

# NBAA Federal Excise Tax Handbook

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## Table of Contents

Official Guidance for Application of Rules .....	2
Overview of Aircraft Taxation .....	2
Contrasting the Tax Deduction, Tax Credit and Tax Refund .....	3
Certain Credits .....	4
Definition of Federal Excise Tax .....	4
Definition of Federal Excise Tax on Aviation .....	4
<i>Transportation of Persons, Property and Use of International Air Travel Facilities</i> .....	5
<i>The 225-Mile Zone</i> .....	5
<i>Domestic Transportation of Persons Tax, Flight Segment Fees and Non-Rural Airports</i> .....	5
<i>Flight Segment Fees and the Rural Airports Exception</i> .....	6
<i>Amounts Paid</i> .....	6
<i>Use of International Air Travel Facilities</i> .....	6
<i>Uninterrupted International Flight</i> .....	7
<i>Transportation Involving Hawaii and Alaska</i> .....	7
<i>Transportation Involving U.S. Possessions</i> .....	7
Commercial vs. Non-Commercial Aviation – FAA vs. IRS Views .....	8
<i>FAA Non-Commercial Flights That Are IRS Commercial Flights</i> .....	8
<i>IRS Definition of Non-Commercial Aviation</i> .....	9
<i>Who Is the Taxpayer?</i> .....	9
<i>Who is the Tax Collector?</i> .....	9
<i>Two Parts to the Fuel Tax</i> .....	10
<i>Federal Excise Tax on Fuels Used for Nontaxable Purposes</i> .....	10
<i>The Purpose of Form 4136</i> .....	11
<i>The Purpose of Form 8849</i> .....	11
<i>IRS Categorization of Types into Groups and the One-Claim Rule</i> .....	12
<i>The IRS Facts and Circumstance Test for Determining Taxable Transportation</i> .....	12
<i>Warning Signs</i> .....	13
FAA Operational Control .....	13
<i>Timeshares</i> .....	14
<i>The Interchange</i> .....	14
<i>Affiliated Group – FAA vs. IRS Views</i> .....	14
<i>Management Companies</i> .....	16
<i>Fractional Programs</i> .....	17
<i>Carriage of Public Officials</i> .....	17
<i>Special Small Aircraft Rules and Exemptions from the Transportation of Persons Tax</i> .....	17
<i>Skydiving Operations</i> .....	18
<i>Exempted Operations from Transportation and Fuel Taxes</i> .....	18
<i>Transportation of Property by Air</i> .....	18
<i>Mixed Loads of Property and Persons</i> .....	18
<i>Rule Changes Pertaining to Deposits and Filings</i> .....	18
IRS Form 720 .....	18
<i>Employer Identification Number (EIN)</i> .....	18
<i>New Rules Effective October 2001</i> .....	18
<i>Contrasting Deposit Periods vs. Tax Liability</i> .....	19
<i>Amount to Deposit and Safe Harbor Rules</i> .....	20
<i>Part 1 of IRS Form 720</i> .....	21

# NBAA Federal Excise Tax Handbook

The *NBAA Federal Excise Tax Handbook* is designed to be a plain-language reference about Federal aviation excise taxes for the flight and accounting departments of NBAA Member Companies and the larger business aviation community. This document provides an overview of all taxes that affect general aviation, followed by a detailed explanation of Federal excise taxes on fuel and commercial transportation. Federal Aviation Regulations (FARs) will be discussed to the extent necessary and in contrast to the Internal Revenue Code (IRC), specifically addressing commercial versus non-commercial carriage. NBAA intends for this handbook to serve as a useful reference that complements the appropriate Internal Revenue Service (IRS) rules and publications.

The Federal excise taxes to be addressed in this handbook include the transportation of persons tax, transportation of property tax, use of international air travel facilities tax and excise taxes on fuels. A partial list of the Internal Revenue Code sections referenced in this document include IRC sections 4041, 4081 and 4091, which apply to fuel; IRC sections 4261 and 4262, which apply to transportation of persons tax; and IRC section 4271, which applies to property tax. The IRS publications you should have available for reference as you read this handbook are Publication 510, Excise Taxes; Publication 378, Fuel Tax Credits and Refunds; and the Market Segment Specialization Program (MSSP) on Aviation Tax. Additional IRS forms and instructions that will prove helpful are IRS Forms 720, 4136 and 8849. For easy reference, these forms and instructions are available on the NBAA Tax Web site at [www.nbaa.org/taxes](http://www.nbaa.org/taxes). You also can retrieve forms at the IRS Web site at [www.irs.gov](http://www.irs.gov).

## Official Guidance for Application of Rules

The Federal Transportation and Fuel Tax Laws covered in this handbook are legislated by Congress. The

IRS mission is to implement, enforce and interpret these laws. While a regulation generally has almost the same status as the law, the transportation tax and fuel tax regulations have not been “reopened” for updating as questions about the specific application of regulations have risen.

It is fairly common for the IRS to issue a Technical Advice Memorandum (TAM) or Private Letter Ruling (PLR). TAMs and PLRs are meant to provide guidance under a specific set of circumstances to field auditors and taxpayers, respectively. The party requesting them alone can rely on the guidance provided. However, since these unofficial (as to the public) and in some cases unchallenged documents are publicly available, they are useful in predicting the probable IRS position in an audit situation.

The IRS often issues official guidance on a particular matter in the form of a Revenue Ruling (Rev. Rul.) or a Revenue Procedure (Rev. Proc.). This guidance carries more weight and has greater significance than TAMs and PLRs but can be more generic. Issued by the IRS Chief Counsel, a Revenue Ruling or Revenue Procedure is issued when a question as to the application of IRS rules is considered more problematic or widespread.

The courts also interpret the tax laws. The courts have a checks-and-balances effect on the IRS mission to implement and collect taxes. Court cases provide precedents and – depending on the level of controversy, number and similarity of the cases involved – guidance for both the IRS and the taxpayer. The most probable path through the court system begins with an audit in which the taxpayer and IRS disagree as to what Congress intended when the law in question was crafted. Due to the expense of such proceedings, a cost-benefit analysis generally will precede a taxpayer’s decision to litigate.

## Overview of Aircraft Taxation

In addition to the operational condition of a new aircraft, prospective owners and operators must consider tax consequences at Federal, state and local levels. Although there is some overlap, each level of government tends to rely on different revenue sources.

Federal and state governments depend heavily on income taxes and excise taxes. State governments also

depend heavily on sales taxes. Local governments depend on property taxes and sales taxes as their main sources of funding. In many countries, in addition to income taxation, a national sales tax, VAT or GST is levied. Although excise taxes arguably are a form of sales tax, at this time there is not a national sales tax in the United States.

The sale of a high-value asset such as an aircraft makes for interesting state tax target practice. Before delivery, aircraft owners should carefully plan and put in place a sales/use tax strategy. Generally, sales tax is a one-time event and dependent on a triggering event, such as a transfer of goods or change of constructive ownership within the boundaries of a taxing authority. However, depending on the particular state laws in question, a lease could require a series of sales tax payments on the revenue stream. Because of the mobility of aircraft, sales tax avoidance is a fairly simple procedure by taking delivery in a state with no sales tax or an appropriate exemption. Caution should be exercised that the exemption that appears to apply is thoroughly researched. Many states write exemptions with narrow application, and although they are available, they may not apply to your circumstances. For instance, a charter operator might find that the commercial exemption is only available to scheduled airlines.

Because of the same aircraft mobility, a company that has not clearly established a tax home for its aircraft could encounter multiple states asserting use tax liability. These states would include the state in which the aircraft is based, states in which the aircraft routinely operates, and possibly states in which the owner has nexus such as employees. Use tax is a backstop to sales tax. The rate will generally be the same as the sales tax. The significant difference is the taxable moment in which the tax is considered due. Use tax is based on the taxable use of an asset in a state and, as the name implies, is dependent on the use, storage and consumption of an asset instead of the transfer of ownership.

With the relatively high valuation of aircraft, shrinking state surpluses, gray areas created by multiple states seeking to levy tax on the same asset, differing state regulations and contradictory intra-agency interpretations and enforcement, use tax will continue to be a major tax-planning factor.

Property taxes recur on a yearly basis and are levied at the local level, with a large emphasis on schools. Although many states set ground rules, the amount and significance of personal property taxes vary greatly by the county, parish, or other even smaller taxing district.

## **Contrasting the Tax Deduction, Tax Credit and Tax Refund**

Since a simplified view of personal U.S. Federal income taxation will prove useful in later discussions, this section will contrast a tax deduction, tax credit and tax refund. However, it is a bit of an understatement to refer to the following as a “simplified view”; the 2001 report from the Joint Committee on Taxation pointed out that in 1999, the tax code contained 1,395,000 words and was supported by greater than 649 forms and schedules.

The IRC treats total worldwide income (individual salaries, taxable fringe benefits, tips, interest, dividends, business income, barter income and capital gains) as taxable unless specifically exempted. Total worldwide income is summed to arrive at the line item “total income.” Total income then is reduced by a small number of expenses, also known as “above the line” deductions. The difference of total income less these deductions is adjusted gross income. For the individual taxpayer, “above the line” deductions or deductions before adjusted gross income are advantageous.

The adjusted gross income line item is often referenced by the IRC as a means to limit deductions or otherwise increase taxes due. Taxpayers with adjusted gross income in excess of given thresholds find their itemized deductions, personal exemptions and other deductions limited or eliminated. The 2001 Bush Tax Bill eliminates this stealth tax increase in the out years of the plan.

From adjusted gross income subtract either the appropriate standard deduction or itemized deductions, but not both, and personal exemptions to arrive at taxable income.

These “below the line” deductions further reduce income, with the remainder being taxable income. Taxable income is the amount that the taxpayer’s marginal tax rate is applied to arrive at total tax. Next,

the total tax is reduced by tax payments previously made, payroll withholding and “certain credits.” The difference is either a shortage, requiring an additional payment, or an over-payment, resulting in a refund.

## Certain Credits

One example of “certain credits,” which we will examine later in greater detail, is the total amount on Form 4136, Credit for Federal Tax Paid on Fuels. The credit reduces the total tax owed. In other words, a credit reduces any taxes owed on a dollar-for-dollar basis. In contrast, a tax deduction simply reduces taxable income. An example of a tax deduction on a corporate return is depreciation; an example of a tax deduction on a personal tax return is the home mortgage interest deduction. A deduction only will lower your taxes by an amount equal to your marginal tax rate, so while a fuel tax credit of \$100 reduces your total tax bill \$100, a \$100 depreciation deduction of a corporation in the 35-percent tax bracket only reduces its tax bill by \$35.

A good understanding of all taxes, including both Federal and state taxes, will allow proper timing, planning and, when possible, legal avoidance. For further information on state taxation – specifically sales and use taxes, personal property taxes, aircraft registration fees and excise taxes – see the *NBAA State Aviation Tax Report*, available on the NBAA Web site at [www.nbaa.org/statetaxreport](http://www.nbaa.org/statetaxreport), and consider attending an NBAA Tax Forum. For an up-to-date listing of NBAA Tax Forums and other Association Seminars, contact NBAA at (202) 783-9283 or visit [www.nbaa.org/seminars](http://www.nbaa.org/seminars).

## Definition of Federal Excise Tax

Dating from about 1791, Federal excise taxes are among the oldest forms of U.S. taxation. These taxes were first levied on whiskey, a widely consumed beverage often distilled in private homes. This taxation resulted in the Whiskey Tax Rebellion. After locals had pinned down a revenue agent in his home with days of heavy gunfire, President George Washington himself led troops to put down the rebellion, which mostly consisted of rounding up a few disgruntled frontiersmen.

Today, a Federal excise tax can be determined by weight, value or gallonage and is generally levied on goods and services. There currently are 48 different Federal excise taxes, ranging from environmental taxes to insurance. These taxes generated 53 billion dollars in net collections for the Federal fiscal year 2000. All excise taxes, non-aviation included, for fiscal year 2000 were 2.8 percent of the \$1.9 trillion net total United States tax collections.

## Definition of Federal Excise Tax on Aviation

Federal excise taxes on aviation are user fees in the sense that the net tax collected is directed to the Airport and Airways Trust Fund, IRC 9502. In fiscal year 2000, transportation of persons taxes generated \$6.9 billion, international head taxes \$1.3 billion, transportation of property taxes \$520 million, excise taxes on jet fuel \$906 million, and aviation gasoline (avgas) taxes \$58.4 million.

Due to the method of collection, the cost of compliance for IRS-defined non-commercial operators is kept to a minimum. The only reason a non-commercial operator would complete and file an IRS form is if a given flight operation were considered fully or partially non-taxable and the fuel consumed was purchased with the tax burden attached.

Commercial operators are burdened with a 4.4-cents portion of the excise tax on jet fuel and avgas plus the cost of compliance. For domestic commercial transportation, the remaining 17.5 cents on jet fuel and 15 cents on avgas are refunded or allowed as a credit when making deposits of transportation taxes. Commercial operations engaged in foreign trade receive a full refund or credit. The cost of compliance for the commercial operator entails collecting the transportation of persons, property and international excise taxes from passengers, creating and maintaining records, filing appropriate forms and remitting funds within the appropriate time frames established by the Federal government. Funds generally are deposited on a semi-monthly basis and forms filed on a quarterly basis.

## **Transportation of Persons, Property and Use of International Air Travel Facilities**

The transportation of persons tax, or “ticket tax,” applies to taxable transportation that begins and ends in the United States or at any place in Canada or Mexico within 225 miles (assumed to be statute miles) from the nearest point on the continental U.S. border.

The transportation of persons tax for 2003 is 7.5 percent of amounts paid plus \$3.00 per person per segment. The transportation of property tax rate in 2003 is 6.25 percent; a segment fee does not attach to the transportation of property. The use of international air travel facilities tax for 2003 is \$13.40 per person for flights that begin or end in the United States. For domestic segments that begin or end in Alaska or Hawaii (this applies to departures only), there is a \$6.70 per person special-rate international “head tax.”

### **The 225-Mile Zone**

The easiest way to think of the 225-mile zone (referred to in the transportation of persons tax definition above) is to extend the irregular U.S./Mexican and U.S./Canadian Borders by 225 miles. For example, a flight from anywhere in the United States to Toronto or Tijuana is considered to be a domestic flight since the flight begins in the United States and the foreign cities are located within 225 miles of the continental U.S. border.

### **Domestic Transportation of Persons Tax, Flight Segment Fees and Non-Rural Airports**

The Taxpayer Relief Act of 1997, Public Law 105-34, enacted transportation tax segment fees that were effective as of October 1, 1997. Since their inception, Congress has periodically reduced the 10-percent transportation-of-persons tax to the 2001 7.5-percent level. The segment fee was enacted at \$2 per flight segment and has increased yearly to its present level of \$3 per person per segment.

A flight segment is defined as transportation involving a single takeoff and a single landing. Segments added to a flight due to mechanical problems, weather problems, or other conditions that are out of the passenger’s control do not create additional segment fees as long as the flight’s origin and destination do not change and as long as the original fare charged to the passenger does not change.

Operation necessities, such as fuel stops, do not qualify as a condition out of the passenger’s control.

The segment fee does not apply to arrivals or departures from rural airports, and generally, flights that do not begin and end in the continental United States are not subject to the domestic segment fee. However, some flights that navigate over international waters enroute to another U.S. destination are subject to the domestic segment fee.

Internal Revenue Code (IRC) section 4261(d) requires the segment fee to be paid by the person making the payment subject to the tax. The 1997 Committee Report states that the percentage tax will apply to “the gross amount paid by the passenger for the transportation plus a \$2 fixed dollar amount per flight segment.”

The IRS Chief Counsel has determined in TAM 200122006, dated February 12, 2001, that the segment fee will apply to each passenger on a FAR Part 135 charter flight. If a record is not maintained recording the number of passengers on each leg, the total number of seats available on the aircraft will be subject to the segment fees. With this TAM, the IRS has not provided any section 7805(b) relief, which means the tax, if the IRS chooses to pursue and subject it to statute of limitations rules, may be charged retroactively. Though this TAM does not carry the significance of a Revenue Procedure or Ruling, it does indicate the IRS view as to the future application of segment fees. NBAA disagrees with this IRS position, but it recommends that it is in the best interest of Association Members to charge segment fees on a per person basis. Deadhead legs (flights without passengers) are not subject to the segment fees. The segment fee will be adjusted at the beginning of each year according to the consumer price index (CPI).

## Flight Segment Fees and the Rural Airports Exception

If a segment is to or from a rural airport, the domestic segment tax does not apply. A rural airport is defined as an airport that during any calendar year has less than 100,000 departing passengers. The rural airport must not be located within 75 miles of an airport, which has 100,000 or more departing passengers or is receiving essential air service subsidies as of the date of enactment. The designated rural airport listing is provided in Rev. Proc. 98-18 and available on the Internet at <http://ostpxweb.dot.gov/aviation/ruralair.htm>

### Amounts Paid

Amounts paid include all costs, including other taxes, incurred to provide transportation, including flight time expenses, such as deadhead/repositioning time, wait charges, landing fees, local taxes, crew expenses and any other expense incurred in the movement of the aircraft. The golden rule to remember is whatever amounts you charge, whether at or below what the market will bear, must be included as part of amounts paid. For instance, Rev. Rul. 72-565 states, "Amounts paid for charges in connection with layover time of chartered aircraft consisting of an hourly rate plus expenses of the pilot and crew are subject to the taxes imposed on transportation."

Rev. Rul. 57-545 provides very limited relief. "Amounts paid by a company for the lease of an aircraft, including its operation and maintenance for transporting the company's personnel, are subject to the tax. The tax does not apply to payments for non-transportation items if the payments are separable from the payments for rental and operation of the aircraft and are shown separately on the carrier's records."

The result is that a few items not related to air transportation and provided for the convenience of the customer, such as ground transportation and catering, are excludable. In other words, the passengers could have called ahead and arranged these services themselves; instead, the operator arranged them for the convenience of the customer only. Therefore, to be excluded, these charges must be itemized.

## Sample Calculation for a Domestic Charter Flight

For a hypothetical domestic charter flight with six passengers from a non-rural airport in White Plains, NY (HPN) to a Raleigh Durham, NC airport (RDU), the cost of the flight is \$3,960. Here is the tax calculation:

- ◆ \$1,650 per hour x 2.4 hours total flight = \$3,960
- ◆ \$3,960 cost of flight x 7.5% transportation of persons tax = \$297
- ◆ \$3.00 non-rural segment fee x 6 passengers x 2 legs = \$36
- ◆ \$297 + \$36 = \$333

On most flights, additional expenses will be normal. For example, when the RDU flight remains overnight (RON), \$500 in additional expenses are incurred, \$50 of which is a passenger ground transportation fee. The remaining \$450 in fees are attributable to crew hotel, meal, ground transportation and ramp fees and the use of a ground power unit. As long as the \$50 passenger ground transportation fee is itemized separately from the rest of the expenses, the amount on which to base the transportation of persons tax would increase by only \$450 instead of by \$500.

Here is the new tax calculation:

- ◆ (\$3,960 cost of flight + \$450 crew and aircraft expenses)(7.5% transportation of persons tax) = \$330.75
- ◆ \$3.00 non-rural segment fee x 6 passengers x 2 legs = \$36
- ◆ \$330.75 + \$36 = \$366.75

If a stopover were added at a rural airport on the return flight from RDU to HPN, the total tax would increase if amounts paid increased. However, segment fees would not attach to the leg from RDU to the rural airport or to the leg from the rural airport to HPN.

## Use of International Air Travel Facilities

The above-mentioned 225-mile zone is also relevant to the international air travel facilities tax. This tax adjusts yearly and is imposed on flights that begin or end, but not both, in the United States. The tax does not apply if all the transportation is subject to the domestic percentage tax. The rate for this tax in 2003 is \$13.40 per person. If the 225-mile zone were not

taken into consideration when computing taxes, the IRS might feel that operators would be tempted to make a fuel stop just outside the United States and pay only the international “head tax” versus the percentage tax on amounts paid.

A special-rate head tax applies to a domestic segment that begins or ends in Alaska or Hawaii and applies to departures only.

There are other fees to be considered when traveling internationally. These include U.S. Customs fees, listed at [www.customs.ustras.gov/impoexpo/facthead.htm](http://www.customs.ustras.gov/impoexpo/facthead.htm); APHIS fees, listed at [www.aphis.usda.gov/bad](http://www.aphis.usda.gov/bad); and INS fees, listed at [www.ins.usdoj.gov](http://www.ins.usdoj.gov). Further information on these fees also is available on the NBAA Web site at [www.nbaa.org/taxes](http://www.nbaa.org/taxes).

### **Uninterrupted International Flight**

Uninterrupted international air transportation is defined as transportation entirely by air that does not begin *and* end in the United States or in the 225-mile zone. If the flight makes an operational stop in either of these areas and there is not more than a 12-hour interval between arrival and departure at any station in the United States or the 225-mile zone, the flight would be subject to the international head tax even though a domestic stop occurred.

### **Transportation Involving Hawaii and Alaska**

The computation for transportation between Alaska and the Aleutian Islands or between any of the Hawaiian Islands is fairly straightforward. Payments of the percentage-based transportation of persons tax plus the segment fee component generally are due. The tax applies even though parts of the flight may transit international waters, or in the case of Alaska over Canada, if no point on the direct line of transportation is greater than 225 miles from any part of the United States, including Alaska or Hawaii.

Leaving or entering U.S. airspace occurs when the route of flight passes over either the U.S. border or a point 3 nm or 3.45 sm from low tide on the coastline, or when leaving the 225-mile zone. Thus, the computation of the transportation of persons tax between the continental United States and Hawaii or Alaska is

not as straightforward as computing tax for flights within Alaskan or Hawaiian regions. Transportation between the continental United States and Hawaii or Alaska is subject to the percentage tax on the part of the trip in U.S. airspace, the domestic segment fee for each domestic segment, and the international head tax at the special rate for departures to/from Hawaii and Alaska.

In short, the percentage tax does not apply to the portion of the trip between the point at which the route leaves the continental United States and the point at which the route re-enters U.S. airspace in Hawaii or Alaska. For example, the domestic segment fee would attach for a Los Angeles (LAX) to Honolulu (HNL) segment and return, as well as the international special-rate head tax. The international special-rate head tax also will be charged for the return departure from HNL to LAX.

To clarify, the international head tax does not apply if all the transportation is subject to the domestic percentage tax. Referring to IRC 4261(b) and 4262(a)(1), because a flight begins and ends in the United States, the flights between the continental United States and Alaska or Hawaii are domestic segments subject to the segment tax, unless the rural airport exception applies. Therefore, using this logic, a nonstop flight departing Los Angeles to Honolulu and a flight departing Honolulu for Los Angeles both are subject to the percentage transportation of persons tax, a domestic segment fee and the special-rate head tax.

### **Transportation Involving U.S. Possessions**

Taxable transportation between the United States, including Alaska and Hawaii, and the following U.S. Possessions are subject to the international air travel facilities head tax versus the domestic transportation of persons tax: U.S. Virgin Islands, Guam, American Samoa, Johnston Atoll, Kingman Reef, Wake Island, Midway Island, Baker, Howland, Jarvis Islands, Palmyra Atoll, Republic of the Marshall Islands, Federated States of Micronesia, Republic of Palau, North Mariana Islands and Commonwealth of Puerto Rico.

## Sample Calculation for a Continental U.S.-to-Hawaii Charter Flight

Using 2003 tax rates, transportation of persons tax for a round-trip charter flight from Chicago (MDW) to Honolulu (HNL) with five passengers would be computed as follows. (Mileage is not exact and is provided for example only.)

- ◆ First, calculate the cost per mile
  - ▼ (\$5,250 hourly cost)(16.9 flight hours) = \$88,725 total cost
  - ▼ MDW to HNL: 4,240 miles x 2 trips = 8,480 miles
  - ▼ \$88,725/8,480 miles = \$10.46 cost per mile
  
- ◆ Second, calculate U.S. taxable miles
 

▼ MDW to U.S. low tide	1,898
Hawaiian low tide to HNL	<u>+ 8</u>
	1,906
Round trip	<u>x 2</u>
Taxable miles	3,812
  
- ◆ Calculate transportation of persons tax
  - ▼ \$10.46 cost per mile x 3,812 taxable miles = \$39,873.52 cost
  - ▼ \$39,873.52 x 7.5% transportation of persons tax = \$2,990.51
  - ▼ 10 passengers x \$6.70 head tax = \$67.00
  - ▼ 10 passengers x \$3.00 seg. fee = + \$30.00
  - ▼ Total transportation tax \$3087.51
  
- ◆ Calculate fuel-stop segment fees
  - ▼ If the aircraft made two fuel stops in Los Angeles (one in each direction), this adds two more taxable segments to the trip:
  - ▼ Previous total (from above) \$3,087.51
  - ▼ 10 passengers (five each way) x \$3.00 segment fee = + \$30.00
  - ▼ New total transportation tax \$3,117.51

## Commercial vs. Non-Commercial Aviation – FAA vs. IRS Views

Knowing how the IRS defines a flight, whether as commercial or non-commercial, helps determine which tax – fuel or transportation – is due.

FAR Part 91, or non-commercial, operators generally will pay fuel taxes “as they go” and are not required to take any further action. However, there are exceptions, such as entering into timeshare or interchange arrangements and accepting the required payments for the carriage of elected officials. Other exceptions that can create liability for transportation taxes include carriage, inter-company but outside the IRS affiliated-group definition, certain management company arrangements, fractional ownership and possibly ownership of a company through an LLC or S-corporation.

An important point for the flight department manager always to remember is that the FAA and IRS do not speak the same language. IRS Rev. Rul. 78-75 states, “The status of an aircraft operator as a ‘commercial operator’ under FAA regulations is not determinative in applying the aviation fuel and transportation taxes.”

Thus, the corporate flight department entering into any of these operations may need to learn the intricacies of collecting and remitting transportation of persons taxes even though they clearly are operating under FAR Part 91. The other application of this rule is commonly thought to mean that because operators choose to operate under the operating rules of FAR Part 135 for their own flights but within the IRS definition of non-commercial operations, the FAA operating rules should not have a bearing on transportation taxes otherwise applying.

### FAA Non-Commercial Flights That Are IRS Commercial Flights

By IRS and FAA standards, a profit motive is not required by a commercial operator. As stated earlier, the FAA allows a few forms of private carriage “for hire” under the traditionally not-for-hire portion of the FARs. The FAA allows limited reimbursement according to the list found in section (d)1–10 of FAR Part 91.501 (see below). The IRS considers these flights, and under certain circumstances the FAA-



defined “affiliated group” under 91.501(b)5, to be subject to the IRS transportation of persons tax. We will cover this subject in greater detail later. First we will examine a timeshare arrangement. According to FAR Part 91.501:

(c)(1) A time-sharing agreement means an arrangement whereby a person leases his airplane with flight crew to another person, and no charge is made for the flights conducted under that arrangement other than those specified in paragraph (d) of this section;

(d) The following may be charged, as expenses of a specific flight, for transportation as authorized by paragraphs (b)(3) and (7) and (c)(1) of this section:

1. Fuel, oil, lubricants and other additives
2. Travel expenses of the crew, including food, lodging and ground transportation
3. Hangar and tie-down costs away from the aircraft’s base of operation
4. Insurance obtained for a specific flight
5. Landing fees, airport taxes and similar assessments
6. Customs, foreign permit and similar fees directly related to the flight
7. In-flight food and beverages
8. Passenger ground transportation
9. Flight planning and weather contract services
10. An additional charge equal to 100 percent of the expenses listed in paragraph (d)(1) of this section.

**Sample Calculation of Transportation of Persons Tax for FAR Part 91.501 Timeshare/Non-Rural Airport**

- ◆ Calculate the cost of Fuel
  - ▼ 3,500 lbs. jet fuel/6.7 lbs. per gallon = 522 gallons. Use 6.0 lbs per gallon for avgas.
  - ▼ 522 gallons at \$2.75 per gallon = \$1,435.50
  - ▼ Expenses d(2) through d(9) = \$925.00
  - ▼ Assume 91.501d(10) utilized = \$1,435.50
  - \$3,796.00
  - x 7.5%
  - \$284.70

- ▼ Two non-rural segments:
  - \$3.00 x 4 passengers x 2 legs + \$24.00
- ▼ Total transportation tax \$308.70

**IRS Definition of Non-Commercial Aviation**

The IRS defines non-commercial aviation as what it is not rather than what it is. The term non-commercial aviation means any use of an aircraft, other than use in a business of transporting persons or property for compensation or hire by air. The term also includes any use of an aircraft, in a business as described in the preceding sentence that is properly allocable to any transportation exempt from the taxes imposed by IRC Sections 4261, Transportation of Persons; 4271, Transportation of Property; 4281, Small Aircraft Exemption on Non-Established Lines; or 4282, Affiliated Group Exemption.

Generally speaking and for Federal purposes only, jet fuel is taxable at the rack; the rack is defined as a loading facility or point of delivery from a refinery tank farm or end of pipeline. Different rules apply to registered wholesale distributors. Avgas is taxable at the rack regardless of the entity taking the delivery’s status. On the other hand, if states were to impose an excise tax at all, they would generally claim delivery at the fuel truck nozzle as the taxable moment.

**Who Is the Taxpayer?**

The taxpayer in the case of non-commercial operations is the person paying for the fuel (possession of receipt) and is generally, but not always, the aircraft operator. The taxpayer in the case of transportation of persons tax or transportation of property tax is the person paying for the transportation.

**Who is the Tax Collector?**

The entity billing the customer for taxable transportation is the tax collector. Because of secondary liability, under certain circumstances, liability may extend, jointly and severally to the employees of the transportation provider.

## Two Parts to the Fuel Tax

IRC Section 4041 imposes the fuel excise taxes on non-commercial aviation.

- ◆ Part 1: The 2002 Federal base rates are 17.5 cents for jet fuel and 15 cents per gallon for aviation gasoline.
- ◆ Part 2: A 4.4-cent tax brings the total Federal tax to 19.4 cents for aviation gasoline and 21.9 cents for jet fuel. The breakdown is important to know in order to identify if a potential credit exists for non-taxable operations. Some operations, such as domestic commercial transportation, will yield only the base rate, while international trade and other domestic operations and air ambulance will yield the entire amount. At one point, the 4.4-cent portion was a combination deficit reduction (4.3 cents) and leaking underground storage tank (0.1 cents) tax. However, this procedure was altered in 1997. The deficit reduction portion was earmarked for the airports and airways trust fund.

### Sample Calculation of Federal Fuel Tax Refund for Timeshare

First, calculate fuel used, then calculate the tax as follows:

- ▼ 3,500 lbs./6.7 lbs. per gallon = 522 gallons
- ▼ 522 gallons x \$0.175 = \$91.35 fuel tax refund
- ▼ \$308.70 transportation of persons – \$91.35 = \$217.35 net tax

### Federal Excise Tax on Fuels Used for Nontaxable Purposes

The IRS does not apply Federal excise taxes on aviation fuel and gasoline used for the operations listed below. These operations are determined on a leg-by-leg basis. For more details, refer to Rev. Rul. 72-360, 1972-2 CB 542 and Rev. Rul. 77-405, 1977-2 CB 381.

- ◆ Foreign trade operations. The term “used in foreign trade” means used in civil aircraft employed in foreign trade or trade between the United States and any of its possessions.
- ◆ Air ambulance operations. The air ambulance aircraft (fixed wing or helicopter) must be equipped for and exclusively dedicated on that flight to acute care emergency medical services.
- ◆ Nonprofit educational organization operations. A nonprofit educational organization is an organi-

zation exempt from income tax under Section 501(a) of the Internal Revenue Code that meets both of the following tests:

- ▼ A regular faculty and curriculum
- ▼ A regular enrolled body of students who attend the place where the instruction normally occurs.
- ◆ A 501(c)(3) organization operations (if both tests above are met)
- ◆ Aircraft museum operations. An aircraft museum must meet all of the following requirements:
  - ▼ Tax-exempt organization under 501(c)(3)
  - ▼ Operated as a museum under a state charter
  - ▼ Operated exclusively for acquiring, exhibiting and caring for aircraft of the type used for combat or transport in World War II
- ◆ State/local government operations. State or local government refers to any state, any political subdivision thereof, or the District of Columbia.
- ◆ U.S. Military operations. A military aircraft is an aircraft owned by the United States or any foreign nation and constituting a part of its armed forces.
- ◆ Certain helicopter operations when the helicopter does not take off from, or land at, a facility eligible for assistance under the Airport and Airway Development Act
  - ▼ Transporting individuals, equipment or supplies in the exploration for, or the development or the removal of, hard minerals, oil or gas.
  - ▼ Planting, cultivating, cutting, transporting or caring for trees (including logging operations)
- ◆ Commercial aviation operations. Commercial aviation means the use of an aircraft in the business of transporting persons or property by air for pay.
  - ▼ Commercial aviation does not include:
    - Any use of an aircraft that has a maximum certificated takeoff weight of 6,000 lbs. or less (for example, Beechcraft Baron and Piper Seneca) unless the aircraft is operated on an established line
    - Skydiving
    - Use by a member of an affiliated group as defined by the IRS.

Once determined that fuel has been used in a non-taxable operation there are a few options available for receiving reimbursement. The timing for making claim of the refund or credit and which form to use depend on the type of use and the amount of the claim involved.

Sufficient records must be kept to enable the IRS to verify that you are the person entitled to the claims made. Records, which you must keep at your principal place of business, minimally include:

- ◆ Dates of each purchase
- ◆ Number of gallons purchased and used during the period covered by your claim
- ◆ Nontaxable use for which you used the fuel
- ◆ Number of gallons for each non taxable use
- ◆ Names and addresses of suppliers and amounts purchased from each in the period covered by your claim.

### **The Purpose of Form 4136**

Refer to your copy of IRS Form 4136. The purpose of Form 4136 is to claim a credit for the Federal excise tax on fuels used for nontaxable purposes. Form 4136 is an attachment to a yearly tax return of an individual or corporation. The form is not available to informational return filers, such as partnerships or entities that do not file state and local government income tax returns. To complete the form, you will need to know the type of use and the number of gallons of aviation gasoline (Line 2) and jet fuel (Line 4) used.

Form 4136's Type of Use Table assigns numbers to a given activity for IRS control purposes. A word of caution, however; Form 8849, covered in the next section, also uses a Type of Use Table, but it does not correlate line item by line item with the items on Form 4136. Form 4136's Type of Use Table shows Number 10, Certain Helicopter Operations, which includes air ambulance and fixed-wing air ambulance, and Number 11, Aviation Fuel Used Other Than as Fuel for the Propulsion of an Aircraft Engine. In addition, notice that commercial use does not have a type of use assigned, and on Lines 2a and 4a, the box is darkened to prevent entry of a code. The number of gallons are entered and extended using the base rate on Lines 2a or 4a as applicable.

Amounts are entered on Lines 2b and 4b when fuel is used in a fully non-taxable operation and fully taxed on purchase. Because under limited circumstances jet fuel, but not aviation gasoline, can be purchased partially tax free, a provider who is able to do so and then engages in nontaxable operations that are fully tax free would claim a 4.4-cent per gallon credit on Line 4b.

Line 9 of the Form 4136 instructs you to add all credits and enter the sum. Then transfer the amount to:

- ◆ Line 64 on Form 1040, U.S. Personal Income Tax Return
- ◆ Line 32g on Form 1120, U.S. Corporation Income Tax Return
- ◆ Line 28g on Form 1120, U.S. Corporation Short Form
- ◆ Line 23c on Form 1120S, U.S. Income Tax Return for an S Corporation
- ◆ Line 24g Form 1041, U.S. Income Tax Return for Estates and Trusts.

### **The Purpose of Form 8849**

Refer to your copy of IRS Form 8849. Form 8849, which enables the taxpayer to file claims on a quarterly basis in lieu of the annual Form 4136, is useful for a couple of reasons. Without the ability to file quarterly, the taxpayer would be making an interest-free loan to the Federal government until the yearly Form 4136 could be filed. Further, Form 4136 is not available to entities that do not file income tax returns.

Refunds are available for the same types of use as those noted on Form 4136. However, unlike on Form 4136, Form 8849's Type of Use Table shows Number 10 as Military Aircraft and Number 11 as Certain Helicopter and Fixed Wing Air Ambulance Uses. A common error takes place when a person accustomed to filing Form 4136 assumes that the Type of Use Table on Form 4136 is identical to that on Form 8849. The military, along with state and local governments (Form 8849 Number 14) and aircraft museums (Form 8849 Number 15), must file Form 8849. To round out the Form 8849 Type of Use Table, the use of aviation fuel other than as fuel for the propulsion of a jet engine moves to Number 16. Schedule 1, Nontaxable Use of Fuels must be completed and attached to Form 8849.

The IRS has established filing periods and dollar thresholds that must be met for Form 8849 to be available. There are three requirements to understand:

- ◆ Dollar Threshold. You may file a claim for refund for any quarter of your current tax year for which you can claim \$750 or more.
- ◆ Filing Periods. You must claim by the last day of the first quarter following the last quarter included in the claim. If you do not file a timely refund

claim for the fourth quarter of your tax year, you will have to claim a credit for that amount via Form 4136 on your income tax return.

- ◆ **Carry Forward.** If you do not meet the \$750 threshold in the first quarter of your tax year you must carry the amount forward to the second quarter. Assuming the threshold amount is then reached you may file.

The Form 8849 quarter is determined by the claimant's tax year. For the purpose of this example, we will use a calendar tax year, in which the first quarter is defined as January, February and March 2002. In this scenario, the claimant must file the first quarter Form 8849 no later than June 2002. Should the claimant not reach the \$750 threshold in March 2002 (the end of the first quarter) but instead reach greater than \$750 in the second quarter, the claimant must file Form 8849 by the end of the third quarter in September 2002. If the claimant does not reach the \$750 threshold by the end of the calendar year in December 2002 and/or promptly file Form 8849 by March 2003, Form 8849 would not be available to the claimant; instead, Form 4136 would have to be filed with the claimant's income tax return.

Form 8849 only can be filed for the current tax year. If a claimant cannot claim at least \$750 dollars by the last quarter of the tax year, Form 4136 must be used. Further, with the "one-claim rule," the IRS takes a negative stance on amended returns.

### **IRS Categorization of Types into Groups and the One-Claim Rule**

The IRS categorizes types of use into groups and contends that for each tax year, a claimant can make only one claim for refund from each group. In other words, should you discover in 2004 that your refunds were not calculated correctly or were incomplete in 2002, according to the IRS "one-claim rule," an amended return would not be available if a credit or refund for the quarter in question was previously submitted. There have been some positive signs on this issue for the taxpayer in the court system. Should the issue arise for you, it may pay to seek out professional assistance. For more information, see the document titled "The One-Claim Rule Inapplicable to Credits Claimed on Income Tax Return" at [www.nbaa.org/taxes](http://www.nbaa.org/taxes).

### **The IRS Facts and Circumstance Test for Determining Taxable Transportation**

Many NBAA Members operating under FAR Part 91 find themselves unknowingly operating within the IRS definition of commercial aviation. In the coming sections, we will provide examples of and differentiate between flights that could be considered commercial for IRS purposes and non-commercial for FAA purposes. Later, we also will take a look at Form 720, Quarterly Federal Excise Tax Return, and break down the individual items into manageable pieces.

The FAA has specific FARs, Parts 91 and 135, that determine operational rules for noncommercial and commercial operators. NBAA Members determine which FAR Part under which they will operate by beginning with FAR Part 119. If their operations as per FAR Part 119 are not considered commercial operations, FAR Part 91 is available. As a general rule, operators may not accept compensation from unrelated individuals or companies; however, there are a few operations available with limited reimbursement allowed. These rules can be found in FAR Part 91.501 under Subpart F. Unless specific exemptions apply, these same Part 91 operations will be considered commercial for IRS purposes and subject to the transportation of persons or "ticket tax." As noted earlier, the IRS defines noncommercial aviation as any use of an aircraft except for use in the business of transporting persons or property for compensation or hire. (The intent to make a profit is irrelevant.)

It is a fairly straightforward proposition to determine which tax – fuel or transportation of persons – applies if the operator is engaged in common carriage and holds FAA commercial certification. Additionally, the operator generally will be versed in the subject and have persons on staff trained to collect and report. However, some other scenarios may not be as clear.

For example, brokers without aircraft of their own or even charter companies without available aircraft sometimes will arrange for one of their customers to travel on another charter company's aircraft. In this arrangement, the broker has the only contact with the customer in arranging and billing. Theoretically, the only contact the charter company providing the aircraft has with the passenger is through the crew. In this case, the broker, acting as the principal, arranges

for departure locations, dates, times and invoicing; therefore, the broker has responsibility for collecting and remitting transportation of persons tax to the IRS on all amounts paid, including his or her own markup and taxes included from the charter provider. It is common for a charter provider to clearly state on its invoice to the broker that the Federal excise tax is the responsibility of the broker. However, there are circumstances in which the broker is merely a conduit and not acting as the principal, and in these cases, it may behoove both parties to contractually define their respective roles.

According to Rev. Rul. 60-311, the IRS Chief Counsel office has determined that an operator is furnishing taxable transportation if the owner provides a flight, receives compensation and retains elements of possession, command and control and compensation. This results in a facts-and-circumstance analysis instead of a “bright line” definition. Factors to consider include:

- ◆ Possession – Ownership, lease, insurance
- ◆ Command – Scheduling, availability
- ◆ Control – Who hires pilots; who determines who uses the aircraft; who performs all services in connection with the operation of the aircraft.

The U.S. Joint Committee on Taxation recommended in its 2001 report to Congress that the IRS adopt the FAA definition of commercial transportation. To determine if an operator is providing commercial transportation, the FAA relies on a combination of FAR Part 119 and whether the operator has received compensation while maintaining operational control. Beyond determining if commercial transportation has occurred, the FAA clearly is concerned that operational control be squarely the responsibility of one individual or shared jointly and severally for enforcement action. For more on FAR Part 119, see the regulatory portion of the NBAA Taxes Web site at [www.nbaa.org/taxes](http://www.nbaa.org/taxes).

The short answer in determining whether the transportation is commercial according to the IRS involves following the money and legal structure. Who has physical possession of the aircraft? Is the owner of record the operator? Who is the named insured and who pays the premium for hull and liability insurance? Who schedules use and determines availability? Who schedules maintenance? Who hires and retains

rights to hire and dismiss pilots? Does one entity perform all services in connection with the operation of the aircraft?

If your company owns an aircraft and is operating that aircraft to transport your company’s employees, guests and property when the transportation is within the scope of, and incidental to, the business of the company, and no charge is made for the transportation, the greatest probability is that you are involved in private carriage/”not for hire” as opposed to private carriage/”for hire” or common carriage.

## Warning Signs

The short answer gets longer if any of the following warning signs present themselves: Your flight department has a legally separate name; utilization has dropped and shared use is being considered to offset cost; you are receiving compensation from unrelated persons or companies (i.e., a strategic alliance or joint venture); or an employee is reimbursing the company for personal use.

To allow for the realities of modern business aviation, the FAA has determined that under certain circumstances normally requiring certification, limited reimbursement while maintaining operational control will not affect safety. The IRS considers these circumstances, delineated under FAR Part 91.501, to remain commercial transportation. Excerpts of FAR 91.501 with examples follow.

## FAA Operational Control

According to Federal Aviation Regulation 91.501:

Responsibility for safety and regulatory compliance

FAR Part 1 definition: The exercise of authority over initiating, conducting or terminating a flight.

Subpart F – Large and Turbine-Powered Multiengine Airplanes

Sec. 91.501 Applicability.

- (a) This subpart prescribes operating rules, in addition to those prescribed in other subparts of this part, governing

the operation of large and of turbojet-powered multiengine civil airplanes of U.S. registry. The operating rules in this subpart do not apply to those airplanes that are required to be operated under Parts 121, 125, 129, 135, and 137 of this chapter.

(c)(1) A time-sharing agreement means an arrangement whereby a person leases his airplane with flightcrew to another person, and no charge is made for the flights conducted under that arrangement other than those specified in paragraph (d) of this section;

(c)(2) An interchange agreement means an arrangement whereby a person leases his airplane to another person in exchange for equal time, when needed, on the other person's airplane, and no charge, assessment, or fee is made, except that a charge may be made not to exceed the difference between the cost of owning, operating, and maintaining the two airplanes;

Both timeshare and interchange agreements are wet leases. In both arrangements, the owner/operator retains operational control and furnishes transportation with crew. These leases are subject to Part 91.123 truth in leasing and must be in writing.

## Timeshares

In the case of the timeshare, the amount on which the transportation tax is applied cannot exceed the charges for expenses of a specific flight as listed under FAR 91.501 (d)1-10. The FAR 91.501 (d)1-10 list is to be followed literally; it includes crew travel expenses, hangar and tie-down costs, insurance, landing fees, airport taxes, Customs fees, foreign permit fees, in-flight catering, passenger ground transportation and flight planning/weather services. The full list specified by FAR 91.501 (d)1-10 appears on page 9 of this handbook.

Treasury Regulation Section 49.4261-8 specifies payments not subject to tax, miscellaneous charges, which were incurred for passenger convenience and

not incurred as a direct result of flight. Items such as catering, ground transportation and storage or transfer of baggage can be excluded, but these charges must be separately stated.

Here are a few extra timeshare points to remember:

- ◆ A timeshare is not a shared ownership arrangement; it is a wet lease with limited reimbursement.
- ◆ It is acceptable to charge less than the amounts stated in FAR 91.501 (d)1-10; however, total charges may not be more than the permitted expense items.
- ◆ Since transportation taxes are due on all amounts paid, it is commonly understood in the industry that the Federal excise tax is the implicit exception to the FAR 91.501 (d)1-10 list.
- ◆ The allowable charges must be incurred and assignable to a specific flight
- ◆ Notice that pilot salaries are not allowed. The timeshare is not intended to allow operators to break even much less make a profit. Items such as depreciation, power-by-the-hour and pilot salaries will only be covered to the extent of FAR 91.501 (d)10, which is 100 percent of (d)1 fuel.
- ◆ The timeshare is useful when recovery of some cost is desirable and compensation is otherwise not allowed by the FARs.

## The Interchange

The interchange is essentially an exchange of wet leases. Ratios are not allowed. A payment for the difference of owning and operating is allowed. However, the Federal excise tax is due on the FMV, not the amounts paid in differential.

## Affiliated Group – FAA vs. IRS Views

After determining if reimbursement is legal under FAR Part 91, the non-commercial business aviation operator still needs to determine under IRS rules if any chargebacks, even non-cash or equity infusion, are taxable. Of course, if no compensation takes place, then neither the FAA nor the IRS has further concern with regard to commercial transportation.

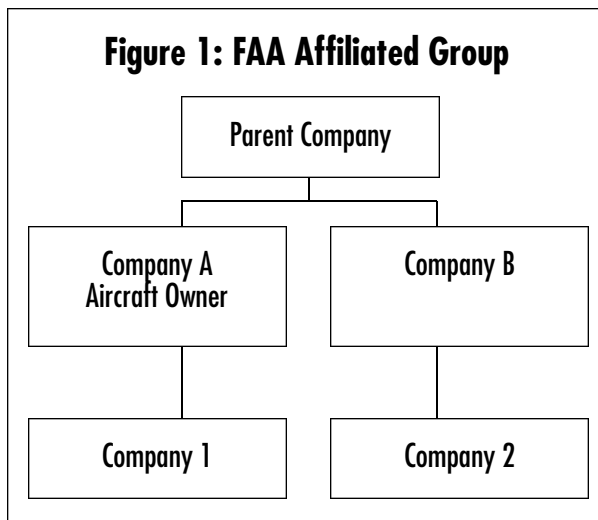
## The FAA Version of an Affiliated Group

FAR 91.501(b)(5) states:

Carriage of officials, employees, guests, and property of a company on an airplane operated by that company, or the parent or a subsidiary of the company or a subsidiary of the parent, when the carriage is within the scope of, and incidental to, the business of the company (other than transportation by air) and no charge, assessment or fee is made for the carriage in excess of the cost of owning, operating, and maintaining the airplane, except that no charge of any kind may be made for the carriage of a guest of a company, when the carriage is not within the scope of, and incidental to, the business of that company.

Refer to **Figure 1**, the FAA Affiliated Group organization chart, and assume that Company A is in the business of servicing air conditioning units as well as owning and operating corporate aircraft. Company A may fly and receive reimbursement for flights provided to the Parent Company (P), a subsidiary of Company A (Company 1), or another subsidiary of the Parent (Company B). Company A cannot charge, cash or barter more than the actual cost of owning, operating and maintaining the airplane.

It is unclear by reading FAR 91.501 whether Company A may charge Company 2 without the benefit of a Part 135 certificate. It is thought and understood by many that Company 2 may be charged for inter-company flights



because it is only one level away from Company A. However, at this time, written guidance is unavailable.

## The IRS version of an Affiliated Group

According to IRC Section 4282 regarding affiliated groups:

*Statute Title 26, Subtitle D, Chapter 33, Subchapter C, Part III, Sec. 4282*

General rule: Under regulations prescribed by the Secretary, if –

(1) One member of an affiliated group is the owner or lessee of an aircraft, and

(2) Such aircraft is not available for hire by persons who are not members of such group, no tax shall be imposed under Section 4261 or 4271 upon any payment received by one member of the affiliated group from another member of such group for services furnished to such other member in connection with the use of such aircraft.

(b) Affiliated group

For purposes of subsection (a), the term “affiliated group” has the meaning assigned to such term by Section 1504(a), except that all corporations shall be treated as includible corporations (without any exclusion under Section 1504(b)).

In addition, IRC Section 1504(a) defines the IRS version of an affiliated group as follows:

*Statute Title 26, Subtitle A, Chapter 6, Subchapter A, Sec. 1504*

(a) Affiliated group defined for purposes of this subtitle –

(1) In general

The term “affiliated group” means –

(A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if –

(i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and

(ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations.

(2) 80-percent voting and value test: The ownership of stock of any corporation meets the requirements of this paragraph if it –

(A) possesses at least 80 percent of the total voting power of the stock of such corporation, and

(B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

The Definition of “includible corporation” as used in this chapter, the term “includible corporation” means any corporation except –

(1) Corporations exempt from taxation under Section 501.

(2) Insurance companies subject to taxation under Section 801.

(3) Foreign corporations.

(4) Corporations with respect to which an election under Section 936 (relating to possession tax credit) is in effect for the taxable year. ((5) Repealed. Pub. L. 94-455, title X, Sec. 1053(d)(2), Oct. 4, 1976, 90 Stat. 1649.)

(6) Regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1.

(7) A DISC (as defined in Section 992(a)(1)).

This means that the parent must be a company, not an individual, and own at least 80 percent of the company being provided and reimbursing for transportation. Otherwise, any reimbursements would be considered made for the purposes of providing commercial transportation.

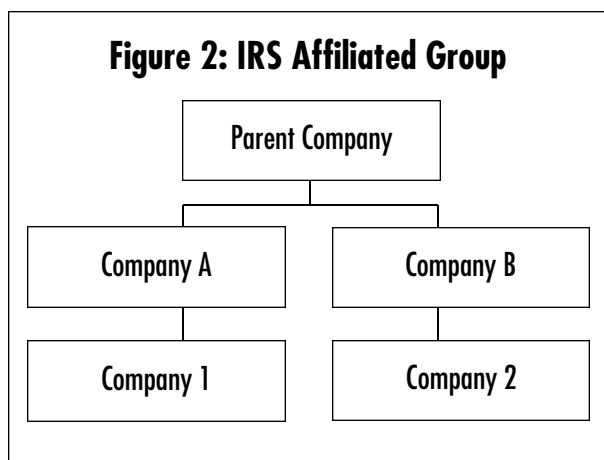
In **Figure 2**, IRS Affiliated Group, assume that Companies A, B and 1 are controlled and owned by their Parent Company with greater than 80 percent of the voting stock. The Parent’s ownership of Company 2 is less than 80 percent. Except for Company 2, any reimbursements for flights provided inside this group of companies are not subject to Federal excise taxes.

## Management Companies

Management companies are not a defined service under the FARs. The key to whether the IRC ticket tax would be due on flights to an owner when using a management company center on the management agreement itself. The IRS Market Segment Specialization Program (MSSP), agent training document, Rev. Rul. 58-215 and Rev. Rul. 60-311 might be useful to help you avoid writing an agreement with a management company or even engaging in a piggy-back arrangement with a charter operator that would expose you to the ticket tax on your own flights.

The management company enters into an agreement with a corporation to operate and maintain its aircraft and provide pilots fuel and insurance for the aircraft. The corporation pays for all costs attributable to the operation of the aircraft for its use, including salaries and standby charges for the pilots and all expenses for fuel, insurance and overnight fees. The corporation has the right to replace any of the certified pilots and to direct them when and where to fly.

Since the corporation owns the aircraft, has exclusive control over the aircraft’s personnel, pays the operating expenses of the aircraft, and maintains liability and risk insurance, the management company that operates the aircraft is acting as an agent of the corporation and is not required to collect the air trans-





portation tax on payments it receives from the corporation for flights it provides for corporate personnel.

## Fractional Programs

A fractional provider is a hybrid of an aircraft sales company, which purchases aircraft and facilitates the grouping of aircraft owners into an aircraft of mutual utility, and a management company, which ensures that maintenance is completed and crews available. Because of the sharing of aircraft among numerous owners in potentially wide geographic locations, the provider has a significant coordination function. Since fractional providers must maximize the use of program aircraft while guaranteeing aircraft availability, outsourcing becomes necessary, as well as potentially high levels of deadheading between the dropoff of Owner A and pickup of Owner B.

An aircraft owner in a fractional program is named on the FAA registration as owner of an undivided interest. For IRS purposes, the owner generally has the ability to capitalize, depreciate and conduct like-kind exchanges. Since ownership is determined by contract, a prospective fractional owner should carefully scrutinize all documents.

In *Executive Jet Inc. v. United States*, the court attempted to address whether the fractional program was commercial or non-commercial. The result was a “splitting of the baby.” With exceptions, the transportation of persons tax generally is due on the hourly operating cost but not on the monthly management fee. The general rule would not apply if under audit it were suspected that a fractional provider, to avoid Federal excise tax, were moving management fees into the hourly operating cost.

## Carriage of Public Officials

Assorted Federal, state and local government agencies limit the source and amounts of funds public officials may receive. Transportation without reimbursement is seen as a contribution and generally forbidden, in the case of a corporation, or limited, in the case of an individual. The Federal Elections Commission requires Federally elected officials and candidates to reimburse companies, in advance of the flight, on a level comparable to a first-class ticket if traveling between two airports with first-class service or to a charter rate if no airline service is available.

FAR Part 91.321 allows compensation for the private carriage of Federally elected officials without certification or incurring the cost and burden of entering into a timeshare agreement. Although the FAA has not yet acted, Public Law 96-104 directs the FAA to extend this same ability to state officials. However, even with FAA “blessing,” individual state laws will have to be addressed. See the NBAA Carriage of State Elected Officials Contact List, available at [www.nbaa.org/taxes](http://www.nbaa.org/taxes), for the correct office in each state. The IRS considers these reimbursements commercial and the amounts paid are subject to the transportation of persons tax.

All persons collecting Federal excise taxes on behalf of the Federal government must file IRS Form 720 on a quarterly basis and depending on the amounts involved make deposits as often as semi-monthly.

Since Federal excise tax on aviation fuel generally is paid at the refinery, a fixed base operator (FBO) generally will pay for fuel shipments with the excise tax included. On subsequent sale of the fuel to individual operators, the FBO will collect the excise tax and recover the amounts paid on purchase from the refinery.

The commercial operator, who subsequently purchased the fuel for use in commercial aviation, is then due a partial recovery, the excise tax less the “old deficit reduction” and leaking underground storage tank (LUST) tax, or a full refund if used in international trade. After use occurs, the operator collects the appropriate transportation of person, property and/or international facilities fees from those paying for the transportation. The determination of which tax, if any, applies is made on a flight-by-flight basis.

## Special Small Aircraft Rules and Exemptions from the Transportation of Persons Tax

Transportation that would otherwise be taxable is not taxable if the flight is furnished on an aircraft having a maximum takeoff weight of 6,000 lbs or less.

As with many IRS rules that have exceptions to an exemption, the same is true of the small aircraft rule. The taxes do apply if the small aircraft is operated on an established line. The IRS has interpreted the con-

cept of an established line fairly broadly to mean that the aircraft operates with some degree of regularity between definite points. In Publication 510, the IRS illustrates the established line concept as an operator with scheduled service between two given cities operating a charter between the same city pairs. However, the IRS has applied the established line concept much more broadly to tour operators.

## **Skydiving Operations**

Skydiving operations are exempt from transportation of persons tax.

## **Exempted Operations from Transportation and Fuel Taxes**

Operations exempt from transportation and fuel taxes are:

- ◆ Military, U.S. or foreign government operations
- ◆ Certain helicopter operations with severe restrictions on use of any airports/facilities, including:
  - ▼ Exploration and mining
  - ▼ Logging operations
- ◆ Emergency medical services (fixed wing or rotorcraft). However, the aircraft must be medically equipped for that flight or exclusively dedicated to acute medical care.

Acute medical care has been taken in some cases not to include the transportation of human organs for donation. Organ donation flights that do not utilize medical personnel and/or utilize aircraft equipped exclusively for use as an air ambulance for the flight in question are considered to be transportation of property by air.

## **Transportation of Property by Air**

The 2003 tax rate for the transportation of property tax is 6.25 percent. Like the transportation of persons tax, it applies to amounts paid and includes all amounts due on a flight that begins and ends in the United States.

## **Mixed Loads of Property and Persons**

Mixed loads of property and persons are fairly common. Charges must be apportioned.

## **Rule Changes Pertaining to Deposits and Filings**

On August 9, 2001, the IRS issued final regulations for Federal excise tax returns and deposit requirements. The final regulations apply to returns and deposits that relate to calendar quarters beginning on or after October 1, 2001. For more information, see *NBAA Alert Bulletin #01-9* at [www.nbaa.org/abs](http://www.nbaa.org/abs).

## **IRS Form 720**

The due date for IRS Form 720, Quarterly Federal Excise Tax Return, is the last day of the first month following the reporting quarter. For example, the return due for the 1st quarter ending March 31 must be filed by April 30. Forms 720 and 8849 are sent to the Internal Revenue Service Center in Cincinnati, OH. The following sections of this handbook provide a breakdown of Form 720 and explain the form's contents in more detail.

## **Employer Identification Number (EIN)**

The only acceptable reason to file Form 720 without an EIN is if you are a one-time filer. Check the appropriate box just below the address label.

## **New Rules Effective October 2001**

Under the new rules effective October 2001, there are two methods to calculate the amount owed, the regular method and the alternate method. These methods are described further on page 19. Under the regular method, there is one deposit option, the 14-day deposit period.

Both the regular and alternate methods maintain the September rule, described in more detail on page 20.

In addition, the new rules simplify the deposit periods for the regular method. The IRS breaks the month into two distinct halves or semi-monthly periods. The 1st semi-monthly period is from the 1st of each month until the 15th. The second semi-monthly period is from the 16th through the last day of the month. Deposits using the 14-day rule are due on the 29th and 14th, respectively.

## **Contrasting Deposit Periods vs. Tax Liability**

For the purpose of orientation, refer to Schedule A of Form 720. You must complete Schedule A if you have a liability for any tax in Part 1 of Form 720, which includes transportation of persons, property and use of international air travel facilities tax. Notice Description (a) under the alternate and 14-day rules. For the alternate rule, the liability to be entered is the amounts “considered as collected.” Under the 14-day rule, the amount to be entered is referred to as simply the “Record of Net Tax Liability.” While the method you choose, regular or alternate, will affect the way you determine the liability to be entered onto Schedule A, the deposit will not necessarily be the same amount. Schedule A delineates only excise tax liability by amount and time period. The amounts you deposited for the quarter are entered onto Line 6, Part 3 of Form 720.

The regular method, 14-day rule, and the alternate method, 3-day rule, each require six reporting periods. Notice that the form depicts the two semi-monthly periods for each of the three monthly periods of each quarter. There is an additional, seventh, line for the yearly “accelerated liability” incurred under the September rule. As we work to contrast and compare the alternate and regular methods, keep in mind the difference between tax liability and the deposits due.

The main difference between the regular method and the alternate method is that under the regular method, excise tax is not due to be deposited until the tax is collected from the customer, whereas under the alternate method, the collector of the tax (the operator) is responsible to collect tax on a deemed collected date regardless of collection status.

Under the alternate method, regardless of collection status, taxes collected within the applicable period are deemed collected during a given seven-day period and must be deposited within three banking days. The use of the deemed collected period creates a shifting back of the months that would be considered a quarter. The alternate method deposit dates are generally due on the 10th and 25th of each month. Some tax consultants will discourage operators from using the alternate method because of the potential

deposit penalties incurred from not applying the deposit rules correctly.

### **Examples of Determination of Liability for a Semi-monthly Period Under Regular and Alternate Methods**

Under the regular method, the taxpayer must report and deposit the air transportation taxes actually collected during the semi-monthly period. For example, under the regular method, excise taxes collected in the first semi-monthly period of January would be due for deposit 14 days later on January 29. Excise taxes collected in the second semi-monthly period would be due for deposit February 14.

Under the alternate method, amounts billed or tickets sold during a semi-monthly period are considered collected during the first seven days of the following semi-monthly period. For example, amounts billed during the December 1 to December 15 semi-monthly period are considered collected after the next semi-monthly period of December 16 to December 31 and during the first seven days of the first semi-monthly period of January (January 1 to January 7). Amounts billed during the December 16 to December 31 semi-monthly period are considered collected during the first seven days of the second semi-monthly period of January (January 16 to January 22). IRS Notice 1009 (Rev. 2-2001) provides charts showing these periods and the proper reporting box to use on each quarterly Form 720. This notice can be obtained from the IRS Web site at [www.irs.gov](http://www.irs.gov) under the Publications and Notices section.

Alternate method taxpayers are required to deposit the air transportation taxes considered collected by the third banking day after the seventh day of that semi-monthly period. For most periods, this means the taxes must be deposited by the 10th for the first semi-monthly period of that month and 25th for the second semi-monthly period of that month. Referring to the previous example, amounts billed during the December 1 to December 15 semi-monthly period are considered collected during the first seven days of the first semi-monthly period of January (January 1 to January 7). These taxes must be deposited by January 10. Amounts billed during the December 16 to December 31 semi-monthly period are considered collected during the first seven days of

the second semi-monthly period of January (January 16 to January 22). These taxes must be deposited by January 25.

According to the IRS's "Changes to the Requirements for Excise Returns, Payments and Deposits, Effective for Calendar Quarters Beginning after September 30, 2001," no deposit is required for taxes listed in Part 1 of Form 720 if the net tax liability does not exceed \$2,500 for the quarter. The threshold was previously \$2,000.

## Amount to Deposit and Safe Harbor Rules

In general, the deposit of tax for each semi-monthly period must be at least 95 percent of the amount of net tax liability incurred during the semi-monthly period. This replaces the requirement to deposit 100 percent of the net tax liability and the current liability safe harbor rule. The look-back quarter liability safe harbor still applies.

### Safe Harbor Rules

Under the old regulations, taxpayers were given two safe harbor methods that could be used to satisfy the Federal excise tax deposit rules. These two rules were the look-back quarter safe harbor rule and the current liability safe harbor rule (95-percent safe harbor rule). The Final Regulations issued on August 9, 2001, eliminated the 95-percent safe harbor rule since the deposit requirements were modified. The Final Regulations retained the look-back quarter safe harbor.

*Look-back quarter safe harbor.* The look-back quarter safe harbor allows taxpayers to use the second preceding calendar quarter as their basis for making current quarter deposits. For example, a taxpayer making deposits for the third quarter of a calendar year can base their deposits for that quarter on the net tax liability as reported in the first quarter of that year. The safe harbor will apply if:

- ◆ Each semi-monthly deposit is not less than 1/6 (six semi-monthly periods per quarter) of the net tax liability for the look-back quarter
- ◆ Each deposit is made on time
- ◆ Any underpayment for the quarter is paid by the due date of the Federal excise tax return
- ◆ The liability for the current taxes does not include a liability for a tax that was not imposed at all

times during the look-back quarter. For alternate method taxpayers, the tax must have been imposed at all times during the look-back quarter and the month preceding the look-back quarter.

If there is an increase in the tax rate imposed between the look-back quarter and the current quarter, the taxpayer is required to deposit 1/6 of the tax liability that would have been imposed if the increased rate was imposed during the look-back quarter.

*95-percent safe harbor.* Under the old regulations, taxpayers were required to deposit an amount equal to the air transportation taxes incurred during the semi-monthly period. The IRS issued a 95-percent safe harbor rule whereby a taxpayer would not be penalized if the taxpayer timely deposited at least 95 percent of each semi-monthly period liability and paid any underpayment by the due date of its tax return. Under the old rules, failure to meet the 95-percent safe harbor rule for one semi-monthly period would invalidate the 95-percent safe harbor rule for the entire quarter. The Final Regulations eliminated this safe harbor since the general deposit requirement was changed to 95 percent of the semi-monthly period liability. The Final Regulations also changed the rules so that each semi-monthly period is a standalone period. Therefore, failure to deposit at least 95 percent of the current semi-monthly period would not invalidate the safe harbor for the entire quarter, but the penalty for underpayment would apply only to the semi-monthly period that failed the 95-percent test.

### Special September Rule

IRC §6302 imposes a special deposit rule for September. The special September rule accelerates a portion of the deposit normally due in October to September. The due date of the special deposit and the amount to deposit is dependent on whether the taxpayer uses electronic funds transfer (EFT) to deposit its Federal excise taxes.

*Special September Rule for Regular Method Taxpayers Using EFT.* Regular method taxpayers using EFT must deposit the taxes collected during the period September 16 to September 26 by September 29. The taxes collected during the remainder of that semi-monthly period (September 27 to September 30) must be deposited under the general deposit rules.

The special September deposit amount may be computed by:

- ◆ Determining the amount of the net tax liability for regular method taxes reasonably expected to be incurred during the second semi-monthly period of September
- ◆ Depositing 11/15 of that amount by September 29.

Taxpayers using the look-back quarter safe harbor also must make the special September rule deposit. Taxpayers using the look-back quarter:

- ◆ Must deposit not less than 11/90 of the look-back quarter net tax liability for regular taxes as their special September deposit
- ◆ Must deposit not less than 1/6 of the look-back quarter net tax liability for regular taxes in total for the second September semi-monthly period.

If September 29 is a Saturday, the special September deposit must be made by September 28. If September 29 is a Sunday, the special September deposit must be made by September 30.

*Special September Rule for Alternate Method Taxpayers Using EFT.* Alternate method taxpayers using EFT must deposit the taxes collected during the period September 1 to September 11 by September 29. The taxes collected during the remainder of that semi-monthly period (September 12 to September 15) must be deposited under the general deposit rules. The special September deposit amount may be computed by:

- ◆ Determining the amount of the net tax liability for alternate method taxes incurred during the first semi-monthly period of September
- ◆ Depositing 11/15 of that amount by September 29.

Taxpayers using the look-back quarter safe harbor also must make the special September rule deposit. Taxpayers using the look-back quarter:

- ◆ Must deposit not less than 11/90 of the look-back quarter net tax liability for alternate taxes as their special September deposit
- ◆ Must deposit not less than 1/6 of the look-back quarter net tax liability for alternate taxes in total for that semi-monthly period.

If September 29 is a Saturday, the special September deposit must be made by September 28. If September

29 is a Sunday, the special September deposit must be made by September 30.

*Taxpayers Not Using EFT.* Taxpayers not using EFT are subject to an earlier deposit date (September 28) and the computation of the amount to deposit is adjusted to take into account the shorter period (10 days versus 11 days). The liability periods are shortened one day (September 25 and September 10 for regular method and alternate method taxpayers, respectively) and the calculations use 10/15 and 10/90 (in lieu of 11/90 and 11/15). See the Final Regulations under §40.6302(c)-2 for regular method taxpayers and §40.6302(c)-3 for alternate method taxpayers.

## Part 1 of IRS Form 720

Enter the appropriate amounts on Lines 26, 27 and 28. Notice that the IRS numbers are not sequential: IRS No. 26 – Transportation of Persons Tax; IRS No. 28 – Transportation of Property Tax; and IRS No. 27 – Use of International Head Tax Air Travel Facilities.

- ◆ Part 1, # 1, Total is on the second page of the Form 720. The gross liability included in Part 1 is summed.
- ◆ Part 2, #2, Total Part 2, does not apply to aircraft. However, an amount is required even if zero.
- ◆ Part 3, #3, Total is the sum of Tax Part 1 and Tax Part 2.
- ◆ #4, Adjustments and Claims is transferred from Line 12, Part 3 of Schedule C. Schedule C is required for the itemization of claims. Part 2 Claims will be used to list nontaxable uses of fuels, which will reduce your tax liability shown on the Form 720.
- ◆ #5, Net tax after adjustments is self explanatory.
- ◆ #6, Deposits made during the quarter.
- ◆ #7, Overpayment from previous quarter is the amount you had applied to your next return instead of a refund. Reference line #10 of your previous return.
- ◆ #8, The sum of #6 and #7.
- ◆ #9, The tax due, if the amount on #5 is greater than the amount found on #8.
- ◆ #10, Your tax refund, if the amount on #8 is greater than the amount on #5.

For more information about Federal excise taxes on business aviation, visit [www.nbaa.org/taxes](http://www.nbaa.org/taxes).