

M e m o r a n d u m**330.1874.040**

To: Mr. J. W. Cornelius
Audit Evaluation & Planning

February 26, 1988

From: David H. Levine
Tax Counsel

Subject: ---.

This is in response to your memorandum dated January 13, 1988 regarding the application of tax to certain leases. You have referred to us a memorandum dated October 6, 1987 from Out-of-State District (New York) along with copies of four lease agreements and a loan and security agreement.

Out-of-State explains:

“A Corporation is basically a financing company which does a limited amount of leasing on its own, but mainly they finance leases which are entered into by other leasing companies. In most instances taxpayer provides funds to other leasing companies who assign their leases to A, who in turn assigns its interests in the leases to B.

“During the course of our current audit several different types of assignments have been encountered. In all of these instances A is the party who is billing the lessee, reporting the tax and handling any collection problems, but in some instances it appears that A is not the true lessor.

“[Summaries of four types of agreements.]

“In all of the above situations A’s agreements with the lessees [sic] are without recourse with respect to the monies involved, as are B agreements with A. Also, A does handle all collection activities and has the right to sue for nonpayment.”

The auditor's questions are:

- “a) Is taxpayer liable to collect and bill the tax on the rentals?
- “b) If not should the original lessor be doing it?
- “c) What adjustments should be made against taxpayer for a true lease and for a conditional sale?
- “d) Is B Co. liable for the tax on rentals when the agreement is assigned to them?

“It should be noted these agreements are standard throughout taxpayer's audit period except where the lessors and persons buying the loan have changed. There are several agreements that require adjustment and auditor needs to know who to proceed against. A is under the assumption all adjustments should be made against them except for conditional sales at inception. These should be adjusted against the original lessor, but can an offsetting credit be given for the rentals reported by A?”

A enters into a loan and security agreement with the lessor/borrower for the first three types of agreements discussed below. That loan and security agreement provides that the property to be leased will be security for the loan and that the rentals will, in effect, be used to pay the amounts due under the loan. The lessor/borrower also executes a loan receipt for each loan. A has the authority, but not the obligation, to collect the rentals. The borrower does not have personal liability for the loan except under certain specified conditions.

Agreement 1

The auditor describes this agreement as follows:

“The lessor ... assigned to taxpayer all of its rights and remedies and all rentals and other sums due and to become due, but not the purchase option. At the end of the agreement the lease reverts back to the original lessor for excision of the option. Taxpayer is the one collecting and billing all the rentals and the tax.

Taxpayer then sells their Loan Receipt to B and assigns B Co all of the rights and remedies.”

Initially I note that upon review of the lease documents I am unable to locate any purchase option. Perhaps this reference is to the fact that the lessor will own the property at the end of the lease and can sell it to the lessee at that time. That is, title was not transferred to A except for purposes of security. I also note that in a memorandum dated December 28, 1987,

Jack Warner refers to his discussion with the auditor. He states that the auditor's memorandum is based on explanations of the taxpayer for administrative practices contradictory to the data received:

“An example is cited in the first agreement in that A informs the lessee of the assignment of the lease to B and instructs them to pay future rentals to B. Although these instructions are in writing, A continued to bill and collect the rentals due.”

Based on my review of the documentation, I conclude that there is no contradiction. The instructions in writing contain the following statement:

“ The undersigned further authorizes and empowers said B to serve a true copy of the Assignment and this Notice of Assignment upon the lessee named herein.”

Thus, although B can serve a copy of this notice on the lessee, it appears that B did not do so and that the lessee was not notified.

The first step in the analysis is to ascertain whether the assignments come within subparagraph (B) or (C) of Regulation 1660(c)(9) (they do not come within subparagraph (D) since not all ownership interest in the property was transferred and the original assignor did retain substantial ownership interest in the leased property).

Under both (B) and (C), the assignee has recourse against the assignor. A does have recourse against its assignor. Although section 10 of the Loan and Security Agreement (pursuant to which the assignment was made) states that Ultra has no recourse against the assignor, the exceptions are such that A does, in fact, have recourse.

The primary difference between the two types of assignments is that under (B), the assignment is of the rental income, and under (C) the assignment is of the entire lease contract. Based on the documents submitted, we conclude that the assignment to A was of the rental income, with the assignor retaining the obligations of the lessor. (See Loan Receipt, Assignment of Lease, and Notice of Assignment, all dated 2/17/81.) The original lessor is therefore obligated to collect and report the tax even though rentals are paid to A. Since A assigned B only those rights in the lease contract that had been assigned to A, the original lessor remain obligated to collect and report the tax.

Taxes collected and reported by A should be regarded as paid on behalf of the original lessor, and only amounts owing after adjustment should be assessed against the original lessor. That is, an offsetting credit must be given for the rentals reported by A.

Assignment 2

A and the lessor/borrower entered into the general loan and security agreement which refers to a purchase money security interest in leased equipment. The lessor executed a loan receipt dated July 18, 1984 which refers back to the loan and security agreement and indicates that A has a purchase money security interest in the equipment. The lessor executed an assignment of lease also dated July 18, 1984 which assigns to A “all of its right, title and interest in, to and under, but not its obligations under, the above-referenced lease ..., including without limitation the leased equipment” (Emphasis added.) A’s assignment to B contains similar language.

Language in the assignments, quoted above, indicates that full title to the equipment was transferred to A and then to B. This would mean that the transactions would come within subparagraph (D) of Regulation 1660(c)(9), with the ultimate assignee, B, assuming the position of lessor. However, the language in the loan receipt is directly contrary to this, transferring only a security interest in the equipment. Furthermore, other language in the assignments, also quoted above, retains obligations under the lease for the original lessor. That is, not all right, title, and interest was transferred. It appears that A drafted the documents. The general rule of construction is to construe ambiguities in contracts against the drafter. Applying this rule, we conclude that the lessor transferred to A only a security interest in the equipment together with an assignment of the rental income for the lease, with the lessor retaining the obligations of lessor under the lease agreement. Thus, the assignment comes within subparagraph (B) of Regulation 1660(c)(9), and the rules discussed above under Agreement 1 apply (the original lessor owes the tax). Since A could assign to B only what it had, that assignment also comes within subparagraph (B).

Agreement 3

The auditor explains these transactions as follows:

“Again the Loan Receipt and Security Agreement are present. The lessor in this case assigns taxpayer ... all of the rights and remedies Taxpayer is doing all the billing for the rentals and the tax. Taxpayer in turn assigns B Co. ... all right, title and interest”

The documents between the lessor and A are similar to those involved in Agreement 1, and the assignment comes within subparagraph (B) of Regulation(c)(9). Since A cannot assign to B more than it has, that assignment also comes within subparagraph (B). The original lessor owes the tax.

Agreement 4

A is the original lessor, and it assigned the right to receive the rental income to a bank. It also granted the bank a security interest in the leased property. This again comes within subparagraph (B) of Regulation 1660(c)(9). A owes any tax due.

Conclusion

All assignments reviewed herein come within subparagraph (B), with the original lessor owing any tax due. The auditor also asks us to consider these situations with tax is paid up front. If the lessor elects to pay sales tax reimbursement or timely pay use tax measured by purchase price, the leases would not be continuing sales and purchases and would not be subject to tax. If the assignments were merely of the rental stream and not a sale of the leased property, there would not be any sales or use tax. If there was a sale of the leased property, that sale would be subject to sales tax measured by gross receipts.

The auditor also asks us to consider these transactions for conditional leases. All leases provided to us appear to be true leases and not conditional sales. It is therefore unclear what the auditor want us to consider in this context. If the auditor has other specific questions, we would be happy to respond to them.

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cc: Mr. E. Leslie Sorensen, Jr.