

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 interstate use...

There is a tremendous amount of rumor swirling around the State of California since the regulations pertaining to vehicles, vessels and aircraft were drastically altered effective October 1, 2004. Some people now believe there are NO legal ways to obtain an exemption. Others still advise their friends that the old ninety day exemption still exists. Neither is correct.

The following is true. I will use an aircraft in this newsletter as an example but the same applies to vehicles and vessels.

There used to be four methods of supporting a claim for an exemption. The first two were under a classification known as the "principal use test." They were a ninety day test and a one-half of the first six-month test. These two forms of test periods have been suspended.

There is now only one test period for the principal use test. It is for 12 months immediately following the possession date.

This means that 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 twelve months 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.

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 twelve months 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 entire year. 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 six weeks of your test period and the aircraft enters California in the thirteenth month, it will be assessed tax.

Additionally, there are two separate ways the new regulation will be enforced. The type of enforcement depends on whether or not the taxpayer is a resident of California. The test period described above is for California residents. If the owner of the aircraft is a non-California resident, the test period is based on the aircraft being stored and used outside California for more than half of the first year.

Before a new aircraft buyer runs out to create an out-of-state LLC or corporation to be able to cut the requirement to six months, here is some additional data. If the Board of Equalization (Board) discovers the owners or shareholders of an out-of-state company are

California residents, they can decide to apply the twelve month requirement. The taxpayer is not the one who gets to decide whether he or she is an out-of-state resident.

The following is intended to give you an idea of how the state determines that a company or person was a California resident. It all starts with wording from the regulation.

An aircraft purchased outside of California after October 1, 2004 and brought into California within 12 months of its purchase was acquired for storage, use, or other consumption in California and is subject to use tax if any of the following occur:

The aircraft was purchased by a California resident (as defined in Section 516 of the CA Vehicle Code); or

The aircraft was subject to property tax in California during the first 12 months of ownership; or

The aircraft is used or stored in CA more than one half the time during the first 12 months of ownership.

"Resident" means any person who manifests an intent to live or be located in this state on more than a temporary or transient basis.

Presence in the state for six months or more in any 12-month period gives rise to a rebuttable presumption of residency.

The following are evidence of residency for purposes of vehicle registration:

- (a) *Address where registered to vote;*
- (b) *Location of employment or place of business;*
- (c) *Payment of resident tuition at a public institution of higher education;*
- (d) *Attendance of dependents at a primary or secondary school;*
- (e) *Filing a homeowner's property tax exemption;*
- (f) *Renting or leasing a home for use as a residence;*
- (g) *Declaration of residency to obtain a license or any other privilege or benefit not ordinarily extended to a nonresident;*
- (h) *Possession of a California driver's license;*
- (i) *Other acts, occurrences, or events that indicate presence in the state is more than temporary or transient.*

I tell all my prospective clients, "It does not matter that you are a resident of Ohio, take possession of your aircraft in Florida and register it in a Delaware Corporation. If the aircraft enters the State of California any time within the first twelve months, the state has the right to assess the tax on your purchase and you have the burden of proof to support a claim for an exemption. If the Board contacts you and you ignore them because you

think you are an out-of-state resident, the Board will ultimately lien your aircraft or worse - raid your bank account."

THERE IS GOOD NEWS

The good news is that there still exists an exemption that allows you to bring your aircraft into the State of California and it can be stored inside California and still support a claim for an exemption. It is known as the "commercial interstate flight hours test."

The restrictions that apply to the principal use test do not apply to the commercial interstate flight hours test (such as California ownership, property taxes, etc.). 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, 2005 the test period will end six months later on September 14,

2005. 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. For the purpose of this test period, all intrastate flights count on the "bad side" of the test.

What may not be so obvious is 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."

How to calculate flight hours:

Flight hours are not calculated by airspace. For example, during the old principal use test if an aircraft flew from San Diego to Medford, Oregon and the flight took three hours, two hours and forty-five minutes were calculated as being in the air space of California and fifteen minutes was considered to be out of state. When the aircraft is supporting a claim for an exemption using the commercial interstate flight hours test, the same three hour flight from San Diego to Medford counts on the "good side" of the test. This would also include the three hour return part of the round trip. As long as the aircraft owner can provide documentation from a third party that affirms there was a business-reason for his flight to Medford, all the flight time

counts as an interstate flight for a business purpose.

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 new principal use test as long as the flights occur outside of California. Obviously, in order to complete a twelve month test, it is based on time. During that time the taxpayer must primarily prove where the aircraft was located every one of the 365 days. 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, 2005 (beginning of the six-month test period) the test period will end on September 14, 2005. 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.

"What makes us unique is that we guarantee the service," says Alston. "As long as the client engages us before possession of the aircraft, and then explicitly follows our instructions, they get a written guarantee that they will legally avoid California sales and use tax, or our entire service is gratis. We've never had to pay anyone back, though, because we've won every case."

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Don't hesitate to protect yourself.