



Saving Taxes with an Aircraft Leasing Company

Most States charge a substantial sales or use tax on the purchase or use of an aircraft – in some cases as much as 10% of the purchase price of the aircraft. However, in most of these States, you can use an aircraft leasing company to avoid this up-front tax. In some cases, you can defer payment of the tax. In other cases, you can entirely avoid the tax. You can also use an aircraft leasing company to buy repair parts and labor tax-free and to minimize your risk of being taxed in other States.

HOW IT WORKS

The sales and use tax laws generally apply only to the purchase and use of property by the final consumer. To avoid taxing intermediate sales, almost all States have a resale exemption which allows resellers to purchase and use property tax-free. This exemption generally applies to lessors. Instead of paying tax on the purchase or use of the property, the lessor will charge sales tax on the lease payments.

An aircraft investor can take advantage of this exemption by creating a captive aircraft leasing company to purchase the aircraft and to lease the aircraft to the users. As long as the leasing company follows the rules, the State will allow the leasing company to take advantage of the special leasing company rules.

DEFERRING OR AVOIDING SALES AND USE TAXES

An aircraft leasing company is not a tax gimmick. In the big picture, the leasing company rules create a win-win situation for both the aircraft investor and the State. The rules are good for the investor because they allow the investor to avoid paying an up-front tax and to instead pay tax based on the use value of the aircraft. The rules are good for the State because they allow the State to charge sales tax on interest payments, which would otherwise be nontaxable.

To illustrate the tax advantages of using an aircraft leasing company, assume that an investor has the choice of purchasing the aircraft directly for \$10 million or creating an aircraft leasing company and leasing the aircraft for \$750,000 per year. If the sales tax rate is 8%, then if the investor purchases the aircraft, they will pay an up-front sales tax of \$800,000. However, if the investor creates an aircraft leasing company, then they will pay a sales tax of only \$60,000 per year (8% of \$750,000). Thus, using an aircraft leasing company generates a net cash benefit of \$740,000 in the first year. At the end of 5 years, the investor will still have a net tax savings of \$500,000.

This tax deferral can have permanent benefits where, as is often the case, the investor only holds the aircraft for a few years. For example, if the investor above buys and sells a couple of similar aircraft in the 5 year period, the investor could end up paying an up-front sales tax on both aircraft – a total of \$1.6 million. However, if the investor uses a leasing company, the tax cost will be unchanged.

Another situation where an investor can use a leasing company to avoid taxes is where the investor leases the aircraft part of the time to a charter company. If the investor purchases the aircraft, the investor will pay the full sales tax of \$800,000, even though the investor plans to use

the aircraft only part of the time. If the investor creates a leasing company, the investor will pay sales tax only on the lease payments attributable to investor use. For example, if the investor used the aircraft only 50% of the time, the annual sales tax would only be \$30,000.

OTHER ADVANTAGES

There are other sales and use tax advantages to using an aircraft leasing company. First, if the lessor is responsible for maintaining the aircraft, the lessor can generally take advantage of the resale exemption to purchase parts and labor tax-free. Second, using a leasing company will reduce the risk that other States will attempt to impose use tax on the aircraft. Many tax-hungry States have tried to impose use tax on the purchase price of aircraft that make regular landings in the State. However, where the aircraft owner is a leasing company, the tax exposure will generally be limited to the tax on the lease payments. Third, along the same lines, those States which have adopted streamlined sales tax registration agree that a leased aircraft is taxable only in the State where the aircraft is based.

FAA AND INCOME TAX ISSUES

Ideally, using an aircraft leasing company will not generate any negative FAA and income tax consequences. However, careful planning is required to insure this result. For example, the FAA allows the use of an aircraft leasing company. However, if the aircraft is a "large civil aircraft", the lessee must comply with certain notification requirements.

The income tax consequences can be more complex, primarily because of the special tax rules that apply to leasing companies, including the "passive activity loss" rules. One easy way to avoid this problem is to use a leasing company which is a single member LLC owned by the user. Generally, the single member LLC is ignored for tax purposes and treated as a separate company for sales tax purposes. However, that is not true in all States.

For State income tax purposes, care should be taken to avoid creating an entity that generates tax losses that cannot be offset against income from other operations.

SALES AND USE TAX PITFALLS

There are also sales and use tax pitfalls. A couple of States do not have special leasing company rules. Some States tax lease payments up-front. Some States require the leasing company to charge a certain lease rate or to use an exclusive lease for a specified period.

CONCLUSION

Almost every aircraft owner can save significant tax dollars by using an aircraft leasing company. However, before doing so, you should consult with your tax advisor.

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