The protested tax liability for the periods January 1, 1990 through April 6, 1991 (SY -- XX-XXXXXX-010); and April 7, 1991 through March 31, 1992 (SY -- XX-XXXXXX-010), is measured by:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease payments to unpermititized out-of-state lessor for the tangible personal property portion of a sale-leaseback transaction:</td>
<td></td>
</tr>
<tr>
<td>SY DH 22-006272-010</td>
<td>$1,039,305</td>
</tr>
<tr>
<td>SY DH 22-841392-010</td>
<td>692,870</td>
</tr>
<tr>
<td>Total Protested Measure</td>
<td>$1,732,175</td>
</tr>
</tbody>
</table>
Contentions

Petitioner contends that the lease payments are nontaxable because the property was purchased tax paid. Petitioner also contends that some property classified as tangible personal property is permanently attached to real property and is a part thereof.

Summary

During the periods in issue petitioner E--- G--- & Co., Inc., now G---'s, Inc., a Delaware corporation, operated department stores in California. In 1988 and 1989, petitioner entered into a sale and leaseback transaction with G--- F--- C--- I--- NO. 2 Corporation (G--- F---), a Delaware corporation, owned by P--- M--- Corporation. 1 In connection with this transaction, a Tax Indemnification Agreement (Indemnification Agreement), dated as of December 1, 1988, was entered into by petitioner with G--- F--- and M--- H--- T--- C--- of California (M--- H---), a California corporation, acting not in its individual capacity but solely as Owner-Trustee under a Trust Agreement (Trust Agreement), also dated as of December 1, 1988. (Exhibit A).

Pursuant to the Indemnification Agreement G--- F--- authorized and directed M--- H--- to purchase certain facilities from petitioner (retail stores in S--- and B---, California and a distribution facility in M---, California; hereinafter "Facilities"), to lease from petitioner the land (Sites) upon which the Facilities were situated, and thereafter lease the Facilities and sublease the Sites back to petitioner pursuant to a lease agreement. (Exhibit A, p.3.) The funds used by M--- H--- to acquire an equity interest in the Facilities were obtained from G--- F---. (Exhibit A, p.3.) For federal income tax purposes, G--- F---, as owner of the entire trust, would be entitled to any federal income tax benefits resulting from the transaction. (Exhibit A, p.3.) The agreement also provided that a lease would be executed and treated as a true lease for federal income tax purposes, with M--- H--- (Owner-Trustee) treated as the lessor of the Facilities and petitioner treated as the lessee. (Exhibit A, p.4.) As required, petitioner, as lessee, and M--- H---, as Owner-Trustee, lessor entered into a Lease Agreement, dated as of December 1, 1988, for the Facilities and Sites first described above. 2

1 The transactions between the parties contemplated that the closing date with respect to the B--- and S--- facilities would occur on December 31, 1988, and on July 1, 1989, with respect to the M--- facility.

2 For clarity, hereinafter, G--- F---, as owner of the entire trust, is substituted for M--- H---.
The Lease Agreement, at Article XII provides that:

"The Lessee and the Lessor agree that each portion of the Facilities is intended to be, and will be treated by such parties as, separately identifiable personal property, severable from any real estate on which it is located. No determination by any court, agency or other entity that any portion of the Facilities is real property or a fixture thereto rather than personal property will relieve the Lessee of any of its obligations hereunder or under any other of the Basic Documents."  

An appraisal conducted by M--- and S--- Incorporated (M--- and S---), resulted in separation of the Facilities into realty and personal property with the following fair market values for each facility:

<table>
<thead>
<tr>
<th></th>
<th>S---</th>
<th>M---</th>
<th>B---</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realty</td>
<td>$3,105,954</td>
<td>$8,950,000</td>
<td>$8,684,797</td>
</tr>
<tr>
<td>Personalty</td>
<td>1,076,859</td>
<td>4,950,000</td>
<td>933,390</td>
</tr>
<tr>
<td>Totals</td>
<td>$4,182,813</td>
<td>$13,900,000</td>
<td>$9,618,187</td>
</tr>
</tbody>
</table>

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3 The Sales and Use Tax Department states that the ground lease between petitioner and M--- H--- for the M--- and B--- land states, at Article V of the agreement, that "each portion of the ... facility is intended to be, and will be treated by such parties as, separately identifiable personal property, severable from any land on which is it (sic) located." With respect to S---, the land and Facility was owned by S--- B--- and ----, and the Facility was quitclaimed by them to petitioner. In section 2 of the quitclaim deed "the parties hereto agree that the S--- Facility and each portion thereof is intended to be severed, and shall be and remain severed, from the real estate constituting the S--- Site and ... shall be (sic) retain the character of personal property, shall be treated as personal property ... shall not be or become fixtures or otherwise part of the S--- site...."

4 For federal income tax purposes the depreciable categories as to the B--- facility, 80.90167 percent of the facility's cost represented nonresidential real property, and 19.0833 percent represented tangible personal property; as to the S--- facility, 75.0832 percent of the facility's cost represented nonresidential real property, and 24.9168 percent represented tangible personal property; and as to the M--- facility, 50 percent of the facility's cost represented nonresidential real property, and 50 percent represented tangible personal property. (Exhibit A, p.4-5.) G--- F---, as owner of the entire owner claimed depreciation deductions as provided by sections of the Internal Revenue Code and the regulations thereunder. The depreciation deductions claimed by G--- F--- for 1988, 1989, and 1990, were $169,178, $1,814,881, and $2,715,390, respectively.
Rental payments were scheduled to commence January 1, 1990, and payable semi-annually thereafter. Subject to conditions elsewhere in the agreement, petitioner had the option to renew the lease after the basic term and each renewal term. Petitioner also had the first right of refusal in the event G--- F--- entered into a binding contract to sell the Facilities.

The Sales and Use Tax Department (Department) became aware of this transaction, and determined that the rental payments were subject to use tax. To arrive at the taxable measure, the Department reduced the personal property values determined by M--- and S--- by the value of materials, as defined by Sales and Use Tax Regulation 1521. (See Audit Rpt. for Account SY -- XX-XXXXXX, Audit Schs. 2C and 2E.) The Department determined the ratio of the remaining tangible personal property to total property, inclusive of real property, and applied the resulting percentage to petitioner's rental payments. The result is the taxable measure of rents attributable to the rental of tangible personal property.

Field Billing Orders, dated July 7, 1992, were issued to petitioner, and on September 2, 1992, the Department issued its Notices of Determination to petitioner for tax due on the rentals.5 On October 2, 1992, petitioner submitted a timely Petition for Redetermination.

Analysis and Conclusions

Sales and Use Tax Regulation 1660 provides in relevant part that transactions structured as sales and leaseback cannot be treated as financing transactions if the purchaser-lessee claims any deduction, credit or exemption with respect to the property for federal or state income tax purposes. Transactions treated as financing transactions are not subject to sales or use tax. (See Sales and Use Tax Reg. 1660, subd. (a)(3)(A) and (B).)

Here, the Tax Indemnification Agreement provides that for federal income tax purposes, G--- F---, as owner of the entire trust, would receive all the federal income tax benefits generated by the transaction. (See Exhibit A, p.3; see also footnote 3 relating to classification of the facilities for federal tax depreciation purposes, and depreciation deductions claimed by G--- F---.) Since G--- F--- claimed the federal tax benefits resulting from the transaction, the transaction cannot qualify as an exempt financing transaction. (Sales and Use Tax Reg. 1660, subd. (a)(3)(A) and (B.).)

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5 Because G--- F--- was an out-of-state lessor operating in-state without a seller's permit, the liability was assessed against petitioner.
Petitioner argues that the lease payments are nontaxable because the property was purchased tax paid.

Revenue and Taxation Code section 6010.65 excludes a lease from the terms "sale" and "purchase" when there is an acquisition sale and leaseback. This statute, however, is not applicable to an acquisition sale and leaseback executed before the statute's operative date of January 1, 1991. Since the transactions here were executed in 1988, and 1989, the exclusion provided by this statute is not applicable.

Section 6006, subdivision (g), provides that "sale" means and includes "Any lease of tangible personal property in any manner or by any means whatsoever, for a consideration...." This subdivision also permits a lessor of tangible personal property to pay sales tax reimbursement to its seller upon the purchase of the property, or to report such lease as a taxable use upon the tax return for the period in which the first lease occurred, and to pay a use tax based upon the purchase price of the property. (Rev. & Tax. Code, § 6006, subd. (g)(5).) The granting of possession of tangible personal property by a lessor to a lessee is a "continuing sale" for the duration of the lease as respects the period the property is in this state. (Rev. & Tax. Code, § 6006.1.)

As provided by section 6006, subdivision (g)(5), G--- F--- had the option to either pay sales tax reimbursement at the acquisition of the property, or to pay the use tax measured by the purchase price of the property. The option to pay the use tax must be made at the first use of the property; that is, upon the initial return for the lease of the property. (See Rev. & Tax. Code, § section 6006, subd. (g); see also Action Trailer Sales, Inc. v. State Bd. of Equalization (1975) 54 Cal.App.3d 125, 131-132.) Because G--- F--- failed to make any tax payments, the Department assessed the use tax against the rental payments.

Section 6010, subdivision (e), provides that "purchase" means and includes "Any lease of tangible personal property in any manner or by any means whatsoever, for a consideration...." The possession of tangible personal property by a lessee is a "continuing purchase" for use in this state by the lessee for the period the leased property is in this state. (Rev. & Tax. Code, § 6010.1.) Section 6201 imposes a use tax on the use in this state of tangible personal property. Section 6202 provides that the consumer of tangible personal property purchased in this state is liable for use tax except where the retailer collects the tax from the consumer and the consumer has a receipt of the kind called for in Sales and Use Tax Regulation 1686.

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6 An "acquisition sale and leaseback" is a sale of tangible personal property by a person, and the leaseback of such property by the person; provided that the person has paid the sales tax reimbursement or use tax at the acquisition of the property, and the acquisition sale and leaseback is consummated within 90 days of the persons first functional use of the property. (Rev. & Tax. Code, § 6010.65, subd. (a)(1) and (2).)
In line with the above authority, the transaction here is a "sale" and "purchase". When a lease is considered a "sale" and "purchase", the tax is measured by the rentals payable. The lessor must collect the tax from the lessee at the time lessee pays the rentals and give him a receipt as required by Regulation 1686. The lessee, however, cannot be relieved from liability for the tax until it receives a receipt or the tax is paid to the state. (Sales and Use Tax Reg. 1660, subd. (c).) Here, the property was purchased by G--- F--- in this state, and petitioner, as lessee of the property, is the consumer of the property. Further, there is no evidence of any payment of the tax to G--- F--- by petitioner, or the payment of tax to this state. Thus, petitioner's argument that the lease payments are nontaxable because the property was purchased tax paid must be rejected.

Petitioner also argues that some property classified as tangible personal property is permanently attached to real property and is a part thereof.

Section 6016 provides that "tangible personal property" means personal property which may be seen, weighed, measured, felt, or touched, or which is in manner perceptible to the senses. The term "tangible personal property" also includes any leased fixtures if the lessor has the right to remove the fixtures upon breach or termination of the lease, unless the lessor is also the lessor of the realty. (Rev. & Tax. Code, § 6016.3.) This section is implemented by Regulation 1660, subdivision (d) (7). For purpose of this section and regulation, the term "lessor of the realty" can refer to a building, and does not only refer to land.

Sales and Use Tax Regulation 1521 defines "materials" and "fixtures" in subdivision (a) as follows:

"(4) MATERIALS. 'Materials' means and includes construction materials and components, and other tangible personal property ... affixed to, real property ... when combined with other tangible personal property, loses its identity to become an integral and inseparable part of the real property...."

"(5) FIXTURES. 'Fixtures' means and includes items which are accessory to a building or other structure and do not lose their identity as accessories when installed...."

The Department relying on R. Barcroft & Sons Co. v. Cullen (1933) 217 Cal. 708; and Teater v. Good Hope Dev. Corp. (1939) 14 Cal.2d 196, argues that the parties may by agreement characterize fixtures as real or personal property, and such agreement is binding between the parties and against third parties. (Citing Oroville-Wyandotte IRR. Dist. v. Ford (1941) 47 Cal.App.2d 531; Standard Oil Co. v. State Bd. of Equal. (1965) 232 Cal.App.2d 91.) Except for Standard Oil, none of these cases involved the application of sales taxes to leased fixtures. As the Standard Oil court
recognized, an area of law separate and distinct from the law governing sales tax cannot be accepted as a "legislative mandate" for the ascertainment of taxable gross receipts. (Standard Oil Co. v. State Bd. of Equal., supra, 232 Cal.App.2d at 100-101.) In Sales and Use Tax Annotation 190.0020, it was held that agreements between parties regarding "materials" or "fixtures" as other than materials or fixtures, i.e. personal property, are not binding; the physical facts of attachment to real property govern. This annotation is not inconsistent with Standard Oil, because the decision there was concerned only with the "sale of fixtures in place".

Here, G--- F--- is the lessor of the fixtures and the Facilities (buildings). Thus, section 6016.3 does not reclassify the fixtures herein as tangible personal property, even though the parties agreed upon a legal severance of the buildings and fixtures from the land. G--- F---, as lessor of the buildings and fixtures, comes within the exception provided when the lessor of the fixtures is also "the lessor of the realty". Therefore, the "fixtures" and "materials" here, that are attached to the realty, do not lose there character as real property simply because by agreement they are characterized as tangible personal property.

To determine the portion of rentals subject to tax, the Department, pursuant to the provisions of Regulation 1521, reclassified some of the personal property values determined by M--- and S--- as "materials". However, the Department did not go far enough because included in the remaining value are items I conclude are attached to the buildings. These items are either "materials" or "fixtures", and should be deleted from the measure of tax. For example, Appendixes A and B, of Regulation 1521 provides a listing of items typically regarded as materials and fixtures, and listed therein is electrical wiring and connections, wallpaper, and lighting fixtures. I assume that electrical and lighting, and Decor, which I presume is wall decor, are similarly attached to the facilities as are these items. Therefore, the values for electrical and lighting, and Decor should be classified as materials. (Sales and Use Tax Reg., § 1521, Appendixes A and B.)

In line with Appendix B, of regulation 1521, I consider sensor tag equipment, and signage to be excludable as fixtures. With respect to toilet accessories and partitions, I presume that they are somehow attached to the building. Therefore, their values should be reclassified as materials. (Sales and Use Tax Annotations 190.0170 (July 5, 1979; Aug. 23, 1982; June 10, 1985; Dec. 11, 1985); 190.0920 (Sept. 25, 1953.) The phone and public address systems, to the extent they do not constitute machinery and equipment under paragraph (a) (6) of Regulation 1521, should be classified as fixtures. (Sales and Use Tax Reg., 1521, subd. (c)(8).) The compactors should be classified as fixtures, by analogy to dishwashers in Annotation 190.0270 (Apr. 5, 1977.) I further find that the alarm systems are within the definition of materials. (See Sales and Use Tax Reg. § 1521, subd. (a)(B)(4).) I consider the remaining items, entrance mats, folding/mesh partitions, show cases, miscellaneous equipment, and fire extinguishers, to be "free standing", and not excludable as materials or fixtures.
Recommendation

Redetermine the taxable measure consistent with the above, and deny the petition in all other respects.

__________________________
Paul O. Smith, Staff Counsel

__________________________
Date