Missouri DOR Bungles Synthetic Lease Reference in Sales Tax Ruling

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David K. Burton discusses a recent ruling from the Missouri Department of Revenue that is intended to address the sales tax consequences of a synthetic lease transaction. Burton argues that the DOR misapplied the term "synthetic lease," leaving taxpayers without reliable guidance.

On July 2 the Missouri Department of Revenue released LR 7395, a ruling that purported to address the sales tax consequences of a synthetic lease transaction but misapplied the term "synthetic lease."

"Synthetic lease" is an industry term for a financing transaction that is characterized as debt for federal income tax purposes (that is, the lessee depreciates the equipment for income tax purposes) and as an operating lease for financial statement purposes for the lessee of the property (that is, the lease obligations are not treated as a liability on the lessee's balance sheet).[1] Because the term refers to an arbitrage of the financial accounting and income tax treatment, it is not defined in either generally accepted accounting principles or the Internal Revenue Code.

The arbitrage in a synthetic lease transaction is achieved by walking a narrow line between income tax and financial accounting principles. A synthetic lease is intended to be characterized as debt for income tax purposes because the purported lessee at the end of the term has both the upside benefit and downside risk associated with the equipment. However, under GAAP, the transaction is intended to be classified as an operating lease because the purchase option is not a bargain, the present value of the obligatory payments is less than 90 percent of the fair market value of the equipment at the outset, the term is less than 75 percent of the useful life of the equipment, and there is no automatic transfer of ownership of the equipment to the lessee.[2]

The Missouri DOR's ruling begins, "Applicant is a leasing company offering long-term synthetic leases of equipment to its customers." There is no discussion of what a synthetic lease is or what significance that categorization has for the sales tax analysis.

The ruling goes on to describe the purported synthetic lease transaction:

> Title to the equipment is in the name of the Applicant. . . . The useful life of the equipment always exceeds the initial term of the lease and any extensions of the initial term; consequently, the equipment always has a remaining value at the end of each lease. Applicant claims the income tax deductions for depreciation associated with the equipment.

Here, the ruling runs into its first problem. As understood in the industry, a synthetic lease is an arrangement that is treated as debt for income tax purposes, meaning the leasing company/applicant should not be claiming depreciation, because the tax characterization is that it is a lender (not an owner/lessor).

The ruling leaves the reader with one of two choices: (i) the transactions the ruling purports to address are not synthetic leases; or (ii) the facts in the ruling are mistaken, and the leasing company/applicant does not claim the deductions for depreciation associated with the equipment.

The ruling goes on to provide:

> At the end of each lease term, the lessee is provided with various options in relation to the equipment: (a) return the equipment to Applicant; (b) extend the term of the lease; or (c) purchase the equipment from Applicant for an agreed-upon amount determined by considering, among other things, the remaining value of the equipment at the end of the lease.

[1]W. Kirk Grimm et al., "Synthetic Leasing," in *Equipment Leasing-Leveraged Leasing* (Apr. 2013), section 15:1; Tom Erlandson, "Synthetic Lease Could Provide Advantages," *Puget Sound Bus. J.* (Sept. 13, 1998).

[2]This is a test for an operating lease under Financial Accounting Standards Board Accounting Standards Codification Topic 840 (formerly known as Financial Accounting Standard No. 13).

However, those are the same options available to a lessee in a "true lease" of equipment for federal income tax purposes,[3] which further raises the question why the beginning of the ruling refers to the transactions as synthetic leases.

The holding of the ruling appears straightforward, but the ruling fails to address how the word 'lease' is defined for purposes of the Missouri sales tax regs.

In a synthetic lease, it is the end-of-term options that make the transaction a synthetic lease. At the end of the term, the user of the equipment (that is, the purported lessee) has the option to either purchase the equipment for a fixed price or return the equipment to the financier (that is, the purported lessor) and pay the financier the difference, subject to a cap on the maximum payment, between the fixed-price purchase option amount and the actual value of the equipment.[4] The Missouri ruling does not explain how the relatively generic-sounding end-of-term options — which are in fact the same options available to a consumer leasing a car from Ford Motor Credit Co. — result in the transactions being synthetic leases. That omission further suggests that the transactions in question are not synthetic leases.

The holding of the ruling — that if the lessor claimed the resale exemption and did not pay Missouri sales tax on its purchase of the equipment, then the lease payments are subject to sales tax — appears straightforward.[5] What the ruling fails to address is how the word "lease" is defined for purposes of the Missouri sales tax regulations. Do the sales tax regulations follow the form of the transaction — that is, if the transaction is called a lease, is it a lease regardless of the substance? Do the sales tax regulations follow the federal income tax characterization of the transaction? Or do the sales tax regulations follow the GAAP characterization? The ruling provides no answer.

The ruling does quote regulations that provide:

> Leases that include an option to purchase the property are taxed like other leases. If the lessee exercises the option to purchase the property, the additional amount paid for the purchase of the property is also subject to tax.[6]

The provision seems to suggest that for sales tax purposes, Missouri follows the form of the transaction: If the contract is called a lease, it is deemed to be a lease for sales tax purposes, regardless of the economic substance of the purchase option arrangements. Missouri taxpayers would have been well served if the ruling could have expressly reached that conclusion. ☆

[3] *See* Rev. Proc. 2001-28, 2001-1 C.B. 1156.
[4] Grimm, *supra* note 1, at section 15:2.1.
[5] *See* Mo. Code 12 CSR 10-108.700.
[6] Mo. Code 12 CSR 10-108.700(3)(G).