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## REVENUE ADMINISTRATIVE BULLETIN 2015-25

**Approved:** December 2, 2015

### SALES AND USE TAXES - LESSORS

**(Replaces Revenue Administrative Bulletin 1988-39)**

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

**RAB 2015-25.** This Revenue Administrative Bulletin (RAB) explains the sales and use tax treatment of tangible personal property acquired for lease or rental. For purposes of sales and use tax, the terms “lease” and “rental” have the same meaning and are used interchangeably in this RAB. “Tangible personal property” will sometimes be referred to in this RAB as “property.”

#### INTRODUCTION

Sales (or use) tax is due on the sales price (or purchase price) of tangible personal property at the time the lessor acquires the property unless the lessor elects to pay use tax on the rental receipts. To make the election to pay on rental receipts, the lessor must satisfy each of the following requirements:

- the lessor must be in the business of leasing, which requires a profit motive;
- the transaction must involve the rental of tangible personal property (as opposed to the provision of a service), and;
- the lessor must register with the Michigan Department of Treasury (Department) to pay use tax unless the lessor already holds a sales tax license.

## ISSUES

- I. What constitutes a lease of tangible personal property?
- II. Is the lessor election available for a single mixed transaction if the property is incidental to the services provided?
- III. Who is a “lessor” under the Use Tax Act?
- IV. What is the effect of making a lessor election to pay use tax?
- V. What is the effect of using the property for non-leasing purposes?
- VI. What is the tax base of rental receipts?
- VII. How are leases sourced?
- VIII. Does a lessor owe use tax on property that is exempt from use tax or that is leased to a lessee that is exempt from use tax?
- IX. Is use tax owed on a sublease?

## ANALYSIS & CONCLUSIONS

I. **Lease or rental of tangible personal property.** “Lease or rental” means transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration, and may include future options to purchase or to extend.<sup>1</sup>

A lease or rental includes motor vehicle or trailer contracts with terminal adjustment clauses that allow the contract payments to be increased or decreased by reference to the amount realized upon the sale or disposition of the property.<sup>2</sup>

A lease or rental does not include installment sales. Nor does a lease or rental include a security agreement or a deferred payment plan where title or possession is transferred after the completion of the required payments or where title is transferred after completion of required payments and the payment of a *de minimis* “option to purchase” price. The purchase price is *de minimis* if it is not more than the greater of \$100 or 1% of the total payments. While the transactions described in this paragraph are not lease or rental transactions, the transactions would be subject to tax if they otherwise involve a sale at retail of tangible personal property.

II. **Services distinguished from a lease of tangible personal property.** A single transaction that involves a mixture of non-taxable service(s) and taxable tangible personal property must be analyzed to determine the nature of the transaction. If the transaction is for a service, then it does not constitute a lease of tangible personal property and the lessor election does not apply. Any tangible personal property used in the completion of the service is merely incidental to the service. Sales or use tax applies at the time the service provider acquires or uses the property.

The “incidental to service” test was established in *Catalina Marketing Sales Corp v Michigan Department of Treasury*.<sup>3</sup> The Court established six factors for determining if a transaction is a service:

- what the buyer sought as the object of the transaction;

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<sup>1</sup> MCL 205.92b(1).

<sup>2</sup> MCL 205.92b(1)(iv) reference to IRC 7701(h)(1).

<sup>3</sup> *Catalina Marketing Sales Corp v Dep’t of Treasury*, 470 Mich 13 (2004).

- what the seller or service provider is in the business of doing;
- whether the goods were provided as a retail enterprise with a profit-making motive;
- whether the tangible goods were available for sale without the service;
- the extent to which the intangible services have contributed to the value of the physical item transferred, and;
- any other factors relevant to the particular transaction.

While all the factors may be considered, the first factor bears the most weight.

In addition to the “incidental to service” test adopted by the Michigan Supreme Court, the Use Tax Act provides a specific standard for determining the nature of a transaction involving both equipment and an operator. If an operator is supplied along with property, and the operator is necessary for the equipment to perform as designed, then the transaction is a service and not a lease of property. The operator must do more than maintain, inspect or set up the property.<sup>4</sup>

Aircraft, watercraft, and bus charter companies are examples of service providers. Charter companies provide tangible personal property and a crew or person who retains control of the property during the period of service. The charter agreements are service contracts.

III. **Lessor defined.** A “lessor” is a “person engaged in the *business* of renting or leasing tangible personal property to others.”<sup>5</sup> A “business” is defined in the Use Tax Act as “all activities engaged in by a person or caused to be engaged in by a person with the object of gain, benefit, or advantage, either direct or indirect.”<sup>6</sup>

The mere existence of a lease does not establish that a person is a lessor. The person must show that the lease is intended to produce a profit. A business purpose that is unrelated to the leasing business is not sufficient to establish that the person is a lessor. For instance, a person might expect property to appreciate in value during the term of a lease even if the lease was not intended to recover the cost of the property, but the expectation of appreciation does not establish that the leasing activity is engaged in for profit.

Pursuant to *Devonair Enterprises, LLC v Department of Treasury*,<sup>7</sup> to be in the business of leasing property for profit, the lessor must satisfy each of the following requirements:

- the rates and terms of the lease must be consistent with arms-length leases;
- the taxpayer must hold itself out to the public as a lessor, and;
- the lease period must be sufficient to produce revenue consistent with other leasing businesses.

IV. **Lessor election to pay use tax on rental receipts.** A lessor may elect to pay use tax on rental receipts.<sup>8</sup> If the lessor makes that election, the property is exempt from sales tax and use

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<sup>4</sup> MCL 205.92b(1)(iii).

<sup>5</sup> 1979 AC, R 205.132 (Rule 82).

<sup>6</sup> MCL 205.92(h).

<sup>7</sup> 297 Mich App 90 (2012).

<sup>8</sup> MCL 205.95(4).

tax at the time the property is acquired.<sup>9</sup> If the lessor does not make the election, the property is taxed at acquisition, but rental receipts are exempt from use tax.<sup>10</sup>

The lessor election is made by registering for use tax with the Department directly or under the Streamlined Sales and Use Tax Agreement. A lessor that holds a sales tax license does not need to separately register for use tax.

If the lessor is leasing an aircraft, the lessor must register for use tax by the earlier of:

- the first date use tax is due on the rental receipts, or
- 90 days after the lessor brings the aircraft into Michigan.

If the lessor election is made, tangible personal property purchased by the lessor for repair or for replacement parts in connection with the leased property is exempt from sales or use tax. Generally, the value of the repair or the replacement parts is reflected in the stream of taxable rental receipts.

**V. Non-lease use invalidates a lessor election.** A lessor that elects to pay use tax on rental receipts may not use the property for purposes unrelated to its leasing business. If the lessor does use the property for a purpose other than leasing, then the lessor election is invalid and use tax is due on the purchase price of the property as of the date of acquisition, less any use tax paid on rental receipts. For example, a lessor purchases an aircraft to use in a leasing business. The owner of the lessor uses the aircraft to fly the owner's family to a resort for a week's vacation. The owner does not have a lease arrangement with the lessor and does not pay a fair market value lease payment for the use of the aircraft. The lessor has used the aircraft for a purpose unrelated to its leasing business and has invalidated its lessor election.

**VI. Tax base of rental receipts.** If a lessor elects to pay tax on its rental receipts instead of on its acquisition cost, then the lessor must pay the use tax on the total rental receipts including payments made to compensate the lessor for the cost of the property, materials, labor or service costs necessary to complete the transaction, taxes other than use taxes, delivery charges, and installation charges. These charges are part of the tax base even if they are separately stated.<sup>11</sup>

**VII. Sourcing.** In general, the first rental receipt and all transportation equipment<sup>12</sup> lease payments are sourced to the location where the property is received by the lessee or where the lessor has been instructed to deliver the property. If the transaction/payment cannot be sourced to that location, then it is sourced to the lessee address maintained by the lessor. If the transaction/payment cannot be sourced based on the address in the lessor's records, then the transaction/payment is sourced based on information obtained at the time of the transaction, including the lessee's check or other payment instrument. Finally, if there is insufficient information to apply any of the above sourcing rules, the transaction/payment is sourced to the shipping address.<sup>13</sup>

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<sup>9</sup> MCL 205.54d(a).

<sup>10</sup> MCL 205.94a(a).

<sup>11</sup> MCL 205.92(f).

<sup>12</sup> MCL 205.110(6)(b).

<sup>13</sup> MCL 205.110(2).

Subsequent rental receipts, except transportation equipment, are sourced to the leased property's primary location for each period covered by the lease based on the address of the property provided by the lessee in the ordinary course of business and in good faith. Intermittent use of the property at other locations will not alter sourcing.

Each periodic lease payment for a motor vehicle, trailer, semi-trailer or aircraft that is not an interstate carrier is sourced to the primary property location as indicated by the address of the property provided in good faith by the lessee for the lessor's business records.

**VIII. Exempt transactions.** If the lessee of the property is an entity that is exempt from tax under the Use Tax Act or the property itself is exempt from use tax then the lessor is not liable for use tax on the rental receipts.<sup>14</sup> The lessor must obtain from the lessee a proper exemption claim or the required identifying information.<sup>15</sup>

**IX. Subleasing.** If a lessor leases tangible personal property to a lessee, and sales or use tax was paid upon the lessor's acquisition of the property, any subleasing of the property by the lessee (sublessor) is not subject to tax.<sup>16</sup>

In a leaseback arrangement where the sublessor leases the property back to the original lessor, use tax will be owed by the sublessor if the original lessor did not pay sales or use tax on the property when it first purchased the property or if the original lessor did not pay use tax on the property under a lessor election.

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<sup>14</sup> See generally MCL 205.94 and 94a.

<sup>15</sup> MCL 205.62.

<sup>16</sup> *Kal-Aero, Inc v Michigan Dep't of Treasury*, 123 Mich App 46 (1983).