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STATE OF CALIFORNIA

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May 12, 1995

Mr. J--- A. H---
Corporate Tax Manager
H--- - P--- C---
XXXX --- Street, MS XX--
--- ---, CA XXXXX

Re: FR – XX-XXXXXX

Dear Mr. H---:

This is in response to your letter dated February 27, 1995 regarding the application of sales and use tax to certain sale and leaseback transactions.

You explain that HPC sometimes enters into sale and leaseback transactions involving tangible personal property not originally sold by HPCC. You indicate that the transactions may not qualify as financing transactions under Regulation 1660 and do not qualify for any special treatment due to the time elapsed from the original purchase. I assume this latter statement means that the transactions will not come within the provisions of Revenue and Taxation Code section 6010.65. You state:

> "It appears to HPC that in these situations the provisions of Regulation 1655 could be applied with respect to the sales tax that was paid on the initial acquisition by the purchaser. The seller/lessee could have the original vendor refund the full sales price, including that portion designated as `sales tax', etc. (This would be done without returning the equipment to the original vendor) The vendor would comply fully with the requirements of R1655 and would be entitled to a returned merchandise credit as per R1655.
>
> "The vendor would then sell the equipment `in place' to HPC, ex-tax as HPC would be acquiring the property for resale/lease and would issue a resale certificate.
>
> "R1655 does not require that the merchandise be returned. Nor does R1655 impose any time limit as to when the merchandise must be `returned.'"

You believe that Regulation 1655 does not require a return of the merchandise. The very name of the deduction, the <u>returned-merchandise</u> deduction, clearly shows otherwise. The statutory basis for the returned-merchandise deduction, subdivision (c)(2) of Revenue and Taxation Code section 6012, is clear on this point. It provides that the retailer may exclude from its taxable gross receipts the "[s]ale price of <u>property returned by customers</u>" under certain stated conditions. (See also Rev. & Tax. Code § 6011(c)(2).) Similarly, subdivision (a) of Regulation 1655 explains that the deduction is available to the retailer with respect to <u>merchandise returned by customers</u> under certain stated conditions. Thus, the deduction requires an actual return of the property.

The statutes and regulation give the conditions which the retailer may impose and still qualify for the returned-merchandise deduction. An example is a retailer who agrees to refund to the purchaser her entire purchase price, plus sales tax reimbursement, conditioned on the purchaser's return of the property, purchase of other property at a cost no greater than the returned property, and purchase of a whole life insurance policy from the retailer's brother-in-law. Although a condition requiring the purchase of an insurance policy is not listed in the statute or regulation, it is a condition that is not authorized by those provisions. The retailer clearly is not entitled to a returned-merchandise deduction if the refund is conditioned on such a requirement.

Your proposal is not legally distinguishable from the example discussed above. You propose that the retailer may take a returned-merchandise deduction when "refunding" the purchase price only if that purchase price is replaced by another person's purchase price in the identical amount, and only if the original purchaser procures the replacement purchaser. Just as in the example discussed above, neither the statutes nor the regulation list a condition requiring the purchaser to procure a second buyer who will pay the same amount as the original purchase price even if that amount is greater than the fair retail value of the property; however, it is a condition that is not authorized in those provisions. The retailer clearly is not entitled to a returned-merchandise deduction if the refund is conditioned on such a requirement.

As you correctly note, there is no time limit regarding the returned-merchandise deduction. Thus, the following example is a likely scenario of what you propose. The purchaser purchases equipment for $1,000,000 on January 1, 1994, and on January 1, 1995 the fair market value of that equipment is $750,000. If the purchaser or the vendor were to sell that equipment (or identical equipment) on January 1, 1995, the selling price would be $750,000, and any purchaser could purchase substantially identical equipment at that price. When the purchaser negotiates a sale and leaseback arrangement with a lessor, the lessor may agree to purchase the property on January 1, 1995 for $1,000,000 even though it is only worth $750,000, but only because of the leaseback connected to that sale contract under which the lessor will recoup its over market-value purchase price. On the other hand, if, unrelated to its transaction with its customer, the lessor were to obtain substantially identical equipment from a third party, e.g., the vendor, it would not pay more than the $750,000 fair market value. That is, the lessor in this example would pay $1,000,000 for the equipment on January 1, 1995 only if that purchase price is part of a sale and leaseback arrangement where the lessor will recoup its entire over market-value purchase price.

In your proposal, the vendor is not merely reselling the "returned" property to a third party unrelated to the "return" transaction. The <u>only</u> way the vendor is able to obtain the above market-value purchase price is to make its so called "refund" conditioned on the purchaser's arranging that above market-value sale (as part of a sale and leaseback arrangement). The returned-merchandise deduction was never intended to cover such transactions. Instead, as discussed below, this is the very reason for treatment of certain sale and leasebacks as financing transactions and for the adoption of Revenue and Taxation Code section 6010.65.

There are two ways to look at the transactions you propose. One is that the purchaser sells the property to the original vendor in a transaction that does not qualify for the returned-merchandise deduction (as discussed above), followed by the vendor's selling the property to HPC who then leases the property to the original purchaser. Under this view, the sale by the original purchaser to the vendor would be a sale for resale, and the sale to HPC or HPC's lease would be taxable. However, as discussed above, HPC would not purchase property for an above market-value price except when that purchase is part of a sale and leaseback transaction. Thus, the better view based on this practical reality is that HPC's purchase is part of a sale and leaseback transaction with the original purchaser, and the vendor is merely acting as a conduit for the sale from the original purchaser to HPC. The person actually making the sale to HPC is the original purchaser, and the fact that the parties may utilize the original vendor as a conduit does not alter the analysis as to the application of tax to that sale and leaseback arrangement. That is, under this view the result is the same: the sale by the purchaser to HPC or the lease back to the purchaser is subject to tax.

I note that the history of the financing rules of subdivision (a)(3) of Regulation 1660 and the history of the acquisition sale and leaseback provision, Revenue and Taxation Code section 6010.65, are entirely consistent with our conclusion herein. As you know, the retail sale of tangible personal property is subject to sales or use tax. There is no unringing the bell. (See, e.g., BTLG Annot. 495.0440 (9/8/65).) Thus, when the purchaser thereafter enters into a sale and leaseback arrangement, the goal of the parties has always been to avoid another sales or use tax on the sale and leaseback. For this reason, as you are well aware, the leasing industry had for years argued that certain sale and leaseback transactions were actually nontaxable financing transactions notwithstanding the structure of each as a sale followed by a leaseback.

Industry eventually prevailed in its arguments in Cedars-Sinai Medical Center v. State Board of Equalization (1984) 162 Cal.App.3d 1182 and in amendments to Regulation 1660 which now set forth the circumstances where a transaction structured as a sale and leaseback will nevertheless be treated as a nontaxable financing transaction. If the method you propose were valid, there would have been virtually no reason for the amount of time and effort spent by industry in advocating its position since the parties could have in effect avoided tax on the first retail sale of the property, with only one tax on the series of transactions which ends with the leaseback.

Even more instructive is the adoption of Revenue and Taxation Code section 6010.65. Although industry was pleased to have the rules in Regulation 1660, those rules are based on the underlying rationale that, notwithstanding the structure of the transaction as a sale and leaseback, it was in all other respects consistent with the assertion that it was a financing transaction. The industry sought a broader exclusion from tax for sale and leaseback transactions. In 1989, industry sponsored the predecessor legislation to section 6010.65. That provision was passed by the Legislature but vetoed by the Governor (it had contained a broader exclusion and longer window period, and had been more complicated than the one actually adopted). Industry then sponsored reintroduction of the same legislation in 1990, finally settling for a simplified, easy to apply exclusion with a shorter window period and a sunset date, which was passed and signed that year. The reason for industry's continued efforts in this area was to eliminate the second tax in these type of transactions, recognizing that the first transaction would not qualify for any other exclusion (such as the one you propose).

Had industry been able to avail itself of the method you propose, there would have been no real need for section 6010.65, because any such transaction would qualify for a returned-merchandise deduction (although the vendors would have to cooperate, very few would refuse their cooperation), meaning that industry would have obtained its most important goal: effectively only one tax on the series of transactions ending with the sale and leaseback without regard to whether the property was used prior to the sale and leaseback transaction. Industry would not have had to settle for a statutory exclusion that was scheduled to sunset after four years. (Section 6010.65 was originally in effect only between January 1, 1991 and January 1, 1995. Legislation was adopted in 1994 deleting the sunset date.) Furthermore, there would have been no 90 day time limit from functional use since, as you note, the retailer may take the deduction with respect to a return meeting the requirements of Regulation 1655(a) without regard to length of time from the first functional use. Industry fought for section 6010.65 in its reduced form because industry knew that it could not use the returned-merchandise deduction in circumstances such as you propose.

For the reasons discussed above, we conclude that the transactions you propose do not qualify for the returned-merchandise deduction.

Sincerely,

David H. Levine
Supervising Staff Counsel

DHL:cl

cc: Mr. William D. Dunn
Mr. Ronald L. Dick
--- --- District Administrator