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450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 322-2976
FAX (916) 323-3387

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November 10, 1994

Mr. D--- N---
F--- C--- Leasing
XXXX ---
XXXX --- Boulevard
---, -- XXXXX-XXXX

Re: F--- C--- Leasing Services Corp.
SS - XX-XXXXXX

This is in response to your letter dated August 15, 19XX regarding the application of tax to leases. You state that F--- C--- Leasing (FCL) is a lessor engaged in business in California which "elects to collect sales tax up front" for its leases.

You explain that in a typical FCL lease, the lessee has the choice at the end of the original lease term of either surrendering the equipment, purchasing the equipment for 10 percent of the purchase price, or continuing to lease the property under a lease extension option. You ask whether a lease extension creates a taxable transaction separate from the original lease. The answer to that question depends upon the characterization of the original transaction.

The lease of tangible personal property in California is a continuing sale subject to use tax measured by rentals payable unless the lessor leases the property in substantially the same form as acquired and has either paid California sales tax reimbursement or use tax to its vendor, or has made a timely election to pay use tax measured by purchase price. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, Reg. 1660.) When a lease is a taxable continuing sale, the lessor must collect the tax from the lessee and pay it to the state. (Rev. & Tax. Code § 6203, Reg. 1660(c)(1).)

If the lessee is to obtain title at the end of the lease term upon completion of the required payments or if the lessee has an option to purchase the property for a nominal amount (an amount not exceeding \$100 or 1 percent of the total contract price, whichever is the lesser amount), then the transaction is a sale at inception. (Reg. 1660(a)(2)(A).) Such a transaction is a sale under a security agreement that takes place when possession of the property is transferred to the "lessee." (Regs. 1641(b) & (c).) Sales or use tax would apply at that time, measured by the full contract price unless the retailer keeps adequate and complete records to show separately the sales price of the property, and the insurance, interest, finance, and carrying charges made in the contract. (Reg. 1641(a).) If such records are kept by the retailer, the insurance, interest, finance and carrying charges may be excluded from the computation of the tax.

You state that the purchase option is for a fixed price, which is 10 percent of the cost. Since the lessee obtains title to the property only if it elects to exercise the option to purchase, and since the option price is not nominal, the transaction is a lease and not a sale at inception.

We assume for purposes of this opinion that the equipment you lease is not mobile transportation equipment (MTE) and that you lease the equipment in substantially the same form as acquired. It appears you may be purchasing the property outside of California; however, it is our understanding that you purchase the property for lease in California. When you state that you collect tax, we assume you mean that you timely report and pay California tax up front on the purchase price. If such is the case, the leases are not continuing sales and no sales or use tax is due with respect to the rentals charged. (Reg. 1660(c)(2).)

If the lessee exercises the option to purchase the equipment for ten percent of the purchase price at the end of the lease term, that transaction will be a sale. Retail sales of tangible personal property in California are subject to sales tax, measured by gross receipts, unless specifically exempt by statute. (Rev. & Tax. Code § 6051.) A retail sale is a sale for any purpose other than resale in the regular course of business. (Rev. & Tax. Code § 6007.) Since the lessee presumably will not purchase the property for resale, the sale will be subject to sales tax measured by the total sales price, which in your example is the 10 percent option price.

If, instead of exercising an option to purchase, the lessee exercises an option to extend the lease (or renegotiates an extension), that transaction will be regarded as a taxable sale at inception if the lessee obtains title to the property at the end of the lease extension or has a nominal option to purchase the property. If the lease extension is a sale at inception, it is taxable at the time of the commencement of the "lease" extension measured by the full contract price except as explained above. If the lease extension is a true lease, the rentals are not taxable since the lease would not be a continuing sale, as discussed above.

Based on the facts and assumptions set forth herein (i.e., you make a timely election to pay tax or tax reimbursement measured by purchase price and you lease the property in

substantially the same form as acquired), your leases of the property will not be taxable continuing sales. Thus, when your transactions are true leases (as opposed to sales at inception), you cannot collect any amount designated as tax with respect to such leases. Any tax you collect in such a case constitutes excess tax reimbursement, which you must refund to the lessees from whom it was collected. (Reg. 1700(b)(1).) Any excess tax reimbursement amounts which you cannot refund to the lessees must be paid to the state. (Reg. 1700(b)(2).)

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

Sincerely,

Kelly W. Ching  
Staff Counsel

KWC:cl

cc: --- District Administrator