Cite as Det. No. 07-0247, 27 WTD 41 (2008)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	
	)	No. 07-0247
. . .	)	
	)	Registration No. . . .
	)	Doc. No. . . ./Audit No. . . .
	)	Docket No. . . .
	)	

RULE 211; RCW 82.04.050: RETAIL SALES TAX – RETAILING B&O TAX – FINANCING LEASE – TRUE LEASE –TELEPHONE EQUIPMENT. In determining whether a lessor of telephone equipment was leasing the equipment under true/operating lease or financing lease we considered a nine factor test, plus additional evidence. Where some of the nine factors were present for a financing lease, but where these factors were either not strong indicators of a financing lease or there were mitigating circumstances, and the majority of the factors strongly indicated a true lease, we conclude that the transaction was a true lease.

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.

De Luca, A.L.J. (Successor to Breen, A.L.J.) – A foreign corporation providing telephone equipment to its customers/lessees protests the assessment of retail sales tax and retailing business and occupation (B&O) tax assessed against it by the Audit Division of the Department of Revenue (DOR) because the Audit Division determined that the taxpayer provided its clients the equipment through financing leases rather than through true leases (also known as operating leases). We hold that the disputed leases are true leases and grant the petition.[1]

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

ISSUE

Did the taxpayer provide telephone equipment to its customers/lessees through financing leases or true leases per WAC 458-20-211?

FINDINGS OF FACT

The taxpayer is a foreign corporation with its headquarters based outside the state of Washington. The taxpayer is in the business of leasing telephone systems to various businesses, government agencies, non-profit organizations, and service organizations. . . . During the audit period, the taxpayer had . . . customers in the state of Washington. The taxpayer treated its agreements with the . . . customers as true leases by billing and collecting sales tax on a monthly basis rather than collecting the sales tax on the full purchase prices at the beginning of the agreements as in installment sales, which we discuss below.

[A related corporation] is engaged in the business of marketing, selling, installing and servicing the . . . telephone communication systems. When [the related corporation] markets a telephone system to a customer, the customer can choose whether it wants to purchase . . . or lease the telephone system from the taxpayer, or arrange to have another leasing company purchase the telephone system and lease it to them. If the customer purchases the system outright or if it arranges to have an unrelated leasing company purchase it and lease it to them the taxpayer will have no involvement in the transaction. If the customer chooses to lease the telephone system from the taxpayer and the customer qualifies as credit worthy, the taxpayer will purchase the system from [the related corporation] and lease it to the customer. The typical lease term is for . . . years.

The parties enter into a “Lease Agreement.” Of the . . . lease agreements that the taxpayer had with Washington customers during the audit period, [a small number] expressly provided for an end-of-lease [small dollar amount] purchase option. The taxpayer concedes that these were financing leases and are not at issue. We will not address them further. Another [small number of] leases expressly provided for an end-of-lease fair market value purchase option. . . . The [vast majority of] leases did not provide for an end-of-lease purchase option at all.

The . . . lease agreements at issue provide that the taxpayer is the owner and has title to the equipment. The lease agreements do not credit lease payments toward the purchase price of the leased property. The agreements do provide that the customers pay all taxes associated with the lease and that the customer is required to reimburse the taxpayer for its personal property tax liability on the equipment. The agreements do not provide that the customers agree to pay all taxes associated with ownership of the equipment.

The agreements declare that in case of default by the customer, the taxpayer, with ten days written notice, has the right to demand a return of the equipment with the present value of all lease payments becoming due and payable, computed with a . . .% discount rate per year. Upon its return, if the taxpayer sells the equipment for more than the present value of the lease payments and the costs of retaking, storing, repairing, and selling, then the customer will be given credit for the excess.

The agreements do not require a security interest either in the equipment at issue and/or any other equipment or property of the customers. The agreements allow the taxpayer to file a financing statement. And for each of its lease agreements the taxpayer does file a UCC Financing Statement, but with [a] declaration written on it [to the effect that the transaction is a rental and not intended as a security transaction].

The taxpayer treated all of the leases as true leases on its federal income tax returns. The taxpayer has provided us copies of such returns for 2000, 2001, 2002, and 2003, which are the years included in the audit. The taxpayer on each return declared the rental payments as income and took a depreciation deduction for the equipment. The rental payments were nearly all of the income reported on the returns and the depreciation of the equipment was by far the taxpayer's largest deduction on the returns. The taxpayer treated the equipment the same way for state income tax purposes in states which impose such taxes. It apportioned the equipment in the property factor and the rental income in the sales factor. And it treated the revenue from the equipment as rental income.

Of the . . . agreements that did not provide for an end-of-the lease purchase option, [the majority] are still in effect and [the rest] expired at the end of their . . . terms. Prior to the agreements expiring, the taxpayer often will contact the customers by letter and provide them with various options. The customers can extend their leases at half the original monthly rental price, or recast the leases (a recast of a lease occurs when the equipment is upgraded with software and/or replaced with some or all new equipment and a new monthly price is negotiated), or purchase outright the existing equipment at a fair market value price to be determined at the time of purchase, or simply return the equipment to the taxpayer as the agreements expressly provide.

Of the . . . customers whose agreements have expired, some extended their leases for another 36 months, [a few] extended for another 24 months, [a few] extended for twelve months, and [a few] extended on a month-to-month basis . . . . [Some] customers with expired agreements recast their leases. The taxpayer testified that even at the end of the extended agreements or the recast agreements the equipment will be returned to the taxpayer unless the customers decide to buy the equipment for a fair market value price to be determined at that time. [Some] of the . . . customers with expired agreements did not extend, recast, or purchase their equipment, but simply returned the equipment to the taxpayer as their agreements provided. . . . [A very small number] actually purchased their equipment at the end of the initial term for what the taxpayer deemed fair market value prices. In other words, the other . . . customers either extended their existing leases, or recast them, or returned the equipment to the taxpayer. Upon return, the taxpayer has the right to sell the equipment back to [the related corporation] for [a portion] of the original purchase price. [the related corporation] refurbishes the telephone systems for new leasing or uses them for spare parts.

Of the . . . lease agreements that provided for an end-of-lease fair market value purchase, [most of the] customers purchased their systems at fair market value prices at the end of their respective terms. [The] others were written off as a bad debt [or] returned to the taxpayer at the end of the agreement.

The Audit Division audited the taxpayer for the period January 1, 2000 through December 31, 2003 and assessed $. . . in retail sales tax, $. . . in retailing business and occupation (B&O) tax, $. . . in service and other business activities B&O tax, plus interest and a five per cent assessment penalty for a total of $. . . . The Audit Division determined that the taxpayer actually was selling the equipment to its customers under financing leases and, consequently, retail sales tax and retailing B&O tax were fully due at the times of sale like an installment sale rather than when monthly rental payments were recognized. The Audit Division did credit the taxpayer for retail sales tax collected and reported at the time the monthly rental payments became due. Thus, with some of the leases having expired, apparently all tax that was due on them has been paid through the monthly payments. The taxes on unexpired leases have been partly paid. The assessment remains unpaid, but the taxpayer does not dispute the relatively small amount of service and other activities B&O tax due on late charges, administrative fees and interest, and, as noted, the retail sales taxes assessed on the [small dollar amount] option-to-purchase provision.

ANALYSIS

A "retail sale" in Washington includes sales of tangible personal property other than to persons who present resale certificates. RCW 82.04.050(1). A retail sale also includes the renting or leasing of tangible personal property to consumers. RCW 82.04.050(4). The taxpayer was renting and/or selling tangible personal property to consumers in Washington. Thus, it was making retail sales in this state according to Washington law. . . . The retail sales tax is imposed by RCW 82.08.020. In the case of installment sales and leases of personal property, DOR is authorized to adopt regulations that 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. RCW 82.08.090 and 82.12.060.

To administer the renting or leasing of tangible personal property, DOR adopted WAC 458-20-211 (Rule 211). The rule provides in pertinent parts:

> (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….

Rule 211(2). The rule continues:

> (6) **Retail sales tax**. 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.[2]

(Footnote added.) In the case of rentals or true leases, DOR has provided for the collection of sales taxes or use taxes as the periodic payments fall due. *See* Rule 211(6) and (7). But DOR has not provided for the periodic collection of sales taxes or use taxes for installment sales of personal property; therefore the retail sales tax applies to the full selling price as discussed in Rule 198(2).

For Washington tax purposes, we consider a variety of factors to determine whether a lease is to be treated as a financing or disguised security arrangement (such as in an installment sale or a loan) rather than a true lease. Such factors include, but are not limited to:

> (1) Whether the lessee is given an option to purchase the equipment, and, if so, whether the option price is nominal;
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> (2) Whether the lessee acquires any equity in the equipment;
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> (3) Whether the lessee is required to bear the entire risk of loss;
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> (4) Whether the lessee is required to pay all the charges and taxes imposed on ownership;
>
> (5) Whether there is a provision for acceleration of rent payments;
>
> (6) Whether the property was purchased specifically for lease to this lessee;
>
> (7) Whether the lessor disclaims all warranties as to the equipment and the lessee agrees to hold the lessor harmless from all liability associated with the equipment;
>
> (8) Whether a security interest has been extended to other equipment of the lessee; and
>
> (9) Whether the lessee treats the lease as a lease for tax purposes.

See Courtright Cattle Co. v. Dolson Co., 94 Wn.2d 645, 619 P.2d 344 (1980) (applying the first six factors to conclude that a lease of equipment was, in substance, an outright sale and disguised

[2] "The seller must report the full selling price of installment sales of tangible personal property in the tax-reporting period during which the sale is made. This is true even when the buyer pays the tax to the seller in installments over time." Rule 198(2)

security agreement); Det. No. 88-458, 7 WTD 75 (1988) (incorporating the six factors of *Courtright Cattle*); Rule 211(2)(g) (listing the six factors of *Courtright Cattle* as indicators that the transaction is a financing lease rather than a true lease); *Rainier National Bank v. Inland Machinery*, 29 Wn. App. 725, 631 P. 2d 389 (1981) (the Washington Court of Appeals identified the last three additional factors).

A lease can be treated as a financing arrangement rather than a true lease if there are sufficient indicators that it is a financing arrangement. It is not necessary that such a lease meet all of the relevant factors. *See Courtright Cattle* 94 Wn.2d at 656 (finding that the lease in question was a disguised security interest when it met four of the six factors).

We will review these nine factors as well as other ones. The first factor we consider is whether a lessee is granted an option to purchase the asset at a nominal price at the termination of the lease. This is a significant factor in determining the nature of the transaction, although it is not determinative by itself: "Even if the option price is considered 'nominal,' a single factor is not controlling." Det. No. 00-072, 19 WTD 1023 (2000). It is one factor to be considered along with all of the other facts and circumstances surrounding the transaction. *Id.* As mentioned, [the majority] of the lease agreements . . . at issue do not have an end-of-lease purchase option. As noted, the taxpayer will often notify the lessees by letter near the expiration of the agreements that the lessee may extend the lease, recast it, or purchase the equipment at fair market value. If the lessee does not extend or recast the lease or purchase the equipment when the lease expires, the agreement provides that the lessee shall allow the taxpayer, upon three days notice, the right and ability to enter the premises during normal business hours to disconnect and remove the equipment. Of the . . . leases without purchase options in them, [some] have expired and [some] of them have been extended or recast, but [a small number of] customers simply allowed the taxpayer to remove the equipment per the terms of the agreement. Only [a few] customers actually purchased their equipment.

In the . . . agreements that contained an end-of-lease option to purchase for a fair market value price, [most of the] customers exercised that right, while [the others] were written off as bad debts [or] returned to the taxpayer in accordance with the agreement. The purchase prices averaged [less than 20] percent of the original price.[3]

The second factor is whether the lessee acquires any equity in the equipment. The agreement expressly states that the <u>taxpayer</u> is "the owner of the equipment and [has] title to the equipment." Consistent with this provision, the taxpayer files a UCC Financing Statement for each agreement. The UCC Financing Statement declares [that the transaction is a rental and not intended as a security transaction]. Furthermore, the agreement does not provide for, and the taxpayer does not credit, the monthly lease payments towards any purchase price of the equipment. And, again, the agreement provides for the return of the equipment to the taxpayer at

[3] Both *Courtright Cattle*, 94 Wn.2d at 655 and *Rainier*, 29 Wn. App. at 730 noted that decisions from other jurisdictions where the amount of the purchase price at the time of the option was less than 25 percent of the fair market value have been held to be for nominal amounts.

the expiration of the agreement unless the parties decide to extend the agreement, recast it, or the customer decides to purchase the equipment at fair market value.

The court in *Rainier, supra,* specifically discussed the nine listed factors, including equity, and stated: "By crediting earlier payments of rent to the purchase price, the lessee is accorded an equity in the collateral." The court then declared: "Thus, an equity arises where the lessee acquires an enforceable ownership interest in the collateral." 29 Wn. App. at 733. With the court's discussion of equity and these facts in mind, we do not find that the present taxpayer's customers had any equity in the equipment during the terms of the leases. Title and ownership of the equipment remained in the taxpayer until, if and when, the customer actually purchased it for a fair market value price at the end of the agreement without receiving credit for the monthly payments towards the purchase price. As we have discussed, in the vast majority of leases, the customers either extended their leases, or recast them, or returned the equipment to the taxpayer rather than purchasing the equipment. All of these options reveal that the lessees did not have equity in the equipment.

The next three factors are whether the lessee bears the entire risk of loss, pays all charges and taxes imposed on ownership, and whether there is an acceleration of rental payments. The court in *Rainier, supra,* addressed these factors by stating:

> While these are factors which should be considered, it must be remembered these costs, insurance, taxes, and the like, are going to be borne by one party or the other. The lessor is either going to include those costs within the rental charge or agree to a lower rent if the lessee takes responsibility for them. The provision for acceleration of rental payments may be relevant, depending upon other provisions of the lease. *See Computer Sciences Corp. v. Sci-Tek, Inc.,* 367 A.2d 658 (Del. Super. Ct. 1976).

29 Wn. App. at 734. In the present matter, the customers pay for insurance on the equipment and pay for all charges and taxes associated with the lease and are required to reimburse the taxpayer for its personal property tax liability on the equipment. But, as the court in *Rainier* explained, if a lessor pays these charges and taxes it will simply pass the costs on to the lessees in the form of higher rent. One way or the other, the lessees will pay these costs.

The agreement does have an acceleration clause in case the customer does not make its payments when due. The agreement allows the taxpayer with . . . written notice to either deactivate the equipment, or make the customer return the equipment and pay the remaining balance of all of the rental payments due under the agreement at present value, using a . . .% per year discount rate. This agreement provision appears to be common in that it attempts to allow the taxpayer to receive the benefit of the bargain under the agreement. That is, the purpose of the clause is to put the taxpayer in as good a position as if the contract had been performed, which is the general measure of damages for a breach of contract. *Eastlake Const. Co., Inc. v. Hess,* 102 Wn.2d 30, 39, 686 P.2d 465 (1984). Otherwise, if the taxpayer merely repossessed the equipment in case of default by the customer it would lose the benefit of the bargain and suffer economic loss until it could find another comparable renter. Without the acceleration clause, the taxpayer likely would have to sue each month when a default occurs or wait until the end of the agreement, either of which may be impractical and more expensive than accelerating the rent.

The taxpayer's agreement contrasts with the one in *Computer Sciences, supra,* cited by the court in *Rainier, supra,* where the *Rainier* court stated that an acceleration clause may be relevant depending on other provisions of the lease In *Computer Sciences,* if the lessee defaulted in its monthly payment, the equipment was to be returned and the lessee became liable not only for the total amount of unpaid rent, but also for any deficiency resulting from a sale of the equipment by the lessor not equaling the estimated market value of the equipment as defined by contract. 367 A.2d at 660. Thus, the lessor did not want the equipment back except to sell to it to the highest bidder. In the present agreements, the taxpayer may take the equipment back and seek the discounted balance of rent due. The taxpayer can sell it back to [the related corporation] for refurbishment to be leased again or to a third party. If it sells the property, any excess over the balance of the payments due and other costs goes to the lessee. Thus, the fact that there is an acceleration clause in the present matter is less of an indication of a financing lease than the acceleration clause in *Computer Sciences* where liability extended well beyond unpaid rent and the return of the equipment. That additional element in part supported the court's finding in that case that the agreement was a financing lease. 367 A.2d at 661.

The sixth factor is whether the equipment was purchased specifically for lease to this lessee. The court in *Rainier, supra,* also addressed this factor by stating "this is of particular interest in a financial transaction or installment sale when the lessor is not the real provider of the equipment." 29 Wn. App. at 735. The court added that the factor may not be as relevant if the lessor is the actual supplier of the equipment. *Id.*. The taxpayer agrees that the factor is present in this matter, but the taxpayer contends that the factor assumes situations where the lessee finds an item it wants to purchase and then seeks a third party financial institution to purchase the item and lease it to the lessee. The taxpayer believes its situation is different because it rents/leases only telephone systems manufactured by [the related corporation]. The taxpayer contends because [the related corporation] supplies and installs the equipment, it is economically reasonable for the taxpayer not to purchase inventory. Although the taxpayer is not the actual supplier of the equipment [the supplier is a related corporation]. Thus, it is closer to the situation of a supplier leasing its equipment than is an unrelated third party bank or lender leasing the equipment to a lessee.

The seventh factor is present. The taxpayer disclaims all warranties and the lessee agrees to hold the taxpayer harmless from liability associated with the equipment. But in the agreement the taxpayer agrees to transfer to the lessee all warranties from the supplier [the related corporation] or another manufacturer.

The eighth factor is whether a security interest has been extended to other equipment of the lessee. The factor is not present because, as discussed, the taxpayer does <u>not</u> claim a security interest in the telephone equipment or any property belonging to the lessee. This situation contrasts with *Computer Sciences, supra,* where the court found a financing lease, in part, because the lessor extended its security interest not only to the subject property, but to other equipment of the lessee. 367 A.2d at 660. The court in *Rainier*, in discussing a section of the U.C.C. (former RCW 62A.1.-201(37)), stated:

> This very specific exclusion section exempts true leases from the category of "security interests" and could not be clearer. Property subject to a true lease is not subject to a security interest, be it under article 2 or article 9. It is equally clear that "collateral" under RCW 62A.9-105(1)(c) is "property subject to a security interest." Therefore, property subject to a true lease cannot be collateral.

29 Wn. App. at 738. We have seen that the taxpayer files U.C.C financing statements specifically declaring that the agreement is a rental and not a security transaction. This statement supports it claim that it is a true lease because a true lease is not subject to a security interest. It gives notice to third party creditors of the lessees that the lessees may not use the telephone equipment as collateral for their loans from the third parties. And the statement gives notice to the world that the taxpayer, not the lessee, owns the equipment and it is merely renting, but not selling or financing the equipment to the lessees. . . .

The ninth factor is whether the lessee treats the lease as a lease for tax purposes. We and the taxpayer do not have information as to how the lessees treat the leases for tax purposes. . . .

In concluding, we find that some of the nine factors discussed are present. But they are either not strong indicators of a financing lease or there are mitigating circumstances. For example, a lessee will pay taxes, charges, and insurance directly or through higher rent. Either way it will pay those costs. There is an acceleration clause in case of default, but it simply attempts to provide the taxpayer the benefit of bargain as if there had been no default with the payment of the discounted balance owing and the return of the equipment. The taxpayer disclaims any warranties, but it does transfer the warranties provided by [the related corporation], the supplier. Finally, it does purchase the equipment for the lessee, but it has no need to maintain an inventory because it leases only the equipment sold and installed by [the related] corporation.

On the other hand, the vast majority . . . of the lease agreements did not contain a purchase option at all. The remaining . . . agreements contained a fair market value purchase option and not all of those options were exercised. All of the agreements provided for the return of the equipment to the taxpayer at the end of their terms unless the lessees chose to extend or recast their leases, or purchase the equipment for a fair market value price. Many telephone systems were returned. By far, the largest amount were extended or recast. Relatively few were purchased.

The lessees did not have any equity in the equipment because the lease agreements identified the taxpayer as the owner with title and the equipment was to be returned to the taxpayer at the end of the leases. The taxpayer did not credit the monthly lease payments towards the purchase price when and if a lessee decided to purchase the equipment.

The taxpayer did not have a security interest in the equipment or any property of the lessees. In fact, the UCC Financing Statements that the taxpayer filed expressly declare that the agreements are rentals and not security transactions. . . .

In sum, when we consider all of the nine factors [and] the declaration on the UCC Financing Statement that these leases are true rentals, . . . we find that the taxpayer's agreements (except for the . . . agreements with [small dollar amount] purchase options that it concedes are financing leases) are true leases and not financing leases because the weight of these factors and the other considerations fall heavily on the true lease side.

DECISION AND DISPOSITION

The taxpayer's petition is granted.

Dated this 11th day of September 2007.