Metropolitan Building Company, a Corporation in the Process of Voluntary Dissolution, Petitioner, v. Commissioner of Internal Revenue, Respondent, 31 T.C. 971 (1959)

The Tax Court distinguished between a leasehold transfer that was essentially a substitute for rental income (taxable as ordinary income) and a true sale of a leasehold interest (potentially subject to capital gains treatment), even when the amount received was based on future rental income.

Summary

The case involved a corporation, Metropolitan Building Co., which transferred portions of its leasehold interests. The first transfer involved the Olympic Hotel, where the company released its interest to the lessor in exchange for a payment from the sublessee, Olympic, Inc. The Tax Court held this payment as ordinary income, finding it was a substitute for rental income the company would have received. The second transfer was the remaining portion of the leasehold to a third party shortly before its expiration. The court determined this to be a sale of property, thus eligible for capital gains treatment under specific circumstances.

Facts

Metropolitan Building Co. (the "petitioner"), leased a significant portion of land in downtown Seattle from the University of Washington. Petitioner constructed office buildings and subleased space. In 1922, Petitioner subleased a portion of the land, where the Olympic Hotel was built. In 1952, the University was considering leasing the Olympic Hotel property to Olympic, Inc., the current sublessee. The University requested Petitioner to release its interest in the Olympic Hotel property. Olympic, Inc., paid Petitioner $137,000 for the release, with the amount calculated to approximate lost rental income and taxes under the existing sublease. In 1954, Petitioner transferred the remaining leasehold interest to Rostev Realty Corporation shortly before the lease expiration date and received $1,083,027 plus $9,778.50 for the furniture and fixtures. The Commissioner of Internal Revenue determined that both payments constituted ordinary income.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Petitioner's income and excess profits taxes for the fiscal years ending June 30, 1953, and June 30, 1954. The Petitioner disputed the determination, arguing that the amounts received from both transfers should be treated as capital gains. The case was heard in the United States Tax Court.

Issue(s)

1. Whether the $137,000 payment received by Metropolitan from Olympic, Inc. for the transfer of the Olympic Hotel property was ordinary income or capital gain.

2. Whether the $1,083,027 payment received by Metropolitan from Rostev Realty Corporation for the remaining leasehold interest constituted ordinary income or capital gain, considering that the lease was transferred shortly before its expiration.

Holding

1. Yes, the Tax Court held that the $137,000 payment was ordinary income because it was a substitute for rental income.

2. No, the Tax Court held that the transfer of the leasehold to Rostev Realty was a sale of property and the gain should not be recognized because of section 392(b) of the Internal Revenue Code of 1954.

Court's Reasoning

For the first issue, the court applied the principle in *Hort v. Commissioner*, where a payment received for the cancellation of a lease was deemed ordinary income. The court reasoned that, while the transaction involved a formal transfer of the leasehold, the substance was a payment from Olympic, Inc., to Metropolitan in exchange for Metropolitan canceling the sublease. The $137,000 payment compensated Metropolitan for the rental income and property taxes it would have received had the sublease remained in effect, thus replacing income that would have been received under the sublease. The court noted, "The purpose of the transaction was not only to free the property from petitioner's leasehold interest but also to secure a cancellation of the sublease."

For the second issue, the Court found the transfer of the entire remaining leasehold interest to Rostev Realty Corporation constituted a sale of property. The court noted that the transfer involved a substantial property right, not a mere assignment of future income. The court distinguished this from cases involving the assignment of income streams or the cancellation of a lease. The Court stated, "It is established law that the transfer of a leasehold interest, even if burdened with subleases by the lessee to a third party, constitutes a sale of property."