STATE OF MICHIGAN
DEPARTMENT OF ENERGY, LABOR & ECONOMIC GROWTH
MICHIGAN TAX TRIBUNAL

Devonair Enterprises, LLC,.,
Petitioner,

v

MTT Docket No. 358558

Michigan Department of Treasury,
Respondent.

Tribunal Judge Presiding
Cynthia J Knoll

FINAL OPINION AND JUDGMENT

The Tribunal, having given due consideration to the file in the above-captioned case, finds:

1. Administrative Law Judge, Thomas A. Halick, issued a Proposed Opinion and Judgment on January 5, 2011. The Proposed Opinion and Judgment states, in pertinent part, "[t]he parties have 20 days from date of entry of this Proposed Opinion and Judgment to file any written exceptions to the Proposed Opinion and Judgment. The exceptions must be stated and are ***limited*** to the evidence submitted prior to or at the hearing and any matter addressed in the Proposed Opinion and Judgment." (Emphasis added.)

2. On January 28, 2011, Petitioner filed exceptions to the Proposed Opinion and Judgment. In the exceptions, Petitioner states:

   Petitioner's exceptions . . . are based on the Administrative Law Judge's ("ALJ") conclusion of fact that the aircraft lease rate from Devonair Enterprises, LLC ("Devonair") to Donald Smith was inclusive of fuel. This erroneous conclusion of fact is expressed several times in the Proposed Opinion and Judgment, notably:

   "The Smith lease was not calculated to produce a profit because the hourly rate was less than the hourly variable costs of operation. . . . Mr. Smith, the lessee, benefited from the transaction, not the taxpayer. This gratuitous use by Mr. Smith constitutes a taxable use. . . . The fee schedule attached to the lease indicates that Mr. Smith may deduct the cost of fuel that he purchased from the hourly base rent, although in practice Mr. Smith never paid for fuel or deducted fuel costs from the rents. According to the Conklin & de Decker publication, the cost of fuel is $420.32 per hour, and the total variable costs are $702 per hour for 2007. . . . Based on the Vref, the total variable cost per hour is $702.23. . . . (This may help explain the below-cost lease rate charged to Mr. Smith). . . .By blending the rates, Respondent's analysis obscures the fact that the Smith lease is clearly below-market." [citations omitted]

The ALJ does note that there is ambiguity regarding this conclusion of fact stating that the lease agreement "could be interpreted to mean that DJS paid for all fuel, even fuel used by Mr. Smith. It could also mean that DJS paid only for fuel consumed while the DJS operated the aircraft. The evidence does not indicate that Devonair ever purchased any fuel in its own capacity. However, the testimony and stipulated facts suggest that Mr. Smith did not deduct any amounts from the stated hourly rental rate for fuel expenses." (Prop. Opinion p. 38). The Petitioner notes that all evidence in the record established that Mr. Smith never deducted the cost of fuel in determining the lease rate paid to Devonair, the Petitioner.

Although Daniel Smith testified that he never personally paid for fuel or other variable costs, it is improper for the Tribunal to infer from this testimony that such costs were borne by Petitioner. In fact, the record evidence establishes that all variable operating costs were paid by the lessees. Moreover, the Respondent never asserted or provided factual support for the proposition that any variable operating costs of the aircraft were borne by the Petitioner in regard to any lease. Accordingly, the ALJ's conclusion of fact that the lease rate between Donald Smith and Devonair, is inconclusive of fuel is unsupported by the stipulations and should be modified accordingly. This modification clarifies that there were no lease agreements in place for the aircraft occurring at below market rates, ...

3. Respondent has not filed exceptions to the Proposed Opinion and Judgment or a response to Petitioner's exceptions.

4. The Administrative Law Judge considered the testimony and evidence submitted in the rendering of the Proposed Opinion and Judgment. More specifically, the ALJ stated:

Petitioner argues that there is no authority allowing Respondent to challenge the lease rate. First, the requirement that the taxpayer be engaged in business provides authority to examine the lease rate. Furthermore, the tax base or "purchase price" for use tax purposes is not necessarily the agreed upon consideration. Rather, the department has the authority to impose tax on the fair market value. "The base price to be used in computing the tax liability shall not be less than its retail dollar value as listed in any recognized guide for use or appraisal purposes." 1979, AC, R 205.135(5). . . . Because payment of tax on lease receipts is an alternative to paying tax on the purchase price and purchase price is required to be market value, it is reasonable that the alternative tax base (lease receipts) should also be market rate.

After strenuously defending the DJS lease rate as reflective of market value, Petitioner argues in the alternative that even if the rate is determined to be "too low," the proper remedy is not to either invalidate the corporate form or to rule that Devonair did not lease the aircraft. There is no need to disregard the limited liability company or to "invalidate" the leases. The outcome of this case turns upon whether Devonair was "engaged in the business of renting or leasing" aircraft. This question turns mainly upon whether Petitioner entered the leases with the object of "gain, benefit, or advantage" from the leases. For purposes of Rule 82, leasing with the object of "gain, benefit, or advantage" means that the taxpayer must seek to earn a profit from the leases, which requires proof that the lease rates and terms are consistent with the market.

5. Petitioner contends that there were no lease agreements in place for the aircraft occurring at below market rates, based upon all of the evidence presented by both parties. Accordingly, Petitioner argues that the reliance on this ground in holding that the exemption does not apply to Petitioner should be vacated. The Tribunal however has considered Petitioner's assertion and notes that the original Owner Flown Personal Use Rental Agreement provides in pertinent part:

> 4. Rent Operator [lessee/Mr. Smith] shall pay [Petitioner] base rent as outlined on Exhibit A for use of the Aircraft. The sum of the base rent and all other charges, payments, and indemnities due by Operator hereunder are hereinafter referred to as "Aggregate Rentals." The hourly charges shall be calculated on the time from takeoff to landing at destination of each leg of the trip based on readings from the Hobbs meter.
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> * * * *
>
> 7. Aircraft Maintenance and Fuel During each Rental Period and until such time as the Aircraft is returned to Owner all maintenance costs and all fuel costs will be borne by Owner.
>
> * * * *
>
> Exhibit A provides: Base Rent $573 per flight hour, less direct cost for any fuel purchased.

The Tribunal finds that the hourly rate charged to Mr. Smith included the cost of fuel, unless he purchased fuel directly in which case the hourly rate would be reduced by the direct fuel cost. Despite testimony that Mr. Smith never purchased fuel nor did he ever deduct any amount for his direct cost of fuel from the hourly flight rate, Mr. Smith's

hourly rental rate did in fact include fuel regardless of whether Petitioner paid for the fuel or some other party bore that cost.

6. After thorough review of Petitioner's Exceptions, the ALJ's Proposed Opinion and Judgment, and the case file, the Tribunal finds that Petitioner has failed to show good cause to justify the modifying of the Proposed Opinion and Judgment. As such, the Tribunal adopts the Proposed Opinion and Judgment as the Tribunal's final decision in this case. See MCL 205.726. The Tribunal also incorporates by reference the Findings of Fact and Conclusions of Law contained in the Proposed Opinion and Judgment in this Final Opinion and Judgment. As a result, the taxes, interest and penalties are as follows:

Assessment Number: P698813

Taxes	Interest*	Penalties
$207,000.00	To be calculated as provided by law	0

*Interest continues to accrue as provided by 1941 PA 122.

IT IS SO ORDERED.

IT IS FURTHER ORDERED that Respondent shall cause its records to reflect the taxes, interest, and penalties, as shown herein within 20 days of entry of this Final Opinion and Judgment.

IT IS FURTHER ORDERED that Respondent shall collect the affected taxes and interest as required by this Order within 28 days of entry of this Final Opinion and Judgment.

MICHIGAN TAX TRIBUNAL

By Cynthia J Knoll

Entered: April 5, 2011

STATE OF MICHIGAN
STATE OFFICE OF ADMINISTRATIVE HEARINGS AND RULES

Devonair Enterprises, LLC,
Petitioner,

v

Michigan Department of Treasury,
Respondent.

Tax Tribunal
MTT Docket No. 358558

Administrative Law Judge Presiding
Thomas A. Halick

PROPOSED OPINION AND JUDGMENT

Petitioner appeals Respondent's assessment of use tax upon an aircraft. A hearing was held on May 10, 2010. Petitioner was represented by Suzanne Meiners-Levy, Advocate Consulting Legal Group PLLC. Respondent was represented by Kevin T. Smith, Assistant Attorney General. Petitioner presented testimonial and documentary evidence. The Tribunal holds that the final assessment of tax and interest shall be affirmed and the penalty shall be waived as follows:

Assessment No.	Tax	Penalty	Interest
P698813	$207,000	$0	To be calculated as provided by law.

Respondent shall credit Petitioner for all use tax remitted on lease or rental payments received from leasing the subject aircraft.

Documentary Evidence

The parties have also stipulated to the admission of the following Exhibits:

Petitioner's Exhibits

P-1. Aircraft Hourly Rental Agreement to Devonair Enterprises Group, LLC.

P-2. Owner Flown Personal Use Rental Agreement.

P-3. Decision and Order of Determination and Informal Conference Recommendation.

P-4. Spring 2007 Aircraft Bluebook Price Digest – Pilatus PC-12 Bluebook data.

P-5. Aircraft Bluebook Price Digest – Historical Value Reference – Pilatus 1995 – PC-12.

P-6. Vref Aircraft Valuation Reference 2007 Volume 2 – Pilatus PC-12.

P-7. Vref Aircraft Valuation Reference 2007 Volume 3 – Pilatus PC-12.

P-8. Conklin and de Decker Aircraft Cost Evaluator Estimated Variable Costs Per Flight Hour and Annual Fixed Costs Per Flight Hour – Pilatus PC-12.

P-9. Department of Treasury Letter to Devonair Re: FAA No. 814D, 2003 Cirrus SR22, A09030057, dated January 23, 2004.

Respondent's Exhibits

Respondent did not offer its proposed exhibits R-1 and R-2 into evidence.

Petitioner's Motion to Exclude Certain Stipulated Facts

The parties filed a Joint Stipulation of Facts dated April 30, 2010 ("Stip."). Petitioner objected to the admission of certain facts related to Petitioner's activities both before and after 1997 because the assessment was issued for the "taxable period" 10/07. The legal basis for Petitioner's motion is set forth in Petitioner's Post Hearing Brief and Reply Brief. However, the assessment of use tax does not apply to a particular year. Rather, the tax arose at an instant in time, when Petitioner used, stored, or consumed the property. Respondent determined that a taxable use occurred and that use tax was immediately due in the amount of 6% of the price of the subject aircraft. The fact that the assessment states that it was issued for the taxable period 10/07 does not limit the factual issues or proofs to circumstances or events from July 31, 2007 to October 2007. The main issue in this case is whether Petitioner was engaged in the business of leasing tangible personal

property to others at the time that it acquired the aircraft and made the Rule 82 election. This inquiry is not limited to a snapshot in time, such as the date of acquisition (July 31, 2007) or the stated taxable period of October 2007. It is relevant to consider Petitioner's activities from 2003 when Devonair Enterprises, LLC was created until the date of the hearing, in order to determine Petitioner's intent and the state of affairs at the time the aircraft was purchased and subsequently leased. Although not dispositive, a taxpayer's history of purchasing and leasing other aircraft is a factor that may support the taxpayer's position. Such facts should be considered. Likewise, Petitioner's business activity and use of the aircraft after acquisition and after the date of the assessment are relevant to the inquiry of whether Petitioner was engaged in the business of leasing the aircraft to others at the time it made the Rule 82 election.

Finally, even if all the facts at the time the election was made support the existence of a qualified leasing business, a taxpayer may disqualify itself for the election by ceasing to lease the aircraft or using the aircraft outside the scope of the leasing business. For example, an otherwise valid election would be lost if the purported lessor remitted use tax on a few monthly rental payments, then stopped, or used the aircraft for personal flights. Issuance of an assessment does not preclude consideration of facts after the assessment date. By analogy to resale exemption cases, courts have considered the fact that the property was actually resold, which may occur after the assessment date, as relevant to the taxpayer's intent to resell at the time of acquisition. *Betten Auto Center, Inc v Treasury*, 272 Mich App 14; 723 NW2d 914 (2006). Even if the facts are limited to July 31, 2007 to the assessment date, the outcome is the same. The facts during that period indicate that Petitioner used the aircraft for purposes outside the scope of a leasing

business. Petitioner's motion to exclude certain stipulated facts is denied. *Gates v Gates,* 256 Mich App 420, 426; 664 NW2d 231 (2003) (concluding that stipulations of fact are binding).

Findings of Fact

Respondent acknowledges that most of the operative facts in this case are not in dispute. The following facts were established by stipulation or by a preponderance of the evidence.

1. Petitioner, Devonair Enterprises, LLC ("Devonair") is a Nevada Limited Liability Company, formed in September 2003. (Stip. 1). The sole member of Devonair is DJS Enterprise Group, LLC.

2. DJS Enterprise Group, LLC, is a Michigan Limited Liability Company formed in September, 2003. The members of DJS Enterprise Group ("DJS") are Donald J. Smith and Cynthia Smith (who are husband and wife). Stip. 2.

3. Petitioner was first authorized to transact business in Michigan on September 22, 2003, and remains in good standing in Nevada and Michigan. Stip. 2 and 3.

4. On July 31, 2007, Petitioner acquired the subject aircraft for $3,610,690.

5. Petitioner registered the subject aircraft with the Federal Aviation Agency on August 22, 2007.

6. Respondent issued two letters of inquiry to Petitioner dated October 4, 2007 and November 15, 2007, informing Petitioner that use tax was due on the retail value of the aircraft.

7. In January 2008, Respondent issued an "intent to assess" tax, to which Petitioner responded that the transaction was exempt as a purchase for resale, and because the aircraft was purchased to lease it on an hourly basis. Respondent determined that Petitioner was liable for use tax on the purchase price.

8. After an informal conference held October 30, 2008, Respondent entered a Decision and Order of Determination on November 21, 2008, and issued a "Final Bill for Taxes Due (Final Assessment)" P698813, dated December 2, 2008, with tax due of $207,000, penalty of $51,750, and interest of $19,582.03, for a total at that time of $278,332.03.

9. Respondent assessed tax on the tax base (retail value) of $3,450,000 ($3,450,000 x .06 = $207,000). The parties stipulated that the purchase price of the subject aircraft was $3,610,690, and Petitioner uses this value to support its contention that the fair market value of the subject increased in 2007. (Respondent admits the value of the subject aircraft was increasing in 2007.) Respondent asserts that that the correct "retail value" against which the tax is applied is $3,450,000, which is supported by Petitioner's Exhibits 4, 5, and 7 (Aircraft Blue Book and Vref). Neither party disputes the retail value used in the assessment.

10. DJS was engaged in the real estate business. TR 12:3-5, 9-11. DJS acquired and improved residential properties and offered them for rental. The properties are located in "downtown Grand Rapids . . . in some resort communities . . . in Tennessee, [and] Northern Michigan." TR 30:25, 31:1-5. Mr. Smith used the Pilatus PC-12 aircraft to travel to various locations in pursuit of the business activity of DJS. Mr. Smith testified that the subject aircraft has a large cargo door and that "I can carry stuff to work on the houses that I own." TR 14:1. He also stated that the aircraft was "great for the business that DJS was in." The aircraft was purchased for use by DJS. TR 15. The aircraft was also purchased for use by Donald J. Smith.

11. Mr. Smith is a member of a limited liability company known as "CDS" that owns and leases one aircraft. TR 33:5-8.

12. Mr. Louis Melvin Meiners, Jr. ("Expert Witness") is an aviation expert who holds a law degree from the University of Louisville and is admitted to practice law in Indiana and is admitted to practice as a certified public accountant in Florida. Mr. Meiners was formerly the chief tax advisor for American Trans Air, a regional airline that later merged into Southwest Airlines. In addition, Mr. Meiners has owned a flight school, conducted business as a "fixed-base operator" and given presentations on aviation matters to aircraft dealers, state bar associations and CPA associations. Mr. Meiners has testified as an expert witness on numerous occasions and has been in the aircraft industry for 30 years. He has experience in industry standards pertaining to aircraft purchases and sales, aircraft leasing,

and business organizational structures for aircraft ownership. TR 46:8-25, TR 47:1-25, TR 48:1-22.

13. Petitioner leased the subject aircraft to DJS on July 31, 2007, and delivered it to DJS on that date at Manchester, New Hampshire. The lease (Exhibit P1 "Aircraft Hourly Rental Agreement" a.k.a., the "DJS lease") includes a "Delivery and Acceptance Certificate" which states that the subject aircraft was delivered to the "operator" (DJS), that DJS accepted the aircraft, including "operational control commencing at the beginning of each Rental Period and ending upon the return of the Aircraft to Owner at the end of each Rental Period throughout the term of this Agreement." Donald J. Smith signed the certificate on behalf of both the owner (Devonair) and the "Operator" (DJS). P1.

14. A "Delivery and Acceptance Certificate" identical to the one described immediately above is appended to exhibit P2, "Owner Flown Personal Use Rental Agreement" dated July 31, 2007, between Devonair and Donald Smith ("the Smith lease"). That certificate indicates that "Don Smith" also accepted delivery and "operational control" of the subject aircraft at Manchester, New Hampshire on July 31, 2007.

15. The certificates of delivery and acceptance indicate that the aircraft would be returned to the owner "at the end of each Rental Period." There is no evidence that Devonair had physical possession of the aircraft after July 31, 2007. The aircraft was stored in a hangar owned by DJS at the airport at Ionia, Michigan.

16. Petitioner leased a Cirrus aircraft to DJS in 2003. TR 12:6-8, TR 19:8-23. Mr. Smith testified that in 2003 "I bought a Cirrus SR-22. You know, I didn't have. . . properties a long distance away, so that was a – that made sense." Mr. Smith chose the Cirrus SR-22 aircraft for its utility to his real estate business (DJS). He also stated that "I thought Devonair could make money" with that aircraft. TR 19:19. The rental rate was $40 per hour. TR 19:45. The terms of that lease are not in evidence. Petitioner sold the Cirrus aircraft (the date of sale is not in evidence).

17. In July 2007, Devonair owned a Piper Seneca 5 aircraft, which it sold (the date of sale is not in evidence). There is no evidence that the Piper Seneca aircraft was leased, and if so, to whom it was leased.

18. Petitioner registered for a Michigan Use Tax Permit with the Department of Treasury in September 2003 indicating on the application that it was in the business of equipment leasing. Stip. 4.

19. The Department of Treasury assigns the filing frequency of sales and use tax returns for holders of Use Tax Permits based upon the estimated revenues of the business, regardless of business type, pursuant to MCL 205.56(4). The taxpayer does not control the filing frequency assigned. Petitioner was assigned an annual filing frequency for use tax returns. Stip. 6. Petitioner is a cash-basis taxpayer. TR 86:2-4.

20. On July 31, 2007, Petitioner purchased the subject aircraft, a Pilatus PC-12. Petitioner was issued an Aircraft Registration Certificate by the Federal Aviation Administration on August 22, 2007. Stip. 10. The aircraft is identified as "N1130D."

21. Petitioner entered into a lease agreement with "Donald Smith" on July 31, 2007, leasing the aircraft to Mr. Smith for his personal use on an hourly basis. The lease agreement is entitled "Owner Flown Personal Use Rental Agreement" and the "operator" is "Donald Smith" (a.k.a., Donald J. Smith). Stip. 12 and Petitioner's Exhibit 2. The "owner" is "Devonair Enterprises, LLC." The title of the rental agreement, "Owner Flown Personal Use Rental Agreement" is a misnomer in that the aircraft was not "owner flown." The owner, Devonair, did not fly the aircraft, rather, the aircraft was leased to and operated by a non-owner, individual: Donald J. Smith.

22. Petitioner calculated the lease amounts due under the lease agreements on an annual basis and received the rental receipts in a lump sum payment in the following year. TR 86:5-25, TR 87:1-9.

23. Before Petitioner purchased the aircraft, Petitioner conducted research into the operating costs and resale value of various types of aircraft through consultation with industry experts and by researching industry journals. TR 12:23, TR13:1-5.

24. Vref and Aircraft Bluebook are publications relied on in the industry to determine valuation of aircraft. TR 59:23-25, TR 60:1-14.

25. Conklin and de Decker is a publication that specializes in calculating the operational costs of an aircraft. TR 63:22-25, TR 64:1-13.

26. Petitioner's Exhibit P8 (page 1) is a page from the Conklin and de Decker publication with variable costs per hour of operating a Pilatus PC-12 aircraft and includes: fuel ($420.32), maintenance labor ($61.56), maintenance parts ($64.66), engine restoration ($110.70), propeller overhaul ($1.81), landing/parking ($8.18), crew ($15.00), and supplies/catering ($20.00), for a total of $702.23 per hour.

27. Petitioner's Exhibit P8 (page 2) is a page from the Conklin and de Decker publication with fixed costs *per year* related to a Pilatus PC-12 aircraft and includes: crew salaries ($77,250), crew benefits ($23,175), hangar ($33,200), insurance - hull ($19,250), insurance- admitted liability ($4,000), insurance – legal liability ($12,250), recurrent training ($5,300), aircraft modernization ($20,000), navigation chart service ($1,961), refurbishing ($11,340), computer program ($2,500), weather service ($700), for total fixed costs of $210,000 per year.

28. The cost of aircraft ownership includes fuel, maintenance, insurance, training, and hangar rental. TR 17:14-22, TR 72:16-18.

29. Petitioner's Exhibit P8 (page 2) includes an "annual budget" based on 479 hours of flight. The total variable and fixed costs are estimated at $547,294 (no depreciation), or $1,143 per hour (based on 479 hours). The total cost with "book depreciation" ($350,000) is

$897,924 per year or $1,873 per hour. The total cost with "market depreciation" ($210,000) is $757,294 per year or $1,581 per hour. Petitioner's evidence indicates that the aircraft suffers market depreciation of $210,000 per year, when used as a typical "corporate" aircraft for 479 flight hours per year. This indicates that for every hour of corporate use, the aircraft depreciates by $438 ($210,000 / 479 hours = $438).

30. Pursuant to Petitioner's purchase contract for the Aircraft, Petitioner placed an initial deposit in July 2006. Between the time of the deposit and the time that Petitioner took delivery of the Aircraft in July 2007, the value of the Aircraft increased. TR 13:9-11, TR 61:3-25, TR 62:1-25, TR 63:1-21; Stip. 36, 37; Exhibits P4 and P7. Mr. Smith testified that "I put my money down to do an initial deposit" on the purchase of the subject aircraft in July of 2006 and after that time the value of the aircraft increased. TR 13:10.

31. Exhibit P5 is a page from the Aircraft Bluebook, which includes information for the Pilatus PC-12 aircraft, which was first produced as a 1995 model (the subject is a 2007 model). The document shows that the "Factory standard price for early production was $1,950,000." As of 2010, the "average retail value" for a 1995 Pilatus PC-12 aircraft remained $1,950,000. P5. According to Vref (P6), the retail value of a 1995 PC-12 was $2,100,000 as of August 31, 2007, for an aircraft with 3,480 hours of operation, and increased to $2,150,000, as of November 30, 2007.

32. Donald J. Smith testified that Petitioner was formed as a legal entity distinct from DJS in order to allow for (1) flexible asset splitting in the event of a sale of DJS, (2) enhanced

privacy, (3) asset protection from liability in the event of an aircraft accident, and (4) increased flexibility in the sale of the aircraft. TR 15:1-25, TR 16:1-16, TR 79:5-25, TR 80:1-7. These purposes are a benefit to DJS and Mr. Smith. Mr. Smith testified that the splitting of the assets was intended to separate the real estate owned by DJS from the aircraft in the event he ever wanted to sell DJS. TR 15:6. He also stated that he did not want tenants to know that the "real estate company also has his airplane sitting in a hangar or over at the tarmac, you know, across the street." TR 16:10. As testified by Mr. Smith, the purposes of asset splitting, limited liability, and privacy all were for the benefit or advantage of DJS and not for Petitioner.

33. It is common in the aircraft industry for aircraft, and contracts for the purchase of aircraft, to be held in special-purpose legal entities, distinct from other business operating entities. Among the advantages of this approach is to maximize privacy, contain liability, and to increase flexibility upon the sale of the aircraft or other business assets, as well as, in the context of aircraft purchase contracts ("positions"), to provide a mechanism for effective transfer or sale of the purchase contract (by selling the LLC membership interest) given that aircraft purchase contracts typically do not allow for assignment by the purchaser. TR 57:10-25, TR 58:1-23.

34. In 2006, positions in the Pilatus PC-12 were being sold at premiums of hundreds of thousands of dollars over what the manufacturer would have sold them for. TR 57.

35. The DJS lease required DJS to pay for the operating costs of the aircraft, including fuel, maintenance, pilot services for its use, insurance, and aircraft storage, and DJS paid for these items. Stip. 33.

36. The variable hourly operating cost of the aircraft is approximately $702 per flight hour, not including pilot services. Exhibit 8 and TR 10:1-3.

37. Fixed costs related to an aircraft include storage, insurance, and depreciation.

38. The rental rate charged by Petitioner to DJS was $200 per flight hour, a rate under which DJS paid for fuel, maintenance, parts, hangar, and insurance costs. TR 17:3-25, TR 18:1-2; Stip. 33. The parties stipulated that DJS paid for "operating costs" consistent with the terms of the agreement. The term "operating costs" includes "variable costs." It was stipulated that "operating costs" also includes certain fixed costs such as hangar and insurance. Mr. Smith testified that DJS purchased insurance on the aircraft, that Devonair is "listed as a party" on the insurance, and that DJS pays for the insurance. TR 37:13-23. Mr. Smith testified that DJS paid for "everything" (TR 17:25) such that the $200 rental fee was "all profit" to Devonair. It is found that DJS was obligated under the lease to incur all costs of operation, variable and fixed, and to pay to Devonair the $200 per hour rental fee.

39. Petitioner relied on industry experts (Advocate Consulting Legal Group, PLLC) in establishing the $200 per flight hour rental rate. TR 18:5-8.

40. The Michigan Department of Treasury reviewed Petitioner's purchase and lease of a Cirrus SR 22 aircraft in 2003 and concluded sales or use tax was not due on the purchase price because Petitioner remitted use tax on the rental revenue. TR 19:9-25, TR 20:1-14 and P9.

41. The subject aircraft increased in value from the date of the initial deposit in 2006 until the date of acquisition in July 2007. Respondent acknowledges this as a fact. P7 and TR 18:12-25, 19:1-6. Petitioner's Exhibit 7 indicates that as of the time of publication (November 30, 2007), a 2007 PC-12/47, with a serial number of 774 and higher, was valued at 103% of "new" and that the current "retail" price was $3,675,000, which indicated an upward trend of $110,000 over the prior quarter. Vref indicates that the value of a 2007 PC-12 had increased as of the date of publication of 2007 Volume 3, as compared to the value of $3,565,000 listed in Volume 2 (applicable to the previous quarter ending August 31). The listed prices for a 2007 aircraft apply to an aircraft with zero hours of operation.

42. During 2007, the fair market value of Pilatus PC-12 aircraft increased due to market conditions. However, the hours of operation by DJS and Mr. Smith diminished the value of the subject aircraft due to physical depreciation, which must be considered as an offset against the increase in value due to market conditions.

43. According to the Vref, the difference in retail value of a 2006 Pilatus PC-12 and a 2007 PC-12, as of September 2007, was $125,000. At that time, the valuation was based on a 2006 aircraft with 290 airframe hours of use, and the 2007 aircraft was valued at zero airframe hours. It may be reasonably inferred that the difference in value between the 2006

and 2007 models is mostly attributable to hours of use. TR 71:22. The difference in value of $125,000 divided by the 290 hours indicates that the value of a Pilatus PC-12 aircraft declined by approximately $431 for each hour of use. (Differences in value between prior year models are similar.) This same calculation applied to a 2005 model compared to a 2007 model indicates a loss in market value of $387 per hour. As applied to a 2005 model, that figure is $373 per hour. This indicates that, even assuming that market values were rising in 2007, two aircraft of the same model year would not have the same value if one had zero hours of operation and the other had 290 hours. The aircraft with 290 hours would be worth approximately $125,000 less than the other. Therefore, even in a rising market, the owner loses value in the asset to physical depreciation by using it.

44. According to Petitioner's expert witness, Mr. Meiners, "The biggest indicator of depreciation in the aircraft is how many hours you're going to put on the aircraft. . . that's what determines the value of the aircraft." TR 71:15-23.

45. If the subject aircraft were leased to a charter operator the increased hours of flight and typical use by a charter operator would negatively impact its value. TR 66:18.

46. Based on typical market rates, if the subject were used as a charter aircraft in 2007, the person chartering the aircraft would pay approximately $1,200 per hour and the charter company's fee would be 15% of that amount. TR 67:23. Charter operators provide air transportation and flight services (pilots and crew) to customers.

47. It has not been demonstrated that the rental fees fully compensated Petitioner for loss in value due to physical depreciation.

48. Based on the knowledge and experience of Mr. Meiners, as well as the valuation manuals, Petitioner expected that the subject aircraft would appreciate in value. TR 72:7-15.

49. The aircraft was leased to Mr. Smith for $626 per flight hour. Mr. Smith operated the aircraft for 6.5 hours from July 31 to October 31, 2007, for total fees of $4,069. Mr. Smith was not responsible for paying operational costs of the aircraft. "Operator shall bear the following operating costs: crew costs, employee benefits, landing, handling, and custom fees and related charges." P2, page 2, paragraph b. The rate charged was adjusted to $680 per flight hour in 2008. TR 21:10-20, Stip. 13. The Smith lease as originally executed indicates a base rental rate of $573 per hour (which was amended by the parties to $626). Stip. 13, 14. Petitioner's Exhibit P8 indicates that variable operating costs in 2007 were $702.23 per hour. Even if the variable costs related to "crew" and "catering" are subtracted, the total variable hourly cost is $667.23, which is greater than the hourly rental fee. The hourly rate was insufficient to cover variable costs. Even after the rates were increased in subsequent years, it has not been proven that they were sufficient to compensate Petitioner for the indicated variable costs (fuel, maintenance parts and labor, engine restoration, propeller overhaul, and miscellaneous expenses). P8. The hourly fees paid by Donald J. Smith were not sufficient to compensate Petitioner for *fixed* costs, such as hangar rental, insurance, and other annual fixed costs totaling $210,000 as set forth on P8. Subtracting crew salaries, recurring training, navigation chart service, and weather service, from the

fixed costs indicates annual fixed costs of $100,040, which Petitioner would need to recover via hourly rents. Assuming 161 average annual hours of rental, this would require the hourly rental fee to include $621 to recover the annual fixed costs. The sum of the variable costs ($702) and the estimated fixed costs allocated on an hourly basis ($621) is $1,323. The Smith lease at $626 per hour was insufficient to cover these costs and could not generate a profit for Devonair.

50. When testifying about the DJS rental rate, Mr. Smith stated that "actually, everything paid towards the airplane came from DJS. . . ." TR 17, 18.

51. With regard to the Smith lease, Mr. Smith stated, "Well, I personally don't pay the fuel and stuff for the plane, and so my lease rate is much higher." TR 21.

52. Petitioner met with four unrelated companies that operated aircraft charter businesses under Federal Aviation Administration ("FAA") Part 135. TR 22:4-25. Mr. Smith decided that Devonair would not lease the aircraft to a charter service that operates under Part 135.

53. A Part 135 operator is an aircraft charter service that sells flight services (including pilots and crew) and aircraft rental to customers. TR 51:11-13 and 52:5-11.

54. Based upon Mr. Smith's research of the prospect of renting the aircraft to a Part 135 operator, such an operator would charge its end customers $1,200 dollars per flight hour for

utilizing this aircraft, a rate that includes insurance, aircraft maintenance, fuel, and additional services. TR 23:18-23, TR 24:2-10.

55. Common Part 135 operator rental arrangements called for the Part 135 operator to retain as its fee 15 percent of the gross end-user revenue. Subtracting this 15 percent would leave Petitioner, out of the gross $1,200 per hour end-user rate, a net of $1,020. The available arrangements would, further, have required that all aircraft operation expenses be borne by Petitioner, including fuel, training, pilot, maintenance, insurance, and hangar. TR 68:23-25 and TR 69:1-21.

56. Petitioner determined that net income from renting the Aircraft to a Part 135 operator would result in either a net loss or a minor gain—in either event, less than the $200 per flight hour rate received from DJS. TR 24:15-18.

57. Petitioner was concerned that the resale value of the aircraft would decrease if it were placed with a Part 135 operator. TR 24:19-25 and 25:1. "What really scared me is that I would lose value in the plane. Basically, how would they treat the plane? That worried me. You know, keep in mind that I was planning for this to be an appreciating asset. . . ." TR 24:19. This establishes that Mr. Smith and Devonair were predominantly motivated to acquire the aircraft in order to hold it as an investment that would increase in value. Mr. Smith sought to minimize physical depreciation by only allowing DJS and Mr. Smith to use the aircraft for a limited number of hours.

58. The resale value of an aircraft that is placed with a Part 135 operator is negatively impacted due to increased wear, flight hours, and typical use by renters. TR 66:4-25 and 67:1-6.

59. All aircraft flight hours to date have been charged to a lessee, and rent has been paid on all of the hours. Stip. 12 - 29.

60. When asked how Devonair financed the aircraft, Mr. Smith stated, "I don't know. I don't remember exactly. . . DJS also has a line of credit and I don't remember if my wife and I had to put money into Devonair to purchase the aircraft, because I know it had funds coming from the sale [of another aircraft] and it had a line of credit." TR 35:8-12.

61. The aircraft was not leased to parties other than DJS and Donald J. Smith. TR 22. No one other than Mr. Smith piloted the aircraft after Devonair acquired it.

62. The subject aircraft was based and stored at an aircraft hangar in Ionia, Michigan owned by DJS. Exhibit P1 ("exhibit A" attached to P1).

63. Devonair leased the subject aircraft to Donald J. Smith, who piloted the aircraft for his personal use.

64. In 2007, the aircraft had a total flight time of 74.4 hours in the lease period of July 31, 2007 to October 31, 2007. Of the total flight time, 67.9 hours occurred pursuant to the lease with DJS at a rate of $200 per flight hour, and 6.5 hours occurred pursuant to the lease with

Donald Smith at a rate of $626 per flight hour. Stip. 14. (Note that Stip. 13 states "$636.00 per flight hour" which conflicts with Stip. 14, which states "$626.00 per flight hour." Based on calculations in Stip. 18, it appears that $626 was the actual rate used.)

65. In 2008, the aircraft had a total flight time of 179 flight hours in the lease period of November 1, 2007 to October 31, 2008. Of the total flight time, 145.8 hours occurred pursuant to the lease to DJS at $200 per flight hour, and 33.3 hours occurred pursuant to the lease to Donald Smith at $680 per flight hour. Stip. 19.

66. The aircraft had a total flight time of 136.5 flight hours in 2009. Of the total flight time, 110.5 hours occurred pursuant to the lease to DJS, charged at $200 per flight hour and 26 hours occurred pursuant to the lease to Donald Smith, charged at $680 per flight hour. Stip. 26.

67. In the 29 month period from July 31, 2007 through December 31, 2009, the subject aircraft accrued approximately 390 hours of operation (390 hours / 29 months = 13.44 hours per month) or an annualized average of 161 hours per year. According to Conklin & de Decker, typical corporate use for a Pilatus PC-12 is approximately 479 hours per year. According to Vref, average annual "AFTT" (airframe time) for a Pilatus PC-12 is 290 hours.

68. Based on average corporate use of 479 hours per year, and typical use of 290 hours per year, it would be feasible for a leasing business to lease an aircraft to others for approximately 290 to 479 hours per year.

69. On January 4, 2008, Devonair received $13,580 from DJS for 67.9 hours of use in 2007. Stip. 15.

70. On March 13, 2008, Devonair received $4,069 from Donald J. Smith for 6.5 hours of use in 2007. Stip. 16.

71. On March 13, 2008, Devonair deposited $24,641.02 from Donald J. Smith and DJS for use of the aircraft in 2007. Stip. 17.

72. Devonair filed its 2007 use tax return on November 4, 2008, claiming total sales of $23,247.00 and tax of $1,394.82. Of the total sales, $17,649 was for the subject aircraft. Stip. 18. The use tax attributable to the subject was $1,058.94.

73. In October, 2008 Devonair's use tax filing period was changed from annual to monthly. Devonair reported $45 in estimated taxes on estimated revenues of $750 on the October, 2008 return filed in November 2008. Stip. 20.

74. In December, 2008 Devonair reported $45 in estimated tax on estimated revenues of $750 for November, 2008. Stip. 21.

75. Devonair filed its 2008 annual use tax return on February 24, 2009, reporting sales of $51,804 and tax of $3,076. Stip. 22.

76. On August 18, 2009, Devonair received payment of $30,909.60, including $1,749.60 in tax, from DJS for use of the aircraft in 2008. Stip. 24.

77. On August 19, 2009, Devonair received payment of $24,002.64, including $1,358.64 in tax, from Donald J. Smith for use of the aircraft in 2008. Stip. 25.

78. In the months of January through November, 2009, Devonair reported $45 in tax each month on estimated revenues of $750 per month for use of the aircraft, totaling estimated sales upon which tax was paid of $8,250. Stip. 23.

79. On December 19, 2009, Devonair received payment of $23,426, including $1,326 in tax, from DJS for use of the aircraft in 2009. Stip. 27.

80. On December 19, 2009, Devonair received payment of $18,740.80, including $1,060.80 in tax, from Donald J. Smith for use of the aircraft in 2009. Stip. 28.

81. Devonair filed its 2009 use tax return on February 10, 2010, reporting sales of $39,780 and tax of $2,314. Stip. 9.

82. There is no market evidence of an arm's-length lease of an aircraft where a lessee agreed to assume all variable and fixed costs pursuant to an hourly lease agreement and pay a lease rate of $200 per flight hour (other than the DJS lease).

83. There is no market evidence of an arm's-length lease where a lessee agreed to pay a lease rate less than the estimated hourly variable costs of operating the leased aircraft (other than the Smith lease).

Petitioner's Contentions

Petitioner's arguments, as set forth in its Post Hearing Brief and Reply Brief, are summarized and analyzed in the Conclusions of Law Section of the opinion, and shall not be reiterated here.

Respondent's Contentions

Respondent asserts that the leases in this matter lack economic substance such that Devonair is not in the business of leasing aircraft as required by Rule 82. Respondent's analysis of the lease revenues is restated below substantially as it appears in Respondent's Post Hearing Brief.

> Aircraft usage from July 31, 2007, to October 31, 2009, totaled 390 hours, of which 324 hours (83%) was by DJS and 66 hours (17%) was by Donald Smith. Stip. 14, 19, 26. Even assuming the highest rate for rentals to Smith, $680/hr, and ignoring the cost of fuel reimbursed by Devonair, this equates to a weighted average of less than $300/hr.[1] At $300/hr, it would take over 12,000 hours of flight time to recoup the initial purchase price.[2] At 14.5 hrs/month[3] it will take Devonair almost 69 years to recoup the purchase price[4] and pay the use taxes otherwise due on the purchase price. If Devonair sells the aircraft in less than 69 years, which is quite likely, the State will lose tax revenue. If Devonair sells the aircraft out of state, as it did with its prior aircraft, Smith Testimony, TR 34, the State will lose taxes on that transaction as well. The option is designed to assist lessors, not deprive the State of tax revenue. But that is exactly what Devonair is attempting to do.

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[1] ($200/hr x .8) + ($680/hr x .2) = $296/hr.
[2] $3.6 million / $300/hr = 12,000 hrs.
[3] 390 hrs / 27 months (July 31,2007 to Oct 31, 2009) = 14.44 hrs/month
[4] 12,000 hrs/14.5 hrs/month = 827 months = 69 years

Devonair suggests because it purchased the aircraft in a rising market it can ignore the $3.6 million cost of owning the aircraft and depreciation thereon. And it is true that the value of the aircraft was rising in 2007. Petitioner's Exhibits 5-7. But it is also true that the value of aircraft varies over time. Thus, the value of the subject aircraft rose from 1995-2000, declined from 2001-2004, rose again from 2004-2008, and has dropped dramatically from 2008-2010, creating real market depreciation, not just book depreciation. Petitioner's Exhibit 5; Testimony of Louis Meiners, Jr ("Meiners Testimony"), TR 59. And even if the aircraft was not depreciating on the market, Devonair is allowed to create book losses through book depreciation,[5] which costs pass through to DJS and Donald and Cynthia Smith. Given the meager rental income under the leases to alter egos, Devonair will never come close to recovering its depreciation, market or book, and the State will never come close to recovering its lost use taxes.

Moreover, Donald Smith has never run Devonair as a "business." For example, although annual use tax returns are due on February 28 of the following year, annual returns for Devonair were filed October 18, 2004 for 2003 (7 months late), March 16, 2005 for 2004 (2 weeks late), January 4, 2006 for 2005 (timely), November 4, 2008 for 2007 (8 months late), February 24, 2009, for 2008 (timely) and February 10, 2010 for 2009 (timely). Stip. 7-9, 18, 22, 29.

Similarly, although lease payments were due by December 31 of each year by the terms of the leases, annual payments were haphazard, at best: January 4, 2008 (DJS) and March 13, 2008 (Donald Smith) for 2007; August 18, 2009 (DJS and Donald Smith) for 2008 (6 months after Devonair filed its 2008 annual return[6]), and December 19, 2009 (DJS and Donald Smith) for 2009. Stip. 15, 16, 24, 25, 27, 28. These patterns are symptomatic of what we really have here: Donald Smith has created separate entities to isolate potential liabilities, but treats them as simple alter egos of himself, shifting money from one pocket to another when he remembers to do so.

Although not directly on point, the Tribunal's analysis of a similar situation involving a lease of a watercraft in *Kruszka v Dep't of Treasury*, 4 MTTR 520; 1986 Mich Tax LEXIS 74 (1986), is instructive. *Kruszka* involved a physician ("Kruszka"), whose wife owned a leasing company. The leasing company owned automobiles and office equipment which it leased to Kruszka, his business associates, and relatives, as well as a sailboat which it leased to Kruszka. The lease arrangement was devised to protect family assets from medical malpractice judgments. Kruszka made monthly lease payments of $1,200 on the watercraft purchased for $101,000 in 1980 and subsequently sold by the leasing company for $62,000 in 1984. After determining that Kruszka as well as the leasing company

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[5] Conklin & de Decker calculate market depreciation for the subject aircraft at $210,000/yr and book depreciation at $350,000/yr. Petitioner's Exhibit 8, p 2.

[6] The timing of the payments for 2008, 6 months after Devonair filed its 2008 annual return, is noteworthy since Devonair is a cash basis taxpayer. Smith Testimony, TR 86.

were "users" of the watercraft, the Tribunal rejected Kruszka's argument that use tax was due only on the lease amounts:

> Finally, this hearing officer denies the Kruszkas' request that the amount of any use tax found to be owing be computed on the basis of the actual rental payments made by Paul Kruszka, rather than on the total purchase price of the watercraft. The "price" of tangible personal property, the base with reference to which the use tax is measured, is defined as the aggregate value in money of anything paid or delivered by a consumer to a seller in the consummation and complete performance of the transaction by which tangible personal property or services were purchased or rented for storage, use, or other consumption in this state. MCL 205.92(f); MSA 7.555(2)(f).
>
> Gloria Kruszka, d/b/a Gloria Kruszka Leasing Co., as the named purchaser of the watercraft, clearly is responsible for use tax premised upon the total purchase price of $101,000.[6] Although there is some facial appeal to Paul Kruszka's assertion that his use tax obligation extends solely to the amount of rental payments made by him under the lease agreement, this contention wholly ignores his position as a de facto purchaser of the watercraft, and disregards the non-arm's length character of the lease. Accordingly, it is determined that Paul Kruszka's use tax liability also extends to 4% of the total purchase price of the watercraft.
>
> [6] At the time of sale, the leasing company was required to pay sales tax on the purchase price unless it opted to remit use tax on rental receipts under Specific Sales and Use Tax Rule 82, 1979 AC R 205.132. It did not avail itself of the rental receipt option; even if it had, the rental option may have been disallowed, given that the lease agreement entered into between it and Paul Kruszka's P.C. can hardly be termed arm's length under the present set of facts.

In *Kruszka* the lessor is a familial entity owned by the lessee's wife—here the lessor is owned by an LLC consisting of the lessee and his wife. In *Kruszka* the lessor leased to the lessor's owner's husband—here the lessor is leasing to its sole member and to an individual who is a member of the lessor LLC's sole member. In neither case can the transactions be classified as arms length transactions. In *Kruszka* the lessee paid $1,200 monthly for use of a $100,000 watercraft—here, the lessees pay, on average, $4,350 monthly for use of $3.6 million aircraft.[7] Consistent with Kruszka, the Tribunal should reject Devonair's attempts to avoid its use tax liability. Respondent's Post Hearing Brief, p 7-10.

In its Reply Brief, Respondent argues that Petitioner has failed to prove that the purported "triple net lease" between Devonair and DJS provides for sufficient rents, at $200 per hour, to cover the debt service or acquisition costs. (There is no indication in the record how the aircraft was

[7] Average use of 14.5 hrs/month x weighted average price of $300/hr.

financed.) "But here, since Devonair has decided not to lease to third parties other than Donald J. Smith or DJS, based on current income from Smith and DJS, it will take Devonair almost 70 years to recoup its initial costs for the aircraft. Respondent's Reply Brief, p 2.

Regarding the penalty waiver claim, Respondent contends that Devonair was not engaged in a leasing business and, therefore, was subject to use tax when it brought the aircraft to Michigan, and that reliance upon counsel is not good cause for waiver of penalty under 1979 AC, R 205.1013(8)(d). Furthermore, notwithstanding the fact that Treasury permitted the Rule 82 election for a prior aircraft owned by Petitioner, Respondent claims that nothing in the record establishes that this case is similar to the prior aircraft. The penalty should be upheld.

Conclusions of Law

Tangible personal property purchased outside of Michigan and brought into Michigan within 90 days of purchase is presumed to be subject to use tax and is considered as acquired for storage, use, or other consumption in this state. MCL 205.93(1). There is no dispute that the subject aircraft was stored, used, or consumed within this state and therefore is subject to use tax. The issue in this case is whether Petitioner is liable for use tax upon the entire "price" of the property, or whether it may calculate and pay tax on receipts from rental of the property.

Burden of Proof

The Tribunal has ruled that the election under Rule 82 is an exemption for which the taxpayer bears the burden of proof. While recognizing that the election under Rule 82 is not a "wholesale exemption from payment of use tax" the Tribunal treated it as an "exemption or exclusion" and

required the taxpayer to "clearly establish its applicability" by a preponderance of the evidence. *Masse v Treasury*, MTT Docket No. 100087 (1989), citing *Edison v Dep't of Revenue*, 362 Mich 158, 162; 106 NW2d 802 (1961).

Storing, using, or consuming tangible personal property for any purpose, including leasing property to others, is a taxable use. MCL 205.93(1) and MCL 205.92(b). Property purchased for purposes of leasing it to others may qualify for an exemption for "property purchased for resale." MCL 205.94(2)(c)(i). The use tax act does not define "resale" or "sale." However, "purchase" is defined to include "rental," and "price" includes lease or rental. MCL 205.92(e) and (f). Therefore, the price of property purchased for resale (which includes leasing) is exempt, but the leasing transaction is itself a taxable use.

The use tax act provides an exemption for rental receipts if the rented property was previously subject to use tax or sales tax. MCL 205.94a(i) and (ii). Property purchased in this state for purposes of leasing is exempt from sales tax on the purchase price if the lessor is licensed under the use tax act and the rental receipts are taxed. MCL 205.54d. A purchase by a leasing company is only exempt from sales tax if the lease receipts are taxed. "Rule 82" explains the interrelated application of the sales and use tax acts. 1979 AC, R 205.132 ("Rule 82"). The rule explains how a qualified lessor claims the exemption from sales or use tax on the purchase price. Rule 82 implements these statutory exemptions. The burden of proof is upon the taxpayer.

History of Rule 82 and MCL 205.95(4)

In 1972, the Department of Treasury adopted "Rule 82" to clarify the sales and use tax implications for a person engaged in the business of leasing property to others. The taxpayer may

either pay sales or use tax on the purchase price upon acquisition of the property, or remit use tax on the rental receipts received from its lessees.

> Rule 82. (1) A person engaged in the business of renting or leasing tangible personal property to others shall pay the Michigan sales or use tax at the time he purchases tangible personal property, or he may report and pay use tax on the rental receipts from the rental thereof. A person remitting tax on the purchase price as a purchaser-consumer or remitting tax on rental receipts as a lessor, shall follow 1 or the other methods of remitting for his entire business operation. A person remitting tax on rental receipts shall be the holder of a sales tax license, or a registration as is provided in the use tax act. Each month such lessor shall compute and pay use taxes on the total rentals charged. 1979 AC, R 205.132.

Respondent's Post-Hearing Brief points out that the Rule 82 election was codified by 2002 PA 255. For the periods at issue, the use tax act provided:

> (4) A lessor may elect to pay use tax on receipts from the rental or lease of the tangible personal property in lieu of payment of sales or use tax on the full cost of the property at the time it is acquired. For tax years that begin after December 31, 2001, in order to make a valid election under this subsection, a lessor of tangible personal property that is an aircraft shall obtain a use tax registration by the earlier of the date set for the first payment of use tax under the lease or rental agreement or 90 days after the lessor first brings the aircraft into this state. MCL 205.95(4).

A question arises as to whether the statute is broader than the administrative rule, in that the statute applies to a "lessor" and is not expressly limited to a "person engaged in the business of renting or leasing tangible personal property to others." The question is whether 2002 PA 255 alters the administrative rule and statutory law that was in effect at the time the statute was enacted. There is nothing in MCL 205.95(4) to indicate that the legislature intended to amend or repeal any part of the rule, or to otherwise alter the statutory framework upon which the Rule 82 election is based. The rule stands as a reasonable interpretation of the term "lessor" that now appears in statute and also implements the substantive statutory provisions regarding taxation

and exemption. The rule continues to have the same force and effect of law as it did before the statute was enacted. The substance of Rule 82 is based on provisions of the sales and use tax acts that were in effect prior to and after 2002 PA 255. Rule 82 includes the word "lessor" as synonymous with "person engaged in the business of renting or leasing." The legislature was aware of the usage of "lessor" in Rule 82 when it adopted that term in 2002 PA 255. Nothing in the statute indicates that the legislature intended to vary the existing usage. By using the term "lessor" in section 95(4) rather than "person engaged in the business of leasing," there is no indication that the legislature intended to refer to anyone other than a "lessor" within the meaning of the existing Rule 82. The legislature did not extend the Rule 82 election to persons not "engaged in the business of leasing."

The purpose of 2002 PA 255 was to define "how the election is to be made" for a lessor of aircraft.

> The General Sales Tax Act and the Use Tax Act, taken together, allow a person or business entity engaged in the business of renting out or leasing tangible personal property the option of paying the sales tax on the property at the time of its purchase or paying the use tax on rental receipts. House Legislative Analysis Section, analysis of House Bill 4507 as enrolled, Public Act 255 of 2002, Second Analysis (7-11-02).

The above analysis specifically quotes Rule 82, including the requirement that a person must be "engaged in the business of leasing" and states that the legislation would clarify "when and how this election is to be made" upon the purchase of an aircraft. Even without reference to the legislative history, it is notable that 2002 PA 255 added a new subsection (4) to MCL 205.95, which pertains to *registration requirements only -- it is not an exemption section.* Had the legislature intended to alter the substantive exemption it would have amended sections pertaining

to exemptions. The placement of the amendment in MCL 205.95 plainly demonstrates that the legislature intended to clarify the procedure for claiming the Rule 82 election, not to change the substantive law. Therefore, the term "lessor" as it appears in sec. 95(4) must be interpreted consistent with Rule 82. There is no conflict between the statute and rule. It is reasonable to interpret the statutory term "lessor" as a "person engaged in the business of renting or leasing" tangible personal property to others. Absent clear indication in the body of the statute or the enacting section of 2002 PA 255, there are no grounds for disregarding any part of Rule 82 after the enactment of 2002 PA 255.

Analysis of the Sales and Use Tax Acts

As discussed above, the use tax act provides an exemption for rental receipts if the rented property was previously subject to use tax or sales tax. MCL 205.94a(i) and (ii). Therefore, if the lessor pays 6% sales or use tax upon acquisition of the property, the rental receipts are exempt from use tax. Rental receipts are also exempt if the lessor pays a sales or use tax to another state "levied at the rate of 6% or more." If sales tax is paid to another state at a rate *less than* 6%, the rental receipts are not exempt. The meaning conveyed by these provisions is that the exemption for rental receipts applies as long as the 6% sales or use tax is paid. If 6% of the purchase price is remitted, the law is satisfied. If 6% of the stream of rental income is remitted, the law is satisfied. The use tax on the rental income from tangible personal property is intended to compensate for transactions to which the sales or use tax is not paid upon purchase of the property.

The sales tax act provides a similar exemption for property purchased for leasing. That is, the seller is exempt from sales tax upon sale to the leasing company, if the property is to be leased to

others, as long as the rental receipts from that property are subject to use tax, or specifically exempt from use tax. MCL 205.54d(a). But for the existence of this exemption, the lessor would be required to pay sales or use tax on 6% of the purchase price. The interrelationship between the sales and use tax acts suggests that there is an equivalency between the two taxable events – the purchase of the property and leasing of the property – such that the tax implications are similar.

The use tax is a ". . . specific tax for the privilege of using, storing, or consuming tangible personal property in this state at a rate equal to 6% of the price of the property. . . ." MCL 205.93(1).

"Price" means "the total amount of consideration paid by the consumer to the seller…for which tangible personal property or services are sold, leased, or rented, valued in money…and applies to the measure of the tax." MCL 205.92(f). "The base price to be used in computing the tax liability shall not be less than its retail dollar value as listed in any recognized guide for use or appraisal purposes." 1979, AC, R 205.135(5). If the stated price of property is not reflective of "retail dollar value" (e.g., fair market value), the tax is nevertheless calculated on the market, or "retail dollar value." This principal has application to our current facts where there are issues regarding whether the lease rates are consistent with fair market value.

In order to qualify to pay use tax on rental receipts, the taxpayer must be a "lessor." MCL 205.95(4). Under Rule 82, an eligible "lessor" is "a person engaged in the business of renting or leasing tangible personal property to others."

Therefore, the Rule 82 election is only available to a person "engaged in the *business* of renting or leasing" and not merely to any person who enters a lease with another person. For example, assume that John Doe is the sole member of JD, LLC, which is registered for use tax. The LLC purchases an aircraft for $1,000,000 and leases it to John Doe for $1 per flight hour. John Doe uses the aircraft for 100 hours per year. Thus, the taxpayer avoids $60,000 in tax on the purchase price and instead remits $6.00 in use tax on the rental receipts. Under such circumstances, it could not be said that JD, LLC is a qualified lessor that is engaged in the *business* of leasing aircraft to others. Even if the lease rate was $200 per hour, the annual use tax on the rental income would be $1,200, thus avoiding (or deferring) $58,800 in tax. At that rate, it would take 50 years for the taxpayer to pay $60,000 in tax. It could be held as a matter of law that JD, LLC was not engaged in the *business* of leasing under a straightforward application of the language of Rule 82, and would be liable for the $60,000 tax based on the price, as would any other person who acquired a vehicle, boat, or aircraft for storage, consumption or use in this state.

The use tax act defines "business" as follows:

> "Business" means all activities engaged in by a person or caused to be engaged in by a person with the object of gain, benefit, or advantage, either direct or indirect. MCL 205.92(h).

In order to be eligible under Rule 82 and MCL 205.95(4), Petitioner must have engaged in the leasing of aircraft with the "object of gain, benefit, or advantage." In order to constitute "business" the *object* of the endeavor must be for gain, benefit, or advantage, to the taxpayer, whether or not actually realized. Neither party has cited any legal authority relevant to the meaning of "engaged in business" or "gain, benefit, or advantage" in the context of Rule 82.

Although they disagree on the significance of profit motive, both parties have sought to prove or disprove that Devonair earned a profit from the leases.

Black's Law dictionary defines "business" as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Black's Law Dictionary, Abridged 7th Edition, p 157. "Engaged" means: 1) Employed, occupied, or busy. 2) Committed as to a cause. The American Heritage College Dictionary, 2002, p 646. Engage, "To obtain the services of; employ..." *id.* The phrase "engaged in the business of leasing" implies a consistent, regular, and systematic effort to produce a gain, benefit, or advantage, from the leasing activity. The dictionary definitions are consistent with and help explain the statutory definition of "business" as that term appears in the context of Rule 82.

The Court of Appeals has considered the meaning of the term "business" in the context of a "business pursuits" exception in an insurance policy.

> To constitute a business pursuit, there must be two elements: continuity, and secondly, the profit motive; as to the first, there must be a customary engagement or a stated occupation; and, as to the latter, there must be shown to be such activity as a means of livelihood, gainful employment, means of earning a living, procuring subsistence or profit, commercial transactions or engagements. *Riverside Insurance Company v Kolonich,* 122 Mich App 51; 329 NW2d 528 (1983).

In *State Mutual Cyclone Ins Co v Abbott*, 52 Mich App 103, 108; 216 NW2d 606, 608 (1974), the court approved of the following definition the term "business":

> There can be no dispute that the definitions announced for (sic) by laymen and those applied by the courts have in common the aforesaid Two factors of

> continuity and the profit motive. *Without these, neither laymen nor jurist would call the rendition of service a business pursuit.* [Emphasis added].

The court noted that the term "business" as used in the law and understood by a layperson encompasses both "continuity and the profit motive." Whether that term appears in an insurance contract, statute, or administrative rule, it carries a commonly understood meaning. This supports the notion that a "business" involves "continuity" or regularity of the activity. As applied to our current case, this would require that Petitioner actively seek to lease the aircraft to others so as to fully utilize the asset. Petitioner entered into two leases of indefinite duration, which arguably shows "continuity." However, both the number of leases and the hours that the aircraft was leased are facts that are relevant to this determination. In a case where a purported leasing business allows its only asset to sit idle, it can hardly be said that the person is *engaged* in the business of leasing tangible personal property.

A taxpayer may not lease property at a perpetual loss, for a minimal number of hours, and qualify as a "person engaged in the business of renting or leasing tangible personal property to others. . ." within the meaning of Rule 82. To the contrary, the leasing activity must be engaged in the object of producing a net profit.

The Smith lease was not calculated to produce a profit because the hourly rate was less than the hourly variable costs of operation. (P2 – "Owner-Flown Personal Use Agreement.") The aircraft was leased to Mr. Smith for 6.5 hours from July 31, 2007 to October 31, 2007, 33.3 hours in 2008, and 26 hours in 2009. Devonair had no reasonable expectation of a "gain, benefit, or advantage" from that leasing activity. Mr. Smith, the lessee, benefitted from the transaction, not

the taxpayer. This gratuitous use by Mr. Smith constitutes a taxable use. This fact alone disqualifies Petitioner under Rule 82. By allowing Mr. Smith to use the aircraft for a nominal rate, Petitioner used the aircraft outside the scope of a leasing business, which constitutes a taxable use under MCL 205.93(1). Even if the taxpayer otherwise qualified for an exemption from tax upon the purchase price, by allowing Mr. Smith to use the aircraft outside the scope of a leasing business, the taxpayer converted the property to a taxable use, even if it was only an interim use. MCL 205.93(1) provides in relevant part:

> The tax levied under this act applies to a person who acquires tangible personal property or services that are subject to the tax levied under this act for any tax-exempt use who subsequently converts the tangible personal property or service to a taxable use, including an interim taxable use. If tangible personal property or services are converted to a taxable use, the tax levied under this act shall be imposed without regard to any subsequent tax-exempt use. MCL 205.93(1)

Total Hours Leased are not Reflective of a Leasing Business

Even assuming that the Devonair-DJS lease could be found to be at or above market rate, the fact that Devonair had only two customers and sought no more, and leased the aircraft for relatively few hours per year, tends to prove that Petitioner did not have as its object a gain, benefit, or advantage from leasing aircraft.

A typical owner of a Pilatus PC-12 aircraft flies it approximately 290 to 479 hours per year. P6, P8. It is quite possible that an aircraft leasing business could employ an aircraft for considerably more than 479 hours. Devonair leased the aircraft for an average of 161 hours per year from July 31, 2007 to December 31, 2009. A leasing company operating with a true business motive would have an incentive to maximize the rental hours, in part to recover fixed costs, which accrue

regardless of the hours of use. Therefore, it is relevant to consider not only the reasonableness of rental rates charged under the leases, but also the total rental receipts when examining the question of whether a purported lessor was "engaged in the business of renting or leasing tangible personal property to others" under Rule 82.

The managing member of Devonair (Donald J. Smith) determined that leasing was only advantageous to Devonair when the aircraft was leased to DJS or Donald J. Smith, and would be piloted and controlled by Donald J. Smith. Mr. Smith testified that he examined the possibility of leasing the aircraft to charter companies. His main concern was that a charter service would cause more depreciation from wear and tear than if Mr. Smith piloted the aircraft. He also testified that at market rates applicable to aircraft leased to charter aircraft companies, Devonair would either earn a small profit or possibly incur a loss. The testimony of Mr. Meiners explains the typical terms under which an owner would lease its aircraft to a charter company, which demonstrates that such business deals do exist. He also testified to the specific charter rate applicable to an aircraft like the subject ($1,200 per hour). TR 68.

Petitioner chose to forego revenue that it could have earned from leasing to a charter operator in order to avoid the additional flight hours and wear and tear. This does not establish that it was not economically feasible to earn a profit from leasing to a charter company, but merely that Petitioner chose not to. This tends to establish that Petitioner's primary goal was to preserve the aircraft's value for its own purposes, including a possible resale in the event of a rising market, rather than to engage in the business of leasing aircraft to others. Furthermore, the fact that the aircraft was leased only to DJS and Mr. Smith shows that the aircraft was purchased to be flown

by Mr. Smith, either for DJS or for his own pleasure. This is likely the predominant purpose for the aircraft, and not to produce income from leasing or sale of the aircraft. It was not purchased for use by a genuine leasing business with intent to earn profits from the leases. Other than the one-time overtures that Mr. Smith made to several charter companies, there is no evidence that the aircraft was advertised as being available for leasing. Devonair did not hold itself out to the public as a lessor of aircraft. By declining to lease the aircraft to anyone other than DJS and Mr. Smith, Devonair did not act like a leasing business.

Do the leases "lack economic substance"?

Respondent's main argument is that the leases "lack economic substance such that it cannot be said that Devonair is in the business of leasing aircraft." Respondent's Post-Hearing Brief, p 7.

The Devonair-Smith Lease

Mr. Smith took operational control and used the aircraft for transporting himself and his guests on a noncommercial basis. P2, pp 1 and 2. Mr. Smith agreed to pay costs of "crew, employee benefits, landing, handling, and custom fees and related charges." P2, p 2, paragraph 6. b. The lease provided for "base rent" of "$573 per flight hour, less direct cost for any fuel purchased." P2, p 7. The fee schedule attached to the lease indicates that Mr. Smith may deduct the cost of fuel that he purchased from the hourly base rent, although in practice Mr. Smith never paid for fuel or deducted fuel costs from the rents. According to the Conklin & de Decker publication, the cost of fuel is $420.32 per hour, and total variable costs are $702 per hour for 2007. P8. (There is no evidence of variable costs in 2008 or 2009). The parties stipulated that the lease rate was adjusted retroactivity to $626 per flight hour in December 2007, and increased to $680 in 2008.

Stip. 14. Devonair agreed to pay for insurance costs. The rent was payable annually prior to December 31 for use through the previous October 31.

When testifying about the DJS rental rate, Mr. Smith stated that "actually, everything paid towards the airplane came from DJS. . . ." TR 18. This could be interpreted to mean that DJS paid for all fuel, even fuel used by Mr. Smith. It could also mean that DJS paid only for fuel consumed while DJS operated the aircraft. The evidence does not indicate that Devonair ever purchased any fuel in its own capacity. However, the testimony and stipulated facts suggest that Mr. Smith did not deduct any amounts from the stated hourly rental rate for fuel expenses. With regard to the Smith lease, Mr. Smith stated, "Well, I personally don't pay the fuel and stuff for the plane, and so my lease rate is much higher." TR 21. Accepting this as true, Mr. Smith paid $626 per hour (July 31 through October 31, 2007), and Devonair was responsible for fuel costs for Mr. Smith's flight hours. P2, p 2, paragraph 6. b. (6.5 hours X $626 = $4,069, per Stip. 13, 18). Devonair would need to receive at least $702 per hour in order to cover the variable hourly costs (including fuel costs). Even if hourly costs related to "Crew expenses, supplies and catering" and "Landing/Parking" (P8) are deducted, the variable hourly costs were $659, which exceeds the $626 per hour rate for 2007. Therefore, the hourly rents do not cover the variable hourly costs of operation, and this is not demonstrated to be a market rate reflective of a true leasing business.

Gain from Appreciation in the Aircraft's Value

Mr. Smith testified that he expected to earn a profit for Devonair by appreciation in the value of the aircraft and by rental fees charged to DJS and Mr. Smith. In essence, Petitioner claims that it

invested in the aircraft with the object of "gain, benefit, or advantage" from the sale of the aircraft. The stated investment motive does not prove that Petitioner was engaged in the business of leasing aircraft.

The testimony establishes that profits can be earned by re-selling a "position" in an aircraft. Manufacturers take orders to build an aircraft for a customer, who places a deposit of perhaps $100,000 on an aircraft such as the subject and acquires a right to purchase an aircraft, which may not be ready for delivery for several years. If demand is sufficient, the buyer may be able to sell the "position" at a premium. A position acquired for $100,000 can trade for several times that amount. Manufacturers prohibit a direct transfer of the position, but it is permissible to sell the single purpose LLC that holds the position. While Petitioner has credibly testified that a market exists for aircraft positions, there is little or no evidence regarding the gain or profit that could be realized from the sale of an aircraft after the buyer takes delivery and uses it.

Mr. Meiners testified that "positions" in the Pilatus aircraft were increasing in value in 2007. He stated that a used 1996 Pilatus PC-12 was selling at a price in 2006 greater than the historical cost new in 1996. The Vref demonstrates that values of Pilatus PC-12 aircraft were "trending up" in 2007 and many years prior. Presumably a typical 1996 aircraft would not be in new condition, but would have accrued substantial flight hours as of 2006 (as opposed to it being stored with few or no hours of operation). Based on this testimony, the retail value of a used Pilatus PC-12 in typical condition may exceed the original purchase price. But, this does not prove that a Devonair could earn a profit on the sale of a used aircraft, after taking into account maintenance, repairs, licensing, storage, insurance, taxes, and inflation. Petitioner has not persuasively

demonstrated that it could reasonably expect to earn a real profit from the sale of the aircraft after it took possession and used it. Even if it could, it does not prove that Petitioner was engaged in the business of *leasing* aircraft, as required under Rule 82.

The DJS Lease

The DJS lease requires DJS to pay all taxes of any kind related to the aircraft, all maintenance costs, and insurance costs. DJS acquired a non-exclusive right to use the aircraft. P1, p 1. DJS used the aircraft during various "rental periods" that commenced upon delivery of the aircraft from Devonair to DJS, and concluded upon return of the aircraft to Devonair. The agreement contemplated that DJS would periodically return the aircraft to Devonair, which could lease it to others. P1, p 1, paragraph 2. The aircraft was in fact stored continuously in DJS's hangar at Ionia, Michigan (with DJS bearing the hangar costs). The rent was charged based on $200 multiplied by the hours elapsed from takeoff to landing. The agreement was terminable at will. DJS agreed to pay for all necessary maintenance, as required by the FAA or the aircraft manufacturer. All parts purchased by DJS became property of the owner (Devonair).

One must question the arm's-length nature of the DJS lease. The lease calls for non-exclusive use by DJS, meaning that Devonair was free to rent it to others. DJS incurred the risk of paying for "everything" including major scheduled maintenance, overhauls, or unforeseen repairs that arose while the aircraft was in its possession, even if others intermittently used the aircraft. If the aircraft broke down while in its possession or if the FAA ordered certain repairs, DJS would bear the entire cost, regardless of whether other persons used the aircraft for hundreds of hours immediately before DJS did. In the event Devonair determined that DJS failed to properly

maintain the aircraft, DJS was obligated pay Devonair for the cost of repair or restoration, and DJS was required to pay Devonair for the "diminished value of the aircraft resulting from the operator's failure to return the Aircraft" in satisfactory condition. P1, p 7. Devonair's remedies in the event of a default by DJS are spelled out in the agreement. P1, p 9, 10, 11. Of course, all of these eventualities were controlled by Donald J. Smith, the member of a DJS, which in turn controls Devonair. Donald J. Smith effectively controlled who would use the aircraft, and could enforce the terms according to his best interest. That reality is the only rational explanation as to why DJS would agree to lease the aircraft under these terms.

While Mr. Smith testified that the $200 per hour rental "should have been all profit," it has not been demonstrated that some, if not all, of that amount would not be needed for reserves for future maintenance or to compensate Petitioner for depreciation. The testimony suggests that Petitioner may have financed the purchase, at least in part, using a line of credit. There is no evidence of the amount borrowed, the interest rate, or the term of the loan. It cannot be determined whether the rental fees are sufficient to cover debt service.

Although DJS was responsible for repairs, it cannot be foreseen how long DJS would continue to rent the aircraft, meaning that certain maintenance or overhaul costs might fall upon Devonair after DJS ceased renting the aircraft. It does not appear reasonable for Petitioner to presume that a person leasing the aircraft for less than 145 hours per year (paying $29,000 in annual rent) would agree to pay all maintenance, even the eventual $250,000 engine overhaul. P6. It is more likely that DJS would terminate the agreement prior to the need for such replacement or repairs. The term of the rental agreement was indefinite and either party could terminate it at will. On the

other hand, there is nothing that would prohibit Devonair from terminating the lease the day after the lessee paid for a major repair or maintenance. DJS had no reason to believe that Petitioner would not lease the aircraft to numerous other individuals or entities. There is no apparent economic reason for DJS to pay for a $250,000 engine overhaul when it was not responsible for all of the hours of operation. The same holds true for other maintenance and repairs. DJS agreed to pay for all such costs regardless of the number of hours it used the aircraft, thus subsidizing use by other lessees (Mr. Smith). There is no evidence from the market that any other leasing business would be able to lease an aircraft on an hourly basis under similar terms to an unrelated party.

Based on the Vref, the total variable cost per hour is $702.23. P8. DJS paid $200, per hour, and assumed all variable costs. Therefore, it cost DJS $702 per hour in variable costs, plus the annual fixed costs that were also shifted to DJS regardless of the number of hours of operation. Assuming 145.8 hours of use (2008) and $100,040 in annual fixed costs (minus pilot costs, P8), this equates to fixed costs of $686 per hour. The sum of the hourly variable costs, fixed costs per hour, and the $200 rental fee, indicates that the total effective lease rate of $1,588 per hour. The testimony establishes that DJS could have chartered an aircraft including a pilot and crew for less ($1,200). Under this analysis, the effective rate under the DJS lease was above-market. Of course, by structuring the lease in this manner, Petitioner remitted use tax on $200 per hour, rather than $1,200 or $1,500 per hour.

In order to demonstrate that DJS paid a market rate, Petitioner argues that the sum of the variable operating costs and the $200 per hour lease payments equal $900 per flight hour. After including

annual fixed costs assumed by DJS, this translates into an hourly rate "beyond $1,300 per flight hour." This is consistent with the above analysis. It is unclear why DJS would agree to such an arrangement, where the evidence indicates that it could have chartered an aircraft, with a pilot and crew, for less. A charter service under Part 135 typically provides a pilot and crew, which would be included in the rate of $1,200 per hour. Even if DJS paid a market rate or an above-market rate, these facts cast doubt upon the arm's-length nature of the lease. It is unlikely that Devonair would be able to negotiate a similar lease with anyone other than its sole member, DJS. Therefore, even assuming that Devonair derived a pecuniary benefit from the DJS lease, it cannot be concluded that the lease was entered into under arm's-length conditions pursuant to a leasing business engaged in by Petitioner.

Analysis of Total Revenues

Even if it were found that Devonair charged a market rate to DJS, this does not establish that Petitioner was "engaged in the business of leasing" aircraft. The total profit in relation to the capital investment must be considered. Devonair invested over $3.6 million in the aircraft. Of the total sales in 2007 (from July 31 to October 31, 2007), $17,649 was for the subject aircraft (average of $5,883 per month). Stip. 18. Assuming that this represented pure profit (which it did not), the effective annualized return on investment in the form of rental receipts ($70,569) was approximately 2% of the capital investment ($70,569 / 3,600,000 = .0196).

Devonair filed its 2008 annual use tax return on February 24, 2009, reporting sales of $51,804 and tax of $3,076. Stip. 22. This indicates a 1.4% return on $3,610,690, under the same assumptions as above. It is highly unlikely that a prudent business person or investor would

acquire a $3.6 million asset in order to receive an annual rate of return of less than 1.4%. Based on Petitioner's own contentions, the amounts received from DJS were pure profit. It has not been demonstrated that DJS earned any profit from the Smith lease. Assuming for the moment that this is true, Devonair earned a profit of $29,160 in 2008 from the DJS lease (145.8 hours X $200 per hour). Therefore, the annual net income represents a rate of return on the $3.6 million asset is less than 1% (.81%). Even if the aircraft had been sold at the end of 2008 for $3.7 million (a $100,000 gain), and included in net income, this would equal a return of 3.6%.

Much of Petitioner's argument relies upon the expectation that as of 2007 it appeared the aircraft would continue to appreciate in value. Even if the aircraft increased in value, and there was a gain from a sale, this would not constitute "leasing" activity but investment activity. Respondent convincingly argues that ". . . Devonair is not engaged in the business of leasing aircraft; it is engaged in the business of holding an investment for limited use by DJS and Smith." Respondent's Reply Brief, p 2. By Petitioner's own contention, Devonair is alleged to have been a "profitable rental business, given that the operational costs were all shifted to the lessee under the terms of the agreement, and the aircraft increased in value." Petitioner's Post Hearing Brief, p 9, paragraph 38. In other words, if the aircraft failed to increase in market value, there would be no gain, benefit, or advantage to Petitioner from the leasing activity alone. As such, this does not establish that Petitioner's leasing activity constituted a "business" within the meaning of Rule 82. Furthermore, the DJS lease is alleged to profitable only because Devonair was able to impose non-arm's-length conditions on DJS, by requiring it to assume all costs.

If the law is applied as Petitioner argues, the Rule 82 election is a gaping tax loophole that could not have been intended by the department when promulgating Rule 82 or by the legislature when enacting 2002 PA 255. As the drafter of Rule 82, the department has standing to opine upon the intent of the rule. The election is available to a "person engaged in the business of renting or leasing tangible personal property to others. . . ." The rule is intended to apply to a business that fully utilizes the asset to generate revenues from leasing, where the revenues would cover all business expenses and provide a profit for owners. Upon review of the two lease agreements, and in consideration of Petitioner's activities as a whole, the trier of fact is not persuaded that Devonair was a lessor engaged in the business of leasing the subject aircraft for its own "gain, benefit, or advantage."

Business Purposes

Although Petitioner spends much effort attempting to demonstrate that DJS paid market rents, it also argues that a profit motive or actual profit is not required and that other business purposes, such as privacy or limited liability, may support the economic and legal substance of the transactions. But in order to be engaged in business as a leasing company, there must be a "gain, benefit, or advantage" *to the leasing business* from the leasing activity. Petitioner asserts that

> Devonair is the taxpayer that was formed as a business entity separate and distinct from Mr. Smith's other business interests for a variety of reasons, including: providing business flexibility in the event of an asset sale, providing a liability shield in the event of an accident or potential third party use, protecting his business and personal privacy, and ensuring FAA compliance. Petitioner's Post-Hearing Brief, p 17.

This argument misses the point. By Petitioner's own statement, the limited liability and privacy motives *were for the benefit of DJS, Inc. or Mr. Smith*, not the taxpayer. That is, Mr. Smith (and

DJS) desired to isolate tort liability in Devonair, in order to protect the assets of DJS. Mr. Smith testified, "If DJS wasn't using the plane at the time and it had a – and there was an accident or something in the plane, then all the real estate that I own would become subject to, you know, a suit or something." TR 15:9-13. He did not testify that the limited liability motive was a benefit to Devonair. The same is true for the "privacy" benefits or the ease of selling the aircraft. None of the stated business purposes establish that Devonair was a lessor that was engaged in the business of leasing aircraft.

Petitioner's Application for Certificate of Authority to Transact Business in Michigan states that its specific business activity is "equipment leasing." There is no evidence that Petitioner has ever leased any "equipment." Devonair has never held itself out to the public as a lessor of equipment or aircraft (other than Mr. Smith's discussions with four charter companies). Respondent is correct that Devonair Enterprises, LLC, exists to hold an aircraft for lease to its sole member, DJS, Inc., and also to the sole member of DJS, Inc., Donald J. Smith.

Under Petitioner's rationale, there is little reason for anyone to pay use tax ever again, as long as the use tax savings justifies the cost of obtaining a use tax registration and forming an LLC. If Donald J. Smith can lease the aircraft for his personal use from an LLC that is owned by an LLC of which he is a controlling member (along with his spouse), there is no apparent reason why he could not hold any valuable asset under the same structure. This scheme would be especially effective for big-ticket items that are infrequently used. For example, recreational boats or collector cars that are used only a few hours per year could be acquired tax free (or virtually tax free) by a single member LLC organized as purported "leasing business."

The legal test for the existence of a leasing "business" under Rule 82 cannot merely require that business reasons exist to support the creation of a single-purpose entity to hold title to the property. The same "business purposes" cited by Petitioner in this case could be cited in almost all similar circumstances.

If Petitioner prevails, there would be no rational basis for limiting the holding to situations where a leasing company leases an aircraft to a related business entity. An LLC could lease its aircraft to an individual who is the single member, at a below-market rate, with no minimum number of hours required, and pay minimal use tax on those receipts.

This is not to say that a valid application of the Rule 82 could not result in tax savings – it clearly could. Assuming a person leased the subject aircraft at $1,200 per hour for 290 hours per year (typical use per Vref), the gross revenue would be $348,000. The annual sales tax on rentals would be $20,800, thus deferring $186,000 in tax that would have been due on the purchase price, clearly an advantage to the taxpayer. If the owner sold the aircraft after leasing it for 10 years, it would pay $208,800 in use tax. Even though the total tax paid is roughly equal to the tax on the purchase price, this would still be a tax savings given the time value of money.

Petitioner's Arguments

Petitioner cites *SLC Meter Service v Treasury*, MTT docket No. 244224 (1999), for the proposition that "related party transactions are subject to sales and use tax . . . whether or not an economic profit is actually realized." Petitioner's Post Hearing Brief, p 22. That case held that a

sale from one related entity to another was subject to sales tax, even if the subsequent sale by the purchasing entity was exempt. Had the tax exempt entity directly purchased the property, then resold it, there would be no sales or use tax on either the purchase or resale; however, the related entity was taxable. This case does not support Petitioner's position.

Petitioner argues that a non-tax reason for the lease was to comply with FAA regulations that require an owner to transfer "operational control" of the aircraft to a user who is not a registered owner of the aircraft. This must be accomplished by a written document, not necessarily a lease, but a lease is commonly used. This provision of federal law does mean that Devonair was engaged in the business of leasing aircraft. As explained by Mr. Meiners, and argued by counsel, there is no requirement that there be any rental payments involved in order to comply with this FAA requirement. (In fact, FAA regulations limit fees that owners may charge for others to use their aircraft.) The federal regulations are irrelevant to our current legal issue. Mr. Meiners cited a legal interpretation issued by the Federal Aviation Administration commonly known as the "Schwab" interpretation. Legal Interpretation 1993-17 issued August 2, 1993; 1993 WL 13581142 (D.O.T.). In that document, the Assistant Chief Counsel representing the FAA Regulations Division, opined that a company-owned aircraft may be used to carry officials, employees, or guests within the scope of, and incidental to, the business of the company, if no charge or fee is made for the carriage "in excess of the cost of owning, operating, and maintaining the aircraft." (This may help explain the below-cost lease rate charged to Mr. Smith.) The company's FAA certification prohibits it from earning a profit from such use within the scope of its business. Furthermore, a corporation may not charge its officials, employees, or guests any fee whatsoever when they are carried on a corporate aircraft for vacation, pleasure

trip, or similar purposes. Charles Schwab & Co. Inc. leased its aircraft, without crew, to Mr. Schwab for his personal use. Under FAA regulations, the company is not allowed to charge Mr. Schwab for such use. Petitioner has not demonstrated how this supports a conclusion that Devonair was engaged in the business of leasing aircraft.

Petitioner argues that there is no authority allowing Respondent to challenge the lease rate. First, the requirement that the taxpayer be engaged in business provides authority to examine the lease rate. Furthermore, the tax base or "purchase price" for use tax purposes is not necessarily the agreed upon consideration. Rather, the department has the authority to impose tax on the fair market value. "The base price to be used in computing the tax liability shall not be less than its retail dollar value as listed in any recognized guide for use or appraisal purposes." 1979, AC, R 205.135(5). In fact, in this case, the tax was imposed upon a tax base of $3,450,000, which is *less than* the actual consideration paid ($3,610,690). Petitioner's own evidence (Vref) supports a "retail value" in excess of $3.5 million as of July 31, 2007. Because payment of tax on lease receipts is an alternative to paying tax on the purchase price and purchase price is required to be market value, it is reasonable that the alternative tax base (lease receipts) should also be market rate.

After strenuously defending the DJS lease rate as reflective of market value, Petitioner argues in the alternative that even if the rate is determined to be "too low," the proper remedy is not to either invalidate the corporate form or to rule that Devonair did not lease the aircraft.

There is no need to disregard the limited liability company or to "invalidate" the leases. The outcome of this case turns upon whether Devonair was "engaged in the business of renting or leasing" aircraft. This question turns mainly upon whether Petitioner entered the leases with the object of "gain, benefit, or advantage" from the leases. For purposes of Rule 82, leasing with the object of "gain, benefit, or advantage" means that the taxpayer must seek to earn a profit from the leases, which requires proof that the lease rates and terms are consistent with the market.

Petitioner argues that if the lease rate was below-market, the remedy would be to impute a market rate to the lease, and impose tax on that rate, citing Michigan L.R. No. 85-8 (1/18/1985); RAB 1989-63 (10/04/1989). Presumably, this would involve increasing the rate under the Smith lease to exceed the variable costs and allocated fixed costs, plus a reasonable profit. In the case of the DJS lease, this may require similar treatment, rather than the cost shifting arrangement with the $200 per hour rate. Petitioner does not specifically assert or prove what a typical "dry lease" rate would be under these circumstances. (Dry lease means the lessor provides the aircraft only, without a pilot or crew.) In any event, other cases have imposed tax upon the full purchase price when the taxpayer fails to qualify under Rule 82. *Masse v Treasury*, MTT Docket No. 100087 (1989).

Respondent's Arguments

Respondent's analysis (set forth elsewhere in this opinion) uses the rate under the Smith lease of $680 per hour and the DJS lease rate of $200 per hour. Respondent demonstrates that based on the lease rates, it would take 69 years before Petitioner collected rents equal to the purchase price, at which time the use tax on the rental fees would equal the tax that would have been due

on the purchase price. This is a legitimate analysis and is persuasive at demonstrating that Petitioner's leasing arrangement is likely contrary to the intent of the law. The two options under the act and rules are stated as tax-equivalent events, which is not the case if the taxpayer can extend the use tax payments over 69 years.

However, as far as Petitioner's ability to recover the cost of its investment in the aircraft, Respondent fails to take into account the fact that DJS assumed all costs of operation and all fixed costs. Stip. 33. As such, the total benefit greatly exceeded the stated hourly lease rate paid by DJS. Therefore, while it would take 69 years for the state to receive revenue equal to the tax on the purchase price, it would take Petitioner approximately 20 years to recover the purchase price. By blending the rates, Respondent's analysis obscures the fact that the Smith lease is clearly below-market. Respondent further fails to take into account that the DJS lease (adjusted for costs assumed by DJS) arguably has an effective rate equal to or greater than $1,100 per hour. Petitioner's analysis set forth above, indicates an effective rate of $1,300.

In its Reply Brief, Petitioner asserts that Exhibit P8 indicates hourly operating costs of at least $1,100 per flight hour for variable costs, aircraft insurance, and storage. Petitioner's Reply Brief, p 6. The sum of annual hangar costs and insurances per Exhibit 8 is $68,700. Assuming average annual flight hours of 161, this indicates fixed cost per flight hour of $426. The sum of variable costs ($702) and the allocated fixed cost per flight hour ($426) is $1,128, which is consistent with Petitioner's estimate of $1,100. Petitioner has not included "crew salaries" in this estimate. The sum of variable and fixed costs allocated on an hourly basis is $1,143 (with no depreciation). P8. Respondent offered no counter argument and there is evidence to support these calculations.

Therefore, the estimated effective lease rate, or benefit to DJS from its lease with Devonair, is in the range of $1,300 per hour (costs plus the $200 hourly rate). It cannot be concluded that this effective rate is sufficient to cover Devonair's fixed and variable costs (including depreciation). Taking these facts into account, for purposes of determining the time for recovering the $3.6 million acquisition cost, Respondent's analysis is recast as follows:

($1,300/hr x .8) + ($680/hr x .2) = $1,076/hr.

$3.6 million / $1,076/hr = 3,345 hrs.

390 hrs / 27 months (July 31, 2007 to Oct 31, 2009) = 14.44 hrs/month

3,345 hrs/14.5 hrs/month = 230 months = 19 years

Respondent's analysis on this point is not entirely persuasive, but neither does it support Petitioner's claim. The "blended" hourly rate indicated above is approximately $1,100 per hour, but, there is no such lease rate involved in this case. That rate is only achieved by treating the two leases as one transaction so as to measure the net benefit from the two leases. The proper analysis considers the market viability of each lease agreement standing alone, which involves consideration of the lease rate, terms, and other facts and circumstances pertaining to each lease.

The existence of a single, valid lease is not conclusive as to the issue of whether Petitioner was engaged in a legitimate leasing business. The total of 324 flight hours over 27 months under the DJS lease or 144 hours per year is substantially less than the typical flight hours for a Pilatus PC-12 (290 to 479 hours). Petitioner argues that there is no case law authority and there is no reason for the Tribunal to "make new law in this case where all of the requirements of the election have

been met and where the profit motive is clear." Even if the DJS lease standing alone could be characterized as producing a "gain, benefit, or advantage" to Devonair, this is only because the DJS lease is not an arm's-length transaction given the duties and risks imposed upon DJS.

Analysis of Kruszka v Treasury

Respondent cites one case to support its position, *Kruszka v Treasury,* 4 MTTR 520 (1986). Petitioner has extensively briefed this issue, claiming that the case is inapposite. In *Kruszka*, the department assessed use tax upon Paul Kruszka, who was found in the possession of an unregistered boat for which no use or sales tax had been paid. Paul Kruszka leased the boat from the Gloria Kruszka Leasing Co., which was owned and controlled solely by Gloria Kruszka, Paul Kruszka's spouse. The Tribunal's hearing officer (Michele L. Halloran) determined that the purchasers were in fact both Paul Kruszka and the leasing company. On the date of purchase, Gloria Kruszka Leasing Co. leased the boat to "Paul Kruszka's medical P.C" over a seven year period for $1,200 per month. Paul Kruszka testified that the boat was acquired by the leasing company rather than by him directly in order to protect family assets from medical malpractice liability. The taxpayer first claimed that the sales or use tax was actually included in the purchase price, and should have been remitted by the dealer. The Tribunal found that the purchaser(s) asserted an exemption at the time of purchase, by claiming that the purchase was for lease or resale. It was held that Paul Kruszka was an owner who used the boat and was liable for use tax. It was also held that Gloria Kruszka Leasing Co. was the "nominal purchaser" and that the lease to Mr. Kruszka was also a taxable use. The Tribunal rejected the taxpayer's claim that tax should be imposed on the rental receipts. The rental receipts option was disallowed because of Paul Kruszka's position as "de facto purchaser of the watercraft" as well as the "non-arm's length

character of the lease." There was evidence that Paul Kruszka signed one of the purchase documents and was an owner. There was a lease between Gloria Kruszka Leasing Co. and Paul Kruszka. The decision gives credence to the concept that a non-arm's length lease may disqualify a taxpayer from the option of paying use tax on rental receipts. It is clear that the Tribunal considered and was influenced by the fact that Paul Kruszka effectively controlled his spouse's leasing company and that the lease was not arm's-length. This is tantamount to holding that the purported leasing company wasn't engaged in the business of leasing.

Credit for Use Tax Remitted on Rentals

Petitioner argues that if tax is imposed upon the full purchase price, it is entitled to a credit for tax paid on the rental receipts. Petitioner is correct. If the tax is assessed and paid on the purchase price, the rental receipts are exempt under MCL 205.94(1), and Petitioner would be entitled to a refund of those amounts or a credit toward the payment of the assessment.

Penalty Waiver

Respondent contends that the penalty was properly imposed under MCL 205.24 because Devonair failed to file and pay tax on the purchase price. Devonair was not engaged in a leasing business and therefore was subject to use tax when it brought the aircraft to Michigan. Respondent asserts that reliance upon counsel is not good cause for waiver of penalty under 1979 AC, R 205.1013(8)(d). Furthermore, although Treasury permitted a Rule 82 election for a prior aircraft owned by Petitioner, Respondent claims that nothing in the record establishes that this case is similar to the prior aircraft.

Petitioner claims that penalty is inappropriate because it relied upon advice from professionals and written approval by the department in a prior aircraft purchase and lease. Petitioner demonstrated reasonable business judgment and attempted to meet the requirements for the Rule 82 election. This constitutes good cause to waive the penalty.

This case involves a matter of first impression. Neither party has cited a similar case precisely on point. The 25% penalty was imposed under MCL 205.24, which applies when a taxpayer "fails or refuses to file a return or pay a tax." This penalty is said to be "nondiscretionary" in that it must be imposed for failure to file or pay, but the taxpayer has a right to request a waiver.

Under, 1979 AC, R 205.1013(7), the department "shall waive the penalty" upon request, if the taxpayer proves by clear and convincing evidence that the failure to file or pay was "due to reasonable cause and not to willful neglect." The rule sets forth six examples that generally constitute reasonable cause, including when the department provides "erroneous written information" to the taxpayer after an inquiry from the taxpayer with full disclosure of the facts and circumstances. 1979 AC, R 205.1013(8)(d).

In this case, there is no evidence that Petitioner made a written inquiry for guidance from the department on this transaction or the prior transaction. Exhibit P9 is a letter dated January 23, 2004, which indicates that the department first contacted Petitioner to inquire regarding the acquisition of another aircraft (2003 Cirrus SR 22). Petitioner did not write to the department first requesting guidance, but supplied "documentation" after being contacted. The documentation allowed the department to determine that no taxes were due on the purchase of

that aircraft in 2003. Respondent permitted the Rule 82 election for the other aircraft. Petitioner argues that this provides reasonable cause for it to believe that this present transaction would be afforded the same treatment. Little is known about the circumstances of the transaction in 2003, other than the lease rate was $40 per hour for a Cirrus SR 22 aircraft. TR 19:25.

Petitioner does not fit squarely within the scope of the above example (R 205.1013(7)(d)), and therefore, the 2003 letter, standing alone, does not constitute reasonable cause. That letter pertained to another transaction with a different aircraft that is not proven to have the same or similar value as the subject aircraft. Also, the letter was not a response to an inquiry from Petitioner prior to engaging in the transaction. In order to qualify under the example, Petitioner was required to have written to the department for guidance before it purchased and leased the subject aircraft. It is reasonable for a taxpayer to believe that the department's position in this present case would be the same as the former, assuming the facts are the same. However, Petitioner has not presented clear and convincing evidence that the two transactions are sufficiently similar. While Petitioner does not establish reasonable cause based on this factor alone, the fact that it had arguably relevant written guidance regarding the taxation of lease receipts may be considered along with other "facts and circumstances" set forth in the rule.

In addition to the prima facie examples of "reasonable cause," the rule sets forth eight non-determinative "factors" that guide the department's discretion to waive penalty. Three of those factors are relevant to this case, including, "the compliance history of the taxpayer." 1979 AC, R 205.1013(8)(a). Petitioner actually remitted use tax on the rental of another aircraft. Also, Petitioner was registered for use tax and remitted tax on all rental payments from the subject

aircraft, consistent with its legal position in this case. This is not a case where the taxpayer simply ignored its tax obligations. In that regard, Petitioner had a good compliance history.

It is also relevant to consider "the nature of the tax." 1979 AC, R 205.1013(8)(b). This case involves the proper method of paying tax. The main legal issue is a matter of first impression. Petitioner failed to pay the use tax on the purchase price that Respondent claims is due, but it *did* remit use tax on the rental receipts, apparently believing that it followed the letter of law. This factor weighs in Petitioner's favor.

Finally, it is relevant to consider whether "the taxpayer was incorrectly advised by a tax advisor who is competent in Michigan state tax matters after furnishing the advisor with all necessary and relevant information and the taxpayer acted reasonably in not securing further advice." 1979 AC, R 205.1013(8)(d). Respondent argues that the rule "makes clear that reliance on counsel does not constitute reasonable cause." Respondent's Reply Brief, p 3. This is not an entirely accurate statement of the law. While reliance upon counsel does not always constitute good cause, it is clearly a relevant factor. Mr. Smith sought counsel from Advocate Consulting Legal Group, PLLC, a firm that with expertise in aviation law. Mr. Meiners is affiliated with that firm as a CPA and "Aviation Tax Consultant." Given the execution of the leases, the creation of the business entities, and registration for use tax, and remittance of tax on the lease payments, it is apparent that Petitioner was guided by expert counsel. Therefore, based on the above factors, and in consideration of the facts and circumstances of this case, clear and convincing evidence exists to support Petitioner's request that Respondent waive the 25% penalty.

Conclusion

This case presents a genuine legal issue as to whether the Rule 82 election applies to any person who merely leases or rents personal property, or whether that person must be "engaged in the business of leasing" property. The term "business" must be given substantive effect to delineate between a qualified "leasing business" and any person who executes a lease. Based upon the legal analysis set forth in this opinion, the following factors are relevant to the determination of whether a person is "engaged in the business of renting or leasing tangible personal property to others" within the meaning of Rule 82:

1. Whether the rates and terms of the lease are consistent with those found in leases resulting from arm's-length transactions between unrelated persons in the relevant leasing market.
2. Whether the taxpayer holds itself out to the public as a lessor of property, such as by advertising its leasing services.
3. Whether the amount of time that the property is leased is sufficient to produce revenue that is consistent with property of the same type that is leased by other leasing businesses under market conditions.

Upon consideration of the facts and law, it is concluded that Petitioner does not qualify for the election under Rule 82 and is liable for use tax upon the price of the subject aircraft.

Judgment

IT IS ORDERED that the tax and interest set forth in Final Assessment No. P698813 are AFFIRMED.

IT IS FURTHER ORDERED that the penalty imposed by Final Assessment No. P698813 is CANCELLED.

IT IS FURTHER ORDERED that all use tax payments remitted on monthly rental receipts shall be credited toward payment of Final Assessment No. P698813.

IT IS FURTHER ORDERED that the parties shall have 20 days from date of entry of this Proposed Opinion and Judgment to file exceptions and written arguments with the Tribunal consistent with Section 81 of the Administrative Procedures Act (MCL 24.281). The exceptions and written arguments shall be limited to the evidence admitted at the hearing. This Proposed Opinion and Judgment, together with any exceptions and written arguments, shall be considered by the Tribunal in arriving at a final decision in this matter pursuant to Section 26 of the Tax Tribunal Act (MCL 205.726).

MICHIGAN TAX TRIBUNAL

Entered: January 5, 2011

___Thomas J Halick_____