INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 23, 2004

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CASE-MIS No.: TAM-131992-03, CC:PSI:8

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

Legend:

Taxpayer =

OAs =

Issues

(1) Is Taxpayer's exchange of the right to award mileage with the OAs an amount paid by Taxpayer for air transportation that is subject to tax imposed by § 4261 of the Internal Revenue Code?

(2) Do Taxpayer's reciprocal redemptions of award mileage with the OAs constitute an amount paid by Taxpayer for air transportation that is subject to tax imposed by § 4261?

Conclusions

(1) Taxpayer's exchange of the right to award mileage with the OAs is an amount paid by Taxpayer for air transportation that is not subject to tax imposed by § 4261 when paid to foreign air carriers or to domestic air carriers for mileage awarded in connection with the purchase of taxable transportation, but is subject to tax when paid to domestic air carriers for mileage not awarded in connection with the purchase of taxable transportation.

(2) Taxpayer's reciprocal redemptions of award mileage with the OAs were not an amount paid by Taxpayer for air transportation and, therefore, are not subject to tax imposed by § 4261.

Facts

Taxpayer is a domestic air carrier and the other air carriers (OAs) are domestic or foreign air carriers. All of the air carriers operate frequent flyer programs under which their customers are awarded frequent flyer miles when they purchase and use tickets for air transportation. Those frequent flyer miles can be redeemed for free tickets for air transportation according to rules established by each air carrier.

Taxpayer entered into separate agreements ("Agreements") with each of the OAs to coordinate their frequent flyer programs. These alliance agreements are part of the air carriers' marketing efforts to increase overall air travel. Under the Agreements, members of Taxpayer's frequent flyer program can purchase tickets for flights on the OAs and accrue Taxpayer frequent flyer miles for those flights. In addition, Taxpayer's frequent flyer members can redeem Taxpayer frequent flyer miles for flights on the OAs. Reciprocally, the OAs' frequent flyer members have the same ability to earn and redeem the OAs frequent flyer miles on Taxpayer. During the periods in issue, Taxpayer and the OAs kept account of mileage earnings and redemptions between themselves and expected a relative balance. If an imbalance resulted, some of the Agreements required an imbalance payment by the deficient air carrier. However, no imbalance payments were made during any of the periods in issue.

Law

Section 4261(a) imposes a tax on the amount paid for taxable transportation (as defined in § 4262) of any person by air. Section 4261(b) imposes a tax on the amount paid for each domestic segment (one takeoff and one landing) of taxable transportation by air. For international travel, section 4261(c) imposes a tax on any amount paid for any transportation that begins or ends in the United States of any person by air.

Generally, under § 4261(d), the person paying for the taxable transportation is liable for the tax, and, under § 4291, the person receiving the payment is required to collect the tax.

Section 4262(a)(1) defines the term "taxable transportation" as generally including transportation by air that begins and ends in the United States.

For amounts paid after September 30, 1997, § 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 any transportation of persons by air as an amount paid for taxable transportation that is taxable under § 4261(a).

Notice 2002-63, 2002-2 C.B. 644, provides that until regulations are issued under § 4261(e)(3), the following rules apply to mileage awards:

(1) Amounts paid for mileage awards that cannot be redeemed for taxable transportation beginning and ending in the United States are not subject to tax. For purposes of this rule, mileage awards issued by a foreign air carrier are considered to be usable only on that foreign carrier and thus not redeemable for taxable transportation beginning and ending in the United States. Therefore, amounts paid to a foreign air carrier for mileage awards are not subject to tax.

(2) Amounts paid by an air carrier to a domestic air carrier for mileage awards that can be redeemed for taxable transportation are not subject to the tax to the extent those miles will be awarded in connection with the purchase of taxable transportation.

(3) Amounts paid by an air carrier to a domestic air carrier for mileage awards that can be redeemed for taxable transportation are subject to the tax to the extent those miles will not be awarded in connection with the purchase of taxable transportation.

In Rev. Rul. 84-12, 1984-1 C.B. 211, an airline company instituted a program for frequent travelers entitling them to free round-trip tickets for amassing sufficient mileage. Travelers who enroll in the airline's program prior to a certain date are entitled to a "free" bonus round-trip ticket without prior accrual of mileage. The traveler must then accumulate the requisite amount of mileage by a certain date. If the traveler does not accrue the requisite mileage, the traveler is billed for the bonus ticket. The ruling holds that the tax imposed by § 4261 does not apply in the case of free bonus tickets issued by an air carrier to its customers who have already satisfied all requirements to qualify for the bonus. The Service reasoned that for purposes of the tax, the amount subject to tax is the actual amount paid for air transportation, and where no amount is paid, the tax does not apply.

Rationale

Issue 1

Both Taxpayer and the OAs operate frequent flyer programs under which their members are awarded frequent flyer miles when their members purchase and use air transportation. Pursuant to reciprocal Agreements with the OAs, Taxpayer's members can earn program miles for flights on the OAs, both foreign and domestic. Likewise, the OAs' members can earn program miles for flights on Taxpayer. Taxpayer argues that the air carriers are merely making accounting entries for the mileage involved and no payments are made under the Agreements. Therefore, by Taxpayer's reasoning, because no payment is made the tax under § 4261 does not apply. We disagree.

The Agreements between Taxpayer and the OAs establish arrangements that effectively are exchanges of rights to award one another's mileage. Such exchanges constitute payments in kind. With similar facts, Rev. Rul. 2002-60, 2002-2 C.B. 641, concludes the same when a domestic air carrier sells rights to provide mileage awards to a foreign air carrier. In the ruling, the foreign air carrier provides the domestic air carrier with mileage awards for transportation on the foreign air carrier's flights rather than pay for the miles with money. The ruling reasons that the foreign air carrier's transfer of mileage awards to the domestic air carrier is a payment in kind for the right to award miles. According to the ruling, the payment in kind does not affect the tax consequences. In this case, each air carrier is effectively granted the right to award the other air carrier's mileage. Therefore, Taxpayer's exchange of its mileage awards for mileage awards of the OAs constitutes payments by Taxpayer for the right to award mileage of the OAs.

Whether Taxpayer's payments are subject to tax under § 4261(a) depends on whether or not the awarded mileage can be redeemed for taxable transportation. Notice 2002-63. Relative to foreign air carriers, Rule (1) of Notice 2002-63 provides that for purposes of the rule, mileage awards issued by a foreign air carrier are considered usable only on that foreign air carrier and thus not redeemable for taxable transportation. Therefore, amounts paid to a foreign air carrier for mileage awards are not redeemable for taxable transportation. In the case of domestic air carriers, mileage awards that can be redeemed for taxable transportation are not subject to the tax under Rule (2) of the notice to the extent they will be awarded in connection with the purchase of taxable transportation, and are subject to tax under Rule (3) to the extent they will not be awarded in connection with the purchase of taxable transportation.

In this case, some of the OAs from whom Taxpayer purchases mileage are foreign air carriers and some are domestic air carriers. In the case of foreign air carriers, because the mileage awards are issued by a foreign air carrier, the miles are

considered usable only on that foreign air carrier and, thus, not redeemable for taxable transportation. Thus, under Rule (1) of Notice 2002-63, the amounts Taxpayer paid to foreign air carriers for mileage awards are not subject to tax. In the case of domestic air carriers, some mileage awards, redeemable for taxable transportation, were awarded in connection with the purchase of taxable transportation and some were not. Under Rule (2) of Notice 2002-63, the amounts Taxpayer paid to domestic air carriers for mileage awards that were awarded in connection with the purchase of taxable transportation are not subject to tax under § 4261. Conversely, under Rule (3) of Notice 2002-63, the amounts Taxpayer paid to domestic air carriers for mileage awards that were not awarded in connection with the purchase of taxable transportation are subject to tax under § 4261.

Issue 2

Taxpayer entered into the alliance agreements with the OAs in order to coordinate their frequent flyer programs. The coordinated programs are part of the air carriers' marketing efforts to increase their overall air travel. The air carriers entered into the alliances by, in part, agreeing to the exchange of redemption obligations. That is, Taxpayer's mileage awards are redeemable for air transportation on the OAs, while the OA's mileage awards are redeemable for air transportation on Taxpayer. The exchange of redemption obligations does not constitute payments for air transportation because such exchanges do not entitle anyone to air transportation. Under the Agreements, only the actual redemption of award mileage by a passenger (a nontaxable event under Rev. Rul. 84-12) entitles a person to air transportation. Therefore, because Taxpayer's payments were not an amount paid for taxable transportation, Taxpayer's reciprocal redemptions with the OAs are not subject to the tax imposed by § 4261.

Caveats

Temporary or final regulations pertaining to the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusions in the memorandum. See § 15.04 of Rev. Proc. 2004-2, 2004-1 I.R.B. 83, 108. However, a technical advice memorandum that modifies or revokes a letter ruling or another technical advice memorandum generally is not applied retroactively if the taxpayer can demonstrate that the criteria in § 15.06 of Rev. Proc. 2004-2 are satisfied.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent. Under § 6110(c), names, addresses, and identifying numbers have been deleted.