10 T.C. 129 (1948)

Payments received by a lessor for the cancellation of a sublease are not excludable as abnormal income for excess profits tax purposes under Section 721(a)(2)(E) of the Internal Revenue Code when the payment is not directly related to the termination of the main lease and cannot be attributed to other tax years.

Summary

Swoby Corporation sought to exclude income received from its tenant for agreeing to the cancellation of a sublease, arguing it qualified as abnormal income under Section 721(a)(2)(E) of the Internal Revenue Code for excess profits tax purposes. The Tax Court ruled against Swoby, holding that the income did not arise from the termination of the primary lease, but from a sublease termination, and Swoby failed to demonstrate how the income was attributable to other tax years as required for abnormal income exclusion. The court emphasized the importance of tracing the income's origin to the specific lease termination and demonstrating its allocability to other years.

Facts

Swoby Corporation received a payment from its tenant in exchange for consenting to the cancellation of a sublease. Swoby's consent was necessary for this cancellation to occur. Swoby then argued that this payment should be excluded from its income as abnormal income for excess profits tax purposes under Section 721(a)(2)(E) of the Internal Revenue Code. The payment was the only one of its kind received by Swoby.

Procedural History

The Tax Court initially ruled against Swoby, finding a failure of proof regarding the abnormality of the income. Swoby then successfully moved to introduce further evidence. The Tax Court then issued a supplemental opinion adhering to its original conclusion but addressing the new evidence presented by Swoby.

Issue(s)

Whether income received by a lessor from its tenant as consideration for agreeing to the cancellation of a sublease constitutes abnormal income under Section 721(a)(2)(E) of the Internal Revenue Code and is thus excludable for excess profits tax purposes.

Holding

No, because the income resulted from the termination of a sublease, not the primary lease between Swoby and its tenant, and because Swoby failed to demonstrate that the income was attributable to other tax years, a requirement for abnormal income

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exclusion.

Court’s Reasoning

The Tax Court reasoned that Section 721(a)(2)(E) applies to income included in gross income “by reason of the termination of the lease,” implying a reference to the primary lease under which the taxpayer is the lessor. The court noted the legislative history of the section, pointing out that while the provision was broadened to include all income arising from “such” source, the intent remained focused on the relationship between the lessor and the primary lease. The court referenced *Helvering v. Bruun, 309 U.S. 461*, and *Hort v. Commissioner, 313 U.S. 28*, in its analysis. Moreover, the court emphasized that even if the income were considered abnormal, Swoby failed to demonstrate that it was attributable to other years. Citing *Premier Products Co., 2 T.C. 445*, and *E. T. Slider, Inc., 5 T.C. 263*, the court reiterated the requirement that abnormal income must be allocated to other years in light of the events from which it originated, per Regulations 112, sec. 35.721-3. The court found no basis for allocating any part of the payment to other years, noting, “Items of net abnormal income are to be attributed to other years in the light of the events in which such items had their origin, and only in such amounts as are reasonable in the light of such events.”

Practical Implications

This case clarifies the scope of Section 721(a)(2)(E) regarding abnormal income exclusion, emphasizing the importance of a direct link between the income and the termination of the primary lease, not a sublease. It also reinforces the requirement that taxpayers seeking abnormal income exclusion must demonstrate how the income is attributable to other tax years. For tax practitioners, this means that when advising clients on potential abnormal income exclusions related to lease terminations, they must carefully analyze the nature of the lease (primary vs. sublease) and be prepared to present evidence supporting the allocation of income to other tax years based on the events that gave rise to the income. This ruling has implications for how businesses structure lease agreements and manage lease terminations, particularly in scenarios involving subleases, to optimize their tax positions. Subsequent cases would likely distinguish *Swoby* if the income stream directly impacted the lessor’s anticipated revenue from its primary lease.

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