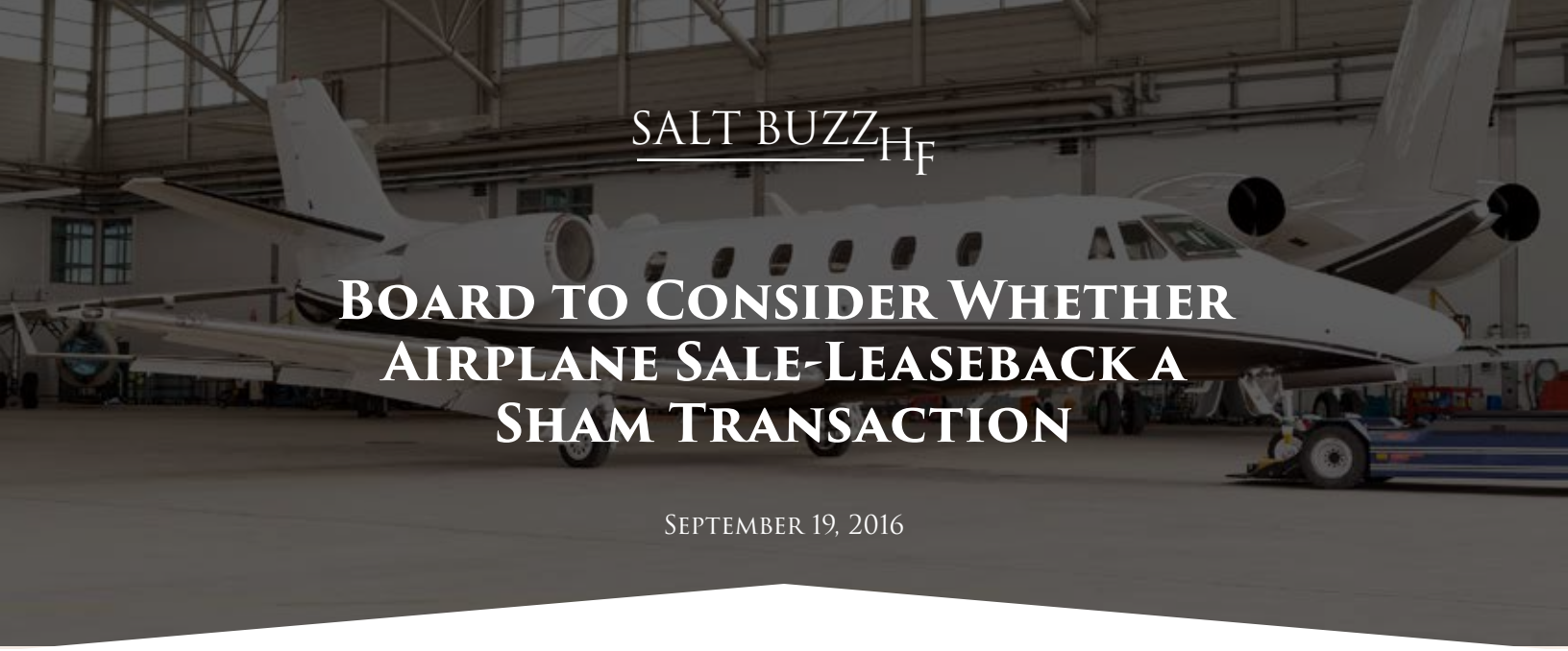

SALT BUZZ HF

Board to Consider Whether Airplane Sale-Leaseback a Sham Transaction

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Member

On October 17, 2016, a hearing will be held at the Ohio Board of Tax Appeals ("Board") to allow testimony and evidence on whether the sale and subsequent leaseback of an airplane between commonly-owned entities constitutes a "sham transaction" for Ohio sales and use tax ("SUT") purposes. The Ohio Tax Commissioner ("Commissioner") issued a Final Determination ("FD") last summer in which it affirmed a sales tax assessment on the purchase of an aircraft by the taxpayer, Pi in the Sky, LLC ("Pi"). Pi appealed the FD to the Board. The case will likely be the first published decision in which the Board addresses the sham transaction doctrine set forth in R.C. 5703.56.

Pi purchased the aircraft outside Ohio. Pi argues the initial purchase of the aircraft qualified for the resale exemption because the aircraft was immediately leased to a commonly-owned entity, Mitchell's Salon and Day Spa ("Mitchell's"). Pi is owned by Mitchell's. The owner and president of Mitchell's is a licensed pilot and the primary user of the airplane. In the FD, the Commissioner asserts that the resale exemption does not apply because "the facts reveal a scheme to avoid taxation with no legitimate business purpose."

The Commissioner affirmed the assessment based on his power to disregard a transaction conferred by R.C. 5703.56, which was enacted in 2003. That statutory provision applies to all Ohio taxes and defines a "sham transaction" as "a transaction or series of transactions without economic substance because there is no business

purpose or expectation of profit other than obtaining tax benefits." The statutory provision authorizes the Commissioner to apply the judicial doctrines of economic reality, substance over form, and step transaction.

In support of his application of the doctrine, the Commissioner references the fact that while Pi asserts the plane was purchased for lease to others, the airplane was never leased to a third party for an arm's length fee. Instead, the Commissioner notes, the plane was only leased to the owner and president of Mitchell's, who was also the indirect owner of Pi. There was also no evidence that the airplane was marketed or made available for another party to lease the airplane. The Commissioner references the fact that the official address of the plane was the owner's residence as further evidence of a sham transaction.

The Commissioner also argues that the lease terms were not arm's length. The owner signed the sales agreement on behalf of Pi and signed the lease agreement for both parties, which the FD states "demonstrates that no sale has taken place." "The contention that Pi in the Sky, LLC is leasing to 'others' is pure fiction." The lease did not have a defined term and charged a minimal hourly rental. Additionally, Pi was responsible for all the airplane expenses. According to the Commissioner's calculations, the rent payments which are based solely on the flight hours by lessee, would be less than one-third of the revenue required to service the loan payments on the plane. Further, the owner was listed as the borrower on the loan. The Commissioner also cited the fact that the plane was not generally used for business but to fly the owner to her lakefront vacation property in Michigan, and there were no other passengers. Finally, there was evidence that advance lease payments were made but the sales tax paid represented only a fraction of those lease payments.

Based on this evidence, the Commissioner concluded that the sale and leaseback had no economic substance and that Pi "sought to obtain the tax benefit associated with the legitimate operation of a dry lease aircraft leasing business (exemption from paying sales tax on the purchase of the aircraft) but failed to operate a legitimate business enterprise." The assessment imposed the sales tax on the purchase of the plane, including penalties. The FD declines to abate the penalties. It appears that the Commissioner did not reduce the assessed sales tax by the sales tax collected on the lease payments.

The case is interesting for a number of reasons. There is little published Ohio authority on the Commissioner's ability to disregard a transaction. There are no published decisions interpreting R.C. 5703.56. There are only a handful of decisions applying the judicial doctrines before the enactment of R.C. 5703.56, and most of those involved assertion by taxpayers that the form of their own transaction or structure

should be disregarded. The case is also interesting since it involves the Ohio SUT. There are a number of SUT cases where the Commissioner asserted that a transaction between commonly-owned legal entities had to be respected and SUT imposed. That precedent underscores the importance of respecting the separate legal entities through documentation and use of arm's length pricing and arm's length practices. While this case is consistent with that precedent, the Commissioner's arguments, if accepted by the Board, could be used by taxpayers to argue that SUT should not be imposed on transactions between commonly-owned entities.

If you would like to discuss the impact of this hearing or the R.C. 5703.56, please contact Deb McGraw or any of the other professionals at Zaino Hall & Farrin LLC.

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