New York State Department of Taxation and Finance
Office of Counsel
Advisory Opinion Unit

TSB-A-13(5)S
Sales Tax
January 24, 2013

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION PETITION NO. S110826A

The Department of Taxation and Finance received a Petition for Advisory Opinion from Petitioner, [redacted]. Petitioner is a lessor of non-vehicle equipment and it inquires about the sales tax implications of two types of lease termination provisions. We conclude that Petitioner's standard lease, using either lease termination provision, is a security agreement for purposes of sales and use tax so that Petitioner has made an outright sale of the equipment. As a result, Petitioner must collect sales tax on the full amount of the payments due under the lease at the outset of the lease.

Facts

Petitioner leases equipment (not including automobiles or other property that is subject to the acceleration provisions in Tax Law section 1111[i]). Its standard course of business is that, after a customer has identified a piece of equipment it wants to acquire, Petitioner purchases the equipment from the supplier of the equipment and enters into a "Equipment Lease Agreement" ("Agreement") with the customer. It collects the full selling price from the customer and remits sales and use tax to the appropriate State. Petitioner submitted a copy of its Agreement in connection with its Advisory Opinion Petition. The Agreement states that it is irrevocable for the specified lease period. The Agreement identifies the "supplier" of the equipment and recites that "You [the lessee] understand and agree that we have purchased the equipment from the supplier, and you may contact the above supplier for your warranty rights, if any, which we transfer to you for the term of this lease. Your approval as indicated below of our purchase of the equipment from the supplier is a condition precedent to effectiveness of this lease."

The Agreement makes the lessee responsible for maintaining the equipment, puts the risk of loss on the lessee, and requires the lessee to insure the equipment against loss and to have Petitioner named as an insured under the policy. Petitioner routinely makes a Uniform Commercial Code (UCC) filing to protect its interest in the leased property.

Petitioner inquires about the implications of using two different lease termination provisions in the Agreement. Under the first, the lessee has the option of either returning the equipment to Petitioner, or purchasing it for a $1. Under the second, the lessee must purchase the equipment from Petitioner for a $1.

Analysis

The Tax Law imposes sales and use tax on retail sales of tangible personal property and the sale, except for resale, of certain services (*see* Tax Law § 1105[a], [c]). The term "sale," as used in article 28, includes "[a]ny transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume, conditional or otherwise" (Tax Law § 1101[b][5]). Section 526.7(c) (1) of the Sales and Use Tax Regulations provides that: "[t]he terms rental, lease, license to use refer to all transactions in which there is a transfer of possession of tangible personal property without a transfer of title to the property. Whether a transaction is a 'sale' or a 'rental, lease or license to use' shall be determined in accordance with the provisions of the agreement." The Regulations recognize that a contract denominated as a lease of tangible personal property may in fact represent a security agreement (*see* 20 NYCRR § 526.7[c][3]).

Under the facts here, Petitioner is the vendor of the equipment and thus is the person required to collect tax on the sale of the equipment. The only issue is whether its sales agreement with the customer constitutes a security agreement or whether it is a true lease. If the agreement is a security agreement, Petitioner would have made an outright sale of the equipment and thus must collect tax on the full amount of the proceeds of the agreement at the outset of the agreement. In contrast, if the sales agreement constitutes a true lease, Petitioner would be required to collect sales and use tax at the time of each payment due under the agreement.

In the past, to determine whether an agreement is a "true lease" or a financing agreement with a security interest, the Department has looked through the form of the lease agreement to examine the intent of the parties and the facts and circumstances that exist at the time of each transaction (*see Clayton Funding Corporation*, Tax Appeals Tribunal, July 8, 1993; TSB-A-90[8]S;TSB-A-97[66]S). C*layton* and the cited Advisory Opinions rest largely on *In re Sherwood Diversified Services, Inc.* (382 F.Supp. 1359 [S.D.N.Y. 1974]). There, a District Court affirmed a Bankruptcy Court decision, which found that a particular lease was security agreement. The court reasoned as follows:

> The Tax Commission would have this Court look to the 'four corners' of the lease and conclude that the intent of the parties was to enter into a true lease transaction, and not a financing agreement. The overwhelming weight of judicial authority and the language of section 1-201(37) [of the New York Uniform Commercial Code (UCC)] necessitate a rejection of this approach. All of the 'facts of each case' must be examined to determine the intention of the parties, and the Court may properly consider 'factors outside of the lease as well as the contents of the lease itself

(382 F. Supp. at 1362). Under this approach, the Department has considered a number of factors, including whether the lease had a purchase option, which party bore the risk of loss, whether the lessee had to obtain insurance to protect the lessor, and whether the lessor has recorded a security agreement noting that the lease was a true lease (*see* TSB-A-90[8]S, *supra*).

In 2001, the Legislature amended UCC section 1-201(37), adopting language originating from a 1987 overhaul of that section in the model UCC (Chapter 84 of the Laws of 2001). The purpose of the amendment to the model act was to remove language that put the focus on the subjective intent of the parties, which led to a "profusion of inconsistent views among the courts regarding the proper criteria to be applied in determining whether an agreement denominated as a lease created a true lease or a security interest" (*In re Murray*, 191 B.R. 309, at 313 [Bkcy Ct, E.D. PA 1996], *affd*, 201 B.R. 381 [District Ct., E.D.Pa.,1996]).

As revised, section 1-201(37) defines a security interest as follows:

> "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation.
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> * * *
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> (a) Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and:
>
> (i) the original term of the lease is equal to or greater than the remaining economic life of the goods,
>
> (ii) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
>
> (iii) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
>
> (iv) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

Under this definition, all the facts must be considered in determining the nature of the lease except for one "bright line" exception, namely that the lease qualifies as a security agreement if it is not cancellable by the lessee prior to the end of the lease period and one of the four conditions in paragraph (a) is satisfied (*see In re Kim*, 232 B.R. 324 [Bkcy Ct. E.D. PA 1999]; *Commerce Commercial Leasing, LLC v. PIO Enterprises, Inc.*, 78 A.D.3d 1105 [2010]). Petitioner's standard lease qualifies as a security agreement under this definition, regardless of which of the two lease termination provisions is used. Petitioner's standard lease states that the agreement is "irrevocable," thus satisfying the "not subject to

termination" condition in section 1-201(37)(a). Under the first lease termination provision, the lessee has the option of buying the equipment for $1 or returning the equipment to the lessor. This provision satisfies the condition in section 1-201(37)(a)(iv). Under the second lease termination provision, the lessee must pay $1 and become owner of the equipment. This provision would satisfy the condition in section 1-201(37)(a)(ii).

In sum, in determining whether a lease is a true lease or a security agreement, the Department is guided by the definition of "security interest" in UCC section 1-201(37). Applying the revised version of UCC section 1-201(37) here leads to the conclusion that Petitioner's standard lease is a security agreement, rather than a true lease, so that Petitioner has made an outright sale, regardless of which lease termination provision is used. Accordingly, Petitioner should collect tax at the outset of the lease on the full amount due under the lease.

DATED: January 24, 2013

/S/
DEBORAH R. LIEBMAN
Deputy Counsel

NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion. The information provided in this document does not cover every situation and is not intended to replace the law or change its meaning.