LEASE EQUIPMENT COMPANY OF MARYLAND, INC. 53 LOVETON CIRCLE, SUITE 100 SPARKS, MO 21152-9201,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 06-558
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

The Revenue Department assessed Lease Equipment Company of Maryland, Inc. ("Taxpayer") for State rental tax for September 2002 through August 2005. 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 September 20, 2007. The Taxpayer's president, Dennis Horner, represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

The Taxpayer is a finance company headquartered in Maryland. It entered into six Lease Agreements (the "agreements") with the Huntsville YMCA during the subject period. The agreements required the Taxpayer to provide the YMCA with fitness machines. The Taxpayer had previously purchased the equipment tax-free outside of Alabama using the YMCA's exemption. The issue is whether the agreements were true leases, as argued by the Department, or sales financing agreements, as contended by the Taxpayer.

The agreements were for 36 months, and required the YMCA to make monthly payments to the Taxpayer. The agreements, and an addendum to the agreements, required the YMCA to exercise one of three options before the lease periods expired. It could purchase the equipment for its current fair market value, not less than 10 percent of

the original cost; it could renew the agreement; or it could upgrade with new equipment, with a new monthly amount due. If the YMCA elected to upgrade with new equipment, the Taxpayer would trade-in the old equipment to the supplier for a credit toward the new equipment.

The Department reviewed the transactions, determined that they were leases, and thus assessed the Taxpayer for the lease tax in issue. The examiner's audit report reads in part:

> I examined the taxpayer's rental agreements and customer rental files to determine the nature of the leases. The lease agreements enumerated the conditions of the lease to include a string of payments to end at a future date. The leases were characterized by a buy out provision to be computed on the fair market value at the end of the lease period. There was no obligation by the lessee to accept and pay for the property at some future time; and the leases provided for the option to upgrade the equipment leased or to renew the current lease. Therefore, the leases were determined to be true leases.

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.

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.

> 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:
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> > 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."

American Ophthalmic at 4, quoting *Alzfan et al. v. Bowers, Tax Comm'r*, 194 N.E.2d 852 (Ohio 1963).

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.

The parties also understood that the agreements were financing agreements, and that the YMCA would in all cases own the equipment. The Taxpayer's president testified that he structured the agreements so that there was a relatively small down payment (a non-refundable deposit), with monthly payments lower than what a customer would be required to pay on a loan from a bank. He explained that he structured the payments, i.e., the non-refundable deposit, the monthly payments, and the balloon payment, to give the Taxpayer a 10 to 15 percent net return. The president of the Huntsville YMCA was present at the September 20 hearing. He did not dispute that the YMCA intended to own the equipment, or that the transactions were financing arrangements.

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.

The final assessment is voided.[1]

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

Entered February 21, 2007.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
cc: Margaret Johnson McNeill, Esq.
Dennis M. Horner
Myra Houser
Joe Cowen

[1] The Taxpayer would have been liable for lease tax if the transactions had been true leases. The Taxpayer is not, however, liable for Alabama sales tax on the sales transactions because the sales tax is on the purchaser, which in this case was the exempt YMCA. See, Code of Ala. 1975, §40-9-10.