Cite as 10 WTD 341 (1990).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition For Correction of Assessment of<br><br>. . . | D E T E R M I N A T I O N<br><br>No. 90-397<br><br>Registration No. . . .<br>. . ./Audit No. . . . |

[1] RULE 211: & RULE 178 -- LEASEBACK -- INTERVENING USE -- ORGANIZATIONAL & PROCEDURAL STRUCTURE -- PREFERENTIAL TREATMENT TO OWNER. Where the lessor/owner attempted to execute a lease and leaseback agreement with a leasing company but paid a substantially lower rate than the general public for the use of the airplane, intervening use had occurred and the use tax applied.

[2] RULE 211: & RULE 178 -- LEASEBACK -- SUBSTANCE OVER FORM -- 93% USAGE BY THE OWNER. Where the lessor/owner executed a lease and leaseback agreement with a leasing company which allowed the leasing company to pay an unreasonably low rental rate for the use of the airplane, and the lessor/owner eventually subleased the airplane for 93% of the plane's total usage, the substance of the transaction was found to be a purchase of the airplane for consumption by the lessor/owner.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

A taxpayer protests additional taxes and interest assessed in an audit report.

DATE OF TELECONFERENCE: . . .

(Conducted by Potegal, A.L.J.)

DATE OF SUPPLEMENTAL TELECONFERENCE: . . .
(Conducted by Okimoto, A.L.J.)

TAXPAYER REPRESENTED BY: . . .

FACTS:

Okimoto, A.L.J. -- [Taxpayer] operates a . . . brokerage business in . . . , Washington. A Department of Revenue (Department) auditor examined the taxpayer's books and records for the period . . . , 1982 through . . . , 1986. As a result of this audit examination, Document No. . . . was issued for additional taxes and interest in the amounts of $ . . . . The taxpayer has protested the entire assessment and it remains due.

TAXPAYER'S EXCEPTIONS:

In the audit report, the auditor assessed use tax on the taxpayer's intervening use of the airplane prior to entering into the lease and leaseback arrangement with [a flying service]. The taxpayer described the facts in its petition and at the teleconference as follows:

On or about April . . ., 1984, [taxpayer] purchased [an airplane] for the approximate sum of $800,000 in the state of Oregon. No state sales tax was paid at that time.

However, prior to [the taxpayer]'s purchase of the airplane, [the taxpayer] had made an oral agreement with [the flying service], ( . . . ) whereby the two parties entered into a lease and leaseback agreement. Pursuant to this agreement, [the flying service] agreed to pay [the taxpayer] $260 for each hour that the airplane was used or rented. There was no guaranteed minimum usage and if [the flying service] never used or rented the plane, then no compensation would be owing to [the taxpayer].

In addition, the agreement provided that [the flying service] would rent the airplane back to [the taxpayer] at a rate of $260 per hour plus a 3% administration fee (for a total of $268/hr). The parties reduced this oral agreement to writing on June . . ., 1984.

The taxpayer testified that [the flying service] rented to other persons at a rate of $450/hr which included the cost of providing a pilot and fuel.

Although the taxpayer concedes that it used the airplane prior to the execution of the formal written agreement on June . . ., 1984, it contends that all use of the airplane by [the taxpayer] during this period was done pursuant the existing oral lease and leaseback agreement.

In addition, the taxpayer points out that it filed a use tax return for the purchase of the airplane on June . . ., 1984 which bore the notation "leaseback" and stated that no tax was due. In addition, Retailing and retail sales tax attributable to lease income for the April, May, and June period was reported on taxpayer's July/84 tax return.

The one year lease and leaseback agreement was extended by both parties on June . . ., 1985 and again on June . . ., 1986.

ISSUES:

1. Where the lessor/owner of an airplane pays $268/hr for the bare rental use of the airplane, and the general public pays $450/hr for the airplane including pilot and fuel, has the lessor/owner been treated in the same manner as the general public?

2. If a lessor/owner has completely complied with the strict technical and organizational requirements for executing a lease and leaseback arrangement, can the transactions nevertheless be evaluated based on the overall substance of the transactions?

DISCUSSION:

[1] Although we are satisfied that an oral lease and leaseback agreement had been consummated between the taxpayer and [the flying service] prior to the taxpayer's use of the airplane, we nevertheless do not believe this to be dispositive of the issue.

Before getting to the substantive merits of the case, however, we believe a brief overview of the Department's position on lease and "leaseback" transactions is in order.

RCW 82.04.050 defines the term "sale at retail" or "retail sale" to mean:

> ... every sale of tangible personal property ... to all persons irrespective of the nature of their business ... other than a sale to a person who (a) purchases for the purpose of resale as tangible personal property in the regular course of business without intervening use by such person, ...
>
> (4) The term ["sale at retail"] shall also include the renting or leasing of tangible personal property to consumers. (Bracketed inclusion ours)

RCW 82.12.020 imposes the use tax for:

> ... the privilege of using within this state as a consumer any article of tangible personal property purchased at retail.

In accordance with the above statutes, a person who purchases an article of tangible personal property for resale or lease without intervening use need not pay sales or use tax, however, no such exemption exists for a purchaser who both leases the article to other persons and uses it for personal purposes. Personal use by a lessor/owner of tangible personal property leased to another ordinarily subjects the lessor/owner to liability for use tax measured by the full purchase price of the property. ETB 481.12.178

However, under certain limited circumstances, we would agree that two separate and independent leases between the owner and a leasing company may exist. The first lease would involve the owner leasing the airplane to the leasing company (in this case, [the flying service]) for a fixed amount and the second lease would involve [the flying sevice]'s sublease to users of the aircraft (which could include the lessor/owner).

If, under the agreement between the lessor/owner and the leasing company, the lessor/owner only has the right to use the plane on a rental basis in the same manner and conditions of use as the general public and subsequently pays the full rental price for the use of its own aircraft, we would agree that no intervening use by the owner has occurred. It is important to note that the foregoing is limited to circumstances where the lessee (leasing company) is formally engaged in a regular leasing business and charges competitive rental rates to its retail customers. In addition, lessor/owner must relinquish all scheduling control to the leasing company which in turn must collect the retail sales tax and report the business tax upon the full rental charges

paid by the lessor/owner for use of its own plane. The underlying reasoning for this policy is that the Department does not believe that the actual lessor/owner should be precluded from renting (or else be subject to tax on the full purchase price) when it rents the airplane on the same basis as the general public. Fundamental to this policy is the presumption that over the life of the rental equipment, the value of sales taxes paid on subsequent rental receipts will equal or exceed the original sales tax that was due, and that the State will eventually receive its fair share of taxes. This policy was not adopted to allow taxpayers to defer or avoid 90% of their sales or use tax liability.

If the above organizational structure is correctly implemented, the lessor/owner will be responsible for payment of Wholesaling or Retailing B&O and if applicable, retail sales tax on gross receipts from the rental of the aircraft to the leasing company because the lessor/owner is a wholesaler or retailer to the leasing company. The leasing company must then collect retail sales tax on all bare rentals to consumers or become personally liable for payment of the tax. RCW 82.08.050.

After applying the above guidelines, we find several problems with the taxpayer's rather confused attempt to minimize its sales/use tax liability by executing a lease and leaseback arrangement.

First, the taxpayer has simply not complied with the strict procedural and organizational requirements needed to avoid triggering use tax based on "intervening use" in a lease and leaseback arrangement. After examining the contract and discussing the various rental transactions with the taxpayer, it is clear that the lessor/owner has not rented the plane from [the flying service] at the same rate nor under the same circumstances as the general public. The general public paid $450/hr whereas the taxpayer was only charged approximately $268/hr. Although the taxpayer attempts to explain this discrepancy by stating that the $450/hr rate included a charge for fuel and pilot, whereas the $268/hr rate does not, we have seen no documentation to substantiate this contention[1]. Even assuming, however, that the taxpayer's price does approximate an equivalent charge made to the general public when adjusted for pilot and fuel charges, it is still clear that the

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[1]The taxpayer has been asked to submit documentation explaining its rentals to outside parties but has so far failed to do so.

taxpayer has been given preferential treatment by the mere fact that it is allowed to rent the plane on a bare rental basis while all other customers must charter the plane with pilot and fuel. To this extent the lessor/owner is simply not treated the same as the general public which, in itself, is sufficient to defeat the lease and leaseback arrangement.

Second, we question whether the taxpayer and [the flying sevice] actually executed and complied with the terms of the lease and leaseback arrangement. We note that the taxpayer reported no wholesaling B&O tax on the $260/hr rental amount due from [the flying service] to the taxpayer for each hour the airplane was rented and that the taxpayer reported the retailing and retail sales tax due on all retail rentals of the airplane. We note that except for the fact that [the flying service] charged the taxpayer sales tax on the use of its own plane, this manner of reporting would be entirely consistent with the taxpayer having placed the airplane with [the flying service] to rent the airplane to others on an agency basis. See ETB 325.08.159.221

Third, we question whether the per use rental rates charged by the lessor/owner to the leasing company can be considered reasonable under RCW 82.08.010 in light of the fact that the leasing company guarantees no minimum amount of usage. RCW 82.08.010 states in part:

> When tangible personal property is rented or leased under circumstances that the consideration paid does not represent a reasonable rental for the use of the articles so rented or leased, the "selling price" shall be determined as nearly as possible according to the value
> of such use at the places of use of similar products of like quality and character under such rules as the department of revenue may prescribe;

The Department normally considers a reasonable rental rate to be an amount (converted to present value) which recovers all hard costs, all soft costs, and a profit factor over the life of the asset. If the rental payments do not recover these amounts, the Department will presume that the rental payments are not reasonable. Using this analysis, it is clear that the $260/hr of airplane use charged by the taxpayer to [the flying service] cannot be considered a reasonable rental rate. We note that the taxpayer originally purchased the airplane for $800,000 in April of 1984. When it eventually sold the plane in 1987 its residual value was $400,000. During the last six

months of 1984, the taxpayer reported $ . . . in retail sales which the auditor has stated was attributable to the rental of the airplane. In 1985 the taxpayer reported $ . . . in airplane rentals, and during the first six months of 1986, $ . . . for a two year total of $ . . . . Using only these two year totals[2] it is abundantly clear that not only did the taxpayer fail to recover all of its hard costs, soft costs, and a profit factor, it failed to even recover the purchase price of the airplane. Accordingly, we find that the $260/hr per use charge by the lessor/owner was not a reasonable rental rate under RCW 82.08.010.

[2] Finally, even assuming arguendo, that the taxpayer had completely and correctly complied with required procedural and organizational structure described above, we would still be inclined to rule against the taxpayer's petition. In essence, the taxpayer asks the Department to evaluate these transactions based strictly on its form without examining the substance of the matter. This, we must decline to do. The U.S. Supreme Court, in Higgins vs. Smith, 308 U.S. 473 (1940) when faced with a similar problem stated:

> ... A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.
>
> On the other hand, the government may not be required to acquiesce in the taxpayer's election of that form of doing business which is most advantageous to him. The government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serve's the purpose of the tax statutes. To hold otherwise would permit the schemes of taxpayers to supercede the legislation in the determination of the time and manner of taxation.

In our effort to examine the substance of the transactions, we have asked the taxpayer to provide copies of its sales journal in order to calculate the percentage of use by persons other

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[2]We have asked the taxpayer to supply additional sales totals, but so for the taxpayer has chosen not to respond. We can only assume that the decreasing sales trend continued into the later years.

than the taxpayer/owner. The taxpayer has failed to do so. In the alternative, we have relied on the auditor for this information. He states that during the audit period only 7% of the plane rentals by [the flying service] were to persons other than the taxpayer. The taxpayer attempts to explain the lack of outside rentals by stating that it badly "misjudged" the [local] rental market of a plane of this type. It also attributes this in part to a subsequent downturn in the local economy. Although this misjudgment could conceivably explain the original purchase of the plane, it does not explain the subsequent extensions of the leasing agreement with [the flying service] in May of 1985, and 1986 both of which occurred well after the rental market (or absence thereof) had become readily apparent.

We also note that Higgins vs Smith, supra involved piercing the corporate veil to determine the true ownership of certain property. In the taxpayer's case, there is no corporate shield, but merely the tenuous distinction between using property for consumption as a sublessee instead of as an owner. Under such circumstances we believe that the substance of the transactions should be even more determinative of the outcome of the case.

In conclusion, we believe that the above facts support the following findings of fact and conclusions of law. That the taxpayer failed to correctly execute the procedural and organizational structures required by a proper lease and leaseback arrangement. That the per hour of use rental rate charged by the taxpayer to [the flying service] was not a reasonable rental rate. That the purchase of the airplane by the taxpayer was primarily for its own personal use and enjoyment. That it placed the plane with [the flying service] primarily for maintenance, and scheduling purposes and not for renting the airplane to outside parties. And, that any outside rentals which did occur were not the primary purpose of the acquisition, but were merely incidental to the personal use by the taxpayer.

Accordingly, we hold that the taxpayer is subject to use tax on the full purchase price of the [airplane] purchased on April . . . , 1984. That the taxpayer is entitled to a credit for Retailing and retail sales tax reported on rentals made by [the flying service] to the taxpayer for the use of its own airplane. It is our understanding that the auditor's current report is consistent with this holding, and we therefore must sustain the assessment.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 30th day of November, 1990.