Rev. Rul. 55-540

1. Purpose.

The purpose of this Revenue Ruling is to state the position of the Internal Revenue Service regarding the income tax aspects of the purported leasing of equipment for use in the trade or business of the lessee. The issues and rules herein discussed are not all-inclusive, and as new questions of importance arise additional Revenue Rulings will be issued.

2. Background.

.01. Many new and unique types of agreements concerning the use and disposition of equipment have been developed to meet the needs and purposes of the users of industrial and business equipment. The lessor, in devising these agreements, is primarily interested in disposing of his wares to customers. (Here and elsewhere in this ruling the terms "lessor" and "lessee" are used for convenience, without intending to suggest the proper characterization of any agreement.) The lessee, on the other hand, may have one or more reasons for leasing instead of purchasing the equipment. He may have use for the equipment for only a comparatively short period of time. He may <Page 40> wish to experiment with a new process or product which requires equipment he does not own. He may have insufficient capital or credit with which to make an outright purchase, or have other needs for his working capital. A significant motive may, in some cases, be the tax advantages which might result because of the different timing of the deductions for rent as compared to depreciation.

.02. The agreements are generally cast in the form of chattel leases and are as varied as the reasons for entering into such arrangements. An approximate pattern is discernible, however, and many of the agreements may be loosely defined and grouped as follows:

(a) Short-term agreements which usually concern mobile equipment or relatively small articles of equipment. The "compensation for use" provisions in these agreements are usually expressed in terms of an hourly, daily, or weekly rental, and the rental rates are relatively high in relation to the value of the article. There may be an option to purchase the equipment at a price fixed in advance which will approximate the fair market value of the equipment at the time of the election to exercise the option. In this type of agreement, all costs of repairs, maintenance, taxes, insurance, etc., are obligations of the lessor.

(b) Agreements entered into by taxpayers engaged in the business of leasing personal property to others either as their principal business activity or incidental thereto. Under the terms of these agreements the amounts payable, called rental rates, are ordinarily based on normal operations or use, plus a surcharge for operations in excess of the normal stated usage. In some instances the rental is based on units produced or mileage operated. Termination of the agreement at stated periods is provided upon due notice by either party. If the agreement includes an option to purchase, the option price has no relation to the amounts paid as rentals.

(c) Agreements providing for a "rental" over a comparatively short period of time in relation to the life of the equipment. The agreed "rental" payments fully cover the normal purchase price plus interest. Title usually passes to the lessee upon the payment of a stated amount of "rental" or on termination of the agreement upon the payment of an amount which when added to the "rental" paid approximates the normal purchase price of the equipment plus interest.

(d) Agreements which provide for the payment of "rental" for a short original term in relation to the expected life of the equipment, with provision for continued use over substantially all of the remaining useful life of the equipment. During the initial term of the agreement, the "rental" approximates the normal purchase price of the equipment, plus interest, while the "rentals" during the remaining term or renewal period or periods are insignificant when compared to the initial rental. These agreements may or may not provide for an option to acquire legal title to the equipment upon the termination of the initial period or at any stated time thereafter.

(e) Agreements similar to the arrangement in (d) above, but with the added factor that the manufacturer of the equipment purports to sell it to a credit or finance company, which either <Page 41> takes an assignment of such an existing agreement with the user or itself later enters into such an agreement with the user. In some instances, the lessor may be a trustee acting for or on behalf of the original vendor.

3. Nature of the Problem.

.01. Section 162(a)(3) of the Internal Revenue Code of 1954 provides that there shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business of the taxpayer, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. Section 23(a)(1)(A) of the Internal Revenue Code of 1939 contains substantially the same language in respect to the allowance of a deduction for rental expense.

.02. In deciding whether a taxpayer is entitled to a deduction for any payments claimed to represent rentals under the provisions of the Code of 1954 or the Code of 1939, it is necessary to determine whether by virtue of the agreement the lessee has acquired, or will acquire, title to or an equity in the property. The determination of that question with respect to agreements of the type here involved will ordinarily depend upon whether the particular agreement should be treated as in reality a lease or a conditional sale contract.

4. Determination Whether an Agreement Is a Lease or a Conditional Sales Contract.

.01. Whatever interest is obtained by a lessee is acquired under the terms of the agreement itself. 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 the light of the facts and circumstances existing at the time the agreement was executed. In ascertaining such intent no single test, or any special combination of tests, is absolutely determinative. No general rule, applicable to all cases, can be laid down. Each case must be decided in the light of its particular facts. However, from the decisions cited below, it would appear that in the absence of compelling persuasive factors of contrary implication an intent

warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in general be said to exist if, for example, one or more of the following conditions are present:

(a) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee. See Truman Bowen v. Commissioner,12 T. C. 446, acquiescence, C. B. 1951-2, 1.

(b) The lessee will acquire title upon the payment of a stated amount of "rentals" which under the contract he is required to make. See Hervey v. Rhode Island Locomotive Works,93 U. S. 664 (1876); Robert A. Taft v. Commissioner,27 B. T. A. 808; Truman Bowen v. Commissioner, supra.

(c) The total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large <Page 42> proportion of the total sum required to be paid to secure the transfer of the title. See Truman Bowen v. Commissioner, supra.

(d) 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 property. See William A. McWaters et al. v. Commissioner, Tax Court Memorandum Opinion, entered June 15, 1950; Truman Bowen v. Commissioner, supra.

(e) 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. See Burroughs Adding Machine Co. v. Bogdon,9 Fed. (2d) 54; Holeproof Hosiery Co. v. Commissioner,11 B. T. A. 547. Compare H. T. Benton et al. v. Commissioner,197 Fed. (2d) 745.

(f) Some portion of the periodic payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest. See Judson Mills v. Commissioner,11 T. C. 25, acquiescence, C. B. 1949-1, 2.

.02. The fact that the agreement makes no provision for the transfer of title or specifically precludes the transfer of title does not, of itself, prevent the contract from being held to be a sale of an equitable interest in the property.

.03. Conditional sales of personal property are, in general, recordable under the various State recording acts if the vendor wishes to protect its lien against claims of creditors. However, the recording or failure to record such a sales contract is usually discretionary with the vendor and is not controlling insofar as the essential nature of the contract is concerned for Federal tax purposes. See Hervey v. Rhode Island Locomotive Works, supra.

.04. Agreements are usually indicative of an intent to rent the equipment if the rental payments are at an hourly, daily, or weekly rate, or are based on production, use, mileage, or a similar measure and are not directly related to the normal purchase price, provided, if there is an option to purchase, that the price at which the equipment may be acquired reasonably approximates the anticipated fair market value on the option date. Thus, agreements of the type described in section 2.02(a) and (b), above, will usually be considered leases, in the absence of other facts or circumstances which denote a passing of title or an equity interest to the lessee.

.05. 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 acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges. Agreements of the type described in section 2.02(c), above, will generally be held to be sales of the equipment.

.06. If the sum of the specified "rentals" over a relatively short part of the expected useful life of the equipment approximates the price <Page 43> at which the equipment could have been acquired by purchase at the time of entering into the agreement, plus interest and/or carrying charges on such amount, and the lessee may continue to use the equipment for an additional period or periods approximating its remaining estimated useful life for relatively nominal or token payments, it may be assumed that the parties have entered into a sale contract, even though a passage of title is not expressly provided in the agreement. Agreements of the type described in section 2.02(d), and (e), above, in general, will be held to be sales contracts.

5. Reporting of Income and Deductions by a Lessor or a Vendor.

.01. The amounts paid for the use of equipment under an agreement which is determined, under the foregoing principles, to be a lease will be held to be rental income to the lessor. Such lessor may deduct all ordinary and necessary expenses paid or incurred during the taxable year which are attributable to the earning of the income. In addition, the lessor will be allowed a deduction for depreciation determined pursuant to the provisions of section 167 of the Code of 1954. If the lessee under the contract pays to the lessor a stipulated rental, and in addition pays certain other expenses which are properly payable by the lessor, the lessor is deemed to have received as rental income not only the stipulated rental but also the amount of such other expenses paid by the lessee to, or for the account of, the lessor, except as provided in section 110 of the Code of 1954.

.02. If the agreement is determined to be a sale, the amounts received under the contract by the vendor will be considered to be payments on the sales price of the equipment to the extent such amounts do not represent interest or other charges.

6. Deductions Allowable to Lessee or Purchaser.

.01. If it is held, under the foregoing principles, that an agreement is a lease, the lessee may deduct the amount of rent paid or accrued, including all expenses which under the terms of the agreement the lessee is required to pay to, for, or on account of the lessor, except as provided by section 110 of the Code of 1954. If the payments are so arranged as to constitute advance rental, such payments will be duly apportioned over the lease term. In computing the term of the lease, all options to renew shall be taken into consideration if there is a reasonable expectation that such options will be exercised.

.02. If under the provisions of this Revenue Ruling the agreement is to be treated as a sale, the amounts paid to the vendor will be considered as payments for the purchase of the equipment to the extent such amounts do not represent interest or other charges. Expenditures treated as payments for the purchase of the equipment may be recovered over the life of the asset through appropriate depreciation deductions.

7. Illustrations.

Revenue Rulings 55-25, C. B. 1955-1, 283, and 55-541 and 55-542, pages 19 and 59 of this Bulletin, illustrate the application of some of the foregoing principles.