U.S. BANCORP EQUIPMENT FINANCE, INC. 13010 SW 68TH PARKWAY PORTLAND, OR 97223-8367,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 06-1276
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed U.S. Bancorp Equipment Finance, Inc. ("Taxpayer") for rental tax for July 2001 through June 2004. 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 March 30, 2007. Robert Walthall represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

ISSUES

The issue in this case is whether contracts between the Taxpayer and one of its customers, Capitol Vial, Inc., during the period in issue constituted true lease transactions, as argued by the Department, or conditional sales, as contended by the Taxpayer.

FACTS

The Taxpayer contracted to provide Capital Vial with special molds and molding machines, drug and dairy testing systems, urine allguot systems, and other specially designed items. Capital Vial used the items to manufacture specialized custom-made vials and containers that are used in drug testing, water sampling, urine collection and transport, and for other specialized functions.

The 29 contracts in issue were designated as leases, and required the Taxpayer to manufacture the equipment in strict accordance with specifications provided by Capital Vial. The agreements required Capital Vial to make 60 monthly payments to the Taxpayer. When the 60 months expired, Capital Vial had the option of returning the equipment to the Taxpayer, or purchasing the equipment for the greater of the fair market value of the equipment or 5 or 10 percent of the original equipment cost.

The Taxpayer depreciated the equipment over a five year life. The equipment had a remaining useful life of less than 15 percent at the end of the contract period, and was not economically or commercially useful to anyone other than Capital Vial. Capital Vial, or an associated company, opted to purchase all of the equipment in issue at the end of the 60 month contract periods.

The Department audited the Taxpayer for rental tax and determined that the 29 agreements constituted true leases because Capital Vial had the option of returning the equipment to the Taxpayer at the end of the contract period, and if Capital Vial opted to purchase the equipment, it was required to pay fair market value instead of a nominal amount. The Taxpayer had also recorded the transactions as leases on its books. The Department accordingly assessed the Taxpayer for the rental tax in issue, plus interest.

ANALYSIS

The Administrative Law Division previously addressed the issue of whether a contract constituted a true lease or a conditional sales agreement in *American Ophthalmic, Inc. v. State of Alabama*, S. 96-253 (Admin. Law Div. 4/22/1997), and *Lease Equipment Company of Maryland, Inc. v. State of Alabama*, S. 06-558 (Admin. Law Div. 2/21/2007).

The issue in *American Ophthalmic*, as in this case, was whether certain agreements were leases or conditional sales. Unlike the Taxpayer in this case, the taxpayer in *American Ophthalmic* argued that the agreements were leases, in which case it would not be liable for the sales tax assessed by the Department. The Administrative Law Division found that the transactions were sales. The Final Order reads in pertinent part as follows:

> The Taxpayer argues that the agreements are leases because (1) the parties intended the transactions to be leases, (2) the Taxpayer retained title to the equipment, and (3) the Taxpayer depreciated the equipment and the equipment would be obsolete at the end of the five-year period due to technical advances.
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> The only authority submitted by the Department in support of its position was *Lawson State Community College v. First Continental Leasing Corp.*, 529 So.2d 926 (Ala. 1988). See, October 24, 1995 letter from Assessment Officer Joe Cowen to the Taxpayer's representative. *Lawson State* is not a tax case, but rather involves whether the transaction in issue was governed by Article 9 of the UCC, which concerns secured transactions. The case turned on whether the transaction was a true lease or a conditional sale secured by a security agreement. The Alabama Supreme Court relied on Code of Ala. 1975, §7-1-201(37) and §7-9-102 in holding:
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> > These sections establish that a "lease" allowing the lessee to purchase at a "nominal consideration" the subject matter of the lease is to be considered a security agreement rather than a true lease. (cites omitted). In the instant case, the right of the College to purchase the equipment for a mere $1.00 at the termination of the lease constitutes an option to purchase at a "nominal consideration," and hence, the arrangement between these two parties is no mere bailment lease, but is instead a disguised conditional sale secured by a security agreement.
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> *Lawson State*, 529 So.2d at 929.
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> Several other states have also addressed the issue. In *Alzfan et al. v. Bowers, Tax Comm'r*, 194 N.E.2d 852 (Ohio 1963), the Ohio Supreme Court held as follows:
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> > Where, as here, a so-called lessee is obligated to accept and pay for personal property at some future time and has no option to return it, the transaction is held to be a conditional sale even though terms commonly used in leases have been

used. As stated in 47 American Jurisprudence, 23, Section 836:

> The test most frequently applied is whether the so-called '"lessee" is obligated to accept and pay for the property at some future time, or, on the other hand, whether his primary obligation is to return or account for the property to the so-called "lessor" according to the terms of the "lease."

Alzfan, 194 N.E.2d at 854.

On the other hand, if the lessee has only the option to purchase, the transaction is in the nature of a lease, not a conditional sale. *Dollar Bank Leasing Corp. v. Limbach*, 1992 Ohio Tax Lexis 1590 (1992).

The difference between a true lease and conditional sale was discussed in Illinois Department of Revenue, Private Letter Ruling No. 96-0074 (1996):

> A true lease generally has no buy out provision at the close of the lease. If a buy out provision does exist, it must be a fair market value buy out option in order to maintain the character of the true lease.
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> * * *
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> A conditional sale is usually characterized by a nominal or one dollar purchase option at the close of the lease term. Stated otherwise, if a lessor is guaranteed at the time of the lease that the leased property will be sold, this transaction is considered to be a conditional sale at the outset of the transaction, thus making all receipts subject (to the Illinois sales tax).

See also, Illinois Private Letter Ruling No. 93-0240 (1993) and 93-0299 (1993).

In this case, the Taxpayer's standard lease agreement provides that when the lease expires, the lessee shall purchase the equipment for one dollar. The purchase is mandatory, not optional, and is for a nominal amount. The transactions thus constituted conditional sales based on the authorities cited above. Substance over form must govern in tax matters. *Brundidge Milling Co. v. State*, 228 So.2d 475 (1969). Consequently, Alabama sales tax is due on the proceeds received by the Taxpayer from the sales. (footnote omitted)

American Ophthalmic at 3 – 5.

The same issue was disputed in *Lease Equipment*. The taxpayer in that case argued that the transactions were conditional sales, in which case it would not be liable for the lease tax assessed by the Department. If the transactions were found to be sales, they would be exempt from sales tax because the taxpayer's customer was an exempt YMCA. The Administrative Law Division found that the transactions were sales.

> The Taxpayer claims that the transactions were not leases, but were instead financing arrangements for the sale of the equipment to the YMCA. It contends that it structured the transactions as leases only so it would receive favorable treatment concerning the leases if it ever declared bankruptcy. It argues that the true intent was to sell the equipment, and that the agreements were not leases because they did not give the YMCA the option of returning the equipment at the end of the lease term.
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> The Department examiner cited *American Ophthalmic, Inc. v. State of Alabama*, S. 96-253 (Admin. Law Div. 4/22/97) in her audit report. The issue in *American Ophthalmic* was whether certain transactions were leases, as argued by the taxpayer, or conditional sales, as contended by the Department. The Administrative Law Division explained that if the "lessee" is required to purchase the goods for a nominal consideration and has no option to return the goods, the transaction is a conditional sale, not a lease.
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> > Where, as here, a so-called lessee is obligated to accept and pay for personal property at some future time and has no option to return it, the transaction is held to be a conditional sale even though terms commonly used in leases have been used. As stated in 47 American Jurisprudence, 23, Section 836:
> >
> > > The test most frequently applied is whether the so-called '"lessee" is obligated to accept and pay for the property at some future time, or, on the other hand, whether his primary obligation is to return or account for the property to the so-called "lessor" according to the terms of the "lease."
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> *American Ophthalmic* at 4, quoting *Alzfan et al. v. Bowers, Tax Comm'r*, 194 N.E.2d 852 (Ohio 1963).
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> The Alabama Supreme Court also addressed the issue in *State v. Kershaw Mfg. Co.*, 137 So.2d 740 (Ala. 1962):

> The (taxpayer) argues that the lease agreements which contained options to purchase are conditional sales within the meaning of the sales tax statute. One of the distinguishing features between a conditional sale and a lease is whether or not the lessee is obligated in all events to pay the total purchase price of the subject of the contract. If return of the property is required or permitted the instrument is a lease; but if on the other hand the so-called lessee is absolutely obligated to pay the purchase price, even though such a price is designated as rental or hire, the contract is one of sale.

Kershaw Mfg., 137 So.2d at 217.

The agreements in issue allowed the YMCA the option of purchasing the equipment for fair market value, and not for a nominal consideration. The agreements also contained a paragraph concerning the YMCA's surrender of the equipment back to the Taxpayer. Taxpayer Ex. 1, ¶14. Those provisions on their face support the Department's claim that the agreements were leases. Various other facts, however, indicate that the transactions were financing sales agreements.

The Department's position is based on its finding that the YMCA was not obligated to accept and pay for the equipment at some later date. I disagree. Addendum A to the agreements specified that when or before the original lease term expires, "the (Taxpayer) hereby grants and the (YMCA) hereby agrees to exercise one of the" two options listed. A third option (allowing the YMCA to upgrade the equipment) was later agreed to by the parties. The YMCA was required to exercise one of the options, and thus required to eventually buy the equipment in all cases. The only time the YMCA could return the equipment to the Taxpayer was as a trade-in for new, upgraded equipment. The fact that the YMCA could not otherwise return the equipment to the Taxpayer indicates that the transactions were financing sales agreements, not true leases.

* * *

As stated in *Kershaw Mfg.*, 137 So.2d at 217 – "If the return of the property is required or permitted the instrument is a lease; but if on the other hand the so-called lessee is absolutely obligated to pay the purchase price, even though such a price is designated as rental or hire, the contract is one for sale." The agreements in issue are designated as leases, but a close reading of the agreements shows that the YMCA was obligated at some point to purchase and own the equipment. That is, it did not have the option of returning the equipment (other than in exchange for newer equipment), which shows that the transactions were not true leases.

Lease Equipment at 2 – 5.

The Taxpayer in this case argues that substance over form must govern, and that in substance the agreements were sales contracts. The Taxpayer points to the fact that in all cases, Capital Vial opted to purchase the equipment, which, according to the Taxpayer, indicates an intent to purchase the equipment, not lease it.

I agree that substance over form must govern. Consequently, the fact that the contracts are designated as leases is not controlling. Rather, the substantive language of the contracts must control.

As indicated in the above quoted cases, the primary distinction between a sales agreement and a lease agreement is that "[i]f the return of the property is required or permitted the instrument is a lease; . . . ." *Kershaw Mfg.*, 137 So.2d at 217. The 29 contracts in issue gave Capital Vial the option of returning the equipment to the Taxpayer at the end of the 60 month period. That indicates that the contracts were leases.

The fact that Capital Vial in all cases elected to purchase the equipment at the end of the contract period is not controlling. Rather, it must be determined at the time an agreement is executed whether it is a lease or a sale. When the agreements in issue were executed, Capital Vial had the option of returning the property after the 60 month period. The agreements were thus leases pursuant to the above case law, and they did not subsequently become conditional sales contracts because Capital Vial later opted to purchase the property at the end of the contract term. The fact that Capital Vial purchased the property for its fair market value, as opposed to a nominal fee, also indicates that the contracts were leases.

The fact that the Taxpayer custom manufactured the items to Capital Vial's specifications, and that the items were of no commercial use to anyone other than Capital Vial, does suggest that Capital Vial intended to keep the items. But by giving Capital Vial the option of returning the items at the end of the contract periods, the parties elected to substantively structure the transactions as leases, not sales. They are bound by that decision.

The final assessment is affirmed. Judgment is entered against the Taxpayer for rental tax of $60,812.52. Additional interest is also due from the date the final assessment was entered, November 27, 2006.

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

Entered December 13, 2007.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Margaret Johnson McNeill, Esq.
Robert C. Walthall, Esq.
Joe Cowen
Mike Emfinger