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Date: 6/25/92

STATE OF CALIFORNIA

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
	)	
	)	No
	)	
Petitioner	)	

The Appeals conference in the above-referenced matter was held by Janice M. Jolley, Staff Counsel, on March 27, 1992, in Sacramento, California.

Appearing for Petitioner:

Appearing for the Sales and Use Tax Department:

Leon Adams
District Principal Auditor

Dennis Ensley, Sr.
Tax Auditor

Protested Items

The protested tax liability for the period January 1, 1988, through December 31, 1991, is measured by:

Item	State, Local and County
A. Unreported sales consisting of lease contracts which are sales from inception, actual basis	$5,786,000
B. Credit for tax-paid purchases resold	(4,311,889)

Petitioner's Contention

Petitioner did not receive gross receipts from the sale of tangible personal property because it assigned its clients' installment contracts as negotiable instruments to a lender at a discount.

Summary

Petitioner sells woodworking machinery and enters into a letter agreement with the purchaser which it designates as a "lease." At the conference both parties agreed that at the end of each such "lease," the purchaser could acquire the property outright for a nominal sum, generally $25.00, and that there were no cancellation provisions under the agreement. The parties therefore stipulated that the transactions should be treated as sales from inception.

Petitioner describes its general operating procedure in Exhibit A, an April 6, 1992, letter from petitioner's president to . Petitioner would obtain a list of the items to be acquired through a specified vendor from prospective purchasers, whom it described as individuals generally incapable of obtaining credit direct from vendors of this type of machinery or who did not wish to disturb their lines of credit with their own banks for a period of sixty (60) months. Petitioner would obtain a credit application and then screen the purchaser to obtain relevant credit information. After confirming the purchase price quoted by the vendor with its client, petitioner submitted the clients' credit information to obtain a loan commitment from a lender. When the loan commitment payable over a specified period of time at a known interest rate was agreed upon with the lender, petitioner placed the order with the vendor. The lender was aware by having screened the client's credit information that petitioner would assign the client's "lease" in redemption of this loan commitment at the time the lender issued its commitment letter to petitioner (Exhibit B), but the lender remitted the loan proceeds by wire into petitioner's bank account so that petitioner could pay the vendor with its own check.

Petitioner caused a "lease" to be drawn in which the purchaser agreed to pay a somewhat higher rate of interest than petitioner had obtained in the loan commitment and the higher rate of interest appeared on the face of the "lease." (Exhibit C) The "lease" was payable incrementally over the same term as the loan. Petitioner states that it did not mark up the machinery, and the cost of machinery on the customer "lease" is identical to the amount petitioner paid to the vendor. The "lease" reflects any sales tax reimbursement, delivery, or other miscellaneous charges petitioner paid to the vendor as part of the purchase price of the machinery being financed under the "lease." Petitioner acknowledges that it always received and retained one or more "prepayments" under the "lease." Petitioner also retained a security interest in the equipment as collateral under the "lease."

Simultaneous with the execution of the "lease" or very shortly thereafter, petitioner discounted its "lease" to the lender which provided the flooring loan and assigned its interest in the security agreement to the lender. Sometimes petitioner obtained a cash discount on the note in addition to the prepayment holdback. Petitioner submitted supporting documents for each phase of the transactions described in Exhibit A which appear at pages 33-52 of the audit workpapers.

Petitioner states that since it did not mark up the machinery, its profit was derived either (1) from the difference between the discounted interest under the "lease" when assigned to the lender and/or (2) the prepayments collected at the time the "lease" was entered into with the purchaser which were retained prior to transferring the client's note to the lender.

The machinery was purchased tax paid by petitioner. Petitioner had the vendor ship the machinery direct to the purchaser. Petitioner erroneously paid transit district taxes on these sales where the vendor shipped the items direct to the client. An adjustment for these payments was made in Audit Item D. A claim for refund has been filed for those overpayments for the first quarter of 1989 and the fourth quarter of 1990 at . These overpayments were offset against liabilities asserted in this notice of determination.

The Sales and Use Tax Department (hereinafter "the Department") calculated the measure of tax by subtracting the known cost of the equipment sold and the amount of interest payable on petitioner's flooring loan from the total "lease" payments, including interest, which the client agreed to pay under the "lease." Since the "lease" bore a higher rate of interest than the note to the lender, the difference was deemed by the Department to be taxable gross receipts which constituted a disguised markup of the sales price of the machinery.

The Department contends that the only documents reflecting the interest discount appeared on the financial institution's records and not on any books or records maintained by petitioner. The Department contends these discounts or prepayments were treated as commissions on petitioner's books. The audit workpapers state:

> "Accordingly, the total receipts from the sale less the amount of discount interest shown to the customer would be considered to be the sale price."

Analysis and Conclusion

I concur with the parties that the "leases" entered into by petitioner with the purchasers were really contracts to finance the equipment in which petitioner retained a security interest. Therefore, they constituted taxable sales under Sales and Use Tax Regulation 1641(b).

The narrow issue to be decided is what is the measure of tax. The Department contends that since the "lease" did not reflect a mark up on the cost of the equipment, all proceeds received by petitioner in excess of its cost of equipment and interest due on its notes to the lender were taxable gross receipts.

The prepayment advances were not taxable gross receipts. They were remitted at the formation of the contract and were no different than any other downpayment. They did not increase the sales price. They did not constitute a disguised mark-up.

The amounts received by petitioner from the lender as a discount of the note did not constitute taxable gross receipts. Sales and Use Tax Regulation 1641(a) provides as follows:

> "If tangible personal property is sold on credit, either under a security agreement, or otherwise the whole amount of the contract is taxable, unless the retailer keeps adequate and complete records to show separately the sales price of the tangible personal property, and the insurance, interest, finance, and carrying charges made in the contract. If such records are kept by the retailer, the insurance, interest, finance and carrying charges may be excluded from the computation of the tax."

It is clear from inception of each "lease" that it was a sales financing agreement and that the purchaser agreed to pay interest at a competitive market rate measured by the known cost for the machinery acquired. The rate of interest is clearly set out on the fact of the "lease." (Exhibit C) Petitioner assigned its right to collect future interest under the "lease" to the lender. The amounts paid by the purchaser were at the higher interest rate under the "lease" than what petitioner had to pay under the loan commitment. Nevertheless, the lender had an enforceable right to receive payment in full because consideration passed between the client and petitioner. The interest was nonusurious. The Department stipulated that the lender's records applied amounts received from the purchaser to principal and interest despite petitioner booking amounts it received as prepayments or note discounts as "commissions." Thus, I find that the provisions of Sales and Use Tax Regulation 1641(a) concerning maintenance of adequate records of interest payments have been met. The party with the right to receive payment under the "lease" maintained a proper accounting of principal plus interest received. The amounts so applied by the lender must be treated as interest. Just as in those cases where a mortgage loan is discounted and sold to another lender, the purchaser is still entitled to deduct interest payable at the rate of the initial loan.

Petitioner's purchase of tangible personal property from the vendor was a sale for resale to petitioner's clients. Petitioner paid sales tax reimbursement on its cost. The contract between petitioner and its client although designated a "lease," was actually a contract of sale. All that was transferred to the lender was a contractual right to receive money. Both petitioner and the lender, as its assignee, were protected by a security interest in the tangible personal property which petitioner resold. The transfer of paperwork assigning a security interest in the collateral from petitioner to the lender was not a taxable transfer of tangible personal property. The Department stipulated during the conference that if petitioner had held each "lease" to termination so as to receive payment in full, the amounts received in excess of its cost of the machinery would have been interest. If the payments were allocable to principal and interest at the rate agreed to by the parties if held to term, the transfer of a right to reserve payment does not ipso facto convert interest into markup.

I recognize that through proper structuring, petitioner has avoided incurring additional sales tax over that already paid by petitioner to its vendors. A taxpayer has a legal right to decrease the amount of what otherwise would be [its] taxes or altogether avoid them by means which the law permits. Automatic Canteen Co. v. State Board of Equalization (1965) 238 Cal.App.2d 372, 383. Each of the assigned contracts appears to have been entered into in an arm's length transaction, each reflects tax was paid on cost, and each reflects that petitioner resold the machinery with no markup. Had petitioner issued resale certificates to acquire the items at wholesale or if the cost of machinery had not been disclosed to the client, I perhaps would have reached a different result. Under the facts of this case, however, the sales and use tax provisions of the revenue and taxation laws do not tax the transfer of intangibles such as commercial paper or negotiable instruments.

Recommendation

Grant the petition.

Janice M. Jolley
Janice M. Jolley, Staff Counsel
(w/Exhibits A, B, and C)
JA

June 25, 1992
Date