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To: Aimee Olhiser
Chief
Tax Policy Bureau, (*Distributed Electronically)*

Date: October 15, 2024

From: Chris A. Schutz 10/15/24
Chief Counsel CAS
Legal Division

Subject: Request for Legal Opinion – Sales of Fuel to Common Carriers
Assignment No. 23-424

This is in response to your memorandum dated September 18, 2023, in which you state, in relevant part:

> We are requesting your opinion regarding certain provisions of Revenue and Taxation Code (R&TC) section 6357.5 and Regulation 1621 as they pertain to exempt sales of fuel sold to common carriers and what qualifies as an international flight. Specifically, we are requesting your opinion on whether a flight needs to be marketed as one flight number in order for it to qualify, whether the length of a layover has any effect, if more than on intermediate stop is still considered the same flight, and what should the department do to verify the exemption.
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> [¶] . . . [¶]
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> As you know, passenger and cargo airlines have different flight planning models – e.g., hub-and-spoke system versus point-to-point model. Further, there are common carriers who perform package delivery services as well as common carriers who perform passenger service. These differ in how flights are scheduled and published. There does not appear to be a one-size-fits-all answer to what makes a given flight an international flight for purposes of the exemption. We have also been in discussions with the airline industry and their interpretations of the statute and regulation appear to differ from the department's. Therefore, we are seeking your opinion on the following areas.
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> Regulation 1621, subdivision (b)(3)(B)3 explains that a flight which has an intermediate stop within the United States will qualify for the exemption if the final destination of that flight is a foreign destination. Some audit team members will allow the exemption when there was more than one stop, while other audit teams members interpreted "an" intermediate stop to mean "only one" intermediate stop, and will disallow the exemption where more than one intermediate stop was made. We are asking for your opinion as to whether the

intermediate stop provision under Regulation 1621, (b)(3)(B)3, is limited to one stop, or will the exemption apply if a flight has more than one stop? Does it matter if the flight number changes?

If a flight makes one or more intermediate stop and the flight "backtracks" before arriving at its international destination, will this disqualify the flight for the exemption? For example, a flight leaves a California city and makes an intermediate stop in a mid-western U.S. city. The flight then departs the mid-western U.S. city and travels to a its foreign destination in Asia. Is the flight from the California city to the mid-western U.S. city disqualified because it "backtracked" its direction before it arrived at its foreign destination? Would your opinion change if the flight stopped at two different mid-western U.S. cities before departing to its foreign destination in Asia?

Audit team members have encountered situations in which a flight would depart a California city and make an intermediate stop in a U.S. city before departing to its foreign destination. In certain situations, there were 5-6 hour layovers. Some layovers were overnight. Auditors were considering layovers with a short 1-2 hour duration the same flight, but layovers in duration of 12-24 hours were not considered the same flight. Audit team members were unsure about the 5-6 hour flights especially if passengers deplaned and none returned for the continuation to the foreign destination. How long can a layover be before it is not considered the same flight? Does it matter if all of the passengers deplane the flight at the intermediate stop city? Does layover time differ because the flight is a cargo flight and does not carry passengers?

In the past, we have provided guidance that flights must be marketed as an international flight in order to qualify for the exemption. While this is somewhat easy to ascertain for passenger flights, cargo flights do not publish or market their flights. Audit team members are unsure if cargo flights are required to be marketed as international flights in order to obtain the exemption. Further they are unaware of any other criteria that could be used to determine if a cargo flight was considered international it if was not marketed as such. Do flights have to be marketed as international flights in order to qualify for the exemption?

Lastly, what is the minimum amount of verification an auditor should consider to support that the final destination of the flight is a foreign destination? Does the auditor need to review every flight schedule and/or every passenger itinerary or cargo manifest to make this determination or are there any assumptions an auditor can make?

DISCUSSION

As a starting point, California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code, § 6051.) The sales tax is imposed on the retailer who may collect reimbursement from the customer if the contract of sale so provides. (Civ. Code, § 1656.1; Cal. Code Regs., tit. 18, § (Regulation or Reg.) 1700.) When sales tax does not apply, use tax is imposed, measured by the sales price of property purchased from a retailer for storage,

use, or other consumption in California. (Rev. & Tax. Code, §§ 6201, 6401.) The use tax is imposed on the person actually storing, using, or otherwise consuming the property. (Rev. & Tax. Code, § 6202.)

Revenue and Taxation Code section (section) 6357.5 provides an exemption from tax for the sale or use of fuel and petroleum products sold to an air common carrier for immediate consumption or shipment in the conduct of its business as an air common carrier, on an international flight. (Rev. & Tax. Code, § 6357.5, subd. (a); Reg. 1621, subd. (b)(3).) "Immediate consumption or shipment," means that the delivery of the fuel and petroleum products by the seller is directly into an aircraft for consumption or transportation on an international flight and not for storage by the purchaser or any third party. (Rev. & Tax. Code, § 6357.5, subd. (c).) "International flight," means a flight whose final destination is a point outside of the United States. (Rev. & Tax. Code, § 6357.5, subd. (d).) A flight which has an intermediate stop within the United States will qualify for the exemption if the final destination of that flight is a foreign destination. (Reg. 1621, subd. (b)(3)(B)3.)

In enacting section 6357.5, the Legislature included the following statement of intent:

> The Legislature finds and declares that the State of California annually loses millions of dollars of sales and use tax revenues due to federal prohibitions on the taxation of imported airline fuel sold in California which is used in international travel. This action by the federal government has placed domestic producers, which must collect the sales and use tax on identical types of sales, at a competitive disadvantage relative to foreign producers. It is the intent of the Legislature, in enacting the exemption provided by this act, to allow domestic producers to compete equally with foreign producers.

(Stats. 1988, Ch. 1227, § 1.)

This statement of intent relates to the federal exemption from custom duties and internal-revenue tax provided by Section 1309 of Title 19 of the United States Code (section 1309) for, among other things, the withdrawal of imported petroleum products from a custom bonded warehouse for use on aircraft "actually engaged in foreign trade or trade between the United States and any of its possessions." (19 U.S.C. 1309(a).) This exemption preempts California's Sales and Use Tax Law from this field of commerce and taxation, making the sale or use of such imported petroleum products exempt from California sales or use tax pursuant to section 6352.[1] (See, e.g., Annotations 325.1580 (11/12/63), 325.1620 (4/11/62), 325.1630 (3/8/77).) Accordingly, in enacting section 6357.5, the Legislature's intent was to provide a parallel exemption for domestic oil producers, thereby allowing them to "compete equally with foreign producers." Consistent with that intent, section 6357.5 will automatically be repealed "[i]n the event that the federal exemption provided in Section 1309 of Title 19 of the United States Code, relating to supplies for certain vessels and aircraft, is repealed." (Rev. & Tax. Code, § 6357.5, subd. (i).)

For the purposes of section 1309, a vessel, including an aircraft, "shall not be considered to be actually engaged in the foreign trade, or in trade . . . between the United States and its possessions . . . unless it is . . . [a]ctually transporting passengers or merchandise to or from a

[1] Section 6352 provides an exemption for the sale or use of tangible personal property "which [] this State is prohibited from taxing under the Constitution or laws of the United States or under the Constitution of this State."

foreign port, . . . or between a port in a possession of the United States and a port in the United States or in another of its possessions." (19 C.F.R. 10.59(a)(2), (d).) There does not appear to be a limitation on the number of domestic stops a vessel or aircraft may make and still be engaged in foreign trade. (See, e.g., Annotation 325.1630, back-up letter citing *Northwest Airlines v. Commissioner of Revenue* (1976) 247 N.W.2d 33, 39 ["a flight is engaged in foreign trade . . . regardless of whether passengers or cargo are enplaned or deplaned at intermediate domestic stops"].) The phrase "actually engaged in foreign trade" is also used with respect to exemptions provided under the Internal Revenue Code. (26 U.S.C. 4221(a)(3), (d)(3.) The Internal Revenue Service has ruled that an aircraft is actually engaged in foreign trade when "at least one person is transported" on that aircraft to the foreign destination. (Rev. Rul. 2002-50, 2002-2 C.B. 292 (2002).) An aircraft can be actually engaged in foreign trade "even though [it] may make intermediate stops in the United States." (26 C.F.R. 48.4221-4(b)(2), (4), (7).)

In sum, the purpose of section 6357.5 is to provide an exemption from sales and use tax for domestic sellers that is consistent with the *sales and use tax* exemption foreign sellers enjoy pursuant to section 6352 and federal law. Therefore, in determining whether an entire series or combination of routes[2] taken by an aircraft, or only a portion thereof, constitutes an international flight, the result should be consistent with the meaning of "actually engaged in foreign trade" for purposes of section 1309. As such, an aircraft can only be engaged in an international flight, when it is actually transporting persons or property to the final destination outside the United States. Additionally, an international flight is not limited to a combination of routes with a single domestic stop.

With these authorities in mind, we turn to your questions concerning sales of fuel to common carriers, some of which have been reordered.

1. We are asking for your opinion as to whether the intermediate stop provision under Regulation 1621, (b)(3)(B)3, is limited to one stop, or will the exemption apply if a flight has more than one stop?

As stated above, it does not appear that the exception provided to foreign sellers pursuant to section 6352 is limited to a series of routes with a single domestic stop. (See, e.g., Annotation 325.1630.) Nor is any such limitation set forth in section 6357.5. Regulation 1621, subdivision (b)(3)(B)3 may contemplate only one intermediate stop on a qualifying international flight, but it also does not rule out the possibility of more. It appears that when adopting the amendment to Regulation 1621, the Board of Equalization had in mind the most common situation of international flights not previously covered by the exemption (i.e., a single domestic stop) but did not intend to limit the exemption so that otherwise qualifying flights would be disqualified. Thus, for purposes of section 6357.5, an international flight is not limited to a single intermediate domestic stop by Regulation 1621, subdivision (b)(3)(B)3. However, as explained above, to constitute an international flight, the aircraft must actually transport a person or package to a foreign destination, regardless of whether there are one or more intermediate domestic stops.

2. [W]hat is the minimum amount of verification an auditor should consider to support that the final destination of the flight is a foreign destination?

[2] We use the term "route" to describe when an aircraft flies from one airport to another, rather than flight or flight segment to avoid confusion.

3. Does the auditor need to review every flight schedule and/or every passenger itinerary or cargo manifest to make this determination or are there any assumptions an auditor can make?

The Department has a duty and an obligation to utilize its audit resources in the most effective and efficient manner possible. (Reg. 1698.5, subd. (b).) In addition, when examining an area being audited, audit decisions are based on CDTFA's determination of the amount of a potential adjustment balanced against the time required to audit the area and the duty to determine whether the correct amount of tax has been reported. (Reg. 1698.5, subd. (b)(4)(B).) Accordingly, while common carriers claiming the exemption must make available, upon request, records, including, but not limited to, a copy of a log abstract, an air waybill, or a cargo manifest, documenting its consumption or transportation of the fuel or petroleum products on an international flight and the amount claimed as exempt (Rev. & Tax. Code, § 6357.5, subd. (f)), as in all cases, the Department may make certain assumptions during the course of an audit based on the information and experience obtained auditing this industry and in consideration of its duty to efficiently utilize audit resources.

For example, if audit staff has found that one-stop route combinations[3] generally constitute an international flight, then it would be reasonable for audit staff to assume that all one-stop route combinations are international flights, unless the auditor has a specific reason to require further documentation with respect to a particular route combination. Conversely, if, in the Department's experience auditing this industry, it finds that route combinations with two or more domestic stops do not generally constitute a single international flight, then it would be reasonable for auditors to assume that such route combinations do not constitute an international flight unless a taxpayer can provide specific documentation to show otherwise with regard to a particular route combination or even particular instances of a route combination being flown.[4]

4. Does it matter if the flight number changes?

There is no indication in section 6357.5 or Regulation 1621 that a flight number must remain the same for multiple routes to qualify as a single international flight, and we are not aware of any applicable Federal Aviation rules, regulations, or standards with respect to how flight numbers are used that would affect this analysis. Thus, the fact that the flight number changes does not, in and of itself, disqualify the combination of routes from constituting an international flight.

5. If a flight makes one or more intermediate stop and the flight "backtracks" before arriving at its international destination, will this disqualify the flight for the exemption?

The Legal Division has previously opined that a combination of routes that backtracks can never qualify as a single international flight because when an aircraft backtracks before continuing to an international destination the routes being flown in the United States are domestic flights that are followed by an international flight. Thus, the fuel is not being used for immediate consumption on an international flight. (Rev. & Tax. Code, § 6357.5, subds. (a), (c).)

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[3] That is, a combination of routes that originates in California and ends at a foreign destination with one intermediate domestic stop of relatively short duration.

[4] For example, audit staff may find that when there are two or more domestic intermediate stops, passengers or property are not usually transported from California all the way to the foreign destination.

However, there appear to be a variety of causes for routes to backtrack, and our previous guidance contemplated relatively extreme examples.[5] Backtracking could also be indicative of the general operations of a common carrier, such as a hub-and-spoke system. In the example you provide, an aircraft leaves a California city and makes an intermediate stop in a mid-western U.S. city. The aircraft then departs the midwestern U.S. city and travels to its foreign destination in Asia. In this circumstance, a combination of routes that backtracks may still qualify as an international flight, if the flight is actually engaged in foreign trade as explained above.

6. Would your opinion change if the flight stopped at two different mid-western U.S. cities before departing to its foreign destination in Asia?

The fact that there are two intermediate domestic stops does not change our opinion; a combination of routes originating in California, stopping in two different midwestern U.S. cities, and traveling to a foreign destination in Asia could qualify as an international flight if it is actually transporting persons or property from California to the final destination outside the United States. However, it seems unlikely that even a single passenger would stay on the aircraft through multiple backtracking layovers. Additionally, as we have already discussed, Department staff may make certain assumptions based on their experience and in the interest of efficiency in auditing common carriers. Taxpayers are, of course, are always free to provide records showing that a combination of routes does, in fact, constitute an international flight, as described above, and those flights will be treated as such.

7. How long can a layover be before it is not considered the same flight?

There is no specific limitation placed on the duration of a layover during an intermediate stop in section 6357.5 or Regulation 1621. However, the longer the duration of a layover, the greater the likelihood that it would not be regarded as a single international flight. For example, if an aircraft left San Francisco and flew to New York and had an overnight layover long enough for the passengers to explore New York before proceeding on to England, then it would be regarded as a flight from San Francisco to New York followed by a separate flight to London.

8. Does it matter if all of the passengers deplane the flight at the intermediate stop city?

As long as at least one passenger (or package) is transported to the foreign destination, the series of routes may constitute an international flight. There is no limitation with respect to whether all passengers are required to deplane during an intermediate stop. We note that Regulation 1621 specifically states that, during the period January 1, 1989, through December 31, 1992, tax applies when there was a loading or unloading of cargo, including mail, passengers, and/or deadheading crew members at an intermediate domestic stop. (Reg. 1621, subd. (b)(3).) It follows that the same activity on or after January 1, 1993, would thus not, in and of itself, affect this exemption. That is, a combination of routes that has an intermediate stop within the United States, where cargo or passengers are loaded or discharged, may still qualify as an international flight.

[5] We stated that if a flight left Los Angeles for New York and then flew back and forth between Miami and New York before eventually departing for Paris, this would be considered a series of domestic flights followed by an international flight and would not qualify for the exemption.

9. Does layover time differ because the flight is a cargo flight and does not carry passengers?

As stated above, there is no specific limitation on the duration of a layover – for packages or passengers. If there were a significant delay at an intermediate stop, similar to an overnight layover for passenger flights, we would consider that to mean that the routes do not constitute a single international flight.

10. Do flights have to be marketed as international flights in order to qualify for the exemption?

The law does not require marketing as an international flight for purposes of the exemption. While the fact that the combination of routes is marketed as an international flight would be an indication that it is an international flight with intermediate stops, the absence of such marketing does not render the exemption inapplicable. For example, if an aircraft carries a passenger or packages from Los Angeles to Miami and then to Lisbon and there are no significant layovers, then that flight would be considered an international flight regardless of any marketing. We understand that cargo carriers most likely do not advertise cargo flights as international flights.

To the extent this memorandum conflicts with a prior opinion issued by the Legal Division, this memorandum supersedes such opinion. If you have further questions, please contact me at (916) 662-2629.

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