

Cite as 6 WTD 141 (1988)

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> <u>N</u>
For Ruling of Tax Liability of)	
)	No. 88-258
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. . . )	Registration No. . . .
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[1] **RULE 211:** RETAILING B&O TAX -- SALES TAX -- LEASE WITH OPTION TO PURCHASE -- SALE -- DISGUISED SECURITY AGREEMENT. A lease is a contract whereby one party gives to another the right to the use and possession of property for a specified time and, ordinarily, for fixed payments. A lease is not a single transaction or sale, but a contract for series of transactions -- the exchange of rental payments for continued enjoyment of possession. Gandy v. State of Washington. Lease with option to purchase auto held not to be a "disguised security agreement" financing the purchase under criteria set forth in Courtright and Rainier cases.

[2] **RULE 211:** RETAILING B&O TAX -- SALES TAX -- LEASE -- PREPAYMENT OF RENTAL CHARGES -- REPORTING OF PREPAYMENT ON TAX RETURN. Where taxpayer is to receive a prepayment of all rental charges due per arrangement at the inception of the lease, the amount received is reported on the tax return for the period in which such prepayment falls due. The arrangement is for a credit union to prepay entirely the rental charges due on behalf of the lessee and for the lessee to make periodic payments to the credit union on a promissory note.

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: . . .  
. . .

NATURE OF ACTION:

Petition for a ruling as to the tax consequences pertaining to a lease with option to purchase which involves prepayment of the rentals due by a credit union on behalf of the lessee.

FACTS AND ISSUES:

Krebs, A.L.J. -- [The taxpayer] (lessor) is engaged in the leasing and sales of automobiles.

The taxpayer enters into "Credit Union Automotive Marketing Agreements" with credit unions which have lease and purchase financing options. The ruling sought is concerned with the lease option of the marketing agreement.

The structure of the lease option transaction is as follows:

1. A credit union member (lessee) wants to lease a specific auto with an option to purchase.
2. The taxpayer-lessor buys the auto from an auto dealer at a fleet price.
3. On a form called "Buyer's Order," the taxpayer computes the "balance subject to lease charge" which consists of the total of the following items: cost of vehicle to the taxpayer, the taxpayer's profit, assignment fee, accessories, the first monthly payment, security deposit, titling fee, sales tax, warranty/service contract, etc. After credits allowed to the credit union for some items such as titling fee, assignment fee and first monthly payment, the net amount due to the taxpayer is reached. For example, a completed transaction showed the following:

Balance subject to lease charge	\$13,161
Net due to taxpayer	\$12,608

4. The lessee issues a promissory note to his/her credit union (per example, in the amount of \$13,161 plus interest). The credit union pays the taxpayer (per example, \$12,608) which serves as a "prepayment of lease payments." The lessee makes monthly payments (per example, \$228) on the promissory note for the term of the lease. The payments consist of principal and interest.
5. Simultaneously, the lessee enters into a "Security and Vehicle Lease Agreement (Closed End with Fixed Purchase Option)" (lease agreement) with the taxpayer-lessor. The lease agreement sets forth the lease term (per example, 60 months), the balance subject to lease charge (per example, \$13,161), the estimated end of term wholesale value of vehicle (per example, \$3,445), and the total monthly payment (per example, \$228) which is the same amount as the monthly payment made by the lessee to the credit union/lender.

6. The taxpayer-lessor assigns the lease to the credit union/lender.

7. The lessee can terminate the lease prior to the scheduled termination date upon giving 15 days written notice. Upon such early termination, the lessee is liable for a termination fee plus the unpaid principal balance of the loan less the proceeds of a wholesale sale of the auto or the determined residual value whichever is greater.

8. The lessee has the option to purchase the auto at early termination of the lease by payment of a termination fee plus the unpaid principal balance of the loan and taxes.

9. The lessee has the option to purchase the auto at scheduled termination of the lease by payment of the estimated end of term wholesale value of the vehicle and taxes.

10. The lessee has no equity in the auto unless he/she exercises the purchase option.

In its petition, the taxpayer framed the issue for a ruling as follows:

Whether the transaction as described above will be considered a lease?

In other words, the taxpayer seeks a ruling as to whether the transaction will be subject to tax consequences pertaining to a lease with option to buy or pertaining to an actual sale of the auto.

#### TAXPAYER'S POSITION

The taxpayer cites Courtright Cattle Co. v. Dolsen Co., 94 Wn.2d 645 (1980) and Rainier National Bank v. Inland Machinery, 29 Wn. App. 725 (1981) as setting forth the criteria distinguishing between a financing of a sales transaction and a leasing arrangement. The taxpayer concedes that both of the cited cases involve significantly different sets of facts than those of the taxpayer's situation.

In the Courtright case, the court held that the lease was a "disguised security agreement to finance purchase of a fixture" (p. 655). In the Rainier case, the court was faced with the issue as to "whether the rental agreement [pertaining to a loading machine] was intended as a true lease or as a disguised security agreement" (p. 731).

Based upon the criteria set forth in the Courtright and Rainier cases, the taxpayer asserts that in its transaction with the

lessee a lease exists, rather than an actual sale, because:

1. The lessee is given the option to purchase the auto at the residual value instead of a low nominal price.
2. The lessee acquires no equity in the auto.
3. While the lessee is required to bear the entire risk of loss of the auto except where covered by insurance obtained by the lessee, the lessor could have increased the rental charges to assume the risk.
4. While the lessee is required to pay all expenses and taxes usually required of an owner, the lessor could have increased the rental charges to cover such expenses.
5. There is no acceleration of rent payments, but there is an acceleration of payments clause where purchase of an auto is being financed.
6. The courts have decided both ways with respect to the significance of the criteria factor: "Whether the property was purchased specifically for lease to this lessee."
7. Both the taxpayer and the lessee intend to enter into a true lease.

#### DISCUSSION:

[1] According to the usual definition, a lease is a contract whereby one party gives to another the right to the use and possession of property for a specified time and, ordinarily, for fixed payments. The right to continued possession under a lease is conditioned upon the payment of rentals and performance of other covenants. Gandy v. The State of Washington, 57 Wn. 2d 690 (1961).

Each rental payment relates to a period of possession. It is this possession for which the lessee contracts and for which the periodic consideration is given. A lease if viewed in this light is not a single transaction (or sale), but a contract for a series of transactions -- the exchange of rental payments for continued enjoyment of possession. Gandy v. The State of Washington, supra.

In this case, the taxpayer-lessor enters into a contract, the Security and Vehicle Lease Agreement (Closed End with Fixed Purchase Option), with the other party, the lessee, giving the lessee the right to the use and possession of the auto for a specified time and for fixed payments. The lessee additionally receives an option to purchase the auto. There is no transfer of ownership nor title to the lessee, only transfer of possession for a specified time and for fixed payments. We conclude that the

transaction is subject to the tax consequences pertaining to a lease with option to purchase the leased vehicle.

We do not find that the taxpayer makes an actual sale of the auto with the Security and Vehicle Lease Agreement serving as a "disguised security agreement" to finance purchase of the auto under the criteria set forth in the Courtright and Rainier cases.

We base this upon the reasons set forth in the Taxpayer's Position part of this Determination which we adopt.

[2] We now turn to the tax consequences of the transaction. WAC 458-20-211 (Rule 211), . . . , in pertinent part provides:

(1) DEFINITIONS. The terms "leasing" and "renting" are used interchangeably and refer generally to the act of granting to another the right of possession to and use of tangible personal property for a consideration.

. . . .

(7) BUSINESS AND OCCUPATION TAX. Outright rentals of bare (unoperated) equipment or other tangible personal property as well as "true" leases or rentals of operated equipment or property are generally subject to the retailing classification of the business and occupation tax. . . .

. . . .

(9) 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. (Emphasis supplied.)

The structure of the transaction in this case is such that a third party, the credit union, is involved by prepaying the lease payments on behalf of the lessee. The credit union prepays also on behalf of the lessee the sales tax due on the lease payments. The documents signed by the lessee clearly indicate that it is intended for the lessee to prepay the rentals, by having the credit union make the prepayment and the lessee becoming obligated to the credit union for such prepayment amount by the lessee's execution of a Promissory Note and Payment Schedule, . . . , to the credit union. The said Promissory Note has the following provision:

Further, Debtor [lessee] grants and assigns all rights to the lender [credit union] to disburse all funds and payments directly to creditors [taxpayer-lessor] in accordance with all of the loan documentation terms, conditions and agreements. (Bracketed words supplied.)

We conclude that the "rental payments fall due" as of the time that the taxpayer-lessor is entitled to receive the prepayment from the credit union, and that time is one month after the lessee has made the first monthly payment directly to the taxpayer-lessor in accordance with all of the loan documentation terms, conditions and agreements including the Security and Vehicle Lease Agreement.

Taking the transaction step by step, we find that the corresponding taxpayer-lessor's tax reporting requirements are as follows:

1. The taxpayer leases the vehicle to the lessee and receives the first monthly payment which includes the charge for rental, sales tax, and miscellaneous items.

The taxpayer should report as subject to Retailing business and occupation (B&O) tax the monthly payment less amount of sales tax included therein, and the (net) amount reported is subject to state and local sales tax.

2. The taxpayer receives the prepayment of lease payments from the credit union one month after the first monthly payment directly from the lessee.

The taxpayer should report as subject to Retailing B&O tax the prepayment less the amount of sales tax included therein and the (net) amount reported is subject to state and local sales tax at that time.

3. The lessee may purchase the vehicle at the end of the scheduled termination or earlier. The option to purchase is a separate transaction. The total option price is also subject to Retailing B&O tax and state local sales tax if and when the option is exercised.

It is noted that by letter dated December 21, 1987 to the taxpayer's president, . . ., the Department's Taxpayer Information Specialist, informed the taxpayer as to the tax consequences pertaining to the Security and Vehicle Lease Agreement. The specialist was not made aware of the credit union prepayment arrangement. Consequently, his letter has no bearing with respect to the tax consequences flowing from the prepayment arrangement.

#### RULING:

The prepayment arrangement lease transaction is subject to the tax consequences and tax reporting applicable to a lease with option to buy as detailed in the Discussion part of this Determination.

This legal opinion may be relied upon for reporting purposes and as support of the reporting method in the event of an audit. This

ruling is issued pursuant to WAC 458-20-100(18) and is based upon only the facts that were disclosed by the taxpayer. In this regard, the department has no obligation to ascertain whether the taxpayer has revealed all of the relevant facts or whether the facts disclosed are actually true. This legal opinion shall bind this taxpayer and the department upon these facts. However, it shall not be binding if there are relevant facts which are in existence but have not been disclosed at the time this opinion was issued; if, subsequently, the disclosed facts are ultimately determined to be false; or if the facts as disclosed subsequently change and no new opinion has been issued which takes into consideration those changes. This opinion may be rescinded or revoked in the future; however, any such rescission or revocation shall not affect prior liability and shall have a prospective application only.

DATED this 30th day of June 1988.