

ALABAMA DEPARTMENT OF REVENUE
REVENUE RULING 2017-003

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To: Taxpayer Company

From: Vernon Barnett
Commissioner of Revenue

Date: October 23, 2017

FACTS¹

Requestor is the awardee of a contract by Entity A for the lease of real property upon which a solar Renewable Energy Generation Facility (“REGF”) will be constructed. Requestor was also awarded a contract to sell electricity from the REGF to Entity A under an agreement. Requestor will novate the lease and agreement to Company B after the award of the contract. Company B is a wholly owned subsidiary of Requestor. Company B will act as the owner or lessee of the REGF and will contract with third-party general contractors to construct the REGF. The term of the lease for the land on which the REGF will be constructed is 27 years, at the end of which Company B will be obligated to remove the REGF from the property.

Company B will contract directly with a licensed contractor for the engineering, procurement, and construction (“EPC”) of the REGF. The REGF will be attached to the realty by the EPC contractor in one of several possible manners. These methods of affixation include driven steel pile foundations (typically 10-14 feet deep), concrete cast-in-place steel pile foundations (typically 6-10 feet deep), or shallow spread footing or ballasted concrete foundations, where site conditions preclude the use of the two above preferred options.

Once operational, the REGF will provide renewable, locally-generated electricity. Within 90 days of the REGF commencement of commercial operation, Company B will enter into a sale/leaseback arrangement with Financer C pursuant to which Company B will sell the REGF to Financer C and lease back the REGF for the term of the lease, which is scheduled to be approximately 20 years. At the expiration of the lease term, Company B will have the option to purchase the REGF from Financer C for its then fair market value or return the REGF to Financer C. Under the sale/leaseback arrangement, the ownership of the REGF will be transferred to Financer C, and Financer C will lease the REGF back to Company B to be used during the term of the lease for generation of electricity and ultimate sale of such electricity to Entity A under the terms of the purchase power agreement.

ISSUE #1

¹ The facts upon which this revenue ruling is based are stated herein. To the extent that any relevant facts asserted by the requestor were omitted or were misstated or if stated, were misleading, this revenue ruling may be invalidated by the Department in whole or in part or withdrawn as the circumstances may require.

Will the construction of the REGF by Company B be considered a contract for the improvement to realty?

ANALYSIS

The question whether the contract is one for the improvement to realty hinges on whether the tangible personal property purchased and installed under the contract is affixed to real estate in a way that identifies it with the realty. This question is one of the determiners of whether the tangible personal property in issue is considered a building material. For purposes of sales and use tax, the definition of the term “building materials,” along with guidance on what constitutes a fixture, is explained in Ala. Admin. Code r. 810-6-1-.28. It states, in pertinent part:

(1) The term “building materials,” as used in the Alabama sales and use tax laws, means all tangible personal property, including any device or appliance used by builders, contractors, or landowners in making improvements, additions, alteration or repair to real property in such a way that such tangible personal property becomes identified with a part of realty.

(2) A device or appliance becomes a fixture and a part of the real property to which it is connected when it is built into or is attached to a structure in such a way that its removal would substantially damage or deface such structure.

(3) Where the removal of the device or appliance would not substantially damage or deface the structure to which it is connected the following factors shall be considered:

(a) Actual connection with or attachment to real property. To become a part of real property, the device or appliance must have some physical connections such as: by bolts, screws, nails, cement piping, or cable; by contact, where by reason of great weight or bulk, no additional attachment is required; by contact, where the device or appliance is necessary to make complete or useable something which is real property; by attachment to another device or appliance which has become a part of real property.

(b) Appropriateness to the use or purpose of the real property to which connected. The use or purpose of the device or appliance must become an element of the use or purpose of the real property to which it is connected.

The Requestor has asserted that the power generation equipment will be affixed to the real property by driven steel pile foundations (typically 10-14 feet deep), concrete cast-in-place steel pile foundations (typically 6-10 feet deep), or shallow spread footing or ballasted concrete foundations. The Requestor has also asserted that the REGF and its power generation equipment will cover almost 60 acres of land. From the description provided by the Requestor, the power generation and associated equipment will have a substantial connection and anchoring to the realty. In addition, the 60 acres of real property will be substantially covered and put to use for the

purposes of operating the installed equipment. Based on the substantial connection to the realty and the use of the real property as an element of the operation of the equipment, the power generation materials and equipment constituting the REGF will be considered to have become identified with a part of realty.

The Requestor has also stated that the construction of the REGF will include the installation of fencing and pole lines. As noted by the Requestor, both fencing and pole lines are specifically addressed in the Department's regulations. "Fencing materials of all kinds including fence posts, fence wire, and fence accessories are building materials, the sales of which are at retail and subject to tax when made to the person who will attach the fencing materials to real property." Ala. Admin. Code r. 810-6-1-.66. Similarly, pole lines and related materials are specifically defined as building materials in Ala. Admin. Code r. 810-6-1-.126, which provides:

Materials used in the construction of pole lines for the transmission of electric power and telephone, telegraph, radio, and television signals are building materials. These materials are purchased at retail subject to sales or use tax, whichever may apply, by the persons who erect the pole lines into place by attaching to real property. These materials include poles, lines, lightning arresters, circuit breakers, switch gear, all pole accessories and also include, all the materials and equipment used in the construction of substations. This class of materials is subject to tax at the four percent rate with the exception of transformers and amplifiers which are taxable at the machine rate of one and one-half percent.

Therefore, based on the provisions of 810-6-1-.66 and 810-6-1-.126, the materials and equipment falling under the definitions of fencing and pole lines are considered building materials and are also considered to be incorporated into the realty.

CONCLUSION

Based on the facts provided by the Requestor, the materials and equipment constituting the power generating equipment for the REGF, and the fencing and power transmission equipment associated with the REGF, will be sufficiently affixed to the real property such that the tangible personal property becomes identified with a part of realty.

Whether the contract is considered a contract for the improvement to realty, in other words, whether the materials and equipment constituting the REGF are sufficiently attached to be identified with a part of realty, however, does not end the analysis for purposes of sales and use tax. As is explained below in response to Issue 2, the sales and use tax implications are also determined in part by whether the materials and equipment are classified as machines or as building materials.

ISSUE #2

What are the sales/use tax implications of the EPC contract for construction of the REGF?

ANALYSIS

Tangible personal property vs. services

Sales and use tax is owed on retail sales of tangible personal property. Services, however, are not generally subject to sales and use tax. Where a customer has contracted with an entity to provide both tangible personal property and services, such as installation, whether the services portion of the contract is subject to sales and use tax depends on the nature of the services provided and the specifics of the contract.

Ala. Admin. Code r. 810-6-1-.84(2) provides:

“(a) Labor or service charges, whether included in the total charge for the product or billed as a separate item, are taxable if the labor or service (i) is incidental to making, producing, or fabricating a new or different item of tangible personal property or otherwise preparing the tangible personal property for sale and (ii) is performed prior to transfer of title to the purchaser.”

Further guidance regarding installation charges is provided by Ala. Admin. Code 810-6-1-.81(1), which states: “Where the quoted or advertised price is a lump sum for both property and installation or where billing and other records do not show separate charges for property and for installation, the measure of the tax is the total amount received by the seller.”

As stated in Ala. Admin. Code r. 810-6-1-.84(2), the services must be separately stated on the invoices to the customer. If the contractor invoices the tangible personal property and services as a combined charge, then sales and use tax is owed on the entire invoiced amount.

As applied to the construction of the REGF, the value of the contract as a whole is not subject to sales tax, provided that the conditions outlined above are met – the services associated with the contract must be separately stated and also must not be incidental to producing the tangible personal property or performed prior to transfer of title to the purchaser.

Building materials and contractor liability for sales and use tax

The statute defining retail sales states, in part, that “[s]ales of building materials to contractors, builders or landowners for resale or use in the form of real estate are retail sales in whatever quantity sold” § 40-23-60(5), Ala. Code 1975. Therefore, for any materials that meet the definition of building materials, the contractor under the EPC is liable for payment of the sales or use tax owed on those items. The Department’s regulations provide guidance regarding what constitutes a building material for purposes of sales and use tax and for the contractor liability provision. Ala. Admin. Code r. 810-6-1-.46 provides that:

(1) Contractors or builders must pay either to the seller or directly to the Department of Revenue sales or use tax on the following:

(a) All of the materials, equipment, tools, and supplies which they use or consume in the operation of their business and

(b) All building materials attached by them to real property except property qualifying for a specific exemption. See Rule 810-6-1-.27 entitled Building Materials

For the contractor liability provisions of 810-6-1-.46 to apply, three conditions must be met. The conditions are: “(i) the taxpayer must be a contractor; (ii) the materials must be building materials; and (iii) the materials must become a part of the real estate.” Ala. Admin. Code r. 810-6-1-.46(b)(4) (citing Alabama Dep’t of Revenue v. James A. Head & Co., 306 So. 2d 5 (Ala. Civ. App. 1974)).

The first question is whether the entity retained under the EPC to construct the REGF is a contractor. “[A] ‘contractor’ is ordinarily understood to be the person who undertakes to supply labor and materials for specific improvements under a contract with an owner or principal.” Head, supra. From the information provided by the Requestor, the entity retained under the EPC to install the REGF appears to meet the definition of a contractor.

Another question that must be asked in determining the application of the contractor liability provision is whether the materials in issue become a part of the real estate. This question was addressed in the affirmative in Issue 1.

The remaining question is whether the equipment and materials installed as part of the REGF are, in fact, building materials. Building materials are broadly defined in Ala. Admin. Code r. 810-6-1-.27(2):

Building materials when purchased by builders, contractors or landowners for use in adding to, repairing, or altering real property are subject to either the sales or use tax at the time of purchase by such builder, contractor, or landowner. Building materials as used in the sales or use tax laws includes any material used in making repairs, alterations, or additions to real property. “Builders,” “contractors,” and “landowners,” mean and include any person, firm, association, or corporation making repairs, alterations or additions to real property. The term “building materials” includes such tangible personal property as lumber, timber, nails, screws, bolts, structural steel, reinforcing steel, cement, lime, sand, gravel, slag, stone, telephone poles, fencing, wire, electric cable, brick, tile, glass, plumbing supplies, plumbing fixtures, pipe, pipe fittings, electrical fixtures, built-in cabinets, sheetmetal, paint, roofing materials, road building materials, sprinkler systems, air conditioning systems, built-in fans, heating systems, flooring, floor furnaces, crane ways, crossties, railroad rails, railroad track accessories, tanks, builders hardware, doors, door frames, windows, window frames, water meters, gas meters, well pumps and any and all other tangible personal property which becomes a part of real property.

Thus, the contractor constructing the REGF pursuant to the EPC is liable for payment of sales or use tax on all of the project materials that meet the definition of building materials under 810-6-1-.27. However, as explained below, the term “building materials” does not include those

materials and equipment that meet the definition of a “machine” and therefore qualify for the reduced 1.5% machine rate. As noted by the Requestor, the classification of materials and equipment as a machine that qualify for the reduced machine rate represents an exemption from the contractor liability provision.

Regular rate vs. machine rate

Alabama sales/use tax rates depend on whether the various materials and equipment purchased for installation at the REGF qualify as a machine – machines and parts of machines qualify for a reduced, 1.5% rate. Building materials and other items are taxed at a general 4% rate. In addition, if an item falls within the definition of a machine, it is excluded from the definition of a building material.

To qualify as a machine and be eligible for the machine rate, the material or equipment must be “machinery which is used in mining, quarrying, compounding, processing, and manufacturing of tangible personal property.” § 40-23-3(3), Ala. Code 1975. Also qualifying for the machine rate are “parts of the machines, attachments, and replacements therefor, which are made or manufactured for use on or in the operation of the machines and which are necessary to the operation of the machines and are customarily so used.” § 40-23-3(3). Electricity has been held to constitute tangible personal property. Curry v. Alabama Power Co., 243 Ala. 53, 8 So. 2d 521 (1942). Thus, machinery used in manufacturing electricity is generally eligible for the machine rate. Further guidance regarding equipment used in electrical generation is provided by Ala. Admin. Code r. 810-6-2-.101, which provides that

transformers used by producers or distributors of electricity and transformers used by other manufacturers, processors, or compounders as a part of their manufacturing, processing, or compounding equipment are entitled to the reduced machine rate of sales and use tax. Power capacitors and voltage regulators qualify for the reduced machine rate when used in the generation, manufacture, or distribution of electricity by public utilities or by other manufacturers, processors, or compounders as a part of their manufacturing, processing, or compounding equipment.

In relation to the REGF, solar panels, steam generators, turbines, condensers, transformers, cooling towers, boilers, and other similar equipment necessary for the generation and distribution of electricity qualify as machines. Other materials and equipment, such as foundations, fencing, poles, lines, switch gear, and similar equipment would be taxed at the general rate.

As explained by the Department’s regulations, materials and equipment that qualify as machines are excluded from being classified as building materials.

“None of the kinds of property designated as “building materials” is to be classified as machines or parts or attachments for machines except such items as can be identified at the time of purchase as a part or an attachment for a machine used in manufacturing, designed and manufactured for such use, customarily so used, and necessary to the operation of the completed machine. Such bulk items as lumber,

random or stock length structural steel, brick, paint, and common nails do not come within the classification.”

Ala. Admin. Code r. 810-6-1-.27(3). “Such items as prefabricated processing tanks, steam boilers, and steel when purchased prefabricated to a special design for a machine do come within machine rate.” Id. Thus, for any equipment that qualifies for the machine rate exemption, Company B would be liable for sales or use tax at the reduced 1.5% rate.

CONCLUSION

For all materials and equipment meeting the definition of building materials, the contractor constructing and installing the materials and equipment constituting the REGF is liable, pursuant to the contractor liability provisions of Ala. Admin. Code r. 810-6-1-.46 for the payment of sales or use tax on those materials and equipment. For all materials and equipment meeting the definition of a machine and qualifying for the reduced machine rate, Company B is liable for the payment of sales or use tax.

ISSUE #3

What are the sales/use tax implications for Company B related to equipment purchased by Company B for incorporation into the REGF?

ANALYSIS

From the narrative submitted with the request, Company B will purchase some of the equipment for the REGF. The equipment purchased by Company B will be provided to the contractor retained under the EPC for installation at the REGF by the contractor. For any materials purchased by Company B and provided to the contractor, Company B will be considered the purchaser of the tangible personal property and, therefore, would be responsible for payment of sales/use taxes. Purchases by Company B of equipment that is used in the manufacture of electricity, such that it qualifies as a machine or a part of a machine, will be taxed at the 1.5% machine rate. Such equipment includes solar panels, steam generators, turbines, condensers, transformers, cooling towers, and boilers. Other materials and equipment purchased by Company B for installation at the REGF by the contractor will be taxed at the regular 4% rate. Such materials and equipment include, but is not limited to, foundations, fencing materials, poles, lines, and switch gear.

CONCLUSION

Company B is liable for sales or use tax on any materials and equipment purchased by Company B and supplied to the contractor for installation by the contractor under the EPC.

ISSUE #4

Would sale/leaseback arrangement contemplated between Company B and Financer C be subject to sales/use and/or rental tax in Alabama?

ANALYSIS

Under the sale/leaseback arrangement between Company B and Financer C, Company B will sell the REGF equipment to Financer C and lease the equipment back for use in generating solar power. Although title will transfer to Financer C, Company B will retain possession of the REGF equipment during the length of the lease. Company B will also remain liable for any risk of loss and will remain responsible for maintenance, insurance, and taxes during the term of the lease.

The facts and circumstances outlined by the Requestor are similar in nature to the situation addressed by the Department in Revenue Ruling 95-007. As noted in that ruling, Alabama looks to the substance of a transaction rather than merely its form. Ex parte Thompson Tractor Co., 432 So. 2d 497 (Ala. 1985); Winner v. Marion County Comm'n, 415 So. 2d 1061. Thus, the question whether sales, use, and/or rental tax applies to the sale/leaseback arrangement presented in this request depends on whether the substance of the transaction is a sale of tangible personal property or if it is a financing arrangement.

From the information provided by the Requestor, Company B will retain physical possession of the REGF, will remain liable for any risk of loss to the REGF, and will remain liable for any maintenance, insurance, and taxes that arise in connection with the REGF. It is apparent from these facts that there is no true transfer of ownership of the REGF from Company B to Financer C under the sale/leaseback agreement, which transfer is required to constitute a sale under § 40-23-1, Ala. Code 175. It is also apparent that Company B will be “the person who owns or controls the possession of tangible personal property” constituting the REGF, even though Financer C will technically have title to the equipment. § 40-12-220(5), Ala. Code 1975. Therefore, no lease tax will be owed due to the sale/leaseback agreement.

CONCLUSION

Under the facts and circumstances presented by the Requestor, the sale/leaseback arrangement between Company B and Financer C is in the nature of a financing agreement or loan. Therefore, there is no sales, use, or rental tax applicable to the sale/leaseback arrangement.

VERNON BARNETT, Commissioner
Alabama Department of Revenue