



USE OF A SPECIAL PURPOSE ENTITY FOR AIRCRAFT: A TRAP FOR THE UNWARY

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Airplanes are a fact of life in modern business. They provide senior management efficiency, safety, and security. Nevertheless, they are also a source of worry for corporate counsel and the risk manager. They expose the company's assets to significant liability in the event of an accident and their appearance on the company's balance sheet may incite stockholder unrest. To avoid these problems, creative corporate counsel often decide to set up a special purpose "flight department" entity with no assets other than the airplanes and no purpose other than their operation for the business of the parent company and perhaps other subsidiaries as well. Of course, paying for the operations of this entity requires funding in some fashion by the parent or other subsidiaries. With this structure in place as a shield against plaintiffs' lawyers and disgruntled stockholders, the CEO and General Counsel sleep easily. But should they?

According to the FAA, business aircraft may generally be operated under the noncommercial rules in Part 91 if compensation is not involved. However, if compensation is received, the FAA generally requires the operator to obtain a certificate and comply with the more stringent rules in Part 135. To the FAA, anything of value (even accounting charge backs between affiliates) represents compensation. How does this affect our "flight department company?" After all, it only flies for its parent company and affiliates, receives no cash for flying, and is never expected to make a profit.

FAA rules do permit a subsidiary company to fly an airplane carrying executives from its parent company or other subsidiaries of the parent under Part 91 without obtaining an FAA certificate. These rules even permit recovery of the costs of the operation.

However, the FAA insists that this flying be "incidental to and within the scope of" some business other than transportation by air. Unfortunately, our "flight department" subsidiary has no business except transportation by air.

The FAA Chief Counsel has issued a legal interpretation saying that a company with no business other than operating a flight department may not fly under Part 91; rather, it must obtain an FAA certificate and comply with Part 135. The FAA has also made it clear that if it discovers a "flight department company," it may bring enforcement action against both the company and its pilots. The company can be penalized as much as \$11,000 per violation and the pilots may lose their licenses. Not a happy result and now the CEO is asking his lawyer some hard questions.

An FAA violation is bad enough. Is that all that can happen? Unfortunately no. First, flights within an "affiliated group" are subject only to the federal excise tax on fuel used. With proper tax planning, flights outside the affiliated group (such as brother/sister companies) can also be subject only to the fuel tax. However, use of a flight department company will subject all flights outside the affiliated group to the "ticket tax" of 7.5% on all amounts paid for such transportation. These amounts could include inter-company charge backs or contributions to capital.

In addition, aircraft may often be acquired free of any state sales or use taxes. However, the use of a flight department special purpose entity may otherwise undermine good sales and use tax planning.

Finally, in the event of an accident, this structure may increase liability exposure-exactly the opposite

of what was intended. If the FAA or the NTSB determines that the flight should have been flown under Part 135 instead of Part 91, a plaintiff's lawyer may be able to use this finding to bolster his case for liability. In some states, it may also help to "pierce the corporate veil" of the flight department subsidiary to get at the assets of the parent. Finally, some insurance policies cover only noncommercial operations, or exclude operations in violation of FAA rules from coverage. If the FAA determines that the flight department company failed to comply with Part 135, this may open the door for an insurance company to deny coverage.

Are there alternative structures that can avoid all these problems and still provide some comfort for the CEO and his lawyer? Yes, there are. Selecting the right one requires careful analysis of each particular situation. However, with the help of an experienced aviation legal team, the right choices can be made. Call an aviation lawyer-you'll be glad you did!



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