

**STATE BOARD OF EQUALIZATION**

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Mr. H--- G. R---, Jr.
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SR – XX-XXXXXX

Re: R--- - R---, Inc.

Dear Mr. R---:

This is in response to your letter of July 6, 1983. We regret the inconvenience caused you by our delay in responding. Your letter set out the detailed facts reiterated below and asked for our opinion as to the application of the Sales and Use Tax Law thereto.

Statement of Facts

A---, Inc. is a relatively new commercial aviation operator which intends to establish a scheduled commuter helicopter operation, centered in --- ---, California, to provide transportation between suburban areas in Southern California and the major regional airports, principally Los Angeles International Airport. To carry out this service, it is purchasing six W--- XX helicopters each of which is powered by two R--- "G---" engines. It is likely that other operators in California will also purchase W--- XX helicopters with the same R--- engines.

A--- is a small helicopter operator which does not have the resources or capability for full in-house support. Consequently R--- has agreed to establish a support program which will minimize A---'s need to invest in spare engines and accessories, and which will assure to A--- a predictable ceiling cost for engine maintenance and repair. This will be accomplished by providing all "off-wing" support for the engines at a fixed cost per flying hour. This arrangement is called "Power by the Hour" (PBTH).

A critical factor in any scheduled airline operation is "down-time" of the aircraft. The failure of any system on the aircraft, including the engine, has to be repaired in the minimum possible time and without extensive "on-wing" work. Therefore, the aircraft is usually made

serviceable by replacing the failed "line-replaceable unit" with a serviceable like line-replaceable unit. The failed unit is then sent to a repair base for repair.

On the W--- XX, the G--- engine and certain of its accessory units are line-replaceable units. The G--- engine is of "modular" design, which allows it to be split into seven major sections for ease of repair and maintenance. Each of these sections can be exchanged without disturbing the remaining modules and therefore a failed engine can be returned to serviceability by exchanging its failed modules with serviceable modules. The failed modules can then be repaired independently. This concept produces a quick turnaround of engines in the repair shop and reduces the number of spare engines required to support a given operation. Because of engine test requirements after module exchange, however, this work must be carried out at an authorized repair base and cannot be done on the flight line. Accordingly, an exchange of a failed module normally involves the removal of the entire engine from the aircraft.

The engine also has a number of accessory units such as fuel pumps, which are mounted on the exterior of the engine and which can also be exchanged if they suffer failure.

A--- and other smaller operators can justify only a modest investment in spare engines and accessory units. A PBTH arrangement will allow A--- and other California operators to have access to a common pool of engines, modules and accessories owned by R---, with resulting substantial savings. The greater the number of aircraft supported by the pool the smaller the ratio of pool value to installed engine value becomes. The pool size is minimized by allowing A--- and other operators to exchange their unserviceable units for serviceable units in the pool. This arrangement results in rapid movement of engines, modules and accessories throughout the total fleet supported by the pool. For example, an item installed in Operator A's aircraft may fail and be returned to the repair base for repair. Operator A then receives a serviceable item in exchange. The failed item is then repaired and may then be dispatched to operator B to replace one of its items, which, in turn, will be repaired and dispatched to Operator C. As most operators (and their secured lenders) will not accept a situation where an item owned by one operator may be flying on any other operator's aircraft, PBTH requires that title be exchanged each time that an unserviceable item is removed from an aircraft and a pool item installed.

Furthermore, any lending or leasing of an item from the pool while an operator's item is being repaired would require (i) a larger support pool, and (ii) a double exchange following each failure.

In exchange for the services provided by PBTH, the operator pays an amount per operating hour which is fixed for each year of the contract. This is his only cost for all "off-the-wing" maintenance and repair, and, therefore, provides him with an overall cost guarantee and the ability to accurately forecast costs against income. For 1984, this cost will be \$50 per hour. R--- estimates that approximately 60% of that charge will represent the retail value of parts necessary for servicing the engines, with the remaining 40% being attributable to repair labor, amortization of capital invested in the pool, and the cost of contract administration. As operations continue this estimate can, and will, be more closely refined.

Engine removal and replacement may involve a negligible consumption of spare parts if, for example, an engine must be removed to correct vibration due to imbalance or to investigate a failure warning light.

Although it is expected that almost all purchasers of the W--- XX aircraft will avail themselves of the PBTH arrangement, it is optional, and R--- spare parts are available to a purchaser who chooses to do its own maintenance.

Engine removals are estimated at the rate of 0.4 per 1,000 hours of engine use. In the case of A---, it is estimated that each aircraft will fly approximately 2,400 hours per year. For a fleet of six helicopters with two engines each, this would be a removal rate of one engine per month leading to a prohibitive cost to the parties if sales tax is to be assessed based on the value of the engines exchanged. In the early years of each PBTH operation the removal rate is generally higher than for a mature program. This has been the case so far in the brief history of the PBTH program.

Pursuant to Clause 8.3 of the Support Agreement, a different payment arrangement exists for the repair of equipment failures resulting from a number of specified causes ("abnormal damage"), including, among others, operator neglect, ingestion of a foreign body, or failure of equipment not furnished by R---. A--- will pay to R--- all charges for labor and material with respect to repairs necessitated by abnormal damage. These charges will be in addition to the hourly rates mentioned above, and the charges for materials will be separately stated.

Opinion

As you know, Regulation 1545 (copy enclosed) pertains to the installing, repairing, and reconditioning of tangible personal property. In our view, the described PBTH arrangement is a pricing mechanism utilized by R--- for exchange of A---'s used engines for reconditioned similar property of R---. Such exchanges are governed by subdivision (b)(4) of Regulation 1545.

"If the method of repairing or reconditioning certain tangible personal property involves commingling property delivered to a repairman or reconditioner with similar property so that the customer receives repaired or reconditioned property which may not be the identical property delivered to the repairman or reconditioner but which is exactly the same kind of property as that so delivered, tax applies to the amount charged by the repairman or reconditioner for the repaired or reconditioned property."

The measure of the tax is the amount charged A--- by R--- for the PBTH program. R--- should report tax from the program quarterly based on amounts received from A--- during the quarter for which it is filing.

As to the charges incurred by A--- for repairs and replacement parts outside the PBTH program, i.e., for "abnormal damage", R--- should charge tax in accord with Regulation

1546(b)(1) and (2). That is to say, if the retail value of the parts furnished is more than 10% of the total charge R--- is the retailer of such parts and should report sales tax on such sales, but if the value is less than 10% it is the consumer and should pay sales tax reimbursement to its vendor or if such tax was not paid at purchase R--- should report use tax with respect to the parts. No tax would be due with respect to charges for installation labor [Regulation 1546(a)].

Your letter suggested that perhaps Regulation 1547 (vehicle engine exchanges) or Regulation 1546(b)(3)(C) (optional maintenance contracts) could apply to the PBTH arrangement. Regarding Regulation 1547, the Board has taken the position that this regulation pertains to motor vehicle engines, not aircraft engines. As to Regulation 1546(b)(3)(C), typically, optional lump sum maintenance contracts require the repair and maintenance of a specific piece of property. Here, R--- is under no obligation to maintain the specific engines on A---'s aircraft. Rather, its obligation under the PBTH arrangement is to provide serviceable substitutes. In our opinion, this is not the kind of contract contemplated by Regulation 1546(b)(3)(C).

We hope this has answered your questions. If it has not, feel free to contact us again

Very truly yours,

Les Sorensen
Tax Counsel

LS:rar

Enclosure

bc: Out-of-State – District Administrator