

*Lease v. conditional sale*

The IRS will consider whether a transaction is a true leasing arrangement rather than a conditional sales contract on a case-by-case basis. The general criteria the IRS will use are contained in *Rev. Rul. 55-540*, 1955-2 CB 39.<sup>7</sup> The usual question centers on whether the lessee will acquire an equity interest in the property.

The IRS has generally required adherence to the following conditions before it will give an advance ruling:

1. If the lease term is under 18 years, there must be at least a 15% residual value of the property at the end of the original lease term.<sup>8</sup>

2. If the lease term is over 18 years, the residual value must equal an amount which, when discounted at 6%, would equal a value of not less than 5% of the original cost.<sup>9</sup>

3. At the end of the original lease term, there must be a remaining useful life equal to the greater of two years or 10% of the lease term.<sup>10</sup>

4. If there are renewal options, a representation would be required that the rent for the renewal term is to be at fair rental value.<sup>11</sup>

5. No more than 85% of the cost of the property can be financed.<sup>12</sup>

6. The equipment must belong outright to the owner-lessor upon termination of the lease. An option to purchase is acceptable if the price is the greater of the fair market value as of the end of the original lease term or 10% of original cost. A fixed nominal sum is unacceptable.<sup>13</sup>

7. At the termination of the lease, it must not be impossible or impractical for the lessor to remove the property.<sup>14</sup>

8. While the designation in the contract as a "lease" or "sale" is not controlling, it will probably be more difficult to show that the parties intended a lease where the designation is a "conditional sales contract."<sup>15</sup>

9. The accounting treatment of the transaction on the books of both the lessor and lessee may influence the determination of whether the transaction is a sale or lease.<sup>16</sup>

10. Where unique property is acquired specifically for the lessee, the IRS may contend that the property will have no value to anyone other than the lessee at the end of the lease term, forcing the lessor to abandon the property to the lessee.

11. The lease contract provides that the lessor shall have the option at the end of the lease term to require that the lessee purchase the leased property at the higher of a specified percentage of original cost or fair market value. The IRS is currently limiting the availability of this "put" option to 10% of original cost.

The desirability of obtaining an advance ruling as to the treatment of the transaction as a lease was demonstrated in *Rev. Rul. 72-408*, 1972-2 CB 86. The Ruling illustrated the scope of the adverse tax consequences of a lease which was subsequently determined to be a sale.

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<sup>1</sup> Reg. 1.167(a)-11(c)(1)(iii).

<sup>2</sup> 1978 CCH — Depreciation Guide ¶124.

<sup>3</sup> Section 48(a)(8).

<sup>4</sup> Section 167(f) and Reg. 1.167(a)-11(c)(1)(v).

<sup>5</sup> Section 48(a)(2)(B)(i) and (iii).

<sup>6</sup> Reg. 801.7701-2(a).

<sup>7</sup> See also *Rev. Ruls. 55-25*, 1955-1 CB 283; 57-371, 1957-2 CB 214; 60-122, 1960-1 CB 56; 55-542, 1955-2 CB 59.

<sup>8</sup> Tax Management Memorandum 69-24, Tidbit 2 (12/1/69) and TM Memo 72-18, Tidbit 3 (9/4/72).

<sup>9</sup> Tax Management Memorandum 72-20, Tidbit 4 (10/2/72).

<sup>10</sup> Zarrow, "Tax Considerations in Leveraged Lease Transactions," Practising Law Institute (1973).

<sup>11</sup> 24 *The Tax Lawyer* 603 (1971).

<sup>12</sup> Smoliar, "Equipment Leasing as a Tax Shelter," *Tax Shelters for High Income Clients*, PLI #57 (1973).

<sup>13</sup> Tax Mgt. Mem. 74-01, Tidbit #1 (1/7/71).

<sup>14</sup> *Midwest Metal Stamping Co., Inc.*, TCM 1965-279; *Mt. Mansfield Television, Inc.*, 239 F.Supp. 539 (DC Vt., 1964), *aff'd*, 342 F.2d 994 (CA-2, 1965), *cert. den.*; *Rev. Rul. 57-371*, 1957-2 CB 214.

<sup>15</sup> See also APB Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee" (September, 1964), and *Oesterreich*, 226 F.2d 798 (CA-9, 1955), *rev'g*, TCM, 3/16/53.

<sup>16</sup> See *Northwest Acceptance Corp.*, 58 TC 836 (1972) (on appeal to CA-9).

<sup>17</sup> Regulation Y, Section 225.4(a)(6).

<sup>18</sup> Regulation Y, Section 225.123(d).

<sup>19</sup> See APB Opinion No. 7, "Accounting for Leases in Financial Statements of Lessors" (May,

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