STATE OF CALIFORNIA

330.3012

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
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June 28, 1994

Mr. R--- F. D---
W--- & S---
XX West --- Drive
---, IL XXXXX-XXXX

Re: I--- H--- Systems
SC --- XX-XXXXXX

Dear Mr. D---:

This is in response to your letters dated March 1, 1994 and May 12, 1994 regarding a transaction structured as a lease between I--- and the --- of --- --- (B). You ask whether the Board regards the agreement as a true lease or instead as a sale under a security agreement.

The agreement provides that I--- (called contractor in the agreement) will provide to each of B's six hospitals (each a "site" for purposes of the agreement) a health financial information system (HFIS), a clinicals information system (clinicals), a laboratory information system (labs), and related computer hardware and services. Following are some of the relevant provisions of the agreement.

"Live" is defined to be successful completion of acceptance testing and "live date" is the date on which that item goes live at the site in question.

B begins making monthly payments for HFIS and clinicals for each site on the date that the HFIS for such site goes live. B begins making monthly payments for labs on the date that the primary laboratory software for such site goes live. (§ 4.1.3.)

I--- is required to have HFIS and clinicals go live at each site in accordance with scheduled completion times. (§ 4.2.1.) If within 30 days after the last scheduled live date the item(s) for any site fails to go live and if that failure to go live is the responsibility of I---, B can suspend payments, but when it does go live, all such suspended payments are added to the scheduled payment due immediately after going live. There are other remedies provided under certain circumstances for certain sites. (§ 4.2.2.)

If, prior to going live, I--- fails to allocate sufficient resources, as defined, I--- is deemed to have abandoned the agreement and B can terminate and seek specified damages. (§ 4.2.3.)

I--- is required to have labs go live at each site in accordance with scheduled completion times. (§ 4.3.) For any site that labs fail to go live within 30 days after last scheduled live date, B can suspend payments provided the failure to go live is the responsibility of I---, but when it does go live, all such suspended payments are added to the scheduled payment due immediately after going live. There are other remedies provided under certain circumstances for certain sites. (§ 4.3.1.)

Within 30 days after the date on which acceptance testing at a site commences, B must issue to I--- either a Notice of Acceptance or a Notice of Rejection which indicates a failure in the testing or other non-compliance of the tendered system or lab products. If B does neither, it is deemed to have accepted. (§ 7.2.1.)

B is obligated to pay scheduled amounts called lease payments. B's obligation to make these payments is absolute and unconditional except as provided in sections 7.4, 7.5, 7.23, and 7.24. (§ 7.3.)

For any site that the HFIS, clinicals, or labs fail to go live within 30 days after last scheduled live date, if that failure to go live is the responsibility of I---, B can suspend lease payments for that item(s), but when it does go live, all such suspended lease payments are added to the scheduled lease payment due immediately after going live. (§ 7.4.)

When B is considered to be without the substantial use of any items at a site and B so notifies I---, the lease payments are abated for the portion of the project at the site in question that is unavailable to B. The period of the payment abatement continues for such period that B is without substantial use and ends when B regains such use. The period during which lease payments are due from B with respect to those components covered by the abatement is extended for a period equal to the period of the abatement (that is, the same amount of payments are required), but in no event is the period during which lease payments are due extended beyond June 10, 1998. (§ 7.5.)

Once all required payments are made, B will take title to the property provided by I--- under the agreement. If the agreement is terminated other that for breach by I--- or B, B will

also take title to the property provided by I--- under the agreement upon payment of a required concluding payment and all other amounts due. (§ 7.6.)

Once B accepts an item, it assumes all risk of loss of, or damage to, such item. (§ 7.13.)

B may buy out the contract on certain dates ("purchase option"). (§7.15.)

B can terminate the agreement for convenience when it deems such action to be in its best interest. (§ 7.22.) "However, this termination right would essentially require [B] to pay off the remaining cost of acquiring the Project." (Letter dated March 1, 1994.)

B is not obligated to make lease payments unless its Board of Supervisors appropriates funds for the agreement in B's budget. However, B covenants that it will include in its annual budget, and will appropriate, sufficient funds to pay all amounts due under the agreement. (§ 7.23.)

If funds are not appropriated for the agreement, the agreement terminates at the end of the last fiscal period for which funds were appropriated. (§ 7.24.)

Between the date the first site goes live and ending on the date that the last site goes live, if I--- fails to provide certain services or fails to correct certain deficiencies as required by warranty provisions, B has certain specified remedies based on the period of continuing default. If the default continues for 180 days or more, B may (but is not required to) terminate the agreement. (§ 29.1.)

As relevant here, these provisions can be summarized as follows. The property for each site is accepted or rejected without regard to the acceptance or rejection of the property provided for any other site. B can terminate the agreement under certain circumstances if I--- breaches the contract by failing to provide certain services or defaults in its warranty obligations. The agreement can also be terminated if B fails to appropriate the funds to make the required payments. Otherwise, after B makes all required payments, it will own all property provided under the agreement.[1/] If there is a basis for delaying certain payments (e.g., for unavailability), those payments must still be made at a later time.

[1/]In your March 1, 1994 letter, you indicate that title to the software does not pass to BA, but rather B is granted a perpetual license to use the software. For sales and use tax purposes, under such circumstances, the software is sold to B. That is, title to the tangible personal property in question (storage media on which the software was transferred) is passed to the purchaser, and the tax is imposed on the sale of that property.

Discussion

Leases of tangible personal property in California are continuing sales subject to use tax measured by rentals payable unless the property is leased in substantially the same form as acquired and the lessor makes a timely payment of tax or tax reimbursement measured by purchase price. (Rev. & Tax. Code §§ 6006(g)(5), 6010.1, Reg. 1660.) I assume that I--- did not (or will not) pay tax or tax reimbursement to its vendor of property or timely report and pay tax measured by purchase price on its sales and use tax return. Thus, with respect to any property regarded as leased under the agreement, the lease is a taxable continuing sale, and I--- would be required to collect use tax measured by rentals payable from B and pay that tax to the Board.[2/]

If, however, the agreement is regarded as a sale under a security agreement, and not a lease, then I--- must remit tax to the Board measured by its selling price to B with its return for the reporting period in which the sale occurs. (Reg. 1641(c).) The taxable measure of such a sale is the full amount of the contract unless the retailer keeps adequate and complete records to show separately the sales price of the property from the interest and carrying charges. If it does so, it may exclude the interest and carrying charges from the measure of tax. (Reg. 1641(a).)

A contract characterized as a lease is treated as a sale under a security agreement, and not as a lease, when it 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 the lessee has the option at the end of the lease term to purchase the property for a nominal amount. (Rev. & Tax. Code § 6006.3.) An option price is regarded as nominal if it does not exceed $100 or 1 percent of the total contract price, whichever is less. (Reg. 1660(a)(2)(A).)

As you know, governmental bodies often enter into contracts designated as leases under which the governmental body has a right to terminate the contract if sufficient funds are not appropriated to pay the amounts due under the contract. In 1986, the Legislature considered the implications of such provisions, and adopted an amendment to Revenue and Taxation Code section 6006.3 which provides that a lessee will be treated as bound for a fixed term within the meaning of section 6006.3 notwithstanding such a right to terminate for failure to appropriate. Thus, when a contract characterized as a lease has such a provision, and the lessee is otherwise bound for a fixed term and will acquire title at the end of the term upon completion of the required payments, the transaction is taxable as a sale under a security agreement. (Reg. 1660(a)(2)(B).)

In a contract characterized as a lease that involves the providing of more than one piece of property, the vendor may be regarded as selling some items under section 6006.3 and leasing

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[2/] In addition, if any property is provided that is not in substantially the same form as acquired by I---, any true lease of such property would be a taxable continuing sale regardless of any payment of tax measured by purchase price.

others. That is, just because a person is regarded as selling one item it provides under a contract such as the one under review here, that does not mean that it will be regarded as selling all items provided under that contract. Similarly, just because a person is regarded as leasing one item it provides under a contract, that does not mean that it will be regarded as leasing all items provided under that contract.

Generally, when items are regarded as sold under a security agreement within the meaning of section 6006.3, the sale occurs when the lease commences. However, as discussed further below, it is also possible that an item provided under a contract characterized as a lease will be regarded as leased for a portion of the period specified in the contract and at a certain point will be regarded as sold outright, before the end of the "lease term," because of the particular terms of the contract.

In the present matter, you recognize the implications of the Legislature's 1986 amendment to section 6006.3, and you do not argue that the nonappropriation provision is sufficient to establish that the agreement is not a sale under a security agreement. (Since such a provision is irrelevant to the question of whether the agreement is a sale under a security agreement, I will disregard it for the remainder of this opinion.) You nevertheless believe that the agreement should be treated as a lease for sales and use tax purposes because of the conditional nature of B's obligation to make lease payments and B's right to terminate the agreement (other than the nonappropriation provision).

If a person enters into a contract for the sale of tangible personal property and that contract includes a provision allowing that purchaser to terminate the contract and return the property upon a material breach by the seller (such as a breach of warranty or failure to provide the necessary support), that provision would not render the contract to be one that is other than a contract for the outright sale of tangible personal property. Similarly, a contract that is characterized as a lease but which is actually a sale under a security agreement under the Sales and Use Tax Law cannot be regarded as a true lease simply because the purchaser has a right to terminate the contract if the seller materially breaches the contract.

When the only basis for regarding a transaction as a lease is the right of the lessee to terminate the agreement, that termination right must be within the control of the lessee and not based on an action, or inaction, of the lessor. (See BTLG Annot. 330.2380 (5/28/68, 6/5/68).) That is, it must be the lessee's right to terminate, and that right cannot be based on the action or inaction the lessor, such as a material breach of contract, since such a limited right of termination gives the lessor the right to bind the lessee to the fixed term specified in the contract.

You cite Business Taxes Law Guide Annotation 330.2000 (7/15/68) which states that an agreement with a cancellation clause allowing the purchaser to cancel the agreement upon a condition subsequent without further liability was a lease rather than a conditional sale. The contract in question was a lease agreement with a governmental agency that permitted the

agency to cancel the contract without further liability if sufficient funds were not appropriated. You note that the later amendment to section 6006.3 nullified this annotation with respect to the facts it considered. However, you believe that the annotation nevertheless "supports the general rule that, absent a special statutory provision, a termination clause, even a contingent one, requires that a transaction be respected as a lease and not re-characterized as a sale." This statement of the applicable rule is overly broad.

Annotation 330.2000 considered facts where the lessee had the right to cancel the agreement based on a condition that was within its control and which was not the result of a breach of contract. The rule expressed in that annotation remains applicable absent contrary statutory provisions. The lessee's right to terminate was not conditional on action or inaction of the lessor, and the lessor did not have the power to require the lessee to complete the lease term by the action or inaction of the lessor. That is, where a lessee has a real right to cancel the agreement based on a condition within its own control, and the right to cancel is not based on a breach of contract or warranty on the part of the lessor, we agree that such an agreement characterized as a lease would be treated for sales tax purposes as a true lease. The annotation does not, however, apply to transactions where the purchaser can terminate the agreement only upon the failure of the seller to meet its contractual obligations, that is, upon breach of contract.[3/]

B does not have the right to terminate the contract except for a breach of the contract by I---. That is, B is bound for a fixed term and, assuming I--- does not breach the contract, B will receive title to the property after making the required payments. Therefore, property provided under the contract will be regarded as sold under a security agreement at the time B becomes bound for a fixed term.

You also assert that B's "conditional obligation" to make the payments is further support for regarding the transaction as a lease. I understand this assertion to relate to when a site goes live and is accepted by B. Rather than being relevant to whether the contract provides for sales under a security agreement or not, this point actually relates to when that sale occurs.

Under the contract between I--- and B, there will not be a single sale, but rather several sales. The sale of the property provided by I--- for a particular site occurs when the site goes live and B accepts since at that point B is bound for a fixed term within the meaning of section 6006.3. Sales tax is due on the gross receipts from that sale at that time. If another site never went live and B never accepted, no sale would occur with respect to such property. That is, that

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[3/]Even if a contract has no specific provision regarding remedies for breach of that contract, the injured party has an election of certain remedies. (See generally, 1 Witkin, Summary of Cal. Law (9th ed. 1987) § 797.) If the breach is material, the injured party has the right to terminate the contract, and even a slight breach at the outset may justify termination. (Id. at § 795.) If the right to cancel a contract due to a material breach were determinative, all agreements would be characterized as leases and section 6006.3 would be meaningless. Section 6006.3 is not meaningless.

a sale would have occurred at the first site would not mean that a sale occurred at the second site. Similarly, that a sale would not have occurred at the second site would not mean that a sale did not occur at the first site.

In your letter dated May 12, 1994, you restate that there are six sites, with a possible total of 10 implementations. As noted above, each of these implementations would be viewed separately (i.e., I--- could be regarded as selling property at one site while at another site not be regarded as selling property because the contract was terminated, as to that site, prior to the sale).

You also indicate that HFIS has only been installed and accepted at 2 sites, the labs at one site, and the clinicals "tentatively accepted" at one site. You note further that this means that 6 of the 10 implementations under the agreement have yet to be accepted. Again, this does not alter the analysis of the agreement. Any implementation that is accepted is accepted under the terms of the agreement. An implementation accepted under the agreement is a sale under a security agreement at the time of that acceptance. If the implementation does not go live and is not accepted, there would not be a sale as to that implementation. Thus, with respect to the implementations discussed in this paragraph, the 2 implementations of HFIS were sales at the time of acceptance as was the implementation of the labs, also at the time of acceptance. I do not know what you mean by the clinicals being "tentatively accepted." I assume this means that this implementation of was also effectively accepted. Thus, I--- would be regarded as selling each of these four implementations at the time each was accepted. If the remaining 6 implementations do not go live and are not accepted, there would be no sale of such implementations from I--- to B under the agreement or within the meaning of section 6006.3. (Prior to acceptance there may be a taxable lease if B is making payments for possession.)

You also recount developments that you believe shows that B can exercise extraordinary flexibility with respect to the agreement. I will discuss the relevance of each of these below.

You state that B has indicated to I--- that it intended to terminate the agreement in its entirety, and return the system to I---. You have not explained the basis for this possibility or the details of its possible execution, nor have you indicated the provision under the agreement pursuant to which B would so act. Without the details of this possibility, its relevance to the analysis is not clear.

You state that B has indicated to I--- that, if it chose not to terminate the entire agreement, it intended to terminate at least the three implementations of clinicals originally ordered. As explained above, property to be provided by I--- under the agreement will not be regarded as sold to B until the implementation of that property goes live and B accepts. If B terminates the implementation of certain property prior to its going live and B's acceptance, no sale occurs. The failure of the implementation of any of the property to go live and be accepted by B does not affect the fact that any property provided pursuant to an implementation that does go live and is accepted is sold by I--- to B at the time of that acceptance. As noted above, it

appears that B has accepted the clinicals at one site. If it does not accept the clinicals at the other two sites, there would be no sales of clinicals at those two sites.

You indicate that one site was damaged during the recent earthquake and that B has indicated its intent to terminate the agreement with respect to this site. You also indicate that I--- has not acquired any hardware for purposes of delivery to this site. If B does terminate prior to the site going live, there would be no sale of any such undelivered property. I note also that a sale of property cannot occur prior to the time that such property is identified to the contract. (Cal.UCC §§ 2401, 2501.)

Finally, you state that B has indicated that it may also elect to terminate the agreement with respect to another site, and that no hardware for that site has been acquired by I---. Again, if B terminates prior to that site going live with respect to the property in question and prior to any acceptance by B, no sale has occurred.

In summary, we conclude that any property provided pursuant to the agreement in an implementation that goes live and that is accepted by B is sold to B at the time of that acceptance. Tax would be due with the return for the reporting period in which that acceptance occurs, and would be measured by the full contract price for such property, with the deductions allowed pursuant to Regulation 1641. That the property provided in such accepted implementations is sold to LA does not mean that other property mentioned in the contract, but not provided in an implementation that goes live and is accepted, is sold to B.

If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Supervising Staff Counsel

DHL:cl

cc: Out-of-State District Administrator
Hollywood District Administrator