

TAX MATTERS

A newsletter dedicated to informing California Aircraft and Vessel owners about taxes

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The Complete Story

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In the everyday world of aircraft and yacht ownership, the following story is played out from coast to coast. The whispers in the crowds of prospective owners often are based on the age-old question, "Is it really possible to legally avoid sales tax, or am I risking embarrassment if I get caught trying?" The stress often crashes into the life of the financial personnel to find workable solutions after the client takes the survey of his friends on the golf course.

The CPA cringes while he is instructed by his client to make the new deal work by tomorrow morning, and "Oh, by the way, I don't want to waste a nickel on tax." He inherently knows that no matter how careful he is to explain every minute detail of the strategy to Mr. Big, it is ultimately the owner who will demand that he be able to use his new toy wherever and however he wants. He will end the meeting by commanding the CPA to, "Make it work out, I'm sure you can find a way."

Many buyers listen to the free advice that comes once they first enter the sales cycle. The sales person who generally works with the belt and suspenders clients often take the most conservative approach and advise against "risky tax schemes." The wheeler-dealer salesperson blabs on about the latest trick and pats the back of his new client while he croons, "Trust me, it is easy to get out of the tax."

Neither approach will serve the new owner very well. The basic problem is that, unlike federal tax advice which is based on a code that applies everywhere in the United States, sales tax laws depend on the codes written in each separate state. Currently, five states have no sales and use tax. However, that leaves forty-five others that will require proper research. Unless you have nothing to do but spend your entire life doing sales and use tax research, it is impossible to keep track of the constant changes state-by-state. The

basic problem with implementing a credible tax strategy for an aircraft or yacht purchase is that the buyer must mesh the details of a strategy that reduces the income tax obligation, minimizes the capital gains tax, reduces property tax and quite possibly eliminates the sales/use tax.

When you add "like kind" forward or reverse exchanges and fractional share ownerships into the components of an aircraft strategy, you then must consider how each piece of ownership or each transaction caused by the exchange through an intermediary may create a potential sales or use tax assessment.

With proper planning and research you can assist your client to legally avoid sales/use tax on the purchase of an aircraft or vessel. However, it depends on how much the purchaser values the money saved, versus, the effort required to go through the legal hoops to avoid the tax. If your client is an aircraft or yacht dealer, you can also help the business to bulletproof their records from an audit by the Board of Equalization. An effective strategy should include components that protect both the buyer and the seller.

Sales tax research must contain a foundation of a basic understanding of the law that will apply in all cases, they must be targeted to focus in on the exact needs of the client. Once the foundation is established, the client can then do a risk analysis of the available options. In all cases the burden of proof rests with the taxpayer.

In order to support a claim for an exemption two basic things are required. It is essential that both the form and the substance of the transaction are met. It is not sufficient enough to actually do all the things the local law requires to exempt the transaction. It is equally vital that the taxpayer can adequately document the actual possession, storage and use of the property. For example, a taxpayer could read the laws in California that pertain to a purchase for out-of-state use. He subsequently actually does all the things that are required, including out-of-state possession, and using and storing the aircraft or yacht outside California enough time to meet the requirements of

California Sales and Use Tax Regulation 1620 (b) (3). The transaction can still be held taxable if the acceptable forms and documents which support the actual use of the property are not provided to the tax agency. The fact that in many cases the state does not question the transaction until after the aircraft or vessel is sold to another party makes it very difficult to gather the logs and receipts.

Some of the various types of exemptions that are available to the CPA's clients are:

1. Common carrier (Aircraft only)
2. Interstate commerce
3. Purchased for out-of-state use
4. Purchase for resale
5. Occasional sale
6. Out-of state-buyer
7. Lease
8. Facts or circumstances defined in law which allows the purchase to fall outside the definition of sale or purchase for sales and use tax purposes.

Even though each state may have sections which relate to each of the above, you cannot presume that the details of the exemption are the same from state to state. For example, the language in certain sections of law in Nevada are exactly the same words used in California Sales and Use Tax. However, Nevada and California interpret the same language differently. You must research the cases to decipher each states pattern of decision making.

The important details actually depend on how the requirement by each state will impact the needs of the purchaser. Some questions that need to be asked of the clients so that the CPA can assist them to differentiate between the possible exemptions are:

1. Common Carrier (Aircraft only)
Do you really want strangers flying in your new aircraft? Exclusive use may void this exemption.
Are you contemplating a lease arrangement with a charter, or are you planning to acquire your own FAA certificate?
Are you aware that the documentation requirements and the term of the test period may be significantly greater than most other exemptions?
2. Interstate Commerce
Do you know how your specific state defines "interstate commerce?"
How do you calculate intrastate flights using this test?
Where must possession occur?
How are first use, first functional use, and operational

use defined?

What are the procedural requirements of the test?

3. Purchased for out-of state-use
Where must possession or title occur?
How is first functional use defined?
How long is the test period?
What are the procedural requirements of the test?
How does the aircraft owner document periods of time when the aircraft is not in flight or the vessel is moored?
What circumstances shorten the test period?
How does storage for shipment affect the exemption?

4. Purchase for resale
Can a purchaser of a single item claim this exemption or must the owner be a registered dealer?
Can any use, other than bonafide demonstration and display be made?
What are the documentation requirements to support demonstration use?
How much use is too much to claim a resale exemption?
Can a charge be levied for a demonstration flight of an aircraft?
How does personal use affect the exemption?

5. Occasional use
Is this exemption available in the state the purchaser intends to claim this exemption?
What characteristics must the seller avoid, in order for the sale to qualify as an occasional sale?

6. Out-of-state buyer
Can an out-of-state buyer avoid sales tax on an aircraft or vessel? If so, what are the requirements?
How long can an aircraft remain in state after the purchase before the transaction becomes taxable?
What if repairs or training are required?

7. Lease
Is it a lease to a common carrier?
Is it a lease to a flight school?
Is it a lease to a private party?
Is it a lease to a contract carrier?
How is the tax reported?
How does the purchaser insure that he can purchase the property ex-tax and pay based on the lease?
Is the tax assessed on the lessor or the lessee?

Based on my research, the types of failures that are inherent by using the possible exemptions are:

- A. Common carrier (Aircraft only)
Many people believe that merely flying the aircraft in Part 135 qualifies for an exemption.

When the owner is in control of the aircraft, he may be causing a failure of the exemption by flying in Part 91. When the owner leases an aircraft to a charter, he puts the control of the documents needed to support the exemption in the hands of another party. Insufficient revenues may void the exemption. All Part 135 flights do not qualify as common carrier flights.

B. Interstate commerce

Failure to keep exact logs.

Failure to document commerce flights.

Is the test accomplished by miles, hours or days?

C. Purchased for out-of-state use

Failure to properly document location of the aircraft or yacht when title or possession is transferred

Failure to keep proper logs

Failure to document storage location and time

Inconsistencies in documentation

Failure to support intent

Registering an aircraft or yacht in Oregon, Nevada or to a Delaware corporation as part of a strategy to avoid tax, can incur a fraud penalty for evasion.

D. Purchase for resale

Making improper use of inventory

Charging for use

Personal use

Documenting demonstration and display

E. Occasional sale

This exemption is not available in all states.

Failing to support the status of the seller

Transferring debt between entities along with the aircraft or vessel

F. Out-of-state buyer

Failure to prove the legal status of the out-of-state resident

In state residency for the purpose of sales tax can require as little as a checking or savings account.

G. Lease

Failure to properly notify the state to be able to purchase ex-tax

Failure to understand against whom the tax is levied and how it impacts the client

Failure to understand whether it is a sales tax or use tax

When a purchase is of a fractional share of an aircraft, it becomes almost impossible to use certain exemptions because of the needs of the other owners.

A winning strategy can be implemented, but it requires the compliance of the fractional partnership.

If an aircraft strategy includes a 1031 like kind exchange, each possible exemption needs to be evaluated versus the four transactions required to complete each exchange. Each of the four transactions has its own tax exposure. When a reverse exchange is used, five transactions are created that need to be evaluated. A further complication is that some states will consider the qualified intermediary as a retailer of aircraft because it is engaged in the business of selling aircraft. It is fatal to forget that IRS rulings have no bearing on how each state views each transaction.

Armed with an understanding of the sales and use tax laws, it is possible to create a strategy that legally avoids the sales and use tax. Acquiring sales tax advice from anyone, other than a sales tax expert is in most cases, a waste of time and money. This area of tax law is too complex, the targets are constantly changing, and the potential tax assessment is very costly. Especially when you add the additional interest and penalties that can range from as little as ten percent for failure to file, up to a fifty percent penalty for registering an aircraft out-of-state in an attempt to evade tax.