

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

330.2670

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition)
for Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)
)
S---, INC.) No. SR CH XX XXXXXX-010
)
Petitioner)

The Appeals conference in the above-referenced matter was held by Senior Staff Counsel H. L. Cohen on April 5, 1994 in Oakland, California.

Appearing for Petitioner:

Mr. R. K---
Director of Tax Compliance

Ms. G. M---
Sales Tax Manager

Mr. R. D---
Senior Vice President
State Tax & Audit Review
Services

Appearing for the
Sales and Use Tax Department:

Mr. O. D. Millette
District Principal Auditor
Oakland District

Mr. R. Roos
Senior Tax Auditor
Oakland District

Mr. A. Shkidt
Senior Tax Auditor
Oakland District

Protested Item

The protested tax liability for the period July 1, 1989 through June 30, 1992 is measured by:

<u>Item</u>	<u>State, Local and County</u>
Unreported taxable rental receipts	\$175,181

Contention

Petitioner contends that tax should be based on the cost of the rented property rather than on rental payments.

Summary

Petitioner is a corporation which operates a chain of grocery stores through wholly owned subsidiary corporations. This seller's permit is for the administrative offices of the chain. The cafeteria makes retail sales. In addition, petitioner purchases equipment for use in California from out-of-state vendors. This equipment is subject to use tax. The last prior audit is for the period through December 31, 1990. The liability protested herein was asserted by way of a Field Billing Order.

The audit staff audited several of petitioner's subsidiaries and noted that the subsidiaries had purchased items of equipment ex-tax and had transferred them to petitioner ex-tax. In some cases, petitioner had made the payment for the equipment directly to the vendor. These transactions are noted in the records of both the subsidiaries and petitioner. After the book transfers of the equipment to petitioner, petitioner made periodic book charges to the subsidiaries. The charges were based on the cost of the equipment plus seven percent divided by the estimated life of the equipment. The auditor concluded that petitioner was leasing ex-tax equipment to its subsidiaries and asserted tax against petitioner based on the lease receipts.

Petitioner contends that the subsidiaries own the equipment at all times. The transactions listed in the books of petitioner and the subsidiaries are primarily for tracking costs. The subsidiaries always issue the purchase orders and take delivery of the equipment. The subsidiaries either pay for the equipment themselves or petitioner pays for the equipment. However, the internal paperwork does not differentiate on the basis of the source of the payment. The vendors are not aware of which corporation is the payor because the purchase orders and checks are in the name of S--- Corporation regardless of which corporate account upon which the checks are drawn. In the past, petitioner's charges to the subsidiaries were labeled "rent", but petitioner contends that the charges were really depreciation charges. The subsidiaries never parted with possession or control of the equipment until the equipment was no longer needed by the particular subsidiary.

Petitioner also contends that the total charge is comprised of the cost of the equipment, the transportation cost, and the installation cost. Petitioner contends that at most, only the charge

for the equipment is subject to tax. Petitioner also contends that the seven percent additional charge is really an internal financing charge to cover the use of capital and the cost of maintaining the records. Petitioner contends that this charge should not be subject to tax in any event.

Petitioner points out that the application of tax to the purchases of some of the equipment is barred by the statute of limitations. Nevertheless, the auditor applied tax to the rental receipts.

Analysis and Conclusions

Section 6051 of the Revenue and Taxation Code imposes the sales tax on retailers based on gross receipts from the retail sale in this state of tangible personal property. Section 6201 imposes the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from a retailer for the purpose of such storage, use, or other consumption in this state. Section 6401 provides that use tax does not apply to the use of tangible personal property, the sale of which is subject to the sales tax, with the exception that the use tax rather than the sales tax applies to rentals.

If petitioner's subsidiaries are not regarded as selling the equipment in question to petitioner, then the subsidiaries would be regarded as having purchased the equipment from out-of-state vendors for the purpose of using it in California. That use would be taxable to the subsidiaries based on the purchase price of the equipment. If the subsidiaries are regarded as selling the equipment to petitioner and leasing it back, the subsidiaries' purchases would be purchases for resale and the subsidiaries would not be liable for the use tax. Inasmuch as leases of ex-tax property are regarded as continuing sales and purchases (see subdivision (g)(5) of Revenue and Taxation Code Section 6006 and subdivision (g)(5) of Section 6010), the subsidiaries' sales to petitioner would be regarded as sales for resale and would not be subject to sales tax. Petitioner at that point would have had the option of reporting and paying tax on cost or on rental receipts. An election to pay tax on cost would have had to have been made with the tax return for the period in which the equipment was first placed in rental service. See subdivision (c)(2) of Sales and Use Tax Regulation 1660. The tax on rental receipts would be a use tax on the subsidiaries' use of the property. However, petitioner would be required to collect the tax and would be liable to the Board for the amount of tax which it should have collected. See Sections 6203 and 6204. It would be immaterial that any failure to pay tax based on cost timely was due to inadvertence. See Action Trailer Sales, Inc. v. State Board of Equalization (1975) 54 Cal.App.3d 125.

I note that because the subsidiaries are wholly owned by petitioner the purchase of the equipment could have been cast in any form desired by petitioner. The transactions could have been cast clearly as financing transactions with title remaining in the subsidiaries or as sales and leasebacks and the tax consequences properly flow from the form in which the transactions were cast. The transactions actually were cast in the form of sales and leasebacks and should be so

treated for sales and use tax purposes. See Simplicity Pattern Co., Inc. v. State Board of Equalization (1980) 27 Cal.3d 900. Petitioner could have self-reported tax on cost at the time of acquisition and so avoided liability for collecting tax on rental receipts. Petitioner failed to exercise this option timely. Tax is thus due on rental receipts.

Section 6012 provides that gross receipts, which is the amount subject to sales tax, does not include installation charges and under specified conditions, does not include transportation charges. Section 6011 provides that sales price, which is the amount subject to use tax, does not include these amounts either. These exclusions would apply if petitioner were paying tax on the acquisition cost. They do not apply to tax on rental receipts.

Tax does not apply to finance charges on installment sales. See subdivision (a) of Regulation 1641. Under certain circumstances, transactions labeled as leases are treated as installment sales for sales and use tax purposes. See subdivision (a)(2)(A) of Regulation 1660. In order for a transaction labeled as a lease to be regarded as an installment sale, the lessee must have the right to obtain title to the property at the end of the lease period for a nominal amount. Here, there is no lease document in evidence. There is thus no specified right of the lessee to obtain title at the end of the lease period. Since the transactions are not regarded as installment sales, there are no finance charges.

While it is true that some of the items of equipment were purchased and the leases initiated prior to the beginning of the audit period, that has no bearing on the application of tax to rental payments. If tax is due on rental payments, the statute of limitations bars application of tax only as to those rental payments which are made prior to the limitation period.

Recommendation

Deny the petition.

H. L. Cohen, Senior Staff Counsel

Date