PLR 9338002

Issue

Whether a rent-to-own (RTO) contract for a consumer good is a true lease or a conditional sales contract for Federal income tax purposes.

Facts

Taxpayer is a dealer in the RTO business. RTO dealers transfer durable consumer goods (televisions, etc.) to consumers under contracts such as that described below. Taxpayer characterizes these transfers as leases; however, the Service's examining agent characterizes the transfers as conditional sales. Taxpayer's RTO contract is a form contract. That is, all of Taxpayer's contracts with consumers are identical, except for the consumer item that is the subject of the contract, the consumer with whom the contract is made, the term of the contract, and the payment amounts called for under the contract. Each RTO contract has the following pre-printed terms and conditions:

1. The customer "rents" the item for a certain number of weeks or months for level weekly or monthly payments.

2. The customer is under no legal obligation to make any particular periodic payment. The customer need only return the property at any time to have no further obligation to make any additional payments.

3. The customer "renews" the contract merely by making each periodic payment. The "renewal" term is until the next payment is due.

4. The customer will receive title to the property at no further cost upon making all the periodic payments specified in the contract. The contract provides for the total amount of the payments necessary for title to be transferred to the customer. This amount generally equals the periodic payment times the number of payments.

5. The customer may purchase the property before the end of the contract (i.e. before the last periodic payment is made) by exercising an early purchase option. The early purchase option payment is calculated according to a schedule of payments that declines with each periodic payment, reaching zero with the final periodic payment.

6. The customer, under certain circumstances, may reinstate a contract terminated for failure to make a periodic payment. For a contract to be reinstated, Taxpayer must have terminated the contract for failure to make a payment, and for no other reason. Also, the customer must have returned the property to Taxpayer if requested. In addition, the reinstatement must occur no more than 60 days after the customer has returned the property to Taxpayer. Moreover, the customer

must pay all payments and late charges then due, as well as a reinstatement charge of $e and a reasonable delivery charge if the property has already been returned to Taxpayer. A customer who reinstates a contract loses no rights or options previously acquired under the contract.

The particular contract at issue is for the transfer of a television to a customer for l8 months at rate of $a per month, which under the contract, includes a specific rate of $b for the TV and $c, a separately stated amount of state sales tax. Consumers, however, have the option of entering into contracts which call for weekly payments. The contract here specifies that the customer will obtain title to the TV upon making all 18 payments, which total $d.

Taxpayer concedes that the total of the payments required under the RTO contract to obtain title is 3 to 4 times the TV's retail sales price at non-RTO stores (its fair market value). Taxpayer and the Service agree that the 18-month term of the contract is less than the useful life of the TV. Taxpayer, however, claims the TV will have little economic value at the end of the contract, even if the TV is in good working order. In addition, Taxpayer represents that it is responsible for servicing the TV throughout the term of the contract. However, it should be noted that generally such products would be covered by the manufacturer's warranty for most of the contract period. The customer is liable for any loss or damage to the TV.

Law and Analysis

Whether a transaction is a sale or a lease depends on the intent of the parties. 1 Haggard v. Comm'r, 24 T.C. 1124, 1129 (1955) aff'd 241 F.2d 288 (9th Cir. 1956). This intent, however, is the intent to create the particular legal relationship embodied in the contract. What the parties label the contract, or even what they honestly believe it to be, does not control. If the contract creates a legal relationship that is a sale, then the contract is a sale. Sun Oil Co. v. Comm'r, 562 F.2d 258, 262 (3rd Cir. 1977), cert. denied 436 U.S. 944 (1978); Osterreich v. Comm'r, 226 F.2d 798, 801-802 (9th Cir. 1955); Bowen v. Comm'r, 12 T.C. 446 (1949); Mills v. Comm'r, 11 T.C. 25 (1948). Thus, the economic substance of the transaction, and not its label, determines whether it is a sale or a true lease. Gregory v. Helvering, 293 U.S. 465 (1935).

The key to determining whether a contract is a conditional sale or a true lease is whether the transferee acquires something of value in addition to the mere use of the property:

A lease contemplates only the use of the property for a limited time and the return of it to lessor at the expiration of that time; whereas, a conditional sale contemplates the ultimate ownership of the property by the buyer, together with the use of it in the meantime.

Bowen v. Comm'r, supra at 459.

Revenue Ruling 55-540, 1955-2 C.B. 39, sets forth the Services's longstanding position for distinguishing conditional sales from leases. Section 4 of the ruling contains 6 factors based on case law, any one of which will make a transaction a sale, rather than a lease:

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 which 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 indicate that the payments may include an element other than compensation for the use of the property.

5. The property may be acquired under a purchase option whose price 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 to the total payments which are required to be made.

6. Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

Although Taxpayer's contract does not specifically require the customer to make all of the "rental" payments needed to acquire title to the TV, the contract does, as explained below, result in an in an economic obligation on the customer to do so. Moreover, the contract clearly contemplates that title must be transferred to the customer once all the periodic payments are made. Accordingly, we think the second factor in Rev. Rul. 55-540 is met.

In addition, Taxpayer agrees with the Service that the term of the contract is less than the useful life of the property. Because the customer will automatically receive title to the TV at the end of the term of the agreement, the customer therefore will pay the entire amount necessary to take title to the TV over a period that is less than its useful life. As a result, the third factor in Rev. Rul. 55- 540 exists in Taxpayer's contract.

Finally, because the contract automatically will vest title with the customer at the end of the contract's term, the purchase option price at this point is zero. Taxpayer acknowledges that the TV then will still have some economic value. A zero purchase price of course is nominal. Thus, the fifth factor in Rev. Rul. 55-540 also is satisfied.

Taxpayer argues that Rev. Rul. 55-540 applies only to equipment used in a trade or business, and cannot apply to RTO contracts because they involve personal-use property. But the ruling rests on case law applicable to any contract, including RTO contracts. Revenue Ruling 55-540 thus fully applies to Taxpayer's RTO contract.

Taxpayer further argues that the term of the contract in the instant case is only the one month following the first payment. After that, the customer renews the contract each month merely by making the next payment. The contract here imposes no legal obligation on the customer to make the next payment and thus renew the contract. Moreover, the purchase price of the TV under the early purchase option's sliding scale exceeds its retail sales price for much of the term of the contract. Accordingly, Taxpayer argues these factors demonstrate that the customer is paying only for the mere use of the property under the contract.

If, however, a contract creates an economic obligation which compels the transferee to renew it to term, then the absence of a legal obligation to do so does not by itself preclude the contract from being a conditional sale. For example, in M&W Gear Co. v. Comm'r, 446 F.2d 841 (7th Cir. 1971), the court found that the taxpayer had an economic obligation to exercise a purchase option to acquire farm land, which it had leased, where a portion of the rentals were credited to the price of the land, and, the taxpayer risked losing a substantial investment in the form of improvements to the land if the option was not exercised.

In this case, the customer makes level monthly payments for the TV, which total at least 3 times the fair market value of the TV. Consequently, the customer will have paid Taxpayer for the fair market value of the TV after making relatively few monthly payments. Further, after the customer has made most of the monthly payments, the remaining payments needed to obtain title will be less than the fair market value of the TV. If the customer stops making payments at this point, he will lose the opportunity to obtain title to the TV for payments totalling less than the TV's then fair market value. Therefore, if the customer fails to "renew" the contract to its conclusion, the customer will lose its investment in the TV. Thus, the contract results in the customer's developing a strong economic incentive to continue to "renew" the contract to conclusion after making relatively few payments.

This potential loss under Taxpayer's RTO contract resembles a customer's potential loss of investment in the usual non-recourse conditional sale, which of course is a sale for Federal income tax purposes. The buyer in both cases loses the item if the payments cease. 2

In addition, Taxpayer's RTO contract here has other characteristics of a non-recourse conditional sale. The following factors are inherent in non-recourse conditional sales: the transfer of title is conditional upon final payment of all installments; the buyer obtains possession of the property before paying all the installments; the seller may sell, assign or transfer the contract before legal title passes; the buyer bears the risk of loss while in possession of the property; and the seller may reclaim the property upon, non-payment. Swift Dodge v. Comm'r, 692 F.2d 651 (9th Cir. 1982); Transamerica Corp. v. U.S. 7 Cls. Ct. 441, 447 (1985). See also section 1.1245-1(a)(3) of the Income Tax Regulations, which states that ". . . a disposition occurs upon a sale of property pursuant to a conditional sales contract even though the seller retains legal title to the property for purposes of security. . . ."

Taxpayer's RTO contract reserves title to the TV in Taxpayer until the customer either makes all the payments or exercises the early purchase option. The contract gives the customer possession of the TV before all installments are paid. The contract imposes full liability on the customer for any loss, theft or destruction of the TV (aside from normal wear and tear). The contract permits Taxpayer to sell, transfer or assign the contract. The contract allows Taxpayer to repossess the TV if the customer fails to make the next monthly payment. Taxpayer's contract thus has many of the features as a non-recourse conditional sale.

Taxpayer represents that, if the customer does not make the next monthly payment, State A law gives it the right to retake the TV without following the usual repossession guidelines of State A. Taxpayer represents this is so regardless of how many payments the customer has already made, and regardless of whether the customer may have filed for bankruptcy. Taxpayer reasons that this demonstrates the customer has acquired no equity in the TV. Taxpayer concludes that this lack of customer equity in the TV under State A law shows the payments under Taxpayer's contract are for the mere use of the property.

However, Taxpayer's right to retake the TV is similar to the right of any seller to repossess property for non-payment. For example, the buyer in a conditional sale obtains immediate possession of the goods, while the seller retains legal title until the buyer makes all payments. The buyer immediately acquires the right to full use and enjoyment of the goods as if he had bought them outright and then mortgaged them back to the seller to secure the sale. The Federal income tax law has long recognized this as a closed transaction and a conditional sale, even though the transfer of title is conditioned upon the buyer making all payments and even though the seller can reclaim the property if the buyer misses a payment. See Transamerica Corp. v. U.S., supra at 446-447. Therefore, because the customer under both a traditional conditional sale contract and Taxpayer's RTO contract obtains legal title to the property by making all payments, or loses the property for non-payment, Taxpayer's repossession rights, although one factor relevant to this analysis, do not alone determine whether the transaction is a sale or a lease. 3 Rather, the character of this transaction as a conditional sale is a result of the fact that Taxpayer's RTO contract clearly contemplates the ultimate transfer of ownership of the TV to the customer once all the payments under the contract are made. That is, the customer in this case is not required to make any further payment to obtain title to the T.V.

Conclusion

The RTO contract between Taxpayer and the customer is a conditional sale, and not a true lease.

1 It is impossible to determine the subjective intent of any particular customer of Taxpayer. Taxpayer characterizes the low weekly or monthly payments for its items as a marketing tool, and admits that Taxpayer's general intent is to "move merchandise out the door."

2 We note that, unlike the situation here where the customer will lose all of its payments if Taxpayer retakes the TV, the buyer may or may not lose all of its investment in the contract in the usual conditional sale. In the usual conditional sale, this possibility exists where, for example, the fair market value of the repossessed item exceeds the buyer's outstanding liability for the remaining payments necessary to own the item free and clear. In such circumstances, the buyer may, under state commercial law, be entitled to a remittance of the difference from the seller. Although, in our view, this distinction is relevant, it is only one factor and does not determine the tax results of Taxpayer's contract, which clearly contemplates the automatic transfer to the customer of the TV's ownership once all payments are made.

3 We further note that whether the customer obtains an equity investment in the TV with each monthly payment is an additional consideration. Taxpayer argues that, unlike the usual conditional sale, the customer here does not obtain an equity interest in the TV under state law with each month's payment. It could be argued that Taxpayer's contract, however, has characteristics of both a lease and a conditional sale. For example, the RTO contract provides for week- to-week, or month-to-month payments with no legal obligation to make any succeeding periodic payment, which is indicative of a lease. However, the contract also provides for the automatic transfer of legal ownership (that is, of title) to the customer after a set number of payments are made under the contract, which is indicative of a sale. In our view, whether the customer obtains an equity interest in the TV for purposes of state law is not dispositive of the tax character of the instant transaction, but must be balanced against all other burdens and benefits of ownership including, for example, which party has the risk of loss, whether title will pass, and who has possession of the property. See Grodt and McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-38 (1981).