

**M e m o r a n d u m****495.0288**

**To :** Mr. Dennis Fox, Supervisor  
Audit Evaluation & Planning Section  
(MIC:40)

**Date:** August 22, 1994

**From :** Pat Hildebrand  
Staff Counsel

(916) 324-2642  
CalNet 454-2642

**Subject :** T--- F---, Inc.  
SN -- XX-XXXXXX

This is in response to your memorandum dated May 5, 1994, in which you ask that we review documents related to an "Agreement to Lease With Option to Purchase" concerning modular office furniture purchased by T--- F---, Inc. (hereafter, T---) for the City and County of --- --- (hereafter, City and County).

This agreement between the parties is structured as an installment sale contract. The agreement may be assigned or transferred by T--- to fund the indebtedness of the City and County for furniture. Such a transfer would be to a trustee or investor who issues certificates of participation to an underwriter for sale to investors. Under this agreement, the sum of the principal payments is \$XX,XXX, which exceeds the \$YY,YYY sale price of the furniture sold to the City and County. You ask if the difference between the sum of principal payments and the sale price, which covers the issuance costs of \$Z,ZZZ.ZZ for certificates of participation, can be regarded as part of the gross receipts of the lease/sale, whether the sum of principal payments is the selling price, and how tax applies to this transaction.

In a memorandum to you dated March 1, 1994, the --- --- District Principal Auditor, Ms. Barbara Lee, described these costs as:

". . . costs associated with closing and funding the principal amount of the lease including, but not limited to, fees for the bond, tax and securities counsel, printing costs, credit enhancement costs (if any), credit rating costs (if any), underwriter's discount (as applicable), financial advisor or other professional fees, governmental filing costs (if any) and, where appropriate, costs of feasibility studies."

The chronology of events involved in this transaction are as follows:

(1) The City and County negotiate to acquire the modular office furniture and equipment (equipment) for a fixed price of \$YY,YYY. These negotiations are independent of the financing described in the following steps (2) through (5).

(2) T--- submits a bid to finance the equipment, is awarded the contract and buys the equipment, paying the applicable sales tax.

(3) T--- sells the equipment to the City and County for a series of 60 monthly payments of \$A,AAA per month on this installment obligation which bears interest at 7.88%. The principal amount is equal to the \$YY,YYY purchase price. There is a sales tax in connection with the sale to the City and County, but T--- is entitled to a tax paid purchase resold deduction equal to the sales tax incurred in step (2).

(4) After the above documentation is complete, T--- then assigns the installment obligation to investors for \$YY,YYY (the note purchase price).

(5) The stream of payments under the installment obligation is relabelled so that the principal payments equal the note purchase price and the adjustment upward of the principal payments is offset by an equal adjustment downward of interest payments on the installment obligation.

Under Revenue and Taxation Code section 6006.3, in the case of a contract designated as a lease with any state or local governmental body, or any agency or instrumentality thereof, the lessee is treated as bound for a fixed term notwithstanding any right of the lessee to terminate the contract in the event that sufficient funds are not appropriated to pay amounts due under the contract. This means that such a contract is recharacterized as a sale for sales and use tax purposes.

Regulation 1660(a)(2)(A) provides:

"Where a contract designated as a lease binds the "lessee" for a fixed term and the "lessee" is to obtain title at the end of the term upon completion of the required payments or has the option to purchase the property for a nominal amount, the contract will be regarded as a sale under a security agreement from its inception and not as a lease. . . ."

This means that, despite the fact that the title is retained buy the so-called lessor to the time that payments are completed, the sale under a security agreement is a sale from its inception and the real question is the tax consequence with respect to the sale. T--- both purchased the modular office equipment and properly paid the applicable sales tax on the

gross receipts of sale. The agreement designated as a lease was, therefore, properly recharacterized and treated as a sale at inception by T---.<sup>1/</sup>

Regarding the transfer of the installment obligation, a sale means and includes any transfer of title, possession, exchange, or barter, conditional or otherwise, of tangible personal property for consideration. (Rev. & Tax. Code § 6006(a).) Tangible personal property means personal property which may be seen, weighed, measured, felt, or touched. (Rev. & Tax. Code § 6016.) This means that in order to be a sale, there must be a transfer of tangible personal property. After the sale, T--- assigned the installment obligation to an investor or trustee who issued certificates of participation to investors. This installment obligation, like bonds, stocks, or other securities, is regarded as an intangible. Since it is not tangible personal property, this transfer does not meet the definition of a sale. Thus, issuance costs for the certificates of participation (which are similar to bonds) are not taxable and tax applies only to the selling price of the equipment on the date of sale, April 22, 1992.

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

PH:cl

cc: --- --- District Administrator

---

<sup>1/</sup>Regulation 1701 allows a tax-paid purchases resold deduction where the retailer resells tangible personal property before making any use thereof if, with respect to his purchase, he has reimbursed his vendor for sales tax or has paid the use tax.