NBAA MEMBER RESOURCE

The Flight Department Company Trap

September 2012

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The "flight department company trap" is a problem that just won't go away. Aviation lawyers have been talking about it for years, but no matter how much it's discussed, aircraft buyers still stumble into it on a regular basis, and new cases come up all the time. There are two main reasons for the trap's continued vitality: (1) the rules don't always make much sense, and (2) few lawyers (other than business aviation specialists) really know anything about them.

WHAT IS A FLIGHT DEPARTMENT COMPANY?

"Flight department company" (also called a "single" or "sole purpose" company) usually refers to an entity that has no other business except *operating* an aircraft. No specific form of entity is required: it can be a corporation, partnership or limited liability company. The entity need not own the aircraft; it could lease it from the actual owner. But whatever kind of entity it is, and however it obtains possession of the aircraft, to be a flight department company, the entity must have operational control of flights for FAA purposes. According to the FAA, this means "the exercise of authority over initiating, conducting or terminating a flight" (FAR 1.1).

The FAA has no objection to a single-purpose entity owning an aircraft (assuming it meets citizenship and other applicable FAA requirements). Nor is there anything inherently wrong with an aircraft being operated by an entity; most business and commercial aircraft are operated by companies. The issue that plagues the flight department company is *how* the aircraft is operated.

WHAT'S WRONG WITH A FLIGHT DEPARTMENT COMPANY?

The short answer is: FAR Part 91 aircraft operations by a flight department company are illegal.

With few exceptions, most business aircraft are operated either under the non-commercial flight rules of FAR Part 91 or the commercial charter rules of FAR Part 135. For FAA purposes, a flight is generally commercial if one party furnishes air transportation to another party for compensation. As noted in FAR Part 1.1, a commercial operator is "a person who, for compensation or hire, engages in the carriage by aircraft in air commerce of persons or property." The compensation doesn't have to take the form of money; any benefit conferred will be sufficient, and an intent to make a profit is unnecessary.

How does the flight department company fit into this situation? If operations are conducted under FAR Part 135 pursuant to an air carrier certificate, the answer is: quite well. By complying with the FAA commercial rules, the company is entitled to be in the business of air transportation and to receive compensation for flights.

But few persons prefer to operate under FAR Part 135 if they can avoid it. First, the company either has to obtain its own air carrier certificate, a lengthy and trying process, or allow an existing certificate holder to operate flights. Either way, there will be start-up and ongoing expenses. The IRS 7.5 percent transportation tax will likely apply, and operations will be subject to the more stringent operating rules of FAR Part 135. In short, in the absence of a compelling reason (such as tax planning), it is hard to see why anyone would voluntarily chose to operate their flights under FAR Part 135.

Therefore, suppose, as is more typically the case, the flight department company operates flights under FAR Part 91. What's the issue? To think of this in a simplistic fashion, the flight department company by definition has no other business than operating an aircraft, so its sole business must be air transportation. But persons engaged in the business of air transportation (carriage of passengers or cargo for compensation or hire) are required to operate under a commercial certificate issued by the FAA. It follows that carriage of persons or property under FAR Part 91 by a flight department company is not permitted.

It might be suggested at this point that flights operated by the flight department company can't really be commercial because the passengers don't pay for them. But though this may be true on a flight-by-flight basis, the flight department company has to pay expenses somehow – and remember, it is engaged in no other business, so it generates no revenue on its own. Its revenue typically comes from the owners of the company, who must make capital contributions to fund ongoing operations. The owners and their guests, of course, are the passengers on the aircraft, so the FAA simply perceives this as a roundabout way of paying for air transportation.

The FAA's thinking here is illustrated by a letter from Rebecca MacPherson, assistant chief counsel in the FAA's Regulations Division, to James W. Dymond, Esq., dated March 9, 2007. The letter considered the following scenario posed by Dymond: "Client" forms an LLC to own and operate an aircraft. The LLC would pay for aircraft operations with capital contributions provided by Client. After characterizing the LLC as a "flight department company," attorney MacPherson noted that "a company whose sole purpose is transportation by air and receives compensation (amounts paid by the Client needed to pay the costs of owning and operating the aircraft) must obtain certification under Part 119 [the regulation under which you would receive an air carrier certificate for operations under Part 135] unless the aircraft has a maximum payload of 6,000 pounds or more than 20 seats, when it could operate under Part 125."

As I noted earlier, one reason this rule is frequently violated is that it makes little sense. Only if the business world is viewed in the most literal and pedantic terms can flights by a company for its owner be viewed as "commercial." Flight department companies are usually created by aircraft buyers (or their lawyers) who want the company to protect the buyer (which can be one or more persons or companies) from liabilities associated with owning and operating the aircraft. So the buyer (Mr. ABC) creates an entity (ABC, LLC), to purchase and operate the aircraft. The company hires the pilots, rents hangar space, buys fuel, etc., and Mr. ABC reimburses these expenses. On the other hand, Mr. ABC could simply purchase and operate the aircraft himself. In this case, he hires the same pilots, rents the same hangar space, buys fuel, etc. Either way, the passengers – the owner and his family – are the same. Apart from the addition of ABC, LLC, there is no difference at all between the two scenarios, and certainly no difference that rises to the level of a safety concern. No wonder aircraft owners are amazed to hear that one scenario is perfectly legal and the other scenario prohibited.

THE MAJOR ENTERPRISE TEST AND FAR 91.501

We have characterized the flight department company as one whose *sole business* is owning and operating an aircraft. Anyone who reflects on this definition will eventually realize that a flight department company can be avoided simply by adding some other business to it. Suppose, for example, that Mr. ABC owns a drug store on Main Street. If he moves the drug store business into ABC, LLC, the latter is no longer a flight department company – or is it?

Unfortunately for Mr. ABC, although dumping businesses other than air transportation into ABC, LLC may mean that it is technically no longer a flight department company, it will not save ABC, LLC from the "flight department company trap." This is because a flight department company (whose sole business is air transportation) is really the clearest and most egregious case of a larger problem: the failure of the company to make sure that flights on the company aircraft support the company's other businesses.

In the FAA's definition of "commercial operator," part of which was quoted earlier, the FAA observes: "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." This oft-quoted language (the "major enterprise test") is not ideal for expressing the FAA's position, since an air transportation business that constitutes a "minor enterprise" and is "not for profit" may still require a commercial certificate. (Don't try telling the FAA that you didn't need an air carrier certificate to charge your friend for a flight on your GV because it wasn't "a major enterprise for profit.")

The FAA's view is clearer in FAR 91.501 and in what the FAA said when the regulation was proposed and adopted. FAR 91.501 (originally FAR 91.181) was created in part to allow "compensation" to be paid under limited circumstances in the case of certain large, multi-engine airplanes. FAR 91.501(b)(5) permits:

> Carriage of officials, employees, guests and property of a company on an aircraft 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.

This is not the easiest regulation to parse. After it was adopted, some readers hoped that the regulation could be read to permit operations of an aircraft by a flight department company as a member of a corporate group. However, the FAA ruled out this interpretation from the outset, noting that such flights must be within the scope of and incidental to some other business of the company operating the airplane. According to the FAA, "if a corporation is established solely for the purpose of providing transportation to the parent corporation, a subsidiary or other corporation," the regulation does not apply. "In that case, the *primary* (my emphasis) business of the corporation operating the airplane is transportation, and the carriage of persons or goods for any other corporation, for a fee or charge of any kind would require the corporation operating the airplane to hold a commercial operator certificate" (37 Fed. Reg. 14,758 (July 25, 1972). Thus, a corporation can operate an aircraft in its business, but it cannot create a wholly owned "flight department" subsidiary to do the same thing, down streaming cash to the subsidiary to pay for the flights. The difference may appear to be one of form only, but the FAA regards it as a difference of substance: one company providing transportation to another for compensation. The fact that the parent company owns the subsidiary is irrelevant to the FAA.

In the passage just quoted, the FAA identified the company's *primary* business as transportation by air. They didn't say it was its *only* business. In other words, the parent corporation cannot steer clear of the flight department company trap by just adding more businesses to the flight department subsidiary. If those other businesses have no relation to the aircraft – if flights of the aircraft are not service of those businesses – then, using the language of the major enterprise test, air transportation would be a major enterprise for profit. In the language of FAR 91.501(b)(5), the flights must be *within the scope* of and *incidental* to the business of the company, other than transportation by air. This is the model of business aviation: aircraft employed in the service of a trade or business.

MANAGEMENT COMPANIES AND FRACTIONAL PROGRAMS

The flight department company trap frequently ensnares owners and lessees of fractional shares. Aircraft in fractional programs are generally operated under either Subpart K of FAR Part 91 or FAR Part 135, and sometimes both. To the extent operations are conducted under Subpart K of FAR Part 91, the program participant generally has operational control of flights. This means that if the entity holding legal title to, or leasing, the share is a flight department company (which is often the case), that entity is not able lawfully to exercise operational control. The solution is to transfer the share to an entity where the flights will be within the scope of and incidental to the entity's other business, or (if the program permits it) elect to have flights operated under FAR 135.

The same issue arises in the case of aircraft "operated" by aircraft management companies, and for the same reason. The fact that an owner or lessee retains a management company does not eliminate its responsibilities to operate the aircraft under FAR Part 91. The management agreement will (or anyway it should) be clear that the management company is merely furnishing aviation services to assist the owner, who retains operational control of FAR Part 91 flights. On the other hand, to the extent that the management company operates the aircraft under FAR Part 135, the flight department company problem disappears.

PROBLEMS CAUSED BY THE FLIGHT DEPARTMENT COMPANY TRAP

A not uncommon reaction people have when they are informed that they are operating in a flight department company (or a company where flights operated by the company are not within the scope of and incidental to the company's other business) is, "Why should I care?" Often a flight department company has been operating their aircraft for many years without incident. What reason is there to change? Here's a list of things to consider.

- It's illegal to conduct FAR Part 91 operations in a flight department company. Most of us don't relish doing things that are unlawful, whether there's penalty or not. Think about whether you'd like to read about the illegal conduct on the front page of the *Wall Street Journal*.
- Since those operations are illegal, they will violate any "compliance with laws" covenants that apply to the flight department company. Most loan agreements, for example, make non-compliance by the borrower or its subsidiaries with law – any law – a default.
- FAR Part 91 operations by a flight department company *should have been* FAR Part 135 operations. But FAR Part 135 operations often have different tax consequences. The Internal Revenue Service may want to charge the 7.5 percent transportation excise tax on the capital contributions, for example, on the theory that the flights should have been commercial.
- If the FAA discovers that operations requiring an air carrier certificate were being conducted under FAR Part 91, it may revoke the certificates of the pilots flying the aircraft.
- The FAA can also fine the illegal operator – up to $11,000 per violation. Operating as a flight department company for a number of years can generate plenty of violations.
- If you're not impressed with these potential pitfalls, consider this: if your company's aircraft is involved in an accident and the company *should have been* operating under FAR Part 135, including observance of its more stringent safety and operating rules, but was in fact operating illegally under FAR Part 91 and not observing those more stringent safety and operating rules, you should not count on your entity's liability shield to protect you in this case.

- If you plan to rely on liability insurance when sued in connection with an accident, be aware that, depending on what the policy says, an insurer may deny coverage. In *Avemco Ins. Co. v. Auburn Flying Serv., 242 F.3d 819* (2001), the insurer denied coverage on the grounds that damages from use of the aircraft for a "commercial purpose" were explicitly excluded by the policy. This rationale might also preclude coverage in the case of an accident that occurred when an aircraft was operated by a flight department company under FAR Part 91. No matter what the policy says, an insurer always has an incentive to deny coverage when confronted with the possibility of a large damage award. In the face of this, operating an illegal commercial air transportation operation cannot be recommended.

The foregoing issues show the manifold dangers of ignoring the flight department company trap. Prudent aircraft operators will find a way to avoid the trap.

DEALING WITH THE FLIGHT DEPARTMENT COMPANY TRAP

How can the trap be avoided? The easiest way is often simply to operate under FAR Part 135. Given the challenges of obtaining your own air carrier certificate from the FAA, this generally means allowing an existing certificate holder to operate the aircraft for you. But though this solution eliminates the problem, it has its own drawbacks. The certificate holder will likely charge you both to put the aircraft on its certificate and to operate the aircraft under FAR Part 135. Moreover, as noted earlier, FAR Part 135 has operational restrictions that may prove cumbersome and inconvenient, such as an inability for your aircraft to operate at certain airports. Finally, operations under FAR Part 135 may expose you to the 7.5 percent transportation excise tax and could require the use of a longer depreciation schedule for income tax purposes.

Are there alternatives, then, to FAR Part 135? The principal alternative is either to transfer aircraft operations to a company engaged in other business or to add one or more businesses to the flight department company. Either way, going forward, the flights on the aircraft must be within the scope of and incidental to the business of the company operating the aircraft (other than transportation by air). Consult an experienced aviation attorney about the best way for you to accomplish this. Most good aviation attorneys have (sadly) plenty of experience finding creative ways to solve the flight department company problem.

THE FUTURE OF THE TRAP

A sure way to deal with the flight department company trap would be to eliminate it. NBAA and other industry groups have tried to do this for years, but the FAA has consistently and steadfastly defended their position.

Perhaps the FAA would consider some limited exemptions. Here are two logical possibilities. First (to borrow a phrase from the IRS), the flight department company could be treated as a "disregarded entity." This would permit FAR Part 91 operations by a flight department company (i.e., a true flight department company that has no other business besides air transportation) that is a wholly owned subsidiary (such as a single-member LLC) of a person who could operate the aircraft him- or herself. From a safety standpoint, it has hard to see the difference between Madame X operating the aircraft and Madame X's wholly owned LLC doing so. Put differently, the FAA would be disregarding the existence of the LLC. The proposed exemption would be limited to a single owner to avoid the possibility of disguised charter flights where more than one owner is involved.

A second proposed exemption would modify the "affiliated group" provision of FAR 91.501(b)(5) to permit a subsidiary to operate flights for other members of the corporate group regardless of whether it is a flight department company. There is no apparent safety rationale to force a parent company to move businesses and operations to a flight department subsidiary simply to permit the subsidiary to operate under FAR Part 91.

It is to be hoped that these and other possible exemptions may someday appeal to the FAA to reduce the impact of the flight department company trap.

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