

M e m o r a n d u m**330.2305.180**

To: San Jose Auditing (KGS)

Date: September 4, 1985

From: E. Leslie Sorensen, Jr.
Tax Counsel

Subject: O--- Inc.

This is in response to your memorandum of May 7, 1985 concerning the application of the Sales and use Tax Law to the subject taxpayer's operations. We understand that O--- Inc. (O---) is being audited by your staff.

During the audit period, O--- had three plans under which it marketed its O--- S--- Catheter Oximetry System and its O--- S--- Hemostatic Scalpel. There apparently was little question with respect to application to the tax to Plans A and C. Suffice to say, we agree with your conclusions that Plans A represent outright purchases while Plans C are leases of equipment. The question for discussion, then, is how the tax should apply with respect to Plans B.

Since Plans B of the Oximetry System and Hemostatic Scalpel are essentially the same, we will only review the Plan B pertaining to the Oximetry System here, noting that the same approach may be used by your staff in analyzing Plan B of the Hemostatic Scalpel. When referring to the attachments to your memorandum, we will utilize the same numbering system you used.

Attachment (A1) describes the system as consisting of a disposable fiberoptic pulmonary catheter that interfaces with an optical module containing light emitting diodes, a photodetector and associated electronics, and a microprocessor based instrument that performs all data processing and control functions with displays, alarms and a built-in strip chart recorder.

Attachment (A3) describes Plans A, B, and C as follows:

Plan A – Outright Purchase

Under this plan a hospital purchases outright the instrument, catheters and supplies as required at List Prices. Multiple Instrument purchases from the same institution ordered for delivery within a twelve month period, are entitled to the following discounts from List Price: 2nd unit – 15% (i.e., a 7 ½% average discount

on the first two units; 3rd unit – 20%; 4th unit – 25%; 5th and beyond – contact Home Office.

Plan B – Catheter Purchase Contract

This plan enables a hospital to acquire continued use of an oximeter instrument, either Model OS/XXXX- or OS/XXX, at no cost by placing a standing purchase order for one box of six -XXXX O--- catheters per month per instrument acquired under Plan B at the prices set forth below.

No. of Instruments Acquired Under <u>Plan B</u>	Catheter Purchase Contract Price	
	<u>Per Catheter</u>	<u>Per Box (of 6)</u>
1 or 2	225.00	1,350.00
3	215.00	1,290.00
4	205.00	1,230.00
5	195.00	1,170.00
6	185.00	1,110.00
7	175.00	1,050.00
8 or more	165.00	990.00

During the first six months of a Catheter Purchase Contract, the hospital may apply 50% of excess of the Catheter Purchase Contract Price paid over the List Price toward the purchase price of the instrument.

Plan C – Instrument Rental

Under this plan a hospital may rent either a Model OS/XXXX- or Model OS/XXX Instrument on a month-to-month basis for the monthly rental set forth below. Catheters, accessories and supplies are purchased at List Prices as required. At any time the hospital may apply 67% of the aggregate rentals toward the purchase price of the Instrument.

<u>Model No.</u>	<u>Monthly Rental</u>
OS/XXXX-	\$475.00
OS/XXX	\$375.00

The list prices for the model OS/XXXX- instrument, the Model OS/XXX instrument, and each catheter were listed respectively, as: \$8,500, \$6,500, \$165 (Attachment (A3)). Additionally, we note under “Other Terms and Conditions” pertaining to Plans B and C that if a

customer returned the O--- instruments before six months had elapsed it was required to pay a \$475 cancellation and refurbishment charge (Attachment (A3)).

We understand that O--- reported sales tax for the audit period based upon all amounts received from customers under Plan B.

The primary issue presented is whether Plan B is to be considered a lease of the instruments and sale of the catheters, or merely a loan of the instruments and sale of the catheters. Secondary issues, which we will mention briefly but not resolve, pertain to the identity and apportionment of the tax.

We turn now to consideration of the primary issue. "Sale" and "purchase" are defined to include "any lease of tangible personal property in any manner or by any means whatsoever, for a consideration..." (Rev. & Tax. Code §§ 6006(g), 6010(e)). "Lease" is defined in the code to include rental, hire and license (Rev. & Tax Code § 6006.3). Section 1925 of the Civil Code defines a hiring as "...a contract by which one give to another the temporary possession and use of property, other than money, for reward, and the latter agrees to return the same to the former at a futher time." Regulation 1660, subsection (a) incorporates the concepts of the foregoing provisions by defining a "lease" as follows:

"The term 'lease' includes rental, hire, and license. It includes a contract under which a person secures for a consideration the temporary use of tangible personal property which, although not on his premises, is operated by, or under the direction and control of, the person or his employees...."

"Good consideration" is defined in Civil Code Section 1605 as:

"Any benefit conferred, or agreed to be conferred, upon the promisor, by any other person, to which the promisor is not lawfully entitled, or any prejudice suffered, or agreed to be suffered, by such person, other than such as he is at the time of consent lawfully bound to suffer, as an inducement to the promisor, is a good consideration for a promise." The general rule is that any valid promise is sufficient consideration for another promise (see Simmons v. California Institute of Technology, 34 Cal.2d 264; Chrisman v. Southern Cal. Edison Co., 83 Cal.App. 249.

Section 1884 of the California Civil Code describes a "loan for use" as follows:

"A loan for use is a contract by which one gives to another the temporary possession and use of personal property, and the latter agrees to return the same thing to him at a future time, without reward for its use." (Emphasis added.)

Applying the foregoing principles to the facts in this matter leads us to conclude that O--- is in the business of leasing, not loaning, its instruments to customers who opt for Plan B. In reaching this conclusion, we note that temporary possession of the instruments transfers to the customers and that there is consideration in the form of the customer's promise to purchase at least one box of catheters per instrument per month while in possession of the instruments. Additional consideration is in evidence in the form of the customer's promise to pay a penalty of \$475 if instruments are returned before a six month period has elapsed.

Plan B clearly does not evidence a "loan for use" of the instruments since O--- realizes "reward" for the use in the form of the customer's promise to purchase and actual purchase of catheters during the term of possession.

Regarding the secondary issues of identity and apportionment of the tax, we note that the identity issue relates to whether the applicable tax is sales or use, while the apportionment issue concerns how the tax should be apportioned between receipts from rental of equipment and receipts from catheter sales. While these issues are potentially very complex, e.g., if the product sold was exempt while the equipment leased was not, they are of no real significance to the matter at hand since neither the leases of the equipment nor sales of the catheters are exempt and since the taxpayer has already reported tax on all amounts received from its customers. Accordingly, we will reserve our opinion in this difficult area until presented with facts which call for specific conclusions.

ELS:rar