



STATE BOARD OF EQUALIZATION

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Executive Director

April 17, 1995

Re: ---

XX.

Dear Mr. ---:

This is in response to your letter dated March 3, 1995 regarding the application of tax to venture leasing transactions by your client, XX. You state:

"A venture lease is a transaction wherein a lessor engaged in business in California leases equipment to a privately held start-up corporation for a 3 to 5 year period. The lessor does not pay California sales tax reimbursement or use tax measured by the purchased price of the leased equipment. The lease agreement requires the lessee to provide the lessor with a warrant to purchase shares of stock ('Warrant') in the lessee corporation and that the lessee make lease payments. Lease payments are based on the fair market value of the leased equipment. The Warrant grants the lessor the right to purchase a specified number of shares of stock in the lessee's corporation at a specified purchase price (the 'Strike Price'). This Strike Price approximates the value of the lessee's underlying shares of stock at the time of the issuance of the Warrant. These Warrants are exercisable for a set period of time, but the lessor is not required to exercise them. These Warrants are generally not reflected on the lessor's financial statements, but may be reflected at an arbitrary value of \$100 per leasing transaction. When a Warrant is exercised, the lessor obtains restricted securities from the lessee. The issuance of these securities is reflected on the lessee's financial statements in accordance with generally accepted accounting principles."

We understand your letter to ask whether tax applies to the granting or execution of a Warrant furnished by XX as part its consideration for an equipment lease. We also understand your letter to ask whether tax applies to a subsequent sale of stock acquired by XX's lessor through the Warrant as part of the rentals payable pursuant to the lease. To facilitate our response, you provided us with a copy of the proposed Warrant Agreement.

Discussion

A lease of tangible personal property is a continuing sale 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.) A lease that is a continuing sale 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.)

In this situation, XX will lease tangible personal property in exchange for the granting of a Warrant and lease payments based on the fair rental value of the equipment. Since XX's lessor did not pay tax or tax reimbursement on the equipment, XX owes tax on the rentals payable for the equipment. The tax due in this situation is measured by the value of the Warrant plus the periodic lease payments for the remainder of the lease period.

In your previous letter to us dated October 20, 1994 regarding venture lease transactions, you state that the Warrant granted by a lessee generally does not have a measurable value at the date of the grant. We note that XX's Warrant Agreement provided to us for review provides no indication as to the value of such a Warrant at the time of commencement of that agreement. That does not mean, however, that a value cannot necessarily be assigned to the Warrant. For example, if the equipment lease agreement specifies a value of the Warrant¹ or the rentals payable under the lease agreement are reduced in exchange for the granting of the Warrant, the amount designated for the Warrant (i.e., the amount stated in the lease agreement or the difference in rental amounts between a lease with and without a Warrant Agreement) would be included in XX's rentals payable.² The value of the Warrant must also included in XX's rentals payable if the value of the Warrant can be determined by other reasonable or generally accepted means.

Based on the information provided to us, we are unable to determine whether XX's Warrant maintains any value at the date of its grant to XX's lessor. If the Warrant can be valued

¹ A copy of the "Master Lease Agreement" referenced in the Warrant Agreement was not provided to us for our review.

² If the rentals payable are reduced, we assume that the total rentals payable on the equipment lease (i.e., the value of the warrant plus periodic rental payments) approximate the fair rental value of the equipment.

with a determinable dollar amount, the value of that Warrant must be included in XX's rentals payable for the lease of equipment. However, if the value of the Warrant at the time the lease commences is sufficiently speculative, the Warrant is **not** included as part of XX's rentals payable for the lease of the equipment. Thereafter, no sales or use tax would be due on the grant or execution of the Warrant, or on the subsequent sale of stock acquired by the lessor through the Warrant as part rentals payable pursuant to the lease.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:plh

cc: Oakland District Administrator - CH