

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

In the Matter of the Petition)	
for Redetermination Under the)	DECISION AND RECOMMENDATION
Sales and Use Tax Law)	
)	No. ----
)	
)	
Petitioner)	

The Appeals conference in the above-referenced matter was held by Staff Counsel Rachel M. Aragon on December 13, 1994 in --- California.

Appearing for Petitioner: -----

Appearing for the	
Sales and Use Tax Department:	Robert Reichmuth
	District Principal Auditor

Type of Business: Lessor of wine barrels

Protested Item

The protested tax liability for the period December 1, 1990 through June 30, 1993, is measured by:

<u>Item</u>	<u>State, Local and County</u>
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Unreported taxable lease receipts	\$ 2,546,281
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Petitioner's Contentions

The sale between --- and --- --- --- was merely a bookkeeping entry with a related shell corporation. The transaction was not a "sale".

Summary

Petitioner is engaged in the winery business. The stock of --- was 99 percent owned by --- and 1 percent by his two adult daughters. Petitioner, in a memorandum of fact and law stated that throughout 1990, --- acquired barrels used for storing and aging wine from unrelated vendors for a purchase price of approximately \$3 million. The barrels were used primarily for the first time in the 1990 crush. Sales tax reimbursement was paid on the bulk of these purchases by --- and --- has agreed to pay use tax on the remainder of the purchases.

The memorandum further states:

"In the summer of 1990, --- became interested in purchasing certain vineyards in Monterey County (--- --- ---). In order to assist in the financing of this purchase, proposed to borrow a considerable sum using the barrels as collateral. Carrying the barrels and the related debt on financial statements would have significantly increased its debt/equity ratio, however, and thus made borrowing from a bank or a vineyard seller difficult. Solely for the purpose of obtaining financing by using the barrels as collateral, --- formed --- --- --- on August 3, 1990. --- was a Subchapter S corporation 100% owned by --- --- ---

"In November 1990, --- purchased the barrels from --- for approximately \$3 million in cash. --- borrowed the entire purchase price using the barrels as security. This loan was explicitly made on the basis of --- credit-worthiness, since --- was merely a shell corporation with no equity and --- was required to guarantee the loan. --- leased the barrels back from --- at a lease rate high enough to allow --- to make debt payments and a slight profit. --- used the cash obtained from its barrel sale, among other things, to purchase --- --- --- --- in February 1991.

"The transfer and leaseback of the barrels to --- were mere bookkeeping entries. -- - had no real separate corporate existence. Its only business activity consisted of buying these barrels from --- In subsequent years, --- bought barrels from third party sellers and leased them solely to --- and its related entities. The barrels were never physically moved from possession, and their usage by --- was never interrupted. --- had neither employees nor payroll. Its operations were run entirely by --- employees. All books and records were kept by --- employees. The only indicia of --- separate corporate existence were (1) a bank account, (2) the books maintained by --- and (3) financial statements and other records required by the lender. Commencing in 1992 and continuing into 1993, --- debt/equity ratio gradually improved to the point that --- was no longer needed. --- was accordingly dissolved in December 1993 through a merger into ---.

"The fact that --- was formed solely for the purpose of removing the barrels and related debt from --- books is readily evident. The transfer was clearly effected for internal bookkeeping purposes, since it is unimaginable that a company would sell assets to an unrelated party in an arm's length transaction, guarantee a 100% loan of the purchase amount, and then lease those assets back from that third party at a total lease rate higher than the debt service payments on original sales price.

"Moreover, this transaction was not consummated for any income tax planning purposes. In point of fact, the transaction caused --- --- to report taxable income, without receiving a matching deduction, on what was essentially an internal paper transaction. Since both --- and --- were essentially wholly owned S corporations, all of their taxable income was passed through each year to --- --- ---. The sale/leaseback arrangement forced --- to report the full amount of lease proceeds received each year as income. --- on the other hand, was required to include those lease payments as a part of its cost of goods sold, which could only be deducted upon eventual sale of the wine. Thus, the arrangement resulted in the creation of artificial income to --- while delaying the taking of the corresponding deduction by --- for a period of approximately one and one-half years. By the end of 1993, this arrangement had caused --- to report net. Subchapter S income on his individual income tax return in the amount of some \$1 million."

Petitioner stated that in *Mapo, Inc. v State Board of Equalization* (1975) 53 Cal.App.3d 245, the court determined that no sales tax was due on sales between Mapo and the other related parties since Mapo was only nominally a separate corporation.

Petitioner stated petitioner's case was very similar to Mapo. "Both, --- and Mapo were created solely to effect bookkeeping entries. In Mapo, the corporation was formed for the purpose of having a separate corporation issue payroll checks to the employees. Here, --- was formed to carry the barrels and the related debt on its financial statements. Like Mapo, --- only dealt with related parties during its existence. Additionally, like Mapo, --- essentially bore no liability for its activities. The full amount of the payments on the debt was intended to come from --- lease payments and --- guarantee of the debt.... Mapo continued in existence for six years, while --- was dissolved only three years after its formation."

Petitioner stated that in *Cedars-Sinai Medical Center v. State Board of Equalization* (1984) 162 Cal. App.3d 1182 the court held that sales tax should not be imposed on a sale--leaseback of equipment between Cedars-Sinai and unrelated leasing companies which was entered into for the purpose of allowing Cedars-Sinai to finance the purchase of the equipment from the vendor. The court 'determined that no sale had occurred for sales tax purposes because the transaction was a financing device where Cedars-Sinai always intended to keep the equipment and bear the ultimate risk of loss or damage to the equipment. Petitioner stated that similarly, --- always intended to retain sole possession and use of the barrels and continued to bear all risk of loss of those assets.

Petitioner citing *Beatrice Company v. State Board of Equalization* (1993) 6 Cal.4th 767, stated that when distinct corporate identities have not been maintained and the corporations do not have separate business purposes (as was the case with petitioner), sale of tangible personal property between them is not considered a taxable sale.

Petitioner stated in the memorandum of law that "the rule of law expressed in these cases is that sales will be imposed only upon economically meaningful transfers of goods and not upon mere bookkeeping transactions, since such treatment would result in double taxation."

Petitioner provided a copy of the "Master Equipment Lease" (pages 55-67 of the petition file). The lease does not provide for lessee to obtain title to the barrels at the end of the lease

term. The lease does not provide an option for the lessee to purchase the barrels at the end of the lease term.

In a memorandum dated March 17, 1994 from William Dunn, Assistant Principal Tax Auditor, Mr. Dunn stated that the cases petitioner relied upon do not support its position. In Mapo the Court held that the taxpayer corporation existed only as a conduit for the 'payment of salaries to persons having to do with a particular project. The Court "noted that Mapo did nothing for its own account or for anyone except its corporate relatives, acted solely on orders from its corporate grandparent, owned no materials, kept no books, bore no liability for its operation, and recorded no profits. Mapo's sole function was that of paymaster." The Court determined that the transactions were not subject to tax because the corporate grandparent was essentially fabricating items for itself and it directed, controlled and employed the Mapo personnel. In contrast, --- was formed to provide --- with financing for the purchase of --- --- --- was in existence for over three years. Petitioner "borrowed money, made debt payments, purchased additional barrels, recorded profits, maintained separate books, prepared financial statements, and filed income tax returns. Consequently --- reported the full amount of the lease proceeds received each year as income and --- included the lease payments it made to --- as a part of its costs of good sold." Petitioner depreciated the barrels on its income tax returns.

The memorandum further stated that in Cedar-Sinai the court determined the transactions were "merely arrangements to obtain alternative financing for the equipment". Whereas, petitioner's purpose for the transfer and leaseback of the property was to obtain financing to purchase the --- --- --- not to finance the purchase of the barrels. The Department stated it saw no relevant similarities.

The Department stated that although it saw extremely close connections between petitioner and --- it is of the opinion that since they were two separate legal entities the transfer of the barrels from --- to petitioner is a taxable sale. The Department writes: "Transactions between related entities which have behaved as separate entities are subject to the same rules that apply to all taxpayers." Here there have been two sales of the barrels; on sale was by the vendors to petitioner; the second sale was by --- to petitioner with petitioner leasing the barrels back to petitioner. Since petitioner did not pay sales tax reimbursement to --- the monthly lease payments by to petitioner are subject to tax.

Analysis and Conclusion

Sales tax is imposed on all retailers measured by their gross receipts from retail sales of tangible personal property in this state. (Rev. & Tax. Code § 6051.)

The issue is whether the transaction between petitioner and --- was a sale within the meaning of Revenue and Taxation Code Section 6006. Subdivision (g) of Revenue and Taxation Code Section 6006 defines "sale" to include " [a]ny lease of tangible personal property in any manner or by any means whatsoever, for a consideration". Transactions between related but different entities are treated no differently from transactions between unrelated entities for sales and use tax purposes. See Pacific Pipeline Construction Company v. State Board of Equalization, (1958) 49.Ca.2d 729, Mercedes Benz v. State Board of Equalization (1982) 127 Ca1.App.3d 871.

Petitioner does not deny that there was a "lease" of the barrels to --- or a "sale" from --- to petitioner.... However, petitioner stated that neither the "lease" nor the "sale" was a taxable transaction because petitioner and --- were not separate corporations, thus there were not taxable transactions between them. Petitioner stated: that --- paid sales tax reimbursement when it purchased the barrels; that the transfers of the barrels from --- to petitioner were merely bookkeeping entries; and, that the "leases" of the barrels from petitioner to --- were merely bookkeeping entries. Petitioner cites *Mapo*, supra, in support of its position that petitioner and --- were not separate corporations.

The court in *Mapo* stated that *Mapo* existed as a separate corporation in name only. *Mapo*, during its existence, did nothing for anyone's account except its corporate relatives. The corporation acted solely as a conduit for payment of salaries. The corporation acted solely on orders from its owners. The corporation owned no materials, kept no books, bore no liability for its operations, and recorded no profits. The apparent reason for the existence of the corporation was to make possible working agreements with a single labor union.

In the instant case, there are some similarities. For instance: petitioner leased the property only to --- and its related entities; petitioner did not have its own employees; and, petitioner's books were kept by ---. However, the dissimilarities cause us to conclude that this case is not controlling. In the instant case, petitioner owned property and depreciated it; petitioner had its own bank account; petitioner assumed debts; petitioner purchased property on its own; petitioner bore the liability to the lender for the purchase price of the barrels; petitioner received profits; the \$3 million which petitioner paid to --- for the barrels was used by --- to purchase other property, not the barrels; petitioner filed income tax returns; and, petitioner kept separate books.

Petitioner, citing *Cedars-Sinai* supra, stated that if the transaction is actually a financing arrangement, tax does not apply. In *Cedars-Sinai*, a process was established between a lender and the hospital that allowed the hospital to pay for and eventually own the equipment involved. *Cedars-Sinai* entered into an agreement with leasing companies for the purpose of obtaining alternate financing for the equipment; that was the object of the agreement. As a result of *Cedars-Sinai*, the Board adopted rules setting out the requirements, which the Court in *Cedars-Sinai* articulated, necessary for transactions which are structured as taxable sales and leasebacks to be treated as nontaxable financing transactions.

These rules are explained in Regulation 1660 (a) (3) , which states that certain transactions structured as sale-leasebacks will be treated as nontaxable financing transactions. As subdivision (a) (3) (A) of Regulation 1660 explains, sales and leaseback transactions are treated as financing transactions: (1) if the lease transaction is regarded as a sale at inception as defined in Regulation 1660 (a) (2) (A); (2) if the purchaser-lessor claims no deduction, credit, or exemption with respect to the property for federal or state income tax purposes; and (3) if the amount which would be attributable to interest, had the transaction been structured originally as a financing agreement, is not usurious under California law. In order to qualify as a nontaxable financing transaction under subdivision (a) (3) (A) of Regulation 1660, the transactions must satisfy all of these requirements.

A lease is a sale at inception under subdivision (a) (2) (A) of Regulation 1660 if the lease binds the lessee for a fixed term and the lessee is to obtain title at the end of that term upon completion of required payments or if the lessee has an option to purchase the property for a nominal amount. The option price is regarded as nominal if it does not exceed \$100 or one

percent of the total contract price (whichever is less). The Master Equipment Lease does not have a provision that the lessee is to obtain title at the end of the lease term nor does it contain an option to purchase the equipment. Also, it is the lessor, not the lessee who claims the deduction, credit or exemption for income tax purposes. Thus, the requirements are not satisfied and this is not a financing transaction pursuant to Regulation 1660 (a) (3) (A).

Subdivision (a) (3) (B) of Regulation 1660 sets forth alternate requirements pursuant to which a transaction structured as a sale-leaseback would qualify as a nontaxable financing transaction. It states:

"Transactions structured as sales and leasebacks will also be treated as financing transactions if all of the following requirements are met:

"1. The initial purchase price of the property has not been completely paid by the seller-lessee to the equipment vendor.

"2. The seller-lessee assigns to the purchaser-lessor all of its right, title and interest in the purchase order and invoice with the equipment vendor.

"3. The purchaser-lessor pays the balance of the original purchase obligation to the equipment vendor on behalf of the seller-lessee.

"4. The purchaser-lessor does not claim any deduction, credit or exemption with respect to the property for federal or state income tax purposes.

"5. The amount which would be attributable to interest, had the transaction been structured originally as a financing agreement, is not usurious under California law.

"6. The seller-lessee has an option to purchase the property at the end of the lease term, and the option price is fair market value or less."

In this case, the barrels were owned by --- the seller- lessee; the sales tax reimbursement on the barrels had been paid to the vendors by --- petitioner (purchaser-lessor) did not pay the balance to the equipment vendor, the proceeds went to --- --- did not have a purchase option;, and, petitioner claimed a deduction, credit or exemption for income tax purposes. Thus, these transactions were not financing transactions pursuant to Regulation 1660 (a) (3) (B). Therefore, Cedars-Sinai does not support petitioner's position that there was not a sale.

We agree with petitioner that Beatrice, supra stated that when distinct corporate identities have not been maintained and the corporations do not have separate business purposes, the sale of tangible personal property between them is not considered taxable. However, based on the analysis aforementioned, we conclude that this was not the case between petitioner and ---.

We conclude that the transaction between petitioner and --- was a sale within the meaning of Section 6006 of the Revenue and Taxation Code as defined above. Therefore, the transaction is subject to tax. The question is which transaction is subject to tax, the sale of the barrels to petitioner or the lease of the barrels to ---.

Sales and Use Tax Regulation 1660 states that a lease of tangible personal property is a continuing sale and purchase unless the property is leased in substantially the same form as acquired and the lessor has paid sales tax reimbursement or use tax to its vendor or made a timely election to pay tax measured by the purchase price. (Rev. & Tax. Code §§ 6006(g) (5), 6006.1, 6010(e) (5).) A lease that is a continuing sale is subject to tax measured by the rentals payable. That tax is a use tax on the lessee and the lessor is required to collect the use tax from the lessee at the time rentals are paid. (Reg. 1660(b) (1), (c) (1).) Since petitioner did not pay tax on the purchase price, the applicable measure of tax is use tax measured by the rentals payable.

Recommendation

We recommend that the petition be denied.

Rachel M. Aragon, Staff Counsel

Date: April 21, 1995