

M e m o r a n d u m**330.2100**

To: San Jose - Auditing (MSS:VW)

Date: March 13, 1970

From: Tax Counsel (JKM)

Subject:

This is in reply to your memo dated February 13, 1970 concerning the application of tax to this taxpayer's rental units.

On November 12, 1965 taxpayer acquired approximately 1,900 water softener units ex tax as the result of a section 6006.5(a) occasional sale and placed them in rental service. However, taxpayer did not report and pay tax measured by the purchase price of the units and did not collect and pay tax measured by rental receipts. Tax measured by rental receipts is now being asserted.

In this regard many of the units acquired were old, and it became necessary for taxpayer to replace various parts thereof. All replacement parts used were purchased tax paid. With regard to these replacement parts, you ask the following questions:

1. Does the commingling of ex-tax and tax-paid parts create new units, thus exempting future rental receipts?, or
2. Does the commingling of ex-tax and tax-paid parts constitute the repair of old units, thus making future rental receipts subject to tax with tax-paid purchase deductions allowed to taxpayer for tax-paid parts used?

If the commingling of the parts constitutes the repair of old units, taxpayer asks what parts of the old units must be replaced in order to create new units, thus exempting future rental receipts.

It is our position that where property acquired ex tax has been placed in rental service, and where the lessor has not elected to report and pay tax measured by the purchase price of the property, the commingling of ex-tax and tax-paid parts constitutes a repair of the

property. Thus, future rental receipts remain taxable, subject to tax-paid purchase deductions for tax-paid parts used in the repair of the property. It is also our position that once ex-tax property has been placed in rental service, tax being measured by rental receipts, the property thereafter retains its ex-tax status for purposes of the law. Thus, the commingling of ex-tax and tax-paid parts does not ever create new property, the rental receipts therefrom which will not be taxable. If over a period of time all parts of taxpayer's units as acquired are replaced with tax-paid parts, its rental receipts will remain taxable, subject to tax-paid purchase deductions for tax-paid parts used.

JKM:smb [lb]