***Highland Amusement Co. v. Commissioner, 22 T.C. 112 (1954)***

A lessee cannot deduct as rent an amount accrued as a reserve for future equipment replacement when the lease agreement stipulates that such amount is retained by the lessee and not paid to the lessor.

**Summary**

Highland Amusement Company deducted a specific amount as rental expense, which was intended as a reserve for future equipment replacement per their lease agreement. The Tax Court addressed whether this amount, retained by the lessee and not paid to the lessor, qualified as a deductible rental expense. The court held that the retained amount did not constitute deductible rent because it was neither paid to nor accrued for the benefit of the lessor. The court also denied the deduction as a repair expense because the relevant expenses had not yet been incurred and therefore no liability had accrued.

**Facts**

Highland Amusement Co. leased five buildings with equipment, machinery, and fixtures under a 25-year agreement. The lease required Highland to pay a percentage of net sales as rent, with a $50,000 minimum. The lease stipulated that the lessor would maintain the exterior of the premises, while the lessee maintained the interior fixtures and equipment. An agreement was reached where the lessor provided an allowance to Highland, calculated as a percentage of the minimum rental or rental paid, for equipment repair or replacement. Highland accrued $1,641.56 as a reserve for equipment replacement, retaining this amount instead of paying it to the lessor.

**Procedural History**

The Commissioner of Internal Revenue assessed a deficiency against Highland Amusement Co., disallowing the deduction of the $1,641.56 as rental expense. Highland Amusement Co. petitioned the Tax Court for a redetermination. The Tax Court upheld the Commissioner’s determination.

**Issue(s)**

1. Whether the amount accrued by the lessee as a reserve for equipment replacement, but retained by the lessee and not paid to the lessor, constitutes deductible rent under Section 23(a) of the Internal Revenue Code.

**Holding**

1. No, because the amount was neither paid nor accrued to the benefit of the lessor, and thus does not qualify as a deductible rental expense.

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## Court’s Reasoning

The court reasoned that the lease agreement, considered in its entirety, effectively granted Highland a reduced rental amount to provide a fund for equipment replacement at Highland’s discretion. The $1,641.56 was not rent because it was not paid to the lessor, nor did it accrue to the lessor’s benefit. It was an amount deducted from payments to the lessor by mutual agreement. The court distinguished this case from those where the issue was whether funds received were trust funds or income, noting that here, the sum was never received by the lessor; it was retained by the lessee. Furthermore, the court held the amount could not be deducted as a repair expense as the expenses for which the reserve was created had not yet been incurred, and no liability had accrued. The court cited *Lucas v. American Code, Inc., 280 U. S. 445*; *Brown v. Helvering, 291 U. S. 193*; and *Amalgamated Housing Corporation, 37 B. T. A. 817*, affd. 108 F. 2d 1010 to support the principle that a deduction cannot be taken until liability for contingent expenses has been fixed and determined.

## Practical Implications

This case clarifies the requirements for deducting rental expenses, particularly in lease agreements involving reserves for future expenses. It demonstrates that a lessee cannot deduct amounts retained for their own use, even if related to the leased property, if those amounts do not represent actual payments to the lessor or accruals benefiting the lessor. Tax advisors and attorneys should carefully review lease agreements to determine if amounts designated as reserves truly constitute deductible rental payments. This ruling has implications for how businesses structure lease agreements and account for expenses related to leased property. It emphasizes the importance of demonstrating that a payment or accrual directly benefits the lessor to qualify as a deductible rental expense.

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