

# TAX MATTERS

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

*Prepared and distributed by Aero & Marine Tax Professionals*

## The Truth About Using a Common Carrier Exemption.

Often people ask my opinion of the various exemptions that can be used to exempt an aircraft from California sales and use tax. I have a canned response that runs them briefly through the available methods. Many times they question why we don't propose using the "Common Carrier" or "Part 135" exemption as it is often referred to in the industry.

If they insist I explain it to them, I start by asking some simple questions:

1. Do you intend to place your aircraft on charter because you want to generate some revenue to offset your costs?
2. Do you think this exemption is a viable method of legally avoiding California sales and use tax?

If they answer yes to either question I attempt to clarify their interest even further.

3. Are you sure that you want someone else in control of your aircraft?
4. Are you sure that you want strangers in your "new" (to you) aircraft?

Once they convince me that they intend to use the common carrier exemption they get "the speech".

California Sales and Use Tax Regulation 1593 is the regulation that details what is required to support this type of claim for an exemption. This is the longest test period of all the possible exemptions. Where Regulation 1620 uses 90 day and six month tests, 1593 requires twelve months.

Unless the aircraft owner is also in possession of a common carrier certificate which is covered under California Sales and Use Tax Law Section 6366, he must enter into a lease with a organization that has a certificate. This lease is covered under section 6366.1. This is where the use of this exemption gets very tricky.

The California Sales and Use Tax Regulation covering this area is explained below. Regulation 1593 exempts from tax aircraft used in this state as a common carrier. The pertinent parts of the regulation are as follows:

"(a) DEFINITIONS.

(2) "COMMON CARRIER." As used herein, the term "common carrier" means any person who engages in the business of transporting persons or property for hire or compensation and who offers his or her services indiscriminately to the public or to some portion of the public.

(b) APPLICATION OF TAX.

(1) AIRCRAFT. Tax does not apply to the sale of and the storage, use, or other consumption of aircraft sold, leased, or sold to persons for the purpose of leasing, to: (A) a person who operates the aircraft as a common carrier of persons or property, provided:

1. the person operates the aircraft under authority of the laws of this state, of the United States, or of any foreign government, and
2. the person's use of the aircraft as a common carrier is authorized or permitted by the person's governmental authority to operate the aircraft;"

(c) USE OF AIRCRAFT.

(1) COMMON CARRIERS. In determining whether a purchaser or lessee of an aircraft is using that aircraft as a common carrier of persons or property, only that use of the aircraft by the carrier during the first 12 consecutive months commencing with the first operational use of the aircraft will be considered. This test period does not include, and is extended by, the amount of time, prior to the first use of the aircraft as a common carrier, during which the aircraft is in the physical possession of a repair station certified by the FAA or a manufacturer's maintenance facility undergoing modification, repair, or replacement. The period of this extension/exclusion shall not exceed 12 months. If the purchaser does not own the aircraft for 12 consecutive months commencing with the first operational use, as may be extended as provided herein, then only the period of time commencing with the first operational use that the purchaser owns the aircraft will be considered.

(A) "Operational use" means the actual time during which the aircraft is operated in powered navigation in the air. Operational use includes positioning or repositioning aircraft by flying the aircraft from one point to another ("ferry flights") except when such flights are solely for purposes of having the aircraft repaired. Ferry flights solely for the purpose of transporting the aircraft to a repair location, or solely to return from a repair location, are not operational use, nor are test flights as described in subdivision (d)(2) or personnel training as described in subdivision (d)(4).

(B) If the aircraft is used as a common carrier for more than one-half of the operational use during the test period the carrier's principal use of the aircraft will be deemed to be that of a common carrier except as provided in subdivisions (c)(1)(D) and (c)(1)(E). Each flight of the aircraft is examined separately for purposes of determining common carrier use. For these purposes, a flight is the powered navigation of the aircraft from one location on the ground or water to the first point on the ground or water at which the aircraft lands.

(C) A flight qualifies as a common carrier use of the aircraft for purposes of the exemption only if the flight is authorized or permitted by the governmental authority under which the aircraft is operated and involves the transportation of persons or property. Where the aircraft does not itself transport the person or property to a location on the ground (or water), the flight does not qualify as a common carrier flight for purposes of the exemption.

For example, John Q. Taxpayer purchases a used King Air in the State of Texas for \$2,000,000.00 and owns the aircraft in a Delaware corporation known as King Aircraft Leasing (KAL). KAL contracts with Western Charter Group (WCG), an organization at Van Nuys Airport with a legitimate Part 135 Carrier certificate to have operational control over KAL's new aircraft.

As of this moment, the insurance for the aircraft and the FAA maintenance requirements just accelerated the cost of operating the aircraft. Unless KAL did an economic analysis of this type of use, it may discover that the additional operating costs may outweigh the tax savings.

KAL operates within its understanding of Regulation 1593 and the scope of the lease agreement with WCG for one year (the test period), then KAL decides to remove the aircraft from Part 135 use and merely use the aircraft for its personal business use. In year three KAL is contacted by the Board of Equalization (Board) and a review of KAL's exempt status is scheduled.

The Board sends a list to KAL and requests the following documents:

## **COMMON CARRIER EXEMPTION CLAIM DOCUMENTATION REQUIRED FOR REVIEW**

1. In order to qualify as a common carrier, the air carrier certificate must be in the name of the common carrier.

2. A certificate holder under this part may not operate an aircraft under part 121 and part 135 of this chapter using a name different than the business name appearing in the certificate holder's provisions of its operations specifications.

3. Aircraft Owner must obtain "operations specifications" that prescribe the authorizations, limitations, and procedures under which each kind of operation must be conducted.

A. Type of aircraft, registration numbers or markings and serial numbers of each aircraft authorized for use must be listed.

1. Copy of the operator's (Aircraft Owner) Federal Aviation Administration (FAA) Part 135 air carrier certificate.

2. FAA registration documents identifying when the aircraft was added to Aircraft Owner fleet.

3. A list of the operators certified pilots.

4. Evidence of insurance coverage (a complete copy of the policy) for common carrier.

5. A complete copy of the aircraft flight logs during the first twelve months of operational use. (Please note: copies of actual flight logs are required. Computer print-outs are not acceptable.)

6. A summary which describes each flight during the first twelve months of operation.

7. Aircraft log books and receipts which support all non common carriage use (i.e. personal use).

8. Aircraft log books, passenger briefing cards, FAA flight plans, trip logs, weight and moment sheets and other related evidence which supports common carrier flights and revenue.

9. Copies of operator's customer revenue billings showing the amount charged on all charter flights, Federal Excise tax returns and customer contracts. Each flight which is claimed to be charter during the first twelve months of operational use must be supported by a corresponding invoice.

10. A complete copy of the aircraft or engine maintenance logs showing total engine hours recorded since the date of purchase.

11. A complete copy of the sales contract which verifies the purchase price, date and location of the delivery of the aircraft.

12. A complete copy of the lease agreement, if the aircraft was leased, to the actual operator.

13. A copy of all lease payment invoices made to lessor (owner) by the lessee (operator).

14. Copy of evidence establishing the pilot was an employee of the common carrier and listed as same in the provisions of the operational specifications .

15. FAA airman competency/proficiency check Federal Aviation Regulation 135 forms for all pilots flying this plane.

16. Copies of flight crew logs.

17. Copies of aircraft logs showing pilot training time, test flights, and maintenance ferry flights.

18. Each certificate holder shall prepare and keep current a manual setting forth the certificate holder's procedures and policies concerning the operation of the aircraft which are acceptable to the FAA administrator. Please provide a copy of said manual.

19. Provide a copy of the air worthiness certificate for the Citation.

20. The common carrier aircraft must be operated by a U.S. certified airman employed by the certificate holder. Please provide copies of employment agreements or payroll records of the certificate holder.

21. Provide a load manifest for each common carrier flight which must contain the following information:

A. Number of passengers

B. Total weight of the loaded aircraft

C. The maximum allowable take off weight for that flight

D. The center of gravity limits

E. The registration number of the aircraft

F. The origin and destination of the aircraft

G. Identification of crew members and their crew position assignments

H. The pilot in command and the second in command pilot

The documentation must establish that the principal use of the aircraft was as a common carrier during the first twelve months of operational use. Effective January 1, 1997, Section 6366 provides a rebuttable presumption that a person is not engaged in business as a common carrier unless the yearly gross receipts from such operations exceed twenty (20%) percent of the purchase price of the aircraft, or fifty thousand dollars (\$50,000), whichever is less. Prior to January 1, 1997, a person was not considered engaged in business as a common carrier unless the yearly gross receipts exceeded ten (10%) percent of the purchase price of the aircraft, or twenty-five thousand dollars (\$25,000), whichever is less."

In response to the onerous document request from the Board, KAL contacts the office of WCG and discovers the phone number is disconnected. After a few weeks of panicked nervousness KAL discovers that WCG went out of business and all of its records are unavailable. In this case, even though KAL met the substance of the transaction by operating the aircraft more than fifty percent of the time as a charter, the aircraft will be assessed tax of approximately \$160,000.00 (assuming a flat rate of eight percent.)

KAL's failure to maintain control over the documents (the form of the transaction) has created the situation where the King Air purchase is taxable.

My advice to all aircraft purchasers who intend to claim this type of exemption, is: Do your homework.

1. Work with reputable charter companies. Make sure the charter company has been around for a long time, has good references, and has solid financial backing. In addition, even if you are secure with your choice of a charter operator, require them to provide you with the required documentation on a monthly basis.

2. The most difficult part of your documentation request is section 12 of the list. The charter company must provide copies of every invoice they issued to their customers for every claimed charter flight. Often, the charter companies are reluctant to make this information public. Make the charter company sign an agreement that guarantees you will receive the documents, otherwise your transaction will be taxed.

3. Do a complete economic analysis before you decide. Consider the additional costs of operation and the effect of federal depreciation before you decide to claim this type of exemption.

If all the above requirements start to give you a headache, or begin to convince you that you'd rather buy a Volkswagen bus then take a sip of cool ice tea and smile. Recently the Board has adopted Regulation

1620 (b4) which will allow you to use a test period known as, the Commercial Interstate Flight Hours test to exempt aircraft. It does not require the extra expense of operating as a common carrier, the test period is on flight hours only and it is only six months long. Even if you want to use a Part 135 Carrier, you can exempt your aircraft in only six months by using this new regulation.

Yes you can have the best of both worlds. You can have a reputable charter company operate your aircraft and you don't have to meet the onerous requirements of the twelve month test.

I will cover this new regulation in a future article.

-- Thomas A. Alston