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Memorandum

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subject: Bifurcation of Award Miles

Airline =

Bank =

Allocation Methodology =

Year =

a% =

b% =

Composite Rate =

Mile Portion =

Marketing Portion =

This Chief Counsel Advice responds to your request for assistance dated April 7, 2015. This advice may not be used or cited as precedent.

ISSUES

1. Whether, in the circumstances described below, a collector and taxpayer may exclude certain amounts from the tax base upon which tax is imposed by § 4261 of the Internal Revenue Code ("air transportation excise tax").

2. Whether, in the circumstances described below, the air transportation excise tax attaches when an amount is paid for frequent flyer miles, rather than when the frequent flyer miles are deposited into (or credited to the benefit of) the taxpayer's customer accounts.

CONCLUSIONS

1. In the circumstances described below, a collector and taxpayer may exclude certain amounts from the tax base upon which air transportation excise tax is imposed.

2. Air transportation excise tax attaches when an amount is paid for frequent flyer miles, not when the frequent flyer miles are deposited into (or credited to the benefit of) the taxpayer's customer accounts (and regardless if the frequent flyer miles are ever actually deposited into (or credited to the benefit of) a customer's account).

FACTS

The facts in this case are complex; they are presented here in simplified form and only to the extent necessary to address the specific legal issues discussed in this memorandum.

Airline is a common carrier that provides scheduled, ticketed travel within the United States. Airline operates a mileage award program that sells mileage awards (generally referred to as frequent flyer miles) to its customers and to certain other entities. Airline's frequent flyer miles are redeemable for transportation beginning and ending in the United States.

Bank, a credit card issuer, is one of the entities that purchases frequent flyer miles from Airline. As an incentive for card holders, Bank distributes frequent flyer miles to the card holder when the card holder engages in certain credit card usage behaviors.

Bank and Airline enter into a series of agreements, letters of understanding, and licenses (referred to collectively as "the agreement") to co-brand a credit card issued by Bank and to engage in other mutually beneficial marketing efforts. The agreement provides that Bank will purchase frequent flyer miles at a certain rate per mile. The agreement also grants Bank the right to use (or benefit from) certain Airline proprietary business information and data (including Airline's customer lists); intellectual property, including trademarks and trade names; brand-related goodwill; and administrative services carried out by Airline's employees assigned to Airline's mileage award program. In addition, the agreement grants Airline the right to use certain of Bank's proprietary business information and data to assist Airline in carrying out its obligations under the agreement and to engage in mutually beneficial marketing efforts.

The agreement includes a "bifurcation" clause that provides that the rate paid by Bank to Airline for each mile is a composite rate; that is, part of the rate per mile is designated as the purchase price for a frequent flyer mile (referred to as the "mile portion") and the other part of the rate per mile is designated as compensation to Airline for the proprietary business information, intellectual property rights, and administrative services

provided by Airline (referred to as the "marketing portion"). With regard to licenses and intellectual property, Bank is not required to pay Airline any royalties or fees; Airline's compensation for the licenses is included in the rate per mile. Further, under the bifurcation clause, Airline and Bank agree to use the number of frequent flyer miles purchased by Bank to determine Airline's compensation for the arrangement under the theory that the volume of frequent flyer miles awarded to Bank's card holders corresponds to the amount of card holder credit card spending, and thus reflects the success of the arrangement.

The following is an illustration of how the "bifurcation" clause works numerically[1]:

> Bank agrees to purchase a certain number of frequent flyer miles at Composite Rate, calculated using Allocation Method. The agreement states that for Year, a% of Composite Rate represents the purchase price for each frequent flyer mile purchased by Bank, and b% of Composite Rate represents compensation to Airline for the arrangement. Bank pays, and Airline collects, the 7.5% air transportation excise tax on the Mile Portion only, rather than on the full Composite Rate amount Bank pays Airline per mile. Bank does not pay, and Airline does not collect, the 7.5% air transportation excise tax on the Marketing Portion of the Composite Rate.

Bank pays, and Airline collects, air transportation excise tax when Bank distributes the frequent flyer miles purchased from Airline to its card holders (that is, when the frequent flyer miles are credited to the card holder's frequent flyer account with Airline). Bank does not pay, and Airline does not collect, air transportation excise tax at the time Bank pays an amount to Airline for frequent flyer miles.

The invoices that Airline sends to Bank break out the amount due that is attributable to the mile portion (i.e., Bank's purchase of frequent flyer miles) as a separate line item from the amount due that is attributable to the marketing portion (i.e., Airline's compensation for the co-brand arrangement).

LAW AND ANALYSIS

Issue 1: "Bifurcation"

Section 4261(a) imposes a tax on the amount paid for taxable transportation (as defined by § 4262) of any person by air. "Taxable transportation" generally includes air transportation that begins and ends in the United States.

Section 4261(e)(3)(A) treats any amount paid (and the value of any other benefit provided) to an air carrier for the right to provide mileage awards for (or other reductions

[1] This paragraph is not intended to describe an actual fact pattern or a particular transaction in this case. This description is merely a simplified conceptual illustration of how the bifurcation clause applies to a hypothetical purchase of frequent flyer miles.

in the cost of) any transportation of persons by air as an amount subject to tax imposed by § 4261(a).

Congress enacted § 4261(e)(3) as part of the Taxpayer Relief Act of 1997, P.L. 105-34, to extend the § 4261(a) tax to certain payments to airlines. According to the Conference Report, Report 105-220, at 555-6, those payments include "(1) payments for frequent flier miles (including other rights to air transportation) purchased by credit card companies, telephone companies, rental car companies, television networks, restaurants and hotels, air carriers and related parties, and other businesses, and (2) amounts received by air carriers (and related parties) pursuant to joint venture credit card or other marketing arrangements."

The General Explanation of Tax Legislation Enacted in 1997 (General Explanation), prepared by the Joint Committee on Taxation, JCS-23-97, 230-231, generally repeats the language of the Conference Report but changes the wording to state: "… and (2) amounts received by airlines (whether paid in cash or in kind) pursuant to joint venture credit card or other air transportation marketing arrangements *as compensation for the right to air travel*." (Emphasis added.)

The Conference Report indicates that Congress contemplated arrangements like those at issue in this case and intended that, generally, all amounts paid to airlines under such arrangements would be taxed. However, when read in conjunction with the language of the General Explanation, it appears that Congress did not intend to tax all amounts paid to an airline under such arrangements. Rather, Congress intended to tax only the amounts paid as compensation for the right to air transportation (i.e. amounts paid that would be taxable had the taxpayer purchased an airline ticket rather than frequent flyer miles). Although we recognize that the General Explanation is not authoritative, we believe that it represents persuasive evidence of Congress's intent when it enacted § 4261(e)(3). Further, the General Explanation is consistent with the plain language of § 4261(e)(3)(A), which essentially equates the purchase of frequent flyer miles with the purchase of an airline ticket.

In this case, Bank paid amounts to Airline for intellectual property rights and marketing services provided by Airline. Just as an amount paid by Bank to an independent third-party advertising firm for services related to promoting a credit card would not be subject to air transportation excise tax, the mere fact that Bank purchases those services (along with other rights and licenses) from the same company (Airline) from which it also purchases frequent flyer miles should not change an otherwise nontaxable amount into a taxable amount. Further, it is an important fact that Airline and Bank agreed to use the number of frequent flyer miles purchased by Bank to determine Airline's compensation for the arrangement because it is a convenient measure of the success of the arrangement, rather than directly linked to a payment for taxable air transportation.

Sections 49.4261-2(c), 49.4261-7(i), and 49.4261-8(f) of the Facilities and Services Excise Tax Regulations (regulations) provide generally that if a payment covers charges for nontransportation services, such as charges for meals, hotel accommodations, etc., as well as for transportation of a person, the charges for the nontransportation services may be excluded in computing the tax payable for such payment, provided such charges are separable and are shown in the exact amounts thereof in the records pertaining to the transportation charge. If the charges for nontransportation services are not separable, the tax must be computed upon the full amount of the payment.

In this case, the agreement covers the purchase of both transportation and nontransportation services as contemplated by the regulations. More specifically, the rate per mile under the agreement's bifurcation clause is a composite rate that consists of a mile portion and a marketing portion. While the mile portion of the composite rate is attributable to taxable transportation, the marketing portion is not. Further, the invoices associated with the agreement meet the "shown in the exact amounts" requirement set forth in the regulations. Based on the foregoing, we conclude that in the circumstances described above, Bank and Airline must include in the tax base upon which air transportation excise tax is imposed amounts that represent the mile portion of the composite rate paid by Bank to Airline pursuant to the agreement. However, Bank and Airline may exclude amounts that represent the marketing portion of the composite rate from the air transportation excise tax base.

Section 49.4261-4(a) of the regulations creates a presumption that the air transportation excise tax applies to any amount paid within the United States for the transportation of any person, unless the taxpayer (or collector, in this case) establishes in accordance with the provisions of § 49.4261-4 that at the time of payment the transportation is not transportation in respect of which tax is imposed by § 4261(a). Thus, Bank and Airline bear the burden of demonstrating that the allocation between the mile portion and marketing portion accurately reflects the split between amounts paid for taxable transportation and amounts paid for nontaxable, nontransportation services. If Bank and Airline do not meet this burden, the entire amount that represents the composite rate under the agreement is subject to the air transportation excise tax.

The IRS has not issued regulations that addresses how a taxpayer (or collector) "establishes in accordance with the provisions of § 49.4261-4" that a portion of the amount paid for frequent flyer miles are properly allocable to nontaxable, nontransportation services as described in the facts, above. In this regard, Notice 2002-63, 2002-2 C.B. 644 (relating, in general, to the taxability of amounts paid for frequent flyer miles that may be used for international travel), is instructive. Notice 2002-63 provides that an air carrier that purchases frequent flyer miles from a domestic air carrier may use any reasonable method to allocate amounts paid (and the value of any other benefits provided) between purchased frequent flyer miles that will be awarded in connection with the purchase of taxable transportation and purchased frequent flyer miles that will not be so awarded. The issue addressed in Notice 2002-63 is analogous to the issue we address here because both deal with allocations between taxable and

nontaxable payments with respect to frequent flyer miles. Applied to the instant case and in the absence of any other IRS guidance, we conclude that Bank and Airline may use any reasonable method to allocate a portion of the amount paid for the agreement to nontaxable, nontransportation services (i.e., the marketing portion of the composite rate).

In our view, the determination of whether a particular allocation methodology is reasonable is not a legal issue. Rather, we believe that the IRS examination function is better suited to make this determination based on the facts and circumstances of a particular case. As a result, we express no opinion regarding whether Allocation Methodology, or any of the rates or allocations based thereon, is reasonable or satisfies the requirements of § 49.4261-4.

Issue 2: Tax Collection Timing

In general, a collector must collect air transportation excise tax at the time payment is made for taxable transportation. Section 4261(d) provides that except as provided in § 4263(a), the taxes imposed by § 4261 are paid by the person making the payment subject to the tax.

Section 4263(a) provides that if the payment upon which the § 4261 tax is imposed is made outside the United States, the person furnishing the initial transportation pursuant to such order must collect the amount of the tax.

Section 4263(c) generally provides that where any tax imposed by § 4261 is not paid at the time payment for transportation is made, then, under regulations prescribed by the Secretary, to the extent that such tax is not collected under any other provision of this subchapter such tax shall be paid by the carrier providing the initial segment of such transportation which begins or ends in the United States.

Section 4263(d) provides that the tax imposed by § 4261 shall apply to any amount paid within the United States for transportation of any person by air unless the taxpayer establishes, pursuant to regulations prescribed by the Secretary, at the time of payment for the transportation, that the transportation is not transportation in respect of which tax is imposed by § 4261.

As discussed above, § 49.4261-4(a) provides that the tax imposed by § 4261 applies to any amount paid within the United States for the transportation of any person, unless the taxpayer establishes in accordance with the provisions of § 49.4261-4 that at the time of payment the transportation is not transportation in respect of which tax is imposed by § 4261(a).

In this case, air transportation excise tax attaches when Bank pays an amount to Airline for frequent flyer miles pursuant to the terms of the agreement, not when the frequent flyer miles are credited into (or credited to the benefit of) customer award miles

accounts (and regardless if the frequent flyer miles are ever actually deposited into (or credited to the benefit of) a customer's account). Thus, Airline must collect air transportation excise tax when Bank pays an amount for frequent flyer miles.

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Please call Michael Beker at (202) 317-5258 if you have any further questions.