

**STATE BOARD OF EQUALIZATION**

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December 19, 1980

Mr. C--- C. B---  
B---, C---, H--- & S---  
XXX --- ---, Suite XXX  
---, CA XXXXX

Dear Mr. B---:

Mr. Hennessy has asked me to respond to the questions in your letter relating to the proper measure reportable by a lessor of mobile transportation equipment who has elected fair rental value as the measure of tax.

You have asked whether or not "cap reductions" would be treated as balloon rentals and taxable when due. By the term "cap reductions" I assume that you are referring to a lump sum payment by a lessee during the term of the lease, which will have the effect of reducing the individual amounts of the further rental payments over the remaining term of the lease. We would expect that over the whole term of the lease the fair rental value would be equivalent to the actual payments by the lessee for the use of the property.

We have not administered any strict rule that the amounts reported as fair rental value during the lease must vary precisely according to the amounts paid by the lessee from time to time during the lease. So the amounts attributable to capital reductions could be spread out over the remaining term of the (fair rental value) lease. Likewise, deficiency payments, which occur because of the decline in value through use of the vehicle (rather than a decline in value through catastrophic loss) would be a reflection of the fair rental value of the equipment under that lease. But the deficiency payable at the end of the lease could not be redistributed over the prior term and so would result in a fair rental value adjustment upon termination, and that adjustment must be included in the amount upon which tax is computed.

As you have noted, the concept of rental receipts applicable under 6011 and 6012 focuses on the actual payments made and billed as the measure of the tax due at the time payments are determined. That concept does not apply to fair rental value. Therefore, where the lessor experiences unusual high or low payments by the lessee, the lessor measuring use tax liability by the fair rental value may report the tax based upon those payments when made or may distribute the excess or deficiency over the term of the lease as a method of reporting fair rental value.

We would agree with you that the lease ceases upon the earlier of repossession of leased property by the lessor or the time the lessor sells its ownership interest in the property. We do not think the lease terminates for sales or use tax purposes at an earlier time which may constitute "termination" as that term is defined in the lease contract. The reason for this, is that the lease for sales and use tax purposes is defined by the sale and use tax law and not by the contract definitions. While the direct definition of lease in Revenue and Taxation Code Section 6006.3 simply recites that "lease" includes rental, hire and license, with one specific exclusion, Revenue and Taxation Code Section 6006.1 defines continuing sale to be granting of possession of tangible personal property by a lessor to a lessee...." Therefore, the Code focuses intention upon the granting of possession. Accordingly, our view that while the lessee retains possession with the acquiescence of the lessor, the lease continues.

Very truly yours,

Phillip R. Dougherty  
Tax Counsel

PRD:ba

cc: Mr. D. J. Hennessy