

# ***IRS Hot Topics***

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## *Court rules on what it means to be operating on an established line for air transportation excise tax purposes*

On October 10, 2007, the IRS issued an examination report asserting that Papillon owed \$6,452,094 in back taxes for unpaid taxable transportation excise tax liabilities pursuant to section 4261 of the Internal Revenue Code. The IRS also asserted \$1,290,375 in negligence penalties under section 6662 in connection with the underpayment. In the report, the IRS asserted that Papillon had been operating its flights on an “established line” and therefore was not entitled to the exemption under section 4281 from taxable transportation taxes under section 4261. Papillon made a partial payment and sought a refund, which the IRS denied. Papillon sued for refund.

On June 5, 2012, the United States Court of Federal Claims issued its opinion in *Papillon Airways, Inc. v. United States*, No. 09-297T (Ct. Cl. May 31, 2012), holding that Papillon Airways (“Papillon”) operated its flights on an established line and therefore, did not meet the exception in section 4282 and thus is liable for taxable transportation excise tax under section 4261. We note that the federal excise tax liability arose in periods prior to October 1, 2005, which is when a change to section 4281 was effective to specifically exempt certain sightseeing flights from section 4261 taxation.



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## *Background*

Based in Arizona, Papillon is one of the largest helicopter companies of its kind averaging 113 daily flights. Papillon's primary business is providing aerial sightseeing services, mostly to international tourists, interested in helicopter tours over the Grand Canyon. Papillon also provides sightseeing flights over other areas in Las Vegas, the Hoover Dam, and portions of the Hualapai and Havasupai Indian Reservations. Though not an issue in the case, Papillon also conducts some charter flights for governments and utility companies.

The majority of Papillon's tour sales are made through third-party vendors, including travel agencies, concierge desks, and online travel sites which are authorized to sell tours directly to consumers. Papillon provides vendors with brochures listing suggested retail rates and profit margins for its various products. Prices are then adjusted by the third-party vendors to achieve desired profit margins. Papillon offers its services as listed in brochures and other marketing materials as consistent product lines or "everyday products," meaning that customers may purchase flights and packages without first contacting Papillon to determine whether Papillon will be able to accommodate the purchaser prior to purchase.

Typically, customers do not pay Papillon directly for its services. Instead, customers pay the third-party vendors and are provided with a voucher to redeem at departure. Papillon then bills the vendor based on its flight record.

In order to accommodate its large customer base and manage costs, Papillon utilizes a computer generated "source board" that assists Papillon in determining the most profitable schedule of flights that Papillon can operate on any given day. Once a purchase has been made, the purchaser or purchaser's agent telephones Papillon to request a reservation and departure time. The request for reservation is an approximate time and subject to Papillon's final approval after Papillon consults the source board.

## *Sections 4261 and 4281*

Section 4261(a) imposes a tax on the "amount paid" for "taxable transportation" by air of persons. The tax is 7.5 percent of the "amount paid" per person. Section 4261(b) imposes a fixed dollar tax, in addition to the percentage tax imposed by section 4261(a), per segment and person of each domestic flight considered to be "taxable transportation." There are special rules with respect to layovers, international flights, and flights involving Alaska and Hawaii, not relevant to the discussion of Papillon.

"Taxable transportation" for purposes of the above provisions is defined in section 4262 as transportation by air which begins in the U.S. or in the 225-mile zone defined in section 4262 and ends in the U.S. or in the 225-mile zone. The 225-mile zone is that portion of Canada and Mexico which is not more than 225-miles from the nearest point in the continental United States.

There is an exception to the imposition of the 4261 tax for certain small aircraft on non-established lines. Subsequent to the periods under examination in Papillon that exception has been explicitly expanded to sightseeing flights. Specifically, section 4281 today includes a sentence that states, "an aircraft shall not be considered as operated on an established line at any time during which such aircraft is being operated on a flight the sole purpose of which is sightseeing." Previously, there was no explicit exception for sightseeing flights, and instead, those flights had to be established as having a maximum certificated takeoff weight of 6,000 pounds or less and not being operated on an established line. The term "maximum certificated takeoff weight" means the maximum such weight contained in the type certificate or airworthiness certificate. At issue in the case was what it means to be operated on an established line.

Treas. Reg. § 49.4263-5(c) provides that the term "operated on an established line" means operated with "some degree of regularity between definite points." The regulation continues by providing that, "it does not necessarily mean that strict regularity of schedule is maintained; that the full run is always made; that a particular route is followed; or that intermediate stops are restricted. The term implies that the person rendering the service maintains and exercises control over the direction, route, time, number of passengers carried, etc." In other words, there are three factors that must be considered in order to determine whether the aircraft is operated on an established line under section 4281: (1) degree of regularity of operation; (2) operation between definite points; and (3) requisite control retained by operator.

The Court of Claims examined Papillon's operations based on the three factors and found that Papillon's flights were operated on an established line. In looking at regularity of operation, the Court found that a fixed schedule, as suggested by Papillon, was not required. Rather, the important thing is that the public can rely on the transportation. Papillon's flight volume and use of the source board created the reliability need to establish regularity. The Court also dispatched Papillon's argument that "between definitive points" does not mean starting and ending at the same point.

Rather, the Court holds that starting and stopping at the same point meets the requirement of "between definite points." The Court also found Papillon to have exercised sufficient control over the flights and that absolute control is not required. Namely, Papillon determined the number of passengers, the departure time, the route, where to land, etc.

## Observations

- There are only a handful of cases addressing the section 4281 exception to the section 4261 tax. This case joins the other cases in closely analyzing each of the factors enumerated in Treas. Reg. § 49.4263-5(c) to reach the conclusion that the service provided by Papillon was operating on an established line and thus, not within the ambit of the section 4281 exception as effective for the periods under examination. See *Sundance Helicopters, Inc. v. United States*, 2012 WL 666576 (Fed. Cl.); see also *Schuman Aviation Company Ltd. v. United States*, 816 F.Supp. 2d 941 (Dist. Hawaii 2011); *Northstar Trekking LLC v. United States*, 637 F.Supp. 2d 676 (D. Alaska 2009); *Lake Mead Air, Inc. v. United States*, 991 F.Supp. 1209 (D. Nev. 1997).
- The opinion in Papillon is on the heels of the March 2012 noteworthy Chief Counsel Advice,

CCA 201210026, in which the Service attempts to define who is the party in possession, command, and control of the aircraft for purposes of section 4261 taxation. It also follows new Code section 4043, which exempts certain fractional aircraft ownership programs from the section 4261 tax, and, instead, imposes a fuel surtax. Currently, the IRS is involved in pending litigation with NetJets, a case in which the taxpayer is seeking a sizeable refund and the IRS has asserted large amounts in back taxes pursuant to section 4261. Viewed together, it would appear that the IRS is taking a firmer stand on the imposition of aviation related excise taxes, especially those involving taxable transportation of persons under section 4261.

- The section 4281 exclusion from section 4261 tax has been the subject of numerous technical advice memoranda. See, for e.g., TAM200314028; TAM9535003; TAM9536001; TAM9527008; TAM9524003; TAM9407001. The IRS is also willing to accept requests for private letter rulings on the subject. See PLR200747003; PLR9052017. The clarification with respect to sightseeing flights added to section 4281 does not change the analysis that is required for non-sightseeing flights and whether other flights will be found to be

taken in an aircraft with a certified takeoff weight of 6,000 pounds or less occurring not on an established line. After reviewing potential factual scenarios that may involve a determination of whether there exists an established line under section 4281, it may be appropriate to seek certainty for the application of the exemption provided by section 4281 through private letter ruling requests or other administrative processes.

- Agreements in force with respect to charter services, taxi

operations, and taxable transportation generally, should be evaluated in light of the most recent IRS developments. Moreover, strategies should be considered to manage potential audit risk and sufficiently prepare necessary books and records in case of a future audit.

- The Court's analysis in this case also serves as a useful reminder that FAA rules and regulations are not controlling for federal excise tax purposes.

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