AMERICAN OPTHALMIC, INC. 250 South Park Avenue, Suite 600 Winter Park, Florida 32789-4388,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. S. 96-253
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

FINAL ORDER

The Revenue Department assessed State, Houston County, and City of Dothan sales tax against American Opthalmic, Inc. ("Taxpayer) for January 1992 through January 1995. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(b)(5)a. A hearing was conducted on September 10, 1996. The Taxpayer's representative, Ruil T. Springer of Ernst & Young, LLP, filed a position statement in lieu of appearing. Assistant Counsel Margaret McNeill represented the Department.

The Taxpayer is a Florida corporation located in Winter Park, Florida. The Taxpayer entered into three transactions in Alabama during the audit period. The issue is whether the transactions were leases, and thus not subject to Alabama sales tax, or conditional sales, in which case sales tax is due.

The evidence submitted at the September 10 hearing does not fully explain the facts of the case. The parties agree, however, that the Taxpayer purchased the equipment of three optometry shops in Alabama during the subject period. The businesses apparently operated as Southeast Eye Clinic ("SEC"), Eye Center South

("ECS"), and American Surgery Center ("ASC"). The Taxpayer then either leased or sold the equipment to a subsidiary or affiliate that continued operating the businesses in Alabama.

The only Asset Purchase Agreement submitted into evidence is between American Opthalmic of Alabama, Inc., as purchaser, the Taxpayer, as parent, Douglas A. Freeley, M.D., P.C., as seller, and Douglas A. Freeley, M.D., individually. Although not named as a party, the Agreement apparently involved SEC because Section 4.1(i) of the Agreement, entitled "Intangible Property," states that there are no existing claims with respect to the seller's right to use the name "Southeast Eye Clinic." SEC is not mentioned anywhere else in the document.

The Taxpayer claims, and the Department does not dispute, that the Agreement is a standard Asset Purchase Agreement used by the Taxpayer. Section 2.1 (a) of the Agreement reads as follows:

> (a) Asset purchase agreement and sale. At the closing, seller shall sell, assign, transfer and convey to parent the equipment specified in Schedule 2.1(a) (hereinafter the "equipment"), and to purchaser all of the other acquired assets, in each case free and clear of any lien, claim, pledge, security interest or encumbrance, of whatever kind or character. Seller shall retain the excluded assets. The parties acknowledge that parent shall lease the equipment to purchaser.

The above section provides that the optometrist shop's equipment will be conveyed to the Taxpayer, and the other assets conveyed directly to the Taxpayer's subsidiary or affiliate in Alabama. The section also acknowledges that the Taxpayer intends to subsequently lease the acquired equipment to its Alabama subsidiary or

affiliate. Two equipment lease agreements were offered into evidence - one between the Taxpayer, as lessor, and ASC, a limited partnership, as lessee, and a second between the Taxpayer, as lessor, and American Opthalmic of Alabama, Inc., as lessee. ECS is not mentioned in the second agreement. However, the initials "ECS" are handwritten on the document, and the parties apparently agree that the document relates to ECS. I will assume so for purposes of this Final Order.

Pursuant to the standard Equipment Lease Agreement, the Taxpayer purports to lease the equipment for five years for a fixed monthly rent. The lessee agrees to maintain and repair the equipment, and accept the risk of all loss or damage. Paragraph (11) of the agreement reads as follows:

> 11. Purchase. Upon the expiration of this lease, lessee shall purchase all of the property for the purchase price of one dollar ($1.00). Upon payment of the purchase price, lessor shall sell, assign, transfer and convey to lessee all of the property AS IS at the time of purchase, without warranty, express or implied, with respect to its merchantability or fitness for a particular purpose or any matter whatsoever.

The Department audited the Taxpayer, determined that the Equipment Lease Agreement was in substance a conditional sales contract, and accordingly assessed sales tax on the gross proceeds derived from the sales. Although the Taxpayer claims that no Equipment Lease Agreement was entered into by SEC, the Taxpayer's books showed monthly payments from SEC to the Taxpayer. The Department accordingly also treated those payments as taxable gross proceeds of sale.

The Taxpayer argues that the agreements are leases because (1) the parties intended the transactions to be leases, (2) the Taxpayer retained title to the

equipment, and (3) the Taxpayer depreciated the equipment and the equipment would be obsolete at the end of the five-year period due to technical advances.

The only authority submitted by the Department in support of its position was Lawson State Community College v. First Continental Leasing Corp., 529 So.2d 926 (Ala. 1988). See, October 24, 1995 letter from Assessment Officer Joe Cowen to the Taxpayer's representative. Lawson State is not a tax case, but rather involves whether the transaction in issue was governed by Article 9 of the UCC, which concerns secured transactions. The case turned on whether the transaction was a true lease or a conditional sale secured by a security agreement. The Alabama Supreme Court relied on Code of Ala. 1975, '7-1-201(37) and '7-9-102 in holding:

> These sections establish that a "lease" allowing the lessee to purchase at a "nominal consideration" the subject matter of the lease is to be considered a security agreement rather than a true lease. (cites omitted). In the instant case, the right of the College to purchase the equipment for a mere $1.00 at the termination of the lease constitutes an option to purchase at a "nominal consideration," and hence, the arrangement between these two parties is no mere bailment lease, but is instead a disguised conditional sale secured by a security agreement.

Lawson State, 529 So.2d at 929.

Several other states have also addressed the issue. In Alzfan et al. v. Bowers, Tax Comm'r, 194 N.E.2d 852 (Ohio 1963), the Ohio Supreme Court held as follows:

> Where, as here, a so-called lessee is obligated to accept and pay for personal property at some future time and has no option to return it, the transaction is held to be a conditional sale even though terms commonly used in leases have been used. As stated in 47 American Jurisprudence, 23, Section 836:
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> > The test most frequently applied is whether the so-called

> "'lessee" is obligated to accept and pay for the property at some future time, or, on the other hand, whether his primary obligation is to return or account for the property to the so-called "lessor" according to the terms of the "lease."

Alzfan, 194 N.E.2d at 854.

On the other hand, if the lessee has only the option to purchase, the transaction is in the nature of a lease, not a conditional sale. Dollar Bank Leasing Corp. v. Limbach, 1992 Ohio Tax Lexis 1590 (1992).

The difference between a true lease and conditional sale was discussed in Illinois Department of Revenue, Private Letter Ruling No. 96-0074 (1996):

> A true lease generally has no buy out provision at the close of the lease. If a buy out provision does exist, it must be a fair market value buy out option in order to maintain the character of the true lease.
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> * * *
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> A conditional sale is usually characterized by a nominal or one dollar purchase option at the close of the lease term. Stated otherwise, if a lessor is guaranteed at the time of the lease that the leased property will be sold, this transaction is considered to be a conditional sale at the outset of the transaction, thus making all receipts subject (to the Illinois sales tax).

See also, Illinois Private Letter Ruling No. 93-0240 (1993) and 93-0299 (1993).

In this case, the Taxpayer's standard lease agreement provides that when the lease expires, the lessee shall purchase the equipment for one dollar. The purchase is mandatory, not optional, and is for a nominal amount. The transactions thus constituted conditional sales based on the authorities cited above. Substance over form must govern in tax matters. Brundidge Milling Co. v. State, 228 So.2d 475 (1969).

Consequently, Alabama sales tax is due on the proceeds received by the Taxpayer from the sales.[1]

The Taxpayer cites the Alabama sales tax definition of "sale" at Code of Ala. 1975, '40-23-1(a)(5) in support of its case. Specifically, the Taxpayer contends that a sale is not closed until title is transferred, which in this case was at the end of the "lease."

However, the definition of "sale" also includes "credit sales," and sales tax is due on credit sales as the sale proceeds are collected. Code of Ala. 1975, '40-23-8.

As in Lawson State, the transactions in issue are conditional sales in the nature of security agreements. The fact that title does not pass until the purchase price is paid in full does not make the prepaid sales proceeds not subject to sales tax. Otherwise, any retailer could technically retain title on a credit sale until an item is paid for, and thereby avoid sales tax.

The Taxpayer also argues that even if the Equipment Lease Agreement is found to be a taxable sales transaction, the SEC transaction should not be taxed because there was no written lease agreement involving SEC. I agree that no lease agreement was provided, but I disagree that the SEC transaction cannot be taxed.

The Taxpayer purchased the SEC equipment pursuant to the standard Asset

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[1]Even if the lease agreements were determined to be true leases, the Taxpayer would still be liable for Alabama lease tax on the transaction involving ASC. Code of Ala. 1975, '40-12-223(11) exempts from lease tax only those leases between related or subsidiary corporations. ASC is a limited partnership, not a corporation.

Purchase Agreement, which stated that the Taxpayer intended to lease the equipment. The Taxpayer's representative also acknowledged that SEC, or the Taxpayer's subsidiary that was to operate the business, leased the equipment from the Taxpayer. See, September 11, 1995 letter from Taxpayer's representative to Assessment Officer Joe Cowen.

Given the above facts, and without testimony or tangible evidence otherwise explaining the SEC transaction, it is reasonable to conclude that the SEC transaction also involved a conditional sales agreement. The Taxpayer failed to present evidence to the contrary. The unsupported verbal assertion of the Taxpayer's representative is insufficient to rebut the Department's prima facie correct assessment. State v. Ludlum, 384 So.2d 1089 (Ala.Civ.App.), cert denied, 384 So.2d 1094 (Ala. 1980); State v. Mack, 411 So.2d 799 (Ala.Civ.App. 1982).

Finally, the Taxpayer argues that if the tax is affirmed, at least the penalty should be waived. I agree. This case involved the disputed legal issue of whether the transactions were true leases or conditional sales. The Taxpayer interpreted the transactions as non-taxable leases. While that interpretation is incorrect, the Taxpayer's position was not unreasonable under the circumstances. In any case, the failure to timely pay penalty applies only to taxes reported on a return but unpaid, not taxes assessed pursuant to an audit, as in this case. Code of Ala. 1975, '40-2A-11(b).

The final assessments, less the penalties, are affirmed. Judgment is entered

against the Taxpayer for State sales tax of $17,548.79 ($20,588.62 less $3,039.83 penalty), plus applicable interest, Houston County sales tax of $4,538.97 ($5,298.93 less $759.96 penalty), plus applicable interest, and City of Dothan sales tax of $12,987.35 ($15,237.13 less $2,249.78 penalty), plus applicable interest.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, '40-2A-9(g).

Entered April 22, 1997.

BILL THOMPSON
Chief Administrative Law Judge