This is in response to your memorandum dated July 6, 1989 regarding whether a lease contract is a sale at inception. As you note, the two provisions especially relevant to this question are Article 9, Early Termination, and Article 10, Purchase Option. Article 9 provides that on May 31 of 1987, 1988, and 1989, the lessee has a right to terminate the lease prior to 1996. Article 10 provides that rent ceases to accrue as of May 31, 1996.

The recitals of the lease indicate that the lessee had originally contracted with H--- S--- I--- for the purchase of 500 container chassis (referred to in the lease individually as “unit” or together as “equipment”). That agreement was cancelled and H--- and the lessor entered into a replacement agreement. These documents were attached as exhibits to the lease; however, they were not included in the copy sent to us. The lease was entered into on the same date as the cancellation and replacement contracts referred to above. Although not clearly specified in the lease, it appears that the lease is for the same 500 units covered by the original contract.

A contract designated as a lease which binds the lessee for a fixed term is regarded as a sale under a security agreement from its inception and not as a lease when the lessee is to obtain title at the end of the fixed term upon completion of the required payments or has the option to purchase the property for a nominal amount. (Rev. & Tax. Code § 6006.3, Reg. 1660(a).) The option price is regarded as nominal if it does not exceed $100.00 or one percent of the total contract price.

Article 10 of the lease agreement provides for option prices per unit in decreasing amounts from 1987 through 1995. If the lessee has not exercised the purchase option before the end of the lease term, Article 10 provides that the lessee “shall purchase all of the Equipment then remaining subject to this Lease for a purchase price of $1.00 per Unit....” As mentioned above, it appears that the agreement provides for the lease of 500 units. Unless units are
removed from the lease under Articles 7 or 8, there would be 500 units at the end of the lease since the early termination and purchase option provisions apply to all, but not less than all, of the equipment. In the absence of default or loss, the purchase price would be more than nominal since it would be $500.00. However, this provision is not an option. Rather, the provision requires the lessee to purchase the equipment at the end of the lease term.

If not for the inclusion of Article 9, we would conclude that this lease is a sale under a security agreement from its inception because the lessee is to obtain title at the end of the term upon completion of the required payments. Article 9, however, provides that the lessee may terminate the lease early as to all, but not less than all, of the equipment by making a payment and returning the leased equipment. Since the early termination payment is considerably less than the option price, we conclude that this provision is not merely a sham. Rather, we conclude that the early termination provision makes this agreement one which is not for a fixed term. Since the agreement is not for a fixed term, we consider it a true lease with respect to which the lessor had the usual election to pay tax on purchase price or collect use tax on rentals payable.

If you have further questions, feel free to write again.