New Taxes Being Levied by the IRS on Corporate Aircraft Operations

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Internal Revenue Service ("IRS") auditors have in recent years become more aggressive in audits of aircraft management companies and charter operators particularly with respect to the imposition of the 7.5% federal excise tax on amounts paid for transportation of persons by air ("FET"). In particular, IRS auditors have begun assessing the FET on a wide variety of non-commercial flight operations, including flight operations conducted by aircraft owners under Part 91 of the Federal Aviation Regulations (FAR) in situations where the aircraft is managed by an outside aircraft management company.

This article analyzes existing guidance regarding whether the FET applies to FAR Part 91 operations of aircraft managed by a management company and whether, in certain situations, some IRS agents may be incorrectly asserting that an aircraft owner has inadvertently and continuously transferred "possession, command and control" of its aircraft to a management company and thereby subjected itself to FET with respect to the owner's flights and therefore on the amounts it pays to the management company.

Background

In April 2008, the IRS published a revised version of its Air Transportation Excise Tax Audit Techniques Guide (the "Guide"). The Guide contains an overview of the application of FET in particular situations; interprets existing law regarding FET; and is a resource used by IRS field auditors in connection with the conduct of FET audits of taxpayers. The objective of the Guide is to provide IRS field auditors with a compilation of the laws, regulations, judicial opinions and IRS rulings applicable to federal air transportation excise tax. However, specific examples in the Guide of the application of those authorities to particular fact patterns do not always reflect "real world" scenarios.

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Consequently, since the time that the IRS published the Guide, some IRS agents, many of whom have little or no understanding as to how the business aviation industry functions, appear to be misinterpreting the law and overreaching to assess FET on management company arrangements.

Description of the FET

FET applies on a person-by-person and a flight-by-flight basis. FET includes three elements: (i) a percentage tax, (ii) a head tax on domestic flight segments and (iii) a head tax on international transportation.[2] Furthermore, FET only applies to "taxable transportation" that consists of the provision of transportation by one taxable entity to a separate taxable entity for compensation.[3] For FET purposes this generally includes FAR Part 121 (airline) and FAR Part 135 (charter) flights but generally does not include FAR Part 91 operations. However, there are certain instances where FAR Part 91 operations are treated as "taxable transportation."

A taxable entity must have "possession, command and control" of an aircraft to be treated as the provider of taxable transportation for purposes of the FET.[4] In some rulings, the IRS has appeared to equate "operational control" with "possession, command and control" but this is not always the case.[5] Furthermore, based on the approach seen in recent audits, it appears that the determination by some IRS agents of who has "possession, command and control" of an aircraft clearly is divergent from the determination of who has operational control of the flight for FAA purposes. Consequently, the key issue in IRS excise tax audits of aircraft management companies is whether the aircraft owner or the aircraft management company has possession, command and control of the aircraft.

Pursuant to Chapter 5 of the Guide, "possession, command and control" is determined by analyzing (i) who chooses and pays for the pilots; (ii) who provides maintenance on the aircraft; (iii) who controls the scheduling of the aircraft; and (iv) who pays for the insurance and other expenses of the aircraft. The foregoing factors have been derived in part from various IRS revenue rulings, including Rev. Rul. 58-215.[6]

Rev. Rul. 58-215 involved the applicability of the FET to payments made by a corporate owner of an aircraft to an airline company, where the airline company serviced, maintained and overhauled the aircraft on behalf of the corporate owner, and provided the services of a pilot and a co-pilot who would serve under the exclusive control of the corporate owner. The aircraft was used for the purpose of transporting the corporate owner's own personnel. The IRS ruled that since the corporate owner owned the aircraft, had exclusive control over aircraft personnel, paid the operating expenses of the aircraft,

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[2] Internal Revenue Code § 4261. The head tax on international transportation does not apply to any flight that is entirely subject to the percentage tax.
[3] I.R.C. § 4261(a), (b).
[4] Rev. Rul. 60-311, 1960-2 C.B. 341.
[5] *See* Rev. Rul. 78-75 (holding that the status of a commercial operator under FAA regulations is not determinative in applying the FET).
[6] 1958-1 C.B. 439.

and maintained liability and risk insurance, all while the airline company operated the aircraft as an agent for the corporation, the airline company was not, with respect to these service, furnishing a transportation service for hire. Accordingly, tax on the transportation of persons did not apply to amounts paid by the corporation to the airline company.

Application of FET to Managed Aircraft

When the IRS determines that a management company has the requisite "possession, command and control" of an aircraft and is therefore providing "taxable transportation" to that aircraft's owner, it typically assesses FET on all amounts paid by the aircraft owner to the management company. These amounts include, but are not limited to, crew salary reimbursements, insurance premium payments, hangar rent, management fees, and aircraft operating costs advanced by the management company on behalf of the aircraft owner. However, the IRS has stated that it will accept the use of a fair market value charter rate in lieu of computing the tax on the foregoing basis.[7]

While the typical fact pattern involves use of the aircraft owner's aircraft for charter to the public, application of the guidance set forth in the ATG by some IRS agents extends to fact patterns that do not involve charter. In other words, some IRS auditors may determine that the owner has transferred "possession, command and control" of its aircraft to a management company when the owner's aircraft has been operated only by the owner and only pursuant to FAR Part 91.

From a practical standpoint, a management company serves as an outsourced version of an in-house flight department by performing various functions necessary to support the operation of the aircraft by the aircraft owner. These functions often include interviewing, hiring/employing/managing the crew, negotiating an insurance policy, leasing hangar space for the aircraft, and coordinating and managing all maintenance related to the aircraft. Regardless of whether these functions are performed by an in-house flight department or are outsourced to a management company, when aircraft flight operations are conducted by the aircraft owner under FAR Part 91, the aircraft owner remains legally responsible for costs and other liabilities related to such flight operations.

When an aircraft owner engages a management company, that company provides the aircraft owner with aircraft management services at the request of the aircraft owner and per its instructions.[8] Unless otherwise agreed to by the aircraft owner and the management company, the management company does not acquire any independent right to dictate which crew members fly the aircraft; to mandate that the aircraft owner continue to use the fleet insurance policy offered by the management company; to require that the aircraft be stored in the management company's hangar; or to have maintenance performed at the maintenance facility designated by the management company. These are all items that the management company provides to the aircraft owner at its request and as agreed upon between the aircraft owner and the management company. Based on

[7] Rev. Rul. 74-123, 1974-1 C.B. 318.
[8] Rev. Rul. 58-215, 1958-1 C.B. 439; Rev. Rul. 60-311, 1960-2 C.B. 341.

applicable guidance described in the Guide and summarized above, at no time during this process does the management company obtain "possession, command and control" of the aircraft.

Furthermore, some IRS agents appear to have a misguided understanding with respect to aircraft that are placed on charter certificates and the concept of who has "possession, command and control" of the aircraft at any given time. If the contract between the aircraft owner and the management company provides that the owner's right to unfettered use of its aircraft may be restricted because of a previously scheduled charter, some IRS agents use those contractual provisions to conclude that the owner has given up "possession, command and control" of the aircraft.

However, scheduling protocol is ultimately based on the owner's needs and in the manner determined by the owner. If the aircraft owner has the unfettered right to cancel a charter flight up until take-off, it is more difficult for the management company to charter the owner's aircraft. The owner may determine that its scheduling requirements do not require that it inhibit the management company's ability to maximize charter revenue for the owner's benefit by providing the owner with the unfettered right to cancel a scheduled charter flight. The myopic focus by some IRS agents on this issue is baffling as it should not be determinative of who has "possession, command and control" of an aircraft. Instead, these IRS agents should take a broader and more balanced approach that takes into account the realities of the aircraft charter business model and the aircraft owner's right to determine its scheduling priorities with respect to its aircraft.

In some cases, IRS agents assess a substantial FET liability based on its erroneous interpretation of the law. As an example, a large cabin class aircraft being operated by an owner for 300-400 hours a year could have a $1.5 million annual budget, and with FET assessed at 7.5% of such amount, the tax liability alone, before interest and penalties would exceed $100,000 for just one year's operations. Since the IRS would generally audit three years of tax filings, on a single aircraft a management company could be assessed over $300,000 plus penalties and interest.[9]

Conclusion

Members of the business aviation community should be aware that some IRS agents are paying particular attention to aircraft management companies and assessing FET on revenues those companies receive from aircraft owners in connection with operations in private carriage in a manner that appears to be contradictory to applicable law. It is therefore essential that business aircraft owners consult with their aviation tax advisors to ensure that their relationships with management companies are structured in a

[9] Some minor offsets against any assessed federal excise taxes exist. The federal excise tax on fuel purchased for the aircraft owner's operations could provide a small offset against FET liability. In addition, a management company should be entitled to claim that the aircraft owner's international flights are exempt from the 7.5% excise tax and that, instead, a de minimis international facilities tax would be due. Finally, it seems reasonable that an aircraft management company could argue that fixed costs should be prorated between owner usage and charter usage, in the event that the aircraft was also used in charter operations.

manner that minimizes the risk of an FET assessment on what are clearly non-commercial flight operations.
