

# Stealth Tax

Stealth aircraft tax flies in under the radar. by Gary I. Horowitz

**J**ean Baptiste Colbert once remarked that “The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing.” This statement succinctly explains why U.S. tax laws are so complicated. It would be easy enough to tax everyone at a single, very high tax rate, but this would cause much hissing from the goose/taxpayer. So instead, taxpayers are faced with a web of income taxes, excise taxes, deductions and credits which, in many ways, disguises the total amount of taxes actually paid.

Consistent with this philosophy, the IRS recently (and quietly) issued new Tax Regulations which will require companies to review their current business aircraft ownership structure and operations, or possibly be subject to federal excise taxes on air transportation beginning January 1, 2008.

## AIR TRANSPORTATION EXCISE TAXES

Under the current Internal Revenue Code (the “Code”), taxpayers that provide air transportation services are required to collect a federal excise tax (“FET”) of 7.5% of the amount paid for such services, plus a flat rate per each domestic flight segment, and remit such FET to the IRS. The FET applies to “any amount paid within the United States for transportation of any person by air” unless the taxpayer establishes that the transportation is not transportation subject to FET.

## COMMON OWNERSHIP STRUCTURE

In a common business aircraft ownership structure, an operating company will set up a wholly owned, single member limited liability company (“LLC”) to own the aircraft. The LLC then leases the aircraft back to the parent company (through a Part 91 Aircraft Lease Agreement), and the parent company uses the aircraft in flight operations.

Under this structure, the lease payments from the parent company to the LLC may be subject to state sales and use taxes, but until now there has been little concern about FET being applied to the lease payments.

Prior to January 1, 2008, if a limited liability company only had a single member, it could be treated as “disregarded” for federal

tax purposes. In a private letter ruling from several years ago, the IRS ruled that a taxpayer was not subject to FET when it paid its wholly-owned LLC for aircraft operating expenses if the LLC was a disregarded entity for tax purposes.

As far as the IRS was concerned, the LLC and the parent company were the same entity, and air transportation excise taxes did not apply to lease payments made to oneself. In other words, the IRS would ignore the lease payments and treat the business aircraft as owned and operated by the same entity, so no FET would be owed because air transportation services were not being provided by one entity to another entity.

Beginning January 1, 2008, this is no longer the case.

## DISREGARDED – NO MORE

Starting January 1, 2008, a single member LLC will no longer be treated as a disregarded entity for purposes of air transportation

excise taxes. In October, 2005, the IRS issued Proposed Regulations which suggested that the disregarded entity status of single-owner entities be eliminated for purposes of certain federal excise taxes, including the federal excise tax on air transportation services.

Therefore, an entity that is otherwise disregarded for federal income tax purposes would now be required to pay and report air transportation excise taxes. The reason for this change, according to the IRS, is that “Difficulties... have arisen from the interaction of the disregarded entity rules and



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certain federal excise tax provision.”

Unfortunately, the IRS’s written example of these “difficulties” has nothing to do with air transportation, and there appears to be no clear reason as to why a single member LLC should be treated as a separate entity for air transportation excise taxes, other than stealth tax purposes.

In August, 2007, the IRS adopted Final Regulations which provide that, beginning January 1, 2008, a single member LLC will now be treated as a separate entity for air transportation excise taxes (but still be disregarded for certain other purposes, such as federal income taxes). Under the Final Regulations, if a single member LLC owns a business aircraft and leases the aircraft to its parent company, then the lease of the aircraft from the LLC to the parent company, along with any other contractual relationships between the entities, must be reviewed to determine whether such arrangements are “taxable transportation” subject to air transportation excise taxes.

#### FET CHECKUP

Now that the FET can apply to a single member LLC owning a business aircraft, new pur-

chasers of business aircraft need to be aware of this “stealth tax” when structuring the ownership and operation of their aircraft. Companies that currently own business aircraft through a single member LLC need to review their operations.

Before January 1, 2008, a company could rely on the disregarded status of an LLC to avoid FET on the LLC’s lease of the aircraft to its parent company. Going forward, a parent company will need to determine whether the LLC, as the aircraft owner, is in “possession, command and control” of the aircraft, because if the answer is “yes”, then FET probably applies to the funding sources for the aircraft’s operation.

In determining who has “possession, command and control” of an aircraft for FET purposes, the IRS considers a number of factors, including: (1) who owns the aircraft, (2) who hires and controls the aircraft’s pilots, (3) who pays aircraft operating expenses, (4) who determines aircraft usage, scheduling and availability, and (5) who maintains liability and hull risk insurance for the aircraft.

Before this change in the law, some of these factors may have been within the control of the LLC, particularly the employment

of the pilots, but no FET would apply as long as the LLC was a disregarded entity. However, now that the LLC will be treated as a separate entity, each of these factors needs to be considered in order to determine whether or not FET applies and how company operations may need to be restructured.

With this new stealth tax, aircraft owners must again adapt to changing circumstances, or get “plucked.”

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