

# Memorandum

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To: Mr. Norman Jung, Staff Tax Auditor  
Mr. Romero Celedon, Supervising Tax Auditor  
GH - San Jose, Audit

April 15, 1992

From: David H. Levine  
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Subject: H--- P--- Co.  
SY - XX-XXXXXX

This is in response to your memorandum dated March 5, 19XX regarding whether certain H--- P--- contracts should be regarded as true leases or as sales at inception.

The contracts in question consist of two parts, a payment plan agreement and a payment plan equipment schedule and payment agreement. The provisions of a representative contract of the type in question are as follows. The term of the contract is for sixty months with a stated amount of rental payment due each month. The contract cannot be cancelled or terminated except as provided in the contract. Title to the property remains with H--- P--- during the entire term of the contract except as provided in the option provision. The option provision provides the customer with two choices, whichever choice is selected becoming effective at the end of the 54th month of the contract term. One choice is that the customer can continue to make payments on the equipment covered by the agreement for the remaining six months, and will obtain title to the equipment at the beginning of that six-month period (i.e., at the end of the 54th month). The second choice is that the customer may return the equipment to H--- P--- at the end of the 54th month. The customer must notify H--- P--- of its election 60 days prior to the end of the 54th month. If the customer fails to so notify H--- P---, then the customer is regarded as having elected the first choice, that is, to continue making payments on the equipment through the remainder of the 60 month term, gaining title at the end of the 54th month.

You believe that this contract is a sale at inception under subdivision (a)(2)(A) of Regulation 1660 since the customer will obtain title at the end of the term, by notifying H--- P--- or by doing nothing, and continuing to make the last six payments. H--- P--- believes that this contract is a true lease since the customer may timely notify H--- P--- and return the equipment, thereby precluding a finding that the lessee is bound for a fixed term to obtain title to the property at the end of that term.

Prior to discussing the specific analysis applicable to this case, it may be helpful to provide you my view on a different type of contract. It is my opinion that a contract designated as a lease with a total contract price of \$10,000,000 and an option price of \$101 at the end of the lease term is clearly a sale at inception and should be taxed accordingly. Obviously, however, I am mistaken since subdivision (a)(2)(A) of Regulation 1660 says that such a contract is a sale at inception if the option price does not exceed \$100, implying that my example is a true lease. In my opinion, the contract about which you inquire is much closer to being a true lease than is the example I have just provided.

Since I am in a comparison-type mode, I wish to provide you another analogy. As you are well aware, when a lessor is leasing property in substantially the same form as acquired, he has an election to pay tax up front and be treated as a consumer of the leased property with no tax on the rentals, or may elect to not pay tax on the purchase price and be regarded as making taxable continuing sales. Looking at it on a prospective basis, at the time of the original purchase of the property by the lessor, the lessor may elect either of two manners of reporting tax. On the other hand, looking back at it two years later, if the lessor failed to pay any tax that lessor has no election. Under such circumstances, we would regard the lease as subject to tax measured by rentals payable, and the lessor may not avoid that result by paying tax on purchase price two years after the property was first leased. I believe that the contract under review is a direct analogy to this scenario.

Looking at the option in the H--- P--- contract on a prospective basis at any time prior to 60 days before the end of the 54th month, the customer may elect to return the property at the end of the 54th month. The customer is not contractually bound to continue paying for 60 months, obtaining title to the property at the end of the 54th month, unless the customer so elects or fails to timely notify H--- P---. The theory of the sale at inception analysis is that the customer is contractually certain to obtain title to the property at the end of the contract term or is economically certain to exercise the purchase option (that is, when the option price does not exceed \$100 or one percent of the total contract price). Here, the customer is not economically certain to exercise the option, which is ten percent of the total contract price when the term is 60 months, nor is the customer contractually required to continuing making payments for the entire sixty-month period unless the customer so chooses (or fails to choose).

This contract is an unusual type of contract (I have never seen one structured in the same way). I assume your gut reaction to reviewing it is similar to my reaction to a contract structured as my example to start this opinion: it sure doesn't look like a lease. However, when

we examine the actual rights of the customer to return the property if so electing to do so, we must conclude that this is a lease contract. Therefore, we conclude that H--- P--- is correct in collecting use tax measured by rentals payable during the first 54 months (or first 30 months of a 36 month contract or first 42 months of a 48 month contract). With respect to the remaining 6 months of the contract, H--- P--- regards that portion of the contract as a sale at inception, and actually passes title to the customer at the beginning of that six-month period. We again agree with H--- P---'s handling of this in reporting sales tax on the full amount of payments due for the remaining six months of the contract at the beginning of that six-month period.

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

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