Personal Use of the Company Aircraft: IRS vs. FAA vs. SEC

By James E. Cooling
Cooling & Herbers, P.C.

With public companies falling under the investigative microscope of the Securities and Exchange Commission ("SEC") and other investor protection groups, and with increased responsibility for CEOs and CFOs for the contents of reports to investors under the Sarbanes-Oxley Act of 2002, executives and directors are looking more closely at the reporting methods of their companies. One of the more common items of investigation and interest is full disclosure (or in some cases lack of disclosure) of top executive compensation including "perks." "Perks" may include executives' and directors' personal use of company aircraft.

IRS Issues

From an employee compensation standpoint, when an employee of a company, including the CEO or other executive officer or director, utilizes a company aircraft for personal travel, the flight is considered by the IRS to be a fringe benefit and, under Treasury Regulation 1.61-21, the employee must either reimburse the company for the value of the flight or the value must be included in the employee's gross income. The value of the flight is determined either using the Standard Industry Fare Level ("SIFL") rate or the fair market value rate (generally, the charter rate) for use of that type of aircraft. Most companies and employees use the SIFL rate because it is more favorable to the employee than the charter rate.

IRC Section 162 generally allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business expenses, including a reasonable allowance for salaries or other compensation for personal services actually rendered. IRC Section 274(a) generally disallows any deduction involving an entertainment, amusement or recreation activity, or a facility used in connection with such an activity.

The American Jobs Creation Act of 2004 amended IRC Section 274(e) to limit deductions for aircraft expenses for use of a business aircraft by a "specified individual" (generally, an officer, director, or more-than-10% owner) for an activity generally considered to be entertainment, amusement or recreation to the amount that is treated properly as compensation to (or reimbursed by) the officer, director or owner. This legislation "overrules" with respect to specified individuals the holding in *Sutherland Lumber-Southwest Inc. v. Comm.*, 255 F.3d 495, (8th Cir. 2001) affirming 114 T.C. No. 14, 2000 WL 31132 (U.S. Tax Ct.), which allowed the full amount of deductions for operating vacation, entertainment or recreation flights as long as the appropriate amount (generally SIFL) was included in the employees' income.

In August 2012, the IRS issued final regulations relating to the disallowance under IRC Section 274 of deductions for the use of business aircraft for entertainment. Aircraft expenses subject to disallowance under the new regulations include all fixed and operating costs, including depreciation. Cost per occupied seat hour (or mile) is determined by calculating occupied seat hours (or miles) of all passengers for all trips during the year, allocating deadhead hours in accordance with the passenger-carrying flights they support, and dividing total occupied seat hours (or miles) into the total annual expenses. The cost of occupied seat hours (or miles) flown by a specified individual (or the family member or guest of a specified individual) for entertainment purposes, less compensation and reimbursement for such use, yields the disallowed amount under amended IRC Section 274.

For employees and owners who are not "specified individuals," entertainment use of the company aircraft treated properly as compensation to the employee or owner will still be fully deductible as business use.

FAA Issues

Employees may prefer to avoid the imputed income or increase the company's deduction for entertainment use of an aircraft by reimbursing the company for personal use of the company aircraft. However, most company aircraft operate under the noncommercial rules of Part 91 of the Federal Aviation Regulations ("FARs"). Under such rules, the company may not be able to accept reimbursement for the value of the flight unless the flight is operated under a time sharing agreement as defined in FAR 91.501(c)(1). A time sharing agreement has drawbacks, which include the general requirement of a written agreement with notification to the FAA, the limit on compensation to the items enumerated in FAR 91.501(d), and application of Federal Excise Tax on transportation of persons by air. In order to comply with both IRS and FAA rules, many companies impute income to their employees for the employees' personal flights, and suffer the related expense disallowance.

SEC Issues

Providing a company aircraft to an executive officer or director for his or her personal use may also require disclosure under federal securities law for publicly held companies. Securities and Exchange Commission ("SEC") Regulation S-K provides the basis for disclosures by reporting companies in the non-financial statement portions of certain registration statements, annual and other reports, proxy statements, and other statements and documents required to be filed under the Exchange Act.

On November 7, 2006, the SEC issued final rules regarding executive compensation and related party disclosure. The rules made substantial changes to previous disclosure requirements including the addition of a compensation discussion and analysis section as well as a director's compensation table. Some of Regulation S-K's requirements are discussed below.

1. Compensation

Item 402(a)(2) of Regulation S-K deals with the disclosure of executive compensation and requires "clear, concise and understandable" disclosure of all compensation of a company's named executive officers. Named executive officers include the chief executive officer ("CEO") or person acting in that capacity during the last completed fiscal year, the company's chief financial officer ("CFO") or person acting in that capacity during the last completed fiscal year, the three most highly compensated executive officers other than the CEO and CFO who were serving as executive officers at the end of the last completed fiscal year, and up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year.

Under Item 402(c)(3) of Regulation S-K, in addition to cash payments such as salary and bonus, the dollar value of "other compensation" is to be reported. Perquisites and other personal benefits are considered "other compensation." The rules require that, unless the aggregate value of perquisites and personal benefits is less than $10,000, any perquisite or other personal benefit must be identified and, if it is valued at the greater of $25,000 or ten percent of total perquisites and other personal benefits, its value must be disclosed. Such disclosures are required for named executive officers and directors.

The Regulation further states that "perquisites and other personal benefits shall be valued on the basis of the aggregate incremental cost to the registrant and its subsidiaries." In a 1983 Release, the SEC commented on a prior version of this provision by stating that the primary focus is disclosure of the cost of management to the company.

Personal use of the company aircraft by an executive is considered a perquisite within the category of "other compensation."[1] The "aggregate incremental cost" to the company of an executive's or director's personal flights is used to determine the dollar amount for reporting purposes.

Advice from the SEC is that "aggregate incremental cost" means the cost to the company of the personal flights, not the value of the benefit to the executive. On October 20, 2004, Alan L. Beller, Director, Division of Corporation Finance at the SEC gave a speech before the Conference of the National Association of Stock Plan Professionals (NASPP), the Corporate Counsel and the Corporate Executive. In his speech, Mr. Beller specifically addressed personal use of company planes. "The appropriate measure of value is the aggregate incremental cost to the company, not the tax value of the benefit," he stated.[2] The SEC reiterated this position in its comments to the 2006 rules.

For SEC reporting purposes, many companies use direct operating costs to value the flights made for an executive's personal purposes. Such companies generally obtain direct operating costs figures from their own experience in operating the aircraft, the aircraft manufacturer, or a reputable aviation industry source. On the issue of whether deadhead flights (repositioning flights) should be included in calculating aggregate incremental costs, a September 2006 speech by SEC Corporate Finance Chief John W. White indicated that there is no bright line rule

[1] SEC-issued interpretive guidance provides a two-step analysis to determine whether an item is a perquisite or other personal benefit: An item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties. Otherwise, an item is a perquisite or personal benefit if it confers a direct or indirect benefit that has a personal aspect, without regard to whether it may be provided for some business reason or for the convenience of the company, unless it is generally available on a non-discriminatory basis to all employees.

[2] Mr. Beller also commented that "simply stating that company executives must always fly in company planes . . . for security reasons does not relieve a company from considering whether these benefits are perks." He suggested that, in order to determine whether something is a "perquisite," a term that is not defined in the SEC rules, it may be useful to ask whether it is an expense that is available to employees generally on a non-discretionary basis like reimbursement for the taxi across town for a meeting (presumably not a perquisite), or whether it is a benefit for which only a chosen few are eligible or selected on a discretionary basis (more likely to be a perquisite). The SEC reiterates this position and discusses it further in its comments to the 2006 rules.

regarding such deadhead flights and that reasonable people could disagree on the answer. White did, however, indicate that a company should look at the goal of the disclosures and, in his opinion, include deadhead flights if such legs cause a company to incur incremental costs. Most companies do include deadhead flights related to personal use in their incremental cost calculations. However, a company might counter that deadhead flights are often, by their nature, short positioning flights; thus, the incremental cost of such flights is de minimis. In addition, other out of pocket costs specific to the flight, such as catering and landing fees, should be included in "aggregate incremental cost."

2. Other Compensation Arrangements

Item 402(k) of Regulation S-K requires the reporting company to describe any arrangements for compensation of directors, stating the amount paid and name of the director, and providing the material terms of such arrangements. The rules require a compensation table for directors similar to that required for named executives. Item 402(e) of Regulation S-K requires disclosure of the terms and conditions of any employment contract between the company and a named executive officer and certain termination of employment or change-in-control arrangements with respect to a named executive officer. Arrangements to provide a director or executive personal use of the company aircraft may trigger disclosures under these items.

3. Related Party Transactions

Item 404(a) of Regulation S-K requires disclosure of any transactions involving over $120,000 in which the company is a party where a direct or indirect material interest is held by any director or executive officer of the registrant, any nominee for election as director, any security holder of more than 5% and any member of the immediate family of the foregoing persons. A similar provision in Item 404(b) of Regulation S-K requires disclosure of certain business relationships between the company and a director or nominee's other business entities. A company should examine its use of any time sharing agreements, leases or other arrangements for executive or director personal use of the company aircraft (or company use of the individual's aircraft) to determine whether related party reporting is required.

SEC Enforcement

Several cases have resulted from SEC enforcement relating to disclosure of an executive's personal use of the company aircraft. The first is In the Matter of General Electric Company, Administrative Proceeding File No. 3-11677 (September 23, 2004). In this matter, the SEC found that the company, with the approval of its board of directors, and its CEO executed an employment and post-retirement consulting agreement that, regarding non-monetary benefits, provided to the CEO "… for the remainder of his life, continued access to Company facilities and services comparable to those provided to him prior to his retirement, including access to Company aircraft, cars, office, apartments, and financial planning services." The CEO retired in 2001. In his first year of retirement, he received approximately $2.5 million in benefits under the agreement, including among other benefits, access to company aircraft for unlimited personal use and for business travel. Approximately $1.2 million of the total cost of the benefits was attributable to the retired CEO's use of company aircraft. However, the company's 1997 proxy statement, and its statements and reports through 2002, did not describe or disclose the benefits the CEO would receive in retirement, stating instead "… the Board agreed … to provide him continued lifetime access to Company facilities and services comparable to those which are currently made available to him by the Company."

The SEC found that as a result of the conduct described above, the company violated the proxy solicitation and periodic reporting provisions of the Exchange Act by filing with the Commission annual reports and proxy statements that failed to fully and accurately disclose the "facilities and services" the CEO would receive in retirement. The company agreed to a cease and desist order with respect to the violations, and the Commission imposed no other sanctions.

In the Matter of Tyson Foods, Inc. and Donald Tyson, SEC Litigation Release No. 19208 (April 28, 2005), the company and its former executive agreed to pay penalties of $1.5 million and $700,000, respectively, and to enter into a cease and desist order, to settle enforcement proceeding arising out of allegedly misleading disclosures of perquisites and personal benefits provided to Donald Tyson both prior to and after his retirement as senior chairman in October 2001. The perks included $426,086 of personal use of company-owned aircraft by Mr. Tyson and his family and friends, including regular use by his family and friends when Mr. Tyson was not on board the aircraft.

In an earlier case, the SEC, In the Matter of W.R. Grace & Co., Administrative Proceeding File No. 3-9460 (1997) issued an Order and a related Report of Investigation pertaining to the company's failure to fully disclose retirement benefits, including the use of company aircraft for personal and business travel. Although the company and the executive entered into the benefits package in 1992, and the executive used the benefits in 1992, the value of such "other compensation" was not disclosed until 1995. The 1995 proxy statement indicated that approximately $2,700,000 in "other compensation" was attributable to the retired executive's access to the company aircraft.

The corporate officers and directors who were familiar with the "other compensation" to the executive, but who failed to challenge the lack of disclosure in the 10-K report or the proxy statement, were strongly criticized by the SEC for their lack of action. The company agreed to a cease and desist order, and no sanctions were entered against the individuals, although the SEC did find their behavior to be in violation of the Exchange Act.

The Commission noted in its Report of Investigation that "the Commission is issuing this Report of Investigation to emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the Federal securities laws. Officers and directors who review, approve or sign their company's proxy statements or periodic reports must take steps to ensure the accuracy and completeness of the statements contained therein, especially as they concern those matters within their particular knowledge or expertise. To fulfill this responsibility, officers and directors must be vigilant in exercising their authority throughout the disclosure process."

The SEC has also issued an order regarding related party transactions disclosure of a company's arrangement to pay a director's corporation for the director's use of the corporation's aircraft on company business. In the Matter of The Walt Disney Company, Administrative Proceeding File No. 3-11777 (December 20, 2004), the SEC found the company, with the approval of its president, maintained a business relationship with a corporation owned by a director/officer of the company, to pay the corporation "fixed hourly amounts plus expenses" when the director used his corporation's planes for company business. These payments exceeded the $60,000 threshold of Item 404. The company's 2001 proxy statement, its 10-K and 10-K/A did not disclose this relationship.

The SEC found that this omission, along with others unrelated to aircraft, violated Sections 13(a) and 14(a) of the Exchange Act, and the rules thereunder. As in the other cases described above, the company agreed to a cease and desist order, and the Commission imposed no other sanctions.

In its order, the SEC commented that the intent of the related party disclosure rule is to "enhance the information available to investors concerning the extent to which these persons are directly or indirectly benefiting from relationships" with the company. The SEC then cited a 1982 Release, stating "The rule is intended to provide information about transactions and relationships that are important to both investment and voting decisions."

In addition to SEC enforcement actions, publicly traded companies have been the target of shareholder derivative actions for alleged improper disclosure of executive and director personal use of corporate aircraft. In May 2012, a shareholder of Chesapeake Energy Corp. filed a derivative lawsuit in Oklahoma state court against the company alleging that the company's board of directors had misstated the cost of personal use of company aircraft in its proxy statements by (1) failing to disclose subordinate officers' personal use of the aircraft, (2) mischaracterizing their own personal flights on the company aircraft as business flights, and (3) failing to disclose the large fixed costs associated with use of company aircraft. *Norris v. Chesapeake Energy Corp.*, case no. CJ-2012-2751, District Court of Oklahoma County, Oklahoma, November 29, 2012. The company argued that the SEC does not require compensation disclosure beyond the named executive officers listed in regulation S-K and that the SEC has consistently and expressly declined to expand the scope of disclosure beyond those officers. *Id.* As to shareholder's argument that the directors had mischaracterized as "business" the costs of their own flights while traveling to and from board meetings, the company noted that directors are not employees commuting to work from home, and that such travel is directly and integrally related to the performance of their duties as directors. *Id*. Even if the directors realized an incidental personal benefit by using the corporate aircraft, the primary purpose of the flight was to accomplish a business benefit for the company and thus the flights were business flights. Finally, the company noted that Regulation S-K requires disclosure of the aggregate incremental costs of personal use of company aircraft, not actual costs as the shareholder had asserted. *Id.* Indeed, none of the authorities cited by the shareholder required the disclosure of fixed costs where the company-owned aircraft were primarily used for business travel. The court agreed with the company and dismissed the shareholder's claims as futile. *Id*.

The Sarbanes-Oxley Act of 2002

The corporate scandals of the early 2000s gave rise to the Sarbanes-Oxley Act of 2002, which includes provisions increasing responsibility for CEOs and Chief Financial Officers for the contents of SEC filings, prohibits personal loans to executives, requires a Code of Ethics for senior financial officers, requires that members of the board of directors' audit committee be independent, increases responsibility for attorneys for the reporting of suspected violations, and impose stiffer penalties for noncompliance with Federal securities law. If an executive or the company desires that the executive reimburse the company for the costs of personal flights on the company aircraft, the executive and company should determine whether the timing, amount of reimbursement, amount of use or manner of use of the aircraft violates the personal loan prohibition of the Act. Another effect of the Act may be to prohibit personal use of the company aircraft by audit committee members, who are required to be independent.

NYSE and NASD (NASDAQ) Rules

The New York Stock Exchange ("NYSE") and National Association of Securities Dealers ("NASD"), which oversees NASDAQ, have adopted rules regarding executive compensation and related party transactions. Both organizations require a majority of listed company directors to be independent, and both organizations require the nominating and audit committees to be independent and perform certain duties, with significant differences between the requirements of the NYSE and NASD. The NYSE provides corporate governance guidelines. Both organizations regulate related party transactions, although with significant differences. The NYSE also requires that each listed company provide a certificate of compliance with exchange rules. NASD requires notification of noncompliance with rules. The intended effect of the rules is to increase scrutiny of executive compensation matters and transactions between the company and its executives and directors.

Conclusion

The provisions of the company bylaws regarding executive compensation and state laws regarding fiduciary duty to the company and board approval for interested party transactions and other actions may also affect personal use of the company aircraft. Two former executives of a Midwestern energy company were the subject of criminal prosecution and conviction on theories including fraud and conspiracy, in part due to alleged failure to report as compensation.

Each federal agency and governing authority treats personal use of the company aircraft differently. Company flight departments or management personnel should be aware of the different requirements, their companies' use of the aircraft and arrangements and policies relating to such use, as well as the companies' reporting method for such use, in order to assist in the compliance with the rules.

James E. Cooling is a partner with the law firm of Cooling & Herbers, P.C. in Kansas City, Missouri. The firm represents aircraft owners and operators in aircraft transactions and tax and regulatory compliance. A graduate of the University of Notre Dame Law School, Mr. Cooling is a pilot, aircraft owner, and former member of the NBAA Board of Directors.