**STATE BOARD OF EQUALIZATION**
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May 12, 1992

Mr. G--- U---
L--- & L---
XXXX --- ---, Suite XXX
--- ---, California XXXXX

Dear Mr. U---:

This is in response to your letter, dated February 28, 1992, which was received by us on March 26, 1992. You ask for a ruling regarding the application of sales or use tax with respect to certain sales and leases of tangible personal property. Initially, I note that the legal staff does not issue rulings. Under Revenue and Taxation Code section 6596, the Board has discretion to relieve a person of liability for sales and use taxes if that person reasonably relied on a written opinion from the Board that was in response to a written request for opinion from the taxpayer that includes all relevant facts, one of which would be the identity of the taxpayer. Section 6596 provides the only basis for relief of a taxpayer for properly due taxes. Since your client is not identified, this opinion does not come within the provisions of section 6596. You set forth the following facts:

> "The taxpayer rents equipment to the public under short-term rental agreements (by the day or week).
>
> "The taxpayer has purchased rental equipment on a non-tax-paid basis.
>
> "The taxpayer has also leased rental equipment from a third party on a non-tax-paid basis. The terms of the leases are for five years. There are no purchase options at the end of the leases.
>
> "The taxpayer has charged sales tax related to the rental of this equipment to the customers.
>
> "The taxpayer is contemplating entering into the following transactions:

"1) The lessor has agreed to sell the leased equipment to the taxpayer at the fair market value of the equipment. The taxpayer will pay use tax based on the sales price of those assets.

"2) Taxpayer will purchase additional rental equipment on a tax paid basis."

Prior to answering your specific questions, it will be helpful to briefly review the general rules for application of tax to leases. A 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 by the lessor and the lessor has paid sales tax reimbursement or use tax to the lessor's vendor or timely reported use tax measured by purchase price. (Rev. & Tax. Code §§ 6006(g), 6006.1, Reg. 1660(c).) You state that the taxpayer has charged sales tax related to the rental of the leased equipment. Actually, this is incorrect. The tax on the lease of tangible personal property is a use tax, owed by the lessee, which the lessor is required to collect from the lessee and pay to the state. (Reg. 1660(c)(1).) Each of your questions is quoted below followed by our response.

"1) Will the tax paid property exclusion apply to the rental of the newly purchased rental equipment?"

Assuming the property is leased in substantially the same form as acquired and a timely election is made to pay tax measured by purchase price, the leases will not constitute continuing sales and will not be subject to use tax.

"2) Will the tax paid property exclusion apply to the rental of the equipment previously leased on a non-tax paid basis and now purchased at fair market value on a tax paid basis?"

Our response to this question is the same as our response to your first question with one important proviso. If the sale to the taxpayer occurs while the taxpayer has an existing lease of the property to taxpayer's lessee, then the taxpayer is bound by the manner of reporting tax under that lease. The analysis applicable to such a transaction is similar to that required for assignments of leases, as explained in subdivision (c)(9) of Regulation 1660, a copy of which is enclosed. When a sublessor of property with an existing sublease obtains title to the subleased property, the sublessor (now the lessor) cannot alter the manner of reporting. If tax was being collected, and reported, measured by rentals payable, then the sublessor (now lessor) must continue to collect and report tax on that basis. On the other hand, when a person acquires property which is not in actual rental service at the time of the sale and that person will lease the property in substantially the same form as acquired, he or she has the usual election to pay tax on purchase price, even if that property had previously been leased on a sublease basis.

"3) Is there a procedure whereby the taxpayer can change its election for property previously purchased on a non-tax paid basis to a tax paid basis?"

No.

"4) If there is no such procedure, could the taxpayer sell this rental equipment at fair market value, to a related party, whereby the related party would pay sales tax on the acquisition and lease the equipment back to the taxpayer and the taxpayer have the tax paid property exclusion apply?"

Initially, I note that it is not possible to change the application of tax to an on-going lease, without regard to whether the ownership of the leased property changes. With that proviso in mind, generally when a person acquires property and timely pays tax measured by purchase price, that person's lease of the property in substantially the same form as acquired is not a sale and is not subject to use tax. On the other hand, when persons enter into transactions solely for the purpose of avoiding or altering sales or use tax liabilities, there is a risk that the transactions will be disregarded for sales and use tax purposes. Thus, when related parties enter into transactions as you propose, those transactions will be disregarded if they are not structured as if at arms length. For example, when a person sells property to a related party who will thereafter lease the property, the sale to the related party will be disregarded for sales and use tax purposes if the sale price does not include all costs of the seller, including the costs of the property and any overhead properly allocated to the cost of that property.

"5) If the taxpayer does not purchase the leased equipment can the taxpayer commence to start paying use tax on the rental paid for this equipment and not collect sales tax on the rental charged to the customers and thereby treat this rental equipment as being subject to the tax paid property exclusion?"

Again, I note the rule that the application of tax to a lease of tangible personal property cannot be changed during the lease term. This means that the taxpayer may not elect to do as you suggest with respect to property currently in rental service with respect to which taxpayer collects use tax measured by rentals payable. Assuming that the question relates to property held for lease but not currently in rental service, taxpayer nevertheless may not change its election with respect to a current lease under which it is subleasing the property. However, at the end of the lease term between the lessor and taxpayer, the renewal of that lease is a new lease and taxpayer has the usual election. (See Reg. 1660(c)(5) (sublease of property not subject to tax if tax paid on prime lease).)

"6) If the taxpayer rents equipment to a customer and the rental covers items acquired both on a tax paid basis and non-tax paid basis will the sales tax charged to the customer be based only on the non-tax paid property or will the entire rental transaction be subject to sales tax?"

The lease of property in substantially the same form as acquired as to which the lessor has timely paid tax measured by purchase price is not subject to use tax even if leased along with other non-tax paid property. When such property is leased along with non-tax paid property, tax applies only to the rentals from the non-tax paid property.

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

Sincerely,

David H. Levine
Senior Tax Counsel

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Enclosure