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Aircraft Owner Update: IRS Imposing Federal Excise Tax on Managed Aircraft

Dave Weil – April 17, 2012

On March 9, 2012, the IRS released its Chief Counsel Advice Memorandum (“Memo”) stating that in most common situations involving fully managed part 91 aircraft, amounts paid by an aircraft owner (or lessee) to a management company may be subject to the 7.5% federal excise tax (“FET”). The Memo has generated a tremendous amount of concern and debate within the industry.

Much of the current debate is focused on what aircraft management companies should do to respond. This article discusses in a non-technical manner the key issues for managed aircraft owners. The material used below comes from the Author’s involvement in National Business Aviation Association (NBAA) Tax Committee discussions on this issue as well as a recent technical article prepared by John Hoover, chairman of the Federal Tax Working Group of the NBAA Tax Committee.¹

Representatives of the NBAA Tax Committee previously met with the IRS to attempt to help shape the IRS guidance on FET. Ultimately the IRS issued its Memo without considering industry input. On April 16, 2012, NBAA Tax Committee representatives again met with the IRS to discuss the Memo. The results of the meeting were inconclusive. The IRS generally agreed to future dialog but no further guidance was provided.

Despite much uncertainty about the future implications of the Memo, most aviation tax advisors agree that:

- 1) The Memo is not completely consistent with past IRS guidance.
- 2) The IRS auditors will likely become even more aggressive in trying to assess FET on managed aircraft arrangements.
- 3) Even though the Memo is viewed as being “wrong”, it may take awhile to resolve the situation with some certainty.

The Memo focused on the presence of four key factors requiring the management company to collect the 7.5% FET. (In IRS jargon, it found the management company exercised “possession, command and control” over the aircraft.) The management company:

- 1) employed the pilots
- 2) performed the maintenance
- 3) maintained the aircraft flight schedule
- 4) selected the aircraft insurance

The IRS Memo indicates the owner must exercise control over the pilots and have some actual control over the aircraft operations as well to avoid the FET but is very unclear as to how sufficient control is achieved. However, it is likely the owner will be found to have the necessary higher level of control over the pilots and aircraft operations in each of the following 4 scenarios:

- 1) The aircraft owner owns the management company
- 2) The aircraft owner also is one of the aircraft pilots
- 3) The owner employs the pilots and the pilots report to the owner
- 4) The owner utilizes a 3rd party pilot services company to hire the pilots

For most aircraft owners, only options 3) and 4) are viable.

If none of these four control options is practical, then the FET risk is increased. Simply amending the aircraft management agreement alone is no guarantee that the tax will not be assessed. To help offset some of this increased risk, the developing

¹ At the NBAA Van Nuys Forum On April 12, 2012, John Hoover, the chairman of the Federal Tax Working Group of the NBAA Tax Committee, presented a draft paper entitled “IRS Chief Counsel Advice 2012-10026 States that Excise Tax Applies to Aircraft Management Service Arrangements”. He is an attorney at the law firm of Dow Lohnes PLLC. His article will be posted on the NBAA website in the near future.

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advice is for the owner to exercise significant control over the pilots and use of the aircraft. One way to accomplish this may be to have a formal arrangement with the management company allowing the owner or the owner's representative to exercise such control. It is suggested that ongoing documentation be created evidencing how the owner/owner's representative is exercising its control authority.

The FET is imposed on the person making a payment for transportation. In the case of a managed aircraft, the IRS now asserts the aircraft owner is "paying" for taxable transportation. Hence, per the IRS Memo, the management company should invoice and collect the tax from the aircraft owner. If the management company fails to collect the tax, the IRS can assess it against the management company and the management company then must decide how to proceed against the aircraft owner for collection if the IRS assessment is successful. Unless or until the IRS issues further guidance on this matter, management companies have limited options as to how to move forward. Two common responses under discussion are:

- 1) Take no action. Some advisors believe that if a management company makes any significant change now, it is an admission of past guilt. However, this choice may run the risk of creating a less defensible position if/when the management company is audited in future periods.
- 2) Modify the management agreements and increase the owner's extent of control. However, there is wide variation in how extensive the modifications should be and how much control should be given to the aircraft owner. As noted above, modification examples include: appoint the management company as the owner's agent, have the pilots work directly for the owner or a 3rd party pilot services company, have the owner pay the aircraft expenses and take out its own insurance policy, and/or have the owner or their representative increase their involvement in decision making over the pilots and the aircraft.

Summary

We recommend that an owner of a managed aircraft request periodic updates from its management company as to how the management company intends to respond to this new FET situation.

The key issues for an aircraft owner to consider are:

- 1) How much FET liability risk are you willing to accept?
 - a. This is really a two-part question – there is potential historical liability and future liability.
- 2) How much additional control responsibility are you willing to accept?
 - a. This issue should also be reviewed with your labor law advisor since there may be co-employer implications related to some of the changes under consideration.
- 3) How satisfied are you with your management company's response to this issue?

This is a complicated tax and legal matter. The above is a summary of current thinking and is not intended to serve as legal or tax advice and cannot be relied upon as such. It is best to discuss this matter with your aviation tax advisor so they may assist you in determining the best way to avoid exposure to additional FET liability given your own particular circumstances.

About the author: Dave is the CEO and Founder of Flight Dept Solutions (FDS). FDS provides a variety of cost-effective services to aircraft owners and flight department managers to support their flight operations. FDS collaborates with aircraft owners and their aviation advisors to put structures in place to mitigate FET exposure. During the past 20 years Dave has held senior executive positions with prominent business aviation companies, including ten years at TAG Aviation USA where he was CFO/Executive VP. He also led TAG's expansion into Asia and served as the first Managing Director for TAG Aviation Asia. Dave is a CPA, holds an MBA and is a past Chairman of the National Business Aviation Association (NBAA) Tax Committee. He can be reached at dweil@flightdeptsolutions.com or 650.619.5232 (<http://www.linkedin.com/in/daveweil>)