

TAX MATTERS

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

Prepared and distributed by Aero & Marine Tax Professionals

Transfer of Tangible Personal Property - Regulation 1595

When contemplating the purchase of an aircraft, a potential owner must consider the ownership structure that will best suit their needs. Often times, only after the aircraft is purchased, the owner realizes they do not own the aircraft in the entity that is most beneficial for tax purposes or in a way that limits their liability in the event of an accident. By transferring ownership of an aircraft from one entity to another, an owner can create additional sales/use tax liability.

The question then arises, "If I transfer my aircraft or vessel into a newly formed LLC, corporation or partnership, can I legally avoid the additional tax liability?" The answer is, "It depends." Ask yourself the following questions:

1. Will the new entity (whether it is a Corporation, LLC or Partnership) be more than 80% owned by the same person(s) from whom the tangible personal property is being transferred from? If you answered "Yes", then it can be a nontaxable transaction.
2. Will the transfer be more than 80% of the assets into the new entity? If you answered "Yes", then it can be a nontaxable transaction.
3. Is there debt on the aircraft? If you answered "Yes", then it can be a taxable transaction.
4. Is the consideration or "trade" for the aircraft only interest in the commencing LLC and partnership or first issue stock in the commencing corporation? If you answered "Yes", then it can be a nontaxable transaction.

Many people consider transferring their aircraft or vessel for personal liability purposes. If they believe that the transfer will create a taxable transaction, they have to decide whether to pay the tax or take a risk of liability in the event of an accident. There is a solution to that dilemma. By supporting a claim for exemption, the tax will be legally avoided and personal liability will be protected by the transfer.

There are different types of transfers of ownerships. They are:

1. Into (a) and Out of (b) corporations, LLC and partnerships
2. Into Revocable Trusts
3. Involuntary transfers
4. Statutory mergers
5. Family transfers
6. Received as a gift

1a. TRANSFER INTO A CORPORATION, LIMITED LIABILITY COMPANY (LLC), PARTNERSHIP AND JOINT VENTURE

The transfer of tangible personal property to a commencing corporation, commencing limited liability company, commencing partnership, or commencing joint venture in exchange solely for first issue stock of the commencing corporation or an interest in the commencing limited liability company, partnership, or joint venture is not a sale since the interest received by the transferor is not regarded as having measurable value at the time of the transfer. The transferor is the consumer of such property. However, such a transfer is a sale if the transferor receives any consideration, such as cash, notes, or an assumption of indebtedness (whether or not the transferor retains any joint liability with respect to the indebtedness assumed by the transferee), and tax applies to that sale unless it otherwise qualifies for exemption. For purposes of determining the measure of tax from the sale, it is irrelevant that any of the transferor's indebtedness assumed by the transferee may have arisen solely in connection with the transferor's acquisition of the tangible personal property transferred, the other property transferred, or some combination thereof. The gross receipts from that sale is allocated among the taxable portion and the

nontaxable portion by dividing the selling price of the tangible personal property transferred to the purchaser for use rather than for resale by the selling price of all property transferred and then multiplying that amount by the total gross receipts (i.e., all consideration) received by the transferor.

TRANSFERS OF SUBSTANTIALLY ALL PROPERTY WITHOUT SUBSTANTIAL CHANGE IN OWNERSHIP. Tax does not apply to a transfer of all or substantially all the property held or used by a person in the course of activities for which the person is required to hold a seller's permit or permits or would be required to hold a seller's permit or permits if the activities were conducted in this state, provided that after the transfer the real or ultimate ownership of the property is substantially similar to that which existed before such transfer. "Substantially all the property" means 80 percent or more of all the tangible personal property held or used by the person in the course of activities requiring the holding of a seller's permit, including tangible personal property located outside of this state. If a person engages in two or more separate selling activities, for each of which the person is required to hold a seller's permit or would be required to hold a seller's permit if the activity were conducted in this state, a transfer of 80 percent or more of the tangible personal property held or used in the combined activities must be made in order to qualify for the exemption described in this paragraph. If a person simultaneously transfers all or substantially all of its assets to more than one entity, the transfer will qualify for the exemption if the ownership remains substantially similar. Stockholders, bondholders, partners, or other persons holding an ownership interest rather than a security interest in the corporation or other entity are regarded as having the real or ultimate ownership of the property of the corporation or other entity.

1b. TRANSFERS DUE TO DISSOLUTION OF A CORPORATION, LLC OR PARTNERSHIP

A distribution of assets, including tangible personal property, by a corporation upon its dissolution to its stockholders in accordance with their ownership interests is a liquidating dividend and is not a sale when no consideration is received by the corporation other than the stockholders' return of stock certificates for purposes of cancellation. The corporation is the consumer of such property and no tax applies with respect to the transfer provided the corporation's use of the property in California would not otherwise be subject to tax. If consideration is given or received for the transfer, such as an assumption of liabilities by the stockholders, tax applies measured by that consideration.

A distribution of assets, including tangible personal property, by a limited liability company upon its dissolution to its members (i.e., persons holding membership interests and persons holding economic interests) in accordance with their ownership interests is a liquidating dividend and is not a sale when no consideration is received by the limited liability company other than cancellation of the members' interests. The limited liability company is the consumer of such property and no tax applies with respect to the transfer provided the limited liability company's use of the property in California would not otherwise be subject to tax. If consideration is given or received for the transfer, such as an assumption of liabilities by the members, tax applies measured by that consideration.

In a typical commercial transaction when a partner "sells the person's interest in a partnership" to another, it is intended that the person "selling the interest" will withdraw from the partnership and the person "purchasing the interest" will be admitted to the partnership. The legal effect of this transaction is to dissolve the first partnership and to create a new partnership, in the absence of a provision in the agreement providing for continued life of the partnership. The effect for sales and use tax purposes is that there is a dissolution of the partnership, a distribution of the assets on a pro rata basis, and a sale by the withdrawing partner of the person's ownership interest in the tangible personal property distributed to that person. Except as provided in subdivision (c), this sale of tangible personal property will qualify as an occasional sale under Revenue and Taxation Code Section 6006.5 and will be nontaxable under Section 6367, unless the withdrawing partner holds a seller's permit or the sale of tangible personal property is one of a series of sales sufficient in number, scope, and character to require the holding of a seller's permit.

2. TRANSFER INTO REVOCABLE TRUST

A transfer of property into a revocable trust is exempt from tax provided the only consideration given, if any, is the assumption of the loan and sole collateral is property being transferred in exchange for the property and 1.the

seller has unrestricted power to revoke the trust; 2.the transfer does not result in any change in the beneficial ownership of the property; 3.upon revocation of the trust the property reverts back to the beneficial seller.

3. INVOLUNTARY TRANSFERS

Use tax normally does not apply if title to the property changes due to circumstances beyond the recipient's control. Some examples are repossession by a legal owner, inheritance from a decedent's estate, recovery of stolen property after settlement from an insurance company, and court settlements such as divorce decrees. Confirming documentation is required, depending on the nature of the transaction.

4. STATUTORY MERGER

A transfer pursuant to a statutory merger is not a sale but is instead a transfer by operation of law. Thus, tax does not apply to a transfer of property of a constituent corporation to a surviving corporation or new corporation pursuant to a statutory merger under Sections 6010-6022, 1100-1305, or 15678.1-15678.9 of the California Corporations Code or similar laws of this state or other states. The surviving corporation stands in the place of each constituent corporation (including the disappearing corporation(s)). As a result, if property acquired by the surviving corporation in the merger had been purchased and held by the constituent corporation for resale, then the surviving corporation must report and pay use tax on the constituent corporation's purchase price if it makes any use of such resale property, just as the constituent corporation would have owed such tax if it had used the property. Similarly, if the constituent corporation had avoided paying tax measured by the purchase price of mobile transportation equipment by making a timely election to report tax on the fair rental value, the surviving corporation must continue to report tax measured by the fair rental value on its leases of the mobile transportation equipment; if the surviving corporation makes any use of that mobile transportation equipment other than leasing it to another person, the surviving corporation must report tax on the purchase price paid by the constituent corporation.

5. TRANSFER OF OWNERSHIP TO A FAMILY MEMBER

The Sales and Use Tax Law provides an exemption from the use tax when the person selling a vehicle, vessel, or aircraft is related to the purchaser as either: parent, grandparent, grandchild, child, spouse, brother or sister, if both are under age of 18 and related by blood or adoption.

This exemption does not apply if the seller is engaged in the business of selling similar property (for example, a car or boat dealer.) Additionally, the exemption does not extend to sales to stepparents or stepchildren if a natural parent or child is not involved in the sale nor does it apply to transactions between ex-spouses after a decree of divorce.

To qualify for the exemption, the relationship between buyer and seller must be verified by marriage license, birth or adoption certificate, or any other documentation that is official or verifiable and confirms the qualifying relationship.

6. RECEIVED AS GIFT

Changing the ownership of a vehicle, vessel, or aircraft does not cause a taxable sale or purchase if there is no consideration given to obtain the property. Consideration can take many forms such as cash, a loan, a trade, or assumption or cancellation of a debt. In order to qualify under this provision, it must be established that the property was transferred from the donor to the recipient with no requirement on the recipient's part to compensate the donor in any way. A signed, notarized statement from the donor is usually required. Please note: The donor must have the legal authority to transfer the vehicle, vessel or aircraft.

Consider carefully at the beginning of your purchase, that the entity you register your aircraft or vessel to is the one that you want in order to prevent trading a sales tax liability for protection of your personal assets with a transfer down the road. There are three tests that will allow you to support a claim for exemption. They are the principal use, commercial interstate hours and common carrier tests. Call us to find out which test best suits your use on the purchase of your next aircraft. (916-691-9192 • E-Mail: talston@aeromarinetaxpros.com)