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March 2, 1993

Ms. J--- P---, CPA
F---, S--- & Company
XXXX --- Street
--- ---, CA XXXXX

Re: Ozone Generator

Dear Ms. P---:

This is in response to your request concerning the application of tax to a contract dated December 1, 1992 entitled "Memorandum of Understanding." The parties to the contract are not named but are referred to as "A Company" and "G Company."

The contract provides that A Company will manufacture, assemble, and install at G Company's premises an ozone generator package. You state in your letter dated February 8, 1993 that the generator produces ozone and that contaminated water provided by G Company is run through the generator. The ozone cleans the contaminated water to a point that the water can be safely disposed of.

The contract further provides that the equipment remains the property of A Company unless otherwise acquired by G Company at the full purchase price. A Company monitors, maintains, and repairs the equipment so that the equipment will produce a minimum of 23 pounds of ozone a day. You state in your letter that a computer monitors the generator. A Company calls the computer twice daily to insure that the ozone generator is running properly. The computer calls A Company if there is a malfunction.

Paragraph 4 reads in part: "G Company agrees to operate the ozonation for not less than 4 million gallons of ozonated wastewater discharged from the plant via the rate of 1-million gallons discharged per 30 days that was ozonated 3 times via 3 ozone treatment passes."

Paragraph 4 also provides that if the combined payments made by G Company equals the full purchase price, G Company becomes the owner of the equipment installed. A Company reserves the right to remove the installed equipment at any time "during the time period mentioned." However, A Company will exercise this option only upon its perception that the equipment is suffering undue damage.

G Company agrees to pay A Company a nonrefundable \$25,000 deposit upon signing of the contract as G Company's contribution to the demonstration installation. In addition, G Company will pay A Company \$20,000 on the tenth day after start-up. G Company may receive all or part of the \$20,000 back from A Company depending upon whether G Company realizes certain savings from the equipment. Finally, G Company must pay \$2,500 per month for at least four months.

The terms of the contract are unclear, but it appears that after four million gallons of wastewater are treated by the generator, G Company must buy the generator if certain savings in electrical costs are realized. Otherwise, the purchase is optional. The purchase price is \$99,635, but it appears that G Company receives a credit towards this purchase price for the \$25,000 deposit and the \$20,000 payment.

G Company may terminate the contract if the equipment does not operate satisfactorily and A Company does not correct the problem within 30 days notice from G Company.

You state in your letter that A Company purchased the component parts of the ozone generator with a resale certificate.

The first question is whether this contract is a true lease or a sale at inception. Revenue and Taxation Code section 6006.3 provides that where a contract designated as a lease binds the lessee for a fixed term and the lessee is to obtain title at the end of the term upon the completion of the required payment or has the option at that time to purchase the property for a nominal amount, the contract shall be regarded as a sale under a security agreement from its inception and not as a lease. An option price will be regarded as nominal if it does not exceed \$100 or 1 percent of the total contract price, whichever is the lesser amount. Regulation 1660(a)(2)(A).

The terms of this contract are not clear, but it appears that G Company will not obtain title unless certain conditions are met. If these conditions are not met, G Company has the option to purchase the generator. The purchase price is not nominal since it exceeds \$100. Since G Company may not obtain title at the end of the lease and it must pay more than a nominal amount to purchase the generator, the contract is a lease.

The next question is how this lease should be taxed. A lease of tangible personal property is a sale and purchase unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax measured by the purchase price. Rev. & Tax. Code §§ 6006(g)(5) and 6010(e)(5). Since A Company manufactured the generator, it did not lease the property in substantially the same form as acquired, and its lease is a sale and purchase.

Regulation 1660(c)(1) provides in part:

"NATURE OF TAX. In the case of a lease that is a 'sale' and 'purchase' the tax is measured by the rentals payable. Generally, the applicable tax is a use tax upon

the use in this state of the property by the lessee. The lessor must collect the tax from the lessee at the time rentals are paid by the lessee and give him a receipt of the kind called for in Regulation 1686. The lessee is not relieved from liability for the tax until he is given such a receipt or the tax is paid to the state."

Thus, although the use tax is imposed upon G Company, A Company must collect the use tax from G Company as the rentals become due. The rentals include the initial \$25,000 payment, the \$20,000 payment, and the \$2,500 monthly payments. The \$25,000 payment is taxable during the quarter it is paid even though it may represent an advance rental. Any part of this charge that represents installation charges, however, is not subject to tax. Installation includes the labor to attach the generator to the building. It does not include fabrication and assembly labor, both of which are taxable.

The final question is the application of tax if G Company purchases the generator. Regulation 1660(c)(7) provides:

"OPTIONS TO PURCHASE. An agreement providing for the lease of tangible personal property and granting the lessee an option to purchase the property results in a sale when the option is exercised. The tax applies to the amount required to be paid by the purchaser upon the exercise of the option."

If G Company purchases the property from A Company, A Company must pay tax on this sale. The measure of tax is \$99,635 less the reduction of this purchase price for prior payments.

Revenue and Taxation Code section 6596 provides the only basis for relief from tax if a taxpayer relies on incorrect written advice from the board. The primary conditions to qualify are that the request for opinion must be in writing and must disclose all relevant facts, including the identity of the taxpayer. Since you have not identified your client, this opinion does not come within the provisions of section 6596 but rather is simply general advice regarding a set of hypothetical facts.

If you have further questions regarding Sales and Use Tax Law, please do not hesitate to write again.

Sincerely,

Elizabeth Abreu
Tax Counsel

EA:cl

bc: --- --- District Administrator