

TAXING THE CEO'S JET:
FEDERAL TAXATION OF
CORPORATE AND PRIVATE AIRCRAFT
OWNERSHIP AND OPERATIONS

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I. INTRODUCTION

Over more than a half-century since the end of World War II, many men and women in the business world have discovered that general aviation aircraft can be remarkably effective business tools. The industry has seen explosive growth in the decade of the 1990's. The growth

has been fueled by a strong economy and in no small part by the advent of fractional aircraft ownership programs and other aircraft ownership and joint-use options that reduce the costs of entry into the world of business aviation. As the industry moves into the 21st century, growth in new and used aircraft sales continues at a spectacular pace. The growth in the industry can be expected to continue as more and more people and businesses discover the advantages of business aircraft ownership.

The world of business aviation can, however, be an extremely confusing place for business executives and their accountants and legal advisors. Aviation is one of the most highly regulated industries in the United States today, and many federal, state, local, and airport entities have a hand in the regulation of the industry. Of these, perhaps no agency plays a greater role than the Federal Aviation Administration.² One quickly learns upon entering the business aviation industry that the regulations promulgated by the FAA that affect business aviation are chock-full of traps for the unwary.³ It is absolutely essential that anyone contemplating entry into the world of business aviation seek the advice of professionals who have a thorough understanding of the business aviation industry and the applicable Federal Aviation Regulations.⁴ All too often, those who fail to do so find out too late that their aircraft operations have been conducted in violation of some technical regulation. The consequences of such violations can be devastating.

Proper planning for business aircraft operations does not end with the successful navigation of the minefield of the Federal Aviation Regulations, however. As is the case with any high-value business asset, proper tax planning is required to ensure that operations are conducted in the most economical and tax-efficient manner possible. In many instances, the best planning solutions for corporate aircraft ownership and operations from a regulatory or corporate law point of view can have serious, adverse tax consequences. Similarly, in some situations the most efficient aircraft operations structure from a tax and business planning perspective may violate the Federal Aviation Regulations. The practical importance of sophisticated tax planning is becoming ever more important as the Internal Revenue Service⁵ trains its agents through its Market Segment Specialization Program to apply the tax laws affecting business aviation in a manner that will maximize tax revenues to the greatest extent possible. Consequently, in choosing a business aviation consultant or advisor, the wise executive will seek someone who not only possesses a thorough understanding of the business aviation industry and the applicable

² Hereinafter "FAA".

³ For a comprehensive discussion of the regulations promulgated by the FAA that affect business aviation, *see generally*, Eileen M. Gleimer, *Corporate Aircraft Operations: The Twilight Zone of Regulation*, 62 J. AIR L. & COM. 987 (1997).

⁴ The Aeronautics Regulations of the United States, 14 C.F.R. Parts 1 to 399, are commonly, and herein, referred to as the "Federal Aviation Regulations" or the "FARs".

⁵ Hereinafter "IRS".

Federal Aviation Regulations, but also an equally thorough understanding of the tax statutes and regulations affecting business aviation.

The purpose of this article is to address in a single document only those issues that arise in tax planning for business aircraft operations, but that do not necessarily arise in other contexts. This document is not intended to be a comprehensive expose on all tax issues that must be considered in planning for corporate aircraft acquisitions and operations, and it is assumed that the reader already has a thorough knowledge of general principles of federal tax law but may not necessarily have a great deal of knowledge of those tax laws that are targeted specifically at the aviation industry. Thus, many concepts that are in fact very important to efficient tax planning for business aviation operations, but are not specific to business aviation, are not discussed. A few examples of such concepts include tax-free exchanges under I.R.C. § 1031, passive activity loss rules, the at-risk rules, and the check-the-box regulations applicable to limited liability companies; while such rules and regulations absolutely must be considered in order to properly plan for business aircraft operations, they are not targeted at business aviation specifically and are therefore outside the scope of this article.

II: INCOME TAX CONSEQUENCES TO THE CORPORATION

A. DEPRECIATION

1. Tax Depreciation of Corporate Aircraft: Generally

Many aircraft owned and operated by businesses today are depreciable for income tax purposes under the Modified Accelerated Cost Recovery System.⁶ The MACRS statute is often considered to be very pro-taxpayer because it permits taxpayers with depreciable assets to accelerate the tax depreciation of the assets by claiming a greater percentage of the depreciation deductions attributable to the assets during the first few years of the applicable recovery period than would result using a straight-line depreciation method. Of course, the tradeoff is that less depreciation will be available to offset income in later years.

In some cases, aircraft are depreciable for income tax purposes, but do not qualify for accelerated depreciation under the MACRS system. In such cases, the aircraft must be depreciated under the generally less favorable Alternative Depreciation System.⁷ Depreciation under ADS is based on a straight-line method and thus results in equal depreciation deductions each year during the applicable recovery period. Recovery periods under the ADS system tend to be longer than recovery periods under MACRS for the same property.

Whether or not a taxpayer may depreciate an aircraft, and if so, the appropriate depreciation method and recovery period to be used, depends on several factors. Chief among

⁶ See, generally, I.R.C. § 168(b). Hereinafter "MACRS".

⁷ See, generally, I.R.C. § 168(g). Hereinafter "ADS".

these are the category of aircraft (e.g., airplane or helicopter), and the type of use to which the aircraft is put (e.g., personal, business, or commercial). Based on these factors, all aircraft may be placed in one of the following asset classes:

a. Aircraft, other than helicopters, used in commercial or contract carrying of passengers and freight by air. Aircraft in this category generally may be depreciated under MACRS over a recovery period of seven years, or under ADS over a recovery period of twelve years.⁸

b. Aircraft used for qualified business purposes or for the production of income, and helicopters used in commercial or contract carrying of passengers and freight by air. Aircraft in this category are listed property⁹ and generally may be depreciated under MACRS over a recovery period of five years, or under ADS over a recovery period of six years.¹⁰

c. Aircraft held as inventory or stock in trade, and aircraft used for purposes not constituting either qualified business use, use for the production of income, or use in the commercial or contract carrying of passengers or freight. Aircraft in this category generally may not be depreciated.

2. Qualified Business Uses

As a general rule, a qualified business use is any use in a trade or business for which a deduction would be allowed under I.R.C. § 162.¹¹ I.R.C. § 162 is the statutory provision that defines deductible trade or business expenses. Certain uses of an aircraft by a business entity that arguably may be considered qualified business uses will nevertheless not qualify as qualified business uses under certain circumstances. Specifically, any use of a business-owned aircraft falling within any one of the following three categories will not be treated as a qualified business use for depreciation purposes unless all qualified business uses, excluding any use falling within one of the three categories, comprises at least 25% of the total utilization of the aircraft during the applicable taxable year:

a. The leasing of the aircraft to any person who owns 5% or more of the company, or to any person who is related (within the meaning of I.R.C. § 267(b)) to a person who owns 5% or more of the company.¹²

b. Use of the aircraft to provide compensation to any person who owns 5% or more of the company, or to any person who is related (within the meaning of I.R.C. § 267(b)) to a person who owns 5% or more of the company.¹³

⁸ Asset Class 45.0. Rev. Proc. 87-56, 1987-2 CB 671.

⁹ I.R.C. § 280F(d)(4)(A)(ii).

¹⁰ Asset Class 00.21. Rev. Proc. 87-56, 1987-2 CB 671.

¹¹ Treas. Reg. § 1.280F-6T(d)(2)(i).

¹² I.R.C. § 280F(d)(6)(C)(i)(I).

¹³ I.R.C. § 280F(d)(6)(C)(i)(II).

c. Use of the aircraft to provide compensation to any other person unless an amount is included in the gross income of such person with respect to such use of the aircraft, and any required income tax was withheld.¹⁴

Example: During taxable year 2001, ABC Corporation used its corporate aircraft 40% of the time for qualified business purposes other than those listed in I.R.C. § 280F(d)(6)(C)(i), and 60% of the time for a purpose specified in I.R.C. § 280F(d)(6)(C)(i)(II), which use specifically constituted the provision of personal, nonbusiness-related transportation to various employees of ABC Corporation, each of whom owned 5% or more of the stock of ABC Corporation. ABC Corporation imputed income to the employees using the Noncommercial Flight Valuation Rule¹⁵ for all personal, nonbusiness-related use of the aircraft.

Because ABC Corporation imputed income to the employees using the Noncommercial Flight Valuation Rule for all personal, nonbusiness-related use of the aircraft, such use constituted use of the aircraft to provide compensation to employees, and the expenses incurred by ABC Corporation to provide such compensation should, therefore, be deductible under I.R.C. §162 as a qualified business use of the aircraft *vis-a-vis* ABC Corporation. However, because the employees to whom income was imputed were persons who each owned 5% or more of the stock of ABC Corporation, I.R.C. § 280F(d)(6)(C)(i)(II) provides that personal, nonbusiness-related use of the aircraft by such persons will constitute a qualified business use only if the 25% test of I.R.C. § 280F(d)(6)(C)(ii) is satisfied.

In this case, the 25% test of I.R.C. § 280F(d)(6)(C)(ii) is indeed satisfied because the aircraft was used 40% of the time for qualified business purposes other than those listed in I.R.C. § 280F(d)(6)(C)(i). Consequently, the use of the aircraft 60% of the time to provide transportation to employees who each owned 5% or more of the stock of ABC Corporation, for the personal, nonbusiness-related purposes of the employees, also constitutes qualified business use. Hence, the aircraft is considered to be used 100% of the time for qualified business purposes.

3. *Mixed Qualified Business Use and Commercial Use: The Primary Use Test*

Many companies that own and operate business aircraft to support the transportation needs of their own non-aviation business interests attempt to offset some of the costs of owning and operating the aircraft by holding the aircraft out, either to the public or to a few select clients, as being available for charter at times when the aircraft is not otherwise being utilized by the

¹⁴ I.R.C. § 280F(d)(6)(C)(i)(III).

¹⁵ Discussed at IV.B.3, below.

owner. Such cross utilization of aircraft can affect the asset class, and hence the depreciation schedule, applicable to the aircraft.

As discussed above, aircraft, other than helicopters, used in commercial or contract carrying of passengers and freight by air generally may be depreciated under MACRS over a recovery period of seven years,¹⁶ and aircraft used for qualified business purposes or for the production of income and helicopters used in commercial or contract carrying of passengers and freight by air generally may be depreciated under MACRS over a recovery period of five years.¹⁷ Consequently, when an aircraft, other than a helicopter, is used part of the time in commercial or contract carrying of passengers and freight by air, and part of the time for other qualified business purposes or for the production of income, questions concerning the appropriate MACRS recovery period are likely to arise.

Treasury regulations specify that when property is used for different purposes at various times in such a manner that the property could potentially be classified into more than one asset class, the property shall be included in the asset class for the activity in which the property is primarily used.¹⁸ Property is to be classified according to the primary use to which the property is put, even though the activity in which the property is used is insubstantial in relation to all of the activities of the taxpayer.¹⁹ In addition, the asset class of an aircraft that is subject to a lease is determined as if the aircraft were owned by the lessee.²⁰

Although not further defined in the regulations, the "primarily used" standard appears to suggest that an aircraft other than a helicopter will be depreciated under MACRS over a seven year recovery period if the proportion of the time it is used in commercial or contract carrying of passengers and freight by air exceeds the proportion of time that it is used for other qualified business purposes or for the production of income, and conversely that the same aircraft will be depreciated under MACRS over a five year recovery period if the proportion of the time it is used for other qualified business purposes or for the production of income exceeds the proportion of time that it is used in commercial or contract carrying of passengers and freight by air. The regulations do not specify a method (e.g., total flights, total flight hours, total days of use) of measuring various types of use.

For purposes of determining the appropriate asset class for a mixed-use aircraft, it is only necessary to determine the primary use of the aircraft during the first taxable year during which the aircraft is in service. Treasury regulations provide that no change in the classification of

¹⁶ Asset Class 45.0. Rev. Proc. 87-56, 1987-2 CB 671.

¹⁷ Asset Class 00.21. Rev. Proc. 87-56, 1987-2 CB 671.

¹⁸ Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b).

¹⁹ *Id.* See *True v. U.S.*, 97-2 USTC ¶50,946 (D.Wyo. 1997), *aff'd, rev'd and remanded*, 99-2 USTC ¶50,872 (10th Cir. 1999)

²⁰ Treas. Reg. § 1.167(a)-11(e)(3)(iii).

property shall be made because of a change in the primary use of the property after the taxable year in which the property was first placed in service.²¹

4. Effect of Personal, Nonbusiness Use on Depreciation: The Predominant Business Use Test

If an aircraft is used during a taxable year part of the time for qualified business purposes, for the production of income, and/or in the commercial or contract carrying of passengers and freight by air (collectively "Depreciable Uses"), and part of the time for personal, nonbusiness purposes (collectively "Personal Uses"), the depreciation deduction allowable for the taxable year will be limited to a fraction of the depreciation deduction that would have been allowed for the taxable year had the aircraft been used solely for Depreciable Uses. The allowable depreciation deduction for such taxable year will be the fraction of the otherwise allowable deduction that bears the same ratio as the Depreciable Uses of the aircraft during the taxable year bears to all the use of the aircraft during the taxable year. The depreciable basis of the aircraft will nevertheless be reduced by the entire amount of depreciation that would have been allowed had all the use of the aircraft during the year constituted Depreciable Use, with the result that the portion of the depreciation deduction that is disallowed in a given taxable year as a result of Personal Use may not be deducted in any subsequent year and is therefore lost forever.²²

In addition, whether the depreciable portion of the aircraft may be depreciated under MACRS, or will be required to be depreciated under the generally less favorable ADS will depend on whether the Depreciable Use or the Personal Use of the aircraft predominates. If more than 50% of the use of the aircraft during each taxable year constitutes Depreciable Use, the Predominant Business Use Test is satisfied and the depreciable portion of the cost basis of the aircraft generally may be depreciated under MACRS.²³ However, if 50% or less of the use of the aircraft during each taxable year constitutes Depreciable Use, the Predominant Business Use Test is not satisfied.²⁴ In such event, the aircraft generally may still be depreciated to the extent of the Depreciable Use, but that portion of the basis of the aircraft that may be depreciated must be depreciated using the straight line ADS system.²⁵

Example: John and Jane Doe, husband and wife, own and operate in commercial service a private jet aircraft with an original depreciable basis of \$12,000,000, and a \$500,000 depreciable basis remaining in the seventh year of a seven-year recovery period after taking into account \$11,500,000 in aggregate depreciation deductions in prior taxable years. During all prior taxable years, the aircraft was used exclusively in commercial service. However, during the seventh taxable

²¹ Treas. Reg. § 1.167(a)-11(b)(4)(iii)(b).

²² I.R.C. § 280F(d)(2).

²³ I.R.C. § 280F(b)(3).

²⁴ *Id.*

²⁵ I.R.C. § 280F(b)(1).

year of the recovery period, Mr. and Ms. Doe used their aircraft 75% of the time in commercial service, and 25% for Personal Uses. (Ignore Half-Year and Mid-Quarter Conventions).

Mr. and Ms. Doe would have been entitled to a \$500,000 depreciation deduction under MACRS for the taxable year if they had used the aircraft solely for Business Uses during the taxable year. However, because they used their aircraft only 75% of the time during the taxable year for Business Uses, they are only entitled to a \$375,000 (75% of \$500,000) depreciation deduction under MACRS for the taxable year. Their depreciable basis in the aircraft is nevertheless reduced by the entire \$500,000 deduction that would have been allowed if 100% of the aircraft use during the taxable year had constituted Business Use. Consequently, their depreciable basis is reduced to zero, and the \$125,000 (25% of \$500,000) disallowed portion of the depreciation deduction is lost forever.

The Predominant Business Use Test must be met during every taxable year that the aircraft is in service.²⁶ The consequences of failing the Predominant Business Use Test in even a single taxable year can be severe. If the Predominant Business Use Test is failed during any taxable year that the aircraft is in service, the aircraft must be depreciated under the ADS system during such taxable year and all subsequent taxable years.²⁷ In addition, if the aircraft had been depreciated under MACRS during any prior taxable year, the taxpayer must recapture prior depreciation to the extent that depreciation deductions taken during prior years exceed the deductions that would have been allowed under the ADS system.²⁸ In other words, the allowable depreciation must be recalculated retroactively to the date the aircraft was first placed in service, and any excess depreciation in prior years resulting from the recalculation must be recaptured and taken into income in the first taxable year in which the Predominant Business Use Test was not satisfied.

Example: Same as the previous example, except that during the seventh taxable year of the seven-year recovery period, Mr. and Ms. Doe used their aircraft 40% of the time in commercial service, and 60% for Personal Uses.

Because Mr. and Ms. Doe failed the Predominant Business Use Test during the taxable year, the aircraft no longer qualifies for accelerated depreciation under MACRS over a seven year recovery period, and the allowable depreciation must be recalculated retroactively under the ADS system over a recovery period of twelve years. Under the straight-line ADS system, the maximum depreciation allowance permitted in each year of the twelve-year recovery period is \$1,000,000 (\$12,000,000 original depreciable basis divided by 12). Mr. and Ms. Doe are

²⁶ *Id.*

²⁷ *Id.*

²⁸ I.R.C. § 280F(b)(2).

only entitled to \$6,000,000 in depreciation deductions for taxable years 1 through 6, and must therefore recapture \$5,500,000 (\$11,500,000 minus \$6,000,000) in excess depreciation deductions actually taken during those years. The \$5,500,000 is recaptured in taxable year 7 (i.e., the first year in which the Predominant Business Use Test was not satisfied). In addition, Mr. and Ms. Doe are entitled to a \$400,000 (40% of \$1,000,000) deduction in taxable year 7 representing the depreciation deduction allowable for the taxable year. However, their depreciable basis in the aircraft is nevertheless reduced by the entire \$1,000,000 deduction that would have been allowed under ADS if 100% of the aircraft use during the taxable year had constituted Business Use. Consequently, their depreciable basis is reduced to \$5,000,000 (\$12,000,000 original depreciable basis minus \$6,400,000 in depreciation deductions for taxable years 1 through 7, minus \$600,000 depreciation deduction disallowed in taxable year 7), and the \$600,000 (60% of \$1,000,000) portion of the depreciation deduction disallowed in taxable year 7 is lost forever.

5. Aircraft Predominantly Used Outside the United States

If an aircraft is used predominantly outside the United States during a taxable year, the aircraft owner will not be entitled to a depreciation deduction under the MACRS methodology for that taxable year, but rather must determine a depreciation deduction for the aircraft under the ADS methodology.²⁹

An aircraft will not be deemed to be used predominantly outside the United States if either of the following two tests is met.

a. Simple Arithmetic Test

The first test involves merely comparing the number of days during the applicable taxable year that the aircraft is physically present within the United States against the number of days the aircraft is physically outside the United States. If the number of days the aircraft is inside the United States exceeds the number of days the aircraft is outside the United States, the aircraft will not be deemed to be used predominantly outside the United States.³⁰

b. "Some Degree of Frequency" Test

If the aircraft fails the simple arithmetic test because it is outside the United States more days than it is inside the United States, it still may not be deemed to be used predominantly outside the United States if it is operated to and from the United States "with some degree of frequency" on a scheduled or unscheduled basis.³¹

²⁹ I.R.C. § 168(g)(1)(A).

³⁰ Prop. Treas. Reg. § 1.168-2(g)(5)(i).

³¹ Prop. Treas. Reg. § 1.168-2(g)(5)(iii)(A).

The question as to precisely what constitutes "some degree of frequency" has never been fully answered. The IRS held in Rev. Rul. 73-367³² that a commercial airline met the "some degree of frequency" standard with respect to an aircraft operated on a regular schedule that included a single stop in the United States approximately once every two weeks. Subsequent private letter rulings have cited Rev. Rul. 73-367 for the proposition that an aircraft making one flight to the United States approximately every two weeks is sufficient to meet the standard.³³ However, those letter rulings addressed scheduled commercial airline operations, and consequently, how those letter rulings would apply in the context of unscheduled operations of business aircraft is unknown.

B. MAINTENANCE AND REPAIR COSTS: DEDUCT OR CAPITALIZE?

1. *The Debate Over Deductibility of Engine Major Inspections*

Among the more vigorously debated tax issues in the aviation industry today is the tax treatment of expenses incurred in connection with engine major inspections. Expenses incurred in connection with maintenance and incidental repairs of an aircraft used in a trade or business generally are deductible in the taxable year in which they are paid or accrued as ordinary and necessary business expenses.³⁴ This is true notwithstanding the fact that a particular repair or maintenance item may provide benefits beyond the year in which the maintenance or repair was performed.³⁵ However, expenses incurred in connection with maintenance or repairs that materially add to the value of the aircraft, or that arrest deterioration and appreciably prolong the useful life of the aircraft, must be capitalized under I.R.C. § 263 and depreciated over time.³⁶ With the foregoing in mind, an analysis of the proper tax treatment requires an analysis of the issue of whether expenses incurred in connection with an engine major inspection materially add to the value of the aircraft, or arrest deterioration and appreciably prolong the useful life of the aircraft.

The IRS addressed the tax treatment of expenses incurred in connection with engine major inspections in Technical Advice Memorandum 9618004³⁷ and determined that such

³² 1973-2 C.B. 8.

³³ See, e.g., Priv. Ltr. Rul. 9008031; Priv. Ltr. Rul. 9008033; Priv. Ltr. Rul. 8622033.

³⁴ Treas. Reg. § 1.162-4.

³⁵ Rev. Rul. 94-12, 1994-1 C.B. 36.

³⁶ *Id.*

³⁷ Hereinafter "TAM 9618004". For a comprehensive discussion of TAM 9618004 and the debate it sparked on Capital Hill, see generally, John W. Lee, Glenn Walberg, and Darryl D. Whitsell, *Capitalizing and Depreciating Cyclical Aircraft Maintenance Costs: More-Trouble-Than-It's-Worth*, 17 VA. TAX REV. 161 (1997).

expenses must be capitalized. However, in *Ingram Industries Inc. et. al. v. Commissioner*,³⁸ the United States Tax Court held on similar facts, albeit in a maritime context, that engine maintenance expenses are deductible and need not be capitalized. TAM 9618004 and *Ingram* are discussed in the sections that follow.

a. TAM 9618004

The taxpayer in TAM 9618004 operated a fleet of turboprop aircraft in commercial service, and depreciated its aircraft under MACRS using a 7-year recovery period.³⁹ The taxpayer projected that by inspecting and maintaining its aircraft in accordance with the Federal Aviation Regulations, it would realize approximately 22 years of service from each aircraft.

In order to comply with the inspection and maintenance requirements of the Federal Aviation Regulations, aircraft operators, like the taxpayer in TAM 9618004, are required to perform a variety of inspection and maintenance tasks at regular intervals. The allowable intervals between various types of inspection and maintenance tasks can range from a single flight to several years or several thousands of flight hours, depending on the nature of the inspection or maintenance task. The greater the allowable interval between inspections for a particular type of inspection or maintenance task, the more comprehensive and expensive the inspection or maintenance task is likely to be. Regardless of the interval between inspections for any given inspection or maintenance task, an aircraft generally may not lawfully be operated in flight beyond such interval until the inspection or maintenance task is performed.

Among the most comprehensive inspection and maintenance tasks performed on aircraft, and the subject of TAM 9618004, is what is commonly referred to as a "major inspection" of an engine. An engine major inspection requires a nearly complete disassembly of the engine and an inspection of each component part to determine whether it is within the manufacturer's tolerances. Parts found to be outside of the manufacturer's tolerances are required to be reconditioned or replaced. During a typical engine major inspection, it is likely that many of the engine's component parts will be reconditioned or replaced.

The taxpayer in TAM 9618004 was required to perform a major inspection of each engine on each aircraft in its fleet at intervals ranging from 6,000 to 7,000 flight hours, depending on the make and model of the engine, which for the taxpayer in question resulted in each engine undergoing a major inspection approximately once every four years. During the taxable year in question, the taxpayer performed major inspections on several engines. Depending on the particular engine inspected and the type of aircraft to which the engine was attached, the costs of the major inspections performed ranged from approximately \$90,000 to \$122,000. Although it is not possible to determine from the text of TAM 9618004 what the average cost of a major inspection was in terms of a percentage of the original cost of an engine, or of the total cost of an aircraft, from the information provided it appears that the average cost of a major inspection was not less than 3%, nor more than 10%, of the total cost of the aircraft, and not less than 10%, nor more than 35%, of the total cost of the engines themselves.

³⁸ T.C. Memo. 2000-323 (October 18, 2000).

³⁹ Aircraft used in commercial air transportation are Asset Class 45.0. Rev. Proc. 87-56.

The IRS held in TAM 9618004 that a major inspection of an engine significantly increased the value and prolonged the useful life of the engine, and hence did not qualify as maintenance or incidental repairs the costs of which could be immediately deducted. Consequently, the taxpayer was required to capitalize the costs incurred in connection with the major inspections. In arriving at its holding, the IRS determined that the useful life of an aircraft engine extended only to the next major inspection of the engine. The IRS ignored the fact that an engine may be in good working order immediately prior to undergoing a major inspection and based its determination in part on the fact that the engine may not lawfully be operated in flight beyond the point in time at which a major inspection becomes required until the major inspection is performed.

b. The Ingram Case

The taxpayer in *Ingram*⁴⁰ operated a fleet of towboats on inland waterways in commercial service. The diesel engines on the towboats required extensive periodic maintenance every 25,000 to 35,000 operating hours, and the taxpayer operated the towboats approximately 8,000 hours each year on average.⁴¹ Consequently, each towboat required such periodic maintenance approximately every three to four years. Like the major inspections at issue in TAM 9618004, the periodic maintenance at issue in *Ingram* required substantial disassembly of the engines, and the reconditioning or replacement of numerous engine parts. The taxpayer in *Ingram* projected that with proper maintenance, it would realize approximately 40 years of service from each towboat.⁴²

Each towboat operated by the taxpayer cost, on average, \$6,250,000 when new, including engines.⁴³ The periodic maintenance of the engines generally required that the towboat be out of service for 10 to 12 calendar days,⁴⁴ and cost approximately \$100,000,⁴⁵ or 1.6% of the total original cost of the towboat. Unlike the taxpayer in TAM 9618004, the requirement to perform the periodic maintenance on the towboat's engines was not imposed by any regulatory authority. Rather, such maintenance was "required" by the economics of the taxpayer's industry in that failure to perform such maintenance would likely result in the engines eventually requiring replacement at a cost of \$600,000 for rebuilt engines, or \$1,500,000 for new engines.⁴⁶

⁴⁰ *Ingram Industries Inc. et. al. v. Commissioner*, T.C. Memo. 2000-323 (October 18, 2000).

⁴¹ *Id.* at 9.

⁴² *Id.* at 25.

⁴³ *Id.* at 4.

⁴⁴ *Id.* at 9.

⁴⁵ *Id.* at 16.

⁴⁶ *Id.*

As it did in TAM 9618004, the IRS asserted that the useful life of the towboats' engines was limited to the 25,000 to 35,000 hours of operation between periodic maintenance cycles after which the engines must be completely overhauled, and that such overhaul significantly increased the value and prolonged the useful life of the engines.⁴⁷ The Tax Court, however, disagreed.

In holding that the useful life of the towboats' engines were not limited to the 25,000 to 35,000 hours of operation between periodic maintenance cycles, the Tax Court found it significant that the taxpayer performed its periodic maintenance at times when the towboats' engines were completely serviceable, as contrasted to cases in which engines were not serviceable and had to be replaced or completely rebuilt or overhauled, and that the purpose of performing the periodic maintenance was to keep the towboats' engines in good operating condition.⁴⁸ In addition, the Tax Court found that there was no basis in the record for treating the engines as assets separate and distinct from the towboats in which they were installed.⁴⁹

The Tax Court also held that the expense incurred in connection with the periodic maintenance of a towboat was incidental when compared to the value of the towboat or the cost of a new, overhauled or rebuilt engine, and did not materially add to the value of the towboat.⁵⁰ The Tax Court conceded that a towboat buyer likely "would be more interested in a well-maintained towboat and, in particular, one that recently had maintenance," but reasoned that there was "no accurate or reliable way to measure the increment in value that could be attributed to how recently maintenance had been performed," and that "[e]ven if \$100,000 was the increment in value, we have found that amount not to be material in the factual context of this case."⁵¹

c. Relevance of TAM 9618004 in the Aftermath of Ingram.

The *Ingram* case provides some degree of hope to the aviation industry that the IRS may one day reverse its position on the tax treatment of engine major inspections, as espoused in TAM 9618004. At first blush, *Ingram* appears to be a repudiation of TAM 9618004. There are, however, important factual differences between *Ingram* and TAM 9618004 that make reliance on *Ingram* as authority for the deductibility of engine major inspections aggressive.

As stated above, the engine major inspections discussed in TAM 9618004 were mandated by the Federal Aviation Regulations and the engines could not be operated beyond their inspection parameters. This fact is in contrast to *Ingram* where no maintenance was mandated, and raises several important questions. Is this an important distinction? Can a regulatory inspection and maintenance requirement establish a useful life for tax purposes? The court in *Ingram* found it significant that the taxpayer performed its periodic maintenance at times when

⁴⁷ *Ingram Industries Inc. et. al. v. Commissioner*, T.C. Memo. 2000-323 at 25.

⁴⁸ *Id.* at 33.

⁴⁹ *Id.* at 26.

⁵⁰ *Id.* at 37.

⁵¹ *Id.* at 37-38.

the towboats' engines were completely serviceable, as contrasted to cases in which engines were not serviceable and had to be replaced or completely rebuilt or overhauled. Is it not, then, similarly significant that the engine major inspections are required to be performed on aircraft engines that are serviceable and in good operating condition and could continue to be used *but for* the federally mandated inspection requirements?

Another key factual difference between TAM 9618004 and *Ingram* lies in the cost of the maintenance at issue in relation to the value of the aircraft and towboats respectively, and in relation to the replacement costs of the engines themselves. As discussed above, periodic maintenance on towboat engines costs approximately 1.6% of the total cost of the towboat, whereas engine major inspections on aircraft cost from 3% to 10% of the total cost of the aircraft. The Tax Court found that an expenditure of 1.6% for periodic maintenance did not materially increase the value of the towboat. Would an expenditure of 3% for a major engine inspection materially increase the value of an aircraft? Would 5%? 10%?

In *Ingram* the Tax Court also found that there was no basis in the record for treating the engines as assets separate and distinct from the towboats in which they were installed. The Tax Court's holding was based at least in part on the fact that towboat engines were very difficult to remove, and the periodic maintenance at issue was performed while the engines were still installed. In contrast, aircraft engines are removed for major inspections, and frequently are not reinstalled on the same aircraft following a major inspection, although such swapping of engines is far less common in the business aviation industry than in the commercial airline industry. Nevertheless, common practice is to sell aircraft, with engines installed, at a single price, so is the fact that aircraft engines are easier to remove than towboat engines a distinction sufficient to require a different tax treatment for aircraft engine major inspections than for towboat periodic maintenance?

The questions posed in this section illustrate that the *Ingram* decision, while important in the analysis of the proper tax treatment of engine major inspections, may not be sufficient to move the IRS to reverse its position as espoused in TAM 9618004. Whether the IRS will ultimately adopt the Tax Court's reasoning in *Ingram* is unknown.

d. An Alternative Analysis

The IRS in TAM 9618004 compared the value and useful life of an aircraft engine immediately before performance of a major inspection with the value and useful life of an aircraft engine immediately after the performance of a major inspection, and found that the value of the engine had been materially increased, and its useful life had been extended. Although the Tax Court in *Ingram* ultimately arrived at a different result than the IRS by holding that neither the value nor the useful life of the towboats in question had been increased, the Tax Court nevertheless started its analysis from the same point in that it compared the value and useful life of a towboat immediately before performance of periodic maintenance with the value and useful life of a towboat immediately after performance of periodic maintenance. Such a comparison may be inappropriate in that it fails to match the expense in question with the revenue to which it relates. A more reasonable basis for comparison may be found in Rev. Rul. 94-38.⁵²

⁵² 1994-1 C.B. 35. See, also, *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), *nonacq. on other grounds*, 1964-2 C.B. 8.

Rev. Rul. 94-38 instructs that the appropriate test for determining whether an expenditure increases the value of an asset is to compare the status of the asset after the expenditure to the status of the asset *before the condition arose that necessitated the expenditure*.⁵³ In the case of the taxpayer in TAM 9618004, the condition that necessitated the expenditure was the use of the engines for 6,000 to 7,000 flight hours. Thus, the proper comparison is the value and usefulness of the engines after the major inspection, to the value and usefulness of the engines before they were operated for 6,000 to 7,000 flight hours. Before the engines were operated for 6,000 to 7,000 flight hours, i.e., when the engines were new, they had a value equal to the acquisition price and a projected useful life of 22 years.

The 22 year projection was, *a fortiori*, contingent upon the proper performance of all inspections and maintenance required by the Federal Aviation Regulations, including the major inspections at issue. With this fact in mind, it seems clear that the performance of the major inspection, without more, could neither extend the useful life of an engine that is otherwise in good working order, nor increase the value of the engine to a level above its initial acquisition price.

From this point of view it becomes apparent that the costs incurred in connection with a major inspection are not capital expenditures in any true economic sense, but are in fact deferred maintenance costs attributable to prior use. Aircraft operators can readily estimate that they will incur a certain maintenance cost after a specific number of flight hours. For financial accounting purposes, aircraft operators may account for such costs on an hourly basis by charges to a deferred maintenance account, and thus match such costs to the revenue produced by the expenditure. For tax accounting purposes, however, aircraft operators are prohibited from accruing such costs on an hourly basis. A perfect matching of expenses and income is therefore not possible in the context of aircraft major inspections, with the result that in real economic terms, taxpayers pay excess taxes on income earned in the years prior to the performance of engine major inspections, and recoup such excess taxes by virtue of the deductions generated by the payment of the costs of the engine major inspections. By requiring aircraft operators to capitalize such costs, the IRS in effect further exacerbates the mis-matching of expenses and income. Permitting aircraft operators to deduct the costs of an engine major inspection in the year such costs are actually paid would facilitate the closest matching of expenses and income possible for an accrual basis taxpayer. In summary, payment of the costs of a major inspection is in a real economic sense a payment in satisfaction of a previously accrued liability and should be deductible as such.

2. Rev. Rul. 2001-4 and the Tax Treatment of Airframe Heavy Maintenance

The most recent guidance from the IRS on the topic of tax treatment of aircraft maintenance and repair costs is Rev. Rul. 2001-4.⁵⁴ Specifically, Rev. Rul. 2001 addresses the tax treatment of expenses incurred in connection with airframe heavy maintenance performed on three different aircraft under three a unique factual scenarios. In each scenario, the aircraft

⁵³ *Id.* (Emphasis added).

⁵⁴ 2001-3 IRB 1.

operator is a commercial airline, originally acquired the aircraft in question with the expectation that the aircraft would have a useful life of 25 years if properly maintained, and is required by the FARs to perform a variety of inspection and maintenance tasks at regular intervals.

Among the periodic inspection and maintenance tasks the airline is required to perform is a series of inspections and maintenance tasks commonly referred to collectively in the industry by the terms "heavy maintenance visit," "D check," "heavy C check," and "overhaul." During a heavy maintenance visit, many components of an aircraft are removed, including the engines, landing gear, seats, side and ceiling panels, baggage stowage bins, galleys, lavatories, floor boards, cargo loading systems, and flight control surfaces. After such disassembly of the aircraft, numerous inspections, tests, checks, and services are performed, damaged, worn, and corroded parts are repaired and/or replaced, and the aircraft is extensively cleaned, refurbished, and repainted. A heavy maintenance visit generally does not include material upgrades to the aircraft or replacement of major aircraft components or systems, however such upgrades and replacements may be accomplished simultaneously with a heavy maintenance inspection. A heavy maintenance inspection can take from several weeks to several months to complete. The airline in Rev. Rul. 2001-4 is required to perform a heavy maintenance visit on each aircraft in question approximately every eight years.

a. Scenario 1: Only Heavy Maintenance

The first factual scenario presented by Rev. Rul. 2001-4 addresses the tax treatment of the costs of a heavy maintenance visit, where no additional work is performed on the aircraft. The IRS held in Rev. Rul. 2001-4 that the work performed during a heavy maintenance visit under such circumstances constitutes incidental maintenance and repairs, and the costs incurred are therefore deductible under Treas. Reg. § 1.162-4.⁵⁵ In arriving at its conclusion, the IRS recognized that the work performed during the heavy maintenance visit did not involve replacements, alterations, improvements or additions that appreciably prolonged the useful life of the aircraft, materially increased its value, or adapted it to a new or different use, but rather that the work merely kept the aircraft in an ordinarily efficient operating condition thus enabling the airline to use the aircraft over its originally anticipated useful life. Furthermore, the IRS also recognized, contrary to its position in TAM 9618004, that the fact that the airline is required by the FARs to perform heavy maintenance visits at regular intervals does not establish such interval as the useful life of the aircraft, and that the value of the aircraft is not materially increased by the performance of the heavy maintenance visit.⁵⁶

b. Scenario 2: Heavy Maintenance Combined With Material Upgrades and Replacement of a Substantial Structural Part of the Airframe

The second factual scenario presented by Rev. Rul. 2001-4 addresses the tax treatment of the costs of a heavy maintenance visit, where a substantial structural part of the airframe is

⁵⁵ *Id.* at 7.

⁵⁶ *Id.* at 6.

replaced, and/or material upgrades to the aircraft have been performed, simultaneously with the performance of the heavy maintenance visit work. Specifically, in this scenario the airline replaced all the skin panels on the belly of the aircraft, which in the aggregate represented a replacement of a substantial structural part of the aircraft, and upgraded the aircraft by installation of several new systems, including a fire detection and suppression system, a ground proximity warning system, and an air phone system.

The IRS held that the replacement of the skin panels and the installation of the new component systems materially added to the value of and improved the aircraft, and that the total labor and materials cost incurred in connection therewith must be capitalized under I.R.C. § 263.⁵⁷ Moreover, because the improvements constitute production within the meaning of I.R.C. § 263A(g)(1), the airline is required also to capitalize the portion of its indirect costs that is allocable to the improvements.⁵⁸ The IRS also held, however, that the mere fact that the improvements were performed simultaneously with the heavy maintenance visit does not also require capitalization of those costs that are allocable to the heavy maintenance visit itself; such costs continue to be deductible under Treas. Reg. § 1.162-4.⁵⁹

c. Scenario 3: Heavy Maintenance as Part of a General Plan of Rehabilitation, Modernization, and Improvement

The third factual scenario presented by Rev. Rul. 2001-4 addresses the tax treatment of the costs of work that would ordinarily be accomplished during a heavy maintenance visit, but where such work is performed on an aircraft at or near the end of its useful life and in conjunction with extensive modification, improvement, and/or replacement of structural components and major systems in an effort to extend substantially the useful life of the aircraft.

The difference between scenario 2 and scenario 3 is only a matter of degree. In contrast to scenario 2, the extensiveness of the work performed in scenario 3 in addition to the heavy maintenance visit constitutes a restoration within the meaning of I.R.C. § 263(a)(2), and establishes the existence of a plan of rehabilitation, modernization, and improvement.⁶⁰ The IRS held that although costs of work normally performed as part of a heavy maintenance visit are generally deductible under I.R.C. § 162, where such work is performed in connection with an overall plan of rehabilitation, modernization, and improvement, the heavy maintenance work is merely incidental to, and cannot be separated from, the overall plan. In such a context, the effect of all the work performed pursuant to the overall plan, including the heavy maintenance work, is

⁵⁷ *Id.* at 7.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.* (Whether a general plan of rehabilitation exists is a question of fact to be determined based on all the facts and circumstances).

to materially increase the value and prolong the useful life of the aircraft. The total direct cost of all the work performed must therefore be capitalized under I.R.C. § 263,⁶¹ and a portion of all the airline's indirect costs allocable to the work performed must be capitalized under I.R.C. § 263A(g)(1).

3. Contrasting Rev. Rul. 2001-4 and TAM 9618004

At first reading, Rev. Rul. 2001-4 appears to overrule TAM 9618004. It may, in fact do so, at least to the extent that the IRS recognized, contrary to its position in TAM 9618004, that the fact that the airline is required by the FARs to perform certain inspection and maintenance tasks on an item of property at regular intervals does not establish such interval as the useful life of the property, and that the value of the property is not materially increased by the performance of the inspection and maintenance task. Aircraft operators must, however, bear in mind the fact that TAM 9618004 specifically addressed the tax treatment of major inspections of engines, while Rev. Rul. 2001-4 specifically addressed the tax treatment of heavy maintenance of airframes. Aircraft operators may consider an engine major inspection to be similar in scope to an airframe heavy maintenance visit because in each case the inspections and maintenance performed are the most extensive likely to be performed during the ordinary useful life of the affected property. This similarity is not, however, controlling for purposes of determining the appropriate tax treatment of the expenses incurred. In Rev. Rul. 2001-4, the IRS based its holding in scenario 1 on findings that notwithstanding the extensive nature of the work performed and the number of parts repaired or replaced during a typical heavy maintenance visit, such work typically does not rise to the level of a replacement of a substantial structural part of the aircraft, and the value of the aircraft is not materially increased by the performance of such work. Such findings are contrary to the findings in TAM 9618004, even if the interval between required engine major inspections is not used to establish the useful life of an engine. Aircraft operators may yet find it difficult to convince the IRS that the costs associated with an engine major inspection should be deductible, given the high percentage of parts that are actually replaced or rebuilt during a typical major inspection. If it is determined that the number of parts, in the aggregate, that are replaced or rebuilt in a typical engine major inspection constitutes a replacement of a substantial structural part of the engine, or that the value of the aircraft is materially increased by the replacement or rebuilding of such parts, it may be necessary to continue to capitalize the costs of engine major inspections.

C. WHIP-SAWING THE INTERNAL REVENUE SERVICE

1. Background: TAM 9715001

Historically, many companies operating business aircraft have, to the extent possible, deducted the full cost of aircraft ownership and operations. However, in Technical Advice

⁶¹ *Id.* at 8.

Memorandum 9715001,⁶² the IRS stated that costs incurred by a company to provide personal-use flights to employees on company aircraft, where the value of the flights were imputed as income to the employee under the Noncommercial Flight Valuation Rule,⁶³ are not fully deductible by the employer. According to TAM 9715001, the amount that the company may deduct is limited to the amount imputed as income to the employee. Expenses incurred in excess of the amount imputed as income to the employee are not deductible. The IRS arrived at its conclusions in TAM 9715001 by relying on the entertainment expense deduction disallowance rules of I.R.C. § 274.

I.R.C. § 162(a) generally allows a taxpayer to deduct from income all ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business. However, I.R.C. § 274(a) overrides I.R.C. § 162(a) by prohibiting a taxpayer from deducting expenses paid or incurred with respect to any activity which is of a type generally considered to constitute entertainment, amusement, or recreation,⁶⁴ and from deducting expenses paid or incurred with respect to any facility which is used in connection with entertainment, amusement, or recreation.⁶⁵ An airplane used for entertainment, amusement or recreation purposes is considered a facility used in connection with entertainment, amusement, or recreation.⁶⁶

I.R.C. § 274(e) provides a number of specific exceptions to the application of I.R.C. § 274(a), i.e., circumstances under which a taxpayer may deduct expenses paid or incurred with respect to any activity which is of a type generally considered to constitute, or a facility which is used in connection with, entertainment, amusement or recreation, notwithstanding the provisions of I.R.C. § 274(a). One such exception, and the exception at issue in TAM 9715001, provides that I.R.C. § 274(a) shall not apply to expenses for goods, services, and facilities, *to the extent that* the expenses are treated by the company as compensation to the employee on the company's income tax return, and as wages to the employee for income tax withholding purposes.⁶⁷

According to the IRS, the "to the extent that" language in I.R.C. § 274(e)(2) requires that where the value of a personal-use flight is imputed to an employee under the Noncommercial Flight Valuation Rule, and where the value so imputed is less than the cost incurred by the employer to provide the flight, the deduction permitted to the employer is limited to an amount equal to the amount imputed to the employee as income. If the IRS's interpretation of I.R.C. § 274(e)(2) is correct, I.R.C. § 274(a) would apply to that portion of the expenses incurred by the

⁶² Hereinafter "TAM 9715001."

⁶³ Discussed at IV.B.3, below.

⁶⁴ I.R.C. § 274(a)(1)(A).

⁶⁵ I.R.C. § 274(a)(1)(B).

⁶⁶ Treas. Reg. § 1.274-2(e)(2)(i).

⁶⁷ I.R.C. § 274(e)(2). (*Italics added*).

company for provision of a personal use flight that is in excess of the amount imputed to the employee as income. As discussed in the following section, the United States Tax Court has recently rejected the IRS's interpretation of I.R.C. § 274(e)(2).

2. *The Sutherland Lumber Case*

The United States Tax Court decision in *Sutherland Lumber-Southwest, Inc., v. Commissioner of Internal Revenue*⁶⁸ turned TAM 9715001 upside-down. The facts in *Sutherland Lumber* were similar to those in TAM 9715001 in that the only issue was whether the taxpayer-corporation was entitled to a deduction for the full cost of providing a personal-use flight to an employee of the company, where the value of the flight was determined and imputed to the employee in accordance with the Noncommercial Flight Valuation Rule, and the amount so imputed was substantially less than the cost incurred by the company to provide the flight.

The Tax Court's analysis of I.R.C. § 274(e)(2) in the *Sutherland Lumber* case focused on whether Congress intended the "to the extent that" language of the statute to provide a complete exception to the applicability of I.R.C. § 274(a) if the conditions of the section are met regardless of whether the amount imputed to the employee as income matched the costs incurred by the company, or only a partial exception to the applicability of I.R.C. § 274(a) that would limit the taxpayer's deduction to the amount imputed to the employee as income. In other words, the issue before the Tax Court was whether I.R.C. § 274(e) provided an absolute, all-or-nothing exception to the applicability of I.R.C. § 274(a), or contained an implied income/deduction matching requirement and thus constituted merely a limitation on the applicability of I.R.C. § 274(a).

In holding that 274(e) provided an absolute exception to the applicability of I.R.C. § 274(a), and that no implied income/deduction matching requirement existed, the Tax Court noted that in the context of various rules providing for the valuation of fringe benefits for imputed income purposes, whether in the context of a general fair rental value rule or a special valuation rule such as the Noncommercial Flight Valuation Rule, the valuation rate generally does not bear a correlation to the actual costs incurred by the company providing the fringe benefit, and that in some situations, the amount imputed to an employee for a fringe benefit may exceed the cost incurred by the employer.

The Tax Court's analysis also included a review of the legislative history of I.R.C. § 274(e), as well as a review of sections in which income/deduction matching requirements are either more clearly stated,⁶⁹ or more clearly absent. In this context, the Tax Court cited several passages from the legislative history containing references to "exceptions" from the applicability of I.R.C. § 274(a), but did not find, or at least did not cite, any references in the legislative history indicating that Congress intended I.R.C. § 274(e) to serve merely as a limitation on the applicability of I.R.C. § 274(a).

⁶⁸ 114 T.C. No. 14 (March 28, 2000).

⁶⁹ See, e.g., I.R.C. § 274(b)(1) (limiting deductions for certain gifts to \$25.00); I.R.C. § 83 (limiting a deduction to "an amount equal to the amount included . . . in the gross income of the person who performed such services").

The Tax Court also noted that I.R.C. § 274(e) is entitled "Specific *exceptions* to application of subsection (a)"⁷⁰ and that the legislative history of another subsection of I.R.C. § 274(e) that contained the same "to the extent that" language, specifically I.R.C. § 274(e)(9), unambiguously provided for an exception from the applicability of I.R.C. § 274(a) without limiting one party's deduction to the amount recognized as income by another party, where the later included the *value* of the benefit in income.⁷¹ The legislative history of the "to the extent that" language in I.R.C. § 274(e)(9) makes clear that "I.R.C. § 274[a] does not apply, and any restrictions are removed with respect to otherwise allowable deductions by employers as long as the value of the benefit is included in the [benefit recipient's] income."⁷²

Finally, the Tax Court rebutted the assertion of the IRS that the failure to read an implied income/deduction matching requirement into I.R.C. § 274(e)(2) would confer a tax benefit on taxpayers of a type that I.R.C. § 274 was intended to prohibit by noting that (i) all parties agree that recipients of personal-use flights were being taxed in accordance with the Internal Revenue Code for benefits received, (ii) the corporation in question did not receive any tax-free benefit, but rather had deducted its expenses of operating the aircraft as permitted by I.R.C. § 162, and (iii) that any mismatch in income and deductions could in some circumstances result in an amount of income being imputed to an employee that exceeds the amount of a deduction permitted to an employer/aircraft operator.⁷³

3. *Tax Planning Opportunities?*

The IRS is currently appealing the Tax Court's decision in the *Sutherland Lumber* case. Consequently, it is not yet clear whether the decision will ultimately become the law of the land, and reliance on the Tax Court's opinion in *Sutherland Lumber* prior to a final disposition in the case may entail a significant degree of risk. However, if the *Sutherland Lumber* decision is ultimately followed by the IRS, the decision could provide a variety of opportunities for tax savings in both the closely-held, and the widely-held business environments.

Under the TAM 9715001 regime, businesses large and small incurred a tax cost each time an employee was provided transportation for the personal, nonbusiness-related purposes of the employee if the amount of income imputed to the employee did not equal or exceed the costs incurred by the company in providing the transportation; the Tax Court's *Sutherland Lumber* analysis notwithstanding, the amount imputed as income to an employee rarely exceeds the

⁷⁰ Italics added.

⁷¹ *Sutherland Lumber*, at 11-12, citing S. Rep. 96-498 (1979), 1980-1 C.B. 517, 546 ("the manufacturer will not be subject to these [deduction] limitations if the value of the entertainment facilities are includible in income of the dealer").

⁷² *Sutherland Lumber*, at 12.

⁷³ *Id.* at 12-13.

actual cost of providing transportation. Consequently, use of corporate aircraft for personal, nonbusiness-related purposes historically has been provided by many corporations only to the most senior executives in the organization. In the closely-held business context, such senior executives often are the sole or majority shareholders of the organizations.

Under *Sutherland Lumber*, however, employers may elect to make corporate aircraft available on a limited basis to provide personal-use transportation to other employees, whether as part of the employees' regular compensation package, or as part of a bonus or incentive compensation arrangement. As discussed in IV.B, below, the Noncommercial Flight Valuation Rule requires corporations to impute income to non-control employees at a rate far below that applicable to control employees. Thus, employers may now be able to provide a fringe benefit to such employees in lieu of, but of comparable extrinsic value to the employee as, other types of compensation, yet receive a full deduction for the costs incurred in providing the fringe benefit to the employee while at the same time reducing the amount that the employee must recognize as income for tax purposes from the amount the employee would be required to recognize as income had the compensation been in another form.

The greatest planning opportunities arising from *Sutherland Lumber* may arise in the context of S corporations and other pass-through entities, where the employee to whom income is imputed is the sole or majority owner. Under TAM 9715001, to the extent that the owner-employees of an S corporation or other pass-through entity were imputed income for personal, nonbusiness-related use of a corporate aircraft, the owner-employees ultimately were unable to deduct that portion of the costs of owning and operating the aircraft; because the items of income and deduction of such entities are passed through to the owners, all income imputed to the owner-employees should, in the aggregate, be offset by an equal deduction item passed through to the owner-employees. That portion of the costs incurred to provide personal, nonbusiness-related transportation to the owner-employees would be disallowed as a deduction, and therefore would not be available to offset other income items passed through to the owner-employees. The net after-tax result produced under TAM 9715001 should be the same, on an aggregate basis, as would be produced if the owner-employees used after-tax dollars to acquire the personal, nonbusiness-related transportation services from a third-party or reimbursed the corporation for all costs incurred by the corporation in providing the personal, nonbusiness-related transportation.

Example: Sam is the President and sole-shareholder of ABC Corporation, a corporation taxable under Subchapter S of the Internal Revenue Code. ABC Corporation operates a corporate aircraft for the sole use of Sam. During calendar year 2001, ABC Corporation incurred a total cost of \$100,000 to own and operate the aircraft, of which \$70,000 was incurred to provide transportation to Sam for business-related purposes, and \$30,000 was incurred to provide transportation to Sam for personal, nonbusiness-related purposes. ABC Corporation imputed \$5,000 in fringe benefit income to Sam under the Noncommercial Flight Valuation Rule with respect to the personal, nonbusiness-related transportation provide to Sam during 2001. Sam received no other salary from ABC

Corporation during 2001; however, ABC Corporation had \$200,000 of other corporate income, and no other deductions, from operations during 2001.

If ABC Corporation accounts for operations under TAM 9715001, Sam will be entitled to deduct \$75,000 of the \$100,000 total costs of owning and operating the aircraft during 2000 (\$70,000 business use plus \$5,000 imputed income) from his \$205,000 of gross income for the year (\$200,000 distributive share of corporate income plus \$5,000 imputed income), leaving Sam with taxable income for the year of \$130,000. Assuming a tax rate of 40%, Sam will have an income tax liability for 2000 of \$52,000 (40% of \$130,000), and will be left with \$48,000 in cash after taxes (\$100,000 pre-tax cash available for distribution from ABC Corporation less \$52,000 tax).

Sam is in the same after-tax position Sam would be in had Sam instead spent \$30,000 of after-tax income to acquire the personal, nonbusiness-related transportation services from a third-party. Under such a scenario, Sam's taxable income would remain \$130,000 and ABC Corporation would have the entire \$130,000 of cash available for distribution to Sam. Assuming a tax rate of 40%, Sam will have an income tax liability for 2000 of \$52,000 (40% of \$130,000), and will have \$48,000 in cash remaining after payment of the tax liability and the \$30,000 cost to obtain the personal, nonbusiness-related transportation services (\$130,000 pre-tax cash available for distribution from ABC Corporation less \$52,000 tax paid, less \$30,000 paid for transportation services).

The aggregate economic consequences to the owner-employees of an S corporation or other pass-through entity of personal, nonbusiness-related use of a business aircraft change in a very taxpayer-friendly manner if *Sutherland Lumber* is followed. In real economic terms, the owner-employees may now be able to, in effect, purchase personal, nonbusiness-related transportation services using a combination of pre-tax and after-tax dollars. To the extent that the actual costs incurred by the company to provide the personal, nonbusiness-related transportation services exceed the amount imputed to the owner-employees as income under the Noncommercial Flight Valuation Rule, the owner-employees will have effectively paid for the transportation services using pre-tax dollars; only that portion of the cost of the transportation services up to the amount imputed to the owner-employees as income under the Noncommercial Flight Valuation Rule will have been paid for using after-tax dollars. This is because that portion of the deduction permitted by *Sutherland Lumber* that would be denied by TAM 9715001 is also distributed to the owner-employees. Thus, the income imputed to the owner-employee under the Noncommercial Flight Valuation Rule is offset by a portion of the deduction available under *Sutherland Lumber*, and that portion of such deduction that exceeds the amount of income imputed under the Noncommercial Flight Valuation Rule may be used to offset other income.

Example: Same facts as the prior example, except ABC Corporation accounts for operations under *Sutherland Lumber*. Sam will be entitled to deduct the full \$100,000 total costs of owning and operating the aircraft during 2001 from his \$205,000 of gross income for the year (\$200,000 distributive share of corporate income plus \$5,000 imputed income), leaving Sam with taxable income for the year of \$105,000. However in real economic terms, ABC Corporation still has

the same \$100,000 of pre-tax cash available for distribution to Sam as in the prior example.

Sam has therefore reduced his *taxable* income by \$25,000, which is the difference between the \$30,000 cost incurred by ABC Corporation in connection with personal, nonbusiness-related use of the aircraft, and the \$5,000 of fringe benefit income imputed to Sam for such transportation. Sam has therefore also reduced his tax liability for the year from \$52,000 (40% of \$130,000) to \$42,000 (40% of \$105,000), and is thus left with \$58,000 of cash after taxes. In essence, Sam has paid \$25,000 of the \$30,000 cost of his personal, nonbusiness-related use of the aircraft with pre-tax dollars, and realized a tax savings of \$10,000.

III. EXCISE TAXES

A. INTRODUCTION: THE COMMERCIAL VS. NONCOMMERCIAL TRANSPORTATION DICHOTOMY

The federal government imposes one or more excise taxes on almost every flight of every powered civil aircraft in the United States. Noncommercial flights are usually subject to a substantial excise tax on aviation gasoline and other aviation fuels. Commercial flights are also usually subject to an excise tax on aviation gasoline and other aviation fuels, albeit at significantly lower rates. However, the tax savings resulting from the reduced rates of taxation on gasoline and fuels used on commercial flights usually is more than offset by excise taxes imposed on amounts paid for the transportation of persons⁷⁴ and property⁷⁵ by air.⁷⁶

Before one can make sense out of the various excise taxes imposed on business aviation, it is critical to develop a good understanding of what constitutes commercial and noncommercial flight operations.

Determining whether a flight is commercial or noncommercial for excise tax purposes is not always as simple and straightforward a task as it may seem. There is no question that charter and scheduled operations conducted pursuant to the rules governing Commuter and On-demand Operations,⁷⁷ and the rules governing Domestic, Flag, And Supplemental Operations⁷⁸ are

⁷⁴ I.R.C. § 4261(a).

⁷⁵ I.R.C. § 4271(a).

⁷⁶ The excise taxes imposed on the transportation of persons and property by air are commonly referred to in the commercial and business aviation industry as "federal transportation excise taxes" or the "FET."

⁷⁷ *Operating Requirements: Commuter and On-Demand Operations and Rules Governing Persons on Board Such Aircraft.* 14 C.F.R. Part 135.

⁷⁸ *Operating Requirements: Domestic, Flag and Supplemental Operations.* 14 C.F.R. Part 121.

considered commercial operations by both the FAA and the IRS.⁷⁹ However, there is often a great deal of confusion among business aircraft operators regarding the tax status of certain types of flight operations conducted under the General Operating and Flight Rules of 14 C.F.R. Part 91.⁸⁰

As a general rule, no consideration may be paid by any person in exchange for air transportation services if the flight in question is operated under the General Operating and Flight Rules.⁸¹ As with any general rule, however, there are exceptions. Section 91.501(b) of the General Operating and Flight Rules⁸² lists a variety of flight operations that may be operated on a limited compensatory basis. Notwithstanding such compensation, the FAA does not consider operations conducted pursuant to 14 C.F.R. § 91.501(b) to be commercial operations. However, the FAA and the IRS do not apply the same standard in determining whether a flight operation is commercial or noncommercial, and the IRS is not bound by a determination of the FAA regarding the commercial or noncommercial nature of any flight operation.⁸³

The provision of an aircraft with a flight crew is commonly referred to in the aviation industry as a "Wet Lease." Conversely, the provision of an aircraft without a flight crew is commonly referred to as a "Dry Lease." The IRS considers most operations conducted pursuant to a Wet Lease to be commercial in nature if any compensation or consideration is paid for the flight, regardless of whether the compensation or consideration was sufficient to generate, or was ever intended to generate, a profit. Furthermore, any cash compensation paid need not cover the full cost of the flight, and in fact consideration need not even be in cash. Thus, for example, flights conducted pursuant to *time sharing agreements*⁸⁴ and *interchange agreements*⁸⁵ are

⁷⁹ A relatively small number of types of flight operations are deemed by the Internal Revenue Code to be noncommercial for excise tax purposes notwithstanding the fact they may be commercial in a real economic sense, or may be subject to 14 C.F.R. Part 121 or 14 C.F.R. Part 135. Examples of such operations include, without limitation, certain sky diving and affiliated group operations. See III.C, below, for a discussion of these issues.

⁸⁰ *General Operating and Flight Rules.* 14 C.F.R. Part 91.

⁸¹ *Id.*

⁸² 14 C.F.R. § 91.501(b).

⁸³ Rev. Rul. 78-75, 1978-1 C.B. 340.

⁸⁴ Defined at 14 C.F.R. § 91.501(c)(1) as "an arrangement whereby a person 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 [14 C.F.R. § 91.501(d)]". The charges specified in 14 C.F.R. § 91.501(d) are 200% of the cost of fuel, oil, lubricants and other additives used during the flight; travel expenses of the crew, including food, lodging, and ground transportation; hangar and tie-down costs away the aircraft's base of operations; insurance obtained for the specific flight; landing fees, airport taxes, and similar assessments; customs, foreign permit, and similar fees directly related to the flight; in flight food and beverages; passenger ground transportation; and flight planning and weather contract services.

considered noncommercial by the FAA, but are considered commercial flights for federal excise tax purposes, and hence are subject to the excise taxes imposed on the transportation of persons and property by air.⁸⁶

While the FAA initially analyzes the issue of *operational control*⁸⁷ as part of its determination as to whether a flight is commercial or noncommercial, the IRS applies a different, but similar, standard in determining whether a flight is commercial or noncommercial; in order to determine whether a flight is commercial or noncommercial, the IRS first attempts to determine which party has "possession, command, and control" of the aircraft during the flight.⁸⁸

Determining who has possession, command and control of an aircraft can be a complicated task. The analysis is similar to that applied by the FAA. That is, if the aircraft and pilots are traceable back to the same source, i.e., if the operation is a Wet Lease operation, the operation will likely be deemed commercial. Conversely, the operation likely will be treated as noncommercial if the person being transported, or the shipper in the case of transportation of property by air, acquires the use of the aircraft pursuant to a Dry Lease, and acquires the services of the pilots from a wholly unrelated source. However, the IRS typically goes one step further than the FAA in the analysis in that for excise tax purposes, if an aircraft owner or Dry Lessee *de facto* cedes possession, command and control of the aircraft to a full service professional aircraft management and pilot services provider, flight operations conducted on behalf of the aircraft owner or Dry Lessee may be viewed as commercial.

In evaluating whether a flight operation is commercial or noncommercial, one must keep two factors in mind. First, the standard to be applied is an objective one. In other words, ownership or possession of a leasehold interest in an aircraft does not necessarily equate to possession, command and control, and provisions in aircraft management or lease contracts specifying who has possession, command and control may not be respected. In the context of an aircraft owner who enters into an aircraft management agreement with a professional aircraft management company, an IRS determination of which party has possession, command and control of the aircraft could be strongly influenced by provisions in the aircraft management agreement limiting the right of the owner to use the aircraft under certain circumstances. Problems in this area are most likely to arise where the aircraft owner has granted the aircraft manager the right to charter the aircraft to third parties when the owner is not using the aircraft. In such cases, the aircraft manager may insist on contract provisions preventing the owner from scheduling the aircraft at times that conflict with previously scheduled charter flights. Such

⁸⁵ Defined at 14 C.F.R. § 91.501(c)(1) as "an 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".

⁸⁶ Priv. Ltr. Rul. 9022011.

⁸⁷ Defined in 14 C.F.R. § 1.1 as "the exercise of authority over initiating, conducting or terminating a flight."

⁸⁸ Rev. Rul. 60-311, 1960-2 C.B. 341.

provisions may be reasonable from a business standpoint, but could be viewed by the IRS as ceding possession, command and control to the aircraft manager.

Second, taxpayers generally must respect the business entity forms they have chosen. In other words, an individual and his or her wholly-owned or partially-owned corporation, are treated as two separate people for excise tax purposes, and hence transportation provided by a corporation to one of its shareholders may be deemed to be commercial air transportation if the shareholder pays a fee to the corporation for the transportation and the corporation is found to have possession, command and control of the aircraft. The same analysis applies in the context of transportation provided by a partnership to its individual partners. This point was illustrated most recently in Technical Advice Memorandum 199946005.⁸⁹

TAM 199946005 addressed a group of four individuals who desired to share the costs of owning and operating an aircraft. Each individual desired to use the aircraft to satisfy his own personal and business transportation needs, and there was no apparent intent to use the aircraft to provide commercial air transportation services to anyone. The four individuals apparently decided that they would contract with an aircraft management company to manage the aircraft and supply pilots, and that each individual would pay, on a monthly basis, all direct operating costs (e.g., fuel) for his or her own flights, and $\frac{1}{4}$ of the fixed and variable ownership and operating costs of the aircraft. Unfortunately, the four decided to form a partnership to formalize their arrangement, and to enter into the aircraft management agreement in the name of the partnership. The IRS determined that the partnership, and not the individual partners, had possession, command and control of the aircraft, and that consequently all payments made by the partners to the partnership to cover fixed and direct operating costs constituted amounts paid for transportation by air and were subject to the commercial transportation excise taxes.

The adverse tax result in TAM 199946005, not to mention a number of other potentially serious issues arising under the Federal Aviation Regulations and various state and sales and use tax statutes implicit in such a partnership arrangement, could easily have been avoided with proper planning.

B. GASOLINE AND AVIATION FUEL TAXES

1. *Introduction: Aviation Gasoline and Other Aviation Fuels*

The Internal Revenue Code divides fuels commonly used in aircraft into two categories. These categories are *Aviation Gasoline* and *Aviation Fuel*.⁹⁰ Aviation Gasoline is generally a high octane gasoline product produced specifically for use in piston-engine aircraft engines. Aviation Fuel on the other hand is generally a kerosene-based liquid designed and intended for use in turbine-powered engines, such as turbo-jet, turbo-prop, and turbo-shaft engines. All but the smallest of today's modern business-class aircraft incorporate some form of turbine-powered engine that uses Aviation Fuel.

⁸⁹ Hereinafter "TAM 199946005".

⁹⁰ I.R.C. § 4093(a) defines "Aviation Fuel" as "kerosene and any other liquid (other than any product taxable under section 4081) which is suitable for use as a fuel in aircraft." Products taxable under I.R.C. § 4081 include aviation gasoline.

2. Taxation of Aviation Fuel

The Internal Revenue Code presently imposes excise taxes on the sale or use of Aviation Fuels by producers and importers at a rate of 21.9 cents per gallon.⁹¹ However, the excise taxes imposed on Aviation Fuels by I.R.C. § 4091 are reduced to 4.4 cents per gallon to the extent the fuel is used or sold for use in *Commercial Aviation*.⁹²

I.R.C. § 4041(c)(1) also imposes an excise tax at the same I.R.C. § 4091(b)(1) rate on the sale of Aviation Fuels for use in, or the use of Aviation Fuels in, *Noncommercial Aviation*.⁹³ The tax imposed by I.R.C. § 4041(c)(1) is not, however, imposed in addition to the tax imposed by I.R.C. § 4091, but rather only on any Aviation Fuel that has not been taxed under I.R.C. § 4091.⁹⁴ In light of the fact that the tax imposed by I.R.C. § 4041(c)(1) exempts from its coverage any Aviation Fuel upon which a tax has been imposed by I.R.C. § 4091, there are relatively few situations in which the I.R.C. § 4041(c)(1) tax will apply when one considers that I.R.C. § 4091 was designed to bring within its scope all Aviation Fuel produced in or imported into the United States by imposing the tax at the source of production or importation, and that to the extent that any flight operation is exempt from the tax imposed by I.R.C. § 4091, the flight operation is also exempt from the tax imposed by I.R.C. § 4041(c)(1).

⁹¹ I.R.C. § 4091(a)-(b). The 21.9 cents per gallon rate is the sum of a 21.8 cent per gallon rate provided for in I.R.C. § 4091(b)(1), and a 0.1 cent per gallon rate provided for in I.R.C. § 4091(b)(1) attributable to the Leaking Underground Storage Tank Trust Fund Tax. Current law provides that the 21.8 cents per gallon rate provided for in I.R.C. § 4091(b)(1) will be reduced to 4.3 cents per gallon after September 30, 2007. I.R.C. § 4091(b)(3). The 0.1 cent per gallon rate provided for in I.R.C. § 4091(b)(1) attributable to the Leaking Underground Storage Tank Trust Fund Tax is unaffected by I.R.C. § 4091(b)(3). Thus the effective total rate of tax after September 30, 2007, will be 4.4 cents per gallon.

⁹² I.R.C. § 4092(b). I.R.C. § 4092(b) defines "Commercial Aviation" as "any use of an aircraft other than in Noncommercial Aviation (as defined in section 4041(c)(2))." The 4.4 cents per gallon rate is the sum of a 4.3 cents per gallon rate provided for in I.R.C. § 4092(b)(2), and a 0.1 cent per gallon rate provided for in I.R.C. § 4092(b)(1) attributable to the Leaking Underground Storage Tank Trust Fund Tax.

⁹³ I.R.C. § 4041(c)(1). I.R.C. § 4041(c)(2) defines "Noncommercial Aviation" as "... any use of an aircraft, other than use in a business of transporting persons or property for compensation or hire by air. The term also includes any use of an aircraft, in a business described in the preceding sentence, which is properly allocable to any transportation exempt from the taxes imposed by sections 4261 and 4271 by reason of section 4281 or 4282 or by reason of section 4261(h)."

⁹⁴ I.R.C. § 4041(c)(1).

Aviation Fuels used in certain *Nontaxable Uses* are entirely exempted from taxation under I.R.C. § 4041(c)(1)⁹⁵ and I.R.C. § 4091.⁹⁶ The Internal Revenue Code defines "Nontaxable Use" in this context as any use exempt from the tax imposed by I.R.C. § 4041(c)(1), other than by reason of a prior imposition of tax.⁹⁷ As stated above, I.R.C. § 4041(c)(1) imposes an excise tax on the sale of Aviation Fuels for use in, or the use of Aviation Fuels in, Noncommercial Aviation at the same rates as the excise tax imposed by I.R.C. § 4091. However, I.R.C. § 4041 exempts from the tax imposed by the section any Aviation Fuel used in connection with one of several types of flight operations.⁹⁸ Flight operations qualifying for exemption from the fuel tax that are most relevant to business aviation include emergency medical transportation services qualifying under I.R.C. § 4261(g) for exemption from the taxes imposed by I.R.C. § 4261 or I.R.C. § 4271⁹⁹ (discussed at III.C.7.d, below), certain helicopter operations in connection with mineral, oil or gas mining, or forestry operations, to the extent qualifying under I.R.C. § 4261(f) for exemption from the taxes imposed by I.R.C. § 4261(a)-(b)¹⁰⁰ (discussed at III.C.7.c, below), flight operations of the government of the District of Columbia or of a State, including political subdivisions,¹⁰¹ and flight operations of nonprofit educational organizations.¹⁰²

3. Aviation Gasoline

The Internal Revenue Code presently imposes excise taxes on the sale or use of Aviation Gasoline by producers and importers at a rate of 19.4 cents per gallon.¹⁰³ As in the case of

⁹⁵ I.R.C. § 4041(f)-(m).

⁹⁶ I.R.C. § 4092(a).

⁹⁷ I.R.C. § 6427(l)(2)(B).

⁹⁸ See I.R.C. § 4041(f)-(m).

⁹⁹ I.R.C. § 4041(l).

¹⁰⁰ *Id.*

¹⁰¹ I.R.C. § 4041(g)(2).

¹⁰² I.R.C. § 4041(g)(4).

¹⁰³ I.R.C. § 4081(a). The 19.4 cents per gallon rate is the sum of a 19.3 cent per gallon rate provided for in I.R.C. § 4081(a)(2)(A)(ii), and a 0.1 cent per gallon rate provided for in I.R.C. § 4081(a)(2)(B) attributable to the Leaking Underground Storage Tank Trust Fund Tax. Current law provides that the 19.3 cents per gallon rate provided for in I.R.C. § 4081(a)(2)(A)(ii) will be reduced to 4.3 cents per gallon after September 30, 2007. I.R.C. § 4081(d)(2). The 0.1 cent per gallon rate provided for in I.R.C. § 4081(a)(2)(B) attributable to the Leaking Underground Storage Tank Trust Fund Tax is unaffected by I.R.C. § 4081(d)(2). Thus the effective total rate of tax after September 30, 2007, will be 4.4 cents per gallon.

Aviation Fuel, however, certain types of flight operations, including emergency medical transportation services qualifying under I.R.C. § 4261(g) for exemption from the taxes imposed by I.R.C. § 4261 or I.R.C. § 4271, and certain helicopter operations in connection with mineral, oil or gas mining, or forestry operations, to the extent qualifying under I.R.C. § 4261(f) for exemption from the taxes imposed by I.R.C. § 4261(a)-(b), are exempt from the excise taxes imposed on Aviation Gasoline.¹⁰⁴ Also, as in the case of Aviation Fuel, the excise taxes imposed on Aviation Gasoline are reduced to 4.4 cents per gallon to the extent the fuel is used or sold for use in *Commercial Aviation*.¹⁰⁵

4. *Exemption Certificates, Credits and Refunds*

Any sale of Aviation Fuel or Aviation Gasoline for delivery directly into an aircraft's fuel tank is presumed to be subject to the full amount of the applicable excise tax.¹⁰⁶ An aircraft operator who qualifies for an exemption from the excise tax and operators who qualify for the reduced rate applicable to Commercial Aviation may purchase the Aviation Fuel or Aviation Gasoline tax-free, or at the reduced Commercial Aviation rate if both the purchaser and the seller are registered under I.R.C. § 4041(i).¹⁰⁷ To become registered, an aircraft operator must file Form 637A, in duplicate, with the IRS.¹⁰⁸

Provided both the purchaser and seller are registered, an aircraft operator desiring to purchase Aviation Fuel or Aviation Gasoline tax-free or at the reduced Commercial Aviation rate must provide to the seller an exemption certificate indicating the date of the purchase, the purchaser's registration number, and a brief statement of the intended tax-free use of the fuel.¹⁰⁹

A separate exemption certificate usually must be furnished for each sale, however, if the purchaser has reasonable grounds to believe that 90% or more of the total of the fuel to be purchased by it during a specified period not to exceed 12 calendar quarters will be used in a tax-free use, it may furnish each of its suppliers an exemption certificate covering all purchases for the specified period.¹¹⁰ In such an event, the exemption certificate provided by the purchaser shall specify the period covered by the certificate, and the purchaser shall give a brief

¹⁰⁴ I.R.C. § 6427(d).

¹⁰⁵ I.R.C. § 6421(f)(2).

¹⁰⁶ I.R.C. § 4041(i).

¹⁰⁷ *Id.* Certain exceptions not applicable to business aviation apply to the registration requirement. *See*, Treas. Reg. § 48.4041-11(c).

¹⁰⁸ Treas. Reg. § 48.4041-11(b).

¹⁰⁹ Treas. Reg. § 48.4041-11(d)(1).

¹¹⁰ Treas. Reg. § 48.4041-11(d)(3)-(4).

explanation of its grounds for belief that 90% or more of its total fuel will be used in a tax-free use.¹¹¹

An aircraft operator that qualifies for an exemption from the excise tax or the reduced rates applicable to Commercial Aviation but that nevertheless pays the full excise tax on a purchase may claim under I.R.C. § 6427 a credit for, or a refund of, the excess taxes paid. An aircraft operator that wishes to claim a credit must file a Form 4136. The form 4136 is submitted together with the taxpayer's annual income tax return. An aircraft operator that wishes to claim a refund must file a Form 8849. The Form 8849 may be filed on a quarterly basis, however, in order to file a Form 8849, the taxpayer must be entitled to a refund of at least \$750.00. If the refund amount at the end of a quarter is less than \$750.00, the amount must be carried forward to the next tax quarter. Alternatively, a taxpayer who is required to file a Form 720 Quarterly Excise Tax Return may claim a refund on Schedule C of Form 720.

C. TAXATION OF TRANSPORTATION OF PERSONS AND PROPERTY BY AIR

1. Taxable Transportation Defined

The term "Taxable Transportation" is defined for purposes of the excise taxes on the transportation of persons by air in I.R.C. § 4262,¹¹² and for purposes of the excise taxes on the transportation of property by air in I.R.C. § 4272.¹¹³

As defined in I.R.C. § 4262(a) (applicable to transportation of persons), Taxable Transportation includes transportation by air that falls within one of two categories, except for transportation specifically excluded by virtue of I.R.C. § 4262(b). The first category includes air transportation that both begins and ends at locations within either the United States or a so-called "225-Mile Zone."¹¹⁴ The 225-Mile Zone is comprised of all locations within Canada and Mexico that lie within 225 miles of any point within the United States other than Alaska or Hawaii.¹¹⁵

The second category includes air transportation falling outside the scope of the first category, but only to the extent that such air transportation is directly or indirectly between two ports or stations in the United States, and then only if such air transportation is not a part of *Uninterrupted International Air Transportation*.¹¹⁶ The term "Uninterrupted International Air Transportation" generally is used to define international air transportation that includes multiple

¹¹¹ *Id.*

¹¹² I.R.C. § 4262(a).

¹¹³ I.R.C. § 4272(a).

¹¹⁴ I.R.C. § 4262(a)(1).

¹¹⁵ I.R.C. § 4262(c)(1)-(2).

¹¹⁶ I.R.C. § 4262(a)(2).

flight segments at least one of which is between any two ports or stations in the United States.¹¹⁷ In order for air transportation to qualify as Uninterrupted International Air Transportation, the interval between the scheduled time of arrival at a port or station within the United States of one flight segment, and the scheduled time of departure of the subsequent flight segment, cannot exceed 12 hours.¹¹⁸

As defined in I.R.C. § 4272(a) (applicable to transportation of property), Taxable Transportation includes transportation by air that both begins and ends at locations within the United States, except to the extent that the transportation is excluded by virtue of I.R.C. § 4262(b).¹¹⁹ Specifically excluded from the definition of Taxable Transportation is the transportation of property in the course of exportation.¹²⁰ The term "property" does not include excess baggage accompanying a passenger traveling on an aircraft operated on an established line.¹²¹

I.R.C. § 4262(b) excludes from the definition of Taxable Transportation for purposes of the excise taxes imposed on the transportation of both persons and property that portion of any flight that meets all four of the following requirements:

- a. Such portion is outside the United States.
- b. Neither such portion nor any segment thereof is directly or indirectly between:
 - (1) a point where the route of the transportation leaves or enters the continental United States or a port or station within the 225-Mile Zone; and
 - (2) a port or station within the 225-Mile Zone.
- c. Such portion both:
 - (1) begins at either the point where the route of the transportation leaves the United States or a port or station within the 225-Mile Zone; and
 - (2) ends at either the point where the route of the transportation leaves the United States or a port or station within the 225-Mile Zone.
- d. A direct line from the point, port or station specified in (c)(1), to the point, port or station specified in (c)(2), passes through or over a point which is not within the 225-Mile Zone.¹²²

2. Domestic Operations

¹¹⁷ I.R.C. § 4262(c)(3).

¹¹⁸ *Id.*

¹¹⁹ I.R.C. § 4272(a)-(b)(1).

¹²⁰ I.R.C. § 4272(b)(2). *See, also*, Treas. Reg. § 49-4271-1(d).

¹²¹ I.R.C. § 4272(c).

¹²² I.R.C. § 4262(b).

The reduction in the fuel tax afforded domestic commercial aviation is usually more than completely offset by a substantially more costly excise tax on amounts paid by passengers and shippers for the transportation of persons or property by air. The federal air transportation excise tax applicable to the domestic Taxable Transportation of persons by air currently is imposed at a rate of 7.5% on amounts paid for the transportation.¹²³ In addition to the 7.5% rate, the Internal Revenue Code currently imposes a \$2.50 tax on each flight segment (i.e., one takeoff and one landing) of a trip.¹²⁴ This additional charge generally applies on a per-person basis.¹²⁵ However, the segment charge does not apply to any individual flight segment that either begins or ends at a "rural airport", which is defined in relevant part to include any airport that neither has, nor is within 75 miles of another airport that has, 100,000 or more commercial passenger

¹²³ I.R.C. § 4261(a). The 7.5% rate became effective on October 1, 1999. The applicable federal air transportation excise tax rates for transportation of persons prior to October 1, 1999, are as follows:

- (i) from October 1, 1998 to September 30, 1999: 8%
- (ii) from October 1, 1997 to September 30, 1998: 9%
- (iii) prior to from October 1, 1998: 10%

¹²⁴ I.R.C. § 4261(b). The \$2.50 segment rate is applicable during calendar year 2000. There is no segment-based component to the federal air transportation excise tax for transportation of persons prior to October 1, 1997. The applicable segment-based rates for transportation prior to 2000 are as follows:

- (i) from October 1, 1999 to December 31, 1999: \$2.25
- (ii) from October 1, 1998 to September 30, 1999: \$2.00
- (iii) from October 1, 1997 to September 30, 1998: \$1.00

The segment-based rate will increase in future years as follows:

- (i) calendar year 2001: \$2.75
- (ii) calendar year 2002: \$3.00

Increases in the segment-based rate in years subsequent to 2002 will be indexed to inflation.

¹²⁵ Treas. Reg. § 49.4261-9(b). Where a single payment is made covering transportation for more than one person, as is often the case in the context of a charter of a corporate jet, the payment must be apportioned on the basis of the total amount of the payment properly allocable to each person.

enplanements per year.¹²⁶ The Department of Transportation provides a list of airports meeting the rural airport criteria on an annual basis.¹²⁷

The federal air transportation excise tax applicable to the Taxable Transportation of property by air currently is imposed at a rate of 6.25% on amounts paid for the transportation.¹²⁸ The Internal Revenue Code makes no provision for an additional segment-based charge for the transportation of property by air.

3. Calculating the Tax Base

The federal air transportation excise tax on domestic Taxable Transportation applies to the total amount paid for Taxable Transportation, including amounts attributable to commissions, landing and parking fees,¹²⁹ and state and local taxes,¹³⁰ but not to amounts attributable to passenger facility charges.¹³¹ Treasury Regulations provide that where a single, total charge is assessed to a customer for services that include not only Taxable Transportation, but also other items in addition to the Taxable Transportation (e.g., meals and beverages, hotel accommodations, ground transportation, etc.), the federal air transportation excise tax applies only to that portion of the total charge attributable to the Taxable Transportation.¹³² In order to exclude charges attributable to such other items in calculating the federal air transportation excise tax base, the operator must maintain records indicating the exact amount of the total charge attributable to each such other item.

In determining what portion of the total amount paid by the customer is attributable to taxable air transportation, and what portion is attributable to other, non-taxable goods and services, one generally accepted methodology is to determine the fair market value of the air

¹²⁶ I.R.C. § 4261(e).

¹²⁷ Current law provides that the excise taxes imposed by I.R.C. § 4261(a) shall apply to (i) transportation beginning on or prior to September 30, 2007, and (ii) amounts paid on or prior to September 30, 2007 for transportation beginning after September 30, 2007. I.R.C. § 4261(i).

¹²⁸ I.R.C. § 4271(a). Current law provides that the excise taxes imposed by I.R.C. § 4271(a) shall apply to (i) transportation beginning on or prior to September 30, 2007, and (ii) amounts paid on or prior to September 30, 2007 for transportation beginning after September 30, 2007. I.R.C. § 4271(d).

¹²⁹ Priv. Ltr. Rul. 8636043.

¹³⁰ Rev. Rul. 73-344; 1973-2 CB 365.

¹³¹ Rev. Rul. 91-61; 1991-2 CB 377. A "passenger facility charge" is an excise tax imposed by individual airports on arriving and departing passengers. As passenger facility charges are local, rather than federal taxes, they are outside of the scope of this article, and will not be addressed in detail.

¹³² Treas. Reg. § 49.4261-2(c).

transportation and each other item separately, as if each item were purchased separately rather than as a package, and apportion the total amount paid by the customer accordingly.¹³³ Under this methodology, it is quite probable that the sum of the fair market values of the individual items will differ from the package price (i.e., the package price may reflect a discount or a premium over the sum of the package components). These data may be incorporated into the following formula from which the taxable portion of the total amount paid may be determined:

Formula:

$$\text{TPd} \quad \times \quad \frac{\text{FMV-TT}}{\text{FMV-Pkg}} \quad = \quad \text{TB}$$

Where: TPd = The total amount paid for the package (exclusive of passenger facility charges);
 FMV-TT = The fair market value of the Taxable Transportation if purchased separately;
 FMV-Pkg = The sum of the fair market values of the Taxable Transportation and the nontaxable goods and services; and
 TB = The tax basis upon which the excise tax is imposed.

Example: Assume that a per-person package deal includes (i) a flight consisting of a single segment valued at \$150 if purchased separately and which is subject to an additional \$6 passenger facility charge, (ii) a meal valued at \$40 if purchased separately, and (iii) ground transportation valued at \$30 if purchased separately. Assume further that the flight will occur during calendar year 2000.

The total cost of the package is \$206, of which \$6 is attributable to passenger facility charges. The package price represents a savings to the consumer of \$20 over the cost to purchase each item separately.

Inserting the foregoing data into the formula described above, the calculation of the tax basis upon which the excise tax is imposed as follows:

$$(\$200 - \$6) \quad \times \quad \frac{\$150}{(\$150 + \$40 + \$30)} \quad = \quad \$136.36$$

Of the \$206 total amount paid by the customer, the portion attributable to taxable air transportation is \$136.36. The air transportation excise tax due is 7.5% of \$136.36, or \$10.23, plus a \$2.50 segment fee, for a total tax due of \$12.73.

4. International Operations

¹³³ Rev. Rul. 63-155; 1963-2 CB 566.

International commercial flights originating within the 48 contiguous United States and terminating at a point that is not within the United States or the 225 Mile Zone, and international commercial flights originating at a point that is not within the United States or the 225 Mile Zone and terminating within the 48 contiguous United States, are taxed a flat rate of \$12.00 per person (\$24.00 round trip), regardless of the number of segments flown.¹³⁴

The excise taxes imposed by I.R.C. § 4271 on the transportation of property do not apply to international transportation.

5. Special Rule for International Operations Involving Alaska and Hawaii

International commercial flights originating in Alaska or Hawaii and terminating at a point that is not within the United States or the 225 Mile Zone are taxed a flat rate of \$6.00 per person. International flights terminating in Alaska or Hawaii are not subject to the federal air transportation excise tax at all.¹³⁵

As previously stated, the excise taxes imposed by I.R.C. § 4271 on the transportation of property do not apply to international transportation.

6. Exempt Operations

a. Small Aircraft on Non-Established Lines

Aircraft having a maximum certificated takeoff weight of 6,000 pounds or less are exempt from the federal air transportation excise taxes imposed on the transportation of both persons and property, except when such an aircraft is operated on an established line.¹³⁶ This exemption is commonly referred to as the "Small Aircraft Exemption."

Many commercial operators and licensed air carriers are authorized by the FAA to conduct only "on demand" operations, and may not lawfully conduct "scheduled" operations, as such terms are defined in 14 C.F.R. § 119.3. However, the fact that a person is not authorized to conduct scheduled operations is not determinative, or even particularly helpful, in determining whether such person operates on an established line. Whereas an air carrier conducting scheduled operations would almost certainly also be operating on an established line within the meaning of I.R.C. § 4281, the inverse is not necessarily true; an air carrier that operates only on demand service may nevertheless be operating on an established line within the meaning of I.R.C. § 4281.

¹³⁴ I.R.C. § 4261(c)(1). International flights taxable under I.R.C. § 4261(c) do not fall within the technical definition of Taxable Transportation set forth in I.R.C. § 4262. The taxes imposed by I.R.C. § 4261(c), therefore, are not imposed on the basis of the transportation of persons or property by air, but rather on the basis of the use of various international travel facilities (*e.g., customs services*).

¹³⁵ I.R.C. § 4261(c)(3).

¹³⁶ I.R.C. § 4281.

As discussed above in III.B.2, I.R.C. § 4041(c)(2) defines *Noncommercial Aviation* in relevant part to include flights exempt from taxes imposed by I.R.C. § 4261 and I.R.C. § 4271 by reason of I.R.C. § 4281 (i.e., the Small Aircraft Exemption). Thus, flights of such small aircraft that are not on an established line are subject to the noncommercial excise tax on Aviation Fuels notwithstanding whether such flights are commercial in any real economic sense.

(1) Historical Perspective; The Three-Prong Test

The Small Aircraft Exemption has changed little since its original enactment as I.R.C. § 134 of the Excise Tax Technical Changes Act of 1958.¹³⁷ At the time the Small Aircraft Exemption was enacted, the Internal Revenue Code imposed a tax on the transportation of persons by motor vehicles, but provided an exemption for vehicles with seating capacity of less than ten adults when such vehicles were not operated on an established line. The exemption was intended primarily to apply to taxicabs that traveled around cities in search of fares. The exemption did not extend to operators that provided shuttle-type services between fixed points regardless of the size of the vehicle. The legislative history of I.R.C. § 134 indicates that Congress intended the Small Aircraft Exemption to apply to operators of small aircraft in a similar manner.¹³⁸

Given the background of the Small Aircraft Exemption, in originally interpreting the "established line" language of the Internal Revenue Code, the IRS applied the same standard that it applied to motor vehicles. In the motor vehicle context, the IRS has interpreted transportation on an established line to mean transportation (i) between definite points (ii) occurring with some degree of regularity (iii) if the primary contract between the operator and the person served is for transportation and not for the hire or use of the vehicle.¹³⁹ In Rev. Rul. 56-61, the IRS states that the term "operates on an established line" implies that the person providing the service exercises control over the direction, route, time, number of passengers carried, etc., and finds that where a small vehicle operator offered shuttle service between a resort hotel and a mountain summit with some degree of regularity, the transportation was taxable as operations on an established line. In contrast, Rev. Rul. 56-61 indicates that a vehicle is not operated on an established line when the pick-up and departure points are determined solely by the passenger.

(2) Application of Three-Prong Test to Aviation

The IRS and the courts have addressed the established line issue in the aviation context in several revenue rulings, private letter rulings, and court cases. In each case, a standard substantively similar to Rev. Rul. 56-61 has been applied. The following analysis summarizes the three-prong test as applied in the aviation context.

¹³⁷ Pub. Law 85-859; 1958-3 CB 92, 109.

¹³⁸ See, e.g., H. R. Rep. No. 481, 85th Cong., 1st Sess. (1958), *reprinted in* 1958-3 CB 372, 419.

¹³⁹ Rev. Rul. 56-61; 1956-1 CB 521.

(a) *The "Between Definite Points" Prong*

The "between definite points" prong does not require that transportation be between two different points to be taxable; continuous transportation beginning and ending at the same point is taxable unless otherwise exempt.¹⁴⁰ In *Lake Mead Air, Inc., v U.S.*, an air tour operator that always returned its passengers to the same point at which the tour began was found to have been providing a taxable service regardless of whether a particular flight involved an intermediate stop.¹⁴¹

(b) *The "Some Degree of Regularity" Prong*

The case law and revenue rulings provide that the term "operated on an established line" does not mean that strict regularity of schedule must be maintained, that the full run must always be made, that a particular route be followed, or that intermediate stops be restricted; it is enough that merely some degree of regularity be maintained.¹⁴² The IRS may determine that an operator meets the "some degree of regularity" prong if the operator generally controls the frequency that it operates over a particular route, as opposed to operating over a particular route only when hired specifically to do so.¹⁴³ An operator will likely be found to control the frequency of operations over a particular route if it advertises services over the route at scheduled or fixed times, or accepts advance bookings to provide service on the route.

Some form of scheduled air service is typically required in order to establish that an operation is on an established line. However scheduled air service may be found to exist for taxation purposes regardless of whether an operator is authorized by the FAA to operate on a scheduled basis within the meaning of the Federal Aviation Regulations, advertises times and locations of service in newspapers or brochures, or merely provides such service on a scheduled-in-fact basis.¹⁴⁴

The degree of regularity prong arises often in the context of the scenic air tour industry. In the air tour operator context, advertising availability of air tour services covering specific points of interest is a factor tending to indicate operation on an established line. However, such

¹⁴⁰ Treas. Reg. § 49.4261-1(c).

¹⁴¹ 991 F. Supp. 1209, 1213 (D. Nev. 1997).

¹⁴² Rev. Rul. 66-301; 1966-2 CB 475.

¹⁴³ The "some degree of regularity" prong does appear to require something more than mere sporadic operation. Thus, in Rev. Rul. 66-301, a helicopter operator was determined to qualify for the Small Aircraft Exemption for sightseeing flights provided to patrons at a community fair where the flights were provided to customers as they presented themselves (i.e., no scheduled or fixed times of departure and no advance bookings or reservations were available), and only during the ten day duration of the fair.

¹⁴⁴ Priv. Ltr. Rul. 9524003.

advertising alone does not necessarily result in a finding that an operation is on an established line. Thus, in Priv. Ltr. Rul. 7731042, a taxpayer who advertised scenic 15-minute glider rides, but provided such flights at times chosen by the customers rather than at times determined by a pre-set or advertised schedule, did not constitute operation on an established line. Similarly, in Priv. Ltr. Rul. 8623005, a scenic air tour operator operating on an island was determined to qualify for the Small Aircraft Exemption notwithstanding the fact that the operator advertised its availability for air tour flights on a seven days per week basis, where the operator did not advertise or set specific departure times or routes, and the route of flight and the particular points of interest to be overflown were determined by the passenger on board each particular flight.

In contrast to the foregoing, air tour operators were determined to be operating on established lines in Priv. Ltr. Rul. 9524003 and Priv. Ltr. Rul. 9527008. In each case, the air tour operator maintained control over the route of the air tour, and was determined to be operating a scheduled service based on oral agreements with participating hotels and agencies to operate the tours at specific times each day.

(c) The "Primary Contract" Prong

Merely operating between two geographic points on a routine basis does not necessarily result in a finding that an aircraft is operated on an established line. Where the details of a flight, such as departure point and time, destination, and scheduling frequency are in the control of the transportation customer, the flights likely will not be found to be operated on an established line, unless the operator of the flight otherwise operates flights between the same points in a manner that would result in an established line finding. In Rev. Rul. 72-617, the IRS held that a charter operator who contracted with the United States Postal Service to provide six round trips per week on a "scheduled" basis between two particular cities was not operating on an established line because the Postal Service, and not the operator, designated the cities and determined the schedule of the flights.¹⁴⁵

Rev. Rul. 72-617 is of limited utility, however, in that it only applies if the operator does not otherwise operate on an established line between the cities selected by the customer. If it can be established that an operator operates flights "on an established line" between any two points, all flights conducted by the operator between those two points are subject to taxation.¹⁴⁶ Thus, for example, if an operator provides scheduled air transportation between cities A and B every day at 10:00 a.m., all flights by the operator between cities A and B, including on demand private charters at times other than 10:00 a.m., are considered to be operated on an established line and will not qualify for the Small Aircraft Exemption.

b. Affiliated Group Exemption

The Internal Revenue Code exempts the provision of air transportation services by one member of an affiliated group to another member of the same affiliated group from the

¹⁴⁵ 1972-2 CB 580.

¹⁴⁶ Rev. Rul 72-219. 1972-1 CB 350.

application of excise taxes on the transportation of persons and property by air, provided that the aircraft is not also made available to corporations that are not members of the affiliated group.¹⁴⁷ For purposes of the application of the Affiliated Group Exemption, the determination whether the aircraft is made available to corporations that are not members of the affiliated group is made on a flight-by-flight basis.¹⁴⁸

Corporations are members of an affiliated group if the parent corporation directly owns at least 80% of the voting power and value of the stock of one other corporations within the group, and at least 80% of the voting power and value of the stock of each other corporation within the group (other than the common parent) is directly owned by one or more members of the group.¹⁴⁹ The IRS, like the FAA, does not recognize an individual as a "parent" for purposes of establishing a parent subsidiary relationship.¹⁵⁰

As discussed above, I.R.C. § 4041(c)(2) defines *Noncommercial Aviation* in relevant part to include flights exempt from taxes imposed by I.R.C. § 4261 and I.R.C. § 4271 by reason of I.R.C. § 4282 (i.e., affiliated groups). Thus, such flights are subject to the noncommercial excise tax on Aviation Fuels notwithstanding whether one member of the affiliated group compensates another member of the group for the provision of the transportation.

c. Helicopter Exemptions

Two types of flight operations are exempt from the excise tax on the transportation of persons by air solely if conducted using helicopters. The first of these exempts the transportation by helicopter of individuals, equipment or supplies in the exploration for, or the development of, hard minerals, oil, or gas.¹⁵¹ The second exempts transportation by helicopter for the purpose of the planting, cultivation, cutting, or transportation of, or caring for, trees (including logging operations).¹⁵² The exemptions for the two types of helicopter operations described above are not absolute in that they are only allowed for any flight segment that does not include a departure or a landing at an airport or heliport that is eligible for assistance under the Airport and Airway Development Act of 1970, or otherwise use services provide by 49 U.S.C. § 44509 (relating to Department of Transportation demonstration projects), 49 U.S.C. § 44913(b) (relating to Department of Transportation grants to continue explosive detection K-9 team training

¹⁴⁷ I.R.C. § 4282(a).

¹⁴⁸ I.R.C. § 4282(b).

¹⁴⁹ I.R.C. § 1504(a). I.R.C. § 4282(c) requires that I.R.C. § 1504(a) be applied for purposes of I.R.C. § 4282(a) without regard to I.R.C. § 1504(b).

¹⁵⁰ *Id.*

¹⁵¹ I.R.C. § 4261(f)(1).

¹⁵² I.R.C. § 4261(f)(2).

programs), and 49 U.S.C. Chapter 471, Subchapter I (relating to airport improvement programs).¹⁵³

It is interesting to note that each of the helicopter exemptions described above clearly contemplates an exemption for the transportation not only of personnel, but also of some form of property. The first contemplates tax-free transportation of, *inter alia*, equipment and supplies, while the second contemplates the transportation of trees (large, heavy-duty helicopters are often used in logging operations in remote areas to lift and transport trees suspended on long cables below the airframe). Yet according to the text of the two helicopter exemptions described above, the exemptions function only as exemptions from the excise taxes imposed by I.R.C. § 4261(a)-(b) on the transportation of persons by air. There is no similar text exempting such operations from the excise taxes imposed by I.R.C. § 4271 on the transportation of property by air, and hence such transportation is presumably taxable under that section. In that I.R.C. § 4261(a)-(b) would not impose a tax on the transportation of property in any event, it is therefore unclear what effect, if any, those portions of the above exemptions relating to property should have.

The helicopter exemptions discussed above are of limited utility in that virtually all public-use airports and heliports are eligible for assistance under the Airport and Airway Development Act of 1970 or otherwise use services provide by 49 U.S.C. Chapter 471, Subchapter I. Consequently, for practical purposes, the exemptions will only be available to those helicopter operations conducted entirely without the use of, or assistance from, government facilities.

As discussed in III.B.2.b, above, helicopter operations qualifying for the exemptions under I.R.C. § 4261(f) are also exempt from the excise taxes imposed on Aviation Fuels under I.R.C. § 4091. Consequently, to the extent that operations described in I.R.C. § 4261(f) are not subject to the excise tax on the transportation of property by air imposed by I.R.C. § 4271, such operation, together with the emergency medical transportation flights described in the following section, are among a very small number of types of powered flight operations that may be conducted free from all forms of federal excise taxes.

d. Emergency Medical Transportation

The Internal Revenue Code exempts certain flights in connection with the provision of emergency medical services from both the excise tax on the transportation of persons under I.R.C. § 4261, and the transportation of property under I.R.C. § 4271.¹⁵⁴ In addition, as discussed in III.B.2.b, above, emergency medical operations qualifying for the exemptions under I.R.C. § 4261(g) are also exempt from the excise taxes imposed on Aviation Fuels under I.R.C. § 4091.

Operations conducted in both helicopters and fixed-wing aircraft may qualify for exemption under I.R.C. § 4261(g). However, in the case of a fixed wing aircraft, the statute

¹⁵³ I.R.C. § 4261(f).

¹⁵⁴ I.R.C. § 4261(g).

requires that the aircraft be "equipped for, and exclusively dedicated on that flight to acute care emergency medical services."¹⁵⁵ There is no similar requirement imposed on helicopters.

The statute provides no guidance concerning what minimum level of equipment must be on board a fixed-wing aircraft in order to qualify. For example, must the aircraft be permanently configured and outfitted as a full service air-ambulance, or may an aircraft normally configured as a passenger or cargo aircraft qualify if the minimum equipment necessary to meet the needs of the particular patient-passenger being transported is on board the aircraft?

Prior to August 27, 1996, the exemption for emergency medical transportation flights was limited to flights that did not use public facilities in a manner similar to the exemptions for oil and gas and logging operations by helicopters discussed in the previous section. This limitation has been removed, and thus emergency medical transportation flights are now free to use public airports without incurring a tax.¹⁵⁶

e. Sky Diving

Flights conducted exclusively for skydiving purposes are exempt from both the excise tax on the transportation of persons under I.R.C. § 4261, and the transportation of property under I.R.C. § 4271.¹⁵⁷ As discussed above in III.B.2, I.R.C. § 4041(c)(2) defines *Noncommercial Aviation* in relevant part to include flights qualifying under I.R.C. § 4261(h) (i.e., skydiving flights). Thus, skydiving flights are subject to the noncommercial excise tax on Aviation Fuels notwithstanding whether such flights are commercial in any real economic sense.

D. EXCISE TAX COLLECTION RESPONSIBILITY AND LIABILITY FOR UNCOLLECTED TAXES

The federal air transportation excise taxes are imposed not on the operator, but on the person making the payment that is subject to the tax.¹⁵⁸ The aircraft operator's responsibility in this regard is that of collection agent for the government. In some situations, the collection responsibility is not directly on the aircraft operator. The Internal Revenue Code provides that the person receiving the payment to which the federal air transportation excise tax applies shall collect the tax.¹⁵⁹ However, this provision does not relieve an aircraft operator from responsibility when a person other than the aircraft operator receives payment for Taxable Transportation in the capacity of an agent of the aircraft operator and not as a principal. The IRS has held that:

¹⁵⁵ *Id.*

¹⁵⁶ Pub. L. 104-188 § 1609(d).

¹⁵⁷ I.R.C. § 4261(h).

¹⁵⁸ I.R.C. § 4261(d).

¹⁵⁹ I.R.C. § 4291.

[w]here independent travel agencies . . . sell tours to be taken on aircraft chartered from a carrier, the travel agencies are acting as principals and are required to collect the transportation tax, file return, and pay the tax to the Government. However, where travel agencies sell taxable tours as representatives of the airlines, they are acting as agents of the airlines. As agents, they are required to collect the transportation tax and remit the tax to the airlines. The airlines, in turn, are required to file returns and pay the tax to the Government.¹⁶⁰

Where a passenger pays a single price for transportation on two or more different carriers, the passenger must pay (and the selling carrier must collect and remit) the tax for the entire transportation service; the tax does not apply to the payments made between the carriers.¹⁶¹

When an operator that is required to collect the federal air transportation excise tax fails to do so, the IRS may nevertheless seek recovery from the operator under one of at least two statutory provisions. For Taxable Transportation generally provided on or after October 1, 1997, to the extent the federal air transportation excise tax is not collected as required by the Internal Revenue Code, the operator providing the initial segment of the Taxable Transportation may be held secondarily liable for the federal air transportation excise tax.¹⁶² Prior to October 1, 1997, the Internal Revenue Code did not permit the IRS to impose the federal air transportation excise tax on an operator directly; however, the Internal Revenue Code did, and still does, provide for indirect liability in the form of a penalty in an amount equal to the uncollected tax where a person who is required to collect a tax willfully failed to collect, or truthfully account for and pay over, any tax.¹⁶³

IV: PERSONAL USE FLIGHTS: INCOME TAX CONSEQUENCES TO SHAREHOLDERS AND EMPLOYEES

¹⁶⁰ Rev. Rul 75-296. 1975-2 CB 440. See also, Rev. Rul 80-34, 1980-1 CB 251; Priv. Ltr. Rul. 972001; Priv. Ltr. Rul. 9835049.

¹⁶¹ Rev. Rul 55-534, 1955-2 CB 665.

¹⁶² I.R.C. § 4263(c).

¹⁶³ I.R.C. § 6672(a). In Air Tour Acquisition Corp. v. U.S., 781 F. Supp. 669 (D. Hawaii 1991), the IRS failed in its attempt to hold an air tour operator liable for uncollected federal air transportation excise taxes. However, the case provides little support *vis-a-vis* a defense against liability for uncollected pre-October 1, 1997, federal air transportation excise taxes because in that case the air tour operator was suing for refund of a tax assessment that the government asserted under an erroneous theory. The government had failed to assess the I.R.C. § 6672(a) penalty at audit and was therefore barred from asserting the penalty as an affirmative defense to the air tour operator's refund claim.

A. INTRODUCTION

Aircraft owned and operated by corporations and other business entities are occasionally, and sometimes exclusively, used to provide transportation services to directors, officers, and employees of the entities for personal, rather than business, purposes. One of the perceived benefits of owning and operating a business aircraft is that the aircraft may be used by selected individuals for transportation not only to business meetings, but to personal and leisure destinations as well. In fact, business-owned aircraft commonly grace airport parking ramps at virtually every popular vacation destination.

Personal use of business aircraft entails certain tax consequences. Precisely what those consequences will be depends on a number of factors. For example, will the aircraft be provided to the employee with or without a flight crew, and will the employee be required to compensate the company for the use of the aircraft?

When an aircraft is made available for the personal use of a director, officer, or employee of a company, and the director, officer, or employee does not pay full value for the use of the aircraft, such use of the aircraft may constitute a fringe benefit taxable to the director, officer, or employee as ordinary income.

The discussion that follows addresses the issue of the imputation of fringe benefit income in respect of personal use of business aircraft by shareholders, directors, officers, and employees. The discussion first addresses the methods by which the amount of income to be imputed may be determined. Next, the discussion addresses rules governing mixed-use (business and personal) flights and the consistency rules. Last, the discussion addresses permitted methods for reducing the amount of income that must be imputed to directors, officers, and employees.

B. VALUATION RULES

The Internal Revenue Code specifies that a taxpayer's gross income includes fringe benefits received as compensation for services.¹⁶⁴ Treasury regulations generally provide that the value of a fringe benefit for purposes of determining gross income equals the amount by which the fair market value of the fringe benefit exceeds the sum of the amount, if any, the recipient paid for the benefit, plus the amount, if any, the recipient may exclude from gross income under any other provision of Subtitle A of the Internal Revenue Code.¹⁶⁵ From this regulation, it is clear that the method by which a value for a fringe benefit is determined may greatly affect the income tax liability of the recipient of the fringe benefit. Three specific valuation methods are relevant in the business aviation context: the fair market valuation rule for

¹⁶⁴ I.R.C. § 61(a)(1).

¹⁶⁵ Treas. Reg. § 1.61-21(b).

use of an employer-provided aircraft for which the employer does not provide a pilot¹⁶⁶; the fair market valuation rule for flights on an employer-provided piloted aircraft¹⁶⁷; and the "Non-commercial Flight Valuation Rule". Each of these is discussed separately below.

1. Fair Market Valuation Rule (Dry Lease)

Occasionally a business entity that owns or operates a business aircraft will provide such aircraft to a director, officer, or employee of the company without a flight crew on a Dry Lease basis. The lease of the aircraft may or may not be pursuant to a written lease document.¹⁶⁸ This type of transaction is probably most common where the lessee-director, lessee-officer, or lessee-employee is properly licensed and qualified to operate the aircraft personally, but in some situations, a lessee-director, lessee-officer, or lessee-employee may separately contract for the services of a qualified pilot. However, if the lessee-director, lessee-officer, or lessee-employee employs the same pilot who normally operates the aircraft for the lessor, the transaction may be deemed to be a Wet Lease notwithstanding the formal separation of the aircraft lease and the pilot employment agreement into separate transactions.

The fair market value of the use of an aircraft without a flight crew, for fringe benefit purposes, is equal to the amount that an individual would have to pay in an arm's length transaction to lease the same or comparable aircraft on the same or comparable terms for the same period in the geographic area in which the aircraft is used.¹⁶⁹ If a use of the aircraft benefits more than one employee, the value of the flight is allocated among the employees benefitted on the basis of the relevant facts and circumstances.¹⁷⁰

2. Fair Market Valuation Rule (Wet Lease)

The rules for valuing a personal-use flight of a business aircraft, where the aircraft is provided to an employee with a flight crew, are similar to the rules governing the provision of an aircraft without a crew, to the extent that the value is determined by reference to the amount that an individual would have to pay in an arm's length transaction to charter the same or a comparable piloted aircraft for that period for the same or a comparable flight, and that if a flight of the aircraft benefits more than one employee, the value of the flight is generally allocated

¹⁶⁶ Hereinafter the "Fair Market Valuation Rule (Dry Lease)".

¹⁶⁷ Hereinafter the "Fair Market Valuation Rule (Wet Lease)".

¹⁶⁸ If the aircraft is registered in the United States and has a maximum certificated takeoff weight in excess of 12,500 lbs., a written lease will be required. See 14 C.F.R. 91.23.

¹⁶⁹ Treas. Reg § 1.61-21(b)(7)(ii).

¹⁷⁰ *Id.*

among the employees benefitted on the basis of the relevant facts and circumstances.¹⁷¹ However, if more than one employee is on board the flight, and the employees can be divided into two categories, one of which includes one or more employees who have the authority to determine the route, departure time, and destination of the flight, and one which includes one or more employees who do not have such power, the general rule that the entire value of the flight is allocated among the employees benefitted on the basis of the relevant facts and circumstances is overruled, and in lieu thereof, the entire value of the flight is allocated among those employees with the authority to determine the route, departure time, and destination of the flight. No portion of the value of the flight is allocated to those employees without such authority, unless all the employees on the flight have agreed in writing to allocate the value of the flight on some other basis.¹⁷²

3. Noncommercial Flight Valuation Rule

The Treasury Regulations provide an alternative to the Fair Market Valuation Rule (Wet Lease). This alternative valuation method is a formulaic method based on the Standard Industry Fare Level¹⁷³ rates published semiannually by the United States Department of Transportation,¹⁷⁴ and hence is commonly referred to as the "Standard Industry Fare Level method", or simply the "SIFL method."¹⁷⁵

¹⁷¹ Treas. Reg. § 1.61-21(b)(6)(ii). Treas. Reg. § 1.61-21(b)(6)(ii) specifically prohibits the use of commercial airfare as a measure of the value of flight on an employer-provided piloted aircraft.

¹⁷² *Id.*

¹⁷³ Hereinafter "SIFL".

¹⁷⁴ The Airline Deregulation Act of 1978, Pub. L. 95-504, mandated that the Civil Aeronautics Board establish a Standard Industry Fare Level based upon airline fares in effect on July 1, 1979, and that the Civil Aeronautics Board periodically update the Standard Industry Fare Level by the percentage change in airline average operating costs per available seat-mile ("available seat-miles" are calculated on a flight-by-flight basis by dividing the total number of miles on the route of flight by the number of seats on board the aircraft available for sale to the public). The Civil Aeronautics Board used the Standard Industry Fare Level as a standard against which a statutory zone of reasonableness was measured until the Civil Aeronautics Board's authority to regulate passenger fare expired on January 1, 1983, and hence the Standard Industry Fare Level is technically obsolete for the purpose for which it was established. However, the Department of Transportation continues to adjust the Standard Industry Fare Level semiannually for use as an aid in evaluating air carrier pricing in the present unregulated environment.

¹⁷⁵ Treasury regulations provide that in the event the calculation of the Standard Industry Fare Level is discontinued, the Commissioner of the IRS may provide a different base aircraft

Use of the SIFL method usually results in significantly less income being imputed to the employee than would otherwise be imputed under the Fair Market Valuation Rule (Wet Lease). A reduced imputed income amount is most likely to occur if the employee is not a Control Employee¹⁷⁶ and travels alone or with only a small number of family members and other guests. However, the SIFL method can result in more income being imputed to the employee than would be imputed under the Fair Market Valuation Rule (Wet Lease) in some circumstances, such as where a Control Employee travels accompanied by a large number of family members and other guests. The reason for this is two-fold. First, the SIFL method requires that income be imputed to Control Employees at rates substantially higher than to Non-Control Employees. Second, subject to a few exceptions discussed below, the SIFL method requires that income be imputed to the employee not only for transportation provided to the employee, but also on a per-person basis for transportation provided to family members and guests who accompany the employee. Thus, the amount that would be imputed to the employee if he or she traveled alone would be doubled if the employee was accompanied by one family member or guest, tripled if the employee was accompanied by two family members or guests, and so on. As the number of family members and guests multiplies, the amount imputed to the employee increases by the same factor.

Conversely, under the Fair Market Valuation Rule (Wet Lease), the amount of income imputed to the employee would generally be fixed regardless of whether the employee was a Control Employee or a Non-Control Employee, and regardless of whether the employee traveled accompanied by family members or guests. As stated in the previous section of this article, the amount that must be imputed to an employee under the Fair Market Valuation Rule (Wet Lease) is determined in relevant part by reference to the amount that an individual would have to pay in an arm's length transaction to charter the same or a comparable piloted aircraft for that period for the same or a comparable flight. In contrast to the commercial airline industry which generally charges fares on a per-seat basis, commercial charter operators typically charge a flat hourly rate for exclusive use of an aircraft or quote a flat fee for a particular flight, and such fees generally are charged without regard to the number of passengers who will accompany the charter customer.

a. The Aircraft Valuation Formula

In order to calculate the value of a flight using the SIFL method, several factors must be considered. Each factor is discussed below.

(1) Define the Flight to be Valued

valuation formula by regulation, revenue ruling, or revenue procedure. Treas. Reg. § 1.61-21(g)(6).

¹⁷⁶ See definitions of "Control Employee" and "Non-Control Employee" *infra* Part IV.B.3.a.(4).

The Aircraft Valuation Formula is applied on a flight by flight basis, with each takeoff and landing being treated as a single flight.¹⁷⁷ Thus, a round-trip flight is treated as two separate flights. Similarly, a one-way trip with a stopover at an intermediate destination is treated as two separate flights.

Example: An employer provides personal, non-business related air transportation to an employee from New York to Los Angeles with a stopover in Chicago. The stopover in Chicago was made for purposes personal to the employee.

For purposes of calculating the value of the flight under the SIFL method, the trip is treated as consisting of two separate flights, one flight from New York to Chicago and another flight from Chicago to Los Angeles.

An exception to the foregoing rule applies to intermediate stops conducted for any reason unrelated to the personal purposes of the employee whose flight is being valued. If the stop is conducted for any reason unrelated to the personal purposes of the employee whose flight is being valued, including intermediate stops necessitated by weather conditions or emergencies, intermediate stops to disembark passengers other than those for whom the value of the flight is being calculate, or stops for refueling or other aircraft-servicing purposes, the intermediate stop is ignored, and the flight is valued as if the intermediate stop had not occurred.¹⁷⁸

Example: Same facts as the previous example, except that the sole purpose of the stopover in Chicago was to refuel the aircraft.

For purposes of calculating the value of the flight under the SIFL method, the trip is treated as consisting of a single non-stop flight from New York to Los Angeles.

(2) Determine Mileage of Flight

For purposes of calculating the value of a flight under the SIFL method, distance is measured as the number of statute miles between the origin and destination points of a flight.¹⁷⁹ Additional mileage flown resulting from any intermediate stop conducted for any reason unrelated to the personal purposes of the employee whose flight is being valued is ignored. Similarly, where actual mileage flown between two points exceeds the straight-line distance between such points, such as would be the case if the route of flight is diverted off a direct course by air traffic control or in order to avoid areas of inclement weather or restricted airspace, the additional mileage flown in excess of the straight-line distance between the points of embarkation and disembarkation is ignored.

¹⁷⁷ Treas. Reg. § 1.61-21(g)(3)(ii).

¹⁷⁸ Treas. Reg. § 1.61-21(g)(3)(iii).

¹⁷⁹ Treas. Reg. § 1.61-21(g)(3)(i).

(3) Determine Weight of Aircraft

The amount of income imputed to an employee is determined in part by the weight of the aircraft used. The Treasury Regulations divide all aircraft into four classes according to the maximum certified takeoff weight of each aircraft.¹⁸⁰ The four weight classes are as follows:

- (a) 6,000 lbs. or less
- (b) 6,001 lbs. to 10,000 lbs.
- (c) 10,001 lbs. to 25,000 lbs.
- (d) 25,000 lbs. or greater

All else being equal, the amount of income imputed will be greater for transportation provided a heavier weight class aircraft than would be the case for similar transportation provided on an aircraft in a lighter weight class.

(4) Determine Whether Employee is a Control Employee or a Non-Control Employee

Income is imputed at a higher level for certain employees defined by the Treasury Regulations as "Control Employees" than for other employees. "Control Employee" is defined with respect to a non-government employer as any employee who falls within one of the following four categories:

- (a) All board- or shareholder-appointed, confirmed or elected officers of the employer; except that the regulation provides that this category will not exceed the lesser of ten employees, or 1% of all employees (rounded up to the nearest integer);
- (b) The top 1 % of the most highly compensated employees of the employer (rounded up to the nearest integer); except that the regulation provides that this category will not exceed the top 50 most highly compensated employees;
- (c) All persons who own 5 % or more of the equity, capital or profits interest in the employer; and
- (d) All directors.¹⁸¹

(5) Determine Number of Persons with Respect to Whom Income is to be Imputed to the Employee

Unlike the Fair Market Valuation Rule (Wet Lease) pursuant to which the amount of income imputed to an employee is the same regardless of whether the employee traveled alone or with guests and /or family members, the SIFL method requires that income be imputed to the employee on a per-person basis if he or she is accompanied by family members and/or guests. Income imputed to an employee with respect to transportation provided to a guest or family

¹⁸⁰ Treas. Reg. § 1.61-21(g)(7).

¹⁸¹ Treas. Reg. § 1.61-21(g)(8).

member of the employee is calculated in the same manner as transportation provided to the employee. Thus, if transportation is provided to guest or family member of a Control Employee, income will be imputed to the Control Employee with respect to each guest or family member at the rate applicable to Control Employees.¹⁸² Exceptions exist, however, for transportation provided to infants; the value of a flight on an employer-provided aircraft for transportation of any person who is less than two years of age is deemed to be zero.¹⁸³

b. The Noncommercial Flight Valuation Formula

The Noncommercial Flight Valuation formula is deceptively simple to use. The amount of income to be imputed to an employee is calculated by multiplying the applicable SIFL cents-per-mile rate, by both the number of miles flown and by an *Aircraft Multiple*, and then by adding the applicable terminal charge. In some cases, however, it will be necessary to divide a single flight into up to three parts, and calculate each portion of the flight separately. This is because the applicable SIFL cents-per-mile rate changes after the first 500 miles of a flight, and again after the next 1,000 miles of a flight. In any case, however, only a single terminal charge will be added. Thus, for any flight over 500 miles, two or three separate calculations must be made, i.e., one calculation covering the first 500 miles of the flight, one calculation covering that portion of the flight that is in excess of 500 miles up to a total of 1,500, and, if applicable, one calculation covering that portion of the flight that is in excess of 1,500 miles. The products of each of the two or three calculations are added together, and then the terminal charge is added. If the employee is accompanied by family members or other guests, the amount derived from the foregoing calculation, including the terminal charge, is applied on a per-person basis.

(1) The Aircraft Multiple

The Aircraft Multiple is a function of two of the factors discussed above: the weight of the aircraft, and the employee's status as a Control Employee or Non-Control Employee. For each of the eight possible combinations of weight class and employee status, the Treasury Regulations prescribe an Aircraft Multiple that will act as a constant in the Noncommercial Flight Valuation formula. The function of the Aircraft Multiple is two-fold. First, to provide a greater valuation for any given flight in an aircraft in higher weight classes than for the same flight in a lower weight class aircraft. Second, to provide a greater valuation for any given flight provided to a Control Employee than for the same flight provided to a Non-Control Employee. The possible Aircraft Multiples are set forth in the following table:

Table 1.¹⁸⁴

¹⁸² Treas. Reg. § 1.61-21(g)(7)(ii).

¹⁸³ Treas. Reg. § 1.61-21(g)(1).

¹⁸⁴ Treas. Reg. § 1.61-21(g)(7)(i).

<u>Weight Class</u>	<u>Aircraft Multiple</u>	
	<u>Control Employee</u>	<u>Non-Control Employee</u>
6,000 lbs. or less	62.5%	15.6%
6,001 lbs. to 10,000 lbs.	125%	23.4%
10,001 lbs. to 25,000 lbs.	300%	31.3%
25,000 lbs. or greater	400%	31.3%

(2) *The SIFL Rates*

As previously stated, the Standard Industry Fare Level rates are published semiannually by the United States Department of Transportation. Following the publication of rates by the Department of Transportation, the IRS generally republishes the rates in a Rev. Rul. The rates applicable to flights conducted during the first six months of 2001 are set forth in the following table:

Table 2.¹⁸⁵

<u>Mileage Range</u>	<u>Amount Per-Mile</u>
0 - 500 Miles	\$ 0.1961
501 - 1,500 Miles	\$ 0.1495
More than 1,500 Miles	\$ 0.1437
	<u>Terminal Charge</u>
	\$35.84

c. A Sample SIFL Calculation

The following example illustrates the steps required to calculate the amount to be imputed to an employee as income using the Noncommercial Flight Valuation Rule:

Example: Assume a Control Employee takes a two thousand three hundred statute mile flight on an employer-provided aircraft with a maximum certified takeoff weight of twenty thousand pounds (20,000 lbs.). Assume also that the flight is primarily for personal purposes and that the employee is accompanied by two personal guests, each of whom is at least two years of age.

¹⁸⁵ Rev. Rul. 2000-13, 2000-12 I.R.B. 774.

Because the aircraft has a maximum certified takeoff weight of twenty thousand pounds (20,000 lbs.) and the employee is a Control Employee, the Aircraft Multiple (from Table 1, above) is 300%. In addition, because the flight is in excess of 1,500 statute miles, the flight must be divided into three segments for purposes of the Noncommercial Flight Valuation formula: one segment comprised of the first 500 miles of the flight; one segment comprised of the next 1,000 miles of the flight; and one segment comprised of the final 800 miles of the flight.

The amount of income to be imputed to the employee is calculated as follows:

- (1) *Calculate Value of First 500 Miles*
 $500 \times \$0.1961^{186} \times 300\% = \294.15
- (2) *Calculate Value of Next 1,000 Miles*
 $1,000 \times \$0.1495^{187} \times 300\% = \448.50
- (3) *Calculate Value of Remaining 800 Miles*
 $800 \times \$0.1437^{188} \times 300\% = \344.88
- (4) *Add Products of Steps 1, 2, and 3, and Terminal Charge*
 $\$270.60 + \$412.80 + \$317.52 + \$35.84^{189} = \$1,123.37$
- (5) *Multiply Sum of Step 4 by Number of Persons (Employee and Guests) Flying*
 $\$1,123.37 \times 3 = \3370.11

d. Combining Business and Personal Flights

Special rules apply in defining a flight for SIFL valuation purposes in situations in which a trip on an employer-provided aircraft serves both personal and business purposes, or includes separate personal and business flights. Where a flight is provided to an employee to a particular destination on an employer-provided aircraft, and the purpose of the employee in traveling to the destination serves both a personal and a business purpose, income must be imputed to the employee only if the personal purpose of the flight is primary. The determination of whether a flight is primarily for personal or business purposes is based on a facts and circumstances

¹⁸⁶ Value from Table 2 for 0 - 500 mile range.

¹⁸⁷ Value from Table 2 for 501 to 1,500 mile range.

¹⁸⁸ Value from Table 2 for 1,501 or more mile range.

¹⁸⁹ Value from Table 2.

analysis.¹⁹⁰ Factors to be considered in making such a determination include the amount of time spent on personal activities and the amount of time spent of business activities.¹⁹¹

In the context of a trip that includes two or more destinations other than the original point of departure, where at least one of the destinations is primarily for personal purposes, and at least one of the destinations is primarily for business purposes, income must be imputed to the employee with respect to the personal-purpose destinations. However, there are two different methods for defining the flight to be valued for imputed income purposes, and a determination as to which of the methods must be used requires a determination as to whether, under the principles described above, the trip as a whole was primarily for personal or business purposes.

(1) Trip Primarily Business

If the primary purpose of a trip that includes flights to both business and personal destinations is business-related, the amount of income that will be imputed to the employee will be the excess of the value of all the flights that comprise the entire trip, over the value of a hypothetical trip that included only the business destinations.¹⁹² Consequently, the amount imputed to the employee in many cases will be less than the amount that would be imputed had the trip not included the business destination.

Example: An employee takes a trip from New York to Chicago, to Los Angeles, and back to New York. Assume that Los Angeles is a personal destination, Chicago is a business destination, and that the primary purpose of the trip is business.

The calculation of the value of the flight to be imputed to the employee is a three step process. The first step is to calculate the total value of all flights flown during the entire trip, i.e., the flights from New York to Chicago, from Chicago to Los Angeles, and from Los Angeles to New York, using the Noncommercial Flight Valuation formula. Assuming the SIFL values of such flights are respectively \$1,500, \$3,000, and \$4,000, the total value of all flights in the itinerary as actually flown would be \$8,500.

The second step is to calculate the total value of all flights that hypothetically would have been flown during the entire trip if the personal-purpose destinations had not been included in the itinerary. In this case, such a hypothetical trip would have included only flights from New York to Chicago, and a return flight from Chicago to New York. Assuming the SIFL values of such flights are \$1,500 each, the total value of all flights in the hypothetical itinerary would be \$3,000.

¹⁹⁰ Treas. Reg. § 1.162-2(b)(2).

¹⁹¹ *Id.*

¹⁹² Treas. Reg. § 1.61-21(g)(4)(ii).

The third step is to subtract the value of the hypothetical trip in step two (\$3,000) from the value of the trip actually flown as determined in step one (\$8,500). The \$5,500 difference is the amount imputed to the employee.

(2) Trip Primarily Personal

If the primary purpose of a trip that includes flights to both business and personal destinations is personal, the amount of income that will be imputed to the employee will be the total value of all flights that would have been flown during the entire trip if the business-purpose destinations had not been included in the itinerary.¹⁹³

Example: Same facts as the prior example, except that the primary purpose of the trip is personal. The amount of income that will be imputed to the employee for the trip will be calculated based on a hypothetical trip that does not include a business stop in Chicago. In this case, such a hypothetical trip would have included only flights round-trip from New York to Los Angeles and back to New York.

Assuming the SIFL values of such flights are \$4,000 each direction, the total value of all flights in the hypothetical itinerary would be \$8,000, which is the amount that is imputed to the employee as income.

e. Minimizing Imputed Income

Certain rules exist permitting a company to provide transportation to an employee for personal purposes while imputing income to the employee under the SIFL rules at a reduced rate, or not at all. One such exception is provided by the "Seating Capacity Rule," and another relates to "Bona Fide Security Concerns." Each is described below.

(1) Seating Capacity Rule

The seating capacity rule provides that if 50% or more of the regular passenger seating capacity of an aircraft is occupied by persons who are traveling primarily for the employer's business, the value of the flight for certain eligible individuals who are not traveling primarily for the employer's business is treated as zero, and the amount of imputed income is therefore zero.¹⁹⁴ Persons eligible for a zero valuation include employees, employees' spouses, dependent children and parents, all children under two years of age, retirees, and retirees' surviving spouses.¹⁹⁵ An employee may not realize a zero valuation for his or her non-eligible guests, but if the requirements of the seating capacity rule are otherwise satisfied, the valuation attributable to a

¹⁹³ Treas. Reg. § 1.61-21(g)(4)(iii).

¹⁹⁴ Treas. Reg. § 1.61-21(g)(12).

¹⁹⁵ Treas. Reg. § 1.61-21(g)(12)(i)(B)(1).

non-eligible guest of an employee will be calculated as if the employee to whom the income will be imputed were not a Control Employee, even if the employee is in fact a Control Employee.¹⁹⁶ In determining whether this valuation rule is available, the 50% seating capacity requirements must be met both at the time the individual whose flight is being valued boards the aircraft, and when the individual disembarks from the aircraft.¹⁹⁷

For purposes of the seating capacity 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, even if some of the seats have been removed for the flight in question.¹⁹⁸ This would include seats that are occupied by flight crew who are not on such flight primarily to serve as flight crew. 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.¹⁹⁹ The calculation does not, however, include seats that could not and have not at any time been legally used during take-off.

(2) Bona Fide Security Concerns and the Working Condition Safe Harbor

The amount of income imputed to an employee for personal flights may be reduced if the employer requires the employee to travel on an employer-provided aircraft for all flights, both business and personal, and if a bona fide business-related security justification for such requirement exists.²⁰⁰ This special valuation rule is commonly referred to as the "Working Condition Safe Harbor". If the Working Condition Safe Harbor rule applies, the value of personal flights must be determined under the SIFL rules, even if the SIFL rules are not otherwise used or permitted, however, the SIFL rules are modified to provide that the aircraft multiple will not exceed 200% regardless of the weight of the aircraft.²⁰¹ The remainder of the calculation remains unchanged.

¹⁹⁶ *Id.*

¹⁹⁷ Treas. Reg. § 1.61-21(g)(12)(ii).

¹⁹⁸ Treas. Reg. § 1.61-21(g)(12)(iii).

¹⁹⁹ Treas. Reg. § 1.61-21(g)(12)(v).

²⁰⁰ Treas. Reg. § 1.132-5(m)(4).

²⁰¹ *Id.* The regulation provides that the excess of the value of the flight, however determined, over the value determined under the SIFL method using a 200% aircraft multiple, will be excluded from the employee's gross income as a working condition fringe benefit. In situations in which the value of the flight would in any event be equal to or less than the value determined under the SIFL method using a 200% aircraft multiple, there would be no excess value to exclude, and the regulation would have no practical effect. Examples of situations in which the value of the flight would in any event be equal to or less than the value determined under the SIFL method using a 200% aircraft multiple include the imputation of income under the SIFL method to Control Employee for use of an aircraft in a weight class of 10,000 lbs. or less, and the imputation of income under the SIFL method to a Non-Control Employee

Similarly, if a bona fide business-related security concern is determined to exist with respect to an employee, it is deemed to exist with respect to the employee's spouse as well, and as such, the aircraft multiple used in calculating the amount of income attributable to the employee's spouse likewise will not exceed 200% regardless of the weight of the aircraft.²⁰²

By specifying an aircraft multiple of 200%, the Working Condition Safe Harbor provides potential savings only to Control Employees obtaining transportation in aircraft that have maximum certified takeoff weights in excess of 10,000 lbs. as such employees would otherwise be subject to an aircraft multiple of 300%²⁰³ or 400%,²⁰⁴ and to any employee to whom income would otherwise be imputed using the Fair Market Valuation Rule (Wet Lease). The 200% aircraft multiple specified in the Working Condition Safe Harbor rule is higher than the aircraft multiple that would otherwise be applicable to Control Employees obtaining transportation in aircraft that have maximum certified takeoff weights of 10,000 lbs. or less, and to all non-Control Employees regardless of aircraft weight, and consequently the use of the Working Condition Safe Harbor rule would actually result in a greater amount of income being imputed to such employees were the rule to be used in such cases.

In order for the Working Condition Safe Harbor valuation rule to apply, the employer must demonstrate that a specific bona fide business-related basis for concern exists regarding safety of the employee in question.²⁰⁵ Such a demonstration requires a facts and circumstances-based analysis; a mere generalized concern for the safety and welfare of the employee is insufficient.²⁰⁶ Types of concerns that would support the use of this valuation rule include threats of death or kidnapping; threats of serious bodily harm to the employee²⁰⁷; or a recent history of violent terrorist activity (such as bombings) in the geographic area in which the transportation is to be provided, unless such activity is focused on a group that does not include the employee.²⁰⁸

regardless of the weight class of the aircraft. In light of the foregoing, the practical effect of Treas. Reg. § 1.132-5(m)(4) is to cap the aircraft multiple at 200%.

²⁰² Treas. Reg. § 1.132-5(m)(4).

²⁰³ Aircraft multiple generally applicable to Control Employees use of aircraft that have maximum certified takeoff weights in excess of 10,000 lbs., but not in excess of 25,000 lbs. Treas. Reg. § 1.61-21(g)(7).

²⁰⁴ Aircraft multiple generally applicable to Control Employees use of aircraft that have maximum certified takeoff weights in excess of 25,000 lbs. *Id.*

²⁰⁵ Treas. Reg. § 1.132-5(m)(2)(i).

²⁰⁶ *Id.*

²⁰⁷ Treas. Reg. § 1.132-5(m)(2)(i)(A).

²⁰⁸ Treas. Reg. § 1.132-5(m)(2)(i)(B).

(a) An Overall Security Program

Even if an actual basis for concern exists, the general rule established by the Treasury Regulations provides that the IRS will consider it to be a *bona fide* security concern only if the employer establishes an overall security program acceptable to the IRS with respect to the employee.²⁰⁹ Such a program must provide security to the employee on a 24 hour-a-day basis, including security at the employee's residence and workplace, and while traveling, whether for business or personal reasons.²¹⁰ In addition, the program must 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 and residence.²¹¹ An overall security program will be deemed to exist if it is established pursuant to an independent security study (discussed below).

(b) Alternative Security Program

In certain circumstances, the IRS will accept an alternative, less comprehensive security program in lieu of an overall security program for purposes of determining eligibility for the Working Condition Safe Harbor valuation rule.²¹² In order to qualify an alternative security program, the security program must be established pursuant to the reasonable recommendations of an independent security consultant, and the consultant's recommendations must meet the following criteria:

- i)* The security consultant must perform, and base his or her recommendations on, a security study with respect to the employer and the employee.
- ii)* The security study must be based on an objective assessment of all the facts and circumstances relating to the threat against the employee.
- iii)* The security study must result in a reasonable determination that an overall (i.e., comprehensive) security program is not necessary under the circumstances.
- iv)* The recommendations of the security consultant must be applied on a consistent basis.

C. CONSISTENCY RULES

As has been shown above, the Noncommercial Flight Valuation Rule potentially could result in either a greater or lesser amount of income being imputed to an employee for personal

²⁰⁹ Treas. Reg. § 1.132-5(m)(2)(B)(ii).

²¹⁰ Treas. Reg. § 1.132-5(m)(2)(B)(iii)(A).

²¹¹ *Id.*

²¹² Treas. Reg. § 1.132-5(m)(2)(B)(iv).

flights than would be imputed to the employee under the Fair Market Valuation Rule (Wet Lease), depending on the number of guests and family members that accompany the employee, and the employee's status as either a Control Employee or a Non-Control Employee. Consequently, there may be a desire on the part of some taxpayers to apply the Noncommercial Flight Valuation Rule to some flights, and the Fair Market Valuation Rule (Wet Lease) to other flights. Unfortunately, the Treasury Regulations prohibit such cherry-picking. As a general rule, in order to use the Noncommercial Flight Valuation Rule, it is necessary that both the employer and all the affected employees agree to apply the Noncommercial Flight Valuation Rule to all flights of all employees that are taken on employer-provided aircraft for the year.²¹³

Two exceptions to the foregoing general rule apply. First, as discussed in IV.B.3.e.(2), above, the Noncommercial Flight Valuation Rule may be used to calculate the value of personal transportation provided to an employee on an employer-provided aircraft if the employee is required to use employer-provided transportation for personal flights as part of an overall or alternative security program, regardless of whether the Noncommercial Flight Valuation Rule is used to value personal transportation provided to other employees.

Second, certain errors on an original or amended tax return by either a Control Employee with respect to a particular flight, or by an employer with respect to a particular flight by a Control Employee, will result in the loss of the ability to use the Noncommercial Flight Valuation Rule to value the flight in question. Errors that will result in the loss of the ability to use the Noncommercial Flight Valuation Rule include imputing income at the Non-Control Employee rates, imputing income at the rates applicable to a lighter aircraft weight class than the class of the aircraft used, and excluding all or a portion of the value of the flight as a working condition fringe under I.R.C. § 132 if it is subsequently determined that I.R.C. § 132 was not applicable to the flight in question.²¹⁴ Treasury Regulation 1.61-21(g)(13) appears to apply a strict liability standard with respect to the errors within its scope in that the regulations provides neither relief from its application in the event an error is inadvertent, nor relief to an innocent Control Employee in the event the error is caused by the employer.

V. CONCLUSION

Corporate aviation is booming. Every day, more and more corporations and business men and women are discovering the benefits of owning and operating private aircraft. As a business tool, a private aircraft affords its owner the opportunity to manage his or her time in a much more efficient manner than may be accomplished using commercial air transportation. Those benefits come at a price, however. Corporate aircraft are expensive to own, and expensive to operate. The acquisition cost of a top-of-the-line corporate jet can easily exceed \$40,000,000.

²¹³ Treas. Reg. § 1.61-21(g)(14).

²¹⁴ Treas. Reg. § 1.61-21(g)(13).

Expenses for fuel, maintenance, hangar, pilots and mechanics, insurance, aircraft management, and other operating costs can run into additional millions of dollars each year. Given the magnitude of the costs involved, no person or corporation should acquire an aircraft without first conducting a thorough analysis of the scope of the operations to be conducted, and preparing an operations plan. Perhaps one of the most critical steps in the process of planning for corporate flight operations is an analysis of all of the tax consequences that are likely to result. Various excise and income tax liabilities arising from corporate aircraft operations can greatly increase the costs of aircraft ownership and operations. However, with proper planning, such tax liabilities may be minimized, and the aircraft may be utilized in the most tax-efficient manner possible.