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Tax Problems Incident To the Management of Acquired Real Estate

II

PROBLEMS OF LEASEHOLD IMPROVEMENTS

Howard M. Kohn

Tax problems involving leasehold improvements deserve careful analysis. This article will consider both lessor's and lessee's problems, taking into account whether the expenditures were made by the lessor, or his predecessor, or by the lessee.

Lessor's Problems Where Improvements are Made by Lessor

Generally, of course, if the lessor has made an improvement to his property, he will take depreciation deductions for such improvement over the life of the improvement. However, there is one exception to this rule: if the lease obligates the lessee not only to maintain the premises but also to restore them at the expiration of the term to the condition they were in when leased to him, then the lessor will not be entitled to a depreciation deduction for such improvement. The rationale is that the lessor suffers no exhaustion with respect to the improvement. Thus, if the lessor wishes to be certain not to lose his depreciation deductions, he should exercise care in spelling out the lessee's duty to return the property in good condition by adding "ordinary wear and tear excepted."

If, however, the lessor makes some particular alteration to meet the special requirements of a prospective lessee, or to obtain a particular lease, which improvement does not add to the value or the life of the property, then he will be entitled to amortize the cost of that improvement over the life of the lease.

A more common item of the lessor's cost relating to a lease arises where a building owned by the lessor has been demolished in connection with a new lease or to permit the lessee to erect a new building.

If the demolition has been by the lessor, then, in addition to the remaining undepreciated cost of the building which was demolished, there is the cost of demolition. In those cases the question always arises — is the remaining undepreciated cost of the improvement which was demolished, plus the cost of demolition if done by the lessor: (1) deductible immediately as a loss? or (2) to be capitalized and depreciated over the life of the new building erected by the lessee? or (3) to be amortized over the life of the lease? The courts have uniformly disallowed the immediate loss deduction and they have paid little attention to the life of the building erected by the lessee. The settled rule, seemingly irrespective of the life of the new building or the term of the lease, is that the lessor's unrecovered cost of the demolished building, plus the cost of demolition, must be amortized over the life of the new lease — on the theory that they constitute the cost of acquiring a new asset, namely, the new lease.4

If the lessor has a basis for his lease which is being amortized over the term of the lease (for example, the unrecovered cost of a demolished building), and if the lessor dies during the lease term, the property will, of course, pass to his heirs or devisees, who will take a new basis for the property equal to its fair market value at the date of the lessor's death (or the optional valuation date).5 They will not be entitled to continue to amortize the deceased lessor's unrecovered basis of his lease.6 This may be a factor to be taken into account in planning by whom the property should be held. If the lessor has a high cost basis for a lease, incorporation or a gift might be indicated. A controlled corporation, or a donee, may take the lessor's basis and be assured of the full write-off of the cost of the lease.7

If the lessor sells the property, including his interest in the lease, any unamortized leasehold cost, together with all other items of basis, will be taken into account by him in computing his gain or loss on the sale. The purchaser will compute his basis with reference to his cost, under the usual rules, and without regard to the seller's basis.8 If, however, the lease is a favorable one with a premium value, and if the purchaser is someone other than the lessee, the purchaser may allocate a portion of his aggregate basis to the premium value of the lease, and amortize that portion over the life of the lease (that is,

5. INT. REV. CODE OF 1954, § 1014.
6. Albert L. Rowan, 22 T.C. 865 (1954); but see Wolan v. Commissioner, 184 F.2d 101 (10th Cir. 1950), holding that after a corporate lessor was liquidated, the shareholders could continue to amortize the corporation's unamortized lease basis over the remaining term of the lease. The latter decision seems questionable unless it be assumed that upon liquidation of the corporation the lease had a value exactly equal to the corporation's unamortized basis.
8. INT. REV. CODE OF 1954, § 1012.
over the period during which that premium value is being exhausted). 9

On the other hand, if the purchaser is the lessee and the lease is a burdensome one from his standpoint, the amount paid by him to be relieved from the burdensome lease is deductible as an ordinary and necessary expense. 10

**LESSOR'S PROBLEMS WHEN IMPROVEMENTS ARE MADE BY LESSEE**

If the lease permits or requires the lessee to improve the property, and assuming that the lessor does not intend the lessee's improvement to constitute rent, the lessor's attorney must exercise care in preparing the lease so as not to invite a contention on the part of the Commissioner that the lessee's improvement does constitute rental income. It is clear that if the lessor and the lessee contract that, as a form of payment of rent, the lessee shall make improvements, such improvements will constitute rental income to the lessor. 11 Whether other improvements are rent, however, will turn on the intention of the lessor and the lessee. 12 The Supreme Court has stated that even though improvements by the lessee are required, they will not be deemed rent unless the intention that they shall be so is clearly disclosed. 13 Therefore, the lease should provide for a reasonable money rent, and care should be taken not to treat the lessee's improvements as a substitute for rent. For example, the lessee may be required to improve the property as additional security for his payment of the rent. Consistent with that intention, the lease might also provide that at the expiration of the term, the lessee shall have the option of leaving the improvement, or removing it and restoring the premises to the condition they were in when the lease was executed.

If the lessee's improvement is not rent, then not only is it not income when made but also it is not income when the lease terminates and the property, with the improvement still on it, reverts to the lessor. 14 Thus, if the improvement is not intended as rent, the lessor is "home free." By reason of the lessor-lessee relationship, the improvement is not income to the lessor at any time.

If there is a second relationship between the lessor and the lessee, however, then consideration must also be given to the question of whether the lessee's leasehold improvements might constitute income
to the lessor by reason of that second relationship. For example, if the lessee is a corporation all of whose stock is owned by the lessor, one form of dividend payment by the corporation would be the making of improvements on the shareholder's property. Thus, if the lessor controls the corporate lessee, care should be taken to avoid a tenancy at will or a short-term lease if the corporation is making improvements. The corporation should be given a lease for a term that will justify its making the improvements, lest the improvements be attacked as a dividend to the lessor on the ground that they are immediately subject to the control of the lessor-shareholder. 15

LESSEE'S PROBLEMS

Perhaps the most troublesome problem for the lessee in connection with leasehold improvements made by him is the determination of the period over which the lessee's improvements may be depreciated or amortized. The general rule is that the depreciation or amortization period will be the life of the improvement or the remaining period of the lease, whichever is shorter. 16 However, in ascertaining what constitutes the remaining period of the lease, a problem arises if the lease contains a renewal option, or if the lessor and lessee are related. These two areas are treated in new provisions which were added to the Internal Revenue Code by the Technical Amendments Act of 1958. 17

Prior to the 1958 amendments, if a lessee, having a lease with a renewal option, erected improvements and claimed the right to amortize the cost over the remainder of the original term of the lease, he could do so unless the lease had been renewed or there was a reasonable certainty that the renewal option would be exercised. 18 If there was a reasonable certainty that the renewal option would be exercised, however, then the renewal period had to be taken into account. This led to considerable litigation.

In the Technical Amendments Act of 1958, 19 Congress attempted to spell out a more objective test for determining when the term of a lease will, or will not, be treated as including a renewal period. What the statute does, in effect, is to create a pair of presumptions. If the lessee makes an improvement, and if, when it is completed, the remaining term of the lease (excluding renewals) is less than 60% of the useful life of the improvement, then the lease is treated as includ-

16. Treas. Reg. §§ 1.162-11 (b) (1) (1958), 1.167(a) (4) (1956). Where the tenancy of the lessee is for an indefinite period, however, depreciation deductions must be based upon the useful life of the improvement. See Ehrlich v. Commissioner, 198 F.2d 158 (1st Cir. 1952).
ing any renewal period, unless the lessee establishes that it is more probable than not that the lease will not be renewed.

Conversely, if the remaining term of the lease is 60% or more of the useful life of the improvement, then the renewal period is not taken into account, unless the lease has in fact been renewed, or the facts show with reasonable certainty that it will be renewed.20

Thus, the effect of the statute is to create one of two presumptions, depending upon whether or not the remaining lease term is equal to at least 60% of the life of the improvement. Further, the statute provides an escape hatch in either case. As a practical matter, however, in most cases those escape hatches will be difficult to use, and the 60% mathematical test will control.

This new provision will create some new problems, however. First, it places a premium on ascertaining accurately the useful life of the improvement. If, for example, the lessee has 20 years of his original term remaining, and he erects an improvement believed to have a useful life of 33 years, the 20-year remaining term of the lease is more than 60% of the estimated useful life of the improvement. Therefore, the lessee may expect to amortize the cost of the improvement over the remaining 20 years of the original lease term, without taking into account the renewal period. However, if the Commissioner successfully contends that the useful life of the improvement is not 33 years but 40 years, or even 35 years, that may be enough to change the result drastically. The 20-year lease term would then be less than 60% of the useful life of the improvement, and the lease would be treated as including the renewal period unless the lessee were able to sustain the burden of showing that it is more probable than not that the renewal option will not be exercised.21 Thus, in this area, there may be more arguments than heretofore about the useful lives of leasehold improvements.

The above problems are complicated by the fact that there must be a yearly re-examination of the question of whether the renewal period is to be considered. For example, if the remaining term of the lease equals more than 60% of the life of the improvement when the improvement is completed, so that the renewal period is not to be taken into account (absent facts showing with a reasonable certainty that the renewal option would be exercised), the matter is not closed. If, in later years, the facts show with a reasonable certainty that the renewal option will be exercised, the Commissioner may at that time require that the renewal period be taken into account and the amortization period adjusted accordingly.

Another problem may arise where there are successive renewal

21. If the lessee is required, for the period in which the improvement may first be depreciated by him, to compute the deduction on the basis of the useful life of the improvement, then the lessee may use any of the rapid depreciation methods authorized by § 167 of the Internal Revenue Code of 1954. See Treas. Reg. §§ 1.167(a)-4 (1956), 1.167(c)-1(c) (1956).
options. If the remaining term of the lease is less than 60% of the useful life of the improvement, then the lease is treated prima facie as including all renewal periods. The lessee, however, can adduce proof as to each renewal option separately, and may be able to show that it is more probable than not that a second renewal option will not be exercised, regardless of whether he was able to make such a showing with respect to the first renewal option.

Under the Internal Revenue Code of 1954, if the lessor and lessee were related, the lessee was generally able to amortize leasehold improvements over the life of his lease. This has been changed by the Technical Amendments Act of 1958.22 Under the new rule, if the lessor and the lessee are related persons as defined in the statute, then for purposes of determining the lessee's deductions for depreciation or amortization of an improvement, the lease is treated as including a period equal to the remaining useful life of the improvement. In effect, the lease is disregarded.

A lessee and lessor are considered to be related persons for this purpose if they are members of an affiliated group of corporations, or if the relationship between them is one described in Internal Revenue Code section 267 (relating to disallowance of losses between related persons), with some modifications.23 Therefore, if the lessor and the lessee are related in any way, care must be taken to check the statutory provisions and ascertain whether the relationship is one which will require the lessee to amortize leasehold improvements over the life of the improvements, rather than over the term of the lease.

With regard to the methods which may be used by the lessee for computing his deductions, the alternatives can be stated very simply. If the period over which the deductions are to be taken is the estimated life of the improvement, then the regulations provide that the deduction is depreciation, and the rules applicable to depreciation control, including the rules applicable to the rapid depreciation methods. On the other hand, if the period over which the deductions are to be taken is the term of the lease, then the regulations provide that the deductions must be spread ratably over the years of the lease, and the rapid depreciation methods are not available.24

If the lessee has made improvements and then buys the fee interest in the property from the lessor, the lessee's remaining unrecovered cost of leasehold improvements made by him on the property will be recovered by him through deductions for depreciation based upon the remaining useful life of the improvements. In addition,

22. INT. REV. CODE OF 1954, § 178 (b). For a discussion of the timing of such deductions see note 28, p. 183 and accompanying text.
23. The "more than 50 percent" ownership of a corporation provided for in § 267 is changed to "80 percent or more" for this purpose; and the family of an individual is defined to include only his spouse, ancestors, and lineal descendants. INT. REV. CODE OF 1954, § 178 (b) (2).
if in fact the amount paid in purchasing the fee is more than the fair market value of the land, and the excess is attributable to the improvements on the land erected by the lessee, the excess amount can be treated as an additional amount paid for the improvements, to be deducted over the remaining useful life of the improvements.\textsuperscript{25}

To summarize briefly, respecting leasehold improvements:

1. The lessor himself may incur leasehold improvement costs. Examples are special alterations or costs for acquiring the lease, or costs incident to demolition to make room for the lessee. Such costs generally must be amortized over the term of the lease.

2. The lessor must exercise great care respecting the lessee's leasehold improvements, lest they be taxed as income to the lessor. However, for the most part, this problem can be controlled by care in drafting, because improvements will not be treated as rent unless the intention that they should be so treated has been clearly indicated.

3. With regard to the lessee, the principal problem is the period over which his leasehold improvements should be depreciated or amortized. If there is a renewal option, then the code provides a new mathematical formula. If the lessor and lessee are related as defined in section 178, then, in effect, the lease term is disregarded.

4. As for the method of computing the lessee's deductions, if the life of the improvement controls, the deduction is depreciation and the rapid depreciation methods can be used. If the life of the lease controls, the deduction is amortization and the rapid depreciation methods may not be used.

\textsuperscript{25} Millinery Center Bldg. Corp. v. Commissioner, 350 U.S. 456 (1956).