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| CITICAPITAL COMMERCIAL LEASING CORPORATION<br>8201 RIDGEPOINT DRIVE<br>IRVING, TX 75063, | § | STATE OF ALABAMA<br>DEPARTMENT OF REVENUE<br>ADMINISTRATIVE LAW DIVISION |
| Taxpayer, | § | DOCKET NO. S. 05-741 |
| v. | § | |
| STATE OF ALABAMA<br>DEPARTMENT OF REVENUE. | § | |

**OPINION AND PRELIMINARY ORDER**

The Revenue Department assessed Citicapital Commercial Leasing Corporation ("Taxpayer") for State sales tax and State and city/county rental tax for March 1997 through January 2003. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on May 23, 2006. Bruce Ely and Matt Houser represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

**ISSUES**

(1) The primary issue is whether a transaction between the Taxpayer and one of its customers during the subject period constituted a taxable sale or lease of tangible personal property, as argued by the Department, or a nontaxable financing arrangement, as contended by the Taxpayer.

(2) A second issue is whether the Taxpayer underreported its liabilities by more than 25 percent in the subject months. If so, the six year statute of limitations for assessing tax at Code of Ala. 1975, §40-2A-7(b)(2)b. applies. If not, the general three year statute at Code of Ala. 1975, §40-2A-7(b)(2) applies.

(3) A third issue is whether a portion of the interest that has accrued on the liabilities should be abated because of undue delay by the Department. See, Code of Ala. 1975, §40-2A-4(b)(1)c.

## FACTS

The Taxpayer leased and financed commercial equipment in Alabama during the months in issue. The Taxpayer did not, however, maintain a place of business or an inventory of goods in Alabama. Rather, it maintained relationships with various Alabama vendors through which if offered financing options to the vendors' customers. If the customer and the Taxpayer agreed on terms, the Taxpayer would pay the vendor the full purchase price for the equipment, including sales tax. The customer would then make fixed monthly payments to the Taxpayer over a given period. A Taxpayer witness explained at the May 23 hearing, as follows:

> A. The relationship that we have would be with a dealer. So the customer went to the dealer first for the equipment that he wanted, identified the cost and decided that he – he could have leased it or he could have financed it. You have that option. And our relationship is with the dealer. He decided to finance it, and that's when we step in and we send a check for the cost of the equipment to the dealer. The dealer gets the equipment – or the customer gets the equipment.
>
> Q. And then the customer pays - -
>
> A. The customer pays us for the principal and interest on a monthly basis.
>
> Q. And you indicated earlier that – on one of the earlier pages that the tax was paid by the vendor. And so when you paid the vendor, that price would have included the sales tax?
>
> A. That's right.

(T. at 20 – 21.)

The Department audited the Taxpayer for State sales tax and State and local rental tax for the months in issue. It computed the Taxpayer's liabilities using a single test month – January 2002.[1] The error rate for that month was then projected over the entire audit period.

The Department examiner determined that the Taxpayer had failed to pay rental tax on 32 taxable leases during the test month. She also determined that one of the 32 transactions was subject to sales tax. She further concluded that the Taxpayer had underreported both sales and rental tax by more than 25 percent. She consequently assessed the Taxpayer for the 70 months in issue based on the six year statute of limitations at §40-2A-7(b)(2)b.

The Department entered preliminary assessments against the Taxpayer on April 21, 2003. The Taxpayer timely petitioned for a review of the preliminary assessments, as allowed at Code of Ala. 1975, §40-2A-7(b)(4)a. The Department failed to conduct an informal conference or otherwise respond to the petition, and instead entered the final assessments in issue on May 31, 2005.

The Taxpayer conceded at the May 23 hearing that 20 of the 32 transactions in issue were true leases subject to rental tax. The Department also conceded that 11 of the transactions were nontaxable financing agreements.[2] Consequently, only one transaction

[1] The examiner indicated in her audit report that she used a single test month "[i]n order to save time for the Department as well as the Taxpayer. . ." There is no evidence that the Taxpayer objected during the audit to the use of a single test month.

[2] According to the Taxpayer's Brief at 1,2, the taxable leases include all 9 leases on the audit rental Schedule RNTLTES1, and lease numbers 3, 4, 9, 11, 12, 14, 17 – 20, and 22 on Schedule RNTLTES2. The nontaxable financing transactions are identified in the Taxpayer's Notice of Appeal and the Department's Answer and Amended Answer.

is still disputed. The Department examiner included that transaction in both the sales tax and rental tax audits. The transaction is, in fact, the sole basis for the sales tax final assessment in issue. The Department now concedes that the transaction was subject to either sales tax or rental tax, but not both.

The disputed transaction is an "Equipment Lease" (the "agreement") entered into in January 1998 by the Taxpayer and Timothy Johnson, d/b/a/ Ranburne Steel Fabrication. The equipment involved was a vertical machining center, with various attachments. The equipment was purchased from Cardinal Machinery, Inc. Pursuant to the agreement, the Taxpayer paid Cardinal the purchase price of $93,732.90 for the equipment, which included sales tax. Cardinal then shipped the equipment directly to Johnson.

The agreement required Johnson to pay the Taxpayer $2,034.35 per month for 60 months, with a final payment of $1. Johnson also paid the property tax and maintained insurance on the equipment during the 60 month period. Johnson retained possession and title to the equipment after the agreement expired.

The Taxpayer perfected a security interest in the equipment by filing Form UCC-1 with the Alabama Secretary of State's Office. The Taxpayer also treated the agreement as a financing arrangement for income tax purposes, and thus did not depreciate the equipment on its federal and Alabama income tax returns.

During the audit test month of January 2002, Johnson made two monthly payments of $2,034.35, one on January 8 for the December 2001 payment due, and another on January 22 representing the January 2002 payment. He also remitted a late fee of $223.78 with the January 22 payment. The Department examiner included all three payments in the

rental tax audit.[3] She also included the entire purchase price of $93,732.90 in the sales tax audit as a taxable sale. When projected over each month in the audit period, that one transaction resulted in sales tax due of $99,825.29. As indicated, that transaction is the only "sale" included in the sales tax audit.

## ANALYSIS

**Issue (1). Was the transaction a taxable sale or lease or a nontaxable financing arrangement?**

The Department contends that the transaction in issue was either a sale subject to sales tax or a lease subject to rental tax. The Taxpayer argues that it was a nontaxable financing arrangement. I agree with the Taxpayer.

The Department previously addressed an almost identical fact scenario in Revenue Ruling 03-002. In that Ruling, a corporation and a customer entered into a lease agreement that required the corporation to pay a third party vendor for certain equipment, including the applicable sales tax. The vendor then delivered the equipment to the customer. The customer was required to pay the corporation in monthly installments, and then purchase the equipment for one dollar at the end of the lease term.

The customer maintained insurance, paid property tax, and depreciated the equipment on its income tax returns. The customer also retained possession and ownership of the equipment after the lease term expired. The corporation held a security interest in the equipment during the lease term.

[3] The examiner included the total as $4,276.51, not the correct amount of $4,292.48. It is assumed that the discrepancy is due to a math error.

The Department concluded that the above transaction constituted a nontaxable financing arrangement. The Ruling reads in pertinent part:

**ANALYSIS OF ALABAMA LAW**

Tax Liability

Alabama legal authorities have recognized that (1) the substance of a transaction, and not its form, governs the appropriate Alabama tax treatment of the transaction, (2) conditional sales contracts, such as the one entered into between Corporation "A" and Customer, are, in substance, loans secured by the leased property and (3) in such circumstances, the lessee, such as the Customer, is the actual owner of the leased property for all Alabama tax purposes.

* * *

The Alabama Supreme Court has ruled that under certain circumstances, leases are, in substance, lending transactions and that the customer is the owner of the equipment. In Ex Parte Thompson Tractor Company, Inc., 432 So.2d 497 (Ala. 1983), the taxpayer, a heavy equipment dealer, sold equipment pursuant to a lease agreement under which all lease payments were applied to the sales price for the equipment and once the lease payments totaled the sales price, plus a five percent (5%) finance charge, title was transferred to the customer. The State sought to assess sales tax on the portion of the lease payments representing the finance charge (interest). The Court held that the lease was a financing transaction and that sales tax could not be assessed on the interest portion of the lease payments. In so holding, the Court noted that both the taxpayer and its customer treated the transaction as a sale with financing rather than a rental of the equipment, and that the customer depreciated the equipment for income tax purposes and took a deduction for the amount of the finance charges. Id. at 499. The Court also noted other provisions of Alabama law which recognize a conditional sale as a financing transaction by holding that "the fact that the agreement which governed the transaction was entitled 'lease' instead of 'installment sales contract' should not affect the substantive rights of the parties." In particular, the Court found such treatment consistent with both the Uniform Commercial Code and the Alabama Consumer Credit Statute. Id. at 500.

The above cases have all been cited approvingly by the Department in rulings that hold that similar arrangements, also labeled "leases," were, in substance, secured lending transactions. In Revenue Ruling 95-007, the Department, using the substance over form analysis, held that a sales-

leaseback transaction was actually a loan for Alabama sales, use and lease tax purposes. In Revenue Ruling 95-007, a financing party obtained title to property by transferring funds to a customer. Without any transfer of possession, the parties simultaneously entered into a lease under which the customer "bears all risk of loss with respect to the Property." Payments under the lease corresponded to a principal and interest amortization table for a loan in the amount of the cash transferred. The parties treated the transaction as a loan for federal income tax purposes, with payments treated as part principal and part interest and with the customer entitled to depreciation deductions as the owner of the property.

Revenue ruling 97-001 agreed with the analysis of Revenue Ruling 95-007 in holding another sale-leaseback transaction to be a loan for Alabama tax purposes.

Both of the above Revenue Rulings recognize that the transfer of bare legal title, without the benefits and burdens of true ownership, did not constitute a true transfer of ownership of the property. Rather, the holding of legal title was evidence of a security interest in the relevant property.

The conditional sales contracts between Corporation "A" and Customer presents a stronger argument for lending treatment than in the cases and rulings cited above. Corporation "A" and Customer treat the transaction as a loan to Customer with which it purchases equipment from the vendor. Evidence of treating the transaction as a loan includes: (1) both Corporation "A" and Customer treat Customer as the property owner for federal and state income tax purposes (with the Customer taking depreciation deductions); (2) sales tax is either charged to Customer by the Equipment vendor or use tax is self-assessed and paid by the Customer; (3) Corporation "A" treats payments received as payments of interest and principal on a loan and allocates the interest into its income for tax purposes; and (4) Corporation "A" files a UCC-1 financing statement evidencing its security interest in the property. These facts reflect the reality that all the benefits and burdens of ownership of the Equipment rest with Customer. The nominal purchase option in favor of Customer for $1.00 at the end of the lease term exists only to evidence Corporation "A"'s security interest in the Equipment until repayment of the loan by the Customer.

In the case of Corporation "A" and its Customer, the $1.00 purchase option on Equipment which has an original cost of over $2,300,000 clearly reflects Customer's ownership. No reasonable circumstance could be anticipated in which the Customer would not exercise the option. The economic reality is that the Customer will always exercise the option and keep the Equipment. If Customer no longer needs the Equipment, it could be sold to another person for a profit. Even if the Equipment becomes worthless, purchasing it for

> $1.00 would be cheaper than returning it under the terms of the lease and, in any case, Customer would have had all the benefits of the Equipment for its entire useful life.

**RULING**

> Based upon the particular facts of this case, the contemplated transaction between Corporation "A" and its Customer do not qualify as a sale under Code of Ala. 1975, § 40-23-1, as there is no true transfer of ownership of the property. Furthermore, the transactions would not be subject to the lease tax as Corporation "A" is not "the person who owns or controls the possession of tangible personal property" as stated in Code of Ala. 1975, § 40-12-220(5). At all times, the Customer owns and controls possession of the Equipment subject only to Corporation "A"'s security interest in the Equipment. The substance of these transactions (including the possible reconveyance of the Equipment from Corporation "A" to the Customer upon an event of Termination) is that of a non-taxable financing arrangement or loan, and there is no sales, use or lease tax applicable.

Revenue rulings are binding on only the requesting party. Code of Ala. 1975, §40-2A-5(a). However, the facts in Ruling 03-002 are in substance identical to the facts in this case. The legal analysis in the Ruling is also a correct application of Alabama law. The rationale and ruling in Ruling 03-002 thus apply in this case.

In substance, the transaction in issue was a loan by the Taxpayer to Johnson, with the Taxpayer only having a perfected security interest in the subject equipment. The Taxpayer did not depreciate the equipment, which indicates that it did not own the equipment. Johnson also paid the property taxes on the equipment and had the equipment insured, which further evidences that he owned the equipment, not the Taxpayer. Because the Taxpayer never owned the equipment, it could not have sold or leased it to Johnson. Rather, as in Ruling 03-002, the transaction was a financing

arrangement, and not subject to either Alabama sales tax or rental tax.[4]

The sales tax final assessment is due to be voided. The rental tax final assessments should be recomputed based only on the 20 transactions the Taxpayer concedes were taxable.

**Issue (2). Does the six year statute of limitations apply?**

The Taxpayer argues in its Brief at 15, that if the transactions conceded by the Department to be nontaxable are deleted from the rental tax audits, the underreporting rate falls to 17.86 percent; and that the rate falls to 16.01 percent if the Johnson transaction is also deleted. If the Taxpayer is correct, the six year 25 percent omission statute does not apply, and the Taxpayer is only liable for rental tax for March 2000 forward under the general three year statute.

The Department failed to respond to the Taxpayer's post-hearing brief. Consequently, its position on this issue is not known. The Department should notify the Administrative Law Division of its position by October 2, 2006. The Department should also notify the Administrative Law Division of the adjusted rental tax amounts due applying the three year statute, and if it contends that the six year statute still applies, also the rental tax amounts due under that statute.

**Issue (3). Should a portion of the accrued interest be abated?**

Section 40-2A-4(b)(1)c. allows the Department's Taxpayer Advocate to abate "interest that has accrued because of undue delay by department personnel." The

[4] The Taxpayer also argued that if the transaction was deemed to be a sale, it was a "casual" sale, and thus not subject to sales tax. It also contended that it would be unreasonable to project the sale over the entire audit period. Those arguments are pretermitted by the above holding, and thus will not be addressed.

Department entered preliminary assessments against the Taxpayer on April 21, 2003. The Taxpayer timely petitioned for a review of the preliminary assessments, but the Department never conducted an informal conference or otherwise responded to the petition.[5] Rather, the Department entered the final assessments in issue on May 31, 2005.

There is no evidence explaining the 25 month gap between when the preliminary assessments were entered and when the final assessments were entered. The Department's Taxpayer Advocate should investigate and determine if the time lapse was caused by undue Department delay. If so, the Taxpayer Advocate should also notify the Administrative Law Division as to the amount of interest that should be abated.

A Final Order will be entered, or other appropriate action will be taken, after the Department and the Taxpayer Advocate respond as directed above. This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered September 12, 2006.

_____
BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Margaret Johnson McNeill, Esq.
Bruce P. Ely, Esq.
Matthew Houser, Esq.
Patrick J. Greene
Myra Houser
Joe Cowen
Henry Mixon

[5] If a taxpayer timely files a petition for review, "the department shall schedule a conference with the taxpayer" concerning the preliminary assessment or assessments in issue. Section 40-2A-7(b)(4)a. The Department thus should have scheduled a conference with the Taxpayer, unless the Taxpayer had indicated that it did not want a conference.