State Sales Tax Considerations in Aircraft Purchases

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I. Overview of State Sales and Use Tax

Most states impose sales and use taxes on aircraft purchase transactions, but there are several notable exceptions to this rule. The tax rate for the use tax in any specific state will be identical to such state's sales tax rate. Sales taxes and use taxes are mutually exclusive and are complementary. In other words, with respect to any individual item of property, a state generally will assess either a sales tax or a use tax, but not both. In order to determine the applicability of a state's sales or use tax provisions, an understanding of the following concepts is essential.

A. Sales Tax

A state may impose a sales tax on the purchase or lease of property within the state in the absence of an applicable exemption. The sales tax is a transaction-based tax and will apply only in the state where the transaction occurs (i.e., the aircraft delivery location). The place where lease transactions occur may be the place where the aircraft is delivered at the beginning of the lease, the hangar location of the aircraft, or any other state that has jurisdiction to tax the aircraft. State sales tax jurisdiction is commonly referred to as nexus.

B. Use Tax

In the event that an aircraft sale does not take place in a specific state, that state may nonetheless impose a use tax on the use, storage, or consumption in the state of property acquired outside the state and subsequently brought into the state. Whether a state will impose its use tax to a particular aircraft depends on the structure and scope of the state's use tax laws. Some states impose a use tax on the first use of property in the state, other states impose a use tax only on property used in the state within a certain time period after it was purchased (e.g., six months), and some states impose the use tax upon presence of the property in the state for a specified number of days (e.g., 30, 60, etc.). Domicile of the property owner may be a key factor in some states. Several states use a very subjective standard such as whether the property in question has become a part of the "mass of property" of the taxpayer located within the state. Many variations are possible.

Due to the mobility of aircraft, they may be used, and, therefore, technically subject to use taxation, in any state where the aircraft has constitutional nexus authorizing a state to impose its use tax thereon. As a practical matter, however, it is unlikely that any state, regardless of its use tax structure, will attempt to assess a use tax against an aircraft owned by a nonresident who only occasionally operates the aircraft in the state. An aircraft owner or prospective aircraft purchaser should become familiar with the use tax provisions of the state where the aircraft will be hangared and primarily based, his or her own domicile, or if the owner is a business entity, the state(s) in which it has its principal place of business, and any other state where the aircraft may be used on a frequent basis.

II. Planning Considerations

In most cases, an aircraft will be subject to a use tax in the state in which it is permanently based and hangared (assuming the state imposes sales and use taxes on aircraft). When a taxpayer intends to hangar and permanently base an aircraft in a state that imposes sales and use taxes, there is seldom any real net tax advantage to taking delivery of the aircraft in another state in an attempt to avoid paying a sales tax. Buyers should, in all cases, avoid purchasing an aircraft in a state with a sales tax rate higher than the use tax rate in the state where the aircraft will be hangared and permanently based (unless the purchase would be subject to an exemption from the sales tax, such as a "fly-away" exemption). In such a case, any available credit against the use tax in the state where the aircraft will be hangared and permanently based would offset the entire amount of such use tax. However, as the credit is "nonrefundable" in every state, the amount of sales tax paid on the acquisition of the aircraft in excess of the amount of the use tax imposed in the state where the aircraft will be hangared and permanently based may not be recovered or used to offset any other tax.

III. Exemptions to Sales and Use Taxes Applicable to Aircraft

A. Isolated or Occasional Sales Exemptions

Several types of exemptions may be available to permit the purchaser of an aircraft to purchase or use an aircraft tax-free. In some states, an "isolated sales" or "occasional sales" exemption exempts from taxation the purchase of property from a person who is not in the business of selling. Often, however, states specifically carve out big-ticket items that are sold infrequently from the exemption. Inasmuch as the casual sale exemption must be relied on in some states to exempt mergers, and formation and distribution transactions, it is important to consider whether the transfer of aircraft in connection with these transactions is truly tax exempt.

B. The Sale-for-Resale Exemption

The most significant exemption to sales and use tax as it relates to aircraft is the "sale-for-resale" exemption. The exemption is based on two concepts. First, sales taxes generally apply to retail sales only, not to wholesale sales, and second, leases are generally considered taxable retail sales. In many states, these two concepts permit an individual or a company to establish a separate business entity as a "Holding and Leasing Company" to purchase an aircraft without the imposition of the state's sales or use tax on such acquisition. However, there are many specific procedures that often must be followed depending on the specific state in question.

Normally, the owner's sole use of the aircraft must be to hold it for lease to other parties on arm's length terms. The intended aircraft operator may then lease the aircraft from the entity that owns the aircraft. In such a case the lease payments would be subject to sales tax. The use of such a structure therefore results in tax-deferral, and ultimately the total tax that will be paid depends on the number of years that the aircraft is owned and the rent amount. In other words, the tax advantage comes from the ability to pay tax on a deferred basis on the lease payments rather than paying the entire sum up front. Present value calculations typically suggest that it would take anywhere from ten to fifteen years to pay the same amount of sales tax on rent payments as the amount of sales or use taxes that would have been paid up front without the use of such a structure.

It is important to keep in mind that the Federal Aviation Regulations generally prohibit a Holding and Leasing Company as described above from leasing the aircraft "with crew" (sometimes referred to as a "Wet Lease") to third parties. Such a company may only lease the aircraft without any aircraft management or pilot services (a "Dry Lease"). Consequently, the person or company to whom the aircraft is leased must separately acquire crew by hiring them as employees, setting up a pilot company, or by entering into an agreement with an independent management company (other than the Holding and Leasing Company).

Another strategy that states use to frustrate the effective use of the sale for resale exemption, as it applies to capital equipment, is to require the lessee or the lessor to pay tax on the total of all lease payments due under the lease as of the commencement date. In some cases, this results in a higher tax than a tax on the sale. Still other states will not tax leases at all. This prevents the use of the sale for resale exemption, because the exemption depends on the existence of at least two taxable transactions: the purchase and the re-lease. If the second transaction, the lease, is not taxable, the first transaction is not a purchase for resale, and tax is due on the original purchase price.

Finally, some states, such as Indiana, are beginning to look beyond the mere form of the transaction to analyze its substance. In these states, revenue agencies are denying the application of the sale for resale exemption when, in the opinion of such state, there are sufficient indicia that the structure is not a bona fide leasing arrangement with arm's length terms. In these states, it is difficult or impossible to know for certain that a successful sale for resale structure can even be implemented between related parties. Many states view the close relationship between lessor and lessee as a strong indication that the structure exists for no other purpose than to avoid the state's sales and use taxes.

C. The Trade-In Credit

Many states permit a "trade-in-credit" or offset against the basis to which a sales tax is applied (i.e., the purchase price), in an amount equal to the value of trade-in property. In order to qualify for a trade-in-credit, two conditions usually must be met. First, the trade-in property must be sold to the same person from whom the new property will be purchased (i.e., an actual exchange of property), and second, the party acquiring possession of the trade-in property must intend to hold such property for resale in the ordinary course of its business. State law may also limit the trade-in credit to transactions involving an exchange of similar property (e.g., an aircraft for an aircraft).

D. Interstate Commerce Exemptions

Another exemption that is frequently available to aircraft owners is the interstate commerce exemption. Unlike the sale for resale exemption, which exists in a similar form in nearly every state, there is wide variation in the nature of the interstate commerce exemption from state to state. In most cases, the aircraft buyer is viewed as a vendor of transportation services that may be taxed under a different tax regime, or not at all. Therefore, many states employ this exemption to benefit the aircraft operator by preventing it from being subject to taxation in multiple states for the sale or use of the same aircraft.

One major difference between states on this issue is whether to exempt sales or leases to charter (FAR Part 135) operators. Some states limit the exemption to scheduled air carriers, other states are silent on the question.

Another point that varies from state to state is whether the focus should be on the use of the aircraft itself, or on use by the end user of the aircraft. Some states allow the exemption if the aircraft is used more than 50% of the time in air commerce. Other states allow the exemption only if the lessee or the purchaser of the aircraft is a certificated air carrier. Under the former, more permissive rule, a non-transportation company can purchase an aircraft and benefit from the exemption, as long as a Part 135 charter operator uses the aircraft more than 50% of the total time that the aircraft is used.

States have various rules on how to calculate the 50% fraction, however. Some states, such as California, include only specific types of flights, e.g. not training flights. Other states count flight hours where passengers are carried, but not repositioning flights. To further complicate matters, there can be questions about whether the charter customers are sufficiently unrelated to the aircraft's owner, e.g. where the charter customers are employees of an affiliate of the aircraft owner. There is frequently little guidance on how unrelated the aircraft owner and the passengers need to be for the exemption to apply. Is 10% common ownership too much? What about 50% or 80%? Like many unanswered questions in this area, the determination is often up to the discretion of state revenue agents.

E. State Specific Exemptions

In addition to the broad categories of exemptions listed above, there are a variety of state specific exemptions for aircraft transactions that are unique to particular states. For example, in Connecticut, all aircraft purchase transactions involving aircraft in excess of 6,000 pounds maximum takeoff weight are exempt from sales tax. In North Carolina and South Carolina, there is a low maximum sales tax, and in Virginia, there is a special, low rate for aircraft sales. Many other unique, aircraft specific rules exist in other states.

Keith G. Swirsky and Christopher B. Younger are both tax specialists concentrating in the areas of corporate aircraft transactions and aviation taxation. The firm's Business Aircraft Practice Group, chaired by Mr. Swirsky, provides full-service tax and regulatory planning and counseling services to corporate aircraft owners, operators and managers. The group's services include Section 1031 tax-free exchanges, federal tax and regulatory planning, state sale and use tax planning, and negotiation and preparation of all manner of transactional documents commonly used in the business aviation industry, including Aircraft Purchase Agreement, Leases, Joint-Ownership and Joint-Use Agreements, Management and Charter Agreements, and Fractional Program Documents.

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