

M e m o r a n d u m**330.5111**

To: Mr. Ed. Pedeupe
Audit Evaluation and Planning Unit

August 28, 1990

From: David H. Levine
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Subject: Claim for Refund – E--- D--- Co., Inc.
(on behalf of U--- B---) – SR -- XX-XXXXXX

This is in response to your memorandum dated August 17, 1990 regarding a claim for refund filed by E--- D--- Company on behalf of U--- B--- for sales tax paid on the sale of furniture and equipment to U---.

U--- purchased the subject property between December 1985 and October 1986. U--- apparently stored the property, and prior to making any functional use of it, U--- entered into a sale/leaseback transaction with P--- L--- Corporation. We do not know whether U--- claimed any income tax benefits, such as depreciation or investment tax credit, with respect to the property during the period of storage.

P--- contends that the rentals payable by U--- are not taxable by virtue of U---'s payment of sales tax reimbursement to E--- D---. U--- originally agreed with this contention. It now apparently believes that the claim for refund should be granted and presumably agrees that the lease is subject to tax measured by rentals payable. The district believes that the most expedient way to handle this transaction is to deny the claim for refund and consider U--- as entitled to a tax-paid purchases resold deduction which was offset against its taxable sales to P---, meaning that P--- holds the property tax paid with no tax due on rentals. You believe that U---'s holding of the property constituted a taxable use, and that the claim for refund should be denied. You further believe that the sale/leaseback transaction is not a financing arrangement and that U--- owes additional tax measured by rentals payable which P--- must collect and pay to the state.

Although the district's suggested handling may be the most expedient way to handle this transaction, such handling would not be legally correct on the basis suggested by the district. The only basis upon which to treat the lease as not taxable would be if it were not a lease at all. That is, if the sale/leaseback transaction qualified for treatment as a financing transaction, then U--- would be regarded as having purchased the property for use, properly having paid sales tax

reimbursement, and using the property in its building. The financing transaction would not affect the parties' liability for sales or use tax. However, the sale/leaseback transaction does not qualify as a financing transaction.

The general rule is that a sale/leaseback transaction qualifies as a financing transaction if the "lease" transaction is regarded as a sale at inception, the purchaser/lessor does not claim any income tax benefits with respect to the property, and the amount attributable to interest is not usurious under California law. (Reg. 1660(a)(3)(A).) The subject lease is not a sale at inception since it has a fair market value option, and this sale/leaseback transaction therefore cannot be regarded as a financing transaction under the general rule. Furthermore, the lease refers to a tax indemnification agreement, a copy of which has not been provided. It appears likely that the tax indemnification agreement provides that P--- has the right to certain income tax benefits, such as depreciation and investment tax credit, and that if it does not obtain those benefits, U--- will indemnify P--- for the expected benefits it fails to receive. If this is true, this is an additional reason that the transaction does not qualify as a financing transaction.

The special application of subdivision (a)(3)(B) of Regulation 1660 provides that the option can be up to fair market value if the seller/lessee has not completely paid the original equipment vendor and the purchaser/lessor pays the balance of that original purchase price to the equipment vendor. This issue is not addressed in the documents provided to me. However, even if the sale/leaseback transaction qualified for the special application, it would not qualify as a financing transaction if my assumptions regarding the tax indemnification agreement are correct. For the remainder of this opinion, I assume that P--- ~~did not~~ had complete[d] payment of the original purchase price to the equipment vendor and/or P--- claimed some income tax benefits with respect to the subject property. That is, I assume that the sale/leaseback transaction does not qualify as a financing transaction.

P--- purchased tangible personal property and did not pay sales tax reimbursement to its vendor (U---). It also did not report use tax measured by rentals payable with its timely return for the first quarter in which the property was leased. Therefore, its lease to U--- is a continuing sale and purchase and is subject to use tax measured by rentals payable which P--- must collect from U--- and pay to this state. Since P--- is not a "transferor" within the provisions of subdivision (g)(5) of Revenue and Taxation Code section 6006 and subdivision (e)(5) of section 6010, there is no basis for P--- to be regarded as holding the property in tax-paid status when sales tax reimbursement or use tax was paid by a different person. P---'s lease to U--- is subject to use tax measured by rentals payable.

We have consistently regarded a person who purchases property for its business and thereafter sells the property in a sale/leaseback transaction prior to functional use as having purchased that property for resale in the regular course of its business. We have reached this conclusion even if there was a period of storage prior to the sale/leaseback transaction provided the seller/lessee made no use of the property (except storage) prior to the sale/leaseback transaction. (Depreciating the property for income tax purposes or taking an investment tax

credit would be regarded as a taxable use.) If that person had paid sales tax reimbursement or use tax, we have regarded them as entitled to a tax-paid purchases resold deduction. When this occurs, it is not inappropriate to grant a refund to the original equipment vendor. However, it is preferable under circumstances where no resale certificate was issued to the original vendor and at the time of that purchase the purchaser was unsure whether it would resell the property in a sale/leaseback transaction, that the original purchaser, that is the seller/lessee, take a tax-paid purchases resold deduction in the quarter in which that right arose. If that person does not claim the credit in the appropriate quarter, it would of course be entitled to file a claim for refund on its own behalf for the tax-paid purchases resold deduction credit which it was entitled to but failed to take.

I assume that U--- did not depreciate the property for income tax purposes or take investment tax credit or make any other use of the property except to hold it for resale in the sale/leaseback transaction. Based on these assumptions, it appears that U--- was entitled to the deduction in the fourth quarter 1986. This means that the statute of limitations on that claim for refund passed on January 31, 1990. (Presumably, the claim for refund filed by E--- D--- was filed several months ago.) Since U--- can no longer file a claim for refund on its own behalf, in this particular case, we believe it is appropriate to grant the claim for refund filed by E--- D--- on behalf of U--- (provided my assumptions are correct).

In summary, we believe that the claim for refund should be granted because U--- is regarded as having purchased the property for resale prior to functional use. (Please note that this is also based on my assumptions regarding the sale/leaseback transaction which led to my conclusion that it does not qualify as a financing transaction.) P--- paid no sales tax reimbursement or use tax measured by purchase price. Therefore, its lease of the property to U--- is a continuing sale and purchase and is subject to use tax measured by rentals payable. If you have further questions, feel free to write again.

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