AIN BUSINESS JET TRAVELER

Bizav Basics

State and local taxes

By Jeff Wieland - December 2008

Aircraft owners often take pleasure in contemplating federal aviation taxes. That's because much federal tax planning in this area focuses on deductions and thus on taxes the aircraft owner might save. Comparable deductions are frequently available for state tax purposes, but when the spotlight shines on state tax it usually illuminates how much the owner must pay.

Here's a look at the key state and local aviation and local taxes and some strategies for dealing with them:

Sales Tax

Sales tax is triggered by a transaction–the sale of an aircraft or aircraft parts, and in some states even labor performed on aircraft. The tax applies to gross receipts (the purchase price), but in most states you can reduce taxable basis by the price of a trade-in aircraft. Although it's called "sales" tax, the buyer is generally responsible for paying it and the seller is responsible for collecting and remitting it to the state. A state's ability to tax an aircraft sale relies on the presence of the aircraft in the state at the moment the transaction takes place.

When is that moment? Knowing when the transfer occurs is important for all sorts of reasons, not just sales tax, so an aircraft purchase agreement should specify how to determine when the transfer of title occurs. In my view, the logical moment to say it occurs is when the bill of sale is filed with the FAA Registry in Oklahoma City. The Registry will give you a filing time–say, 2:34 p.m. Central Time–so if the aircraft is in Iowa then, that state can charge sales tax, assuming no exemption applies.

The easiest way to avoid sales tax is to close when the aircraft is someplace where no tax applies. We've all heard stories about aircraft flying out over the ocean for a closing, but sales of aircraft that are to be U.S.-registered must close within the country. That's because, until the aircraft is registered to the new owner–which will take at least a day or two–that owner lacks the authority to operate it outside the U.S.

Besides, an over-ocean closing for a U.S. aircraft is unnecessary. Several states (Alaska, Connecticut, Delaware, Massachusetts, Montana, New Hampshire, Oregon and Rhode Island) have basically no sales tax on business jet sales. I say "basically" because even in these states laws may have little quirks that result in tax on some aircraft transactions. In Alaska, for example, local sales taxes may apply, and Delaware has a little-known tax on leases. In addition, a few states have a minimal tax. South Carolina limits the tax to $300 and North Carolina caps it at $1,500. Again, you can take advantage of these low taxes by making sure your aircraft is in the state at the time of closing.

And that means all of it. Even if the airframe is in sales-tax-free New Hampshire at closing, if the engines are off-wing and being overhauled in a jurisdiction with a sales tax, there's a potential for the state where the overhaul is taking place to charge sales tax on the value of the engines. That's because title to the engines was transferred when they were in the overhaul state. Of course, you could just wait to close until the engines are back on the aircraft to avoid the tax, but if that's not practical you may have to arrange a separate closing for the engines, which may involve moving them to a tax-free jurisdiction before their purchase is consummated.

Given how important it is for the aircraft to be in a sales-tax-friendly jurisdiction at closing, the buyer will want to be able to prove the aircraft was actually there. The paperwork between buyer and seller may reflect this but it's prudent to have third-party verification, such as a receipt for jet fuel purchased at closing.

You can sometimes avoid sales tax if a state has a "fly-away" exemption. Thus, even though you buy the aircraft in a state with sales tax, if you leave within a prescribed period (say, 10 days) the tax won't be imposed, assuming the aircraft doesn't return, at least not right away. You can find fly-away exemptions in states where business jets are manufactured, such as Arkansas (Falcon), Georgia (Gulfstream) and Kansas (Cessna, Hawker Beechcraft and Learjet). But you can also find them in states that simply recognize that an aircraft is a mobile asset that may be purchased in a state even though the buyer doesn't intend to use it there.

Use Tax

Given how easy it is to avoid sales tax on an aircraft, it's no surprise that states have found a way to levy an equivalent amount even when the sale takes place elsewhere. Use tax applies to the use or storage of the aircraft in the state and is assessed in an amount equal to the sales tax. In some states, "first use" of the aircraft in the state may be a necessary or sufficient condition for imposing the tax.

The most common reason use tax is imposed on an aircraft is that it is based in the state. Suppose you purchase a Challenger 604 in

Dodge City, Kan., for $20 million and, taking advantage of the state's fly-away exemption, get out of Dodge the next day. You fly the aircraft to Waukegan, Ill., where it will be hangared and maintained. Waukegan, in other words, is the aircraft's home. Unless an exemption applies, Illinois will charge a 6.25-percent tax for the privilege of using the aircraft in the state, which comes to $1.25 million. In addition, local taxes in Illinois may add $600,000 (another 3 percent) to the tax bill. Plainly, use tax is an expense to plan for, not ignore.

Basing an aircraft in a state isn't the only reason use tax may apply. If an aircraft is a frequent visitor to the state, a use tax assessment may result. Maine, for example, has recently been charging use tax on certain aircraft that come into the state at least 20 times in the first 12 months after their purchase. But in some states you don't even have to be a frequent visitor to get a use tax bill. Florida, for instance, presumes that any aircraft that shows up in the state during the first six months of ownership was purchased for use there, leaving the taxpayer to show why the tax is not due.

Use tax is much harder to beat than sales tax, but you can do it. First, there are U.S. Constitutional limits on a state's ability to impose use tax. U.S. Supreme Court decisions require that you and/or your aircraft must have sufficient "nexus"–a Latin word meaning "connection"–to the state before it can impose use tax. Moreover, in apparent recognition of the Constitution's commerce clause, many states have introduced an "interstate commerce," "commercial" or "common carrier" exemption. The details of such exemptions vary widely, but they generally involve the aircraft's employment in "commercial" aviation, which can be as simple as flying under Part 135 rules.

Before rushing off to put your aircraft on a commercial certificate, however, you should check to see whether another exemption applies. A strategy to minimize use tax that works in many jurisdictions is the "sale for resale." Like sales tax, use tax is designed to tax the ultimate end-user of the aircraft. When an avionics manufacturer sells equipment to the airframe manufacturer, sales tax isn't due. Nor is sales tax due when the manufacturer sells the aircraft to a dealer who holds it for resale. But when you buy the aircraft to use in your business, the sale-for-resale process has ended–unless you find a way to extend it. One way to do that is by leasing the aircraft to an affiliated entity that will operate it for you. In that case, like the aircraft dealer, you are passing the aircraft on to the real end user. But since you are leasing rather than selling it, the tax should be due on the lease payments, not the purchase price. This can result in significant tax savings.

The sale-for-resale exemption, however, is fraught with peril and must be used with great caution. Some states don't recognize a lease as changing the character of the tax due, and others tax the full value of the aircraft, not the lease payments, or the aggregate amount of the lease payments at the beginning of the lease. Moreover, a sale-for-resale exemption usually rules out the lessor using the aircraft before leasing it; the lease should be in place the moment the aircraft is acquired. In theory, if you don't handle the lease properly you could wind up paying tax twice: first on the purchase and then on the lease.

And the lease has to pass muster with the state as a real lease. At a minimum, payments should reflect a fair market value lease rate. Some states are satisfied with a lease between affiliates (basically, leasing the aircraft to yourself), while others are not. The FAA generally won't permit a lease of an aircraft with crew unless you have a commercial certificate. Finally, leases can have significant income tax consequences. You don't want to solve your state tax problem only to lose all your federal income tax deductions.

A final note on use tax. In most cases, a state will credit sales tax paid in another jurisdiction. Suppose you purchase an aircraft in a state where you pay 3-percent sales tax and then move it to a state that has a 7-percent use tax. The second state should (but may not) give you credit for the 3 percent already paid, and thus you would owe it only 4 percent.

Property Tax and Registration Fees

Aircraft purchasers often overlook property taxes on aircraft because, unlike sales taxes, they aren't due right away. But in some states property taxes can mount up annually to a significant number. States that impose property taxes on aircraft include California, Georgia and Wyoming. As with real estate, property taxes on aircraft are usually levied at the local level. Even states that don't have a "property" tax on aircraft per se may have a similar tax under another name, such as a tax on "assets owned by businesses" or "income-producing assets."

Aircraft registration fees are usually charged in lieu of a property tax, although Utah and a few other states charge both. Indeed, an easy way for a state to stay on top of collecting sales and use tax on aircraft hangared within its borders is to require the aircraft to be registered. The state may charge a nominal registration fee; in Massachusetts, it's capped at $300 per annum. But from a revenue standpoint, the advantage of registration is that the state can require proof that the sales/use tax has been paid as a condition of registration.

Miscellaneous Fees

When evaluating a state's aircraft taxes, don't stop with the usual suspects. States can be creative in designing ways to tax aircraft. New Hampshire, for example, helps to compensate for having no sales tax by imposing an "aircraft operating fee," calculated as a

function of the “manufacturer’s list price” and the aircraft’s maximum certified gross takeoff weight. For a factory-new Gulfstream G450 purchased and brought into New Hampshire in 2008, the tax bill will be well over $200,000 for the first year, declining annually thereafter.

Income and Excise Taxes

Many states tax jet fuel and avgas, usually at a fraction of the federal rates. Aircraft owners should also be aware of state income tax issues, especially where they differ from federal law. Not all states, for example, recognize an IRC Section 1031 like-kind exchange, and some may treat a bona fide exchange as a separate sale and purchase for state income tax purposes. And basing your aircraft in a state may obligate you to file income tax returns there. Indeed, recent case law suggests that aircraft might be subject to income taxes in states where the aircraft has never even been present.

An important lesson about state and local taxes is that they vary widely and are described in different ways. A thorough study of your state’s and local community’s taxes before you buy an aircraft is crucial. Guides and summaries like the National Business Aviation Association’s excellent State Tax Report are helpful, but ultimately you need the advice of an aircraft tax professional.

Tax havens... at least for now

Because business jets are expensive, there is endless controversy about whether they should be subject to sales and use tax. The story in New England is instructive. At first, the only state there without sales tax was New Hampshire, so for years it was the most attractive place in the region in which to purchase and base aircraft.

But in 1997, Connecticut introduced an exemption for aircraft with maximum certified takeoff weight of at least 6,000 pounds—in other words, business jets. This made Connecticut a magnet for basing business aircraft from nearby states.

Bracketed by New Hampshire and Connecticut, Massachusetts repealed its sales and use tax on aircraft in 2002. Rhode Island followed in 2005, making New England the country’s most business-jet-friendly region.

Second thoughts set in quickly. In 2007, Connecticut considered eliminating all exemptions to sales and use tax, including those for aircraft. And in 2008, Massachusetts and neighboring New York considered cutting back or eliminating sales tax exemptions for aircraft. None of these proposals were enacted, though you can expect them to resurface periodically.

Meanwhile, Ohio airport managers successfully lobbied in 2008 to repeal the sales tax on parts and labor for aviation services in Ohio. And so it goes…