M e m o r a n d u m

330.5110

To: Mr. Brian Manuel
Associate Tax Auditor – Van Nuys

April 12, 1990

From: David H. Levine
Tax Counsel

ATSS 485-5550
(916) 445-5550

Subject: L--- F--- C--- (L---)
SN -- XX-XXXXXX

This is in response to your memorandum dated March 1, 1990 regarding sale-lease back transactions. L--- finances equipment purchased by [---] subcontractors through the use of agreements structured as sale and leaseback agreements. You have concluded that most of the contracts you reviewed qualified as financing transactions. However, you believe that the agreements with S--- S--- and W--- do not qualify under subdivision (a)(3)(A)1 of Regulation 1660 (the leases do not constitute sales at inception) or under subdivision (a)(3)(B)2 (the seller/lessee apparently did not assign the purchase order and invoice to the purchaser/lessor). You ask our opinion on the proper application of tax.

As you know, the general rule under which a transaction structured as a sale-leaseback will be regarded as a financing transaction is when: 1) the "lease" is a sale at inception; 2) the purchaser/lessor does not claim any deduction, credit, or exemption with respect to the property for federal or state income tax purposes; and 3) the amount which would be attributable to interest, had the transaction been structured as a financing agreement, is not usurious under California law. (Reg. 1660(a)(3)(A).) The special application rule of subdivision (a)(3)(B) of Regulation 1660 allows a transaction structured as a sale-leaseback to be regarded as a financing transaction even when the lease is a true lease and not a sale at inception (the other two requirements of the general rule remain applicable). To qualify for this special rule, the seller/lessee must still owe the original equipment vendor some or all of the initial purchase price of the equipment and the seller/lessee must assign to the purchaser/lessor all of its right, title, and interest in the purchase order and invoice, the balance of the initial purchase price being paid by the seller/lessee.

You ask what the parties must show in order to satisfy subdivision (a)(3)(B)2 of Regulation 1660. Actually, subdivisions (a)(3)(B)2 and (a)(3)(B)3 should be viewed together. In summary, title to the equipment must be transferred to the purchaser/lessor and the purchaser/lessor must establish that it paid some or all of the initial purchase price of the

property to the original equipment vendor (the person selling the property to the seller/lessee). If part of the initial purchase price remains to be paid at the time of the audit (which would normally be a case where the seller/lessee purchased the property on installments payable to the original equipment vendor), the purchaser/lessor must establish that it has assumed that liability from the seller/lessee.

The lease between L--- and S--- S--- will not be treated as a financing transaction under Regulation 1660. Section 11.06 of the lease provides that L---, as owner of the equipment, is entitled to depreciation under applicable income tax law. Furthermore, Section 11.02 provides that, under certain circumstances, the lessee must reimburse the lessor, if any such income tax benefits are lost, so that L---'s net after-tax return will be the same as if L--- had not lost the income tax benefits. Since L--- retained the right to take income tax benefits as an owner of the leased equipment, the lease agreement cannot be treated as a nontaxable financing transaction under the general or special rule. (Reg. 1660(a)(3)(A)2, (a)(3)(B)4.)

Even if the lease did not contain the provisions discussed above regarding the taking of income tax benefits, we would nevertheless conclude that this agreement cannot be treated as a nontaxable financing agreement. At the end of the lease term, the lessee may elect to extend the lease. (§ 4.01.) The lessee may also elect to purchase the equipment for the greater of the fair market value of the equipment at the time the lease term expires or an amount equal to ten percent of L---'s cost. This clearly does not constitute a sale at inception under subdivision (a)(2)(A) of Regulation 1660 and, on this basis, the transaction does not qualify for treatment as a financing transaction under the general rule of (a)(3)(A) of Regulation 1660. Even if all other requirements of the special rule were satisfied (they were not), to qualify the lessee must have an option to purchase the property at the end of the lease term at an option price of fair market value or less. (Reg. 1660(a)(3)(B)6.) Under the L--- - S--- S--- lease, the option price is the greater of fair market value or ten percent of L---'s cost. That is, fair market value is the least that the option will be, and it might be greater. The lease therefore cannot be treated as a financing transaction even if all other requirements of the special rule were satisfied.

The lease between L--- and W--- does not contain an option for W--- to purchase the leased property at the end of the lease term. Rather, Section 17 specifically states that, unless otherwise agreed in writing, W--- is to return the leased equipment to L---. Therefore, since the lease is not a sale at inception, and since there is no option to purchase the property at fair market value or less, when this lease is part of a sale-leaseback transaction, the transaction cannot be regarded as a financing transaction. However, it is not entirely clear to me that all of the L--- - W--- leases were part of sale-leaseback transactions.

Sections 2 and 3 of the lease contemplate that property to be leased to W--- will be purchased by L---. A number of the invoices you have forwarded to us indicate that this is what occurred, that is, that the vendors sold the equipment to L--- (the property was shipped to W--- but shown on the vendor's sale invoice as being sold to or billed to L---). These invoices indicate that title passed directly from the vendor to L--- and that there was no sale transaction

between the vendor and W---. Of the invoices you have forwarded to us, only two indicate that the property was sold to W---. If this is the case, these sales to W--- would be taxable if W--- used the property prior to resale to L---. The sale-leasebacks would not qualify for treatment as financing transactions for the reasons discussed above.

If you have further questions, feel free to write again.

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