

Memorandum

330.2715.905

To : Mr. Robert Shaw
Return Analysis Section, MIC:35

Date: August 22, 1997

From : Kelly W. Ching
Tax Counsel

Subject: *L--- R--- G---*
SC -- XX-XXXXXX

This is in response to your memorandum dated June 27, 1997 in which you ask how tax applies to certain leases of heating and air conditioning equipment.

In his letter to you on behalf of his client, L--- R--- G---, Mr. K--- L. J---, C.P.A., states as follows:

“Last month I spoke with you by phone regarding the facts pertaining to Mr. G--- and a revised lease entered into effective February 1, 1995. Prior to that date, Mr. G--- had an operating lease with L--- P--- wherein he leased to L--- certain heating and air conditioning equipment located on an office building in San Diego. When the lease term expired in January, 1995, a new lease was negotiated between the parties. The new lease involved a monthly payment of \$7,024.60 with title transferring to the lessee (L---) at the end of the term. The present value of the lease payments, agreed to by both parties, was \$359,018.03.

“For tax purposes, both parties treated the new lease as a sale. However, for reporting sales tax to California, it was continued as an operating lease which per our discussion, was most likely incorrect. It is my understanding from our discussion, that you felt it should have been treated as a sale for sales and use tax purposes also.

“I have spoken to the representative at L---, Mr. J--- C---, who indicated they want to handle the transaction properly as well, and understand they may have an obligation for use tax. If you need to speak with Mr. C---, he can be reached at L--- Partners, XXX --- ---, Suite XXXX, ---, IL XXXXX. His phone number is (XXX) XXX-XXXX.

“Insofar as sales tax has been paid by Mr. G--- during this new lease period, we respectfully request all taxes paid be refunded to him. Per our records, the total

sales tax paid beginning February 1, 1995 totals \$4,506. A schedule of payments is enclosed for your reference.”

I note that we have not been provided with a copy of the February 1, 1995 lease contract.

DISCUSSION

As you know, retail sales of tangible personal property in California are subject to sales tax, measured by gross receipts, unless specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) A sale includes any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. (Rev. & Tax. Code § 6066(a).) When sales tax does not apply, use tax, measured by the sales price of the property sold, applies to the use of property purchased from a retailer for storage, use or other consumption in California, unless such use is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6201, 6401.)

A lease of tangible personal property in California is a continuing sale and purchase unless the lessor leases the property in substantially the same form as acquired and has made a timely election to pay California sales tax reimbursement or use tax measured by the lessor's purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, 6010(e)(5), 6010.1, Reg. 1660(c)(2).) When a lease is a continuing sale and purchase because either or both of the foregoing conditions set forth above are not satisfied, the lease is subject to use tax measured by rentals payable. (Reg. 1660(c)(1).) The lessee owes the tax, which the lessor is required to collect from the lessee and to pay to this Board. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c).) Our understanding is that the original lease was a continuing sale and purchase under the rules set forth above, and that Mr. G--- collected use tax on his rental receipts and remitted the tax to the Board.

In discussing the second lease contract dated February 1, 1995, I note that some contracts designated as leases do not actually constitute lease contracts. A contract designated as a lease will be regarded as a sale under a security agreement at its inception, rather than as a lease, where the contract binds the “lessee” for a fixed term and the “lessee” is to obtain title at the end of the term upon completion of the required payments, or has the option to purchase the property for a nominal amount. (Rev. & Tax. Code § 6006.3, Reg. 1660(a)(2)(A).) The option price will be regarded as nominal if it does not exceed \$100 or 1 percent of the total contract price, whichever is the lesser amount. (Id.) In other words, a contract designated as a lease is actually a sale at inception if the “lessee” is certain to own the property at the end of the lease term.

Since we have not been provided with a copy of the “lease” contract, we do not know what the contract set forth as the term of the “lease.” If we were to review the contract, we might conclude that it represents a true lease. For purposes of this opinion, we assume that the contract binds L--- for a fixed term. Since you have stated that L--- obtains title at the end of the lease term, it appears that L--- is certain to own the property at the end of that term. This means

that the transaction constitutes a sale at inception, rather than a true lease, and that the sale at inception took place when possession of the property was transferred to L---. (See Regs. 1641(b) and (c).) As such, tax applies to the sale.

Mr. G---, as the retailer, is liable for payment of tax measured by the full contract price, except that if he keeps adequate and complete records to show separately the insurance, interest, finance, and carrying charges with respect to this transaction, such charges maybe excluded from the measure of tax. (Rev. & Tax. Code § 6010.5; Reg. 1641(a).) That tax was required to be reported and paid with Mr. G---'s timely return for the period in which the sale occurred; that is, when the "lease" commenced. Thus, he is entitled to a refund only if the payments he has made exceed the amount he should have paid as provided in Regulation 1641 with respect to the sale at inception, taking into account any interest due for late payment of such amount. However, based on the monthly payment and present value amounts set forth in your memorandum, it does not appear that Mr. G--- could have yet paid the full amount of tax for which he is liable.

If you have further questions, please feel free to write or call me.

KWC:cl

cc: Out-of-State District Administrator