

Amendment to Tax Regulations Creates
Federal Transportation Excise Tax Risks for Single Member LLCs

By John B. Hoover¹

Effective January 1, 2008, the Treasury Regulations were amended to provide that “Disregarded Entities” (such as single member limited liability companies (“SMLLCs”) and qualified Subchapter S subsidiaries (“QSubs”)) would no longer be disregarded for excise tax purposes.² This amendment raises the possibility that air transportation provided by, or to, a Disregarded Entity could be subject to the Federal Transportation Excise Tax (“FET”).³ Previously, air transportation provided by a Disregarded Entity to its owner or other Disregarded Entities owned by the same person was not subject to FET, because Disregarded Entities were treated as operations conducted directly by their owners for tax purposes.⁴ This change in the law can result in significant unexpected FET liabilities.

Background

FET is imposed on domestic air transportation at the rate of 7.5% of the amount paid for such service plus a domestic segment tax on each passenger.⁵ FET typically applies to charter flights,⁶ but it also applies to flights provided under fractional programs,⁷ time share agreements⁸ and other arrangements in which the provider retains possession, command and control of the aircraft.⁹ 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.¹⁰

¹ John B. Hoover is an attorney with the law firm of Dow Lohnes PLLC. He can be reached at (202) 776-2391 or jhoover@dowlohn.com.

² T.D. 9356 (Aug. 15, 2007).

³ I.R.C. § 4261.

⁴ Priv. Ltr. Rul. 2002-03-019 (Jan. 18, 2002).

⁵ I.R.C. § 4261(a), (b). The domestic segment tax is indexed for inflation. For the first six months of 2008, the tax on each passenger on each domestic segment is \$3.50. I.R. 2007-208 (Dec. 27, 2009).

⁶ *Shell Oil Co. v. United States*, 607 F.2d 924 (Ct. Cl. 1979).

⁷ *Executive Jet Aviation, Inc. v. United States*, 125 F.3d 1463 (Fed. Cir. 1997).

⁸ See Priv. Ltr. Rul. 93-22-002 (Feb. 9, 1993).

⁹ See Rev. Rul. 60-311, 1960-2 C.B. 341.

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.¹¹

Under an exception to the FET rules, FET does not apply to air transportation provided between corporations in an “affiliated group.”¹² An affiliated group is generally a group of corporations that are at least 80% owned (directly or indirectly) by a common parent corporation.¹³ 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.¹⁴ The default classification of a domestic SMLLC for income tax purposes is a Disregarded Entity.¹⁵ 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.¹⁶

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.¹⁷ Pursuant to the entity classification rules, SMLLCs that cannot be disregarded for excise tax purposes are treated as corporations for excise tax purposes.¹⁸ This dual status for SMLLCs can be complex. A similar dual status applies to QSubs.¹⁹

¹⁰ 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).

¹¹ Rev. Rul. 72-245, 1972-1 C.B. 347; *see also* IRS MSSP Training Guide, Aviation Tax, Ch 8.

¹² I.R.C. § 4282.

¹³ I.R.C. § 1504(a).

¹⁴ 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.

¹⁵ Treas. Reg. § 301.7701-3(b). The default classification for a foreign SMLLC is a corporation.

¹⁶ I.R.C. § 1361(b)(3); Treas. Reg. § 1.1361-4(a)(1).

¹⁷ Treas. Reg. § 301.7701-2(c)(2)(v).

¹⁸ Treas. Reg. § 301.7701-2(b)(2),-3(a).

¹⁹ Treas. Reg. § 1.1361-4(a)(8).

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 situations 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. 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. In the case of a fractional program, the individual could engage the fractional program operator to provide the management services under the fractional program.²⁴

QSubs; SMLLCs Owned by Corporations

When a corporation owns an SMLLC, the SMLLC is disregarded for income tax purposes,²⁵ but it is treated as a separate corporation for excise tax purposes. Since the SMLLC is regarded as a wholly-owned corporate subsidiary of a corporation 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. Likewise, flights provided between a QSub and its parent S corporation and other QSubs

²⁰ Rev. Rul. 2005-64, 2005-2 C.B. 600, *Situation 1*.

²¹ *Id.* *Situation 2*.

²² *See* note 6 above. If the SMLLC is reimbursed for such flights, it may be in violation of FAA Regulations, unless it 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 7 and 8 above.

²⁴ 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.

²⁵ Alternatively, the SMLLC could elect to be treated as a corporation for income tax purposes. *See* note 15 above.

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,²⁶ 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.²⁷ 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 services to the other entities. Under this structure, the SMLLC may be viewed as using the aircraft for its own 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.

Effective Date

The amendment to the regulations was issued on August 15, 2007, effective January 1, 2008, for excise taxes. The amendment also provides that Disregarded Entities will similarly be treated as separate entities for *payroll tax* purposes effective January 1, 2009.²⁸ The IRS decided to delay the effective date of the amendment with respect to payroll taxes, in response to

²⁶ As noted above, the SMLLC could elect to be treated as a corporation for income tax purposes.

²⁷ 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.

²⁸ Treas. Reg. § 301.7701-2(c)(2)(iv), (e)(5).

comments submitted on the proposed regulations.²⁹ Those comments explained that a delay in the effective date was needed to address the complex legal and administrative issues arising from this change in the treatment of Disregarded Entities for payroll tax purposes. Unfortunately, the IRS was unaware of the complexities caused by the change with respect to excise taxes³⁰ and failed to delay the effective date with respect to excise taxes.

This amendment with respect to excise taxes was a surprise to many taxpayers and practitioners and it raises many complex and unanticipated legal and administrative issues. Accordingly, even though the effective date of January 1, 2008, has passed, it would still seem appropriate for the IRS to consider delaying the effective date to January 1, 2009, with appropriate interim guidance for 2008.

Amendment With Respect to Payroll Taxes

The amendment effective January 1, 2009, to treat Disregarded Entities generally as separate corporations for payroll tax purposes contains 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 SMLLCs 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).³¹ 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.³² If that tax treatment of the value of flights is desired, it may be advisable to admit a second member to the LLC.³³

Conclusion

Amendments to Federal Tax Regulations effective January 1, 2008, treat SMLLCs (and QSubs) as separate corporations for Federal excise tax purposes, but not for income tax purposes. 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

²⁹ T.D. 9356.

³⁰ *Id.* No comments were submitted to the IRS on the Proposed Regulations with respect to excise taxes.

³¹ Treas. Reg. § 301.7701-2(c)(2)(iv).

³² Treas. Reg. § 1.61-21(g)(1) (special valuation rules apply to employees).

³³ 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).

to FET on air transportation provided to other entities. Possible solutions to this problem include (1) dry leasing the aircraft to the entity that uses it; (2) having the entity operating the aircraft hire the individuals who will be the passengers; or (3) 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.

The effective date of the amendment to the Disregarded Entities regulations regarding excise taxes was not delayed until January 1, 2009, like the effective date regarding payroll taxes, because the IRS believed that the amendment regarding excise taxes would not raise substantial legal and administrative complexities. However, in view of the complexities discussed above and the need for companies to rearrange their aircraft arrangements to address these complexities, the IRS should reconsider whether to delay the effective date of the amendment with regard to excise taxes to January 1, 2009.

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