Sales and Use Taxes and the “Use” of Aircraft

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INTRODUCTION
States are experiencing sharp and unexpected declines in revenue as a result of the recession that began in December 2007. According to the Michigan Senate Fiscal Agency, for example, Michigan sales tax revenue declined 18% in February 2009, the fastest rate of decline in 25 years. A recent study by the Rockefeller Institute of Government shows that state revenue dropped significantly in the fourth quarter. Unwilling or unable to cut budgets or increase taxes by enough to cover the shortfall, state officials all over the nation are beginning to consider how they can raise additional revenue from existing laws, such as the sales and use tax.

Business aircraft owners have long been a target of state revenue departments. In fact, many revenue departments have developed close relationships with local airports to obtain lists of the tail numbers of every business aircraft that lands. These lists are used to generate the audit letters with which many aircraft owners have become familiar.

Fractional Aircraft Ownership
The rise of fractional ownership has frustrated states’ efforts to raise revenue, because of the position taken by many owners that the aircraft is eligible for one of several exceptions to sales and use tax, or that an aircraft hangared outside the state and rarely present except to pick up or drop off passengers is beyond the state’s use tax jurisdiction.

Fractional aircraft ownership — in which the ownership of each aircraft is divided into shares as small as a 1/16th interest, and the fractional owner is entitled to a specified number of hours of use during the year — has become a popular way to combine the convenience of an air taxi shuttle with the higher level of service that comes with jet ownership. Although the owner of a fractional aircraft share owns its share for federal tax purposes and, therefore, is entitled to depreciation, fractional aircraft ownership has been equated to a type of air transportation service by state courts in New York and Texas.

Courts in these states have concluded that because the service aspect of the transaction predominates, the fractional owner is not purchasing or using tangible personal property in a manner that allows for the imposition of sales or use tax. Four other states (Arizona, Illinois, Missouri, and Minnesota) have concluded that fractional owners are subject to use tax if their aircraft enters the state, even if it is not hangared there, or if it enters while being operated under FAA Part 135 commercial operating rules. The status of fractional aircraft is disputed elsewhere.

In many cases, a fractional owner may not ever use the specific aircraft in which he or she owns a share. Instead, the fractional interest agreement often gives the owner the right to travel on any one of the aircraft in the fractional manager’s fleet, but not any aircraft in particular. The agreement may even specify that the aircraft must be kept out of the owner’s state of residence. That appears to have been the fact pattern in a recent case decided by the Michigan Court of Appeals.
Expanding Use Tax Jurisdiction to Cover Out-of-State Property: Fisher & Company, Inc. v Dep’t of Treasury

Until recently, no state had attempted to impose use tax on an aircraft that never landed with its borders. However, the Michigan Court of Appeals recently published an opinion describing just that scenario. In this case decided in January, the Michigan Department of Treasury succeeded in convincing a three judge panel of appellate judges that the 25% fractional owner of a jet aircraft managed by Netjets Aviation, Inc. that never landed in Michigan is subject to the 6% Michigan use tax on the entire purchase price of the aircraft.

In the past, use taxes have been imposed only on the actual use of property within a state and this requirement often has been thought to be jurisdictional. The effect of the Michigan Court of Appeals ruling is to define “use” so broadly as to encompass the exercise of a right or power over property located in another state. Specifically, this would appear to include leasing property or any transfer of possession, even if the property never enters the State of Michigan.

When the litigation is over, if the Department ultimately prevails, the state of Michigan stands to collect millions of dollars in use tax from fractional aircraft owners who believed that their fractional aircraft shares were not subject to use tax in Michigan.

Implications for Multistate Businesses

In its zeal to impose use tax on Michigan fractional owners of interests in aircraft that never enter the State, the Department has blazed a new trail in use tax law that could have broad implications for businesses in Michigan and other states. Under a broad interpretation, this ruling could arguably render multistate businesses subject to Michigan use tax on any type of out-of-state property.

In theory, a Michigan company with a branch in New Hampshire, might have to pay the full 6% Michigan use tax on computer equipment used by the company in New Hampshire. If the Court of Appeals’ reasoning were followed by other states, every multistate business could be subject to the higher of the use tax in its headquarters state or the use tax in the state where the taxable property is located.

Possible Relevance of the Quill Physical Presence Standard for Use-Tax-Collection

While it is possible the decision of the Michigan Court of Appeals in Fisher will be confined to the world of fractional aircraft ownership, the breadth and scope of the ruling will concern many other multistate property owners and lessees. The Supreme Court ruled in 1992 that states could not require out-of-state companies to collect sales tax on sales to in-state residents — although the residents themselves remain subject to use tax. The Court stated that the Commerce Clause of the Constitution protects businesses from this obligation unless they have more than a de minimus “physical presence” in the State seeking to impose it.

Recently, the States have redoubled their efforts to overturn the Court’s ruling in Quill legislatively by lobbying Congress, and some states have maintained that physical presence is not required to impose state income tax on out-of-state financing companies or intangible asset holding companies. The Michigan Court of Appeals ruling raises the prospect that the Supreme Court’s physical presence standard could be tested in the area of state use tax as well.

If you have any questions you may contact Wayne D. Roberts at (616) 776-7514 or wroberts@dykema.com or Payson Peabody at (202) 906-8605 or ppeabody@dykema.com with questions.

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1 Michigan Ct App Nos 280476 & 280498 (for publication)
2 Quill Corp. v North Dakota, 504 U.S. 298 (1992)