Industry Response to Chief Counsel Advice Memorandum 201210026

The following is the memorandum submitted by NBAA and NATA to the IRS Chief Counsel's Office in response to Chief Counsel Advice Memorandum 2012-10026 (the "CCA"). The CCA and this response were discussed by NBAA and NATA representatives and IRS representatives on June 19, 2012.

This publication is being provided to NBAA and NATA Members for their general information and should not be construed as legal advice or legal opinion on any specific facts or circumstances. You are urged to consult your attorney or other advisor concerning your own situation and for any specific legal questions you may have.

1. FET Should Not Be Imposed Retroactively Because Management Companies' Obligation To Collect and Remit On Owner Flights Was Vague and Speculative

The CCA should not be used to apply federal excise tax on air transportation ("FET") retroactively on management companies and their customers, which would impose an undue burden on such companies and persons. Management companies and other aviation services providers range in size from large businesses that manage large fleets of aircraft to small businesses that manage one or two aircraft each. FET is a collected tax, and management companies are secondarily liable for the tax. If the current CCA is applied retroactively, management companies would become liable for the FET not only on payments for aircraft that they currently manage, but also on aircraft that were formerly managed by the management companies. Management companies would have to attempt to collect tax from former clients who may no longer own aircraft or even exist. If they cannot collect the tax from such clients, the management companies would themselves be liable for the amount of FET. Many management companies may not be able to afford to pay the tax and continue operating. Such a retroactive imposition of FET based upon an apparent change in IRS position is grossly unfair and inequitable.

FET is imposed on the "amount paid for taxable transportation of any person" under I.R.C. § 4261(a).[1] The tax imposed by § 4261 is a collected tax. The person paying for the taxable transportation, *i.e.*, the passenger, is liable for the tax.[2] Section 4291 requires the person who is paid for taxable transportation to collect and remit the tax paid by the passenger. Under § 4263(c), the taxable transportation provider has secondary liability for FET.

Neither the operation of an aircraft by its owner nor the mere provision of management services is subject to FET. See Rev. rul. 58-215, 1958-1 C.B. 439. Only commercial-air transportation is taxable. In looking back to determine where that line was crossed, it is instructive to keep in mind the most salient difference between the owner-operator and the commercial passenger is that the owner-operator owns the plane on which he flies and the commercial passenger does not. Payments for travel on aircraft owned by the air transportation service provider are generally subject to FET, and the IRS has imposed FET accordingly. For example, in Rev. Rul. 60-311, 1960-2 C.B. 341, the IRS considered whether an oil company owed FET on fees paid to helicopter-rental companies for helicopter charter services. The helicopter-rental companies owned the subject helicopters and performed all services with respect to operating the helicopters. The IRS determined that all of the fees paid to the service provider/helicopter rental company, including in-kind payments, were subject to FET.

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[1] *See also* Treas. Reg. § 49.4261-1(b).

[2] § 4261(d).

Conversely, the IRS has ruled that FET does not generally apply to air travel by an aircraft owner, even when that owner contracts certain aircraft-management responsibilities to another party to act as that owner's agent. For example, in Rev. Rul. 58-215, a corporation purchased an aircraft and "appoint[ed] an airline company as its agent to service, maintain, overhaul, and operate [the] aircraft." In return for those services, the aircraft owner paid both a monthly management fee and an occupied hourly fee. The IRS determined that "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 and the airline operates the aircraft as an agent for the corporation," the airline company was not providing taxable transportation and the corporation's payments were not subject to FET.

However, IRS guidance does not uniformly track this straightforward distinction. In one outlier ruling, Rev. Rul. 74-123, 1974-1 C.B. 31, the IRS subjected a government agency to FET for fees the agency paid to a charter company for transporting government personnel both on aircraft owned by the charter company and on government-owned aircraft. However, Rev. Rul. 74-123 involves a highly unique fact pattern and is expressly limited to "the circumstances of the case" considered in the ruling. Moreover, Rev. Rul. 74-123 does not involve a management fee arrangement as background files demonstrate that the government agency paid the service provider under a single contract entitled "Air Charter Agreement." Also, the price structure in Rev. Rul. 74-123 is distinguishable as it was a "charter fee" as opposed to payment for management services. Also, in *Executive Jet Aviation, Inc. v. United States*, Dkt. No. 95-7T, slip op. (Fed. Cl., Mar. 29, 1996), *aff'd.* 125 F.3d 1463 (Fed. Cir. 1997), wherein the IRS challenged the bona fides of the management activities as substantively disguised charter activities, the IRS nonetheless stipulated that management fees were not subject to FET.

Given the IRS' long history of excluding management fees from the tax base, even where the IRS challenges the bona fides of the management relationship, case law suggests strongly that the IRS cannot impose retroactive secondary FET liability for all fees collected in the absence of clear guidance under which management companies could have determined that they were liable to collect and remit FET on those fees.

For example, in *Central Illinois Public Service Co. v. United States*, 435 U.S. 21 (1978)—which involved the scope of an employer's secondary liability for allegedly failing to withhold and deposit employment taxes on an employee's "wages"—the Supreme Court explained that when a taxpayer (the employer in that case) acts as the Government's tax collector, its collection and deposit obligations must be clear and certain at the time the taxpayer is required to collect the tax. As the court stated, "[b]ecause the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific Congressional action, the employer's obligation to withhold be precise and not speculative." *Id* at 31. Thus, a person in a secondary liability position is protected by the *Central Illinois* principle from liability for failing to collect the tax from the person primarily liable for the tax when it lacks a contemporaneous "precise and not speculative" notice of its duty to collect the tax. Similarly, in *General Elevator v. United States*, 20 Cl. Ct. 345, 353 (1990) (quoting *Central Illinois.* at 31-32), the U.S. Claims Court cited *Central Illinois* for the principle that an employer, as "deputy tax collector," must have "adequate notice so that it 'will know what the IRS thinks the law is and therefore what actions they have to take.'" The court concluded that the facts in *General Elevator* did not establish a "precise and clear duty to withhold," and that therefore secondary tax liability could not be imposed retroactively.

Following the Supreme Court's decision in *Central Illinois*, a number of cases and administrative pronouncements have applied the Supreme Court's "duty of clarity/deputy tax collector defense." Generally, those cases turn on the clarity of the guidance provided by the government. *See e.g. HB & R v. United States,* 229 F.3d 688 (8th Cir. 2000) (holding that the deputy tax collector defense applied because "no employer, in viewing the regulations…could reasonably suspect that a withholding obligation existed); *General Elevator Corp. v. United States*, 20 Cl. Ct. 245 (1990) (holding that the deputy tax collector defense applied because General Elevator could not have known, by examining the relevant statutes, regulations, and IRS pronouncements, that it had withholding and FICA obligations with respect to the benefits); *Western Reserve Academy v. United States*, 619 F. Supp. 394 (D.C. Ohio 1985) (holding

that the deputy tax collector defense applied because the law on the taxation of tuition awards was imprecise at the time the awards were made); *McGraw-Hill, Inc. v. United States*, 623 F. 2d. 700 (Cl. Ct. 1980) (holding that in dealing with the withholding tax liability of an employer, the employer must have a precise idea of what they are supposed to do and why).

In the case of FET, the available guidance consists of one ruling wherein the IRS conceded the application of FET to management services and *EJA* wherein the IRS did not impose FET on management fees (although not precedential, most recently the IRS' Audit Technique Guide admits the lack of guidance).[3] Other rulings, such as Rev. Rul. 74-123 do not even consider management fees. Read as a whole, the management company, as deputy tax collector, is left to sift through the facts of the various rulings and EJA and compare and contrast them with the company's own facts. Certainly, no "clear guidance" of taxability can be gleaned from these rulings. This is hardly the model for a "precise and not speculative" notice of duty to collect FET. The IRS' repeated reliance in examinations that Rev. Rul. 74-123 provided guidance that FET was due. Since the only ruling that considered such fees was the 1958 ruling, it is not appropriate for the IRS to impose secondary liability under § 4263(c) on management companies for FET on owner flights. Accordingly, NBAA requests that the IRS grant relief to management companies with respect to uncollected FET.

2. The CCA Incorrectly Interprets Existing IRS Revenue Rulings

The CCA relied heavily on Rev. Rul. 58-215 when determining that the management company was providing taxable transportation to the owner. This is understandable because Rev. Rul. 58-215 is the first and only revenue ruling dealing with a management company arrangement. For over 50 years, the IRS has relied on Rev. Rul. 58-215 as a basis for concluding that a management company is not providing taxable transportation to the owner.

In analyzing these rulings, it is important to understand that the issue of whether a flight constitutes taxable transportation for FET purposes is determined on a flight-by-flight basis.[4] The CCA appears to assume that since the owner flights are taxable, all other flights are taxable, however, the Committee Report to the Airport and Airway Revenue Act of 1970 provides that the use of aircraft would be subject "either to the taxes on transportation of persons and freight or else to the fuel taxes, but not to both as to any one trip." Senate Finance Committee Report, S. Rep. No. 706, 91st Cong., 2d Sess., 1970-1 C.B. 386, 396. The Report explains in an example that "it is necessary to determine on a *flight-by-flight basis* whether the aircraft is being used in a business of transporting persons or property for compensation or hire." The rule that the flight-by-flight method applies to FET has been recognized by the IRS in its rulings. Rev. Rul. 77-405, 1977-2 C.B. 381. In addition, a flight-by-flight approach is applied throughout the Internal Revenue Code sections governing FET. For example, the flight-by-flight method is applied in the affiliated group exemption in I.R.C. § 4282(b), the air ambulance exemption in I.R.C. § 4261(g), the skydiving exemption in I.R.C. § 4261(h), and the seaplane exemption in I.R.C. § 4261(i). Since the determination of whether to impose the FET is made on a flight-by-flight basis, the determination of whether the aircraft is constructively leased to an aircraft management company must be determined on a flight-by-flight basis.

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[3] The applicable Treasury Regulations have not changed since the early 1960s.

[4] There are circumstances where owners elect to fly under FAR Part 135, where possession, command and control does not pass to the management company and thus flights are not subject to FET.

a) Rev. Rul. 58-215

Rev. Rul. 58-215 involved a management company arrangement between an aircraft owner ("corporation") and a management company ("airline"). According to the ruling, "the corporation entered into an agreement which appointed the airline company its agent to service, maintain, overhaul, and operate the aircraft." Furthermore, "the airline company furnishes, subject to the approval of the corporation, the pilot and copilot to operate the aircraft."

The IRS held that: "since [1] the corporation [a] owns the aircraft, [b] has exclusive control over the aircraft's personnel, [c] pays the operating expenses of the aircraft, and [d] maintains liability and risk insurance and [2] the airline operates the aircraft as an agent for the corporation, the airline company is not, with respect to this service, furnishing a transportation service for hire." [numbers in brackets added] Although the use of the word "and" suggests that the IRS considered to agency relationship to be just one factor among many, the more logical interpretation is that the agency relationship is the key factor and that the presence of an agency relationship is demonstrated by factors [1][a] through [1][d]. This is consistent with subsequent IRS interpretations of Rev. Rul. 58-215.

For example, TAM 9343002 described Rev. Rul. 58-215 as holding that "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 airline company that operates the aircraft does so as the agent of the corporation." The IRS used the same formulation in the 1999 MSSP dealing with "Aviation Tax" (p. 8-5).

b) Contrast with Rev. Rul. 56-608

Rev. Rul. 58-215 notes that "the views expressed herein are not inconsistent with those expressed in Revenue Ruling 56-608." In that ruling, the IRS concluded that a carrier was providing transportation to an owner ("manufacturer") where the carrier operates a shipper's tank truck equipment (a) with its own employees, under its own exclusive control, management, and supervision; (b) at its own expense.

The status of the management company, in turn, depends on the totality of the circumstances, including whether the owner has sufficient control over the flight crew and whether the owner is responsible for the costs and risks associated with the activity.

This is the approach the IRS took in TAM 9347007, where an aircraft owner ("FA") hired a management company ("X") to provide management and pilot services. IRS concluded that "the totality of the contract provisions, particularly those whereby FA pays the operational expenses, retains and exercises substantial operational control, and assumes the risk of loss, indicate that X is acting as an agent of FA."

c) CCA Application of Rev. Rul. 58-215

The CCA compared the arrangement in question with the arrangement in Rev. Rul. 58-215. The CCA noted that, consistent with Rev. Rul. 58-215, "Owner is the insured party under the aircraft's insurance policy and it bears all risk of loss that result from aircraft operations". However, the CCA then concluded that "Management exercises virtually all decision making with regard to the operation and maintenance of the aircraft." Specifically, the CCA stated that "Unlike the corporation in Rev. Rul. 58-215, [a] Owner does not have exclusive control over the aircraft's personnel and [b] Management does not operate the aircraft as an agent for Owner." [numbering added]

1. <u>Exclusive control over the aircraft's personnel</u>

Neither Rev. Rul. 58-215 nor the CCA provide a detailed explanation of the meaning of the term "exclusive control". Rev. Rul. 58-215 indicates that "exclusive control" relates to the operation of the

aircraft and is different than the ability to hire and fire the pilots. Furthermore, the "exclusive control" may be "subject to the discretion of the pilot and the co-pilot as to safety of operation."

The CCA does not define "exclusive control" but reaches various conclusions that seem to bear on the subject. In addressing Issue #1, the CCA concludes "the ability to direct the pilots as to destination and time of flights" is "not determinative" for purposes of determining whether the owner has control over the pilots. However, in addressing Issue #2, the CCA concludes that the fact that "the persons being transported have the power to schedule and direct flights" is "not relevant" for purposes of determining whether a flight is taxable. This conclusion is clearly incorrect. Authority to decide when and where the aircraft is flown must be relevant to the determination of which party has control of the aircraft. Equally erroneous is the IRS' heavy reliance on hiring pilots as a key factor in determining taxability the management company in the 1958 ruling hired the pilots.

More importantly, the CCA appears to state that "The operational authority that Owner exercises over the aircraft is limited to selecting flight destinations, which are then scheduled by Management." This indicates that either the CCA is misinterpreting the arrangement, or the arrangement is not a typical management company arrangement. First, in a normal management company arrangement, the owner has the right to schedule not only the destination, but the time of the flight. Second, in a normal management company arrangement, owner flights are conducted under FAR Part 91. These rules require the owner to maintain "operational control" over the aircraft. FAR 1.1 provides that, with respect to a flight, "operational control" means "the exercise of authority over initiating, conducting or terminating a flight."

Thus, while the pilots may have the discretion to take actions relating to the safety of flight, the owner has the exclusive right to direct the pilots to initiate or terminate a flight and to direct the pilots as to the conduct of the flight.

2. <u>Agent for the Owner</u>

The CCA is devoid of reasoned, or any other analysis, for the conclusion that the management company was not an agent of the owner. Rev. Rul. 58-215 appeared to reach the conclusion that the management company was an agent of the owner based on several factors, including ownership of the aircraft, exclusive control over the pilots (although the management company hired the pilots), responsibility for operating expenses, and liability risk, as evidenced by insurance policies.

In contrast, the CCA focuses only on a single factor - exclusive control of the pilots (that agents equate with hiring the pilots)– and ignores the ownership of the aircraft.

d) Conclusion

Although the CCA purports to rely on Rev. Rul. 58-215, the CCA does not follow Rev. Rul. 58-215. First, in determining that the management company was not an agent of the owner, the CCA does not consider the totality of the circumstances, but considers only a single factor - whether the owner has exclusive control over the pilots. Second, in addressing the question of whether the owner has "exclusive control" over the pilots, the CCA fails to address the variety of owner responsibilities and control, including whether the owner has control over "initiating, conducting or terminating" a flight - as is typical in a management agreement. Thus, the CCA is either misinterpreting the "exclusive control" test or is reviewing an unusual management company arrangement. Either of these factors should limit the application of the CCA to other management company agreements.

3. The CCA Is Fundamentally Flawed by Ignoring Three Critical Facts

The CCA states that in determining which party has possession, command, and control of the aircraft, it is irrelevant that the owner controls the movement of the aircraft, that the owner actually owns the aircraft, and that the aircraft is operated under FAR Part 91 (which means that the owner has operational control of the aircraft under applicable Federal law). In order to determine who has possession, command, and control of the aircraft, it is important that all relevant facts be considered. By stating that these three items are irrelevant, the CCA is stating that it failed to consider three very important facts.

a) Right of Owner To Direct When and Where the Aircraft Will Be Flown

The CCA states that the owner's ability to direct when and where the aircraft will be flown is irrelevant. This statement cannot be correct. Control over the movement of the aircraft, including on the owner's flights, must be a relevant factor in determining who controls the aircraft. The ability to control the movement of an aircraft seems particularly relevant in view of the fact that the sole purpose of the aircraft is to transport people from place to place.

In Rev. Rul. 74-123, the management company operated a fleet of "public aircraft" on scheduled routes and dates. The conclusion that the management company had possession, command, and control of the owner's aircraft was based on the fact that the management company operated the aircraft in the same way as the rest of its charter fleet. Accordingly, the owner was not exercising any control over the scheduling of the flights on its aircraft. Likewise, in Priv. Ltr. Rul. 94-04-007, the IRS cited the charter company's exclusive right to schedule the aircraft as an important factor.

The CCA cites Rev. Rul. 60-311 for the proposition that the passenger's power to schedule and direct flights is irrelevant. However, Rev. Rul. 60-311 involved a wet lease in which the lessor started with possession, command, and control by virtue of its ownership of the aircraft. Since the lessor provided both the aircraft and pilot service to the lessee, the lessor provided taxable transportation. It makes sense that the ability of the lessee (the customer) to direct the routes would not change the conclusion that the lessor provided taxable transportation.

In Rev. Rul. 60-311, the lessor entered the transaction with possession, command, and control of the aircraft. In contrast, in a typical management services arrangement, the management company does not enter the transaction with possession, command, and control of the aircraft. The issue of whether the management company has possession, command, and control must be decided based on whether the management company obtains the right to control the aircraft from the owner. Consistent with Rev. Rul. 74-123 and Priv. Ltr. Rul. 94-04-007, the ability of the owner to determine when and where the aircraft is to be used (or determine the conditions under which the management company may do so in the case of third party charters) would seem to be an important indication that the owner retains the right to control the aircraft.

By contrast, the CCA states that (a) the management company provides flight scheduling services which the CCA apparently takes into account in concluding that the management company exercises virtually all decision making regarding the aircraft, and (b) the owner's power to schedule and direct flights is irrelevant. This logic seems backwards. Providing scheduling services by merely recording the dates and routes dictated by the owner appears to be in the nature of merely performing personal services at the direction of the owner. It does not indicate that the management company is exercising any right to control the aircraft. On the other hand, dictating the movement of the aircraft (particularly in view of the fact that the aircraft's purpose is transportation) seems like a very important element regarding the control of the aircraft.

b) Ownership of the Aircraft

The CCA states that the ownership of the aircraft is irrelevant in the determination of which party has possession, command, and control of the aircraft. This assertion cannot be correct.

Before entering into a management arrangement, an aircraft owner clearly has possession, command, and control of the aircraft. The critical issue is whether the management company attains sufficient rights to control the aircraft to effect a transfer of possession, command, and control from the owner. Accordingly, it seems impossible for ownership of the aircraft to be irrelevant in the determination of which party has possession, command, and control. Note that ownership of the aircraft was listed as a relevant consideration to the possession, command, and control issue in Rev. Rul. 158-215, TAM 2004-25-048, and PLR 94-04-007.

c) Operational Control of the Aircraft (i.e., Operation Under FAR Parts 91 and 135[5]

Citing Rev. Rul. 78-75, 1978-1 C.B. 340, the CCA asserts that it is irrelevant whether the aircraft is operated under FAR Part 91 or 135. In fact, Rev. Rul. 78-75 only states that the Part of the FARs under which the aircraft is operated is not "determinative." The assertion that the FAR Part is not "determinative" is sensible, because tax laws differ from aviation laws and are applied for different purposes (collection of revenue versus air travel safety). However, the assertion that the governing FAA regulations are "irrelevant" is entirely unsupportable and inconsistent with the revenue ruling. The FAR Part under which the aircraft is operated determines which party has "operational control" of the aircraft which is defined as the exercise of authority over the initiation, conduct, or termination of the flight. 14 C.F.R. § 1.1. While operational control may not be exactly the same standard as possession, command, control, it is clearly relevant to the determination of which party has possession, command, and control.

To apply Federal tax laws, it is necessary to first determine the taxpayer's rights and obligations in the relevant transaction under applicable nontax law. This often requires analysis of the taxpayer's rights and obligations under contracts. Typical aircraft management services contracts specify the FAR Part under which the aircraft is to be operated. Thus, the parties' respective rights and duties are significantly defined by the FARs by reference in the management contract. For example, the FARs are very important in the determination of which party has the right to control the pilots during flights and the responsibility for maintenance and recordkeeping. Part 135 operators must monitor the progress of each flight and initiate timely actions when the flight cannot be completed as planned, including diverting or terminating the flight. In addition, note that in Rev. Rul. 74-123, the IRS considered the fact that the aircraft were "public aircraft" under FARs, and in Priv. Ltr. Rul. 94-04-007, the IRS considered the fact that the management company had "operational control" over the aircraft which is the level of control required by the FAA for aircraft operated under FAR Part 135.[6]

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[5] As noted above, there are circumstances where owners elect to fly under FAR Part 135, where possession, command and control does not pass to the management company and thus flights are not subject to FET.

[6] This section of the analysis does not consider that management fees are paid regardless of operation or usage of an aircraft. Therefore, whether a flight is operated under Part 91 or Part 135 may well be unrelated, in whole or in part, to the application of FET to management fees.

4. Under Relevant Case Law, Aircraft Management Service Arrangements Should Not Be Subject to FET

The above discussion seeks to interpret and apply the relatively scant guidance regarding management services arrangements presented by the IRS rulings. Additional guidance is provided below by property law concepts of possession and control of property and by case law in various contexts with respect to management agreements.

In typical management services arrangements, the management company provides the pilot but not the aircraft. To conclude that the management company also provides the aircraft and thereby provides all of the elements of transportation service, the CCA argues that the management company takes possession, command, and control of the aircraft from the owner. This concept of possession, command, and control does not appear in § 4261 or the regulations thereunder but instead is borrowed from common law in the IRS rulings. This concept is applied by the courts and the IRS in various contexts including with respect to determining when property is leased and when it is subject to a mere management services arrangement. As shown by the analysis below, the CCA's conclusion that possession, command, and control of an aircraft is transferred to the management company in a typical management services arrangement is out of step with the rest of legal precedents addressing essentially the same issue.

a) Under General Property Law Concepts, Aircraft Are Typically Not Constructively Leased to Management Service Providers

At one time, the IRS seemed inclined to analyze the issue based on whether the relationship with the management company was a principal-agent relationship or a lessor-lessee arrangement. Gen. Coun. Mem. 39169 (Mar. 5, 1984) (charter company treated as agent of owner). However, the CCA appears to deviate from this approach of considering the common law concepts of possession and control, in favor of a test that apparently would find the party that performs the day to day management services to be in possession, command, and control of the aircraft.

Only one court case has considered the application of FET to an aircraft management company. In *Petit Jean Air Service, Inc. v. United States*, 33 A.F.T.R.2d 74-1526 (E.D. Ark. 1974), *appeal not recommended*, AOD 1975-33 (Mar. 27, 1974), the court held that the constructive lease of an aircraft by an aircraft management company to the individual owner of the company was not subject to FET. Since there was no written lease, the court considered the "actual intent of the parties" to determine that there was a constructive lease based on common law concepts of a lease. The court explained its analysis as follows:

> If the parties intended a given agreement for the use of one of the jets to constitute a lease, and if the transaction was characterized by the objective attributes of a lease, notably the right to possess, use, and control the aircraft during the life of the agreement, the inference is justified that the agreement was in fact one of lease or bailment, and that the user's payment for such use was not a mere payment for transportation taxable under section 4261.

In finding that the individual aircraft owner's control of the aircraft was "essentially absolute," the court focused on his role as the sole shareholder of the company. As the sole shareholder, the individual was "in control of the affairs of the corporation, and in that sense he had control at all times of the use of the jets and of other aircraft belonging to the corporation." Moreover, his position as the sole shareholder was relevant with respect to "the willingness of the corporation to lease the planes to him, on his willingness to lease the planes from the corporation, and on his right to possession and control of the planes during the lease periods." The court also noted that he could prescribe "destinations, routes, and times of departure," and he had the "right, subject to the discretion of the pilot and co-pilot, to exercise at least some control over the actual flying of the aircraft." Based on these findings, the court treated the

aircraft as constructively leased to him, and held that his use of the aircraft did not constitute taxable transportation.

Likewise, in the context of a fractional program in *Executive Jet Aviation, Inc. v. United States*, Dkt. No. 95-7T slip op., at *17, *20 (Fed. Cl.. Mar. 29, 1996), *aff'd*, 125 F.3d 1463 (Fed. Cir. 1997), the Court of Federal Claims analyzed the concept of possession, command, and control by reference to incidents of ownership including "the rights to its possession, use, and enjoyment, usually to the exclusion of all others" and "the right to enjoy the thing owned and do with it as one pleases."

In this regard, the *Restatement (Second) of Property, Landlord & Tenant* § 1.2 (1977) provides the following guidance on the concept of a lease:

> A landlord-tenant relationship exists only if the landlord transfers the right to possession of the leased property. . . . The right to possession is normally transferred if the arrangement contemplates that the transferee will assume a physical relationship to the leased property which gives him control over and power to exclude others from the property.

A "lease" is generally defined by the courts as a "contract by which one owning such property grants to another the right to possess, use and enjoy it for a specified period of time in exchange for periodic payment of a stipulated price, referred to as rent." *See Undercofler v. Whiteway Neon Ad, Inc.*, 152 S.E.2d 616, 618 (Ga. Ct. App. 1966). Several courts have gone as far as to hold that a lease gives a tenant exclusive possession of the leased property. *Chubb Group of Ins. Cos. v. C. F. Murphy & Associates*, 656 S.W.2d 766, 778 (Mo. Ct. App. 1983); *Lincoln Park Traps v. Chicago Park Dist*., 55 N.E.2d 173, 176 (Ill. App. 1944); *see also Restatement (Second) of Property*, *Landlord & Tenant* §§ 1.1, 1.4 (1977). In fact, the concept of exclusivity is often included in the general determination of a landlord/tenant relationship. *See* 49 Am. Jur. 2d *Landlord and Tenant* § 1 and *In re Dunes Hotel Associates v. Hyatt Corporation*, 212 B.R. 110 (Bankr. D.S.C. 1997); see *also Layton v. Namm & Sons*, 89 N.Y.S.2d 72, 74 (N.Y. App. Div. 1949), *aff'd*, 98 N.E.2d 590 (N.Y.1949) (stating that "[a] tenancy involves an interest in real property which passes to the tenant, and a possession exclusive even of that of the landlord, except as the lease permits the landlord's entry, and saving always his right to enter to demand rent or to make repairs.").

For example, in *Chubb Group*, the court was called upon to determine whether an agreement between Ringling Brothers-Barnum & Bailey Combined Shows, Inc. ("RBBB") and the city of Kansas City (the "City") granting RBBB the use of an arena constituted a lease or a license. In evaluating the agreement, the court stated that the agreement would constitute a lease if RBBB could establish that the agreement gave RBBB "exclusive possession of the premises, or a portion thereof, as against the world, including the [C]ity." *Chubb Group*, 656 S.W.2d at 778. Because RBBB's pleading stated that the agreement gave it the exclusive right to use, possess, and occupy the arena for a definite period, the court reversed the trial court's dismissal and remanded the case.

In addition to the extent to which a purported lessee has the right to use and enjoy the property, the determination of whether a lease arrangement in fact exists also depends on the purported lessee's possession and control over the property involved. *Mason Metals Co., Inc. v. Indiana Dep't of State Revenue*, 590 N.E.2d 672, 674 (Ind. Tax Ct. 1992). The determination of whether a party had possession and control was clarified in *AWHR America's Water Heater Rentals, LLC v. Indiana Dept. of State Revenue*, 941 N.E.2d 573 (Ind. Tax Ct. 2010), under which a company (AWHR) provided water heaters to its customers in return for a fee. The Court determined that the customers had complete control over access to the water heaters because AWHR was unable to enter the customers' homes to provide any services. Furthermore, the customers used the water heaters for their own benefit, decided when they wanted hot water and how much of it they needed. The customers supplied the water and electricity necessary for the water heaters' operation at their sole cost and expense. Accordingly, the Court determined that AWHR's customers had the requisite possession of, and control over, AWHR's water

heaters and found the contract to be a lease for tax purposes. Unlike the customers in *AWHR*, an aircraft management company ordinarily does not have the right to prevent the aircraft owner from accessing their aircraft, and therefore does not have complete control over access to the aircraft. Rather, management companies are hired to maintain and store the aircraft so that it is ready when the owner desires to use it. Moreover, the expenses incurred in operating the aircraft are borne by the owner and not by management company.

The importance of the landlord's limited right of entry was recently highlighted in *Women's Interart Center, Inc. v. New York City Economic Development Corporation (EDC)*, 2012 WL 1726671, (N.Y. App. Div. 2012), in which the New York Supreme Court, Appellate Division distinguished a lease from a management agreement. In this case, the Court examined a claim by the Women's Interart Center (WIC) that it was, among other things, improperly evicted from its leased space. In the early 1970's, WIC leased space in a building located on West 52nd Street and owned by the City of New York (City). WIC later leased additional space in an adjacent building also owned by the City. In 1999, the City entered into a "net-lease" agreement with the Clinton Housing Development Fund Corp (CHDFC) for the entirety of both buildings, including the space then leased to WIC. The "net-lease" agreement stated that the "sole and exclusive relationship of [the City] and [CHDFC] hereunder shall be that of landlord and tenant. [CHDFC] is not and shall not be deemed to be an agent… of [the City] by virtue of this Net Lease." The "net-lease" agreement also obligated CHDFC to operate and manage the properties.

In determining whether the "net lease" agreement constituted an actual lease, the court focused on whether exclusive control of the premises had passed to CHDFC. The court determined that the terms of the "net-lease" demonstrated that CHDFC had exclusive control and possession of the leased space. "Like a typical commercial net lease, the agreement imposes the responsibility for all expenses arising from the property, including the costs of repairs of every nature, utilities and insurance, upon the tenant." *Women's Interart Center,* at *4 (*citing First Fed. Sav. & Loan Assn. of Rochester v. Minkoff*, 575 N.Y.S.2d 197 (N.Y. App. Div. 1991). CHDFC bore the expense of leasing space in the buildings to third parties and was also granted the sole authority to maintain legal actions against month-to-month tenants, like WIC. Most importantly, the City reserved minimal rights to the leased buildings, including the right to inspect the building, audit CHDFC's records, and cure a default on behalf of CHDFC. The City's limited right of entry was instrumental in the Court's determination that CHDFC was the tenant under the agreement.

On the other hand, the Court defined a management agreement as merely a service contract under which CHDFC's rights would be limited to the collection of rent and day to day management of the buildings. "While property management responsibilities are also part and parcel of net leases, a managing contract does not delegate such an extensive dominion and control over the premises . . . to constitute a lease." *Women's Interart Center,* at *5.

Another case applying the general principles discussed above is *Feder v. Caliguira*, 171 N.E.2d 316 (N.Y. 1960). In *Feder*, a company (Feder) entered into a written agreement with an owner of a restaurant (Caliguira) providing for the installation of an automatic coin-operated juke box on Caliguira's premises. Pursuant to the terms of the contract, Caliguira did not pay rent for the juke box, but rather, shared in the profits generated by the juke box. In concluding that the contract was not a lease of the juke box from Feder to Caliguira, the court considered it of high significance that Caliguira did not pay any rent for the juke box. Moreover, the contract provided that the juke box was to remain the sole property of Feder and Caliguira was required to keep the juke box connected to an electrical outlet and ready for operation. Based on these terms, the court concluded that Caliguira was given neither the use of the juke box for himself, the right to control its use, nor any other form of dominion over the juke box.

Based on the above analysis, typical management services agreements cannot be treated as constructive leases, which transfer possession and control of the aircraft to the lessee, unless the management company is granted exclusive possession of the aircraft against the world, including the owner. Such a right is not granted to aircraft management companies in typical aircraft management services arrangements. Management companies have no right to select the passengers on owner flights,

exclude others from such flights, or exclude the owner from using the aircraft. As between the owner and the management company, the owner has the right to use the aircraft at any time it desires. Any agreement made with third-party regarding the use of the aircraft is entered into with the owner's consent and cannot represent a right of the management company to control the aircraft to the exclusion of the owner.

Aircraft management companies have no right to possess the aircraft for their own benefit, but instead they provide services for the benefit of the owner. Management companies merely provide services to support the owner's possession, use, and operation of the aircraft. The management company's services are provided to transport the owner when and where the owner directs. The management company is not responsible for paying any of the costs associated with the operation of the aircraft. The owners are responsible for paying for the expenses, including crew, fuel, maintenance, and repairs either directly or by reimbursing the management company. Because the management company does not have the right to the absolute control and possession of the aircraft, the management services agreements are not leases, and therefore, the owners maintain control of their respective aircrafts.

b) State Tax Law Concepts of Dominion and Control

Under New York tax law, the transfer of "dominion and control" of an aircraft constitutes a rental of such aircraft for sales tax purposes. In *Ontario Pipeline*, Adv. Op TBS-H-85(55)S (N.Y. Comm'r of Tax'n & Fin. Dec. 31, 1984), the New York Tax Department stated that the concept of dominion and control is derived from the definition of the "transfer of possession" with respect to a rental, lease, or license. Transfer of possession with respect to a rental, lease, or license to use means the transfer of one of the attributes of property ownership, including custody or possession, the right to custody or possession, and the right to use, or control or direct the use of, the tangible personal property.

In *Ontario Pipeline*, the purchaser of an aircraft, simultaneously with the purchase, entered into a flight service agreement with, and transferred possession of the aircraft to, an air carrier operating under FAR Part 135. The air carrier agreed to provide the purchaser with all flight services for the aircraft, including the provision of charter service to the purchaser and maintenance and inspection service for the purchaser's flights. The air carrier also received the right to use the aircraft in its charter service for other customers and agreed to compensate the purchaser for the use of the aircraft in charter services for its regular customers. Under this arrangement, the air carrier had complete "operational control" of the aircraft under the FARs at all times.

According to the New York Tax Department, because the air carrier had the right to possession of the aircraft, actual possession, and the right to control or direct the use of the aircraft, the purchaser relinquished all dominion and control over the aircraft when it transferred possession to the air carrier. Unlike *Ontario Pipeline*, nothing in a typical aircraft management agreement provides the management company with the right to use the aircraft for its own benefit with respect to owner flights. *Ontario Pipeline* involved aircraft operating under FAR Part 135, whereas the owner flights in the typical management company situation are operated under FAR Part 91.

In contrast, in *Ernst & Young, LLP*, Adv. Op. TBS-A-04(2)S (N.Y. Comm'r of Tax'n & Fin. Jan. 28, 2004), a company purchased an aircraft to provide transportation services to officers and employees of affiliates of the company. The company entered into a management agreement with a third-party to provide all flight related services that the company would not be performing itself. Under the arrangement, the company maintained the right to determine when and where the aircraft would fly, and which passengers it would carry, and was responsible for obtaining insurance on the aircraft. The New York Tax Department concluded that the company maintained complete dominion and control over the operations and maintenance of the aircraft.

Similar to the purchaser in *Ernst & Young*, the owners in a typical management services arrangement maintain the right to direct when and where the aircraft will be flown and the passengers the aircraft will

carry, and the owner is responsible for paying the costs of insuring the aircraft. Under New York tax law, when such significant rights are retained by the owner of property, dominion and control has not been transferred to the management company.

c) Tax Treatment of Hospital Management Contracts

In Rev. Rul. 98-15, Situation 1, 1998-1 C.B. 718, the IRS determined that a management company, that was hired to provide day-to-day management of a hospital under a management contract, had not obtained control of the hospital from its charitable organization owner. In the ruling, the IRS focused on the fact that the management company was subject to the direction of the owner and the management contract was for a term of only five years. One would expect the IRS to be especially sensitive to the risk of a for-profit management company potentially taking over control of a hospital from a nonprofit organization.

In contrast, in *St. David's Health Care System v. United States*, 349 F.3d 232 (5th Cir. 2003), a nonprofit organization ("St. David's") entered into a partnership agreement with a for-profit entity. The court was called upon to determine, in part, whether St. David's ceded control of the hospital as a result of a management agreement whereby the hospital hired a management company, a subsidiary of the for-profit partner, to manage the day-to-day operations of the hospital. In remanding the case to the district court, the court focused on the fact that St. David's had very little control over the management company and the management company was appointed for "an extraordinarily long term" of fifty years. *See also Redlands Surgical Services v. Commissioner*, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001) (the fifteen-year term of a management contract was a factor that showed the management company had control).

Unlike *St. David's*, aircraft owners have significant control over the aircraft. Typical management agreements between owners and management companies are not for "an extraordinarily long term" of fifty (or fifteen) years as was the agreement in *St. David's* (and *Redlands*). Rather, the management agreements with management companies are ordinarily for terms of less than five years, and often can be terminated with relatively little notice (e.g., 60 days). Under most management agreements, the management company serves at the direction of the owner. In both *St. David's* and *Redlands*, the management company was controlled by a for-profit entity that was a member of the LLC that owned the property being managed, thereby giving the for-profit entity the rights of an LLC member to control the property. However, an unrelated management company would have no such affiliation with the owner of the aircraft.

d) Treatment of Management Contracts in Tax-Exempt Bond Financing

Another context in which a distinction is drawn between a management agreement and a lease is tax-exempt bond financing. In this context, the question typically is whether the agreement is (i) a management contract, which does not transfer possession and control to the management company, or (ii) a lease, which does transfer possession and control to the management company. In determining whether an agreement is a management contract or a lease, one must take into consideration all of the facts and circumstances, including the degree of control that the management company has over the facility and the risk of loss borne by the management company with respect to the facility. *See* Treas. Reg. § 1.141-3(b)(3). Treas. Reg. § 1.141-3(f), Example 3, provides the following illustrative example:

> City L issues 30-year bonds to finance the construction of a city hospital. L enters into a 15-year contract with M, a nongovernmental person that operates a health maintenance organization relating to the treatment of M's members at L's hospital. The contract provides for reasonable fixed compensation to M for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the hospital. However, the contract also provides that 30 percent of the capacity of the hospital will be exclusively available to M's members and M will bear the risk of loss of

> that portion of the capacity of the hospital so that, under all of the facts and circumstances, the contract is properly characterized as a lease for federal income tax purposes.
>
> The IRS has provided an additional example of the application of these rules:
>
> City uses proceeds of bonds to finance an office building. The office building includes a cafeteria that is open to the general public. City enters into a contract with Corporation to manage the cafeteria for a term of 10 years. Corporation receives all the receipts of the cafeteria and in turn gives $X per month to City. Corporation has complete discretion to manage the cafeteria without any input from City. The contract is labeled "management contract." Notwithstanding its title, the contract seems to be a lease.

See IRS Module D, Governmental and Private Activity Bonds Overview, http://www.irs.gov/pub/irs-tege/teb_phase_1_course_11204_-5module_d.pdf.

Under this guidance, the owners in a typical management services arrangement would not be deemed to have transferred possession and control of their aircraft. The two most important factors in making such a determination for purposes of tax-exempt bond financing are the degree of control that the management company has over the aircraft and the extent to which the management company bears the risk of loss for the aircraft. In a typical management services arrangement, the owner maintains nearly all substantial control over the aircraft throughout the duration of the management agreements, including the right to direct the time and destination of their flights, to determine the passengers on their flights, to approve the pilots for the owner's flights, and to approve major repairs and refurbishments. Furthermore, the management company typically does not bear any risk of loss with respect to the aircraft. The entire risk of loss typically either covered by insurance or borne by the owner.

e) Treatment of Management Contracts Under Federal Income Tax Law

The distinction between a management contract and a lease has also been analyzed in the context of the federal income tax law. In this context both the courts and the IRS focus on the existence of control exercised by the property owner and the risk of loss retained by the property owner. *See* PLR 82-41-010 (Jun. 30, 1982), *State National Bank of El Paso v. United States*, 509 F.2d 832 (5th Cir. 1975), *Meagher v. Comm'r*, T.C. Memo 1977-270, *Kingsbury v. Comm'r*, 65 T.C. 1068 (1976), *acq*. 1976-2 C.B. 2. If the property owner exercises control over the property and bears risk of loss with respect to the property, the arrangement is generally treated as a management contract rather than a lease.

In *Meagher*, the taxpayers purchased a railroad tank car and at the same time entered into a management agreement with Relco Tank Lines, Inc. (Relco). Under the Relco agreement, Relco agreed to exercise its best efforts to arrange for utilization of the tank car and to perform all managerial and administrative functions necessary for the operation of the car, including collecting the mileage and per diem charges, repairing and maintaining the car and keeping adequate records of its operation. In return, Relco received thirty-five percent of the gross operating profit generated by the tank car. The taxpayers, as the owners of the car, were obligated to reimburse Relco for any expenses incurred in maintaining the car and received income only if the tank car was used by a third party. The agreement further provided that it was terminable at any time by either the taxpayers or Relco, subject to the performance in full of all terms and conditions of any existing leases of the car, but only after the agreement had been in effect for 10 years.

The Tax Court held that the Relco agreement was not a lease but rather was a management agreement. In arriving at this conclusion, the Court emphasized two key factors indicating a management agreement: (1) the degree of control over the venture exercised by the taxpayers, and (2) the risk of loss retained by the taxpayers.

With respect to the first factor, control over the venture, the Tax Court commented:

> While petitioners did not directly control the leasing activities of Relco with respect to their railroad car, they exercised a degree of control over the venture at the outset by including certain provisions in the agreement which controlled Relco's participation. Such provisions required Relco to keep adequate records of the tank car's operation, to use its best efforts to arrange for leasing of petitioners' tank car to shippers, railroads, or others, to obtain insurance coverage for the tank car naming petitioners as co-beneficiaries, and to pay the net earnings of the tank car (as defined herein) to petitioners within ninety days after the end of each calendar quarter except that Relco was authorized to maintain a $200 reserve for expenses. While the terms and conditions of the leases with third parties were left to Relco's discretion, petitioners nevertheless had sufficient control over the venture to support our conclusion that Relco was acting as petitioners' agent, under a management contract, in leasing the tank car. This view is strongly supported by the fact that risk of loss rested squarely on petitioners' shoulders.

With regard to the second factor in the Tax Court's analysis in the *Meagher* case, the risk of loss, the Court noted:

> Under the Relco agreement, petitioners agreed to reimburse Relco promptly upon demand for the amount of any expense incurred by their tank car in excess of the amount of the $200 reserve and to defend, indemnify, and hold Relco harmless from and against all risk of loss or damage to their tank car as well as all claims, damages, expenses, or liabilities, incurred by, or asserted against it, as a result of the operation, possession, control, or use of their tank car.

Similarly, PLR 82-41-010 discussed the treatment of a boxcar management company arrangement entered into between the owner of certain boxcars and a corporation. In the ruling, the IRS stated as follows:

> In determining whether or not the instrument in question is a ‘management contract’ or a lease, the substance of the transaction, and not the form, should determine how it will be interpreted for tax purposes. All of the facts and surrounding circumstances should be looked into in order to determine the intent as revealed in actions and statements and the economic realities of the transaction.

The IRS adopted the two-part test applied by the Tax Court in *Meagher* and concluded that the arrangement at issue was a management agreement and not a lease. As evidence of control exercise by the owner over the boxcars, the IRS considered the fact that the corporation was required to keep adequate records and supply reports regarding the use of the boxcars to the owner upon the owner’s request. Furthermore, the corporation was required to use reasonable effort to integrate the owner’s boxcars into the fleet of boxcars controlled by the corporation and was responsible for obtaining insurance on the boxcars. With respect to the risk of loss factors, the IRS concluded that the insurance obtained by the corporation effectively shielded the corporation from any real risk of loss with respect to the box cars. Furthermore, the owner was required to pay property taxes on the boxcars and was also required to pay a management fee to the corporation, even if the owner’s boxcars are not utilized and no income is earned. Based on these factors, the IRS concluded that the owner bore the risk of loss with respect to the boxcars.

The test applied by the courts and the IRS in this context is very similar to the test applied in the tax-exempt bonds context. As discussed above, the owners maintain nearly all relevant aspects of control over the aircraft under typical management agreements, including the right to direct the

time and destination of their flights, to determine the passengers on their flights, to select the particular pilot for their flight, and to approve major repairs and refurbishments. Management companies typically bear no risk of loss with respect to the aircraft. Therefore, typical management services agreements cannot be viewed as transferring possession and control to the management company as those terms are generally interpreted under property and tax law in various contexts including in analyzing whether property is being leased or managed.

f) Analysis of Typical Management Company Arrangements Under General Property Law Principles and General Tax Treatment of Management Services Arrangements

Based on these concepts, it would appear that possession, command, and control should be determined based on common law concepts of whether the owner has the right to control the aircraft, the right to operate the aircraft for his own benefit or enjoyment, and the right to exclude others. Under these standards, it would seem that the owner has control of the aircraft in a typical management services arrangement based on the contractual relationship between the owner and management company and their overall business relationship. The owner typically has control over all movement of the aircraft (not merely the right to select the destination like a passenger in a charter flight), control over the hiring and firing of the management company, control over all use of the aircraft, control over who gets access to the aircraft, and control over what major repairs are made. On the other hand, the management company typically does not have the right to operate the aircraft for its own benefit (particularly in the case of owner flights). In addition, the management company's role is to perform day-to-day management services, typically under a contract that can be cancelled on relatively short notice by the owner.

5. Only Amount Paid for Actual Air Charter Services Should be Subject to FET

The CCA asserts that third party charter flights flown under FAR part 135 and flights for the owner are both taxable transportation under § 4261. Not only does the CCA assert that the amounts paid by the charter customer taxable but it also asserts that, *in addition*, the management fees and other separately reimbursed amounts paid by the aircraft owner are taxable.

a) Incorrect Application of Tax to Full Cost of Owner Expenses

In reaching the conclusion that separately reimbursed amounts are subject to the tax, the CCA fails to account for the fact that a portion of the use triggering those costs has already been taxed due to the third party charter use.

Consider, as an example, that the aircraft hours for a given period of time are 40% by the owner and 60% for third party charter. Should these total hours flown trigger a required maintenance event, it would be incorrect to apply the transportation taxes to the full maintenance cost when paid for by the owner. In such a case, the charter rate paid by the third party would have been subject to the transportation tax that is collected and remitted by the FAR part 135 certificate holder.

A portion of the amounts paid by the third party charter customer are allocable to the maintenance costs for the aircraft. Therefore, to impose the transportation tax on 100% of the maintenance costs paid by the owner would result in a double tax on the portion allocable to the commercial use. At most, the taxes imposed on costs reimbursed by the owner should be apportioned to those expenses directly related to the owners use.

The same holds true for other expenses paid by the owner when the aircraft is also used in charter transportation which may include, but are not limited to, hangar fees, insurance and pilot costs.

b) Taxes Only Apply to Amounts Paid for Air Transportation

With regard to the monthly management fee, again there exists the opportunity for double taxation and ambiguity over what portion of amounts paid are indeed taxable. The taxes imposed by § 4261 are only applicable when air transportation actually occurs. The CCA concludes that the taxes are due on the management fee in a mixed use FAR part 91/135 scenario, but is silent on how one would determine the tax base upon which the taxes are assessed, other than the presumption that the entire management fee is taxable.

The monthly management fee is not a variable dependent upon the number of owner hours flown or on whether the aircraft is operated under Part 91 of Part 135. The aircraft owner is generally obliged to the pay the management company the monthly management fee, regardless of the amount of time the owner utilizes his aircraft in any given period or the amount of third party charter that occurs.

The CCA wrongly concludes that the management fees as a whole is an amount paid for transportation subject to tax and fails to provide any method for determining the proper tax basis when mixed use occurs or an explanation of why the management fee should be tied to the operation of the aircraft. If management fees are to be included in the tax base, the portion of management fees attributable to third party charter flights nevertheless should be excluded from the tax base. Since FET is already being collected on the charter rate received on third party flights, and since Rev. Rul. 74-123 caps the amount subject to tax at the fair market charter rate, there is no need to also impose FET on the portion of the management fees attributable to the third party charter flights.