DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 04-0209
Sales and Use Tax
For Tax Years 2001 and 2002

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superceded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Sales and Use—Aircraft Purchase

Authority: Gregory v. Helvering, 293 U.S. 465 (1935); IC 6-2.5-2-1; IC 6-2.5-5-27; IC 6-6-6.5-9; 45 IAC 2.2-5-15; 45 IAC 2.2-4-27; Horn v. Commissioner of Internal Revenue, 968 f.2d 1229 (D.C. Cir. 1992); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); Black's Law Dictionary (7th ed. 1999)

Taxpayer protests the imposition of sales tax on the purchase of an aircraft.

STATEMENT OF FACTS

Taxpayer purchased three aircraft, but did not pay sales tax on the purchases. Taxpayer claimed that the purchases were exempt from sales tax because the aircraft were to be used for rental or leasing to others. The Indiana Department of Revenue ("Department") conducted an investigation regarding the rental or leasing of the aircraft and determined that there was insufficient evidence to support the claim of rental or leasing as the use of the aircraft. As a result of this investigation, the Department denied the claim for exemption and issued a proposed assessment for sales tax on the purchase of the aircraft. Taxpayer protests the assessment. Further facts will be supplied as required.

I. Sales and Use—Aircraft Purchase

DISCUSSION

Taxpayer purchased two aircraft in 2001 for one million, seven hundred thirty thousand dollars ($1,730,000.00) and four million, two hundred thousand dollars ($4,200,000.00) respectively. Taxpayer purchased one aircraft in 2002 for eleven million, eight hundred two thousand, three hundred and fifty-five dollars ($11,802,355.00). Taxpayer claimed a sales tax exemption on the purchase of all three aircraft. The Department compared a non-related aircraft rental company's

rate to the rate taxpayer charged for its aircraft. The rental rates taxpayer charged its customer were far below the market rates for comparable aircraft. The Department determined that taxpayer was not renting the aircraft and denied the exemption. Taxpayer protests the denial.

Taxpayer offers several arguments in support of its claim for the exemption. First, taxpayer refers to IC 6-6-6.5-9(a)(4), which states:

> (a) The provisions of this chapter pertaining to registration and taxation shall not apply to any of the following;
>
> …
>
> (4) An aircraft owned or operated by a person who is either an air carrier certified under Federal Air Regulation Part 121 or a scheduled air taxi operator certified under Federal Air Regulation Part 135, unless such person is a corporation incorporated under the laws of the state of Indiana or an individual who is a resident of Indiana.

Taxpayer states that IC 6-6-6.5-9(a)(4) provides that an aircraft owned or operated by a person who is either an air carrier certificated under Federal Air Regulation Part 121 or an air taxi operator certified under Federal Air Regulation Part 135, is exempt to state sales and use tax. Taxpayer is incorrect.

As plainly stated in IC 6-6-6.5-9(a), "The provisions of this chapter pertaining to registration and taxation shall not apply to any of the following;". The chapter referred to is chapter 6.5 of article 6 of title 6 of the Indiana Code. Chapter 6.5 of article 6 of title 6 deals with aircraft license excise tax. IC 6-6-6.5-9(4) only applies to aircraft license taxes, not the sales tax which is the tax at issue in this protest. Therefore, taxpayer's reliance on that subsection is misplaced.

The sales tax is established at IC 6-2.5-2-1, which states:

> (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
> (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

Sales tax is due on retail transactions, such as the purchase or rental of an aircraft. Neither taxpayer nor its customer provided documentation establishing exempt use of the aircraft. The Department never received any documentation establishing that any other third party used the aircraft. This contributed to the Department's determination that taxpayer was not renting or leasing the aircraft.

Next, taxpayer refers to IC 6-2.5-5-27, which states:

> Transactions involving tangible personal property and services are exempt from the state gross retail tax, if the person acquiring the property or service directly uses or consumes it in providing public transportation for persons or property.

Taxpayer claims that this exemption applies to its purchase of the aircraft.

By taxpayer's own explanation, it did not directly use the aircraft in providing public transportation. Taxpayer states that it rented to another business which in turn provided public transportation. The exemption, if applicable at all, would apply to taxpayer's customer since it is the one claiming to directly use the aircraft in public transportation. Therefore, the exemption found in IC 6-2.5-5-27 is not applicable to taxpayer.

Next, taxpayer states that the aircraft was used for rental to others, and therefore was exempt from sales tax under 45 IAC 2.2-5-15, which states:

> (a) The state gross retail tax shall not apply to sales of any tangible personal property to a purchaser who purchases the same for the purpose of reselling, renting or leasing, in the regular course of the purchaser's business, such tangible personal property in the form in which it is sold to such purchaser.
> (b) General rule. Sales of tangible personal property for resale, renting or leasing are exempt from tax if all of the following conditions are satisfied:
> (1) The tangible personal property is sold to a purchaser who purchases this property to resell, rent or lease it;
> (2) The purchaser is occupationally engaged in reselling, renting or leasing such property in the regular course of his business; and
> (3) The property is resold, rented or leased in the same form in which it was purchased
> (c) Application of general rule.
> (1) The tangible personal property must be sold to a purchaser who makes the purchase with the intention of reselling, renting or leasing the property. This exemption does not apply to purchasers who intend to consume or use the property or add value to the property through the rendition of services or performance of work with respect to such property.
> (2) The purchaser must be occupationally engaged in reselling, renting or leasing such property in the regular course of his business. Occasional sales and sales by servicemen in the course of rendering services shall be conclusive evidence that the purchaser is not occupationally engaged in reselling the purchased property in the regular course of his business.
> (3) The property must be resold, rented or leased in the same form in which it was purchased.

Taxpayer states that it was in the business of leasing aircraft and therefore qualifies for the exemption provided by 45 IAC 2.2-5-15. 45 IAC 2.2-5-15(b) requires that three conditions be met in order to qualify for the exemption. One condition is 45 IAC 2.2-5-15(b)(2) states that the

purchaser must be occupationally engaged in reselling, renting or leasing such property in the regular course of his business. As previously explained, the rental rates were a fraction of rental rates charged by third parties for similar aircraft. Under these circumstances, taxpayer does not satisfy 45 IAC 2.2-5-15-(b)(2) and does not qualify for the leasing exemption.

Taxpayer states that it was formed for the purpose of leasing the aircraft to charter companies and, since the charter companies would have been exempt from paying sales tax on the aircraft had they purchased it directly, that there is no tax savings involved in the transaction. The Department notes that taxpayer has not provided documentation establishing that its customer was in fact tax-exempt. Also, the Department has not received documentation establishing that the aircraft was leased or rented to any other parties. Taxpayer has not provided any other documentation concerning the use of the aircraft.

The only activity upon which the Department has documentation is the rental from taxpayer to its customer at a rental rate far below the rate charged by third parties for similar aircraft. The leasing agreements supplied to the Department were unsigned by both lessor and lessee. Again, 45 IAC 2.2-5-15 requires a taxpayer to be occupationally engaged in reselling, renting or leasing such property in the regular course of his business. The documentation and lack thereof show that taxpayer does not qualify for this exemption. Taxpayer's claim that there are no tax savings under its arrangement is incorrect.

Next, taxpayer explains that its customer paid a lower lease rate because it was paying other expenses which, when added to the lease rate, brought the total customer paid closer to comparable lease rates. Taxpayer explains that, under the "dry lease", the lessee was responsible for paying expenses such as insurance, hangar, fuel, maintenance and crew. This supposedly brought the leasing costs to appropriate levels. 45 IAC 2.2-4-27(d) states in relevant part:

> The rental or leasing of tangible personal property, by whatever means effected and irrespective of the terms employed by the parties to describe such transaction, is taxable.
>
> (1) Amount of actual receipts. The amount of actual receipts means the gross receipts from the rental or leasing of tangible personal property without any deduction whatever for expenses or costs incidental to the conduct of the business. The gross receipts include any consideration received from the exercise of an option contained in the rental or lease agreement; royalties paid, or agreed to be paid, either on a lump sum or other production basis, for use of tangible personal property; and any receipts held by the lessor which may at the time of their receipt or some future time be applied by the lessor as rentals.
>
> …

This regulation means that taxpayer was required to collect sales tax on all consideration it received from its customer for lease of the aircraft. Taxpayer was not collecting sales tax on the consideration it received from its customer when the customer paid for insurance, hangar, fuel, maintenance and crew. This is further evidence that taxpayer's relationship with its customer was not a valid lessor/lessee relationship.

Next, taxpayer states that it only created the leasing corporation in order to avoid liability in the event of a catastrophic loss. Taxpayer explained that it was difficult if not impossible to purchase enough insurance to cover potential liabilities from a crash, so it created the lessee corporation to shelter the lessor corporation from those potential liabilities. While this may or may not be the case, it is ultimately irrelevant since it does not explain why the rental rate was set at a fraction of the rate charged for comparable aircraft in the area. The fact that the rental rate was so low makes it plain that the rental agreement was set up to avoid sales tax, since the rental rate would have nothing to do with potential liabilities from a crash.

Finally, the Department notes that a lease is defined as "[a] contract by which the rightful possessor of personal property conveys the right to use that property in exchange for consideration." Black's Law Dictionary 898 (7th ed. 1999). The parties' agreement reflected the fact that pilot/lessee never expected to pay consideration sufficient to justify recognizing the agreement as a lease. Instead, the lease agreement falls squarely within the definition of a "sham transaction." The "sham transaction" doctrine is long established both in state and federal tax jurisprudence dating back to Gregory v. Helvering, 293 U.S. 465 (1935). In that case, the Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and "[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Id at 470. The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert. denied*, 338 U.S. 955 (1950). "[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Commissioner of Internal Revenue, 968 f.2d 1229, 1236-7 (D.C. Cir. 1992). The rental/lease rate charged by taxpayer for the aircraft in question here can only be considered a "sham transaction". The only reason to charge a fraction of the fair market rate for rental/lease of the aircraft and arrange for alternate compensation is to avoid tax. Since taxpayer was not involved in a valid lease or rental agreement with its sole customer the Department was correct to deny taxpayer's claim for the rental/lease exemption.

In conclusion, taxpayer's reference to IC 6-6-6.5-9(a)(4) is inapplicable since it deals with aircraft licensing tax rather than sales tax. Taxpayer was not directly providing public transportation and was not eligible for the exemption described in IC 6-2.5-5-27. Taxpayer was not occupationally engaged in renting to others and does not qualify for the exemption found in 45 IAC 2.2-5-15. It is irrelevant if the leasing corporation was formed to shield taxpayer from liability in the event of a crash, since that would have no influence on the rental rate. Taxpayer was not collecting sales tax on the consideration it received from its customer when the customer paid for insurance, hangar, fuel, maintenance and crew, as required by 45 IAC 2.2-4-27(d). Taxpayer's relationship with its customer was too close and the terms of the rental agreement too generous to establish an arms-length business relationship. The rental/lease arrangement

between taxpayer and its customer constitutes a "sham transaction" entered into for the sole purpose of avoiding taxes, as established in Gregory v. Helvering. Without a valid rental/lease agreement, taxpayer is ineligible for the rental exemption on the purchase of the aircraft.

FINDING

Taxpayer's protest is denied.

WL/JM/JS 052402