Private Letter Ruling 9313001

ISSUE

Whether the leases described below for the use of automobiles constitute true leases for federal income tax purposes.

FACTS

X, a wholly-owned subsidiary of Taxpayer, filed consolidated federal income tax returns with Taxpayer for the years in question. The majority of X's business involves leasing new automobiles to retail customers.

Pursuant to its leasing business, X enters into agreements with retail automobile dealers under which the dealer arranges lease transactions between X and retail customers ("lessees"). Under the dealer agreements, the dealer promotes X's leasing transactions, and prepares and executes the lease agreements and other necessary forms. The dealer also receives and inspects any vehicle returned upon the expiration of a lease, and provides storage for the returned vehicle for up to 30 days. In return, X checks the credit of the proposed lessee and, if X approves the lease, purchases the vehicle from the dealer at the inception of the lease at a cost not to exceed the manufacturer's suggested list price (MSLP). However, with X's approval the dealer may sell the vehicle to X for an amount that exceeds [*2] the MSLP, provided that the excess amount is held by X until the lease account has been liquidated and there is no loss to X. X administers each lease by collecting monthly rentals and, if necessary, repossessing the vehicle.

The terms and conditions of the lease are determined by using a worksheet provided by X to the dealer. Monthly rentals are determined in part by using vehicle residual values established by X. However, if the sale price to X does not exceed the MSLP, with X's prior approval the dealer may use a higher residual value. In this event, X will withhold from its payment to the dealer the difference between the dealer's established residual value and the residual value established by X.

Monthly rental payments are determined in the following manner. The "capitalized cost" of the vehicle is determined by subtracting any down payment made to the dealer by the lessee from the sales price of the vehicle to X, and then adding a $300 administrative expense. Monthly depreciation is based on the capitalized cost of the leased vehicle less its residual value, divided by the number of months in the lease term. The monthly depreciation is added to a monthly lease fee, which is the [*3] capitalized cost plus the residual value multiplied by a certain percentage, to arrive at a base monthly rental. The lessee's monthly rental payment consists of the base monthly rental plus a monthly sales/use tax.

Vehicles returned upon the termination of a lease were either sold to the dealer, wholesaled, or sold to the lessee pursuant to a lease purchase option. X did not keep or release any of the vehicles. To protect itself against any shortfall between the expected residual value of a vehicle and the amount realized on the remarketing of the vehicle at the lease's termination, X insured the residual value of the vehicle with an independent insurance company.

You have requested Technical Advice concerning whether Lease 1 and Lease 2 (the Leases) are, in substance, true leases or financing devices. Under both Leases, the lessee is required to maintain public liability and physical damage insurance on the leased vehicle and to name X as an Additional Insured and loss payee. The lessee must pay for excess mileage at a stated rate, and for maintenance and repairs. In addition, the lessee must pay all taxes, and all license, registration, and inspection fees. Lease 1 is for a term of [*4] 60 months, and contains an option to purchase the vehicle at the end of the lease term for the "clean" value of the vehicle as shown in the National Auto Research Black Book in effect upon the lease termination for the state in which the vehicle is garaged. Lease 2 is for a term of 48 months, and contains an option to purchase the vehicle at the end of the lease term for a predetermined price that is equal to the lease residual value as established by X's Lease Residual Guide. Under both Leases, if the option is not exercised, the lessee must return the vehicle in good condition (reasonable wear and tear excepted), and pay any amounts owed on the lease.

LAW AND ANALYSIS

The characterization of a transaction for federal income tax purposes is controlled by the substantive provisions of the agreement and the parties' conduct, rather than by the particular terminology used in the agreement. Frank Lyon Co. v. United States, 435 U.S. 561, 55 L. Ed. 2d 550, 98 S. Ct. 1291 (1978), 1978-1 C.B. 46. In general, a transaction constitutes a sale for federal income tax purposes when the benefits and burdens of ownership have passed to the purported purchaser. Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987). [*5] This is a question of fact which must be ascertained from the written agreements, which are read in light of the attending facts and circumstances. Tolwinsky v. Commissioner, 86 T.C. 1009 (1986).

Among the factors that the Tax Court uses in determining whether a transaction is a lease or something else (such as a sale or a financing device) are the following: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the federal, state, local, and property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981).

In Rev. Rul. 55-540, 1955-2 C.B. 39, the Service published similar guidelines for distinguishing a lease from a conditional sales contract. Whether a lease agreement is, in substance, a conditional [*6] sales contract depends upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed.

Section 4 of Rev. Rul. 55-540 sets forth factors based on Tax Court precedent that would warrant a finding that, for federal income tax purposes, a transaction is a sale and not a lease: The factors most indicative of a sale include: (1) portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee; (2) the lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make; (3) the total amount that the 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 the title; (4) the agreed "rental" payments materially exceed the current fair rental value (this may be indicative that the payments include an element other than compensation for the use of the property); (5) the property may be acquired under a purchase option at a price that is nominal in relation to the value of [*7] 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; and (6) some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

Under each of the subject Leases, the lessee will not acquire title to the vehicle unless the lessee exercises its purchase option. The option price is not nominal in relation to the value of the vehicle at the time when the option may be exercised. Also, in both cases the option price is not a relatively small amount when compared with the total payments that are required to be made. The monthly rental payments do not materially exceed the fair rental value of the vehicle. Although the way in which the monthly lease payments are determined gives rise to an argument that a portion of the monthly rental payments may be recognizable as the equivalent of interest, the Supreme Court has not given that factor much weight. See. e.g., Frank Lyon Co. v. United States, 435 U.S. 561, 55 L. Ed. 2d 550, 98 S. Ct. 1291 (1978), [*8] 1978-1 C.B. 46.

In Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), rev'g 76 T.C. 547 (1981), the Ninth Circuit addressed the question of whether certain transactions characterized by the taxpayer as motor vehicle leases were, in substance, conditional sales contracts. Swift Dodge was in the business of selling motor vehicles. It also offered the vehicles to its customers under a standard lease agreement. The typical lease had a term of 36 months and was a net lease, requiring the lessee to provide insurance for the benefit of Swift Dodge, to pay all taxes, and to perform all necessary maintenance and repairs for the vehicle. The agreement was "open-ended," which the court defined as an agreement in which the lessee assumes the risk of residual value fluctuation. Upon termination of the lease, the lessee was required to pay Swift Dodge the amount, if any, by which the "depreciated value" of the vehicle, as set forth in the agreement, exceeded its actual wholesale value. Likewise, if the actual wholesale value of the vehicle exceeded the depreciated value, the lessee was to receive gain from the sale of the vehicle.

The Ninth Circuit analyzed the benefits, obligations, and rights [*9] of the parties and determined them to be consistent with a conditional sales contract. It then analyzed the parties' risks. Although the lessee assumed the risk of damage, theft, or loss, Swift Dodge's only risk was that of default by the lessee. Further, the court observed that "because this was an `open-ended' lease the customer assumed the risk of depreciation ... [this is] the same risk a buyer assumes under a conditional sales contract. ..." Swift Dodge at 654. The court held that the transactions were conditional sales contracts.

Under the Leases in this case, each lessee assumes the risk of damage, theft, or loss, and is required to obtain insurance for the benefit of X. The lessee also must pay all taxes and license fees on the vehicle, and perform all necessary maintenance and repairs. However, unlike the transactions in Swift Dodge, the Leases in this case are closed-end leases because the lessee assumes no risk of residual value fluctuation. If the lessee does not exercise its option to purchase the vehicle, the lessee has no risk of depreciation--its only responsibility at the termination of the Lease is to return the leased vehicle in good condition to X and to pay any [*10] amounts owed on the Lease.

X bears the risk of loss should the fair market value of the leased vehicle at the termination of the lease term be less than the expected residual value of the vehicle. X has elected to insure itself against that risk of loss. X also has the possibility of gain should the lessee not exercise its purchase option.

As noted earlier, the option price under each Lease is not nominal in relation to the value of the vehicle at the time when the option may be exercised. Indeed, the option price under each lease is close to the average retail price of the vehicle at the time the option may be exercised, as shown in the N.A.D.A. official Used Car Guide in effect at the end of each lease term.

Finally, you noted in your submission that Section 4.05 of Rev. Rul. 55-540 provides that in the absence of compelling factors indicating a different intent, it will be presumed that a conditional sales contract was intended if the total of the rental payments and any option price payable in addition thereto approximates the price at which the equipment could have been purchased at the time of entering into the agreement, plus interest and carrying charges. We note first of all [*11] that the factors discussed above indicate that the transaction was intended by the parties to be a lease and not a conditional sales contract. Secondly, with respect to each lease, the purchase price of the vehicle at the time of the agreement, plus interest and carrying charges, does not approximate the total of the rental payments and the option price. Therefore, the agreement cannot be presumed to be a conditional sales contract under Section 4.05 of Rev. Rul. 55-540.

Accordingly, in light of the above factors, and after analyzing the benefits, obligations, and rights of the parties to these Leases, we conclude that the Leases are true leases for federal income tax purposes.

CONCLUSION

The Leases described above are true leases for federal income tax purposes.