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State of California

Board of Equalization
Legal Division (MIC:82)

CONFIDENTIAL ATTORNEY-CLIENT PRIVILEGE

Memorandum

To : Mr. Ray Morse
Business Taxes Compliance Supervisor

Date: March 23, 1995

From : Kelly W. Ching
Staff Counsel

Telephone: (916) 322-2976
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Subject:

This is in response to your memorandum dated December 12, 1995 regarding the application of tax to certain transfers of mobile transportation equipment (MTE).

Our understanding of the facts is that sold truck tractors to formerly known as on May 21, 1990 for $4,545,522.46. On May 23, 1990, entered into an agreement with under which was to pay $89,517.70 per month for a term of forty-eight months, and had an option to purchase the equipment at the end of that term. It appears that the delivered the truck tractors directly from its location in , California to location in California.

With your memorandum, you have enclosed a copy of a letter dated October 28, 1994 from the attorney for . Copies of invoices for the sale by to and a copy of the contract between and are attached to letter. explains that the contract between and includes the "Equipment Lease" agreement, the Terminal Rental Adjustment Clause, and the "Supplemental Terminal Rental Adjustment Clause-Lease Motor Vehicle Operating Lease Certification by Lessee," all dated May 23, 1990.

You and raise a question as to whether the transaction between and might be excluded from tax under one of the sale and leaseback provisions. Our understanding of the facts is that a sale took place between and and a subsequent transaction took place between and There is no evidence that acquired title to the truck tractors from Since did not have title, it could not have sold the

equipment to , and then leased the equipment back from . Since no transaction structured as a sale and leaseback occurred, the transaction that took place between and not excluded from tax under any of the sale and leaseback provisions.

As you know, the application of tax to sales and leases of mobile transportation equipment such as truck tractors differs from the application of tax to sales and leases of other tangible personal property in that a lease of MTE never constitutes a sale and purchase. (Rev. & Tax. Code §§ 6006(g)(4), 6010(e)(4), Reg. 1661.) Thus, a sale of MTE which the purchaser subsequently leases is not a sale for resale. Nevertheless, a purchaser of MTE who intends to use the MTE only by leasing it may issue a resale certificate for the limited purpose of electing to pay tax measured by the fair rental value rather than on purchase price. To effect the election, the purchaser must report tax measured by fair rental value on its timely return for the first reporting period in which the MTE was leased. (See Reg. 1661(b)(2).)

At this point, in order to determine the proper application of tax to the transaction that took place between and we must resolve the issue of whether the agreement between and constitutes a sale at inception, or whether it is instead a true lease.

Regulation 1660(a)(2)(A) explains that where a contract designated as a lease binds the "lessee" for a fixed term and the "lessee" is to obtain title at the end of the term upon completion of the required payments or has the option to purchase the property for a nominal amount, the contract will be regarded as a sale under a security agreement from its inception and not as a lease. The option price will be regarded as nominal if it does not exceed $100 or 1 percent of the total contract price, whichever is the lesser amount. This "sale at inception" rule applies whether the property is MTE or another type of tangible personal property.

Here, if is certain to obtain title after completing the required payments, the transaction between and will be regarded as a sale at inception. On the other hand, if is not certain to obtain title after completion of the required payments, the transaction will be regarded as a true lease.

With respect to whether is certain to obtain title, states at page 5 of his letter that "under the Contract's TRAC clause, Paragraph B, 'purchase rights' are mandatory. Specifically, TRAC Paragraph (c)(i) establishes

that shall be deemed the highest bidder on the Equipment and shall purchase the Equipment at Scheduled Termination for said Actual Residual Value.'"

In the next paragraph of his letter, however, states: "Further, as required in TRAC Paragraph (c)(ii), in the event and could not agree on the Actual Residual Value of the Equipment, then has the affirmative duty to obtain bids for the equipment from other prospective purchasers within the thirty (30) day period prior to Scheduled Termination, in which case both and would be free to bid on the Equipment during that period with the Equipment being sold to the highest bidder."

Our understanding of the contract between and is as follows: pursuant to paragraph (b) of the TRAC, rights to bid for or purchase the MTE pursuant to the provisions set forth in paragraphs (c)(i) and (c)(ii) are subject to a condition that if a law, regulation, procedure, ruling, or determination were to go into effect that would result in not being able to obtain certain tax benefits, purchase rights under paragraphs (c)(i) and (c)(ii) would be void, and instead, paragraph (f) would apply. Paragraph (f) provides essentially that would have a right to purchase the equipment for an appraised value to be determined as set forth in that paragraph.

Paragraph (c) provides that if no law such as that described in paragraph (b) goes into effect, and the lease has not been terminated and there has been no default prior to expiration, then the Actual Residual Value for the MTE may be determined up to thirty days prior to the scheduled termination by mutual agreement between and . If the value is so established shall be deemed the highest bidder as set forth in paragraph (c)(i), and shall purchase the MTE for that Actual Residual Value. Thus, when paragraph (c) applies and and can agree to the sale price, is required to purchase the property. If, however, and cannot agree on the actual residual value, then paragraph (c)(ii) applies. would have the duty to obtain bids, and both and , as well as other parties, would have the right to bid on the MTE. Paragraph (c)(iii) provides that will bear all expenses of a sale, regardless of who purchases the MTE. Paragraph (c)(iv) provides that if no bids are received and the MTE is not sold during the 30 day bid period, "the Actual Residual Value shall equal zero; provided, however, that when Lessor sells the Equipment, the net proceeds after expenses of sale actually received by Lessor shall be deemed the Actual Residual Value."

The provisions of the contract discussed above, and the statements in ' letter, indicate that parties other than might purchase the MTE at the end of the lease term. Furthermore, appears to bear responsibility for disposal of the MTE. Since is not certain to own the MTE at the end of the lease term and is not responsible for its disposal, the transaction between and is a true lease, and not a sale at inception.

I note that even if were required to purchase the property at the end of the lease term whenever paragraph (c) applies, that would not be sufficient to constitute a sale at inception. As discussed above, paragraph (c) applies only if certain laws or interpretations thereof do not prevent from obtaining certain tax benefits. If attorney determines that such benefits are not available because of the presence of paragraph (c), that provision is deemed void and only the purchase rights available under paragraph (f) apply. Those purchase rights constitute a true option (that is, is not required to purchase the property under paragraph (f) and the option price is not nominal). Our understanding is that it is a realistic possibility that the tax benefits sought by might not be available to it. That is, even if paragraph (c) simply required to purchase the property, there is no reasonable certainty that paragraph (c) would even apply and that paragraph (f) would not.

For the two reasons discussed above, we conclude that the contract is a true lease, and not a sale at inception. As discussed above, the lessor of MTE is always the consumer of that MTE, and tax is due with respect to the purchase price of the MTE unless the lessor makes a timely election to report tax on fair rental value.

The invoices attached to ' letter show that paid sales tax reimbursement to when it purchased the MTE. Thus, the election to pay tax on fair rental value instead of on purchase price is not available. No further tax is due with respect to the leases. However, if purchases the MTE at the end of the lease, tax will be due on that sale.

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

Kelly W. Clay

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