

DOH
DHL

SRR

330.3161 Leasing - lease between
related parties must
be at FRV to be honored.

916/445-2242

August 25, 1986

[REDACTED]

Dear

Your letters of June 4 and June 10, 1986, addressed to Mr. Gary Jugum, have been referred to me for a response. You requested on behalf of your clients, [REDACTED] and [REDACTED], a ruling on Sales and Use Tax Law as it applies to the following factual situation:

[REDACTED], a California corporation, [REDACTED] will purchase passenger vehicles from independent vendors and, relying on its resale certificate, will pay no sales tax. [REDACTED] will lease the vehicles to [REDACTED] for a rental rate which will be established in an arm's length negotiation. [REDACTED] will pay tax measured by the amount of its lease payments. [REDACTED] will then sublease the vehicles to its customers who will not pay a sales or use tax."

The facts, as they pertain to [REDACTED], are the same, except that the [REDACTED], which is a wholly owned subsidiary of [REDACTED], will purchase passenger vehicles ex-tax and then lease the vehicles to [REDACTED]. [REDACTED] will sublease the vehicles to its customers who will not pay use tax.

You requested from the staff of the Board the following three rulings:

- "1. The rental of the leased vehicles to customers of [redacted] shall be treated as tangible personal property leased in substantially the same form as acquired; or alternatively
- "2. The rental of the leased vehicles to customers of [redacted] shall be treated as tangible personal property leased in substantially the same form as acquired; and
- "3. The customers of [redacted] (sublessees) shall not be required to pay a use or sales tax on vehicles on which [redacted] (lessor) has already paid a use tax.

The legal staff of the Board of Equalization is unable to make a "ruling" which will bind the members of the Board. The following analysis is an "opinion" of the legal staff which the members of the Board may take into consideration as a basis for overturning any future tax assessments which might be made upon the leasing transactions discussed herein (Revenue and Taxation Code Section 6596).

Analysis

The leasing of tangible personal property within the State of California constitutes both a "sale" and a "purchase", unless otherwise exempted (Revenue and Taxation Code Sections 6006 and 6010). Regulation 1660, which interprets Revenue and Taxation Code Sections 6006 and 6010, provides that the general measure of tax is a use tax on the use of the tangible personal property by the lessee (Reg. 1660 (c)(1)). The lessor has the burden of collecting the use tax and remitting the tax to the state (Rev. & Tax. Code §§6203 and 6457).

Excluded from the definitions of both "sale" and "purchase" are leases of tangible personal property, leased in substantially the same form as acquired, as to which the lessor has paid sales tax reimbursement or use tax measured by the purchase price (Rev. & Tax. Code §§6006(g)(5) and 6010(e)(5)).

If the lease is a continuing sale, it is a continuing sale whether exempt or not. (The exemption just means that no tax applies to that (continuing ss) I refering to a provision that says that a lease isn't a sale, that provision would not be an exemption (exemptions are needed only when there is a sale).

*DH
4/17/59*

Sales and Use Tax Regulation 1660 (c)(5) provides that "tax does not apply to receipts from subleases of tangible personal property...if the tax is paid on rental receipts derived under the prime lease, or any prior sublease." Under the factual scenario you have presented, both and will pay use tax on rental receipts derived from the prime lease.

However, literal compliance with statutes or regulations is not necessarily sufficient for exemption. In Commissioner v. Court Holding Co., 324 U.S. 331, a corporation desired to sell its assets to a third party. In order to avoid federal income tax on the sale, the corporation first transferred the assets to its shareholders in the form of a "liquidating dividend", and the shareholders then sold the assets to the third party. The United States Supreme Court concluded that the corporation and not the shareholders had in fact sold the assets, citing the following reasons:

"...the incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of the transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." [324 U.S. at 334.]

Along the same lines, Sales and Use Tax Annotation 330.2800 [8/14/69] provides:

"Tax evasion occurs when taxpayer, a corporation and the manufacturer of mechanical equipment, sells the equipment at cost to the sole owner of the corporation who pays sales tax on the equipment and leases it back to the corporation ex-tax. The corporation then rents the equipment without collecting a use tax. Although such a transaction might be proper if there was true separation of the identities of the parties, the sale

[REDACTED]

and leaseback transaction is not at arm's length and the sale at cost, rather than at fair market value, indicates an attempt to evade the use tax the manufacturer would be required to collect if he rented the equipment himself."

The California Supreme Court has indicated that the policy of the Sales and Use Tax Law is to ensure that property is "taxed at its highest value." (Kaiser Steel Corp. v. State Board of Equalization, 24 Cal. 3d 188 at 198.) We interpret this policy as requiring that property be taxed at a fair retail price. By "fair retail price", we mean a price which is calculated not only to return the wholesale cost of the property to the seller, but also at least to cover the seller's ordinary and necessary business expenses from the transaction.

We recognize, of course, that business exigencies often necessitate sales at reduced prices. Examples include distress sales where a seller is going out of business, and cases where property has been damaged or becomes obsolete. We do not mean to imply that a fair retail price could or should be required in such situations. We are addressing only situations where property is sold or leased between related entities in transactions which are not at arm's length.

In order for the rental receipts received under the sublease to be excluded from the imposition of sales or use tax, pursuant to Regulation 1660 (c)(5), the primary lease between a related lessor and lessee must be as though the parties are operating at arm's length, and the rental receipts received by the lessor must be at a fair retail price. In other words, the rental receipts received by the prime lessor must not only cover the cost of purchasing the vehicles, but also the cost of the business administration of the prime lessor. When rental receipts received on the prime lease fall below this standard, then the transaction between the prime lessor and lessee will be treated as a tax avoidance scheme and tax will be measured by the rental receipts received on the sublease.

*For "fair retail" selling price " under such circumstances may be far less than when the property is sold & the seller has all the time in the world to make the sale; so even if it were required, the result wouldn't likely change
D.H.
1/17/81*

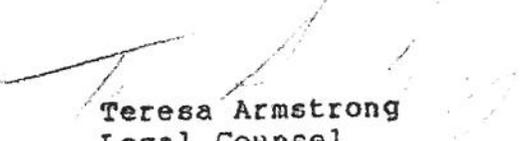
In response to the specific rulings that you requested, we find as follows:

1, 2 & 3. The sublease of tangible personal property leased in substantially the same form as acquired by the lessor will only be excluded from tax measured by rental receipts from

the sublease if the lessor either has paid tax or tax reimbursement measured by the purchase price or has reported tax based on a fair retail price pursuant to the prime lease.

If you have any further questions, please contact us again.

Sincerely,


Teresa Armstrong
Legal Counsel

TA:ba

bc:


Mr. Les Sorensen