

# Memorandum

Legal Division MIC: 85

**330.3095**

**To :** Out-of-State District (OH)  
Auditing EWH

**Date:** October 6, 1993

**From :** Rachel M. Aragon  
Staff Counsel

**Subject:** C--- C--- Corporation

SS --- XX-XXXXXX

This is in response to your memorandum of June 17, 1993. The taxpayer is making a claim for refund of tax it has paid on rental receipts. Although taxpayer had been treating its monthly fees as taxable, it is now taking the position these are non-taxable services. Taxpayer claims other providers of filtration equipment/service are not charging tax for the same service.

C--- is in the business of renting activated carbon treatment systems. C---'s standard contract provides for equipment, maintenance, and labor. C--- offers a filtering system that reduces the amount of pollutants in the wastewater to an allowable level. C---'s agreement is for a fixed term, and C--- removes the equipment and carbon from the property of customer at the end of that term.

A standard contract includes the following provision:

"This agreement is for services only and therefore all equipment supplied pursuant to this contract remain the property of C---...." (Section 1.)

The question is whether C--- is leasing tangible personal property to its customers or transferring tangible personal property incidental to a service. The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. (Reg. 1501.)

A lease of tangible personal property in any manner whatsoever for consideration is a taxable continuing sale and a purchase, unless the property is leased in substantially the same form as acquired and the lessor has paid sales tax reimbursement or use tax to its vendor or made a timely election to pay tax measured by the purchase price. When a lease is a continuing sale, the lessor is required to collect tax from the lessee, measured by the rentals payable, at the time rentals are paid. (Reg. 1660(b)(1), (c)(1).)

In circumstances similar to those here, the true object test was applied in Culligan Water Conditioning v. State Board of Equalization (1976) 17 C.3d 86. Culligan had furnished water conditioning units to its customers which converted hard water to soft water by removing hardness. The water supply passed through a conditioning unit along lead-in pipes, and thereafter throughout the household water system.

Culligan argued that transfer of these units to its customers was not a lease of tangible personal property because the customer did not have use of it, nor dominion or control over it, although the customer had possession of the unit. Culligan further argued that even if the elements of a lease were present, its providing the conditioning units should have been classified as a service business because it provided a water conditioning service. Culligan processed, regenerated, and installed ion-exchange material which required the skill and labor of its employees. Culligan alleged that the water conditioning exchange unit was merely the vehicle by which such service was provided. In addition, similar to the C--- contract, the Culligan water conditioning contract was called a service.

The Supreme Court, addressing the lease issue, stated Civil Code section 1925 provides that "the chief characteristic of a renting or a leasing is giving up possession to the hirer, so that the hirer and not the owner uses and controls the rented property". The Court stated: "Certainly, the customer uses the exchange unit by having the water pass along the lead-in pipes, through the conditioning unit, and thereafter throughout the entire water system of his residence. He also has dominion and control over the unit." The Court further noted that the customer controlled how much and when customer used it and reasoned that simply because Culligan had owner's control and the exclusive right to replace one unit with another did not derogate the customer's right to use and control the unit while on its premises.

The Court concluded there was present the requisite elements of a hiring, namely the temporary possession and use of the exchange water condition for reward. There was also present all the requisite elements of a lease, mainly the giving up of possession to the hirer so that he uses and controls the rental property. The Court found that the true object of the water conditioning contract was furnishing the exchange unit. The Court further stated that although human labor or service was involved in regenerating the material, realistically the customer's purpose in entering the contract was to obtain a properly generated and efficiently functioning water conditioning unit, not personal services. Once the unit was regenerated, it softened the water without requiring any additional performance of human labor. The service of regenerating

and installing was required in order to provide the desired tangible personal property to the customer.

The C--- filtering system works in very much the same way as the Culligan Water System and the same rationale would apply. The customer uses the filtering system by allowing the unfiltered influent to flow into the carbon vessels and the filtered effluent to flow out of the vessel into customer's piping. This reduces the pollutants in the wastewater to an allowable level. The carbon is replaced as needed. C---'s customers have dominion and control of the filtering refill. The customer's use determines how much reactivated carbon is replaced. Although C--- owns the equipment while it is in its customer's premises, its customer has temporary possession and use of the filtering system. These elements are generally present in all leases of tangible personal property (ownership by the lessor and use by the lessee).

In our opinion, as in Culligan Water, the object of the contract is for use of the filtering system and not for the service C--- provides by replacing the spent carbon. C---'s customers seek tangible personal property, and C--- provides that tangible personal property under a lease of tangible personal property to its customers.

RMA:jlh

cc: Tom Glab - ---