STATE OF CALIFORNIA

330.3438

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 324-2637
FAX: (916) 323-3387

May 7, 1996

VIA FACSIMILE AND U.S. MAIL

Mr. A--- R. R---
---, --- & ---
XXXX --- --- --- ---
--- ---, New York XXXXX-XXXX

Re: Unidentified Taxpayer

Dear Mr. R---:

This is in response to your April 9, 1996 letter to the Honorable Ernest J. Dronenburg, Jr. regarding your client's recent settlement offer. We initially note that settlement offers are administered by our Settlement Section in instances where this Agency has issued a determination of tax liability, the taxpayer has made a timely petition for redetermination of that amount, and the taxpayer has presented a settlement offer. Since a notice of determination has not been issued against your client, the Settlement Section cannot respond to your client's settlement proposal. Instead, the Legal Division of this Agency can only address your concerns regarding the application of tax to your client's situation. If you would like the Settlement Section to consider your client's proposal, you must identify your client so an audit and tax determination (if applicable) may be made. If a determination is made, your client must then make a timely petition for redetermination and submit its settlement offer to:

Board of Equalization
450 N Street, MIC:87
P.O. Box 942879
Sacramento, CA 94279-0087
Attn: Settlement Section

With regard to the application of tax to your client's leasing operations, you provide the following:

> "[R Corp.] has determined that it might be responsible for the collection and payment of California sales tax on receipts from maintenance services performed in conjunction with equipment it leases to unrelated customers....
>
> "R Corp. is a company involved in, among other things, the selling and leasing of business equipment. R Corp. sells and leases this equipment to businesses across the country, including California. Although R Corp. generally includes maintenance provisions as part of its equipment leases, it sometimes offers customers the choice of excluding the maintenance provisions from the lease and entering into a separate maintenance contract (which is comparable to maintenance agreements that R Corp. offers for sale to those who have purchased equipment from R Corp.), which must be with R Corp. When a customer chooses the option of excluding the maintenance agreement provisions from the equipment lease and entering into a separate maintenance contract, the equipment lease and the maintenance contract are separate documents, the prices are separately stated, and, perhaps most significantly, the prices are arm's length in nature and amount. It is the separate lease and maintenance contract situation that is in issue here."

You dispute that tax applies to your client's sales of its "separate" maintenance agreements under these circumstances. For purposes of this opinion, we assume that R Corp. charges its customers a "one-time" lump sum lease payment for its separate maintenance agreements. That is, we assume that R Corp. does not collect its charge for the separate maintenance agreement by collecting a fractional portion of that amount over the life of the lease.

Discussion

A lease of tangible personal property in California is a continuing sale and purchase unless the lessor leases it 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).[1/]) When the lease is a continuing sale and purchase because either or both of the foregoing conditions are not satisfied, the lease is subject to use tax measured by rentals payable. (Reg. 1660(c)(1).) The lessee owes the tax and the lessor is required to collect it from the lessee and pay it to this Board. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c).)

---

[1] A copy of Regulation 1660 is enclosed for your review.

We understand from your letter that R Corp. does not pay California tax or tax reimbursement on its purchase price of the property that it leases to its customers inside this state. This means that R Corp. is required to collect use tax from its lessees measured by the rentals payable on the leased property. "Rentals" subject to tax include **any** payments required by the lease. (Reg. 1660(c)(1).) Taxable rental payments do not, however, include amounts paid to the lessor for separately stated optional maintenance or warranty contracts. (*Id*.)

The application of tax to R Corp.'s operations is similar to the rules regarding the application of tax on maintenance agreements. Pursuant to Regulation 1546(b)(3)[2], the charges for mandatory maintenance contracts are included in the measure of tax (i.e., gross receipts or sales price) whether or not the charges for these types of maintenance agreements are separately stated. That is, the sale of a mandatory maintenance agreement for tangible personal property is regarded as part of the sale of that property and the charges for the agreement are included in the gross receipts or sales price of the property. On the other hand, charges for optional maintenance agreements are not regarded as part of the sale of tangible personal property and are not subject to tax. (Business Taxes Law Guide Annots. 490.0580 (12/13/63); 490.0700 (5/10/60).) The difference between a mandatory and optional warranty contract is set forth in subdivision (c)(1) of Regulation 1546 as follows:

> "A warranty is mandatory within the meaning of this regulation when the buyer, as a condition of the sale, is required to purchase the warranty or guarantee contract from the seller.... A warranty is optional within the meaning of this regulation when the buyer is not required to purchase the warranty or guarantee contract from the seller, i.e., he is free to contract with anyone he chooses."

We understand that R Corp.'s customers have the option of either leasing your client's equipment pursuant to lease agreements containing a maintenance agreement or that these customers may purchase the "separate" maintenance agreement from your client. Under either scenario, however, we understand that R Corp.'s customers are **required** as a condition of leasing of R Corp.'s equipment to purchase some form of a maintenance agreement exclusively from your client. That is, R Corp. will not lease equipment to a customer unless that customer also purchases a maintenance agreement. Under these facts, R Corp.'s "separate" maintenance agreement is regarded as a mandatory maintenance contract and is therefore part of the taxable rental receipts from the lease of its equipment. R Corp. is therefore required to collect use tax from its customers on this amount and remit it to this Board.

---

[2] A copy of Regulation 1546 is enclosed for your review.

We trust this answers your concerns regarding the application of tax to your client's operations. If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz

Enclosure - Regs. 1546, 1660

cc: Mr. James B. Levinson (via facsimile and U.S. Mail)
Out-of-State District Administrator - (OH)