28 T.C. 933 (1957)

A 99-year leasehold cannot be amortized over the remaining life of a building on the leased property when the lessee did not construct or own the building, and a lease with options to terminate is not equivalent to a lease with renewal options for tax amortization purposes.

Summary

The U.S. Tax Court addressed two key questions in this case concerning the amortization of a leasehold for tax purposes. First, the court considered whether a 99-year lease could be depreciated over the shorter remaining life of a building on the leased property. Second, the court examined whether a 99-year lease with options to terminate at specific intervals was equivalent to a lease with an initial term equal to the interval until the first termination option, with renewal options. The court held that the leasehold could not be depreciated over the building's life and that the two types of leases were not equivalent for tax purposes.

Facts

In 1948, the Second Presbyterian Church leased property in New York City to B. R. D. Realty Corporation for 99 years. The lease included a building constructed in 1928 by a predecessor of the lessor. The lease allowed the lessee to terminate the lease at the end of the 25th, 50th, and 75th years. The B. R. D. Realty Corporation assigned the lease to a partnership. David Dab, the petitioner, acquired a 15% interest in the partnership. The partnership depreciated the leasehold over 20 years, the estimated remaining life of the building. The IRS allowed amortization over the full 99-year term, resulting in a deficiency determination for the Dabs.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the income tax returns of David and Rose Dab for 1950 and 1951. The Dabs challenged the determination in the United States Tax Court. The Tax Court reviewed the factual and legal arguments and rendered a decision in favor of the Commissioner, holding that the leasehold should be amortized over its entire term and not over the life of the building.

Issue(s)

1. Whether a 99-year lease can be depreciated or amortized over the estimated remaining life of a building located on the leased property when the lessee did not build or own the building.

2. Whether a leasehold for 99 years, with options to terminate after 25, 50, and 75 years, is the legal equivalent of a lease for a 25-year original term with options to renew.

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Holding

1. No, because the partnership did not have a depreciable interest in the building, and the leasehold's amortization period should be based on the lease term.

2. No, because the lease with termination options is an entity for 99 years unless affirmatively terminated, whereas a lease with renewal options has an original term with the possibility of extension.

Court's Reasoning

The court found that the partnership's depreciation of the leasehold over 20 years (the building's estimated remaining life) was erroneous because the partnership did not own the building and had no depreciable interest in it. The court cited *City National Bank Building Co.*, and *Weiss v. Wiener* to support its position that a taxpayer with a leasehold on land and improvements, but without a depreciable interest in the improvements, cannot deduct depreciation for the building or use its life as a base to depreciate the leasehold. The court referenced Section 29.23(a)-10 of Regulations 111, which addresses the amortization of leaseholds, emphasizing that amortization should occur over the lease term, not the building's life, when the lessee did not construct the building. The court distinguished cases where the lessee constructed the improvements. Regarding the second issue, the court held that a lease with options to terminate is distinct from a lease with renewal options. A lease with termination options remains in effect for the full term unless an option is exercised. In contrast, a lease with renewal options expires at the end of the original term unless renewed. The court held that the two types of leases were not equivalent for tax amortization purposes.

Practical Implications

This case clarifies the rules for leasehold amortization for tax purposes. It highlights that a lessee cannot depreciate a building on leased land if the lessee did not build or own the building. The decision emphasizes the importance of distinguishing between leases with termination options and those with renewal options. Taxpayers should consider the entire lease term when amortizing leaseholds for tax purposes. Real estate investors and businesses that lease property must carefully analyze the lease terms, the ownership of improvements, and the relevant tax regulations when calculating depreciation or amortization. This case underscores the importance of proper characterization of lease terms and its impact on tax liability.

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