STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
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May 12, 1992

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Dear Mr. ---:

This is in response to your letter to our New York District office dated February 5, 1992 which, as you know, has been referred to the Legal Division for response. You have several questions related to the application of tax to your purchase of certain property and subsequent sale and leaseback. In a telephone conversation on April 17, 1992, I advised you that we needed copies of the relevant contracts in order to answer your questions. In response, you provided us a copy of a Licensed End User Agreement for Redistributed **C** Licensed Programs between **A**, as the end user, and **B**, as the industry remarketer. You have also provided us a copy of a Term Lease Master Agreement between **A** and **C.**

Factual Background

A executed a Licensed End User Agreement with **B** dated April 29, 1991. This agreement apparently related only to a software program, A---, for a designated computer (which was purchased at the same time). The agreement was executed on behalf of **B** on May 15, 1991, and thereafter **C** executed its acceptance. This agreement apparently was part of **A**'s purchase from **B** of a computer as reflected in an invoice from **B** to **A** dated April 30, 1991. The invoice indicated that the property was shipped on that date, and showed a total sales price of $67,000, plus tax of $4,690, for a total invoice amount of $17,690. **A** issued to **B** a check dated April 29, 1991 for $17,500 towards the purchase price. **A** thereafter apparently purchased an additional piece of hardware for $3,000 plus $210 in tax for a total amount of $3,210. This is reflected in an invoice dated May 29, 1991, which indicates that the property was shipped on that date. **A** made a second payment to **B** towards these purchases by a check dated July 29, 1991 in an amount of $29,601.

As you note in your letter, although **A** intended to finance the full amount of the purchase price, at the time of the purchase it did not have such financing lined up. **A** therefore purchased the property in its own name and awaited **B**'s search for a financing source. After locating only one other financing source at what you considered an exorbitant rate, you eventually entered into an agreement with **C**.

A's agreement with **C** is entitled Term Lease Master Agreement, and was executed by **A** on September 20, 1991. Although the primary provisions of the agreement relate to the lease portion, there are also provisions for the sale of the property by **A** to **C**. The main portion of the agreement is structured as one not involving an outside vendor. The agreement includes amendments to modify the agreement's provisions so that they apply to transactions such as **A**'s, wherein a third-party vendor (not **C**) sells the property to **C**'s customer and that customer sells the property to **C** and leases it back. Section 40 of the lease agreement provides that the equipment under lease is and shall be the property of **C** and that **A** has no right, title, or interest therein except as set forth in the lease. Section 40 also provides that the licensed program materials are licensed and provided by **C** directly to **A** under the terms and conditions of the license agreement.

Pursuant to the terms of the agreement between **C** and **A**, **C** remitted $70,000 to **B** with reference to **C**'s purchase of the subject equipment from **A**. This was the same amount **A** paid **B** when **A** purchased the property, except for the taxes that had been collected by **B** from **A**. Since **B** had already received total payments from **A** of $47,101, **B** refunded $42,201 to **A** after receiving the payment of $70,000 from **C**. This refund by **B** to **A** was the total amount **A** had paid **B**, less the amount of taxes **B** had collected from **A**. I assume that this amount not refunded to **A** by **B** was actually paid by **B** to this Board as tax on the sale of the equipment to **A**.

Discussion

A. Sale from **B** to **A**

Sales tax applies to a retailer's retail sale of tangible personal property in California. (Rev. & Tax. Code § 6051.) When sales tax does not apply, such as when the sale occurs outside California, then use tax applies to the use of property purchased from a retailer for use in California. (Rev. & Tax. Code §§ 6201, 6401.) Sales or use tax only applies to retail sales or to purchases for use. A retail sale is a sale for any purpose other than resale in the regular course of business. (Rev. & Tax Code § 6007.) **A** did not purchase the property for resale, and more importantly, did in fact functionally use the property for its intended purpose prior to **A**'s eventual resale of the property to **C**. Therefore, the sale by **B** to **A** was a retail sale and was subject to tax. It appears that the property may have been shipped from outside California by common carrier to **A** in California. Assuming this to be the case, the applicable tax was a use tax which was owed by **A** and which was required to be collected from **A** by **B** and paid to this Board. (Rev. & Tax. Code §§ 6202,6203.)

As just discussed, **B**'s sale to **A** was a retail sale and was subject to tax notwithstanding **A**'s later transactions with **C**. Therefore, **B**'s retention of the amount of tax it had collected from **A** when refunding the rest of the purchase price (because **C** had paid the full purchase price to **B**, less tax) was entirely appropriate. That is, the sale by **B** to **A** was a taxable retail sale, and transactions occurring later do not affect that application of tax. Please note that under the California Sales and Use Tax Law, each retail transaction is subject to a sales or use tax unless there is a specific statutory exemption from that tax. In this case, there is no applicable exemption.

The conclusion that it was appropriate for **B** to retain the amount of the tax **A** had paid to it is based on the assumption that **B** actually paid that amount of tax to this agency. Nevertheless, since you paid tax on a taxable transaction to a retailer registered with this Board, even though the tax appears to have benn a use tax which **A** owed, **A** would have no further liability for the tax even if **B** had not paid the tax to this agency. (Under such circumstances, the amount of tax owed to this state would be a debt owed by **B**.) There appears to have been some discussion of this issue among **A**, **B**, and **C**. It appears that **C** may have been insisting that **B** should refund the amount to this tax to **A**. If **C** so indicated, **C** is incorrect.

B. Sale and Leaseback Transaction

In your letter you indicate your concern that the Board will regard **A**'s transaction with **C** to be a sale and leaseback transaction resulting in additional taxes. The transaction between **C** and **A** was structured as a sale and leaseback transaction. Unless qualifying for one of the two exceptions discussed above, that transaction will be regarded as an additional retail transaction and, unfortunately, subject to tax.

Revenue and Taxation Code section 6010.65 became effective January 1, 1991. That section excludes from the definition of "sale" for purposes of the Sales and Use Tax Law, an acquisition sale and leaseback transaction when meeting certain conditions. The first condition is that tax was paid by the original purchaser upon acquisition. **A** paid tax to **B** on its initial acquisition. Therefore, this first condition is satisfied. The second condition is that the sale and the leaseback transaction is consummated within 90 days of the original purchaser's first functional use of the property. **A** purchased the property on April 30, 1991, and presumably put the property into functional use shortly thereafter. In your letter you state that the effective date of the lease between **A** and **C** was May 15, 1991, which you state is supported by **A**'s payment of certain amounts to **C** for that period. Notwithstanding this purported effective date, **A** purchased the subject equipment from **B** and owned that equipment from the time it obtained ownership, until the time it sold that equipment to **C**. **A**'s sale of the equipment to **C** could not, and did not, occur prior to **A**'s contract with **C** to sell the property to **C** and lease it back. This contract was not executed until September 1990, which is the time the sale of the property from **A** to **C** occurred and the time the lease from **C** to **A** commenced. Thus, well over 90 days passed from the date of first functional use to the date the sale and leaseback transaction was consummated, and the transaction between **C** and **A** therefore does not meet the conditions set forth in section 6010.65.

The other possibility is provided by Regulation 1660, a copy of which is enclosed. Subdivision (a)(3) explains when a transaction structured as a sale and leaseback will be treated as a financing transaction. There are several conditions for such treatment, one of which is that the purchaser/lessor (here, **C**) does not claim any deduction, credit, or exemption with respect to the property for federal or state income tax purposes. (Reg. 1660(a)(3)(A) & (a)(3)(B)4.) Section 29 of the agreement between **C** and **A** provides that the agreement is entered into on the basis that **C** is entitled to the maximum Accelerated Cost Recover System (ACRS) deductions for five-year property, and that **A** would not make any election under the Internal Revenue Code which would cause any item of equipment to cease being eligible for **C**'s ACRS deductions. Thus, the sale and

leaseback transaction cannot be regarded as merely a financing agreement, but rather must be regarded for purposes of sales and use tax as a sale from **A** to **C** followed by a lease by **C** to **A**. Since **C** did not make an election to pay tax measured by the purchase price, tax applies to the lease measured by rentals payable.

C. Specific Questions

You have four additional questions. Your first question is who is the taxing authority, **C** or **B**. By this question, I assume you mean who is the retailer required to collect from **A** the tax due to California. It seems this question is related to your second question, which is whether **C** is correct in only taxing the hardware portion of the payment. Apparently, **C** believes that **B** is somehow responsible for collection or payment of tax with respect to the software portion of the payment.

B made a retail sale of tangible personal property to **A** and collected tax with respect to that sale. As noted above, I assume that **B** paid the amount of the tax it collected from **A** to California. That transaction was subject to tax, and that tax was apparently paid to this Board. Assuming this to be the case, **A** has satisfied its tax obligations with respect to that purchase, and **B** has satisfied its collection responsibility with respect to its sale to **A**. Any further tax due with respect to the transactions about which you inquire would be due with respect to the second retail transaction, that is, the lease from **C** to **A**.

C apparently believes that it is **B**'s responsibility to tax the software sold to **A** since **B** is what **C** characterizes as a "remarketer." We agree that **B** is the party responsible for collection and paying the tax with respect to its sale of software to **A**. However, that sale is not the transaction in question when analyzing the lease transaction. **A** purchased hardware and software from **B**. **A** thereafter sold hardware and software to **C**. **C** in turn leased hardware and software to **A**. This was a new retail transaction subject to tax. As a lease of tangible personal property with respect to which the lessor did not timely pay tax measured by purchase price (that is, **C** did not timely pay tax to **A** or to this Board measured by the $70,000 sale price of property **C** purchased from **A**), **C** is regarded as making a continuing sale of all of the tangible personal property, including the software, which it is leasing to **A**. This continuing sale, the lease, is subject to use tax measured by the full amount of rentals payable. **B** is neither the owner nor the lessor of that software and has no responsibility with respect to the taxes due on the lease.

You ask what is the effective lease date. Parties to a lease cannot by backdating a contract create a lease that is deemed to have commenced before its execution at a time when the purported lessor does not own (or lease from another person) the property purportedly leased to the lessee, at least for purposes of the Sales and Use Tax Law. **A** executed the agreement with **C** on September 20, 1991. **C** apparently executed the lease in September, but showing a date of acceptance as may 15, 1991. Based upon this information, we conclude that the lease commenced September 20, 1991.

Your remaining question is what, if any, refunds are due **A** by **B/C**. It unfortunately appears that no refunds are due to **A**. The first transaction was a retail sale subject to tax. The second transaction is again a retail transaction subject to tax, as discussed above. Furthermore, it appears that **C** is not collecting the proper tax from **A**. The full amount of all rentals due under the lease agreement is subject to use tax, which tax **C**, as the lessor, must collect from **A** and pay to this Board.

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

Sincerely,

David H. Levine
Senior Tax Counsel

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Enclosure