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April 16, 1997

Ms. C--- B---
Financial Accountant
F--- P--- Company
P.O. Box XXXXX
---, WA XXXXX-XXXX

Re: *Default and "Transfer" of a Conditional Sales Contract*
F--- P--- Company
SC -- XX-XXXXXX

Dear Ms. B---:

This is in response to your letter of February 26, 1997 in which you inquired about the tax consequences of the assumption of a lease set up as a conditional sales contract.

You briefly describe your situation, which takes place in California, as follows:

"A restaurant owner sells his restaurant and the new owner decides to lease some freezers from [your company, F--- P--- Company]. This lease is set up as a conditional sales contract, where ownership of the equipment transfers to the lessee upon payment of \$1. At inception, sales tax is paid on the equipment cost.

"The original owner later decides to buy the restaurant back and assumes the lease. The lease is rewritten to reflect the change in ownership and lower equipment cost due to use."

You make the following inquiries:

"F--- P--- holds title to the equipment until the end of the lease-as owners of the equipment, would we pay sales tax only once?"

"Would F--- P--- take a sales tax refund upon the disposition of the old lease, then recompute sales tax and pay on the assumed equipment cost?"

When I spoke with you on Monday, April 7, 1997, you indicated that the file regarding these transactions was not readily available. However, you stated that is your recollection that the person who originally acquired the freezer defaulted under the original contract and that the second contract with the original owner of the restaurant was drafted under the same terms with the provision that upon termination of the lease period, ownership to the equipment would transfer to the "lessee" upon the payment of \$1.00.

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) A sale includes any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. (Rev. & Tax. Code § 6006(a).) When sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for the storage, use or other consumption in California. (Rev. & Tax. Code § 6201.)

A lease of tangible personal property in California is a continuing sale and purchase unless the lessor leases it in substantially the same form as acquired and has made a timely election to pay California sales tax reimbursement or use tax measured by the lessor's purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, 6010(e)(5), 6010.1, Reg. 1660(c)(2).) When the lease is a continuing sale and purchase because either or both of the foregoing conditions are not satisfied, the lease is subject to use tax measured by rentals payable. (Reg. 1660(c)(1).) However, although classified as a lease, a transaction may be considered to be a sale under a security agreement (outright sale) or sale at the inception under Regulation 1660(a)(2)(A). This subdivision explains that a contract designated as a lease is treated as a sale under a security agreement:

"Where a contract designated as a lease binds the 'lessee' for a fixed term and the 'lessee' is to obtain title at the end of the term upon completion of the required payments or has the option to purchase the property for a nominal amount, the contract will be regarded as a sales under a security agreement from its inception and not as a lease. The option price will be regarded as nominal if it does not exceed \$100 or 1 percent of the total contract price, whichever is the lesser amount."

We understand your statement that "ownership of the equipment transfers to the lessee upon payment of \$1" to mean that F--- P--- (F--- P---) will transfer the freezer to the lessee at the end of the contract period for \$1.00. We assume that this \$1.00 amount does not exceed 1 percent of the total contract price. F--- P---'s contract, under these facts, is not a true lease but is a sale under a security agreement. That is, F--- P--- is required to report and pay tax on the full contract price in the quarter in which the sale takes place, as set forth in Regulation 1641, a copy of which is enclosed. You state that the sales tax was paid, at inception, on the cost of the freezer. Since this transaction is considered to be a sale at inception, sales tax should have been paid on the purchase price or full contract price of the freezer. If sales tax was paid on the

contracted purchase price, in accordance with Regulation 1641, then F--- P--- has met its sales tax obligations with regards to its contract with the original purchaser.

Since F--- P--- reacquired the freezer for resale to the original owner of the restaurant, no tax is due on this aspect of the transaction. However, you are not entitled to a deduction for the sales tax paid on the original sale by virtue of Regulation 1655 (a). This regulation provides that gross receipts do not include amounts charged for merchandise returned by a customer **if** the full price, including the portion designated as sales tax, is refunded in either cash or credit provided the purchaser is not required to purchase merchandise at a price greater than that charged for the returned merchandise as a condition of receiving the refund or credit. Thus, unless F--- P--- establishes that the full purchase price was returned to the original purchaser, F--- P--- is not entitled to a deduction with respect to the sale to the original purchaser. However, you may be entitled to a bad debt deduction for the amount owed under the contract with the original purchaser. Regulation 1642(a), copy enclosed, explains the general rule that a retailer is entitled to relief from sales tax liability attributable to accounts which are found to be worthless and which have been treated as a bad debt deduction for income tax purposes. Thus, if F--- P--- has taken a bad debt deduction attributable to the amounts owed by the original purchaser on its income tax return it is entitled to a bad debt deduction on its sales and use tax return. Regulation 1642(f) explains the information required and the manner for computing bad debt deductions attributable to repossessed merchandise.

You indicate that it is your recollection that the subsequent contact with the original restaurant owner was drafted under the same terms as the contract with the original purchaser with the provision that upon termination of the lease ownership would transfer to the lessee upon the payment of \$1.00. We assume this is the case, accordingly, as explained above, the subsequent contract with the original restaurant owner will also be considered to be a sale at the inception and sales tax will also apply based upon the purchase price or full contact price negotiated for the freezer.

If you have any further questions please feel free to contact this office again.

Sincerely,

Patricia Hart Jorgensen
Senior Tax Counsel

PHJ:cl

Enclosures (Regulations 1641 & 1642)

cc: Out-of-State District Administrator