

PRIVATE TAXPAYER RULING LR96-012

December 5, 1996

The following private taxpayer ruling is provided in response to your letter dated September 9, 1996, 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 the original request for a private taxpayer ruling dated May 30, 1995.

Statement of Facts:

... ("Taxpayer") is a leasing company with headquarters located at Taxpayer's customer owns tangible personal property located in Arizona. The tangible personal property consists of motor vehicles, manufacturing equipment, furniture, store fixtures, office equipment, machine tools, food and beverage processing equipment, aircraft and miscellaneous business equipment.

As owner of the property, customer depreciated the items for financial reporting and federal income tax purposes. Customer paid the applicable sales or use tax resulting from the acquisition of the property.

Taxpayer plans to enter into a transaction with customer in which taxpayer will refinance the debt associated with the tangible personal property. In order to satisfy financial reporting requirements, the customer will sell the property to the taxpayer pursuant to a bill of sale. The bill of sale expressly states that the transaction is intended to provide the taxpayer with a security interest in the property and that customer retains legal title to the property. Additionally, the customer will continue to take a depreciation deduction for income tax purposes. Where the property in the transaction involves motor vehicles, the customer will remain the owner on the title and taxpayer will be listed as lien holder. Taxpayer will file a security instrument pursuant to the provisions of Article 9 of the Uniform Commercial Code.

Following the initial transaction, the taxpayer will lease the property back to the customer. The lease payments will correspond to a principal and interest amortization schedule. Customer will have the option of extending the lease for an additional period of time at an amount established at the beginning of the lease.

At the conclusion of the lease, customer may purchase the property at a price determined at the commencement of the lease. The predetermined purchase price will be a reasonable

estimate of the fair market value of the property. Since the price is based on an estimate of the fair market value and is determined at the commencement of the lease, the actual fair market value at the time of sale may differ from the predetermined price. If the customer elects not to purchase the property, the property will be sold to a third party by the taxpayer and the customer. If the price received from the sale is greater than the price at which the customer could have paid by exercising its purchase option, customer will receive the excess. If the amount received from the sale is less than the option purchase price, the customer is required to pay a portion of the difference.

In the event of a voluntary or involuntary termination of the lease during the term of the lease, customer is obligated to pay any accrued and unpaid rent, late charges and interest, plus the termination value as provided by the lease.

Your Position:

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

The transaction should be considered financing since the lessee retains title and bears all risk of loss. In addition, the transaction is a lease intended as security interest for commercial law purposes and a financing for federal income tax purposes.

Applicable Statutory Provisions:

A.R.S. § 42-1310.01 imposes the transaction privilege tax on the business of selling tangible personal property at retail. A.R.S. § 42-1310.01.P.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. § 42-1310.11 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:

Transaction privilege tax is imposed on the business of leasing or renting tangible personal property for a consideration. The fact that an agreement is called a lease is not sufficient to determine 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 is not determinative of the application of Arizona's transaction privilege tax to the transaction.

Whether an individual agreement represents a lease or a financing agreement is determined by the facts and circumstances of each case. The factors which are examined to make such a determination are: which party holds title to the property; whether the risk of loss of the property is borne by the lessor or the lessee; 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, that the lessor bears the risk of loss of the property, and requires the exercise of a 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 ownership of the property is vested in the lessee, where the lessee bears all risk of loss, where the lessor's only interest in the property is a security interest, and where ownership in the property is vested in the lessee at the end of the lease term without the exercise of an option may be considered to be a financing agreement.

An agreement which has the characteristics of a financing agreement, even if termed a lease, is not considered to be a lease for the purposes of the imposition of transaction privilege tax on the income derived under the agreement.

The agreement between taxpayer and customer provides that customer shall bear all risk of loss to the equipment which is the subject of the agreement. However, the agreement requires the exercise of an option in order to purchase the equipment at the end of the lease term. (Paragraphs XVIII and XIX.)

On the first termination date, lessee may either renew the lease, terminate the agreement, purchase the equipment at a price equal to fair market value or have the equipment sold to a third party. If customer has not elected any of these options, lessee must provide lessor with a detailed inventory of the equipment and return the equipment to the lessor. Until customer complies with these requirements, the terms of the agreement continue in effect on a month to month basis. During this time, taxpayer may terminate the extended leasehold on ten days notice to customer. At the end of the renewal term, customer shall purchase all equipment that is the subject of the lease for \$1.00.

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 a lease of tangible personal property. As such, the payments under the lease are 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 letters dated May 30, 1995, and September 3, 1996, 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 and is valid for a period of four years from date of issuance except as set out herein. 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.