STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 445-3723
FAX: (916) 323-3387

November 29, 1995

Mr. M--- P. D---
S--- T---, Inc.
XXXX --- Road, Suite XXX
--- ---, California XXXXX

Re: Account No. SR --- XX-XXXXXX

Dear Mr. D---:

This is in response to your November 7, 1995 letter to Mr. Travis Fullwood regarding the application of tax to various leasing arrangements involving S--- T---, Inc. ("STI") and S--- Ltd. ("SL").

You state:

> "[STI], a California Corporation organized July 1993, is an affiliate of [SL], a company located in the United Kingdom. They are affiliated in that both companies have the same owners. Both company's business is manufacturing and sale of memory devices. [SL] is interested in transferring production capability to [STI] which requires substantial capital equipment. [SL] leased test equipment in August of 1994 and continues to lease additional equipment as volume increases. The lessor is a German leasing company which allows for the transfer of equipment to the US after being delivered and used in the UK. The initial transfer of equipment from [SL] to [STI] is scheduled to take place in January 1996. Additional equipment will be transferred as the production process and capacity in the US increases."

You ask a series of questions based on the above facts. For purposes of this opinion, we assume that any leasing agreements between SL and STI are at arms length and would not be disregarded for purposes of the California Sales and Use Tax Law since SL and STI are related parties. (See e.g., Business Taxes Law Guide Annots. 330.1875 (7/8/92), 330.2800 (8/14/69).) Our responses to each of your questions are set forth below.

> "Situation #1:
>
> > "[SL] transfers existing leased equipment to [STI]. [STI] would make lease payments to [SL] equivalent to the lease payments required by the German leasing company. Is this a taxable transaction? Does the time period of ownership and possession of the equipment prior to transfer effect taxability? If so, how? Our understanding is that if [SL] possesses and used the equipment for a minimum of 90 days then any subsequent transfer and lease is non-taxable. Is this true?"

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).[1]) 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).) The lessee owes the tax and the lessor is required to collect it from the lessee and pay it to this Board. (Rev. & Tax. Code §§ 6202, 6203, 6204, Reg. 1660(c).) Similarly, a sublease of tangible personal property is a continuing sale and purchase subject to use tax on the rentals payable from the sublease unless the subleased property is leased in substantially the same form as acquired and the prime lessor paid California sales tax reimbursement or use tax measured by the purchase price of the property, or California use tax is paid on the rental receipts derived under the prime lease or any prior sublease. (Reg. 1660(c)(5).)

SL leases the test equipment from a German leasing company which allows for the transfer of this equipment to the United States after its use in the United Kingdom. SL proposes to sublease this equipment to STI in California for an amount equivalent to the amount of the lease payments SL is required to pay to the German lessor. We assume that the German leasing company did not pay California sales or use tax with respect to the leased property. We further assume that SL does not pay California use tax measured by the rentals payable from its lease with the leasing company. Under these facts, SL's sublease of the equipment to STI will be regarded as a continuing sale and purchase since the German lessor did not pay California tax or tax reimbursement on its purchase price of the property and SL does not pay California use tax measured by the rental receipts it pays to the leasing company. This means that SL's sublease of the property to STI will be subject to tax measured by STI's rental receipts. STI owes the tax and SL is required to collect this tax and pay it to this Board.

[1] A copy of Regulation 1660 is enclosed for your review.

You also ask whether the length of SL's possession and use of the equipment outside this state affects the application of tax on the rental receipts paid by STI. As set forth above, a lease of tangible personal property is subject to tax measured by rentals payable unless the lessor leases the property 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 purchase price of the property. That is, when a lessor pays tax up front to avoid having to collect tax on rentals payable, the lessor is electing to be a consumer (and not a retailer) of the property. This means that if the lessor's *own* use of the property in California would be subject to use tax, it may elect to pay tax on purchase price and no further tax would be due with respect to its use of the property by leasing it to a third party. On the other hand, if the lessor may itself use the property in this state without incurring a use tax liability, that lessor has no potential use tax liability with respect to which it can report tax measured by purchase price. Such a lessor may not elect to exclude its leases from the definition of a continuing sale and purchase by paying use tax measured by purchase price without specific statutory authority to do so. (Cf. Rev. & Tax. Code § 6094.1.)

Here, the lessor's own use of the property inside this state would be taxable only if the lessor purchased the property for use in California. Property purchased outside this state from a retailer is regarded as purchased for use in California if the property is first functionally used inside this state or if the property is brought into California within 90 days of its purchase (exclusive of any time of shipment to California, or time of storage for shipment to California). (Reg. 1620(b)(3).) Thus, a lessor who purchases property outside this state may elect to pay California use tax on the purchase price of the property only if the property is first functionally used inside this state or is brought into California with 90 days of its purchase. A lessor has no election to pay California use tax on property purchased outside this state where the property is first functionally used outside California and is not brought into this state within 90 days of its purchase.

Under the facts of your letter, California tax will be due on the use of the equipment inside this state. The relevance of the equipment's use outside California pertains only to whether the lessor has an election to pay California use tax measured by purchase price or if instead the rentals payable are subject to tax. As set forth above, we assume that the German lessor did not pay California sales tax reimbursement on the equipment leased to SL. We further assume that the equipment was first functionally used outside this state and that it was not brought into California within 90 days of its purchase. As such, the German lessor has no option to elect to pay California use tax on the equipment which will ultimately be subleased to STI. This means that tax applies to STI's rentals receipts with respect to the leased property regardless of the time SL may (or may not) have possessed this property outside this state.

> "Situation #2:
>
> "[STI] leases new assets directly from a European Lessor. Is this a taxable transaction? If so how is the liability determined and what is the timing of payment of tax?"

Tax applies to STI's rental receipts unless the European lessor leases the assets in substantially the same form as acquired and has made a timely election to pay California sales tax reimbursement or use tax measured by its purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, 6010(e)(5), 6010.1, Reg. 1660(c)(2).) Rental receipts subject to tax include

any payments required by the lease including amounts paid for personal property taxes (if any) on the leased property. (Reg. 1660(c)(1).) If tax applies to STI's lease payments, the European lessor must collect the tax at the time rentals are paid by STI and pay it to this Board. (Rev. & Tax. Code §§ 6202, 6203, 6204; Reg. 1660(c).)

We hope this answers your questions. If you have any further questions, please write again.

Sincerely,

Gary J. Jugum
Assistant Chief Counsel

GJJ:WLA:rz

Enclosure – Reg. 1660

cc: Mr. Travis S. Fullwood, MIC:77
San Diego District Administrator – (FH)

bcc: Mr. Glenn Bystrom, MIC: 43