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December 30, 2005

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Mr. A--- G---  
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Re: Request for Written Opinion  
Application of Annotation 335.0089.800

Dear Messrs. A--- and G---,

This is in response to your joint inquiry requesting clarification of certain aspects of a legal opinion dated January 20, 2004, authored by Tax Counsel Chris Schutz. I will begin by summarizing the fact pattern initially presented to Mr. Schutz. I will then quote extensively from the relevant portion of Mr. Schutz's analysis regarding the application of tax to this fact pattern. Next, I will set forth the specific requests for clarification that you have made. Finally, I will provide the requested clarification.

**The Fact Pattern at Issue**

A taxpayer purchases an aircraft for use in California on an ex-tax basis (i.e., without paying tax or tax reimbursement) with the intent to limit the use of the aircraft to leasing. The taxpayer timely elects to report and pay use tax measured by the fair rental value (FRV) pursuant to Revenue and Taxation Code section 6094, subdivision (d). After 10 years of leasing the aircraft and properly reporting tax measured by the FRV, the taxpayer makes a nonconforming use of the aircraft (i.e., a use other than leasing). Subsequent to the nonconforming use, the taxpayer begins to lease the aircraft again.

**Mr. Schutz's Letter**

In his January 20, 2004, letter, Mr. Schutz writes:

“Aircraft are included in the definition of MTE [mobile transportation equipment]. (Rev. & Tax. Code, § 6023.) If a person purchases MTE ex-tax and the person’s use is limited to leasing the MTE, the person may elect to pay use tax measured by the FRV.<sup>1</sup> The election to report tax on the FRV of the MTE must be made by reporting tax measured by the FRV on a timely filed return for the period in which the MTE is first leased. Tax must thereafter be paid with the return for each period.<sup>2</sup> (Rev. & Tax. Code, § 6094, subd. (d); Cal. Code Regs., tit. 18, § 1661, subd. (b)(2).)

“The above election may not be revoked with respect to the MTE for which it is made. (Rev. & Tax. Code, § 6094, subd. (d); Cal. Code Regs., tit. 18, § 1661, subd. (b)(2).) However, the Board’s Legal Department has previously opined that if a taxpayer who leases MTE has elected to report tax on that lease based on FRV and then subsequently makes a personal use of the mobile transportation equipment, the use of the MTE has not been limited to leasing the property as required in Revenue and Taxation Code section 6094, subdivision (d). The consequence of a taxpayer using the MTE in a manner other than to lease it is that use tax measured by the purchase price of the MTE becomes due. The amount of tax previously reported on the lease receipts may be offset against the tax computed on the purchase price. When use tax is paid on the purchase price of the MTE and the taxpayer subsequently leases the MTE no additional tax is due, just as if the taxpayer had originally elected to pay tax measured by the purchase price. (Sales and Use Tax Annotation 335.0089.800 [08/05/87]<sup>3</sup>.)

“In the scenario presented in your letter, you state, in sum, that after many years of reporting on the lease of the MTE measured by the FRV of the MTE, Taxpayer made personal use of the MTE other than to lease it. According to your letter, Taxpayer leased the MTE for nearly 10 years before making any personal use of the MTE. Although your letter does not describe the length or type of personal use the Taxpayer made of the MTE, I assume that this use was limited and that Taxpayer continued to lease the MTE when not making this limited

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<sup>1</sup> With respect to the lease of MTE, the sale to the lessor is the retail sale and the lessor is the consumer of the MTE. Thus, either sales tax applies to the sale of the MTE to the lessor, or use tax is due on the lessor’s use of the MTE. (Cal. Code Regs., tit. 18, § 1661, subd. (b)(1).)”

<sup>2</sup> For the limited use of making the election to report tax based on the FRV of the MTE, the lessor/purchaser may issue a resale certificate to the retailer. (Cal. Code Regs., tit. 18, § 1661, subd. (b)(2).)”

<sup>3</sup> Annotations do not have the force or effect of law but are intended to provide guidance regarding the interpretation of the Sales and Use Tax Law with respect to specific factual situations. (Cal. Code Regs., tit. 18, § 5200.)”

personal use. Because taxpayer made use of the MTE other than to lease it, you conclude that taxpayer no longer has to report on the FRV, because the election to do so can only be made by a person who only leases the MTE.

“As stated above, Section 6094, subdivision (d) requires that in order to elect to report tax based on the FRV, the use of the MTE must be limited to leasing it. However, as the scenario presented in your letter illustrates, applying and enforcing the limit on the use of the MTE in perpetuity is untenable. For statutes that require tangible personal property to be in a particular place or used in a particular manner in order to qualify for some exclusion or exemption, the Board has established test periods to determine whether the use of the tangible personal property qualifies for that exemption or exclusion.<sup>4</sup> While there is no precise test period or time frame the Board will look at in order to determine that a taxpayer’s use of MTE was limited to leasing the MTE, it is not necessary to establish one in order to respond to your letter. This is because Taxpayer after limiting its use of the MTE to leasing it for nearly 10 years has clearly established that its use of the MTE was limited to leasing it for purposes of meeting the requirement of Section 6094, subdivision (d). Thus, Taxpayer’s recent limited personal use of the MTE while continuing to lease the MTE does not jeopardize its election to report tax based on [FRV].

“Moreover, Section 6094, subdivision (d) also states that the election (to report tax based on [FRV]) once made may not be revoked. Thus, if a taxpayer attempted to revoke this election at any time after making it by simply making some limited personal use of the MTE; this attempt would obviously be in direct contradiction to the requirement that the election may not be revoked.

“Accordingly, the application of Sales and Use Tax Annotation 335.0089.800 must be limited to those circumstances where a taxpayer has not yet established that its use of the MTE is limited to leasing for purposes of satisfying Section 6094, subdivision (d) and the taxpayer makes some personal use of the MTE during that time. Additionally, Annotation 335.0089.800 would also apply to instances where a taxpayer has established that its use of the MTE is limited to leasing for purposes of satisfying Section 6094, subdivision (d), but stops leasing the MTE for significant length of time, so that it substantially changes its use of the MTE. Under these guidelines, the scenario you presented does not fit within the confines of the example presented in Annotation 335.0089.800. In short,

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<sup>4</sup> For example, Revenue and Taxation Code section 6009.1 excludes keeping, retaining, or exercising any right or power over tangible personal property for the purpose of subsequently transporting it outside the state for use thereafter solely outside the state. Obviously, neither the taxpayer nor the state can be expected to make sure that that particular tangible personal property to which the exclusion applies remains outside of California forever. Thus, by annotation, we have limited the amount of time we will look to for purposes of this exclusion to six months. (See Sales and Use Tax Annotation 570.1040 [02/03/66].)”

based on the facts as stated in your letter and the assumptions I have made herein,  
Taxpayer must continue to report tax based on [FRV].”

### **Specific Requests for Clarification**

With respect to the guidance set forth in Mr. Schutz’s letter, you have requested clarification regarding: (1) how a taxpayer may establish that the taxpayer’s use of MTE is limited to leasing the MTE for purposes of satisfying the election requirements of subdivision (d) of Section 6094; and (2) how a taxpayer, after previously satisfying these election requirements, may establish that the taxpayer has stopped leasing the MTE for such a significant amount of time that the taxpayer has substantively changed its use of the MTE, resulting in the abrogation of the election that would otherwise be irrevocable.

### **Clarification Provided**

As you know, Mr. Schutz’s letter does not provide specific test periods that can be utilized for purposes of applying the analysis set forth in his letter. However, as alluded to in footnote 4 of the above-quoted portion of Mr. Schutz’s letter, the Board’s administrative approach for addressing a similar need to establish a test period, arising from the use tax exclusion provided under Section 6009.1, is instructive for purposes of analogy.

In relevant part, Section 6009.1 provides that “keeping, retaining or exercising any right or power over tangible personal property for the purpose of subsequently transporting it outside the state for use thereafter *solely* outside the state” [emphasis supplied] does not constitute a taxable use. However, when the subject tangible personal property is transported outside California, because the possibility exists that the property could reenter the state, a “safe harbor” is necessary for purposes of making a determination that the property is being transferred for use “solely” outside California. The Board has determined that, for purposes of making such a determination, if the subject property remains and is used outside California for at least six months, the property will be deemed to be used “solely” outside California for purposes of the use tax exclusion Section 6009.1 provides. (See, e.g., Business Taxes Law Guide, vol. 2, Annotations 570.1038 (6/9/95) & 570.1040 (2/3/66).)

By analogy, we find it is reasonable to conclude that, for purposes of applying the guidance set forth in Annotation 335.0089.800, the following six-month test periods apply. First, a taxpayer has established that it has made a valid election to report tax measured by FRV pursuant to Section 6094, subdivision (d), if the taxpayer can demonstrate that it has limited its use of the subject MTE to leasing for at least the first six months of use. Of course, under the guidance set forth in Annotation 335.0089.800, if the taxpayer makes a nonconforming use (i.e., a nonleasing use) of the MTE at any time (whether during or after the six-month test period), use tax is due, measured by the purchase price of the MTE (but offset by the amount of tax previously reported measured by FRV). Second, a taxpayer that has previously made a valid election to report tax measured by FRV has established that it has stopped leasing the MTE for

such a significant amount of time that the taxpayer has substantively changed its use of the MTE when the taxpayer refrains from leasing the subject MTE for at least the first six months following the nonconforming use. If a taxpayer satisfies the requirements of this second six-month test, while the taxpayer will owe use tax, measured by the purchase price of the MTE (with appropriate offsets), to the extent the taxpayer leases the MTE after the expiration of this test period, the taxpayer will not be obligated to report tax measured by the FRV.

I trust that this provides the clarification you are seeking. To the extent any questions or concerns remain, please do not hesitate to contact me.

Sincerely,

Randy M. Ferris  
Supervising Tax Counsel

RMF:ef

cc: Jeff McGuire (MIC:92)  
Dave Rosenthal (MIC:50)  
Joseph Young (MIC:49)  
Oveta Riffle (MIC:37)  
Vic Anderson (MIC:44)



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January 9, 2006

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Re: Request for Written Opinion  
Application of Annotation 335.0089.800

Dear Messrs. A--- and G---,

This is in response to your telephone call through which you brought to my attention that my recent letter to you regarding the above-referenced topic was inadvertently dated "December 30, 2006," instead of "December 30, 2005." Enclosed is an amended version of the letter. The only change made is the correction of the date. To the extent any questions or concerns remain, please do not hesitate to contact me.

Sincerely,

Randy M. Ferris  
Supervising Tax Counsel

RMF:ef

Enclosure: Letter dated December 30, 2005

cc: Jeff McGuire (MIC:92)  
Dave Rosenthal (MIC:50)  
Joseph Young (MIC:49)  
Oveta Riffle (MIC:37)  
Vic Anderson (MIC:44)