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IRS Publishes Proposed Regulations for Aircraft Management Services Exemption to Federal Excise Tax

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Section 4261 of the Internal Revenue Code (IRC) generally imposes a 7.5 percent aviation excise tax on amounts paid for "taxable transportation," along with certain specific dollar fees per segment. However, certain "aircraft management services" are exempted from the tax after paragraph (e)(5) was added to IRC section 4261 as part of the Tax Cuts and Jobs Act of 2017. The IRC defines aircraft management services to include (1) administrative and support services, (2) obtaining insurance, (3) maintenance, storage, and fueling of aircraft, (4) hiring, training, and provision of pilots and crew, (5) establishing and complying with safety standards, and (6) other services necessary to support flights operated by an aircraft owner.

Section 4261(e)(5) generally exempts from the aviation excise tax any amount paid by the aircraft owner (or lessee) for aircraft management services provided for the owner's (or lessee's) aircraft. The theory is that someone should not have to pay the excise tax on amounts for expenses they pay in connection with the ownership or lease of their own aircraft. However, for a variety of state tax and liability protection reasons, aircraft management is often separated from aircraft ownership. Where parties related to the aircraft owner perform aircraft maintenance/support/flight

services, tax practitioners have worried whether and how the new exception applies.

An aircraft owner includes the lessee of an aircraft unless the lease is considered a "disqualified lease" under IRC section 4261(e)(5)(C)(ii). That section defines a disqualified lease as a lease from a person providing aircraft management services with respect to the aircraft (or a related person) if the lease is for a term of 31 days or less. Therefore, in many circumstances, aircraft management services paid by a lessee may also qualify for the paragraph (e)(5) exemption.

On July 31, the IRS released proposed regulations relating to the federal excise taxes imposed on certain amounts paid for the transportation of persons and property by air. The regulations interpret the exemption in ways that should please many taxpayers who own or manage aircrafts so long as they are careful to arrange their affairs with appropriate consideration to the guide rails provided.

The National Business Aviation Association (NBAA) — which had requested guidance on several open issues — welcomed the proposed regulations. Those open items included (a) an expanded definition of "aircraft owner," (b) clarifying that aircraft operation under Federal Aviation Regulations Part 91 or Part 135 has no impact on the applicability of federal excise tax, and (c) clarifying the impact, if any, of payment arrangements for management services.

"Aircraft Owner"

The IRS ***declined*** to adopt a taxpayer-friendly approach of expanding the definition of aircraft owner to include members of an affiliated group or to the tax-owner of a disregarded entity. Refusal to expand the definition is unfortunate. Many clients who own private aircraft do so through wholly-owned (single member) limited liability companies. The default tax classification for a single member limited liability company is a "disregarded entity" for federal *income* tax purposes, which effectively means that they do not exist separate from their owners and thus report their activities on their owner's income tax returns. However, this treatment does not extend to other types of federal taxes, such as employment and excise taxes. A similar issue arises for S corporations and the use of qualified subchapter S subsidiaries (QSubs).

Takeaway: In order to qualify for the IRC section 4261(e)(5) exemption, the legal owner of the aircraft must make the payments; payments by the tax owner of a disregarded entity or a related service affiliate are not exempt from the excise tax. Additionally, the lessee, if not part of a disqualified lease, must make the payments to secure the exemption.

In some cases, it might not be administratively practical to have the owner or lessee make payments. In such situations, the aircraft owner should have documentation that reflects a disclosed payment agency relationship between the aircraft owner and the person making the payment. We recommend clients review their existing documentation and update it as needed.

Part 135 Versus Part 91

The IRS declined to deviate from its longstanding policy that rules promulgated by the FAA do not control for federal excise tax purposes. Whether an aircraft operates under Part 91 or Part 135 has no bearing on the application of federal excise taxes under Code section 4261.

Takeaway: Operating under Part 135 or Part 91 should not affect federal excise tax considerations.

Payment Arrangements

Aircraft owners structure their aircraft management services agreements in a variety of ways. Some include fixed monthly or quarterly payments. Some include reimbursement for specified expenses and hourly rates for flight services. Others include reimbursement for specified expenses plus a markup (cost plus method). The proposed regulations require both the aircraft owner and the service provider to maintain adequate records. However, the structure of the agreement does not affect whether the exemption from air transportation excise tax applies to amounts paid for services.

Takeaway: Details matter in an IRS examination. We have regularly encountered clients with inadequate recordkeeping. Detailed flight logs, documentation of business purpose, and financial transactions that align with the intercompany agreements are all extremely important. We

recommend working with tax counsel familiar with IRS exam techniques to ensure that your financial hygiene is sufficient to withstand IRS scrutiny.

Mixed-Use

While not explicitly noted in the NBAA request, the IRS also addressed the issue of mixed-use aircraft. Mixed-use occurs when aircraft owners permit their aircraft to be used by third parties for charter purposes. The IRS agreed with commentators that such use does not affect the application of section 4261(e)(5) amounts paid by the aircraft owner for management services.

Takeaway: The decision by aircraft owners to monetize otherwise idle aircraft by leasing to charter operators should not impact the section 4261(e)(5) exemption.