STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-5550

February 23, 1990

Mr. R--- W. H---
Senior Tax Counsel
B--- N---
T--- and S--- A---
Box XXXXX
--- ---, CA XXXXX

Re: S--- P--- T--- Co.
SZ -- XX-XXXXXX

Dear Mr. H---:

This is in response to your letter dated January 17, 1990 regarding the application of sales or use tax to a transaction structured as a sale-leaseback.

You describe the transaction as follows. S--- P--- T--- Company (S---) purchased locomotives and rail cars (units) and has entered into an agreement to sell the units to lessor and simultaneously lease them back over a five-year period. You believe that this transaction qualifies as a nontaxable financing transaction under subdivision (a)(3)(A) of Regulation 1660 because:

> "S--- is required to purchase the units for 36.47% of the purchase price (balloon payment) or sell the units to a third party and remit the balloon payment to the trustee. If the latter option is elected, and the proceeds exceed the balloon payment, S--- keeps the excess. If the proceeds are less than the required balloon payment, S---is required to make up the difference; however, S--- will not have to pay an amount in excess of 18.24% of the purchase price. In addition, the lessor will not claim any deduction, credit or exemption with respect to the units for federal or state income tax purposes. Finally, the interest charged amounts to 10.48% annually, which is not usurious under California law."

Subdivision (a)(3)(A) of Regulation 1660 provides:

> Transactions structured as sales and leasebacks will be treated as financing transactions if (1) the 'lease' transaction would be regarded as a sale at inception under paragraph (a)(2) of this regulation, (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 originally as a financing agreement, is not usurious under California law. Transactions treated as financing transactions are not subject to sales or use tax."

These rules are applied to determine whether a transaction structured as a sale-leaseback is actually a financing transaction. The reason for these rules is that under a financing transaction, the borrower retains ownership of the property and transfers only a security interest to the lender. Since the borrower retains ownership, the borrower also retains the incidents of that ownership, such as the right to claim deductions, credits, or exemptions with respect to the property for federal or state income tax purposes.

A transaction designated as a lease is actually a sale at inception under subdivision (a)(2) of Regulation 1660 when, at the end of the lease term, the "lessee" is certain to obtain title to the "leased" property. The reason the "lease" transaction in a sale-leaseback must be regarded as a sale at inception in order for the sale-leaseback to qualify as a financing transaction is that the "seller" must be certain to retain ownership of the property at the end of the "lease" term. If the lease is not a sale at inception and it is therefore not certain that there will be no true transfer of title, then the transaction must be regarded as a sale and a leaseback, just as it is structured.

Based on your description of the transaction, the second and third conditions of subdivision (a)(3)(A) of Regulation 1660 are clearly satisfied. We also regard the transaction, as described, as satisfying the first condition since S--- is required to either purchase the units or to sell them to a third party. Under the actual lease provisions you have furnished us, we would regard S--- as being the actual seller to the third party and we would regard the interest acquired by the "lessor" as merely a security interest.

However, we note that there is an aspect to the transaction that is not discussed in your letter. S--- L--- S--- R--- Company (Subsidiary), which is an approximately 99.9% owned subsidiary of S---, is also involved in the transaction. That is, the agreement provides that S--- will cause Subsidiary to sell certain units to the lessor, and those units would be leased to S---. S--- is then required to sublease those units to Subsidiary. Of course, the usual financing agreement structured as a sale-leaseback does not involve a sale from one person to another for lease to a third party for sublease back to the original owner. However, we would nevertheless regard this as a nontaxable financing arrangement if the conditions set forth in subdivision (a)(3)(A) of Regulation 1660 were satisfied. With respect to this transaction, the critical condition for this analysis is that the seller/lessee retain ownership of the leased property at the end of the lease term.

With respect to the property sold by Subsidiary, S--- is required to lease that property from the purchaser/lessor and is required by that agreement to sublease those units to Subsidiary. If Subsidiary retained the income tax benefits and, at the end of the lease term, was certain to retain ownership of these units, we would conclude that the agreement constitutes a financing agreement with respect to those units. However, as discussed below, my understanding of the lease agreement is that Subsidiary is not certain to retain ownership of the units.

Attached as part of the master agreement is a schedule that sets forth the provisions regarding ownership of the units at the end of the lease term. These provisions cover all the units sold to the lessor, including units previously owned by S--- together with units previously owned by Subsidiary. Paragraph (f) provides an election to S--- for early termination of the lease whereby S--- would acquire title to all the leased units. Also under paragraph (f) is a provision for an election under certain circumstances for each individual lessor to require S--- to repurchase certain units. If early termination is not affected under paragraph (f), S--- must elect to repurchase the units at the end of the lease term or to cause the units to be sold to a third party, as set forth in your letter. As discussed above, these provisions satisfy the first condition for a transaction to qualify as a financing transaction with respect to units sold to the lessor by S---. However, these provisions also pertain to the units originally owned by Subsidiary.

Attached to the master agreement is Exhibit C, the sublease to be entered into between S--- and Subsidiary. Section 2 of the sublease provides that if S--- exercises its option for early termination under paragraph (f) of the schedule discussed above, S--- is required to sell, and Subsidiary is required to purchase, the units subleased to Subsidiary (that is, the units originally owned by Subsidiary). However, S--- is not required to exercise the election under paragraph (f) of the schedule. If S--- does not exercise that election, S--- is required to either purchase the units or cause them to be sold. If S--- purchases the units under these provisions, I have found no provision in any of the agreements that requires a resale to Subsidiary. That is, the agreement permits S---, upon termination of all agreements, to own units originally owned by Subsidiary.

As discussed previously, a primary condition to the treatment of a transaction structured as a sale-leaseback as a financing transaction is that, at the end of the sale-leaseback arrangement, the original owner remains the owner of the "leased" property. With respect to units originally owned by Subsidiary, it is not certain, at the beginning of the agreement, that Subsidiary will remain the owner of those units at the end of the term of the agreement. Thus, the agreement cannot be regarded as a financing transaction under subdivision (a)(3)(A) of Regulation 1660. Rather, the agreement, structured as a sale-leaseback, must be regarded as a sale and a leaseback with respect to units originally owned by Subsidiary. Had Subsidiary simply sold the units to S---, such sale would not be a financing transaction. Since the same result may be obtained with respect to the transaction examined herein, it also cannot qualify as a financing transaction.

In conclusion, with respect to units originally owned by S---, we regard this arrangement as a financing transaction, and no sales or use tax applies. With respect to units originally owned by Subsidiary, we regard this transaction as a sale and leaseback. You note that the sale and use of some of these units are exempt from sales or use tax under Revenue and Taxation Code

Section 6368.5. If not exempt under this or some other statutory exemption, the sale and leaseback of units originally owned by Subsidiary will be subject to sales or use tax.

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

Sincerely,

David H. Levine
Tax Counsel

DHL:wak/1946C