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Three Tax Exemption Takeaways In Contractor Case

A recent Ohio Ninth District Court of Appeals' decision in *Karvo Paving Co. v. Testa*^[1] addressed several of Ohio's most commonly utilized sales and use tax exemptions. This article will focus specifically on how the Karvo case shapes the application of Ohio's sales and use tax exemptions for sales for resale, affiliated party transactions and casual sales. Companies and their advisers need to be aware of how and when these exemptions apply, particularly when engaging in business operations and investments that, if structured correctly, could prevent the imposition of unnecessary sales and use tax.

Karvo Paving Co. v. Testa

The Ninth District rendered its decision in *Karvo Paving Co. v. Testa* on Sept. 30. This was on appeal following a 2018 decision at the Board of Tax Appeals. Karvo Paving Co. is an Ohio-based highway and road paving contractor wholly owned by George Karvounides. A substantial portion of its contracts are with the Ohio Department of Transportation, or DOT, hiring Karvo to pave and maintain roads. Additionally, Karvo leases personnel and equipment from an affiliated entity, K&H Excavating LLC.

K&H is 45% owned by Karvounides and 55% owned by his wife, Ana; however, K&H governance documents established that George Karvounides managed K&H. In conducting its business operations, Karvo did not collect and remit sales and use tax on a variety of its transactions because it believed that it qualified for various sales and use tax exemptions under Ohio law.

In this case, the court addressed Ohio's sale for resale exemption with respect to equipment Karvo leased to the DOT, the affiliated party exemption for K&H's provision of employment services to Karvo, and the casual sale exemption for the lease of equipment from K&H to Karvo.

Sale for Resale Exemption

Under Ohio law, sales and use taxes apply to retail sales. Per Ohio Revised Code Section 5739.01(E), the terms “retail sale” and “sales at retail” include “all sales, except those in which the purpose of the consumer is to resell the thing transferred or benefit of the service provided, by a person engaging in business, in the form in which the same is, or is to be, received by the person.”

Put another way, “when the purchaser’s intent in buying goods or services is to resell them to yet another purchaser without changing the goods or services in any way, the original purchase is not considered a ‘retail sale’ and is therefore not subject to sales tax or use tax.”^[2] Therefore, purchasers do not need to pay, and sellers do not need to collect, sales tax on the purchase of property that is intended to be resold by the purchaser.

Karvo took the position that its traffic maintenance property, such as barrier walls, temporary traffic signs and message boards were resold to the DOT during the scope of Karvo’s construction projects. Thus, Karvo’s original purchase of the property was not a retail sale and it therefore did not owe any use tax on that original purchase. The tax commissioner disagreed and argued that the sale for resale exemption did not apply because Karvo used the equipment it purchased in the performance of its construction contract with the DOT.

The Ninth District agreed with Karvo and found that Karvo did not use the taxable equipment while working on the DOT contracts. Instead, it rented the DOT the equipment to allow the DOT to maintain traffic during Karvo’s paving work. Contrary to the tax commissioner’s position, the court held that it did not matter that Karvo’s workers may have drawn some benefit from use of the traffic maintenance equipment and that it effectively helped Karvo complete its projects.

In fact, representatives from Karvo testified at the Tax Appeals hearing that Karvo may have preferred different equipment for work on smaller sections of the highway, but that the DOT required this particular equipment be used because it is statutorily required to keep the public safety. Importantly, the benefit that Karvo’s workers

received did not prevent Karvo from receiving the sale or resale exemption on the equipment that it leased to the DOT.

The tax commissioner also argued the sale for resale did not apply because Karvo retained ownership, control, use and possession of the equipment at all times during the construction projects. Contrary to this assertion, the testimony at the Board of Tax Appeals proved that the DOT had possession of the equipment while Karvo was performing the work. Even though Karvo delivered and installed the equipment, the DOT specified the “type, quantity and placement location” of the equipment. Thus, the DOT effectively took possession.

The result here may have been different based on prior case law if Karvo provided an operator for the equipment such as a pilot for plane, but Karvo did not do that here.[3] The court stated to fall outside of a definition of a lease, however, “the operator must do more than maintain, inspect, or set up the tangible personal property.”[4] In other words, the fact that Karvo installed and maintained the equipment did not prohibit the transaction from qualifying as a lease under Ohio law.

The court also noted that Karvo was not precluded from the sale for resale exemption because it ultimately retook possession of the equipment after the construction project. Citing Section 5739.01(B)[5], the Ninth District found that the separate, distinguishable sale occurred when Karvo rented the traffic equipment to the DOT within the duration of the construction projects.

Affiliated Party Sales Exemption for Employment Services

Generally, Ohio will impose sales and use tax on affiliated party transactions unless an exemption specifically applies.[6] In this case, K&H provided maintenance services on the equipment leased to Karvo at Karvo’s business location/shop, and another related company, Karvo Trucking Ltd. These were considered employment services for sales and use tax purposes.

However, there is a specific exemption to the general rule in Section 5739.01(JJ)(4), which excludes from the definition of employment service “[t]ransactions between members of an affiliated group.” Per Section 5739.01(B)(3)(e), an affiliated group is defined as: two or more persons related in such a way that one person owns or controls the business operation of another member of the group. In the case of corporations ... one corporation owns or controls another if it owns more than 50% of the other corporation’s common stock with voting rights.

Importantly, in Karvo, the taxpayer was able to prove that Karvounides effectively controlled Karvo Paving and K&H, even though 55% of K&H was owned by his wife. This determination was based on Karvounides’ testimony at a hearing before the Board of Tax Appeals and a 1997 governance agreement between the owners of K&H which stated that George Karvounides would manage K&H.

The key takeaway here is that in certain instances parties may be able to establish group affiliation based on testimony and contracts. With LLCs such as K&H, affiliation can be proven by demonstrating one’s control over another entity, using extrinsic evidence beyond mere voting percentage.

Alternatively, the statutory language of Section 5739.01(B)(3)(e) seems to indicate that majority voting rights are a requirement for ownership or control in the case of corporations. Thus, it is not clear based on the court’s decision whether the same result in K&H’s situation would apply for related corporations that do not have common majority voting rights.

Casual Sales

Another exemption under Ohio’s sales and use tax is for casual sales. Under Section 5739.01(L), the definition of casual sale has several elements. The exemption applies to a “[i] sale of [ii] an item of tangible personal property [iii] that was obtained by the person making the sale, through purchase or otherwise, [iv] for the person’s own use and [v] was previously subject to any state’s taxing jurisdiction on its sale or use.”[7]

The court interpreted the casual sale exemption broadly to include leases of excavation equipment from K&H to Karvo. This appears to be the first case in which the casual sale exemption applied to leases. From the tax commissioner's perspective, the repetitive nature of leases precludes them from being casual, arguing that there is no concept of "casual leases." The Board of Tax Appeals agreed and determined that the only business conducted by K&H during the period in question [Jan. 1, 2008 to June 30, 2013] was leasing equipment. Therefore, the leases could not be deemed casual.

The Ninth District overturned the board's ruling by employing a plain reading of the definition of casual sale. It reviewed the elements and found that the commissioner failed to prove that K&H's leases of equipment did not meet all the elements of the casual sale. The court focused on the issue of whether the company had ever used the equipment for its own use. The company had conducted activities beyond leasing, including certain excavation activities before the audit period in question (over 11 years ago).

Referencing Section 5739.01(L), the court noted that the casual sales exemption did not contain any temporal or time limitations on when those activities had to occur. Because K&H had used the equipment at some point in its existence for excavation activities, K&H proved it previously purchased the equipment for its own use. Thus, it appears that a taxpayer that purchases property for its own use but later converts the property to inventory may be able to qualify for the casual sale exemption.

The court also pointed out that K&H only leased equipment to Karvo. While this point is not discussed at length in the opinion, it appears that the holding may be different if K&H were leasing equipment to multiple customers. Because Karvo was its only customer, K&H could reasonably argue that the leases were isolated, casual sales.

This holding is important because it applies the casual exemption to leases. However, questions remain on how broad a court's application can be. For example, if a business engages in more than one activity with an item and sells/leases to multiple customers,

could it obtain a casual sale exemption? The court seems to suggest that the amount of activities undertaken by a purchaser with respect to certain property and number of customers it has will impact whether the subsequent sale or lease is deemed casual.

Conclusion

The *Karvo* case provides important guidance on three of the most commonly utilized exemptions to Ohio sales and use tax: the sale for resale, the affiliated party sales exemption for employment services and the casual sale exemptions. As of the date of submission of this article, the tax commissioner has not filed its notice of appeal to the Ohio Supreme Court.

Companies and their advisers should consider the implications of the *Karvo* decision and evaluate whether any these exemptions may apply to their operations. Businesses should also consider whether refund opportunities exist. The statute of limitations for sales and use tax refunds is four years from the date the erroneous tax payment was made.

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[1] *Karvo Paving Co. v. Testa*, 2019-Ohio-3974.

[2] *Pi In The Sky, L.L.C. v. Testa*, 155 Ohio St.3d 113, 119 N.E.3d 417 (2018).

[3] See *Laurel Transportation, Inc. v. Zaino*, 92 Ohio St.3d 220, 749 N.E.2d 296 (2001).

[4] O.R.C. 5739.01 (UU)(1)(c).

[5] Leases and rentals can be considered sales for purposes of this exemption, as the very definition of "sale" under O.R.C. 5739.01(B) includes certain "transactions for a consideration in any manner, whether absolutely or conditionally, whether for a price or rental..."

[6] There are certain exemptions under case law that may apply to affiliated party transactions that are beyond the scope of this article. (e.g., IBEC Industries Inc. v. Lindley, 62 Ohio St.2d 279 (1980)).

[7] O.R.C. 5739.01(L). See also O.R.C. 5739.02(B)(8) (explaining that the casual sales exemption does not apply to motor vehicles, watercraft, outboard motors, snowmobiles, or all-purpose vehicles).

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