

**STATE BOARD OF EQUALIZATION**

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January 16, 1991

Ms. V--- T---
Staff Accountant
I--- U--- W--- Corporation
XXXX --- Avenue
---, California XXXXX

RE: SR -- XX-XXXXXX

Dear Ms. T---:

I am responding to your letter of November 1, 1990, to the Legal Division. You have requested an opinion that your company's purchases of certain items are not subject to sales or use tax because they are carried on its books as capital assets.

I. FACTUAL BACKGROUND

You state the factual background of your problem as follows:

"I--- U--- was audited for the years 1987-1989. The auditor found during the audit that I--- U--- had paid Sales Taxes on personal property purchased for leasing (Resin and Columns) to our vendors. I--- U--- has always paid sales tax measured by rental receipts for resin and columns to the State Board. The rental receipts for I--- average about \$50,000 per month in which all taxes are paid.

"Do [sic] to the nature of our business it is very complicated to determine on which purchases should I--- be paying Sales Taxes. Our employee turnover has been high in the last few years. When new employees are hired it is very difficult for them to understand all our capital assets. As accountants we assume that all capital assets are taxable until we find out the hard way that it is not true. I--- ended up paying Sales taxes due to the fact that we didn't pay sales taxes on some capital assets that we should have, but yet we were unable to receive a credit for those capital assets on which we paid sales taxes, but we shouldn't have. Resin and Columns are

capitalized in out balance sheet, but these are rented out and all rentals are taxable.

I--- U--- has two major vendors for resin and columns. I--- U--- has all the records showing that sales taxes were paid.”

You do not explain what “resin” and “columns” are nor what function in the water purification process they perform. From the context, they appear to be components of the water purification units, and so we assume they are not leased to the customer in the same form in which I--- U--- acquired them.

In California, except where specifically exempted by statute, Revenue and Taxation Code Section 6051 imposes a sales tax, computed as a percentage of gross receipts, upon all retailers for the privilege of selling tangible personal property at retail in this state. (Unless otherwise noted, all statutory references are to the Revenue and Taxation Code.) “Tangible personal property” is defined as “property which may be seen, weighed, measured, felt, or touched or which is in any other manner perceptible to the senses.” (§ 6016.)

“[I]t shall be presumed that all gross receipts are subject to tax until the contrary is established. The burden of proving that a sale of tangible personal property is not a sale at retail is upon the person who makes the sale” (§ 6091.) The retailer owes the sales tax, but it may collect sales tax reimbursement from the purchaser pursuant to agreement. (Civ. Code § 1656.1.)

A lease of tangible personal property in California is a continuing sale and purchase unless (among other things) the property is leased in substantially the same form as acquired and at the time of purchase the lessor pays sales tax reimbursement or makes a timely election to pay use tax measured by the purchase price. (§§ 6006(g), 6010(e), 18 Cal.Code Regs., Reg. 1660. Regulations are Board promulgations that have the force and effect of law.) When a lease is such a sale under the Sales and Use Tax Law, the tax is generally a use tax on the lessee’s use of the property measured by rentals payable which the lessor is required to collect and pay to the board. (Rev. & Tax. Code §§ 6201, 6202, 6203, Reg. 1660.) Leases of water conditioning units to customers are subject to the Sales and Use Tax Law. (See, e.g., Culligan Water Conditioning v. State Bd. of Equalization (1976) 17 Cal.3d 86, [130 Cal.Rptr. 321, 550 P.2d 593].)

B. Tax Consequences to I--- U---.

It is vital to distinguish between income tax and sales tax principles. Although they have many concepts which overlap, they are separate and distinct taxes. The term “capital asset” is an income tax accounting principle. It is defined as “property held by the taxpayer (whether or not connected with his trade or business) but does not include [certain property listed in the statute].” (26 U.S.C. § 1221; § 18161.) A “capital asset” may be personal or real, tangible or intangible. (See, e.g., Holt v. C.I.R. (9th Cir. (1962) 303 F.2d 687, 690.)

The term "capital asset" then refers to the purposes for which the income taxpayer holds the property once acquired. On the other hand, it is the nature of the property and the nature of the means of transfer which determine if sales or use tax applies. Sales and use tax applies if there is a "sale" (as defined in § 6006, above) of "tangible personal property," (as defined in § 6016, above) and not statutory exemption applies.

Consequently, when I--- U--- buys tangible personal property, and does not issue a resale certificate, the seller pays sales tax and collects sales tax reimbursement from I--- U--- on the transaction. I--- U--- then retains the property on its books as a capital asset while leasing it out to customers.

I--- U--- is not leasing the resins and columns in substantially the same form as acquired because they are assembled into the purification units. For sales and use tax purposes, then, I--- U--- is considered to sell the items to the lessee when it leases them out. (Reg. 1660(b)(1)(E). It must collect use tax measured by the rentals payable. (Reg. 1660(c)(1).) For this reason, it may purchase these items free of tax in the future by issuing its suppliers resale certificates in substantially the same form as required by Regulation 1668.

However, for past transactions, since I--- U--- paid sales tax reimbursement in a situation where it could have avoided the payment by issuing resale certificates, (Regulation 1701(b)(4).) It permits it to take a tax-paid purchases resold deduction on those resins and columns first placed into service in periods for which a return has not been filed to offset the tax liability accruing from the rental receipts in that quarter. For quarters for which a return has been filed, I--- U--- must file a claim for refund. (§ 6904.)

Enclosed for your information, please find copies of Regulations 1660, 1668, and 1701. I hope the above discussion has answered your question. If you need anything further, please do not hesitate to write again.

Sincerely,

John L. Waid
Tax Counsel

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Encs.