New Federal Excise Tax Liabilities for Whole Aircraft Operations
Under FAR Part 91 and for Fractional Ownership
By Keith G. Swirsky

There is a common perception among industry professionals and aircraft owners that Federal Excise Taxes (FET) are not applicable to FAR Part 91 operations for whole aircraft owners and that the fractional aircraft programs collect all applicable FET. Effective January 1, 2008, for many fractional owners and whole aircraft owners operating under the rules of FAR Part 91, these perceptions will be, in many cases, ***wrong.*** Even prior to January 1, 2008, as will be discussed below, owners have inadvertently created ownership and operating structures that result in liability for FET.

New Law

The IRS issued final regulations (T.D. 9356) under the Self-Employment Contributions Act that treat qualified subchapter S subsidiaries (QSubs) and single member limited liability companies (SMLLC's), currently considered disregarded entities, as separate entities for purposes of FET. These regulations were effective August 16, 2007, and apply to FET liabilities for periods beginning on or after January 1, 2008. Under these regulations, an entity that is disregarded for federal income tax purposes is nonetheless required to pay and report excise taxes, required and allowed to register with the IRS, and allowed to claim fuel tax credits and refunds. Since a disregarded entity does not file an income tax return, the fuel tax credit may be claimed on the owner's personal income tax return. The regulations provide few examples of their applicability; there exists a real possibility that the IRS will interpret the regulations to treat an SMLLC or QSub as an entity that provides "transportation services" to its member or shareholder, thereby subjecting the contributions and payments to the SMLLC or QSub to the FET imposed under IRC Section 4261, for periods commencing on or after January 1, 2008.

Application to Fractional Aircraft Owners

It is very common for fractional aircraft owners to set up a new legal entity to acquire ownership of their fractional share. In many cases this entity is set up as an SMLLC, or as a QSub, which is treated as a disregarded entity for federal income tax purposes (or possibly an S corporation, discussed later in this article). In many cases this SMLLC or QSub will enter into all of the fractional program governing documents. The fractional program will invoice the SMLLC or QSub for the monthly management fee and the periodic occupied hourly rate charges and other incidental fees. In order to pay the invoices, the owner of the SMLLC, or the parent corporation of the QSub, will generally make capital contributions or provide other funding to the SMLLC or QSub to pay such monthly charges.

If this fact pattern fits your current operating structure, the new law effective January 1, 2008, may directly impact you. Specifically, under a conservative reading of the regulations, your SMLLC or QSub will be deemed to have provided a transportation service to you as the SMLLC's single member, or to the QSub's parent corporation, and you will need to perform an analysis to determine the "amounts paid" subject to FET. This result is inconsistent with the current fractional industry paradigm whereby the program collects and remits to the IRS federal excise taxes on the occupied hourly rates.

Possible Solutions

It may be possible to restructure the fractional ownership and operating structure to avoid FET, other than FET collected by the fractional program on the occupied hourly rate. The key to avoiding application of these regulations for SMLLCs and QSubs, relates to bifurcating ownership from operations. In particular, the approach to bifurcation would require separation of the ownership from the management into two separate entities and/or persons. The fractional program documents will need to be revised slightly, and an additional "Dry Lease" will need to be entered into between the "Owner" and the "Operator".

In addition, an anlysis should be performed to determine if the "affiliated group" exemption contained in IRC Section 4282 applies. This section provides that amounts paid for transportation services between and among entities, eligibile for filing their federal income tax returns on a consolidated basis, are exempt from the FET imposed under IRC Section 4261. For these purposes, the exclusion of certain entities, under the affiliated group rules such as S corporations, does not apply. Therefore, it is likely that a QSub will be eligible for the affiliated group exemption, but, more often than not, an SMLLC will not be eligible.

Application to Whole Aircraft Ownership Operated Under FAR Part 91

Many owners of whole aircraft have also set up SMLLCs or QSubs to acquire ownership of their aircraft and to fund all aircraft operations. As of January 1, 2008, the new regulations described above may apply to these structures, and these entities may no longer be treated as disregarded entities for purposes of FET. Accordingly, under IRC Section 4261, all capital contributions and other funds provided to these SMLLCs and QSubs to cover aircraft operations will be deemed "amounts paid" for taxable transportation and may be subject to FET. Simply put, if your P & L shows a payment to an SMLLC or QSub of pilot salaries, fuel, landing fees, catering and other direct and fixed operating costs associated with aircraft operations, then it is likely that an aircraft transportation service has been provided by the SMLLC or QSub to another person or legal entity, creating the FET liability dilemma.

Professional Management

Many whole aircraft are managed by professional management companies. In the event you utilize a professional management company and, assuming the facts above, the contract for management services has been entered into by this SMLLC or QSub, it is likely that there is an inadvertent FET liability applicable to the cost of the "owners" flights.

Application to New York Residents.

Of particular interest, many owners of aircraft based in the State of New York will have created ownership and operating structures to comply with the New York "interstate" commerce exemption, in order to avoid sales and use tax in the State of New York. The New York interstate commerce exemption applies to operations conducted under FAR Part 91, and, with properly structured aircraft operations, the purchase and use of an aircraft hangared in the State of New York may be exempt from sales and use tax. The problem, however, is that such structures will in most cases result in FET being imposed on the amounts charged by the aircraft owning entity to the affiliated entity or entities. This issue is specifically targeted to structures utilizing SMLLCs and QSubs for purposes of qualifying for the New York State interstate commerce exemption. Those structures that utilize C-corps eligible for filing on a federal consolidated income tax return will not have such a problem as payments between C-corporations eligible for filing on a federal consolidated income tax return will remain exempt from FET.

Possible Solutions

As with fractional aircraft owners, whole aircraft owners may restructure their operations to avoid the impact of the regulations. Once again, the solution to the problem rests with creating the bifurcated ownership and operating structure. In other words, ownership of the aircraft must be separated from operation of the aircraft into two persons or legal entities and an additional "Dry Lease" will need to be entered into between the "Owner" and "Operator". In addition, the affiliated group exemption should be reviewed, to determine its applicability. For those owners in the State of New York and utilizing a highly structured situation to avoid state sales and use taxes, restructuring should be done only in the context of an analysis of the impact thereof on liability for state sales and use taxes.

Federal Excise Tax Liabilities for S Corporations

If your aircraft is owned by an S corporation, that is owned by you or several individuals, longstanding rules promulgated by the IRS provide that amounts you contribute or pay to the S corporation to cover the costs of operating the aircraft (including fixed costs) are subject to FET. If you operate a whole aircraft under FAR Part 91, this FET liability still applies. If you are in a fractional program, and remit FET on the occupied hourly rate charges, then you have shifted the point of taxation to your S corporation, and an analysis will be needed to determine the "amounts paid" by you to your legal entity that are subject to FET. As with SMLCCs and QSubs, the possible solutions to the FET problems are identical.

FLIGHT DEPARTMENT COMPANY DILEMMA

It is also noteworthy that in the event an SMLLC, QSub or Scorporation, with no other business operations, owns and operates a whole aircraft, or enters into all of the fractional program documents, there is the likelihood of a violation of the Federal Aviation Administration's (FAA) so called "flight department company" rule. This "flight department company" rule is violated because the primary activity of the legal entity is to provide aircraft transportation services for the entity's owner(s). The FAA can impose civil fines and/or undertake pilot enforcement actions in these circumstances. At worst, if you own an insurance policy that requires all aircraft operations to comply with the laws of the United States, such as structure would potentially violate the terms of such a policy.

Overall Federal and State Tax Considerations

Any restructuring of aircraft ownership and operations to account for the changes in the law described above will also require a review of issues such as eligibility for depreciation deductions, characterization of depreciation as passive or active, and in general, deductibility of operating expenses. Many aircraft ownership and operating structures set up through S corporations, whose primary activity is ownership (and operation) of an aircraft, have other problems in the area of eligibility for depreciation, and deductibility of operating expenses under IRC Sections 162 and 183 (Section 183 deals with hobby loss rules).

It is also likely that the restructuring through a bifurcation of ownership and operations will necessitate an examination of state sales and use tax liabilities. The sales and use tax analysis will differ significantly for fractional owners versus whole aircraft owners because fractional ownership allows for additional theories of exemptions from sales and use tax.

My Brain Hurts

It is clear that federal income and excise tax planning, state sales and use tax planning and FAA regulatory planning requires a "melting pot" approach. To determine the best approach to depreciate an aircraft and deduct operating expenses, to eliminate or substantially reduce sales and use taxes, to avoid FET, to plan for FAA regulatory compliance, and liability protection and economic/cash flow considerations, requires significant aviation and tax expertise and a large dose of business judgment. The FET liabilities discussed in this article are only the tip of the iceberg for those readers who have recognized that they have a problem with their ownership and operating structure.

The aviation lawyers at Galland, Kharasch, Greenberg, Fellman & Swirsky are adept at analyzing these issues and providing tax, FAA and business oriented guidance on creating an ownership and operating structure to produce the most advantageous results with the least amount of risk. The National Business Aircraft Association (NBAA), is also alert to these FET concerns, and together with members of the NBAA Tax Committee and its lobbyists, will be working with the IRS to achieve a positive result for its members.

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Keith G. Swirsky is a tax specialist concentrating in the areas of corporate aircraft transactions and aviation taxation. The firms business aircraft practice group, chaired by Mr. Swirsky, provides full-service tax and regulatory planning and counseling services to corporate 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 purchase agreement, leases, joint-ownership and joint-use agreements, management and charter agreements, and fractional program documents.

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