Recent Tax Changes that Affect Aircraft Owned or Operated in Washington State

The purchase/lease structure used to acquire the vast majority of business aircraft in Washington is at serious risk of being invalidated by the Washington Department of Revenue – retroactively four years. As a result of recent legislative and policy changes, the DOR is changing the way it imposes and administers Washington Sales, Use and Business & Occupation Taxes as they apply to general aviation.

For the past 40 years most Washington business aircraft owners purchased their aircraft using a leasing structure where the aircraft is purchased in a separate entity (usually an LLC) that would lease the aircraft to the ultimate user(s) of the aircraft -- generally the owner(s) of the entity. Assuming the formalities of the structure were followed, this planning complied with the Federal Aviation Regulations (FARs), as well as the sale for resale exemption provided by Washington law.

Under the statutory resale exemption, the purchasing entity was exempt from sales and use tax on the initial acquisition, but collected sales tax on the arms’ length lease payments that were made by the aircraft lessees. Aircraft lessees were then permitted to take a tax deduction from the gross lease revenue based on any use of the aircraft outside of Washington.

As a result of recent changes, however, the DOR is now auditing aircraft owners, denying sales tax deductions for out-of-state usage, and in some circumstances, even retroactively denying the owner/lessor’s right to purchase the aircraft exempt from tax under the resale exemption.

Given these changes, I write to you to: (1) recommend that you conduct a review of your current aircraft operations and/or leasing structure with a qualified aviation attorney; (2) encourage you to contact the Department of Revenue and Governor’s office; and (3) ask you to contact our office if you have been or are audited based on the “Tax Avoidance Rule” or over the apportionment of aircraft lease revenues.

The “Tax Avoidance Rule” - New Law

In an effort to resolve the Washington State budget deficit, the legislature recently passed a broad tax bill that included specific language designed to disregard the resale exemption for certain transactions that the legislature identified as “unfair tax avoidance”. As it relates to aircraft entity structuring and leasing activities, the law identifies as potential “tax avoidance” any transaction or arrangement through which a taxpayer “attempts to avoid Washington sales or use tax by vesting legal title or ownership of the property in another entity over which the taxpayer effectively retains control.” See RCW 82.32.655(3)(c).
Under these “tax avoidance” provisions, the DOR is provided with the statutory authority to disregard the otherwise exempt resale nature of the initial aircraft acquisition, assuming that the transaction meets the statutory definition of “unfair tax avoidance,” and accordingly assess sales and use tax, plus interest and penalties, on the purchase of the aircraft, retroactively four years.

The DOR has been working with us and other stakeholders to develop a regulation more precisely interpreting the “tax avoidance” statute as it applies to aircraft operations; however, no proposed regulation has been issued to date. Because of the broad language of the “tax avoidance” statute as currently written, and without a clarifying interpretative regulation, an aircraft leasing structure may be deemed “unfair tax avoidance” under DOR audit.

The impact of that conclusion is an assessment of 9.5% sales/use tax on the purchase price of the aircraft, specific “tax avoidance” penalties equaling 35% of the unpaid tax attributable to the “unfair” avoidance, plus any statutory penalties and interest resulting from the assessment. Last week, we learned of what we believe to be the first audit and assessment based on the “Tax Avoidance Rule.”

**Disallowance of the Ability to Apportion Aircraft Leasing Revenues – Policy Change**

For decades, it has been commonplace for business aircraft owners in Washington State to take advantage of the leasing structure described above, effectively deferring sales tax on the initial purchase by collecting sales tax on the value of each lease payment made over the lease term. For over 40 years, a Washington Supreme Court case, published guidance from the DOR, a letter ruling and audit results expressly permitted aircraft lessors to collect and remit sales tax on only that proportion of lease payments attributable to “in-state use” based on a proportion of “flight hours” within Washington to total hours; a proportion of days spent in Washington to total days during the lease period; or some hybrid methodology including days and flight hours; although we are aware of several recent and ongoing DOR audits where the lease payment apportionment methodology has become a specific issue within the audit. Taxpayers reported their total lease revenues to Washington, but took an interstate deduction from both Retail Sales Tax and Business & Occupation Tax for the amount of use outside of Washington.

In 2008, Washington officially adopted the Streamlined Sales and Use Tax Agreement (SSUTA). The DOR has taken the position that under the SSUTA provisions, the lease payments for tangible property (including aircraft) are “sourced” or taxable at the property’s “primary location,” which we do not argue. See RCW 82.32.730. Although the SSUTA does not mention or contemplate the DOR’s historic policy of allowing an “apportionment” of the lease revenues, the DOR began interpreting the specific “sourcing” provisions as a statutory prohibition against the right to apportion the lease payments instead of sourcing the transaction to Washington and
then following Washington law requiring the apportionment of lease payments for sales tax purposes.

Instead of providing notice of the reversal of the Department’s longstanding policy that permitted apportionment, they simply added a note on the top of one of the two Excise Tax Advisories permitting apportionment that says, “This Excise Tax Advisory applies to rental transactions appropriately recognized for Washington State tax purposes on or before June 30, 2008.” Based upon our public records requests on this issue, the DOR contemplated the need to inform the industry of this change as early as 2009, but no published guidance was issued until this year.

As a result of its interpretation of the SSUTA provisions, and despite the lack of notice to taxpayers, the DOR is retroactively disallowing any deductions for amounts attributable to out-of-state use on lease payments made after June 30, 2008. While we disagree with the DOR regarding the effect of SSUTA on the taxability of the lease payments, the fact of the matter is that the Department is confident in its interpretation and moving forward with audits.

Call to Action

CenterPoint Aviation Law has been active in stakeholder meetings with the DOR on both the “tax avoidance” and lease apportionment issues, and is currently both working with and fighting the DOR on these issues at the rulemaking level for the “Tax Avoidance Rule” and both the rulemaking and the Audit and Administrative Appeals levels on the apportionment issue.

Alan Burnett has also been working on this issue on behalf of the National Business Aviation Association as a member of the NBAA Tax Committee and for the Pacific Northwest Business Aviation Association as a Board Member and as the Director of Legislative Affairs. In light of these changes, we recommend reviewing your aircraft ownership and leasing structure with a qualified aviation attorney to ensure that your operations are in conformity with current DOR policy and within the framework of the “Tax Avoidance Rule.” More importantly, if you haven’t been audited by the DOR to date, you can structure your arrangement now to help mitigate future tax risks.

We would be happy to assist in this regard.

We would also appreciate the opportunity to speak with you the extent that you have recently gone through an audit of your aircraft operations, or have otherwise been contacted by the DOR with regard to your flight operations, on either the “Tax Avoidance Rule” or the apportionment issue.
On behalf of the Washington business aviation community, we ask and encourage you to contact the DOR and the Governor to protest the targeting of legitimate business aviation ownership and use structures, and to request that: (1) the “Tax Avoidance Rule” exclude aircraft ownership and leasing structures where the aircraft is being leased to a bona fide operator that is using it predominantly within the scope of the company’s business; and (2) the DOR reinstate the ability to apportion aircraft lease revenues based on “in-state use”. Please go to our website www.centerpointaviationlaw.com under the Washington State Tax tab for sample letters for your use and further updates. To contact the DOR regarding your concerns, please email Carol Nelson, Director at caroln@dor.wa.gov or Gil Brewer, Senior Assistant Director of Tax Policy at gilb@dor.wa.gov. To contact the Governor’s Office of Aerospace please email Alex Pietsch, Director at alex.pietsch@gov.wa.gov or by visiting http://www.governor.wa.gov/contact/default.asp.

Kind Regards,

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