

730,2154  
1/14/88

R-1660 Computers held for use only if  
a disaster occurs to clients computers  
are not being held for sublease in  
regular course of business. Tax due on  
STATE OF CALIFORNIA *prime lease.*  
BOARD OF EQUALIZATION

In the Matter of the Petition )  
for Redetermination Under the ) DECISION AND RECOMMENDATION  
Sales and Use Tax Law of: )

No.

Petitioner )  
 )

The preliminary hearing on the above taxpayer's  
petition for redetermination was held on December 9, 1987,  
in Van Nuys, California.

Hearing Officer: John B. Adamo

Appearing for Petitioner:

Appearing for the Board: Raymond Croxen  
Tax Auditor

Protested Item

The protested tax liability for the period August  
15, 1981 through March 31, 1985 is measured by:

<u>Item</u>	<u>State, Local and County</u>
Unreported taxable rental charges	\$125,031

Contentions of Claimant

1. Subscription fees do not constitute taxable  
lease receipts because they are paid in consideration for  
exempt services.

2. In the alternative, petitioner contends that it is the consumer of the equipment, and is liable only for use tax on its lease payments to

#### Summary

Petitioner is a wholly-owned subsidiary of . This is the first audit of this account. This petition is the companion to the Claim for Refund of For the period August 15, 1981 through March 31, 1985.

This petition relates to computer equipment which was originally purchased under issuance of resale certificates by . The equipment was then leased by to petitioner; petitioner in turn issued a resale certificate to its parent representing that it intended to re-lease the equipment.

Petitioner is engaged in the business of providing disaster recovery. Its clients are typically large concerns which have their own computer equipment. In the event of a "disaster", i.e., an unplanned interruption of the operations of, or inaccessibility to, the customer's computer facility, petitioner's clients, referred to as "subscribers", are entitled to draw upon petitioner's computer equipment inventory, thereby enabling the customer to mirror its processing environment with minimal disruption to the conduct of business. Petitioner maintains disaster recovery centers in various strategic locations throughout the country.

Petitioner offers what it refers to as "an integrated strategy for maximizing disaster preparedness" to its clients. Petitioner's advertising literature defines the primary services offered as follows: (1) disaster recovery methodology, the development of a recovery methodology assists subscribers in progressing through the various phases of disaster recovery. Essential to the methodology is anticipating the various phases of a particular client's recovery such that appropriate products and services can be supplied; (2) disaster recovery planning, this service results in the production of a maintainable and workable data processing disaster recovery plan. Also included is a blueprint for enhancing and maintaining an overall disaster recovery capability; (3) recovery site software preparation, on-site systems software and teleprocessing specialists work directly with subscribers to tailor operating systems software and

communications controller software to maximize the capability of the recovery site hardware; (4) recovery plan bridge building, the review and updating of the disaster recovery plan so as to integrate changes, e.g., a change necessitated by a customer requirement; and (5) technical support services, includes the implementation of effective contingency planning, the provision of on-site support in the event of a customer-declared disaster, and the transition from the customer's data center to the recovery center.

Subscribers enter into an agreement with petitioner which allows access to the backup capability, i.e., petitioner's computer equipment. The length of the contract term is from one to five years. In consideration, the subscribers pay a monthly subscription fee, the amount of which varies based upon the type of equipment needed. In the event of a disaster, the subscriber must pay a notification fee and also a usage fee for each day it has access to the equipment. Subscribers are allowed an established number of hours to test the equipment during the contract term. If they exceed the allowed hours, they must pay a fee for the excess test time.

During the audit period, petitioner collected use tax from its customers on the subscription fees, usage fees, and excess test time, and paid the taxes collected to this Board. Upon audit, the staff concluded that petitioner was liable for an additional \$7,501.86 in tax for certain transactions wherein it had collected use tax, but not paid it to the Board, and where petitioner had incorrectly collected the use tax. Upon reflection of its practices, petitioner argues that it incorrectly originally concluded that the subscription fees represented lease receipts paid to it by the subscribers. Instead, petitioner contends that the subscription fees are not subject to use tax because those fees relate to the aforementioned services. Consequently, petitioner argues that \_\_\_\_\_, properly issued a resale certificate for the purchase of the equipment, that petitioner also properly issued a resale certificate to \_\_\_\_\_ and that the only amounts which can ever be subject to use tax are the receipts paid to petitioner as usage, notification, and excess time fees. Petitioner accordingly has filed the companion claim for refund for the amounts paid to the Board, and has also filed this petition for redetermination. Amounts paid to petitioner by subscribers during the audit period as notification, usage, and excess test time fees were negligible.

### Analysis and Conclusions

Leases of tangible personal property are defined as "sales" by Revenue and Taxation Code Section 6006(g), except, among other exceptions not relevant here, where sales tax reimbursement or use tax is paid upon acquisition of the tangible personal property which is leased in substantially the same form as acquired. (Revenue and Taxation Code Section 6006(g)(5).) The principal tax imposed on a lease transaction is a use tax imposed on the lessee; the sales tax is imposed on the lessor when the use tax is not applicable. (Revenue and Taxation Code Section 6390 and 6401.) The lessor is required to collect the use tax from the lessee. (Section 6203.)

Revenue and Taxation Code Section 6006.3 defines the term "lease" to include "rental, hire and license...." Hiring is defined in Civil Code Section 1925 as "a contract by which one gives to another the temporary possession and use of property, other than money, for reward, and the latter agrees to return the same to the former at a future time." In Entremont v. Whitsell, 13 Cal.2d 290, 295 (1939), the California Supreme Court held that the chief characteristic of a lease is the giving up of possession to the lessee, so that the lessee and not the owner uses and controls the rented property. (See also Culligan Water Conditioning v. State Board of Equalization, supra; Cooperative Bldg. Materials, Inc. v. Robbins and Larkey, 80 Cal.App.2d 85 (1947); Sales and Use Tax Regulation 1660(a).)

The term "use" is defined in Revenue and Taxation Code Section 6009 as "the exercise of any right or power over tangible personal property incident to the ownership of that property, and also includes the possession of, or the exercise of any right or power over, tangible personal property by a lessee under a lease, except that it does not include the sale of that property in the regular course of business."

Upon consideration of the record of this petition, it is our conclusion that petitioner is the lessee of the computer equipment and that it is liable for use tax measured by its lease payments to Petitioner exercises complete dominion and control over the equipment during all periods when it is not being used by subscribers during disasters. As demonstrated by the facts of this case, as well as by the testimony of petitioner's representatives at the preliminary hearing, use of the equipment by subscribers is extremely rare. Petitioner is solely responsible for the continual maintenance of the equipment, and decides when to replace the equipment. In

every sense, petitioner alone uses and controls the leased property at all times except when a subscriber experiences a disaster.

The subscribers' use of the property during a disaster constitutes a sublease thereof. The lease receipts from such subleases are exempt from tax when use tax is paid on the rentals derived under the prime lease.

Petitioner's contention that only the notification, usage, and excess test time fees are subject to tax is rejected for the reasons set forth above as well as because that contention is contingent upon the incorrect conclusion that petitioner merely maintains the equipment in resale inventory, holding it for sale (lease) in the regular course of business. (Cf. Revenue and Taxation Code Section 6009.) First, as explained above, petitioner's use of the equipment exceeds that of mere "demonstration or display". (Cf. Sales and Use Tax Regulation 1669(a).) Equally important, petitioner cannot accurately be described as holding the equipment for sale (lease) in the regular course of business. The equipment is available for use only by a select group of persons, i.e., the subscribers, and then only in the event of an infrequent contingency.

In this instance, petitioner collected tax from its subscribers, and paid it to the Board. The tax so paid is to be credited against petitioner's liability for use tax on its lease payments to Comdisco. (Revenue and Taxation Code Section 6901.5; see also Sales and Use Tax Regulation 1700.) A reaudit will need to be performed by the Board's Out-of-State District to properly compute the tax. The amount of the refund, if any, will be contingent upon the results of the reaudit. Assuming that the credit exceeds petitioner's liability, the excess is to be refunded to petitioner only upon its undertaking to refund such excess to its subscribers in the same proportion as which they paid tax to petitioner. In the absence of such refunds by petitioner to its clients, any excess shall constitute an obligation due by petitioner to the Board.

Recommendation

Reaudit in accordance with the views expressed above. Reaudit to be performed by Out-of-State District. Redetermine in accordance with reaudit results.

John B. Adamo, Hearing Officer  
*John B. Adamo*  
*JBA*

January 14, 1988  
Date

REVIEWED FOR AUDIT:

\_\_\_\_\_  
Principal Tax Auditor

\_\_\_\_\_  
Date