

**STATE BOARD OF EQUALIZATION**

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February 2, 1998

Mr. M--- L---
Tax Accountant
C--- P--- L---
XXXXX West XXth Parkway
---, Oregon XXXXX

Re: Taxation of Lessee's Exercise of Option
to Purchase Leased Equipment

Dear Mr. L---:

This letter is in response to your letter of December 3, 1997 requesting our opinion as to what portion of a lessee's purchase price is taxable when the lessee opts to purchase leased equipment on which tax has been paid at inception. Revenue and Taxation Code section 6596, attached, sets forth circumstances under which a taxpayer may rely on a written response to a written request for an opinion.

You state:

"When Pamphlet #46 - LDA (Tax Tips for Leasing of Tangible Personal Property in California) came out in 1994, some of us in Leasing Industry, lessors and lessees alike, had a bit of a problem in arriving at an unanimous agreement as regard the tax on purchase of the leased equipment on which tax has been paid on the cost of equipment at the inception, in exercising his option to purchase the equipment. If lessee opts to buy the equipment at the end of the lease term, it is clear, purchase price (usually stated residual amount) is subject to tax. However, if lessee decides to buy before the lease expires (in this situation there will be some remaining leasepayments), we were not at all sure whether only the stated residual amount or remaining leasepayments also were taxable.

"We therefore, contacted Board of Equalization at that time for clarification and direction. We were advised by the Board that although tax was paid at the inception of the lease, when lessee decides to buy the equipment, the total purchase price (Stated Residual Amount + Remaining Leasepayments) is

subject to tax. Since that time we have been collecting tax on the purchase price on leases which were terminated earlier than scheduled.

“Recently, some of our brokers and lessees started questioning our practice of collecting tax on remaining leasepayments. They contend that we should be collecting tax only on residual amount not on remaining leasepayments.

“We would therefore, appreciate a Board’s ruling or directive as to which portion of lessee’s purchase price is taxable when he opts to purchase the leased equipment on which tax has been paid at inception, before the lease expires.”

When you refer to a lease, we assume that the transaction is a true lease, not a sale under a security agreement. We assume that the equipment that you lease is not mobile transportation equipment as defined in Revenue and Taxation Code section 6023.1. Since you state that tax has been paid on the cost of the equipment at the inception of the lease, we assume that the equipment is leased in substantially the same form as acquired and that you paid tax reimbursement or use tax to the vendor when purchasing the equipment or reported and timely paid tax with your return for the period during which the property was first placed in rental service. Finally, we assume that the sale of equipment to the lessee/purchaser upon the exercise of its option to purchase was a sale in California. Our conclusions in this letter are based upon these assumptions and may be different if any of the assumptions are incorrect.

When the lessee/purchaser exercises its option to purchase the equipment that was the subject of the lease before the lease term expires, paying an amount equal to the amount it would pay to purchase the equipment upon expiration of the lease (which you call “residual amount”) plus an amount equal to the sum of the (perhaps discounted) remaining lease payments, you ask whether you are correct in paying sales tax (and collecting sales tax reimbursement from the lessee/purchaser) measured by the “total purchase price” paid to you by the lessee/purchaser, or whether the tax should be measured by only the “residual amount” and not the amount measured by the sum of the remaining lease payments. You are correct -- as in any other sale of tangible personal property, tax applies to gross receipts: that is, the entire amount the lessee/purchaser is required to pay to acquire title to the tangible personal property.

Discussion

Sales tax is imposed on a retailer’s retail sale of tangible personal property in this state, measured by a percentage of gross receipts, unless the sale is specifically exempt by statute. (Rev. & Tax. Code § 6051.) Although sales tax is imposed on the retailer, the retailer may collect sales tax reimbursement (usually itemized on the invoice as “sales tax”) from the purchaser if the contract of sales so provides. (Civ. Code § 1656.1.) When sales tax does not apply, use tax applies to the storage, use or other consumption of tangible personal property purchased from any retailer for the storage, use or other consumption in this state, measured by a

percentage of the sales price, unless that use is specifically exempt by statute. (Rev. & Tax. Code §§ 6201, 6401.) “Gross receipts” or “sales price” generally include all amounts received with respect to the sale of tangible personal property, with no deduction for the cost of materials used, labor or service costs, or other expenses of the retailer, unless there is a specific statutory exclusion. (Rev. & Tax. Code §§ 6011, 6012.)

A lease of tangible personal property in California is a continuing sale and purchase unless the lessor leases the property in substantially the same form as acquired and timely pays sales tax reimbursement or use tax measured by the purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6001.1, 6010(e)(5), 6010.1; Reg. 1660 subds. (b)(1) and (c)(2).) When both of the foregoing conditions have been satisfied, a lease is not a “sale” or a “purchase” and therefore is not subject to sales or use tax; this is sometimes referred to as a “tax paid lease.” When either or both of the foregoing conditions have not been satisfied, a lease is a continuing sale and purchase and is subject to use tax measured by rentals payable, which include any payments required by the lease. (Reg. 1660(c)(1).) The lessee owes the tax, which the lessor is required to collect from the lessee and pay to the Board of Equalization. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c)(1).)

Based upon the information you provided us and the assumptions previously set forth, the lease in question is a tax paid lease, and your lease of tangible personal property to the lessee is not a sale or purchase subject to sales or use tax.

When the lessee exercises its option to purchase, the sale of the equipment is treated the same as any other sale of tangible personal property. The measure of tax on the sale of equipment is the amount required to be paid by the lessee-purchaser (Reg. 1660(c)(7)); gross receipts from the sale, or in your words, “the full purchase price,” is subject to tax. The fact that the purchase price is higher than the lowest option price (“residual amount”) listed in the lease agreement is immaterial. Your taxable gross receipts from the sale are the amount that the lessee pays for the transfer of title of equipment, even if calculated with reference to amounts that the lessee otherwise would have paid as rents. Of course, a lessee may avoid this application of tax by continuing to pay rent, and then purchase the equipment at the expiration of the lease for the residual amount. In that case, tax would apply measured only by the residual amount you charge.

You also faxed us a letter from Tom Yowell, Business Taxes Representative of the Board of Equalization to S--- S--- of H--- I--- V--- dated January 16, 1998 regarding tax on a sale of equipment when a lessee exercises an option to purchase equipment before the expiration of the lease. We understand the letter concerns equipment leased by C--- P--- L--- to Mr. S---. The purchase price upon exercise of the option is equal to the sum of the remaining lease payments, which include use tax, and a ten percent (10%) buyout amount. Unlike the situation posed in your letter in which the leases were tax paid leases (leases which are not a “sale” or “purchase” under the Sales and Use Tax Law), the letter to Mr. S--- states that payments made to the lessor

include use tax due. We therefore assume that the lease referred in that letter is a continuing purchase and sale, with the lessor required to collect use tax from the lessee, measured by rentals payable, and remit the tax to the Board. Mr. Yowell correctly informed Mr. S--- that tax is measured by the amount required to be paid by the purchaser upon exercise of the option. He further explained that if the lease payment amounts include use tax due, the only additional tax due would be on the buy-out amount, with the lessor/purchaser required to pay the "use tax" portion of the lease payment and tax on the buyout amount to the Board. To look at this from a different perspective, the amount the lessee/purchaser is required to pay, including sales tax reimbursement, is (1) the remaining rental payments less use tax amounts (the lease terminates upon exercise of the option, so there is no use of property by the lessee on which to owe tax), plus (2) the ten percent (10%) buyout price, plus tax on (1) and (2) -- which is equal to the sum of the lease payments including use tax plus the buyout amount and tax on the buyout amount.

To summarize, upon a lessee's exercise of an option to purchase leased equipment, irrespective of whether the lease is a tax paid lease or a continuing purchase and sale, the entire amount -- whether determined with reference to what otherwise would have been lease-payments, or determined in any other manner -- paid to the lessor/seller by the lessee/purchaser for the equipment is subject to tax.

If you have further questions, please write again.

Very truly yours,

Janice L. Thurston
Tax Counsel

JLT/cmm

cc: Out-of-State District Administrator