

## PRIVATE TAXPAYER RULING LR03-002

March 27, 2003

This private taxpayer ruling is in response to your letter dated September 23, 2002, as updated on October 21, 2002, in which you request a ruling on behalf of ... ("Taxpayer-Lessor") regarding whether a debt-servicing lease arrangement between Taxpayer-Lessor, as lessor, and ..., as lessee ("the Lessee"), falls outside of Arizona Revised Statutes ("A.R.S.") § 42-5069, the commercial lease classification of Arizona's transaction privilege tax ("TPT").

Statement of Facts:

The following is a restatement of the facts presented in your letters dated September 23, 2002 and October 21, 2002.

Taxpayer-Lessor, a limited partnership that engages in the business of leasing personal and real property, and the Lessee entered into an operating lease dated ... (the "Lease"). Under the terms of the Lease, Taxpayer-Lessor, as lessor, purchases various parcels of real property (including any improvements thereon) located in Arizona (the "Properties" or, individually, a "Property") from one or more third parties and leases the Properties to the Lessee. In the event any further improvements are constructed on the leased Properties, these improvements become property of Taxpayer-Lessor and will accrete to the Lease only by execution of a related lease supplement.

During the term of the Lease (five years with five renewal options of two years each), the Lessee makes rent payments according to a payment schedule that is closely related to the demands of two non-lease transactions. These separate transactions comprise a loan ... (the "Lender") makes to Taxpayer-Lessor (the "Loan") and the placement of commercial paper the Lender, as issuer, offers to third party investors under a private placement memorandum dated ... (the "Notes"). Proceeds from the sale of the Notes provide the Lender with funds that constitute the Loan to Taxpayer-Lessor. ..., a Delaware corporation that is affiliated with the Lessee (the "Guarantor"), guarantees repayment of the Loan and Notes to the extent of the Lessee's obligations under the Lease. The Loan funds provide Taxpayer-Lessor, as borrower, with up to 97% of the amount Taxpayer-Lessor needs to purchase and develop the Properties it intends to lease to the Lessee. Taxpayer-Lessor covers the remaining purchase and development costs with its own equity investment in the Properties. The Lease ensures that rent payments are sufficient to meet interest payments due on the Loan and provide some return on Taxpayer-Lessor's equity investment. The Lender, in turn, depends upon Taxpayer-Lessor's payments on the Loan to meet the majority of its own payment obligations with respect to the Notes.

According to the terms of the Lease, Taxpayer-Lessor is treated as the owner and lessor of the Properties and the Lessee is lessee of the Properties. For federal and state and local income tax purposes, however, the Lease states that the Lessee will be treated as the owner of the Properties and is entitled to all associated tax benefits. The Lessee also bears all risk of loss with respect to the Properties.

At any time during the term of the Lease (subject to some restrictions), the Lessee may exercise a purchase option with respect to any Property. To receive title of the Property, in addition to paying any outstanding rent, the Lessee must pay a purchase price (the "Lessee Purchase Price") equal to the following amount: the sum of the balance of unpaid principal, interest, and other obligations under the Loan (which amount will equal the unpaid interest and principal due on the Notes) and Taxpayer-Lessor's remaining equity investment multiplied by a fraction, the numerator of which is Taxpayer-Lessor's purchase price and cost of improvements made with respect to the particular Property or Properties and the denominator of which is the aggregate purchase prices and improvement costs Taxpayer-Lessor paid with respect to all the Properties.

At the end of the initial term or a renewal term, the Lessee has the option to purchase all the Properties from Taxpayer-Lessor or to attempt to remarket all the Properties on behalf of Taxpayer-Lessor. If exercising the purchase option, the Lessee pays the Lessee Purchase Price detailed above. [\[FN1\]](#) If exercising the remarketing option, the Lessee transfers all proceeds of the sales to Taxpayer-Lessor together with an amount equal to 84% of the Lessee Purchase Price. The total remarketing-related amount the Lessee transfers to Taxpayer-Lessor, however, is capped at the Lessee Purchase Price. At the end of a term, if the Lessee fails to renew for another term or to exercise either end-of-term option, the Lease deems the Lessee to have exercised the all-Property purchase option. If the Lessee chooses the remarketing option and no buyer is found for a Property, the Lessee may elect to purchase such Property or to return it to Taxpayer-Lessor (subject to certain conditions, including Lessee's payment of an amount equal to 84% of the Lessee Purchase Price).

Under the terms of the Lease, Taxpayer-Lessor has the right to inspect the Properties. The Lease also outlines various events of default that will cause possession of the Properties to revert to Taxpayer-Lessor. These default events include the Lessee's failure to pay rent, the Lessee's failure to maintain insurance, Lessee or Guarantor bankruptcy, and adverse judgments in excess of certain amount against the Lessee or the Guarantor. Under the terms of the Lease, upon an event of default, Taxpayer-Lessor has the right to rescind the Lease, retake possession of the Properties, and/or sell the Properties free and clear of any rights of the Lessee. Additionally, certain terms of the Lease restrict the Lessee's rights with respect to the Properties. These limitations include anti-waste provisions, restrictions on structure modification, and a statement that title in any modifications by the Lessee immediately vests in Taxpayer-Lessor. The Lease also names specific remedies that Taxpayer-Lessor may obtain, together with other common law breach-of-contract remedies, in the event the Lessee violates the terms of the Lease.

Issue:

Are the gross proceeds from the Lease subject to TPT under the commercial lease classification?

Your Position:

It is your position that the Lease constitutes a "synthetic lease" financing agreement, not an A.R.S. § 42-5069 commercial lease. Viewed together with the Loan and Notes transactions it ultimately services, the Lease is a mortgage-type of arrangement that does not fall under any specifically recognized TPT classification. You have concluded that the financing agreement character of the Lease renders Taxpayer-Lessor a party to a non-taxable financing agreement, not a lessor of real property for commercial purposes. Accordingly, Taxpayer-Lessor is not subject to TPT.

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Conclusion and Ruling:

On the basis of the information provided, the Lease does not in substance constitute a lease of real property for commercial purposes as contemplated by A.R.S. § 42-5069. While Taxpayer-Lessor is in the business of leasing and holds legal title to the Properties, the Lease in combination with the Lessee-parent guaranteed Loan creates a nontaxable financing arrangement.

The following ruling is given based on the facts presented in your request.

The Department rules that proceeds from the lease dated June 25, 1996 between the Taxpayer-Lessor and the Lessee are not subject to Arizona Transaction Privilege Tax under the commercial lease classification.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your letters dated September 23, 2002 and October 21, 2002.

[\[FN1\]](#) At this point, because all the Properties are involved, the Lessee Purchase Price equals the balance of all unpaid principal, interest, and other demands of the Loan plus the remainder

of Taxpayer's equity investment.

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

The determinations in this private taxpayer ruling are applicable only to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.