

TAX MATTERS

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

Prepared and distributed by Aero & Marine Tax Professionals

In October of 2004 the system was broken by the legislature and now we are putting it back together.

The flurry of questions to our office has been primarily in the following areas. Therefore we are providing what might be considered an FAQ (frequently asked questions) list to help reorient the taxpaying public to the return of proper understanding of the available exemptions.

Does the change back to the old way of enforcing the regulation have any effect on the commercial interstate exemption?

No. All the rules regarding this type of exemption have remained the same from the beginning. This exemption was not part of the law change for the period between October 1, 2004 and July 1, 2007.

What determines what “business use” means for me?

This question is best handled in a personal conversation because it has many complexities and possible different interpretations.

If we have returned to the old 90 day rule, shouldn't everyone use that instead of the commercial interstate exemption?

No. Each taxpayer's circumstances are unique to him or her. The only way to make an informed decision is having a communication with one of our consultants who know all the right questions to ask you.

If we have returned to the old 90 day rule, shouldn't everyone use that instead of the half of six months rule listed in the BOE bulletin?

No. The only way to understand and apply which form of exemption fits your specific case is through a conversation with one of our knowledgeable consultants who know what to ask you so that you are not making a decision without all the information you need.

How do I decide which test period to use?

In general, the commercial interstate exemption is suited best for business use and the 90 day test/principal use test is best suited for personal use. However, you need to let our consultants walk you through a very detailed and time-tested process to make sure you know how to accurately decide.

The 90 day test means if you

1. take possession of an aircraft, vessel or vehicle outside of the State of California,
2. make first functional use of that aircraft, vessel or vehicle outside the state of California before it enters our state for the first time
3. and it remains outside the State of California for at least 90 DAYS before it enters the state for the first time, it would be exempt from tax.

Although that may seem onerous enough, there is actually more to it. In the example of an aircraft:

1. You must be able to prove without a shadow of a doubt where the aircraft was located when the title transferred.
2. The definition of first functional use depends on what type of aircraft you purchase.
3. The burden of proof of providing documentation that supports the aircraft “never” landed inside California even once during the first 90 days rests entirely on the taxpayer. For example: providing hangar receipts that the aircraft owner paid for a hangar in Medford, Oregon does not prove the aircraft was in the hangar.
4. The documentation will have to support that the aircraft was used and not just stored during the 90 day period. If there is a long period in the last part of the test period where the property is merely stored and not flown, the auditor can attempt to throw out the storage time as “storage for shipment to California.” If the auditor is able to throw out the last FEW weeks of your test period and the aircraft enters California after the first 100 days, it will be assessed tax.

The half of six months test means if you

1. take possession of an aircraft, vessel or vehicle outside of the State of California,
2. make first functional use of that aircraft, vessel or vehicle outside the state of California before it enters our state for the first time
3. and it remains outside the State of California for at least half of the six months after it enters the state for the first time, it would be exempt from tax.

The actual difference between the 90 day test and the half of six month test is that although both require more than 90 days outside California, the half of six month test accumulates the days outside over a six month period where the 90 day version requires that the 90 days are consecutive and without interruption before you enter the state for the first time.

Without trying to overload you with the details here, it is suffice to say that the half of six-months test is much more flexible because it allows for travel in and out of California and it eliminates the BOE from throwing out storage days as “storage for shipment.”

The storage restrictions that apply to the principal use test do not apply to the commercial interstate flight hours test. There are three things you must do and they must be done in the following order:

1. The purchaser must be able to document that he took title to the aircraft outside the State of California.
2. The property must be first functionally used outside the State of California before it enters California the first time after the out-of-state possession occurs. As was explained above, this depends on the type of aircraft. Typically for this form of exemption, an interstate flight for a business purpose with passenger on board who is not part of the flight crew is required.
3. It must be flown in interstate commerce for more than half of the flight hours accumulated after the date of first entry into California. Our firm raises the standard to 60%.

This means that if the purchaser has any business that requires him to fly outside the State of California, he is eligible to consider this form of exemption.

The test period is based on flight hours only and does not include the flight hours prior to entering California the first time. The flight hours commencing from the out-of-state possession point to the new destination for a business purpose, then on into California are not part of the test period but are required in order to get into the test period.

For example, we will create a scenario to explain how it works: Dan Jones is in the manufacturing business

and it is located inside California. He purchases a new Citation aircraft and takes possession in Kansas. Mr. Jones is a passenger on the jet and his two pilots fly him from Wichita to Denver, Colorado to meet with a client who buys bolts from Mr. Jones' manufacturing company. After the meeting in Denver, Mr. Jones is flown to Van Nuys, California aboard his new Citation.

The above steps are examples of out-of-state possession, first functional use and date of first entry into California. The test period has been properly started, but no hours are calculated yet. Those hours start with the first flight after the date of first entry.

If the aircraft enters the state on March 15, 2008 the test period will end six months later on September 14, 2008. If the aircraft is flown 100 hours during the six months, the regulation requires at least half of the total hours are flown in interstate commerce. Our firm always insists on at least 60% to create a margin of error.

Obviously this means that 40% of the hours can be a combination of personal or intrastate use. What may be less obvious is, exactly how to figure which hours are on the "good side" of the test and which are on the "bad side."

Definition of commercial:

The flight hours must be for a business purpose. They can be 100% Part 91 hours or a combination of Part 91 and Part 135.

Definition of intrastate vs. interstate:

One needs a basic understanding of the definition of interstate and intrastate to start with. An interstate flight is one which commences in one state (or country) and ends in another. For example, flying from Van Nuys, California to Las Vegas, Nevada is an interstate flight. A flight from Van Nuys to Cabo San Lucas, Baja, Mexico also qualifies as an interstate flight.

An intrastate flight is one which commences and terminates in the same state. An example of an intrastate flight would be a flight from Van Nuys to San Francisco. Similarly, a flight from Reno, Nevada to Las Vegas, Nevada is an intrastate flight.

What may not be so obvious is that there are three types of flights - not just two. All intrastate flights count on the bad side. All interstate flights for a business purposes count on the "good side." Those are the easy ones to understand. However, there exists a third type and they all fall on the bad side of the test. Any interstate flight that is not supported with documents that establish a business purpose for the flight counts on the "bad side." An example would be a flight from Van Nuys, California to Aspen, Colorado for skiing. Additionally, an interstate flight where the taxpayer fails to provide documentation to support the business purpose also moves those flight hours to the "bad side."

The basic difference between the principal use test and the commercial interstate flight hours test:

The principal use test is based primarily on location and storage. It matters little "where" an aircraft is flown during the principal use test as long as the flights occur primarily outside of California. Obviously, in order to complete a 90 day or half of six month test, it is based on time. During that time the taxpayer must primarily prove where the aircraft was located every one of the days of the six month or 90 day period. Aircraft spend most of their lives "on the ground." Therefore, storage documentation becomes very important. The taxpayer must prove where the aircraft is located every minute it is on the ground as well as in the air.

The commercial interstate flight hours test is based solely on the total flight hours during the six-month test period. Therefore, this test is based primarily on flight hours where the principal use test is based primarily on storage.

One of the perks of the commercial interstate flight hours test is that the aircraft could be hangared inside California every night of the test period at the airport closest to the owner's home and still be exempt from tax.

For example, returning to Dan Jones and his new Citation purchase. Presuming that Mr. Jones arrived at Van Nuys on March 15, 2008 (beginning of the six-month test period) the test period will end on September 14, 2008. During that time, Mr. Jones traveled exclusively between the home office of his company and the regional office in Seattle, Washington. He leaves Van Nuys every Monday morning and returns on Monday evening to Van Nuys. For the purpose of this example, no other flights are made other than the weekly flights to Seattle. This would mean 100% of the flight hours were for a business purpose (this exceeds our 60% requirement). It also means the aircraft was on the ground at Van Nuys every night of the test period during the entire six months. With proper documentation, this aircraft will support a claim for an exemption.

If one were to look at the same use of this aircraft from the point of view of the principal use test which is based primarily on storage, it would be taxable. Therefore, if you can support business use of an aircraft, this test is perfect for you.

The common carrier test is fully explained in multiple articles on our web site.

Can the law be changed back?

Yes. However, the BOE does not write the law. It has to be changed by the legislature.

What can I do to make sure that the exemptions remain in place?

Never trust a governor no matter what party he is in. Make sure the minority party (even though California currently seems to have a lock on the Republicans being the minority this applies to any minority party that will block tax increases) has enough votes to block the super majority rule. Stay involved in the political process.