ALABAMA DEPARTMENT OF REVENUE
REVENUE RULING 97-013

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

TO:

FROM: Commissioner of Revenue
Alabama Department of Revenue

DATE: November 24, 1997

FACTS

The facts as stated by Taxpayer's representative, are:

Taxpayer and its direct and indirect wholly-owned subsidiaries, Company A and Company B (collectively the "Companies") have recently spent in excess of $____ million on the modernization and expansion of a plant in Alabama, which is owned by such companies collectively. One of the major components of the expansion is a new machine with certain associated equipment (collectively the "Equipment") which will be the subject of the Transactions.

In 1993, the Companies were preliminarily approved by SIDA and entered into a Preliminary Agreement with SIDA pursuant to Act 93-851 (the "1993 Act") respecting the expansion project. The Project as finally developed was substantially larger than estimated in Taxpayer's application to SIDA for credits under the 1993 Act. In a resolution, SIDA's Board acknowledged the larger scope of the project and confirmed that the larger project was an approved project for purposes of the 1993

Act and that the Companies were "approved companies" for purposes of the 1993 Act. At the time of such resolution, Taxpayer also advised SIDA of its intention to simplify Taxpayer's corporate structure by merging Company B and Company A into Taxpayer and SIDA's Board confirmed in such resolution that upon completion of such mergers, Taxpayer would constitute the approved company with respect to the entire expansion project for purposes of the 1993 Act.

At year end 1996, Taxpayer and the other Companies filed Form INT-3 indicating their intention to elect benefits under Act 95-187 (the "1995 Act") in lieu of the benefits they were entitled to under the 1993 Act.

In addition, the Companies obtained, by Inducement Agreements with The Industrial Development Board of the City, Alabama certain tax abatements, including an *ad valorem* tax abatement applicable to all aspects of the expansion project.

As of the date of this letter, the Equipment is owned by Company B. Company B acquired the Equipment under a series of purchase orders issued by it to the specific vendors thereof and under an Engineering Procurement and Construction Agreement with Company C.

By letter, Taxpayer's authorized representative advised the Department of the details of its plan to simplify its ownership structure in Alabama by merging Company A and Company B into Taxpayer and asked for a formal ruling confirming that the proposed merger would not adversely impact the availability of any of the foregoing abatements and tax credits. The requested ruling was granted on January 8, 1997, in the Department's Ruling 96-011 (the "1997 Ruling"). Taxpayer still intends to complete the mergers that were the subject of the 1997 Ruling. However, prior to completing such mergers, it expects to

complete the Transactions described below which will affect a major portion of the expansion project.

Transactions

Taxpayer is currently considering entering into a series of transactions with a foreign finance company and a foreign bank which will permit the foreign finance company to obtain certain tax benefits under foreign tax laws (but not federal U.S. or Alabama tax law) for which the finance company will provide Taxpayer with certain compensation described herein.

The details of the Transactions are as follows:

1. Company B will transfer title to the Equipment to the foreign company ("Lessor"), pursuant to a "Sale and Purchase Agreement" (the "Purchase Agreement") for a purchase price that is equal to Company B's cost of designing, acquiring, and installing the Equipment ("Lessor's Cost"), expected to be approximately $____ million. All of the items included in the Equipment are part of the expansion project.

2. The Equipment has been delivered and installed. It was placed in service for federal and state income tax purposes as of the end of May, 1997.

3. Concurrently with its execution of the Purchase Agreement, the Lessor and Taxpayer will enter into a "Lease Agreement" (the "Lease") providing for use of the Equipment and payments to the Lessor during the term of the Transactions, and a "Sales Agency Agreement" (the "Sales Agreement"), relating to sale of the Equipment at the end of the Extended Term of the Lease. The Lease and the Sales Agreement will be governed by foreign law.

4. Under the Lease and the Sales Agreement, the Lessor will have: (1)

the right to receive equal semi-annual payments of 4.6%[1] of Lessor's Cost for 15 years (the "Base Term"); (2) the right to receive 75% of Lessor's Cost at the end of the Base Term if Lessee exercises a purchase option (the "Purchase Option") provided in the Lease; (3) if the Purchase Option is not exercised, the right to receive semi-annual payments of 4.6% of Lessor's Cost for an additional two years (the "Extended Term"); and (4) if the Purchase Option is not exercised, the right to receive a "Security Payment" of 71.5% of Lessor's Cost at the end of the Extended Term. In addition, the Lease contains various tax and other indemnity provisions. Subject to certain limited exceptions relating to foreign taxes, the Lease is a triple net lease which requires Taxpayer to pay all taxes, insurance, and other costs associated with the Equipment so as to ensure that the Lessor, or its assignee, receives the full amount of the scheduled payments.

5. The Lease provides for early termination upon the occurrence of events of default or changes in law which subject one or both of the parties to additional early termination if continuation of the Lease will impose an undue burden on its ability to operate, finance, or structure the ownership of the plant. In the event of such an early termination, Taxpayer is required to make an early termination payment which consists of a Base Termination Payment and an additional termination payment which varies in amount depending on the cause of the termination. The Base Termination Payment schedule is structured so that it will always provide sufficient funds to repay the outstanding principal balance and accrued and unpaid interest on the loan described below. The additional termination payments are in the nature of compensation to the Lessor for its loss of expected tax benefits over the remaining term of the Lease. These payments do no more than make the Lessor whole and do not increase the value of the transaction to the Lessor. Upon receipt of the full amount of the early termination

---

[1]All percentage amounts are rounded to avoid excessive complexity in this description.

payment, the Lessor is obligated to convey the Equipment to Taxpayer.

6. If Taxpayer does not exercise the Purchase Option, the Lease remains in effect to the end of the two year Extended Term and the Lessor may at its option either retain the Equipment (in which event, as described below, it must use its own funds to repay the Security Payment to Taxpayer) or it may, pursuant to the Sales Agreement, require Taxpayer to arrange for a sale of the Equipment to a third party at a price which is guaranteed by Taxpayer to be not less than 71.5% of the Lessor's Cost. In either case, Taxpayer is required to dismantle, crate and ship the Equipment to any location in the world specified by the Lessor or its purchaser. The cost of such action will be substantial (estimated at $____ million in today's dollars). In addition, a purchaser would have to make a substantial investment in custom engineering, installation costs, design, purchase and installation of additional equipment, and construction of customized supporting infrastructure to utilize the Equipment. As a result, it is expected that the value of the dismantled Equipment at a site designated by the Lessor or its purchaser, is expected to be not more than one-half of its value, in-place and in-use, and that, taking into account the costs of dismantling and shipping, the Equipment would lose over 50% of its in-place, in-use value if dismantled and shipped to third-party purchaser in the manner provided in the Sales Agreement and Lease.

7. The Lessor will obtain the funds used to acquire title under the Purchase Agreement from two sources: its own equity as to approximately 5% of Lessor's Cost, and a loan (the "Loan") from foreign Bank (the "Bank") of approximately 95% of Lessor's Cost. The Loan will be repayable in level semi-annual installments of principal and interest equal to 4.6% of the Lessor's Cost (the same as the semi-annual payments under the Lease) over 17 years with a balloon payment at the end of year 17 equal to approximately 69.5% of Lessor's Cost. At the end of the initial term of the Lease, the principal balance on the

Loan is 75% of Lessor's Cost (the same as the price of the Purchase Option). The Loan may be prepaid without penalty at any time that the Lease terminates.

8. The Loan will be secured by an assignment by the Lessor to the Bank of the Lessor's rights to (i) rental payments to be made under the Lease, (ii) the purchase option price payment to be made by Taxpayer if it exercises the option to acquire the Equipment, (iii) the Base Termination Payment to be made under the Lease if it is terminated before the end of its term, and (iv) the Security Payment to be made by Taxpayer at the end of the Extended Term of the Lease (collectively the "Assigned Payments"). The Bank's recourse against the Lessor is limited to the proceeds of the Assigned Payments and the Lessor will irrevocably instruct Taxpayer to make the Assigned Payments to the Bank.

9. The periodic rent payments under the Lease will precisely match the periodic debt service requirements under the Loan. The Base Termination Payment, the option price, and the Security Payment for disposition of the Equipment at the end of the extended lease term will each equal the principal balance of the Loan at their respective points of payment (except for the Security Payment, which is two percentage points above the Loan balance). Thus, the assigned cash flow stream under the Lease is designed to satisfy the principal and interest that will become due over the life of the Loan, regardless of when the Lease ends.

10. Immediately following closing of the leasing transaction, Taxpayer will enter into a Payment Agreement with the Bank, under which it will pay the Bank an amount equal to the principal amount of the Loan (approximately 95% of the proceeds of the sale of the Equipment). In exchange for such payment, the Bank will assume Taxpayer's obligations to make the Assigned Payments when and as they become due. Such assumption, however, will not include the last two percentage points of the Security Payment. That amount will have to be paid

directly by Taxpayer to the Lessor if Taxpayer does not exercise the Purchase Option. In addition, Taxpayer will receive at that time a full and final release of its obligations to make the Assigned Payments. The release will be granted by the Bank on its own behalf, as the assignee of the Assigned Payments, and on behalf of the Lessor, pursuant to an express grant of authority contained in the Loan Agreement. This will permit Taxpayer to effect a legal defeasance of the capitalized lease obligations that would otherwise be recorded in its financial records. It also creates, in combination with the Lessor's assignments to the Bank described in Section 7 above, a circular structure in which all of the Assigned Payments are made by the Bank to itself.

11. Whether or not the Lessor exercises its rights under the Sales Agreement, Taxpayer must make a Security Payment to the Lessor at the end of the Extended Term equal to 71.5% of Lessor's Cost. All but two percentage points of this amount will be paid directly to the Bank to satisfy the Loan, pursuant to the Lessor's assignment of its rights to secure the Loan.

If the Lessor exercises its rights under the Sales agreement, this 71.5% serves to guarantee Taxpayer's obligation to ensure that the Lessor will receive net sales proceeds of at least 71.5% of Lessor's Cost. The Lessor has the right to forgo its rights under the Sales Agreement, in which event it must promptly repay such amount to Taxpayer. Since all but two percentage points of the funds provided by Taxpayer will have been used to repay the Loan from the Bank, the principal source of such repayment will be from the Lessor's own funds.

12. In order to secure the Lessor's obligations under the Lease to Taxpayer to protect its quiet enjoyment during the term of the Lease and the Lessor's obligation to convey the Equipment to Taxpayer upon termination of the Lease, the Lessor will grant Taxpayer a first priority security interest in the Equipment. The Bank will not hold a security interest in the Equipment.

13. Prior to the onset of the Lease, an appraisal of the Equipment will be obtained that indicates that the current fair market value of the Equipment is not less than the Equipment Cost and that the expected fair market value (in place and in use) at the end of year 15 is not less than the Purchase Option price.

14. Taxpayer will receive a closing opinion to the effect that for U.S. Federal income tax purposes, it is the owner of the Equipment. Its ability to obtain a satisfactory legal opinion to that effect will be a condition precedent to its entering into the Transactions. In addition, Taxpayer will carry the Equipment on its books as equipment owned by it and, by virtue of the Payment Agreement referred to in Paragraph 10 above and the release granted pursuant thereto, it will not record indebtedness on its books in respect of the Lease. The Lessor will take the position for foreign income tax purposes that it is the owner of the Equipment and its ability to obtain a satisfactory legal opinion to that effect will be a condition precedent to its entering into the Transactions.

15. It is expected that the Transactions will be closed on or about December 1, 1997, and that the mergers described in the 1997 Ruling will be completed on or before December 31, 1997.

Based on these facts, Taxpayer requests that the Department of Revenue ("Department") confirm its conclusions:

1. That the Transactions will result in Taxpayer being treated as the owner of the Equipment for purposes of Alabama income tax laws.

2. That none of (i) the sale of the Equipment by Company B to the Lessor, (ii) the Lease of the Equipment by the Lessor to Taxpayer, nor (iii) the eventual sale of the Equipment to Taxpayer, pursuant to exercise of Taxpayer's purchase option or upon an early termination of the Lease, will be subject to

Alabama sales tax, use tax, or lease tax.

3. That, assuming completion of the mergers described in the 1997 Ruling, the completion of the Transactions will not adversely affect Taxpayer's ability to claim capital tax credits under the 1995 Act in respect to the Equipment.

4. That the completion of the Transactions prior to execution of the mergers described in the 1997 Ruling will not change the conclusions reached in the 1997 Ruling, except that the abated property taxes will become payable by the new legal owner of the Equipment.

RULING AND ANALYSIS

1. The Transactions will result in Taxpayer being treated as the owner of the Equipment for purposes of Alabama income tax law.

The evidence supports the classification of the Lease as a financing transaction. The Lease is structured in a manner that insures that Taxpayer will become the owner of the Equipment upon the expiration of the Lease. Taxpayer is required to guarantee a minimum sales price for the Equipment to Lessor which is higher than the price payable under Taxpayer's Purchase Option. Taxpayer will be economically compelled to repurchase the Equipment from Lessor upon the expiration of the Lease.

Despite the fact that Lessor holds title to the Equipment pursuant to the Transactions, Taxpayer should be treated as the substantive owner of the Equipment for Alabama income tax purposes, pursuant to the "substance over form doctrine." A taxpayer may insist on the substantive characterization of a transaction. Illinois Power Company v. Commissioner, 87 T.C. 1417 (1986). The Department does not dispute that in substance, the Lease is a financing transaction. Pursuant to the Lease, all incidences of ownership remain with

Taxpayer. Consequently, for Alabama income tax purposes, the Lease is nothing more than a financial transaction.

2. Neither (i) the sale of the Equipment by Company B to Lessor, (ii) the lease of the Equipment by the Lessor to Taxpayer, nor (iii) the eventual sale of the Equipment to Taxpayer, pursuant to exercise of Taxpayer's purchase option or upon an early termination of the Lease, will be subject to Alabama sales tax, use tax, or lease tax.

The Lease does not qualify as a sale pursuant to Code of Ala. 1975, §40-23-1, since there is no true transfer of ownership of the Equipment to the Lessor. Taxpayer retains possession of the Equipment along with all other incidences of ownership during the term of the Lease. No sale means no sales tax or use tax consequences, for either the initial transfer or the repurchase of the Equipment.

Further, there is no lease tax as a result of the Transactions. The Lessor is not the entity which owns or controls the possession of the property. See Code of Ala. 1975, §40-12-220(5). In addition, a one-time lease transaction is not subject to lease tax. State v. G M & O Land Company, 275 So.2d 687, cert. denied, 275 So.2d 690 (1973). Assuming that the Lease is a one-time event, Lessor is not in the "business of leasing property" and therefore, is not subject to Alabama lease tax.

3. Assuming completion of the mergers described in the 1997 Ruling, the completion of the Transactions will not adversely affect Taxpayer's ability to claim capital tax credits under the 1995 Act in respect to the Equipment.

Since Taxpayer retains all incidences of ownership of the Equipment, there is no true transfer of ownership pursuant to the Lease. Taxpayer should be treated as the owner of the Equipment for the purpose of applying the capital

credit allowed by Code of Ala. 1975, §40-18-194(b). This conclusion is further supported by the fact that pursuant to Code of Ala. 1975, §40-18-190(2)g the costs of the project would have otherwise qualified as "capital costs" if the project had originally been structured as a capital lease.

4. **The completion of the Transactions prior to execution of the mergers described in the 1997 Ruling will not change the conclusions reached in the 1997 Ruling, except that abated property taxes will become payable by the new legal owner of the Equipment.**

Abatements of property taxes depend on legal ownership. Therefore, because title to the Equipment is transferred to Lessor pursuant to the Lease, the Lessor is subject to property taxes. However, as the successor owner of abated Equipment, the Lessor will be able to claim the remainder of the abatements. See Department of Revenue Reg. 810-4-3-.03(6).

ALABAMA DEPARTMENT OF REVENUE

By:________________________________

H. E. "GENE" MONROE, JR.
Commissioner of Revenue

HEMJr.:MG:pj