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SOME TAX ASPECTS OF LEASEHOLDS

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The drafting of a lease should never be undertaken without an objective appraisal of the possible tax consequences and their impact on either the lessor or the lessee, depending upon whom the attorney is representing.

Excursions into the realm of theoretical and academic dominions are sometimes stimulating and provocative, but to satisfy the desire of the practitioner, who is usually too "busy" to enjoy such luxurious cruises, we have attempted to steer a course through this area with the hope that it will provide the answers to many tax questions so often an incident to the landlord-tenant relationship.

Some of the questions and problems which arise and which should be anticipated by the attorney drafting a lease can be categorized as follows:

A. What Constitutes Rent?—Lease-Purchase Agreements.

B. Occupancy—Buy, Lease, or Sale and Lease-back.

C. Purchase of Fee by Lessee.

D. Close Relationship Between Lessor and Lessee.

E. Advance Payments by Lessee.

F. Depreciation, Amortization, and Related Problems of Lessee.

G. Depreciation, Amortization, and Related Problems of Lessor.

H. Bonus to Cancel Lease.

What Constitutes Rent?

Generally, rent may be in the guise of expenditures seemingly made for purposes other than for the use and occupancy of the property. The lessor and the lessee may agree as to what expenditures will constitute rent under a particular lease. For example, interest,[1] taxes,[2] and certain maintenance and other expenditures[3] may under certain conditions constitute rent payments insofar as the lessee's obligation under the lease is concerned. In most instances, no problem arises where the intentions of

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1. Denholm & McKay, 39 B.T.A. 767 (1939).
2. U.S. Treas. Reg. 118, Sec. 39.23 (a)-10 (1953). An exception is made in the case of certain leases entered into before January 1, 1954, and renewals of such leases if the option to renew is contained in the lease on December 31, 1953. INT. REV. CODE of 1954, § 110.
3. *But see* Frank & Seder Co. v. Commissioner, 44 F.2d 147 (3rd Cir. 1930).

the parties are fully expressed in the lease.[4] Nevertheless, where the expenditure by the lessee is reasonable, and is an incident to the occupancy by the lessee, if not an allowable deduction for rent it will generally be allowable as an ordinary and necessary business expense.[5] But, in at least one situation,[6] where more than $22,000 was paid by the lessee for taxes on leased property, it was held not deductible as an ordinary and necessary business expense since the lessee could show no obligation under his lease to pay such taxes.

It is axiomatic that where a deduction is allowed the lessee for rent payment, the lessor's income should ultimately be increased by an identical amount. Consequently, the Commissioner may, for purposes of increasing the income of the lessor, decide that expenditures made by the lessee should be construed as rent. However, in *M. E. Blatt Co. v. United States*,[7] the Supreme Court held that improvements by the lessee will not be deemed rent unless such intention is plainly disclosed. The Court stated, in part:

> Rent is a fixed sum to be paid at stated times for use of property . . . it does not include payments, uncertain both as to amount and time, made for the cost of improvements. . . .[8]

Where payments by the lessee have dual potentialities of classification, namely, whether such payments will constitute rent or whether they are to be applied to the purchase price of the property,[9] has always been a difficult characterization problem for income tax purposes. Generally, if such payments exceed the allowable depreciation on the property, it is less of a distortion of income to regard them as payments toward the purchase price and allow the deduction for depreciation on the property than to consider the payments as rent and utilized as an offset against the income for the year.[10] Where, in the opinion of the Commissioner, the taxpayer acquires an equity interest in the property, monthly payments are not deductible as rent.[11]

Occupancy — Buy, Lease, or Sale and Lease-Back

After disposing of the preliminary problems incident to the acquisition of property and it is decided that leasing is more favorable tax-wise than an outright purchase, the problems of buyer and seller become integrated with the problems of lessor-lessee (landlord-tenant). This is best illustrated in the sale and lease-back situations, where a taxpayer who owns real prop-

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4. See M. E. Blatt Co. v. United States, 305 U.S. 267 (1938).
5. *Supra* note 3.
6. Robinson v. Commissioner, 53 F.2d 810 (8th Cir. 1931).
7. 305 U.S. 267 (1938).
8. *Id.* at 277.
9. Watson v. Commissioner, 62 F.2d (9th Cir. 1932).
10. Chicago Stoker Corp., 14T.C. 441 (1950); *cf.* Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952) (where the intention of the parties controlled).
11. Judson Mills, 11 T.C. 25 (1948); Goldfields of America, Ltd., 44 B.T.A. 200 (1941); *But see* Calcasieu Paper Co., 12 CCH Tax Ct. Mem. 74 (1953).

erty but who has only a limited amount of current funds would like to use these funds and additional monies resulting from the sale of real property as working capital. By so doing, he still has the use of the necessary or desirable real property or equipment in addition to strengthening his current position. In selling his real property a provision should be made for a lease-back from the purchaser for a term of years. After the transaction is closed, the rental paid would be deductible as an operating expense, and, if the real property had been sold at a gain, the rental expense would reduce the taxable income. If the real property had been sold at a loss, the taxpayer would have a loss in addition to the operating expense deduction.

A sale of property used in the business followed by a lease-back from the new owner can sometimes convert a capital loss into an ordinary loss.[12]

Assuming that most of the problems have been analyzed incident to the advantages and disadvantages of a sale and lease-back, in addition to the questions of depreciation deduction as compared with rental expense, there are still certain important problems which should not be overlooked. First, is it a bona fide business transaction?[13] Further, what is the duration of the lease? To avoid the transaction being classified as a tax-free exchange, thus disallowing a loss deduction on sale of the property, the lease should be less than 30 years.[14] Also, to prevent disallowance of the loss deduction, options of renewal should be avoided;[15] likewise, options to repurchase should be avoided.[16] However, where the sale would result in a gain, it is conceivable that it would be desirable to have such a transaction classified as a tax-free exchange.[17]

If a sale is intended, there should be a close relationship between the

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12. For example, a corporation has suffered a capital loss in the current year with a carry-over to the current year. There is either no tax benefit from the carry-over or at best an offset against a 25% tax. The corporation now sells business property to an investor and realizes a gain to match the capital loss. It leases back the property and pays rent which will reduce ordinary income taxable at 52%. It has obtained the following advantages:

1. In place of a loss which is non-deductible or which reduces a 25% tax, it has a deduction which will reduce a 52% tax.

2. It has realized working capital from the sale. While the working capital will be paid back over the years as rent, it may fill an immediate and pressing need. Mahon, *The Tax Clinic*, 101(2) THE JOURNAL OF ACCOUNTANCY 81, (Feb. 1956).

13. Standard Envelope Mfg. Co., 15 T.C. 41 (1950). The court, in holding that the sale was a bona fide business transaction, looked to the following factors:

1. No evidence of any relationship between buyer and seller;

2. Lease was for a term of less than 30 years, and therefore was not the equivalent of a fee;

3. Although seller's cash position was benefited, it made no difference. A taxpayer may give consideration to the tax consequences of transactions. United States v. Cumberland Pub. Ser. Co., 338 U.S. 451 (1949);

4. Seller proved that the rental agreed upon was a fair rental of the property.

14. U.S. Treas. Reg. 118, 39.112 (b) (1)-1 (1953).

15. Note 13 *supra*.

16. May Dep't. Stores Co., 16 T.C. 547 (1951); Standard Envelope Mfg. Co., 15 T.C. 41 (1950).

17. See INT. REV. CODE of 1954, § 1031.

sale price and the fair market value.[18] And remember, that wherever a close relationship exists between the buyer and the seller, such transactions will always receive close scrutiny, and underlying such instances there should be a sound business purpose which will withstand the tests for substance and form.[19]

Purchase of the Fee by the Lessee

Where the lessee purchases the fee on which he has erected a building to avoid an onerous lease, and the purchase price is in excess of the fair market value of the unimproved land, a significant problem is presented to the practitioner when he must determine how the excess is to be treated. Prior to 1956, the courts followed the theory laid down in *Cleveland-Allerton Hotel, Inc. v. Commissioner*[20] case, wherein lessee paid $241,250 in excess of the unimproved value of the land as purchase price for the fee. The Tax Court denied the lessee any deduction, treating the lessee as a third party purchaser who would be required to depreciate the purchase price over the remaining life of the asset. The Circuit Court, however, in reversing the Tax Court, characterized the transaction as the purchase of a nondepreciable asset plus the purchase of a release from a burdensome obligation. Thus, the lessee was allowed a deduction of $241,250 in the year of purchase. The Circuit Court relied on cases holding that a lessee's cost in abandoning a lease are deductible as a business expense.[21] However, they overlooked the fact that the lessee's economic position was not substantially changed; that he continued to occupy and use the land, and at the same time allowed to accumulate into one large deduction items which would have been future costs under the terms of the now extinct lease.

The *Cleveland* case was followed six years later in *Troc, Inc. v. United States*,[22] under similar facts, where the taxpayer was allowed to deduct the difference between the fair market value of the land and the agreed option price as an ordinary and necessary business expense in the year in which the option to purchase was exercised.

It was not until 1956 that the Supreme Court clarified the problem, as decided in *Millinery Center Bldg. Corp. v. Commissioner*.[23] In this case, taxpayer had a 21 year lease on land with renewal options. The lease required the taxpayer to erect a building and transfer it to the landlord at

18. May Dep't. Stores Co., 16 T.C. 547 (1951).
19. Albert T. Felix, 21 T.C. 794 (1954). INT. REV. CODE of 1954, § 1239 may have the effect of deterring some sale and lease back transactions. This provision results in taxation as ordinary income, rather than capital gain, of any gain involved in a transfer of depreciable property between spouses or between an individual and a controlled corporation.
20. 166 F.2d 805 (6th Cir. 1948).
21. Henry C. Rowe, 19 B.T.A. 906 (1930); A. H. Fell, 7 B.T.A. 263 (1927).
22. 126 F. Supp. 786 (N.D. Ohio 1954).
23. 350 U.S. 456 (1956).

the expiration of the tenancy. The taxpayer erected the building and fully depreciated the cost over the 21 year term. The taxpayer renewed the lease for an additional 21 years and then purchased the fee in both the land and the building. The difference of $1,440,000 represented the excess value of the purchase price over the value of the unimproved land.

The petitioner's main argument was that the $1,440,000 should be deductible as an ordinary business expense as the price of cancellation of an onerous lease. Alternatively, it suggested amortization of this amount over the unexpired term of the new lease. The Supreme Court denied both of the petitioner's contentions, injecting a new interpretation not previously recognized by either the 6th Circuit which decided the *Cleveland* case or the 2d Circuit which had decided the instant case. The Court said that the lessee had acquired rights in both the land and building which should be identical with the rights of an original purchaser, including the right to depreciate the cost of the wasting asset, namely the building. Thus, the cost of the building, allocated from the purchase price, was to be depreciated over the useful remaining life of the building. The Court went furthem and ruled that this would be the result regardless of whether the purchase was made a short time before the expiration of the original lease or shortly after the lease was renewed.

In view of the foregoing decision, where the purchase price exceeds the fair market value of the land, such excess can only be depreciated by the lessee over the useful remaining life of the building rather than the elections heretofore made, namely:

1) deduction as an ordinary or necessary business expense;[24]
2) deduction over the unexpired portion of the old lease.[25]

Close Relationship Between Lessor and Lessee

Where the problem of close relationship is confronted, reasonableness usually is the criterion to determine whether the claimed deduction will be allowed. However, the question of reasonableness, being one approached with objectivity, sometimes becomes enmeshed with subjective interpretations by the court. Consequently, special care must be taken to preclude deductions ordinarily allowable in an arm's length transaction from being disallowed. The burden of proof, being on the taxpayer, must be met with sufficient quantum to satisfy the most rigid requirements of the Code. being mindful that deductions are a matter of "legislative grace."[26]

Mere formalities are not sufficient. The transaction must have substance and generally must be associated with a business purpose.[27]

Where the lessee is the sole stockholder in the lessor corporation, there

24. See INT. REV. CODE of 1954, § 162 (a).
25. Willcutts v. Minnesota Tribune Co., 103 F.2d 947 (8th Cir. 1939).
26. Kamen Soap Products, PH—TCM 1956-157.
27. Riverpoint Lace Works, Inc., 54143 PH Memo TC (1954).

is a possibility that no deduction will be allowed, either as a leasehold amortization or depreciation charge,[28] and the "rent deduction" closely scrutinized for reasonableness. However, in one instance, where the petitioner company was an operating entity actively engaged in a legitimate business, the close relationship of the corporate officers of the participating corporations did not prevent a depreciation of $565,221.90 over a ten year period,[29] because the facts disclosed a reasonable relationship, one that would be occasioned in an arm's length transaction between lessor corporation and lessee corporation. The underlying theory which permeates the court's thinking in instances such as the foregoing appears to be predicated upon the adequacy of the rental payment as being necessary for continued use and occupancy of the premises. Close relationship per se is not the sole criterion in determining deductibility, however, where it does exist it places an additional burden upon the taxpayer to justify such payments. Reasonableness itself appears to be the keynote. Where the required conditions have been met, the deductions will be allowed.[30]

Advance Payments by Lessee

In considering the subject matter of "advance" payments, a characterization of the nature of the payment is necessary. For example, is the payment a loan,[31] or in fact rent for a later period;[32] is it a security deposit conditioned upon satisfactory performance by the lessee of certain conditions in the lease;[33] is it in the nature of a bonus to guarantee acquisition of the premises;[34] or is it a payment for some obligation of the lessor which is assumed by the lessee.[35] It is an elementary proposition, but one worthy

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28. Wade Motors Co., 26 T.C. 28 (1956).
29. Fort Wharf Ice Co. v. Commissioner, 23 T.C. 202 (1954).
30. Neel Co., 22 T.C. 1083, 1090 (1954), where the court aptly stated:

> . . . [W]hile the actions of a family corporation or family group should be carefully scrutinized, it is entirely conceivable that the relations each with the other . . . may be such that they will deal with each other strictly at arm's length. In fact, it sometimes happens that their very nearness in blood leads them to be more independent in action than strangers in blood. . . .

In Henry C. Bender, 47108 PH Memo T.C. (1947), the court reversed the Commissioner's holding that partnership rental paid to a corporation owned by the partners and their wives was excessive:

> . . . (The rent) was such an amount as a landlord dealing at arm's length with a tenant, neither of them being under compulsion, might reasonably require the tenant to pay for the privilege of occupying the premises involved.

See Walter H. Sutliff, 46 B.T.A. 446 (1942); *Cf.* Hort v. Helvering, 313 U.S. 28 (1941).

31. Atlantic Refrigerating Co., 42382 PH Memo B.T.A. (1942).
32. Hirsch Im-Provement Co., 143 F.2d 912 (2d Cir. 1944); Schultz, 44 B.T.A. 146 (1941); Mead Coal Co., 31 B.T.A. 190 (1934).
33. Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968 (5th Cir. 1942); Warren Service Corp. v. Commissioner, 110 F.2d 723 (2d Cir. 1940); Estate of Geo. E. Barker, 13 B.T.A. 562 (1928).
34. Baton Coal Co., 51 F.2d 469 (3rd Cir. 1931); Butler, 19 B.T.A. 718 (1930); O'Day Investment Co., 13 B.T.A. 1230 (1928).
35. Allard & Bro., Inc. v. United States, 28 F.2d 792 (D.C. Mass. 1928); W. M. Scott, 27 B.T.A. 951 (1933); Saks & Co., 20 B.T.A. 1151 (1930).

of repeating, namely, that to the lessor these payments constitute income and to the lessee they constitute expense. Likewise, where unconditional payments (unrestricted in their use) are made to the landlord, such payments are taxable income when received, but are deductible expenses over the period of the lease by the lessee[36] regardless of what method of accounting is employed by either landlord or tenant.[37]

Where a bona fide security deposit is paid to the lessor, no income results because the security will be returned to the lessee upon faithful performance of the conditions in the lease. In a true security deposit transaction, consequently, no income or expense would be reported. However, most problems arise because of the failure of the lease to clearly reflect the real nature of the advance payment, so that its true character is shrouded in ambiguity. Labeling a payment as a security deposit is not sufficient. Such funds should not be used by the lessor for operating purposes, but should, in fact, be physically identified as a restricted fund. The payment of interest is only a superficial consideration.[38]

Usually the lessor is confronted with an anamolous situation where the "advance payment" is considered income in the year in which received, but the expenses incident to the acquisition of such lease must be spread over the term of the lease. Suppose, for example, the lessor negotiated a 99 year lease with the last 10 years' rent ($20,000) being paid in advance, with the broker's commission amounting to $10,000 being paid by the lessor.[39] The broker's commission would necessarily be deducted over the term of 99 year lease (1/99 per year) although the rent received for the 10 years would be included in income in the current year. Further, assuming that the commission represented 5% of the value of the lease, the lessor would then be required to include approximately $20,000 in income and allowed only approximately $100 as a deduction for amortization of leasehold expenses!

The court's comment in the foregoing case decided in 1936, was that although the result was unfair, they were helpless and that legislative relief was needed.[40] However, even after 20 years, including several major revisions of the Code, the "relief" as originally envisioned by the court still remains forthcoming from the legislature.

Depreciation, Amortization and Related Problems of Lessee

It is a generally recognized accounting principle that an allowance for exhaustion of the leasehold should be spread equally over the term of the

36. United States v. Boston & Prov. R.R., 37 F.2d 670 (1st Cir. 1930).
37. I.T. 2263, CUM. BULL. V-1, 66 (1939).
38. *E.g.*, Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1938); *Cf.* Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943).
39. See Renwick v. United States, 87 F.2d 123 (7th Cir. 1936).
40. *Ibid.*

lease unless the estimated useful life of the capital expenditure is a shorter period, in which event the shorter period becomes the term over which this deduction is allowed.[41]

Where the nature of the payment by the lessee becomes difficult to characterize, that is, as to whether it is rent, loan,[42] or purchase, the practitioner should be aware that the Commissioner will naturally place the burden of proof on the taxpayer, particularly when a rent deduction would result in a greater tax advantage than a depreciation deduction.

A lessee will be permitted the deduction for rent expense without incurring a simultaneous expenditure where the accrual method of accounting is employed and the accrued liability reflects the obligation to the landlord. A seemingly incongruous situation arises where the landlord is on the cash basis because no income is reported until the rental payments are received from the lessee.

Expenditures made in the course of business for the acquisition of a lease covering a period of more than one year are not deductible as ordinary and necessary business expenses regardless of whether the taxpayer is on the cash or the accrual basis. Such expenditures must be amortized over the term of the lease.[43]

Many factors must be considered in determining whether expenditures by the lessee are to be capitalized or expensed in the year in which such expenditures are made.

Leasehold improvements made by the lessee are generally amortized over the term of the lease, or depreciated over the life of the improvement, whichever is shorter.[44] The element of obsolescence is a factor which should not be overlooked.[45]

Where no written lease exists, and the relationship is one of tenancy at will, the cost of improvements generally cannot be deducted as an expense in the year in which made, but must be depreciated over the useful life of the property.[46] To illustrate, a corporation erected a building on land which it rented on a month to month basis from its principal stockholders. It was reasonable to assume that the tenancy would continue indefinitely inasmuch as the principal stockholders profited by having such a relationship continue. Therefore, the life of the building was the only basis upon which a reasonable depreciation could be computed.[47] Unfortunately, however, this reasonable attitude of the Commissioner was aban-

41. Duffy v. Central R.R. of N.J., 268 U.S. 55 (1925); T.D. 3704, IV-1 CUM. BULL. 143 (1925).
42. Helvering v. Lazarus, 308 U.S. 252 (1939).
43. See note 57 *infra*.
44. Alamo Broadcasting Co., 15 T.C. 534 (1950).
45. Alaska Realty Co. v. Commissioner, 141 F.2d 675 (6th Cir. 1944).
46. Thatcher Medicine Co., 3 B.T.A. 154 (1925).
47. *Ibid.*

doned in at least one instance[48] where substantial capital improvements were made in excess of $90,000 during the last three years of a 10 year lease. The Commissioner claimed that the entire amount should have been fully deducted by the end of the original lease although the lease was renewed and extended. The Tax Court, however, realistically and in accordance with the weight of authority, felt that the depreciation should be based upon the life of the improvements.

In some instances where multiple interdependent leases are involved,[49] it is recommended that the leases expire at the same time in order to preclude an unrealistic interpretation by the Commissioner for amortization and depreciation deductions.

In instances where the nature of the expenditure is not specifically governed and expressly contained in a lease, the question of classification will arise, namely, is it one of a capital or revenue nature.[50] To avoid unanticipated interpretations, the intentions of lessor and lessee with regard to classification of the expenditures should be expressly contained in the lease.

Conjectural or estimated loss in value based on obsolescence, inadequacy, or deterioration are not deductible under any circumstance.[51]

In all instances, where the lease duration is difficult of ascertainment, and the useful life of the improvement is the basis upon which the amortization or depreciation deduction is calculated, the taxpayer will ultimately have his deduction for any unamortized or undepreciated balances in the year in which the premises are abandoned[52] or the lease is cancelled.

Depreciation, Amortization and Related Problems of Lessor

Depreciation, an allowable deduction to the landlord, as an ordinary and necessary business expense, is more directly related to the allocation of the cost of the asset over its useful life, rather than the use to which the asset is put by the lessee or the period of time that its use is granted to the lessee by the lessor.

To allow the deduction for depreciation, there must be a present loss. For example, where a lease requires the lessee to repair the property and return property of equal value, the lessor is not entitled to deduct depre-

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48. Standard Tube Co., 6 T.C. 950 (1946).
49. See I.G. Zumwalt, 25 B.T.A. 566 (1932).
50. Journal-Tribune Publishing Co. v. Commissioner, 216 F.2d 138 (8th Cir. 1954); Terre Haute Housing Co., 17 B.T.A. 384 (1929); Shugerman, *Basic Criteria for Distinguishing Revenue Charges from Capital Expenditures in Income Tax Computations*, 49 MICH. L. REV. 213 (1950).
51. Weiss v. Weiner, 279 U.S. 333 (1929); Harris-Emery Co., 10 B.T.A. 297 (1928).
52. I.T. 1676, CUM. BULL. II-1, 122 (1923).

ciation.[53] Likewise, deposits to a depreciation fund are not classified as present losses.[54]

An interesting situation arises, however, where a landlord has his building demolished to secure a tenant. The cost of the old building is generally deductible over the lease term. In denying a loss in the year the buildings are demolished, the court feels that there is a compensating value (a lease) for the loss of the buildings. In such an instance, the transaction is in effect an exchange of the leasehold estate for the lessee's obligations, and must be amortized over the lease term. The loss is interpreted as one to secure a new lease, and may not be deducted as a loss or expense in the year incurred.[55]

Generally, expenses incurred in procuring a lease are capitalized and should be spread over the life of the lease regardless of what method of accounting the taxpayer uses.[56]

A problem which is sometimes confronted by counsel and the corporate taxpayer is the disposition of unamortized leasehold expenses upon the dissolution of the lessor corporation. Generally, only such part of the unamortized balance of these expenses applicable to the taxable year may be deducted, thus disallowing the entire deduction in the year of dissolution.[57] The court's reasoning is predicated upon the theory that the transfer of the right to this annual amortization of the capital expenditure has been made to the corporation's successor in interest, namely, the stockholders.[58]

Where, however, a lease is cancelled or expires and unamortized leasehold expenses exist, a new lease may prevent the deduction of these unamortized costs in the year in which the lease expires. Such costs are extended over the period of the new lease or the estimated life of the improvement, whichever is the shorter.[59]

With regard to the right of the lessor's successors in interest to amortize the adjusted basis of buildings demolished by the lessee, an interesting illustration is the *Rowlan*[60] case, where buildings were demolished by the lessee to make way for a new building. The lessor was allowed an annual deduction on account of the demolition, deductible over the remain-

53. Commissioner v. Terre Haute Elec. Co., 67 F.2d 697 (7th Cir. 1933). See Atlantic Coast Line RR. v. Commissioner, 81 F.2d 309 (4th Cir. 1936) (where both lessee and lessor were denied a deduction for depreciation on the theory that the lessee sustained no loss and the lessor had no capital improvement).

54. Minneapolis Sec. Bldg. Corp., 38 B.T.A. 1220 (1938) (where the name "depreciation fund" was not controlling as to its real nature).

55. Young v. Commissioner, 20 B.T.A. 692, *aff'd* 59 F.2d 691 (4th Cir. 1932).

56. Babbage, 27 B.T.A. 57 (1932); Lovejoy, 18 B.T.A. 1179 (1930); Walter & Co., 4 B.T.A. 142 (1926).

57. Plaza Investment Co., 5 T.C. 1295 (1945); *Cf.* S & L Bldg. Corp., 19 B.T.A. 788 (1930).

58. Wolan v. Commissioner, 184 F.2d 101 (10th Cir. 1950).

59. Phil Gluckstern's Inc., T.C. Memo 1956-9; Pig & Whistle Co., 9 B.T.A. 668 (1927).

60. Rowlan, 22 T.C. 865 (1954).

ing life of the old lease. Upon the death of the lessor, an heir to a 1/3 interest in the property claimed 1/3 of the amortization as previously deducted by the testator (lessor). The court, of course, disallowed this novel interpretation, citing Section 113 (a) (5) of the Code.

Where a new lease is executed prior to the expiration of the old lease, a problem is sometimes created as to the allocation of any unamortized leasehold costs at the time of execution of the new lease. This problem was presented in the *Pig & Whistle Co.*[61] case where the lessee claimed the unamortized costs of the old lease became a loss on execution of the new lease and that a deduction of the total amount should be allowed in the year in which the new lease is executed. The court held that these costs should be prorated over the term of the new lease, although there was a "constructive" cancellation of the old lease. Had there not been a new lease entered into, this cost undoubtedly would have been deductible, but the court held that there was such a continuity of rights and such an interrelation between the two leases that the unextinguished costs of the first lease were part of the cost and consideration of the second lease.[62]

Bonus to Cancel Lease

A. *By the landlord.* Cancellation of leases occur generally for the following reasons: landlord no longer feels that the tenant is desirable; landlord wishes to sell the property and his prospective buyer does not desire the present tenant; landlord wants to change the character of the tenancy; landlord wants to demolish the present building and erect a new building; landlord has elected to exercise a condition of the lease wherein bonus is to be paid in the event of cancellation.

Generally, where a bonus is paid for any of the aforementioned reasons, the cost thereof is capitalized. Where a new lease is effected, usually the cost of cancelling the prior lease is amortized over the remaining period of the old lease.[63]

Receipt of these bonus payments by the tenant usually results in capital gain as a sale of a leasehold interest.

61. 9 B.T.A. 668 (1927).

62. Suppose a taxpayer is considering a lease of business realty, and intends to construct a new building costing $100,000 on the leased premises. If a 20-year lease contained an option to renew for an additional 20 years at the same rental figure, and the building had an estimated useful life of 50 years, under the present law the taxpayer would be allowed an annual deduction of $5,000. Only the original lease term need be taken into consideration.

The practitioner should be reminded that under the proposed tax changes listed in the Mills Committee Release by the Joint Staff and Treasury Department, proposed effective date for taxable years beginning after December 31, 1956, the taxpayer would be required to add on the renewal term. Since the original lease plus the renewal aggregate 40 years, the annual amortization deduction would be only $2,500 per year.

63. H. B. Borland, 27 B.T.A. 538 (1933); C. B. Bretzfelder, 21 B.T.A. 789 (1930); *Contra*: Wells Fargo Bank & Union Trust Co. v. Commissioner, 163 F.2d 521 (9th Cir. 1947) (where lessor had the right to amortize the cost of cancelling the old lease over the term of a new lease).

Although not considered as a bonus payment, an interesting problem arises where the lessee subleases, thus creating a lessee-sublessor relationship with his lessor. Prior to 1956 payments received by a lessee-sublessor were includible in the gross income of the lessee-sublessor as ordinary income.[64] However, the Internal Revenue Service now holds that amounts received in consideration of the surrender or release by the tenant to the landlord of possessory rights in real estate under a lease or under a statute entitling the tenant to continue in possession following expiration of a lease, or amounts received by a tenant from the landlord in consideration of the relinquishment of a lease covenant restricting the use of the real estate by the landlord, constitute proceeds from the sale of a capital asset within the meaning of Section 117 of the Internal Revenue Code of 1939.[65] The foregoing holding does not apply to a situation involving the transfer, for a lump sum, of the right to collect ordinary income.

B. *By the tenant.* A tenant will often pay a bonus to the landlord to be released from onerous conditions, or, to induce the landlord to change or include certain advantageous conditions in an existing lease. Bonuses received by the landlord under these circumstances are construed as ordinary income and taxable when received. Where bonus payments are made by the tenant and he continues in occupancy, said payments are generally amortized over the remaining life of the lease. But where the tenancy is terminated, such bonus payment is deductible as an ordinary expense in the year of payment.

In *Hort v. Commissioner*,[66] the petitioner (lessor) attempted to relate the fair rental value of the premises to the present value of unmatured rentals and by virtue thereof sustained a $21,494.75 loss, thus reducing the taxable income which included a bonus payment of $140,000. The Board of Tax Appeals, not agreeing with the petitioner's position, disallowed the loss and held the bonus payment to be a substitution for rental payment and taxable as ordinary income. Apparently, from an accounting standpoint, the landlord had set up these unmatured rentals as a receivable and similarly set up the rental as deferred income. The petitioner, in his pleadings, elected to discuss the receivable aspect of the problem but ignored the impact on deferred income. The lessor was using a device which sounded good, but he overlooked the fact that taxable income had not been increased by these unmatured receivables.

In all cases it must be remembered that any loss must be a "real" loss, not conjectural, and the landlord does not suffer a loss for accrued rentals when the premises have been abandoned by the tenant, unless such rentals had previously been recorded as taxable income.[67]

64. Rev. Rul. 129, CUM. BULL. 1953-2, 97.
65. Rev. Rul. 56-531, INT. REV. BULL. 1956-43 (Oct. 22, 1956).
66. 313 U.S. 28 (1941).
67. Georgia Ry. & Elec. Co. v. Commissioner, 77 F.2d 897 (5th Cir. 1935).