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Ober|Kaler on State Sales and Use Tax Audits of Corporate Aircraft

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Negotiating your way through a federal income tax audit of aircraft acquisition or ownership can be daunting and difficult. Similarly, state sales and use tax audits are fraught with many potentially complex tax compliance pitfalls. If you are unfortunate enough to receive a notice or other inquiry from a state taxing authority regarding potential liability for state sales or use tax on your purchase or use of an aircraft, you must tread carefully through the minefield of issues surrounding the audit.

By way of general background, the purchase or use of business aircraft is typically treated as a sale or use of tangible personal property that is subject to state sales or use tax unless a state exemption or similar limitation applies. Many states, facing increasingly large budget deficits and decreasing sources of new tax revenue, are more thoroughly and carefully scrutinizing the acquisition and use of business aircraft to determine whether that state's sales or use taxes apply to such transactions. Furthermore, a substantial number of states have raised, or are raising, their sales and use tax rates, which are typically in the range of 4% to 8% of an aircraft's purchase price or fair market value. Thus, due to business aircraft purchase prices that typically range in the millions of dollars, a negative outcome following such an audit would likely result in a large sales or use tax liability.

Even in states that have not necessarily decided to wage all out "war" on what were once perfectly acceptable and legal aircraft ownership and operating structures that reduced or eliminated sales and use tax relating to such aircraft, there is a growing trend to make compliance with such strategies administratively difficult, overly time consuming or simply confusing. Many states insist that, in order to qualify for a particular exemption from sales or use tax, a taxpayer must precisely follow each intricate administrative step involved in such compliance without "any" leeway for inadvertent or

unintentional errors. These requirements may involve having certain items in place prior to the acquisition of the aircraft or its importation into the state, such as an executed aircraft lease or the approval of a lessor's application to become a registered "retail merchant" for purposes of collecting and remitting that state's sales tax. In addition, some states require that their forms relating to the application of a particular sales or use tax exemption be filed within a certain time period prior to or following the aircraft's acquisition or importation into the state, in a certain specific number, and with one or more agencies within the state government. In many instances it is extremely difficult, if not impossible, for an aircraft purchaser/owner to know all of the procedural requirements that must be followed in a particular state in order to qualify the acquisition/importation of their aircraft for an available exemption from sales or use tax without having previously completed such a transaction in that state.

It is also becoming more common for state taxing authorities to routinely send audit letters to aircraft owners requesting additional information regarding an aircraft that is (or was) located in such state, even if for only a brief period of time. The primary purpose of such letters is to enable the state to assess sales or use tax on such aircraft if it obtains a response from an aircraft owner that contains information supporting the state's right to make such an assessment.

Fortunately, the news in this area is not all bad. Some states appreciate the economic benefit of encouraging business aircraft owners to hangar their aircraft within the state or to fly their aircraft into the state for maintenance and repairs. For instance, certain states have enacted blanket exemptions from their sales and use taxes for the purchase and/or use of business aircraft within that state.

Other states have enacted sales and use tax exemptions that aim to encourage a particular type of business aviation activity within that state. These states recognize that such incentives encourage other tax generating businesses that maintain and repair aircraft or that are ancillary to having aircraft hangared within their borders. However, it is important to remember, as discussed earlier in this article, that there are often numerous bureaucratic, technical and potentially cumbersome procedural requirements that must be followed to qualify for these exemptions.

Maryland has a broad exemption from its sales and use taxes for aircraft that are used primarily in interstate commerce. Under that exemption, Maryland sales and use taxes are not applied to the purchase of an aircraft that is used by the purchaser principally to cross state lines in interstate or foreign commerce. The key to complying with the Maryland exemption is to ensure that the use meets one of the three tests that Maryland uses to determine whether the exemption applies. If the use does not meet one of these tests, an

aircraft purchaser can expect to pay sales or use tax in the event of an audit, which is always a distinct possibility.

Due to the increased scrutiny of aircraft by state taxing authorities in connection with the potential assessment of such state's sales and use taxes and the increasing complexity of methods for compliance with the requirements to qualify for available sales and use tax exemptions, it is of paramount importance that aircraft owners carefully plan an aircraft acquisition to avoid potential (and unexpected) taxation with respect to the aircraft transaction to the extent possible. Aircraft owners also must continually monitor the use of such aircraft thereafter to ensure that state taxing authorities are provided as few avenues as possible to assert that such aircraft are subject to their own sales or use tax structure.

Naturally, all of this reinforces the need for thorough sales and use tax planning prior to the purchase of an aircraft. Such planning can often eliminate or at least minimize the harsh results of a sales or use tax assessment on an aircraft.

However, whether or not such planning has been undertaken prior to the receipt of an audit notice from a state taxing authority with respect to an aircraft, it is imperative that the response to such a notice be prepared with meticulous thought and expert guidance from a well experienced tax professional. In many instances, the response to a notice from a particular state and the subtle nuances of that response will, if properly crafted, eliminate any additional inquiry from the state. On the other hand, if a state decides to assess its sales or use tax following its audit of an aircraft transaction and review of a taxpayer's responses to related audit inquiries, it is imperative that those responses create clear and convincing evidence to support a logical argument against the assessment. Such an argument will be absolutely necessary to support a taxpayer's position in an appeal of such an assessment and will make the taxpayer's subsequent argument against such an assessment infinitely stronger.

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