

ARIZONA TRANSACTION PRIVILEGE TAX RULING

TPR 03-7

This substantive policy statement is advisory only. A substantive policy statement does not include internal procedural documents that only affect the internal procedures of the agency and does not impose additional requirements or penalties on regulated parties or include confidential information or rules made in accordance with the Arizona administrative procedure act. If you believe that this substantive policy statement does impose additional requirements or penalties on regulated parties you may petition the agency under Arizona Revised Statutes § 41-1033 for a review of the statement.

ISSUE:

The imposition of transaction privilege tax on the business of leasing automobiles on a long-term basis.

APPLICABLE LAW:

Arizona Revised Statutes (A.R.S.) § 42-5001(6) states, in part, that "gross income" and "gross proceeds of sales" do not include the value of merchandise traded in on the purchase of new merchandise when the trade-in allowance is deducted from the sales price of the new merchandise before completion of the sale.

A.R.S. § 42-5001(7) states:

"Gross receipts" means the total amount of the sale, lease or rental price, as the case may be, of the retail sales of retailers, including any services that are a part of the sales, valued in money, whether received in money or otherwise, including all receipts, cash, credits and property of every kind or nature, and any amount for which credit is allowed by the seller to the purchaser without any deduction from the amount on account of the cost of the property sold, materials used, labor or service performed, interest paid, losses or any other expense. Gross receipts do not include cash discounts allowed and taken nor the sale price of property returned by customers if the full sale price is refunded either in cash or by credit.

A.R.S. § 42-5001(13) states, in part, that the term "sale" includes lease or rental.

A.R.S. § 42-5061 imposes the transaction privilege tax on the business of selling tangible personal property at retail. The tax base is the gross proceeds of sales or gross income derived from the business.

A.R.S. § 42-5071 imposes 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 gross income derived from the business.

A.R.S. § 42-5071(B)(1) provides a deduction from the tax base for reimbursements by the lessee to the lessor of a motor vehicle for payments by the lessor of vehicle title and registration fees, license plate fees, and vehicle license tax, if such amounts are separately identified as such fees and tax and are billed to the lessee.

Arizona Administrative Code (A.A.C.) R15-5-1512 states:

- A. A lessor's gross income from the leasing of tangible personal property that includes an option to purchase the tangible personal property is taxable under the personal property rental classification until the lessee exercises the purchase option.
- B. Gross income received after the lessee exercises the purchase option is taxable under the retail classification.

A.A.C. R15-5-2002 states, in part:

The transaction privilege tax is imposed directly on the person engaging in a taxable business within Arizona.

DISCUSSION:

Unless a specific exemption applies, a person engaged in the business of leasing automobiles ("automobile lessor") to a customer on a long-term basis ("lessee") is subject to tax on the gross receipts derived from the business. Nevertheless, the tax base does not include reimbursements by the lessee to the automobile lessor for payments by the automobile lessor of vehicle title and registration fees, license plate fees, and vehicle license tax, if these amounts are separately identified as such fees and tax and are billed to the lessee.

In addition to making periodic lease payments, a lessee may be required to make a payment at the inception of the lease that is commonly referred to as "capitalized cost reduction" or "cap cost reduction."

"Capitalized cost reduction" is the amount paid by the lessee that reduces the gross capitalized cost. "Gross capitalized cost" means the agreed-upon value of the vehicle and any items that the lessee pays for over the term of the lease, such as service contracts or insurance. The gross capitalized cost less the capitalized cost reduction is the "adjusted capitalized cost." The adjusted capitalized cost is the amount used in calculating the base monthly lease payment. The amount paid as a capitalized cost reduction ultimately reduces the amount to be paid on the periodic lease payments.

The capitalized cost reduction represents income derived by the automobile lessor from engaging in the business of leasing tangible personal property. With the exception of a trade-in, all amounts received by the automobile lessor are subject to tax under the rental classification, including any cash payment, manufacturer's rebate, credit card bonus, or any other item for which credit is given to the lessee. The amount of credit allowed for a vehicle that is traded in on the leased vehicle is not subject to tax.

An automobile lessor normally collects the first month's lease payment at the time of the inception of the lease. This lease payment is taxable under the personal property rental classification.

There may also be additional charges incurred by a lessee at the time of lease termination, such as an early termination fee, excessive mileage charge, or excessive wear and tear charge. The income derived by the automobile lessor from these additional charges is income from the business of leasing tangible personal property and, therefore, is subject to transaction privilege tax under the personal property rental classification.

It is common practice for automobile dealers and other automobile lessors to assign automobile lease contracts to third-party leasing companies. Whether it is the automobile dealer, automobile lessor, or the third-party leasing company that is liable for the transaction privilege tax on the income from the capitalized cost reduction and the subsequent lease payments is determined by the facts in each situation.

If a customer enters into a lease agreement with an automobile dealer or other automobile lessor and thereafter the automobile dealer or automobile lessor sells the vehicle and assigns the lease to a third-party leasing company, the third-party leasing company is liable for the tax accruing after the date of the sale and assignment of the lease. The tax on the subsequent lease stream shall be calculated at the tax rate in effect at the leasing company's business location. "Business location" means the business address appearing on the privilege license under which the leasing company remits tax due on the lease to the department. If the leasing company does not have a business address in Arizona, the business location shall be the lessee's residential or primary business street address. The business location shall not be altered by intermittent use at different locations.

See *Arizona Transaction Privilege Tax Ruling TPR 95-8* for information regarding leases of motor vehicles that have a gross vehicle weight in excess of 12,000 pounds.

Most automobile lease agreements provide a purchase option. If the lessee elects to purchase the vehicle, the amount paid for the vehicle is taxable to the leasing company under the retail classification, at the current state and county tax rate of the purchaser's location.

Note: Cities impose tax under the provisions of the Model City Tax Code and the application of city tax on the capitalized cost reduction and the vehicle sale may differ from the state tax treatment. Please refer to the Model City Tax Code (or the appropriate city) to determine the proper city tax treatment for your particular location.

RULING:

A person engaged in the business of leasing automobiles on a long-term basis is subject to tax on the gross receipts derived from the business. Nevertheless, the tax base does not include reimbursements by the lessee to the automobile lessor for payments made by the automobile lessor for vehicle title and registration fees, license plate fees, and vehicle license tax, if these amounts are separately identified and billed to the lessee.

In addition to the lease payments received, an automobile dealer or automobile lessor is also subject to tax on the amount received for the capitalized cost reduction and additional lease termination charges. With the exception of a trade-in, the taxable capitalized cost reduction includes any cash payment, manufacturer's rebate, credit card bonus, or any other item for which credit is given to the lessee. The amount of credit allowed for a vehicle that was traded in on the leased vehicle is not subject to tax. Lease termination charges may include, but are not limited to, an early termination fee, excessive mileage charge, or excessive wear and tear charge.

If a lessee enters into a lease agreement with an automobile dealer or automobile lessor and thereafter the automobile dealer or automobile lessor sells the vehicle and assigns the lease to a third-party leasing company, the leasing company is liable for the tax accruing after the date of the sale and assignment of the lease, at the state and county tax rate in effect at the leasing company's business location. "Business location" means the business address appearing on the privilege license under which the leasing company remits tax due on the lease to the department. If the leasing company does not have a business address in Arizona, the business location shall be the lessee's residential or primary business street address. The business location shall not be altered by intermittent use at different locations.

Example:

A customer enters into a motor vehicle lease agreement with an automobile dealer ("Auto Dealer"). The lease agreement names Auto Dealer as the lessor but states that the lease agreement will be assigned to a third-party leasing company ("Leasing Co."). The customer writes a check to Auto Dealer to pay for: (1) capitalized cost reduction, (2) title, registration and license fees, and (3) first monthly lease payment.

Auto Dealer is subject to tax under the personal property rental classification on the amounts received for the capitalized cost reduction and the first-month lease payment. Leasing Co. is subject to tax under the personal property rental classification on all subsequent lease payments and any lease termination charges.

If a lessee exercises an option to purchase the vehicle, the amount paid for the vehicle is taxable to the leasing company under the retail classification, at the current state and county tax rate of the purchaser's location.

J. Elliott Hibbs, Director
Signed: May 22, 2003

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.