'The New Untouchables'

IRS taxation of unsanctioned charters.

by Greg Cirillo and Gary I. Horowitz

In the 1920s, Al "Scarface" Capone was a notorious Chicago gangster and infamous crime boss who led a crime syndicate dedicated to the illegal trafficking of alcohol during Prohibition. "The Untouchables" – an elite group of incorruptible law enforcement agents was formed to "take down" Al Capone. They could not get him for the murders he allegedly ordered, or the sale of contraband, or bribery of public officials. It was the tax man that brought him down. He failed to pay taxes on his ill-gotten gains!

There is a lesson in this for anyone who receives compensation or reimbursements for "loaning" their aircraft with crew to anyone else, or making seats available, without holding a charter (Part 135) certificate. Aviation attorneys have tirelessly advised clients that this practice is contrary to the laws and rules administered by the Federal Aviation Administration and the Department of Transportation. But the FAA and DOT do not always actively enforce these requirements. 'The New Untouchables', that is, the Internal Revenue Service (IRS), could be acting as surrogate enforcers of these rules through the collection of Federal excise taxes. The IRS has a way of getting people's attention.

A Federal excise tax (detailed below) is assessed on any payment received for providing air transportation. There are a few common practices in the business aircraft industry that could trigger the excise tax in situations that you would not consider traditional chartering. Those practices are summarized below and as a recent case shows, the IRS is not limited to collecting unpaid excise taxes from just the aircraft operating company. The IRS can also collect unpaid taxes directly from the people that own the company and run the aircraft operations, without regard to the limited liability protection normally associated with corporations and LLCs.

COMMON ERRORS

Business jets are expensive, and the owner/operator has a very strong incentive to identify ways to defray the costs of ownership. Putting an aircraft into charter service when it would otherwise sit idle is the obvious solution, but to do it correctly, the charter must be operated by a certificated (Part 135 of the Federal Aviation Rules) carrier affording passengers the enhanced safety and security that this certification imposes.

Putting an aircraft into charter requires that the aircraft meet certain technical requirements, operational restrictions, and it introduces a third party (the certificate holder) who also has bills to pay. So, it is not unheard of for an owner to "loan" an aircraft to an associate, or even to let that associate "hop a ride" on the owner's flight in exchange for compensation. This activity is contrary to the FAA and DOT laws and regulations, and this compensation may trigger the excise tax.

A separate problem arises when an aircraft buyer decides - for good and valid reasons - to hold an aircraft in a single-purpose entity (creatively named "[Your Company] Aviation"). The bean counters then set up cost sharing plans involving payments from the main company (or companies) to the aircraft owning company to cover operating and finance costs. This structure runs afoul of FAA laws and regulations (called by the FAA an "illegal flight department company"); and the payments may trigger the excise tax.

The FAA and DOT are not flexible on these points, and apply these rules as firmly to a jet owner giving a ride to an old friend as it would to an overt illegal air charter company flying unsuspecting consumers on uncertificated, unsafe aircraft. Except as specifically permitted, you cannot accept compensation or reimbursement for providing air transportation to others.

Does this seem unfair? Well, the FAA has a few ways to recapture some costs when making your aircraft available to others (FAR Part 91, Section 501), but none of the permitted practices allow the owner to receive anything approaching a fair market charter rate. The FAA may not raise these issues, but the aircraft activity may nonetheless have Federal excise tax consequences.

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UNEXPECTED AIR TRANSPORTATION FEDERAL EXCISE TAXES

Under the Internal Revenue Code of 1986, as amended (the "Code"), aircraft operators providing "taxable transportation" are required to collect a Federal excise tax ("FET") of 7.5% of the amounts paid for such services, plus a flat rate per each domestic flight segment.

Federal excise taxes can apply to private aircraft operations if the IRS successfully asserts that an aircraft owner (and not the passenger) is in "possession, command and control" of the aircraft. In making this determination, the IRS considers a number of factors, including: 1) who owns the aircraft; 2) who controls the aircraft's pilots; 3) who pays aircraft operating expenses; and 4) who maintains liability and hull risk insurance for the aircraft.

If the answer to these questions is the same entity or person, then FET liability can exist and apply to the funding sources for the ›

aircraft's operation (including capital contributions or loans to the aircraft operating company by the company's owners). If the IRS determines that FET is owed, but not collected, then the IRS can go after the individuals involved with the aircraft operating company through a mechanism called "trust fund recovery penalties."

UNANTICIPATED TRUST FUND RECOVERY PENALTIES

The Federal excise taxes paid to an aircraft operator belong to the United States and are treated as being held in a special fund "in trust" for the United States by the person obligated to collect the FET. If these taxes are not remitted to the United States, then the IRS can collect from the individual owners, directors and officers of the aircraft operating company.

The fact that the aircraft may be owned by a corporation or limited liability company provides no protection. The Code states that any person required to collect, truthfully account for, and pay over the FET that willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat such tax, shall be liable for a penalty equal to the total amount of the tax evaded, not collected, or not accounted for and paid over.

This penalty is generally referred to as the "trust fund recovery penalty". An individual who is properly assessed a large trust fund recovery penalty by the IRS cannot escape the obligation by filing bankruptcy because this is a "penalty", not a "tax", and cannot be discharged in bankruptcy. Would the IRS ever assess a trust fund recovery penalty against an individual if that person's company did not remit the FET to the IRS? They do in Iowa.

UNFRIENDLY SKIES

In a recent Federal Appeals Court decision, the Eighth Circuit ruled that the former president and chief financial officer of a failed airline was personally liable for the FET collected by the airline from its customers, but not actually remitted by the airline to the IRS.

The facts of Ferguson v. U.S. are fairly straightforward: AccessAir provided commercial passenger air transportation in the United States from February 1999 until November 1999. Richard Musal served as the Chief Financial Officer of AccessAir from its inception, and later served as President and Chief Operating Officer. As the CFO, Mr. Musal was in charge of overseeing the company's finances and accounting, and was authorized to sign checks on behalf of AccessAir. Once Mr. Musal became President and COO, all of AccessAir's departments reported to him.

AccessAir failed to remit to the IRS the FET that was collected from the sales of airline tickets, and it was determined that the company's total FET liability was over $1.4 million. When AccessAir failed to pay the amount due, the IRS assessed a trust fund recovery penalty of over $1.3 million against Mr. Musal and two other company officials.

The 'nice' thing about the trust fund recovery penalty (from the IRS's point of view) is that more than one person can be assessed the penalty. Any individual that is a "responsible person" and who "willfully" fails to pay over the tax in question can be liable for the trust fund recovery penalty.

A "responsible person" is someone who has the status, duty and authority to avoid the corporation's default in collection or payment of the taxes. A responsible person acts "willfully" if he "acts, or fails to act consciously and voluntarily and with knowledge or intent that as a result of his action or inaction trust funds belonging to the government will not be paid over but will be used for other purposes, or by proceeding with a reckless disregard of a known or obvious risk that trust funds may not be remitted to the government."

Mr. Musal was a "responsible person" because as CFO, COO and President, he was authorized to sign checks and disburse corporate funds on behalf of AccessAir, and had the authority to pay the company's FET without board or management approval. Mr. Musal also acted "willfully" in failing to pay the FET because he knew AccessAir's financial condition and was fully aware that the company was not turning over the required FET to the IRS. Despite this knowledge, Mr. Musal continued to direct payments to the company's other creditors in lieu of paying the excise taxes. That was a mistake.

Knowing that the FET was not being paid to the IRS, but that payments were being made to other creditors, was proof of Mr. Musal's "willfulness" as a matter of law. Mr. Musal may have thought that he was doing the right thing in paying certain creditors in order to keep the airline flying, but in the end, the airline still failed and Mr. Musal was left personally holding the bag for unpaid taxes.

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FINAL THOUGHTS

The threat of FAA or DOT enforcement is often insufficient to deter aircraft owner/operators from seeking compensation or reimbursement for aircraft usage; but the possibility of an IRS audit, taxation and penalties needs to be given careful consideration.

In some circumstances, the entire issue can be easily avoided. For example, the entity set up to own a corporate aircraft (the "illegal flight department company") simply needs to be papered as an aircraft owner-lessor, with an actual operating company (or multiple companies) dry leasing the aircraft from the owning entity, with the lessees supplying their own crew and related services. By doing this, the owner-lessor is not providing transportation – it's just providing an aircraft – so no excise tax should be due.

As to the flights provided to, or seats filled by, your associates for compensation, perhaps the amount you accepted (and plan to accept) will fit within the exceptions described in FAR Part 91, Section 501. If not, you might even consider paying the excise tax – although that might be an admission against your interest that you are conducting illegal charters.

Finally, if the IRS asserts that FET is owed and tries to assess a trust fund recovery penalty against the aircraft company's owners, officers or directors, a responsible person is not "willfully" failing to pay the FET if such person did not know that the FET was owed to the IRS (and that lack of knowledge was not "reckless").

Given the complexities of aircraft ownership and operation, such a position would not be unreasonable.

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