BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SUPERWELD CORPORATION)

For Appellant: Ernest R. Mortenson, Attorney at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Superweld Corporation to proposed, assessments of additional franchise tax in the amounts of $51.03, $263.65 and $570.15 for the income years ended April 30, 1953, 1954 and 1955, respectively.

Appellant is a California corporation engaged in the business of furnace brazing. During the fiscal year ended April 30, 1953, Appellant expended $1,309.06 for office partitions and other improvements to its building.

During the calendar year 1954 Appellant acquired several items of property, including a steel building, furnaces, an automobile and machinery and equipment of various types. The property was obtained under written agreements, each of which was called a "Personal Property Lease Agreement." As and when Appellant required each item it was purchased by a leasing broker who then entered into an agreement with Appellant for its use. Under the terms of each lease Appellant agreed to pay a total sum, which was approximately equal to the purchase price of the property, in monthly installments over a period of two years. The leases provided for subsequent annual renewal options at an annual rental approximating one percent of the original purchase price of the property. The items obtained under the agreements had useful lives varying from three to twenty-five years and averaging thirteen years. Appellant agreed to pay any taxes on the property in addition to the monthly payments and to insure the property against loss or damage. The leases did not provide for an option to purchase.

The first question presented is whether the expenditures during the income year ended April 30, 1953, for office partitions and improvements must be capitalized rather than deducted as current expenses. Disbursements for office partitions and other similar improvements have been held to be capital expenditures. (Harriet B. Borland, 27 B.T.A. 538.) Appellant has not seriously pressed its position on this question and has failed to show that

the expenditures in question are not capital in nature. We conclude that the Franchise Tax Board properly considered them as capital expenditures.

The next question posed is whether the payments made in the income years ended April 30, 1954 and 1955 under the leasing arrangement should be capitalized, as the Franchise Tax Board contends, or deducted as current rental expenses, as contended by Appellant. In short, did the agreements between the Appellant and the leasing broker constitute sales or leases?

Section 24121(a)(1) (now 24343(a)(2)) of the Revenue and Taxation Code provides for the deduction of "rentals or other payments required to be made as a condition to the continued use or possession for business purposes of property to which the taxpayer has not taken or is not taking title or in which it has no equity."

The question of whether particular payments are rentals or whether the "lessee" is acquiring an equity is to be determined from the intent of the parties as evidenced by their agreement and the circumstances existing at the time the agreement is executed. (D. M. Haggard, 24 T.C. 1124, 1129, aff'd, 241 F. 2d 288.)

A strong factor indicating intent which warrants the treatment of a transaction for tax purposes as a sale rather than as a lease or rental agreement exists where the payments materially exceed the fair rental value. (D. M. Haggard, supra, 1130; Rev. Rul. 55-540, 1955-2 Cum. Bull. 9, §4.01(d).) Under the lease agreements Appellant may possess and use property for its entire useful life by making monthly payments for two years which approximately equal the purchase price of the property and by then making nominal payments annually for the remainder of the useful life. If the payments are deductible as rent for tax purposes, Appellant will be able to write off the value of the property in two years although its useful life is as much as twenty-five years. It would be less a distortion of income to capitalize the payments and allow depreciation on the property than to offset the payments against the current income. (Chicago Stoker Corporation, 14 T.C. 441, 445.)

The payments in question may properly be treated as purchase payments even though there is no express provision in the agreements for passage of title, such as an option to purchase. It seems clear that the parties expected Appellant, after paying the entire cost of the property in "rentals," to make the nominal annual payments thereafter and retain the property. Similar arrangements involving options to renew for nominal amounts have been held to constitute purchases rather than rentals. (Starr's Estate v. Commissioner, 274 F. 2d 294; Rev. Rul. 57-371, 1957-2 Cum. Bull. 214.)

Appellant relies upon Benton v. Commissioner, 197 F. 2d 745, wherein the taxpayer obtained the use of a taxicab business for a ten-month period by paying $5,000.00 per month, and realized a net profit of $32,277.31. The taxpayer had an option to purchase the business at the end of the period for $35,000.00. The court indicated that the parties had anticipated a large decline in value because the equipment would be badly worn. In view of these facts the court found that the monthly payment was reasonable when considered strictly as rental and the option price was not unreasonably low, The present case is distinguishable. It cannot be maintained that an annual rental of fifty percent of the value of assets having useful lives averaging thirteen years is reasonable, or that the option to renew after two years for one percent annually is not unreasonably low,

The facts indicate that the parties to the so-called lease agreements intended that Appellant should acquire an equity in the properties for their entire useful lives. We conclude that the payments made during the first two years were capital expenditures and were not currently deductible as rental expenses.

It is noted that in the case of Starr's Estate, supra, the court decided that an element of interest in the "rental" payments should be deductible. Appellant, however, has made no claim for such a deduction and has not presented us with a reasonable basis for determining the amount of any interest that might be inherent in the payments.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefore,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Superweld Corporation to proposed assessments of additional franchise tax in the amounts of $51.03, $263.65 and $570.15 for the income years ended April 30, 1953, 1954 and 1955, respectively, be and the same is hereby sustained.

Appeal of Superweld Corporation

Done at Sacramento, California this 6th day of April, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Alan Cranston, Member

Paul R. Leake, Member

Richard Nevins, Member

ATTEST: Dixwell L. Pierce, Secretary