

330.3424

Ms. Lori A. Senitte  
Return Review Section

August 21, 1991

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This is in response to your memorandum dated July 30, 1991. In a memorandum dated July 19, 1991, I responded to your previous memorandum regarding the application of use tax to certain charges under a taxable lease contract. In your correspondence with the taxpayer, you indicated that there were certain guidelines from the legal staff regarding the distinction between taxable rentals and nontaxable penalties. I stated that a charge set forth in the lease contract for retention of possession of the leased property beyond the due date should be regarded as a taxable rental. I asked you to send me a copy of guidelines from Legal which would be contrary to this conclusion. You have now sent a copy of a memorandum from Legal dated September 21, 1984 and ask for further guidance.

As noted in the memorandum you forwarded to me, "the critical factor is whether the lessee has the right to possess the property after the due date. If possession is wrongful and unlawful, then late charges cannot be interpreted as rental charges because the period for which the charges are assessed would be a period during which the lessee was no longer acting as lessee and had no right of possession." This statement remains the applicable rule; however, if the lease contract specifies the amount which the lessee must pay to the lessor if the property is retained beyond the termination date of the lease, then the lessee would generally not be regarded as unlawfully and wrongfully holding the property. The lease contract does not have to specify that this is an amount for an extended rental for us to conclude that the amount is part of the taxable rentals payable for lawful possession of the property. Thus, except as noted below, if the lease specifies the charge for retention of property beyond the lease termination date, the presumption must be that the charge is part of the taxable rentals payable. (Reg. 1660(c)(1) (taxable rentals include any payments required by the lease).)

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Nevertheless, it is true that an amount charged for retention of the property beyond the due date could be so substantial that it would be regarded as liquidated damages. The Legislature has set forth specific requirements for a valid liquidated damages provision. With respect to a contract for the retail purchase or rental primarily for personal, family, or household purposes, a provision in a contract for liquidated damages is void except when the parties to the contract agree upon an amount which the parties agree is presumed to be the amount of damages sustained by a breach of the contract, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damages. (Civ. Code § 1671(d).) Obviously, to meet these minimum requirements, the provision for liquidated damages must specify that it is a provision for liquidated damages and must specify that the parties agree that the amount of damages would be impracticable or extremely difficult to estimate.

I note that even if the contract meets these minimum requirements, any agreed amount must represent the result of a reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained. (Feary v. Aaron Burglar Alarm, Inc. (1973) 32 Cal.App.3d 553.) The party who relies on a liquidated damages provision has the burden of proof with respect to its validity. (Garrett v. Coast and Southern Federal Savings and Loan Association (1973) 9 Cal.3d 731, 738.) Thus, to avoid the requirement to collect use tax on the entire amount of the charge for retention of property by the lessee beyond the termination date of the contract, the lessor must establish that the payment was pursuant to a provision meeting the requirements of a valid liquidated damage provision. Otherwise, the payment cannot be regarded as liquidated damages, but rather must be regarded as additional rentals under the contract. I note that parties to a lease contract could, under many circumstances, properly set the liquidated damages equal to the normal rental. If all such charges were regarded as nontaxable, this would create a substantial loophole not authorized by the Sales and Use Tax Law. Rather, only those amounts specified in a valid liquidated damages provision which are in excess of the normal rentals are excluded from the measure of tax.

If you have further questions, feel free to write again.

bc: Ms. Victoria Lani Arena

This should be annotated as 330.3430 as follows:

Late Charges. An additional payment required by the lease contract which is made by the lessee for failing to return the leased property timely is a charge for continued possession of the property and is therefore subject to use tax regardless of whether the payment is designated as a rental or a penalty unless the contract provision meets the statutory requirements for a liquidated damages provision. To be regarded as liquidated damages, the contract must specify that the payment is for liquidated damages and that the parties have agreed that the amount of liquidated damages is presumed to be the amount of damages sustained by breach because it would be impracticable or extremely difficult to fix the actual damages. If meeting these requirements, the amount in excess of the normal rental charges would be regarded as nontaxable liquidated damages.