Starr's Estate v. Commissioner, 9 T.C. 883 (1947)

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The true character of a contract as a lease or a conditional sale for tax purposes is determined by its substance, not its form; where payments closely approximate the value of the property and the "lessee" acquires an equity, it is likely a conditional sale.

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Summary

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The Tax Court addressed whether payments received by a partnership under contracts with the government constituted rental income or payments under a conditional sales agreement. The Commissioner argued the payments were rent, leading to increased deficiency assessments. The court held that the agreements were conditional sales contracts, not leases, as the payments effectively transferred equity to the government and were applied toward the purchase price. The partnership was not required to report income under a method it did not elect, thus rejecting the Commissioner's alternative contention.

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Facts

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A partnership entered into contracts with the U.S. Government to provide equipment. The contracts, using Standard Form 40-2111, stipulated that the government would make monthly payments and, upon the completion of work or termination of the primary contract, could take title to the equipment by paying a final sum that, when added to the monthly payments, equaled the equipment's value plus a 1% monthly increment. The government ultimately acquired title to the equipment in 1942. The monthly payments often equaled a significant portion of the equipment's value within a short period.

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Procedural History

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The Commissioner initially determined a deficiency based on allocating profits over the contract's duration, citing I.T. 3533. Subsequently, the Commissioner amended the assessment, arguing the entire 1941 payments were rental income. The Tax Court reviewed the Commissioner's determination and the petitioner's challenge.

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Issue(s)

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Whether the payments received by the partnership from the government in 1941 under Standard Form 40-2111 contracts constituted ordinary rental income or payments under a conditional sales contract.

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Holding

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No, because the agreement's substance indicated a conditional sale, not a lease, where the payments built equity and were ultimately applied to the purchase price. Also, no, because the Commissioner cannot force the partnership to use a specific method of reporting income (I.T. 3533) that it did not elect to use.

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Court's Reasoning

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The Tax Court emphasized the substance of the agreement over its form. They noted that the monthly payments rapidly approached the equipment's value, transferring equity to the government. This was supported by the fact that these payments were carried in the supplemental agreement as "Equity" and were credited towards the purchase price on the government purchase orders. The court found that the intent of the parties, especially the government's

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