Brief Outline of Taxpayer

INTRODUCTION

Taxpayer submits the following brief. The assessments are for taxes claimed to be due in two regards:

1. Taxes due on leases assigned where the effect is to transfer title to the equipment.

2. Taxes due on documentation fees in $1 purchase option leases.

CONCLUSIONS

1. As to true leases where there may have actually been a second sale of the equipment:

a. Substance, not form, should rule, and thus where the residual was retained, there was, in fact, no sale.

b. Where the residual was not retained and thus a sale occurred, the measure of tax should be governed by Regulation 1701.

2. No tax is due on documentation fees in connection with $1 purchase option leases since these payments are in the nature of interest and not in the nature of sale profits.

DISCUSSION

1. <u>Tax on Assignments</u>.

a. <u>Context</u>. It is important to understand the context of these leases. Taxpayer provides a means of arranging or facilitating equipment leases and financings. It contacts businesses and offers to assist them in leasing or financing their equipment acquisition needs and as such competes with other brokers, direct lessor and banks and other lenders. Taxpayer has no inventory. Rather the customer negotiates a purchase with the vendor and then comes to Taxpayer to arrange the financing.

Moreover, Taxpayer does not carry its own paper. What this means is that Taxpayer is really only brokering a financing or lease transaction and not entering into the deal for its own account. This brokering nature of Taxpayer's activities further means that Taxpayer never enters into a commitment with a customer to arrange financing before Taxpayer has lined up a lender to take the transaction immediately. Taxpayer is never investing any significant amount of its own funds in the deal. Clearly this business model differs from both dealers, which enter into leases as well as sales out of inventory assets, and lessors which consummate transactions for their own accounts and actually hold paper in an inventory of chattel paper.

Transaction closing typically occurs as follows. The customer negotiates the purchase price of the equipment with the vendor and then decides which of its available funding options to utilize. Assuming Taxpayer is chosen; Taxpayer obtains a credit package and reviews the information. If Taxpayer believes it can place the deal with a third party funder, Taxpayer sends the package to a lender for approval and, after obtaining an acceptable lender commitment, indicates to the customer and the vendor that the transaction is approved. In some cases the customer will have signed a purchase order with the vendor and Taxpayer typically issues a purchase order to the vendor once final lease documents have been received from the customer.

When the equipment is delivered, the customer signs a delivery receipt and verbally accepts the equipment. Taxpayer immediately packages the documents, executes the lease agreement and individual Assignment form, and furnishes them to the precommitted lender. The lender then forwards funds to the vendor directly and sends Taxpayer its fee, or cuts a single present value check to Taxpayer who then is obligated to fund the vendor. The actual procedure used will depend on the relationship between Taxpayer and the lender.

The lender's acquisition of a transaction may take one of several forms. In the case of true leases, which are the concern in this portion of the brief, the lender may discount the payment stream but not acquire the residual position, and thus the depreciation tax benefits arising out of equipment ownership and duty to file returns for and pay property tax remain with Taxpayer. This is what happened with the Exhibit A leases discussed below.

In other cases the lender will acquire the whole transaction including the payment stream and residual. This would typically occur when the lender has a tax appetite and pays Taxpayer an advantageous fee for relinquishing the tax benefits and residual at the end of the term. The Exhibit B leases were handled this way.

In either case, following the funding of the transaction, the payments are billed and collected by the lender and, in most cases; property taxes are either the responsibility of Taxpayer if the residual is held or lender if sold. Since these leases are all tax paid up front, there is no sales tax collected on the rentals. In the case of a default the lender forecloses and there is no recourse to Taxpayer.

Once the lease ends, the residual is collected by Taxpayer if the residual is retained (again the Exhibit A scenarios) or by the lender if the residual was sold (Exhibit B).

If the transaction is done as a discounting, the lender takes a security interest in the equipment and usually files a UCC 1 against Taxpayer to insure its perfection. Where there is actually a sale of the whole transaction, the lender at times files also as a precaution, but the filing has no legal effect as to the related equipment.

One final point is important. Again, these leases are all tax paid up front. Accordingly, the issue is not whether the State has been deprived of revenues to which it is entitled. It has received full tax on the equipment cost. Moreover, it would have been possible to structure these transactions to eliminate a potential second tax. The question thus evolves into one where the ultimate decision is the extent to which the State should be penalizing its businesses who are legitimately operating within its borders. As will be developed below, Taxpayer believes this question has been clearly answered in Regulation 1701, which should be applied here.

b. Form Should not be Allowed to Govern over Substance. There are a specific number of leases where the auditor determined back-to-back sales occurred based solely on the language of the funder's agreement. Exhibit A lists the transactions where, notwithstanding the terms of the funder's agreement, the residual was retained and thus there was not a transfer of "all right, title and interest." Exhibit B lists the audited transactions where, in fact, there was a sale "of all right, title and interest" as the funder's agreement indicated. As indicated, the audit staff and the hearing officer totally ignored this obvious substantive difference of which evidence was provided and double taxed all leases.

To put this discussion in its proper context, assume the funder's agreement said only a security interest was granted but in one case the residual was transferred and thus the lessor retained nothing. Obviously the auditor would ignore the contract and look at the substance, thus assessing a second tax. Taxpayer is only asking for reciprocity.

To allow the audit staff so clearly to exalt form over substance is inconsistent with what Taxpayer understands to be Board wishes and policy and obviously counter to proper governmental conduct. Only those Exhibit B transactions should have been written up.[1]

Perhaps even more important, the audit staff approach ignores the Board's clear directive in Annotation 330.1878 which requires substance govern over form and further notes 4 factors to be considered. Here factor (4) is irrelevant. Analyzing factors (1) through (3) shows Taxpayer retained title as to all the equipment after the payments were made under the Exhibit A leases, UCC1's were usually filed by the lender to preserve its security interest and Taxpayer took the ownership tax benefits and paid the property tax, all of which conclusively show that under the Board's rule a taxable sale did not occur.

c. §1701's Tax-paid Credit Approach Which Results in Taxing only Taxpayer's Fee Sets Forth the Proper Tax Calculation Method for Transactions which, in fact, involve a Second Sale. The Staff, having already collected a tax on equipment cost paid by Taxpayer, now seeks to tax that same amount plus any fee Taxpayer received when selling the transaction to the funder. Regulation 1701 was enacted with the sole purpose of avoiding this type of wholly inequitable result.

This regulation would allow Taxpayer to take the 1701 "tax-paid credit" based on the cost of the equipment on which tax was initially paid against the measure of tax relative to the second sale. Here there is no question the initial tax was paid in error as there are various ways it could have, and would have, been avoided had Taxpayer the remotest idea it was facing a duplicate tax.

More specifically, §1701 requires the retailer who utilizes this section after unnecessarily paying tax on acquisition to "resell the tangible personal property before making any use thereof." The audit staff has taken the position that no leasing company can ever use this equitable provision because by definition the property will have been placed in service under the lease before the funder funds.

Taxpayer, on the other hand, believes that narrow reading has three major flaws. First, it again exalts form over substance in a context not clearly considered in drafting the regulation. Second, it fails to address the fact that the lease was executed by taxpayer and assigned to lender at exactly the same time. And third, it totally ignores the reality that the funder had in each case <u>pre-committed</u> to fund the lease long before any delivery or acceptance under the lease occurred. To argue in the face of a <u>pre-commitment to acquire</u> that Taxpayer used the equipment under the lease before selling it and thus is not entitled to the §1701 offset is inequitable, contrary to the regulatory intent and punitive to Taxpayer in particular.

It is interesting to note that this is not the first time this question has arisen. During the 1980's, the then Western Association of Equipment Lessors was in discussions with the SBOE legal department in connection with the identical issues present here. The discussions were wide-ranging covering, among other matters, tax on property tax in tax on rent leases, as to which there was legislation pending, the proper measure of tax on rent in the context of charges such as late charges, insurance fees, interest and tort indemnity payments, and the issues faced by lessors which inadvertently found themselves in Taxpayer's shoes.

In dramatic contrast to the audit staff in this matter the Board's then position was unequivocally:

i. Substance should govern over form, and only when, in fact there was a second sale, which occurred only when the residual was transferred, should there be a second taxable event.

ii. The proper measure of tax as to the second sale would be dependent on its timing. If basically simultaneous and reflective of a prior commitment, §1701 would apply. If, however, the lessor held the transaction in inventory in a warehouse line, §1701 would not apply.

2. **<u>Documentation Fees</u>.**

Regulation 1660(a)(2)(A) provides that $1 purchase option leases are treated as a "sale at inception under a security agreement." Ignoring the issue of how one can sell something under a security agreement, the audit staff interprets this regulation to contemplate 2 sales; one from the vendor to the lessor and one from the lessor to the customer. This analysis ignores the fact that the customer actually negotiates the purchase and purchase price with the vendor and that the lessor is in reality providing financing only. This latter truth reflects that the lessor is not an inventoried dealer.

These transactions and this regulation have both been around for a long time and up until recently, it appears the audit staff focused on the reality of this type of transaction as a financing and did not tax documentation fees. Certainly this shift from substance to form was not formally announced and caught Taxpayer by surprise. Fairness would preclude such an unannounced shift in approach. Once the staff has postulated these 2 sales, the staff goes on to conclude Regulation 1701 applies since there is a simultaneous resale before usage. The effect of application of §1701 is that the measure of tax is only the documentation fee; there, of course, being no markup of the purchase price the customer has negotiated and the leasing company has agreed to finance.

The audit staff has looked at sales by dealers where documentation fees are clearly gross receipts from sales and applied the same logic to Taxpayer's leases which are financings and include documentation fees. This interpretation, as noted, reflects long-standing practice and artificially places banks and other regulated financial institutions, which by law cannot sell property as the staff assumes they are doing, as well as independent lessors, such as Taxpayer, in the position of paying tax on a charge which is in reality an additional interest amount and never was designed as anything else. Expressed alternatively, treating documentation fees as gross proceeds of a sale in connection with a transaction which is in reality by definition a financing is clearly to exalt form over substance.

These $1 option transactions, unlike dealer sales of cars and the like from inventory which are obviously true sales, are from the inception secured loans which finance the sale the customer negotiated with the vendor which is, in fact, a seller and not second sales. All amounts due, as with a loan, are either return of principal or in the nature of non-taxable interest. This reality should govern and no tax should be imposed on the documentation fees in $1 purchase option deals.[2]

Taxpayer would urge the Board to follow its historical logical and equitable approach in contrast to the audit staff's hypertechnical and obviously punitive current suggestions.

SUMMARY

With respect to the double sale assessment only the Exhibit B leases should have been taxed. The proper tax measure should only be the excess of the payments Taxpayer received on the second transfer over the tax paid to the original vendor.

As to the documentation fees, the reality of the financing nature of the transactions and the fact that Taxpayer is not a dealer should govern, the fees should be viewed as the form of interest they are and no tax should be imposed.

Respectfully submitted

2