Cite as Det. No. 00-072, 19 WTD 1023 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment/Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 00-072
	)	
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 211: RETAIL SALES TAX -- FINANCING LEASE. Financing leases are treated as installment sales. The Department considers all the factors set out in WAC 458-20-211(2)(g), and other critical portions of the lease documents, to determine whether an arrangement is a financing lease rather than a true lease.

[2] RULE 211; RCW 82.04.050: RETAIL SALES TAX -- SALE/LEASEBACK -- INTEVENING USE. The Department may determine there was no "intervening use" for purposes of RCW 82.04.050, and therefore no retail sales tax was due on the initial purchase of equipment that was subsequently sold and leased back under a financing lease, when the documentary evidence and the parties' course of dealing establish that the taxpayer and the buyer/lessor agreed to the terms of a sale and leaseback before the taxpayer purchased the equipment, and the purchases were handled in accordance with that agreement.

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.

NATURE OF ACTION:

A taxpayer that purchased equipment, paying sales tax, then sold and leased the equipment back from a financing source, protests the treatment of its lease as a true lease rather than a financing lease, and protests the assessment of additional sales tax. It contends no additional sales tax is due because it paid sales tax on the original purchase.[1]

FACTS:

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

Prusia, A.L.J. -- The taxpayer, ..., is a Delaware corporation engaged in business in Washington. Its principal business activity in Washington is bio-technical research and development of vaccines.

The Department of Revenue (Department) conducted a partial audit of the taxpayer's books and records for the period July 1, 1997 through September 30, 1998. On April 23, 1999, the Department's Audit Division issued the assessment referenced above. The taxpayer protests a portion of the assessment and petitions for correction.

The disputed portion of the assessment is Schedule 3, which assesses use tax in the amount of $. . . on tangible personal property, consisting of office equipment, the taxpayer leased from . . . ("Finance") during 1997 and 1998, without paying retail sales tax on monthly lease payments. The Audit Division's report accompanying the assessment characterizes the transaction involving Finance as a sale and lease back of equipment the taxpayer had previously purchased, with sales tax due on each lease payment at the time payment is due. The taxpayer contends the transaction between it and Finance is a financing arrangement, with Finance holding title as a security interest only, and contends no additional sales tax is due because the taxpayer paid sales tax on the original purchase from the equipment vendors.

The facts are as follows. The taxpayer was formed in 1997. At its inception, it needed equipment for its operations. In May 1997, the taxpayer approached Finance about financing equipment purchases.

On July 17, 1997, Finance submitted an "Equipment Lease Line Proposal" to the taxpayer, proposing to lease "laboratory, production, computer and office equipment" up to a total cost of $. . . . The proposal stated: "This proposal is for evaluation and discussion purposes only and should not be considered as a commitment by the Lessor." The document proposed a lease term commencing "Upon delivery of the Equipment or upon each completion of deliveries of items of Equipment with aggregate cost of not less than $. . ., but no later than July 31, 1998." It proposed a lease term of 42 months, and monthly rental of 2.84% of equipment cost. It proposed the lessee would be responsible for maintenance, insurance, taxes, and all other costs and expenses. It proposed: "Sales or use taxes would be added to the Equipment Cost or collected on the gross rentals, as appropriate." It proposed that the lessee would have the option to purchase the equipment at the expiration of the lease term "for the greater of 10% of the original Equipment Cost or Fair Market Value, plus applicable sales and other taxes. It would be agreed that the Fair Market Value would not be less than 10% nor more than 20% of Equipment Cost." It proposed that if the lessee did not exercise the purchase option, the lease would automatically renew for a term of one year, with monthly rentals equal to 1.5% of equipment cost, and the lessee would have the option to purchase the equipment for $1.00.

On July 31, 1997, Finance submitted a revised "Equipment Lease Line Proposal," which differed from the earlier version mainly in changing the monthly rent, to 2.828% of equipment cost. Both the July 17 and July 31, 1997, documents provided a space for the taxpayer to sign its acceptance of the proposal. The copies of the documents the taxpayer provided the Department are not signed by the taxpayer.

The taxpayer began making equipment purchases to be financed by Finance around the end of July 1997, and the first deliveries were made in August 1997. The taxpayer paid sales tax to the vendors at the time of purchase.[2]

On September 17, 1997, Finance and the taxpayer signed an offer and acceptance that included the terms in the Equipment Lease Line Proposal. It added the following term: "The Lessor shall make available $. . . of the lease line to Lessee upon Lessee and Guarantor signing this letter, and the remaining $. . . upon the Lessee demonstrating [additional equity financing]." The taxpayer states it and Finance reached agreement on financing arrangements in July 1997, but the September 17 offer and acceptance is the earliest written confirmation the taxpayer has provided of an agreement.

In November 1997, Finance and the taxpayer signed a "Master Lease." The Master Lease provides that Finance "will purchase the Equipment [in the attached schedule] from the Supplier you chose," and will lease it to the taxpayer. The schedule covers already-delivered purchases totaling $. . . . At the same time, the taxpayer gave Finance a bill of sale to the equipment described in the lease schedule. Upon execution of the documents, Finance paid the taxpayer the purchase price of the equipment, plus the sales tax the taxpayer had paid at the time of purchase.

The Master Lease includes the terms set out in the offer and acceptance, and adds additional terms. It provides that the taxpayer will pay all delivery and installation expenses. It provides that the equipment is Finance's property, and the taxpayer will not own the Equipment unless the schedule gives it an option to purchase the equipment, and the taxpayer has exercised the option. The lease is non-cancelable. The lessor provides the lessee no warranty for the machine. If the equipment is unsatisfactory, the lessee must continue to pay the lessor, and must seek repair or replacement of the equipment solely from the manufacturer or supplier. The lessee is required to maintain the machine and keep it in good working order. The lessee also is required to maintain insurance coverage at its own expense. In the event of the lessee's default, the Master Lease allows the lessor a choice of remedies, including to "Require [the lessee] to immediately pay us all rent for the entire Term for any or all Schedules," and to sue for all rent owing plus the residual value of the equipment. The lessee may return the equipment at the end of the lease period, by giving 120 days' notice, returning all equipment in good operating condition (or paying for its repair), bearing all costs of packaging and shipping, and bearing all risk of loss.
The Master Lease provides:

> While this lease is intended to be a lease (and not a loan), you grant us a security interest in the Equipment to protect our interest in the Equipment if this Lease is later determined

[2] The taxpayer paid sales tax on all purchases except items of laboratory and production equipment that qualified for a tax deferral. That property is not included in Schedule 3, and is not a subject of this appeal.

> to be a security agreement. You give us permission to file this Lease or a Uniform Commercial Code financing statement, at your expense, in order to perfect this security interest.

It also provides:

> This Lease is a "Finance Lease" under Article 2A of the Uniform Commercial Code. You agree that (a) we have advised you of the identity of the Supplier, (b) you may have rights under the "supply contract" under which we are purchasing the Equipment from the Supplier and (c) you may contact the Supplier for a description of those rights.

The schedule modifies the Master Lease, adding the provision that if the taxpayer does not purchase the equipment at the end of the lease, it gives Finance permission to try to resell or auction the equipment from the taxpayer's location.

Between November 1997 and July 1998, the parties executed several additional schedules to the Master Lease, covering additional property. The schedules incorporate the terms of the Master Lease, and repeat the option to purchase and automatic renewal provisions of the Master Lease. The taxpayer followed the same pattern as with its earlier equipment acquisitions, purchasing the equipment, paying the sales tax at time of purchase, then periodically combining the purchases into a sale and leaseback arrangement, executing a new bill of sale and a new schedule to the Master Lease. All equipment was purchased and installed by the taxpayer before being sold to and leased back from Finance.

For federal tax reporting purposes, the taxpayer treats the lease transaction as a financing arrangement, not as a sale and lease back. For financial statement purposes, the taxpayer includes the leased assets in its fixed assets and recognizes depreciation expense. Finance is billed for property taxes, and in turn bills the taxpayer for reimbursement.

The taxpayer contends the transaction between it and Finance is a financing arrangement, with Finance holding title to the "leased" equipment as a security interest only. It states it would not have purchased the equipment had it not already reached agreement with Finance for the financing it needed. It argues that because it paid sales tax on the original purchase of the property, no additional sales tax is due. It contends that if the Department deems the transaction a sale to Finance, followed by an operating lease to the taxpayer, the taxpayer is entitled to a refund of the sale tax it paid the vendors when it purchased the equipment.

The Audit Division contends that under the facts presented, the transaction must be viewed as a purchase of the equipment by the taxpayer, followed by a period of use by the taxpayer, followed by a sale to Finance and lease back by the taxpayer. Its analysis, based on this characterization, is that the taxpayer properly paid sales tax on its purchase, and must also pay sales tax on its subsequent lease of the equipment from the new owner. These were separate taxable transactions. The taxpayer is not entitled to a refund of the sales tax it paid to the vendors, because its intervening use of the equipment prior to selling it to Finance precludes characterizing the taxpayer's purchase as a purchase for resale.

ISSUES:

1. Is the agreement between the taxpayer and Finance a true (or operating) lease or a financing (or capital) lease?
2. Is retail sales tax due on both the taxpayer's original purchase of the equipment and its lease of the equipment from Finance; is additional sales tax now due?

DISCUSSION:

The taxpayer's argument presents the issue as a choice between whether the arrangement between the taxpayer and Finance was a financing arrangement, or a sale to Finance followed by an operating lease back to the taxpayer. It argues that if we find it was a financing arrangement, sales tax was due at the time the financing lease commenced, but since sales tax had already been paid by the taxpayer, no further tax is due. We believe that oversimplifies the issues before us.

If <u>Finance</u> had purchased the equipment from the vendors, and then leased it to the taxpayer, the only issue would be whether the lease was a true lease or in substance a loan. However, that is not what occurred. Instead, the <u>taxpayer</u> purchased the equipment from the vendors, paying retail sales tax on the purchases, and as the aggregate cost of its purchases reached certain amounts, sold the equipment to Finance and signed leases. There were two sales plus the lease. Whatever the nature of the lease, the manner in which the parties handled the acquisitions and financing presents the issue whether tax is owed both on the taxpayer's original purchase from the vendors and its subsequent lease from Finance. We first will address the issue of whether the lease is a "financing lease" or a "true" lease.

<u>Financing lease or true lease?</u>

WAC 458-20-211 (Rule 211) explains how persons are taxable who rent or lease tangible personal property. Rule 211(2) defines the term "leasing" as referring generally "to the act of granting to another the right of possession and to and use of tangible personal property for a consideration."

Rule 211(6) provides, in pertinent part:

> Persons who rent or lease tangible personal property to users or consumers are required to collect from their lessees the retail sales tax measured by gross income from rentals as of the time the rental payments fall due.

. . .

> (b) Financing leases are treated for state tax purposes as installment sales. The retail sales tax applies to the full selling price. Refer to WAC 458-20-198.

Rule 211(2) defines the terms "true lease" and "financing lease" as follows:

> (f) The term "true lease" (often referred to as an "operating lease") refers to the act of leasing property to another for consideration with the property under the dominion and control of the lessee for the term of the lease with the intent that the property will revert back to the lessor at the conclusion of the lease.
>
> (g) The term "financing lease" (often referred to as a "capital lease") typically involves the lease of property for a stated period of time with ownership transferring to the "lessee" at the conclusion of the lease for a nominal or minimal payment. The transaction is structured as a lease, but retains some elements of an installment sale. Financing leases will generally be taxed as if they are installment sales. The presence of some or all of the following factors indicate a financing lease with the transaction treated as an installment sale:
>
> (i) The lessee is given an option to purchase the equipment, and, if so, the option price is nominal (sometimes referred to as a "bargain purchase option");
>
> (ii) The lessee acquires equity in the equipment;
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> (iii) The lessee is required to bear the entire risk of loss;
>
> (iv) The lessee pays all the charges and taxes imposed on ownership;
>
> (v) There is a provision for acceleration of rent payments; and
>
> (vi) The property was purchased specifically for lease to this lessee.

Regarding the use of a lease as a disguised security agreement to finance the purchase of tangible personal property, the Washington Supreme Court said, in *Courtright Cattle Co. v. Dolsen Co.*, 94 Wn.2d 645, 655, 619 P.2d 344 (1980):

> [T]he use of this type of financing arrangement is widespread. It is provided for by article 9 of the U.C.C. [Uniform Commercial Code] and has been considered in other jurisdictions.
>
> RCW 62A.9-102(2) states that Article 9 applies to leases intended as security. RCW 62A.1-201(37)(b) provides that "an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security."

The lease from Finance to the taxpayer has many attributes of a financing lease. The taxpayer appears to acquire equity in the equipment by capitalizing and depreciating it on its federal tax returns. *See*, Det. No. 99-21, 19 WTD 37 (2000). The taxpayer is required to bear the entire risk of loss by maintaining insurance on the equipment at its expense. The lessor provides no warranty and the taxpayer is required to provide all maintenance on the equipment. The taxpayer is required to pay all delivery and set-up charges, and is required to pay all personal property taxes and sales taxes on the equipment. The agreement provides for acceleration of lease payments upon default in a payment. The Master Lease provides the lessor is purchasing the equipment specifically to lease it to the taxpayer. Moreover, the Master Lease expressly provides that it is a "'Finance Lease' under Article 2A of the Uniform Commercial Code."

The primary point of dispute is whether the option price under the lease is "nominal." In its explanation accompanying the audit assessment, the Audit Division explained its basis for the assessment as follows: "The option to purchase the equipment at market value rather than a nominal price is indicative of a 'true or operating' lease. If the taxpayer does not exercise the purchase option, the automatic renewal clause creates a financing lease." The taxpayer, on the other hand, argues the purchase price is nominal, because if the taxpayer "does not exercise its initial purchase option at the end of the lease term, [Taxpayer] has a bargain purchase option [$1.00] one year later."

Court decisions and the Department's determinations generally base a determination whether an option price is "nominal" on its size relative to the fair market price of the property. For example, in *Rainier Nat'l Bank v. Inland Machinery,* 29 Wn.App. 725, 732, 631 P.2d 389 (1981), the Washington Court of Appeals noted: "For the most part, decisions from other jurisdictions where the amount of the purchase price at the time of option was less than 25 percent of the fair-market value have been held to be nominal amounts." By that test, 100% of fair market value (the option price at the end of the original 42 month lease period), would not be considered "nominal."

However, the taxpayer was offered alternative purchase options, one of which unquestionably was nominal. Considering the financing terms and the two option provisions together, it is clear Finance intended to recover its cost plus a reasonable return, and structured the terms so that there would be no reason for the taxpayer to return the property. Finance intended to recover a total amount equal to at least the monthly payment times 42, plus 10% of its cost. The payments were structured so that at the end of 42 months Finance would already have recovered 119% of its cost, or roughly its cost plus 8% interest. The taxpayer was given alternative purchase options for paying the relatively small balance, which assured it a "nominal" price at the end.

[1] Even if the option price is not considered "nominal," a single factor is not controlling. All the *Courtright Cattle* considerations, and other critical portions of the contract, must be considered. Most factors are consistent with a financing lease. The option provisions, read together, also are consistent with an intent to sell the equipment rather than lease it. Returning the equipment was not a real option. The taxpayer could not return the equipment for any reason during the first 42 months, and could return it after 42 months only by giving 120 days' notice, returning all equipment in good operating condition (or paying for repair), paying all costs associated with returning the equipment, and assuming all risk of loss or damage. That Finance did not intend the return of the property is further evidenced by the provision in the schedules allowing it to sell or auction the equipment from the taxpayer's site. Reading the lease as a whole, we find the parties intended a sale with a security provision, rather than a lease in which the equipment would eventually be returned to Finance.

<u>Is sales tax due both on the taxpayer's purchase of the equipment and its lease of the equipment; is additional sales tax now due?</u>

RCW 82.08.020 imposes a retail sales tax on each retail sale in this state. RCW 82.04.050 provides, in relevant part:

> (1) "Sale at retail" or "retail sale" means every sale of tangible personal property . . . other than a sale to a person who presents a resale certificate under RCW 82.04.470 and who:
>
> (a) Purchases for the purpose of resale in the regular course of business <u>without intervening use</u> by such person; . . . (Emphasis added.)

The failure to give resale certificates at the time of purchase is curable, and does not preclude the Department from giving a taxpayer a credit or refund for tax paid at source. *See* WAC 458-20-102(5), (5)(d); Audit Directive 8211.1 (August 10, 1987), Det. No. 89-548, 8 WTD 451 (1989).

Det. No. 87-4, 2 WTD 127 (1986), stated as follows concerning the requirements of RCW 82.04.050:

> Accordingly, if a person purchases property, uses it, and then executes a sale/leaseback, the retail sales tax applies to the initial retail purchase and the subsequent lease payments. Pursuant to [RCW 82.08.020 and 82.04.050], the two transactions are separate and independent taxable events. . . .
>
> A purchaser can avoid payment of the sales tax on the first transaction where property is purchased with the intent to execute a sale/leaseback if there is no intervening use of the property between the time of the initial purchase and execution of the sale/leaseback or a commitment to lease the property is executed at the time of the initial transaction. The retail sales tax is then collected from the lessee as the rental payments fall due. WAC 458-20-211.

Based upon the documentary and other evidence provided, we find the taxpayer purchased the equipment with the intention of reselling it to Finance. The taxpayer's intent was to finance all the equipment acquisitions through Finance.

Was there "intervening use" for purposes of RCW 82.04.050(1)(a)? Det. No. 87-4 held that under the facts presented in that case, sales tax was due because the decision to lease was made <u>after</u> the taxpayer acquired the property. A recent determination, Det. No. 99-104, 19 WTD 76 (2000), held that the no intervening use requirement was met when the taxpayer used the property between its purchase and execution of the sale/leaseback documents, but the taxpayer and the lessor had signed a <u>commitment</u> to lease the property <u>before</u> the taxpayer purchased it.

[2] In the present case, both the documentary evidence, and the parties' course of conduct, are consistent with the taxpayer's claim that it made all purchases with the intent that they be financed by Finance, after reaching an agreement with Finance on financing terms. The

documentary evidence establishes the parties were negotiating financing terms in July 1997. There are no substantial differences between the terms set out in the July Equipment Lease Line Proposals and the subsequent documents, indicating the parties reached an agreement in July 1997. The first financed equipment was delivered in August 1997. The parties have followed a course of dealing, both before and after their formal agreement, in which the taxpayer purchases the property first, and the financing documents are signed afterward. A determination of whether there was "intervening use" for purposes of RCW 82.04.050 depends upon the particular facts of a case. Under the facts of this case, we find the taxpayer purchased all of the equipment it financed through Finance for the purpose of resale in the regular course of business without intervening use by the taxpayer.

Retail sales tax is due only once under these circumstances. The taxpayer should have presented its vendors with resale certificates when it purchased the equipment for resale, Finance should have presented its vendor (the taxpayer) with resale certificates when Finance purchased the equipment for resale, and Finance should have collected retail sales tax on the full "installment price" when it "leased" the equipment to the taxpayer. Although the taxpayer has paid retail sales tax once, the amount it paid (which was on the first sale) was less than the amount it owed (which was on the last sale). This is because each sale in the sequence was for a higher sales price than the previous sale. The taxpayer is properly assessed retail sales tax on the "lease" by Finance, and given credit for the tax paid at source.

DECISION AND DISPOSITION:

The taxpayer's petition is granted, in part. The lease will be treated as a financing lease, and retail sales tax is owed only once. The taxpayer's request for a determination that no additional sales tax is due is denied, because the amount of sales tax the taxpayer has already paid is less than the amount due on the transaction that is subject to tax, as stated above. The assessment is remanded to the Audit Division for adjustment consistent with this determination.

Dated this 25th day of April, 2000.