



Key Issues To Consider Concerning Use of an Aircraft Management Company/Federal Excise Tax Update

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Overview of Key Issues Discussion

- ➔ Ownership and Operating Structure
- ➔ Operational Control
- ➔ Business Considerations
- ➔ Tax Considerations



Ownership/Operating Structure

- ➔ Aircraft Ownership and Operation Separated?
- ➔ Who will employ the pilots?
 - Management company
 - One of the Part 91 lessees
 - A third party
- ➔ Must consider federal excise tax implications (discussed below)!



Operational Control Planning

- ➔ Exclusively Part 135: Management company will always have Operational Control
- ➔ Both Part 91 and Part 135: Management company always has Operational Control of Part 135 flights/Lessee always has Operational Control of lessee's flights
 - Part 91 ferry, positioning, test and similar flights may be under Operational Control of Management company or lessee
- ➔ Exclusively Part 91: Lessee always has Operational Control



Operational Control Planning

➔ **Ensure that Operational Control is allocated clearly and unequivocally per the operative documents**

- Management company – Part 135
- Lessee – Part 91

➔ **Control of pilots**

- Part 135 – Pilots must be employees or agents of management company
- Part 91 – Lessee must control pilots even if employees of management company
- Must consider FET implications interwoven throughout



Business Considerations

Part 91 Management

- ➔ **Term of agreement**
- ➔ **Deposit**
 - Commingled
 - Segregated funds
- ➔ **Monthly management fees**
- ➔ **Hangar rent**
- ➔ **Flight crew salaries and benefits**
 - Right to control pilots
 - Dedicated vs. cross-utilization
 - Day-rate
 - Allocation of training costs
- ➔ **Aircraft maintenance and cleaning**
 - Cost of labor
 - Cost of parts
 - Prior approval required
- ➔ **Fuel**
- ➔ **Insurance**
- ➔ **Catering**



Business Considerations

Part 135 Charter

- ➔ **Conformity inspection fees**
- ➔ **Charter rates**
- ➔ **Allocation of charter revenue**
 - Manager-originated charters
 - Owner-originated charters
 - Occupied flight legs
 - Empty flight legs
- ➔ **Allocation of charter expenses**
- ➔ **Scheduling priority**
 - Rights to preempt charters
 - Compensation for preempted charters
- ➔ **Fuel surcharges**
- ➔ **Incidental expenses**



Tax Considerations

Part 135 Charter

➔ Federal income tax - deducting expenses

- Trade or business (Code Sec. 162)
- Hobby loss (Code Sec. 183)
- Depreciation limitations – Personal Use (Code Sec. 280F)
- Depreciation schedule – 5/7 Year MACRS (Code Sec. 168(c)) (recapture risk)
- Passive activity loss limitations (Code Sec. 469)

➔ State sales and use tax

- Sale for resale exemption
- Common/commercial carrier exemption
- Interstate commerce exemption

➔ Federal air transportation excise taxes

- Federal fuel excise tax credits





Federal Excise Tax Overview and Update

Overview

Most flights are taxable

- ➔ Non-Commercial flights are subject to excise taxes on aviation gasoline and jet fuel.
- ➔ Commercial flights are subject to a smaller excise tax on aviation gasoline and jet fuel, plus excise taxes imposed on amounts paid for the transportation of persons and property by air.



Overview

- ➔ The FAA and the IRS do not apply the same standard in determining whether a flight operation is commercial or non commercial.
- ➔ The IRS is not bound by the FAA's determination regarding the commercial or non-commercial nature of any flight operation.



Overview

➔ FAA Commercial v. Non-Commercial Determination

- Generally, a flight is commercial if the party who exercises *Operational Control* receives any compensation (cash or non-cash) for the provision of an air transportation service to another party.
- *Operational Control* is defined in FAR 1.1 as the exercise of authority over initiating, conducting or terminating a flight.



Overview

➔ IRS Commercial v. Non-Commercial Determination

- *Non-commercial aviation* is defined as any use of an aircraft, other than use in a business of transporting persons or property for compensation or hire by air.
- *Commercial aviation* is defined as any use of an aircraft other than in *non commercial aviation*.
- *A flight is considered commercial aviation if the party who exercises Possession, Command and Control is providing transportation of persons or property for compensation or hire.*



Overview

- ➔ Part 135 Operations. Operations conducted under FAR Part 135 are generally considered commercial by both the FAA and the IRS (unless a specific exemption applies).
- ➔ Part 91 Operations. Operations conducted under FAR Part 91 are considered non-commercial by the FAA, *but could be considered commercial by the IRS*.



Overview

➔ Examples of Part 91 operations considered *non-commercial* by the FAA, but *commercial* by the IRS include:

- Carriage of candidates in federal elections
- Demonstration, time sharing, and interchange flights
- Fractional programs (effective April 1, 2012, flight operations conducted by fractional programs under Part 91, Subpart K are classified as non-commercial subject to fuel excise taxes totaling \$0.36 per gallon (the \$0.219 per gallon excise tax for fuel used in non-commercial flight operations, plus a new fuel surtax of \$0.141 per gallon)
- Any reimbursements from shareholders, members, partners, directors, employees, etc., to a corporation, LLC, partnership or other business entity generally, including for personal use
 - Includes reimbursements or capital contributions to a special purpose entity to cover the aircraft budget (discussed in greater detail later)



Commercial Air Transportation Taxes

Base Rates for Domestic Flights.

- Passengers: 7.5%
- Property: 6.25%

Segment Fees for Domestic Flights

- Currently \$3.80 (subject to increase annually) per person for each segment of taxable transportation, excluding any segment that begins or ends at a designated *rural airport*



Commercial Air Transportation Taxes

➔ Rates for International Flights

- Currently \$16.70 (subject to increase annually) per person on international flights beginning or ending in the United States.

➔ *The 7.5% and 6.25% Base Rates do not apply to international flights.*



Jet Fuel and Aviation Gasoline Tax Rates

Non-Commercial Operations

- ➔ Jet Fuel: 21.9 cents per gallon
- ➔ Aviation Gasoline: 19.4 cents per gallon

Commercial Operations

- ➔ Jet Fuel: 4.4 cents per gallon
- ➔ Aviation Gasoline: 4.4 cents per gallon

If tax is paid "at the pump" at the non commercial rates, the purchaser is entitled to a claim a refund or credit of the 17.5 cents per gallon difference between the non commercial and commercial rates for jet fuel, or the 15 cents per gallon difference between the non commercial and commercial rates for aviation gasoline.



Commercial Air Transportation Taxes

Charges Included in the Tax Base.

- ➔ All flight time, including ferry time
- ➔ Waiting time
- ➔ Landing fees
- ➔ FBO handling fees
- ➔ Crew expenses, including hotels, rental cars, and meals
- ➔ Any other expense incurred in the movement of the aircraft



Commercial Air Transportation Taxes

Charges Excludable from the Tax Base.

➔ The following charges may be excluded from the tax base *if separately stated on the invoice*:

- Catering
- Passenger ground transportation
- Other services provided for the convenience of the passenger if not related to the air transportation



Commercial Air Transportation Taxes - Use of Special Purpose Entities

- ➔ A common operations planning error is to form a special purpose entity (SPE) for the sole purpose of owning and operating an aircraft on behalf of a parent company, affiliate, shareholder, etc. According to the IRS, if the SPE has possession, command and control of the aircraft, all funds paid into the SPE (including capital contributions) are compensation for air transportation, and as such the air transportation is commercial and is subject to excise tax
- ➔ Since 2008, the IRS has applied the foregoing rule to disregarded entities (i.e., SMLLC's and QSSS's)



Federal Transportation Excise Taxes

- ➔ Air Transportation Excise Tax - Audit Technique Guide – Interprets existing law; used as a resource by IRS Agents
 - Publication Date: April, 2008
 - Wet Lease Considerations
 - Dry Lease Considerations
- ➔ CCM 201210026, Released March 9, 2012 and dated February 15, 2012
 - Virtually all amounts paid to aircraft management company are subject to FET.
 - Control of an aircraft's pilots is a primary factor in determining which party has possession, command and control of an aircraft
 - The CCM synthesizes and restates over 50 years of rulings issued by the IRS



Wet Lease to Aircraft Management Company from IRS ATG

- ➔ “With a wet lease, the aircraft owner pays for all costs attributable to the operation of the aircraft, including the pilot and crew salaries, fuel, insurance, and fees incurred when the aircraft is used
- The aircraft owner retains the right to direct the pilots when and where to fly as well as to be able to replace a pilot certified to fly the aircraft
 - Therefore, the aircraft owner retains possession, command, and control of the aircraft



Wet Lease to Aircraft Management Company from IRS ATG

- ➔ The aircraft management company in this case acts as an agent of the corporation. In this capacity, the aircraft management company is not required to collect the air transportation tax on amounts it receives from the aircraft owner (Cite: Rev. Rul. 58-215, 1958-1 C.B. 439, Rev. Rul. 60-311, 1960-2 C.B. 341)
- ➔ The aircraft owner is responsible for collecting and depositing the tax under Section 4261 on amounts paid for any use by the management company or on the amounts paid for unrelated third party flights.
- ➔ When the aircraft owner uses its own aircraft, no tax is due.”



Dry Lease to Aircraft Management Company from IRS ATG

- ➔ Under a dry lease, the aircraft owner is leasing the aircraft itself and the management company is providing the pilot. The management company will also coordinate all scheduling of the aircraft
 - In this case, possession, command, and control of the aircraft has been transferred from the aircraft owner to the management company
 - The management company now becomes responsible for collecting and remitting the air transportation excise taxes under sections 4261 and 4271 on amounts paid for the use of the aircraft
 - Auditors are instructed to analyze certain additional factors:
 - Which party obtains the insurance
 - Which party is responsible for conducting maintenance
 - Does the owner have the right to pre-approve aircraft scheduling for third party charter usage, and to cancel a previously scheduled charter flight
 - Are the owner's rights to the aircraft restricted in any way



Dry Lease to Aircraft Management Company from IRS ATG

- ➔ Under a dry lease, since possession, command, and control has been relinquished by the aircraft owner, amounts it pays for its own flights are taxable
- In other words, the aircraft owner's flights are treated the same as flights of unrelated third parties
 - In this case, the affiliated group exemption from the air transportation tax under Code Section 4282 would not apply because the management company has possession, command, and control.
 - The IRS is treating this as essentially a wet lease of the aircraft by the management company back to the aircraft owner
 - The tax under section 4261 is calculated on all amounts paid to the management company by the aircraft owner



Where the IRS Is Wrong

- ➔ The description of a “wet lease” is an extremely rare contractual arrangement between an aircraft owner and a management company
- ➔ There are really two functions, only one is based on a lease
 - Management Services
 - Agency relationship, not lessee/lessor
 - Charter
 - In the context of giving access to the aircraft for charter, the owning entity must lease the aircraft to the management company in order to effect the transfer of Operational Control of the aircraft for FAA purposes
 - The aircraft owning entity may also employ the crew
 - The lease arrangement in this situation would typically be prepared as a “non-exclusive” arrangement, reserving rights to the owner or another lessee to use the aircraft as well



Where the IRS Is Wrong Cont...

- ➔ Under the IRS definition of “dry lease” the IRS states that the Management Company employs the crew
- ➔ The IRS is focusing on who has employment control of the crew and decisions regarding management of the aircraft for the owner’s use under Part 91
- ➔ The IRS does not understand that the owner has ultimate control on all matters; and that the management company serves as the owner’s agent



Planning Opportunities

- ➔ To fully address possession, command and control arguments of the IRS
- Owner must employ the crew, and if the aircraft is also chartered, the management company can use them under the terms of an agency agreement
 - Owner should obtain its own insurance
 - Owner should enter into its own hangar lease
 - Owner should have a high degree of control over the performance of maintenance
 - Owner should unequivocally control all aircraft scheduling



Planning Opportunities

- ➔ To greatly minimize the risk that possession, command and control has shifted to the management company:
 - As many factors, listed on the prior slide, as possible
 - Owner should retain management company as its “agent” in all respects
 - NOTE, there are “agency” liability issues that might concern owners
 - Owner should have the sole and absolute right, without restriction, to supply or provide, directly or through alternate third party vendors, any of the services offered by the management company
 - Example: The owner must be able to use any crew member of its sole choosing on a Part 91 flight, and to require the management company to reassign a crew member
 - Example: The owner must be able to obtain its own insurance policy, without restrictions



Planning Opportunities

➔ To reduce the amount of money received by the management company potentially subject to FET (a belt and suspenders approach)

- The owner should set up its own bank account to pay all third party vendor invoices
- The third party vendor invoices should be addressed to the owner

Query: Can the management company personnel have signatory authority on the bank account?

- What if the third party vendor invoices were in the name of the management company?



Planning Opportunities – Triangle Structure

- Segregate the Charter Agreement from the Management Agreement
 - Rights conveyed under the Management Agreement are contracted with the operating business
 - Rights conveyed under the Charter Agreement are contracted with the aircraft owning entity



Additional Planning

→ Visibility Issues

- Change the names of the Agreements
- Use different words that imply less “control” by the management company
- What business is listed on tax return filings



Closing Remarks



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