Estate of Starr v. Commissioner
274 F.2d 294 (9th Cir. 1959)

Chambers, *J*.:

Yesterday's equities in personal property seem to have become today's leases. This has been generated not a little by the circumstance that one who leases as a lessee usually has less trouble with the federal tax collector. At least taxpayers think so.

But the lease still can go too far and get one into tax trouble. While according to state law the instrument will probably be taken (with the consequent legal incidents) by the name the parties give it, the Internal Revenue Service is not always bound and can often recast it according to what the service may consider the practical realities.[1] . . . The principal case concerns a fire sprinkler system installed at the taxpayer's plant at Monrovia, California, where Delano T. Starr, now deceased, did business as the Gross Manufacturing Company. The 'lessor' was 'Automatic' Sprinklers of the Pacific, Inc., a California corporation. The instrument entitled 'Lease Form of Contract' (hereafter 'contract') is just about perfectly couched in terms of a lease for five years with annual rentals of $ 1,240. But it is the last paragraph thereof, providing for nominal rental for five years, that has caused the trouble. It reads as follows:

> '28. At the termination of the period of this lease, if Lessee has faithfully performed all of the terms and conditions required of it under this lease, it shall have the privilege of renewing this lease for an additional period of five years at a rental of $32.00 per year. If Lessee does not elect to renew this lease, then the Lessor is hereby granted the period of six months in which to remove the system from the premises of the Lessee.'

Obviously, one renewal for a period of five years is provided at $32.00 per year, if Starr so desired. Note, though, that the paragraph is silent as to status of the system beginning with the eleventh year. Likewise the whole contract is similarly silent.

The tax court sustained the commissioner of internal revenue, holding that the five payments of $1,240, or the total of $6,200, were capital expenditures and not pure deductible rental. Depreciation of $269.60 was allowed for each year. Generally, we agree.

Taxpayers took the deduction as a rental expense under trade or business pursuant to . . . Section [162].

[1] Thus it shifts rental payments of a business (fully deductible) to a capital purchase for the business. If the nature of the property is wasting, then depreciation may be taken, but usually not all in one year.

The law in this field for this circuit is established in Oesterreich v. Commissioner, supra, and Robinson v. Elliot, 9 Cir., 262 F.2d 383. There we held that for tax purposes form can be disregarded for substance and, where the foreordained practical effect of the rent is to produce title eventually, the rental agreement can be treated as a sale.

In this, Starr's case, we do have the troublesome circumstance that the contract does not by its terms ever pass title to the system to the 'lessee.' Most sprinkler systems have to be tailor-made for a specific piece of property and, if removal is required, the salvageable value is negligible. Also, it stretches credulity to believe that the 'lessor' ever intended to or would 'come after' the system. And the 'lessee' would be an exceedingly careless businessman who would enter into such contract with the practical possibility that the 'lessor' would reclaim the installation. He could have believed only that he was getting the system for the rental money. And we think the Commissioner was entitled to take into consideration the practical effect rather than the legal, especially when there was a record that on other such installations the 'lessor', after the term of the lease was over, had not reclaimed from those who had met their agreed payments. It is obvious that the nominal rental payments after five years of $32.00 per year were just a service charge for inspection.

. . . .

In Wilshire Holding Corporation v. Commissioner, 9 Cir., 262 F.2d 51, we referred the case back to the Tax Court to consider interest as a deductible item for the lessee. We think it is clearly called for here. [T]he normal selling price of the system was $4,960 while the total rental payments for five years were $6,200. The difference could be regarded as interest for the five years on an amortized basis. . . .

We do not criticize the Commissioner. It is his duty to collect the revenue and it is a tough one. If he resolves all questions in favor of the taxpayers, we soon would have little revenue. However, we do suggest that after he has made allowance for depreciation, which he concedes, and an allowance for interest, the attack on many of the 'leases' may not be worthwhile in terms of revenue.

Decision reversed for proceedings consistent herewith.