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May 16, 2002

Ms.

JAMES E. SPEED
Executive Director

RE: **Transfers under Capital Leases.**

Dear Ms. :

This is in reply to your letter dated June 22, 2001 to the Property Taxes Department of the Board of Equalization related to the taxation of properties leased under capital leases. Please excuse the delay in responding, as previously scheduled Board matters have occupied our time.

As discussed further below, it is our opinion based upon the information you have provided us that under a capital lease: (1) the lessee is considered to be the owner of the leased property pursuant to Assessors' Handbook Section 504 and Property Tax Rule 462.200, subsection (a); (2) the lessee, as the owner of the property, is responsible for filing business property statements for the leased property under Revenue and Taxation Code section 441; and, (3) the lessee owner of the property is liable for the payment of the personal property tax accrued.

Factual Background

Corporation (I-CC) is the lessor of computer equipment in California. I-CC has two types of capital leases, Type One and Type Two. A Type One capital lease, as described in your letter, provides that I-CC retains legal title to the leased property as security until the end of the lease term and the completion of lease payments by the lessee. The lessee then has the option of purchasing the property for \$1. In practice, however, I-CC does not seek payment of the \$1 and title automatically passes to the lessee at the end of the lease term.

A Type Two capital lease, like a Type One lease, also provides that I-CC retains legal title to the leased property as security until the end of the lease term and the completion of lease payments by the lessee. However, at the end of the Type Two lease term, the lessee has the option of purchasing the property at a pre-stated price, significantly less than what I-CC projected the fair market value of the leased property to be at the end of the lease term (i.e., a bargain purchase option). The lessee, under this type of lease, only receives title to the property if it exercises the purchase option.

I-CC's leases are structured as follows:

1. As the Type One and Type Two capital leases provide lessees with end-of-lease nominal or bargain purchase options, these leases are structured as

conditional sales. As such, I-CC does not depreciate these properties for either income tax or financial accounting purposes and the leases are recorded as "capital" leases (i.e., sales type or direct financing leases) for financial accounting purposes. Conversely, lessees under these leases capitalize and depreciate the underlying assets for income tax and financial accounting purposes.

2. The Type One and Type Two capital leases are noncancelable, such that a lessee's obligation to make all scheduled lease payments for the term of the lease is absolute and unconditional.
3. The Type One and Type Two capital leases hold lessees liable for all personal property taxes due on the leased property. However, the leases are not specific regarding property statement filing requirements.
4. It has been I-CC's practice to file property statements and to remit the property tax due on behalf of lessees. I-CC subsequently seeks reimbursement of the taxes paid from lessees.

Based upon these facts, you have posed the following questions:

- (A) Whether the lessor or lessee under an I-CC capital lease is considered to be the owner of the leased property for purposes of personal property tax.
- (B) Whether the lessor or lessee under an I-CC capital lease is responsible for filing business property statements for leased property.
- (C) Whether the lessor or lessee under an I-CC capital lease is liable for the payment of personal property tax accrued.

Law and Analysis

Attorney General's Opinion No. CV 78-58 (November 3, 1978),¹ mentioned in your letter, provides guidance in distinguishing true leases and conditional sales contracts. This opinion states that

It is often difficult to distinguish between a true lease (bailment for hire) and a finance lease (conditional sale or secured transaction) . . . Basically, a true lease provides exclusive possession of property for a limited period of time, while a finance lease provides the transfer of complete ownership at some future point in time. A finance lease is usually intended if at the time of entering into the agreement, (1) the parties have a fixed intention to buy and sell, and (2) the entire obligation to pay arises, payments being on a deferred basis, or (3) the "lessee" is under an economic compulsion to exercise the "purchase" option. . . .

¹ 61 Ops.Cal.Atty.Gen. 472 (1978). In Footnote 170 below, from Assessors' Handbook Section 504 (AH 504), this opinion is incorrectly referenced as being located in Volume 78 of Attorney General's Opinions.

* * *

In a finance lease or conditional sales agreement, the "true owner" is considered to be the purchaser; even though legal title to the property remains in the seller for purposes of security, he is not considered to have a taxable interest in the property. . . . Conversely, in a true lease arrangement, the lessor is considered to be the "true owner" and subject to the tax. . . .

Revenue and Taxation Code section 405² gives assessors broad authority in assessing property, stating

- (a) Annually, the assessor shall assess all the taxable property in his county, except state-assessed property, to the persons owning, claiming, possessing, or controlling it on the lien date.

The assessor may assess the property on the secured roll to the person owning, claiming, possessing or controlling it for the ensuing fiscal year.

- (b) The assessor may assess all taxable property in his county on the unsecured roll jointly to both the lessee and lessor of such property.
- (c) Notices of assessment and tax bills relating to jointly assessed property on the unsecured roll shall be mailed to both the lessee and the lessor at their latest addresses known to the assessor.

Consistent with the Attorney General's Opinion above, Property Tax Rule 462.200, subsection (a) states that "[t]here are transactions that may be interpreted to be either a conveyance of the property or a mere security interest therein, depending on the facts. . . ."³ Additionally, Assessors' Handbook Section 504 (AH 504), *Assessment of Personal Property and Fixtures*, at pages 102-103, states:⁴

Assessee

A person who owns, claims, possesses, or controls property on the lien date is the assessee of that property. This is either the lessor or the lessee. Under section 405, the assessor may assess leased property to either, or both, whether or not there is a private agreement between the parties to the lease. . . .

However broad this statute, the courts and most counties have reasonably construed the language.¹⁷⁰ That is, property is generally *not* assessed jointly although the assessor has that option pursuant to section 405. Property under true lease is usually assessed only to the lessor and property under conditional sales contract only to the lessee. Exceptions to this rule mainly occur when the lessor requests to be assessed

² Unless otherwise indicated, all statutory references are to the Revenue and Taxation Code.

³ Although Property Tax Rule 462.200 specifically addresses real property transactions, it has been applied to personal property transactions as well.

⁴ The quoted language is from the June 2000 version of this handbook section.

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to ensure the taxes are paid or one of the parties to the lease is an exempt entity.
[Underlines added.]

Revenue and Taxation Code section 23 codifies the definition of "assessee" as "the person to whom the property or a tax is assessed."

And, at page 109 of AH 504, true leases and conditional sales contracts/financing leases (i.e., capital or synthetic leases) are discussed:

True Leases

True leases, whether short-term or extended-term as defined earlier, are agreements under which an owner gives up possession and use of his/her property for valuable consideration and for a definite term and at the end of the term, the owner has the absolute right to retake, control, or convey the property. It is an agreement under which there is no intention of transferring ownership. At termination of the lease, the property will be returned to the lessor.

Conditional Sales Contracts or Financing Leases

Conditional sales contracts or financing leases (agreements) are purchases rather than true leases. They can be short-term or extended-term agreements whereby the seller (vendor) accepts periodic payments for the purchase price while retaining title to the property for security purposes. Possession of the property transfers to the buyer (vendee) without full legal title until payment of the purchase price or a predetermined date occurs.¹⁸³

These contracts provide possession, use and control to the buyer. The buyer or lessee is the beneficial owner of the property, and therefore becomes the assessee, regardless of whether or not they hold title. [Underlines added.]

Enclosed is a table from page 110 of AH 504 which, by issue, distinguishes true leases and conditional sales contracts.

Thus, a true lease (i.e., operating lease) typically secures to a lessee the temporary use and control of property and, at the end of the lease term, the property reverts to the lessor. Under such terms, the lessor retains ownership of the property and, therefore, has the taxable interest in the property. By contrast, a conditional sales contract or financing lease (i.e., capital lease) transfers ownership of the leased property to the lessee, except that legal title to the property remains with the lessor for security purposes. As the lessee or buyer is the beneficial owner of the property, it becomes the assessee of the property.

Based upon the above, the answers to your questions are as follows:

¹⁸³ Miller & Starr, *California Real Estate*, 2d "Specific Real Estate Contracts," section 2:42.

QUESTION 1—Is the lessor or the lessee under an I-CC capital lease considered to be the owner of the leased property for purposes of personal property tax? **UNDER A CAPITAL LEASE, THE LESSEE IS CONSIDERED TO BE THE OWNER OF THE LEASED PROPERTY.**

The capital leases that you described in your letter are analogous to the conditional sales contracts discussed in AH 504 and the finance leases discussed in Attorney General's Opinion No. CV 78-58 and Property Tax Rule 462.200, subsection (a). Lessees under such leases are the beneficial owners of the properties leased, as they gain possession, use, and control of the leased properties and the leases include bargain purchase options at the end of the lease terms. As the beneficial owner, a lessee is considered the owner and assessee of the leased property.

QUESTION 2—Is the lessor or the lessee under an I-CC capital lease responsible for the filing of business property statements for leased property? **UNDER A CAPITAL LEASE, THE LESSEE, AS THE OWNER OF THE PROPERTY, IS RESPONSIBLE FOR FILING BUSINESS PROPERTY STATEMENTS FOR THE LEASED PROPERTY.**

As discussed above, lessees under capital leases are considered the owner and assessee of the leased properties. As such, lessees are responsible for filing business property statements to report their leased properties, pursuant to section 441.⁵

In your letter, you quoted section 442 for purposes of identifying the owner of leased property and the proper party for filing property statements. This statute states in part that

Property which is now or hereafter the subject of a contract designated as a lease wherein the property being leased qualifies for the property tax exemption provided for by subdivision (d) or (e) of Section 3 of Article XIII of the California Constitution, and the lessee has the option of acquiring the property leased at the end of the lease term for one dollar (\$1), or any other nominal consideration, shall be regarded as owned by the lessee and shall not be required to be shown on any property statement of the lessor. [Emphasis added.]

This paragraph of section 442 was added to the Revenue and Taxation Code in 1987 to specifically provide lessors utilizing capital leases with a business property statement filing exemption when leasing equipment to free public libraries, free museums, public schools, and/or colleges.⁶ The two clauses in this sentence are read together to provide for this filing exemption. In other words, leases must be made with a qualified party and include a bargain purchase option to qualify for the filing exemption. As such, capital leases to parties other than libraries, museums,

⁵ Revenue and Taxation Code section 441, subdivision (a) states in part that: "Each person owning taxable personal property, . . . , having an aggregate cost of one hundred thousand dollars (\$100,000) or more for any assessment year shall file a signed property statement with the assessor. Every person owning personal property that does not require the filing of a property statement or real property shall, upon request of the assessor, file a signed property statement. . . ."

⁶ Article XIII, section 3 of the State Constitution states in part that: "The following are exempt from property taxation: . . .
(d) Property used for libraries and museums that are free and open to the public and property used exclusively for public schools, community colleges, state colleges, and universities.
(e) Buildings, land, equipment, and securities used exclusively for educational purposes by a nonprofit institution of higher education."

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public schools, and colleges as specified in Article XIII, section 3, subdivisions (d) and (e), are not eligible for this exemption from filing business property statements.

QUESTION 3—Is the lessor or the lessee under an I-CC capital lease liable for the payment of the personal property tax accrued? **UNDER A CAPITAL LEASE, THE LESSEE, AS THE OWNER OF THE PROPERTY, IS LIABLE FOR THE PAYMENT OF THE PERSONAL PROPERTY TAX ACCRUED.**

As discussed above, lessees under capital leases are considered the owner and assessee of the leased properties and the parties responsible for filing business property statements to report such properties. As such, the lessee under a capital lease would be liable for the payment of the property tax accrued. Section 2187 states that every lien on real property is a lien against the property assessed and section 2186 provides that every tax has the effect of a judgment against the person. As noted above, under section 23, the person to whom the property or the tax is assessed is the assessee—here, the lessee.

The views expressed in this letter are advisory in nature only; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Very truly yours,

/s/ Anthony S. Epolite

Anthony S. Epolite
Tax Counsel

Attachment

ASE: eb

Prop/prec/13leases/02/02ase

cc: Honorable Larry Stone, President
California Assessors' Association

Mr. David Gau, MIC: 63

Chief, PPSD, MIC: 64

Mr. Charlie Knudsen, MIC: 62

Ms. Jennifer Willis, MIC: 70