STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 323-7712

May 7, 1991

S---
XXXX --- Avenue
--- ---, CA XXXXX

Dear Madam or Sir:

Re: M--- at F---'s W---
SN -- XX XXXXXX-010

Enclosed is a copy of the Decision and Recommendation pertaining to the petition for redetermination in the above-referenced matter.

I have recommended that the petition be granted as explained in the Decision and Recommendation.

You are advised that this recommendation has not yet become final and that there are three options available to the Board's Sales and Use Tax Department.

1. If, after reviewing the Hearing Decision and Recommendation, the Department believes that it has new evidence and/or contentions not previously considered by the Hearing Officer, it may file a Request for Reconsideration within 30 days from the date of this letter and clearly set forth any new contentions. If new evidence is the basis for filing the request, the evidence must be included. The Department will direct any such request directly to me with a copy to you. I will subsequently notify you whether the request has been taken under review or whether the request is insufficient to warrant an adjustment. If I conclude that no adjustment is warranted, I will then notify the Department of the procedure it can follow to request an oral hearing before the Board.

2. If, after reading the Hearing Decision and Recommendation, the Department finds that there is no basis for filing a Request for Reconsideration, but nevertheless desires to have an oral hearing before the Board, a written request must be filed within 30 days from the date of this letter with Ms. Janice Masterton, Assistant to the Executive Director. A copy of any such request will be sent to you.

3. If neither a request for Board hearing nor a Request for Reconsideration is received within thirty (30) days from the date of this letter, the Hearing Decision and recommendation will be presented to the Board for final consideration and action.

Very truly yours,

H. L. Cohen
Hearing Officer

HLC:cc
Enc.

cc: Mr. M--- H---
Attorney at Law
M--- & F---
XXX --- Street
--- ---, CA XXXXX
(w/enclosures)

Ms. Janice Masterton
Assistant to the Executive Director (w/enclosure)

Mr. Glenn Bystrom
Principal Tax Auditor (file attached)

E. L. Sorensen, Jr., Chief Counsel (w/enclosure)

--- --- – District Administrator (w/enclosure)

STATE OF CALIFORNIA

BOARD OF EQUALIZATION **330.2460**

APPEALS DIVISION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	HEARING DECISION AND RECOMMENDATION
S--- dba M--- AT F---'S W---	)	NO. SN -- XX XXXXXX-010
Petitioner	)	

The above-referenced matter came on regularly for hearing before Hearing Officer H. L. Cohen on February 28, 1991, in --- ---, California.

Appearing for Petitioner: Mr. M. W--- - H---
Attorney at Law

Appearing for the Sales and Use Tax Department: Mr. J. Speed
District Principal Auditor
--- --- District

Protested Items

The protested tax liability for the period August 20, 1984 through December 31, 1988 is measured by:

	Item	State, Local and County
A.	Unreported rental receipts	$1, 399,212
B.	Property tax payments related to rented property	$ 173,285
	Total	$1,572,497

Contention

Petitioner contends that the contract in question is a management contract, not a lease. If it is regarded as a lease, the amount upon which the tax is based is excessive.

Summary

Petitioner is a joint venture consisting of M--- - F---'s W--- and the E--- L--- A--- S--- of the United States. The joint venture owns the M--- hotel at F---'s W--- in --- ---. It does not hold a seller's permit. M--- - F---'s W--- developed and built the hotel paying sales tax reimbursement or use tax on all property going into it. In August 1984, M--- - F---'s W--- contributed the hotel and E--- contributed cash to form petitioner.

M--- - F---'s W--- is a limited partnership of which W.B. J--- P---, Inc. is the general partner. Petitioner is the holder of the franchise from M--- Corporation. Petitioner and J--- entered into an agreement on August 20, 1984 under which J--- was to operate the hotel. The title of the agreement is "Operating and Lease Agreement". It describes petitioner as "owner" and J--- as "operator".

Article I of the agreement contains definitions of terminology used in the contract. Pertinent paragraphs contain definitions as follows:

> "25. The term 'operating term' shall mean the period for which the hotel is leased by owner to operator as provided for in Article III hereof as such period may be shortened by termination pursuant to provisions of this agreement.
>
> • * *
>
> "33. The term 'total revenue' shall mean the gross guest revenues plus other gross revenues but shall exclude (i) federal, state and municipal excise sales and taxes collected directly from patrons and guests or as part of the sales price of any goods, services, or displays such as gross receipts, admissions, cabaret or similar or equivalent taxes and paid over to federal, state or municipal governments; (ii) credit card and travel agents commissions; (iii) insurance proceeds received as compensation for lost, damaged or stolen property of the hotel; and (iv) bad an uncollectible debts of the hotel to the extent previously included in total revenue."

Article II of the agreement provides in pertinent paragraphs as follows:

"ARTICLE II

LEASING AND MANAGEMENT OF HOTEL

"1. Authorization. Owner hereby authorizes and contracts for Operator, subject to this Agreement, the Franchise Agreement and to conditions, restrictions, limitations and encumbrances of record affecting the Project, to lease and manage the Hotel, and Operator hereby agrees and contracts to lease and manage the Hotel on such terms. Owner and Operator agree that Operator shall receive the Operator's Fee in full payment for Operator's operating and managing the Hotel.

"2. Acceptance. Operator hereby accepts the Hotel on the Commencement Date for the purpose of leasing and management of same in its then existing state without any representation or warranty by Owner as to the condition thereof, except that owner agrees to complete construction of the Hotel, at Owner's sole expense, and Operator agrees to cooperate with Owner in connection therewith. Neither Owner no Operator shall be responsible to the other for any latent defect or change of condition in the Hotel or any part thereof or of any property located on the Premises, except that Operator shall be responsible for any failure to perform the terms of this Agreement. Operator agrees to lease, operate and manage the hotel only in the manner set forth herein."

Article V of the agreement provides in pertinent paragraphs as follows:

"OPERATION OF THE HOTEL ON AND AFTER COMMENCEMENT DATE

"1. Operation. Operator shall be the lessee, operator and manager of Hotel during the Operating Term and shall operate the Hotel as a first class hotel in accordance with the terms of the Franchise Agreement as they relate to the operation obligations of Owner, the standards of comparable hotels in the --- ---, California, metropolitan area, and as required by this Agreement and applicable law.

> "2. Powers of Operator. Operator shall have complete control and discretion in the operation, direction, management and supervision of the Hotel, subject only to those specific approvals of Owner set forth herein and the requirements of this Agreement and the Franchise Agreement. Such authority of Operator shall include, without limitation, determination of labor policies (including wage rates and the hiring and discharge of all employees), credit policies (including entering into agreements with credit card organizations), terms of admittance, charges for rooms and commercial space, entertainment and amusement policies, food and beverage policies (including the right to conduct catering operations outside of the Hotel) and leasing, licensing and granting of concessions for commercial space at the Hotel, the hiring of outside specialists which may be temporarily required at the Hotel, the institution of such legal proceedings in the name of Operator as Operator shall deem appropriate in connection with the operation of the Hotel, and all phases of promotion and publicity relating to the Hotel. In exercising such authority, Operator may enter into such contracts, leases, concession agreements and other undertakings in its own name as it shall from time to time consider appropriate."

Revenues from the operation of the hotel were to be handled in accordance with Article XI, pertinent paragraphs of which are as follows:

> "1. Operator's Fee. For each Fiscal Year (and proportionately for any fraction thereof) during the Operating Term, Operator shall pay over to Owner one hundred percent (100%) of the Gross Operating Profit. Operator shall retain for itself from the Total Revenue an amount (the "Operator's Fee") equal to five percent (5%) of Total Revenues for such Fiscal Year as Operator's Fee. The Operator's Fee for each Accounting Period shall be payable on or before the twentieth (20^{th}) day of the succeeding Accounting Period during the Operating Term, out of the Agency Account, and be accounted for cumulatively on a Fiscal Year to date basis. On or before the twentieth (20^{th}) day of each Accounting period during the Operating Term, Operator shall, after payment of the Operator's Fee for the next preceding Accounting Period and retention of Working Capital reasonably required for the uninterrupted and efficient operation of the Hotel for the immediately foreseeable future, remit to Owner all remaining funds in the Agency Account.

* * *

> "3. Operating Loss. In the event there is an Operating Loss in any Fiscal Year, such Operating Loss shall be borne by Operator and the amount thereof shall not be carried forward or backward to any other Fiscal Year except that any Operating Loss for the first Fiscal Year and first full Fiscal Year of the Operating Term hereof may be carried forward to the second full Fiscal Year."

The agreement contains one additional reference to rent which is in Article XVIII, paragraph 1a, which provides as follows in defining default:

> "The failure of Operator to pay any rent or money to owner provided for herein when the same is payable or the failure of Owner to pay or furnish to Operator any money Owner is required to pay or furnish to Operator in accordance with the terms hereof."

There are no references anywhere else in the agreement to rent or lease.

The auditor took the agreement at face value and concluded that it constituted a lease of both real and tangible personal property. The auditor calculated that 11.564 percent of the value of the hotel and contents was attributable to furniture and fixtures. This percentage was applied to payments to petitioner in property tax payments to arrive at an estimate of rental payment attributable to tangible personal property. Tax was applied to this amount.

Petitioner contends that the receipts from J--- with respect to the operation of the hotel constitutes profits from the operation of the hotel and not rents. J--- merely operates the hotel on behalf of petitioner and receives a fee. All income other than the fee belongs to the petitioner as owner. The amount specified in the agreement to be paid to petitioner is not labelled "rent". The terms of the agreement are typical of provisions in standard management agreements. In substance, the contract is for the management services of J---.

The agreement imposed specific limitations on Johnson which are not consistent with a lessor/lessee agreement. These included controls on legal proceedings, on concession agreements, on salaries to J--- personnel, on large expenditures, and on labor relations. Although there are references to lease in the agreement, the agreement lacks the normal characteristics of a real estate lease. There is no provision for rent, only for payment to petitioner of gross operating profits. There is no rent schedule and amounts paid to petitioner are based solely on operating profits.

Petitioner points out that the courts in analogous contexts have made it clear that management or operating agreements do not constitute leases. Petitioner cites Pacific Grove-Asilomar Operating Corp. v. County of Monterey (1974) 43 cal.App.3d 675 and Meagher v. Commissioner, (36 T.C.M. (CCH) 1091. A key element in finding management contracts not to be leases is that any "rent" is only if there is a net profit in the business operation. In State National Bank of El Paso v. United States, 509 F.2d 832, an agreement was found to be a management contract because the owner had the final word on expenses, the expenses were borne by the owner, the owner's income depended on the profits of the business, and the risk of loss was on the owner.

Petitioner contends that the calculation of deemed rent by the auditor was incorrect because the auditor used general ledger values for a single date to calculate the taxable percentage and because the auditor included fixtures in the taxable amount which is contrary to Sales and Use Tax Regulation 1660(d)(8). That subdivision provides that leases of fixtures in circumstances such as these are not taxable.

Analysis and Conclusions

Sections 6006 and 6010 of the Revenue and Taxation Code provide that, in general, leases of tangible personal property constitute sales and purchases. The exceptions are not applicable here. Section 6401 provides that in the case of leases of tangible personal property, the applicable tax is the use tax. Section 6203 requires retailers engaged in business in this state to collect the use tax from their customers. In short, if the agreement in question is regarded as a lease, Johnson is liable for use tax on its use of the leased property and petitioner is required to collect that tax and pay it to the Board.

I note initially that even if the agreement is regarded as a lease, the inclusion of fixtures in the amount of tangible personal property is incorrect since the "lessor" of the fixtures is also the "lessor" of the realty. See Sales and Use Tax Regulation 1660(d)(8).

Petitioner's argument is basically that the application of tax should be based on substance rather than form. In general, a taxing authority is not necessarily bound by the language a taxpayer chooses to describe a transaction, but the taxpayer does not have the same freedom to disregard the form he has chosen. See W. E. Hall v. Franchise Tax Board, 260 Cal.App.2d 179 and Moline Properties v. Commissioner, 319 U.S. 436.

Nevertheless, it is necessary to examine the terms of the contract and determine whether or not it represents a lease in actuality.

Regulation 1660 defines "lease" in subdivision (a)(1) to include a contract under which a person secures for a consideration the temporary use of tangible personal property which is operated by or under the direction of and control of the person or his employees. I conclude that the contract here is not a lease because it fails to meet two of the elements in this definition.

In a typical lease arrangement, the lessor receives a rental consideration consisting of a fixed stated amount or of a fixed amount plus a percentage of gross profits. The lessee is the party at risk so far as the profitability of the business is concerned. Here, petitioner, as the lessor, is not guaranteed any "rental" payments. J---, as the lessee, has no risk because its remuneration is based on gross receipts. This is contrary to the usual rental arrangement.

The second criterion is less clear; however, there is definitely a question as to the degree of control which J--- can exercise. The agreement requires more than mere maintenance of the premises. A lessor would not typically exercise control over a lessee's salary arrangements with its employees or a lessee's expenditures.

In summary, I conclude that the agreement is a management contract, not a lease. No tax is due.

Recommendation

Grant the petition.

_____ 4-23-91

H. L. Cohen, Hearing Officer Date