

Home | Print

**May 2008**

***Extreme Caution Advised!  
Properly Responding to State Sales and Use Tax Audits  
of Aircraft Acquisitions and Ownership***

Stuart M. Schabes

**410-347-7696**

smschabes@ober.com

Christopher B. Younger

**410-347-7679**

cbyounger@ober.com

Appeared in *World Aircraft Sales Magazine*

May 2008

As we discussed in our article "IRS Income Tax Audits are Increasing: What Should You Do When You Receive an Audit Notice?" published in last month's edition of *World Aircraft Sales Magazine*, negotiating your way through a federal income tax audit can be daunting and difficult.

Similarly, state sales and use tax audits are fraught with many potentially complex tax compliance pitfalls. If you are unfortunate enough to receive a notice or other inquiry from a state taxing authority regarding potential liability for state sales or use tax on your purchase or use of an aircraft, you must tread carefully through the "minefield" of issues surrounding the audit.

This article will highlight several of the most important issues relating to sales and use tax audits and provide some practical advice for aircraft owners and/or operators with respect to such audits. By way of general background, the purchase or use of business aircraft is typically treated as a sale or use of tangible personal property that is subject to state sales or use tax unless a state exemption or similar limitation applies.

Many states, facing increasingly large budget deficits and decreasing sources of new tax revenue, are more thoroughly and carefully scrutinizing the acquisition and use of business aircraft to determine whether that state's sales or use taxes apply to such transactions. Furthermore, a substantial number of states have raised - or are raising - their sales and use tax rates, which are typically in the range of 4% to 8% of an aircraft's purchase price or fair market value. Thus, due to business aircraft purchase prices that typically range in the millions of dollars, a negative outcome following such an audit would likely result in a large sales or use tax liability.

It is common practice now in the State of Indiana, for example, for the Indiana Department of Revenue to issue a proposed sales or use tax assessment to an aircraft purchaser/owner who is required by law to register their aircraft in Indiana. Often such a proposed assessment is issued despite the fact that the aircraft purchaser has meticulously followed Indiana's prescribed procedure for establishing an exemption from its sales and use tax for such purchase or use of the aircraft.

Moreover, the Indiana Department of Revenue has increasingly taken the position that all claimed sale for resale exemptions based on aircraft leasing structures between related parties are subject to further scrutiny. Based on recently issued rulings of the Indiana Department of Revenue on this issue, the Department has made it clear that many aircraft ownership and leasing structures will be presumptively treated as "sham" transactions to which the sale for resale exemption from Indiana sales and use tax will be routinely denied.

This appears to be the case even when those structures serve legitimate business planning, federal regulatory compliance or liability limitation purposes. This approach may not only effect new transactions but also places at risk those transactions that took place over the last several years.

Even in states that have not necessarily decided to wage all-out "war" on what were once perfectly acceptable and legal aircraft ownership and operating structures, and that reduced or eliminated sales and use tax relating to such aircraft, there is a growing trend to make compliance with such strategies administratively difficult, overly time consuming or simply confusing. Many states insist that, in order to qualify for a particular exemption from sales or use tax, a taxpayer must precisely follow each intricate administrative step involved in such compliance without "any" leeway for inadvertent or unintentional errors.

These requirements may involve having certain items in place prior to the acquisition of the aircraft or its importation into the state, such as an executed aircraft lease or the approval of a lessor's application to become a registered "retail merchant" for purposes of collecting and remitting that state's sales tax. In addition, some states require that their forms relating to the application of a particular sales or use tax exemption be filed within a certain time period prior to, or following, the aircraft's acquisition or importation into the state, in a certain specific number, and with one or more agencies within the state government.

In many instances it is extremely difficult, if not impossible, for an aircraft purchaser/owner to know all of the procedural requirements that must be followed in a particular state in order to qualify the acquisition/ importation of their aircraft

for an available exemption from sales or use tax without having previously completed such a transaction in that state.

It is also becoming more common for state taxing authorities to routinely send audit letters to aircraft owners requesting additional information regarding an aircraft that is (or was) located in such state, even if for only a brief period of time. The primary purpose of such letters is to enable the state to assess sales or use tax on such aircraft if it obtains a response from an aircraft owner that contains information supporting the state's right to make such an assessment.

### **Some Good News**

Fortunately, the news in this area is not all bad. Some states appreciate the economic benefit of encouraging business aircraft owners to hangar their aircraft within the state or to fly their aircraft into the state for maintenance and repairs. For instance, certain states have enacted blanket exemptions from their sales and use taxes for the purchase and/or use of business aircraft within that state.

Other states have enacted sales and use tax exemptions that aim to encourage a particular type of business aviation activity within that state. Michigan - for example - recently enacted laws that exempt from state tax the sale of some aircraft parts and materials installed on aircraft that are temporarily located in Michigan for purposes of pre-sale evaluation of such aircraft and post-sale work relating to such evaluation. These states recognize that such incentives encourage other tax generating businesses that maintain and repair aircraft or that are ancillary to having aircraft hangared within their borders.

However, it is important to remember, as discussed above, that there are often numerous bureaucratic, technical and potentially cumbersome procedural requirements that must be followed to qualify for these exemptions.

### **Careful Planning Essential**

Due to the increased scrutiny of aircraft by state taxing authorities in connection with the potential assessment of such state's sales and use taxes and the increasing complexity of methods for compliance with the requirements to qualify for available sales and use tax exemptions, it is of paramount importance that aircraft owners carefully plan an aircraft acquisition to avoid potential (and unexpected) taxation with respect to the aircraft transaction to the greatest extent possible.

Aircraft owners also must continually monitor the use of such aircraft thereafter to ensure that state taxing authorities are provided as few avenues as possible to assert that such aircraft are subject to their own sales or use tax structure.

Naturally, all of this reinforces the need for thorough sales and use tax planning prior to the purchase of an aircraft. Such planning can often eliminate, or at least minimize the harsh results of a sales or use tax assessment on an aircraft.

However, whether or not such planning has been undertaken prior to the receipt of an audit notice from a state taxing authority with respect to an aircraft, it is imperative that the response to such a notice be prepared with meticulous thought and expert guidance from a well experienced tax professional. In many instances, the response to a notice from a particular state and the subtle nuances of that response will, if properly crafted, eliminate any additional inquiry from the state.

On the other hand, if a state decides to assess its sales or use tax following its audit of an aircraft transaction and review of a taxpayer's responses to related audit inquiries, it is imperative that those responses create clear and convincing evidence to support a logical argument against the assessment. Such an argument will be absolutely necessary to support a taxpayer's position in an appeal of such an assessment and will make the taxpayer's subsequent argument against such an assessment infinitely stronger.

For the foregoing reasons, it is essential that an aircraft owner who is faced with a state audit engage expert assistance in the area of sales and use tax audits and the exemptions from sales and use taxes that typically apply to aircraft at the beginning of the audit process.

This area is ever-changing and the aviation tax attorneys at Ober|Kaler are well versed in the intricacies of state sales and use tax audits and exemptions from sales and use taxes relating to aircraft and are fully prepared to represent such aircraft owners throughout the audit process.

---

**Stuart M. Schabes** is a principal in the law firm of Ober|Kaler, and chairs the firm's Aviation Tax and Transactions group. An experienced tax and corporate attorney, Stuart handles tax planning, tax controversy, tax compliance, and transactional matters for an array of domestic and foreign entities. He is nationally recognized for his expertise in handling aviation related income and excise tax audits and refund claims. Stuart also acts as Special Tax Counsel to several multi-national companies with an emphasis on federal excise tax and frequent flyer/customer loyalty program matters. He is a frequent speaker on tax audit and IRS representation issues.

**Christopher B. Younger** is an attorney at Ober|Kaler, and a member of the firm's Aviation Tax and Transactions group. He is a tax and FAA specialist concentrating in the areas of corporate aircraft transactions and aviation taxation. He has

extensive experience in planning and implementing unique aircraft ownership and operating structures on a global level. He has worked on numerous tax audits with the IRS and with various state taxing authorities.

Ober|Kaler's Aviation Tax and Transactions group provides full-service tax and regulatory planning and counseling services to corporate aircraft owners, operators and managers. The group's services include Code Section 1031 tax-free exchanges, federal tax and regulatory planning, state sales and use tax planning, and preparation and negotiation of transactional documents commonly used in the business aviation industry, including aircraft purchase agreements, leases, joint-ownership and joint-use agreements, management and charter agreements, and fractional program documents.

### **Ober, Kaler, Grimes & Shriver**

#### **Maryland**

120 East Baltimore Street, Baltimore, MD 21202  
Telephone **410-685-1120** , Fax 410-547-0699

#### **Washington, D.C.**

1401 H Street, NW, Suite 500, Washington, DC 20005  
Telephone **202-408-8400** , Fax 202-408-0640

#### **Virginia**

407 North Washington Street, Suite 105, Falls Church, VA 22046  
Telephone **703-237-0126** , Fax 202-408-0640