

NBAA MEMBER RESOURCE

Amendment to Tax Regulations Imposes Federal Transportation Excise Tax on Single Member LLCs

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Final Treasury regulations issued October 26, 2011,¹ clarify that single member limited liability companies (SMLLC) are treated as separate corporations for purposes of the federal transportation excise tax (FET).² Although the final regulation is effective upon its issuance on October 26, 2011, the above clarification explained in the preamble to the regulation is retroactively effective to January 1, 2008. Comments submitted to the IRS by NBAA had argued that imposing FET on payments to an SMLLC by its owner for transportation service would unintentionally create a tax liability where one did not exist previously. However, the preamble to the final regulations explains that “amounts paid after December 31, 2007, to an SMLLC by its owner for air transportation are subject to the tax imposed by section 4261.”³

The following is an update to an article previously issued by NBAA in April 2008, following the issuance of regulations effective January 1, 2008, that provided that “disregarded entities” (such as SMLLCs and qualified Subchapter S subsidiaries, or “QSubs”) would no longer be disregarded for excise tax purposes.⁴ Those regulations raised the possibility that air transportation provided by, or to, a disregarded entity could be subject to FET. Prior to 2008, air transportation provided by a disregarded entity to its owner, or other disregarded entities owned by the same owner, was not subject to FET, because disregarded entities were treated as operations conducted directly by their owners for tax purposes.⁵

In 2008, NBAA was concerned that this change in the regulations could result in significant unexpected FET liabilities. Accordingly, NBAA representatives met with IRS staff and submitted comments regarding these regulations. It was apparent that the 2008 regulations were not intended by the IRS to change substantive law, and for that reason NBAA pointed out that the 2008 regulations changed substantive law by imposing FET on payments to an SMLLC

by its owner for transportation service. Notwithstanding NBAA's efforts, the IRS has now issued final regulations with an accompanying preamble clarifying that such payments are subject to FET.

BACKGROUND

FET is imposed on domestic air transportation at the rate of 7.5 percent of the amount paid for such service plus a domestic segment tax on each passenger.⁶ FET typically applies to charter flights,⁷ but it also applies to flights provided under fractional programs,⁸ time share agreements,⁹ and other arrangements in which the provider retains "possession, command and control" of the aircraft.¹⁰ If domestic air transportation service is provided between related parties, FET may be imposed on the fair market charter rate on such flights even if no amount is actually paid.¹¹ However, flights provided by a company to its employee as compensation for services (without reimbursement from the employee) are typically not subject to FET, because there is no "amount paid" for the flights.¹²

Under an exception to the FET rules, FET does not apply to air transportation provided between corporations in an "affiliated group."¹³ An affiliated group is generally a group of corporations that are at least 80 percent owned (directly or indirectly) by a common parent corporation.¹⁴ Since an affiliated group includes only corporations, a partnership (or an LLC with two or more members taxed as a partnership) cannot be a member of an affiliated group and therefore cannot qualify for the affiliated group exception to FET.

For income tax purposes, SMLLCs may be classified as either disregarded entities or as corporations under the "check-the-box" regulations.¹⁵ The default classification of a domestic SMLLC for income tax purposes is a disregarded entity.¹⁶ An affirmative election is required to obtain corporation status for income tax purposes for a domestic SMLLC. Similarly, if an S corporation is wholly-owned by another S corporation and otherwise meets the requirements to be a QSub, the subsidiary can elect to be a disregarded entity of its S corporation parent for income tax purposes.¹⁷

Under the amendment to the regulations effective January 1, 2008, SMLLCs and QSubs may continue to be disregarded for income tax purposes, but not for excise tax purposes.¹⁸ SMLLCs and QSubs are treated as separate corporations for FET purposes.¹⁹ This dual status for SMLLCs and QSubs can be complex.

SMLLCs OWNED BY INDIVIDUALS

Individuals often place their aircraft in SMLLCs. If the SMLLC leases the aircraft, without crew, to the individual or to another entity, the lease ordinarily would not constitute transportation service subject to FET.²⁰ However, if the SMLLC provides both the aircraft and the crew, the flights may be subject to FET.²¹ For example, FET would ordinarily apply to flights provided to the individual owner of an SMLLC if the SMLLC employs the pilots and the flights are neither for the SMLLC's business nor to compensate the individual for services rendered to the SMLLC.²² FET would ordinary apply to such flights if the pilots were provided by an aircraft management company hired by the SMLLC, or by the operator of a fractional program (NetJets, Flexjet, etc.) in the case of a fractional interest held by the SMLLC.²³

There are several possible solutions to this problem. An SMLLC that engages in substantial business operations could provide the flights to the owner as compensation for services to the SMLLC.²⁴ Alternatively, the aircraft could be leased, without crew, to the individual owner, and the individual could hire the crew directly or through an aircraft management company.²⁵ In the case of a fractional program, the individual could engage the fractional program operator to provide the management services under the fractional program.²⁶

QSUBS AND SMLLCs OWNED BY CORPORATIONS

When a corporation owns an SMLLC, the SMLLC is disregarded for income tax purposes,²⁷ but it is treated as a separate corporation for excise tax purposes.²⁸ Since the SMLLC is respected as a wholly-owned corporate subsidiary of a corpora-

tion for excise tax purposes, the two corporations would ordinarily qualify for the affiliated group exception to the FET rules. Therefore, air transportation service provided between the SMLLC and its parent corporation as well as other such members of the affiliated group (for excise tax purposes) should be free of FET.²⁹ Likewise, flights provided between a QSub and its parent S corporation and other QSubs owned by that S corporation parent ordinarily would qualify for the affiliated group exception to FET.

SMLLCS OWNED BY PARTNERSHIPS (OR LLCs TAXED AS PARTNERSHIPS)

When an SMLLC is owned by a partnership (or a multi-member LLC taxed as a partnership), the SMLLC is disregarded for income tax purposes,³⁰ but it is treated as a separate corporation for excise tax purposes. Since partnerships cannot qualify as members of an "affiliated group," the SMLLC and its partnership owner would not qualify for the affiliated group exception to FET.³¹ Therefore, flights provided between the SMLLC and its partnership owner as well as other SMLLCs owned directly by the partnership would be subject to FET.

There are several possible solutions to this problem. The SMLLC providing air transportation could lease the aircraft, without crew, to the other entities, and they would hire the crew directly or through an aircraft management company. Alternatively, the SMLLC could employ the individuals who use the aircraft and provide management services to the other entities. Under this structure, the SMLLC may be viewed as using the aircraft for its own management services business, which ordinarily would be free of FET.

A third alternative would be to create a new SMLLC owned by the partnership (or LLC taxed as a partnership) and have the new SMLLC own the other SMLLCs. Under this alternative structure, the new SMLLC and its subsidiary SMLLCs could qualify for the affiliated group exception, notwithstanding the fact that the partnership could not be included in their affiliated group. Therefore, flights provided between the SMLLCs would be free of FET, although any flights provided to the partnership (or LLC taxed as a partnership) would continue to be subject to FET.

PAYROLL TAXES

Effective January 1, 2009, the regulations treat disregarded entities generally as separate corporations for payroll tax purposes.³² However, these regulations contain an exception with respect to the owner of the SMLLC. Since the SMLLC will continue to be a disregarded entity for income tax purposes, the activities of the SMLLC are treated as activities conducted directly by the owner of an SMLLC for income tax purposes. It would be inconsistent with this concept for the SMLLC to treat its owner as an employee for payroll tax purposes. Therefore, the SMLLC is treated as a separate corporation for payroll tax purposes with respect to everyone except its owner, who continues to treat the activities of the SMLLC as his or her own activities for both income and payroll tax purposes (but not for excise tax purposes). Since an individual owner of an SMLLC cannot be treated as an employee of the SMLLC for payroll tax purposes, the value of any flights provided by the SMLLC cannot be taxed to the individual at Standard Industry Fare Level (SIFL) rates.³³ If that tax treatment of the value of flights is desired, it may be advisable to admit a second member to the LLC.³⁴

CONCLUSION

The preamble to recently-issued final regulations clarifies that effective January 1, 2008, SMLLCs and QSubs are treated as separate corporations for FET purposes, but not for income tax purposes. Under these rules, it appears that SMLLCs owned by corporations and QSubs owned by S corporations may qualify for the affiliated group exception to FET. However, SMLLCs owned by partnerships (or by LLCs taxed as partnerships) may not be able to qualify for the affiliated group exception and may be subject to FET on air transportation provided to other entities. Possible solutions to this problem include:

- Dry leasing the aircraft to the entity that uses it;
- Having the entity operating the aircraft hire the individuals who will be the passengers; or
- Forming an affiliated group of SMLLCs that qualify for the affiliated group exception.

Of course, in planning any changes in aircraft arrangements, it is important to comply with applicable FAA regulations and consider implications on sales taxes, passive loss limitations, depreciation, taxable fringe benefits, liability limitation, securities law disclosure and other matters.

ABOUT THE AUTHOR

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ABOUT NBAA

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END NOTES

- ¹ T.D. 9553 (Oct. 26, 2011).
- ² I.R.C. § 4261.
- ³ T.D. 9553. The preamble explains that this change in the treatment of SMLLCs for FET purposes (from disregarded entities to separate corporations) is consistent with the treatment of SMLLCs for FET purposes prior to the issuance of the check-the-box rules in Treas. Reg. § 301.7701-2 in 1997. This is a surprising justification for treating SMLLCs as corporations for FET purposes, since the check-the-box rules were issued to address the extraordinary level of complexity under the entity classification rules prior to 1997. As discussed below, treating SMLLCs as corporations for FET purposes and as disregarded entities for income tax purposes causes an unnecessary level of complexity.
- ⁴ T.D. 9356 (Aug. 15, 2007).
- ⁵ Priv. Ltr. Rul. 2002-03-019 (Jan. 18, 2002).
- ⁶ I.R.C. § 4261(a), (b). The domestic segment tax is indexed for inflation. For calendar year 2012, the tax on each passenger on each domestic segment is \$3.80. Rev. Proc. 2011-52, § 3.33, 2011-45 I.R.B.
- ⁷ *Shell Oil Co. v. United States*, 607 F.2d 924 (Ct. Cl. 1979).
- ⁸ *Executive Jet Aviation, Inc. v. United States*, 125 F.3d 1463 (Fed. Cir. 1997).
- ⁹ See Priv. Ltr. Rul. 93-22-002 (Feb. 9, 1993).
- ¹⁰ See Rev. Rul. 60-311, 1960-2 C.B. 341.
- ¹¹ See Priv. Ltr. Rul. 81-09-014 (Nov. 26, 1980) (applying FET to flights provided between related parties under I.R.C. § 482 at the arms-length charge that unrelated parties would have paid for the flights).
- ¹² Rev. Rul. 72-245, 1972-1 C.B. 347; see also IRS MSSP Training Guide, Aviation Tax, Ch 8.
- ¹³ I.R.C. § 4282.
- ¹⁴ I.R.C. § 1504(a).
- ¹⁵ Treas. Reg. § 301.7701-3(a). The check-the-box regulations apply to business entities. Other entity classification regulations apply to trusts. Treas. Reg. § 301.7701-4.
- ¹⁶ Treas. Reg. § 301.7701-3(b). The default classification for a foreign SMLLC is a corporation.
- ¹⁷ I.R.C. § 1361(b)(3); Treas. Reg. § 1.1361-4(a)(1).
- ¹⁸ Treas. Reg. § 301.7701-2(c)(2)(v); Treas. Reg. § 1.1361-4(a)(8).
- ¹⁹ Treas. Reg. § 301.7701-2(c)(2)(v); Treas. Reg. § 1.1361-4(a)(8).
- ²⁰ Rev. Rul. 2005-64, 2005-2 C.B. 600, *Situation 1*.
- ²¹ *Id.* *Situation 2*.
- ²² See note 7 above. If the SMLLC is reimbursed for such flights, the reimbursement may violate FAA Regulations, unless the SMLLC holds an FAA certificate authorizing it to provide charter service under Part 135 of the FAA Regulations. In addition, if the SMLLC's aircraft operations are not incidental to its other operations, the SMLLC may constitute a "flight department company" in violation of FAA Regulations.
- ²³ See notes 8 and 9 above.
- ²⁴ As discussed below, the individual owner of an SMLLC that is disregarded for income tax purposes is taxed directly on the SMLLC's income and is not an employee of the SMLLC. Therefore, the SMLLC does not have the opportunity to report the owner's personal flights as fringe benefits for income tax purposes. One possible approach is for the individual owner and the SMLLC to document that personal flights are provided as compensation for services in minutes, an agreement, or some other document.
- ²⁵ This alternative structure of leasing the aircraft to an individual who independently hires pilot services from an unrelated aircraft management company can raise other FET concerns. Under that alternative structure, it is possible that the IRS would argue that the management company, rather than the individual, has possession, command, and control over the aircraft and provides taxable transportation service to the individual.
- ²⁶ Under this alternative, the SMLLC that owns the fractional interest would lease it to the individual. It would be necessary to work with the fractional program operator to conform the related fractional program agreements.

- ²⁷ Alternatively, the SMLLC could elect to be treated as a corporation for income tax purposes. See note 16 above.
- ²⁸ Treas. Reg. § 301.7701-2(c)(2)(v)(B).
- ²⁹ See I.R.C. § 4282. While IRS representatives have informally confirmed that the affiliated group rule applies to SMLLCs that are treated as corporations for FET purposes, the IRS has not issued any published guidance confirming this point.
- ³⁰ As noted above, the SMLLC could elect to be treated as a corporation for income tax purposes.
- ³¹ The fact that SMLLCs now have a dual status (Disregarded Entity for income tax, and corporation for excise tax) suggests that an LLC with two or more members could be classified as a partnership for income tax purposes and as a corporation for excise tax purposes. However, the amendment to the regulations requiring dual status for Disregarded Entities does not apply to multi-member LLCs, because they are not Disregarded Entities. In the absence of regulations providing for the dual status of multi-member LLCs, taxpayers should not expect dual status to apply to such LLCs.
- ³² Treas. Reg. § 301.7701-2(c)(2)(iv).
- ³³ Treas. Reg. § 1.61-21(g)(1) (special valuation rules apply to employees).
- ³⁴ With a second member, the LLC could be treated as a partnership and the value of flights could be calculated at SIFL rates as "guaranteed payments." Treas. Reg. § 1.61-21(a)(4).