STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 324-2642

December 30, 1993

Mr. P--- -. M---
Law Offices Of
C---, W--- & C---
XXX --- Street
--- Floor
--- ---, CA XXXXX

Re: Application of Sales Tax
Regulation 1660(c)(9)
Election/Credit
Subject to an Existing Lease

Unidentified Taxpayer

Dear Mr. M---:

This is in response to your letter dated November 5, 1993, regarding the application of tax to your client's purchase of cable converter boxes that are subject to an existing lease agreement. In your letter you state:

> "The rental property in question consists in the aggregate of roughly 7,400 cable television converter boxes and remote control units (the units), which are currently leased to a number of the Company's subscribers in a single franchise area, and as to the rental of which use tax was collected by the Company until September 1, 1993. The Company also at present leases to a number of its subscribers in the same franchise area comparable units which were purchased tax-paid, and as to the rental of which use tax was not collected.

"The Company's objective in undertaking this tax-paid sale of the units is to bring itself into compliance with newly effected federal law by eliminating use tax obligations to which some, but not all, of its subscribers have been subject.

"....

"For purposes of this description, assume that the units are subject to existing, individual month to month leases. Use tax measured by payments for rental of the units has been collected from the lessees of the units, and remitted to the Board, since the units first entered lease service.

"In order to comply with federal law, the Company was required to curtail the collection of use tax from lessees of the units as of September 1, 1993, the effective date of rate regulation under the 1992 Cable Act. The Company intends soon to (1) terminate existing month to month agreements for the rental of the units, and (2) sell the units to a related legal entity (the `Buyer') at fair market value in an arms length transaction which will retroactively take effect as of September 1, 1993.

"At the time the units are acquired, Buyer intends to (1) pay to the Company, as vendor of the units, sales tax reimbursement measured by the purchase price of the units, which tax payment will be timely remitted to the Board and (2) create new month to month agreements for the rental of the units, retroactively effective as of September 1, 1993. [Footnote omitted.]

"The units will at all times be leased in the same form as acquired, and will at all times remain on the premises of lessees. Buyer will, after acquiring the units and creating new agreements with lessees for the rental of the units, contract with the Company to serve as Buyer's billing agent for the collection of payments for the rental of the units.

"The company will, on its own behalf and on behalf of Buyer, transmit for execution to each lessee documents intended to effect the (1) termination of existing month to month lease agreements between the lessee and the Company for the rental of the units and (2) creation of new month to month lease agreements between the lessee and Buyer for rental of the units. The new lease agreements between Buyer and the lessees will be created by Buyer sending each lessee a notice of the terms of the new agreement. This notice will state that the rental amount for the unit does not include sales or use tax on the lessee and that the lessee's continued payments will indicate acceptance of the new lease."

A lease of tangible personal property in California is a continuing sale and purchase unless the lessor leases the property in substantially the same form as acquired and pays sales tax

reimbursement or timely pays use tax measured by purchase price. (Reg. 1660(b)(1).) In effect, a lessor who will lease property in the same form as acquired may choose to pay sales tax reimbursement or use tax measured by purchase price or collect use tax from the lessee measured by rentals payable.

However, this election is not available to a person who purchases property subject to an existing lease. If the existing lease is not a continuing sale and purchase (that is, the lessor paid sales tax reimbursement or use tax measured by purchase price) and the lessor is therefore not required to collect use tax measured by the rentals payable, then the purchaser of that property who receives an assignment of the lease must pay sales tax reimbursement or use tax measured by purchase price. The new lessor may not convert the existing lease to one which is subject to use tax measured by rentals payable. On the other hand, when the existing lease is subject to use tax measured by rentals payable, the new lessor is purchasing the property for resale and cannot elect to pay tax measured by purchase price. Rather, the new lessor must continue to collect use tax from the lessee measured by rentals payable and pay that tax to the state. This is discussed in subdivision (c)(9) of Regulation 1660.

You state that your client intends to soon terminate its existing month to month agreements for the rentals of the units. Next your client will sell the units to a related legal entity (Buyer) at fair market value. Buyer intends to pay sales tax reimbursement to the seller measured by the purchase price of these units. After acquiring the units tax-paid, buyer will create new agreements with the lessees. The units will then be leased in the same form as acquired.

I note that when related persons enter into a transaction, we examine the transaction to ensure that it is as if at arms length and not solely for the purpose of avoiding or altering sales or use tax liabilities. Thus, when related parties enter into transactions as you propose, those transactions will be disregarded if they are not structured as if at arms length. For example, when a person sells property to a related party who will thereafter lease the property, the sale to the related party will be disregarded for sales and use tax purposes if the sales price does not include all costs of the seller, including the costs of the property and any overhead properly allocated to the cost of that property.

As noted above, the application of tax to a lease of tangible personal property cannot be changed during the lease term. This means that your client may not elect to change the payment method with respect to an existing lease in which property is currently in rental service and subject to use tax measured by rentals payable, as you had suggested in our telephone conversation on November 4, 1993. However, at the end of the lease term between the original lessor and lessee, the renewal of that lease is a new lease and a person who acquires such property during the period after the previous lease ends and the new lease begins is not regarded as having acquired the property subject to an existing lease. Under such circumstances, the new owner has the usual election to pay tax on the purchase price or collect tax on rentals payable. (See Reg. 1660(c)(6).)

You state that your client hopes to complete this transaction during the fourth calendar tax quarter of 1993. There will be a notice of the new lease agreements between buyer and the lessees. My understanding is that in this notice, buyer will inform the lessees that the new lease agreement will take effect retroactively to September 1, 1993. As stated above units that are sold to buyer before the existing lease is terminated are sold subject to that existing lease. This means that unless the units which are currently subject to tax by the rentals payable method are sold completely free and clear of an existing lease the 1purchaser has no right of election to pay tax with respect to those units on the purchase price method. This termination cannot be done on a "retroactive" basis. In order to accomplish your goals, all of the current leases on the units must have already been terminated prior to the time of the actual sale to buyer. If at the time of the actual sale some of the units are still under an existing lease agreement which makes those units subject to tax by the rentals payable method, then there can be no election to pay tax by the purchase price method on those particular units. Accordingly, since the application of tax to a lease of tangible personal property cannot be changed during an existing lease term, your proposed transaction cannot be applied retroactively and will accomplish your goals only with respect to those units for which the lessees were notified, prior to the sale date, that their leases would be terminated at a time prior to the sale.

For example, if your client notifies all lessees with existing month to month lease agreements with your client that their leases will be terminated as of 8:00 a.m. on February 1, 1994, then as of that time the units would no longer be subject to an existing lease. In this situation, the notice could also inform the lessee's that their continued payments and/or continued usage of the service after 8:00 a.m. on February 1, 1994 would indicate acceptance of a new lease. Under these facts since the former lease has effectively terminated as of 8:00 a.m. on February 1, 1994, buyer could purchase the units completely free clear of an existing lease if the sale occurred at 8:00 a.m. on February 1, 1994. If such were the case, buyer would have the usual election to pay tax measured by the purchase price method.

If you have further questions, please write again.

Sincerely,

Gerald Morrow
Tax Counsel

GM/md

Enclosures

cc: --- --- - District Administrator

STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-5550

April 7, 1994

Mr. P--- -. M---
C---, W--- & C---
XXX --- Street, --- Floor
--- ---, CA XXXXX

Re: A--- C--- of California
SZ -- XX-XXXXXX

C--- C--- of C---, Inc.

Dear Mr. M---:

Your letter dated January 24, 1994 to Chief Counsel E. L. Sorensen, Jr. has been referred to me for response. In response to a previous inquiry from you, Staff Counsel Gerald Morrow wrote a letter to you dated December 30, 1993 regarding the application of tax to a sale of property subject to existing leases. You have now identified your clients and ask for confirmation that your "client may, in effecting the proposed transaction, rely on Mr. Morrow's December 30, 1993 letter as constituting written advice from Board staff, as contemplated in Code Section 6596."

Initially, I note that Mr. Morrow's letter cannot, retroactively, be considered a letter that comes within the provisions of Revenue and Taxation Code section 6596. Rather, only this letter is a letter coming within the provisions of section 6596 (to the extent of the facts you have disclosed), and it is effective as such as of the date set forth above.

Your inquiry relates to cable television converter boxes (units). These units are currently owned by A--- C--- of California and are subject to leases which are taxable continuing sales. A--- plans to sell the units to a related entity, C--- C--- of C---, Inc. C--- wishes to pay tax on the purchase price of the units and then lease them without having to collect use tax on rentals payable.

As Mr. Morrow explained in his letter, we disregard a transaction between related persons unless the transaction is as if at arms length and not solely for the purpose of avoiding or altering sales or use tax liabilities. For example, when a person sells property to a related party who will thereafter lease the property, the sale to the related party will be disregarded for sales and use tax purposes if the sales price does not include all costs of the seller, including the costs of the property and any overhead properly allocated to the cost of that property. When such a transaction is disregarded, the original owner of the property is regarded as the lessor of the property. As pertains to your inquiry, if the sale between A--- and C--- were disregarded, A--- would still be regarded as the lessor, and it would not be entitled to change the payment of tax from rentals payable to purchase price. For purposes of this opinion, I assume that the sale from A--- to C--- will be as if at arms length.

As Mr. Morrow explained, a person who purchases property subject to an existing lease is bound by the seller/lessor's tax treatment of that property. If the existing lease is not a continuing sale and purchase (that is, the original lessor paid sales tax reimbursement or use tax measured by purchase price) and that lessor was therefore not required to collect use tax measured by the rentals payable, then the sale of that property to a purchaser who receives an assignment of the lease is subject to sales or use tax measured by purchase price. The new lessor may not convert the existing lease to one which is subject to use tax measured by rentals payable. On the other hand, when the existing lease is subject to use tax measured by rentals payable, the new lessor is purchasing the property for resale and cannot elect to pay tax measured by purchase price. Rather, the new lessor must continue to collect use tax from the lessee measured by rentals payable and pay that tax to the state. This is discussed in subdivision (c)(9) of Regulation 1660. Thus, if the units are sold subject to existing taxable leases, those leases continue to be subject to use tax measured by rentals payable.

In your previous letter, you indicated that the sale being considered by A--- would occur, retroactively, as of September 1, 1993. We do not recognize such "retroactive sales." For example, if the parties to the sale executed the sale contract today, and it stated therein that the sale occurred on September 1, 1993, we would regard the sale as occurring today, the actual date of the sale.

You also indicated in your previous letter that the lessees would be notified that their leases with A--- had been terminated as of September 1, 1993, retroactively, and that a new lease from C--- had begun as of September 1, 1993, also retroactively. Again, we do not recognize such retroactive treatment. As Mr. Morrow explained, in order to accomplish your goals, all of the current leases on the units must be terminated prior to the time of the actual sale to buyer. Neither the sale nor the termination of the leases can be done on a retroactive basis. If, at the time of the actual sale, some of the units are still under existing taxable lease agreements which have not been terminated, then there can be no election to pay tax measured by purchase price with respect to those particular units. Accordingly, since the sale of tangible personal property cannot be a means to alter the application of tax to the lease of that property during an existing

lease term, your proposed transaction cannot be applied retroactively and will accomplish your goals only with respect to those units for which the lessees were notified, prior to the time of sale, that their leases would be terminated at a time prior to the sale.

Due to the timing of the critical events, terminating the leases, selling the property, and starting the new leases immediately, a change of tax reporting could not result from this type of transaction unless we were to regard the simultaneous occurrence of all such events as satisfying the requirements discussed above. As applied in the example below, we do accept such simultaneous transactions as meeting the requirements of subdivision (c)(9) of Regulation 1660.

If A--- were to notify each lessee that his or her existing month to month lease agreement with your client will be terminated as of 8:00 a.m. on June 1, 1994 (more than 30 days from the date of the notice to properly terminate month to month leases), then as of that time the units would no longer be subject to an existing lease. That notice, or a separate advance notice, could also inform each lessee that the unit he or she is currently leasing from A--- is being sold to C--- as of 8:00 a.m. on June 1, 1994 and that the lessee's continued usage of the unit after 8:00 a.m. on June 1, 1994 would indicate acceptance of a new lease from C---. Under these facts, if the sale from A--- to C--- also occurred at 8:00 a.m. on June 1, 1994, C--- would not be regarded as purchasing the units subject to existing leases. If such were the case, based on the assumption that C--- is regarded as purchasing the units at fair market value in a transaction as if at arms length, it would have the usual election to pay tax measured by purchase price.

I also would like to make a couple additional points so that you can assist us in serving you and other taxpayers and representatives in the most efficient manner. Prior to writing your letter to Mr. Morrow, you discussed this matter with him, and he advised you what his answer would be. You did not identify your client in your first letter. After receiving a written response from Mr. Morrow, you wrote a second letter which neither included new facts nor asked for clarification. Rather, the sole purpose of your second letter was to identify your client for purposes of coming within section 6596. One result of this approach is the additional workload of answering two letters when one response would have been sufficient, and this of course affects our efficiency. Even more important to you and your client is the time it took to receive a response coming within section 6596. If you had identified your client in your first letter, you would have received a letter coming within section 6596 over three months ago, which stated just what Mr. Morrow indicated to you in your telephone conversations. I note, in this regard, that as mentioned above this letter is not "retroactive" to the date of Mr. Morrow's letter.

I note also that you addressed both your first letter and the current letter to the Chief Counsel. While you are certainly free to direct your letters in the manner you deem appropriate, I wish to alert you that addressing your letters to the Chief Counsel can delay our response. It is the addressee of letters we receive who is responsible for answering the letter or forwarding it to the appropriate person for response (persons who are copied with the letters would regard those copies as informational and await the forwarding of the letter from the addressee). The Chief

Counsel does not usually answer letters asking general sales tax questions, but rather refers such letters to the Sales Tax Section. You can avoid the additional delay caused by that referral by addressing your letters directly to the Sales Tax Section. We suggest that, if you discussed the matter with an attorney in the Sales Tax Section, you address your letter to that attorney, with copies to whomever you wish to know of your letter (e.g., the Chief Counsel). Otherwise, you may address you letter to Assistant Chief Counsel Gary J. Jugum, Supervising Staff Counsel Gordon P. Adelman, or me. In any event, if you have discussed a matter with an attorney in the Sales Tax Section prior to writing, please always mention that fact in your letter and identify the attorney with whom you spoke.

Sincerely,

David H. Levine
Supervising Staff Counsel

DHL:wk

cc: --- --- District Administrator - --
--- District Administrator - --