ALABAMA DEPARTMENT OF REVENUE
REVENUE RULING 98-008

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TO: ("Taxpayer")

FROM: Commissioner of Revenue
Alabama Department of Revenue

DATE: September 22, 1998

RE: Whether cross-border lease with foreign company will adversely affect industrial tax incentives

FACTS

Taxpayer is the owner of an expansion project located in Alabama ("Expansion Project"). The Expansion Project is a qualified project for income tax credits under the 1995 capital credits act ("1995 Act") and has received certain tax abatements, including an ad valorem tax abatement, under the Tax Incentives Reform Act of 1992, as amended ("TIRA").

Taxpayer and its direct and indirect wholly owned subsidiaries, A and B (collectively, the "Taxpayer Companies"), have recently spent in excess of $500 million on the modernization and expansion of a pulp and paper mill in Alabama. The expansion of the mill included the design, procurement, and installation of certain pieces of paper production and converting equipment which will be the subject of the Transactions described below (the "Equipment").

Transactions

In 1993, the Taxpayer 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 dated December 16, 1996, 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 Taxpayer 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 A and B 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.

All such mergers were completed at year-end 1997 and Taxpayer is now the successor by merger to A and B and the sole owner of the Equipment.

In addition, the Taxpayer Companies obtained, by Inducement Agreements with an Industrial Development Board of a city ("IDB") dated February 28, 1995, and November 20, 1995, as confirmed by an Inducement Agreement with the City on dated December 12, 1995, certain tax abatements, including an ad valorem tax abatement applicable to all aspects of the expansion project.

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

Taxpayer is considering entering into a series of transactions with a foreign furniture distributor, ("Lessor") and certain other parties described below which will permit Lessor to obtain certain tax benefits under foreign tax laws (but not federal U.S. or Alabama tax laws) for which Lessor will provide Taxpayer with certain compensation described herein.

The details of the Transactions are as follows:

1. Sale of Equipment. Taxpayer will transfer all of its rights, title and interests in the Equipment to Lessor pursuant to a Purchase Agreement for a purchase price that is equal to its cost of designing, acquiring, and installing the Equipment but not in excess of its current appraised value (the "Purchase Price"). The Purchase Price is expected to be in the vicinity of US $200,000,000. All of the items included in the Equipment are part of the Expansion Project.

2. Status of Equipment. All of the Equipment has been delivered and installed. With the exception of the third production line in the sheeter plant, all of the equipment was placed in service for federal and state income tax purposes as of the end of May 1997. The third sheeter line is expected to be placed in service prior to year end 1998.

3. Leaseback of Equipment. Concurrently with the conveyance of the Equipment to Lessor, Taxpayer will enter into a Lease Agreement with Lessor (the "Lease") under which it will be entitled to retain possession of the Equipment and to utilize it for the term of the Lease in exchange for making certain payments

described below. The Lease is a triple net lease under which Taxpayer bears all U.S. and Alabama taxes, insurance costs, operating costs and other costs and expenses associated with the ownership and use of the Equipment and all risk of loss of the Equipment during the term of the Lease. In addition to the payments described below, Taxpayer will provide Lessor with certain indemnities against tort claims and environmental liabilities arising out of Taxpayer's possession and operation of the Equipment.

4. Term of Lease. The Lease is expected to have an Initial term of approximately seven and one-half years. In addition the Lessor will have an option for a Renewal Term of approximately four and one-half years.

5. Early Termination. The Lease provides for early termination upon occurrence of events of default, upon changes in law which subject one or both of the parties to material additional costs or which invalidate or prohibit performance of a material portion of the Transaction documentation, by Taxpayer following exercise by Lessor of its discretionary right to withhold its consent to assignment of the Lease to a third party who meets certain minimum qualifications, and at the option of either party at any time after the fourth year of the Lease.

6. Taxpayer Payment Obligations. Under the Lease Taxpayer will be obligated to make the following payments to Lessor or its assignee:

a. During the Initial Term, equal semi-annual payments of approximately 4.3% of the Purchase Price.

b. During the Renewal Term, equal semi-annual payments of approximately 4.3% of the Purchase Price.

c. If the Lease expires at the end of the Initial Term, a Termination Payment of approximately 71.8% of the Purchase Price.

d. If the Lease expires at the end of the Renewal Term, a Termination Payment of approximately 60% of the Purchase Price.

e. If the Lease is terminated prior to the natural expiration of the Initial Term (or the Renewal Term, if applicable), a scheduled Termination Payment which declines over time, but is always greater than the Termination Payment which would have been payable had the Lease run through its natural expiration. The amount of the Termination Payment due for early termination of the Lease will vary somewhat depending on the cause of the termination. If termination results from the natural expiration of the Lease, a Lessor, default, or certain other events within the control of the Lessor, the Termination Payment will be determined from Schedule C. Amounts payable pursuant to Schedule C will be fully defeased from day one (see discussion at paragraph 8 below). Schedule A Termination Payments are applicable to termination for Lessee defaults or other events within the control of the Lessee. Schedule B applies to terminations initiated by either party because of a change in law which makes all or any portion of the transaction illegal or unenforceable or due to a lease termination declared by Taxpayer following a refusal of Lessor to consent to the assignment of the Lease by Taxpayer to a qualified purchaser of the entire mill. Termination Payments under Schedules A and B are defeased up to the amount of the Schedule C Termination Payment for the corresponding date.

7. Disposition of Equipment. Upon natural expiration of the Lease or upon earlier termination for any other reason, Taxpayer will have an option to purchase the equipment at the higher of fair market value or the applicable Termination Payment with the proceeds to be applied to rebate to Taxpayer the amount paid by it as a Termination Payment and the excess, if any, to be split between Taxpayer and Lessor on a 25-75 basis with 75% going to Taxpayer and the remainder to Lessor.

If Taxpayer elects not to exercise such option, the Equipment will be sold under a Conditional Sales Agreement for a purchase price equal to the applicable Termination Payment for the termination date. The only conditions to the buy-sell obligations of Lessor and its counterparty under the Conditional Sales Agreement, will be that the Lease has terminated for a reason that entitles Taxpayer to exercise its option to purchase described in the preceding paragraph and that Taxpayer shall have failed to exercise such option within the period provided for exercise.

The counterparty under the Conditional Sales Agreement will be a single member LLC (the "LLC") owned at the outset of the transaction A Bank. In order to induce Bank's participation in the transaction, Taxpayer will agree, at or before closing, with Bank that immediately after closing Taxpayer will acquire Bank's equity interest in the LLC for a nominal price and that it will indemnify Bank against any loss or liability in connection with the transaction. Following such acquisition, Taxpayer will either merge or liquidate the LLC into Taxpayer so that it will become the counterparty under the Conditional Sales Agreement.

The net result of the structure is that under the circumstances Taxpayer will be obligated, and have a right, to purchase the Equipment for an amount not less than the applicable Termination Payment. At the outset of the Lease all but approximately 11% of the Applicable Termination Amount (assuming a Schedule A termination for an event such as a Taxpayer default) will have been prepaid pursuant to the defeasance arrangements and the un-prepaid percentage drops rapidly. Thus the only cash payment required of Taxpayer to regain title to the equipment will be the spread between the C Termination Payment and the Schedule A or Schedule B Termination Payment if applicable. The contingencies that could cause Taxpayer to incur such additional costs are all either within its sole control or remote in nature.

8. Defeasance. Approximately 15% of the Purchase Price will be funded by Lessor as an equity investment from its own funds. The remaining 85% will be funded by Lessor under an Accounts Receivable Purchase Agreement (the "ARPA") with a bank. (the "Factor"). The ARPA will provide for an absolute sale, without recourse, by Lessor to the Factor of a portion of Taxpayer's payment obligations under the Lease representing on a present value basis approximately 85% of the combined scheduled rental payments and Schedule C Termination Payments. In addition Lessor will sell to the Factor all of its rights to receive payments under the Conditional Sales Agreement and in return the Factor will assume Lessor's obligation under the Lease to rebate to Taxpayer an amount equal to the applicable Termination Payment (the "Conditional Rebate Obligation").

Taxpayer will enter into a Payment Agreement with the Factor under which it will pay the Factor an amount equal to the amount paid by the Factor to Lessor under the ARPA plus a small fee and it will assume the Conditional Rebate Obligation. In return for such payment, the Factor will assign to Taxpayer its rights to the Factored Receivables and its rights to the proceeds of the Conditional Sales Agreement.

In addition, Taxpayer will enter into a Credit Support Agreement with Lessor and Leasing, a foreign corporation which is affiliated with Lessor. Under this agreement Taxpayer will make a payment to Leasing equal to approximately 10.5% of the Purchase Price. In return, Leasing will assume all of the payment obligations of Taxpayer arising under the Lease (except for those previously sold to the Factor, certain indemnification obligations, and the conditional obligation to make Termination Payments under Schedules A&B to the extent they exceed in amount the amount payable under Schedule C for a termination on the same date). In addition, the Credit Support Agreement will include an agreement by Lessor that it will look solely to Leasing for payment of the obligations of Taxpayer assumed by Leasing.

As a result of the arrangements described in the preceding two paragraphs, Taxpayer will either be legally released from all of its financial payment obligations under the Lease or it will owe those obligations to itself. Its only remaining payment obligations will be those which will be solely within its control and certain obligations which are subject to conditions precedent (such as changes in tax laws) which have a remote probability of occurrence. An opinion will be obtained by Taxpayer at closing from its German counsel to the effect that the foregoing structure should remain in effect in the event of a bankruptcy of Lessor.

11. Security Interest. In order to secure Lessor's obligations under the Lease (including the obligation to return title of the assets), Lessor will grant to Taxpayer a security interest in the Equipment. Lessor will also grant a security interest in the Equipment to the Factor and to the LLC securing its obligations to such parties. Both such additional security interests will become the property of Taxpayer following closing under the arrangements described above. All of such security interests will be perfected by Taxpayer in Alabama by appropriate UCC filings.

12. Tax and Accounting Treatment. The structure will permit Taxpayer to effect a full defeasance of the Lease obligations on its financial records. It will continue to carry the equipment on its books as an asset for federal income tax and accounting purposes and the amount by which the Purchase Price exceeds the payments to the Factor, Leasing, and the Counterparty (approximately 4.5% of the purchase price) as further reduced by its transaction expenses will be treated as income for book and federal income tax purposes. The receipt of a satisfactory legal opinion confirming its status as the owner of the Equipment for purposes of U.S. income tax law will be a condition to Taxpayer's obligation to close the transaction.

Lessor will take the position for foreign income tax purposes that it is the owner of the Equipment. Its ability to obtain a satisfactory legal opinion confirming that status will be a condition precedent to its obligation to close the transaction.

ISSUES

1. Whether the Transactions will result in Taxpayer continuing to be treated as the owner of the Equipment for purposes of Alabama income tax laws.

2. Whether none of (i) the sale of the Equipment by Taxpayer 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 the terms of the Lease or the conditional Sales Agreement, will be subject to Alabama sales tax, use tax, or lease tax.

3. Whether the consummation of the Transactions will adversely affect Taxpayer's ability to claim capital tax credits under the 1995 Act in respect of the Equipment.

4. Whether upon consummation of the Transactions, the Equipment will continue to be abated pursuant to agreements between Taxpayer and the IDB.

ANALYSIS AND CONCLUSION

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

Alabama follows federal precedent in determining the true owner of property for income tax purposes. "The command of income and its benefits marks the real owner of property for income tax purposes." Snow v. State, 257 Ala. 614, 617, 60 So.2d 346 (1952), (citing Helvering v. Horst, 311 U.S. 112 (1940), and Helvering v. Clifford, 309 U.S. 331 (1940)); State v. Acker, 636 So.2d 470 (Ala. Civ. App 1994); State v. Gulf Oil Corp., 47 Ala. App. 434, 256 So.2d 172 (1971).

Where the lessee has use of the leased property for the lease term, bears all expenses and risks of operating the leased property, and has both the cost of depreciation in value and the benefits of appreciation in the value of leased property at the end of the term, the lease will normally be regarded as a financing lease and the lessee will be regarded as owner of the property. Swift Dodge Co. v. Commissioner, 692 F.2d 651, 652 (9th Cir. 1982) (terminal rental adjustment clause negates "true lease" characterization). Similarly, the Internal Revenue Service in Revenue Ruling 72-543, 1972-2 C.B. 87, and the Tax Court in Aderholt Specialty Corp. v. Commissioner, 50 T.C.M. (CCH) 1101, T.C.M. (P-H) ¶ 85,491 (1985), concluded that, in the case of a net lease incorporating a put\call arrangement at a single price and with simultaneous decisions, the lessee would receive the benefits and bear the burdens of ownership of the leased property and would therefore be treated as the owner of the property for tax purposes.

If the Equipment loses value (actually depreciates), the entire risk of loss is on Taxpayer. If the Equipment appreciates in value, the Lessor will not enjoy the benefit of the increase. If the Equipment breaks, Taxpayer must repair it. If property taxes increase, Taxpayer must pay them. The Lessor has none of the risks and none of the benefits normally associated with ownership.

Taxpayer will be treated as the owner of the Equipment for federal income tax purposes, and Taxpayer will be the owner of the Equipment for purposes of Alabama income taxes during and upon consummation of the Transactions.

2. Neither (i) the sale of the Equipment by Taxpayer 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 Equipment disposition provisions 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 incidents 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 generally subject to lease tax. State v. G M & O Land Co., 275 So.2d 687, cert. denied, 275 So.2d 690 (1973). Assuming that the Lease is a one-time event in Alabama, Lessor is not in the "business of leasing property" and, therefore, is not subject to the Alabama lease tax.

3. The completion of the Transactions will not adversely affect the Taxpayer's ability to claim capital tax credits under the 1995 Act in respect to the Equipment.

Since Taxpayer retains all incidents 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 under 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. Upon consummation of the Transactions, the Equipment will continue to be abated pursuant to agreements between Taxpayer and the IDB.

Abatements of property taxes depend on legal ownership, except to the extent that the Tax Incentives Reform Act of 1992 requires that ownership for federal income tax purposes be determinative. Under Department of Revenue Reg. 810-4-3-.03(6), the Equipment will continue to be abated in the hands of the appropriate owner during and following completion of the Transactions for the remaining term of the granted property tax abatements.

H. E. "GENE" MONROE, JR.

HEM:pj