

Cite as 11 WTD 39 (1989).

BEFORE THE INTERPRETATION AND APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition	)	<u>D</u> <u>E</u> <u>T</u> <u>E</u> <u>R</u> <u>M</u> <u>I</u> <u>N</u> <u>A</u> <u>T</u> <u>I</u> <u>O</u>
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for Correction of Assessment	)	
of	)	No. 89-505
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[1] RULE 211: RETAIL SALES TAX -- LEASES -- EARLY TERMINATION PAYOFFS. Where an automobile lease is prematurely terminated, the taxability of the proceeds derived from a subsequent transaction involving that automobile is determined by the nature of the subsequent transaction. An automobile lease which is terminated and subsequently paid off by a consumer is a retail sale. A lease paid off by a dealer is a wholesale sale. A lease paid off by an insurance company is a wholesale sale to the extent that the amount paid represents the salvage value of the destroyed vehicle. Any amounts in excess of the salvage value of the destroyed vehicle are liquidated damages and taxable under the Service and Other Activities Tax classification.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .

DATE OF TELEPHONE CONFERENCE: . . .

NATURE OF ACTION:

The taxpayers protest the imposition of Retailing B&O and Retail Sales taxes asserted on the proceeds received from the sale of a lease vehicle which has been returned to the lessor upon premature termination of a lease.

Because of the close affiliation of the four taxpayers and the identical nature of the issue being appealed, the taxpayers' petitions have been consolidated for appeal.

FACTS & ISSUES:

Okimoto, A.L.J. -- . . . (hereinafter referred to as taxpayer) are all affiliated corporations engaged in the business of leasing automobiles. Their books and records were examined by a Department of Revenue (Department) auditor for audit periods beginning either on January 1, 1984 or January 1, 1985 and ending on December 31, 1987. Audit reports resulted in additional taxes and interest owing for the individual taxpayers and as a result, the above stated tax assessments were issued. The taxpayers have protested the assessments and they remain due.

In the audit report, the auditor asserted retailing and retail sales tax on the unreported proceeds received by the taxpayers from the sale of leased vehicles which had been returned to the taxpayer upon premature termination of a lease and subsequently paid off by either the lessee, a dealer, or an insurance company.

A sample lease transaction is as follows:

1. The customer selects a car from a dealer and the dealer writes up a lease worksheet.
2. The dealer then completes a lease agreement showing the customer as lessee and the dealer as lessor. At this time, the dealer collects from the customer a down payment plus retail sales tax, a refundable security deposit and the amounts needed for title, license, and registration fees. The dealer also collects the first month rental payment plus

retail sales tax. The dealer reports the down payment to the Department as a retail sale and remits the first monthly payment to the taxpayer. Upon execution of the 48 month lease agreement, it is immediately assigned to the taxpayer along with title to the vehicle. The taxpayer reports this payment and any subsequent payments to the Department as retail sales. The dealer also remits the security deposit to the taxpayer which is refunded or credited back to the lessee when the lease is terminated.

3. If the lease is prematurely terminated, a termination worksheet is completed. This early termination worksheet takes the total unpaid monthly base payments plus the residual less a rebate for the residual lease service charge, unearned management fees, and depreciation on the lease service charge. This amount is computed on the worksheet signed by the taxpayer and the lessee makes payment directly to the taxpayer.

Early termination may occur under the three following situations.

1. Early Payoff by the lessee or lessee's loan institution. - In this case, the lessee pays an amount computed in accordance with an early-payoff formula agreed to by both parties, and title to the vehicle is transferred to the lessee or its lending institution.

2. Early Payoff by a Dealer - In this case, the lessee normally desires to rent a higher priced vehicle. The lessee picks out a new vehicle to lease, and subsequently brings in the old vehicle to taxpayer's office and relinquishes control. The taxpayer holds the lessee liable only for previously unpaid monthly lease rentals and/or any damages to the vehicle at the time the vehicle is returned. The taxpayer releases the lessee from the balance of the contract in return for possession of the car and the execution of a new lease on a new vehicle. After the vehicle is brought in, the taxpayer will sell the returned vehicle to a dealer. The taxpayer applies the proceeds of the sale to payoff the remaining early-payoff amount on the original lease. Any excess or shortfalls in the proceeds from the sale of the vehicle are borne by the taxpayer.

3. Early Payoff by an Insurance company - In this case, the car has been in an accident and been considered a total loss by the insurance company. The insurance company will normally write a check for the early-payoff amount computed in the same manner as above. Upon payment, the taxpayer transfers title

to the car to the insurance company who will normally sell it for salvage.

In the audit report, the auditor asserted retailing and retail sales tax on all early payoffs made by either the lessee, lessee's lending institution, an insurance company, or a dealer. The auditor reasoned that the original dealer, or insurance company were merely fulfilling the lessee's contractual obligation and that any funds paid by the subsequent purchaser must be on behalf of the lessee. The auditor saw no distinction between whether the lessee, the insurance company, or dealer paid the funds.

At the teleconference, the taxpayer conceded that early payoffs, unpaid rental charges, and payments made for damages to the car, which were made by the lessee or its financial institution were properly subject to retailing and retail sales tax. The taxpayer states, however, that this is because the subsequent payoff is made by the lessee (a consumer) and not by someone who will resell the vehicle, such as a dealer. The taxpayer argues that once the lease is terminated, it is at an end and any subsequent sale of the returned car is an entirely separate and independent transaction. The taxpayer explained that once it receives the car, it immediately sells the used car to a dealer and if the selling price is greater than the early-payoff amount, the taxpayer receives a windfall, and if it is less, it absorbs the loss. The taxpayer states that in no event is the lessee held liable for unpaid lease payments.

#### ISSUE:

Upon mutual early termination of the rental contract by both the lessee and the assignee/lessor of a rental car, are the proceeds which are received from the subsequent sale of the car and applied to payoff the balance of the lessee's rental contract subject to Retailing B&O and retail sales tax.

#### DISCUSSION:

[1] The Supreme Court of Washington has ruled that leases of tangible personal property constitute a series of consecutive individual sales of such property for excise tax purposes. Gandy v. State, 57 Wn.2d. 690 (1961) As such, a 48 month lease is merely a promise to make a series of one month rentals.

In this case, we believe that both parties have successfully performed in accordance with the contract for a portion of its term, at which time both parties agree to rescind the balance of the contract. Once the lessee returns the car and it is accepted by the taxpayer, the rental contract is terminated and car rental payments under the rental contract cease. As a result, any subsequent transaction, whether that be the sale of the vehicle, or the recovery of insurance proceeds, must be taxed in accordance with the tax consequences of that particular transaction. We do not believe that the proceeds derived from transactions occurring after the contract is terminated relate back to previous rental periods nor do they constitute unpaid future rentals.

PAYOFF BY DEALER:

Because we believe the taxability of the second sale, which occurs after termination of the original lease, is totally independent of the prior lease, the correct classification of that sale is solely determined by the type of purchase. If the dealer has purchased the car for resale in the regular course of business, the sale is a wholesale sale and must be taxed accordingly. An adjustment to the audit report will be made upon presentation of the proper documentation to the audit section.

We distinguish this from the case where the lessee is in default of the contract, and the taxpayer terminates the contract, repossesses the vehicle, and sells the repossessed vehicle to a third party, and thereafter holds the lessee liable for any shortfall in the remaining rental payments. In this case, the sale to the third party remains either wholesale or retail, but any amounts paid by the lessee to the taxpayer in excess of the selling price of the vehicle, constitute liquidated damages received as compensation for the lessee's breach of its rental contract. Since the lessee no longer has possession of the property, we do not consider these amounts to be lease payments because they are not received for "... the act of granting to another the right of possession to and use of tangible personal property for a consideration." WAC 458-20-211. However, because the receipt of liquidated damages in lieu of the actual rental payments is attributable to the same property that the taxpayer is in the business of leasing, we believe that the receipt of those funds must be considered an integral part of the automobile leasing business. As such, these amounts would be fully taxable under the Service and Other Activities Tax classification.

PAYOFF BY INSURANCE COMPANY:

When the lessee's vehicle is destroyed in an accident, the lease provides as follows:

REPLACEMENT VEHICLE: If the vehicle is destroyed, stolen or damaged beyond repair, I hereby agree to accept a replacement vehicle of comparable actual cash value from you or the insurer of the vehicle. When I accept delivery of the replacement vehicle, all of the terms and conditions of this Lease shall apply to the replacement vehicle. If I refuse to accept any such replacement vehicle within five days after you or the vehicle insurer offers it to me, my refusal will be a default.

Under the terms of the contract, if the car is destroyed, the terms of the original rental contract continue in force once the lessor delivers a replacement vehicle to the lessee. Therefore, monthly rentals for the replacement vehicle under the original contract would constitute retail sales.

As to the original destroyed vehicle, however, once a replacement vehicle is tendered and accepted by the lessee, the lessee's obligation to rent that destroyed vehicle is suspended. Any amounts paid by the lessee or its insurance company to the owner (taxpayer) primarily constitute a satisfaction of the lessee's obligation to pay liquidated damages for the early termination of the rental contract of the original vehicle.

Consequently, we believe that when the insurance company tenders a check for the early-payoff amount, it is actually making two separate transactions. First, it is purchasing the destroyed rental vehicle at its salvage value. Because insurance companies normally resell the wrecked vehicles in the regular course of business this transaction is taxable under the Wholesaling Tax classification. Second, to the extent that the insurance proceeds exceed the salvage value of the destroyed vehicle, the insurance company is paying liquidated damages to the owner (taxpayer) which resulted from the lessee's early termination. Because these liquidated damages are derived from the taxpayer's rental property they must be considered an integral part of the business of leasing automobiles. As such, these amounts are fully taxable under the Service and Other Activities Tax classification.

## DECISION AND DISPOSITION:

The taxpayers' petitions are partially sustained. The matter will be remanded to the audit section for adjustments consistent with this determination.

DATED this 6th day of November 1989.