

**BENJAMIN J. CAYETANO**  
GOVERNOR

**MAZIE HIRONO**  
LT. GOVERNOR



**RAY K. KAMIKAWA**  
DIRECTOR OF TAXATION

**SUSAN K. INOUE**  
DEPUTY DIRECTOR

STATE OF HAWAII  
**DEPARTMENT OF TAXATION**  
P.O. BOX 259  
HONOLULU, HAWAII 96809

February 27, 1998

## **TAX INFORMATION RELEASE NO. 98-2**

RE: Application Of The General Excise And Use Taxes To Certain Leasing Transactions

This Tax Information Release (TIR) clarifies the application of the general excise and use taxes in situations involving a true lease of tangible personal property (property), the installment or conditional sale of property, and the sale-leaseback of property. The correct application of the general excise and use taxes will depend on the circumstances of each case with the substance of the transaction controlling, not its form. See In re Taxes, Dobbs Houses, Inc., 53 Haw. 195 (1971). This TIR reverses the prior position of the Department that looked to title passage as the sole criterion in making this determination.

This TIR does not apply to taxpayers who are subject to the franchise tax imposed under chapter 241, Hawaii Revised Statutes (HRS), or amounts received by financial institutions which are exempt under section 237-24.8, HRS.

### **I. General Rule: Lease vs. Installment or Conditional Sale Contract**

A true lease of property involves a situation where one person grants to another person the right to use the property for a specified period in return for periodic payments of a specified amount of rent. However, a lease may in substance be a "disguised sale" if, for example, it includes an option to purchase for nominal consideration at the end of the term or provides for automatic passage of title to the lessee upon full payment of the "rent."

The mere existence of a purchase option does not, per se, convert a lease into a conditional sale. Where the rental payments represent a fair return for the use of the leased property, such that the purchase price remaining at the end of the term is not "nominal," the agreement is a lease and not an installment or conditional sale. See Dobbs Houses, Inc., 53 Haw. at 198.

A lease, therefore, may be distinguished from an installment or conditional sale as follows: (1) the lease contains no express option to purchase; (2) if the lease contains an express option, the purchase price remaining at the end of the lease is not "nominal"; (3) the lease has no provision for present or future passage of title from the lessor to the lessee; and (4) the lease specifically negates any suggestion that the lessee has any title to or equity in the property. See

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Dobbs Houses, Inc., 53 Haw. at 199. A “nominal” purchase price is a purchase price which is merely named, stated, or given, and is small or slight in comparison to the fair market value of the property at the end of the lease.

**Example 1:** Company A leases property from Company B. The lease provides for Company A to make periodic payments to Company B for the use of the property. Company B paid the use tax at the rate of  $\frac{1}{2}$  of one percent on the importation of the property into Hawaii for further leasing. Haw. Rev. Stat. § 237-4(9) and 238-2(2) (1993). Company B has title to the property. There is no provision for Company A to acquire title or equity to the property during or at the end of the lease term. This transaction is classified as a true lease. Company B is subject to the general excise tax at the rate of 4 percent on the lease income received from Company A.

**Example 2:** Company C enters into a lease agreement with Company D, a Hawaii vehicle dealer and leasing company. The lease agreement provides that a truck (normally selling for \$100,000) may be leased by Company C under a 36-month agreement that requires monthly lease payments, including finance charges of \$3,333.34 and a \$1.00 end of term payment. Company C’s payments for the 36-month period total \$120,000 ( $\$3,333.34 \times 36$ , rounded). The \$120,000 represents the purchase price of \$100,000 and \$20,000 in finance charges. The lease provides for the passage of title to the lessee at the end of the lease term upon payment of the nominal amount of \$1.00. This lease agreement is properly classified as an installment or conditional sale of property, rather than a lease. In effect, the lessee acquires equity in the property upon entering into the lease and has financed the purchase on an installment basis.

If Company D is an accrual basis taxpayer, the transaction is reported by classifying \$100,000 as Retailing income at the inception of the lease and the \$20,000 finance charge is accrued as Interest income ratably in accordance with the lease agreement, whether received by Company D or not.

If Company D is a cash basis taxpayer, the monthly payments received are reported by allocating the amount received between the purchase price of the property and the finance charge. In this case, \$2,777.78 ( $\$100,000/\$120,000 \times \$3,333.34$ ) is reported by Company D on the monthly general excise tax return under the classification of Retailing income and \$555.56 ( $\$3,333.33 - \$2,777.78$ ) as Interest income.

## **II. Sale-leaseback.**

### **A. True sale-leaseback.**

One type of a sale-leaseback transaction is a sale of property to a leasing company which immediately leases the property back to the seller/lessee. Title to the property is transferred from the seller/lessee to the leasing company. The seller/lessee has an option to purchase the property at its residual fair market value at the end of the lease.

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**Example 3:** Company E owns property currently used in its business. The applicable use tax at the 4 percent tax rate was paid by Company E on the importation of the property into Hawaii (Haw. Rev. Stat. § 238-2(3) (1993)) or the general excise tax was paid on the proceeds received from the original sale of the property to Company E. Company E sells the property to leasing Company F. Title to the property is transferred to Company F; Company F immediately leases the property back to Company E. Company E, the seller/lessee, has an option to purchase the property at its residual fair market value at the end of the lease.

This transaction is classified as a sale of property to leasing Company F and a lease-back of property from leasing Company F to Company E. In this situation, the sale of the property to leasing Company F coupled with Company E's lease and option to purchase the property at its residual fair market value makes the transaction a true sale-leaseback transaction. The lease-back of the property to Company E is classified as a true lease.

The gross income received by Company E from the sale of the property to leasing Company F is subject to the general excise tax at the rate of  $\frac{1}{2}$  of one percent, section 237-4(9), HRS, unless the sale is a nontaxable casual sale. A casual sale means an occasional, isolated, irregular, infrequent, or incidental sale of tangible personal property which is not ordinarily sold in the course of the person's trade or business. Haw. Rev. Stat. § 237-1 (1993).

The lease income received by leasing Company F is subject to the general excise tax at the 4 percent rate.

If Company E exercises the option at the end of the lease to purchase the property at its residual fair market value from leasing Company F, the transaction is not a casual sale for Company F because the sale of property by a lessor to a lessee or other party is a normal business activity. The gross income received by Company F from Company E is subject to the general excise tax at the 4 percent rate.

**B. Sale-leaseback as loan.**

Another type of sale-leaseback transaction is a conditional sale of property to a leasing company or other vendor who immediately leases the property back to the seller/lessee. Title to the property may or may not pass from the seller/lessee to the leasing company. The "sale" price of the property may be for a nominal amount. The lease provides for the seller/lessee to pay a nominal amount at the end of the lease term to the leasing company to "purchase" the property.

Under these facts, the transaction is classified as a loan. In this situation, the "sale" of the property is for purposes of providing collateral under a security agreement. As a result, the lease-back transaction is not classified as a true lease. The fact that title to the property may or may not pass is not critical to this determination.

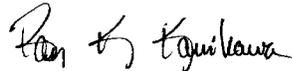
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The conditional "sale" of the property for purposes of providing collateral under a security agreement is not subject to the general excise tax either on the initial "sale" to the leasing company or vendor or at the end of the lease when the security interest is released.

Since this transaction is classified as a loan, the finance charge or interest received by the leasing company or vendor is subject to the general excise tax at the 4 percent rate.

**III. Prior Determination Letters.**

To the extent not consistent with this TIR, the prior determination letters by the Department of Taxation using title passage as the sole factor in classifying leases of tangible personal property are superseded as of the date of this TIR.



RAY K. KAMIKAWA  
Director of Taxation

HRS Sections Explained: HRS Sections 237-1, 237-4(9), 237-13(10), 237-16, 238-2