

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 03-06**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

Application of Tennessee sales and use tax to federal “like-kind exchange” transactions.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling, and a retroactive revocation of the ruling must inure to the taxpayer’s detriment.

FACTS

[THE TAXPAYER] is a lessor of motor vehicles (i.e., tangible personal property).¹ The Taxpayer requests a letter ruling regarding the taxability and reporting requirements for sales and use tax purposes, concerning federal “like-kind exchange” transactions.

I. Overview and Business Purpose

The transactions at issue involve the typical purchase, lease, and sale of motor vehicles as modified to qualify under Internal Revenue Code (“IRC”) § 1031. The Internal Revenue Service has ruled that exchanges of property (including rental property) by a corporation through an intermediary can qualify under IRC § 1031 as tax-free like-kind exchanges for federal income tax purposes.² The Taxpayer has entered into an agreement with Q1 Exchange, LLC (“Intermediary”) that qualifies for the federal tax-free like-kind exchange treatment.³

II. Form of the Transaction for Federal Tax Purposes

During the course of a leasing transaction, events can be divided into the following three segments or categories: (a) the acquisition of the property by the lessor; (b) the term of the lease; and (c) the disposition of the property by the lessor at the conclusion of the lease term. Simply stated, the lease is born, it lives for a period of time, and it dies (terminates). The complexities of IRC § 1031 only impact the lease transaction(s) at issue (a) when the motor vehicle is sold at the conclusion of the lease, and (b) when a new or replacement vehicle is acquired.

The IRC § 1031 transaction does not impact the relationship between the lessor and lessee during the term of the lease. The lessee will continue to remit all payments during the term of the lease to the lessor. The lease payments will continue as they currently exist, and the lessor will continue to issue invoices to the lessee. The only change in business operation for the proposed IRC § 1031 transactions is upon (1) the sale of the motor vehicle at the conclusion of the lease, and (2) the purchase of a new motor vehicle for lease by the lessor.

¹ The Taxpayer operates several leasing divisions, operating under the trade names [NAME] Financial Services and [NAME] Credit.

² The Taxpayer has developed a deferred like-kind exchange program under IRC § 1031 and § 1.1031(k)-1 of the Federal Treasury Regulations. The Taxpayer’s program encompasses acquisitions and dispositions of vehicles subject to lease under its [NAME] Lease Plan, [NAME]-branded and private label lease programs, with the exception of “totaled” vehicles (i.e., vehicles involved in an accident). Insurance proceeds received from totaled vehicles are reinvested in acquisitions and gain is deferred under IRC § 1033.

³ The Taxpayer has entered into a written “Master Exchange Agreement” with Q1 Exchange, LLC, an independent third-party financial institution. (A copy of the master agreement was attached to the ruling request.) Q1 is a single member limited liability company treated for federal income tax purposes as a division of its sole member, [NAME] Bank, N.A.

Sale of the Motor Vehicle – Relinquished Property

The Taxpayer leases motor vehicles. On termination of the leases, the Taxpayer disposes of (i.e., sells) vehicles in one of several ways: (1) the Taxpayer directly sells the motor vehicle to the lessee through the purchase option of the lease; (2) the Taxpayer sells the motor vehicle to the vehicle dealer for resale to the lessee, who exercises the purchase option; (3) the Taxpayer sells the motor vehicle directly to the vehicle dealer for resale to someone other than the lessee; or (4) the Taxpayer sells the motor vehicle at auction to a dealer for purposes of resale.

Under any of these described scenarios, the Taxpayer will dispose of the vehicles (“Relinquished Property”) at the termination of the lease through the Intermediary. The Intermediary has been assigned the Taxpayer’s rights (but not its obligations) with respect to the sale of the Relinquished Property at the termination of the lease.⁴ The property is sold in accordance with the Taxpayer’s directions and instructions either to (a) the lessee or (b) the dealer for resale.

In the first instance, the transaction would be generally considered taxable for sales and use tax purposes as a sale to consumer. In the second instance, the transaction would be generally considered not taxable for sales and use tax purposes since it would be deemed a sale for resale. The Taxpayer controls the disposition of the Relinquished Property, and the title to the property is transferred directly from the Taxpayer to the purchaser.⁵ The proceeds from the sale are received in a Taxpayer and Intermediary joint bank account (“Account”)⁶ which restricts the Taxpayer’s right to receive or otherwise obtain the immediate benefit of the proceeds. The Intermediary serves as a qualified intermediary for federal like-kind exchange purposes, but its involvement does not change the basic character of the transaction. For this service, the Intermediary receives a fee.⁷

Purchase of a New Motor Vehicle – Replacement Property

After disposing of old leased vehicles at the conclusion of their respective leases, the Taxpayer acquires new vehicles for lease (“Replacement Property”) using the services of the Intermediary.⁸ As with the Relinquished Property, the Intermediary has been assigned the Taxpayer’s rights (but not its obligations) with respect to the acquisition of “Replacement Property”. At the Taxpayer’s direction, the Intermediary pays for the

⁴ Article Two, Paragraph C of the Master Exchange Agreement.

⁵ Article Two, Paragraph E of the Master Exchange Agreement.

⁶ Article Three, Paragraph A of the Master Exchange Agreement describes the various accounts established by the Intermediary and the Taxpayer with respect to the program.

⁷ Article Four, Paragraph A of the Master Exchange Agreement.

⁸ [NAME] acquires leases and vehicles from a number of “sourcing agents” with whom it has contractual relationships. The contractual agreement between [NAME] and each sourcing agent provides that the sourcing agent will originate and purchase vehicles and leases from eligible dealers and sell them to [NAME] if they meet [NAME]’s eligibility criteria. The sourcing agent assigns its rights in the vehicles and leases its rights under its contract with the dealer to [NAME]. Each vehicle is titled in the name of [NAME] or one of its private label names (such as [NAME] Credit) for state law purposes.

Replacement Property out of the Account with funds⁹ from the sale of Relinquished Property. If there is a shortfall (i.e., the funds in the Account are less than the purchase price of Replacement Property), the Taxpayer will pay the difference.

Replacement Property obtained in a particular transaction is identified within 45 days of the sales of the Relinquished Property. If a Replacement Property purchase does not occur within the shorter of (a) 180 days or (b) the due date, including extensions, of the Taxpayer's federal income tax return, the Taxpayer will recognize gain on the exchange for federal income tax purposes. Again, as in the sale of Relinquished Property, the role of the Intermediary in the purchase of the Replacement Property is to provide a service to the Taxpayer. The title for the motor vehicle is transferred directly from the dealer to the Taxpayer and never vests in the Intermediary.

III. Transactions at Issue for Sales and Use Tax Purposes

1. Sale of Motor Vehicle to a Taxable Individual or Other Taxable Entity

In Scenario I, an individual purchaser (which for the purposes of this ruling is defined as any person or other legal entity) exercises an option to purchase the leased vehicle at the conclusion of the lease term.

By way of comparison, in a typical taxable scenario (not an IRC § 1031 transaction), the Taxpayer (i.e., lessor) (a) sells a motor vehicle, (b) collects the payment (i.e., purchase price plus tax), (c) remits the appropriate sales and use tax on the transaction, and (d) transfers the motor vehicle title to the purchaser.

However, in Scenario I, the individual purchaser will be directed to (b) remit their payment for the vehicle to the Account (rather than to the Taxpayer). For sales and use tax purposes, the Taxpayer will continue to document, report, and remit all taxes due on the transaction.

2. Sale of Motor Vehicle to a Nontaxable Dealer

In Scenario II, the lessor, at the conclusion of the lease sells the used motor vehicle to a vehicle dealer or another nontaxable reseller. The dealer may subsequently sell the vehicle to the lessee or to another third-party.

By way of comparison, in a typical nontaxable scenario (not an IRC § 1031 transaction), the Taxpayer (i.e., lessor) (a) sells a motor vehicle, (b) receives payment (i.e., purchase price without tax) and a resale certificate, (c) does not remit sales and use tax on the transaction, and (d) transfers the title to the motor vehicle to the dealer.

In a qualified IRC § 1031 transaction, the Taxpayer will continue to (a) sell a motor vehicle, (b) receive payment and a resale certificate, (c) not remit sales and use tax,

⁹ All electronic funds transfer ("EFT") disbursements are made out of a joint Intermediary-Taxpayer disbursement account ("JDA") which serves as a cash clearinghouse for disbursements. See Article Three, Paragraph A of the Master Exchange Agreement.

and (d) transfer the motor vehicle title to the dealer. However, as noted above, the dealer will be directed to remit its payment for the vehicle to the Account (rather than to the Taxpayer).

For sales and use tax purposes, the Taxpayer will continue to document and report the non-taxability of the transaction.

3. Purchase of a Motor Vehicle for Purposes of Leasing

In a situation where the lessor purchases tangible personal property (i.e., motor vehicles) and the lessee pays tax based upon the rental costs, typically the lessor acquires the property without being subject to sales or use tax (i.e., purchase for resale).

In Scenario III, typically the Taxpayer (i.e., lessor) (a) purchases the vehicle from the seller, (b) makes payment for the vehicle (i.e., purchase price without tax) and provides a valid resale certificate, and (c) receives the motor vehicle title from the seller.

In an IRC § 1031 transaction, the Taxpayer will direct the Intermediary to make payment from the Account to the seller (rather than make the payment itself). The Taxpayer will continue to (b) supply a valid resale certificate to the seller and (c) receive the motor vehicle title. The related lease of the motor vehicle will remain unchanged, and the lessor will continue to remit all rental taxes due upon the lease payments.

IV. Summary of Important Sales and Use Tax Considerations

The proposed transactions do not seek to reduce or eliminate any sales or use tax that is currently due and payable. The Taxpayer seeks to continue its current business practices, without an administrative change for its sales and use tax compliance effort. The Taxpayer believes that the transfer of the cash from or to an Account for IRC § 1031 purposes should not change current sales and use tax reporting practices.

ISSUES

1. In Scenario I, does the required IRC § 1031 payment made by the individual lessee, at the direction of the lessor/Taxpayer, to the Intermediary-managed Account, change the sales and use tax billing and payment process of the Taxpayer on the sale of a motor vehicle at the conclusion of the lease?
2. In Scenario II, does the required IRC § 1031 payment made by the vehicle dealer, at the direction of the lessor/Taxpayer, to the Intermediary-managed Account, change the sales and use tax billing and payment process of the Taxpayer on the sale of a motor vehicle at the conclusion of the lease?

3. In Scenario III, does the required IRC § 1031 payment made by the Intermediary – from the Account – to the seller change the sales and use tax billing and payment process of the lessor/Taxpayer on the purchase of Replacement Property (i.e., a new motor vehicle to replace the vehicle sold at the conclusion of the lease)?

RULINGS

1. In Scenario I, the sale of a motor vehicle at the conclusion of the lease to an individual lessee is a taxable transaction for sales and use tax purposes between the Taxpayer and the customer. The Taxpayer would be the party responsible for remittance of the appropriate sales or use tax to the State of Tennessee. The required IRC §1031 payment to the Intermediary-managed Account does not change the sales and use tax billing and payment process of the Taxpayer.
2. In Scenario II, the sale of a motor vehicle at the conclusion of the lease to a vehicle dealer is a nontaxable transaction for sales and use tax purposes between the Taxpayer and the dealer. The required IRC §1031 payment to the Intermediary-managed Account does not change the sales and use tax billing and payment process of the Taxpayer.
3. In Scenario III, the purchase of Replacement Property for leasing operations (i.e., a new motor vehicle purchased to replace the vehicle sold at the conclusion of the lease) is a nontaxable transaction, for sales and use tax purposes, between the Taxpayer and the dealer, if made pursuant to a valid resale certificate. The required IRC §1031 payment to the Intermediary-managed Account does not change the sales and use tax billing and payment process of the Taxpayer.

ANALYSIS

1. Scenario I: Sale of Motor Vehicle to Individual

In general, the sales tax is levied on the retail sales price from the sale of tangible personal property and on the gross proceeds from rental or leasing of property. Tenn. Code Ann. § 67-6-202 and § 67-6-204. The use tax is levied on the cost price or fair market value of items not sold, but used, stored, distributed, or consumed in the state. Tenn. Code Ann. § 67-6-203.

“Sale” is defined as any transfer of title or possession, or both, exchange, barter, lease or rental, conditional, or otherwise, in any manner or by any means whatsoever of tangible personal property for a consideration. Tenn. Code Ann. § 67-6-102(26)(A). “Retail sales” or a “sale at retail” is defined as a taxable sale of tangible personal property or specifically taxable services to a consumer or to any person for any purpose other than for resale. Tenn. Code Ann. § 67-6-102(25)(A).

“Sales price” is the total amount for which a taxable service or tangible personal property is sold, including any services that are part of the sale of tangible personal property,

valued in money, regardless of whether payment is made in money. Tenn. Code Ann. § 67-6-102(27).

An individual's exercise of a purchase option at the end of a lease, resulting in the lessee's acquisition of the leased vehicle, is generally a retail sale subject to sales and use tax. The Taxpayer making the sale is required to (a) bill the tax to the purchaser and (b) remit the tax to the state. Generally, the customer must present the bill of sale that evidences the sales price and also present evidence that the sales or use tax has been paid on that amount as a prerequisite to the registration of or licensing of any such motor vehicle by the state or local officials. Tenn. Code Ann. § 67-6-406.

In an IRC § 1031 like-kind exchange, the sale of the motor vehicle, which includes the transfer of title, will occur directly between the Taxpayer (i.e., lessor) and the individual (i.e., lessee). However, as described in Scenario I, the payment of the purchase price must be submitted by the purchaser to the Account for deposit by the Intermediary. This payment procedure is required in order to qualify for the federal income tax deferred gain treatment under IRC § 1031. In this scenario, the Intermediary is merely acting as a third-party providing a necessary service to enable the Taxpayer to obtain IRC § 1031 like-kind exchange treatment.

The actual retail sale and transfer of title, possession, or control of the motor vehicle is made by the Taxpayer to the individual. The Intermediary never receives title or possession of the motor vehicle. The Intermediary's involvement is primarily limited to the receipt, management, and subsequent distribution of funds obtained from the sale and purchase of motor vehicles.

In addition, the Taxpayer receives consideration, through its vested interest and ownership rights in the Account, equal to the purchase price paid by the individual. The Taxpayer's receipt of consideration in exchange for the transfer of title or possession provides further evidence that the retail sale is between the Taxpayer and the individual. Although the purchaser remits the consideration to the Intermediary, the funds are deposited into the Account held in interest for the Taxpayer. Ownership rights in the Account are evidenced by the Taxpayer's receipt of the interest income earned on the funds in the Account.

Finally, the title to the motor vehicle passes directly from the Taxpayer to the purchaser upon the sale of the vehicle. The Taxpayer, making the retail sale and transfer of title, is required to bill sales tax to the purchaser for remittance to the state.

Therefore, the Taxpayer should continue to bill the appropriate sales or use tax to the purchaser and remit such tax to the state. The tax will continue to be based upon the purchase price as defined by statute. The Intermediary's services, as defined under IRC § 1031, will have no impact on the sales and use tax imposition or compliance on the sale of the motor vehicle by the Taxpayer to the individual purchaser. The tax imposition will be the same whether the purchaser submits payment directly to the Taxpayer, as in the past, or to the Taxpayer's proposed Account managed by the Intermediary.

2. Scenario II: Sale of Motor Vehicle to Nontaxable Dealer

As noted in Scenario I, “retail sales” or a “sale at retail” is defined as a taxable sale of tangible personal property or specifically taxable services to a consumer or to any person for any purpose other than for resale. Tenn. Code Ann. § 67-6-102(25)(A).

“Sales for resale” means those whereby a supplier of materials, supplies, equipment, and services makes such tangible personal property or services available to legitimate dealers actually selling such property or services as such. TENN. COMP. R. & REGS. 1320-5-1-.62. Therefore, sales of tangible personal property for resale by legitimate dealers are excluded from the definition of “retail sale” and are not subject to sales and use tax.

In addition, “sale” is defined as any transfer of title or possession, or both, exchange, barter, lease or rental, conditional, or otherwise, in any manner or by any means whatsoever of tangible personal property for consideration. Tenn. Code Ann. § 67-6-102(26)(A).

When an individual declines to exercise the purchase option at the end of a lease, the motor vehicle is typically sold by the Taxpayer to a third-party, such as a vehicle dealer. The sale to the dealer is a nontaxable sale for resale, which is specifically excluded from the definition of “retail sale.” As a result, the Taxpayer making the sale must (a) obtain a valid resale certificate from the dealer (TENN. COMP. R. & REGS. 1320-5-1-.68), (b) bill the dealer for the purchase price without sales tax, and (c) transfer the title to the dealer.

In an IRC § 1031 like-kind exchange, the sale of the motor vehicle, which includes the transfer of title, will occur directly between the Taxpayer and the dealer. Similar to Scenario I, the payment of the purchase price must be submitted by the dealer to the Intermediary for deposit into the Account. This payment procedure is required in order to qualify for the federal income tax deferred gain treatment under IRC § 1031. In this scenario, the Intermediary is merely acting as a third-party providing a necessary service to enable the Taxpayer to obtain IRC § 1031 like-kind exchange treatment.

The actual sale for resale and transfer of title, possession, and control of the motor vehicle is made by the Taxpayer to the dealer. The Intermediary never receives title or possession of the motor vehicle. The Intermediary’s involvement is primarily limited to the receipt, management, and subsequent distribution of funds obtained from the sale and purchase of motor vehicles.

In addition, the Taxpayer receives consideration, through its vested interest and ownership rights in the Account, equal to the purchase price paid by the dealer. The Taxpayer’s receipt of consideration in exchange for the transfer of title and possession provides further evidence that the sale for resale is between the Taxpayer and the dealer. Although the dealer remits the consideration to the Intermediary, the funds are deposited into the Account held in interest for the Taxpayer. Ownership rights in the Account are evidenced by the Taxpayer’s receipt of the interest income earned on the funds in the Account.

Finally, the title of the motor vehicle passes directly from the Taxpayer to the dealer upon the sale of the vehicle. The Taxpayer, making the nontaxable sale for resale to the dealer and executing the transfer of title, is required to obtain a valid resale certificate from the dealer. The Taxpayer would also be responsible for reporting the nontaxable sale for resale on the periodic sales and use tax return filed with the state.

Therefore, the Taxpayer should continue to obtain a valid resale certificate relative to the leased vehicles sold to dealers for purpose of resale. Sales tax is not due on a nontaxable sale for resale and no remittance of tax is due to the state. The Intermediary's services, as defined under IRC § 1031, will have no impact on the sales and use tax imposition or reporting requirements for the sale of the motor vehicle by the Taxpayer to the dealer. The tax implication, including the collection of a valid resale certificate, will be the same whether the dealer submits payment directly to the Taxpayer, as in the past, or to the proposed Taxpayer's Account, managed by the Intermediary.

3. Scenario III: Purchase of a Motor Vehicle for Leasing Purposes

In general, the sales tax is levied on the gross proceeds from the rental or leasing of property. Tenn. Code Ann. § 67-6-204. As noted under Scenarios I and II, "sale" is defined as any transfer of title or possession, or both, exchange, barter, lease or rental, conditional, or otherwise, in any manner or by any means whatsoever of tangible personal property for a consideration. Tenn. Code Ann. § 67-6-102(26)(A). In addition, "lease or rental" means the leasing or renting of tangible personal property and the possession or use by the lessee or renter for consideration, without transfer of the title of such property. Tenn. Code Ann. § 67-6-102(16).

Accordingly, sales tax is imposed on sales of tangible personal property, including motor vehicles. The motor vehicle may be purchased tax-free, provided a resale certificate is submitted to the seller. TENN. COMP. R. & REGS. 1320-5-1-.68. However, tax is due when the property is leased and the lessor is required to collect sales tax on the lease payments and remit such to the Commissioner.

In Scenario III, the Taxpayer purchases motor vehicles from the seller for purposes of leasing to individuals. Upon payment of consideration to the seller, the Taxpayer will receive title to the motor vehicles. Such purchases are considered exempt sales not subject to sales tax. In order to obtain the exemption, the Taxpayer must provide a valid resale certificate. Upon the Taxpayer's lease of the property, the lessee must be billed tax on the gross lease charges. The taxpayer is required to remit such tax to the state.

In an IRC § 1031 like-kind exchange, the purchase of the motor vehicle, which includes the transfer of title, will occur directly between the Taxpayer and the seller. However, as described in Scenario III, the Taxpayer's payment to the seller will be withdrawn from the Account and submitted to the seller by the Intermediary. This payment procedure is required in order to qualify for the federal income tax deferred gain treatment under IRC § 1031. In this scenario, the Intermediary is merely acting as a third-party providing a necessary service to enable the Taxpayer to obtain IRC § 1031 like-kind exchange treatment.

The actual sale of the motor vehicle and transfer of title, possession, and/or control is made by the seller to the Taxpayer. The Intermediary never receives title to or possession of the motor vehicle. The Intermediary's involvement is primarily limited to the receipt, management, and subsequent distribution of funds obtained from the sale and purchase of motor vehicles.

In addition, the seller receives consideration, through the Taxpayer's vested interest and ownership rights in the Account, equal to the purchase price paid by the Taxpayer. The Taxpayer's payment of consideration in exchange for the title to the motor vehicle provides further evidence that the retail sale is between the Taxpayer and the seller. Although the Intermediary remits the consideration to the seller, the funds are disbursed from the Account, which is held in interest for the Taxpayer. Ownership rights in the Account are evidenced by the Taxpayer's receipt of the interest income earned on the funds in the Account.

Finally, the title of the motor vehicle passes directly from the seller to the Taxpayer upon the sale of the vehicle. The Taxpayer making the purchase and receiving the title is required to submit a resale certificate to the seller.

Therefore, the Taxpayer should continue to submit a resale certificate to the seller upon the purchase of the motor vehicle. The Taxpayer, when it leases the motor vehicle (i.e., Replacement Property), has the responsibility to collect sales tax from its lessee and remit tax to the state. However, the Intermediary's services, as defined under IRC § 1031, will have no impact on the sales and use tax imposition or compliance on the sale of the motor vehicle by the seller to the Taxpayer. The imposition of tax will be the same whether the Taxpayer submits payment directly to the seller, as in the past, or the Intermediary makes the payment from the Account.

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APPROVED: Loren L. Chumley
Commissioner of Revenue

DATE: 8/29/03