E.L. Lester & Co., 32 T.C. 727 (1959)

Rental payments made under a lease agreement with an option to purchase, prior to the exercise of that option, are considered rental income and not part of the purchase price for tax purposes, even if those payments are later credited towards the purchase price.

Summary

In this case, a company rented machinery and equipment under agreements that included an option to purchase. The company initially treated rental payments as ordinary income. Later, it changed its method, treating all payments received from the lessees as part of the purchase price of the depreciable property from the start of the rental agreement. The Tax Court held that rental payments made before the option to purchase was exercised were considered ordinary income, not capital gains, despite a provision in the agreement allowing the rental payments to be applied toward the purchase price if the option was exercised. The Court emphasized the intent of the parties and the nature of the payments before the option was exercised. The decision focused on when the sale actually occurred for tax purposes.

Facts

E.L. Lester & Co. was in the business of renting and selling machinery and equipment. The company entered into lease agreements with customers. Some leases included an option to purchase the equipment. During the taxable years 1952 and 1953, the company sold some of this equipment. The company initially reported the amounts received on rental equipment as rental income. However, it later changed its accounting method, treating all payments received from the lessees from the date of the rental agreement as part of the purchase price, reducing the rental income account by the amount credited to the rental income account. The Commissioner of Internal Revenue disagreed, arguing that the rental payments prior to the exercise of the option to purchase were rental income, and not proceeds from the sale of the equipment.

Procedural History

The Commissioner of Internal Revenue issued a deficiency notice, reclassifying the rental payments as ordinary income. E.L. Lester & Co. petitioned the Tax Court to challenge the Commissioner's determination. The Tax Court heard the case and ruled in favor of the Commissioner.

Issue(s)

1. Whether rental payments made before the exercise of an option to purchase should be treated as rental income or as proceeds from the sale of equipment.
2. Whether the rental payments should be taxed in the year received or if taxation

should be deferred until the option is exercised.

Holding

1. No, rental payments before the exercise of the purchase option are considered rental income.
2. No, the payments were taxable in the year they were received as rental income.

Court’s Reasoning

The court focused on the nature of the payments and the intent of the parties, as well as when a sale actually occurred. The court cited prior case law, stating that when payments give the lessee something of value beyond just the use of the property, the payments may be considered building equity. However, where the intent is to enter a lease agreement, the lessee does not acquire title or equity until the option is exercised. The court found that, until the option was exercised, the customer was renting the equipment, and those payments were rent. "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." The Court also emphasized that each tax year stands as a separate unit for tax accounting purposes. The fact that payments made by the lessee are later credited towards the purchase price, upon exercising the option, does not change the nature of rental payments received prior to this event. "When that event takes place, the final payment is, of course, a capital payment and the Commissioner has so treated it."

Practical Implications

This case clarifies that, for tax purposes, rental payments made under lease-purchase agreements are generally treated as ordinary income until the option to purchase is exercised. Attorneys advising clients engaged in similar transactions must carefully consider the timing of income recognition. The timing of the sale of the equipment (exercise of the purchase option) is crucial for determining whether the income is treated as rental income or as a capital gain, which is important for calculating the company’s tax liability. Businesses structuring lease-purchase agreements must understand the implications of the timing of when the sale occurs. This also impacts the amount of depreciation that can be claimed. The decision should be considered in cases involving the sale or lease of other assets as well, not just machinery and equipment.

