State of California

Board of Equalization
Legal Division

M e m o r a n d u m

330.2335

To : Mr. William D. Dunn
Assistant Principal Tax Auditor

Date: January 13, 1993

From : David H. Levine
Senior Tax Counsel

Subject: ---.

This is in response to your memorandum dated November 24, 1992. A furnished a truck and driver to B, along with cement. A mixed the cement in its truck together with B's hazardous waste to fabricate a solid that could be disposed of in a hazardous waste disposal facility for solids. In a memorandum dated January 18, 1990, -- District Auditing asked whether we agreed that all the charges were taxable. In a memorandum dated February 8, 1990, I responded that we agreed that the charges in question were for fabrication. An assessment was thereafter issued on this basis.

A filed a petition for redetermination. Appeals attorney Janet Saunders agreed with the staff and upheld the assessment. A has filed a Request for Reconsideration. The basis of the request is that the truck and driver were under the sole direction and control of B's employees, and that the transaction was therefore a rental of the truck to B. A cites annotation 435.1380 (1/22/65) in support of its argument. You have provided a copy of the backup letter to that annotation, relevant portions of the contents of a speech given to DPAs by Mr. Thomas P. Putnam in 1970, and a copy of the contract in question.

Discussion

The annotation indicates that we accepted that taxpayer's representation that the exclusive right to control the details of the work and the right to manage and control the equipment operator was vested in the lessees. You believe that this annotation lacks sufficient information concerning the amount of direction and control that is necessary. We agree that it lacks sufficient information to be of assistance for any purpose, and for this reason should probably be deleted. We believe that the fundamental flaw in this annotation relates to the basis of its analysis. That is, what does it mean to have direction and control of property?

In Mr. Putnam's speech, he indicated the difficulty in ascertaining whether a transaction is a lease when equipment is furnished with an operator. He also mentions the direction and control test, and he notes the difficulty in ascertaining who has direction and control of the equipment. He notes that some other factors to consider include whether the contract is designated as a lease, and whether the charge is based on time or production.

Actually, the critical question in determining whether a lease has occurred is whether possession and control has been transferred to another person. The California Supreme Court addressed this issue in Entremont v. Whitsell (1939) 13 Cal.2d 291. Entremont's contract with the Department of Public Works provided that it would rent three dump trucks, with drivers, to the Department for a fixed hourly rental price. After the deduction of a discount for payment in cash, Entremont's charge was below the amount set for such service by the Railroad Commission. This action was instituted to annul action taken by the Commission based on its finding of an undercharge.

One argument made by Entremont was that its contract was not for transportation but rather was for the lease or rent of trucks. The contract, which was entitled "Service Agreement," provided that Entremont would furnish the services or rental specified therein. The equipment was to be operated by Entremont, and Entremont was to furnish competent operators and operating supplies (gasoline, oils, etc.) and repairs necessary to keep the equipment in efficient operating order. The agreement provided that the operators furnished thereunder "are to perform their duties to the satisfaction of the Department of Public Works ...."

The Court concluded that the contract was not for the lease of the equipment:

> "This conclusion follows from the fact that under the contract the possession and control of the trucks and the operators did not pass to the department - the operators did not become the employees of the department - but such possession and control remained in Entremont. The chief characteristic of a renting or a leasing is the giving up of possession to the hirer, so that the hirer and not the owner uses and controls the rented property. (Civ. Code, secs. 1925, 1955.) The record is clear that the only supervision exercised by the department over the operators of the trucks was to direct them where to load and unload the material hauled, when to go on or leave the job, and to inform the operators whether the load should be dumped or spread. The department had no power to discharge the drivers - that power, and the power of selection, rested in Entremont. That is a factor of some importance in ascertaining whether Entremont or the department controlled the operators...." (Id. at 295.)

Other courts, following Entremont, have reached the same conclusion. In Rice Bros.,

Inc. v. Glens Falls Indem. Co. (1953) 121 Cal.App.2d 206, the plaintiff had a contract to perform grading and paving. It owned and used on the work 10 or 12 dump trucks and needed more. It therefore made arrangements with Holloway, which furnished two trucks "fully operated and maintained," for which plaintiff paid an hourly fee. One of plaintiff's trucks, driven by plaintiff's employee, damaged one of Holloway's trucks. This case arose because plaintiff's insurer denied coverage based on an exclusion in the policy for damage to "property owned by, rented to, in charge of, or transported by the insured."

Thus, in the Rice Bros. case, the plaintiff had available a number of trucks, two of which were owned by Holloway, who supplied the operators. Plaintiff could not discharge the operators of those trucks. However, the Holloway trucks were there for use in doing whatever was necessary to be done on the job and this work was in charge of plaintiff's superintendent. The trial court held that Holloway did not rent the trucks to plaintiff, and the appellate court agreed, holding that there was substantial evidence to support the trial court's conclusion. The court held that the trial court could have concluded that the parties did not intend to give, and did not give, any possession of the Holloway trucks to plaintiff, nor any use of those trucks apart from the services rendered by the driver and the truck in combination, and that plaintiff could not have broken up this combination and be left with a right either to the possession or the use of the truck. (Id. at 209.)

Northbrook Excess & Surplus Ins. Co. v. Coastal Rescue Systems Corp. (1986) 182 Cal.App.3d 763 is another case in which an insurance company sought to escape liability for a claim for benefits under a policy it issued. (The case was an action for declaratory relief filed by plaintiff insurance company. The named defendant, Coastal, was the insured who sought coverage, and any necessary defense, from plaintiff.) The exclusion upon which the insurer relied was for damages arising out of the ownership, maintenance, operation, use, loading, or unloading of any automobile or aircraft owned or operated by, or rented or loaned to, any insured.

Coastal conducted rescue training programs for public safety agencies and for community colleges. The episode in question occurred during a three-day course on helicopter rescue techniques. The army provided at no charge an aircraft and crew for the first two days. For the third day Gibson (one of Coastal's owners) arranged for Spirit Airways to provide a helicopter and pilot for two hours. (Although Gibson understood that the helicopter and pilot were to be provided at $350 per hour and Coastal would have paid such amount if so invoiced and obtained reimbursement from the college, Spirit did not charge Coastal or the college for its services.) One of the students was injured during the flight conducted by Spirit.

Citing the two cases I have already discussed, the court noted that one of the determinative factors in deciding whether there is a rental agreement is whether the person engaging the services of the operator and the vehicle has possession and control of the

vehicle. (Id. at 768.) The court explained:

> "Coastal did not have temporary possession and use of the helicopter within the meaning of the Civil Code and the cited cases. Like the equipment contracts in Rice Bros. and Entremont, the agreement here was that the helicopter was to be provided with a pilot who had complete control of the aircraft. The parties here could not have intended for Coastal to have possession or use of the helicopter apart from the services rendered by Spirit's pilot Anderson and the helicopter, in combination. Coastal could not break up the combination and be left with the helicopter.
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> "Although Gibson provided some direction to Anderson, possession of the helicopter remained with Spirit. If Gibson asked that the exercise be performed in a manner that Anderson thought inappropriate for a helicopter, he would not proceed, and in so doing, he would be acting as an employee under the control of his employer, Spirit. The management of the helicopter remained with Spirit at all times. Coastal had no control over the manner in which Anderson piloted the helicopter. Anderson could have departed with the helicopter at any time. While in so doing, Spirit may have been in breach of the agreement to provide services, the fact remains that it had the power to do so as Anderson was the person solely in control of the helicopter. Spirit was engaged to render a service as part of the training exercise. There was no delivery of possession of the helicopter to Coastal."

As you know, it is not uncommon for us to adopt a test for administrative convenience that may result in making it easier for a taxpayer to avoid paying tax that would otherwise be due but for the administratively adopted test. An example is the 180 day test we have administratively adopted to ascertain whether a person has used property "solely" outside California within the meaning of section 6009.1. Technically, perhaps we should apply the test that if the property ever comes back into California, it has not been used solely outside California (that is what the statute says). Obviously, we have a valid and important reason for applying this test: we need to have some certainty for our benefit and the benefit of taxpayers. However, there is absolutely no reason to adopt a test that is contrary to law and makes life more difficult for everyone.

I am not sure if references to "direction and control" are based on a test adopted for administrative convenience or, more likely, simply as an inaccurate statement of applicable law. However, we have not applied such a test here for some time, but rather have applied the true and accurate test of whether possession and control is transferred. This test is also simple (usually), accurate, and consistent with the governing judicial interpretations in effect for over fifty years. If a person obtains for consideration temporary possession and control of property without an operator, then of course that person has leased the property. When a person

obtains property with an operator, the simple test is whether that person could have obtained that property under that contract without the operator. If so, we regard the transaction as a lease with an optional operator.[1/]

We recognize that there are some annotations that may be inconsistent with this view. They should be deleted, and we suggest that it would be appropriate for someone to cull through the annotations to select such inaccurate or misleading annotations for deletion. Prime examples are those which consider whether charges for operators are taxable, one of which is Annotation 330.3160. It indicates that all charges for a leased aircraft are taxable when the lessor requires that his pilot fly the plane, but if the lessee has the option, the charge for the pilot is not taxable. This annotation is wrong, is contrary to advice we have been giving for some time, and should be deleted (as should others of its ilk). Its error is that it assumes a fact that has not been shown to exist. That is, it analyzes the question of the proper measure of tax from lease payments based on the assumption that the transaction is, in fact, a lease. However, if a person requires his or her operator to operate the property, then there is no lease at all. Rather, the owner of the equipment is using it and should pay tax on purchase price.

Thus, there are two major classifications of services which may be provided along with property. One group does not involve possession and control of the equipment but rather is ancillary to the equipment whose possession and control is clearly transferred to a lessee. An example would be telephone support services provided along with the lease of a computer. If such services are required along with the taxable lease of tangible personal property, the charge for such services is taxable. If such services are optional, the charge is not taxable.

The other major classification of services consists of operators provided along with property. When the operator is optional, there is a lease of property along with nontaxable services.[2/] When the operator is mandatory, implicit in the terms of the agreement is that the

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[1/]Arguably, we could analyze such a transaction as not transferring possession, but our long-standing view that such a transaction is a lease is consistent with the analysis of the Rice Bros. and Northbrook Excess & Surplus Ins. Co. cases. Those cases indicate that the customers in the transactions they considered could not obtain the equipment without the operator.

[2/]As noted above, it could be argued that such transactions are not leases even though the operator is optional. Since, however, the operator is optional, we believe that there is a transfer of possession and control. As implied by the cases discussed above, in such a case the parties do show their intent that the property can be transferred without the operator. The lessee could presumably discharge the optional operator and thereafter operate the equipment itself, or have one of its employees operate it, since the lessee could have simply done so in the first place (what amount such a lessee might owe the lessor for the partial use of the operator does not affect the analysis).

owner will not transfer possession of the equipment to the customer. Since there is no transfer of possession and control, there is no lease whatsoever. Rather, the equipment owner is providing a service (or here, fabrication) and is the consumer of the equipment it consumes in providing such service or fabrication. As noted above, notwithstanding some ambiguous and confusing annotations, this has been our view for some time and is reflected in Regulation 1529(b)(6)(A).

Based upon the cases discussed above, we believe that it is clear that A did not lease the trucks to B. The contract does not even by its own terms assert that it is a lease. Rather, the contract provides that A was to furnish equipment, cement, and labor to perform the necessary fabrication. A was required to furnish all labor, materials, tools, equipment, facilities, and services, and do all things necessary to perform the work specified in the contract. The contract comes squarely within the cases discussed above.[3/]

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

DHL:cl

cc: Mr. Gordon P. Adelman
Mr. Ronald L. Dick
Ms. Elizabeth Abreu

[3/]It is true that it may be difficult in certain cases to ascertain whether an operator is optional or not, but such a determination will generally be easier to ascertain than applying the incorrect direction and control test. That an operator is optional may be clear from the contract or from advertising literature of the taxpayer. As you know, we also often look to see whether the taxpayer has ever provided the equipment without the operator. I note, however, that even if the taxpayer has on occasion provided the equipment without an operator, the particular contract in question may not qualify as a lease if by its terms it shows that in that particular instance the operator was not optional. Here, I believe the contract shows that the parties sought to have a truck and operator provided as a unit and that the parties did not contemplate a lease of the truck alone. I therefore do not address the issue of whether A ever leased its trucks without an operator. Of course, if it never did so, I believe that should unequivocally resolve any doubt that anyone could have on this issue.