STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:85)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0085)
Telephone: (916) 324-2653
FAX: (916) 324-2618

August 23, 1996

Ms. C--- R. W---
Tax Manager
K--- L--- Ltd.
P.O. Box XXXX
---, New York XXXXX-XXXX

Re: Request for Opinion

Dear Ms. W---:

You have requested our opinion as to the California Sales and Use tax consequences related to your company's acquisition and subsequent leasing of rail cars and other rolling stock.

You indicated that your company purchases equipment for lease. In particular, K--- L--- Ltd. proposes to purchase rail cars, hopper cars, locomotives and other rolling stock and lease the property to lessees engaged in interstate commerce. While I will try to address all your specific questions, I will not answer them exactly as presented because although your inquiries are clear and direct, our opinion will be a bit more complicated.

Sales and Use Tax - Generally

Revenue and Taxation Code section 6051 imposes a sales tax on all retailers measured by their gross receipts from retail sales of tangible personal property in California. The sales tax is imposed upon the retailer, but the retailer may collect sales tax reimbursement (usually itemized on the invoice as "sales tax") from the purchaser if the contract of sale so provides. (Civ. Code § 1656.1.)

Revenue and Taxation Code section 6201 imposes a use tax, on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer for storage, use, or other consumption in this state. The use tax complements the sales tax and is most frequently imposed upon in-state leases, out-of-state purchases of property for use in California, and use of property purchased with a resale certificate.

Sales or use tax does not apply to a transaction which is exempt by statute or under the provisions of the United States Constitution.

Rail Freight Cars

Initially, I will deal only with "rail freight cars." Rail cars are defined as "mobile transportation equipment" (MTE) under Revenue and Taxation Code section 6023.[1] Your lease of the rail cars is a lease of MTE and is therefore not a "sale" or "purchase" under sections 6006(g)(4) and 6010(e)(4). Rather, it is a "use" of the property under section 6009. Tax applies to the sale of the MTE to you, or to your use of the MTE unless an exemption applies. The relevant exemption is section 6368.5, which exempts from sales and use tax the sale and use of rail freight cars in interstate commerce. Since you are the consumer of the MTE you lease out, your lessee's use of that MTE is attributed to you for purposes of determining whether the section 6368.5 exemption applies; that is, the lessee's use of the property in interstate commerce will determine whether the exemption applies.

How long must the property be used in interstate commerce before the exemption cannot be lost due to an intrastate use of the property? The board has not adopted any regulation regarding the "lookback" period for rail freight cars. However, when examining the amount of time property is used in multi-state operations or in interstate commerce the board uses a six-month period. (*California Business Taxes Law Guide, Annot.* 570.0430, 1/7/74;3/23/84;1/28/91.) Therefore, it is our opinion that if the rail freight cars are used by your lessee principally in interstate commerce for at least six months following the date of your purchase of them, the subsequent use of the cars in intrastate commerce would not render the initial sale taxable. Please note that an occasional intrastate use during the lookback period does not disqualify the property. For purposes of determining whether the sale or use of rail cars qualifies for exemption under Revenue and Taxation Code section 6368.5, the Board applies a principal use test. (See *Annotation* 325.0100 in *California Business Taxes Law Guide*, 3/12/64.)

If you purchase the property for a purpose such that the sale to you or your use of the property is exempt from sales and use tax, and your purchase is from a person who holds a California seller's permit or a Certificate of Registration-Use Tax, you should provide the seller with an exemption certificate so that the seller does not collect sales tax reimbursement or use tax from you. You should be aware that if the use of the property by your lessee is not as certified, i.e. it is not used in interstate commerce, then K--- L---, as the purchaser issuing the exemption certificate will be liable for the sales tax.

[1]Unless otherwise specified, all references are to the California Revenue and Taxation Code.

If the rail freight cars are purchased outside of California for use in California, such that the use tax, rather than the sales tax would potentially apply, and your lessee's use is not in interstate commerce, then unless you had made a timely election to pay tax on fair rental value, you would owe use tax measured by your purchase price. You must make the election by reporting and paying the tax with a timely return for the period in which you first lease the MTE.

Other Rolling Stock Purchased in California

The exemption provided by section 6368.5 is limited to the sale and use of "rail freight cars." The sale and use of locomotives and other non rail freight car "rolling stock" (hereinafter collectively referred to as "engines") does not qualify for the exemption. The intended use of the property in interstate commerce is irrelevant. However, in the case of property purchased from a retailer for subsequent lease, you have two options on payment of the tax. You may either pay the appropriate sales tax reimbursement or use tax at the time or sale, measured by the purchase price, or you may give the seller a "resale certificate" which will allow you to purchase the property without payment of tax or tax reimbursement through the seller. You will then have to self report and pay a use tax on the purchase, measured by the fair rental value. (*Sales and Use Tax Reg*. 1661(b)(2).) You may give the retailer a "resale certificate" because a purchaser of mobile transportation equipment property <u>for lease</u> is authorized to issue a "resale certificate" for the limited purpose of reporting use tax on the mobile transportation equipment based on fair rental value. (*Sales and Use Tax Reg*. 1668(f).)

The election to pay the use tax based on fair rental value must be made by reporting use tax measured by the fair rental value on your timely return for the period in which the property is first leased. Once the election is made it cannot be revoked, and tax must thereafter be reported and paid based on the fair rental value, whether the equipment is used within California or not, and whether rent or lease payments are actually received or not. I am enclosing a copy of California Sales and Use Tax Regulation 1661, *Leases of Mobile Transportation Equipment*, for your further information.

Engines Purchased Outside California

We now turn to the scenario where the property is purchased from a retailer outside of California. In that situation, California imposes a use tax which will apply if the engines are purchased for use in California, unless an exemption applies.

If property purchased outside California is first functionally used in this state, then it is regarded as purchased for use in this state and California use tax applies. This would be true without regard to later (or immediate) use in interstate commerce, continuous or otherwise. (*Sales and Use Tax Reg*. 1620(b)(3).) If the only use of the engines outside of California was to drive them into California to pick up the first available cargo (as opposed to a specific payload), the first functional use would be regarded as having occurred in California. (*Anno*. 570.0430, *Cal. Bus. Taxes Law Guide, supra.*)

If the engines are not first functionally used in California, then the following rules apply:

> "When the property is first functionally used outside of California, the property will nevertheless be presumed to have been purchased for use in this state if it is brought into California within 90 days after its purchase, unless the property is used or stored outside of California one-half or more of the time during the six month period immediately following its entry into this state. Prior out-of-state use in excess of 90 days from the date of purchase to the date of entry into California, exclusive of any time of shipment to California, or time of storage for shipment to California, will be accepted as proof of an intent that the property was not purchased for use in California." (*Sales and Use Tax Reg*. 1620(b)(3).)

In other words, if the engines are first "functionally used" outside California and are used outside California for at least 90 days after purchase before entering this state, or if they enter into California within the first 90 days after purchase, but spend more than half of the next six months outside California after initial entry into California, then we will not presume they were purchased for use in California. No use tax would be payable even if subsequent use was primarily or even exclusively within California.

Interstate Commerce Exemption

If the engines are regarded as having been purchased for use in California under the tests set out above, then we must analyze whether an exemption from use tax is applicable. *Sales and Use Tax Regulation* 1620(b)(2)(B) provides that "Use tax does not apply to property purchased for use and used in interstate or foreign commerce prior to its entry into this state, and thereafter used continuously in interstate or foreign commerce both within and without California and not exclusively in California." To qualify for this exemption, the engines must be actually used in interstate commerce before they enter California and must enter California while engaged in interstate commerce. For example, if an engine delivers cargo to a point in California from out-of-state, it enters this state in interstate commerce. If it enters this state without cargo, it enters engaged in interstate commerce only if it is dispatched to pick up a specific interstate cargo. It is not engaged in interstate commerce if it is dispatched empty to pick up the next available, non-specified, cargo.

After entry into California, the engines must be continuously used in interstate commerce both within and without California and not exclusively in California. The board uses a test period of six months after the vehicle enters California to determine if it is continuously used in interstate commerce. The interstate commerce test set out above is contained in Business Taxes Law Guide Annotation 570.0430 which further states:

> ". . . A vehicle is used in interstate commerce so long as any part of its cargo is interstate in nature, even though part of its cargo on a given trip may be intrastate in nature. A vehicle may be engaged in interstate commerce while operating entirely within the state if any part of its cargo has an origin in one state and a destination in another. A vehicle is regarded as used in intrastate commerce if the origin and final destination of its entire cargo is within California."

Please note that if the property is found to have been used in intrastate, rather than interstate commerce, on even one occasion during the six month test period, the exemption is lost for that property.[2] Further, if you had not reported and paid use tax on the first return due after entry into California measured by the fair rental value, your opportunity to elect that method is lost, so a disqualifying intrastate use would require that the tax be paid on the entire purchase price of the property.

I hope the foregoing has been responsive to your inquiries, but if not, or if you have further questions, please feel free to write again.

Very Truly Yours,

John S. Butterfield
Tax Counsel

JSB/cmm

cc: Out-of-State District Administrator OH)

[2]Note that in this context, we apply a different, i.e. "exclusive use" test, as opposed to the "principal use" test we applied for the exemption for the sale and use of rail freight cars provided by section 6368.5.