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Federal Income Taxation: Lease or Conditional Sale

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to safeguard the rights of witnesses.⁵¹ Another possibility is found in the method used by the Royal Commissions in England. This method would employ such help as impartial experts and use a greater selectivity in the calling of witnesses.⁵²

JAMES H. YAGLA

Federal Income Taxation—Lease or Conditional Sale: Plaintiff, in its taxable year 1953, inaugurated a tool lease program and by the end of 1954 had entered into agreements with respect to eighty-seven machines that it manufactures. Under this program the lessee had a choice of three plans, A, B or C. Plan A called for a mandatory rental period of three years at 25% of the list price per year, B for two years at 30% and 25% respectively, and C for one year at 35%. If the lessee so desired, it could purchase under plan A at the end of the third year for 45% of the list price, under plan B at the end of the second for 60%, and under plan C at the end of the first for 80%. There were also provisions whereby a lessee could return the property or exercise the option to purchase at times subsequent to the mandatory rental period. All three plans ran for a maximum of seven years and carried a minimum option to purchase at 25% of the list price at the end of that time. In its 1954 tax return plaintiff treated the revenue derived from such agreements as rental income and deducted depreciation on the leased machines. Thereafter, the Internal Revenue Service audited plaintiff's books and declared the leases to be conditional sales for federal income tax purposes. After paying the additional taxes plaintiff sued for refund. *Held*: The lease-option agreements were what they purported to be, and petitioner was thereby allowed to treat the proceeds as rental income and deduct depreciation. *Kearney & Trecker Corporation v. Commissioner*, 195 F. Supp. 158 (E.D. Wis. 1961).

The lease-option agreement has both tax and non-tax advantages.¹ The principal non-tax benefits are a freeing of the working capital of the lessee and an added selling feature in the sales pro-

⁵¹ Galloway, *Congressional Investigations: Proposed Reforms*, 18 U. CHI. L. REV. 478, 483 (1951). The article also suggests several other alternatives: 1) delegation of certain types of inquiries to various outside agencies; 2) a ban on the creation of special investigating committees of Congress; or 3) voluntary adoption of codes of fair conduct by congressional committees. *Supra* at 483. See also, Chase, *Improving Congressional Investigations: A No-Progress Report*, 30 TEMP. L. Q. 126 (1957).

⁵² Finer, *Congressional Investigations: The British System*, 18 U. CHI. L. REV. 521, 554 (1951). This article has a complete analysis of the British system of investigation. For a comparison of the Australian system of investigation see, Campbell, *Parliamentary Investigations: The Australian Experience*, 9 J. PUB. L. 382 (1960).

¹ For detailed discussion of lease-option agreements see: Schneider, *Tax Considerations in Planning Leases*, 1960 TULANE TAX INST. 455; Kirby, *Considerations in Business Lease Arrangements*, 34 TAXES 34 (1956); Griesinger, *Pros and Cons of Leasing Equipment*, 33 HARV. BUS. REV. 75 (1955).

gram of the lessor. The tax consequences are decidedly advantageous to the lessee. The rental deduction² may exceed an allowable depreciation rate; whereby the lessee, in effect, acquires a faster return of capital.³ Also, a lease of unimproved land with an option to purchase may provide a return of capital where depreciation is not available.⁴ One tax advantage to the lessor may be capital gains treatment on the subsequent sale of the leased equipment.⁵ Whatever the reasons are for a taxpayer to enter into a lease-option agreement, he can be assured that the Commissioner will look with a discerning eye upon the transaction. In the past when such agreements have come to the attention of the field examiners, the lessor and lessee have been told that the contracts were actually conditional sales. A prospective lessee should be hesitant to enter into leasing plans where the tax advantages appear too attractive because the probability of future tax difficulties is great.⁶

From the time of its inception in the Revenue Act of 1916, the rental deduction provision⁷ has caused frequent litigation in regard to lease-option agreements. Prior to 1950 the case law appeared to be conflicting. When the Tax Court in a 1950 decision, *Chicago Stoker Corporation v. Commissioner*,⁸ laid down a definite economic or mechanical test to be followed, the law appeared to be clarified. However two years later in *Benton v. C. I. R.* the Fifth Circuit reversed the Tax Court stating:

The economic relation of the value of the property to the option price was only one factor to be considered in determining intent. Further, that factor must be considered not as of the time for the exercise of the option, but rather in

² See Int. Rev. Code of 1954, §162(a) (3) which provides for a deduction from gross income for "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

³ See *Benton v. C.I.R.*, 197 F.2d 745 (5th Cir. 1952).

⁴ See *Robert A. Taft v. Commissioner*, 27 B.T.A. 808 (1933). The taxpayer unsuccessfully attempted to secure a return of his expenditures for land by rental deduction and then exercise the option to purchase for a fraction of its original price. If the plan had been upheld, the land would have been acquired at a basis far below its fair market value and taxpayer would have deducted part of the "cost" as a rental which otherwise would not be allowed as a depreciation deduction if he had purchased it outright.

⁵ See *Eaton v. Commissioner*, 10 T.C. 869 (1948). But see, also, *Truman Bowen v. Commissioner*, 12 T.C. 446 (1949) where the court finds the lease agreement to be a conditional sales contract.

⁶ See *Griesinger, Pros and Cons of Leasing Equipment*, *supra* note 1.

⁷ *Supra* note 2.

⁸ 14 T.C. 441 (1950). Here the court held, "If payments are large enough to exceed the depreciation and value of the property, it is less of a distortion of income to regard the payments as purchase price and allow depreciation on the property than to offset the entire payment against the income of one year." The intent of the parties and the formalities of the contract were considered immaterial.

the light of the facts and circumstances as they existed at the time the parties entered into the contract.⁹

Due to the obvious difficulty that confronted taxpayers, tax practitioners, and courts with respect to lease-option agreements, the Revenue Service in 1955 issued a set of rulings designed to aid in the determination of the tax treatment of several variations of such agreements.¹⁰ These rulings accept the reinstatement of the intent of the parties test as set forth in the *Benton* case, but they do not provide any conclusive criteria for the determination of "intent." The Revenue Service in an illustration points out that one factor indicating a lease arrangement to be a conditional sale is where the amount of the rentals approximates "82% of the total value of the equipment for a period of use of only 75% of the useful life of the equipment."¹¹ As a tentative answer to this adverse factor, it is possible for a taxpayer, under the accelerated depreciation methods of the 1954 Code, during the first 75% of the life of the equipment to write off over 81% of the cost under the declining-balance method and 93% under the sum-of-the-digits method. Therefore, it appears doubtful that rentals "which do not exceed the authorized depreciation rates should be used as 'compelling' evidence of a sale rather than a lease."¹²

Upon an analysis of the facts in the principal case it appears that an adherence to the rulings could have resulted in a sale rather than a lease.¹³ If a lessee chose plan A, it would be paying 75% of the list price in three years on equipment that could be purchased for 45% of the list price at the end of that time. Hence, almost two-thirds (65.2%) is required to be paid in a period which is definitely less than one-half of the minimum useful life of seven years indicating that the rentals are excessive and the lessee is acquiring an equity. By applying the same test to plans B and C the result is even more indicative of a sale. In plan C the lessee is paying 35% rental in one year on equipment that could be purchased for 80% at the expiration of that time. Here over 30% (30.4%) of the total sum to

⁹ *Supra* note 3, at 752. The holding in the *Benton* case was followed by the Seventh Circuit. *Breece Veneer and Panel Co. v. Commissioner*, 232 F.2d 319 (7th Cir. 1956).

¹⁰ Rev. Rul. 540, 1955-2 Cum. Bul. 39: "Whether an agreement, which in form is a lease, is in substance a conditional sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement read in light of the facts and circumstances existing at the time the agreement was executed."; See also Rev. Rul. 541, 1955-2 Cum. Bull. 19 and Rev. Rul. 542, 1955-2 Cum. Bul. 59.

¹¹ Rev. Rul. 542, *supra* note 10, at 60.

¹² Kirby, *Considerations in Business Lease Arrangements*, *supra* note 1, at 44.

¹³ Rev. Rul. 540, *supra* note 10, at 41 indicates that a sale is intended if the "total amount which lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of title." Also see *supra* note 11.

be paid will be charged off in one year when the equipment carries a minimum useful life of seven. However, the court pointed out:

The mere fact that rentals are high does not indicate that a portion thereof is in reality a payment on an installment sale, particularly when there is no evidence to show that such rentals, though high, are unreasonable, and there is positive ; credible evidence that they are fair.¹⁴

The plaintiff explained that the rentals were determined by utilizing the service of its own employees, dealers, and dealers' employees. From these individuals a price was arrived at that would compensate plaintiff for its average cost to rebuild, insure, store and resell machines returned to it, plus depreciation and possible obsolescence. Defendant called no witness to testify that the rentals exceeded a fair market value¹⁵ Defendant argued that the rentals were not related to use. This was answered when plaintiff produced testimony which explained that there was no practical way to measure use. This testimony was uncontradicted by the defendant. The defendant then argued that the option prices were unreasonable.¹⁶ Plaintiff explained that the option prices were also formulated by a composite judgment of its employees, dealers, and dealers' employees who took into account the fact that the used tool market would fluctuate over a seven year period. These prices were to represent a probable market value. Evidence showed that beginning in 1955 through 1958, sixty-four lessees exercised their options granted to them under their respective plans. Of these, 44% chose to terminate and 56% exercised the option to purchase. The fact that the percentages were so close indicated the reasonableness of the option price to the market value. Defendant limited its case on the unreasonableness of the option prices to what it could elicit on cross-examination.

The principal case is an example of two points likely to be checked by the Revenue Service when it discovers these agreements: excessive rentals and the option prices.¹⁷ As the case points

¹⁴ *Kearney & Trecker Corporation v. Commissioner*, 195 F.Supp. 158, 163 (E.D. Wis. 1961).

¹⁵ Two recent cases where the Commissioner failed to produce evidence to prove the rental payments to be excessive are: *Fishing Tackle Products Company v. Commissioner*, 27 T.C. 638 (1957) and *WBSR Inc. v. Commissioner*, 30 T.C. 747 (1958).

¹⁶ Rev. Rul. 540, *supra* note 10, at 42 indicates that a sale is intended if, "The property may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made."

¹⁷ Other pitfalls to avoid are when the lease-option agreement provides for an automatic passage of title when the rentals equal the original list price plus any added expenses such as freight or financing charges. And, if the

out, the fact that the plaintiff had credible evidence showing how it arrived at both the rentals and the option prices indicated that the parties intended to enter into lease-option agreements and not conditional sales. The case leaves open the question as to whether rental payments must be related to use where the latter can be determined.

Jerry L. Haushalter

Zoning: Restriction of Church Construction in Residential Districts—A Village of Bayside, Milwaukee County, ordinance of 1954 failed to provide any district wherein a church could be constructed. The Lake Drive Baptist Church obtained its property, partly by gift and partly by option, from a parishioner, in 1955, after it had been given an encouraging reception from the Bayside village board concerning the building of a church on the property. A plat plan and plans for construction and off street parking were submitted to the board upon request.

In 1956 the board engaged a consultant to aid in determining areas suitable for institutional purposes. After this the zoning ordinance was amended to provide for several class "E" districts in which land could be used for institutional purposes including churches. However, relator's property was not included in a class "E" district, despite the recommendation of the planning commission. In 1957 the church presented plans and specifications drawn by its architects along with its application for a building permit. The planning commission recommended rezoning the property into a class "E" district. The village board denied the request, apparently basing its action on 1). a petition signed by three hundred residents of the village which requested that the board preserve the residential character of the area; 2). the traffic problems involved; 3). the decrease in property values in the area resulting from the construction of a church.

Relator sought a writ of mandamus to force the issuance of a building permit on the grounds that the action of the village board was arbitrary and capricious. The trial court held that the board was within its authority under the zoning provisions as found in the Constitution of the United States, and that the equities were in favor of the board. The trial court apparently relied upon the factors considered by the village board in reaching its decision and considered that these outweighed any claim that could be made by the church. The Supreme Court *held*, that the action of the board was arbitrary and capricious. It remanded the cause with directions to enjoin enforcement of the zoning ordinance against construction of the church on relator's site,

rentals do not equal the above, the lessee can apply the rentals to the purchase price. *Truman Bowen v. Commissioner*, *supra* note 5.