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# State and Local Tax Challenges With Leases of Equipment and Other Assets

Navigating Differing State Approaches With Sales, Business Personal Property and Income Taxes

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THURSDAY, JUNE 27, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

Valerie Pfeiffer, Managing Principal and Founder, **Tax Coefficient**, Metamora, Mich.

Brian Strahle, Senior Manager of State and Local Taxes, **Baker Tilly Virchow Krause**, Tysons Corner, Va.

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# State and Local Tax Challenges With Leases of Equipment and Other Assets Seminar

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June 27, 2013

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# Today's Program

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Who Are The Lessor And Lessee?

*[Valerie Pfeiffer]*

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Sales Tax Issues With Leases

*[Brian Strahle]*

Slide 16 - Slide 36

Business Personal Property Tax Issues With Leases

*[Valerie Pfeiffer]*

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State Corporate Income Tax Issues With Leases

*[Brian Strahle]*

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Complex Transactions

*[Valerie Pfeiffer and Brian Strahle]*

Slide 50 - Slide 63

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Valerie Pfeiffer, Tax Coefficient

# **WHO ARE THE LESSOR AND LESSEE? AND OTHER TERMS**

# Lease Terminology

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- ▶ Parties to a lease
  - ▶ Lessor: Generally the owner of the equipment
  - ▶ Lessee: Generally user of the equipment
  - ▶ Creditor or guarantor: Party with the credit that can guarantee lessee will fulfill the lease terms
  - ▶ Assignee: Party receiving rights and interest in lease, with or without title to equipment
  - ▶ Assignor: Generally the lessor; assigns rights under lease to assignee – with or without ownership

# Lease Terminology (Cont.)

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- ▶ Types of leases
  - ▶ Net lease: Lessee responsible for tax, maintenance, insurance
  - ▶ Several variations under different disciplines
    - ▶ Accounting: Operating, capital, direct finance, sales type
    - ▶ Tax: True lease, finance lease, conditional sale, installment sale
    - ▶ Legal: Lease, security interest, Article 2a lease, synthetic
    - ▶ Vehicle: Fleet, TRAC
  - ▶ References based on end of term
    - ▶ \$1 purchase option, \$1 out, buck-out
    - ▶ 10%: 10% of original cost - optional or mandatory
    - ▶ FMV: Fair market value option or mandatory
    - ▶ Residual: Option
    - ▶ PUT: Purchase upon termination – mandatory
    - ▶ Auto renewal, evergreen

# Lease Types And End Of Term

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## Type Of Lease

- ▶ Lease
- ▶ True lease
- ▶ Operating lease
- ▶ TRAC

## End Of Lease Options

- ▶ 10% option
- ▶ FMV option
- ▶ Residual option
- ▶ Evergreen
- ▶ Auto renewal with return option
- ▶ Terminal rental adjustment clause

# Lease Types And End Of Term (Cont.)

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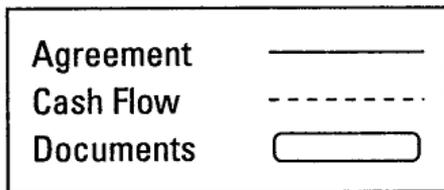
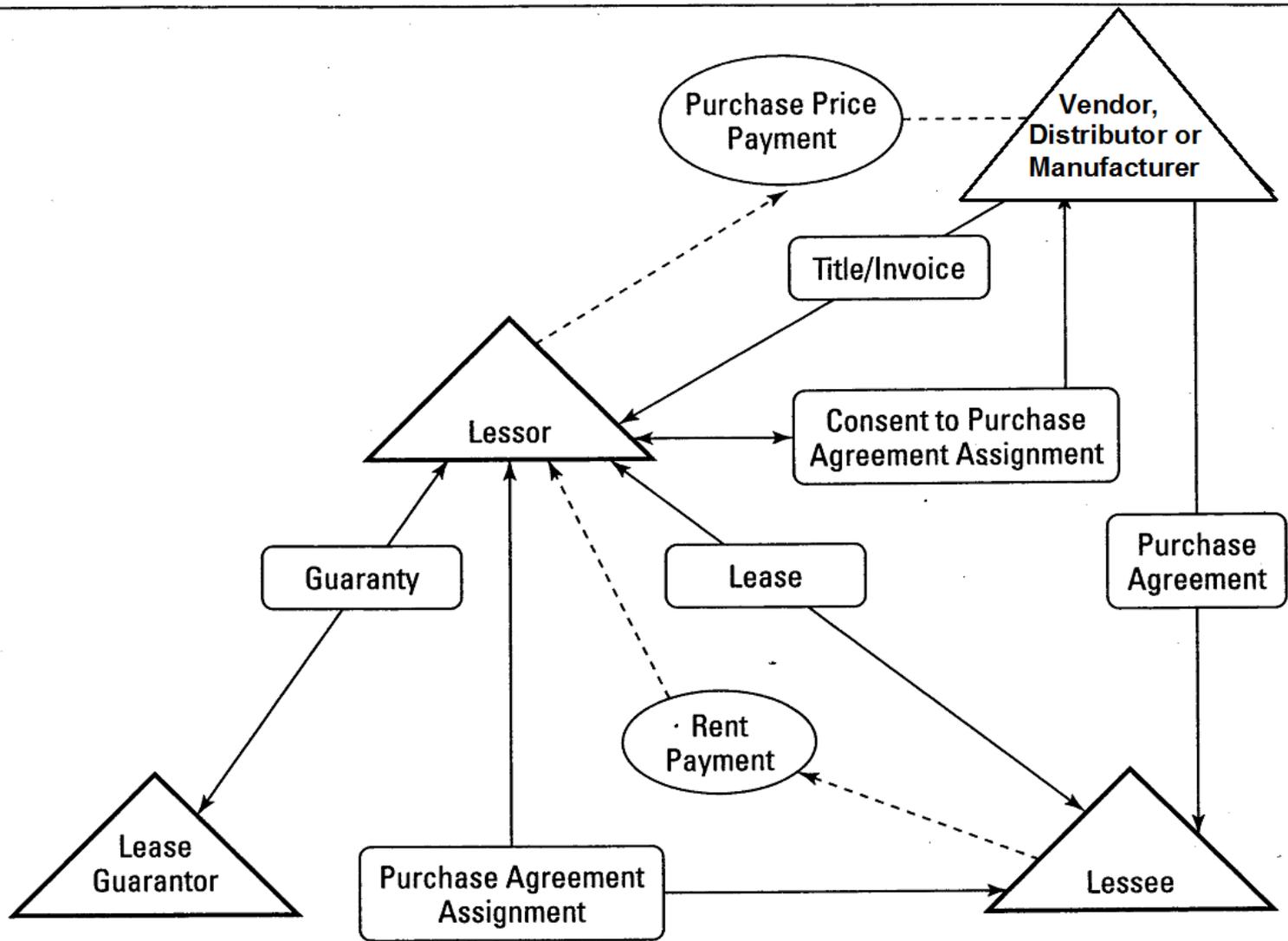
## Type Of Lease

- ▶ Lease
- ▶ Finance lease
- ▶ Capital lease
- ▶ Security interest
- ▶ Conditional sale type
- ▶ Installment sale

## End Of Lease Options

- ▶ \$1 p.o., \$1 out, buck-out
- ▶ 10% “must” purchase
- ▶ FMV “must” purchase
- ▶ Residual < 10%
- ▶ PUT
- ▶ Auto renewal with no return, purchase inevitable

# LEASE



From Business Leasing For Dummies®  
 By David G. Mayer, Partner, Patton Boggs LLP  
 Published by Wiley Publishing

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# License

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- ▶ License to use
  - ▶ Intangible, copyright
    - ▶ Software, technology, digital goods
  - ▶ No rights of ownership or limited rights
  - ▶ Permanent, perpetual, specified time period
- ▶ Licenses may be bundled with equipment on a lease.
- ▶ Licenses may be financed on a lease.

Brian Strahle, Baker Tilly Virchow Krause

# **SALES TAX ISSUES WITH LEASES**

# Sales Tax Issues: Why Is This Important?

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- ▶ States are aggressively seeking revenue.
- ▶ Companies that own assets in a state are prime targets.
- ▶ Leasing industry has not had a clear, concise, consistent approach to handling taxes.
- ▶ Leasing can reduce or defer sales and use tax.

# **Sales Tax Issues: Why Is This Important? (Cont.)**

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- ▶ Jurisdictions may impose multiple levels of tax on leasing transactions.
- ▶ Risk of double-taxation exists for mobile property.
- ▶ Determining correct tax jurisdictions is critical to reducing the number of incorrectly filed returns.

# Sales Tax Issues: Problem Areas

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- ▶ When a license to use an intangible requires some minimal transfer of tangible personal property
- ▶ Some states tax the transaction by focusing on the method of transfer rather than the intangible involved.
- ▶ Some states have held that the right to use tangible personal property cannot be separated from the property itself.
  - ▶ **Examples:** Licensing of computer software, the right to exhibit motion pictures, and the use of mailing lists are common problem areas.
- ▶ **State example:** Pennsylvania court ruled the true object of software license was the software itself, not the right to use an intangible.

# Sales Tax Issues: Why Do I Care?

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- Type of lease determines method of taxation (when tax is paid)
- Tax generally due on lease payments
- Leases of real property generally not taxable
  - A few states tax leases of real property (AZ, FL, etc.)

# Sales Tax Issues: Types Of Leases

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- **Operating lease/true lease**
  - Lessor treated as owner
  - No transfer of title at end of lease
  - No bargain purchase option - FMV
  - States generally treat as a "retail sale"
  - Sales tax generally remitted based on rental payments received

# Sales Tax Issues: Types Of Leases (Cont.)

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- **Capital/finance lease**
  - Lessee treated as owner
  - Title MAY transfer at end of lease
  - May contain a bargain purchase option
  - States often treat as “installment sale” or “sale at inception”
  - Sales tax generally due up front

# Sales Tax Issues: Types Of Leases (Cont.)

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- **Factors of a capital/finance lease**
  - Lessee has option to purchase at a minimal price
  - Lessee acquires equity in the equipment
  - Lessee is required to bear the risk of loss
  - Lessee pays all charges and taxes imposed on ownership
  - Lease provision for acceleration of rent payments
  - Property was purchased specifically for lease to this lessee

# Sales Tax Issues: Types Of Leases (Cont.)

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- **Equipment leased with an operator**
  - If treated as a service = not taxable
  - If treated as sale of equipment = taxable
  
  - Generally treated as a service
  - Most states do NOT impose sales tax,
  - Underlying service generally not taxable
  
  - **Key point:** Who has control of the operator?

# Sales Tax Issues: Tax Base

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- Most states include total amount of payments received by the lessor from the lessee in their taxable receipts.
- Taxable receipts may also include payments that are made by the lessee to a third party for the benefit of the lessor, and that are required by terms of agreement.
- Personal property taxes on leased property (whether assessed against lessee or lessor)
- Separately stated charges may be subject to tax.
- Installing, applying, remodeling, repairing, damage waiver fees, transportation charges, supervision, early termination fees, interest under a financing lease, freight/delivery charges

# Sales Tax Issues: Tax Base (Cont.)

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- **Tax base may include:**
  - Delivery charges
  - Late-payment fees
  - Installation charges
  - Insurance
  - Maintenance and/or service charges
  - Personal property tax
  - Early termination fees
  - Rental payments
  - Other miscellaneous charges

# Sales Tax Issues: Tax Base (Cont.)

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- **Bad debts**

- State statutes determine treatment
- May be based on accounting method
- Some states treat taxes on leases as taxes on the lessor; therefore, no bad debt deduction is taken when the lessee doesn't make required payments.
  
- **Issues:** Who is the taxpayer? Who can take the bad debt deduction?

# Sales Tax Issues: Reported When?

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- **Cash vs. accrual**
  - States vary on which period sales tax must be paid.
  - Some states impose tax when the payment is due.
  - Some states impose tax when the payment is received.

# Sales Tax Issues: Imposition Of Tax?

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- Varies from state to state
- Depends on type of lease, type of property, term of lease
- **Intent is that “last use” be the “taxed” use**
  
- **Examples:**
  - Due at time of purchase (IL, ME, NJ)
  - Due on the periodic rental stream
  - Due on accelerated basis
  - States may allow election to pay tax up front OR on the rental stream.
  - OR, states may require tax to be paid on rental stream up front (IL)

# Sales Tax Issues: Where? (From SSTP)

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- **General sourcing rules**

- Sourced similar to retail sales
- Seller's location, when product received at seller's location
- Purchaser's location or delivered location, when product is not received at seller's location
- Periodic payments made subsequent to the first payment are sourced to the primary location for each period covered by the payment.
- Motor vehicles, trailers and aircraft have specific rules.

# Sales Tax Issues: Exemptions

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- **Leases enjoy some exemptions as other sales of tangible personal property.**
  - Property used in manufacturing, fabricating or processing property
  - Property used in agriculture
  - Property used in research and development
  - Resale exemption
  - Casual, isolated and occasional sale exemption
  - Related parties (in some states)
  - Tax-exempt and charitable organizations
  - Federal and state governments

# Sales Tax Issues: Exemptions (Cont.)

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- **Resale exemption**

- Property purchased for lease to others usually exempt
- May not be available to leasing of equipment with an operator (if treated as the sale of a service)
- Subleasing (sale for resale)
- If property is used by purchaser in addition to being leased, then both the original purchase and subsequent lease are taxable.
- Exemption may not be available if the purchase of tangible personal property is incidental to the leasing of real estate.

# Sales Tax Issues: Exemptions (Cont.)

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- **Casual, isolated and occasional sale exemption**
  - States differ
  - Increasingly, exemption is limited to activities that do not require registration as a “retailer.”
  - Typically, if a business makes more than two retail sales in a 12-month period, then it is considered a retailer and subject to tax.

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# Sales Tax Issues: Elections

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- **Election to pay sales tax on purchase price or on rental stream**
  - Some states allow an election.
  - Lessor would purchase property free of tax under a resale exemption.
  - Once election is made, it may not later be revoked.
  - May be contingent upon whether rental receipts will be subject to state's use tax and whether lessor is licensed to collect tax

# Sales Tax Issues: Audit Issues

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- **Record retention** - contracts for entire lease term
- **Sampling periods** - statistical sampling vs. actual basis
- **Tax rate changes** - may not be grandfathered to existing lease contracts
- **Exemption certificates** - from lessee not on file or acceptance of “good faith” exemption may be questioned
- **Exemption claimed may not apply to leased equipment.**
- **Tax may be imposed on lessor**, making the exemption certificate not applicable.

Valerie Pfeiffer, Tax Coefficient

**BUSINESS PERSONAL  
PROPERTY TAX ISSUES WITH  
LEASES**

# Business Personal Property Tax

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- ▶ Proper party to report and pay
  - ▶ Generally, tax jurisdictions require both parties to file; owner receives the bill.
  - ▶ Standard terms require the lessee to pay; the lessor files.
  - ▶ Some require lessee to file and the lessee to pay direct.
  - ▶ Variations by jurisdiction
    - ▶ California, Indiana
  - ▶ Capitalized leased assets
  - ▶ Duplicate assessments

# Business Personal Property Tax (Cont.)

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- ▶ Valuation and appeals – timing challenges
  - ▶ Lessee pays the tax bill, and the lessor isn't compelled to appeal.
  - ▶ Lessee receives a tax bill after an appeal period.
  - ▶ Some jurisdictions allow corrections after appeal period; others don't.
    - ▶ Missouri, Texas, Wisconsin
  - ▶ Valuation issues can be identified before filing declarations; proactive action brings best results.

# Business Personal Property Tax (Cont.)

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- ▶ Tax bills – timing challenges
  - ▶ Time lapse between assessment date and bill due date
    - ▶ Colorado, Indiana, Washington
  - ▶ Lessee receives tax bill after lease expires.
    - ▶ Tax reimbursements survive lease termination date.
    - ▶ Lessee purchase order closes at termination.
  - ▶ Lessor advance-bills estimated tax at the end of the lease.
  - ▶ Multiple tax bills
    - ▶ Michigan, Texas

# Business Personal Property Tax (Cont.)

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- ▶ Accounting challenges
  - ▶ Bundled equipment and services
    - ▶ Generally, a lessor will require unbundling, for legal and pricing purposes.
  - ▶ Classification of assets – asset life, value in use, industry class
  - ▶ Software
    - ▶ Operating or application, canned or custom
    - ▶ Enterprise license – multiple devices – multiple locations
  - ▶ Lessee and lessor may have different book treatments.
    - ▶ Different opinions on residual or debt rate
    - ▶ Different accounting firm opinions
  - ▶ Assessment dates
    - ▶ Equipment returns, rent obligation may continue
    - ▶ Book year-end, short periods
      - South Carolina

# Business Personal Property Tax (Cont.)

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- ▶ Audit trends
  - ▶ More jurisdictions are actively auditing.
  - ▶ Outsourced auditing
    - ▶ Indiana, Michigan, North Carolina
  - ▶ Frequent audit issues
    - ▶ Proper party filing
    - ▶ Sales tax uplift to cost

Brian Strahle, Baker Tilly Virchow Krause

# **STATE CORPORATE INCOME TAX ISSUES WITH LEASES**

# State Corporate Income Tax Issues

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## ▶ Tax base – general guidance

- ▶ Who carries the leased assets on their books for tax purposes and deduct depreciation expense?
  - ▶ Generally, states follow federal income tax treatment.
  - ▶ Based on type of lease and treatment/intent of parties to lease
  - ▶ Operating lease/true lease
    - Lessor treated as owner
  - ▶ Capital/finance lease
    - Lessee treated as owner
  - ▶ Synthetic lease
    - Lessee treated as owner
    - Lessee treated as “lessee,” for financial reporting (GAAP)

# State Corporate Income Tax Issues (Cont.)

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## ▶ **Tax base**

- ▶ Leases between related parties may trigger addback of rent expense deductions to tax base.
- ▶ Depends on state
- ▶ Must be arms-length transaction/transfer pricing
- ▶ Other requirements may apply.

# State Corporate Income Tax Issues (Cont.)

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## ▶ Nexus – who has it?

- ▶ Lessor: Leasing tangible property to others for in-state use
- ▶ Lessor: Owning property
- ▶ Lessee: Using, leasing or renting property
- ▶ Mobile property: Lessee only?
  - ▶ Lessee doesn't provide information regarding where property is used.
  - ▶ Isolated trip or landing may not create nexus for lessor.
  - ▶ Presence of leased property on regular or systematic basis creates nexus for lessor.
  - ▶ **Tip:** Lessor should require lessee to supply information about where property is used.

# State Corporate Income Tax Issues (Cont.)

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- ▶ **Apportionment - what will the apportionment impact be on the lessor and lessee?**
  - ▶ Property factor
    - ▶ Who is treated as the owner – lessor or lessee?
    - ▶ Assets included at cost or as rent expense (x8)?
  - ▶ Sales factor
    - ▶ Rental, leasing or licensing of tangible personal property
    - ▶ Rental, leasing or licensing of real property, intangible personal property
    - ▶ Sourcing?
      - Location of property (destination)
      - Movable property – time, mileage, landings, trips, etc.

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# State Corporate Income Tax Issues (Cont.)

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## ▶ **Apportionment method?**

- ▶ Service income apportionment method or special industry apportionment?
  - ▶ Cost of performance vs. market-based sourcing?
  - ▶ Revenue miles, etc.?
- ▶ Special formula
  - ▶ Example: Maryland
    - A corporation engaged primarily in leasing or rental operations must use an equally weighted, two-factor formula of receipts and property, except that receipts from intangible items are excluded. [Reg. 03.04.03.08(E)(1)]

Valerie Pfeiffer, Tax Coefficient

Brian Strahle, Baker Tilly Virchow Krause

# **COMPLEX TRANSACTIONS**

# Complex Transactions

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- **Sale-leasebacks**

- Owner of property sells to a third party.
- Third party leases property back to original owner.
- May contain a bargain purchase option at end of lease term
- Leasing company purchases equipment from supplier exempt.
- If not structured as a single transaction that could be characterized as a loan, it may be treated as two or more separate transactions upon which tax may be imposed.
- Transactions should be simultaneous or concurrent in order to prove intent.
- Marketing and arms-length treatment can be key factors.
- **Problem:** States address with rulings, not statutorily

# Complex Transactions (Cont.)

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- ▶ Sale-leasebacks (continued)
- ▶ Statutory exemptions and rulings
  - ▶ Separate transactions – and duplicative tax relief
    - ▶ Resale exemption for lessees original purchase?
      - Connecticut
      - No prior use
    - ▶ Additional sales tax on lease payments?
    - ▶ Lease is deemed a financial arrangement and exempt.
      - Missouri, New York
    - ▶ Time window to exempt lease or lessee purchase
      - California, Connecticut, New Jersey
- ▶ Personal property tax issues
  - ▶ Historical acquisition date and cost – property tax

# Complex Transactions (Cont.)

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- ▶ **Mixed transactions (when leasing both real and tangible personal property)**
  - ▶ If property can be severed from real estate without causing material harm, it may be treated as tangible personal property and subject to sales tax. (KS Rev. Rul. 19-78-6)
  - ▶ Rental of equipment that requires installation onto real property is NOT subject to sales tax, when it is affixed to the ground or becomes real property. (North Dakota)
  - ▶ Rental or lease of tangible personal property that is attached or affixed to real estate is subject to sales tax, unless real estate is also subject to the lease. [KS Reg. 92-19-5(g)]
  - ▶ Treatment may depend on lessor's accounting or financial treatment of property.

# Complex Transactions (Cont.)

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- ▶ Bundled transactions, also referred to as mixed transaction (taxable and exempt property or services)
  - ▶ Taxable if not separately stated or itemized
  - ▶ Maximum local tax and single article tax
    - ▶ Florida, Tennessee
  - ▶ Tangible and intangible
  - ▶ Tangible, realty or fixture
    - ▶ Form over substance – terms of agreement require the property to remain as tangible and returnable to lessor.

# Complex Transactions (Cont.)

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## ▶ Interstate transactions

- ▶ Property delivered to out-of-state destinations is generally exempt, if:
  - ▶ Required by lease agreement
  - ▶ Actually shipped to out-of-state destination by seller OR seller delivers to carrier, customs broker or forwarding agent
- ▶ Lessor bears burden of proving that leased property was delivered to out-of-state destination.
- ▶ Lease payments may be subject to tax **only while property is located in-state. Exceptions . . . Tennessee and Texas**
- ▶ Some states may impose tax on lease payments based on **where the lease was executed**, rather than where the leased property is used.

# Complex Transactions (Cont.)

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## ▶ **Foreign transactions**

- ▶ Exports may be required to be “irrevocably committed to the export process” at the time of sale.
- ▶ Delivered to foreign destination prior to any use

# Complex Transactions (Cont.)

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- ▶ **Movable property**
  - ▶ **Location, location, location**
    - ▶ Location of property at time of entering lease = how much tax is paid and what state gets paid
  - ▶ **Tax Credits and double-taxation?**
    - ▶ Lessor could pay tax on full purchase price to one state **AND** pay tax based on lease payments to another state.

# Complex Transactions (Cont.)

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## ▶ Leases between related parties

- ▶ A few states exempt lease transactions between related parties.
- ▶ A few states may exclude transactions from tax only when **both parties are equally liable** on the debt secured by the property at issue.
- ▶ Some states follow federal rules regarding disregarded entities, and **some DO NOT**.
- ▶ Transactions must be **arms-length**.
- ▶ Majority of states view transactions between related parties as transactions between **separate entities**.
- ▶ States often exclude from taxation those transactions on which the **beneficial ownership** of property remains the same.

# Complex Transactions (Cont.)

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- ▶ Cloud computing – SAS (software as service)
  - ▶ Underlying servers and data centers
  - ▶ Licenses to use software
  - ▶ Access to a bundled offering (platform and software)
  - ▶ Form over substance – terms of agreement
- ▶ Is it pre-written software, a communications service, an information service or a digital good?
- ▶ States taking aggressive positions
  - ▶ Massachusetts, Michigan, New York

# Complex Transactions (Cont.)

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- ▶ Software licenses
  - ▶ Leased or financed
  - ▶ Electronically delivered, load-and-leave, hosted
  - ▶ Maintenance agreements with software updates
  - ▶ Enterprise license and multiple points of use

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# Complex Transactions (Cont.)

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## ▶ **Synthetic lease**

- ▶ Financing structure for ownership of an asset
- ▶ Asset owned indirectly by operating company/leases asset to itself
- ▶ Accounting purposes: Asset owned by special-purpose entity and leased to operating company
  - ▶ Special purpose entity not on operating company's balance sheet
- ▶ **Tax purposes:** Asset owned by operating company (special-purpose entity consolidated with operating company)
- ▶ Substance of transaction/parties' intent reflect **financing** rather than lease
  - ▶ Treated as **financing arrangement**, for both mortgage recording tax and sales tax purposes

# Complex Transactions (Cont.)

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## ▶ Lease syndication transactions

- ▶ The process of involving a number of different lessors and funding sources in providing various percentages of a particular lease's debt and equity components
- ▶ Typically a hallmark of large lease transactions
- ▶ A lease syndication can allow any one lessor or funding source to maintain a more prudent and manageable credit exposure and competitive pricing, while still providing the lessee with the total financing it desired and/or required.
- ▶ **Problem:** Who is liable for the sales tax and personal property tax?