STATE BOARD OF EQUALIZATION
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July 8, 1992

Mr. G--- A---
Comptroller
P--- A--- L--- W---, Inc.
XXXXX --- ---, Unit #X
--- ---, California XXXXX

Re: S- -- XX-XXXXXX

Dear Mr. A---:

This is in response to your letter dated June 8, 1992 regarding the application of use tax to your leases of tangible personal property.

P--- A--- L--- W--- ("W---") does not own the equipments it rents. It acquires the equipment it will rent to its customers from its sister organization in New York, P--- A--- L---, Inc. ("L---"). You explain:

> "There exists a consignment agreement between the firms to facilitate this arrangement. The cost of this agreement, a function of the rental income generated by the equipment, is borne by W--- and included as an expense subject to use tax on line 2 of the quarterly return.
>
> "Thus, L--- NY who does own the equipment but has paid no sales tax to NY on their purchase of it transfers it directly to the customer of W---.
>
> "Whereby W--- will incur sales tax on the equipment cost due California and consequently not burden our customer with this tax nor include the rental income arising from this transaction as a taxable event. It is treated as a 'tax-paid rental' and deducted as an exempt transaction on line 6 of the quarterly return."

Initially, I note that I am confused by your explanation, in particular the first paragraph quoted above. So that I can provide you some guidance at this time, my opinion will be based on the following assumptions. I will assume that the document you refer to as a "consignment agreement" is simply a lease between W--- and L---. This would mean that W--- is subleasing the equipment to W---'s lessees. By cost of the agreement being borne by W---, I will assume that you mean W--- pays L--- a rental fee. It appears that this rental fee is a percentage of the rentals W---'s lessee's pay to W--- and that W--- is reporting this rental as subject to use tax. Since W--- is leasing the property from a related entity, there is a special rule applicable, which I will discuss below. First, however, I will discuss the general rules applicable to leases of tangible personal property in California.

The lease of tangible personal property in California is a continuing sale subject to use tax measured by rentals payable unless the lessor leases the property in substantially the same form as acquired and has paid California sales tax reimbursement or use tax to its vendor or timely reports to California use tax measured by purchase price. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, Reg. 1660, a copy of which is enclosed.) Similarly, a sublease of tangible personal property is a continuing sale subject to use tax measured by rentals payable from that sublease unless the subleased property is leased in substantially the same form as acquired and, as relevant to your inquiry, the sublessor has timely paid use tax measured by the rentals payable under the prime lease. (Reg. 1660(c)(5).)

Thus, if W--- and L--- were unrelated parties, your timely payment of use tax measured by rentals payable to L--- would mean that your sublease of the leased equipment would not be a continuing sale and would not be subject to use tax. However, since the lessor and prime lessee/sublessor are related parties, further analysis is required. In such circumstances, for purposes of application of sales and use tax, we disregard the transaction between the related parties unless that transaction was entered into as if at arms length. In the context of your inquiry, if we were to conclude that the transaction between W--- and L--- was not structured as if at arms length, we would disregard it, which would mean that we would regard the lease to W---'s customer as a continuing sale subject to use tax measured by the rentals payable from that lease.

A lease transaction between related parties is generally regarded as being entered into as if at arms length if the rentals payable under that lease cover all costs of the lessor with respect to that lease. The term "all costs" includes the cost of the leased property. If manufactured by the lessor, it includes all costs of property incorporated into the leased property or used during the manufacturing process and the cost of all direct and indirect labor. The term "all costs" also includes overhead costs attributable to the leased property (which would include costs such as employee costs of purchasing the property and accounting costs, utility costs, etc.).

Provided the assumptions made above are accurate and W--- timely reports use tax measured by the rentals payable under those leases, then we agree that, if the leases between W--- and L--- are as if at arms length, W---'s subleases of the equipment are not continuing sales and are not subject to use tax. Please bear in mind, however, that without reviewing the contract between W--- and L---, we are unable to ascertain whether we would regard it as a lease or as some other type of arrangement. If we were to conclude it is not a lease, the opinion above would not be applicable.

W--- is apparently currently reporting the rentals from its leases as receipts from nontaxable repair and installation. These receipts are from neither repair nor installation. Assuming the leases are not subject to tax, as discussed above, W--- should report such amounts under line 10(e) of the return (other nontaxable receipts) with the explanation "tax-paid lease."

If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Senior Tax Counsel

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Enclosure