State of California **Board of Equalization**
Legal Division

M e m o r a n d u m

490.0092

To : Mr. Michael P. Kitchen
Audit Refund Section (MIC:39)

Date: September 28, 1993

From : David H. Levine
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Subject: G--- S--- T---
SR – XX-XXXXXX-001

This is in response to your memoranda dated May 13, 1993 and August 19, 1993. I note that Robert Buntjer, Robert Pieroni, and you had a meeting with Gordon Adelman and Elizabeth Abreu of this office prior to writing your August 19 memorandum, and at that time they were not aware that someone else on the staff was responding to your May 13 memorandum.

G--- S--- (claimant) sold equipment to A--- M--- Co. (consumer) in October 1992. Claimant invoiced consumer for the selling price plus sales tax reimbursement. Claimant paid the applicable sales tax to the state. Thereafter, consumer contracted with C--- Inc. (lessor) in December 1992 to sell the equipment to lessor and lease it back. At that time, well after the original sale, consumer provided claimant with a resale certificate and claimant credited consumer's account in an amount equal to the sales tax reimbursement originally invoiced. Lessor then remitted the balance of the invoice to claimant (i.e., the sales price with no sales tax reimbursement). Claimant is now claiming a refund of the tax it paid on its sale to consumer. You state that lessor has made a timely election to report tax on rentals payable.

In your May 13, 1993 memorandum, you indicate that claimant's contention is that the sale by claimant was a sale for resale and that the subsequent sale and leaseback is in accordance with Revenue and Taxation Code section 6010.65 and Regulation 1660. You state the staff's contentions as follows:

> "The staff is of the opinion that the sale is a valid sale for resale. However, section 6010.65(a)(1) requires the seller/lessee to actually pay the sales tax reimbursement to the vendor. This did not happen. The tax was self-reported by the vendor prior to payment by the seller/lessee or the purchaser/lessor. The lease appears to be true lease with the lessor retaining title and all tax credits. The sales/leaseback agreement was consummated within 90 days of the actual purchase. With the exception noted above, this transaction seems to meet the parameters of section 6010.65 and Regulation 1660. Does this omission disqualify the sale and leaseback as a financing

transaction? In which case the subsequent lease would not have any taxable consequence."

I will first address the questions raised by the staff's contentions quoted above before addressing the revised contentions in your later memorandum. First, I note that the staff has not addressed the most important of all factors in determining whether the sale to consumer was a taxable retail sale. If consumer made no use of the equipment prior to entering into the sale and leaseback agreement with lessor, then we would regard it as having purchased the property for resale.[1] Since I know that you are well aware of this, I assume that the staff has concluded that consumer cannot be regarded as having purchased the property for resale on this basis because it functionally used the property between the time of its purchase in October and the time of the sale-leaseback agreement in December.[2] The staff has therefore overlooked the fact that consumer's functional use of the property prior to any resale means that claimant made a taxable retail sale and that there can be no refund based on any sale for resale theory.

There apparently is confusion regarding the financing concept embodied in Regulation 1660 and the statutory exclusion provided by Revenue and Taxation Code section 6010.65. These are not the same concept, but rather completely separate and independent. (Although a provision will be added to Regulation 1660 to cover the exclusion of section 6010.65, they are separate concepts.)

The financing concept of Regulation 1660(a)(3) is based on the theory that, although the transaction is described as a sale and leaseback, it is in actuality only a financing agreement. When the contract provides for an element that could not have been accomplished via a financing agreement but could only be accomplished by a sale and leaseback, then the regulation says that the transaction is, in fact, a sale and leaseback as described. One element that prevents such a transaction as being regarded by us as a financing agreement is when the purchaser/lessor takes tax depreciation for that property. Since a person must own property to take such tax benefits, that purchaser/lessor must actually be the owner of the property and the transaction must actually be a sale and a leaseback and not merely a financing agreement.

Revenue and Taxation Code section 6010.65 is completely different than subdivision (a)(3) of Regulation 1660, even if they sometimes cover the same transaction (that is, sometimes a transaction comes within the regulation and also comes within section 6010.65). When applying section 6010.65,

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[1]Even if the purchaser does not actually intend at the time of the purchase to resell the property, we accept it as a purchase for resale if it is, in fact, resold prior to any use by that original purchaser. (See, e.g., Reg. 1701 (tax-paid purchases resold deduction).)

[2]In a memorandum dated September 28, 1993, you indicate that you wish us to consider additional information. Claimant contends that it is standard industry practice to "test" equipment for a period of up to 90 days prior to "accepting" the sale. By "test," I assume you mean that the purchaser functionally uses the property for the intended purpose. (As you know, true testing is not regarded as a functional use.) If the equipment is deemed acceptable, the lessor is then contacted. The staff believes that this is a reasonable and practical approach to purchasing specialized equipment. We agree that it may be a practical approach, but it is essentially irrelevant to the analysis herein. If a vendor transfers possession of property to a purchaser, and passes title to that property to the purchaser, then it is irrelevant that the contract may provide for a return of the property if not acceptable. If that purchaser, who has possession of the property and who *has title to that property*, functionally uses the property prior to reselling it, the sale by the vendor is a taxable retail sale.

we do not care whether there is depreciation taken, or whether interest would be usurious if structured as a financing agreement, or anything else except whether the transaction meets the requirements of that provision: the sale and leaseback transaction is entered into on or after January 1, 1991 and before the current expiration date of the statute, January 1, 1995 (the date of the original purchase is irrelevant); the seller/lessee in the sale and leaseback transaction paid sales tax reimbursement or use tax with respect to that person's purchase of the property; and the sale and leaseback is consummated within 90 days of the seller/lessee's first functional use of the property.

When a transaction comes within either subdivision (a)(3) of Regulation 1660 or section 6010.65, or both, the seller/lessee is the consumer of the property (it is also possible for the sale and leaseback to be consummated prior to functional use of the property and that the seller/lessee would have a choice as to the transaction upon which tax would apply, but such is not the case here so I do not address the ramifications). Under such circumstances the sale to that person, or that person's use of the property, is subject to tax.

In this case, consumer used the property prior to the sale and leaseback. Claimant's sale to consumer is therefore a taxable retail sale, and whether the sale and leaseback transaction qualifies under either Regulation 1660 or section 6010.65 is irrelevant to the claim before you. That is, the claim you must resolve is for tax paid by claimant with respect its retail sale to consumer. Since you do not have a claim related to tax paid with respect to the sale and leaseback, the provisions in Regulation 1660 and section 6010.65 are irrelevant to the claim before you.

In the August 19, 1993, the staff proposed an additional theory why the refund should be granted. You state:

> "Our discussion then focused on whether the sale might be exempt pursuant to the provisions of the returned merchandise deduction per Regulation 1655(a). The contention of the audit Refund Section was (a) the purchaser/lessee effectively received a full refund of the selling price, and (b) the title to the property was transferred by the vendor to the seller/lessor under a valid resale certificate which constituted a return of the property. In the alternative, the sale to the purchaser/lessee was a rescinded sale and the subsequent sale to the seller/lessor became the true sale."

Initially, I note that there is no exemption provided by Regulation 1655(a). If a return meets the requirements of that provision, the retailer may take a *deduction*, not claim an exemption.[3] I note also that you have included a document you refer to as the "original sales invoice between the vendor and the purchaser/lessee (A--- M--- Corp.)." That invoice is dated December 29, 1992, the same date as on the reinvoice from the vendor to the lessor (C---). Since you had stated in your previous memorandum that the original sale occurred in October 1992, I assume that the invoice you now refer to as the original is actually a revision of the original. That is, I assume for purposes of this opinion (in

[3]This distinction is important not only because we should be precise with our language (e.g., resale versus exemption versus exclusion versus deduction). Here, the difference between an exemption and a deduction is critical for the analysis and for the calculation of interest on the refund, as discussed further below.

particular, for purposes of the *previous* analysis) that the sale actually occurred in October and that consumer functionally used the equipment prior to the transaction with lessor in December 1992.

Staff believes that the transaction qualifies for the returned-merchandise deduction. That deduction of course requires a return of the property and, except as noted in Regulation 1655(a), that return must be unconditional and the purchaser must receive a full refund of the purchase price. The only condition that the seller may impose on the return and still qualify for the deduction is that the purchaser buy something at a price up to the price of the item returned. The seller can make no other conditions and still qualify for the deduction.

If the seller will accept the return only if some, as of the time of the return unknown, person purchases the property for an equal or greater price than the original purchaser, then the "return" does not qualify for the deduction. Actually, it is not a return at all but rather a consignment (see generally Reg. 1569), with the seller acting as the consignee and the purchaser the consignor. The fact that the seller/consignee gives the purchaser/consignor an advance, or loan, against the sale proceeds does not alter the analysis. If the seller will accept the return only if some identified person purchases the property, with the amount paid by that person being transmitted to the original purchaser (as a credit or otherwise), then the original seller is merely a conduit. The true seller in that transaction is the original purchaser.[4]

In this case, there was no unconditional return of the property, nor was there any return of the property at all. The transaction ***cannot*** qualify for the returned-merchandise deduction. At this point it is appropriate to consider the adoption of section 6010.65. A previous incarnation of that provision had been passed by the Legislature, but vetoed by the Governor in 1989 (it had contained a broader exclusion and had been more complicated than the one actually adopted). The equipment lessors' industry, its sponsor, then reintroduced it and finally settled for a simplified, easy to apply exclusion which was passed and signed in 1990.

Had the industry been able to avail itself of the method staff proposes, there would have been no need for section 6010.65, because any such transaction would qualify for the deduction (although the vendors would have had to cooperate, very few would refuse their cooperation). The industry would not have had to settle for a statutory exclusion that sunsets after four years (section 6010.65 is in effect only between January 1, 1991 and January 1, 1995). Furthermore, there would have been no 90 day time limit from functional use since a return meeting the requirements of Regulation 1655(a) qualifies for a deduction without regard to length of time from the first functional use. The industry fought for section 6010.65 in its reduced form because the industry knew that it could not use the returned-merchandise deduction to avoid tax on the second retail transaction.[5]

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[4]These types of transactions often bypass the original seller altogether, with the new purchaser paying the original purchase directly. The fact that the parties may utilize the original vendor as a conduit does not alter the analysis.

[5]This point applies equally to the argument mentioned above that a retail sale in which the purchaser acquires possession and title to property and functionally uses that property should nevertheless be disregarded for purposes of sales tax just because the buyer and seller have an agreement for a return of the property if it proves unacceptable. If this were a sufficient argument, since, as you explain, this is common industry practice, the industry would not have needed section 6010.65.

The staff's alternative argument regarding the original sale not being taxable because it was rescinded is a weaker argument than the returned-merchandise argument. Almost all returns qualifying for the deduction would also qualify as rescinded sales. Why would sections 6011(c)(2) and 6012(c)(2) and Regulation 1655(a) be necessary if a rescission meant that the original sale was not taxable? They would not be necessary.

Actually, if a rescission meant the original sale were not taxable, that would be a more favorable analysis from the taxpayer's point of view than would qualifying for the returned-merchandise deduction. If the first sale were not taxable, the refund would be of the tax paid, plus interest, when applicable, *from the due date of the sales tax return covering the original sale*. A refund granted based on the deduction would be of the tax, plus interest, when applicable, *from the date of the sales tax return covering the return of the property*. That is, the returned-merchandise deduction is just that, a deduction; it is not an exemption, which would mean that the original sale was never taxable. Rather, the statute requiring and the regulation applying the deduction recognize that the original sale was taxable, *and remains taxable*.

I note that it is not necessary to do a logical analysis of rescission versus the returned-merchandise deduction to figure out that, even if the parties enter into an agreement rescinding a taxable sale, that sale remains subject to tax. Instead, one need only look at this long-standing rule in Annotation 490.0080 (9/4/64) ("the original sale is taxable and no returned merchandise deduction is allowable because the full purchase price was not refunded"). As explained in Annotation 495.0440 (9/8/65):

> "A contract rescinding the purchase of business assets and calling for the return of the property to the original seller is not a sale. This is true even though the sale which is rescinded is a taxable retail sale for which the seller cannot claim a returned merchandise deduction because the full purchase price was not refunded...."

In summary, the issue before the Refunds Section is whether a refund of tax paid by claimant with respect to its sale to consumer should be granted. Since consumer functionally used the property prior to its transaction with lessor, claimant did not sell the property for resale, but rather made a taxable retail sale. Whether the sale and leaseback comes within section 6010.65 or Regulation 1660 is relevant only to the determination of whether the sale to lessor, or the lease back to consumer, is subject to tax. It is irrelevant to the matter before the staff now. There was no rescission here, but even if there had been, the sale by claimant to consumer remains taxable. There can be no returned-merchandise deduction because the property was not returned, constructively or otherwise. Even if we regarded the property as "returned," such a return cannot qualify for the deduction since the credit given by claimant was conditioned on someone else purchasing the property.

As far as I know, Legal has not written anything inconsistent with this memorandum, but I do not know what, if anything, may have been written by other Board divisions which is inconsistent with the analysis herein. Also, considering the history of this particular inquiry, it seems probable that there have been actions taken by some at the Board which are inconsistent with this memorandum. To the

extent that there has been anything written, or any action taken, inconsistent with the analysis herein, they are superseded by this memorandum.

cc: Mr. Robert Buntjer
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