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Aviation Law Update

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IRS to Extend 7.5 Percent Federal Excise Tax to Cover Business Aircraft Operations

Tax Significantly Impacts Business Aircraft Owners and Management Companies

If your aircraft is managed by a third party (or potentially by a *related* entity), or if your company manages aircraft, the IRS's recent guidance expanding the applicability of federal excise tax will significantly impact your costs and tax collection obligations.

A 7.5 percent federal excise tax ("FET") has long been assessed on amounts paid for commercial air transportation in the U.S. Until now, the IRS accepted that this FET for aircraft "transportation" only applies to Part 135 operations, such as aircraft charters or commercial aircraft flights. However, in a memorandum issued by the IRS Office of Chief Counsel on March 9, the IRS drastically departed from this standard, signaling that the IRS will broadly apply the excise tax to cover nearly all aircraft management fees and operational costs incurred by many non-commercial business aircraft owner/operators (i.e., Part 91 operators). This departure will have significant and broad impact on the business aviation community because many (if not most) aircraft owners hire aircraft management companies for their expertise in maintaining and operating aircraft. Owners often don't want the burden or liabilities associated with aircraft management.

Impact on Aircraft Owners: The FET expansion heavily hits business aircraft owners. If the manager is deemed to have "possession, command and control" of an aircraft, then the manager will be deemed to be providing taxable "air transportation" and the FET will be imposed on nearly everything that is paid by the owner to the manager. Plainly stated, the IRS position means that under most management arrangements, even when an owner is being flown on its own aircraft with pilots of the owner's choice, the IRS says that the management company has assumed "possession, command and control" of the aircraft. The IRS memorandum provides that the main determining factor is who controls the pilots. The most startling aspect of this IRS position is that the IRS no longer considers whether the owner has "operational control" of the flight pursuant to the Federal Aviation Regulations (and thus exercises authority over initiating, conducting or terminating a flight) as pertinent or even applicable in determining whether the owner has "possession, command and control" of an aircraft for IRS purposes.

Moreover, even if an aircraft owner has the aircraft managed internally by use of an affiliated entity that provides the management services, this structure might be viewed just as if the owner hired an unrelated third-party manager for FET purposes. Accordingly, large companies that manage their aircraft internally will still be impacted by the new FET interpretation and should be just as wary as smaller operators that hire purely unrelated management companies.

The new IRS position is that if the manager has "possession, command and control," the FET is due on nearly *all* expenses incurred in operating a business aircraft, including not only the hourly flight expenses, but also monthly management fees, maintenance and repair costs, and even separately reimbursed amounts that are paid by the owner to the manager. Aircraft management fees often cover all of the expenses of owning and operating an aircraft, including insurance, pilot salaries and maintenance costs. Reimbursements can also be expansive, covering costs such as fuel, parts and third-party labor. This translates into some hefty numbers, as many private aircraft owners pay hundreds of thousands of dollars in flight operation, management and reimbursement fees to their aircraft managers. To illustrate, an owner who pays $1.2 million a year to a manager for aircraft management and reimbursement fees (a normal amount for a small to mid-sized business jet) is now subject to a new FET of $90,000 per year.

Impact on Aircraft Managers: Although the tax obligation falls on the aircraft owners, aircraft managers are responsible for collecting the FET and remitting it to the IRS. If a manager fails to collect the tax from the owner, the manager must still pay it (plus potential penalties), regardless of whether the manager collected the tax or is able to collect it in the future. Aircraft owners rely on their managers to properly address aviation tax and regulatory issues, and would likely be disgruntled to learn that FET is now due and could potentially have been avoided by taking some precautions. Managers should be aware of how the FET expansion impacts their customers so that there are no surprise fees down the road, and so that managers can structure their management agreements in a way that could minimize FET exposure.

Industry Reaction: The IRS insists that this is not a new conclusion but simply a reinterpretation of existing law. Industry participants strongly disagree and uniformly view this as "disguised rulemaking." In any event, the memorandum is unequivocal and sends a signal that the IRS will be enlarging its enforcement accordingly. In the meantime, aviation industry groups are banding together to discuss this issue with the IRS, with the hope of obtaining a more appropriate resolution. It is unclear whether such efforts will be successful or how long this process will take.

How Can You Minimize Your Exposure to the FET Expansion? The Aviation Group at Lane Powell has extensive experience working with aircraft owners and management companies and is currently developing strategies aimed at complying with the new IRS position in a way that minimizes or eliminates FET for owners and managers operating under Part 91. The starting point in making this determination is a review of the pertinent aircraft management agreement(s). Each aircraft management agreement is unique and should be reviewed for additional factors that might tilt the IRS for or against finding that the manager has retained "possession, command and control" and whether FET is due.

For more information, please contact the Aviation Practice Group at Lane Powell: aviationlaw@lanepowell.com

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