STATE OF ALABAMA, DEPARTMENT OF REVENUE, vs. KERSHAW MANUFACTURING CO., INC. P. O. Drawer 17340 Montgomery, AL 36117-0340, Taxpayer.	§ § § § § § § §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION DOCKET NO.S. 93-302

FINAL ORDER

The Revenue Department assessed Kershaw Manufacturing Company, Inc. ("Taxpayer") for use tax for the period April 1, 1989 through April 30, 1992, and for sales tax for the period May 1, 1989 through April 30, 1992. The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on January 25, 1994. Buck Counts and Jeff Davis appeared for the Taxpayer. Assistant counsel Jeff Patterson represented the Department.

The Taxpayer manufactured three brushcutter machines to specifications as requested by Burlington Northern Railroad Company ("Burlington Northern"). The issue in dispute is whether the Taxpayer subsequently leased or sold the machines to Burlington Northern. If the machines were leased, then the Taxpayer is liable for the sales tax in issue under the sales tax "withdrawal" provision found at Code of Ala. 1975, §40-23-1(a)(10). If the machines were sold, then Alabama sales tax is not owed because the sales occurred outside of Alabama.

A second issue is whether the Department properly assessed the failure to timely pay penalty levied at Code of Ala. 1975, §40-2A-11(b). The penalty makes up all of the use tax assessment in issue, and is also included in the sales tax assessment.

The Taxpayer is located in Alabama and is engaged in the business of manufacturing and then either selling or leasing various types of railroad maintenance equipment.

The Taxpayer entered into an "Equipment Lease" on February 26, 1990 whereby the Taxpayer agreed to manufacture three brushcutter machines and then lease the machines to Burlington Northern. The lease was for a period of 11 months, beginning on the month following delivery of the machines to Burlington Northern. Title to the machines remained exclusively with the Taxpayer during the lease term. The parties also agreed that the lease agreement constituted the entire agreement of the parties and could only be amended in writing.

The Department argues that the transaction was a lease, and that sales tax accrued under the sales tax withdrawal provision when the Taxpayer withdrew the machines from inventory in Alabama.

The Taxpayer argues that the transaction, although designated a lease, was in fact a conditional sales agreement. If the transaction was a sale, then Alabama sales tax is not due because the sale occurred upon delivery of the machines outside of Alabama.

The Taxpayer explains that the transaction was structured as a lease only because Burlington Northern did not have sufficient money in its capital budget to purchase the machines outright. The Taxpayer argues that the parties at all times intended and understood that Burlington Northern would eventually purchase the machines from the Taxpayer.

The Taxpayer provided a daily sales report relating to the transaction dated February 16, 1990. The report states in part as follows:

> This conversation was to complete details of the lease of three brushcutters to B. N. Originally we quoted this with very favorable prices over a three year period. However, their financial department will not allow them to lease for over an 11 month period.
>
> As no money was budgeted in 1990 for these machines, several changes had to be made. First, we reached a selling price of the units at $173,980 each, for a total of $521,940 for the three machines. We agreed we would lease the machines to B. N. for $26,097 per month and apply 100% toward the purchase at any time they decide to purchase.
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> The terms and length can be in a written lease but any mention of a purchase cannot and be ethical. Thus, several verbal agreements were made as to the amount of the lease we would credit toward the purchase and their plans to purchase. It was also agreed the lease payments would stop if the machines were down and we could not ship parts within a 24 hour period, and the payments would resume on receipt of the parts.

The Taxpayer also submitted a memorandum dated August 26, 1991. That memorandum verifies that Burlington Northern had requested the Taxpayer to notify it when the balance owed reached

$250,000, at which time Burlington Northern would purchase the machines in question.[1]

This case turns on whether the transaction in issue was a sale or a lease. In my opinion it was a lease.

The written agreement between the parties constituted a lease transaction in both form and substance. Title to the machines remained exclusively with the Taxpayer and the agreement did not include an option to purchase. The parties had verbally agreed and understood that Burlington Northern had the option to purchase the machines at any time during the lease term. However, Burlington Northern was not obligated to purchase the machines, and until the option to purchase was actually exercised, the transaction clearly remained a lease.

The third paragraph of the February 16, 1990 sales report quoted above states that the parties agreed that the lease payments would stop if the machines were down and repair parts were not

[1] The August 26, 1991 memorandum is included in the administrative record, but was not formerly introduced at the administrative hearing and therefore does not have an exhibit number.

provided within 24 hours. That provision confirms that Burlington Northern was leasing the use of the machines, not purchasing them. If the transaction had been a sale, Burlington Northern would certainly have continued making the scheduled payments even when the machines were not working.

An earlier Alabama Supreme Court case involving the Taxpayer is directly on point. In State v. Kershaw Manufacturing Company, 137 So.2d 740, the Supreme Court held that numerous equipment lease agreements between Kershaw and various railroads, some of which included options to purchase, were leases, not conditional sales contracts. The Court concluded in Kershaw as follows, which is equally applicable in this case:

> It appears clear that the agreements involved in this case were leases, which did not place upon the lessee the obligation to pay the full purchase price. Machines would be returned at the expiration of the term, or the lessee could elect or exercise the purchase option. It is clear that title to the property did not pass with the execution of the agreements, but at all times remained in the taxpayer until the purchase option was exercised. Such is a characteristic of a lease.

The withdrawal of the machines from inventory in Alabama also constituted a taxable transaction in Alabama pursuant to the sales tax withdrawal provision. Code of Ala. 1975, §40-23-1(a)(10). The withdrawal provision provides that a "retail sale" shall include the withdrawal from inventory of property previously purchased at wholesale for personal and private use or consumption.

The Taxpayer in this case purchased the materials used to manufacture the three brushcutter machines at wholesale. The subsequent leasing of the machines to Burlington Northern constituted a personal and private use of the machines by the Taxpayer, and sales tax accrued when the machines were withdrawn from the Taxpayer's inventory in Alabama for subsequent leasing. See generally, Home Tile and Equip. Co. v. State, 362 So.2d 236.

The Supreme Court explained the applicability of the withdrawal provision in the earlier Kershaw case, as follows:

> The taxpayer has, instead of selling the manufactured product, leased the same for profit. It is true that the taxpayer is in the business of manufacturing these machines for sale. But, more accurately, we think, he is in the business of manufacturing machines for profit. If the profit is a result of sale, he is under an obligation to collect sales tax, assuming the sale is not otherwise exempt from tax. It is the transaction itself which is taxable. If, on the other hand, instead of selling the machines for profit, the appellee leases them, then it is our view that the transaction amounts to a "withdrawal" for the use and benefit of the taxpayer, and as such the transaction is taxable. It is just this kind of transaction, as we see it, which Section 752, Title 51, sub.(j) was enacted to reach. State v. Helburn Company, supra.

The Taxpayer also argues that the delinquent penalties in issue should be waived because the Department waived the penalties under similar circumstances in prior audits. The Department is authorized to waive any penalty for cause. Code of Ala. 1975, §40-2A-11(h). However, the Taxpayer in this case admits that it underpaid its tax liability with the intention of remitting the

balance upon audit by the Department. The Department also submitted a memorandum dated March 31, 1992 indicating that the Taxpayer's strategy was to pay one-half of its estimated liability each month and thereby delay audit by the Department.

The Taxpayer's representatives discount the memorandum and argue that the strategy set out therein was never followed. However, the disputed memorandum aside, the Taxpayer concedes that it intentionally underpaid its sales and use tax liabilities during the audit period. The fact that the Department had waived the delinquent penalties in prior audits does not obligate the Department to do so in this case. The discretion to waive a penalty is with the Department. Accordingly, the Department's decision not to waive the penalties must be upheld.

The above considered, the sales and use tax assessments in issue are upheld. Judgment is entered against the Taxpayer for State sales tax in the amount of $14,869.10, and State use tax in the amount of $434.20. Additional interest is owed from the date of entry of the final assessments, August 31, 1993.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered on May 3, 1994.

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BILL THOMPSON
Chief Administrative Law Judge