UT 11-08
Tax Type: **Use Tax**
Issue: **Use Tax on Aircraft Purchase**

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
SPRINGFIELD, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	
v.	**Docket #** XXXX
	Acct ID: XXXX
ABC BUSINESS	**Letter ID:** XXXX
Taxpayer	

RECOMMENDATION FOR DISPOSITION

Appearances: John D. Alshuler, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Robert A. McKenzie and Adam S. Fayne of Arnstein & Lehr, LLP for ABC Business

Synopsis:

The Department of Revenue ("Department") issued a Notice of Tax Liability ("NTL") to ABC Business ("taxpayer") that assessed tax, penalty and interest on the use of an aircraft pursuant to the Use Tax Act (35 ILCS 105/1 *et seq.*). The taxpayer filed a timely protest to the NTL. The parties filed a Stipulation of Facts, with attached exhibits, and subsequent briefs. The parties agreed to have the case decided based on the documents that were filed. In its brief, the taxpayer raised the following issues: (1) whether the members of the taxpayer are the owners of the aircraft for use tax purposes and the nonresident exemption bars imposition of the tax; (2) whether the Department miscalculated the depreciation allowance; and (3) whether the taxpayer should be allowed a credit for use taxes paid to the State of Colorado. After reviewing all of the evidence presented, it is recommended that this matter be resolved in favor of the Department.

<u>FINDINGS OF FACT</u>:

1. The taxpayer is a limited liability company organized under the laws of the State of Colorado on or about December 11, 2002. (Stip. #1)
2. Since its organization, the taxpayer has been treated as a disregarded entity for federal and state income tax purposes. (Stip. #2)
3. On or about December 11, 2002, the taxpayer entered into a written Piston Aircraft Purchase Agreement ("Purchase Agreement") with XYZ Aviation, Inc. ("XYZ Aviation") to purchase a new model T182T Cessna Aircraft Company aircraft bearing serial number XXXX and U.S. Registration Number XXX ("aircraft"). (Stip. #3; Ex. A)
4. On or about December 20, 2002, the taxpayer purchased the aircraft from XYZ Aviation in Broomfield, Colorado for $315,200. (Stip. #4; Ex. B)
5. The taxpayer paid for the aircraft with three checks. The total amount paid by check was $315,200. (Stip. #5; Ex. C)
6. On or about December 20, 2002, John Doe, a member of the taxpayer, on behalf of the taxpayer, signed a written agreement with XYZ Aviation appointing XYZ Aviation to make the aircraft available for rental on a short-term basis ("Rental Agreement"). (Stip. #6; Ex. D)
7. Beginning on December 20, 2002, the taxpayer based the aircraft at Jefferson County Airport a/k/a Rocky Mountain Metropolitan Airport, Broomfield, Colorado. (Stip. #7)

8. Pursuant to Colorado Revised Statutes §39-26-713(1)(a), the State of Colorado permits taxpayers to remit sales tax on lease payments in lieu of paying sales or use tax on the purchase of an aircraft. (Stip. #8; Ex. E)

9. Pursuant to Colorado Revised Statutes §39-26-713(1)(a), the taxpayer did not pay sales or use tax on the purchase of the aircraft. (Stip. #9)

10. To date, the taxpayer has been unable to locate documents substantiating the payment of sales tax (on the lease payments) paid to the State of Colorado. The Colorado Department of Revenue has refused to provide any information regarding the same, despite being served with a Subpoena issued by the Office of Administrative Hearings. (Stip. #10; Ex. F)

11. The taxpayer relocated the aircraft to Illinois on or about September 21, 2003 and leased the aircraft to LMN School, a flight school located at Schaumburg Regional Airport, Schaumburg, Illinois. (Stip. #11)

12. The taxpayer has not paid any sales or use taxes to the State of Illinois with respect to the aircraft. (Stip. #12)

13. The taxpayer has not filed a sales or use tax return with respect to the aircraft in Illinois. (Stip. #13)

14. On or about July 9, 2008, the Illinois Department of Revenue sent the taxpayer notice that it had initiated an audit of the aircraft. (Stip. #14)

15. As a result of the audit, the Department of Revenue sent the taxpayer a Notice of Tax Liability for Form EDA-95 dated November 18, 2009 with the following balances:

Audit Tax	$18,614.00	
Late Payment Penalty	250.00	
Interest	6,255.99	
Balance	$25,119.99	(Stip. #15)

16. On January 15, 2010, the taxpayer filed a request for an administrative hearing initiating the above-captioned proceeding. (Stip. #16; Ex. G)

CONCLUSIONS OF LAW:

Under the Use Tax Act ("Act") Illinois imposes a tax upon the privilege of using in Illinois tangible personal property purchased at retail from a retailer. 35 ILCS 105/3. The word "use" means "the exercise by any person of any right or power over tangible personal property incident to the ownership of that property …." 35 ILCS 105/2. Section 12 of the Act incorporates by reference section 5 of the Retailers' Occupation Tax Act ("ROTA") (35 ILCS 120/1 *et seq.*), which provides that if the taxpayer fails to file a return, the Department shall determine the amount of tax due "according to its best judgment and information." 35 ILCS 105/12; 120/5. A certified copy of the Department's determination of the amount of tax due "shall, without further proof, be admitted into evidence… and shall be prima facie proof of the correctness of the amount of tax due, as shown therein." *Id.*

Once the Department has established its prima facie case, the burden shifts to the taxpayer to overcome this presumption of validity. Clark Oil & Refining Corp. v. Johnson, 154 Ill. App. 3d 773, 783 (1st Dist. 1987). To prove its case, a taxpayer must present more than testimony denying the Department's assessment. Sprague v. Johnson, 195 Ill. App. 3d 798, 804 (4th Dist. 1990). The taxpayer must present sufficient documentary evidence to support its claim. *Id*. In addition, tax exemption provisions must be strictly construed in favor of taxation. Quad Cities Open, Inc. v. City of Silvis, 208 Ill. 2d 498, 507 (2004); Heller v. Fergus Ford, Inc., 59 Ill. 2d 576, 579 (1975). The party claiming the exemption must prove by clear and convincing evidence that it is entitled to the exemption. Heller, at 579; Provena Covenant Medical Center v.

Department of Revenue, 236 Ill. 2d 368, 388 (2010). All doubts are resolved in favor of taxation. *Id*.

Whether the Members are the Owners and the Nonresident Exemption Applies

Since its organization on December 11, 2002, the taxpayer has been treated as a disregarded entity for federal and state income tax purposes. (Stip. #2) The taxable activities of a disregarded entity "are treated in the same manner as a sole proprietorship, branch, or division of the owner." 26 CFR §301.7701-2(a); see also 86 Ill. Admin. Code §100.9750. As a disregarded entity, the activities of the taxpayer are treated as the activities of its individual members for income tax purposes. For example, the State of Illinois permits the members of a disregarded entity to pay personal income taxes based on their federal adjusted gross income, which is generally increased and reduced by their entity's income and expenses. The taxpayer believes that if the Department imposes use tax in this case, it will result in a patent contradiction because the payment of the use tax will be treated as a payment made by the taxpayer's members when they file their personal income tax returns.

The taxpayer also argues that the taxpayer is exempt from the use tax because its members qualify for the nonresident exemption in the first paragraph of section 3-70 of the Act. Section 3-70 provides as follows:

> Property acquired by nonresident. The tax imposed by this Act does not apply to the use, in this State, of tangible personal property that is acquired outside this State by a nonresident individual who then brings the property to this State for use here and who has used the property outside this State for at least 3 months before bringing the property to this State.
>
> Where a business that is not operated in Illinois, but is operated in another State, is moved to Illinois or opens an office, plant, or other business facility in Illinois, that business shall not be taxed on its use, in Illinois, of used tangible personal property, other than items of tangible personal property that must be titled or registered with the State of Illinois or whose registration with the United States

> Government must be filed with the State of Illinois, that the business bought outside Illinois and used outside Illinois in the operation of the business for at least 3 months before moving the used property to Illinois for use in this State.
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> 'Acquired outside this State', whenever used in this Act, in addition to its usual and popular meaning, also means the delivery, outside Illinois, of tangible personal property that is purchased in this State and delivered from a point in this State to a point of delivery outside this State. 35 ILCS 105/3-70.

The taxpayer contends that because (1) the aircraft should be treated as the property of the taxpayer's members for use tax purposes; (2) the members were Colorado residents at the time the aircraft was purchased; and (3) the members used the aircraft for more than 3 months before relocating it to Illinois on September 21, 2003, the use tax should not apply.

In addition, the taxpayer maintains that the case of JB4 Air, LLC v. Department of Revenue, 388 Ill. App. 3d 970 (2nd Dist. 2009) does not apply to this case. In JB4 Air, LLC, a Delaware limited liability company purchased an aircraft that remained in Wisconsin for approximately 12 months before it was relocated to Illinois. The taxpayer argued that it qualified for the nonresident exemption under section 3-70 because the term "individual" in the first paragraph included limited liability companies. The taxpayer also argued that a "substance over form" analysis should apply and JB4 would be exempt from use taxes because its sole member was the substantive owner of the aircraft. The court rejected both arguments. The court found that the term "individual" in section 3-70 does not include limited liability companies because the two terms are used separately and distinctly throughout the Use Tax Act, and the second paragraph of section 3-70 would be rendered ineffective. *Id*. at 974-975. Also, the court found that the "substance over form" doctrine did not apply because the identity of the purchaser was undisputed, and the doctrine is not used to reclassify an entity that purchased the property. *Id*. at 976-977. The taxpayer in the present case argues that JB4 Air, LLC does not apply because the court did not consider whether the taxpayer was a disregarded entity.

The Department argues that no legal requirement exists to treat the taxpayer as a disregarded entity. The Department believes that the taxpayer has not cited any statute or case law that requires the Department, for sales tax purposes, to treat the taxpayer as a disregarded entity because there is no such requirement. The Department states that although there are no cases in Illinois dealing with this question, a Michigan appellate court in Kmart Michigan Property Services, LLC v. Department of Treasury, 283 Mich. App. 647 (2009) found that filing as a disregarded entity for federal income tax purposes does not require a single member LLC to be a disregarded entity for purposes of Michigan's Single Business Tax Act ("SBTA") (MCL 208.1 *et seq.*). The court found that nothing in the SBTA or the federal regulations require an entity to be consistent in its self-classification with respect to its state and federal tax filings for a given year.[1]

The Department also argues that the stipulations are silent as to whether any member of the taxpayer personally flew the aircraft during the times that it was being leased. Therefore, there is a presumption that the use of the aircraft was limited to the taxpayer. The Department contends that because the aircraft was used for business purposes in both Colorado and Illinois, the second paragraph of section 3-70 applies in this case. Under the second paragraph, the aircraft "must be titled or registered with the State of Illinois" or the "registration with the United States Government must be filed with the State of Illinois." 35 ILCS 105/3-70; see also 620 ILCS 5/42(1) (federal licenses, certificates or permits of civil aircrafts must be registered every 2 years). The Department argues that although the aircraft was used by a business that was not operated in Illinois for a period of at least 3 months, because the aircraft must be registered with the State of Illinois, the exemption under paragraph 2 of section 3-70 does not apply.

[1] Under the Illinois Income Tax Act, if a taxpayer is a disregarded entity for federal income tax purposes, then the taxpayer is also a disregarded entity for Illinois income tax purposes. See 35 ILCS 5/1501(a)(4); 86 Ill. Admin. Code §100.9750(b)(1).

As the Department has stated, nothing in the Use Tax Act or case law requires that an LLC that is treated as a disregarded entity for income tax purposes must be treated as a disregarded entity for use tax purposes. Contrary to the taxpayer's argument concerning the reporting of the use tax, if the taxpayer owes use tax on an aircraft that was purchased from an out-of-state retailer, then the taxpayer cannot report that use tax on a Form IL-1040. The taxpayer must file Form RUT-25 (Vehicle Use Tax Transaction Return), which is filed by both individuals and businesses.[2] See 86 Ill. Admin. Code §150.705(e), (i).

Although the specific issue concerning disregarded entities was not raised in JB4 Air, LLC, the taxpayer's arguments are similar to those raised in that case. The taxpayer argues, essentially, that the aircraft should be treated as property of the LLC's individual members so that the nonresident exemption in the first paragraph of section 3-70 would apply. This argument was rejected by the court in JB4 Air, LLC. The court clearly found that for use tax purposes, the property of a single-member LLC is not considered property of an individual. In the present case, because nothing requires treating an LLC as a disregarded entity for use tax purposes and the property of an LLC is not considered to be the property of an individual, the first paragraph of section 3-70 does not apply. Instead, the second paragraph of section 3-70 applies, and because an aircraft must be titled or registered with the State of Illinois, the exemption for tangible personal property that is used by a business for at least 3 months before moving the property to Illinois also does not apply. Therefore, use tax must be assessed on the aircraft.

Whether the Department Miscalculated the Depreciation Allowance

[2] If an individual purchases tangible personal property (other than vehicles) and the amount of use tax owed is more than $600, then the amount cannot be reported on Form IL-1040. Form ST-44 (Illinois Use Tax Return) must be filed. See Instructions 2010 Form IL-1040, line 22.

The taxpayer argues that the depreciation allowed on the aircraft should be 2% per month for 9 months, which is the allowable depreciation for a motor vehicle. Ex. H, p. 10; Ill. Aircraft/Watercraft and Vehicle Tax Information Guide (Dec. 2008), pp. 6, 13. The auditor's work papers state that there is "nothing in the regulations for depreciation of aircraft," and the Department merely uses an "allowance of 1% per month for aircraft and watercraft."[3] Ex. H, pp. 2, 10. The auditor, however, "checked the class life for an aircraft for federal purposes," and found it to be 6 years. Ex. H, p. 2. The auditor then used straight line depreciation that resulted in a rate of 1.39% per month. That rate was multiplied by 9 months, which totaled 12.51%. *Id*. The auditor multiplied 12.51% by the purchase price, $315,200, which resulted in the depreciation amount of $39,431.52. *Id*.

The taxpayer contends that the Department has no basis for denying depreciation of 2% per month for an aircraft.[4] The aircraft should be allowed 2% because that is what the Department allows for motor vehicles, and the aircraft fits within the Department's definition of "motor vehicle" in that it is self-propelled and not operated upon rails. Ill. Aircraft/Watercraft and Vehicle Tax Information Guide (Dec. 2008), p. 6.

The taxpayer also contends that if 2% is not allowed, then at the very least the taxpayer should be allowed 1.67% per month because that is the rate that is allowed for aircrafts under federal guidelines.[5] The taxpayer states that although the auditor claimed to follow federal guidelines, the auditor's depreciation does not comport with federal guidelines. The IRS requires taxpayers to use the Modified Accelerated Cost Recovery System ("MACRS") to depreciate aircrafts. IRS Pub. 946 (March 11, 2010), p. 8. The taxpayer claims that under MACRS, airplanes are asset class 00.21 and have a recovery period of 5 years. The taxpayer

[3] At the rate of 1% per month, the class life would be 8 years and 4 months.
[4] At the rate of 2% per month, the class life would be 4 years and 2 months.
[5] At the rate of 1.67% per month, the class life would be 5 years.

argues that the class life used by the Department (6 years) is applicable only as an exception to depreciation under MACRS, which is known as the Alternative Depreciation System ("ADS"). *Id*. at 35, 103. The taxpayer believes that the Department applied the ADS class life without noting why that class life applies. Therefore, the taxpayer claims that at the very least, if the 2% rate is not applied, then the 1.67% rate should apply. The taxpayer also argues that the 1.67% should apply because that would be the rate used for automobiles under MACRS.

Under the federal guidelines for depreciating property for federal income tax purposes, most property must be depreciated using MACRS. *Id*. at 8. MACRS consists of two depreciation systems, the General Depreciation System ("GDS") and the Alternative Depreciation System ("ADS"). *Id*. at 34. These two systems provide different methods and "recovery periods" to use in figuring depreciation deductions.[6] *Id*. Generally, a taxpayer must use GDS unless the taxpayer is specifically required by law to use ADS, or the taxpayer elects to use ADS. *Id*. A taxpayer must use ADS for certain types of property, one of which is the following: "listed property" used 50% or less in a qualified business use.[7] *Id*.

Under the federal guidelines, airplanes are included in asset class 00.21 and have a "class life" of 6 years.[8] *Id*. at 103. The guidelines also show that the recovery period for airplanes is 5 years for the GDS method and 6 years for the ADS method. *Id*. In the present case, as the auditor indicated, she used the "class life for an aircraft for federal purposes," which is 6 years. Ex. H, p. 2. The auditor's depreciation method, therefore, comports with federal guidelines.

As previously stated, the federal guidelines are used for depreciating property for federal income tax purposes. Nothing requires an auditor to use the federal guidelines to determine

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[6] A "recovery period" is the period of time, in years, over which the property is depreciated using the MACRS method. *Id*. at 41, 103.
[7] "Listed property" includes airplanes. *Id*. at 58-59.
[8] "Class life" is a period of time, in years, that is used to determine the class in which the property is put. *Id*. at 113. It is also used to determine the recovery period for most types of property. *Id*.

depreciation for Illinois use tax purposes. The auditor indicated that the Department usually uses a rate of 1% per month for depreciating airplanes for use tax purposes. By using the federal class life of 6 years, the auditor increased the rate to 1.39%. The taxpayer is now arguing that the recovery period under the GDS method of 5 years should be used, resulting in a rate of 1.67%. As previously mentioned, the recovery period is the time over which the property is depreciated using the MACRS method, but nothing requires the auditor to use that recovery period or that method to depreciate the aircraft. In addition, the recovery period under the ADS method is 6 years, which is the same as the class life. The ADS method must be used for airplanes that are used 50% or less in a qualified business use. It is possible that the taxpayer's aircraft falls under this category. Nevertheless, the auditor followed the federal guidelines for determining the class life, and nothing warrants a change in the rate to 1.67%.

Furthermore, nothing warrants using the rate of 2%. The Department allows 2% per month for motor vehicles. 86 Ill. Admin. Code §150.110(a); Ill. Aircraft/Watercraft and Vehicle Tax Information Guide (Dec. 2008), pp. 6, 13. The Department's regulation further states as follows:

> Effective January 1, 1968, as to tangible personal property other than motor vehicles, a "reasonable allowance for depreciation" is deemed by the Department to be the amount of depreciation determined by use of the straight line method of depreciation. 86 Ill. Admin. Code §150.110(c).

As discussed previously, the Department determined a reasonable allowance for depreciation. Although the taxpayer argues that the aircraft fits within the Department's definition of "motor vehicle" because it is self-propelled and not operated upon rails (Ill. Aircraft/Watercraft and Vehicle Tax Information Guide (Dec. 2008), p. 6), the Department's Information Guide has separate definitions for aircrafts and motor vehicles. *Id*. at 5, 6. The term "aircraft" includes "airplanes, helicopters, hot-air balloons, gliders, blimps, dirigibles, seaplanes, and anything else defined as 'aircraft' by the Federal Aviation Administration." *Id*. at 5. Nothing in the Information Guide indicates that an aircraft should be treated the same as a motor vehicle or that the depreciation allowed for motor vehicles should be used for aircrafts.

Whether the Taxpayer Should be Allowed a Credit for Use Taxes Paid to the State of Colorado

The taxpayer argues that it should be allowed a credit for sales taxes paid to the State of Colorado pursuant to Colorado Revised Statutes §39-26-713(1)(a). The taxpayer refers to the following section of the Illinois Use Tax Act:

> Multistate exemption. To prevent actual or likely multistate taxation, the tax imposed by this Act does not apply to the use of tangible personal property in this State under the following circumstances: …
>
> (d) The use, in this State, of tangible personal property that is acquired outside this State and caused to be brought into this State by a person who has already paid a tax in another State in respect to the sale, purchase, or use of that property, to the extent of the amount of the tax properly due and paid in the other State….[9]
> 35 ILCS 105/3-55 (d).

The taxpayer states that Colorado permits its taxpayers to remit sales tax on lease payments in lieu of paying sales or use tax on the purchase of an aircraft. Colo. Rev. Stat. §39-26-713(1)(a). Upon purchasing the aircraft, the taxpayer signed a Rental Agreement with XYZ Aviation that appointed XYZ Aviation to make the aircraft available for rental on a short-term basis. Stip. #6; Ex. D. The taxpayer notes that the State of Colorado refused to respond to the taxpayer's subpoena regarding sales taxes remitted by XYZ Aviation on account of the rental of the aircraft, and the taxpayer claims that it cannot otherwise obtain records of the sales tax paid. Stip. #10. The taxpayer contends that it should be allowed a credit for sales taxes remitted to the State of Colorado.

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[9] The term "person" includes a limited liability company. 35 ILCS 105/2.

The Department argues that the taxpayer has failed to provide any documentary proof that it paid any tax to the State of Colorado or that tax was paid on its behalf with respect to the purchase of the aircraft. The Department states that section 12 of the Act incorporates by reference section 7 of the ROTA, which states in relevant part as follows:

> It shall be presumed that all sales of tangible personal property are subject to tax under this Act until the contrary is established, and the burden of proving that a transaction is not taxable hereunder shall be upon the person who would be required to remit the tax to the Department if such transaction is taxable. 35 ILCS 120/7.

The Department also states that mere testimony without corroboration by evidence identified with the taxpayer's books and records is insufficient to rebut this presumption. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 835 (1^{st} Dist. 1988). Therefore, because the taxpayer has failed to provide documentary proof that the tax was paid, the taxpayer is not entitled to credit.

As the taxpayer indicated, under Colorado law, "[t]he department of revenue may permit a lessor of tangible personal property leased for a period of three years or less to acquire the property free of sales or use tax if the lessor agrees to collect sales tax on all lease payments received on the property." Colo. Rev. Stat. §39-26-713(1)(a); Ex. E. Although the taxpayer signed a Rental Agreement with XYZ Aviation so that XYZ Aviation could make the aircraft available for rental on a short-term basis, the Rental Agreement states that the "[o]wner [taxpayer] shall pay all taxes, assessments, and charges attributable to the ownership of the Aircraft." Ex. D, p. 3. Colorado did not respond to the taxpayer's subpoena regarding sales taxes remitted by XYZ Aviation because those records are confidential. Ex. F, p. 8. Under the Rental Agreement, however, XYZ Aviation was not responsible for paying the taxes. Because the taxpayer was required to make the payments, if the taxpayer actually did make the payments, then the taxpayer should have documents to verify that. As the Department has indicated, without documentary evidence showing that taxes were paid, the credit cannot be given.

Recommendation:

For the foregoing reasons, it is recommended that the NTL be upheld.

Linda Olivero
Administrative Law Judge

Enter: August 26, 2011