STATE OF CALIFORNIA

BOARD OF EQUALIZATION **495.0707**

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition for Redetermination and Claim for Refund Under the Sales and Use Tax Law of:	)))))	SUPPLEMENTAL DECISION AND RECOMMENDATION
M--- C--- F--- Petitioner	))))	No. SS --- XX XXXXXX-020 -002

The original Decision and Recommendation in this matter was issued by Senior Staff Counsel W. E. Burkett under a cover letter dated May 22, 19XX. The Sales and Use Tax Department (the Department) filed a Request for Reconsideration on August 3, 19XX, and petitioner responded by letters dated August 20 and October 23, 19XX. In the meantime, Mr. Burkett began an extended leave of absence and this matter was therefore reassigned to Senior Staff Counsel James E. Mahler. A Supplemental Appeals conference was held in Hollywood on September 22, 19XX, to discuss the Request for Reconsideration.

Appearing for Petitioner:	M--- S. P--- Attorney at Law
	A--- R--- Attorney at Law
Appearing for the Sales and Use Tax Department:	Joseph J. Cohen District Principal Auditor

Protested Item

The protested tax liability for the period July 1, 1986, through June 30, 1989, is measured by:

	Item	State, Local and County
A.	Taxable lease receipts not reported	$X,XXX,XXX

Department's Contentions

1. L--- could not have been acting as petitioner's agent for property acquired prior to the contract date, since no agency or other agreement existed between petitioner and L--- at that time.

2. L--- could not have been acting as petitioner's agent for any equipment acquired prior to the execution and delivery of the appropriate equipment schedule, since there were no mutual obligations to transfer and accept the equipment.

Summary

The relevant facts are outlined in Mr. Burkett's Decision and Recommendation, which we incorporate herein by this reference. Briefly summarized, the law firm L--- & W--- (L---) purchased personal computers and other equipment for its Los Angeles office beginning in April 1987. At the time, L--- intended to finance the purchases by transferring title in the equipment to Security Pacific National Bank and leasing it back. The deal fell through, and L--- ultimately entered into a sale/leaseback arrangement with petitioner on or about August 28, 1987. (Our files include a copy of the leaseback portion of this agreement, but we have not seen any documentation regarding the purchases by L--- or the transfers from L--- to petitioner.)

The Department contends that these transactions resulted in two distinct tax liabilities: a sales tax on the vendor (which L--- paid in the form of tax reimbursement); and a separate use tax on L--- (with a corresponding duty to collect the tax which has been assessed against petitioner). In the Department's view, two taxes are required because L--- made an "intervening taxable use" between the time it purchased the equipment and the time of the sale/leaseback. Petitioner contends that the sale by the original vendor was the only taxable transaction.

Mr. Burkett agreed with petitioner. He concluded that L--- was acting as petitioner's purchasing agent when it acquired the property from the vendors. The tax reimbursement paid by L--- was thus in effect paid by petitioner, and the subsequent leases to L--- were nontaxable leases of tax-paid equipment in substantially the same form as acquired. (Rev. & Tax. Code § 6010(e)(5).)

The Department argues that L--- could not have been petitioner's purchasing agent for two reasons. First, with respect to equipment which L--- acquired prior to August 28, 1987, the Department notes that L--- had no contractual or other relationship with petitioner at the time of purchase. Second, with respect to all the equipment, the staff points out that L--- had no obligation to transfer title to petitioner, and petitioner had no obligation to accept title from L---, at the time L--- made the purchases from the vendors. The premise of both arguments is that an agency relation did not exist at the time of purchase and cannot be created after the fact.

Petitioner contends that an agency relationship can be created after the fact by ratification. Petitioner argues that it ratified L---'s actions when it accepted the benefits of the purchases, that is, when it accepted title in the property and leased it back to L---.

In support of these contentions, petitioner states that it agreed to have L--- make the purchases in L---'s own name because: L--- had already placed orders for some of the equipment and delivery was imminent; attempts to set up credit accounts with the vendors in petitioner's name would have caused further delay in the ordering and delivering of equipment; and L--- was able to obtain substantial purchase discounts by dealing directly with local vendors.

For its part, L--- states that its status as a purchasing agent is shown by the following facts: L--- did not record the purchases in its own books, but instead set up a separate "suspense account" to track the acquisitions; L--- did not disclose the equipment on its balance sheet as would have been necessary if the equipment had been purchased for L---'s own account; L--- never claimed depreciation deductions or other income tax benefits as owner of the equipment; and L--- paid rent to petitioner for all periods between the installation of the equipment and the execution of the lease agreements, which is inconsistent with the proposition that L--- was the owner of the equipment during such periods.

Analysis and Conclusions

Civil Code Section 2307 provides that an agency may be created either "by a precedent authorization or a subsequent ratification." (See, generally, Tetra-Pak, Inc. v. State Bd. of Equalization, 234 Cal.App.3d 1751 at 1758.) Civil Code Section 2313 further provides: "No unauthorized act can be made valid, retroactively, to the prejudice of third persons, without their consent."

The Board has traditionally been reluctant to accept claims that a purchaser was acting as an agent of another when the claim is not made until after the purchase. Once a purchase has been completed, the tax is due and the state has an interest in collecting the liability, an interest which could be prejudiced by a subsequent agency claim. The Board's policy is reflected in subdivision (a)(2)(A) of Sales and Use Tax Regulation 1540, which in effect requires evidence of precedent authorization to show the existence of an agency.

As Mr. Burkett pointed out in the original Decision and Recommendation, however, Regulation 1540 applies only to advertising agencies. The Board has never seen fit to adopt a regulation requiring evidence of precedent authorization to prove agency in other contexts. Accordingly, we conclude that petitioner's claim of agency by ratification is not foreclosed by the Board's policy in this area.

The next question is whether petitioner has established that an agency was created by ratification. Our analysis of this question begins with Ellison v. Jackson Water Company, et al., 12 Cal. 542, a case decided by the California Supreme Court in 1859. It was contended therein that defendant had ratified a contract entered into by a corporation, where the corporation had neither acted in his name nor purported to act for his benefit. The court rejected the contention, stating that the term "ratified":

> "...[is] properly applicable only to contracts made by a party acting or assuming to act for another. The latter may then adopt or ratify the act of the former, however unauthorized. To adoption and ratification there must be some relation, actual or assumed, of principal and agent."

Section 85(1) of the Restatement of Agency, second edition, chapter four, summarizes the rule as follows:

> "Ratification does not result from the affirmance of a transaction with a third person unless the one acting purported to be acting for the ratifier."

The Restatement goes on to explain that one reason for allowing ratification is to give the third party the benefit of what he or she expected in dealing with an agent acting for a principal. That reason does not exist if the third party dealt only with the agent in the agent's own name, with no knowledge that the deal was intended to benefit someone else. In its example four to illustrate the rule, the Restatement indicates that a purchase of goods by a merchant who purports to act for "my principal" can later be ratified by any principal.

In 3 California Jurisprudence 3d, Agency, section 70, the rule is expressed somewhat differently:

> "...[S]ince ratification contemplates an act by one person on behalf of another, there must exist at the time the unauthorized act was done a relationship, either actual or assumed, of principal and agent between the person alleged to have ratified and the person by whom the unauthorized act was done. For example, one cannot ratify a contract entered into by a corporation which did not in fact act, or assume to act, for him.
>
> * * *
>
> "However, the cases dealing with ratification by undisclosed principals create some confusion concerning the extent to which the rule requiring that the person performing the unauthorized act profess to be an agent is applicable in this state. This confusion arises from the fact that, although the requirement of professing to

> be an agent can, by definition, never be satisfied in the case of a totally undisclosed principal, the courts have nevertheless recognized, generally without explanation, that a totally undisclosed principal may ratify an unauthorized act done in his behalf." (Footnotes omitted.)

Among the cases cited in support of this comment is Central Savings Bank v. Coulter, 72 Cal.App. 78. In that case, a person who contracted to act as a purchasing agent borrowed money from a bank to facilitate the purchase. Although he borrowed the money in his own name and was acting outside the scope of his agency, the court held that the principal could and in fact did ratify the loan by accepting its benefits. (See also Althof v. Conheim, 38 Cal. 230 [wife's purchase in own name ratified by husband]; Knoch v. Haizlip, 163 Cal. 146 [act done by the owner of an equity in land ratified by the owner of legal title]; Menveg v. Fishbaugh, 123 Cal.App. 460 [son's sale of parents' land ratified by parents]; and Pacific Factors, Inc. v. St. Paul Hotel, Inc., 113 Cal.App. 657 [corporation ratified actions of its secretary by accepting benefits].)

These authorities indicate that an agency may be established by ratification only if one of two circumstances is present: the person performing the act must have revealed, at the time of the transaction, that he or she was acting as the agent of a disclosed or undisclosed principal; or alternatively, if the person purported to act only in his or her own name, there must be evidence (such as a pre-existing relationship) to show that the act was in fact done on behalf of the specific person who later ratified it. We have found no case holding, and no comment suggesting, that an act done by a person in his or her own name can later be ratified by a person who was a stranger at the time.

This rule was developed by the courts in litigation between or among the parties to alleged agency transactions. As noted by the commentators, equitable considerations of notice and reliance have greatly influenced the decisions. In a tax case, while the state is certainly interested in determining the proper liability, the state was not a party to the original transaction and cannot claim that it relied to its detriment on the purported agent's status. The equitable considerations are therefore much less significant.

Nevertheless, the rule is well settled and is appropriate in tax cases. One major concern of any tax program is to preclude fabricated claims of agency made after the fact solely to avoid tax. That concern is best served by accepting claims of agency by ratification only in those limited situations allowed by the courts; that is, only where the purchaser was expressly acting on behalf of a disclosed or undisclosed principal, or where a purchaser who acted in his or her own name can demonstrate that the purchase was in fact made with the intent to benefit the ratifier.

In this case, L--- had no obligation to transfer any equipment to petitioner at the time of purchase, and petitioner had no obligation to accept any equipment from L---. Almost by

definition, however, ratification means the acceptance of an act which was not authorized at the time and which the purported principal was not obligated to accept. (See Rakestraw v. Rodrigues, 8 Cal.3d 67 at 73.) If contemporaneous mutual obligations were a requirement for ratification, no unauthorized act could ever be ratified, and agency could be established only by precedent authorization. That is obviously not the law.

On the other hand, L--- apparently made all these purchases in its own name, with no representation to the vendors or anyone else that it was acting as the agent of a principal. Further, L--- and petitioner had no known relationship until August 28, 1987, and L--- therefore could not have been acting on behalf of petitioner when it made the purchases prior to that date. Under the rule discussed above, therefore, petitioner cannot ratify these earlier purchases.

As for the remaining purchases, it seems clear that L--- intended to act for petitioner's benefit and not for its own account. L--- recorded the purchases in a special suspense account rather than on its regular balance sheet. It did not depreciate the equipment or claim any other benefits of ownership. Perhaps even more telling, once the sale/leaseback agreement was executed, L--- paid rent to petitioner on all the equipment from date of installation, even if the installation had occurred prior to the sale/leaseback agreement. We agree with Mr. Burkett that L--- was petitioner's purchasing agent in these transactions.

To sum up, L---'s purchases prior to August 28, 1987, were not made as an agent on behalf of petitioner. The purchases were therefore subject to tax, and the leases back to L--- are also taxable. (These transactions do not qualify as nontaxable loans for the reasons explained by Mr. Burkett; nor do they qualify as purchases for resale, since L--- installed and used the equipment prior to any resale.) Purchases on and after that date were made as agent, however, and the leases are therefore not subject to tax.

A purchase generally occurs at the time and place title or possession passes to the customer. (Rev. & Tax. Code §§ 6010 and 6010.5.) Here, the purchases occurred upon the completion of installation at L---'s offices in Los Angeles. Thus, the leaseback of any equipment which was installed prior to August 28, 1987, should remain as taxable in the audit; but a reaudit should be initiated to delete the leases of equipment installed on and after that date.

* * *

It appears that petitioner subsequently assigned some of these leases and transferred title in the equipment to third parties. The audit did not assert tax on these subsequent transactions under the theory that the leases were taxable "sales" and "purchases", so the assignments and title transfers were nontaxable sales for resale. (See Sales & Use Tax Reg. 1660, subd. (c)(9).) If the leases were not taxable, however, the subsequent transactions would be taxable sales at retail. The Department therefore issued a notice of increase to protect the state's interests should Mr. Burkett's recommendation be adopted by the Board. In view of

our decision herein, that some of the leases were taxable and some were not, an adjustment to the proposed increase may be necessary and should be included in the reaudit.

It also appears that the San Diego Justice Facility tax may have been assessed on some transactions in the audit. If so, it should be deleted in the reaudit. (Rider v. County of San Diego, 1 Cal.4th 1.)

Recommendation

Reaudit to exclude leases of equipment installed on or after August 28, 1987, from the taxable measure; to make corresponding adjustments to the notice of increase; and to delete any San Diego Justice Facility tax. Grant the claim for refund to the extent payments exceed the reaudited liability.

James E. Mahler, Senior Staff Counsel

5/23/93
Date