



STATE BOARD OF EQUALIZATION

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May 30, 1991

Mr. C--- L. N---, C.P.A.
Attorney and Counselor at Law
XXXX --- --- East, Eleventh Floor
--- ---, California XXXXX

Re: H--- F--- S---, Inc.
SR -- XX-XXXXXX

Dear Mr. N---:

As you know, your letter dated March 11, 1991 to Principal Tax Auditor Glenn A. Bystrom has been referred to the Legal Division for response. Your client, H--- F--- S---, Inc. (HFS) rents beds known as the Mark IV, collecting use tax measured by rentals payable. For reasons discussed in your letter, HFS wishes to sell these beds to a subsidiary who will pay tax measured by purchased price and thereafter rent the beds tax free. You ask our opinion as to whether we will accept the validity of this transaction.

After HFS's sale of the beds to its subsidiary, it would lease back whatever beds it requires during a transition period in which it acquires new beds. After the old beds are no longer required in HFS's business, the subsidiary would lease the beds to other companies in the industry. You note that the determination of the fair market value for the beds is difficult since the beds were assembled by HFS and are not generally sold. The average capitalized cost of each bed in inventory is \$1,529. The average cost for beds manufactured in 1989 was approximately \$1,200 per bed. In 1988 and 1989, HFS sold ten new beds to an English company for \$1,567 per bed. HFS believes that there are no comparable beds in the market from which to derive a fair market value. You state that HFS never capitalized the cost of assembly and labor performed by its own employees and that the capitalized cost of the assets reflects only the costs paid to the outside vendors. Now I am confused. As noted above, you also state that the average capitalized cost was \$1,529 per bed but that the average cost was approximately \$1,200 per bed.

You provide a description of a calculation of the capitalized costs, and it appears that the \$1,529 figure is based upon this calculation. You also include a calculation for additional costs which includes assembly, labor, and overhead. I assume the \$1,529 figure is not the amount actually capitalized by HFS as implied in your letter but rather the amount it would have capitalized had it included these additional costs in its calculation. From this capitalized cost figure, you deduct 60.1 percent for depreciation which is based upon HFS's federal income tax

returns. Finally, you add a markup of 20 percent for an estimated fair market value of \$468,785 for 600 beds, or \$781 per bed. You ask four questions each of which is quoted below followed by my response.

“1. Assume that HFS sells the old beds to their subsidiary at what they estimate to be ‘fair retail value’, and that they timely report tax on the transaction. Will the Board consider the beds to be on a ‘tax paid basis’ with future rentals exempt from tax or will the Board consider the transaction a sham transaction and continue to look for tax on rental receipts?”

Your letter shows that you are well aware of the potential problems in a transaction such as this. A transaction between a parent and wholly-owned subsidiary presents the possibility of a sham transaction designed to evade the otherwise applicable taxes. If the price set between the related parties is not set as if at arms length, then we regard the transaction as a sham attempt to evade taxes and we disregard it. (BTLG Annot. 330.2800 (8/14/69).)

If HFS sells the old beds to its subsidiary at a fair market value and tax is timely reported measured by that sales price, the subsidiary’s lease of those beds would not be subject to sales or use tax because the beds would be leased in substantially the same form as acquired and tax would have been paid measured by the purchased price in a transaction regarded as legitimate for purposes of sales and use tax.

Although the following discussion does not relate to your particular facts, I provide it so that you understand the extent of this treatment. We would disregard a transaction if, rather than selling the beds to a subsidiary for lease by that subsidiary, HFS sold the beds to a subsidiary and then repurchased the beds in order to pay tax on purchase price and thereafter lease the beds tax free. Even if the subsidiary or HFS were to pay tax reassured by the sales price from HFS to the subsidiary or the sales price from the subsidiary to HFS, and regardless of the amount of these sales prices, we would regard bed rentals by HFS as continuing sales subject to use measured by rentals payable. The original lessor would continue to be the lessor, the strawman transaction being solely for the purpose of transforming a taxable lease into a tax-paid lease. The reason this analysis does not apply to the particular facts you present is that there are reasons other than tax implications for HFS’s sale to its subsidiary, and most importantly because an entity that is separate for sales tax purposes will thereafter be the lessor of the beds. Thus, the determining question will be whether the sales price is at fair market value.

“2. Will the Board accept the above calculation of ‘Fair Market Value’?”

In your explanation regarding this question, you note your realization that it may be difficult to answer this question since we have limited facts and since the beds are assembled by HFS and there is no established market from which to derive the fair market value. I note that we could not necessarily regard depreciation for federal income tax purposes as appropriate for calculation of fair market value. It is possible that depreciation is taken much faster for federal tax purposes than would be appropriate for purposes of calculating fair market value of beds when sold to an unrelated person.

Prior to making a final decision on this question, we would have to compare the figure you derive from the cost minus depreciation plus markup method to the figure derived from rentals payable fair market value calculation, as explained in the following example. Assume the average remaining life of each bed is three years and the rentals to be received for each bed averages \$50 per month. The present value of \$50 per month for three years at 6 percent interest, compounded monthly, is \$1,644. Given these facts and an interest rate of 6 percent, \$1,644 would be a legitimate reference point for determining fair market value. If the interest rate were 10 percent, \$1,550 would be a legitimate reference point.

If you wish a definitive answer regarding this question, please provide us the necessary figures to perform this calculation for purposes of comparing to your proposed fair market value.

“3. My third question is what will be the tax consequences if the Board subsequently determines that the ‘fair market value’ of the beds should have been a larger amount. Will the Board take the position that the election to report on cost was not effective and therefore determine tax is due on rental receipts, or will the Board just assert additional tax on the difference between what was reported and what the Board considers the ‘fair retail value’ of the beds?”

The question of whether the sales price is at fair market value relates to the question of whether the sales prices has been set between the related parties as if the transaction were negotiated at arms length. If the transaction is not negotiated as if at arms length, we would disregard the transaction for sales tax purposes. Since HFS’s rentals are now subject to use tax reassured by rentals payable, this means that the rentals would continue to be subject to use tax measured by rentals payable. The Board would not simply assert additional tax or the difference between what was reported and what the Board considers to be the fair market value.

“4. My fourth question deals with the timing of the transfer of the beds from HFS to their subsidiary corporation. At any given time, over 50% of the beds are out on rental. Pursuant to Regulation 1660(c)(9)(A), when an existing lease that is a ‘sale’ is assigned, the rental payments remain subject to tax. It will therefore be necessary that any existing rental be terminated prior to the transfer from HFS to the subsidiary.

“Rentals are billed on a daily basis. HFS bills for the day the bed is delivered to the customer, but not for the day on which the bed is picked up. HFS only bills for actual days the patient uses the bed. If a patient has to leave the convalescent hospital for a week to go to an acute hospital, the convalescent hospital is not billed for any days the patient was not actually using the bed even though the nursing home has retained the bed. Although the rentals are billed on a daily basis, a particular bed could be on rental to a particular customer for an average of six weeks at a time. Customers can cancel the rental at any time. In the case of rentals reimbursed by Medi-Cal, HFS receives a treatment authorization from the state for the requested period of rental. Such rentals are still cancelable at the discretion of the customer.

“When does the Board consider a particular daily rental terminated? Is the rental considered terminated automatically at the end of every 24 hour period with the next 24 hour period being considered a renewal? Is the rental considered terminated only at such point in time as the customer gives up physical possession?”

Under the facts you describe, the subject leases commence when HFS transfers possession of the beds to the lessee and continue until the beds are returned. That the rentals payable by the lessee to HFS are determined based upon the actual days the bed is used for a patient has no relevance with respect to when the lease ceases. That is, sales of beds which are in current rental service subject to use tax measured by rentals payable would be regarded as sales of property with an assignment of taxable leases that come within the provisions of subdivision (c)(9)(A) of Regulation 1660.

In answer to your specific question whether a rental will be considered terminated only at such point as the customer gives up physical possession, yes and no. Based on your description, the answer must be yes. The customer has an oral agreement with HFS to lease property subject to use tax measured by rentals payable. The property is sold, subject to those existing leases, and the customer thereafter finds out that some other person is the owner of the rental property. This is a sale of property subject to an existing taxable lease. For the lease to be considered as terminated, it must be terminated.

Under these facts, the only way that the beds in rental service would be regarded as sold not subject to leases would be for HFS to notify the lessee that the leases would terminate at a specific time (assuming the rental agreement permits this), the lessees would have to contract with the subsidiary for a new lease to commence at that same specific time, and the sale would have to occur at that time. If these transactions do not occur simultaneously, the beds not returned to HFS would be subject to an existing lease at the time of the sale and tax would be due measured by rentals payable from leases of those beds.

I hope this answers your questions. If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:cl

cc: Mr. Glenn A. Bystrom
bc: --- District Administrator