

ALABAMA DEPARTMENT OF REVENUE
REVENUE RULING 97-001

This document may not be used or cited as precedent. Ala. Code § 40-2A-5(a) (1993 Replacement Volume).

TO:

FROM: Commissioner of Revenue
Alabama Department of Revenue

DATE: March 14, 1997

RE: Applicability of Alabama sales, use and lease tax to a sale and leaseback transaction that is, in substance, a financing arrangement or loan.

ISSUES AND FACTS

The facts as represented by Requestor are as follows:

1. Corporation "A" is a State "X" Limited Partnership which is engaged in the business of installing and utilizing digital telecommunications equipment.

2. Corporation "B" is a special purpose Country "Y" entity, a type of Country "Y" partnership, which will provide financing with respect to the transaction described herein. Corporation "A" may enter into substantively similar financing arrangements with another entity or entities (Corporation "B" and such other entity or entities are collectively referred to herein as the "Financier").

3. Corporation "C" ("Seller") is a State "X" corporation engaged in the business of selling digital telecommunications equipment.

4. Corporation "A" is a party to a contract with Seller under which Corporation "A" will purchase digital telecommunications equipment from Seller which will be located

in Alabama (the "Equipment"). Under the terms of this sale, title to the Equipment will pass from Seller to Corporation "A" no later than the date of delivery of the Equipment to the installation site. Corporation "A" and Seller acknowledge that the sale of the Equipment by Seller to Corporation "A" is subject to Alabama sales tax, and Corporation "A" and Seller will collect and remit the appropriate amount of such sales tax to the Alabama Department of Revenue.

5. In order to finance the purchase of the Equipment from Seller, subsequent to the purchase of the Equipment from Seller and upon installation of the Equipment, but before any commercial use of the Equipment occurs, Corporation "A" will transfer title to the Equipment to Financier via a bill of sale and Financier will transfer cash to Corporation "A" equal to the Equipment's fair market value.

6. Immediately after the transfer of title to Financier and without Corporation "A" ever surrendering possession of the Equipment, Financier will lease the Equipment back to Corporation "A" (the "Lease").

7. The Lease will be a triple net lease and under the terms of the Lease, Corporation "A" will bear all risk of loss with respect to the Equipment and will be liable for all maintenance, insurance and taxes due on the Equipment.

8. The Lease will be for a term of seven to eight years. At the end of the Lease term, Corporation "A" may acquire the equipment from Financier for an amount equal to ten percent (10%) of the original purchase price ("Fixed Option Price"). If Corporation "A" does not acquire the Equipment, Corporation "A" has agreed to make a payment equal to the deficiency, if any, between the amount realized by the Financier on the disposition of the Equipment and the Fixed Option Price.

9. Payments due under the Lease will correspond to a principal and interest amortization table for a loan of an amount equal to the cash transferred to Corporation "A" from Financier at a market rate of interest.

10. Due to the constraints of Country "Y's" tax law, Financier is required to take title to the Equipment before it is placed in commercial service in order to obtain certain benefits that are central to the financing. Since Equipment may

be placed in service before the closing of such financing, title to the Equipment will be passed to Financier before the closing of such financing. However, in the event of (i) a change in the tax laws of Country "Y" or the United States, (ii) the failure of a condition precedent to the financing, or (iii) a change in interest rates prior to the closing of the financing (collectively, an "Event of Termination"), the Financier will be required to reconvey title to the Equipment to Corporation "A" without consideration.

11. For federal income tax purposes, Corporation "A" and Financier will treat this transaction as a loan from Financier to Corporation "A" secured by the Equipment. Corporation "A" will take depreciation deductions on the Equipment and will treat a portion of the payments under the Lease as interest, in accordance with the amortization schedule. The Financier will treat the Lease payments as part interest income and part principal repayment in accordance with the amortization schedule.

The issue is as follows:

Whether Corporation "A" or Financier will incur any Alabama sales, use or lease tax in connection with the Lease of the Equipment from Financier to Corporation "A" or upon the possible reconveyance of the Equipment from Financier to Corporation "A" upon an Event of Termination?

LAW AND ANALYSIS

Alabama law recognizes that a transaction's substance, and not its form, prevails in determining tax consequences.

In the case of *Rust Engineering Co. v. State*, 286 Ala. 589, 243 So.2d 695 (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 consequences. *Id* at 700.

Similarly, other Alabama cases have held that a transaction's substance, and not its form, determines its tax consequences. In the case of *Winner v. Marion County Commission*, 415 So.2d 1061 (Ala. 1982), the Alabama Supreme Court, in a non-tax case, stated the following in holding that a lease was indeed

a lease for a term of years, and not a disposition of property:

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.

In *Ex parte Thompson Tractor Company, Inc.*, 432 So.2d 497 (Ala. 1985), a case with facts similar to the instant matter, Taxpayer was a dealer in heavy equipment manufactured by the Caterpillar Tractor Company. Taxpayer sold equipment for cash and on an installment sales basis, and in addition, leased heavy equipment. Some of the leases entered into between Taxpayer and its customers contained a written option to purchase the equipment, and other leases featured the right to purchase the equipment based on an unwritten understanding. However, all leases entered into between Taxpayer and its customers contained a cash sales price agreed on by Taxpayer and its customers. It was the intention of the parties from the outset that once sufficient payments were made to cover the sales price plus interest, title would be transferred to the customer. Both Taxpayer and the customers treated these lease-purchases as sales for both income tax and accounting purposes. The Alabama Supreme Court held that finance charges charged by Taxpayer were not subject to the sales or lease tax as the rental payments were a part of the price of purchasing the equipment, and were a part of the transaction which resulted in the passing of title from the Taxpayer to the its customer. The Court specifically stated that "to view the lease as an entirely separate transaction from the sale places form over substance." *Id* at 499.

Therefore, based on the above cases, it is clear that "substance over form" is the established rule in Alabama.

HOLDING

Based upon the particular facts of this case, the contemplated transactions between Corporation "A" and Financier do not qualify as a sale under *Ala. Code §40-23-1* (1993 Replacement Volume), as there is no true transfer of ownership of the property. Nor would the transactions be subject to the lease tax as Financier is not "the person who owns or controls the possession of tangible personal property" as stated in *Ala. Code §40-12-220(5)* (1993 Replacement Volume). At all times, Corporation "A" owns and controls the possession of the Property subject only to Financier's security interest in the property. The substance of these transactions (including the possible reconveyance of the Equipment from Financier to Corporation "A" 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.

H. E. "Gene" Monroe, Jr.

HEM:MJM

cc: Russell L. Irby, III, Esq.