STATE OF COLORADO

DEPARTMENT OF REVENUE
State Capitol Annex
1375 Sherman Street, Room 409
Denver, Colorado 80261
Phone (303) 866-3091
FAX (303) 866-2400

John W. Hickenlooper
Governor

Barbara J. Brohl
Executive Director

GIL-13-016

May 14, 2013

XXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXX

Re: Fair Market Value Lease Rate

Dear XXXXXXXXXXXXX,

You submitted on behalf of your client ("Company") a request for guidance to determine the fair market value lease rate for a related party transaction.

The Colorado Department of Revenue ("Department") issues general information letters and private letter rulings. A general information letter provides a general overview of the relevant tax issues and is not binding on the Department. A private letter ruling provides a specific determination for a specific set of facts, is binding on the Department but not on the taxpayer, and requires payment of a fee. For more information about general information letters and private letter rulings, please see Department regulation 24-35-103.5 at www.colorado.gov/revenue/tax > Tax Library > Rulings.

The Department initially treats your request as one of a general information letter. If you would like the Department to issue a private letter ruling on the issues you raise, you can resubmit a request and fee in compliance with regulation 24-35-103.5. It is important to remember that general information letters, such as this one, are general discussions of tax law and are not a determination of the tax consequence of any particular action or inaction.

Issue

Does the proposed method of calculating a lease rate fall within the Department's interpretation of fair market value for related parties?

Background

Company, who is the lessor, owns an aircraft that is leased to a related party for a monthly lease payment. Company is structured to operate as an equipment leasing company, which typically lease equipment through a triple net lease where the lessee pays for all the operating costs including the insurance, maintenance and taxes. The lease rate for equipment leasing companies is composed primarily of three main components: the cost of capital, obsolescence factor and profit factor. The three components taken together represent a lease rate factor that is multiplied by the value of the equipment to generate an annual lease rate.

Company purchased an aircraft for the sole purpose of leasing the aircraft. The aircraft dry lease transfers continuous use and possession of the aircraft from Company to a related company ("Lessee"). The aircraft dry lease requires Lessee to obtain their own pilots and pay for all operating costs, including the insurance, maintenance and taxes. The lease period is longer than three years and Lessor collects sales tax on the monthly lease payments. The lease is based on the three components of an equipment leasing company to ensure that the lease payments from a related party are a fair market value.

In August 2007, the Department issued a letter stating that when an aircraft lease exists between related parties, the lease payments must be at a fair market value; based on industry standards for a dry lease, the monthly lease payments should equal between 1 and 1.5 percent of the purchase price of the aircraft. The 1 to 1.5 percent represented an annual lease rate between 12 and 18 percent in 2007, which is similar to the lease rate that was being charged at the time by equipment leasing companies.

Two of the three components to the lease rate (profit and obsolescence factor) remain relatively stable over time. However, the cost of capital is tied to either the U.S. Prime Rate or the London Interbank Offered Rate (LIBOR), which fluctuate over time. In August 2007, the U.S. Prime Rate was 8.25 percent and the one-month LIBOR was 5.5 percent. Since then, Company represents that these benchmark interest rates have dropped significantly; the current U.S. Prime Rate is 3.25 percent and the current one-month LIBOR is 0.21 percent.

Company represents that the decrease in the cost of capital for equipment leasing companies has resulted in a corresponding decrease in the lease rate. The current industry standard annual lease rate for equipment leasing companies ranges from 7.5 to 13 percent of the equipment value. This translates into a monthly lease rate between 0.625 to 1.08 percent of the equipment value. This valuation is reflected in a financing lease proposal and quote received by Lessor in October 2012 from a major U.S. bank active in aircraft finance.

Bank's Cost/Purchase Price:	$15,000,000
Monthly Lease Payment:	$95,710 or 0.64 percent.

Company represents that this calculation is the current industry standard for a monthly lease payment and is the fair market value for lease payments between related parties.

Discussion

As an initial matter, it is important to note that the Department generally uses the lease price resulting from arms-length transactions as the best method for valuing the lease price that is not the result of an arms-length transaction. Only when the former are not available as comparables will the Department look to other methods for evaluating the lease prices described in your letter.

In 2007, the Department offered guidance regarding the fair market value of lease payments for aircraft leases. This estimate (1% to 1.5% of the purchase price of the aircraft) was based on various cost components, including the rate of interest in effect during that period. You correctly point out that interests rates have dropped significantly since 2007. This reduced cost will generally result in smaller lease payments.

The 1 to 1.5% factor was offered as guidance as to what the Department expected to see for fair market value. Interest rates have declined since 2007 and the Department would expect this to lower the fair market value of aircraft leased in recent years. Moreover, taxpayers always have the right to present evidence that demonstrates their costs components justify a smaller fair market value for lease payments. We cannot, in the context of a general information letter, provide you a binding determination that the cost components, their values, or calculation you provide are correct. A general information letter is issued for general guidance and does not address specific facts. With this caveat, the cost components that you identify are components that the Department typically considers in calculating the fair market value of lease payments.

Miscellaneous

This letter represents the good faith opinion of Department personnel who are knowledgeable on state taxes issues. However, the Department does not make a specific determination here on any of the issues raised and the Department is not bound by this general information letter.

The Department administers state and state-administered local sales and use taxes. This letter does not address sales and use taxes administered by home-rule cities and home-rule counties. You may wish to consult with local governments which administer their own sales or use taxes about the applicability of those taxes. Visit our web site at www.colorado.gov/revenue/tax for more information about state and local sales taxes.

Enclosed is a redacted version of this letter. Pursuant to statute and regulation, this redacted letter will be made public within 60 days of the date of this letter. Please let me know in writing within that 60 day period whether you have any suggestions or concerns about this redacted letter.

Sincerely,

Neil L. Tillquist
Colorado Department of Revenue
Tele: (303)866-5627
Email: neil.tillquist@state.co.us