COLORADO
Department of Revenue
Taxation Division

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PLR 11-005

October 5, 2011

XXXXXXXXXXXXXX
ATTN: XXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXXXXXXXX

Re: Private letter ruling re: local sales tax

Dear XXXXXXXXXXX,

Your firm submitted on behalf of XXXXXXXXXXXXXXXXXX ("Company") a request for a private letter ruling to the Colorado Department of Revenue ("Department") pursuant to Regulation 24-35-103.5. This letter is the Department's private letter ruling.

Issue

How does Company collect and report taxes related to adjustment payments made to or from lessee pursuant to a motor vehicle lease?

Conclusion

Company collects and reports sales and uses taxes as set forth in the Discussion section, below.

Background

Company enters into motor vehicle leasing arrangements with corporate clients, often for periods greater than three years. Lease payments are calculated based on depreciation, interest, and a management fee. Company collects sales taxes on lease payments pursuant to §39-26-102(23), C.R.S. At the end of the lease period, Company sells the leased vehicles to wholesale dealers. Because the dealer transactions are at wholesale, Company does not collect sales tax on these sales to wholesalers. If the price paid by the wholesaler exceeds the calculated depreciated price of the vehicle, Company issues a refund to the customer based on the overstated amount of the projected depreciation. Customers have the option of applying this refund against the cost of a new leased vehicle. Conversely, if the purchase price is lower than the projected depreciation, then the customer pays Company the difference. Company seeks advice on how it is to treat for sales and use tax purposes the payment of the depreciation adjustment.

Discussion

1. *Price adjustments that affect tax calculation*

Before addressing the issues identified in the ruling request, we thought it helpful to address a preliminary issue we found necessary to resolve. This request presents the interesting question of whether the adjustment payments are adjustments to the prior lease payments and, if so, whether lease payments (and, therefore, the sales tax upon which it is calculated) can be readjusted at the end of a lease. We conclude that adjustment payments from lessor to lessee result in adjustment(s) of one or more prior lease payments and that sales tax originally paid on the lease payment(s) can be adjusted even though the lease period has expired.

Sales tax is a transactional tax and from this flows the general axiom that, once a transaction is completed, parties cannot later retroactively adjust the price to reflect subsequent events. The most common application of this principal is when retailer offers, after the completion of a sale, to lower retroactively the price of the goods as a method for compensating the buyer for damages related to the purchased goods. Similarly, retailers sometimes offer buyers a discounted purchase price if the buyer pays in full within thirty days of the sale. In each of these cases the question arises whether the sales tax is due on the original amount or on the subsequent discounted price. Most states, including Colorado, take the view that the sales tax is incurred at the time of sale and generally cannot be adjusted by the subsequent events. See, DOR regulation 39-26-102.7(a)(4); GIL-07-033.

This question of retroactive adjustment of price arises in this case because each lease payment arguably represents a separate sale. If each lease payment represents a separate sale, then the issue arises whether the final true-up payment is a retroactive adjustment of the price (i.e., the monthly lease payment). [1] Colorado levies sales tax only on lease payments actually made rather than on than the total lease payments whether or not payment is actually made. By imposing tax only on installments, if and when paid, one can argue that each lease payment constitutes a separate sale. Under this view, events subsequent to each lease payment cannot be used to modify the sales tax paid on the already-paid lease payments. For example, if the retailer determines that completed lease payments were too high, then arguably the retailer cannot retroactively reduce the individual lease prices (at least for purposes of the sales tax calculation).

On the other hand, if we viewed the lease as a single transaction as and the lease payments as only partial or estimated payments of the purchase price, the individual lease payments are not individual sales and, therefore, the retailer can readjust those lease payments as part of the final payment (or refund) under the lease agreement. And it is the case that the Department view leases as one transaction, at least for purposes of setting the tax rate. A lease entered into on January 1 when the sales tax rate is 2.9% will continue to use that tax rate throughout the term of the lease even if the tax rate is later increased or decreased during the term of the lease.

[1] We considered whether we could view the true-up payment simply as another payment and not as a retroactive adjustment of prior lease payments. Although this might be possible if the true-up could only be an additional payment (i.e., a payment from lessee to lessor), it is difficult to characterize the true-up as not retroactive when it involves a refund to the customer. The refund is clearly not another lease payment and, therefore, is most naturally understood to be a readjustment (partial refund) of prior lease payments.

We conclude that, regardless of whether the lease payments are viewed as separate sales[2] or not, these lease payments are only estimated prices and can be retroactively adjusted based on the price paid by the wholesaler. As a general matter, parties to a commodities transaction may peg the purchase price to some future external event which is not knowable at the time the agreement is entered into. For example, a farmer can make a present sale of farm goods for a price to be determined by a commodities index at some future date. The buyer may be required to make an estimated payment to the farmer at the time of the contract signing based on a mutually agreed to estimate of the future price but the parties also agree that there will be a true-up payment based on the final price determined by the index at the time of delivery. Tax in such cases is properly measured on the final price and not on the estimated price when the contract was entered into.

Such an approach was adopted, for example, California Sales Tax Counsel Ruling No. 295-0965, where related parties to a sale of equipment agreed that the purchase price would be calculated on certain costs that could not be determined until several months after the sale. The parties agreed that the buyer would make an initial payment based on an estimate of those costs, but that either the buyer or seller would make a true-up payment once the costs were finally determined. The department held that the initial payment was only an estimate and that the sales tax should be calculated on the final price, which included the true-up.

In GIL-07-033, we considered a slightly different scenario in which the seller readjusted its price based on later events. There, a wholesaler provided product to distributors at one price and samples to distributors at a discounted price. At the time of delivery, the parties could not determine whether the product would be used as a sample or for resale to the consumer. If the product was used as a sample, the wholesaler had to collect sales tax from the retailer (who could not claim a sale for resale exemption); if the product was resold, then the sale from the wholesaler to the distributor was an exempt wholesale sale. The wholesaler initially charged the distributor the full price and then periodically adjusted its accounting records to reduce the discounted price when it was ultimately determined how many of the products were used as samples. We concluded there that the wholesaler could retroactively adjust its selling price to reflect the final accounting by the distributors as to how many of the products were used as samples. It was important to our decision there, as it is here, that the agreement specifically state that there would be true-up of the price.[3]

The agreement entered into by the parties in the present case specifically contemplates that the total payment due can be adjusted. It is understood that this price is only an estimate and will be finally determined once the vehicle is sold to the wholesaler. For the reasons we discuss above, we conclude that the adjustment mechanism proposed by lessor will result in a refund of sales and use taxes previously paid on lease payments.

2. *Calculation of state and local sales taxes*

We next consider the taxpayer's principal question: how are state and local sales taxes calculated and reported for true-up payments. To understand and explain how the true-up payment is treated for sales and use tax purposes, we consider the following hypothetical transaction.

[2] The notion that a payment is an estimated payment applies whether there are multiple payments or a single payment.

[3] In GIL-07-033, we expressly stated that we are not addressing how discounts for volume sales should be handled for sales tax purposes. This is a complex area and we again disclaim any inference that we reach that issue in this ruling.

The fully capitalized price on which the lease payments are calculated is $20,000 and lessor estimates that the vehicle will have a residual value of $12,000 at the end of a three year lease. There are at least three separate scenarios to consider:

If wholesaler pays $12,000 at the end of the lease, then there is no true-up payment and there is no adjustment to state or local sales and use taxes.

If wholesaler pays $13,000, then lessor agrees either to pay $1,000 cash to lessee or to give lessee $1,000 credit on a subsequent lease. In the case of a cash payment to lessee, Lessor will reduce its gross and net taxable sales by $1,000 on its state and local sales tax return(s) in the tax periods in which the refund(s) is made and remit to lessee $1,000 plus state sales tax, state-administered city and county sales taxes, and special district sales or use taxes. In the case of a credit on a subsequent lease, the credit is either spread over all lease payments or it is use to eliminate as many of the subsequent lease payments as are necessary to equal the amount of credit. Both approaches are acceptable and, of course, both assume that the local sales and use tax jurisdictions and/or the state and local sales tax rates (and use tax rates for special districts) applicable to the subsequent lease are the same as that applied to the original lease. If these assumptions are not applicable, then lessor must file amended sales tax returns for as many tax periods applicable to the original lease period as needed to effectuate the refund the state and local taxes applicable to the original lease. If the lessee paid special district use taxes under the original lease, lessor shall refund to lessee the special district use tax on the $1,000..

If wholesaler pays $11,000, then lessee pays lessor $1,000 in cash or lessor capitalizes the liability into payments for the subsequent lease. In the case where lessee pays lessor $1,000 in cash, lessor treats the payment as another lease payment under the original lease and reports it as such on the department's sales tax return. In the case where lessor includes the $1,000 in the payments for the subsequent lease, then lessor simply reports the subsequent lease payments, including the increase, as gross and net taxable sales. This assumes that the local tax jurisdictions and the state and local tax rates applicable to the original lease are also applicable to the subsequent lease. If this assumption is not correct, lessor must adjust its reporting in order that state and local tax jurisdictions receive their tax at the proper rate on the $1,000. If lessee paid special district use taxes under the original lease, lessor shall collect those special district use taxes at the rate applicable to the original lease on the $1,000 payment.

The department does not administer use taxes levied by cities, counties, and home-rule cities and counties. Lessor should discuss with those jurisdictions how they administer these true-up payments. This ruling cannot and does not address how these jurisdictions will or should treat these tax adjustments.

Miscellaneous

This ruling is premised on the assumption that the Company has completely and accurately disclosed all material facts. The department reserves the right, among others, to independently evaluate the Company's representations. This ruling is null and void if any such representation is incorrect and has a material bearing on the conclusions reached in this ruling. This ruling is subject to modification or revocation in accordance to Department Regulation 24-35-103.5

Enclosed is a redacted version of this ruling. Pursuant to statute and regulation, this redacted version of the ruling will be made public within 60 days of the date of this letter. Please let me know in writing within that 60 day period whether you have any suggestions or concerns about this redacted version of the ruling.

Sincerely,

Office of Tax Policy
Colorado Department of Revenue