Lester v. Commissioner

32 T.C. 711 (T.C. 1959)

The Commissioner has determined deficiencies in petitioners' income tax and an addition thereto under *section 294(d)(1)(A)*, [1] as follows:

Year	Deficiency	Addition to tax, sec. 294(d)(1)(A)
1952	$ 7,544.12	$ 2,618.79
1953	5,625.26	

1 All section references are to the Internal Revenue Code of 1939.

The deficiency for 1952 is due to the addition to the net income reported by petitioners on their return of "(a) Ordinary income $ 15,994.09" and to an additional deduction allowed petitioners of "(b) Capital gains $ 7,996.89." These adjustments are explained in the deficiency notice as follows:

(a) It is held that ordinary [**3] income is properly increased in the amount of $ 15,994.09 from the partnership of E. L. Lester & Company in that a portion of the gain from the sale of rental equipment is ordinary income to the extent rental payments were included in the sale price of the equipment.

(b) Due to the inclusion in ordinary income of rental payments reported as capital gains, capital gains reported are herein decreased in the amount of $ 7,996.89.

The deficiency for 1953 is due to similar adjustments to those described above and are explained in the deficiency notice in a similar manner as were the adjustments for 1952. The only difference is as to the amounts of the adjustments.

Petitioners assigned error as to these adjustments made by the Commissioner. As to the addition to the tax for the year 1952 imposed by the Commissioner under *section 294(d)(1)(A)*, petitioners in their brief state as follows:

Petitioners concede the correctness of such penalty, if any, as may be computed on their 1952 income tax as determined by the Court in this proceeding pursuant to the provisions of para. *294(d)(1)(A) of the Internal Revenue Code of 1939*, as amended. * * *

Effect will be given to this concession under [**4] Rule 50.

FINDINGS OF FACT.

Some of the facts were stipulated and the stipulation of facts, together with the exhibits attached thereto, is incorporated herein by reference.

The petitioners, Earl L. Lester, hereinafter sometimes referred to as petitioner or Lester, and Mary Gray Lester, are husband and wife and reside in Houston, Texas. The petitioners own, under the community property laws of the State of Texas, a community interest in the partnership of E. L. Lester & Company, hereinafter referred to as the company.

The petitioners filed joint income tax returns for the taxable years 1952 and 1953 with the director of internal revenue at Austin, Texas, [*713] and filed a declaration of estimated tax for 1952 on September 9, 1952, with the collector of internal revenue, Austin.

The partnership, the company, filed partnership tax returns for the fiscal years ended January 31, 1950, through January 31, 1954, with the director of internal revenue at Austin.

Since 1949, the company has been in the business of renting and selling air specialty equipment such as air compressors, air tools, and sandblasting equipment. It also rents and sells spider staging equipment, pumps, concrete [**5] equipment, and small hoses. The company has been engaged primarily in the rental business.

During the fiscal years ended January 31, 1952, and January 31, 1953, the company sold 90 units of rental equipment which are the subject of this controversy. These units of rental equipment were being used under rental agreements executed by the company and the lessee of the equipment. The 90 units of rental equipment forming the basis of the dispute, hereinafter referred to as the 90 units, were rented by final lessees. A "final lessee" means the user of the equipment who, during the rental period, purchased the unit of equipment. The period of use while in the possession of the final lessee is designated as the final rental period. The company maintained a repair shop for the maintenance of its equipment and paid the insurance premiums on its equipment.

The company maintained its books of account and filed its tax returns on the basis of a fiscal year accounting period, such accounting period ending on January 31. The company maintained its books and filed its tax returns under an accrual method of accounting. A journal was maintained by the company in which one section was denominated [**6] "Sales Journal." The columns in the sales journal were captioned as follows: Date; Name of Customer; Invoice Number; Sales Credit; Rental Credit; Spider Sales; Spider Rental; Accounts Receivable -- Debit and Credit; Cash Sales -- Debit; Sundries -- Debit and Credit.

The company maintained two classifications for its equipment. The equipment was classified either as merchandise inventory, which comprised equipment held for sale to customers in the ordinary course of business, or rental equipment. The company maintained cards on all its equipment and the card was denominated as either merchandise or rental equipment depending upon expected use of the equipment when the unit was acquired by the company.

The company maintained the following records in connection with its rental equipment: (a) Rental equipment cards, hereinafter referred to as rental cards, (b) order tickets, (c) delivery tickets, (d) contracts, (e) correspondence, (f) monthly rental invoices, and (g) "final billing" invoices. All of the documents, with the exception of [*714] the monthly rental invoices, were maintained in the company's rental equipment files.

Each rental card had typed at the top an appropriate [**7] description of the unit of equipment. The columns in the rental card referred to the date of the invoice, the invoice number, the customer to whom the invoice was issued, the beginning date that the rental equipment was delivered and thereafter refers to the beginning period of each monthly invoice, the date to which the invoice covered payments, the rental period covered by the invoice, the amount charged, and the accrued rentals received on the unit of equipment to date.

On some occasions the company executed an order ticket when it received an order for the rental of a unit of rental equipment. The order ticket contained the following: The date the unit of equipment was required to be delivered, the customer's name, the place where the unit was to be shipped, the terms of the agreement as either rental or purchase, the number of units ordered, the description of the unit, and the price.

The company prepared a delivery ticket at the time a unit of rental equipment was delivered to the customer. This delivery ticket contained essentially the same information as described in the order ticket in the paragraph above. A place was provided at the bottom of the delivery ticket where [**8] the person receiving the equipment could sign the delivery ticket and acknowledge receipt of the equipment. Above the space provided for the receipt of the equipment were the words "General conditions of rental on reverse side." On the reverse side of the delivery ticket the following was printed:

GENERAL CONDITIONS OF RENTAL

The Contractor or Lessee of listed rental equipment agrees:

To accept full responsibility and liability for any and all damages to listed equipment due to improper operation, maintenance, and/or lubrication, freezing, fire, theft, windstorm, hailstorm, flood, riot, insurrection, strike, explosion, collision, upset, damages while being transported, loaded, or unloaded, or for any causes whatsoever other than ordinary wear and tear.

To return all equipment and accessories to E. L. Lester & Co. warehouse, in as good condition as when received, ordinary wear and tear excepted.

To pay for repairs or replacements of all parts damaged by misuse, or for all other extraordinary damage done.

To notify E. L. Lester & Co. if this equipment, or any portion thereof, is in use for more than 8 hours in one day, 56 hours in one week, or 240 hours in one month, and to pay to [**9] E. L. Lester & Co. a pro rata portion of the applicable rental rate for the extra use of the equipment.

To hold E. L. Lester & Co. free and harmless for all liability or damages to persons or property while equipment is in his or their possession.

Not to assign, transfer, sublet, or part with the possession of listed equipment either directly or indirectly.

Not to commit or permit any act whereby listed equipment or any part thereof shall or may be seized, taken in execution, attached, removed, destroyed or injured.

[*715] In case of default of any of the terms of this agreement, E. L. Lester & Co., their agents or servants, may at its option enter the premises where listed equipment is used or any premises where said equipment may be found and remove same therefrom, without notice, or demand, and without being guilty of any trespass or wrong. E. L. Lester & Co. is not liable for any damage because of such removal of equipment, and the Contractor or Lessee agrees to pay all expenses incidental to said removal, and to pay an additional 15% as a collection charge in cause of any default in payment whereby it becomes necessary for E. L. Lester & Co. to place the account in the hands [**10] of an attorney for collection.

After the unit of rental equipment was delivered to the final lessee, the company issued invoices covering a period of use designated in the invoice. The invoices stated that the charges were for "Rental From-To" or, in other words, the specific period covered by the invoices which was usually monthly periods. The data on the monthly rental invoices was transcribed to the rental cards by the company's employees.

The rentals charged under the invoices covering the 90 units were the fair rental value of the units of equipment. The rentals charged a final lessee using a unit of equipment under a straight rental agreement and the final lessee using the same type of equipment under a rental-purchase agreement were the same.

The monthly rental invoices on the 90 units were recorded in numerical sequence in the sales journal. The income shown on the monthly rental invoices was credited to the rental income account.

At the end of each month, each of the columns in the sales journal, which included the rental income column, was totaled and posted to the appropriate ledger sheets in the general ledger maintained by the company. All of the monthly payments [**11] received by the issuance of the monthly rental invoices for the 90 units were credited to the rental income account.

When the company sold a unit of equipment it issued a "final billing" invoice. The amount stated in this invoice was credited to either the "Rental Cr." account or the "Sales Cr." account in the sales journal.

The 90 units of rental equipment here involved were in the possession of the final lessees under either straight rental agreements, or rental agreements in which the final lessees had the option to purchase the units of equipment. In the case of straight rental agreements, there was an implied option to purchase because of the trade practice in Houston and adjacent territory. The customers were aware of that practice when they rented the equipment from the company.

The documents, letters, and contracts executed contemporaneously with the delivery of equipment show that the company entered into the following types of agreements with the final lessees: [*716]

	Year ended Jan. 31 -- 1952	1953
Straight rental with no written option to purchase	25	23
Rental-purchase agreements	16	26
	41	49

The following schedule summarizes the pertinent [**12] data contained in the above-stated documents, letters, and contracts:

	Fiscal years ended Jan. 31, 1952 and 1953
Number of units of rental equipment in dispute	90
Number of units rented 1 or more times prior to final rental	59
Number of units with no rental prior to final rental	31
Number of units where equipment card showed monthly rental rate	74
Monthly rental charged final lessee:	
Same as monthly rental rate on equipment card	61
Less than monthly rental rate on equipment card	9
More than monthly rental rate on equipment card	4
Number of units where all or a portion of cost of 90 units of	

	Fiscal years ended Jan. 31, 1952 and 1953
rental equipment recovered through depreciation deduction:	
100 per cent depreciated	29
75 per cent-99 per cent depreciated	6
50 per cent-75 per cent depreciated	13
25 per cent-49 per cent depreciated	29
0 per cent-24 per cent depreciated	3
Information pertaining to agreements set forth on delivery	
tickets covering some of the disputed units	
Straight rental agreements:	
Rental block checked	55
Words "On Rental" written on delivery ticket in addition to	
rental block checked	24
Rental-purchase agreements:	
Rental and purchase blocks checked or the word "purchase"	
written in rental block	28
Terms of rental-purchase agreement written on face of	
delivery ticket but rental and purchase blocks	
not checked	4
Delivery tickets containing terms of rental-purchase	
agreement	15
Sale of 90 units	
Year ended Jan. 31, 1952	41
Year ended Jan. 31, 1953	49

[**13] The rental agreements applicable to 88 of the 90 units of rental equipment contained no requirements for a minimum or maximum rental period. Two of the rental agreements specified minimum rental periods which were guaranteed by the final lessees.

[*717] On the straight rental agreements executed by the company which did not contain any express option to purchase, there was a possibility, though not a part of the rental agreement, that the final lessee could purchase the unit of equipment he was using under the rental agreement. The company allowed him to do so if he wished.

When the renter-purchaser decided to exercise his option to purchase, the company sent a final billing showing the agreed purchase price and allowing credit for all of the periodic "rental" payments received by the company. Until that time, generally the company did not know whether the renter-purchaser would exercise his option or not but it was understood that the periodic "rental" payments received by the company would be retained by it in all events, either as rentals, if the option was not exercised, or as a part of the sales proceeds, if the option was exercised.

On all 90 units of rental equipment, [**14] whether they were used under straight rental agreements or rental-purchase agreements, when they were subsequently sold the company treated all payments received during the final rental as part of the purchase price (except as to two items). In order that the sales of the 90 units could be classified as sales of depreciable property, the company, during the fiscal years of actual sale (January 31, 1952, and January 31, 1953), made adjusting journal entries to remove from the equipment rental income account and the sales account the amounts which had been credited to those accounts during the entire final rental period. The rental income account and the sales account were debited with the collections which have been credited to those accounts previously from the date of final rental and the account designated "Gains on Sale of Depreciable Property" was credited with a like amount.

The account designated "Gains on Sale of Depreciable Property" was a compound account and takes into account the proceeds received and the adjusted cost of the property. The company debited this account with the adjusted cost basis of the 90 units of equipment.

The company's rental income in the years [**15] ended January 31, 1952, and January 31, 1953, according to its books and returns, was as follows:

	Year ended Jan. 31 -- 1952	1953
Rental income per books prior to reclassification of rentals	$ 358,695.26	$ 324,890.92
Rental income reclassified as proceeds from sale of depreciable property	(36,717.20)	(26,944.59)
	321,978.06	297,946.33
Other adjustments	(186.60)	(2,225.40)
Rental income per books and returns	321,791.46	295,720.93

[*718] The company's Federal tax returns for the years ended January 31, 1952, and January 31, 1953, reported net long-term capital gains from the sale of depreciable property in the amounts of $ 31,987.57 and $ 30,139.45, respectively. In determining whether each unit of equipment was held longer than 6 months, the company used the date of final billing in respect to each unit of equipment as the date the company's holding period terminated. The date of the final billing was considered by the company, for the purpose of depreciation, as the date each unit of equipment was sold.

During the fiscal years ended January 31, 1952, and January 31, 1953, the company claimed depreciation until the final billing date on 41 [**16] units and 49 units, respectively.

During the fiscal years ended January 31, 1950, and January 31, 1951, the 2 fiscal years prior to the ones which we have before us, the company sold rental equipment which it had out on rental agreements. All the income received from the rental of these units of rental equipment during those fiscal years was reported as rental income and the gains realized from the sale of the rental equipment were reported as sales income. No capital gains or losses were reported by the company on its partnership returns for those years.

For the taxable years 1952 and 1953, the petitioners reported on their joint income tax returns their percentage of profit from the company, as reported by the company on its partnership returns for the fiscal years ended January 31, 1952, and January 31, 1953. Petitioners listed as their percentage of net long-term capital gains $ 15,993.79 and $ 15,069.72 for the taxable years 1952 and 1953, respectively.

In his determination of the deficiency, respondent determined: (a) That the partnership income for the fiscal years ended January 31, 1952, and January 31, 1953, was understated, in that all payments made by the final lessees [**17] to the company which were credited to the rental income account prior to the final billing were rental income, and not proceeds of the purchase price of the equipment, thus, for the fiscal years ended January 31, 1952, and January 31, 1953, the respondent increased the rental income of the partnership $ 36,717.20 and $ 26,944.59, respectively; and (b) that the amount paid under the final billing was the purchase price of the 90 units and computed the gain or loss from the sale of the rental equipment by deducting from this price the adjusted cost of the equipment as shown by the company on its tax returns for the fiscal years involved. For the fiscal year ended January 31, 1952, respondent determined that there was a loss on the sale of the rental equipment and allowed $ 4,729.03 as an ordinary loss. For the fiscal year ended January 31, 1953, the respondent determined that there was a long-term capital gain of $ 3,194.84. Thus, the respondent disallowed $ 31,987.57 and $ 26,944.59 as long-term [*719] capital gains for the fiscal years January 31, 1952, and January 31, 1953, respectively, and held against petitioner's contention in that respect.

OPINION.

The primary issue in [**18] this case is whether certain rental payments received by the company, a partnership, during its fiscal years ending January 31, 1952 and 1953, which were allowed as a credit against the option (purchase) price of rental equipment are section 117(j) proceeds from the sale of such rental equipment, as the petitioners contend, or are merely rental income from such equipment prior to its sale, as the Commissioner has determined in his deficiency notice. The respondent concedes that the final payment made when the option to purchase was exercised (but only that amount) constitutes section 117(j) [2] proceeds.

2 SEC. 117. CAPITAL GAINS AND LOSSES.

(j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business. --

> (1) Definition of property used in the trade or business. -- For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, * * *

[**19] The partnership of E. L. Lester & Co. kept complete records of its receipts and disbursements. As to that the Commissioner makes no complaint. The Commissioner's complaint arises as to the company's manner of treating the rental payments which it received. The partnership of which petitioner was a member was in the business of renting machinery and equipment to others. It also was in the business of selling machinery and equipment. However, its main business was that of renting machinery and equipment to others. As to that both parties seem to agree.

During the taxable years 1952 and 1953, the company sold some machinery and equipment which it was holding primarily for sale. As to these sales there is no dispute. The dispute arises as to the treatment by the company of rental payments received. That treatment may be summarized as follows:

At the end of the fiscal years ended January 31, 1952 and 1953, the amounts received by the company on the units of equipment not sold during the year were reported as rental income. The company, on all units of equipment sold, treated all payments received from the lessees, from the date of the rental agreement, as part of the purchase [**20] price on the sale of depreciable property. The company reduced the rental income account in each of the fiscal years ended January 31, 1952 and 1953, by the amounts credited to the rental [*720] income account from the 90 units of equipment prior to their sale. The company, on its tax returns, claimed depreciation on the 90 units of equipment up to the date of the "final billing." In determining whether the company had held the units of equipment more than 6 months for the purpose of determining long-term capital gains, the "final billing" date was considered as the date the company's holding period terminated. This date was listed on the company's tax returns as the date the unit of equipment was sold.

The company reported long-term capital gains on the 90 units of equipment sold during the fiscal years ended January 31, 1952 and 1953, in the amounts of $ 31,987.57 and $ 30,139.45, respectively.

The respondent's position is that the sale of the units of rental equipment took place when the option to purchase was exercised under rental-purchase agreements, or when negotiations produced a sale under straight rental agreements. The amounts received up to the date of the "final [**21] billing" are rental income and not part of the purchase price. Respondent contends this was the intention of the parties and that the company is now seeking to rewrite its contracts. Respondent made his adjustments shown in the deficiency notice in accordance with the foregoing contentions.

To begin with, it may be pointed out, as we understand it, that in prior years the company treated the payments received on its rental contracts pretty much the same as the Commissioner contends they should be treated in the taxable years which we have before us. But in its fiscal year ending January 31, 1952, the company changed its method of handling these transactions and adopted the method for which it now contends and it has followed that method down to the present time. Undoubtedly, if the method used by the company in years prior to the ones we have before us was wrong, it had the right to change it. The Commissioner does not contend otherwise. But was the company's prior method wrong and is its present method correct? That is the question which we must decide based on the facts which we have before us and the applicable law.

Petitioner had as one of his witnesses at the hearing an [**22] accountant of long training and experience. The substance of his testimony was that if the method used by the company in the 2 years which we have before us is used consistently over a period of years, it will correctly reflect the income of the company. But methods of accounting do not solve the problem taxwise which we have before us. Cf. *Curtis R. Andrews, 23 T.C. 1026*. It is rather the agreement and intention of the parties that determine the nature and character of the payments in question. It is true, of course, that all the proceeds of the company's business were reported by the method of accounting adopted by it, but the question before our Court is whether these rental payments received *prior* to the exercise of the option to purchase are to be reported [*721] as rents and therefore ordinary income as the Commissioner contends, or as capital payments as the petitioner contends. The answer to this question depends upon applicable law and regulations rather than on what some might term "good accounting practice."

In *Chicago Stoker Corporation, 14 T.C. 441*, where we held that payments made during each of [**23] the taxable years were purchase price of a business in which the taxpayer was acquiring an equity and were not expenses deductible as made, we said:

Cases like this, where payments at the time they are made have dual potentialities, i.e., they may turn out to be payments of purchase price or rent for the use of property, have always been difficult to catalogue for income tax purposes. A fixed rule for guidance of taxpayers and the Commissioner is highly desirable, and it is also desirable that the rule, whatever it is, be as fair as possible, both to the taxpayer and the tax collector. * * *

In their respective briefs both parties cite and discuss many cases which have dealt with one phase or the other of the problem. We do not think it would be helpful to take up and discuss these various cases and undertake to decide on which side of the line they fall. We think it is sufficient to say that, in our opinion, a study of these cases discloses that the principle extending through them is that where the "lessee," as a result of the "rental" payment, acquires something of value in relation to the overall transaction other than the mere use of the property, he is building up an equity [**24] in the property and the payments do not therefore come within the definition of rent contained in section 23(a)(1)(A). *D. M. Haggard, 24 T.C. 1124*. On the other hand, if the parties actually intend to enter into a lease contract containing an option to purchase, with normal rentals to be paid thereunder, then the lessee, up until the time he exercises his option to purchase, acquires no title to or equity in the property. What he has paid as rent up until he exercises his option to purchase is rent and should be treated as such in dealing with his tax liability. *Benton v. Commissioner, 197 F. 2d 745*.

We have carefully examined and considered the evidence in the instant case and it seems to us to show that the customers who rented the equipment from the company in the taxable years intended to rent it. What they paid the company prior to the exercise of the option to purchase was rent and was so understood by the parties. In some cases the rental contract contained an express provision permitting the lessee an option to purchase and when the option to purchase was exercised, to have the rentals theretofore paid [**25] apply as a part of the purchase price. In other cases there was no express option to purchase but a mere rental contract. However, the testimony as to these latter-described contracts is to the effect that there was an implied right in all of them of the lessee to purchase and have the rentals apply to the purchase price.

[*722] Therefore, in our decision on the primary issue here involved we shall treat the rentals under both classes of contracts in the same manner. But we do not think that the company, in computing its income from these transactions, has any legal right to treat the rental payments as part of the purchase price until the option to purchase has been exercised. When that event takes place, the final payment is, of course, a capital payment and the Commissioner has so treated it. We agree with the Commissioner, however, that, although under the terms of the agreement, when the option to purchase was exercised, the rental payments theretofore made were treated as payments on the purchase price, this fact does not convert the rental payments theretofore made into capital payments for tax purposes.

We sustain the Commissioner in his manner of treating these rental [**26] payments.

Alternative Contention.

In the event that we should decide the primary issue against them, the petitioners raised an alternative issue which is to the effect that the rental payments made to the company in the current taxable years should not be taxed until their correct nature as rental income or sales proceeds can be determined in a future year when the option to purchase is either exercised or forfeited by the renter-purchasers. We think this alternative contention is without merit. What we have held in deciding the primary issue is that the rental payments were ordinary income when received by the company and are income in the year when received. Their character was not changed when the lessee exercised his option to purchase. That is the very essence of our holding.

The principle is well established that each taxable year is a separate unit for tax-accounting purposes. *United States v. Lewis, 340 U.S. 590*; *North American Oil Consolidated v. Burnet, 286 U.S. 417*; *Burnet v. Sanford & Brooks Co., 282 U.S. 359*. Petitioners' alternative contention is not sustained.

[**27] Lengthy schedules are attached to the stipulation of facts which show relevant data with respect to each of the 90 units of equipment which are involved in the controversy between the parties. We have not set out these schedules in our findings because to do so would lengthen the findings and we do not think it is necessary. The schedules have been incorporated in our Findings of Fact by reference. What we have held as to rental payments and purchase price payments as to the 90 units of equipment included in these schedules should be given effect in a recomputation under Rule 50. Also, depreciation should be computed to the date of sale, which date was the date when the option to purchase was exercised. Up until that [*723] time the company was the owner of the equipment -- we do not understand that respondent contends otherwise.

Decision will be entered under Rule 50.