

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-94 (14)S
Sales Tax
April 4, 1994

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S931213A

On December 13, 1993 a Petition for Advisory Opinion was received from General Electric Capital Corporation, 260 Long Ridge Road, Stamford, CT 06927.

The issue raised by Petitioner, General Electric Capital Corporation, is whether the transaction hereinafter described, which is a financing transaction for Federal income tax purposes but is structured as a sale leaseback for financial accounting purposes constitutes a security or financing agreement which is not subject to New York State sales or compensating use tax.

Petitioner's customer, hereafter referred to as "Customer", currently has furniture, leasehold improvements and fixtures located in New York City. Customer is the owner of said furniture, leasehold improvements and fixtures for financial reporting and Federal income tax purposes. Customer currently claims depreciation on the furniture, leasehold improvements and fixtures for financial reporting and Federal income tax purposes.

Customer proposes to enter into a transaction with Petitioner whereby Customer will refinance the debt associated with the furniture, leasehold improvements and fixtures in such a manner that both the debt and objects are removed from Customer's financial reporting balance sheet. Customer will remain the owner of the furniture, leasehold improvements and fixtures for Federal income tax purposes.

Customer will sell the furniture, leasehold improvements and fixtures to Petitioner pursuant to a Bill of Sale. The Bill of Sale transfers bare legal title sufficient to satisfy financial reporting requirements. For commercial law purposes Petitioner will not view itself as owner, but as a secured party.

After the transfer, Petitioner will "lease" the furniture, leasehold improvements and fixtures to Customer. However, the "lease" payments will correspond to a principal and interest amortization schedule. At the end of the lease Customer can "purchase" the furniture, leasehold improvements and fixtures for a fixed amount which is not a bargain, but may be below fair market value. If Customer chooses not to "purchase" furniture, leasehold improvements and fixtures, a sale will be made to a third party. Customer will receive all the upside over the fixed purchase amount. Further, Customer will guarantee a portion of the downside residual for Petitioner.

In the event that there is an early termination event, Customer is only responsible for the termination value payment plus all unpaid rentals, fees, taxes and other charges. Any amount received in excess of said termination value and other unpaid amounts will be for the account of the Customer.

In determining whether the "lease" agreement between Petitioner and Customer is a true lease or constitutes a security agreement, the pivotal issue is to ascertain whether Petitioner is acting as a financing agency or as a vendor. The proper method for analyzing the transaction in question is to examine the intent of Petitioner and Customer and facts and circumstances existing at the time of the agreement. Sherwood Diversified Services, Inc., Debtor, 382 F. Supp. 1359 (S.D.N.Y. 1974).

In making this determination, the following factors and applicable sections of the lease agreement between Petitioner and Customer are pertinent:

The first factor is that where a lease is intended as a security device, the lessee usually becomes or has the option to become the owner of the leased equipment.

Section 1-201 (37) of the Uniform Commercial Code provides that "... the inclusion of an option to purchase does not of itself make the lease one intended for security..." However, it also states that "... an agreement that upon compliance with the terms of the lease, the lessee shall become or has the option to become the owner of the property, for no consideration does make the lease one intended for security."

Pursuant to Section XVII of a sample master lease agreement submitted by Petitioner, for income tax purposes, Petitioner will treat Customer as the owner of the Equipment. Petitioner will not claim any tax benefits available to an owner of the Equipment. Lessee grants to Petitioner a first priority security interest in the Equipment, together with all additions, attachments, accessions, accessories and accessions thereto whether or not furnished by the Supplier of the Equipment and any and all substitutions, replacements or exchanges therefor, and any and all insurance and/or other proceeds of the property in and against which a security interest is granted hereunder.

Pursuant to Section XIX of the sample master lease agreement, Customer may exercise an early purchase option to purchase all (but not less than all) of the Equipment listed and described in this schedule on any Rent Payment Date following the First Termination Date as set forth in this Schedule, and prior to the date which is the scheduled expiration of this Lease (the "Early Purchase Date"), for a price equal to (i) the Termination Value (calculated as of the Early Purchase Date) for the Equipment, and (ii) all rent and other sums due and unpaid as of the Purchase Date (the "Early Option Price"), plus all applicable sales taxes on an as is basis, provided Customer gives Petitioner at least 30 days but not more than 270 days prior written notice of Customer's irrevocable election to exercise such option.

This section also provides that if Customer exercises its Early Purchase Option, Customer shall pay Petitioner any rent and other sums due and unpaid and shall pay the Early Option Price, plus all applicable sales taxes, on the Early Purchase Date.

Additionally, Section XX of the agreement provides Customer the option, upon the scheduled expiration of the term of the Lease, to return or purchase all (but not less than all) of the Equipment for the applicable Realized Value. If Customer elects to purchase the equipment, the applicable

Realized Value of each unit will be its Estimated Residual Value. If Customer elects not to purchase any unit(s) of Equipment, Petitioner will sell such units at each unit's determined fair market value. Customer will not be allowed to bid directly or indirectly on the units. In the event the Realized Value of the Equipment is less than the Estimated Residual Value Customer will pay Petitioner an amount equal to the difference between the Realized Value and the Estimated Residual Value. In the event the Realized Value exceeds the Estimated Residual Value, Petitioner shall pay Customer an amount equal to 100% of such excess, but only to the extent Petitioner actually receives the Realized Value in cash.

This section also defines certain terms as follows:

- (i) "Equipment" means all but not less than all units of the Equipment described on the Schedule.
- (ii) "Estimated Residual Value" means 20% of Petitioner's Cost of the Equipment as set forth on the Schedule.
- (iii) "Realized Value" means the net proceeds realized by Petitioner from sale of the Equipment after deduction of expenses of such sale, if any, and all sums due under the Lease as of Schedule Expiration.
- (iv) "Schedule Expiration" means the last day of the scheduled term of the Lease as to the Equipment.

The second factor is that if a lease is intended to be a security device, the lessee often bears the risk of loss or damage to the property. In such a case the lessee would be required to make payments under the lease regardless of loss or damage to the property. The lessee would, however, receive the proceeds of any insurance payment resulting from such loss or damage. If the transaction is a true lease, then the lessor would be expected to receive any insurance proceeds. Similarly, if the property is sold to a third party, the lessee may be entitled to any surplus if the transaction is a sale with retained security interest while the lessor would be so entitled if the transaction is a true lease.

Section VIII of the sample master lease agreement provides that Customer assumes and will bear the entire risk of any loss, theft, damage to, or destruction of, any unit of Equipment from any cause whatsoever from the time the Equipment is shipped to Customer.

Section IX of the sample master lease agreement provides that Customer will keep all Equipment insured for the amounts and against hazards as Petitioner may require. Customer will appoint Petitioner as Customer's attorney-in-fact to receive payment of and execute or endorse all documents, checks or drafts in connection with payments made as a result of such insurance policies. This section also provides that Petitioner may, at Petitioner's option, apply proceeds of insurance, in whole or in part, to repair or replace Equipment or any portion thereof, or to satisfy any obligation of Customer or Petitioner hereunder.

Section XX of the sample master lease agreement provides that where the Equipment is sold to a third party, Customer will be entitled to any surplus from such sale.

The third factor is that the filing of a security instrument by the "lessor" pursuant to the provisions of Article 9 of the Uniform Commercial Code in an attempt to perfect the security interest tends to indicate that the intention of the parties was other than to create a leasehold interest since a true lease creates no interest which could be subject to an Article 9 security interest. However, a lessor may record his interest, even though a true lease is intended, as a means of protecting his claim in the event a court characterizes the transaction as a sale governed by the provisions of Article 9.

Section XVII of the sample master lease agreement provides that Customer grants Petitioner a first priority security interest in the Equipment, together with all additions, attachments, accessions, accessories and accessions thereto whether or not furnished by the Supplier of the Equipment and any and all substitutions, replacements or exchanges therefor, and any and all insurance and/or other proceeds of the property in and against which a security interest is granted hereunder.

The fourth factor is that a requirement, under the terms of the lease, that the lessee has full responsibility to select, order, take delivery, set up, operate and maintain the property is an indication that the transaction is a sale with a retained security interest rather than a lease. The presence of only a single factor (i.e., responsibility for maintenance) is considerably less persuasive. Maintenance of the property by the lessor or establishment of maintenance standards by the lessor to be followed by the lessee tends to indicate a lease rather than a sale with a retained security interest unless there exists a separate maintenance charge or contract. Similarly, restrictions on the lessee's use of the property or the right to sublease or assign tend to indicate a true lease.

Section V of the sample master lease agreement provides that all Equipment shall be shipped directly from the Supplier to Customer.

Section VI of the sample master lease agreement provides that Customer, at its sole expense, will maintain each unit of Equipment in good operating order, repair, condition and appearance in accordance with manufacturer's recommendations, normal wear and tear excepted.

The fifth factor is that a true lease is ordinarily of a definite duration. If the terms of the lease do not provide for the expiration or termination of lessee's payments, other than by purchase of the leased equipment, this tends to indicate that the lease was intended to be a security device.

Section XX of the sample master lease agreement provides Customer the option, upon the scheduled expiration of the term of the Lease, to return or purchase, for the applicable Realized Value all (but not less than all) of the Equipment in accordance with the terms as discussed in 1. above.

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The combined effect of these factors supports the conclusion that the sample master lease agreement applied to the transaction presented by Petitioner will result in that Customer and Petitioner having a security agreement with the Petitioner acting as a financing agency and not a vendor and that therefore the sale and leaseback will not be subject to sales and compensating use tax.

DATED: April 4, 1994

/s/
PAUL B. COBURN
Deputy Director
Taxpayer Services Division

NOTE: The opinions expressed in Advisory Opinions
are limited to the facts set forth therein.