

Cite as Det. No. 97-208, 18 WTD 183 (1999)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	<u>D E T E R M I N A T I O N</u>
	)	No. 97-208
	)	
. . .	)	Registration No. . . .
	)	FY. . . /Audit No. . . .

RCW 82.08.010(1); ETB 337: RETAIL SALES TAX -- SELLING PRICE -- EARLY LEASE TERMINATION -- NEGOTIATED SETTLEMENT. The retail sales tax imposed on lease payments can be adjusted when the lease agreement provides for a negotiated settlement upon early termination of the 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.

NATURE OF ACTION:

Automobile leasing company protests the assessment of retail sales tax on the amounts refunded to lessees upon the early termination of open-ended leases.<sup>1</sup>

FACTS:

Mahan, A.L.J. -- The taxpayer is a new and used automobile dealer. It has a leasing division that does business under the name . . . This division leases new and used vehicles and sells vehicles at retail and wholesale. Most of its leases are structured as open-end leases.<sup>2</sup>

The taxpayer collects retail sales tax on the total payments as they are made and remits the tax to the state. On early termination of a lease, the taxpayer usually sells the vehicle to a third-party.

<sup>1</sup> Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

<sup>2</sup> In materials provided to its customers, it describes an open-end lease as one whereby a settlement is made at the end of the lease, based on the value of the vehicle at lease end. If the actual depreciation is less than anticipated the customer gets money back. If the depreciation is more than anticipated, the customer pays the difference.

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The lessee may also purchase the vehicle. If it sells it at retail, the taxpayer collects retail sales tax and remits it to the state along with retailing B&O tax. If it sells it at wholesale, the taxpayer remits wholesaling B&O tax to the state.

If the sale price exceeds the residual (original value, interest, and costs of sale less payments received) owed on the vehicle, the excess is paid to the lessee along with a proportionate share of the retail sales tax. The taxpayer reasons that, when a payment is due to the lessee, the total lease payments were excessive and the refund was the result of an overpayment on the lease. If the sale proceeds is less than the residual identified in the lease, the lessee is charged for the deficit plus sales tax on that amount, because there had been an underpayment on the lease.

With respect to the early termination of the lease, the contract between the taxpayer and its lessees provides:

Lessee's obligation under the lease as to the said unit shall continue until disposal of the unit in the manner following.

A soon as practical after the Lessor has received said unit from Lessee under the terms of this paragraph, Lessor may recondition the unit and offer it for sale to not less than two (2) motor vehicle equipment wholesalers, as the case may be. Lessee shall be given notice of such bids received. Not less than 5 business days after the mailing of such notice Lessor may accept or reject any or all bids. . . .If the Net High Bid plus the Accumulated Depreciation Reserve exceeds the Original Value of the leased unit. Lessor will refund such excess to Lessee after deducting reasonable costs for any storage, maintenance and recondition and sale. If such Original Value plus reasonable costs for any storage, maintenance and reconditioning and sale exceeds such Net High Bid plus Accumulated Depreciation Reserve, Lessee shall pay, as additional rental, such excess to Lessor upon demand.

(Emphasis added.)

The Department of Revenue (Department) audited the taxpayer for the January 1, 1992 through December 31, 1995 period. Under Schedule 6 of this audit, the taxpayer was assessed additional retail sales tax and retailing B&O tax. The Department concluded the lease agreement and the subsequent sale of the vehicle were separate taxable transactions and that the lease contract "continued until the remaining residual is satisfied." Accordingly, it reasoned that retail sales tax was due on the full amount of the lease agreement, including any amount potentially needed to satisfy the lease agreement, with no credit for amounts refunded. Sales tax was also due on the full amount received from third-party purchasers. According to the Department:

The moneys refunded were not an adjustment on monthly "estimated" lease payments. The lease contract stated the method for calculating the settlement amount, irrelevant of

the actual value of the vehicle. The settlement amount was established and set before the actual vehicle value was set by the market. . . . Therefore, the money returned to the lessee is not an adjustment of the monthly lease payments and is a disallowed deduction from gross revenue.

The taxpayer's and the Department's position on the taxability of these transactions is summarized in the following example:

***UNDERPAYMENT***

Residual	5,000
Sale Proceeds	<u>2,000</u>
Subtotal	7,000
Original Value	<u>10,000</u>
To Be Paid	(3,000)

*Above Amounts Subject to Tax*

Taxpayer:

Lease	8,000
Sale	<u>2,000</u>
Total	10,000

Department:

Lease	10,000
Sale	<u>2,000</u>
Total	12,000

***OVERPAYMENT***

Residual	5,000
Sale Proceeds	<u>7,000</u>
Subtotal	12,000
Original Value	<u>10,000</u>
To Be Refunded	2,000

*Above Amounts Subject to Tax*

Lease	3,000
Sale	<u>7,000</u>
Total	10,000

Lease	10,000
Sale	<u>7,000</u>
Total	17,000

The net effect of the Department's position is to treat the open-end leases like an installment sale. With an installment sale, retail sales tax is paid by the purchaser on the original value at the outset, no tax is owed on monthly payments, and sales tax is owed on any subsequent sale. See WAC 458-20-198; Det. No. 88-458, 7 WTD 75 (1988). Here, instead of tax being owed on the original value at the outset, the Department has assessed tax on the residual value in addition to collecting tax on the monthly payments. The net effect is to have tax owed on the original value and on any subsequent sale. However, the Department has not claimed that the sale was not a true lease.<sup>3</sup>

<sup>3</sup> In Courtright Cattle Co. v. Dolson Co., 94 Wn.2d 645, 619 P.2d 344 (1980), the Washington Supreme Court held that the lease in that case was, in substance, an outright sale and disguised security agreement. Relying on that authority, the Department issued Determination No. 88-458, 7 WTD 75 (1988), which identified various factors to be considered in determining whether a lease is to be treated as an installment sale and disguised security agreement and not a true lease. See also Rainier Nat'l Bank v. Inland Machinery, 29 Wn. App. 725, 631 P. 2d 389 (1981).

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ISSUE:

Is the retail sales tax imposed on open-ended lease payments subject to adjustment when the lease agreement provides that payments are adjusted based on the market value of the vehicle when the lease is terminated and the vehicle sold to a third-party?

## DISCUSSION:

[1] In general, a lease is a contract whereby one party gives to another, usually for fixed payments, the right to the use and possession of property for a specified time. The right to continued possession under a lease is conditioned upon rental payments and performance of other covenants. Gandy v. The State of Washington, 57 Wn. 2d 690, 359 P.2d 302 (1961); Det. No. 88-258, 6 WTD 141 (1988). It is this possession for which the lessee contracts and for which the periodic consideration is given. If viewed in this light, a lease is not a single transaction, but a contract for a series of transactions. Id. at 695.

Here, the periodic payments received on the lease and any payments received as a result of covenants concerning early termination are transactions separate and apart from the sale of the vehicle to a third-party. Each is a separate taxable transaction. See, Det. No. 89-505, 11 WTD 39 (1989). This does not mean, however, that a contract cannot specify that payment amounts or other contractual obligations are not subject to change based on extra-contractual events. In this case, this involved a negotiated settlement of the rental amounts upon early termination based on the market value of the vehicle, which was determined in a separate transaction at the time of termination. Contrary to the Department's position, the contract between the parties provides that the negotiated settlement amount on early termination was subject to modification.

Excise Tax Bulletin 337.08.211 (1969) (ETB 337) discusses whether sales tax is due upon payment of a negotiated settlement upon the early termination of a lease. It provides:

[B]y mutual agreement, the taxpayer and seller canceled the lease; the cancellation agreement called for acceleration and payment of 75% of the unmatured rental payments. The taxpayer contended that without further use or possession of the [personal property], the 75% settlement amount did not constitute either rental income or a substitute for rental income.

RCW 82.08.010(1) defines "selling price" as including any "consideration whether money, credits, rights or other property, expressed in the terms of money paid or delivered by a buyer to a seller. . . ." The Department of Revenue ruled that the negotiated settlement was consideration arising out of the original lease; it effectively decreased the term of the lease and increased the rental payments for the actual period of use. Hence, the taxpayer was not entitled to a refund of sales tax paid to the seller on the settlement agreement.

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(Emphasis added.)

Applying this policy statement to the early termination provisions quoted above, increased rental payments were due for the period of use when the residual amount was unsatisfied by the sale of the vehicle to a third-party. In a consistent manner, a refund was due when the rental payments were decreased for the actual period of use when the market value exceeded the residual. To the extent the taxpayer's leases are otherwise valid leases, it paid tax in a manner consistent with this policy statement, and we reverse the assessment of additional retail sales tax on the early termination of leases on this basis.

However, this conclusion is without prejudice to the Department considering whether the taxpayer's leases are true leases. Some aspects of the lease agreements indicate that they may be financing leases, e.g., lessees may acquire equity in the vehicles, as shown by the refunds, all risk of loss is on the lessees, and lessees may acquire the vehicles for nominal or no additional payments once the residual has been satisfied. However, this issue was not raised below and, therefore, was not addressed by either the Department or the taxpayer. Accordingly, we make no ruling on this issue and remand this case to the Audit Division for consideration of this issue.

#### DECISION AND DISPOSITION:

The matter is remanded to the audit division to consider whether the open-end leases used by the taxpayer are financing leases, whereby retail sales tax should be collected at the outset of the lease. To the extent that it is determined that the leases are true leases, an audit adjustment should be issued in accordance with this decision.

Dated this 27th day of October 1997.