

**ALABAMA DEPARTMENT OF REVENUE
REVENUE RULING 03-002**

This document may not be used or cited as precedent. Code of Ala. 1975, § 40-2A-5(a).

TO:

FROM: Commissioner of Revenue
Alabama Department of Revenue

DATE: June 24, 2003

RE: Applicability of Alabama sales, use and lease tax to a transaction whereby equipment is subject to a lease with a purchase option at the end of the lease term for a nominal amount.

Dear Sir/Madam:

Your client, Corporation 1 ("Corporation A"), is in the equipment leasing business. Equipment leasing is a means of financing the acquisition of equipment used by businesses. Equipment leases are of two types: True Leases and Conditional Sales Contracts. Corporation "A" uses the same basic form of lease agreement for both transactions, but for Conditional Sales Contracts Corporation "A" includes a purchase option in favor of its customer/lessee allowing the customer/lessee to purchase the equipment for \$1.00 at the end of the lease term. Conversely, under a True Lease, any purchase option will be at fair market value or some reasonable estimate of what fair market value of the equipment will be at the end of the lease term.

ISSUE

In your request for a Revenue Ruling you have asked for the Alabama Department of Revenue's ("Department") position concerning the following issue:

1. Whether the proposed transactions whereby Corporation "A" will lease equipment to a Customer and allow the Customer to purchase the

equipment at the end of the lease term for a nominal amount will be treated as a financing arrangement/loan?

FACTS

The facts as stated by Corporation "A":

According to Corporation "A", the proposal letter shows that the equipment cost, including applicable sales taxes, is estimated to be \$2,300,000 and that the "rental amount" due to Corporation "A" is \$68,496.45 on a portion of the Equipment to be leased for thirty-six (36) months and \$43,411.36 on a portion of the Equipment to be leased for sixty (60) months. (Actual figures based on invoice costs will be inserted at the time of closing.) Corporation "A" will file a UCC-1 Financing Statement evidencing its security interest in the Equipment.

For all accounting and income tax and sales tax purposes, Corporation "A" and its Customer will treat the above-described transaction as a loan from Corporation "A" to the Customer with which it purchases the equipment (the "Equipment") from the vendor. The following are indicative of this treatment:

1. Corporation "A" will lend the full purchase price of the Equipment to its Customer by paying the equipment vendor the purchase price for the Equipment.
2. The vendor will collect and remit sales tax on its sale of the Equipment and the Equipment will be delivered to the Customer.
3. Customer will list the Equipment as its property on its personal property tax returns and will depreciate the Equipment for federal and state income tax purposes.
4. Corporation "A" will neither list the Equipment as its property on its personal property tax returns, nor will it depreciate the Equipment for federal and state income tax purposes.
5. Corporation "A" will calculate the payment schedule under the lease according to a loan amortization schedule. Corporation "A" and Customer will treat each payment as the repayment of a loan, with part of each payment representing principal repayment and part of each payment representing interest.
6. During the term of the lease, Corporation "A" will hold a security interest in the Equipment as collateral for the repayment of the loan.

7. The terms of the lease are “triple net”, meaning that the Customer will be responsible for all maintenance, insurance, and taxes related to the Equipment. Corporation “A”’s interest in the Equipment will only be a security interest collateralizing its loan to Customer.
8. In case of any casualty with respect to the Equipment, all risk of loss will be borne by the Customer.
9. Corporation “A” will have absolutely no expectation of ever possessing or owning the Equipment and the entire transaction will be structured with that fact in mind.

ANALYSIS OF ALABAMA LAW

Tax Liability

Alabama legal authorities have recognized that (1) the substance of a transaction, and not its form, governs the appropriate Alabama tax treatment of the transaction, (2) conditional sales contracts, such as the one entered into between Corporation “A” and Customer, are, in substance, loans secured by the leased property and (3) in such circumstances, the lessee, such as the Customer, is the actual owner of the leased property for all Alabama tax purposes.

The Alabama courts have consistently recognized that a transaction’s substance, rather than its form, governs its tax treatment. In the case of Rust Engineering Co. v. State, 243 So.2d 695, 286 Ala. 589 (Ala. 1971), the Alabama Supreme Court specifically recognized the fact that the mainstream of federal cases that have decided matters of taxation “emphasize and re-emphasize” that a transaction’s substance, and not its form, must prevail in determining its tax consequence and adopted this doctrine as governing Alabama tax treatment. Id. at 700.

Other Alabama cases have also recognized that a transaction’s substance, and not its form, determines its tax consequences. In Winner v. Marion County Commission, 415 So.2d 1061 (Ala. 1982), the Alabama Supreme Court stated the following:

We are constrained to comment on one other point raised by plaintiffs. They contend that if Act 80-128 is held inapplicable to the lease in question, the county commission may avoid the requirements of the act as to almost any property transaction by structuring it as a lease, rather than as a sale. However, in determining whether there has been compliance with Act 80-128, the courts are certainly not limited to deciding whether the form in which the commission has couched a particular transaction constitutes a sale or disposal of property, but may look to the substance of the transaction to determine its true nature. This approach of “substance over form” is often taken by the federal

courts in tax cases when holding that certain transactions structured as leases, are, in fact, disguised installment sales.

Id. at 1064.

The Alabama Supreme Court has ruled that under certain circumstances, leases are, in substance, lending transactions and that the customer is the owner of the equipment. In Ex Parte Thompson Tractor Company, Inc., 432 So.2d 497 (Ala. 1983), the taxpayer, a heavy equipment dealer, sold equipment pursuant to a lease agreement under which all lease payments were applied to the sales price for the equipment and once the lease payments totaled the sales price, plus a five percent (5%) finance charge, title was transferred to the customer. The State sought to assess sales tax on the portion of the lease payments representing the finance charge (interest). The Court held that the lease was a financing transaction and that sales tax could not be assessed on the interest portion of the lease payments. In so holding, the Court noted that both the taxpayer and its customer treated the transaction as a sale with financing rather than a rental of the equipment, and that the customer depreciated the equipment for income tax purposes and took a deduction for the amount of the finance charges. Id. at 499. The Court also noted other provisions of Alabama law which recognize a conditional sale as a financing transaction by holding that “the fact that the agreement which governed the transaction was entitled ‘lease’ instead of ‘installment sales contract’ should not affect the substantive rights of the parties”. In particular, the Court found such treatment consistent with both the Uniform Commercial Code and the Alabama Consumer Credit Statute. Id. at 500.

The above cases have all been cited approvingly by the Department in rulings that hold that similar arrangements, also labeled “leases”, were, in substance, secured lending transactions. In Revenue Ruling 95-007, the Department, using the substance over form analysis, held that a sales-leaseback transaction was actually a loan for Alabama sales, use and lease tax purposes. In Revenue Ruling 95-007, a financing party obtained title to property by transferring funds to a customer. Without any transfer of possession, the parties simultaneously entered into a lease under which the customer “bears all risk of loss with respect to the Property.” Payments under the lease corresponded to a principal and interest amortization table for a loan in the amount of the cash transferred. The parties treated the transaction as a loan for federal income tax purposes, with payments treated as part principal and part interest and with the customer entitled to depreciation deductions as the owner of the property.

Revenue Ruling 97-001 agreed with the analysis of Revenue Ruling 95-007 in holding another sale-leaseback transaction to be a loan for Alabama tax purposes.

Both of the above Revenue Rulings recognize that the transfer of bare legal title, without the benefits and burdens of true ownership, did not constitute a true transfer of ownership of the property. Rather, the holding of legal title was evidence of a security interest in the relevant property.

The conditional sales contracts between Corporation "A" and Customer presents a stronger argument for lending treatment than in the cases and rulings cited above. Corporation "A" and Customer treat the transaction as a loan to Customer with which it purchases equipment from the vendor. Evidence of treating the transaction as a loan includes: (1) both Corporation "A" and Customer treat Customer as the property owner for federal and state income tax purposes (with the Customer taking depreciation deductions); (2) sales tax is either charged to Customer by the Equipment vendor or use tax is self-assessed and paid by the Customer; (3) Corporation "A" treats payments received as payments of interest and principal on a loan and allocates the interest into its income for tax purposes; and (4) Corporation "A" files a UCC-1 financing statement evidencing its security interest in the property. These facts reflect the reality that all the benefits and burdens of ownership of the Equipment rest with Customer. The nominal purchase option in favor of Customer for \$1.00 at the end of the lease term exists only to evidence Corporation "A"'s security interest in the Equipment until repayment of the loan by the Customer.

In the case of Corporation "A" and its Customer, the \$1.00 purchase option on Equipment which has an original cost of over \$2,300,000 clearly reflects Customer's ownership. No reasonable circumstance could be anticipated in which the Customer would not exercise the option. The economic reality is that the Customer will always exercise the option and keep the Equipment. If Customer no longer needs the Equipment, it could be sold to another person for a profit. Even if the Equipment becomes worthless, purchasing it for \$1.00 would be cheaper than returning it under the terms of the lease and, in any case, Customer would have had all the benefits of the Equipment for its entire useful life.

RULING

Based upon the particular facts of this case, the contemplated transaction between Corporation "A" and its Customer do not qualify as a sale under Code of Ala. 1975, § 40-23-1, as there is no true transfer of ownership of the property. Furthermore, the transactions would not be subject to the lease tax as Corporation "A" is not "the person who owns or controls the possession of tangible personal property" as stated in Code of Ala. 1975, § 40-12-220(5). At all times, the Customer owns and controls possession of the Equipment subject only to Corporation "A"'s security interest in the Equipment. The substance of these transactions (including the possible reconveyance of the Equipment from Corporation "A" to the Customer upon an event of Termination) is that of a non-taxable financing arrangement or loan, and there is no sales, use or lease tax applicable.

Dwight Carlisle,
Commissioner
Department of Revenue

