

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 91A-0255
ALAMEDA BANCORPORATION, INC.,	)	
ALAMEDA FIRST NATIONAL BANK,	)	
FIRST LEASING CORPORATION	)	

Appearances:

For Appellant:

Cary C. Boyden, Counsel  
Vincent M. Leveroni,  
Executive Vice President

Kirk D. Misaka, C.P.A.

For Respondent:

Karen Smith, Counsel  
Allison Clark, Counsel

OPINION

This appeal is made pursuant to section 19405<sup>1/</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Alameda Bancorporation, Inc., et al., against proposed assessments of additional franchise tax in the amounts and for the income years ended as follows:

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<sup>1/</sup> Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

<u>Appellants</u>	<u>Income Years Ended</u>	<u>Proposed Assessments</u>
Alameda Bancorporation, Inc.	12/31/77	\$ 299
	12/31/79	1,351
Alameda First National Bank	12/31/77	110,288
	12/31/78	102,154
	12/31/79	29,891
First Leasing Corporation	12/31/77	136,116
	12/31/78	79,799
	12/31/79	88,853

Appellant Alameda Bancorporation, Inc. (Alameda Bancorp.), is a bank holding company and a Delaware corporation which is doing business in California. Appellant Alameda First National Bank (Alameda First) is a subsidiary of Alameda Bancorp. and a national banking association. Appellant First Leasing Corporation (First Leasing) is also a subsidiary of Alameda Bancorp. and purportedly a leasing company.

First Leasing has arrangements with various California Porsche, Audi, BMW, and Mercedes dealers to purchase and allegedly lease automobiles for the dealers' customers. Some of these "leases" are obtained for Alameda First. First Leasing receives fees for arranging and obtaining financing for the vehicles and for servicing the agreements. Once the terms of the agreements are finalized and the documents are signed, First Leasing purchases the vehicles and the customer takes possession of the automobiles. First Leasing purchases the vehicles only when requested to do so by customers who want immediate use; no vehicles are purchased for inventory purposes.

In order to finance the purchase of the vehicles, First Leasing obtains loans from Alameda Bancorp. and other financial institutions. The customers' monthly payments are based on the original value of the vehicle, which is the cost thereof, plus a markup that usually depends on the cost of money (i.e., interest) and the amount of sales tax paid. On their books, appellants report the customers' payments as accounts receivable, with corresponding accounts payable to the dealerships; appellants' profit was recorded as interest income.

Each lease contains a "terminal rental adjustment clause" (TRAC), which provides that at the end of the lease, the lessee is liable to the lessor for any decline in value of the leased property. Generally, the financial aspects of these types of transactions are as follows: The leasing company estimates the residual (or salvage) value of the vehicle at the end of the lease term. The customer's payments are based on the difference between the residual value and the cost of purchasing the vehicle by the leasing company (i.e., current fair market value, plus dealer markup), plus finance charges and sales tax paid. (Essentially, the customer is paying for the depreciation in value of the vehicle, plus the cost of borrowing money.) At the end of the lease term, if the customer does not exercise an option to purchase the vehicle, the leasing company will sell the vehicle. If the vehicle is sold for less than the estimated residual value, the TRAC obligates the customer to pay the difference to the leasing company. If the vehicle is sold for more than its residual value, the excess is refunded to the customer.

Appellants' 1977 and 1978 returns were audited by the Internal Revenue Service (IRS). In 1982, after obtaining the revenue agent's report from appellants and reviewing it, and after conducting its own audit of the 1979 returns, respondent determined appellants were not entitled to take depreciation deductions for the vehicles because the transactions in question were not operating leases,<sup>2/</sup> but conditional sales contracts. Its determination was based in large part upon Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), where the court found, according to the respondent, that substantially identical "leases" were conditional sales contracts for federal income tax purposes because the putative lessor had retained little or no actual economic risk of gain or loss.

During protest, appellants submitted documentation from the IRS indicating there would be no deficiencies resulting from the audit of their 1977 and 1978 returns. Because the documentation did not explain the basis of the IRS' position<sup>3/</sup> and because California and federal law concerning whether the transactions in question are operating leases differed from 1982 through 1984, respondent affirmed its determinations. In addition, because these transactions were deemed to be financing arrangements, respondent determined that First Leasing was a financial corporation subject to tax at the rate set for banks and financial corporations.<sup>4/</sup> Appellants were also not allowed to file combined reports because they did not establish any out-of-state operations.<sup>5/</sup> This appeal followed.

The issues to be decided are: (1) whether First Leasing's automobile "leases" are operating leases rather than conditional sales contracts, so that it is entitled to depreciation deductions as the owner of the vehicles; (2) whether First Leasing is a financial corporation; (3) whether this board has the authority to apply subdivision (b) of section 23183 of the Revenue and Taxation Code retroactively; and (4) whether appellants are engaged in business outside of California, thus allowing them to file combined reports and to allocate and apportion their income.

To determine whether the transaction is an operating lease or a financing arrangement, reference must be made to the distribution between the parties of the relative burdens and benefits of

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<sup>2/</sup> Operating leases require the lessee to expense and the lessor to record as income the lease payments; the lessor is the owner of the property and is entitled to depreciation and investment tax credit; capital leases require the recording of a sale or a financing by the lessor.

<sup>3/</sup> In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) was enacted by Congress which contained a retroactive provision (section 210) instructing the IRS to discontinue classifying a lease as a financing transaction merely because it contained a TRAC provision. The IRS' decision is apparently based on this legislation. But, section 210 applies only to commercial leases, and is not part of the Internal Revenue Code (I.R.C.). Section 210 was amended in 1984 and enacted as I.R.C. section 168(f)(13). The Tax Reform Act of 1986 repealed I.R.C. section 168(f)(13), and its provisions now appear in I.R.C. section 7701(h). California enacted conforming legislation, but only for income years beginning after December 31, 1984. (See Rev. & Tax. Code, § 24349, subd. (d).)

<sup>4/</sup> Likewise, since Alameda Bancorp. was deemed to be lending money to First Leasing in competition with other banks, Alameda Bancorp. was determined to be a financial corporation subject to tax at the rate set for banks and financial corporations. However, upon further review, respondent has withdrawn this part of the proposed determination and it is no longer part of this appeal.

<sup>5/</sup> Appellants filed combined reports for income years ended December 31, 1978, and December 31, 1979, but did not do so for the income year ended December 31, 1977.

ownership. (Frank Lyon Co. v. United States, 435 U.S. 561 [55 L.Ed.2d 550] (1978); Helvering v. Lazarus and Co., 308 U.S. 252 [84 L.Ed. 226] (1939); Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982).) The reference to a transaction as a lease is irrelevant, if the facts indicate otherwise. (Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955).) It is the substance, not the form, of the transaction which governs its legal characterization. (Sun Oil Co. v. Commissioner, 562 F.2d 258, 262 (3rd Cir. 1977).) An entity which establishes either a financial ownership or an investment in the property so that he "bears the burden of wear and tear and exhaustion" of the property is entitled to deduct the depreciation of that property. (See Helvering v. Lazarus & Co., supra.)

In its analysis, respondent made the following determinations:

### **Benefits of Ownership**

#### Customer

1. right to possess the car
2. right to use the car
3. availability of the manufacturer's warranty
4. right to sublet the car
5. right to extend the lease term
6. either an option to purchase or First Leasing's permission to purchase the car at its residual value at the termination of the lease
7. right to retain excess proceeds from disposition of the vehicle

#### First Leasing

1. legal title to the car
2. the right to be advised of the location of the car
3. the right to dispose of the car upon termination of the lease if the lessee does not have or did not exercise an option to buy it

### **Burdens of Ownership**

#### Customer

1. costs of operating the car
2. costs of maintaining the car
3. costs of repairing the car
4. payment of licensing fees
5. payment of taxes
6. payment of official fees
7. the obligation to obtain

#### First Leasing

1. disposition of the car upon termination of the lease if the customer does not have or did not exercise an option to purchase it
2. the risk of loss if the customer defaults

- insurance<sup>6/</sup>
8. the obligation to comply with governmental requirements regarding the car's operation
  9. the liability for an early termination fee
  10. the risk of loss or damage
  11. the cost of indemnifying First Leasing for any loss resulting from, among other things, the condition, operation, or use of the vehicle
  11. the risk of decline in value of the car

Appellants claim they bear the burdens of ownership, including the costs of maintenance, operation, and insurance, but the sample leases submitted do not so indicate, because, in most instances, the customer either directly pays for those expenses or reimburses First Leasing for those expenses.

Furthermore, appellants assert section 183 of the federal Consumer Leasing Act (effective 1977) limits the customers' liability to three rental payments (3-payment rule), thereby minimizing the effects of the TRAC and shifting the risk of loss back to the lessor.<sup>7/</sup> Since the Swift Dodge case involved tax years prior to the operative date of the 3-payment rule, its holding does not reflect the impact of this rule. But respondent contends that under a TRAC, customers cannot merely walk away at the end of the lease term without incurring some further financial responsibility, which distinguishes this case from the facts in Frank Lyon Co. v. United States, supra. It is respondent's position that the existence of a TRAC makes the "lease" an open-end lease<sup>8/</sup> and renders the transaction a financing arrangement rather than an operating lease. Respondent refers to a Federal Reserve Board (FRB) policy statement (Resp. Exh. H) which provides that the Consumer Leasing Act does not shift any burdens of ownership to the lessor because if it did, then bank holding companies would be engaging in an otherwise impermissible activity. The FRB cites M & M Leasing v. Seattle-First National Bank, 391 F. Supp. 1290 (W.D. Wash. 1975), modified, 563 F.2d 1377 (9th Cir. 1977), which holds that an automobile lease with a TRAC is the functional equivalent of a loan. Respondent

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<sup>6/</sup> It is relevant to note that the customer is required to obtain liability insurance naming First Leasing as the loss payee, but is not required to obtain theft or casualty insurance with First Leasing named as the loss payee.

<sup>7/</sup> Apparently, the 3-payment rule is aimed at unscrupulous leasing companies who attempt to entice customers with very low lease payments, while inflating the residual value which, in effect, forces the consumer to make a balloon payment at the end of the lease term.

<sup>8/</sup> In an open-end lease, the lessee bears the risk of fluctuation in value; in a closed-end lease, the lessor bears this risk. (See M & M Leasing v. Seattle-First National Bank, 391 F. Supp. 1290, 1294 (W.D. Wash. 1975), modified, 563 F.2d 1377 (9th Cir. 1977).)

correctly notes that the 3-payment rule only applies to consumer leases and, again referencing the FRB's policy, avers it does not shift a significant risk of loss to the lessor - it merely forces lessors to be more conservative when estimating the residual value of the vehicle.

Appellants further contend that California's franchise tax law specifically recognizes that open-end leases are true leases and not sales or financing transactions, relying on this Board's letter decision in Appeal of Central Banking Systems, Inc., and Subsidiaries, decided October 23, 1990, and on the enactment of Revenue and Taxation Code section 23183, subdivision (b), which provides that a corporation whose principal business activity consists of leasing tangible personal property is not a "financial corporation." However, appellants must be cognizant of the fact that the Central Banking Systems decision contains no analysis and cannot be cited as precedent. (See Appeal of Charles W. Fowlks, 88-SBE-023A, Oct. 31, 1989.)<sup>9/</sup>

It is clear from the record that the customers under the First Leasing contracts bear most of the benefits and burdens of ownership. The TRAC is but one factor to be weighed; all benefits and burdens of ownership must be considered. (See Swift Dodge v. Commissioner, supra.) Furthermore, we do not believe the 3-payment rule has the effect of tipping the scales in favor of First Leasing. As the parties indicate in their post-hearing briefs, the IRS, in private letter rulings issued subsequent to the enactment of the 3-payment rule, virtually ignores the 3-payment rule in its analysis. (See, e.g., Private Letter Ruling 80-46-013, Aug. 8, 1980.<sup>10/</sup>) Even appellants readily admit that in Private Letter Ruling 80-46-013, no analysis was given with respect to the 3-payment rule other than a statement saying the lessee bears the risk of the car depreciating at a faster rate than anticipated at the time the contract is executed. Respondent also cites Private Letter Rulings 82-40-018 and 82-52-0004 where the IRS felt the 3-payment rule had little or no impact in determining whether a particular transaction is a sale or a lease. The methodology used in these private letter rulings was to determine which party to the transaction, the taxpayer or the consumer, possessed more of the attributes of ownership. This board, in attempting to assess the impact of the 3-payment rule on First Leasing's transactions, inquired as to the number of consumer versus commercial leases during the appeal years. No specific evidence was offered on this issue. Moreover, First Leasing failed to offer any evidence specifically establishing that it suffered asset-based losses, as opposed to credit-based losses, as a consequence of the adoption of the 3-payment rule. Therefore, we find that First Leasing's transactions are not true operating leases, but conditional sales. As such, appellants are not entitled to the claimed deductions for depreciation. (See Frank Lyon Co. v. United States, supra; Swift Dodge v. Commissioner, supra.)

With respect to the second issue, First Leasing maintains it is not a financial corporation because it is principally engaged in leasing tangible personal property. (See Rev. & Tax. Code, §

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<sup>9/</sup> Indeed, in a more comprehensive summary decision rendered by this board on April 23, 1992, Appeal of Mechanics Bank of Richmond (which also cannot be cited as precedent), the result in Central Banking Systems was not followed.

<sup>10/</sup> While appellants correctly point out that the transactions in this letter ruling were true leases, the contracts involved contained terms different from the First Leasing agreements - most notably, the taxpayer, not the lessee, in the private letter ruling retained any excess proceeds after disposition of the vehicle.

23183, subd. (b).) A corporation is a financial corporation if it predominantly deals in money or moneyed capital and is in substantial competition with national banks. (Cal. Code Regs., tit. 18, § 23183; Crown Finance Corp. v. McColgan, 23 Cal.2d 280 [144 P.2d 331] (1943); Appeal of Motion Picture Financial Corp., Cal. St. Bd. of Equal., July 22, 1958). Respondent's determination that an entity is a financial corporation is presumed to be correct. (Appeal of The Diner's Club, Inc., Cal. St. Bd. of Equal., Sept. 1, 1967.) Because of our conclusion that First Leasing's transactions are conditional sales and not leases, appellants' contention must fall. First Leasing's financing of the conditional sales puts it in substantial competition with national banks and, thus, respondent correctly determined that it is a financial corporation. Moreover, this finding renders moot the issue of the retroactive application of subdivision (b) of section 23183 (which is operative only for income years beginning after December 31, 1978).

Finally, during the appeal years, only taxpayers having income from sources both within and without California may file a combined report and allocate and apportion their income in accordance with the Uniform Division of Income for Tax Purposes Act contained in sections 25120-25139. (Rev. & Tax. Code, § 25101.) Appellants allege that since they are engaged in leasing, and vehicles were leased both within and without California, appellants should be allowed to apportion their income. However, appellants have not established that they did business in another state or that First Leasing had offices or employees outside of California. Moreover, applications for the leases were made and approved in California. Appellants also indicate that they did not pay taxes or file returns in any other state, but instead state that they may have had to if they wanted to enforce their contracts in another jurisdiction. Furthermore, some of First Leasing's contracts required its customers to store the subject vehicles in California. Based on these factors, we find appellants have not proven that they had income from sources both within and without California. Thus, they are not entitled to file combined reports and to allocate and apportion their income.

Accordingly, respondent's action in this matter will be sustained, except with respect to respondent's concession concerning the financial corporation status of Alameda Bancorp.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Alameda Bancorporation, Inc., et al., against proposed assessments of additional franchise tax in the amounts and for the income years ended as follows:

<u>Appellants</u>	<u>Income Years Ended</u>	<u>Proposed Assessments</u>
Alameda Bancorporation, Inc.	12/31/77	\$ 299
	12/31/77	1,351
Alameda First National Bank	12/31/77	110,288
	12/31/78	102,154

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	12/31/79	29,891
First Leasing Corporation	12/31/77	136,116
	12/31/77	879,799
	12/31/79	88,853

be and the same is hereby modified in accordance with respondent's concession concerning the financial corporation status of Alameda Bancorporation. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 9th day of March, 1995, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Dronenburg, Mr. Sherman, and Ms. Scott present.

\_\_\_\_\_, Chairman

Dean F. Andal \_\_\_\_\_, Member

Ernest J. Dronenburg, Jr. \_\_\_\_\_, Member

Brad J. Sherman \_\_\_\_\_, Member

Windie Scott\* \_\_\_\_\_, Member

\*For Kathleen Connell, per Government Code section 7.9.