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## Directive 04-3: Motor Vehicle Leases

### Introduction:

DD 04-3 updates and clarifies the application of the sales and use tax statutes, G.L. c. 64H and G.L. c. 64I, the Department's sales tax regulation on Discounts, Coupons and Rebates, 830 CMR 64H.1.4 and Motor Vehicles, 830 CMR 64H.25.1, to motor vehicle leases. Directives 2, 3 and 4, below, also apply to rentals of motor vehicles for a period of less than one year. DD 04-3 repeals and replaces Directive 97-4.

In many motor vehicle leasing transactions, the retail customer negotiates the terms and executes the lease contract with a dealer. The dealer then sells the vehicle and assigns the executed lease contract to a financing corporation, which may be a subsidiary of the manufacturer. The financing corporation subsequently collects the balance of the lease payments due under the contract.

Cash down payments, trade ins of other vehicles, and manufacturer's rebates paid to the dealer at the time the lease is signed are often referred to as "Capitalized Cost Reductions," as they decrease the amount of the monthly payments due from the lessee during the term of the lease.

1. Capitalized Cost Reductions on Motor Vehicle Leases: Cash Down Payments, Trade ins, and Manufacturer's Rebates

### Issue 1(a):

When a retail customer makes a cash down payment on a motor vehicle lease to a dealer in Massachusetts, is that payment subject to Massachusetts sales tax and, if so, who is responsible for collecting and remitting the tax?

### Directive 1(a):

A cash down payment on a motor vehicle lease made by a retail customer to a dealer in Massachusetts is part of the sales price subject to tax. The dealer is responsible for collecting and remitting sales tax on this payment with Form ST 9 or ST 7R.

### Issue 1(b):

If a retail customer trades in a motor vehicle to a dealer and receives credit on a motor vehicle lease, is the amount of the credit attributable to the trade in part of the sales price subject to tax and, if so, who is responsible for collecting and remitting the tax?

### Directive 1(b):

A trade in credit on a motor vehicle lease, either as a Capitalized Cost Reduction or otherwise applied toward payments due under the lease, is not part of the sales price subject to tax if all of the following criteria are met:

- (1) the dealer holds a valid Massachusetts Vendor's Registration Certificate,
- (2) the dealer entered into the transaction in the regular course of business,
- (3) the lessee previously paid tax on the vehicle traded in or was exempt from tax on the vehicle traded in or tax was not due on the vehicle traded in under 830 CMR 64H.25.1(3)(c)2, and
- (4) the vehicle traded in was titled to the lessee.

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The amount of a trade in credit is generally the value of the vehicle traded in less any debt encumbering that vehicle. If all of the above criteria are not met, the amount of a trade in credit is part of the sales price subject to tax in accordance with the provisions of 830 CMR 64H.25.1 and DD 04-3.

Issue 1(c):

When a manufacturer's rebate is paid on a leased vehicle at the time of the sale, is the amount of the rebate included in the sales price subject to tax?

Directive 1(c):

In Massachusetts, a rebate from a motor vehicle manufacturer to a motor vehicle dealer or to the lessee of the vehicle that is used as a Capitalized Cost Reduction at the time the lease is signed is not part of the sales price subject to tax.

Issue 1(d):

How does Massachusetts sales or use tax apply to Capitalized Cost Reductions and other taxable charges when a retail customer leases a motor vehicle from an out of state dealer and the dealer delivers the vehicle to the lessee in Massachusetts?

Directive 1(d):

When an out of state dealer delivers a vehicle to a lessee in Massachusetts, the dealer must collect and remit Massachusetts tax on Capitalized Cost Reductions and other taxable charges in accordance with this Directive, DD 04-3, and DD 01-5.

Issue 1(e):

How does sales or use tax apply to Capitalized Cost Reductions when a retail customer leases a motor vehicle from an out of state dealer for use, storage or consumption in Massachusetts, and the lessee takes possession of the vehicle outside of Massachusetts?

Directive 1(e):

A retail customer who leases a motor vehicle from an out of state dealer and takes possession of the vehicle outside of Massachusetts generally must pay sales tax as required by the jurisdiction where the sale takes place. However, when an out of state dealer leases a vehicle for use, storage or consumption in Massachusetts, and the lessee takes possession of the vehicle out of state, the dealer must collect and remit use tax to Massachusetts<sup>[1]</sup> on Capitalized Cost Reductions that are taxable under Directives 1(a), 1(b), and 1(c), and other taxable charges to the extent that the use tax exemption for tax paid under the laws of another state does not apply. See TIR 03-1. A vehicle is presumed to be leased for use, storage or consumption in Massachusetts if the address where the vehicle will be registered is in Massachusetts.

## 2. Other Charges Included in Vehicle Lease Payments: Extended Warranty/Service Contracts and Life, Accident or Health Insurance, and Motor Vehicle Excise Taxes

Issue 2(a):

Is tax due on charges for optional extended warranty/service contracts or "roadside assistance" contracts sold by a dealer in Massachusetts at the time a motor vehicle lease is executed?

Directive 2(a):

If charges for an optional extended warranty/service contract or "roadside assistance" contract are included in the lease payments and separately stated in the lease, then that portion of the lease payment is not subject to tax. If the charges for the optional extended warranty/service contract or "roadside assistance" contract are included in the lease payments and not separately stated in the motor vehicle lease, then the lease payment is subject to tax in accordance with the provisions of 830 CMR 64H.25.1(9).

Issue 2(b):

Is tax due on charges for optional life, accident or health insurance policies that are sold by a dealer in Massachusetts at the time a motor vehicle lease is executed?

Directive 2(b):

If the cost of an optional life, accident or health insurance policy is included in the lease payments and is separately stated in a lease, then that portion of the lease payment is not subject to tax.<sup>[2]</sup> If

the cost of the policy is included in the lease payments and not separately stated in the motor vehicle lease, then the lease payment is subject to tax in accordance with the provisions of 830 CMR 64H.25.1(9).

Issue 2(c):

Is tax due on local motor vehicle excise taxes that are billed to the lessee by the lessor?

Directive 2(c):

Separately stated charges for local motor vehicle excise taxes billed to the lessee by the lessor are not subject to tax. Generally, if local motor vehicle excise taxes are not separately stated and included in the lease payments, the entire lease payment is subject to tax except as provided in 830 CMR 64H.25.1(9)(a).

### 3. "Separately Stated" Charges

Issue 3:

For a charge to be considered "separately stated," must the separate statement be in the lease contract or on the monthly payment coupon or both?

Directive 3:

Generally, the Department will consider charges for an item "separately stated" if the total cost for that individual item is stated in the lease contract as a distinct component of the total lease charges. A monthly payment coupon prepared by the lessor need not also break down the amount due for that month into separate components. The amount of the monthly payment attributable to a separately stated charge in the lease is the total cost for that item as stated in the lease contract divided by the total number of months in the term of the lease.

### 4. Other Charges on Termination of Lease or Lessee's Default

Issue 4(a):

At the end of a lease term for a motor vehicle, are charges paid by the lessee for excess mileage, excess wear and tear, reconditioning, early termination of the lease, or other similar charges subject to tax?

Directive 4(a):

Charges paid by the lessee at termination of a motor vehicle lease for excess mileage, excess wear and tear, reconditioning, early termination of the lease, or other similar charges are included in the sales price upon which tax is calculated for that period.

Issue 4(b):

Are payments received by the lessor from its customer or an insurance carrier for the cost of repairing physical damage resulting from a casualty loss to a leased or rented vehicle subject to the sales tax?

Directive 4(b):

If a vehicle incurs physical damage in a casualty loss<sup>[3]</sup> that is not covered by collision damage waiver provisions in the lease or rental contract, and the lessee or renter (or that individual's personal insurance) pays for the damage, that payment is not part of the "sales price" for the lease or rental of the vehicle within the meaning of G.L. c. 64H, § 1.<sup>[4]</sup> Therefore, payments received by the lessor for the cost of repairing physical damage to a leased or rented vehicle are not subject to the sales tax.<sup>[5]</sup> However, payments received by the lessor from the lessee for the cost of repairing minor damages such as excessive wear and tear, burn holes, rips or stains in the upholstery, etc., are subject to the sales tax as provided in Directive 4(a).

Issue 4(c):

If the lessee of a motor vehicle defaults on its lease obligations, the lessor may incur legal or other expenses in connection with the repossession of the vehicle. Are charges for such expenses subject to tax when recovered from the lessee?

Directive 4(c):

Legal expenses or other costs incurred by a motor vehicle lessor in connection with repossession following the lessee's default are not lease or rental charges subject to tax when they are recovered from the lessee.

Issue 4(d):

What are the sales tax consequences when the lessee of a motor vehicle fails to make monthly payments or otherwise defaults on his or her obligations under the lease?

Directive 4(d):

For sales tax purposes, a motor vehicle lessor must report lease payments on an accrual rather than a cash basis. Sales tax is remitted on accounts later determined to be worthless and written off as bad debts may be recovered by the lessor upon timely filing a claim for reimbursement of tax paid on such amounts in accordance with TIR 00-3. Sales tax due upon defaulted monthly payments may not be recovered by deducting same from lessor's sales/use tax returns.

Issue 4(e):

What are the sales tax consequences of a lessor applying a security deposit to past due lease payments, charges on termination of a lease, and legal or other costs incurred in connection with repossession following the lessee's default?

Directive 4(e):

A security deposit is not subject to tax when paid by a lessee to a lessor of a motor vehicle. However, absent explicit agreement in the written lease to the contrary, the Department will consider security deposits retained by the lessor to be applied to the lessee's obligations in the following order: (1) outstanding lease payments, (2) termination charges and (3) legal expenses or other costs incurred by the lessor in connection with repossession. In accordance with Directives 4(a) and 4(c), above, security deposits applied toward outstanding lease payments and termination charges are taxable while amount paid for legal expenses are not.

Discussion of Law:

Massachusetts imposes an excise upon all retail sales of tangible personal property and telecommunications services in Massachusetts by a vendor unless otherwise exempt. The definition of sale includes any transfer of title or possession, or both, for a consideration including leases or rentals of tangible personal property. Where applicable, the excise is imposed at the rate of five percent of the sales price of the property or services sold. G.L. c. 64H, §§ 1,2. A complementary five percent use tax is imposed on tangible personal property and telecommunications services purchased from any vendor for storage, use or consumption in Massachusetts. G.L. 64I, §§ 1,2.

Where the transfer of title or possession of a motor vehicle takes place outside of Massachusetts and the vehicle is thereafter stored, used or otherwise consumed in Massachusetts, use tax may be due. A vehicle is presumed to have been sold or transferred for storage, use, or other consumption in Massachusetts, unless the vehicle is used exclusively outside of Massachusetts for a period of six (6) months before the date it is first delivered, brought into, or used in Massachusetts. See 830 CMR 64H.25.1(3).

The sales price on which tax is calculated is generally the total amount paid by a purchaser to a vendor as consideration for a retail sale, valued in money or otherwise. G.L. c. 64H, § 1. In sales of motor vehicles involving a trade in of another vehicle, the sales tax is computed on the sales price reduced by any amount credited towards the sales price by reason of a trade in if the sale is being made by a Massachusetts dealer in the regular course of business and the purchaser either previously paid a tax on the vehicle traded in or was exempt from tax on the vehicle traded in. See G.L. c. 64H, § 26 and 830 CMR 64H.25.1(5)(c).

If a vendor sells tangible personal property to a retail purchaser who applies a manufacturer's rebate to reduce the sales price at the time of the sale, the rebate is generally treated as a cash discount and excluded from the sales price subject to tax. See 830 CMR 64H.1.4(3). However, if a vendor sells tangible personal property to a customer who will receive a rebate after the sale, the sales tax is based on the full purchase price of the property. *Id.* If a vendor offers a retail purchaser a cash discount upon the purchase of tangible personal property and the customer also receives a rebate from the manufacturer of the property after the sale, the sales price subject to tax excludes only the cash discount given by the retailer. The amount of the manufacturer's rebate is not deducted from the sales price. *Id.*

Unlike vendors of other types of tangible personal property, motor vehicle dealers are generally precluded from collecting sales tax from the retail customer; the tax is instead paid by the retail customer to the Registrar of Motor Vehicles. G.L. c. 64H, § 3(c). However, the Supreme Judicial Court has ruled that G.L. c. 64H, § 3(c) is not applicable to lease transactions and that a lessor must collect and remit tax due on such sales. See *Baker Transport v. State Tax Commission*, 371 Mass. 872, 360 N.E. 2d 860 (1977) and LR 82 47.

Each period for which a motor vehicle lease or rental payment is charged is considered a completed retail sale for the purpose of imposition, collection, and payment of sales tax. The sales price on which the tax is computed for each period is the total lease or rental charges for that period. However, if the lease is for a period of one year or more, and if the monthly lease payments include separately stated charges for fuel, insurance, motor vehicle excise or registration fees, then the charges for those items are not included in the sale price on which the tax is computed. See 830 CMR 64H.25.1(9) for rules for computation of tax when such charges are included in monthly lease payments but not separately stated.

A vendor generally must report sales on an accrual rather than a cash basis for sales tax purposes. *Continental Hyannis Furniture Company, Inc. v. State Tax Commission*, 318 N.E. 2d 618 (1974). A motor vehicle dealer (vendor) must timely apply to the Department on Form ST-BDR in order to be reimbursed for sales tax remitted on accounts later determined to be worthless and written off as bad debts. The vendor may not deduct these amounts from the receipts reported on its periodic sales tax returns. G.L. c. 64H, § 33. See TIR 00-3.

/s/ Alan LeBovidge

Alan LeBovidge

Commissioner of Revenue

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[1] Subject to any applicable constitutional limitations. *Cf. Quill Corp. v. North Dakota*, 112 S. Ct. 1904 (1992).

[2] Also see DD 02-9 for additional guidance on optional insurance charges in motor vehicle rentals.

[3] *Blacks Law Dictionary, 5<sup>th</sup> Edition*, defines casualty loss as “the complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected or unusual nature, e.g. floods, storms, fires, auto accidents.”

[4] For purposes of DD 04-3, we assume that title to the vehicle is not transferred to the lessee, as was the case in LR 82-47. Sales of motor vehicles by lessors, whether damaged or not, and whether or not the lessor has received payment for a casualty loss to the vehicle, are governed by the general sales tax rule in G.L. c. 64H, § 3(c). See generally LR 02-10.

[5] If the lessee is required to repair damage to a leased vehicle, charges from a body shop to the lessee or the lessee’s insurer are generally subject to sales tax on parts and materials in accordance with DD 99-10. Repairs made by a lessor to a leased vehicle are generally not subject to sales tax. See LR 83-71.