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STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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March 15, 1996

REDACTED TEXT

Re: REDACTED TEXT

Dear REDACTED TEXT:

This is in response to your letter of October 23, 1995, as modified by your letters of November 28, 1995 and February 8, 1996, written to us on behalf of your client, REDACTED TEXT. You have requested our opinion as to whether certain payments made pursuant to a proposed lease-leaseback equipment financing transaction described below are subject to California sales or use tax.

REDACTED TEXT is interested in raising additional cash as inexpensively as possible. After discussions with several advisers, REDACTED TEXT has determined that one of the most advantageous financing methods available to it is a lease-leaseback equipment financing. REDACTED TEXT has paid California sales tax reimbursement (or California use tax) on the equipment to be used in the financing, and will retain title to the equipment during and after the financing. The proposed transaction is functionally very similar to a secured borrowing. You have requested our opinion that no California sales or use tax is payable in connection with the proposed financing transaction.

STRUCTURE

The proposed lease-leaseback financing will be structured as follows:

1. REDACTED TEXT will lease previously acquired equipment (in the same form as acquired by REDACTED TEXXT and on which it has already paid California sales tax reimbursement or California use tax) to one or more financing companies (the "Financing Company") for a limited term of 32 years (the "Lease"). The equipment will be divided into several separate groups which correspond to production units of REDACTED TEXT (each, a "Production Unit Group"). The Financing Company will satisfy its payment obligations under the Lease by paying REDACTED TEXT a lump sum on the closing date for the financing.

2. Simultaneously with the lease of the equipment, the Financing Company will sublease the equipment back to REDACTED TEXT for a period of up to 14 years and eight- or nine-months (the "Sublease"). In each case, the leaseback does not exceed 80 percent of an independent appraiser's estimate of the useful life of the Production Unit Group, viewed as a whole.

3. REDACTED TEXT will retain title to the equipment throughout the financing transaction; the Financing Company will neither obtain title to the equipment nor have any option to obtain title to the equipment.

4. During the term of the Sublease, REDACTED TEXT will retain possession, control and risk of loss of the equipment. The Sublease will be on a "net" basis to the Financing Company – REDACTED TEXT will be responsible for the operation of the equipment and for all costs associated with the equipment including, without limitation, maintenance, insurance, cost of complying with applicable laws and regulations (including all environmental laws and regulations), and property taxes.

5. At the end of the Sublease, REDACTED TEXT will have the option (but not the obligation) to acquire all of the Financing Company's remaining rights under the Lease. In addition, REDACTED TEXT will have the option, during the term of the Sublease, to acquire the Financing Company's then-remaining interest in the Lease at a price sufficient to preserve the Financing Company's anticipated return on the Sublease.

6. Generally, the Lease and the Sublease will be noncancelable. If any item of equipment is destroyed, taken in condemnation, damaged by casualty to the extent it cannot be economically repaired or becomes uneconomic to operate or surplus, REDACTED TEXT will be obligated to pay the Financing Company, with respect to such item or equipment, a previously stipulated loss amount which will be sufficient to preserve the Financing Company's anticipated return with respect to that item of equipment. Alternatively, REDACTED TEXT will have the option of substituting for the affected equipment like kind of equipment of equal value, utility and remaining useful life. (Any such replacement equipment will be equipment with respect to which REDACTED TEXT will have paid California sales tax reimbursement or California use tax.)

7. Although REDACTED TEXT will retain title to the equipment (and possession, control and risk of loss of the equipment during the term of the Sublease and after the term of the Lease), REDACTED TEXT anticipates that the Financing Company will depreciate its economic interest in the leased equipment for both federal and state income tax purposes.

8. Our understanding is that short-lived properties have been removed from the pool of properties transferred under the proposed transaction. Most of the properties have an appraised useful life of 20 years, but certain Production Unit Groups have an appraised useful life of 18.5 or 19 years.

* * * * *

We concur in your analysis that tax will not apply to the described transaction. California Revenue and Taxation sections 6006(g) (5) and 6010(e) (5) provide that the terms “sale” and “purchase” exclude a lease of tangible personal property leased in substantially the same form as acquired by the lessor as to which the lessor has paid sales tax reimbursement or has paid use tax measured by the purchase price of the property. Payment of tax on the original acquisition shelters from subsequent taxation both the lease and any sublease of the property.

The sales and use tax recharacterization rules do not come into play here. It is true that the initial lease transaction is for a term of 32 years, which far exceeds the useful life of the properties in question. In other circumstances, especially where there has been a transfer of possession, such transaction would be recharacterized for sales and use tax purposes as a sale (title transfer) transaction at inception. Here, however, the transaction must be looked at in its entirety. The term of the leaseback is 14 years, nine months (or 14 years, eight months), a period shorter than the expected life of the aggregate properties. This is a financing transaction which has been structured to produce an income tax benefit. The circumstances here are not sufficient to justify application of the sales and use tax recharacterization rules.

In other words, the transaction on its face is a lease-leaseback transaction. The property remains in the possession of the lessor. It is apparent from the terms of the agreement that there is no real likelihood that the financing company will acquire direct use of the property or title to the property. The transaction may be creative. The Lease may lack substance as a lease (the term is incompatible with the concept that a lease is a temporary transfer of possession or the right to possess). But the Lease is no more a sale (title transfer) transaction than it is a lease transaction. The transaction is essentially a financing transaction for sales and use tax purposes. See Sales and Use Tax Regulations 1641(b) and 1660(a)(2)(A).

Very truly yours,

Gary J. Jugum
Acting Chief Counsel

GJJ/cmm