

ALABAMA DEPARTMENT OF REVENUE  
REVENUE RULING 98-012

**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: November 12, 1998

RE: Applicability of Alabama sales, use and lease tax to a transaction that is, in substance, a lease with an option to purchase.

**ISSUES AND FACTS**

The facts as represented by Requestor are as follows:

Corporation "A", a State "X" corporation, is a full service marine builder and supplier with principal offices located in State "X".

Corporation "A" contracted with a ship builder to build a vessel in State "Y", and Corporation "A" is the ship builder of record. After the vessel was built, Corporation "A" sold the vessel to a third party leasing company located in Alabama. The leasing company, Company "B" will then lease (pursuant to a Capital Lease) the vessel back to Corporation "A" d/b/a "ABC" Towing in Alabama. "ABC" Towing will operate the vessel within Alabama territorial waters. The possession of the vessel will at all times remain with Corporation "A". Corporation "A" will be liable for all maintenance, insurance, and taxes due on the vessel.

At the time that the lease agreement is signed, the vessel will be physically transferred from State "Y" to Alabama. The agreement is a capital lease with a purchase option to buy the vessel for the lesser of fair market value or 26% of its acquisition cost at the end of the lease term. Officers from Corporation "A" will sign the capital lease in the State of "X".

The issues are as follows:

1. Whether the transaction between Corporation "A" and Company "B" will be construed under Alabama sales, use and lease tax laws as a financing agreement or a true lease?

2. If the answer to issue No. 1 is in the affirmative, will Corporation "A" be subject to any Alabama sales, use or lease tax on either the initial sale to the third party leasing company or on the subsequent payments under the capital lease to the third party leasing company?

### **LAW AND ANALYSIS**

#### ISSUE NO. 1:

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 main stream 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 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. Applying this principle, however, yields a different result from the one suggested by Requestor. The lessor owns or controls the tangible personal property as evidenced by numerous provisions establishing the lessor, Company "B", as owner. The provisions of the Equipment Lease and Supplement No. 1 indicate a passage of title to the lessor and an intent of the parties that the transaction constitutes a true lease with three possible final dispositions: the Lessee exercising the option to purchase for an amount that is not nominal, the Lessee exercising the option to renew the lease at the end of the lease term, or the Lessee returning the equipment to the Lessor upon expiration of the lease term. Neither the Equipment Lease nor Supplement No. 1 contain evidence that the intent of both parties is that the title will pass at the end of the lease term. In other words, the substance of the agreement between the parties is that the transaction is a lease with no predetermined option to be exercised at a future date. The following language in the Equipment Lease and Supplement No. 1 indicate the true intent of the parties:

Section 6 provides that, "[n]o right, title or interest in the equipment shall pass to the Lessee other than, conditioned upon Lessee's compliance with and fulfillment of all the terms and conditions of this lease, the right to retain possession of and use of the Equipment for the full lease term and the right to purchase the Equipment pursuant to Section 11 (the purchase option). Section 6 also provides that, "Lessor may require plates or markings to be affixed to or placed upon the Equipment, at Lessee's expense, indicating that Lessor is the owner thereof." Paragraph 6 further provides that, "Lessee shall, ..., protect and defend Lessor's title to the Equipment ..."

Section 8 requires that the Lessee, "shall keep all Equipment in good repair, condition and working order, ordinary wear and tear excepted, and furnish all labor, parts, mechanisms, devices and supplies required therefor. All such parts, mechanisms and devices shall immediately become the property of the Lessor." Paragraph 8 further provides that Lessee shall not make any "alterations, additions or improvements to the equipment which are

permanent or which detract from its economic value ..." And most importantly, Section 8 further provides that, "[a]ll additions and improvements to the equipment shall belong to and immediately become the property of Lessor, shall become subject to the terms of this lease and shall be returned to Lessor with the equipment upon the expiration or earlier termination of this lease ..."

Section 11 provides for a purchase option which states that if the Lessee does not elect to exercise said purchase option, then "Lessee shall either: (a) renew the lease ... (b) return each item of equipment to the Lessor ..." The paragraph labeled Purchase Option in Supplement No. 1 modifies Section 11 of the Equipment Lease to provide the purchase price under the purchase option shall be equal to the lesser of: "(a) its then fair market value or (b) 26% of its acquisition costs, plus in either case any applicable sales tax with respect thereto."

Section 14 relating to the return of the equipment in the event the purchaser or lease renewal option is not exercised provides "... Lessee shall forthwith surrender and return possession of all items of Equipment ... on the day immediately following the date of expiration ..."

Section 20 provides that, "Lessor and Lessee agree that the Lessor and any affiliated group, ... with which Lessor joins in the filing of a consolidated Federal income tax return ... shall be treated for federal income tax purposes (and to the extent allowable, for state and local tax purposes) as the owner of all equipment leased ..." Also, "Lessee represents, warrants and covenants; (i) that it will not take any action inconsistent with Lessor's status as owner of the equipment for federal, state and local tax purposes, (ii) ... the entire cost of all equipment leased hereunder will qualify for accelerated cost recovery deductions ... and (iv) Lessee will not take any action which affects the right of the lessor to claim the deduction ... attributable to the equipment." Most importantly, Section 20 further provides that, "this lease has been entered into on the basis that Lessor shall be entitled to such deductions that are tax benefits including applicable tax rates as are provided on the day of this lease by federal, state and local law to an owner of property."

The section of Supplement No. 1 entitled Exhibit Copy Of Lease requires the Lessee to, "place and keep prominently exhibited in the chart room and master cabin of the Equipment, a notice, at least six inches wide by nine inches high and framed reading "The equipment is owned by Company "B" ... and is under lease." Also, "... neither the Lessee, the master of this vessel nor any other person has any right, power or authority to create, incur or permit to be placed or imposed upon this Equipment any lien whatsoever ..."

The section of Supplement No. 1 entitled Certain Additional Covenants provides "Lessee ... will maintain the registration and documentation of the equipment in lessor's name ... throughout the lease term."

The section of Supplement No. 1 entitled Holding Over provides' "[a]ny use of the

Equipment by Lessee beyond the lease term ... shall be deemed an extension of the lease term ...; provided, however that nothing in this paragraph or otherwise shall be deemed to grant Lessee a right or other privilege to retain possession of the Equipment beyond the end of the lease term."

The section of Supplement No. 1 entitled Redelivery Of The Vessel provides, "Lessee shall ... on the expiration date of the lease term (unless Lessee exercises the right to purchase the Equipment under Section 11 of the lease), redeliver the equipment to Lessor ... .

These numerous excerpts from both the Equipment Lease and Supplement No. 1 clearly show that the Lessor, Company "B", is "the person who owns or controls the possession of tangible personal property" as stated in Ala. Code 40-12-220 (5)." The transaction at issue, between Corporation "A" and Company "B" does not provide for passage of title if the option to purchase is not exercised, unlike those in Ex parte Thomas Tractor. If this option is not exercised, Lessee must renew the lease or return the vessel to the Lessor. Neither the Equipment Lease nor Supplement No. 1 provide that the Lessee will become the owner of the vessel upon the making of all the lease payments.

In Revenue Ruling 97-001, cited by the Requestor, the conclusion that rental tax is not due is based on a situation where the financier is not the person who owns or controls the possession of the tangible personal property. In Revenue Ruling 97-001, Corporation A (the lessee) at all times owned or controlled the possession of the property. In addition the conclusion stated in Revenue Ruling 95-007, also cited by Requestor, is based on the fact that the customers, and not the Taxpayer, owned the tangible personal property. In the transaction between Corporation "A" and Company "B", the Lessor, Corporation "B", does have title to the vessel.

Therefore, the lease by Company "B" to Corporation "A" is a true lease with an option to purchase, and not merely a financing arrangement. See Ala. Code 40-12-220 (5). Company "B" is liable for leasing or rental tax on the gross proceeds from the lease. The applicable rate of lease tax is the 1 1/2% automotive rate. See Ala. Code 40-12-222. If the lessee, Corporation "A", exercises the purchase option, the amount paid at the time the option is exercised is taxable at the 2% automotive rate of sales tax. See Ala. Code 40-12-224 and 40-23-2 (4).

Ala. Code 40-23-4(12), cited by the Requestor, specifically excludes the following from Alabama sales and use tax:

The gross proceeds of the sale or sales of railroad cars, vessels, barges, and commercial fishing vessels of over five tons load displacement as registered with the U.S. Coast Guard and licensed by the State of Alabama Department of Conservation and Natural Resources when sold by the manufacturer or

builders thereof. (Emphasis added).

Corporation "A" is not the builder or manufacturer of the vessel. The purchase of the vessel by Corporation "A" from the builder qualifies as a wholesale sale, not subject to sales or use tax. See Ala. Code 40-23-1(a)(9)a and 40-23-60(4)a. Additionally, the subsequent sale of the vessel by Corporation "A" to Company "B" is a wholesale sale not subject to sales or use tax. See Ala. Code 40-23-1 (a)(9)j and 40-23-60(4) i.

ISSUE NO. 2:

Not applicable.

### **HOLDING**

Based upon the particular facts of this case, the contemplated transaction between Corporation "A". and Company "B" is subject to the lease tax as Company "B" is "the person who owns and controls the possession of tangible personal property" as stated in Ala. Code 40-12-220(5). The substance of this transaction is that of a lease with an option to purchase. Therefore, Company "B" will owe the lease tax, unless and until Corporation "A" exercises the purchase option. If this option is exercised, sales tax is due.

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H. E. "GENE" MONROE, JR.

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