TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 04-23

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

Whether, upon default of a Lessee of tangible personal property, the guarantors' payments to the Lessor pursuant to contract agreements guaranteeing the Lessee's performance are subject to Tennessee sales tax.

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 his detriment.

FACTS

Prior to ceasing business operations, [LESSEE] was a manufacturer located [IN TENNESSEE]. The Lessee designed and manufactured high temperature, co-fired multi-layer ceramic packages and sub-assemblies. [OWNER I] and [OWNER II] were majority owners of the Lessee. Owner I and Owner II are not located in Tennessee. They are private investment funds based in [STATE – NOT TENNESSEE].

On [DATE], the Lessee entered into an equipment Lease agreement (the Lease) with [LESSOR], a business located outside Tennessee. The Lease had three equipment schedules as follows:

	Schedule 1	Schedule 2	Schedule 3	Total
Invoice Cost	[$AMOUNT]	[$AMOUNT]	[$AMOUNT]	[$AMOUNT]
Monthly Payment	[$AMOUNT]	[$AMOUNT]	[$AMOUNT]	[$AMOUNT]
Equipment Acceptance Date	[DATE]	[DATE]	[DATE]	
Term In Months	[NUMBER]	[NUMBER]	[NUMBER]	

With the exception of one piece of equipment worth approximately [$ AMOUNT] located at a subsidiary's place of business in [STATE – NOT TENNESSEE], all leased equipment was utilized in the Lessee's manufacturing process at its Tennessee location and qualifies as tax exempt industrial machinery under Tenn. Code Ann. § 67-6-102(a)(14).

The Lessee applied for and received a Tennessee industrial machinery exemption certificate and therefore no sales tax was paid on the manufacturing equipment Lease. Owner I and Owner II entered into agreements with the Lessor that guaranteed the Lessee's performance under the Lease. Owner I guaranteed [X%] of the Lease liability and Owner II guaranteed [Y%] of the Lease liability.

On or about [DATE], the Lessee ceased operations and became unable to fulfill its contractual obligations under the Lease. The Lessor declared the Lessee in default. On [DATE], the Lessor sold all of the leased equipment located in Tennessee for [$ AMOUNT]. The two parties that purchased the equipment will utilize it in their Tennessee manufacturing process and both have applied for and have received the proper Tennessee sales and use tax exemption certificates. Therefore, the equipment sale was made exempt from sales and use tax. The single piece of equipment located in [STATE – NOT TENNESSEE] was sold at auction and yielded net proceeds of [$ AMOUNT] for the Lessor.

As a result of the Lessee's default, the total damages payable to the Lessor by either the Lessee or Owner I and Owner II, as guarantors pursuant to the terms of the Lease and guarantee, totaled [$ AMOUNT]. After reducing that total by the

proceeds from the equipment sales, the damages outstanding to the Lessor as of [DATE] totaled [$ AMOUNT]. Since the Lessee is not able to make payment of such damages, Owner I and Owner II, as guarantors, will pay the outstanding amount to the Lessor.

QUESTION PRESENTED

Is the [$ AMOUNT] payment made by Owner I and Owner II, as guarantors of the Lessee's performance, subject to Tennessee sales and use tax?

RULING

No, with regard to the payments applicable to the guarantees on leased equipment located in Tennessee. If, however, the leased equipment located in Massachusetts was delivered to the Lessee in Tennessee then the payments applicable to the guarantees on such equipment are subject to the tax.

ANALYSIS

A "sale" is defined by Tenn. Code Ann. § 67-6-102(a)(27) to include the lease or rental of tangible personal property.

Tenn. Code Ann. § 67-6-204(a) makes the following provisions concerning the taxation of gross proceeds from the lease or rental of tangible personal property:

> It is declared to be the intention of this chapter to impose a tax on the gross proceeds of all leases and rentals of tangible personal property in this state where the lease or rental is a part of the regularly established business, or the same is incidental or germane thereto. The tax is levied as follows:
>
> (1) At the rate of the tax levied on the sale of tangible personal property at retail by the provisions of § 67-6-202 of the gross proceeds derived from the lease or rental of tangible personal property, as defined herein, where the lease or rental of such property is an established business, or part of an established business, or the same is incidental or germane to the business.
>
> (2) At the rate of the tax levied on the sale of tangible personal property at retail by the provisions of § 67-6-202 of the monthly lease or rental price by lessee or renter, or contracted or agreed to be paid by lessee or renter, to the owner of the tangible personal property.

Tenn. Comp. R. & Regs. 1320-5-1-.32(1) confirms that the gross proceeds paid for the lease or rental of tangible personal property within Tennessee is subject to Tennessee sales and use tax.

Tenn. Code Ann. § 67-6-206(a) provides the following exemption with regard to "industrial machinery" defined in Tenn. Code Ann. § 67-6-102(a)(14):

> After June 30, 1983, no tax is due with respect to industrial machinery.

The above cited statutes and rule make it clear that, although gross proceeds from the lease or rental of tangible personal property within Tennessee are normally subject to sales and use tax, gross proceeds from the lease or rental of tangible personal property that qualifies as industrial machinery are exempt from the tax.

Accordingly, the Lessee was not required to pay Tennessee sales tax on the gross proceeds paid for the lease of equipment qualifying as industrial machinery.

The leased property located in [STATE-NOT TENNESSEE] apparently did not qualify as exempt industrial machinery, however, the facts do not state whether such property was delivered to the Lessee in Tennessee. If the property was delivered to the Lessee in Tennessee, sales tax should have been paid on the Lease's gross proceeds notwithstanding the fact that the Lessee later removed the property from Tennessee. *Williams Rentals, Inc. v. Tidwell,* 516 S.W.2d 614 (Tenn. 1974).

Likewise, the Lessor's sale of the Lessee's Tennessee manufacturing equipment upon the Lessee's default on the Lease was not subject to Tennessee sales or use tax assuming the equipment qualified as industrial machinery in the hands of the purchasers.

The facts do not state whether the Lessor's default sale of the leased equipment located in [STATE-NOT TENNESSEE] took place in Tennessee or in [STATE-NOT TENNESSEE], but the equipment apparently did not qualify as industrial machinery in the hands of the buyer. Thus, if the sale took place in Tennessee, sales tax should have been paid on the sales price.

Neither the Lessor, Owner I nor Owner II (the guarantors) is located in Tennessee. However, upon default of the Lessee, the guarantors step into the shoes of the Lessee with regard to their guarantee payments.

Since no sales tax was due on the leased manufacturing equipment located in Tennessee assuming it qualified as exempt industrial machinery in the hands of the Lessee, no sales tax is applicable to the guarantee payments made by Owner I and Owner II to the Lessor.

If the leased equipment located in [STATE-NOT TENNESSEE] was delivered to the Lessee in Tennessee, the Lease payments were subject to Tennessee sales and use tax and consequently the payments by Owner I and Owner II applicable to the guarantees on such equipment are subject to the tax.

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APPROVED: Loren L. Chumley, Commissioner

DATE: 8/9/04