UT 99-4
Tax Type: Use Tax
Issue: Occasional Sales – Non-Retail Transactions (Exempt)

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

THE DEPARTMENT OF REVENUE	)	
OF THE STATE OF ILLINOIS	)	Case No. 98 ST 0000
	)	IBT No. 0000-0000
v.	)	NTL No. SF-190000000000000
	)	
"ICARUS AVIATION, INC.",	)	Administrative Law Judge
Taxpayer	)	Mary Gilhooly Japlon

RECOMMENDATION FOR DISPOSITION

SYNOPSIS:

The Department of Revenue (hereinafter "Department") issued a Notice of Tax Liability (hereinafter "NTL") to "Icarus Aviation, Inc." (hereinafter "Icarus" or "taxpayer") on October 14, 1997 for Use Tax, penalty and interest in the amount of $369,976 based upon the taxpayer's purchase of an aircraft for use in this state from a retailer. A protest was filed on behalf of the taxpayer by its legal counsel. Representing the Department in these administrative proceedings was Special Assistant Attorney General John Alshuler. In lieu of hearing, the parties elected to file a Stipulation of Issues and Facts (hereinafter "Stip.") with accompanying exhibits, as well as memoranda of law in support of their respective positions.

After reviewing the record herein comprised of the Stipulation of Issues and Facts, the accompanying exhibits and the memoranda of law filed by the parties in support of their respective positions, it is my determination that this matter be resolved in favor of the Department of Revenue.

FINDINGS OF FACT:

1. The Department's prima facie case, inclusive of all jurisdictional elements, was established by the admission into evidence under the Certificate of the Director of Revenue of the Audit Correction and/or Determination of Tax Due for the period of June 3, 1994 for Use Tax on a purchase, plus penalties for a total of $327,600. (Stip. Ex. No. 1).
2. Notice of Tax Liability (hereinafter "NTL") SF-970000000000000 was issued to the taxpayer by the Department on October 14, 1997 for Use Tax, penalty and interest in the total amount of $369,976 concerning the taxpayer's June 3, 1994 purchase of the aircraft at issue. (Stip. Ex. No. 1).
3. On May 25, 1994 "ABC Corporation" ("ABC") and "Icarus Aviation, Inc." entered into an Aircraft Acquisition Agreement ("Agreement") wherein "ABC" agreed to sell and "Icarus" agreed to purchase a Gulfstream II aircraft for the purchase price of $3,900,000. (Stip. Ex. No. 3, par. 2).
4. "ABC" physically delivered the Gulfstream II aircraft at issue herein to "Icarus" from Savannah, Georgia to Manchester, New Hampshire on June 3, 1994. (Stip. par. 4; Stip. Ex. Nos. 11, 13).
5. The taxpayer agreed to reimburse "ABC" for the expense of flying the Gulfstream to New Hampshire. (Stip. Ex. No. 3, pars. 3, 5(f), 5(m)).

6. “ABC” represented to “Icarus” that its sale of the aircraft was an isolated or occasional sale, and that “ABC” is not regularly engaged in the business of selling aircraft. (Stip. Ex. No. 3, par. (n)).
7. On June 3, 1994 an “Icarus” representative in Savannah, Georgia, flew, inspected and accepted the condition of the Gulfstream II pursuant to paragraph 8 of the Aircraft Acquisition Agreement. (Stip. Ex. No. 3, par. 8; Stip. Ex. No. 5).
8. Subsequent to “ABC’s” delivery of the Gulfstream II to the closing location in Manchester, New Hampshire on June 3, 1994, “Icarus” wire transferred to the escrow account the purchase price, less deposit and expenses in accordance with the Aircraft Acquisition Agreement. (Stip. Ex. No. 3, pars. 2, 5(m); Stip. Ex. Nos. 11, 12).
9. Paragraph 18(c) of the Aircraft Acquisition Agreement allowed “ABC” to assign its right, title and interest in and to the Aircraft Acquisition Agreement and to the Gulfstream II to “Fictitious” Leasing Corporation of North Carolina no sooner than the time that the aircraft was at the closing location. (Stip. Ex. No. 3, par. 18(c)).
10. On June 3, 1994 “ABC” (“Assignor”) and “Fictitious” Leasing Corporation of North Carolina (“Assignee”) entered into an Assignment and Assumption Agreement (“Assignment”). (Stip. Ex. No. 6).
11. Pursuant to the Assignment and Assumption Agreement, “ABC” assigned its rights and benefits under the Aircraft Acquisition Agreement, the obligation to accept the purchase price and its title to the aircraft to “Fictitious”. (Stip. Ex. No. 6).
12. Also executed on June 3, 1994 was a Federal Aviation Administration Aircraft (“FAA”) Bill of Sale wherein “ABC”, as Seller, did “SELL, GRANT, TRANSFER

AND DELIVER" to "Fictitious", as Purchaser, all of the Seller's "RIGHTS, TITLE AND INTEREST IN AND TO SUCH AIRCRAFT". (Stip. Ex. No. 7).

13. Likewise, on June 3, 1994 "Fictitious", as Purchaser, received a Bill of Sale from "ABC", as Seller, wherein "ABC" did "BARGAIN, SELL, ASSIGN, CONVEY, TRANSFER AND DELIVER" to "Fictitious" "all of the Seller's right, title and interest in and to that certain aircraft...". (Stip. Ex. No. 7).

14. On the same date, June 3, 1994, a Warranty Bill of Sale was executed between "Fictitious", as Seller, and "Icarus", Inc., as Purchaser, wherein "Fictitious" did "bargain, sell, transfer, assign, set over and deliver unto purchaser all of its right, title and interest" in and to the Aircraft. (Stip. Ex. No. 7).

15. The Aircraft Bill of Sale dated June 3, 1994 from "ABC", as Seller, conveying title to the Gulfstream II to "Fictitious" was filed with the FAA at 2:49 p.m., C..D.T. (Stip. Ex. No. 8).

16. The Warranty Bill of Sale dated June 3, 1994 from "Fictitious", as Seller, conveying title to the aircraft to "Icarus" was filed with the FAA at 2:50 p.m., C.D.T. (Stip. Ex. No. 8).

17. The Aircraft Acquisition Agreement allowed "ABC" to assign its right, title and interest in and to the Agreement and to the aircraft to "Fictitious" at the time that the aircraft was delivered to the closing location in Manchester, New Hampshire. (Stip. Ex. No. 3, par. 18(c)).

18. The above stated provision, however, was premised upon the condition that the agreements, covenants, representations, and warranties of "ABC" set forth in the Aircraft Acquisition Agreement survive any such assignment and for the benefit of

"Icarus" and "ABC" shall not be relieved of its obligations under the Agreement. (Stip. Ex. No. 3, par. 18(c)).

19. "Icarus" agreed to receive title to the Gulfstream II from "Fictitious" as an accommodation to "ABC" based on "ABC's" representation that such transfer of title to "Fictitious", and "Fictitious's" retransfer, was necessary for "ABC" to satisfy the requirements of Internal Revenue Code Section 1031, thereby deferring "ABC's" federal income tax gain on its disposition of the Gulfstream II. (Stip. par. 5; Stip Ex. No. 3, par. 18(c); Stip. Ex. No. 6, Recital C; Stip. Ex. No. 9).

CONCLUSIONS OF LAW:

The Department of Revenue prepared corrected returns for Use Tax liability pursuant to section 5 of the Retailers' Occupation Tax ("ROT") Act (35 **ILCS** 120/5). Said section is incorporated into the Use Tax Act via section 12 thereof (35 **ILCS** 105/12). Section 5 of the ROT Act provides in pertinent part as follows:

> In case any person engaged in the business of selling tangible personal property at retail fails to file a return, the Department shall determine the amount of tax due from him according to its best judgment and information, which amount so fixed by the Department shall be prima facie correct and shall be prima facie evidence of the correctness of the amount of tax due, as shown in such determination. ... Proof of such determination by the Department may be made at any hearing before the Department or in any legal proceeding by a reproduced copy or computer print-out of the Department's record relating thereto in the name of the Department under the certificate of the Director of Revenue. ... Such certified reproduced copy or certified computer print-out shall, without further proof, be admitted into evidence before the Department or in any legal proceeding and shall be prima facie proof of the correctness of the amount of tax due, as shown therein. (35 **ILCS** 120/5).

As certified copies of the Audit Correction and/or Determination of Tax Due and the Notice of Tax Liability are part of the record via Stip. Ex. No. 1, the Department has established its prima facie case. It is now the burden of the taxpayer to prove the Department's determination of tax liability incorrect by way of competent evidence in the form of books and records. (A.R. Barnes and Co. v. Department of Revenue, 173 Ill.App.3d 826 (1st Dist. 1988)). Until such proof is provided by the taxpayer, the corrected return prepared by the Department is presumed to be correct. (Copilevitz v. Department of Revenue, 41 Ill.2d 154 (1968)).

In the case at bar, the taxpayer is challenging the assessment by the Department of Use Tax, penalties and interest on the purchase of a Gulfstream II aircraft. The Department contends that the June 3, 1994 purchase was a sale at retail, while the taxpayer asserts that it is exempt from tax as an occasional sale pursuant to section 2 of the Use Tax Act. (35 **ILCS** 105/2). Also at issue in this cause is whether a late filing penalty that the Department has assessed is abatable for reasonable cause pursuant to section 3-8 of the Uniform Penalty and Interest Act (UPIA) (35 **ILCS** 735/3-8).

The taxpayer herein asserts that application of the doctrine of substance over form necessitates a finding that "ABC" was the seller of the Gulfstream aircraft, all the while retaining substantive ownership and physical possession of the aircraft until completion of the transaction. According to the taxpayer, "Fictitious" acted solely as a conduit for transferring legal title to the aircraft to the taxpayer, as an accommodation to "ABC", thereby allowing "ABC" to defer federal income taxes it would have otherwise incurred on its sale of the aircraft.

"ABC" points to the various stipulation documents as support of its position that the transaction at issue is a nontaxable occasional sale from "ABC" to "Icarus". For example the Aircraft Acquisition Agreement provides that "ABC" could not assign title to the aircraft to "Fictitious" until "ABC" delivered the aircraft to Manchester, New Hampshire, the closing location. When the aircraft arrived at the closing location on June 3, 1994, and the escrow agent received "Icarus's" wire transfer payment in the amount of $3,864.141, title was transferred to JI pursuant to two functions performed by the escrow agent: 1) filing the Aircraft Bill of Sale transferring title from "ABC" to "Fictitious" with the FAA at 2:49 p.m.; and 2) filing the Warranty Bill of Sale transferring title from "Fictitious" to "Icarus" at 2:50 p.m. (Stip. Ex. Nos. 8, 9, 10). Possession of the aircraft, along with any and all maintenance manuals, log books and any other items that pertained to the operation of the aircraft were to be delivered by "ABC" to "Icarus" at Manchester, New Hampshire, the closing location of the agreement between "ABC" and JI. On June 3, 1994, "ABC", via Pennzoil Company, gave "Icarus" permission to fly the aircraft at issue from Manchester, New Hampshire to Dallas, Texas utilizing Pennzoil's Tail No. 1707Z. (Stip. Ex. No. 13).

The Department maintains that on the face of things, "ABC" transferred title to "Fictitious", which then transferred title to "Icarus". The facts are that an Aircraft Bill of Sale was filed with the FAA on June 3, 1999 indicating that "ABC" conveyed to "Fictitious" all its rights, title and interest in and to the aircraft. Also, on the same day a Bill of Sale was executed wherein "ABC" transferred to "Fictitious" all of its right, title and interest in the aircraft. "Fictitious" immediately thereafter transferred its right, title and interest in the aircraft to "Icarus" via a Warranty Bill of Sale filed with the FAA.

Section 2 of the Use Tax Act (35 **ILCS** 105/2) defines a sale at retail as "any transfer of the ownership of or title to tangible personal property to a purchaser...". As title was transferred from "Fictitious" to "Icarus", the Department assessed use tax on that transaction. Granted, the parties herein stipulated that "Icarus" agreed to receive title to the aircraft from "Fictitious" as an accommodation to "ABC" based on "ABC's" representation that such transfer of title to "Fictitious", and "Fictitious's" retransfer, was necessary for "ABC" to satisfy the requirements of IRS section 1031, enabling "ABC" to defer its federal income tax gain on its disposition of the aircraft. (Stip. par. 5). There is, therefore, no mystery as to the catalyst behind the manner in which the Gulfstream II was ultimately sold to "Icarus". The various stipulation exhibits indicate that "ABC" retained possession of and control over the aircraft until legal title was transferred from "Fictitious" to the taxpayer. "ABC's" obligations under the Aircraft Acquisition Agreement survived the assignment and transfer of title to "Fictitious" (Stip. Ex. No. 3, par. 18(c)). "Fictitious" did not assume any of "ABC's" obligations under the Agreement except for the obligation to transfer title to the taxpayer and to accept the purchase price of the aircraft via the escrow agent. (Stip. Ex. No. 6, par. 2). The question is, therefore, whether the form of the transaction prevails, or the substance of it controls.

The Department contends that the parol evidence rule prohibits the consideration of any evidence outside of the FAA Aircraft Bill of Sale and the Warranty Bill of Sale wherein it is reflected that "Fictitious" was titleholder and sold the aircraft to the taxpayer. I concur with the taxpayer's position that the parol evidence rule is not applicable when a third party, such as the Department, is interpreting the terms of a written instrument. That is, the rule prohibiting parol or extrinsic evidence is applicable

to or invocable solely by the parties to the contract, not third parties. (Williston on Contracts, Vol. 4, Section 647, 3rd Ed.; Black's Law Dictionary, Special Deluxe Fifth Edition, 1979).

The taxpayer poses the issue as whether the substance of a transaction prevails over form. However, also to be considered herein is whether the taxpayer should be bound by the form of the transaction in which it was a willing participant. What apparently began as a plan for "ABC" to defer certain federal tax consequences is being advanced by the taxpayer with the resultant outcome being an avoidance of state Use Tax.

There is certainly abundant case law to the effect that the courts will look to the substance rather than the form of a transaction in determining tax liability. (Young v. Hulman, 234 N.E.2d 797 ((1968)). This established principle, however, is generally invoked by the government in attempting to decipher the true nature of a transaction. As cited by the U.S. Supreme Court in Frank Lyon Co. v. United States, 435 U.S. 561 (1978), "[i]n the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." (Citations omitted). "Nor is the parties' desire to achieve a particular tax result necessarily relevant." (Citation omitted).

The taxpayer cites In re Stoecker, 202 Bankr. 429 (Bankr. N.D. Ill. 1996) in support of its position. In Stoecker, the court held that some intermediate title transfers did not affect the substance of the transaction between the purchaser and the seller, a lessor, but not retailer of aircraft. Title transferred from Bezwada to Opex Aviation on May 30, 1988, from Opex to Jack Prewitt & Associates on June 1, 1988, and then from

Prewitt & Associates to Prewitt Leasing also on June 1, 1988, the same day that the aircraft was purchased by Chandler. It must be noted that the court determined the transfer of title from Opex to Jack Prewitt & Associates (a retailer), was a mistake. Title was to have transferred directly to Prewitt Leasing, a nonretailer of aircraft.

The instant case is distinguishable in that there was no mistaken transfer of title to the intermediary titleholder, "Fictitious". Rather, "Icarus" agreed to receive title to the aircraft from "Fictitious" as an accommodation to "ABC" in order for "ABC" to defer certain federal tax obligations that would have otherwise arisen. Whatever federal tax deferment plan advanced by "ABC" for "ABC's" benefit that was agreed to by the taxpayer cannot now be disavowed by the taxpayer to avoid state Use Tax. For federal purposes, the parties claim that "Fictitious" is the seller of the Gulfstream. For state purposes, "Icarus" asserts that "ABC" was really the seller. In the case of <u>Comdisco, Inc. v. United States</u>, 756 F.2d 569 (1985), the court stated,

> Indeed, the Government is correct when it notes that, in a wide variety of tax litigation, while the Commissioner may attack the nominal form of a transaction in order to enforce the tax laws, (citations omitted), a taxpayer generally may not disavow the form of a deal (citations omitted). (756 F.2d 569,577).

This general rule is applicable in cases wherein the government faces potentially conflicting claims from the parties to the transaction. Granted, this is not a case wherein the federal government faces potentially conflicting claims from the parties herein. However, there is certainly a conflict between how "ABC" and the taxpayer characterize the nature of the transaction, with beneficial consequences for both. For federal purposes, it is purported that "Fictitious" is the seller; for state purposes, it is claimed that

"ABC" is the seller. In both scenarios, tax is avoided. As the court also stated in Comdisco, citing Weinert's Estate v. Commissioner, 294 F.2d 750 (5th Cir. 1961),

> Resort to substance [over form] is not a right reserved for the Commissioner's exclusive benefit, to use or not to use – depending on the amount of the tax to be realized. The taxpayer too has a right to assert the priority of substance – at least in a case where his tax reporting and actions show an honest and consistent respect for the substance of a transaction. (756 F.2d 569, 578).

Certainly, in the instant case, this taxpayer does not have the right to assert that the substance of the transaction, rather than the form, should prevail. There is no consistency in the taxpayer's characterization of the transaction. This taxpayer should not be allowed to avoid Use Tax, while one of the other parties to the transaction prevailed at the federal level by characterizing the transaction differently and with the full knowledge and consent of "Icarus". It is my determination, therefore, that the taxpayer failed to prove that it purchased the Gulfstream II aircraft from "ABC", allegedly a nonretailer. Rather, as "Fictitious" transferred title to the taxpayer via the Warranty Bill of Sale, the taxpayer incurred Use Tax on the transaction.

Also at issue is whether the late filing penalty assessed by the Department pursuant to 35 **ILCS** 735/3-3 is abatable for reasonable cause pursuant to 35 **ILCS** 735/3-8. The taxpayer argues that the regulations adopted by the Department provide that the most important factor in determining reasonable cause is the extent to which the taxpayer made a good faith effort to identify a tax liability. Furthermore, "Icarus" argues that it made a reasonable determination that its purchase of the aircraft was tax exempt as it negotiated the purchase contract with, and acquired possession of the aircraft directly from "ABC", a non-retailer.

The Department's Regulations concerning reasonable cause are set forth in 86 Ill. Admin. Code ch. I, Sec. 700.400 and provide in pertinent part as follows:

> a) The penalties imposed under the provisions of Sections 3-3, 3-4, and 3-5 of this Act shall not apply if the taxpayer shows that his failure to file a return or pay tax at the required time was due to reasonable cause. Reasonable cause shall be determined in each situation in accordance with rules and regulations promulgated by the Department.
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> b) The determination of whether a taxpayer acted with reasonable cause shall be made on a case by case basis taking into account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion.
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> c) A taxpayer will be considered to have made a good faith effort to determine and file and pay his proper tax liability if he exercised ordinary business care and prudence in doing so. A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education....

It is my determination that the penalties at issue imposed pursuant to section 3-3 of the UPIA do not qualify for abatement for reasonable cause. It cannot be argued that the taxpayer made a good faith effort to identify a tax liability. "Icarus" did not exercise ordinary business care and prudence when it made the calculated decision to not file or pay. The taxpayer knowingly involved itself in a transaction structured to benefit one of the parties at the federal tax level, which resulted in a clear transfer of title from "Fictitious" to the taxpayer. The taxpayer did not act prudently, but rather, took a risk that it hoped would result in beneficial results at the state level. Based upon the stipulated facts and evidence, I have determined that Use Tax is due on the transaction at

issue. The taxpayer is not to be rewarded with a waiver of penalties due to its unsound decision.

RECOMMENDATION:

Based upon the foregoing, it is my determination that Notice of Tax Liability No. SF 970000000000000 be affirmed in its entirety as issued.

Enter: August 5, 1999

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Administrative Law Judge