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Federal Excise Tax Audit Assessments to Be Suspended While Guidance Developed and IRS Clarifies Procedures Relating to Aircraft Management Fees with Respect to the Federal Excise Tax

Federal Excise Tax Audit Assessments to be Suspended

According to a press release, dated May 16, 2013, by the National Business Aviation Association, the Internal Revenue Service "suspended tax assessments that could be applied to aircraft management companies during federal excise tax audits, giving the agency time to work with industry on additional guidance." The NBAA continued in the press release by saying:

> "We applaud this decision by the IRS as it addresses an issue that has caused unprecedented concern about potential retroactive and future tax liabilities throughout the business aviation community. While the IRS will complete open audits, management companies can be secure in the fact that while additional guidance is developed, they will not face potentially crippling tax assessments as a result of those audits."

Clarified IRS Procedures Designed to Create Uniformity in Taxpayer Audits

The latest decision by the IRS to suspend tax assessments with respect to FET audits comes on the heels of a March 27, 2013, Advice Memorandum (the "2013 Advice Memorandum") issued by the IRS which provided new administrative handling procedures relating to FET examinations where aircraft management arrangements are encountered. These new procedures were designed to create uniformity among the IRS field examiners with respect to audits related to the FET.

Background Information Regarding the FET and the 2012 Chief Counsel Advice Memorandum

As many of our readers are aware, the Chief Counsel to the IRS issued an Advice Memorandum on March 9, 2012 (the "2012 Advice Memorandum") asserting that the FET applies to amounts paid by an owner of an aircraft to an aircraft management company for aircraft management services with respect to owner flights conducted under FAR Part 91. The FET is 7.5% of the amount paid for taxable air transportation service. I.R.C. § 4261(a) and (b). The FET is imposed on the person making the payment, but it must be collected and remitted to the IRS by the person receiving the payment. I.R.C. §§ 4091 and 4261(d). Based on the 2012 Advice Memorandum, a management company under a typical aircraft management agreement could be deemed to be providing air transportation services for the owner of an aircraft during the owner's Part 91 operation of its aircraft and thereby be required to collect FET on all amounts received from the owner including, without limitation, management fees. If the management company does not collect and remit the FET to the IRS, then the IRS can collect the FET from the management company. I.R.C. § 4263(c). The NBAA has been lobbying the IRS regarding this issue for the past year to convince the IRS to change or clarify its position.

Since the 2012 Advice Memorandum was released, the IRS has conducted audits of management companies regarding the FET issue and has assessed FET tax against the management companies. According to a press release by the NBAA, dated May 16, 2013,

> Since the release of an audit technique guide in 2008 and [the 2013 Advice Memorandum], the IRS has become more aggressive in audits of aircraft management companies and charter operators. In particular, auditors were assessing FET on a wide variety of non-commercial flight operations, including flights by aircraft owners under Part 91 of the Federal Aviation Regulations in situations where services are provided by a management company.

While the IRS is working on its policies with respect to the application of the FET to management fees, there are some ways to structure an aircraft management agreement to reduce the risks to the management company and fit the terms of the aircraft management agreement within the exceptions referenced in the 2012 Advice Memorandum so the management company will not be deemed to be providing taxable aircraft transportation services to the owner of the aircraft during the owner's Part 91 operations of the aircraft. For

example, we recommend that the aircraft management agreement be structured as a "services" agreement so the management company will be providing various services in support of the owner's control and management of its own aircraft (rather than the owner ceding all management and authority to the management company). The management agreement should make it clear that the owner is "calling the shots" with respect to all important issues and decisions. The owner should ideally directly hire and employ all pilots. The owner should have the right to direct and approve all maintenance providers and all significant maintenance on the aircraft. The owner should be the insured party and loss payee under all aircraft insurance covering the aircraft with the management company included as an additional insured. The management company's scope of services should be clearly limited to support services for the owner's command and control of its aircraft. In addition, it would be better for the owner to pay all aircraft expenses directly or to set up a bank account in the name of the owner which would be accessible by the management company only for the purpose of paying aircraft expenses as directed by the owner. While several of these provisions make the management agreement less of a convenience (and contrary to an owner's expectation of the management company "taking care of everything") they are necessary in the interim until the IRS can reverse its position or at least provide more clarity as to its intended application of the FET to Part 91 management agreements.

We will keep you posted regarding future developments regarding the FET as the IRS applies it to aircraft management companies, but the latest developments are encouraging.

The FET can be a significant amount and it is important that knowledgeable and experienced aviation counsel review your management agreement to reduce the risks that the FET will be applicable. Procopio's Aviation Practice Group is knowledgeable, experienced and available to assist you with respect to all of these important issues.

Procopio's Aviation Practice Group is well-versed on all aspects of aviation transactional and litigation matters and provides clients with prompt and cost-effective representation. By bringing together aviation attorneys with diverse practices, our team has the expertise and experience to counsel clients at every stage of their aviation transaction cycles including tax, litigation and bankruptcy issues.

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