

December 2, 1969

Attention:
 President

Dear Mr. _____

Because your problem was somewhat unique, it has taken somewhat longer to determine what we think is the proper application of the California Sales and Use Tax Law to your business operations.

Basically, it is our understanding the following facts exist:

You are in the business of manufacturing machines and accessories and transferring them to your franchisees. In order to become a franchisee and in turn use the equipment, each franchisee must pay a franchise fee of \$350. After this payment, the franchisee can and usually does purchase certain equipment. The cost of the equipment equals your manufactured cost plus a reasonable profit. The contract signed by the franchisee is a territorial franchise, which allows him to use the equipment in his designated area. The contract also provides that the machines are to remain the property of _____ and must be returned if the franchise agreement is cancelled. In addition to the initial franchise fee and the payment for the use of the machine (hereinafter referred to as "payment fee") the franchisee pays an additional monthly franchise fee of \$25 per 50,000 population.

It is your opinion that you do not rent the machines to anyone. We respectfully disagree.

A lease is defined in section 6006.3 of the Sales and Use Tax Law as a rental, hire, or license. A hiring is defined in section 1925 of the California Civil Code as "...a contract by which one gives to another the temporary possession and use

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of property, other than money, for reward, and the latter agrees to return the same to the former at a future time."

In view of the fact that title to the machines remains in _____ and the machines are to be returned upon cancellation or termination of the franchise, it is our opinion that you are making a lump-sum hiring of those machines. Our decision is not altered by the fact that you contend that the only reason you wish the machines back is because of the trademark problems. The fact still remains that they are to be returned and they remain your property.

We next turn to the question of what is the proper measure of the tax. It is my opinion that both the initial franchise fee and payment fee are part of the rental receipts. The monthly franchise fees are not.

To my way of thinking, the initial franchisee fee must be considered as part of the rental receipts because without such payment the franchisee could not acquire the use of the property. To hold otherwise would lead to the conclusion that in a true sale situation a retailer could split the purchase price into two distinct items such as advertising allowance and purchase price and only charge tax on the purchase price. Such a procedure would not be of any force and effect for sales tax purposes. There does not appear to be any question that the payment fee should be subject to tax, even though it is a lump-sum charge. Such charge is clearly for the use of the machine.

Our reason for concluding that the monthly franchise fee is not part of the rental receipts is that you have shown that the fee has no relation to the number of units the franchisee has in use. It is purely based on population. As you indicated in one of your examples in two areas of comparable size, one franchisee paid \$65 per month and had thirteen machines and the other paid \$65 and had six machines.

In conclusion, it is our opinion that you are leasing the _____ machines and accordingly any agreement entered into on or after August 1, 1965, is subject to tax measured by the initial franchise fee and payment fee. You would, of course, have an offset against the amount of tax you already paid. As for the agreements entered into before August 1, 1965, no additional tax would be due as you have paid tax on the cost of the machines.

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One further point which I would like clarification on and that is what is the "transfer fee" paid for, i.e., is it a substitute for the initial franchise fee.

Very truly yours,

Glenn L. Rigby
Tax Counsel

GLR:lt

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