

PRIVATE TAXPAYER RULING LR00-002

February 10, 2000

The following private taxpayer ruling is provided in response to your letter dated September 17, 1998, and renewed on August 19, 1999, in which you requested the department to rule regarding the taxable status of transactions entered into by your client,

The following is a restatement of the facts as presented in your request for a private taxpayer ruling dated September 17, 1998 and the additional information provided on November 18, 1999.

Statement of Facts:

... ("Company") enters into an arrangement with its customer, (the "Customer") which is referred to as a "sale and leaseback". Customer owns tangible personal property located in Arizona. The tangible personal property consists of manufacturing equipment, furniture, store fixtures, or office equipment. (the "Equipment") The Customer has paid sales and/or use tax when it purchased the Equipment. The Customer wishes to refinance existing debt associated with the Equipment, or to receive cash for the Equipment, in a manner that results in the Equipment, and any associated debt, being removed from the Customer's financial reporting balance sheets.

Company and Customer execute a document called a "Bill of Sale" pursuant to which Customer, "sells" certain Equipment. The bill of sale clearly states that the transaction is intended to provide the Company with a security interest in the property and that Customer retains legal title to the property. In addition, the equipment is to remain in the possession of Customer.

Following the initial transaction, the Company will lease the property back to the Customer. The lease payments will correspond to a principal and interest amortization schedule.

The initial lease agreement consists of a Basic Term of 36 months. On the first termination date of the initial lease and on each renewal term's expiration date, Customer has the following options:

1. Renew the lease agreement for up to two renewal terms of 12 months each for a total additional term of 24 months. Following the renewal terms, Customer may extend the lease for a final 12 month "Extension Term". At the end of all of the renewal terms, including the extension term, Customer purchases all equipment that is the subject of the lease for a nominal price of \$1.00.

2. Purchase the property at a price determined at the commencement of the lease. The determined price is an amount equal to a "make whole amount". This "Make Whole Amount" equals the difference between the original fixed purchase price plus interest and the remaining scheduled rent payments during the maximum lease term. The "make whole amount" is calculated to compensate Company for the loss of any future financial benefits resulting from an early termination of the agreement. This is therefore characterized as a non-fair market value purchase.

3. If Customer has not elected either of the first two options, lessee must provide lessor with a detailed inventory of the equipment and return the equipment to the lessor. Upon return of all of the equipment subject to the agreement, Company and Customer shall arrange for the commercially reasonable sale, scrap or other disposition of the equipment to a third party. Upon transfer of the equipment, the proceeds with respect to the equipment will be paid to, and held and applied by, Company as follows: Company shall promptly pay Customer an amount equal to the Residual Risk Amount (an amount calculated to meet the FASB 13 requirement that the present value of payments must not exceed 90% of the original equipment cost) plus all net proceeds, if any, of such sale in excess of the Residual Risk Amount of the equipment. According to Company this option is never exercised.

Your Position:

The transaction should be characterized as a nontaxable financing agreement rather than a taxable sale-leaseback for Arizona transaction privilege tax purposes.

Applicable Statutory Provisions:

A.R.S. § 42-5061 imposes the transaction privilege tax on the business of selling tangible personal property at retail. A.R.S. § 42-5061.U.3 defines "selling at retail" as a sale for any purpose other than for resale in the regular course of business. All sales of tangible personal property are subject to tax unless specifically exempted by statute.

A.R.S. § 42-5071 levies the transaction privilege tax on the business of leasing or renting tangible personal property for a consideration. The tax base for the personal property rental classification is the gross proceeds of sales or the gross income derived from the business. Sales of tangible personal property to be leased or rented by a person engaged in a business classified under the personal property rental classification are exempt from transaction privilege tax as sales for resale.

Discussion:

Company raises the argument that since the "Bill of Sale" entered into between Customer and Company does not transfer ownership of the equipment to Company, there is no transfer of title, and therefore, there can be no lease. The conclusion and ruling in this private taxpayer ruling is not based solely on the bill of sale argument but is based on the other factors discussed below as well.

Arizona's *transaction privilege ("sales") tax* is a tax on the privilege of conducting business in the State of Arizona. It is a tax on the seller, not on the purchaser. The seller may pass the burden of the tax on to the purchaser; however, the seller is ultimately liable to Arizona for the tax. The Arizona transaction privilege tax is imposed under 17 separate business classifications, including *retail* sales of tangible personal property. Additionally, county excise taxes "piggyback" the imposition of the state's transaction privilege tax. All sales that are subject to the transaction privilege tax are also subject to applicable county excise taxes.

Transaction privilege tax is imposed on the business of leasing or renting tangible personal property for a consideration. (A.R.S. § 42-5071) The fact that a taxpayer chooses to call an agreement a lease is a factor to be considered when looking at the tax status of the payments received under the agreement for transaction privilege tax purposes. In addition, the treatment of the income derived from an agreement for financial accounting purposes or federal income tax purposes may also be taken into consideration when determining the application of Arizona's transaction privilege tax to the transaction.

Two factors which are examined to make such a determination are: which party holds title to the property and the terms under which ownership of the property may be vested in the lessee at the end of the lease term.

Generally, an agreement which provides that the lessor holds title to the property and requires the exercise of a fair market value purchase option for the lessee to purchase the property at the end of the lease term is considered to be a lease for transaction privilege tax purposes. The gross income from such an agreement is subject to transaction privilege tax under the personal property rental classification.

In contrast, an agreement which is termed a lease but in which title of the property is vested in the lessee, where the lessor's only interest in the property is a security interest, and where lessor's interest in the property is divested at the end of the lease term without the exercise of a fair market value purchase option may be considered to be a financing agreement. An agreement that has the characteristics of a financing agreement, even if termed a lease, is not considered to be a taxable lease for the purposes of the imposition of transaction privilege tax on the income derived under the agreement.

The agreement between Company and Customer provides that Customer shall retain possession of the property at all times. Under the anticipated options of the agreement, Customer never returns the property to Company. And the facts presented establish that the buyout amount is a function of the purchase price plus interest without having any relation to the value of the equipment.

This agreement is made up of a basic term of 36 months. On the first termination date of the agreement and on each term's expiration date, the lessee has three options. 1) Renew the lease agreement for up to two additional renewal terms of 12 months each. After the Customer has exercised the two renewal terms, Customer has the option to extend the agreement for an additional 12 months. At the end of all of the renewal terms, including the extension term, Customer purchases all equipment that is the subject of the lease for a nominal price of \$1.00. 2) Purchase the property at a price determined at the commencement of the lease. The determined price is an amount equal to a "make whole amount". This "Make Whole Amount" equals the difference between the original fixed purchase price plus interest and the remaining scheduled rent payments during the maximum lease term. The "make whole amount" is calculated to compensate Company for the loss of any future financial benefits resulting from an early termination of the agreement, and is therefore, characterized as a non-fair market value purchase. 3) If Customer has not elected either of the first two options, lessee must provide lessor with a detailed inventory of the equipment and return the equipment to the lessor. Upon return of all of the equipment subject to the agreement, Company and Customer shall arrange for the commercially reasonable sale, scrap or other disposition of the equipment to a third party. Upon transfer of the equipment, the proceeds with respect to the equipment will be paid to, and held and applied by, Company as follows: Company shall promptly pay Customer an amount equal to the Residual Risk Amount (an amount calculated to meet the FASB 13 requirement that the present value of payments must not exceed 90% of the original equipment cost) plus all net proceeds, if any, of such sale in excess of the Residual Risk Amount of the equipment. According to Company option 3 is never exercised.

Conclusion and Ruling:

On the basis of the information provided, we rule that the agreement between ... and its customer, as included in the request for a private taxpayer ruling, is not a lease of tangible personal property. As such, the payments under the lease are not subject to transaction privilege tax under the personal property rental classification.

The conclusion in this private taxpayer ruling does not extend beyond the facts as presented in the letter dated September 17, 1998 and the additional information provided in your November 18, 1999 letter, in this request for a private taxpayer ruling.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determination in this

taxpayer ruling is the present position of the department. This determination is subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.