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ALABAMA DEPARTMENT OF REVENUE REVENUE RULING 95-007

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§40-2A-5(a) (1993 Replacement Volume).

TO:

FROM: Commissioner of Revenue
Alabama Department of Revenue

DATE: August 31, 1995

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:

Corporation "A", a corporation, is in the general business of commercial leasing and finance. Corporation "A" is considering a certain financing transaction with Alabama customers that would take the form of a sale and leaseback of certain tangible personal property presently owned by Corporation "A's" potential Alabama customers. Corporation "A's" potential customer ("Customer") currently owns tangible personal property ("Property") in Alabama which is used in its trade or business. The Customer claims depreciation on the property for financial reporting and federal and state tax purposes. The Customer has paid all applicable Alabama sales or use tax on the acquisition and use of the Property.

The Customer desires to obtain cash equal to the value of the Property, but does not want to incur indebtedness that will affect its balance sheet for financial reporting purposes. Corporation "A" desires to advance such cash to the Customer and requires an appropriate interest in the Property. To achieve these business purposes, the Customer and Corporation "A" contemplate the following transaction:

1. Customer will transfer title to the Property to Corporation "A" via a bill of sale and Corporation "A"

will transfer cash to Customer equal to the Property's fair market value.

2. Immediately after the transfer of title to Corporation "A", and without Customer ever surrendering possession of the Property, Corporation "A" will lease the Property back to Customer.

3. 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 Customer from Corporation "A" at a market rate of interest.

4. At the expiration of the lease term, the Customer may either (1) purchase the Property back from Corporation "A" for a predetermined fixed amount (which would return to Corporation "A", in the form of a purchase price, an amount equal to that unamortized portion of its original advance to the Customer); or, alternatively, (2) decline to purchase the Property and surrender it to Corporation "A", in which case Customer and Corporation "A" will sell the Property to a third party. If the Property is sold for more than the amount the Customer could purchase the Property for at the end of the lease, Corporation "A" will receive only the lease option price and the Customer will receive the additional amount. If the Property is sold for less than the lease option price, Corporation "A" will receive the proceeds and Customer will pay some (but not all) of the difference to Corporation "A".

5. In the event of a voluntary or involuntary termination during the lease term, Customer must pay Corporation "A" any accrued and unpaid rent, late charges and interest, plus the termination value (unpaid principal) under the lease, which is established according to the amortization schedule explained in paragraph 3 above.

6. Under the terms of the lease, the Customer bears all risk of loss with respect to the Property and is liable for all maintenance, insurance, and taxes due on the Property.

7. For federal income tax purposes, the Customer and Corporation "A" will treat these transactions as a loan from Corporation "A" to Customer secured by the Property. Customer will continue to take depreciation deductions on the same basis as before these transactions and will treat a portion of the payments under the lease as interest, in accordance with the amortization schedule. Corporation "A" 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" will incur any Alabama sales, use, or lease tax liabilities because of their financing transactions with Alabama Customers that would take the form of a sale and leaseback of certain tangible personal property owned by Corporation "A's" potential Alabama customers?

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 "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 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 its Customers 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 Corporation "A" 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, the Customer owns and controls the possession of the Property subject only to Corporation "A's" security interest in the property. The substance of these transactions is that of a non-taxable financing arrangement or loan, and there is no sales, use or lease tax applicable.


RALPH P. EAGERTON, JR.

RPE:MJM:pj