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STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

In the Matter of the Petition )  
for Redetermination Under the )  
Sales and Use Tax Law )

DECISION AND RECOMMENDATION

Petitioner

The above-entitled matter came on regularly for hearing on Thursday, June 26, 1980, in Sacramento, California before Susan M. Wengel, Hearing Officer.

Appearing for Petitioner:

Appearing for the Board:

Protested Items

The petitioner has filed a petition for redetermination of a tax deficiency determination issued on March 27, 1979, for the period 1-1-74 through 12-31-76. The protest involves tax determined on the following audit items:

TAXABLE MEASURE UNDERSTATED:

Audit Item A: Tax included in mobile transportation equipment lease income erroneously netted in reporting \$ 5,658

Audit Item B: Unreported lease income applicable to timely reported leases (advance payments (deposits) and outstanding receivables) 6,018

Audit Item C: Cost of mobile transportation equipment involving untimely reported lease income. Transactions with three firms:

(1)	[REDACTED]	
(2)	[REDACTED]	
(3)	[REDACTED]	\$ 521,557

Audit Item D: Reported lease receipts from untimely reported lease units -292,740

\$ 240,493

Audit Items F and G were conceded as being correct.

#### Contentions of Petitioner

1. The computations for reporting the fair rental value on mobile transportation equipment leases were in accordance with the prior auditor's instructions and current legal digest #394 of December 26, 1975.
2. The lease deposits were not taxable until the deposits were actually applied to meet a rent payment.
3. Timely elections for reporting on the fair rental value of the mobile transportation equipment was made as the equipment is "first leased", not when the lease is executed but when the equipment is placed in the possession of the lessee.
4. The negligence penalty should not apply as the majority of the measure assessed arose from the true belief that the manner of calculation was correct.

#### Summary of Petition

The petitioner is a corporation with offices in Fresno, Sacramento, Modesto and Redding. It engages in the business of selling, servicing, and renting trailers.

Since 1975 the petitioner has been a wholly owned subsidiary of [REDACTED]. The [REDACTED] was represented at the preliminary hearing by [REDACTED]. The prior owners were represented at the hearing by [REDACTED].

During a routine audit, deficiencies were found in each of the four accounts and a negligence penalty was imposed.

The petitioner contends that the lease deposits were not taxable; the computations for reporting were accurate; the elections to report were timely; and the negligence penalty is not warranted.

### Analysis and Conclusion

1. The computations for reporting the fair rental on mobile transportation equipment leases were in accordance with the prior auditor's instructions and current legal digest #394 of December 26, 1975.

The petitioner was leasing mobile transportation equipment. The election was made to measure the use tax liability by fair rental value. The petitioner was computing the measure of tax on the amount of the lease minus the tax and was charging the lessee a lump sum. The audit staff concluded that the fair rental value was the entire lump sum charged which would include the amount for tax. The petitioner contends that the policy of the Board as told by Board employees and as recorded in Current Legal Digest 394 are controlling.

On December 26, 1975 [redacted] an attorney for the Board, authored a memorandum which was summarized in the Current Legal Digest (#394) in April of 1978 as follows:

"Leases of Mobile Transportation Equipment -  
Fair Rental Value as Measure of Tax --  
Where a lessor of mobile transportation equipment elects to measure his use tax liability by fair rental value under Section 6094(d), and ... charges, for example, a lump sum of \$106, the fair rental value will also be regarded as \$100 for purposes of computing his use tax liability."

Revenue and Taxation Code § 6094(d) allows a purchaser to pay his use tax measured by fair rental value if the use of the mobile transportation equipment is limited to leasing. The petitioner made the election and reported use tax as outlined in [redacted] memorandum. The audit staff relied on a memorandum issued by [redacted] on August 24, 1978 which provides that the entire amount charged to the lessee is the appropriate measure for the petitioner's use tax. It is concluded that during the audit period which runs from January of 1974 through December of 1976 it was not the policy of the Board to consider the fair rental value as the entire lump sum amount charged to the lessee. The petitioner relied on this policy and the verbal advice of the Board's employees which was in effect during the audit period. Therefore, it is recommended that this item be deleted from the measure of tax.

2. The lease deposits or advance payments were not taxable until they were actually applied to meet a rent payment.

In setting up a lease of mobile transportation equipment with a customer, the petitioner would require the first month's rental in advance. Because of the value of the equipment the petitioner would also require the last month's rental or perhaps the last few months' rental. The entire amount of the "advance rentals" or "deposits" would be put into the advance payments section of the lease receivables. The amounts would be adjusted out of the subsidiary ledger when the payment was due from the lessee and debited to lease receivables and credited to the petitioner's income. The audit staff included the advance payments in the first month's measure of tax.

The petitioner, as the lessor of the mobile transportation equipment, must pay use tax on the leasing of the equipment. (Sales and Use Tax Regulation 1661(e).) The tax will not be due until the equipment is used. As the "use" has not occurred at the time the advance payments are paid by the lessee, they cannot be considered part of the measure of tax. The advance payments should not be considered as part of the fair rental value of the first month's use, but rather should be taxed in the months when they are applied to meet the rental payment.

3. Timely elections for reporting on the fair rental value of the mobile transportation equipment was made as the equipment was "first leased" not when the lease is executed but when the equipment is placed in the possession of the lessee.

Revenue and Taxation Code § 6094(d) provides that if the property is mobile transportation equipment and if the use is limited to leasing the equipment the purchaser/lessor may elect to pay his use tax measured by the fair rental value if the election is made on or before the due date of the return for the period in which the equipment is first leased. The audit staff concluded that "first leased" means the date the lease was executed. The petitioner contends the phrase "first leased" means the date the lessee receives possession of the equipment.

This conflict between the audit staff and the petitioner applies only to those situations where the date of the lease falls in one reporting period and the date the lessee took possession of the equipment falls in another. By using the date of the contract as the date the equipment was "first leased", the petitioner was found not to have made a timely election to report on rental receipts. Hence, tax was assessed on cost with a credit given for the amount of tax paid measured by fair rental value.

*This is true but only if the lessee's rental obligation begins upon transfer of possession. I.e. lessee starts owing rentals when lease has commenced.*  
*[Signature]*  
*2/11/78*

Regulation 1661(e) does not specifically define the phrase "first leased". The Board does, however, consider physical delivery to be an important element to consider when determining whether a sale has occurred. (Sales and Use Tax Regulation 1628(b)(3)(D)). The contracts between the petitioner and the lessees state that the lease is to commence on a particular date. We would conclude that the parties agreed that on that specific date the lessee was to get possession of the equipment and the "use" by the lessor would begin.

The date the parties agreed upon as the date the lease was to commence should be the date the equipment was "first leased". The election to report on fair rental value should be considered "timely" if reported on or before the due date of the return for the period in which the lease was to commence.

4. The negligence penalty should not apply as the majority of the measure assessed arose from the true belief that the manner of calculation was correct.

Revenue and Taxation Code § 6484 provides that if any part of the deficiency is due to negligence a ten percent penalty of the amount of the determination shall apply.

Although no evidence of intent to evade the tax was found, the audit staff imposed the ten percent penalty because of the relatively large overall deficiency and the fact that prior audit discussion involved several of the types of errors found during this period. Due to the fact that adjustments in the petitioner's favor will substantially decrease the amount of the assessment, it is recommended that the negligence penalty be deleted from the audit.

The petitioner has also requested that the Board review the bad debt accounts for the years 1974, 1975, and 1976. The district audit staff should review all the evidence and records submitted by the petitioner to determine whether a bad debt credit should be given.

Recommendation

It is recommended that an audit be conducted by the district audit staff in accordance with the provisions of this decision. At the hearing the petitioner also questioned the sales of vehicles on the last day before the tax rate increased from

five to six percent. The date of the delivery receipt will be controlling if available. However, if the petitioner had possession of the vehicle and the contract date and the D.M.V. report of sale indicate the vehicle was sold before the rate increase, the sales should be allowed at the lower tax rate.

Susan M. Wengel  
Susan M. Wengel, Hearing Officer

August 4, 1980  
Date

Reviewed for Audit:

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Principal Tax Auditor

\_\_\_\_\_  
Date