



Tennessee Court Rules Aircraft Purchase and Lease Qualifies As Exempt Sale for Resale

By Patricia Head Moskal and Brett R. Carter

In a much-anticipated decision on the tax exemption for aircraft sales and purchases, a Tennessee trial court has ruled that a taxpayer's purchase of an aircraft outside the state and subsequent transportation into the state is exempt from Tennessee use tax as a sale for resale when the aircraft was leased to a third party. In this case the aircraft was leased to an affiliate of the taxpayer. *CAO Holdings Inc. v. Roberts*, Davidson County, Tennessee, Chancery Court Dkt. No. 06-719-II (Sept. 29, 2011).

The case was tried on remand after the Tennessee Supreme Court reversed a summary judgment ruling in favor of the taxpayer by the trial court that had been affirmed by the Tennessee Court of Appeals. *CAO Holdings, Inc. v. Chumley*, No. M20081679COAR3CV, 2009 WL 1492230 (Tenn. Ct. App. 2009). The Supreme Court found that there were genuine issues of material fact precluding summary judgment as a matter of law and remanded the case for trial on these merits. *CAO Holdings, Inc. v. Trost*, 333 S.W.3d 73 (Tenn. 2010).

Background

The taxpayer purchased the Cessna aircraft in Kansas and immediately leased the aircraft to an affiliated entity before bringing it to Tennessee. The affiliated entity managed and operated the aircraft and provided air transportation services to third parties. Despite the relatively straightforward application of the Tennessee sale for resale exemption under these facts, the Tennessee Department of Revenue challenged the transaction, arguing that the taxpayer's use of the aircraft was inconsistent with the lease transaction and, instead, the taxpayer was the actual user of the aircraft. The Department argued in the alternative that the transaction should be disregarded because it lacked "economic substance." Following a bench trial and briefing, the trial court rejected both of the Department's arguments and entered a judgment in favor of the taxpayer.

At trial, the taxpayer offered evidence that the aircraft was used exclusively for leasing to the affiliated management company. The proof included a nonexclusive lease agreement between the taxpayer and the management company, time-share agreements between the management company and third party users of the aircraft, invoices from the management company to the time-share users, documentation of payment of the invoices and deposits to the management company's separate bank account, and the management company's payments of the amounts due to the taxpayer under the lease on which Tennessee sales tax was paid.

Court Rules in CAO's Favor

The court concluded that, collectively, the evidence demonstrated that the management company was the actual user of the aircraft under the nonexclusive lease agreement and paid the taxpayer all amounts due for the commercial use of the airplane. Consistent with its role as the manager/operator of the aircraft and provider of air transportation services, the management company filed federal excise tax returns and paid federal taxes owed on the services it provided. Based on this evidence, the trial court concluded that the taxpayer was not the user of the aircraft and held that the lease to its affiliate qualified as a sale for resale and therefore was exempt from Tennessee use tax.

On the issue of the lack of economic substance of the transaction as argued by the State, the

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taxpayer offered proof through an aircraft leasing consultant, who had advised the taxpayer about the structure of the purchase and lease transaction. The purchase and subsequent lease of the aircraft were carefully documented; and the lease agreement addressed the use, liability, insurance, and rental rate. The trial court rejected the Department's position on the grounds that Tennessee has not adopted the economic substance doctrine. Even if the economic substance doctrine were applied, however, the trial court held that "this transaction was motivated by a clear business purpose that had economic substance and viability. . . . Accordingly, both entities were formed for business reasons and [the taxpayer] was entitled to the sale for resale exemption."

The Department **did not appeal the trial court's decision** a second time, thereby ending the five-year journey of this case through the Tennessee courts.

Practice Pointers: *The taxpayer and the management company that operated the aircraft maintained well-documented records of the purchase and lease transaction, as well as the air transportation services provided by the management company to the time-share use. This evidence was critical in proving that the management company was the actual "user" of the aircraft. Other taxpayers with similar affiliated company transactions involving aircraft should carefully review their documentation to determine whether the transaction is being executed as planned, including the signing of agreements, issuance of invoices, and making intercompany payments with separate bank accounts. In addition, the rental rate should reflect a fair market charge for the dry lease of the aircraft.*

The trial court's ruling on economic substance will likely provide useful authority for taxpayers in other transactions, although it is anticipated that the State will assert this theory again in a future test case.

Note: The authors represented the taxpayer in this litigation.



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WE ARE PLEASED TO ANNOUNCE

Brett Carter, partner in the Nashville office, has recently been appointed as the Vice Chair of the firm's [SALT Practice Group](#). Brett represents taxpayers before the Tennessee Department of Revenue and local taxing authorities as well as the chancery and appellate courts of Tennessee, focusing on all Tennessee taxes. In this new role, Brett will be working with Practice Group Chair, Bruce Ely, to further strengthen the SALT practices in each of Bradley Arant Boulton Cummings' multistate offices to improve the quality of service that BABC provides to its SALT clients.

Brett is a frequent lecturer on Tennessee and multistate tax matters for national organizations such as COST, IPT and various state and local tax institutes. He is also a contributing author to the ABA Property Tax Desk book (Tennessee), State Tax Notes, and the Journal of Multistate Taxation. Brett is also a member of the Tennessee and Nashville Bar Associations, the Institute for Professionals in Taxation, the American Bar Association Tax Section, and the Independent SALT Alliance.

Brett received a B.S. degree in Accounting from the University of Tennessee (much to the chagrin of his Alabama partners), his law degree (with honors) from the University of Memphis, and his LL.M. in Taxation from Georgetown University Law Center. Brett clerked for Chief Judge Mary Ann Cohen on the United States Tax Court and is a Major in the Tennessee Army National Guard, having served a tour of duty in support of Operation Iraqi Freedom III and earning a Bronze Star for his work with the Regiment's detainee operations program. Brett was also the Democratic Nominee for the 6th Congressional District Seat of Tennessee in 2010. Yes, there are still a few Democrats in Tennessee.

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