Taxation of Rentals & Leases: Puzzle Solved!

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On-Demand Webinar

Charles Maniace

- Vice President, Regulatory Analysis and Design, Sovos
- 20 years of Indirect Tax experience.
- Has appeared in publications such as the Wall Street Journal, Forbes and Bloomberg.
- Accounting Today's 100 Most Influential People in Accounting for 2019, 2020, 2021 and 2022.

Erik Wallin

- Regulatory General Counsel, Sovos
- Member of the Sovos team for over 10 years
- Focus on U.S. transaction tax law with special expertise in the taxation of technology and the taxation mechanisms that apply throughout the Colorado home rule jurisdictions.

Diane L. Yetter

- Strategist, advisor, speaker, and author
- President of YETTER
- Founder of the Sales Tax Institute
- Testified before Senate Finance Committee
- Accounting Today's 100 Most Influential People in Accounting for 8 times between 2011 and 2022
- Woman Business Owner of the Year 2020

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Introduction

Leases and Rentals in General

- Tax challenges can be minimized on leases and rentals when lessors and lessees communicate and work together.
- Although generally these are taxed as sales, there are special situations.
- Lessors may make elections that could have negative tax consequences on their business.
- Lessees may not understand the tax implications as they apply to these types of transactions.

Leases and Rentals in General (cont.)

- A lease involves the transfer or possession of goods to a person for consideration without accompanying transfer of the title to the goods.
- Rentals are more periodic and there is no expectation or anticipation that ownership will change.
- Rentals are generally considered more short-term (1 year or less) and leases are generally longer-term.

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Leases and Rentals in General (cont.)

- Lessors have an option to pay tax on acquisition of property in some states.
- Some states tax the leasing of intangible property and services such as hotel rooms and lodgings, and computer software.

Nexus and Sourcing

Nexus

- Defines a level of connection between a taxing jurisdiction and an entity
- Substantial *Physical* Presence
  - Maintaining, occupying or using permanently or temporarily, directly or indirectly or through a subsidiary, an office, place of distribution, sales or sample room or place, warehouse or storage place or other place of business
  - CA: "Retailer engaged in business in this state" specifically includes, but is not limited to, any of the following: As respects a lease, any retailer deriving rentals from a lease of tangible personal property situated in this state." Sec. 6203 Rev. & Tax Code.
- Substantial *Economic* Nexus
  - Exceeding a defined level of sales by a dollar or transaction level of activity

Nexus (cont.)

- Physical presence is still relevant post-*Wayfair*.
- It is still the first question you ask when determining if you have nexus in a state.
- If you have physical presence in a state, you have nexus and the economic nexus thresholds are irrelevant.
- Physical presence could also create state income tax or property tax obligations.
- Trend for economic nexus for state income tax also

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Nexus (cont.)

- Since lessors own property in every state where they have leases in effect, they have established nexus everywhere they do business.
- When the property that is being leased is movable, nexus can be established without the lessor’s knowledge.
- Home Rule tax jurisdictions can result in significant tax burdens on lessors.

Impact of Delivery or Possession

- Where the lessee takes possession or delivery of the property can have an impact.
- Chicago example:
  - Leases are deemed to take place at the location where the lessee takes possession or delivery of the personal property.
  - When delivery or use of leased property takes place in Chicago, the transaction is taxable unless it is proved that the agreement was not entered into within the City and that 50% or more of the use did not occur within the City.
  - A lessee of personal property leased or rented in the city is not required to pay tax for any lease or rental payment period in which the personal property is used solely outside the city. This doesn't apply to the lease or rental payment period in which the lessee takes possession or delivery of the personal property at a location in the city. This only applies if the agreement is signed outside the city or requires a separate payment for each period.

Sourcing

- Per Streamlined Sales Tax Agreement sourcing rules for the lease or rental of tangible personal property, if the property is picked up at the lessor's location, the first periodic payment is sourced to that location. Subsequent periodic payments are sourced to the lessee's location.

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Types of Leases and Rentals

Operating Leases

- Generally:
  - The user has no option to purchase the leased equipment at the end of the lease term.
  - Payments are in the form of "rents" and tax is generally due on the periodic lease payments of the rental stream.
  - The equipment is usually returned or purchased at fair market value at the end of the lease term.

Operating Leases (cont.)

- Generally:
  - Most states tax the rental stream
    - Illinois and Maine tax the lessor on the acquisition of property for lease. There is no tax on the lease stream.
    - Ohio - short term rentals of less than 30 days on stream; long term rentals tax up front on sum of payments
    - Some states including California, Michigan, North Dakota, and Rhode Island allow an option for lessor to pay tax on purchase and then no tax on lease payment

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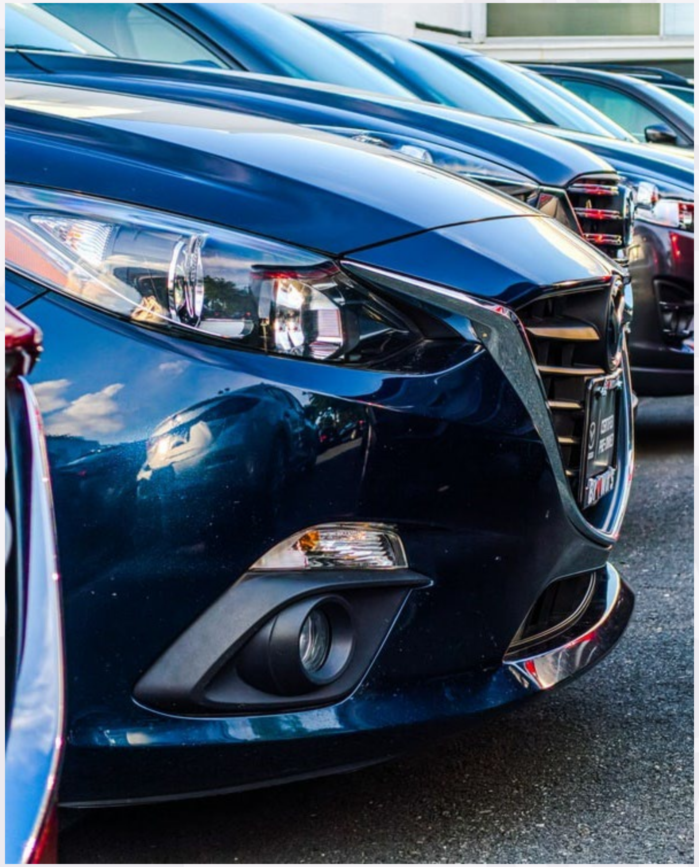
Operating Leases (cont.)

- Leases of motor vehicles are usually taxed differently than other leased property.
- There are often special rules for short-term and long-term motor vehicle leases.
  - In Texas, if the motor vehicle is leased more than 180 days, the tax is due at the beginning of the lease.



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Out-of-State Car-Sharing Platform Not Responsible for Collecting Tax in Texas

- An out-of-state peer-to-peer car sharing platform was not responsible for collecting and remitting Texas motor vehicle gross rental receipts tax since it is not the owner of the vehicles on the platform.
- The taxpayer is a technology platform that allows vehicle owners ("hosts") to list their personal vehicles as available for sharing. Platform users ("guests") can identify available vehicles. The host and guest agree on a price and fixed period for the use of the car. Taxpayer accepts payment from the guest and distributes proceeds to the host.
- The hosts are the owners of the vehicles. As such, the hosts are required to obtain a Texas Motor Vehicle Rental Permit and remit gross rental receipts tax on the rental of the motor vehicle rented in Texas.
- (Letter No. 202207023L, Texas Comptroller of Public Accounts, July 15, 2022, released August 2022)

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Operating Leases (cont.)

- Location of property
  - The jurisdiction where the property is located will generally determine the applicable tax.

Operating Leases (cont.)

- Short-term vehicle rentals
  - The IL Supreme Court held that Chicago’s taxation of car rentals outside city limits under the personal property lease transaction tax ordinance violates the home rule article of the IL Constitution.
  - Chicago attempted to impose a tax collection requirement on rental companies located within 3 miles of the city limits if the lessee had a Chicago driver’s license.
  - The court ruled that Home Rule units such as Chicago may not extend their taxing powers beyond the home rule unit’s borders absent express legislative authority.
  - (The Hertz Corp. v. The City of Chicago, Illinois Supreme Court, No. 119945, 119960, January 20, 2017)

Operating Leases (cont.)

- Things to consider for rental contracts:
  - Many states tax gross proceeds
  - Understand items listed on invoice
  - Know state specific tax treatment
  - Laws may allow lower rate or exemption
  - Some states impose a cap on tax (FL, TN)
  - Expenses may be included as part of rental proceeds subject to tax
  - Other states may allow certain items to be exempt if stated separately

Operating Leases (cont.)

- Chicago Transaction Lease Tax
  - 9 percent tax if leased property is located within the city limits
  - Also applies to leases of intangible property
  - There are different exemptions that apply to related party transactions and financial institutions
  - IL State and City use tax still applies on the purchase price to the lessor.

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Operating Leases (cont.)

- Florida Commercial Rent Tax
  - The total amount of rent paid for the right to use or occupy commercial real property is subject to sales tax and applicable discretionary sales surtax, unless the rent is specifically exempt.
  - If the tenant makes payments such as mortgage, ad valorem taxes, or insurance on behalf of the landlord, those payments are included in the total amount of rent paid and are subject to sales tax and surtax.
  - The current tax rate is 5.5%. The rate will be reduced to 2% once Florida's Unemployment Trust Fund is replenished to pre-pandemic levels.
- Arizona also imposes a tax on commercial leases.

Operating Leases (cont.)

- Alabama Rental Tax Rates
  - Alabama has separate rental tax rates for certain types of property
  - The state's general sales tax rate is 4%
  - The general rental tax rate is 4%
  - The rental tax rate for linens and garments is 2%
  - The rental tax rate for automobiles is 1.5%
  - The rental tax rate for manufacturing machinery is 1.5%
  - Local authorities can also impose special rental rates that align with the same categories

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Operating Leases (cont.)

- Arkansas Short-Term Rental Tax
  - In addition to AR gross receipts tax and compensating use tax, there is a short-term rental tax of 1% on the gross receipts received from the short-term rental of tangible personal property.
  - "Short-term rental" means a rental or lease of tangible personal property for a period of less than 30 days, except rentals or leases of motor vehicles, trailers, or farm machinery and equipment.
  - The short-term rental tax is due whether or not the gross receipts tax or compensating use tax was paid on the rented tangible personal property at the time of purchase by the lessor.

Delaware

- Delaware does not have a sales tax.
- However, it taxes leases and rentals at the rate of 1.9914%.
- Accordingly, rental companies in Delaware must obtain a business license and collect/remit this tax on any applicable rental transactions.

Heavy Equipment Rentals

- Special rental rates and rules often apply to heavy equipment rentals.
- States like Connecticut, Washington and South Carolina have special taxes on heavy equipment rentals.
- In North Carolina, counties are enabled to tax, at the additional rate of 1.2%, the short-term lease or rental of heavy equipment.

Heavy Equipment Rentals

- In Texas, a special surcharge applies to both the sale and rental of off-road heavy duty diesel equipment.
- Michigan recently simplified their taxation of heavy equipment rentals by exempting these rentals from personal property tax and imposing a 2% excise tax on rental transactions of heavy equipment.
  - (H.B. 4833, H.B. 4834, effective January 1, 2023)

Rent-to-Own

- Some rental contracts will include a rent to own provisions. Questions arise as to the impact to the tax base on the final payment.
- Does the credit for a portion of the rental charges paid reduce the tax base of the purchase amount? The determination will likely be based on whether the purchase price is fair market value or bargain purchase price.
- In states where the tax is paid upfront by the lessor it is unlikely that a credit will be allowed. Tax would likely be due on the full selling price without the credit.

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Financing Leases

- A financing lease, also known as a capital lease can be considered as a type of conditional sale.
- Generally include a nominal purchase option or mandatory purchase price.
- Legal title transfers at conclusion of lease term.
- Financing leases or conditional sales are generally taxed at the inception on the purchase price with limited exceptions.

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Financing Leases (cont.)

- While rentals are generally not taxed in Maine, this rule does not apply to "lease in lieu of purchase" transactions.
  - Transfer of ownership at lease conclusion
  - A bargain price option
  - The lease term either covers at least 75% of the property's useful life or the present value of the lease payments must account for at least 90% of the fair value of the property measured at the lease inception.
- These transactions occur when the contract terms create a security interest in the property, provide an option to purchase the property for nominal consideration, and the customer must assume responsibility for the disposition of the property at the end of the term.

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Equipment Provided with Operator

- Some states do not impose the tax on leases or rentals if the equipment is provided with an operator. They consider this charge to be for a service and not for the rental of property.
- Key factors in determining whether the transaction is a lease or service include whether there has been a transfer of possession of the property to the lessee; who has control of the property; if the use is restricted to the lessor's operators; and the scope of services provided by the lessor's employees.

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Washington Amends Lease and Rental Excise Tax Rule for Certain Construction Scenarios

- The Washington DOR has amended the state's excise tax rule on leases or rentals of tangible personal property to clarify the department's policies regarding charges for specific construction services.
- Specifically, the revision clarifies the distinctions between charges for the rental of concrete pumping equipment with an operator, sales of construction services, and sales of construction materials.
- In Washington, equipment rentals without an operator and leases of operated equipment are generally subject to the retailing B&O tax. In certain scenarios, when services are eligible for resale, the wholesaling B&O tax may apply.
- The rule revision provides several specific examples for taxpayers.

Washington Amends Lease and Rental Excise Tax Rule for Certain Construction Scenarios (cont.)

- In one example, a prime contractor hires a concrete pumping company to pump premixed concrete. The concrete pumping company operates its own equipment but does not provide the concrete mix. The stand-alone concrete pumping services are classified as a rental of equipment with an operator. Charges for this transaction are subject to retailing B&O tax and retail sales tax.
- In another example, a subcontractor is hired by a prime contractor to pave a parking lot. The subcontractor uses its own equipment and is required to meet contractual specifications set by the end consumer. The prime contractor provides the subcontractor with a reseller permit instead of paying retail sales tax. The subcontractor's business activity is classified as a construction service and not "rental of equipment with an operator." Charges for this transaction are subject to wholesaling B&O tax, as construction services are eligible for resale.
- (WAC 458-20-211, Washington DOR, effective April 23, 2021)

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Equipment Provided with Operator - Arkansas

- The taxpayer leases equipment for special events, is responsible for setting up and taking down the equipment and remains with the equipment during the event.
- The presence of the taxpayer's representatives does not convert the lease of equipment into a service as the taxpayer's representative was not required to operate the equipment. The rentals were also subject to short-term rental tax since the equipment was rented in four-hour intervals.
- (*Administrative Decision Nos. 17-198, 17-199, 17-200*, Arkansas Department of Finance and Administration, Office of Hearings and Appeals, March 27, 2017)

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Portable Toilet Rentals Subject to Tax, Not Exempt as a Service in Missouri

- The Missouri Supreme Court held that the provision of portable toilets and related services were taxable as the rental of tangible personal property, not exempt as waste removal services.
- The taxpayer advertises itself as a portable toilet rental company. The taxpayer delivers and picks up portable toilets and performs ancillary services.
- The taxpayer's invoices contain two charges: one for the rental and services for the portable toilets and one for the delivery fee.
- The taxpayer was audited and assessed tax due since it was not collecting sales tax on the rentals. The taxpayer argued that the entire portable toilet business is a tax-exempt service.
- The court noted that the taxpayer holds itself out as a portable toilet rental service, and without providing the portable toilets to its customers, it has no service to provide.

Portable Toilet Rentals Subject to Tax, Not Exempt as a Service in Missouri (cont.)

- In Missouri, gross receipts that are subject to sales tax are “the total amount of the sale price of the sales at retail including any services ....” This includes the rental of tangible personal property.
- The taxpayer does not separate any amount representing its cleaning or servicing from the rental of the portable toilet.
- Since the taxpayer failed to separate these amounts, the court stated that it is impossible to determine whether a portion of the receipts should be excluded from taxation. As such, the taxpayer’s gross receipts are subject to tax.
- The court stated that the applicable statute’s “plain language is clear and resolves this dispute without having to resort to the “true object” test.”
- (Opinion No. SC98444, Supreme Court of Missouri, December 22, 2020)

Sale/Leaseback

- Taxpayer acquires property from a vendor in a sale transaction
- Property is sold by taxpayer to financing company
- Financing company leases property back to taxpayer

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Sale/Leaseback (cont.)

- States often treat a sale/leaseback transaction as two separate transactions and tax each of them.
- However, some states may view the leaseback as purely a financing arrangement and only tax the property when originally purchased.
- States have very particular rules related to these transactions that must be followed very closely.

Sale/Leaseback - Key Factors

- What was the length of time between original acquisition and the sale/leaseback transaction?
- Was sales tax paid on the original acquisition of the property?
- Is the sale/leaseback a financing arrangement or a sale?
- Is the transaction between related parties?
- Is there title transfer to lessee at conclusion?
- Was the property acquired under a Lease Line?
- What was the intent of the parties entering into the agreement?

Sale/Leaseback - Issues

- No resale exemption on original purchase
- Financing company can buy for resale
- Financing company required to charge tax on lease stream
- Can result in double tax
- Utah exempts sale/leaseback when
  - the lessee paid tax when initially buying the tangible personal property;
  - the transaction is intended to be, and is treated for accounting purposes, as financing; and
  - the lessee capitalizes the property for financial reporting purposes
  - (Sec 59-12-104)

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Utah to Impose Sales and Use Tax on Sales of Leased Personal Property Effective July 1, 2023

- The Governor of Utah signed S.B. 14, which will impose the state's sales tax on charges for sales of previously leased personal property.
- The language of the bill adds "sales of leased tangible personal property from the lessor to the lessee made in the state" to the definition of tangible personal property that is subject to sales tax.
- Rentals and leases of tangible personal property continue to be subject to tax on the rental/lease stream.
- Utah's update will go into effect July 1, 2023.
- (Utah S.B. 14, 2023)

Lease Assignments

- When lease portfolios are transferred, sales tax may be imposed on the underlying property.
- The original lessor may still be required to collect and remit the taxes on the rental stream.

Lease Assignments - Factors to Consider

- Does the assignment include transfer of right, title & interest in the property?
- Is the assignment recourse or non-recourse?
- Did the lessor make election to pay tax on acquisition?

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Tax Base

Tax Base

- For taxes imposed on the rental stream, the tax base is generally the principal payment. However, if the lease amount is a single charge representing various items, these other items are usually included in the tax base.

Tax Base (cont.)

- Ancillary Charges
  - Taxability differs state by state. The contract language and invoice presentation can have an impact.
  - Interest & Finance Charges: If separately contracted for and separately stated in the lease agreement these charges should be exempt
  - Personal Property Taxes: Taxability may be dependent on who has the ultimate burden of the tax.
  - Insurance & Maintenance: Taxability may be dependent on whether they are mandatory or optional. If mandatory, they are usually subject to tax as being part of the lease fee. If optional and separately stated, taxability should follow general rules for these items.

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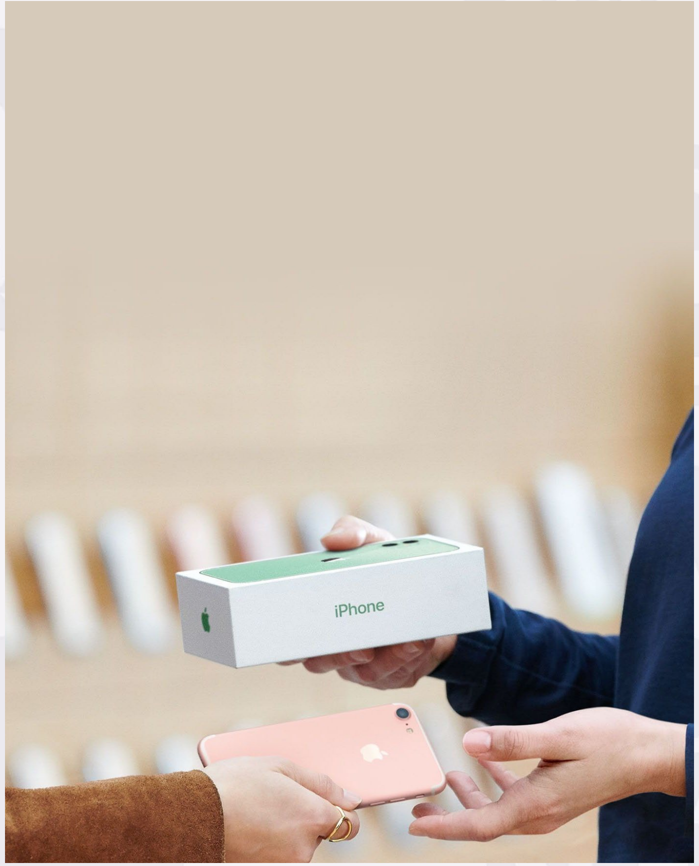
Tax Base (cont.)

- Rate Changes
  - A lease agreement should contemplate how sales and use tax rate changes will be handled.
  - Some states may provide for a grandfather rule for long term contracts that do not allow for recovery of increased rate changes.



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Tax Base (cont.)

- Exempt Leases
  - Generally, rental and lease transactions are treated the same as sales transactions. Therefore, a lessor can generally acquire property that will be rented or leased exempt under the resale exemption. Tax is then charged on the rental or lease amount.
  - Exemptions may exist for certain lessees and for certain uses of the leased property.

Tax Base (cont.)

- When the tax is assessed on the lessor, care should be taken to ensure that an exemption that applies to the lessee also applies to the lessor.
  - Illinois will recognize these sorts of “flow through” exemptions generally
  - Maine generally will not recognize these exemptions.
- Tax on lessor may preclude exemptions
  - New Mexico leases to Federal Government are generally taxable

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Moveable Property

Moveable Property

- Problems arise with moveable property because the tax calculation is dependent on where the property is used. Most states will cease imposition of their tax if the property is moved out of their state.
- When property is moveable, the lessor must maintain communication with the lessee to maintain documentation of where the property is located.
- A difference in the tax base between the states provides opportunities for complexity and errors on tax calculation.

Moveable Property

- Property that is moved from a state that taxes the acquisition of the property by the lessor into a state that taxes based on the stream generally will not allow a credit for the tax paid on acquisition
- Property that is moved from a state that taxes on stream into a state that taxes on acquisition will impose use tax on the depreciated value of the property at the time it enters the state

Audit Issues

Audit Issues

- Registration & Collection Issues
  - Generally, sales tax is imposed on the lease and collected on the periodic lease payments.
  - The location of lease property typically creates nexus in that jurisdiction. Consequentially, registration and collection of sales tax will then be a responsibility of the lessor.

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Audit Issues (cont.)

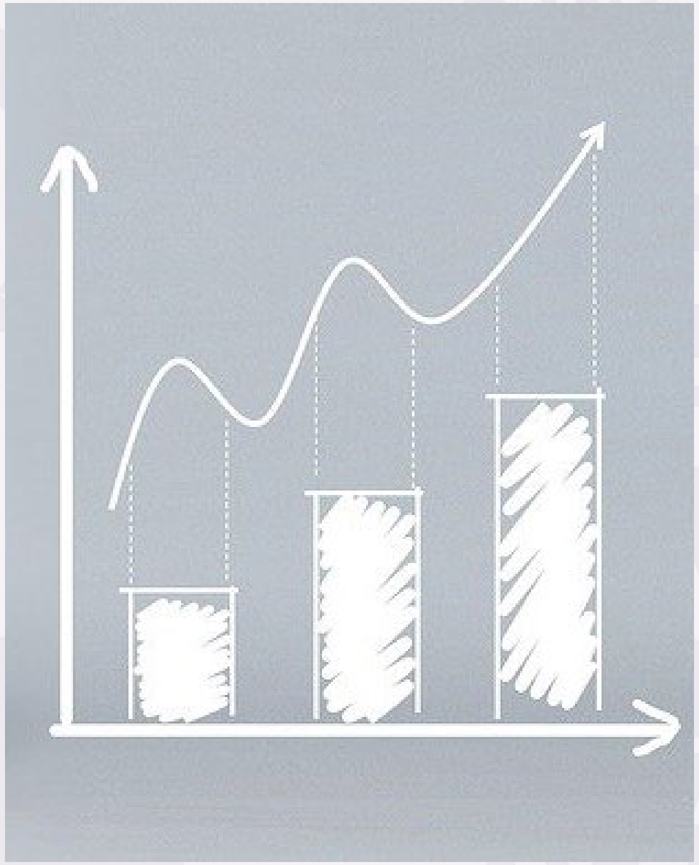
- Responsible Party for Tax Payment
  - Some states allow lessors the option to either pay tax on the acquisition cost of the property or collect the sales tax on the rental stream. The lessor should consider present value of the lease stream, length of time the asset will be held, administrative costs and audit issues, as well as whether the equipment will move between states.
  - Communication is necessary between lessors and lessees to ensure that both parties do not pay audit assessments.

Audit Issues (cont.)

- Record Retention Period
  - Lease contracts should be retained for the entire lease term
    - Often ancillary charges are detailed in the contract but not on the monthly statements/invoices
    - Tax may be identified in the contract but not on the periodic statement
  - Original purchase documents should be retained for the life of the assets particularly if tax paid on asset acquisition

Audit Issues (cont.)

- Tax Rate Changes
  - If any long-term contracts are eligible for grandfather rate provisions, document the rates that apply and when they expire
  - Typically any grandfather provisions expire if there is a change to the contract such as a renewal



Audit Issues (cont.)

- Sampling Procedures
  - The decision as to whether to use a sample or detail audit should evaluate whether there is uniformity in transactions such that a sample will be representative.
  - Using a sample approach may limit the ability to reimburse the lessor itself for the tax paid under audit by billing the lessees.
  - If the tax is based on the acquisition of the property rather than lease stream it may not be appropriate to use a sample if there are limited acquisitions of property.

Virginia Denies Request for Reconsideration of Tax Determination on Lease/Purchase Transaction

- A taxpayer's request for reconsideration of a Virginia sales and use tax determination was denied since the taxpayer failed to prove that the Virginia Department of Taxation (DOT) erroneously assessed tax on equipment purchased under a lease/purchase agreement.
- The DOT's audit had developed an audit sample factor and extrapolated the factor over the entire audit period since the taxpayer had not filed returns or remitted tax.
- One transaction included in the sample was the exercise of an end of lease option and the purchase of the leased equipment. The auditor determined that the taxpayer was liable for tax on the end of the lease purchase option because it could not identify the equipment purchase as an asset.

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Virginia Denies Request for Reconsideration of Tax Determination on Lease/Purchase Transaction (cont.)

- The taxpayer appealed the determination, contending that the lease was exercised for a one-time purchase of computer equipment, which was not representative of normal business purchases.
- The DOT agreed that the purchase of equipment at the end of a lease would constitute an isolated transaction that should be removed from the sample, provided that the taxpayer produce clear evidence that the equipment purchased at the end of the lease was the same equipment that was assessed in the audit.
- The taxpayer did not furnish any evidence that the computers listed on the invoice it provided are the same equipment that is the subject of the lease agreement. The taxpayer failed to meet its burden of proof. As such, the taxpayer's request was denied.
- (Ruling of Commissioner, P.D. 20-89, Virginia Department of Taxation, May 27, 2020, released July 2020)

Questions & Comments

Charles Maniace

Sovos

charles.maniace@sovos.com

(978) 527-1120

Erik Wallin

Sovos

erik.wallin@sovos.com

(978) 527-1250

Diane Yetter

Sales Tax Institute

diane@salestaxinstitute.com

312.701.1800, ext. 2

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Sales Tax Institute
910 W. Van Buren, Suite 100-321
Chicago, IL 60607
(312) 701-1800

webinars@salestaxinstitute.com

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