STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 324-2637
FAX: (916) 323-3387

December 4, 1995

Mr. R--- T---
Vice President
G--- P---F--- Corporation
XXXX S. --- Blvd. #-
--- ---, California XXXXX

Re: Account No. SY -- XX-XXXXXX

Dear Mr. T---:

Your letter dated September 25, 1995 to Mr. Mike Hilbert was referred to the Legal Division for a response. You ask how the partial sales and use tax exemption set forth in Revenue and Taxation Code section 6377[1] applies to leasing/financing transactions entered into by your company.

We understand that G--- P--- F--- Corporation ("GPFC") leases and finances tangible personal property. In some instances, GPFC purchases tangible personal property from a third party vendor for the purpose of leasing it to a customer. In other instances, we assume that GPFC finances a customer's purchase of tangible personal property by entering into a sale/leaseback transaction with that customer.

You ask a series of questions regarding the application of the partial sales and use tax exemption to these types of transactions and have provided us with a copy of an "Equipment Finance Lease Agreement" (hereafter "EFL agreement") and "Purchase Option Agreement" for our review. For purposes of clarity, we have separately responded to each of your questions below.

> "1. Can our Equipment Finance Lease Agreement as attached qualify for the Manufacturer's Exemption?"

Before answering your specific question, a brief overview of the partial sales and use tax exemption may be helpful in understanding our response. Section 6377 provides an exemption from a portion of the state component of the sales and use tax. As originally enacted, section 6377 provided an exemption from the state component of the sales and use tax, which is imposed at the rate of 6 percent. As of January 1, 1995, the exemption provided by section 6377 was

[1] All further references are to the Revenue and Taxation Code unless otherwise noted.

reduced to tax imposed of 5 percent. Thus, if a sale meeting the requirements of the section 6377 exemption occurs on or after January 1, 1995 where the total sales tax rate is 7-3/4 percent, tax of 2-3/4 percent is due. For the remainder of this opinion, I will refer to the section 6377 exemption as a partial sales and use tax exemption.

The partial sales and use tax exemption generally applies to persons that commence a new trade or business (discussed below) on or after January 1, 1994 inside this state which is described in codes 2000 to 3999 of the 1987 Standard Industrial Classification Manual (hereafter "SIC code"). A person meeting these requirements is a "qualified person"; however, a qualified person does not include a person who undertakes a manufacturing activity inside this state within the same SIC code division as a prior trade or business operated by that person (or any related person within the meaning of sections 267 and 318 of the Internal Revenue Code) inside this state within the previous 36 months. The partial sales and use tax exemption generally applies to the sale or use of tangible personal property used primarily for manufacturing, processing, refining, fabricating, recycling, research and development and the repair of qualified property.

A new trade or business is one which a person (or any related person) has not engaged in within the preceding 36 months inside this state[2] or which is classified in a different division of the SIC code than that person's (or any related person's) current or prior trade or business activities in this state. (Rev. & Tax. Code § 6377(b)(5)(A)(ii).) In addition, a new trade or business must commence such operations inside this state on or after January 1, 1994. (Reg. 1525.2(c)(5)(A)[3].) Generally, we regard business operations to begin upon the acquisition of operating assets that are necessary to the type of business contemplated. (See Reg. 1525.2(c)(5)(A)1.)

Regulation 1525.2(i)(1) provides that the partial sales and use tax exemption applies to taxable rental receipts which are paid by a qualified person on the lease of tangible personal property used in a manufacturing activity. Staff interprets this to mean that the partial sales and use tax exemption is not available to lessors who lease property to qualified persons when the lessor elects to pay sales tax reimbursement at the time of acquisition of the property or pays use tax measured by the purchase price of the property. This position is set forth in subdivision (d) of proposed Regulation 1525.3[4] which further clarifies the application of the partial exemption to leasing transactions. Thus, the application of the partial sales and use tax exemption is only available with respect to the lease transaction itself and not with respect to the lessor's acquisition of the property. This means that only the taxable rental receipts from the lease of tangible personal property to a qualified person for use in a manufacturing activity may qualify for the partial exemption.

---

[2] Section 6377 makes a distinction between persons engaged in a trade or business inside this state and those that are not. Persons engaged in business wholly outside the state who commence doing business in California on or after January 1, 1994 qualify as a new trade or business regardless of that person's prior trade or business activity. (See Rev. & Tax. Code § 6377(b)(5)(A)(iii).)

[3] A copy of Regulation 1525.2 is enclosed for your review.

[4] This regulation is pending and has not yet been adopted by the Board.

You specifically ask whether GPFC's EFL agreement can qualify for the partial sales and use tax exemption. Since the partial tax exemption only applies to taxable rental receipts paid by a qualified person in leasing situations, any taxable rental receipts paid by a qualified person pursuant to an EFL agreement may qualify for the partial exemption provided the qualified person uses the leased property in a manufacturing activity. To the extent that an EFL agreement constitutes a sale at inception within the meaning of Regulation 1660(a)(2)(A) (copy enclosed), GPFC's sale to a qualified person may qualify for the partial sales and use tax exemption in accordance with Regulation 1525.2. (Proposed Reg. 1525.3(b).)

> "2. What are the procedures to qualify our Lessee, to report and pay the sales or use tax as equipment Lessor under the following two situations:
>
> a. Vendor in California
> b. Vendor is out-of-state."

We understand this question to consist of two separate parts: a) what is the procedure for qualifying for the partial sales and use tax exemption; and, b) how does GPFC pay and report taxes when it purchases equipment for lease to its customers from either an in-state or out-of-state vendor.

a. <u>Qualification of lessees</u>

A person must be both pre-qualified by the Board and either registered to hold a seller's permit or maintain a consumer use tax account in order to claim the partial sales and use tax exemption. (Reg. 1525.2(f).) GPFC's lessees may obtain an application for a partial sales and use tax exemption certificate at any Board office. Once qualified, GPFC's lessee must provide a copy of its partial exemption certificate to GPFC in order to obtain a partial exemption from tax on the rental receipts. GPFC is required to provide the Board with copies of these exemption certificates if it collects more that $25,000 of rental receipts from a single qualified person in any quarter, or if the Board makes a written request for such copies. (See Reg. 1525.2(f)(1)(B).)

b. <u>GPFC purchases of property for lease</u>

A lease of tangible personal property in California is a continuing sale and purchase unless GPFC leases it in substantially the same form as acquired and has made a timely election to pay California sales tax reimbursement or use tax measured by the its purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, 6010(e)(5), 6010.1, Reg. 1660(c)(2).[5]) When the lease is a continuing sale and purchase because either or both of the foregoing conditions are not satisfied, the lease is subject to use tax measured by rentals payable. (Reg. 1660(c)(1).) GPFC's lessee owes the tax and the GPFC is required to collect it from the lessee and pay it to this Board. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c).)

---

[5] A copy of Regulation 1660 is enclosed for your review.

As set forth above, the partial sales and use tax exemption only applies with respect to taxable rental receipts paid by a qualified person who is leasing tangible personal property for use in a manufacturing activity. This means that the partial exemption is not available to GPFC's lessees where GPFC purchases property for lease on a tax-paid basis. Thus, if GPFC's lessees wish to utilize the partial sales and use tax exemption, GPFC must purchase property it intends to lease to its customers on an extax basis. In that regard, we assume that GPFC purchases all the property it intends to lease to its customers on an extax basis whether its vendors are located either inside or outside this state by providing these vendors with timely and valid resale certificates. (See Reg. 1668.)

> "3. What is our liability as a Lessor as well as buyer on the invoice? e.g. Whose liability to report and pay the state tax measured by the sales price of the property if Lessee is determined [to] not qualify for the exemption during the lease term or after it is terminated?"

As set forth above, the exemption provided by section 6377 is only a partial sales and use tax exemption. Any tax not exempt by section 6377 must be paid by the person responsible for the tax. Where GPFC leases property to a qualified person in which the lease is regarded as a continuing sale and purchase, GPFC's lessee owes the difference between the full amount of tax on the rental receipts and the amount of the partial sales and use tax exemption. GPFC is required to collect this amount of tax from the lessee and pay it to this Board. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c).) If a lessee is not pre-qualified by the Board, GPFC must collect the entire amount of tax due on rental receipts subject to tax. If the Board later revokes a lessee's section 6377 partial exemption certificate, the lessee is responsible to pay the tax (plus interest) which was previously exempted by section 6377.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz

Enclosures - Regs. 1525.2, 1660

cc: Mr. Michael J. Hilbert, MIC: 40
--- District Administrator - --