

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of )  
[Redacted], ) DOCKET NO. 22188  
 )  
 )  
Petitioners. ) DECISION  
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\_\_\_\_\_ )

On June 30, 2009, the staff of the Sales, Use, and Miscellaneous Tax Audit Bureau (Bureau) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (Notice) to [Redacted] (taxpayer) proposing use tax, penalty, and interest for the tax period November 1, 2004, through December 31, 2007, in the total amount of \$232,489.

In correspondence received August 27, 2009, the taxpayer filed a timely appeal and petition for redetermination. At the taxpayer’s request, the Commission held a hearing on March 25, 2010. For the reasons that follow, the Commission upholds the audit findings.

**BACKGROUND**

[Redacted] administers related companies that primarily manufacture, promote, and distribute [Redacted] products. The audit resulted from a refund request initiated on behalf of the taxpayer by its representative in this case, [Redacted] The amount of the deficiency is net of refund amounts allowed. The Commission received \$21,817.31 on August 28, 2009, toward the Notice of Deficiency Determination amount and adjusted the outstanding liability accordingly.

## ISSUE

During the audit period, the taxpayer purchased fractional interests of [Redacted]. This is a brief definition and history of fractional ownership as it relates to [Redacted]:

[Redacted]

Two fractional interests (3/16 and 1/8) in [Redacted] were acquired on October 31, 2005.

Total acquisition costs were \$2,844,375.

The taxpayer views its fractional interest purchases as nontaxable [Redacted] services. The auditor views the transactions as purchases of tangible personal property for which no sales tax exemption applies. Since the seller did not collect a sales tax on the fractional interest transactions, the auditor imposed a use tax, as defined below.

### RELEVANT SALES TAX STATUTES

In Idaho, the sale of tangible personal property is subject to tax unless an exemption applies (Idaho Code §§ 63-3612 and 63-3619). If the seller does not or cannot collect the tax, the purchaser owes a use tax directly to the state because Idaho Code § 63-3621 imposes a tax on the storage, use, or other consumption of tangible personal property in the state. When property is stored, used, or consumed in Idaho, the user owes use tax unless he has paid sales tax on the purchase of the property or an exemption applies. Idaho Code § 63-3615(b) defines “use” for the purpose of imposing the tax as “... the exercise of any right or power over tangible personal property incident to the ownership or the leasing of that property ...”

Some sales transactions, other than those involving the exchange of tangible personal property for a consideration, are taxable, but they are not relevant to the issue disputed in this decision. Idaho Code § 63-3612 lists transactions that are subject to tax, and [Redacted] is not among those taxed.<sup>1</sup>

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<sup>1</sup> [Redacted]

## SUMMARY OF THE TAXPAYER'S PROTEST

The disagreement between the Commission and the taxpayer lies in characterizing [Redacted] and whether they are the taxable purchase of tangible personal property or the nontaxable purchase of [Redacted] services.

The taxpayer provides extensive documentation of its position in a compendium addressed to the Commission and dated March 25, 2010. Appendix C of the compendium contains copies of several contracts, agreements, and acknowledgements that bind the taxpayer with the seller and affiliated [Redacted] entities.

The taxpayer's timely protest letter, the compendium described above, and references to prior court cases and rulings that are part of the compendium, constitute the defense of the taxpayer's position. At the informal hearing with the Commission, noted previously, the documents and references were discussed.

In its petition for redetermination, the taxpayer restricts its protest to transactions related to interests in [Redacted] fractional ownership program. The amount at issue, it states, is \$142,218.75 plus penalty and interest.

According to the taxpayer's written protest, it has not purchased tangible personal property as defined in the Idaho Sales Tax Act. Rather, the transactions "[Redacted].

[Redacted].

The taxpayer states that the foregoing is precisely what a [Redacted] service does and that the only differences (e.g., prepaid services and a preferred [Redacted] selection) are not relevant to its characterization of the purchases.

[Redacted].

During the hearing, the taxpayer raised an additional defense referred to as “the object of the transaction” test. This test is used in Idaho to determine if tax is due when there is a mixed transaction, i.e. the exchange of tangible personal property along with the provision of non-taxable services. Application of this test can determine if the transaction is the sale of property with an immaterial service component, a sale of service with an immaterial element of property, or, a transaction with consequential elements of both property and service (IDAPA 35.01.02.11.02-.03).

The taxpayer claims that it does not want to purchase [Redacted]; it only wants to purchase [Redacted] services. [Redacted]. When asked at the hearing, the taxpayer said that it was unaware of why [Redacted] required an array of contracts merely to provide [Redacted] services.

While the taxpayer calls the Commission’s attention to two court cases that found in favor of the respective states in actions against taxpayers for purchases of [Redacted] fractional interests, it believes those courts failed to consider the “object of the transaction” test in their determinations.

The taxpayer further notes that the states of Texas and New York have both addressed the issue of fractional ownership of [Redacted] and have concluded that they constitute non-taxable [Redacted] rather than the taxable sale of tangible personal property.

The taxpayer requests that all taxes and related interest and penalty associated with the fractional interest transactions be removed from the audit findings.

## ANALYSIS OF THE ISSUE

The fractional ownership or interest issue is not new to the Commission, but it has not been the focus of a disputed audit. The issue was litigated in other states, as noted previously, and some states have issued opinions with respect to it, also noted by the taxpayer. These findings are discussed as part of this decision. Further, the various contracts the taxpayer signed in order to purchase the fractional interests are discussed as well.

The Commission believes that an analysis of the facts and precedents in their entirety weighs in favor of viewing fractional interests in [Redacted] as a purchase of tangible personal property more persuasively than as a purchase of transportation services. The documents the taxpayer signed are testimony to that as is the treatment afforded these transactions in the taxpayer's books of accounting as well as in its preparation of income tax returns.

### ACCOUNTING AND TAX TREATMENT AS ASSET PURCHASES

First, it is uncontested that the transactions in question were located by the auditor on an asset schedule. Assets are afforded specific accounting treatment for balance sheet purposes as well as for advantageous tax purposes. The taxpayer took advantage of asset depreciation as well as Idaho's Investment Tax Credit, which is only available for asset purchases.

### PURCHASE AGREEMENTS SPECIFY PROPERTY ACQUISITION

The seller [Redacted] uses unequivocal language in describing its purpose in contracting with the taxpayer. Here are relevant excerpts from a signed document, Fractional Interest Purchase Agreement, for the subject [Redacted].

[Redacted]

The taxpayer also signed an agreement entitled, "[Redacted]" This document binds the taxpayer with [Redacted] and provides that:

[Redacted]

Tenancy-in common is defined as, “[j]oint-ownership of property by two or more related or unrelated entities (co-tenants) in equal or unequal shares. Each co-tenant's share is undivided: no co-tenant has exclusive right to any portion of the property and each has equal right to possess the whole property.” Chattel is defined as “transferable personal property” ([www.businessdictionary.com](http://www.businessdictionary.com)). The agreement signed by the taxpayer expresses a particular type of personal property ownership.

TAXPAYER FUNCTIONS AS LESSOR AND LESSEE  
WITH RESPECT TO [Redacted]

Under the contract with [Redacted], the taxpayer agrees to use alternative [Redacted] when its named [Redacted] is unavailable and that its named [Redacted] can be used by others at [Redacted] discretion when it is otherwise idle. The substitute [Redacted] are provided from an [Redacted] pool under the direction of [Redacted] Owners Agreement, Taxpayer’s compendium, Appendix C-4). This [Redacted] exchange feature is cited by the taxpayer as evidence against the Commission’s position that the taxpayer purchased tangible personal

property rather than [Redacted] services. Yet, here is how one of the signed documents characterizes the [Redacted] exchange element:

The [Redacted] Exchange Agreement is among Owners, alternatively referred to as Participants, and [Redacted] to assure that fractional share owners can participate as [Redacted]

In Idaho, the definition of “sale,” with respect to tangible personal property, includes leasing (Idaho Code § 63-3612(2)(h)). While the lease of goods does not include all of the privileges of ownership, such temporary exchanges of tangible personal property for a consideration are nevertheless held taxable under Idaho’s code. In order to lease the property to others, you must have ownership rights to confer. In order to lease from another, you must be bestowed some rights akin to ownership.

## EXERCISE OF RIGHT OR POWER OVER TANGIBLE PERSONAL PROPERTY

Ownership, possession, and control are important concepts to the taxpayer because they are manifestations of the purchase of tangible personal property. The taxpayer states that the subject [Redacted] can be reacquired by [Redacted] and is always under [Redacted] possession and control. From these facts, the taxpayer asserts that it did not make a purchase of tangible personal property.

The sales contracts' language does not support the taxpayer's position. [Redacted]:

[Redacted].

[Redacted] Bill of Sale and Assignment is a bill of sale signed contemporaneously with the one noted above, while not identical to it. The seller [Redacted] "has bargained, sold, transferred, assigned, set over and conveyed....an undivided ...interest in all of the personal property....listed on the Schedule...." (taxpayer's compendium, Appendix C-8). The schedule attached to the bill of sale refers to an 18.75 percent interest in a named [Redacted] "[Redacted]..." This language conveys a sale of tangible personal property, not the sale of [Redacted] services.

An excerpt from another document signed by the taxpayer addresses the issue of control.

[Redacted]

Summarizing from other portions of the document cited in the previous paragraph, the taxpayer owner acknowledges responsibility for safe operations, even though it may delegate performance of certain tasks to the program manager. In fact, according to the document, the taxpayer continues, with the program manager, to be jointly, as well as individually, responsible for task performance and compliance. By its signature, the taxpayer acknowledges liability risk with respect to regulating body enforcement actions and for personal injury or property damage resulting from [Redacted] occurrences.

The [Redacted] Fractional Ownership Program Management Services Agreement discusses monthly management fees and various variable charges payable to [Redacted]. It unequivocally states that, while both parties agree that [Redacted]. The forgoing responsibilities, as well as the exposure to liability, have not been shown by the taxpayer to be a characteristic of a contract for transportation with a charter [Redacted].

The taxpayer does not ignore that the taxpayer is granted or required to accept a certain amount of control, but it does not believe the level of control rises to a threshold necessary to characterize the fractional interests as the purchase of tangible personal property.

This was the particular argument of a Missouri taxpayer, Fall Creek Construction Co., Inc, in a court case involving aircraft fractional interests and sales tax. The state's taxing authority prevailed in this case. Specific to the issue of control, the court said the following:

Fall Creek is simply incorrect in its assertion that “operational control” is de minimus control of the aircraft. One of the regulatory advantages of fractional ownership is the ability to operate within Part 91 of the Federal Aviation Regulations. Philip E. Crowther, Taxation of Fractional Programs: “Flying Over Uncharted Waters”, 67 J. AIR L. & COM. 241, 249 (Spring 2002). “With certain exceptions, in order to operate under Part 91, the user must accept responsibility for ‘operational control’ of the aircraft.” Id. Such responsibility is more than token. Id. The user-owner is held responsible by the FAA and civil courts if there is an incident. Id.

The Federal Aviation Regulations ensure that owners are fully aware of the consequences of having operational control. Id. An aircraft owner accepting “operational control” must acknowledge that he or she: “(i) has responsibility for compliance with all Federal Aviation Regulations applicable to the flight; (ii) may be exposed to enforcement actions for noncompliance; and (iii) may be exposed to significant liability risk in the event of a flight-related occurrence that causes personal injury or property damage.” Id. (internal citations omitted); 14 C.F.R. section 91.1013. (Fall Creek Construction Co., Inc. v. Director of Revenue, 109 S.W.3d 165 (Mo., 2003)).

A more recent court case in which the taxing authority also prevailed found control of the aircraft to be central to the assessment of tax. The plaintiff taxpayer, Fisher and Company, Inc.

(Fisher), is a Michigan corporation. It purchased a 25 percent undivided interest in a small turboprop jet airplane from [Redacted]. That partial interest was formally considered to be a tenant-in-common ownership interest, along with several other part owners. The plaintiff was designated as a “buyer.” Each part owner, including the plaintiff, was entitled to share in the airplane’s depreciation, gain, loss, deduction, or other tax benefit that might arise. Notably, the Michigan court determined use tax was due even though the aircraft in question was never used by [Redacted] and, therefore, it certainly was never present in [Redacted] on behalf of the taxpayer. The court said the following:

We are persuaded that plaintiff “used,” within the meaning of the [Use Tax Act], its fractional ownership interest in the airplane in Michigan. The right to control what happens-in layman's terms-to one's property is one of the most fundamental rights incident to ownership. Entering into a contract to give up some of one's rights to possession or control is, itself, an exercise of those rights. It would be an exercise of an ownership right for a person in a time share pooling arrangement to use someone else’s share in exchange for that person’s own share. We conclude that plaintiff's use of any airplane in the fleet at issue was pursuant to its contracts to share ownership rights to its own airplane. Therefore, we conclude that plaintiff “used” its property in Michigan within the meaning of the [Use Tax Act] (Fisher & Company, Inc. v. Department of Treasury 282 Mich.App. 207, 769 N.W.2d 740).

#### APPLICABLE FEDERAL REGULATIONS STRESS OWNER CONTROL UNDER FRACTIONAL OWNERSHIP PROGRAMS

Earlier, this decision pointed out that the taxpayer was unaware of why the seller, [Redacted], required multiple contracts in order to provide what the taxpayer refers to as merely transportation services. Since the Commission relies heavily on the contracts to defend its position that a sale of tangible personal property has taken place, it is curious on this point, although it does not think that the answer is necessary to prove its case.

Nevertheless, the Commission notes that the Missouri court in Fall Creek stresses the role of Part 91 of the Federal Aviation Regulations (FAR) as important to its decision. Part 91

regulates aircraft owned by and under the control of individuals and companies. It defines the general operating rules for all aircraft (14 CFR, FAR Part 91). FAR Part 91, Subpart (K), prescribes operating rules for fractional ownership programs.

Fractional Ownership Program Management Services Agreement and Master Dry-Lease Aircraft Exchange Agreement (taxpayer's compendium, Appendices C-5 and C-6), mentioned earlier, indicate that the aircraft in question are managed under Part 91 and that the flights are owner-operated. In contrast to Part 91, Part 135 of the FAR regulates flight services. Part 135 is a set of rules with more stringent standards for commuter and on demand operations (14 CFR, FAR Part 135.1).

In the protest before the Commission, there is no reference to Part 135 in the contracts binding the seller with the taxpayer. While the Commission does not view a reference to Part 135 as essential to the taxpayer's position, it does note that the omission weakens the taxpayer's case since Part 135 regulates transportation services, the definition the taxpayer gives to the transactions at issue in this decision.

#### THE "OBJECT OF THE TRANSACTION" TEST

The taxpayer, in the present case, raised an "object of the transaction" defense, as noted previously. This test is included in many state's sales and use tax rules, as it is in Idaho.

Guidance on using this test in Idaho is as follows:

Rule 011 . . .

02....to determine whether a transaction is a retail sale of tangible personal property or a sale of services, the following tests must be applied.

b. To determine whether a mixed transaction qualifies as a sale of services, the object of the transaction must be determined; that is, is the buyer seeking the service itself, or the property produced by the service.

c. When a mixed transaction involves the transfer of tangible personal property and the performance of a service, both of which are consequential elements whose

costs may be separately stated, then two (2) separate transactions exist. The one attributable to the sale of tangible personal property is subject to sales tax while the other is not.

03. Determining the Type of Sale. To determine whether a specific sale is a sale of tangible personal property, a sale of services or a mixed transaction, all the facts surrounding the case must be studied and the tests described above must be applied. (Idaho's Sales Tax Administrative Rules, IDAPA 35.01.02.011.02-.03 in relevant part.)

The Michigan case cited previously includes a dissenting opinion in favor of the plaintiff Fisher based on this defense, although it refers to it as the "incidental to services" test. For the dissenting opinion, one Justice weighed in favor of treating fractional interests as transportation services rather than purchases of tangible personal property:

[Redacted]

The dissenting Justice's opinion is precisely what the taxpayer in the present case proposes to the Commission in the defense of its position. The taxpayer did not wish to purchase an aircraft, it wanted to purchase transportation services, and the only way to meet its needs was to sign the numerous contracts that unambiguously specify the sale of tangible personal property.

The majority in the Michigan court did not ignore the plaintiff's defense and, by extension, the defense the current taxpayer brings to the Commission. It meets it directly in the following text:

We appreciate the fact that, at the end of the day, plaintiff [Fisher] ultimately just wanted to have on-demand corporate jet transportation without the need to purchase and maintain a whole airplane. However, the dispositive issue is not so much plaintiff's motivation as what actual transaction plaintiff entered into. The documents involved all reflect a sale of an ownership interest in an airplane, coupled with a contractual arrangement under which multiple airplane owners shared maintenance, administration, and access to their airplanes. In effect, this is a time share in an item of tangible personal property; in this case, an airplane (Fisher & Company, Inc. v. Department Of Treasury (282 Mich.App. 207, 769 N.W.2d 740).

## MOTIVATIONS AND ACTUAL TRANSACTIONS

The Michigan court's majority opinion, with respect to its treatment of a taxpayer's intentions, has precedents at the federal level.

The Eleventh Circuit Court of Appeals in Bradley v. United States, 730 F.2d 718,720 (1984) stated that:

... as a general rule, the Commissioner may bind a taxpayer to the form in which the taxpayer has cast a transaction, Spector v. Commissioner, 641 F.2d 376, 381 (5<sup>th</sup> Cir. Unit A 1981).

The United States Supreme Court in Commissioner V. National Alfalfa Dehydrating and Milling Co., 417 U.S. 134 (1974) stated that:

This court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, Higgins v. Smith, 308, U.S. 473, 477, 84 L.Ed. 406, 60 S. Ct. 355 (1940); Old Mission Portland Cement Co. v. Helvering, 293 U.S. 289, 293, 79 L.Ed. 367, 55 S. Ct. 158 (1934); Gregory V. Helvering, 293 U.S. 465, 469, 79 L.Ed. 596, 55 S. Ct. 266, 97 ALR 1355 (1935) and may not enjoy the benefit of some other route he might have chosen to follow but did not.

Aircraft are bought as a conveyance. Some choose to purchase transportation services through commercial or charter services; others choose to purchase, lease, or co-own aircraft. Still others choose to purchase fractional interests on the [Redacted] model.

The Missouri Supreme Court case referred to earlier noted that the unambiguous language of the contract demonstrated that the taxpayer, Fall Creek, knew it was buying an interest in personal property. While the seller was not [Redacted], as it was in the Michigan case cited previously, the relevant circumstances are identical. Much of the following parallels the present case:

In order to purchase these [aircraft] interests, Fall Creek was required to enter into a series of four separate agreements for each aircraft-an aircraft purchase agreement, a joint ownership agreement, a management agreement, and a master

interchange agreement (these documents are collectively referred to as the “governing documents”). The purchase agreement indicates that Fall Creek “desires to purchase ... an undivided property interest in the aircraft” and also provides: (1) the buyer must execute the governing documents and must perform such actions as are required by the closing date; (2) no buyer may place a lien on the aircraft; (3) transfers to third parties are conditioned upon meeting strict requirements of Raytheon; (4) Raytheon has a right of first refusal on the transfer of interest; and (5) after 60 months, Raytheon must purchase the interest back from the buyer. Each owner also must execute an irrevocable power of attorney allowing Raytheon to file the appropriate application with the Federal Aviation Administration (“FAA”) on each occasion that a fractional interest in the aircraft is purchased.

While the purchase agreement places restrictions on the fractional owners, the bill of sale recites that Raytheon “does ... hereby sell, grant, transfer and deliver all rights, title, and interests in and to an undivided ... interest in such aircraft unto: Fall Creek Construction Company, Inc.” The FAA recognizes Fall Creek and the other co-owners as legal owners of a partial interest in each particular aircraft. Additionally, Fall Creek depreciates the aircraft on its accounting ledgers (Fall Creek Construction Co., Inc. v. Director of Revenue, 109 S.W.3d 165 (Mo., 2003)).

#### MISCELLANEOUS OPINIONS ON FRACTIONAL INTERESTS

In the present case, the taxpayer relies on favorable rulings from New York, in the form of an advisory opinion, and Texas, which wrote an “FYI” (For Your Information) notice. Both were issued in 2000 and were mentioned in Fall Creek’s defense. The Missouri court responded to that defense:

Fall Creek cites a New York advisory opinion and an “FYI” notice in Tax Policy News by the Texas Comptroller in support of its argument. While these sources do offer some support for Fall Creek's contention, they are not binding on this Court and, upon close review, appear to offer an incomplete analysis of fractional ownership taxation. The “FYI” is a half-page announcement applying to no specific case or controversy and with no citation to law, Carole Keeton Rylander, FYI: SalesTax, TAX POLICY NEWS (Vol. X, Issue 8 Dec. 2000), while the New York advisory opinion concludes that there is never an actual sale at all in fractional aircraft ownership. Gap, Inc., No. S990720A, 2000 N.Y. Tax LEXIS 37 (N.Y. Dept. of Taxation and Fin. Jan. 28, 2000). Neither source is persuasive in this case. Missouri law is well settled that, where no ambiguity exists in the contract language, “the court need not resort to construction of the contract, but rather the intent of the parties is determined from the four corners of the contract.”

Eisenberg v. Redd, 38 S.W.3d 409, 411 (Mo. banc 2001). (Fall Creek Construction Co., Inc. v. Director of Revenue, 109 S.W.3d 165 (Mo., 2003).

Despite this unambiguous contract language, Fall Creek argues that an “essence of the transaction” test should determine the nature of the transaction. Fall Creek claims that its ownership of the physical aircraft is merely incidental and that the true nature of the transaction is one for transportation services. Clearly this was a complex transaction between sophisticated parties designed to maximize regulatory and tax advantages. However, the mere fact that the purchase agreement was executed along with other agreements does not render the contract ambiguous nor does it change the nature of Fall Creek's interest. Extrinsic evidence of contractual intent, including a determination of the “essence of the transaction,” is necessary only if the contract contains an ambiguity. There is no ambiguity as to Fall Creek's purchase of fractional interests in the aircraft; therefore, an “essence of the transaction” analysis is not necessary.

In its protest, the taxpayer relies upon two additional New York State opinions. The most recent is an Advisory Opinion, TSB-A-09(23)S, dated June 5, 2009. The other is an Advisory Opinion, TSB-A-08(23)S, dated June 6, 2008. These two opinions, as the one discussed by the Missouri court previously, conclude that possession, command, and control of the aircraft have not been transferred to the fractional interest owners, thereby rendering the transactions to be nontaxable transportation services.

The most recent of the advisory opinions from New York, TSB-A-09(23)S, dated June 5, 2009, refers to aircraft regulated under Part 135 of the FAA Regulations, not Part 91, which regulates the aircraft in the present case. As the 2009 opinion notes, “the only decisions made by the Fractional Share Owners are the times and pickup/destination points” (Page 2). This is in sharp contrast to the requirements and operational standards more relevant to this case, Part 91, which the Missouri court in Fall Creek notes, “the user must accept responsibility for ‘operational control’ of the aircraft” (Fall Creek Construction Co., Inc. v. Director of Revenue, 109 S.W.3d 165 (Mo., 2003)). The other two New York advisory opinions relied upon by the taxpayer do not specify which FAA regulations control the aircraft in question.

Based on the foregoing, the Commission upholds the audit findings.

WHEREFORE, the Notice of Deficiency Determination dated June 30, 2009, is hereby AFFIRMED, and as AFFIRMED is MADE FINAL, in accordance with the provisions of this decision.

IT IS HEREBY ORDERED and THIS DOES ORDER that taxpayer pay the following tax, penalty, and interest:

<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
\$179,926	\$9,166	\$43,298	\$ 232,390
	Less payment on August 28, 2009		(21,817)
	Add accrued interest to October 15, 2010		<u>10,179</u>
		TOTAL	\$220,752

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2010.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2010, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

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