

## Accounting

# Lease termination payments: Taxpayers should proceed with caution



**Sandy Klein**  
Shanholt Glassman  
Klein Kramer & Co.

Costs incurred to acquire property are required by taxpayers to be capitalized. When a lease is terminated as part of a transaction to purchase a piece of property, taxpayer's are generally required to capitalize the lease termination payment as part of the purchase price of the property. However, a recent case from the U.S. Court of Appeals for the 6<sup>th</sup> Circuit treated the amount paid in excess of the appraised value of the acquired property as a deductible lease termination payment.

In *ABC Beverage Corporation v. U.S.*, the taxpayer entered into a lease for a bottling plant. After concluding that the rent under the current lease

agreement was too high, the taxpayer exercised a purchase option on the plant. The lease provided a means for calculating the purchase price upon the exercise of the option. The purchase price was the greater of (a) the fair market value of the leased premises or (b) the sum of the acquisition cost and any prepayment penalty which may be payable under the note or mortgage covering the leased premises. As defined in the lease "Fair Market Value" shall mean the fair market value of the Leased Premises as affected and encumbered by this Lease and assuming that the Term has been extended for all extension provided herein. Both the taxpayer and the property owner secured appraisals on the property. The taxpayer's appraisal valued the property at \$2.75 million, and the property owner's appraisal valued the property at \$14.8 million. The taxpayer and the property owner

ultimately agreed upon a purchase price of \$9 million.

The taxpayer deducted as lease

that, in the absence of further direction by congress, property "acquired subject to a lease" didn't include

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termination payment \$6.25 million on its 1997 tax return and capitalized the remaining amount of \$2.75 million. The Sixth Circuit specifically rejected the IRS argument that the enactment of Code Sec. 167(c)(2) which required that (A) no portion of the adjusted basis shall be allocated to the leasehold interest; and (B) the entire adjusted basis shall be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease. The reasoning was that Code Sec. 167 (c)(2) applied to property "acquired subject to a lease" and

property for which the acquisition extinguished the lease. The property was subject to a lease before the plaintiff acquired it with plaintiff as lessee. Therefore, when plaintiff acquired the property, the leasehold merged with the larger estate and the property was no longer subject to a lease. In this 2014 case, the district court's grant of summary judgement in favor of ABC is affirmed. The plaintiff established the fair market value of the property, that the lease was excessive, and that the amount it paid to acquire the property over the fair market value of the property

is attributable to buying out the onerous lease.

In contrast, the 2000 tax court case with Union Carbide resulted in no deduction being allowed. Similarly, Union Carbide as lessee purchased a ship in which the lease payments exceeded the value of the ship they were leasing. Union Carbide to terminate the burdensome lease acquired the ship for \$108 million allocating \$94 million of the purchase price to the lease termination and claimed a deduction for that amount. The tax court disallowed the deduction holding that Code Sec. 167 (c)(2) applies even where the lease terminates immediately after the acquisition.

Taxpayers in similar situations still should proceed with caution when deducting lease termination payments. As they say in real estate, its location, location, location so to those within the purview of the Sixth Circuit may get a better result than those elsewhere. Taxpayers who believe they might be in a similar position should closely analyze which court they want to contest this issue in.

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**Sandy Klein, CPA, is a partner at Shanholt Glassman Klein Kramer & Co., New York, N.Y.**

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