CHARGING FOR USE OF CORPORATE AIRCRAFT: FEDERAL EXCISE TAXES

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Determining whether a flight is commercial or noncommercial for purposes of determining applicability of Federal Air Transportation Excise Taxes (a.k.a. "FET") is not always a simple or straightforward task. There is no question that Part 135 charter operations and scheduled Part 121 operations are considered commercial operations by both the FAA and the IRS. However, there is often a great deal of confusion among business aircraft operators regarding the taxability of certain types of flight operations conducted under Part 91.

Perhaps nowhere is this confusion greater than in the context of a corporation, limited liability company, partnership, or other business entity that provides air transportation to its parent, subsidiaries, affiliates, shareholders, directors, partners, and/or employees under Part 91, and is reimbursed for the costs incurred in providing the air transportation. If certain conditions are met, such transportation may be exempt from the FET under an affiliated group exemption or another statutory exemption. However, absent an exemption, the IRS has historically considered air transportation under such circumstances to be commercial in nature and subject to the FET, except when an explicit statutory exemption applies.

The IRS may find commercial air transportation to have occurred where, for example, a company provides air transportation services to another closely affiliated company for business-related purposes if reimbursement for the costs of the flight is made and the requirements of the affiliated group exemption are not satisfied; or where a company makes its aircraft and crew available for personal use by its executives under conditions requiring the executives to reimburse the company for the incremental costs of personal-use flights. Taxpayers who are not completely familiar with the IRS position on the issue often are shocked to learn how broadly the IRS defines "commercial" air transportation for FET purposes. Perhaps nowhere is this point better illustrated than in TAM 199946005.

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 air transportation services to anyone outside the ownership group. 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 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 FET. (The partnership structure may also have been in violation of the Federal Aviation Regulations, but that is a topic for another article).

Notwithstanding the IRS's long-held position on the issue, as set out in TAM 199946005, the IRS partial-

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ly reversed itself recently and held in Priv. Ltr. Rul. 200203019 that the FET does not apply to amounts paid by a taxpayer to a wholly-owned limited liability company as compensation for air transportation services provided by the limited liability company in cases in which the limited liability company was disregarded as a business entity separate from the taxpayer.

Priv. Ltr. Rul. 200203019 involved a limited partnership that owned 100% of the interests in three separate limited liability companies. One of these limited liability companies owned and operated an aircraft for the sole purpose of providing air transportation services to the parent limited partnership and to the other two limited liability companies. Treasury Regulations provide that a limited liability company that has only a single owner and that neither is characterized as a corporation under Section 301.7701-2(b) of the regulations, nor has elected under Section 301.7701-3(a) of the regulations to be treated as a corporation for Federal income tax purposes, will be disregarded as an entity separate from its owner. None of the limited liability companies were characterized as corporations under Section 301.7701-2(b), nor had any elected under Section 301.7701-3(a) to be treated as a corporation for Federal income tax purposes. Consequently, none were treated as entities separate and apart from the parent-limited partnership. Based on these facts, the IRS determined in Priv. Ltr. Rul. 200203019 that each of the limited liability companies were to be treated in the same manner as sole proprietorship, branch, or division of the parent limited partnership, and that consequently the payments made to the aircraft operating limited liability company by the parent limited partnership and the other two limited liability companies could not be considered amounts paid for air transportation services within the meaning of IRC Section 4261.

Although not directly addressed in Priv. Ltr. Rul. 200203019 or any other IRS rulings, the IRS' analysis in Priv. Ltr. Rul. 200203019 logically should apply with equal force to air transportation payments between a corporation taxable under Subchapter S of the IRC (an "S Corp) and its Qualified Subchapter S Subsidiary (a "QSSS"). Just as a wholly owed limited liability company may be ignored as an entity separate from its sole member, a corporation that qualifies as a QSSS is not treated as a corporation separate from its parent corporation, and all assets, liabilities, income, deductions, and credits of the QSSS are treated as assets, liabilities, income, deductions, and credits of the parent corporation.

A domestic corporation that is not an ineligible corporation as such term is defined in IRC Section 1361(b)(2) qualifies as a QSSS if 100% of the stock of the corporation is held by a corporation taxable under IRC subchapter S, and the parent corporation elects to treat the subsidiary corporation as a QSSS. Thus, if the analysis in Priv. Ltr. Rul. 200203019 is transferred and applied to S Corps and QSSS's, then where a QSSS provides air transportation services to its parent S Corp, or any other QSSS, limited liability company, or other entity that is disregarded as an entity separate from the parent QSSS, the air transportation payments should not be subject to FET. As previously stated, however, to date the IRS has not directly addressed the issue in the context of S Corps and QSSS's.

Effective planning for corporate aircraft ownership and operations requires a complete and in-depth understanding of applicable State and Federal tax issues, as well as the Federal Aviation Regulations. Troy A. Rolf is an aviation and tax attorney concentrating in the areas of corporate aircraft transactions and operations in the Minneapolis Office of Galland, Kharasch, Greenberg, Fellman & Swirsky, P.C. The firm's business aircraft practice group provides full-service tax and regulatory planning and counseling services to aircraft owners, operators and managers. The group's services include Section 1031 tax-free exchanges, federal tax and regulatory planning, state sales and use tax planning, and negotiation and preparation of all manner of transactional documents commonly used in the business aviation industry, including aircraft

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