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LETTER RULING NO. 2010-32

[REDACTED TEXT]
[REDACTED TEXT]
[REDACTED TEXT]
[REDACTED TEXT]

December 2, 2010

**RE: APPLICATION OF THE USE TAX TO A PORTFOLIO OF
COMMERCIAL AIRCRAFT**

Dear [REDACTED TEXT]:

This letter is in response to your [REDACTED TEXT], request for a ruling on behalf of your client, [REDACTED TEXT] (the Company), relating to the imposition of the Hawaii use tax on commercial aircraft used in interstate air transportation that are destined for or originate from Hawaii airports.

ISSUE PRESENTED

Whether the use tax applies to commercial aircraft used in interstate air transportation for the transportation of passengers or goods that are destined for or originate from Hawaii airports where the aircraft are leased or purchased by the Company.

BRIEF ANSWER

Based upon the analysis below, the use tax does not apply to the use of commercial aircraft in interstate air transportation for the transportation of passengers or goods that are destined for or originate from Hawaii airports where the aircraft are leased or purchased by the Company subject to a conditional sales contract or sold pursuant to installment mortgage financing.

STATEMENT OF FACTS

The Company is a commercial airline that operates in interstate commerce with destinations throughout the United States, including several destinations in Hawaii. The Company maintains a fleet of commercial aircraft used in the transportation of passengers or goods as a common carrier in interstate air transportation as defined in 49 USC § 40102.

The Company has posed the question presented in this letter in the interest of obtaining clarity from the Department of Taxation (Department) on its interpretation of the use tax as applied to commercial aircraft that have occasion to be destined for or originate from Hawaii airports as part of an airline's service.

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In its discussions with the Department, the airline demonstrated that a vast majority of other states in the United States have express exemptions from the use tax for commercial aircraft used in interstate air transportation (or do not impose a use tax altogether). Relative to its specific facts, the Company has demonstrated that the other states where it lands and/or departs either expressly refrain from imposing the use tax on commercial aircraft used in interstate air transportation or do not assess a use tax altogether.

The Company’s commercial aircraft fleet consists of aircraft: (1) leased by the Company under operating leases or financing leases; and (2) purchased by the Company and financed by seller financing (under conditional sales contracts) or third party mortgage financing (whether the financing proceeds are paid to the seller directly or to the Company¹).

ANALYSIS

Hawaii law provides an express exemption from the use tax for certain use of commercial aircraft in interstate air transportation. Section 238-1, Hawaii Revised Statutes (HRS) states:

§238-1 Definitions, generally. Whenever used in this chapter, unless otherwise required by the context:

* * * * *

"Use".... means any use..., but the term "use" shall not include:

* * * * *

(6) The leasing or renting of any aircraft or the keeping of any aircraft solely for leasing or renting to lessees or renters using the aircraft for commercial transportation of passengers and goods or the acquisition or importation of any such aircraft or aircraft engines by any lessee or renter engaged in interstate air transportation. For purposes of this paragraph, "leasing" includes all forms of lease, regardless of whether the lease is an operating lease or financing lease. The definition of "interstate air transportation" is the same as in 49 U.S.C. 40102.

HRS § 238-1.

The Department analyzes the Company’s portfolio of commercial aircraft by discussing each of the Company’s possessory interests in its equipment fleet—

A. The Hawaii Use Tax Does Not Apply to Operating Leases.

Section 238-1, HRS, expressly states that “[f]or purposes of [the aircraft use tax exemption], ‘leasing’ includes all forms of lease.”

¹Depending upon the structuring of any particular closing transaction, the Company may be the direct recipient of third party mortgage financing proceeds in instances where the closing involves the Company first utilizing its own funds to acquire the aircraft from the seller, followed by the simultaneous disbursement of third party mortgage financing proceeds to the Company equaling a substantial portion of the purchase price.

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One of the most common forms of lease arrangement is known as an operating lease. An operating lease, also known as a “true lease,” is generally defined as:

A lease agreement, usually cancellable, which provides the lessee with the use of an asset for a period of time which is considerably shorter than the useful life of the asset. Unlike a capital lease, the lessee in an operating lease does not assume the economic risks of ownership, and the lessor generally provides all of the maintenance and services on the leased assets.

BLACKS LAW DICTIONARY, 6th Ed., p. 1091; *see also* HRS § 490:2A-103(a)(10). From a tax perspective, an operating lease is distinguished from other lease forms by the allowance of a current expense deduction for rent paid in the taxable year the rent is incurred (versus a depreciation expense over the life of the asset for leases other than operating leases, *i.e.*, disguised sales). *See generally* Treas. Reg. § 1.162-11.

In this case, the Company represents that certain of its aircraft fleet are leased by the Company pursuant to an operating lease. Section 231-8, HRS, expressly exempts from the use tax all forms of leased commercial aircraft used in interstate air transportation of goods or persons. Ordinary operating leases, in substance, are included within the definition of all forms of lease exempt under this provision. Therefore, the Company’s portfolio of commercial aircraft subject to an operating lease is exempt from Hawaii use tax when used in interstate air transportation to or from Hawaii airports.

B. The Hawaii Use Tax Does Not Apply to Financing Leases.

As is discussed above, HRS § 238-1 exempts from the Hawaii use tax all forms of commercial aircraft leasing used in interstate air transportation of passengers or goods. For purposes of the use tax exemption, “‘leasing’ includes all forms of lease, regardless of whether the lease is an operating lease or financing lease.” HRS § 238-1.

In the most general of terms, a financing lease is one whereby the economic life of the asset is ordinarily transferred to the lessee at the expiration of the lease term. The transfer typically is for a nominal amount or for no value at all. A financing lease, which in substance is equivalent to a conditional purchase, is also known as a “capital lease.” A capital lease is defined as:

A contract that transfers ownership of property to the lessee at the end of the lease term. A contract for the lease of property which possesses the characteristics of a purchase.

BLACKS LAW DICTIONARY, 6th Ed., p. 209; *see also* HRS § 490:2A-103(a)(7)². From a tax

² “Finance lease” under the Hawaii Uniform Commercial Code presupposes that the transaction involves three parties—a lessor, a lessee, and a seller, manufacturer, or supplier. In a typical finance lease transaction, the lessee selects the equipment; the lessor purchases the equipment from the seller and leases the equipment immediately to the lessee.

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perspective, a financing lease or capital lease is distinguished from other forms of leases (*i.e.*, operating leases, discussed above) because the transaction is treated as a sale for tax purposes. For instance, a lessee in a financing lease is treated as a purchaser and is allowed a depreciation deduction for the recovery of wear, tear, and obsolescence on the leased asset. *See generally* Treas. Reg. § 1.167(a)-1, *et. seq.* Notwithstanding the fact that the transaction is called a lease, the lessee is entitled to a depreciation allowance rather than a current rent deduction because the taxpayer is the economic owner of the property, which was purchased pursuant to a disguised sale.

In this case, the Company represents that certain of its aircraft fleet are leased by the Company pursuant to a financing lease or a capital lease. Section 231-8, HRS, expressly exempts all forms of leased commercial aircraft used in interstate air transportation from the use tax. Financing leases, in substance, are included within the definition of all forms of lease exempt under this provision. Therefore, the Company's portfolio of commercial aircraft subject to a financing lease is exempt from Hawaii use tax when used in interstate air transportation to or from Hawaii airports.

C. The Hawaii Use Tax Does Not Apply To All Other Forms of Leases.

As discussed previously in this letter, HRS § 238-1 exempts from the Hawaii use tax all forms of commercial aircraft leasing used in interstate air transportation of passengers or goods. The Company's portfolio of commercial aircraft subject to any other form of lease arrangement would likewise be exempt from Hawaii use tax when used in interstate air transportation to or from Hawaii airports.

D. The Hawaii Use Tax Does Not Apply to Conditional Sales Contracts or Installment Mortgage Financing, which are in substance, Equivalent to Financing Leases.

The use tax does not apply to the use of commercial aircraft in interstate air transportation for the transportation of passengers or goods where the aircraft are purchased by the taxpayer pursuant to a conditional sales contract or installment mortgage financing because such sales arrangements are the functional equivalent of a financing lease. As discussed in more detail below, the Department looks to the substance of a transaction and not its form for tax treatment. Because financing leases are the economic equivalent of conditional sales contracts or installment mortgage financing, such transactions will all be treated the same for tax purposes.

As is discussed previously in this letter, Hawaii law provides a use tax exemption for leases, including financing leases, of commercial aircraft used in interstate air transportation of passengers or goods. *See* HRS § 238-1.

It is a well settled principle of tax law that a financing lease is treated the same as a purchase for tax purposes where the substance of the transaction is as such. The Department has considered numerous tax authorities to conclude that, based upon the economics of financing leases, the Legislature's broad definition of "lease" set forth in HRS § 238-1, and to ensure rational application of Hawaii's tax law, (1) financing leases; (2) conditional sales contracts; and (3) installment mortgage financing are to be treated as equivalents for tax purposes.

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1. Financing Leases are Considered Sales for Tax Purposes.

The distinction between leases and sales is most prominent for tax purposes because of the competing tax implications affecting a lessee or purchaser. A transaction involving the lease of equipment is allowed a current deduction for lease rent paid where the transaction involves a true lease. *See* IRC § 162. A transaction involving a sale, even where the property is subject to a security interest in favor of a third party, permits the buyer depreciation allowances over the useful life of the asset. *See* IRC § 167. Either method of cost recovery can have considerable impact on the tax position of any given taxpayer.

In its seminal authority on the issue of leases or disguised sales, the Internal Revenue Service issued Revenue Ruling 55-540 discussing the application of the Internal Revenue Code to such transactions. Revenue Ruling 55-540 presents the issue of whether an asset transaction involving a purported “lease” arrangement is to “be treated as in reality a lease or a conditional sales contract.” Rev. Rul. 55-540, 1955-2 CB 39. The IRS concludes that the substance of the transaction controls, and not its form.

i) IRS Rulings Related to Lease Transactions Treated as Sales.

In construing substance over form, the IRS concluded that two factual scenarios involving purported financing leases are to be treated as sales contracts for tax purposes. These two specific situations are instructive for the facts involving commercial airline financing leases:

[Lease Example 1]

Agreements providing for a “rental” over a comparatively short period of time in relation to the life of the equipment. The agreed “rental” payments fully cover the normal purchase price plus interest. Title usually passes to the lessee upon the payment of a stated amount of “rental” or on termination of the agreement upon the payment of an amount which when added to the “rental” paid approximates the normal purchase price of the equipment plus interest.

[Conclusion 1]

In the absence of compelling factors indicating a different intent, it will be presumed that a conditional sales contract was intended if the total of the rental payments and any option price payable in addition thereto approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges. Agreements of the type described...above, will generally be held to be sales of the equipment.

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[Lease Example 2]

Agreements which provide for the payment of “rental” for a short original term in relation to the expected life of the equipment, with provision for continued use over substantially all of the remaining useful life of the equipment. During the initial term of the agreement, the “rental” approximates the normal purchase price of the equipment, plus interest, while the “rentals” during the remaining term or renewal period or periods are insignificant when compared to the initial rental. These agreements may or may not provide for an option to acquire legal title to the equipment upon the termination of the initial period or at any stated time thereafter. **** [These agreements may include] the added factor that the manufacturer of the equipment purports to sell it to a credit or finance company.

[Conclusion 2]

If the sum of the specified “rentals” over a relatively short part of the expected useful life if the equipment approximates the price at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount, and the lessee may continue to use the equipment for an additional period or periods approximating its remaining estimated useful life for relatively nominal or token payments, it may be assumed that the parties have entered into a sale contract, even though a passage of title is not expressly provided in the agreement. Agreements of the type described... above, in general, [including those involving credit or finance companies], will be held to be sales contracts.

Rev. Rul. 55-540, 1955-2 CB 39 at 40, 42-43 (emphasis added). Where factual situations involve leases that include the terms similar to those in the Revenue Ruling’s examples, a sale will be found. Because the substance of such leases is truly that of a sale, taxpayers are treated as owners of the equipment for tax purposes and are permitted depreciation allowances under the IRS’ interpretation.

- ii) *Lease Transactions Are Treated as Sales, Whether Seller-Financed or Third-Party Financed.*

The conclusions in Revenue Ruling 55-540 stand for the proposition that a lease arrangement will be treated as a sale for tax purposes whether the transaction involves a seller financed transaction or a third-party financed transaction.

A seller financed financing lease transaction typically involves only the seller/lessor and the purchaser/lessee. A seller financed financing lease is analogous to a conditional sales contract where the seller conveys substantially all rights to the equipment to the purchaser/lessee; however retains sufficient rights to the equipment in the event of default, many times equivalent to a security interest.

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A third-party financed transaction typically involves the seller/manufacturer; the finance company/lessor; and the purchaser/lessee. A third-party financed lease transaction is analogous to an installment mortgage financing where the seller/manufacturer sells the equipment to the finance company/lessor, which finances the purchase price and in turn leases substantially all rights to the equipment to the purchaser/lessee; however the finance company/lessor retains rights equivalent to a security interest or mortgage over the equipment in the event of default.

The conclusion that: (1) financing leases; (2) conditional sales contracts; and (3) installment mortgage financing are economic analogs for tax purposes under Revenue Ruling 55-540 applies whether the transaction is seller-financed or third-party financed, and whether under lease or by purchase.

2. *In Substance, Conditional Sales Contracts or Installment Mortgage Financing are the same as Financing Leases for Hawaii Tax Purposes.*

As is the case under federal law discussed above, it has long been the case in Hawaii that the substance of a transaction controls its tax treatment. *See In re Ulupalakua Ranch, Inc.*, 52 Haw. 557, 481 P.2d 612 (1971) (holding that either the government or the taxpayer may utilize the substance over form doctrine to characterize tax treatment). Equalizing the treatment of financing leases and certain purchases has been the position of Hawaii courts and the Department for many years.

Hawaii courts have drawn the conclusion that leases in substance may constitute disguised sales in the form of conditional sales contracts or installment sales arrangements for tax purposes, providing equivalent treatment for each. *See In re Dobbs Houses, Inc.*, 53 Haw. 195, 490 P.2d 902 (1971).

In construing Hawaii's tax law, the Department has previously announced that the substance of a lease transaction will dictate the tax consequences for general excise and use tax issues. "The correct application of the general excise and use taxes will depend on the circumstances of each case with the substance of the transaction controlling, not its form." Tax Information Release (TIR) No. 98-2, *see also* TIR 89-4. In TIR 89-4, for example, the Department provided guidance treating certain leases and purchases as equivalents.

Based upon the historical treatment of certain lease arrangements and purchases as equivalents under prior Hawaii case law and Department policy, such authorities are relevant in the analysis of the facts in this case, which looks to the substance of the transaction to dictate that the tax consequences of: (1) financing leases; (2) purchases subject to a conditional sales contract; and (3) installment mortgage financing are to be treated as equivalents.

3. *No Rational Basis to Discriminate Between the Tax Consequences of Financing Leases and Certain Purchases.*

Having taken the opportunity to review the authorities discussed in this part, as well as the Legislature's broad definition of "lease" for purposes of the use tax exemption for certain commercial aircraft, the Department finds no rational basis to discriminate in the tax consequences

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of commercial aircraft acquired by financing lease or acquired by conditional sales contracts or installment mortgage financing. A financing lease is the functional equivalent of a purchase subject to a conditional sales contract or installment mortgage financing; therefore, (1) financing leases; (2) conditional sales contracts; and (3) installment mortgage financing are treated the same for tax purposes.

4. The Company's Portfolio of Commercial Aircraft Used in Interstate Air Transportation is Not Subject to the Use Tax.

As discussed above, Hawaii law provides a use tax exemption for the use of commercial aircraft for the interstate air transportation of passengers or goods acquired by lease. HRS § 238-1. "Lease" is defined to include all forms of lease, including financing leases. Numerous tax authorities stand for the proposition that, in substance, financing leases and purchases subject to a conditional sales contract or installment mortgage financing are treated as equivalents for tax purposes. It has long been the Department's policy to look to the substance of a transaction and not its form for tax purposes. Therefore, where commercial aircraft used in interstate air transportation are: (1) leased pursuant to financing lease; (2) sold pursuant to a conditional sales contract; or (3) sold pursuant to installment mortgage financing, such transactions will be treated the same as financing leases within the meaning of HRS § 238-1 for tax purposes and will not be subject to the use tax.

CONCLUSION

Based upon the discussion above, the Hawaii use tax does not apply to the Company's use of commercial aircraft in interstate air transportation for the transportation of passengers or goods where such aircraft are destined for or originate from Hawaii airports because such use is exempt under the broad definition of "lease" under HRS §238-1, which includes certain purchases that are the economic equivalent of financing leases, as described above in the above facts and analysis.

This ruling is applicable only to the Company and shall not be applied retroactively. It may not be used or cited as precedent by any other taxpayer. The conclusions reached in this letter are based on our understanding of the facts that you have represented. If it is later determined that our understanding of these facts is not correct, the facts are incomplete, or the facts later change in any material respect, the conclusion in this letter will be modified accordingly.

The Company has reviewed and agreed that the redacted version of this ruling attached as Exhibit A will be available for public inspection.

If you have any further questions regarding this matter, please call me (808) 587-1569. Additional information on Hawaii's taxes is available at the Department's website at www.state.hi.us/tax.

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Very truly yours,

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Administrative Rules Specialist

APPROVED BY:

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