Cite as Det. No. 99-021, 19 WTD 37 (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. 99-021
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 211; RULE 178; RULE 198; RCW 82.08.090; RCW 82.12.060: USE TAX – FINANCING LEASE. In light of the factors in Rule 211(2)(g), the taxpayer, as "lessee", had a "financing lease" rather than a "true lease" of tangible personal property. Thus, sales tax is due on the total selling price at the time a sale of tangible personal property is made on an installment basis. If sales taxes are not collected and remitted, the Department may pursue the buyer/lessee for use tax on the total selling price.

[2] RCW 82.32A.020(2): ESTOPPEL. The Department is not estopped from assessing tax where the taxpayer has failed to show that it detrimentally relied on prior reporting instructions.

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 corporation (the taxpayer) protests the assessment of use tax on machinery it acquired by lease from a separate company owned by the taxpayer's two shareholders.[1]

FACTS:

De Luca, A.L.J. -- The taxpayer's business is to collate, bind, stack, etc., printed materials belonging to its customers. In order to help provide these services, the taxpayer on April 10,

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

1994 entered into a "Lease Agreement" with a separately registered company (the lessor) to acquire a machine that could perform these multiple tasks. The two owners of the lessor are also the taxpayer's sole shareholders.

The lease agreement provides that the lessor purchased the machine specifically to lease it to the taxpayer. The lessor provided the taxpayer no warranty for the machine other than what the machine's manufacturer provided. The taxpayer is required to maintain the machine and keep it in good working order. The taxpayer also is required to maintain insurance coverage on the machine at its own expense. All delivery and set-up expenses and taxes for the machine were to be paid by the taxpayer. The lease agreement requires the taxpayer to pay the lessor $. . . in 84 monthly installments beginning May 10, 1994. Each installment payment is for $. . . plus sales tax. Failure to make a monthly installment allows the lessor to accelerate payment of the balance due. The lessor has the right to repossess the machine upon default by the taxpayer. At the end of the lease, the taxpayer has the option to purchase the machine for $. . . (10% of the purchase price or market value).

The Department of Revenue (the Department) audited the lessor for the period January 1, 1992 through June 30, 1995 and assessed $. . . in retailing business and occupation (B&O) tax, retail sales tax, and interest. Document No. FY. . ./Audit No. . . . . The basis of the assessment was that the lessor had failed to charge and collect retail sales tax from the taxpayer for the personal property taxes it had billed the taxpayer for the machine. The lessor had collected and remitted sales tax on the balance of the monthly charges, other than for the personal property taxes, that it billed the taxpayer.

The Department later audited the taxpayer for the period January 1, 1993 through June 30, 1997 and assessed $. . . in taxes and interest. Document No. FY. . ./Audit No. . . . . The item at issue resulting from this audit was the assessment of $. . . in use tax on the subject machine. The Department's Audit Division credited the taxpayer for the sales tax it had paid the lessor monthly on the machine from April 1994 through June 1995.[2] The Audit Division determined the lease agreement between the taxpayer and the lessor was not a "true" or "operating lease," but was actually a "capital" or "financing lease." In support of this finding, the Audit Division noted that the taxpayer treated the lease of the machine as a capital lease for federal income tax purposes (i.e. capitalized and depreciated it) while treating it as an operating or true lease for state tax purposes. The Audit Division declared that such a practice is prohibited by Det. No. 87-354, 4 WTD 293 (1987). Consequently, the Audit Division decided the transaction was an installment sale rather than a rental or true lease and, pursuant to WAC 458-20-198 (Rule 198), it assessed use tax on the full value of the machine as of April 1994, the time when the taxpayer acquired it.

[2] After June 1995, the lessor did not collect sales tax from the taxpayer because the parties believed their lease agreement qualified them for the sales tax exemption allowed sales of manufacturing machinery and equipment under RCW 82.08.02565, which became effective July 1, 1995.

TAXPAYER'S EXCEPTIONS:

The taxpayer believes it is entitled to rely on the Department's prior audit instructions to the lessor concerning the machine. The Audit Division, in that audit report, treated the lease agreement as a true or operating lease because it assessed retail sales tax against the lessor only on unreported sales for personal property taxes billed to the taxpayer. The Audit Division did not otherwise question the lessor's monthly charges to the taxpayer for the machine. Those monthly charges included sales tax for everything, but the personal property taxes.

The Audit Division found that the taxpayer would pay only a nominal price (10% of the original price) to purchase the subject machine at the end of the seven-year agreement. This fact, in part, supported the Audit Division's decision that the agreement was a financing lease and not a true lease. The taxpayer believes the Audit Division misinterpreted Courtright Cattle Co. v. Dolsen Co., 94 Wn.2d 645, 619 P.2d 344 (1980) in determining the lease agreement was a financing lease. The court in Courtright ruled that a lessee's right to purchase equipment for 10% of its market value at the end of a lease amounted to nominal consideration, which supported the finding that the lease was intended by the parties to be a security agreement and not a true lease. The taxpayer believes the Audit Division in the present matter failed to account for the significant technological changes in the printing and binding industry, including increasing competition from desktop publishers. Therefore, the taxpayer argues the Audit Division failed to consider the technological obsolescence of the machine when evaluating whether the option price met the Courtright nominal consideration test.

Finally, the taxpayer concedes it incorrectly accounted for the machine differently on its state excise tax returns compared to the way it accounted for the machine on its federal income tax returns. The taxpayer blames the problem on erroneous advice from a prior accountant. Nonetheless, the taxpayer believes its situation is distinguishable from the one reported in Det. No. 87-354, supra. In that case, both the lessor and lessee treated their transaction on their respective federal income tax returns as a sale/leaseback, while they treated the transaction as a loan for state tax purposes. By contrast, in the present matter, the lessor treated the transaction on its tax returns only as an operating lease while the taxpayer also treated it as an operating lease on its state tax return.

ISSUES:

1. Is the agreement between the taxpayer and the lessor a true (or operating) lease or a financing (or capital) lease?

2. Is the taxpayer entitled to rely on the audit instructions the Department provided the lessor about reporting the monthly lease payments for the machine as a true lease?

DISCUSSION:

WAC 458-20-211 (Rule 211) 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 indicates 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;
>
> (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.

In light of these factors, we find the present taxpayer, as lessee, has the option to purchase the machine at the end of the lease for a nominal price of 10% of its market value. The taxpayer appeared to acquire equity in the machine by capitalizing and depreciating it on its federal tax returns. The taxpayer is required to bear the entire risk of loss by maintaining insurance on the machine at its expense. The lessor provides no warranty and the taxpayer is required to provide all maintenance on the machine. Furthermore, the taxpayer paid all delivery and set-up charges as well as personal property taxes and sales taxes on the machine. The agreement does provide for acceleration of lease payments upon default in a payment. Finally, the lessor purchased the machine specifically to lease it to the taxpayer.

In short, the transaction was an installment sale because the taxpayer’s agreement with the lessor clearly meets the “financing lease” factors in Rule 211(2)(g), including the nominal option purchase price factor discussed in Courtright. See also Det. No. 88-458, 7 WTD 75 (1988). Conversely, we find that the agreement was not a true lease or rental.

RCW 82.08.090 provides:

> **Installment sales and leases.** In the case of installment sales and leases of personal property, the department of revenue, by regulation, may provide for the collection of taxes upon the installments of the purchase price, or amount of rental, as of the time the same fall due.

See also RCW 82.12.060. In the case of rentals or trues leases, the Department has provided for the collection of sales taxes or use taxes as the periodic payments fall due. See Rule 211(6) and (7). However, the Department has not provided for the periodic collection of sales taxes or use taxes for installment sales of personal property. Instead, WAC 458-20-198 (Rule 198) provides:

> Persons making conditional sales or other installment sales of tangible personal property must report the total selling price of such sales in the tax period in which the sale is made.
>
> The foregoing is true irrespective of the fact that such sellers arrange to receive payment of tax in installments or that a contract may be discounted or pledged with or sold to a finance company. In the latter case, although as a part of the agreement with the seller the finance company actually makes collection of the tax from the buyer as the installments fall due, the finance company should not report to the department of revenue the amount of tax collected since the total tax already has been reported by the seller.

If the seller has not advanced the tax at the time of the installment sale, the Department is not restricted from pursuing the buyer for the full amount of use tax (or deferred sales tax) prior to the running of the installments, as provided in RCW 82.08.050. See Det. No. 91-321, 11 WTD 515 (1991). Therefore, the Audit Division correctly assessed use tax/deferred sales tax against the taxpayer on the full purchase price because the taxpayer and the lessor had an installment sales contract as of April 1994, and not a true lease.

The remaining issue is whether the taxpayer had a right to rely on the audit instructions the Department provided the lessor that allowed the lessor to continue collecting sales tax on the monthly payments for the machine.

The Taxpayer Rights and Responsibilities Act, Chapter 82.32A RCW, provides, in pertinent part, that taxpayers of this state have...

> The right to rely on specific, official written advice and written tax reporting instructions from the department of revenue to that taxpayer, and to have interest, penalties, and in some instances, tax deficiency assessments waived where the taxpayer has so relied to their proven detriment;

(Emphasis added). RCW 82.32A.020(2).

We find the taxpayer has not established all the required elements of RCW 82.32A.020(2). Specifically, the taxpayer did not act on the faith of the subject reporting instructions. Prior to the Department auditing the lessor, the taxpayer was paying sales tax on each monthly payment it made for the machine. After the lessor's audit, the taxpayer was to pay more sales tax each month as a result of the Audit Division's instructions to the lessor to collect additional sales tax for the personal property tax it charged the taxpayer. We fail to see how the taxpayer changed its position in reliance upon the instructions.

Furthermore, we do not know how the taxpayer detrimentally relied on, or was injured by, the reporting instructions given to the lessor in November 1995. Whether the lease agreement was a true lease (which we have decided it was not) or a financing lease (which it is), sales tax was due from the taxpayer. If the agreement had been a true lease, sales tax was due with each monthly payment. Because it was an installment sale, sales tax was due on the entire purchase price when the transaction occurred in April 1994. Rule 198. . . . . Likewise, the taxpayer cannot show that it was injured by, or detrimentally relied on, the Department's reporting instructions given to the lessor 18 months after the parties signed the lease agreement.

Similarly, the taxpayer does not meet the elements of equitable estoppel as established by court decisions. Equitable estoppel would bar the Department from enforcing the assessment. In order to create an equitable estoppel against the Department, the burden is on the taxpayer to establish the following three elements. (1) There must be an admission, statement, or act inconsistent with the claim afterwards asserted. (2) There must be action by the other party on the faith of such admission, statement, or act. (3) There must be injury to such other party resulting from allowing the first party to contradict or repudiate such admission, statement, or act. Shafer v. State, 83 Wn.2d 618, 521 P.2d 736 (1984); Det. No. 93-300, 13 WTD 396 (1993).

When a party seeks to assert equitable estoppel against the Department, that party must also show (1) that equitable estoppel is necessary to prevent a manifest injustice; and (2) that the exercise of governmental powers will not thereby be impaired. Finch v. Matthews, 74 Wn.2d 161, 443 P.2d 833 (1968); Det. No. 93-300, supra.

Because application of the doctrine of equitable estoppel against the Department is disfavored, a party seeking to invoke the doctrine has the burden of proving each of the elements by clear, cogent, and convincing evidence. Chemical Bank v. Washington Public Power Supply System, 102 Wn.2d 874, 691 P.2d 524 (1984); Kramarevcky v. Department of Social & Health Services, 122 Wn.2d 738, 863 P.2d 535 (1993); Det. No. 93-300. Where public revenues are involved, a general rule has been articulated that, at least in tax cases, courts should be "most reluctant" to find the Department equitably estopped. Harbor Air Service, Inc. v. Board of Tax Appeals, 88 Wn.2d 359, 560 P.2d 1145 (1977); Det. No. 93-300, supra.

Thus, to establish equitable estoppel, a taxpayer must first meet the three elements required by RCW 82.32A.020 (a statement, reliance, and injury). Additionally, the taxpayer must show that equitable estoppel is necessary to prevent a manifest injustice and that the exercise of government powers will not be impaired. Furthermore, the taxpayer must prove all of these elements by clear, cogent, and convincing evidence. We have shown above the taxpayer has not met all the required elements of RCW 82.32A.020. Obviously, if the taxpayer has not met the statutory requirements, it does not meet those same elements required by equitable estoppel. Consequently, the taxpayer has no basis under either RCW 82.32A.020 or equitable estoppel to rely on the lessor's audit instructions.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

Dated this 29th day of January 1999.