Rev. Rul. 2005-64

Interaction of sections 469 and 4261. This ruling describes the circumstances in which losses incurred by an individual who provides air transportation through a passthrough entity can qualify as passive losses under section 469 of the Code. In addition, this ruling describes the applicability of section 4261 to the amounts paid for the air transportation services.

ISSUES

(1) Whether the losses incurred by an individual who engages in an air transportation activity in the circumstances described below are passive losses within the meaning of § 469 of the Internal Revenue Code?

(2) Whether the amounts paid for the air transportation services described below are subject to the tax imposed by § 4261?

FACTS

Situation 1. *A* is the CEO and part owner of the closely held C corporation, *Corp1*. *A* participates in the activities of *Corp1* for more than 500 hours during the year. *A* is also the sole owner of *SCorp1*, an S corporation. *SCorp1*'s sole asset is an aircraft with a maximum certificated takeoff weight of more than six thousand (6,000) pounds. *SCorp1* leases the aircraft to *Corp1* to satisfy *Corp1*'s air transportation needs, but supplies neither the pilot necessary to operate the aircraft nor the crew necessary to maintain the aircraft. *Corp1* pays *SCorp1* only for the lease of the aircraft. *A* has incurred significant losses from the operation of *SCorp1*.

Situation 2. *B* is the CEO and part owner of the closely held C corporation, *Corp2*. *B* participates in the activities of *Corp2* for more than 500 hours during the year. *B* is also the sole owner of *SCorp2*, an S corporation. *SCorp2*'s sole asset is an aircraft with a maximum certificated takeoff weight of more than six thousand (6,000) pounds. *SCorp2* employs a pilot and crew to operate and maintain the aircraft. *Corp2* pays *SCorp2* a guaranteed monthly fee plus an additional amount for each flying hour. *Corp2* uses the aircraft to transport its employees throughout the continental United States. In the conduct of its air transportation activity, *SCorp2* usually supplies its own aircraft, but is solely responsible for the provision of alternative aircraft in the event that *SCorp2*'s aircraft is undergoing maintenance or is being provided to other customers. *SCorp2*'s activities include the provision of air transportation services to *Corp2*, including, but not limited to, the use of the aircraft, with pilot and crew, fuel, and food provided by *SCorp2*. *SCorp2* is the only air transportation business in which *B* is involved. Upon initiation of *SCorp2*'s business, *B* decided to group *B*'s activities conducted through *SCorp2* with *B*'s activities conducted through *Corp2* for purposes of § 1.469-4 of the Income Tax Regulations. *B* has incurred significant losses from the operation of *SCorp2*.

LAW AND ANALYSIS

Section 469(a) disallows passive activity losses and credits for the taxable year for individuals, estates, trusts, closely held C corporations, and personal service corporations. Section 469(c)(2) provides that, except as provided in § 469(c)(7) (concerning special rules for taxpayers engaged

in real property businesses), the term passive activity includes any rental activity. Section 469(c)(4) provides that § 469(c)(2) shall be applied without regard to whether or not the taxpayer materially participates in the activity.

Section 469(j)(8) defines "rental activity" as any activity where payments are principally for the use of tangible property.

Section 1.469-1T(e)(1) of the temporary Income Tax Regulations provides in general that an activity is a passive activity of the taxpayer for a taxable year if and only if the activity: (i) is a trade or business activity (within the meaning of § 1.469-1T(e)(2)) in which the taxpayer does not materially participate for the taxable year; or (ii) a rental activity (within the meaning of § 1.469-1T(e)(3)), without regard to whether or to what extent the taxpayer participates in the activity.

Section 1.469-1T(e)(3)(i) provides in general that an activity is a rental activity for a taxable year if: (A) during the taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and (B) the gross income attributable to the conduct of the activity during the taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of the tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

Section 1.469-1T(e)(3)(ii)(C) provides that an activity involving the use of tangible property is not a rental activity for a taxable year if for the taxable year extraordinary personal services (within the meaning of § 1.469-1T(e)(3)(v)) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers (without regard to the average period of customer use).

Section 1.469-1T(e)(3)(v) provides that for purposes of § 1.469-1T(e)(3)(ii)(C), extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of the services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

Section 1.469-1T(e)(3)(viii) provides several examples to illustrate the operation of § 1.469-1T(e)(3). In Example (1), the taxpayer is engaged in an activity of leasing photocopying equipment. The average period of customer use for the equipment exceeds 30 days. Pursuant to the lease agreements, skilled technicians employed by the taxpayer maintain the equipment and service malfunctioning equipment for no additional charge. Service calls occur frequently (three times per week on average) and require substantial labor. The value of the maintenance and repair services (measured by the cost to the taxpayer of employees performing these services) exceeds 50 percent of the amount charged for the use of the equipment. Under these facts, services performed by individuals are provided in connection with the use of the photocopying equipment, but the customers' use of the photocopying equipment is not incidental to their receipt of the services. Therefore, extraordinary personal services (within the meaning of § 1.469-1T(e)(3)(v)) are not provided in connection with making the photocopying equipment available for use by customers, and the activity is a rental activity.

In Example (3) of § 1.469-1T (e)(3)(viii), the taxpayer is engaged in an activity of transporting goods for customers. In conducting the activity, the taxpayer provides tractor-trailers to transport goods for customers pursuant to arrangements under which the tractor-trailers are selected by the taxpayer, may be replaced at the sole option of the taxpayer, and are operated and maintained by drivers and mechanics employed by the taxpayer. The average period of customer use for the tractor-trailers exceeds 30 days. Under these facts, the use of tractor-trailers by taxpayer's customers is incidental to their receipt of personal services provided by the taxpayer. Accordingly, the services performed in the activity are extraordinary personal services (within the meaning of § 1.469-1T(e)(3)(v)) and, under § 1.469-1T(e)(3)(ii)(C), the activity is not a rental activity.

Section 1.469-4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of § 469. Section 1.469-4(a) further states that a taxpayer's activities include those conducted through C corporations that are subject to § 469, S corporations, and partnerships.

Section 1.469-4(b)(1) states that "trade or business activities" are activities, other than rental activities or activities that are treated under § 1.469-1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment, that: (i) involve the conduct of a trade or business (within the meaning of § 162); (ii) are conducted in anticipation of the commencement of a trade or business; or (iii) involve research or experimental expenditures that are deductible under § 174 (or would be deductible if the taxpayer adopted the method described in § 174(a)). Section 1.469-4(b)(2) provides that "rental activities" are activities that constitute rental activities within the meaning of § 1.469-1T(e)(3).

Section 1.469-4(c)(1) states that one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of § 469. Section 1.469-4(c)(2) provides that a facts and circumstances test determines whether activities constitute an appropriate economic unit.

Section 1.469-4(c)(3) provides several examples that illustrate the application of § 1.469-4(c). In Example (2), Taxpayer *B*, an individual, is a partner in a business that sells non-food items to grocery stores (partnership *L*). *B* also is a partner in a partnership that owns and operates a trucking business (partnership *Q*). The two partnerships are under common control. The predominant portion of *Q*'s business is transporting goods for *L*, and *Q* is the only trucking business in which *B* is involved. Under § 1.469-4(c), *B* appropriately treats *L*'s wholesale activity and *Q*'s trucking activity as a single activity.

Section 1.469-4(d)(1) limits a taxpayer's ability to group a rental activity with a trade or business activity and § 1.469-4(d)(5)(ii) provides that an activity that a taxpayer conducts through a C corporation subject to § 469 may be grouped with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity.

Section 1.469-5(f)(1) provides in general that any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated as participation of the individual in the activity.

Section 1.469-5T(a) provides in general that an individual shall be treated, for purposes of § 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if: (1) the individual participates in the activity for more than 500 hours during the year; (2) the individual's participation in the activity for the taxable year constitutes substantially all of

the participation in the activity of all individuals (including individuals who are not owners of interests in the activity) for the year; (3) the individual participates in the activity for more than 100 hours during the taxable year, and the individual's participation in the activity is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year; (4) the activity is a significant participation activity (within the meaning of § 1.469-5T(c)) for the taxable year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours; (5) the individual materially participated in the activity (determined without regard to § 1.469-5T(a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year; (6) the activity is a personal service activity (within the meaning of § 1.469-5T(d)), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or (7) based on all of the facts and circumstances (taking into account the rules in § 1.469-5T(b)), the individual participates in the activity on a regular, continuous, and substantial basis during the year.

Section 4261(a) imposes a tax on the amount paid for taxable transportation of any person by air and § 4261(b) imposes a tax on the amount paid for each domestic segment of taxable transportation. Section 4262(a)(1) generally defines taxable transportation as including transportation by air which begins and ends in the United States. Section 4262(d) provides that the term "transportation" includes layover or waiting time and movement of the aircraft in deadhead service. All amounts paid for air transportation service, including hourly, *per diem*, or monthly fees, are subject to the tax imposed by § 4261. Rev. Rul. 76-556, 1976-2 C.B. 354.

Under § 4261(d), the tax generally is paid by the person making payment for the air transportation service and § 4291 generally provides that the person receiving the payment is responsible for collecting the tax. Section 40.6011(a)-1(a)(3) of the Excise Tax Procedural Regulations provides that the person required to collect the tax must file the return.

If the owner of an aircraft leases it to others for the transportation of persons but retains possession, command, and control of the aircraft, the owner is furnishing taxable transportation within the meaning of § 4261. However, if the owner of the aircraft transfers the complete possession, command, and control of the aircraft, the owner is not engaging in a taxable transportation service, but is merely leasing the aircraft. Rev. Rul. 60-311, 1960-2 C.B. 341. If the owner of the aircraft employs the pilot and crew and provides their services with the aircraft, the owner is deemed to have the essential elements of possession, command, and control of the aircraft at all times, irrespective of the fact that the lessee may direct the pilot as to destination and other details concerning actual flights when using the aircraft. Rev. Rul. 76-394, 1976-2 C.B. 355.

Situation 1. In this situation, *SCorp1* holds an aircraft in connection with its activities, such aircraft is used by customers or held for use by customers, and the gross income attributable to the conduct of the activities represents an amount paid or to be paid principally for the use of the aircraft. Therefore, the activity conducted in *SCorp1* is a rental activity. Section 1.469-1T(e)(3)(i). Section 1.469-1T(e)(3)(ii)(C) does not alter this conclusion because there are no extraordinary personal services provided in connection with making the aircraft available to *Corp1* and because the use of the aircraft, rather than the provision of services, is the dominant element of the relationship between *SCorp1* and *Corp1*. *See Frank v. Commissioner*, T.C. Memo 1996-177 (1996) (holding that taxpayer's losses from its airplane leasing activities were passive because the services rendered to the lessee were not the dominant element of the relationship between the taxpayer and the lessee).

This ruling does not address whether § 1.469-4(d)(1), which limits a taxpayer's ability to group a rental activity with a trade or business activity, would prevent *A* from grouping the rental activity conducted through *SCorp1* with the trade or business activity conducted through *Corp1*. Even if such a grouping were permitted, however, § 1.469-4(d)(5)(ii) provides that a taxpayer can group activities conducted through a closely held C corporation with other activities of the taxpayer only for the purpose of establishing material or significant participation in the other activities. Consequently, grouping the activities *A* conducts through *Corp1* and *SCorp1* will not change the character of the activity *A* conducts through *SCorp1*. The activity will remain a rental activity because the grouping is only for purposes of establishing material or significant participation and will remain a passive activity because, under § 469(c)(4), material participation in rental activities does not change their passive nature. Accordingly, the losses incurred by *A* through *SCorp1* are losses from a passive activity and are subject to the limitations of § 469.

SCorp1 does not provide taxable transportation within the meaning of § 4262(a)(1) to *Corp1* because *SCorp1* does not retain possession, command and control of the aircraft; thus, the taxes imposed by § 4261 do not apply to amounts paid by *Corp1* to *SCorp1* for the lease of the aircraft.

Situation 2. In this situation, the services provided by *SCorp2* in connection with the use of the aircraft by *Corp2* are provided by individuals. In addition, the use of the aircraft by *Corp2* is incidental to *Corp2*'s receipt of the services provided, as the use of a seat on the aircraft is incidental to the passenger's receipt of the personal services provided by the aircraft's air transportation staff. Accordingly, extraordinary personal services within the meaning of § 1.469-1T(e)(3)(v) are provided on behalf of the owner of the aircraft in connection with making the aircraft available for use by customers. Therefore, the activity *B* conducts through *SCorp2* is not a rental activity for purposes of § 469. Section 1.469-1T(e)(3)(ii)(C).

Pursuant to § 1.469-1T(e)(1)(i), the air transportation activity is not a passive activity if *B* materially participates in the activity. In this situation, *Corp2* and *SCorp2* are under common control, the predominant portion of *SCorp2*'s air transportation service business is transporting executives for *Corp2*, and *SCorp2* is the only air transportation service business in which *B* is involved. *B* has consistently chosen to group the activity conducted through *SCorp2* with *Corp2*'s trade or business activity and to treat those activities as a single activity for the measurement of material participation in the activity of *SCorp2*. Section 1.469-4(c)(1) and (c)(3), Example (2). Because *B* participates for more than 500 hours in the *Corp2* activity that is grouped with the activity conducted through *SCorp2* for purposes of measuring material participation in the *SCorp2* activity, *B* materially participates in the *SCorp2* activity under § 1.469-5T(a)(1). Accordingly, the provision of air transportation services is not a passive activity, and losses incurred by *B* through *SCorp2* are not subject to the limitations of § 469. If, however, *B* did not participate in *Corp 2* for more than 500 hours and did not otherwise materially participate in the grouped activities, the losses incurred by *B* through *SCorp2* would be subject to the passive loss limitations of § 469.

SCorp2 provides taxable transportation service to *Corp2* because *SCorp2* retains possession, command and control of the aircraft; thus, the taxes imposed by § 4261 apply to the amounts paid (including monthly and hourly fees) by *Corp2* to *SCorp2* for the taxable transportation. *Corp2* is liable for the tax and *SCorp2* is responsible for collecting the § 4261 taxes and filing the return.

HOLDINGS

(1) In *Situation 1*, *A*'s activities conducted through *SCorp1* are rental activities, and therefore the losses incurred in the activities are passive losses subject to the limitations of § 469. In *Situation 2*, *B*'s activities conducted through *SCorp2* are not rental activities because extraordinary personal services are provided. Because *B* consistently grouped the activities conducted through *Corp2* and *SCorp2* for purposes of measuring material participation in the activity of *SCorp2*, and participates in the *Corp2* activity for more than 500 hours a year, *B* materially participates in the *SCorp2* activity. Therefore, the losses incurred by *B* through *SCorp2* are not losses from a passive activity.

(2) In *Situation 1*, *Corp1* does not pay *SCorp1* for taxable transportation and § 4261 does not apply. In *Situation 2*, *Corp2* pays *SCorp2* for taxable transportation; therefore, § 4261 applies to the amount paid for the services.

DRAFTING INFORMATION

The principal author of the § 469 portion of this revenue ruling is Timothy J. Leska of the Office of Associate Chief Counsel (Passthroughs & Special Industries). The principal author of the § 4261 portion of this revenue ruling is Taylor Cortright of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Mr. Leska at (202) 622-3050 or Ms. Cortright at (202) 622-3130 (not toll-free calls).