New Taxes Being Levied by the IRS on Corporate Aircraft Operations

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Over the last several years, owners of corporate aircraft have been confronted with cumbersome new rules governing tax deductions and reporting requirements for corporate aircraft. These new rules relate primarily to personal use of corporate aircraft, eligibility for the MACRS depreciation method, and characterization of tax losses as passive. Additionally, in recent years the IRS has expanded the scope of its audits of aircraft owners and charter operators to place a greater emphasis on federal transportation excise taxes. In particular, in recent IRS audits, the IRS has begun asserting that in the circumstances described in this article, an aircraft owner's use of its aircraft under Part 91 of the Federal Aviation Regulations (FAR) will be subject to the same 7.5% federal transportation excise tax that is normally applicable only to commercial aircraft operations.

In the IRS handbook published for use by IRS field auditors, the IRS provides guidance concerning the issues of "possession, command and control." Generally, the handbook provides that, when an aircraft is managed by an external management company, there are circumstances whereby the aircraft owner may be deemed to have transferred possession, command and control of the aircraft to the management company. If this happens, the management company is deemed to be providing "transportation services" to the aircraft owner, resulting in the application of the 7.5% federal transportation excise tax, regardless of whether the aircraft is operated by the owner under Part 91, or by the management company under FAR Part 135.

If the IRS determines that the management company is providing "transportation services" to the aircraft owner, it will typically assess the 7.5% federal excise tax on all amounts paid by the aircraft owner to the management company, including such things as reimbursements for crew salaries, insurance premium payments, hangar rent, management fees, and all aircraft operating costs advanced by the management company on behalf of the aircraft owner. While the typical fact pattern involves use of the aircraft owner's aircraft for charter to the public, application of the guidance provided by the IRS to its auditors is not limited only to fact patterns involving charter. In other words, while it is more likely that an IRS auditor will conclude that possession, command and control have shifted to the management company when the aircraft owner's aircraft is also being utilized in FAR Part 135 charter operations by the management company, an IRS auditor may conclude that possession, command and control have shifted to the management company when the owner's aircraft has not been used in the conduct of FAR Part 135 charter operations.

Per the IRS handbook, auditors are instructed to analyze certain factors to determine whether possession, command and control of the owner's aircraft has shifted including which party (i.e., the aircraft owner or the management company) employs the crew, which party obtains the insurance, and which party is responsible for conducting maintenance on the aircraft. In a common scenario, it is typical for the management company to provide all of these services on behalf of the aircraft owner.

Additional factors include whether the aircraft owner has a right to pre-approve the scheduling of the aircraft for third-party charter usage, and whether the aircraft owner has the right to cancel any previously scheduled charter flight if, after approving a charter, the aircraft owner later determines that it will need the aircraft for its own purposes at a time that conflicts with the previously scheduled charter. 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, the IRS may use those contractual provisions to conclude that the owner has given up possession, command and control of the aircraft.

The IRS's audit position is alarming and simply wrong. As a practical matter a management company merely serves as an outsourced version of an in-house flight department by providing all of the services necessary to manage the aircraft for the aircraft owner's operations. These services most often include interviewing and hiring crew, negotiating a fleet insurance policy on more comprehensive terms and with competitive pricing, and coordinating and managing all maintenance related to the aircraft. Regardless of whether these services are obtained from an in-house flight department or are outsourced to a management company, when operations are conducted under Part 91, the aircraft owner is the operator of the aircraft and remains legally responsible for its own flight operations.

An aircraft owner's decision to outsource the management of these functions rather than perform them in-house should not convert an otherwise non-taxable, non-commercial flight operation to a taxable commercial flight operation. Simply put, the IRS has created guidelines for its auditors that are illogical and have significant ramifications for the aircraft industry. Furthermore, the IRS does not provide its auditors with adequate training in aviation related matters, and the auditors are "thrown into the deep end" with little understanding of the rules they are supposed to enforce.

As set forth in applicable law, when an aircraft owner engages a management company to provide aircraft management services on behalf of the aircraft owner, the management company is doing so as the aircraft owner's "agent." 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, or to agree to have maintenance performed at the maintenance facility designated by the management company. Rather, the management company offers its guidance and expertise and wants to be as flexible and cooperative as possible. It is inherent in the relationship between an aircraft owner and a management company that the aircraft owner has the right to require that the crew be replaced, to provide its own insurance and to choose to have aircraft maintenance performed at the authorized maintenance facility of its choice rather than the facility recommended by the management company. The entire relationship is fluid and it must be, because an aircraft owner can terminate its relationship with a management company at any time pursuant to the terms of the management agreement if it is not satisfied with the management services it receives. So, at no time does the management company act as an independent principal that somehow obtains possession, command and control of the aircraft.

Furthermore, the IRS has a misguided understanding with respect to aircraft that are placed on charter certificates. The IRS contends that if an aircraft owner gives up the right to cancel a scheduled charter flight, then the aircraft owner has transferred possession, command and control of the aircraft to the management company. The IRS fails to understand the nature of the business relationship between the aircraft owner and the management company. In particular, in order for a management company to schedule a charter flight and to commit the aircraft for charter to the public, it needs the aircraft owner's consent to schedule the aircraft. Once the aircraft owner gives its consent, it is commercially unreasonable to expect the aircraft owner to have unlimited rights to cancel the scheduled charter flight at a moment's notice.

The IRS's audit guidelines would require the aircraft owner to be able to cancel the scheduled charter flight up until the actual point in time that the aircraft is ready to take off. While this is an idealistic objective, it is not practical. The aircraft owner wants to maximize revenue from chartering, and if the owner could cancel a flight up until take-off, the management company would be hampered in marketing the aircraft for charter. It is a lose/lose scenario. The IRS guidelines would force an aircraft owner to have an unprofitable and therefore undesirable business relationship with the management company. It is clear that the IRS's position is unsustainable.

It is simply a matter of time before the right case goes to trial and the courts recognize that the IRS's audit guidelines are unsupported by the law and common sense. Until this happens, the industry should be fully alerted that the IRS is now paying particular attention to aircraft management companies, and assessing federal transportation excise taxes on the management companies' revenues relating to aircraft owners' operations in private carriage.

In many cases, the unpaid federal excise tax can be quite significant. 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 a federal transportation excise tax of 7.5%, 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.

There are some minor offsets against any assessed federal excise taxes. The federal excise tax on fuel purchased for the aircraft owner's operations could provide a small offset against this liability. In addition, the management company would be entitled to claim that the aircraft owner's international flights would be exempt from the 7.5% excise tax and 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.

Unfortunately, what has been described above is simply a quagmire. Thoughtful planning can be of only limited benefit until the IRS audit guidelines are revised.

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