

Memorandum

330.2302

To: Mr. Dennis Fox (MIC:49)
Principal Tax Auditor

Date: April 8, 1994

From: Gary Jugum
Assistant Chief Counsel

Subject: Lease of Equipment with Optional Operator
(The P--- & C--- F---)

This is in response to your memo dated March 14, 1994 concerning a proposed lease of equipment with an optional operator by The P--- & C--- F--- (PCF).

PCF has submitted a sample contract under which it proposes to operate an on-site copy, fax and mail center on the premises of its customer as follows. PCF will purchase and pay tax or tax reimbursement on the purchase of copiers, fax machines and mailing meters. PCF will lease this equipment to the customer in the same form as acquired by PCF. PCF will provide all of the supplies used by the equipment.

At its option, the customer may supply the personnel to operate the equipment or may contract with PCF to supply the personnel to operate the equipment. If PCF personnel operate the equipment, PCF will provide a full-time manager, two full-time copy machine operators, one full-time fax machine operator/delivery person, and one full-time mail meter operator/mail receiving and delivery person. PCF will select, hire and train the personnel it provides.

The contract states that the customer, at its option, may choose to maintain the equipment itself or "direct" PCF to maintain the equipment. By "direct", we assume the contract means that the customer may choose to pay extra for maintenance.

The contract provides for "total monthly fees" of \$13,000, consisting of \$3,000 for a "monthly management fee" and \$10,000 for "monthly fees for allowance". The monthly management fee, according to PCF's November 1, 1993 letter to Senior Tax Auditor Tze-Ming Lau, is to provide management reports and counseling to the customer.

The monthly copy allowance is 150,000 copies. Although not stated, the \$13,000 monthly fees apparently include all rental charges for the equipment, all charges for supplies, and all charges for PCF supplied equipment operators, within the 150,000 copy per month allowance. For additional copies beyond the monthly allowance, there is a \$.022 per copy charge, which includes the cost of supplies. There is also an hourly rate charge for an additional operator if needed due to workload. The contract further provides that if the workload is beyond the capabilities of either machine or normal working hours, the customer may elect either to send the overflow copying work to PCF's off-site main plant at a per copy charge or to have PCF personnel work overtime on-site at a specified overtime rate.

Discussion

Within the context of the Sales and Use Tax Law, the contract is either (1) a contract for the sale of copies by PCF to the customer or (2) a contract of which the three primary components are the lease of equipment which the customer will use to make copies, the providing of personnel by PCF, and the sale of supplies. If the contract is deemed a sale of copies by PCF to the customer, all amounts paid under the contract are taxable as gross receipts from the sale of tangible personal property (the copies) with no deduction for the cost of the materials used, the labor or service cost, or any other expense. (Rev. & Tax Code § 6012.)

On the other hand, if there is a true lease of equipment in substantially the same form as acquired and PCF timely pays tax on the purchase price of the equipment, then the rentals payable from the lease are not taxable. (Rev. & Tax. Code § 6006(g)(5); Reg 1660(c)(2).) In a true lease situation, additional charges for things other than the equipment rental may or may not be taxable, as discussed later.

An issue of whether there is a true lease arises when property is furnished with an operator. There is not a true lease if it is mandatory that the operator come with the equipment. This is because there cannot be a true lease unless possession and control of the property has been transferred from one person to another. (Entremont v. Whitsell (1939) 13 Cal.2d 291.) If a person obtains for consideration temporary possession and control of property without an operator, the person has leased the property. However, when a person obtains property with an operator, the question arises whether possession and control actually has been transferred to that person.

The test we use to decide the question is whether the person could have obtained the property under the contract without the operator. If so, we regard the transaction as a lease with an optional operator. In effect, since the operator is optional, the operator is acting on behalf of the lessee. Thus, when the operator is optional, there is a lease of property along with services of the operator. When the operator is mandatory, the operator acts on behalf of the

owner and that owner is not regarded as transferring possession and control of the equipment to the customer. Since there is no transfer of possession and control, there is no true lease.

In PCF's sample contract, the customer is presented with an option to either supply its own personnel to operate the equipment or elect to have PCF personnel operate the equipment. We regard this contract as a true lease with an optional operator provision.

Since it is a true lease, and tax on the equipment is paid by PCF at the time of purchase with the equipment then leased in substantially the same form as acquired, the rentals payable from the lease are not taxable. Likewise, charges attributable to the optional equipment operators are not taxable rentals payable. Nonetheless, the charges for the equipment operators may be taxable for another reason. This is because an additional question arises here of whether the operators of the copy machines are performing fabrication of tangible personal property. If so, charges by PCF for their employees' fabrication labor are taxable as a sale, unless the transaction falls within what is known as the loaned employee rule, as discussed below.

Under the Sales and Use Tax Law, if someone produces, fabricates, or prints tangible personal property for consideration for a customer who furnishes the materials, that producing, fabricating, or printing is a sale. (Rev. & Tax Code § 6006(b).) Making photocopies for consideration out of materials furnished by a consumer is fabrication, and, therefore, is a sale. Reg. 1528(a)(1).) It is a taxable sale at retail. (Rev. & Tax Code §§ 6007, 6051.) However, because a person cannot make a taxable sale to itself, it is important to determine whether PCF or the customer performs the fabrication. Fabrication for oneself is not a taxable sale.

Under the contract, PCF sells the supplies used in making the photocopies to the customer. This is a taxable sale of tangible personal property to the customer. The customer becomes the owner of the supplies. Under PCF's sample contract, the basic copying service is performed at the customer's site using equipment leased by the customer. Since it is a true lease, for the purposes of this analysis the equipment is regarded as provided by the customer. Although the customer supplies the equipment and materials, the photocopying by PCF personnel is fabrication using materials furnished by the customer, and is regarded as a taxable sale unless it falls within the specific guidelines set forth below. (I note that the persons who operate the facsimile and mail meter equipment and who make deliveries are not regarded as performing fabrication. The charges for their optional services are not taxable. (See BTLG Ann. 515.0010; Reg. 1504(b).))

As noted above, a person's fabrication of property for its own use does not constitute a sale. Thus, if a company purchases paper and other supplies and makes photocopies for its own use, sales or use tax applies to the purchase of the supplies, but not to the value of its own employees' fabrication labor in creating the photocopies.

We have adopted a rule, called the loaned employee rule, which recognizes that one company may "loan" employees to another. In essence, we treat the loaned employee as an employee of the "borrower" company. In order to qualify for treatment as a loaned employee, the loaned employee must be an employee of the "lender", the borrower/customer must provide

the tools or equipment used, the raw materials and the premises at which the work is done, and the charge must be at an hourly rate. In addition, the customer must have other persons who clearly are employees performing similar work or the customer must employ persons who are capable of giving meaningful direction to the loaned employees beyond describing only the result desired. Also, the customer, not the lender, must supervise the loaned employees.

Under the sample contract, PCF's customer does provide the equipment and raw materials since it is leasing the equipment and purchasing the supplies. We also assume for the purposes of this opinion that the customer with which PCF contracts supervises the equipment operators and in reality has the capability of supervising how the work is done beyond just stating the result desired. The contract, however, must also specify an hourly rate charged for the loaned employee in order to fall within the loaned employee rule. The sample contract contains no hourly charges attributable to equipment operator labor. Therefore, as currently written, the sample contract does not meet the loaned employee rule and charges attributable to fabrication labor are taxable. Similarly, the overtime charges also do not meet the hourly requirement of the loaned employee rule. Although specified at an hourly rate, these charges are not solely for the services of the personnel, but rather cover "all the cost of copying and duplicating, machine operators, maintenance and repairs."

In conclusion, our review of the sample contract indicates that it is a true lease of equipment. Because PCF timely elects to pay tax on the purchase price of the equipment and leases it in substantially the same form as acquired, no tax is due on the portion of the contract charges attributable to rentals payable from the lease. Because the supplies sold by PCF to the customer are taxable retail sales, the portion of the contract charges attributable to those sales is taxable. Because the fabrication labor provided by PCF personnel who operate the copy machines does not fall within the loaned employee rule, as the contract is currently written, the portion of the contract charges attributable to that labor is taxable. The portion of the contract charges attributable to the labor provided by PCF personnel who operate the facsimile and mail meter machines and who make deliveries is not taxable because the charges are for nontaxable services, as are any added charges for optional maintenance services.

In regards to the "monthly management fee", it is part of an integrated contract for the lease of equipment, the sale of supplies, fabrication labor, and services. As discussed above, some of those components of the contract are taxable. Tax applies to the gross receipts from transactions regarded as sales of tangible personal property without any deduction for the work, labor, skill, thought, time spent or other expense of producing the property. (Rev. & Tax. Code § 6012.) Therefore, any portions of the management fee attributable to the sale of supplies by PCF to the customer and to the fabrication labor provided by PCF personnel are taxable.

GJJ/SJ:es

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