Aircraft Transactions Continue to Receive Heightened Scrutiny from State Tax Authorities

By Brett R. Carter and Bruce P. Ely

Brett R. Carter and Bruce P. Ely explore the various legal theories relied on by state revenue departments that attempt to impose use tax and other taxes on aircraft purchased out-of-state, as well as provide planning insights for aircraft purchases and leases.

In this down economy, aircraft owners have heard politicians in Washington turning up the rhetoric, complaining about corporate aircraft "tax breaks" while the government continues to run at a deficit. Although it remains to be seen what changes will be forthcoming from Congress or the Internal Revenue Service, it is clear that state taxing authorities continue to be focused on transactions involving business aircraft, making aggressive arguments to impose sales or use taxes and *ad valorem* property taxes on aircraft transactions. During 2011, there were a number of key court rulings and administrative decisions across the country that will have an impact on the aviation community. This article summarizes the recent published decisions involving the state taxation of aircraft transactions and highlights the practical state tax consequences that must be considered by owners and operators of business aircraft.

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Tennessee

In a much-anticipated decision in Tennessee on the use tax exemption for aircraft sales and purchases, a Tennessee court ruled that a taxpayer's purchase of an aircraft outside the state and subsequent transportation into the state is exempt from Tennessee use tax as a sale for resale when the aircraft was leased to a third party. In this case, the aircraft was leased to an affiliate of the taxpayer.[1] The Tennessee Department of Revenue did not appeal. The case was tried on remand after the Tennessee Supreme Court reversed a summary judgment ruling in favor of the taxpayer that had been affirmed by the Tennessee Court of Appeals.[2] The Supreme Court found that there were genuine issues of material fact precluding summary judgment as a matter of law and remanded the case for trial on the merits.[3]

In *CAO Holdings*, the taxpayer purchased the Cessna aircraft in Kansas and immediately leased the aircraft to an affiliated entity before bringing it to Tennessee. The affiliated entity managed and operated the aircraft and provided air transportation services to third parties. Despite the relatively straightforward application of the Tennessee sale for resale exemption under these facts, the Tennessee Department of

Revenue challenged the transaction, arguing that the taxpayer's use of the aircraft was inconsistent with the lease transaction and that the taxpayer was the actual user of the aircraft. The Department argued in the alternative that the transaction should be disregarded because it lacked "economic substance." Following a bench trial and briefing, the trial court rejected the Department's arguments and entered a judgment in favor of the taxpayer.

At trial, the taxpayer offered evidence that the aircraft was used exclusively for leasing to the affiliated management company. The proof included a nonexclusive lease agreement between the taxpayer and the management company, time-share agreements between the management company and third-party users of the aircraft, invoices from the management company to the time-share users, documentation of payment of the invoices and deposits to the management company's separate bank account, and the management company's payments of the amounts due to the taxpayer under the lease on which Tennessee sales tax was paid.

The court concluded that, collectively, the evidence demonstrated that the management company was the actual user of the aircraft under the nonexclusive lease agreement and paid the taxpayer all amounts due for the commercial use of the airplane. Consistent with its role as the manager/operator of the aircraft, the management company filed federal excise tax returns and paid federal taxes owed on the air transportation services it provided. Based on this evidence, the trial court concluded that the taxpayer was not the user of the aircraft and held that the lease to its affiliate qualified as a sale for resale.

In response to the sham-transaction/economic-substance arguments advanced by the state, the taxpayer offered proof that the lease was motivated by legitimate business concerns, including liability and ease of management. The taxpayer also proved that the rental rate was set at an arm's-length market rate. The trial court rejected the state's position on the grounds that Tennessee has not adopted the economic-substance doctrine. Even if the economic-substance doctrine were applied, however, the trial court held that "this transaction was motivated by a clear business purpose that had economic substance and viability. . . . Accordingly, both entities were formed for business reasons and [the taxpayer] was entitled to the sale for resale exemption." The state chose *not to appeal the trial court's decision* a second time, thereby ending the five-year journey of this case through the Tennessee courts.

Practice Pointers: The taxpayer and the management company that operated the aircraft maintained well-documented records of the purchase and lease transaction, as well as the air transportation services provided by the management company to the time-share users. This evidence was critical in proving that the management company was the actual "user" of the aircraft. Other taxpayers with similar affiliated company transactions involving aircraft should carefully review their documentation to determine whether the transaction is being executed as planned, including the signing of agreements, issuance of invoices, and making intercompany payments with separate bank accounts. Moreover, clear nontax business reasons for the structure should be considered and documented along with the determination of what reflects a fair market charge for the dry lease of the aircraft. While the trial court's ruling on economic substance will likely provide useful authority for taxpayers in other transactions, it is anticipated that the Tennessee Department of Revenue will assert this theory again in a future test case.

Michigan

The Department of Treasury in Michigan made similar sham-transaction/economic-substance arguments in a case involving the purchase and lease of an aircraft between affiliates.[4] In *Ponderosa Farms*, the taxpayer/owner purchased an aircraft and leased the aircraft to an affiliated entity. The purchase occurred outside Michigan, and the lease took effect while the aircraft was outside the state. Following the lease, the aircraft was principally operated in Illinois, but traveled to Michigan on multiple occasions. Michigan sales and use tax was not remitted on the purchase of the aircraft, but tax was remitted on the rental payments from the lessee. The Department contended that the lease was a sham and that the taxpayer was, therefore, the user of the aircraft when the aircraft was flown to Michigan and should have remitted sales and use tax on the full purchase price of the aircraft.

The Department's sham arguments were based on proof that the taxpayer and the lessee had common ownership, the taxpayer retained the right to direct and control the use of the aircraft, and the aircraft

was registered with the Federal Aviation Administration using an address in Michigan. Despite this proof, the court rejected the Department's sham arguments, concluding that the aircraft was not used by the taxpayer in Michigan. Rather, the court stated that the aircraft was "used exclusively" by the lessee, and there was no indication that the taxpayer or its members operated the aircraft or exercised control over the aircraft while it was subject to the lease.

Another Michigan case reached a similar conclusion that an owner/lessor could remit sales and use tax on the rental payments received for the lease of an aircraft pursuant to nonexclusive leases to multiple parties.[5] The principal issue considered in *Lakeshore Leasing* was whether the taxpayer's use of the aircraft for training and pilot certification and for maintenance of the aircraft disqualified the taxpayer from the election under 1979 AC, R 205.132 ("Rule 82") to remit sales and use tax on rental payments rather than on the original purchase price.

The court rejected the Department's challenge concluding that the taxpayer's use of the aircraft for pilot training was consistent with its business activity of renting or leasing the aircraft to others and that this was not a case where the taxpayer's officers or employees used the aircraft for their own private purposes unrelated to the taxpayer's leasing business. "Nothing in Rule 82 … prohibits the lessor from ever taking possession of its aircraft for purposes related to its leasing business. Under the facts presented in this case, where Petitioner entered into several non-exclusive leases with others, it would be expected that Petitioner would take possession of the aircraft from time to time when the lessees were not operating it, and such possession and use does not defeated the Rule 82 election."

In a more recent decision, the Michigan Tax Tribunal rejected a taxpayer's claim that it was a "lessor" for purposes of Rule 82, concluding that use tax should have been paid on the purchase price of the aircraft rather than on the lease payments.[6] In *Heidrich*, the taxpayer/limited liability company purchased an aircraft and entered into leases with the taxpayer's owners and other related parties. The court determined that the taxpayer was not a "lessor" because the leases were not arm's-length transactions and did not reflect market rents. The court also found persuasive, proof that the taxpayer (1) made no effort to hold itself out to the public as a leasing company and (2) could not prove the total number of hours the aircraft was leased to unrelated parties. Accordingly, the court concluded that taxpayer was not a lessor and, therefore, could not make the election under Rule 82 to remit use tax on the rental receipts.

Practice Pointer: These Michigan cases highlight the various factors that taxing authorities will rely on when challenging sale-for-resale exemptions in aircraft transactions. From ancillary terms in lease agreements and addresses used on registration forms, to flights conducted by the owner for maintenance and training purposes, all these details will be examined for any opportunity to challenge the economic substance or business purpose of a transaction. Careful planning and execution are critical.

> "The taxpayer offered proof that the lease was motivated by legitimate business concerns, including liability and ease of management"

Michigan addressed the application of the use tax exemption for "domestic air carriers" in *Aerogenesis, Inc. v. Dept. of Treasury*.[7] In *Aerogenesis*, the taxpayer purchased an aircraft and leased it to a subsidiary that was certified to operate the aircraft under Part 135 of the Federal Aviation Administration Regulations as a charter operator. The Michigan Department of the Treasury assessed the use tax, contending that the owner/lessor did not qualify as a "domestic air carrier," even though the operator/lessee *did* qualify for the exemption.

The lease agreement between the affiliates was an exclusive lease, except that the taxpayer reserved the right to use the aircraft for its own purposes, subject to availability. The taxpayer also reserved the right to maintain and repair the aircraft and prohibited the subsidiary from altering, modifying, or making improvements to the aircraft. Ultimately, the court rejected the taxpayer's arguments that the two entities should be considered as one entity for purposes of the "domestic air carrier" use tax exemption. Accordingly, the owner/taxpayer was not exempt even though its operating subsidiary was exempt.

Practice Pointer: The taxpayer in this case did not argue that its purchase of the aircraft qualified

for the sale-for-resale exemption under Rule 82. This is likely due to the taxpayer/lessor's retention of the right to use the aircraft and actual use by the taxpayer that would be inconsistent with the resale exemption. When structuring aircraft ownership and operation in separate entities, parties should be careful to consider the consequences of separating ownership and operation, and if that decision is made, the form of the transaction should be respected, and use by the owner should be limited to use that is not inconsistent with the lease to avoid the risk that use by the owner does not void the potential exemption.

Illinois

The Illinois Department of Revenue issued a hearing officer decision in 2011, addressing multiple issues involving an aircraft imported into Illinois.[8] The taxpayer at issue was a limited liability company (LLC) that was treated as a disregarded entity for federal income tax purposes. The member of the LLC was a Colorado resident. The taxpayer purchased an aircraft in Colorado and leased the aircraft to short-term users there. In Colorado, taxpayers are authorized to remit sales tax on lease payments in lieu of paying sales or use tax on the purchase of an aircraft.[9] The taxpayer subsequently relocated the aircraft to Illinois and leased the aircraft to a flight school. The taxpayer failed, however, to retain documentation substantiating payments of Colorado sales tax nor did the taxpayer file Illinois sales and use tax returns or pay Illinois sales or use tax when the aircraft was relocated.

The taxpayer first claimed that it was exempt from use tax because its member qualified for the nonresident exemption in 35 I.L.C.S. § 105/3-70. The basis for this argument was that the LLC was disregarded for federal purposes, and the member was a Colorado resident. The Administrative Law Judge, relying in part on *JB4Air, LLC v. Dept. of Revenue*,[10] concluded that nothing in the Illinois sales and use tax code required treating an LLC as a disregarded entity for *use tax* purposes. Thus, the nonresident exemption did not apply.

The taxpayer also argued that it was entitled to a credit for sales and use tax paid to Colorado on the lease of the aircraft prior to the Illinois lease. However, the taxpayer was unable to produce records substantiating payment of Colorado sales and use tax, and the Colorado Department of Revenue failed to produce documents as part of a third-party subpoena. The administrative law judge concluded that the credit could not be given "without documentary evidence showing that taxes were paid."

Practice Pointers: This case is a reminder that states have different rules regarding disregarded entities, which may impact what types of entities can be used in an aircraft transaction. Morover, the case presents a stark contrast to the record-keeping in *CAO Holdings*, above, illustrating the practical consequences of failing to maintain records that the formalities of aircraft transactions were followed. The case also presents the common situation in which a subsequent use tax issue can arise when an aircraft is relocated after the initial tax planning is completed. Taxpayers must remain vigilant when making a significant decision (*i.e.*, relocating an aircraft to a different state or changing the organizational structure of ownership) during the course of the ownership and operation of an aircraft not to defeat the purpose of the planning that should be performed when the aircraft is purchased.

Maine

The Supreme Judicial Court of Maine addressed the application of a use tax exemption for an aircraft used only partially in Maine.[11] Blue Yonder was an LLC with two members. The LLC purchased an aircraft in Minnesota and transferred it to Massachusetts, where it was registered. No sales or use tax was paid to any jurisdiction upon the acquisition or use of the aircraft. The aircraft was operated in Massachusetts and was flown to Maine on at least 21 full days during the 12 months following the purchase of the aircraft.

During the tax years at issue, the Maine sales and use tax code provided an exemption from taxation for "[s]ales of property purchased and used by the present owner outside the State … [f]or more than 12 months."[12] The court analyzed the applicable statute and concluded that the statute was inherently ambiguous because the statute could be read to indicate either of two extremes: that the exemption would apply (1) if the aircraft was used outside the state at any time during the first 12 months, or (2) only when the aircraft was used exclusively outside the state for the first 12 months. The court considered these interpretations and rejected both, choosing instead to construe the statute in a reasonable manner to avoid an "absurd result."

> We cannot agree with the Assessor's position that an aircraft that is "used outside the Sate" for about ninety-four percent of its first year of use does not qualify for the exemption. Rather, applying a reasonable interpretation of the exemption, as it existed at the time, we hold that subsection (45)(B) exempted Blue Yonder's aircraft from taxation because Blue Yonder used the aircraft outside of Maine for the first twelve months after purchase, with the exception of only six or seven percent of the year. The use of the aircraft outside Maine during the first twelve months was, therefore, sufficiently substantial to make the use tax exemption provided in subsection (45)(B) applicable.[13]

While this case was pending, the Maine legislature amended the statute, effective January 1, 2007, to specify that, as applied to aircraft, the use tax exemption is available only when the aircraft is present in Maine for no more than 20 days during the first 12 months of ownership.[14]

Practice Pointer: This case provides an example of one state's attempt to address situations in which aircraft are only temporarily located in that state. In most cases, these statutes allow for a temporary presence from the time of acquisition to the time of removal.[15] With the exemption at issue in *Blue Yonder*, Maine also exempts property used for 12 months before it is relocated to Maine, subject to the 20-day rule referenced above. This type of exemption is less common and therefore requires careful planning when relocating an aircraft to that state.

Washington

A decision out of the State of Washington in 2011 focused on the authority of the Washington Department of Revenue to assess apportioned *ad valorem* property taxes against a fleet of airplanes managed by an out-of-state company.[16] The taxpayer was located out-of-state but managed a fleet of private aircraft that frequently used Washington airports for landings and take-offs. The taxpayer used the airplanes in two programs, consisting of a fractional-ownership program and a charter program. The applicable agreements provided that the taxpayer retained possession of all the airplanes in which it sold an ownership interest, and the taxpayer was responsible for maintenance and insurance.

The Department of Revenue issued a property tax assessment against the taxpayer and calculated the amount of property tax due by multiplying the total value of the fleet of airplanes by the percentage of the fleet's take-offs and landings in Washington. Although the taxpayer contended the Department lacked the authority to impose a property tax against it under the Due Process Clause, the court found that the minimum contacts test was met and that the taxpayer's average of two daily visits to the state was more than adequate to put it on notice that it would be subject to taxation there, even when those airplanes did not operate over fixed routes or on regular schedules.

> "The court rejected the Department's challenge concluding that the taxpayer's use of the aircraft for pilot training was consistent with its business activity of renting or leasing the aircraft to others"

The taxpayer also challenged the Department's application of the tax statute, contending that the property was not situated in Washington for *ad valorem* tax purposes nor did the statute authorize the taxation of a nonowner, considering the fractional-ownership structure utilized by the taxpayer, arguing instead that the aircraft were based in other states. The court rejected the "home port" case law relied upon by the taxpayer, concluding that the doctrine has been replaced with a "fair apportionment" scheme that allows taxation among the states. The court also concluded that Rev. Code of Wash. Ch. 84.12.270 permits the Department to assess property tax against a nonowner that controls, operates, or manages the property in state. Accordingly, the Washington Supreme Court concluded that the taxpayer was properly assessed an apportioned property tax. The court also held that the apportioned property tax imposed on the taxpayer's planes was reasonably related to the opportunities, benefits, and protections afforded by the state.

Virginia

In a contrasting ruling from Virginia, the Virginia Department of Taxation relied on the "home port"

doctrine in concluding that an aircraft hangared at a city's airport for less than six months during the 2009 tax year was not subject to business tangible personal property (BTPP) taxes in Virginia. [17]

Under Va. Code Ann. §58.1-3511, the situs for any vehicle, including airplanes, is the locality in which it is normally garaged, docked, or parked. The Department relied on an old Virginia Supreme Court decision, which held that situs means more than the physical location of the property on tax day and that the situs of property for BTPP tax purposes is its permanent location, not a casual or incidental location during the course of transit.[18] In addition, the Department cited Virginia Attorney General opinions from 2003 that established a standard in Virginia that vehicles not garaged, docked, or parked in a Virginia locality for at least six months could not be taxed in that locality.

> "When structuring aircraft ownership and operation in separate entities, parties should be careful to consider the consequences of separating ownership and operation, and…the form of the transaction should be respected"

Practice Pointer: Unlike sales and use taxes, there are typically no credits for personal property taxes paid in other states. Thus, taxpayers must carefully evaluate the situs rules in states in which aircraft will be hangared and regularly operated to take into consideration the varying property tax treatment applicable to mobile property such as airplanes. The Washington and Virginia rulings highlight the distinct tax consequences that can result depending on whether a state has adopted the old "home port" doctrine or a more modern apportionment scheme.

Endnotes

1 *CAO Holdings Inc. v. Roberts*, Davidson County, Tennessee, Chancery Court Dkt. No. 06-719-II (Sept. 29, 2011).

2 *CAO Holdings, Inc. v. Chumley*, No. M20081679COAR3CV, 2009 WL 1492230 (Tenn. Ct. App. 2009).

3 *CAO Holdings, Inc. v. Trost*, 333 S.W.3d 73 (Tenn. 2010).

4 *Ponderosa Farms, LLC v. Dept. of Treasury*, Dkt. No. 358038 (Mich Tax Trib. Apr. 11, 2011).

5 *Lakeshore Leasing, Ltd. v. Dept. of Treasury*, Dkt. No. 36100 (Mich. Tax Trib. Jan. 24, 2011).

6 *Heidrich Aviation, LLC v. Dept. of Treasury*, Dkt. No. 358557 (Mich. Tax. Trib. Jan. 11, 2012).

7 *Aerogenesis, Inc. v. Dept. of Treasury*, No. 00-272692, 2011 WL 5454573 (Mich. Ct. App. Nov. 11, 2011).

8 *Illinois Dept. of Rev. v. ABC Business Taxpayer*, Dkt. No. 11-08 (Ill. Dept. of Rev. Aug. 26, 2011).

9 *See* Colo. Rev. Stat. § 39-26-713(1)(a).

10 *JB4Air, LLC v. Dept. of Revenue*, 388 Ill. App. 3d 970 (2nd Dist. 2009).

11 *Blue Yonder, LLC v. State Tax Assessor*, 17 A.3d 667 (Me. 2011).

12 36 M.R.S.A. § 1760(45)(B).

13 *Blue Yonder*, 17 A.3d at 671.

14 P.L. 2005, ch. 519, § EE-1 (codified and subsequently amended at 36 M.R.S. § 1760(45)(A-3) (2010)).

15 M.R.S.A § 1760(23-C)(C) and (82); see also Tenn. Code Ann. § 67-6-313(h) (exemption when airplane is removed from the state within 15 days).

16 *Flight Options, LLC v. Washington Dept. of Rev.*, 259 P.3d 234 (Wash. 2011).

17 Va. Pub. Doc. Rul. No. 11-34 (Mar. 4, 2011).

18 *See Hogan v. County of Norfolk*, 96 S.E.2d 744 (Va. 1957).