DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 06-0071
Use Tax for 2004

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ISSUE

I. Use Tax–Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-3-4; IC 6-2.5-5-8(b); IC 6-2.5-4-10(a); IC 6-2.5-2-1; Form 7695; Indiana Dept. of State Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helvering, 293 U.S. 465 (1935); Horn v. Commissioner, 968 F.2d 1229 (D.C, Cir. 1992); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft.

STATEMENT OF FACTS

Taxpayer is a registered for-profit corporation that purchased an aircraft in October 2004. Taxpayer leases the aircraft to an affiliated entity and to its sole registered officer. Taxpayer filed its application for aircraft registration and claimed a sales and use tax per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the exemption claim. The Department assessed use tax.

A protest was filed and a hearing was scheduled for June 14, 2006. Taxpayer was sent a letter on May 15, 2006, notifying it of the hearing. On May 22, 2006, the letter was returned to the Department marked with a yellow tag by the USPS stating, **return to sender**. The tag listed an alternate, forwarding address. The hearing officer was unable to find an updated address for Taxpayer, but noticed that Taxpayer and its affiliated entity had the same address listed on many of the documents in the file. The hearing officer looked up the current address for the affiliated entity and on May 22, 2006, sent a copy of the original letter along with an updated letter informing Taxpayer that the Post Office had returned the original letter to the Department. The letter further informed Taxpayer that the hearing was still set for June 14, 2006. The Department received no reply from Taxpayer and Taxpayer did not appear for the hearing. This letter of findings is written based upon the information available within the file.

I. Use Tax–Assessment on Purchase of Aircraft

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b).

In October 2004, Taxpayer purchased an aircraft and named itself as the owner on Form 7695, **application for aircraft registration or exemption**. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft–unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to sales and use tax exist. *See* IC 6-2.5-5 and IC 6-2.5-3-4. IC 6-2.5-5-8(b) exempts from sales tax, property acquired for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

> It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.
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> Indiana Dept. of State Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

When Taxpayer filed Form 7695 to register the aircraft with the State, it claimed in Section D a sale and use tax exemption for "Rental or Lease to others." IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from lessees when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This claim requires an analysis of the substance and form of Taxpayer's lease and rental agreements. But first, this requires a discussion of FAA regulations.

FAA Regulations:

> Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts

and Subparts. Part 91 contains the general operating and flight rules. In general–with few exceptions not relevant to this protest before the Department–Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority provide personal transportation to themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a "dry lease." "Operational control" is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft–with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

Analysis of the Form and Function

The affiliated entity has a need for an aircraft to transport officers and employees. Because Taxpayer and the affiliated entity are related, some of the officers and employees of Taxpayer and the affiliated entity are the same persons. If the affiliated entity had purchased an aircraft or a fractional share in an aircraft, sales or use tax would have been due because no applicable tax exemption could be leveraged. But if the aircraft is purchased by an affiliated company and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales and use tax by claiming to "rent" the aircraft to themselves. The sales and use tax burden on an aircraft purchase can be substantial. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of the affiliated. Under FAA regulations, control of the aircraft must be placed with the affiliated entity. Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer does not operate the aircraft–it merely holds the asset for the benefit of the affiliated entity and the officer as an individual.

The Department asked Taxpayer to produce copies of the insurance policy secured on the aircraft. Item 4 in the **coverage summary page** of the **aircraft insurance policy** states, "The **aircraft** will be used only for **non-commercial use**" [bold original]. In the definition section, the policy excludes coverage for renting the aircraft to persons or organizations. Taxpayer's argument that the placement of the aircraft into a separate entity serves to insulate it from liability seems counterintuitive because the insurance policy does not extend liability coverage for rental purposes. Under the FAA rules and the insurance coverage, liability is reverts to the lessee–in this case, the affiliated entity. Taxpayer cannot be in the business of renting and leasing because its insurance coverage does not cover the attendant liability.

Taxpayer does not and cannot operate the aircraft because the sole purpose for the creation of Taxpayer as a business entity is to hold the aircraft as an asset. If it operates the aircraft–it becomes a transportation company and is held to the higher FAA regulations of Part 135. Part 91 requires that a lessee in a dry lease provide and pay for operation expenses, such as pilot services, maintenance, fuel, and insurance. FAR § 91.403 states that those with operational control are responsible for maintaining an aircraft in an airworthy condition.

Application of the Sham Transaction Doctrine

The lease agreements fall squarely within the doctrine of sham transaction. The sham transaction doctrine is well establish in state and federal tax jurisprudence. In Gregory v. Helvering, 293 U.S. 465, 469 (1935), the United States Supreme 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. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. *See* Horn v. Commissioner, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If the affiliated entity or the corporate officer as an individual were required to purchase transportation services in accordance with FAA regulations, each would need to secure a third-party to provide it with air travel services–operated under Part 121, an airline, or Part 135, an air-taxi/charter service. What the affiliated entity or the corporate officer would pay to the third-party would be applied to the purchase and operational costs. But the

affiliated entity and the corporate officer do not wish to pay those costs–and they need not. What the affiliated entity and the corporate officer as an individual each wants is an aircraft of its own that it each can control; that is what each has acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer, the affiliated entity, and the corporate officer as an individual structured the transaction to secure the benefits of an exemption–but did not assume the associated burdens. The Indiana Supreme Court–as well as courts across the land–have stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured a tax benefit by avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of the affiliated entity or the corporate officer as an individual; Taxpayer has to give the aircraft and operational control to the lessees, each of whom is required to maintain the aircraft and pay the necessary associated expenses. The rental rate is set to cover the cost of using the aircraft asset–and that is all that can be charged and still comply with FAA regulations. Taxpayer states that the rental rate paid by the affiliated entity and the corporate officer as an individual is reduced because Taxpayer is responsible for maintaining the aircraft. The net effect that each lessee gets what it wanted all along–control and use of an aircraft; but it has avoided the upfront, one-time cost of having to pay the sales and use tax due. If the affiliated entity and the corporate officer as an individual had purchased the aircraft outright in whole or as a fractional share, each still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as each has, while each still has to pay those associated costs, the lease payments made to Taxpayer remain with those who have ownership interests–the affiliated entity and sole corporate officer as an individual. The lease payment is a nullity. In addition, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by the affiliated entity and the corporate officer. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance.

The relationship between Taxpayer, the affiliate entity, and the corporate officer is interfamilial. There is no rental and leasing to others; the parties are renting and leasing to themselves. In fact, the lease agreement for use by the individual corporate officer, for strictly personal purposes, changes the title and role of Taxpayer. In the lease between Taxpayer and the related entity, Taxpayer is named as the Owner (lessor) of the aircraft and the related entity is named as the Operator (lessee). However, in the lease between Taxpayer and the corporate officer as an individual, Taxpayer is named as Lessee and the corporate officer is named as the Sublessee. The agreement was signed by the affiliated entity as Lessee and the corporate officer as Sublessee. But within the agreement, Taxpayer is named as the Lessee. The reasonable conclusion is that the transactions between Taxpayer, affiliated entity, and corporate officer as an individual are entirely circular. Taxpayer has structured a questionable arrangement by which Taxpayer owns the aircraft and is lessor to the affiliated entity, but is named as a lessee in the sublease to the corporate officer as an individual and then has the affiliated entity sign on its behalf. No rental and lease agreement was submitted to the Department to document from whom Taxpayer is leasing the aircraft. When Taxpayer registered the aircraft with the Department, it represented on Form 7695 that it is the owner. Taxpayer cannot be simultaneously an owner and a lessee. Given the presumption that Taxpayer authorized the affiliated entity to sign on its behalf, the rental agreements document circular transactions of rental to the taxpayer itself.

IC 6-2.5-5-8(b) grants a sales and use tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. Black's Law Dictionary 192 (7th ed. 1999) defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing in the ordinary course of its business for the purposes of the sales and use tax statutes. Additionally, as of the hearing date, Taxpayer has remitted to the Department the *de minimis* amount of $119 in sales tax revenues from its leases entered into with itself.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

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