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Distinguishing "Commercial" From General Aviation – Avoiding Tax and FAA Pitfalls

A central concept in aviation tax planning is distinguishing between commercial aviation – the "transportation of persons or property by air" from general aviation. The difference is significant in a number of respects. First, commercial flights versus non-commercial flights may be subject to an excise tax on "amounts paid" for these services. Second, commercial aircraft are subject to different depreciation rules than non-commercial aircraft. The former may be depreciated, for example, under the MACRS depreciation rules on seven year recovery period while non-commercial aircraft may be depreciated over five years. There are other legal distinctions for international flights (some of which may be subject to excise tax on commercial flights), and the tax consequences for aircraft used "predominantly outside the United States".

Steering clear of FAA regulatory violations is equally important. The federal aviation regulations provide that an aircraft owner may not engage in commercial transportation without being certificated as such, most commonly under Parts 135 (charter activities) or 121 (regularly scheduled commercial flights). As such, it is important for the aircraft owner to have a clear understanding of what type of conduct qualifies as commercial versus non-commercial aviation. Naturally if someone is in the business of providing commercial services the rules are clear. More problematic, however, are those situations in which the aircraft owner finds himself in a position where he is engaged in unintended commercial transportation, unequipped for either the tax or regulatory consequences.

In these cases whether one is engaged in "commercial" activities is a fact-specific determination. One might "follow the money" for an indication of whether the taxpayer has paid for such a service. For further guidance one also looks to FAA, IRS and common law (case law) guidance. Courts and the Service have held the following:

- Payments to an aircraft management company to manage a privately-owned aircraft, including where the management company transports the company's personnel, are not "amounts paid" for the transportation of persons or property by air.

- Conversely, a sole shareholder of a corporation has collected payments for "taxable transportation" where the shareholder leases the plane to third parties (including employees, business associates and relatives) and the payments are based on operating expenses of such flights. The shareholder's own payments, however, to his corporation for leased flights are not considered to be taxable transportation, the key difference being to whom the plane was leased and whether the plane is held out to the public as available for hire.

- A company has *not* engaged in commercial transportation where its plane is used by a charter company to train the charter company's pilots. This is common where the owner purchases a

new plane (or one unfamiliar to the charter company pilots) and allows the unrelated, non-employee pilots to train on the plane.

- There was no amount paid for "taxable transportation" where a taxpayer pays its wholly-owned, disregarded limited liability company for aircraft operating expenses. The result was the same for payments from other companies to the aircraft-owning company where both entities were disregarded as to the taxpayer. Note, however, an important caveat: recent IRS guidance has suggested that a disregarded entity may in fact be treated as a separate entity for excise tax purposes where the taxpayer's principal leases the aircraft for personal use.

- A group of people who create a corporation to buy and operate an aircraft for their exclusive use is engaged in the taxable sale of air transportation where the shareholder using the plane establishes regularly scheduled flights, the corporation employs a full-time pilot, and charges each shareholder amounts according to the operating expenses of the flight.

- A court found that monthly management fees paid by an aircraft fractional owner to the fractional ownership program manager were for taxable transportation. The fees covered inspections and servicing to maintain FAA certification, maintenance of aircraft's appearance, FAA-required recordkeeping, the cost of pilots, hangar space, tie-down service, weather and flight planning, catering, fueling and communications, takeoff, flight, and landing arrangements and liability insurance. Fractional owners who bought an undivided interest in an aircraft agreed (among other things) to pay the management fees to the program manager, for which they were guaranteed a set number of flight hours.

From a planning perspective, unless one intends to be in the business of commercial aviation, prudence dictates that:

1. Private aircraft owners not create regularly scheduled flights for their aircraft or bill an entity's owners based on the operating expenses of the flight
2. Collect payments, again where based on operating expenses, from third parties (although there may be other acceptable "dry lease" arrangements)

Please contact me for further guidance in this or other areas concerning aircraft tax law or other aviation legal questions.

- Ari Good, Esq.