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August 12, 1994

BURTON W. OLIVER
 Executive Director

S--- P. S---
 C---, S--- M--- and Company
 XXXX --- --- Boulevard, Suite XXXX
 ---, California XXXXX-XXXX

**Re: C--- S--- Company
 No Seller's Permit**

Dear Mr. S---:

This is in response to your letter dated June 10, 1994 concerning a transaction involving a piece of equipment called an A--- S--- and R--- S--- (AS/RS) owned by C--- S--- Company (C---) for which your client M--- C--- Corporation (M---) is seeking to arrange a sale and leaseback transaction.

You write that C--- purchased the equipment from L--- Industries in 1989 for approximately \$XX,000,000 and paid California sales tax reimbursement. C--- financed the purchase at that time, and now wishes to refinance. The appraised value of the equipment is \$XX,500,000.

You request a written opinion that the transaction qualifies as a nontaxable financing transaction for purposes of the California Sales and Use Tax Law. You describe the planned transaction as follows:

"C--- would 'sell' the AS/RS equipment for an amount approximately equal to its appraised value of --- million, five hundred thousand dollars (\$XX,500,000). Title would transfer to a buyer/lessor who would lease the equipment back to C--- . The lease would have an estimated imputed interest rate of 8.8% compounded annually, the combined principal and interest payments over a term of eleven (11) years would be \$X,857,360 annually, paid in arrears. Of course, the interest rate, which will be adjusted for like treasury rates at time of closing, does not appear to

be usurious. At the end of the eleven year term, the equipment could be purchased at the option of C--- for one dollar (\$1.00)....

"C--- will report the proposed transaction as a loan, deducting the interest expense portion as indicated in the loan amortization schedule. Despite the transfer of title for security purposes, the benefits and burdens of ownership will be retained by C---. C--- will continue to depreciate the equipment as it has done in the past. Although the buyer/lessor has not yet been identified, a representation will be required from such party that their treatment of the transaction be consistent with that of the seller/lessee's.

"Although subject to review, the planned financial accounting treatment is to treat the sale portion of the transaction as a sale, the net gain from which would be amortised over the eleven year term. The net gain is reduced for any prepayment penalties associated with early retirement of the notes. The lease portion of the transaction would be treated as a capital lease."

Discussion:

A retail sale in California of tangible personal property or a purchase from a retailer outside of California of property for use in California is taxable unless otherwise exempt. (Rev. & Tax. Code §§ 6051, 6201.) If a transaction is not a "sale" or "purchase" under the California Sales and Use Tax Law, no tax applies.

A sale and leaseback transaction qualifying as an "acquisition sale and leaseback" is specifically excluded from the definition of either "sale" or "purchase" by Revenue and Taxation Code section 6010.65. To qualify for the exclusion, the acquisition sale and leaseback must be consummated within 90 days of the first functional use of the property by the person who sells it and leases it back. Since C--- has owned and, I assume, used the AS/RS equipment since 1989, the transaction described in your letter does not qualify for a section 6010.65 exclusion.

Even if a transaction structured as a sale and leaseback does not qualify for an exclusion under section 6010.65, it may nevertheless be a nontaxable transaction if qualifying under the California Sales and Use Tax Law as a financing transaction. (Reg. 1660(a)(3).) Transactions structured as sales and leasebacks will qualify as financing transactions if three conditions are met: (1) if the lease transaction would be regarded as a sale at inception as described in subdivision (a)(2) of Regulation 1660, (2) if the purchaser-lessor does not claim any deduction, credit or exemption with respect to the property for state or federal income tax purposes, and (3) if the amount which would be attributable to interest, had the transaction originally been structured as a financing agreement, is not usurious under California law. (Reg. 1660(a)(3)(A).)

If your proposed transaction satisfies each of these three requirements, it will qualify as a nontaxable financing transaction.

First, the transaction must be a sale at inception as described in Regulation 1660(a)(2)(A). Subdivision (a)(2)(A) states that a contract designated as a lease is regarded as a sale under a security agreement at inception if the contract binds the "lessee" for a fixed term and the "lessee" has the option to purchase the property at the end of the term for a nominal amount (\$100 or less, or 1% of the total contract price or less). In the situation which your letter describes, C--- will have an eleven year "lease" of the equipment with the option to purchase the equipment for \$1.00 at the end of the "lease" period. As defined in Regulation 1660(a)(2)(A), such a transaction would be a sale under a security agreement at inception.

Second, your letter states that C--- will report the transaction as a loan for income tax purposes, deducting the interest expense portion and continuing to depreciate the equipment as it has done in the past. Your letter also indicates that the "buyer/lessor" of the equipment will be required to treat the transaction in a manner consistent with this. If the "buyer/lessor" will not claim any deductions, credit or exemption for state or federal income tax purposes with respect to the transaction, the second condition under Regulation 1660(a)(3)(A) would be met.

Third, your letter describes the interest rate as an estimated imputed rate of 8.8% compounded annually which will be adjusted for like treasury rates at time of closing. If the actual imputed interest rate, as determined at the time of closing, is not usurious, the third condition under the regulation would be satisfied. (See California Constitution, Art. XV, § 1; Civ. Code § 1916 et seq.)

In conclusion, if all the conditions of Regulation 1660(a)(3)(A) are satisfied as discussed above, the transaction would qualify as a financing transaction for sales and use tax purposes and would not be subject to sales or use tax.

I hope this information is of assistance. Please write again if you have further questions.

Sincerely,

Sharon Jarvis
Staff Counsel

SJ:es