

Using a Lease Back Strategy When Purchasing Mobile Transportation Equipment Can Save Thousands of Dollars in Taxes

by Thomas Alston

Regulation 1661 sets out the guideline for paying sales or use tax based on fair rental value. If the aircraft is going to be owned for a period of time that results in a usage rate that is calculated to create less tax than the original purchase price, this clearly is a legal, viable option for mitigating sales tax.

Most of the failed attempts at using a lease back arrangement are because the taxpayer didn't understand the nuances of how the tax agency interprets the law. Although some agencies publish Regulations which are their interpretations of the law, it is nearly impossible for a novice to steer his own ship through the maze of sales tax laws and regulations without years of research into the underlying documents of each case. The information that is buried in the annotations, case histories, and internal memos can take years to read through and understand. It takes a clear understanding of these documents in order to be certain of using any exemption strategy.

Basically, the issue of leasing aircraft that may be used inside California has many pitfalls. The primary danger is that leases of tangible personal property in California are regulated very similarly to the leasing rules in most other states where a sales tax is due on the monthly payment amount. This type of lease is covered in Regulation 1660.

However, in California, aircraft and certain types of vessels and vehicles are not classified as tangible personal property. Under Regulation 1661 they are classified as "mobile transportation equipment" (MTE). Leases of MTE are not considered a continuing sale and the tax is a use tax on the lessor, not a sales tax. In simple terms, you must throw most of what you know about sales and use tax on leases out the window. The ground rules pertaining to the language on the invoices and the defaults are reversed if a proper election is not made.

However, there is a great deal of good news hidden in all these methods of avoiding or mitigating the use tax on an aircraft. By using proper planning, a lessor can exempt an aircraft by using one of the many exemption strategies and no tax is ever owed on the fair rental value payments. The same can not be accomplished with a lease of tangible personal property. In fact, if a lessor is not sure if his aircraft will qualify for an exemption, he can start the lease by properly reporting and paying tax based on fair rental value while he is leasing the aircraft in its first several months of ownership. Once it is determined that the aircraft has supported a claim for an exemption and no tax is due on the purchase cost, the lessor may file a claim for refund and get all the previously paid tax on fair rental value refunded.

The use of a lease back arrangement is an excellent way to mitigate the use tax on a purchase of MTE without suffering the inconvenience of actual out of state use or the tedious record keeping required by the attempt to support an exemption based on using an aircraft in "common carriage," or a vessel in commercial fishing.

For the purpose of this strategy, if you are purchasing an aircraft, the first thing you should do is create a corporation or limited liability company whose sole purpose is to be in the business of leasing aircraft. The

creation of the corporation also creates a separate entity that is necessary for there to be an arm's length relationship so that a lease can take place.

Once you have established your new leasing company - "XYZ Leasing" - and obtained the proper sales tax exemption certificate, you can purchase MTE without paying the tax. Once you have made the purchase you can enter into a lease agreement between a lessee and XYZ Leasing. For example, XYZ Leasing acquires MTE for a price of \$500,000.00. XYZ Leasing has to pay \$40,000.00 (presuming an 8% tax rate) in sales tax at the time of the purchase, or, give a resale certificate to the seller and purchase it exempt from tax. If the leasing company purchases the aircraft without paying tax by providing an exemption certificate to the seller, it must make a "timely election" to the Board that it will remit the tax based on the fair rental value. In the absence of making the timely election the tax is due immediately on the entire purchase price.

California Sales and Use Tax Regulation 1661 provides very precise wording that defines the steps that must be completed in order to use this method of remitting use tax to the Board of Equalization. In lay terms, it gives you an option of paying the tax over the life of the asset based upon the fair rental value. You can establish fair rental value by finding out what several rental operations charge for a "dry" rental rate for a similar aircraft. At a minimum, most tax agencies will require the amount to at least cover the actual costs of the aircraft.

If a lease back option is not elected in a timely manner, the tax is due on the sales price. Many taxpayers interpret the "timely election" section as describing the situation to be one where the tax on the fair rental value is not due until the leasing company begins to collect rents on the use of the aircraft. This is a common pitfall that invalidates their exemption.

In an actual case in California, a leasing corporation purchased an aircraft in June of 1990 and issued a resale certificate and signed a leasing Company Exemption Certificate which accepted delivery of the aircraft from the seller and stated that the equipment was purchased for the purpose of leasing. It immediately entered into a lease with a lessee effective June 1 of 1990 and established a flat rental rate per month.

The leasing corporation then filed monthly sales tax returns for June and July which reported zero rental receipts. Their records show that it first posted rental receipts on August 31, 1990. The first period that rental receipts were reported to the Board was for the August 1990 monthly period.

The audit staff determined that the reporting of rental receipts on the August 1990 return was not timely and assessed tax on the purchase price of the aircraft. The Board contended that the leasing company had use and possession of the aircraft from May of 1990. Repair orders dated May, June, and July of 1990 showed that the aircraft was being used in those months, even though only repairs were being made on the aircraft.

The key word that was missed by the taxpayer is in the first sentence of Regulation 1661 (b) (2). The word is "limited." Although it is easy to bypass the word when the sentence is being read, the word "limited" impacts the meaning to the degree that it alters the understanding by the reader which causes the reader to misapply the law. The definition of "limited" that should be applied in this case is "confined or restricted within certain limits."

When the Board reads the word limited, it appears that they interpret it to mean that every hour the aircraft is used, tax on the fair rental value is owed. It makes it clear that even if the lessor has a signed lease it must report and pay the tax for each hour of usage even though no receipts were generated. The rate must be at "fair rental value."

Fair rental value means the money required by the lease, except where the Board determines the receipts are nominal. There are no regulations that require a specific kind of usage by the lessee. Therefore, the lessee's type of usage is not limited to business use. The only requirements are that all the guidelines are clearly met to the Board's satisfaction.

Additionally, there are no exclusions for any usage that must be paid for, including out-of-state usage. It isn't

like a sales tax transaction where the tax is not due because the sale occurred out-of-state. The lessor is the consumer of the aircraft by definition. The tax is on the lessor for all usage. The application of tax to sales and leases of aircraft is never a "sale" or "purchase." (Rev. & Tax. Code 6006(g) (4) and 6010 (e) (4).) Thus, a sale of aircraft which the purchaser subsequently leases is not a sale for resale; which means the purchasers, owners and users of the aircraft are liable for the use tax. The lessee has no California sales or use tax liability as a result of any lease from the lessor or use of the aircraft pursuant to any such lease. It is irrelevant even if the lease is signed in or out-of-state.

Another area of the regulation that is easily misunderstood is, once the lessor has made his timely election to pay the tax based on fair rental value the tax must be paid on the rental as long as the lessor owns the aircraft. This is a situation where the amount of time that a lessor intends to own the equipment can dramatically affect whether using the exemption granted under regulation 1661 is cost effective. An accurate analysis of the expected hours of usage over the life of the ownership can create a situation where significantly more tax is paid measured by fair rental value than if it had been paid on cost at the time of the purchase.

For example, if MTE was purchased for \$500,000.00 and the option was exercised to pay on the fair rental value, the purchaser must have a good understanding of the expected usage and the ownership life of the aircraft, otherwise, the taxpayer may wind up paying a lot more tax than would have been originally due. Using a "dry" fair rental value of \$500.00 per hour, the example table will show you when the fair rental method becomes more expensive than remitting the tax at the time of the transaction.

Dry rate per hour	Monthly hours of usage	Total monthly usage	Tax due monthly	Months required to equal \$40000
500	50	\$25,000	\$2,000	20
500	40	\$20,000	\$1,600	25
500	30	\$12,500	\$1,000	33
500	20	\$10,000	\$800	50
500	10	\$5,000	\$400	100

For example, let's say you plan on using the MTE 50 hours a month and then selling it in two years. You would have to pay \$48,000.00, an additional \$8,000.00 (\$2,000.00 x 4 more months). It would be wiser to pay the entire tax at the beginning than on a monthly basis.

On the other hand, let's say you plan on using the MTE 10 hours a month and then selling it in two years. You would only have to pay \$9,600.00 (\$400.00 x 24months). Therefore it is better to pay monthly.

IMPORATANT NOTES

- This relates to California only and not any other state's treatment of sales and use taxes on leases
- Risk of Taxable Use by Lessor prior to the lease.

"For federal income tax purposes leasing is per se a "passive activity". You would need to confirm with your federal and state income tax advisors whether or not this (or any other limitation, such as AMT) would affect XYZ's ability to make use of any losses created under the structure - especially the tax losses created if you elect an accelerated depreciation schedule."

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