STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
TELEPHONE (916) 327-2291
FAX (916) 323-3387

January 2, 1998

Ms. T--- G. S---
A--- A--- L---
XXX East --- Boulevard, Suite XXX
---, --- XXXXX-XXXXX

Re: Sales and Leases of Pallets and Produce Containers
C--- U---
SS --- XX-XXXXXX

Dear Ms. S---:

This is in response to your letter of October 23, 1997 in which you inquire about the application of California's Sales and Use Taxes on sales and leases of pallets and containers.

You explain that your client, C--- U--- (C---), a New York general partnership authorized to do business in California, leases and sells pallets and containers to manufacturers for use in shipping products to their respective customers. You describe a typical scenario of C---'s customer's usage as follows:

> "In a typical scenario, C---'s customer, the manufacturer, uses the pallet/containers in the same way whether the pallet/containers are leased or purchased. In the scenario of pallets, the manufactured items are placed on the pallet and generally secured through the use of load formers, cornerposts and stretch wrap. The assembled pieces are then sold to customers as one unit load. The manufacturer charges its customers by the unit price. It does not charge separately for any of the other items used to ship the items (i.e. cornerposts, stretch wrap or the pallets/containers). In the scenario of the produce containers, the agricultural commodity is placed in the produce container and then sold to customers as one unit load."

You further explain that:

> "C---'s customer buys purchased pallet/containers and pays a 'per pallet/container day' rental for the leased pallet/containers. The pallet/ containers leased by and used in the delivery of products to customers may or may not be used again by C---'s customers. They are 'recycled' by C--- and used again. The same leased pallet/containers may be returned to the same customer. Likewise, the

> pallet/containers purchased are recycled by the 'secondary market' and used again. Some of the purchased pallet/containers may also be returned to the same customer. In neither situation are the pallet/containers returned to C---'s customers from its [respective] customers.
>
> "C---'s customers do not pay sales tax on the pallet/containers it purchases, nor do they pay sales tax on any of the other parts of the unit load delivered to its customers, i.e. cornerposts or stretch wrap, regardless of whether the pallet/containers involved are leased or purchased.
>
> "C---'s customers do, however, pay sales tax to C--- on the leased pallet containers . . . [measured by the rental price]."

You inquire whether the sales and leases of the pallets and containers should be subject to California's Sales and Use Taxes.

Retail sales of tangible personal property in California are subject to sales tax, measured by the gross receipts, unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) When sales tax does not apply, use tax, measured by the sales price, applies to the use of tangible personal property purchased from a retailer for the storage, use, or other consumption in California, unless the use is exempt from taxation by statute. (Rev. & Tax. Code §§ 6201, 6401.) The exemption relevant to the pallets/containers described in your letter is found in Revenue and Taxation Code Section 6364, which states in relevant part:

> "**Containers.** There are exempted from the taxes imposed by this part, the gross receipts from sales of and the storage, use, or other consumption in this State of:
>
> "(a) Nonreturnable containers when sold without the contents to persons who place the contents in the container and sell the contents together with the container.
>
> "...
>
> "(c) Returnable containers when sold with the contents in connection with a retail sale of the contents or when resold for refilling.
>
> "As used herein the term 'returnable containers' means containers of a kind customarily returned by the buyer of the contents for reuse. All other containers are 'nonreturnable containers'."

This statute is interpreted in Sales and Use Tax Regulation 1589, copy enclosed, which provides that the term "containers" means the articles in or on which tangible personal property is placed for shipment and delivery. Subdivision (a) of Regulation 1589 defines the term "returnable containers" as containers of a kind customarily returned or resold by the buyers of the contents for re-use by the packers, bottlers, or sellers of the commodities contained therein. In addition, this subdivision provides that if title to the container is retained by the seller of the contents or the seller takes a deposit to insure return of the container, it is a returnable container.

Regulation 1589(b)(1)(A) explains that sales of "nonreturnable" containers "when sold without the contents to persons who place the contents in the container and sell the contents together with the container" are not subject to sales tax. Based upon your explanation of the facts, while the subject pallet/containers may be reacquired by C---, it appears that the containers sold by C--- to its customers, the manufacturers, are sold as "nonreturnable" containers. However, you have not provided us with copies of the contracts for the purchases of the pallet/containers to the manufacturers nor have you indicated whether either the manufacturers or the manufacturers' customers are required to pay a deposit or whether a "credit" or other compensation is received for the pallet/ containers which are returned to C---. In addition, you have not indicated whether more than 50% of these pallet/containers are retrieved or repurchased by C---. Without this information we are unable to conclude that the pallet/containers purchased by C---'s customers, the manufacturers, qualify as "nonreturnable" for purposes of Regulation 1589(b)(1)(A).

We will next analyze the tax consequences of the pallets/containers **leased** to C---'s customers. In your analysis, you state that C---'s customers, the manufacturers consider both the purchased and the leased pallet/containers as "nonreturnable" containers. We disagree with your analysis as to the leased pallet/containers. You explain that C---'s customers lease the pallets/containers and pay rent on a "per pallet/container day" basis. Under these circumstances, it is in C---'s customers' best interest that the pallets/containers be returned as soon as possible in order to terminate the rental obligations under the terms of the lease. The fact that C--- retrieves the pallet/ containers on behalf of its customers does not support a conclusion that C---'s customers consider the leased pallets/containers to constitute "nonreturnable" containers. Accordingly, we conclude that under these circumstances, the pallet/containers leased to C---'s customers constitute "returnable" containers rather than "nonreturnable" containers.

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 timely pays sales tax reimbursement or use tax measured by the purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, 6010(e)(5), 6010.1; Reg. 1660, subds. (b)(1) and (c)(2).) When a lease is a continuing sale and purchase because either or both of the foregoing conditions have not been satisfied, the lease is subject to use tax measured by rentals payable. (Reg. 1660(c)(1).)

The lessee owes the tax, which the lessor is required to collect from the lessee and pay to this board. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c)(1).)

Since C--- has been charging sales tax on its lease receipts, we assume that C--- has either not elected to pay sales tax on the acquisition of the pallet/containers or that these products are not being leased in the same form as acquired. Accordingly, under these circumstances C---'s initial lease of the new returnable pallet/containers for the first filling would constitute a continuing taxable sale and purchase for the entire term of the lease. However, with respect to C---'s leases for refilling, under Revenue and Taxation Code section 6364(c), the lease of returnable pallet/containers when "resold for refilling" are exempt from tax. Thus, the lease of a new returnable pallet/container for the first filling is taxable. Once the returnable pallet/container has been sold for filling, any subsequent lease for refilling is exempt from tax.

If C--- has collected use tax from lessees on its subsequent leases for refilling and has paid that amount to the Board, the lessees may receive a refund of their overpayment by timely filing a claim for refund with the Board. (Reg. 1684(d).) Revenue and Taxation Code section 6901 requires that any overpayment of use tax be credited or refunded only to the purchaser who made the overpayment. No refund of the overpayment may be made to C--- even though C--- paid the amounts collected from the lessees to the Board. (Reg. 1684(d).)

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

Sincerely,

Patricia Hart Jorgensen
Senior Tax Counsel

PHJ:cl

Enclosure (Regulation 1589)

cc: --- District Administrator

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May 14, 1998

Ms. T--- G. S---
A--- A--- L---
XXX East --- Boulevard, Suite XXXX
---, --- XXXXX-XXXX

Re: Sales and Leases of Pallets and Produce Containers
C--- U---
Account No. SS --- XX-XXXXXX

Dear Ms. S---:

This is in response to your letter of April 14, 199X, which is a follow-up to your original inquiry of October 23, 199X. Both of your inquiries seek guidance on the application of California's Sales and Use Taxes to leases of pallets and produce containers.

In your original letter of October 23, 199X, you explained that your client, C---, U--- (C---) "is engaged in the business of leasing pallets and produce containers to manufacturers who use the containers and pallets to ship produce to their customers." You further explained:

> "In a typical scenario, C---'s customer, the manufacturer, uses the pallet/containers in the same way whether the pallet/containers are leased or purchased. In the scenario of pallets, the manufactured items are placed on the pallet and generally secured through the use of load formers, cornerposts and stretch wrap. The assembled pieces are then sold to customers as one unit load. The manufacturer charges its customers by the unit price. It does not charge separately for any of the other items used to ship the items (i.e. cornerposts, stretch wrap or the pallets/containers). In the scenario of the produce containers, the agricultural commodity is placed in the produce container and then sold to customers as one unit load.
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> pallet/containers may be returned to the same customer. Likewise, the pallet/containers purchased are recycled by the 'secondary market' and used again. Some of the purchased pallet/containers may also be returned to the same customer. In neither situation are the pallet/containers returned to C---'s customers from its [respective] customers.
>
> "C---'s customers do not pay sales tax on the pallet/containers it purchases, nor do they pay sales tax on any of the other parts of the unit load delivered to its customers, i.e. cornerposts or stretch wrap, regardless of whether the pallet/containers involved are leased or purchased."

As can be seen above, in your original letter you referred to C---'s customers as "leasing" as well as "purchasing" the pallets and containers at issue. In your letter of April 14, 1998 you now explain that C--- does not sell pallets and containers, but rather leases these items to its customers. In your April 14, 1998 letter you also provide additional details regarding C---'s method of billing its customers. You explain that C--- has a "three prong" billing system whereby the manufacturers are charged an "issue fee" for pallets sent to a manufacturer customer. In addition, the manufacturer is charged a per day rental fee, which ceases when the manufacturer sends the pallet/container, filled with the manufacturer's merchandise, to the distributor. The third fee is another flat fee referred to as a "transfer fee" which is charged when the manufacturer delivers the filled pallet/container to the distributor.

After the distributor receives the manufacturer's merchandise, arrangements are made for a "third party depot," hired by C---, to recover the pallet/containers. You state that in some circumstances the distributor bears the cost of returning the pallet/container to the third party depot, whereas in others C--- bears the cost of retrieval. You stress that except for the cost which may be borne by the distributor in returning the pallets, there are no rental fees imposed upon the distributors. You add that since the distributor is generally barred from returning the pallet/containers to any one other than the third party depots, it is unlikely that the pallet/containers received by the distributor will be returned to the manufacturer that delivered the pallet to the distributor. Thus, you conclude, based upon your interpretation of Business Taxes Law Guide (BTLG) Annotation 195.0728[1], that the transactions between the manufacturers and the distributors involve non-returnable containers. You then appear to take the position that the nature of the transactions between the manufacturer and the distributor should be controlling in determining whether the lease between C--- and the manufacturers constitutes a lease of non-returnable containers.

Your position is without merit. Each transaction must be considered independently to determine whether that use of the pallet/container is returnable or non-returnable. Thus, the character of the pallet/container in the transactions between the manufacturer and its distributors is irrelevant in determining the character of the pallet/containers leased by C--- to the manufacturers.

[1]The validity of this annotation is currently under review.

You have not provided any information which would cause us to reverse our original conclusion that the pallet/containers leased to the manufacturers should be considered non-returnable. In fact, the sample "Rental Agreement" you provided serves to bolster our original conclusion that these containers are returnable. Of note are Paragraphs 5-7 of this agreement. Paragraph 5 explains there will be no charges for reasonable wear and tear; however, for damages which exceed reasonable wear and tear, "C--- shall be entitled to bill Lessee a reasonable charge for repair or replacement." Paragraph 6, entitled "Lost Equipment," provides that lost or destroyed pallet/containers continue to be included as equipment leased to the lessee until (1) written notification of the loss or destruction has been made and (2) C--- has been reimbursed for the "cost of recovering such equipment and/or lost rental revenues." Paragraph 7 of the agreement, entitled "Marking of Equipment," explains that the pallet/containers leased by C--- have been marked to reflect C---'s ownership. In addition, Paragraph 7 explains that the lessee "shall not interfere with, remove, deface, duplicate or cover up" the identification placed on the pallets/containers leased by C---. These provisions reflect an understanding that the pallet/containers are returnable and that, in the event the pallet/containers are not returned or are damaged, the lessees are to be held accountable .

Accordingly, based upon the foregoing, our original analysis and conclusions remain the same, the pallet/containers leased by C--- to the manufacturers constitute returnable containers. We apologize for any confusion caused by our original analysis of the pallet/containers had they been purchased rather than leased from C---.

Sincerely,

Patricia Hart Jorgensen
Senior Tax Counsel

PHJ:rz

cc: --- District Administrator (--)