Journal of Air Law and Commerce

Volume 83 | Issue 1 Article 9

2018

Tax Reform Up in the Air: Redefining the Test for Qualification of an Air Carrier for Sales Tax Exemption

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TAX REFORM UP IN THE AIR: REDEFINING THE TEST FOR QUALIFICATION OF AN AIR CARRIER FOR SALES TAX EXEMPTION

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I. INTRODUCTION

IN *EPIC AVIATION V. TESTA*, the Supreme Court of Ohio examined an exception to an Ohio sales tax statute for the purchase of jet fuel by an air carrier working as a public utility service.[1] Specifically, the court looked at whether that exception requires the air carrier to have a "certificate of public convenience and necessity from the federal government."[2] In reviewing applicable case law, including its own prior holdings, the court found not only that the statute requires no such thing, but that its own former decisions needed clarification.[3] The court declared that the proper test for an air carrier to qualify as a public utility service, and therefore qualify for the sales tax exception, was the common-carrier test and not the existence of sufficient agency regulation.[4] In doing so, the court corrected a loophole that effectively prevented air carriers without a certificate of public convenience and necessity from qualifying for the exception altogether,[5] one that likely was the result of the Airline Deregulation Act (ADA) implemented over thirty years prior.[6] Had the court taken the easy way out and agreed with the lower courts, the exception would have no teeth and its purpose would have been thwarted. In remedying its own prior oversight,

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[1] Epic Aviation, L.L.C. v. Testa, 74 N.E.3d 358, 359 (Ohio 2016).

[2] *Id.*

[3] *Id.* at 362–63.

[4] *Id.* at 365.

[5] *Id.* at 363.

[6] Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (1978).

the court's decision is laudable and should serve as a model for other courts.

The plaintiff in the case, Epic Aviation (Epic), was a jet fuel vendor.[7] Epic brought suit to obtain a refund for the $1,727,790.27 of sales tax that its customer, AirNet Systems (AirNet), "paid . . . on its purchases of jet fuel from Epic" over the course of a little over three years.[8] As such, it was AirNet's operations that had to accord with the requirements of the statute to qualify for the exception and ultimately for the sales tax refund in the tax court.

AirNet owned a fleet of planes and operated as a cargo-service provider.[9] Its "core . . . business" had largely been the delivery of cancelled checks, but it also delivered "time-sensitive . . . pharmaceuticals" that frequently required delivery only a few hours after time of manufacture.[10] While it lacked a certificate of public necessity and convenience, it did hold an air carrier certificate which expressly allowed for common carriage operations.[11] Most notably, however, AirNet's representative testified that AirNet held itself out to the public, and anyone could access the company website to request its services.[12] This fact was significant because it got right to the heart of the distinction the court was making between a service classified as a common carrier and a service classified as a private charter.[13]

The statute at issue in *Epic Aviation* makes an exception for the payment of otherwise applicable sales tax for items the purchaser will "use . . . directly in the rendition of a public utility service."[14] The statute further declares that the definition of "public utility service" includes those who have a certificate of public convenience and necessity issued by the federal government.[15] Naturally, then, the court in this case was interested in determining how an air carrier could be classified as a public utility service provider. This involved examining the government regulations of air carriers, since those regulations often

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[7] *Epic Aviation*, 74 N.E.3d at 359.

[8] *Id.* at 359–60.

[9] *Id.* at 358, 360.

[10] *Id.*

[11] *Id.* at 361–62.

[12] *Id.* at 360.

[13] *Id.* at 365–66.

[14] Ohio Rev. Code Ann. § 5739.02(B) (West 2015).

[15] *Id.* at § 5739.01(P).

unilaterally dictate whether an air carrier can be classified as a public utility service provider.[16]

The implementation of the ADA in 1978 significantly affected the airline regulatory environment, and the requirements applicable to AirNet were no exception.[17] For AirNet to operate as an air carrier, both economic and safety regulations applied.[18] These regulations dictated, in part, how the court would view AirNet's purchase of jet fuel for its operations.[19]

In this case, the court focused on the economic regulations. AirNet satisfied its economic regulation obligations as a Part 135 air taxi operator.[20] Further, Part 298 of the same regulation[21] did not require AirNet to obtain a certificate of public necessity and convenience to engage in the services it provided.[22] This fact proved significant in the eyes of the Ohio Supreme Court in a prior case.[23]

The tax commissioner ruled that "AirNet's lack of a certificate of public convenience and necessity [from the federal government], along with other similarities" to prior companies who failed to qualify for the exception, was sufficient to deny Epic's claim for a refund of sales tax paid.[24] The Board of Tax Appeals agreed, although it clarified in its decision that the lack of a certificate of public necessity and convenience was not a sufficient reason on its own.[25]

II. LEGAL BACKGROUND

In this case, the court had to decide whether Epic proved that AirNet should have qualified as a public utility service provider per the Ohio statutes.[26] It looked first to the applicable statute. Upon first hearing the case, the tax commissioner declared that

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[16] *See* Leonard A. Ceruzzi, *Quasi-Regulation of a Deregulated Industry by a Safety Agency*, 54 J. AIR L. & COM. 889, 892 (1989).

[17] *Id.*

[18] *See* Castle Aviation, Inc. v. Wilkins, 847 N.E.2d 420, 422 (Ohio 2006).

[19] *See id.* at 421–22.

[20] 14 C.F.R. § 135 (2014).

[21] 14 C.F.R. § 298 (2005).

[22] *Castle Aviation*, 847 N.E.2d at 422 ("While Section 298.11, Title 14, C.F.R. provides that air taxi operations may be exempted from the economic requirement to obtain a certificate of public convenience and necessity, there is no prohibition against . . . voluntarily choosing to obtain [one].").

[23] *Id.*

[24] Epic Aviation, L.L.C. v. Testa, 74 N.E.3d 358, 362 (Ohio 2016).

[25] *Id.*

[26] Ohio Rev. Code Ann. § 5739.02(B) (West 2015); *id.* at § 5739.01(P).

the lack of a certificate of public necessity was a significant reason for AirNet's failure to qualify for the tax refund.[27] In argument before the Ohio Supreme Court, the tax commissioner went further, claiming that such a certificate was a "prerequisite" per the applicable statute.[28] On appeal, the Board of Tax Appeals stopped short of declaring such a requirement but did affirm the commissioner's decision.[29] The Ohio Supreme Court examined the language of the statute and declared that it clearly does not require the certificate, rather it merely includes those who do in fact hold one.[30] The court further noted that both the commissioner and the Board of Tax Appeals relied on its prior decision in *Castle Aviation*.[31] It also noted that, since that prior decision, the Ohio legislature amended the applicable statute.[32] The court seemed to imply that these amendments were significant to its ruling in the principal case and perhaps hinted that it may have overlooked the effect of its ruling in *Castle Aviation*.[33]

After declaring that the statute did not require a certificate of public convenience and necessity, the court turned to prior case law. Specifically, it addressed its prior decision in *Castle Aviation*.[34] In that case, the Supreme Court of Ohio faced a similar question: whether Castle Aviation, Inc. (Castle) should qualify for the sales tax exception as a public utility provider.[35] It reviewed several cases and determined that "one of the most important criteria, if not the most important . . . is special regulation and control by a governmental regulatory agency."[36] Applying that observation to the facts in *Castle Aviation*, the court determined that Castle did not qualify.[37]

In *Castle Aviation*, the court reviewed five prior tax law cases.[38] The first case it reviewed showed that a taxpayer need not only be certified as a common carrier but that it also needed to be operating as one to qualify for the sales tax exception.[39] Another

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[27] *Epic Aviation*, 74 N.E.3d at 362.
[28] *Id.*
[29] *Id.*
[30] *Id.* at 359.
[31] *Id.* at 362.
[32] *Id.*
[33] *Id.*
[34] *Id.* at 365.
[35] Castle Aviation, Inc. v. Wilkins, 847 N.E.2d 420, 421 (Ohio 2016).
[36] *Id.* at 425.
[37] *Id.* at 427.
[38] *Id.* at 423–25.
[39] *Id.* at 423.

case was particularly noteworthy in the eyes of the court; it observed that the taxpayer did not qualify for the exception because it was not subject to regulatory approval as a prerequisite for running its business.[40] The court overlooked another case in which a taxpayer was not regulated, but nevertheless qualified for the sales tax exception.[41] Because the rule that the tax commissioner relied on in that case was subsequently repealed, the court disregarded it for its analysis in *Castle Aviation*.[42] Yet another case explicitly declared that agency regulation was a primary consideration in determining if a taxpayer qualifies as a public utility.[43] Finally, the court reviewed a case that explained the level of regulation required for a business to qualify for the exception.[44] Thus, in *Castle Aviation*, the court declared that the most important factor was significant governmental agency regulation.[45]

Applying that rule to the facts in the principal case, the result would likely have been the same, since it appears that AirNet was under the same level of governmental agency regulation as Castle as a Part 135 air taxi operator.[46] However, the court recognized another issue. Citing a "general federal deregulation" trend, it noted that focusing on regulatory oversight of a taxpayer's business operations—an extensive oversight at that—would potentially preclude any air carrier from qualifying for the exception at all.[47]

To resolve the issue, the court turned to a case involving a motor carrier and deemed that the test for status as a public utility in that case could be applied to an air carrier as well.[48] Equating common carrier status with public utility status, the court then turned back to an air carrier case to tie it in with the tax issue.[49] The test would now be two-fold: (1) whether the air

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[40] *Id.* at 423–24.

[41] *Id.* at 424.

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.* at 425.

[46] *See* Epic Aviation, L.L.C. v. Testa, 74 N.E.3d 358, 360–61.

[47] *Id.* at 364–65; *see* Ceruzzi, *supra* note 16, at 898–99 (noting that passage of the ADA caused big changes, given the interdependent nature of the air transportation system); see also Michael A. Katz, The American Experience Under the Airline Deregulation Act of 1978 – An Airline Perspective, 6 HOFSTRA LAB. L.J. 87, 93 (1988).

[48] *Epic Aviation*, 74 N.E.3d at 363.

[49] *Id.* at 364.

carrier was acting as a common carrier and (2) whether the nature of its service was such that the "public . . . ha[d] a legal right to demand" the service of the air carrier and receive it.[50] The court acknowledged that it overemphasized a single factor in *Castle Aviation*. It amended its prior holding to provide clarity for the aviation community and for the tax commissioner going forward.

III. ANALYSIS

The Supreme Court of Ohio correctly interpreted the plain language of the applicable statute and properly amended its own reasoning in a prior case to clear up this foggy area of law.

A. The Statute Included Holders of a Certificate

The court held that the language the Ohio legislature added in the last sentence for the definition of "public utility" in Ohio Rev. Code Ann. § 5739.01(P) merely included holders of a certificate of public convenience and necessity.[51] While the tax commissioners argued before the court that such a certificate was a prerequisite, even the commissioners stopped short of declaring so much in their opinion.[52] Not only is the language clear, but prior case law never indicated that "includes" was meant to exclude anyone.[53] Even the dissent agreed that such a reading was untenable.[54]

B. The Court Aligns Castle Aviation with the "Deregulated" Environment

The Supreme Court of Ohio amended its failure to wade through the effects of the ADA in its 2006 *Castle Aviation* holding with an admirable opinion that redefines the law for sales tax exceptions in air law in Ohio. The analysis in *Epic Aviation* is inexorably tied to that which it engaged in with *Castle Aviation*.[55] It started to evaluate Castle's claim with a factor analysis but seemed to settle on what it decided was the most important criterion: regulation by a governmental agency.[56] That focus mis-

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[50] *Id.*
[51] *Id.* at 362.
[52] *Id.* at 362–63.
[53] *Id.* at 362.
[54] *Id.* at 368.
[55] *See id.* at 364–65.
[56] *Id.* at 365.

led lower courts and likely confused air carriers.[57] In fact, the Ohio legislature stepped in immediately following the court's ruling in *Castle Aviation* in an apparent attempt to clarify what had become muddled.[58] But while *Castle Aviation* was wrong, the court's decision in this case to clarify its prior reasoning was right.[59]

Regulation in the airline industry has a turbulent history.[60] The passage of the ADA had several intended effects, among them to make small air carriers, like AirNet, more competitive and to attract more capital to the airline industry.[61] While many of the intended benefits did come to fruition,[62] shifting the regulatory responsibilities between government agencies has come with some difficulties,[63] the effects of which continue to present themselves in *Epic Aviation*. After the ADA, many continue to believe that the airline industry is far less regulated than it once was.[64] But in fact, "nothing less than a systematic, comprehensive compliance program will suffice" to meet the regulations airlines face today.[65]

This makes the court's focus on regulation by a government agency in *Castle Aviation* difficult for two reasons. First, all air carriers, whether classified as Part 121, Part 135, or some other classification of the Federal Aviation Administration, face significant regulation today.[66] Because all air carriers face significant regulation, it would seem to follow that all should qualify for the exception from sales tax under this Ohio statute, given the holding in *Castle Aviation*.[67] This clearly was not the desired purpose

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[57] *Id.* at 363 ("The BTA considered and rejected [Castle's] claim 'in reliance upon the earlier case law'" (emphasis added)). Consequently, the BTA in Epic Aviation "devoted little attention to Epic's argument that AirNet was a common carrier in a manner different from the charter service whose attempt to obtain exemption in Castle Aviation was denied." *Id.* at 362.

[58] *Id.* at 365.

[59] *Id.* at 363.

[60] *See* Ceruzzi, *supra* note 16, at 892 (passing the ADA brought significant change to the airline industry, some of which was neither expected nor desired).

[61] *See* Laurence E. Gesell & Martin T. Farris, *Airline Deregulation: An Evaluation of Goals and Objectives*, 21 TRANSP. L.J. 105, 108 (1992).

[62] *See* Ceruzzi, *supra* note 16, at 892 (noting that the passage of the ADA significantly increased the delivery of overnight small packages by air).

[63] *See id.* at 917.

[64] DAVID HEFFERNAN, COMPLIANCE WITH US AVIATION ECONOMIC AND SAFETY REGULATIONS 5 (2014).

[65] *Id.*

[66] *Id.*

[67] *See id.*

of the statute and perhaps not even the intent of the Ohio Supreme Court. Second, the changes in the regulatory environment were significant in the decade following the ADA and appear to continue to be in flux.[68] As such, if the test remained tied to governmental regulation of a taxpayer's business, qualification for the exception would fluctuate right along with it, tracking a different measure than the legislature likely intended.

The court appears to grasp this reality.[69] It addresses it too, albeit not directly.[70] In doing so, it not only moves away from the problems associated with regulation but settles on a test that is both easier to apply and more closely tied to the probable intent of the legislature.[71] After all, case law in areas outside of tax equate common carrier status with that of a public utility service,[72] why shouldn't tax law do the same?

IV. CONCLUSION

In the end, the court allowed Epic the opportunity to have its day before the tax commissioner once more, remanding the case all the way back down.[73] This, again, was the right move. Given that Epic's claim for a refund on all fuel purchases would have been denied because it appeared that a portion of its services were not those of a common carrier, the court allowed Epic to amend its claim.[74] This too was in compliance with applicable case law because the court deemed it unforeseeable that Epic would have anticipated such a significant change in the law.[75] This, perhaps more than any other fact, betrays the admission of the Ohio Supreme Court that its prior decision was wrong. As it applies to tax law in a season of major tax reform discussion at the highest level of government—and every other area of law—courts would do well to follow the example of the Ohio Supreme Court in *Epic Aviation*.

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[68] *See* Ceruzzi, *supra* note 16, at 892.

[69] Epic Aviation, L.L.C. v. Testa, 74 N.E.3d 358, 363 (Ohio 2016).

[70] *Id.* (While the court does cite federal deregulation as the purpose for its decision to revisit *Castle Aviation*, it stops there, choosing not to discuss its reasoning any further.).

[71] *See id.* at 365.

[72] *Id.* at 363.

[73] *Id.* at 367–68.

[74] *Id.* at 365–67.

[75] *Id.* at 367.