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November 5, 1981

Dear :

This is in response to your letter of September 3, 1981. We are also in receipt of your letter of September 8. We apologize for the delay in our reply.

You have sought our opinion as to the sales and use tax consequences of a certain described transaction involving your client.

We understand that [redacted] is expanding its brewery in [redacted]. It proposes to enter into the transactions hereinafter described. You suggest that their net effect will be to transfer mere legal title to certain equipment to a United Kingdom company, with [redacted] continuing to have all of the incidents of ownership pursuant to what is cast in the form of a lease. For entering into these transactions, [redacted] will receive and be entitled to retain approximately \$4.5 million.

You conclude that under the applicable U.S. laws the following will be considered to have occurred:

1. [redacted] will continue to be the owner of the assets (i.e., it will have all incidents of ownership), with the title that is transferred to the U.K. being a security interest only (California U.C.C. § 1201(37))--i.e., the sale/leaseback will not transfer ownership.

2. For federal income tax purposes, [redacted] will continue to be considered the owner of the assets--i.e., the sale/leaseback will not transfer ownership.

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3. For California Franchise Tax purposes, will continue to be considered the owner of the assets-- i.e., the sale/leaseback will not transfer ownership.

sole purpose in entering into the proposed transaction is to receive and retain \$4.5 million by enabling the U.K. company to claim certain statutory writing down allowances available in the U.K. where certain conditions are met. No U.S. benefits of any kind are available to or U.K. company by reason of the proposed transactions.

The \$50 million in assets that will be the subject of this transaction will be a part of over \$400 million in assets that is acquiring in the expansion. The specific assets will be selected from those listed on Exhibit A attached to your letter. You note that and its contractors have paid (or will pay) sales or use tax on that portion of those expenditures which are subject to such tax.

At the closing of the title transfer and as an integral part of that transaction, approximately \$45.5 million of the total consideration of \$50 million paid to will be deposited by (or an affiliate) with , an affiliate of the . company that is acquiring legal title to the assets. As a result, will receive net proceeds of \$4.5 million and the affiliated group of U.K. companies will have net outflow of the same amount. Interest and principal from that deposit will be precisely equal to, and will be used to pay, all rentals due under the lease during the 15-year lease term, so that at the end of that term the deposit will be exhausted and ; rental obligations during that term will have been satisfied. The remaining \$4.5 million will be retained by . At the end of the 15-year lease term, will have the following rights (i) to continue to use the assets ad infinitum upon payment of a nominal annual rental (designed primarily to defray the U.K. company's administrative expense) for 5 years and a lump sum payment of approximately \$400,000 (.8% of equipment cost); (ii) to sublease or assign its right to use the assets in perpetuity to whomever it chooses, or (iii) if it has no further use for the assets, to sell them to a third party (for scrap or otherwise) and retain all but 2-1/2 percent of the proceeds.

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In order to satisfy the technical requirements of U.K. law, the U.K. company will be given the right of removal of the assets upon breach or termination of the transaction. Since these assets are highly specialized and of practical value to only, neither party contemplates removing the assets during their useful life except for obsolescence. Furthermore, such removal would not be feasible since the assets or the buildings housing them would have to be dismantled in order to remove the assets from premises. Moreover any such dismantling would be at the U.K. company's expense which would be highly unlikely since the cost of such removal would exceed the value of the assets.

It is your position that this transaction is no more than a transfer of certain nominal rights designed to satisfy the U.K. legal requirements for claiming the writing down allowance. You state that none of the benefits or burdens of ownership of the assets subject to this transaction shift to the U.K. company. Thus, will have the entire risk of loss of the assets and will be responsible for all property taxes, insurance, repair, maintenance and all other expenses customarily associated with ownership. While it is expected that the useful life of the assets will extend beyond the 15-year term of the lease, will have the right to use the assets as long as it desires for a nominal charge and can transfer that right to whomever it chooses. It is your position that, in substance, has parted with nothing more than mere legal title. The absence of a reconveyance of legal title to is again a U.K. legal requirement.

As noted the Internal Revenue Service and Franchise Tax Board will tax as if these activities were no more than a financing transaction. will be entitled to depreciation and investment tax credit with respect to these assets. Also, we have been advised that's outside auditors will not require financial statement disclosure of this transaction (except possibly in a footnote), as either a leasing or a financing transaction, because substantially all of obligations will be satisfied from the deposit with the U.K. company's affiliate.

In your letter of September 8, 1981, you commented upon the two and one-half percent (2-1/2%) of sales and proceeds that belonged to the U.K. company if the assets in question were sold. You state that you are informed that the

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U.K. company's opportunity to realize that amount is totally illusory. This results from [redacted] right to sell its interest in the assets without paying the 2-1/2% amount so long as it does not purport to transfer the bare legal title that is in the hands of the U.K. company. You state that thus [redacted] would sell its rights only to maximize any return that would be available from any sale of the assets in question.

With respect to the lump sum payment upon termination of [redacted] s obligation to make payments, you suggest that the amount in question is nothing more than another aspect of the general financial terms of the transaction. You state that it satisfies [redacted] ; responsibility for any further payments and leaves the U.K. company with nothing but bare legal title which secures only the 2-1/2% amount described above. You state that this element of the transaction serves no purpose other than to satisfy certain technical requirements of British law.

We have discussed this matter with you and with Mr. [redacted] who is associated with you in this matter on July 13, August 11, August 20, August 25, September 1, September 4, September 10, and September 11, 1981. On September 4 we advised you preliminarily that in our opinion for California sales and use tax purposes this transaction is properly a sale of tangible personal property from [redacted] to [redacted] and as a leaseback by [redacted]

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The transaction in question is cast in the form of a sale and a leaseback. "Sale" under general California law --Commercial Code Section 2106--is defined to consist "in the passing of title from the seller to the buyer for a price." Under general California law "hiring" is defined as "a contract by which one gives to another the temporary possession and use of property, other than money, for reward and then later agrees to return the same to the former at a future time." The California Sales and Use Tax Law provides, in Revenue and Taxation Code Section 6006, that "sale" means and includes "any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration." The Sales Tax Law provides that "lease" includes "rental, hire and license." Rev. and Tax. Code Sec. 6006.3.

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While the transaction in question is in form a sale and a lease--absolute upon their face by agreement between the parties--you have requested that we recharacterize the transaction as a financing transaction only.

As you are aware, it has been our position that a sale and leaseback transaction should be classified as affecting only secured loans and sales where: (1) it is demonstrated that the sole purpose of the whole transaction is to obtain a loan of funds, (2) the parties do not treat the transfer as sales to obtain tax benefits (rental deduction, interest deduction, investment tax credit, accelerated depreciation, etc.), and (3) the seller-lessee has the right to reacquire title upon completion of the specified lease payments without being required to pay any additional consideration.

As we have discussed previously, the difficulty in the transaction in question is with the third requirement set forth in the paragraph immediately above. At the end of the 15-year lease term, title to the property remains in the owner-lessor. At the end of the five-year extension period, title remains in the owner-lessor, and the owner-lessor has the right to participate in the proceeds of disposition of the property.

We are of the opinion that the nominal owner and the real owner of the property in question remain one and the same until such time as the property in question is disposed of by sale. rights with respect to the property appear to be dependent exclusively upon the continued existence of the contractual relationship between it and the owner-lessor. That is, we are of the opinion that the right of to possess and use the property derives from the contract only, which remains in effect, and not from ownership of the property. This right to possess and use the property flows from payments made by it under the contract.

right to sell the property, one of the most significant incidents of ownership, is not absolute. would have no right to pledge, hypothecate, or give any other security interest in the property in exchange for a loan of money--again one of the significant incidents of ownership. Thus it is our conclusion that the permanent retention of title, coupled with the retention by the owner-lessor of the

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right to participate in the proceeds of sale, would prevent our recharacterizing the transaction in question as a mere financing transaction.

It is the parties which have chosen the form of the transaction, not the State Board of Equalization. If this were truly a financing transaction only, then there are many alternative forms in which the transaction could have been cast. Failure of the parties to utilize one of these other forms is suggestive to us that the true intent of the parties is that this transaction be what it appears to be on its face, a sale of tangible personal property and a lease of tangible personal property. The residual interests and manifestations of ownership following the specified lease terms are compatible with the interests of the party from the commencement of the transaction. Substance follows form, and this transaction is thus a sale and a leaseback for purposes of the California Sales and Use Tax Law.

Very truly yours,

Gary J. Jugum  
Assistant Chief Counsel

bc: District Administrator