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August 22, 1994

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Mr. R--- D. U---
B---, P--- & H---
Attorneys at Law
--- Street ---
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--- ---, CA XXXXX

Dear Mr. U---:

This is in reply to your June 29, 1994 letter regarding the application of sales tax to charges to W--- F--- for merchant card readers. You described the following facts:

"W--- F--- acquired 10,000 merchant card reader terminals from V--- in a noncancellable lease officially entered into on January 30, 1993. Merchant card reader terminals link a merchant to a central computer for immediate computer authorization of a customer's credit card purchase.

"W--- F--- and V--- structured the original lease as a true lease, and calculated the principle (sic), interest and tax ramifications accordingly. The original lease required W--- F--- to make 36 monthly payments of \$62,243.75. Of this amount, \$57,500 per month represented principle (sic) and interest payments for the terminals (based on a 4.77533% annual rate of return). \$4,743.75 per month represented use tax on the lease payments computed at an 8.25% tax rate.

"W--- F--- signed the original lease on November 19, 1992. V--- signed the lease on January 30, 1993. After the terms of the original lease were set (including the tax treatment), W--- F--- and V--- apparently agreed to amend the lease to include a bargain purchase option - V--- agreed that W--- F--- could purchase all 10,000 machines at the end of the lease for \$1. At approximately the same time, W--- F-- - and V--- agreed to another change in the original lease terms, which would

allow W--- F--- to transfer ownership of the terminals to merchants prior to the termination of the original lease

"On November 1, 1993, W--- F--- reached an agreement with an unrelated company, C--- E--- S--- ("CES"), to transfer ownership of the 10,000 terminals to CES. Under the agreement, CES subleased the 10,000 terminals from W--- F--- under the exact same terms as W--- F---'s main lease with V---. As of the sublease date, W--- F--- had utilized the terminals acquired from V--- in a variety of ways ... :

- 4,345 terminals were still held in inventory awaiting future lease to merchants;
- 15 terminals were permanently lost with no records of what happened to them;
- 2,699 terminals were sold to merchants for \$225 each from March 1993 through October 1993;
- 1,081 terminal were given away, mostly to W--- F---'s branches for cash-advance services. The remainder were simply given away to merchants because of the competitive nature of the business;
- 1,683 were leased to merchants at monthly rents of either \$7.99 or \$12.35 per month;
- 10 terminals were leased rent free to select merchants (again due to the competitive nature of the business); and
- 167 terminals remained in W--- F---'s repair pool as a resource to allow for immediate replacement of broken terminals and for parts when terminals needed repair. In general, broken terminals were either returned to the repair pool or placed in inventory for future lease.

"For sales and tax purposes, W--- F--- and V--- treated the master lease transaction as a true lease, with V--- collecting use tax on the rental payments received from W--- F---. Consistent with this treatment, W--- F--- opted to not collect taxes from merchants when W--- F--- subleased the terminals to merchants. Thus, the tax treatment for the master lease and the subleases was set prior to the transaction with CES."

Given this information, you asked for the correct application of sales and use tax to the transaction.

TRANSFER TO W--- F---

Since the contract for the lease of the terminals by V--- to W--- F---, as amended, bound W--- F--- to the lease for 36 months and provided W--- F--- an option to purchase the equipment for \$1, we consider this contract to be a sale under a security agreement from inception and not a true lease. (Sales and Use Tax Reg. 1660, Leases of Tangible Personal Property - In General, subd. (a)(2)(A).) We note that the retailer, V--- F---, is located in O---. Assuming there was no participation in the transaction by any local branch, office, outlet, or other place of business of V---, the applicable tax to the transaction is the use tax on W--- F---'s use of the terminals in this state. Since W--- F--- did not timely provide a resale certificate to V---, V---'s sale to W--- F--- is a retail sale, unless W--- F--- either has resold the property without an intervening use of the property. Under the facts you provided, W--- F--- is holding 4,345 terminals in resale inventory, has sold 2,699 terminals to merchants, and has leased 1,683 terminals to merchants for a monthly rent. Assuming W--- F--- has not made an intervening use of those terminals, such as by providing them "rent free" to merchants, the sale of those terminals to W--- F--- is a nontaxable sale for resale. V---'s sale of the remaining 1,273 terminals is a retail sale.

Based on the terms of the contract between W--- F--- and V---, W--- F--- was obligated to make 36 payments of \$57,500 for a total of \$2,070,000. Since that amount was paid for 10,000 terminals, it appears V--- sold each terminal for \$207. Unless V--- has kept adequate and complete records to show separately a lower charge for a sales price of the terminals and charges for insurance, interest, and finance charges, the \$207 is the taxable sales price. (See Sales and Use Tax Regulation 1641, Credit Sales and Repossessions.)

TRANSFER BY W--- F---

Sales tax applies to W--- F---'s retail sale of the 2,699 terminals to merchants. Use tax applies to W--- F---'s lease of the 1,683 terminals to merchants; that is, W--- F--- is required to collect use tax on the rental receipts for the lease of those terminals.

Although you note W--- F--- transferred ownership of 10,000 terminals to CES, by the time of the sale to CES, W--- F--- had disposed of, or lost, a total of 3,795 terminals. We assume that, if CES contracted to pay the same amount to W--- F--- that W--- F--- had agreed to pay to V---, then W--- F--- sold to CES a total of 6,205 terminals for \$2,070,000, and the sale price was \$333.60 for each terminal.

We believe the following is the application of tax to W--- F---'s sale to CES of the 6,205 terminals. The sale of the 1,683 which are leased to merchants is a sale for resale. CES does not have the option to pay sales tax reimbursement to W--- F--- and consider the leases as nontaxable. Sales and Use Tax Regulation 1660, Leases of Tangible Personal Property - In General, provides at subdivision (c)(9)(A), that, when an existing lease that is a "sale" and "purchase" is assigned, the rental payments remain subject to tax, without any option to measure tax by the purchase price. CES must continue to collect use tax from the lessees measured by rentals payable and remit that tax to the Board.

CES may elect to pay sales tax reimbursement to W--- F--- on the sale of the 4,345 terminals in W--- F---'s inventory. CES may then lease those terminals ex-tax. The sale of the 167 terminals committed to the repair pool is a retail sale subject to sales tax. Also, the sale of the 10 terminals loaned at no charge to the merchants is a retail sale if CES will continue to provide them to the merchants at no charge.

We hope this answers your questions; however, if you need further information, feel free to write again.

Very truly yours,

Ronald L. Dick
Senior Tax Counsel

RLD:plh

cc: --- --- District Administrator - --