associated with the operation of their aircraft.

One of the major problems stems from the FAA's requirement that the operation of aircraft be incidental to another business purpose of the company before any form of compensation may be received by the operator, even if such compensation is merely a chargeback from an affiliated company. This requirement virtually eliminates the company's ability to protect its assets and overall business by prohibiting it from establishing a subsidiary that does nothing more than operate the aircraft for the affiliated companies.

The FAA-imposed requirement that compensation for intracorporate family operations not only be incidental to another business purpose, but also within the scope of the business of the company operating the aircraft, effectively requires the primary business to be placed at risk. Such requirements clearly fail to take into account business realities. In addition, and perhaps of even more significance, is the possibility that the failure to abide by these often confusing rules could result in a determination that the operation of the aircraft was not in accordance

with the law—a determination that could adversely affect insurance coverage.

The obvious policy question is: What are the *safety* considerations that permit a company engaged in manufacturing widgets to transport its parent's employees on a cost-reimbursable basis under Part 91 (without FAA certification), whereas the same company would require an FAA certificate if it did *not*? If the FAA has determined generally in Subpart F that the company can safely transport *employees* of its parent *on a cost-reimbursable basis*, it should not matter whether the company has been established solely to transport its parent's employees by air or is engaged in another business as well.

The IRS's insistence on arm's-length, intra-corporate family charges raises the question of whether such reallocation of income would be viewed as compensation for FAA purposes. Based on the fact that the FAA and IRS interpretations are not always consistent, are often difficult to reconcile (especially with the day-to-day operations of corporate aircraft), and that the agencies' objectives are different, there appears to be no rationale for the FAA to proffer such a position. If the FAA were to take such a stand, it would make it extremely difficult, if not impossible, for a corporate operator to meet the requirements of both agencies. This is an absurd result that clearly has no basis in the purpose or history of either agency. However, since there are no decisions addressing whether a reallocation for tax purposes of such intra-family charges constitutes compensation for purposes of the FAA's rules, the risk remains.

The IRS's attempt to maximize the collection of the transportation tax also fails to account for a common method of operating corporate aircraft—namely, through the use of a management company. The IRS has construed possession, command, and control so restrictively that it would appear the only safe way to avoid the application of the excise tax would be for a company to establish an in-house flight department, something that many companies do not desire. Does the mere fact that a management company is taking care of many of the administrative responsibilities relating to an aircraft, or that an owner has agreed to use the aircraft in charter service operated by the manager, justify the application of the ticket tax? It is still the owner's aircraft, with the expenses related to the owner's operation being paid by the owner.

The DOT rules restricting the operation of foreign civil aircraft further limit the value of the Subpart F operations. If a

company is based in the U.S. and its day-to-day operations are managed by U.S. citizens, does the fact that its ultimate parent is owned by non-U.S. citizens justify licensing, at best, and a prohibition, at worst, of operations for affiliated companies on a cost-reimbursable basis?

These questions only serve to highlight the fact that not only are the regulations of different agencies on related matters frequently inconsistent, they also appear to have no relationship to furthering the policies and goals of that particular agency. Notwithstanding the regulatory mine field, many companies continue to rely upon corporate aircraft as their primary mode of air transportation. The inability to resolve many of these critical issues with a high degree of certainty poses risks for corporate aircraft operators far beyond those frequently perceived by management when a decision is first made to acquire aircraft. Since it is unlikely that these rules will be significantly changed to address the practical concern raised in this Article, the only hope lies in the possibility that a body of case law and interpretations will be developed over time which takes practical issues into account. Until then, reasoned business decisions must be made, and aircraft operations must be structured, in a fashion that defensibly fits within the existing rules, case law, and interpretations.