Union Carbide Foreign Sales Corp. v. Commissioner, 115 T. C. 423 (2000)

When a lessee acquires a leased asset, no portion of the acquisition cost may be allocated to the termination of the lease as a current business expense deduction.

Summary

Union Carbide leased a vessel and later faced burdensome lease terms. It had the option to either terminate the lease or acquire the vessel. Choosing the latter, Union Carbide paid $107,748,925, which was less than the termination cost. The company sought to allocate $93,883,295 of this amount as a business expense for terminating the lease, with the remainder as the vessel's basis. The Tax Court, interpreting I. R. C. § 167(c)(2), held that the entire acquisition cost must be allocated to the vessel's basis and cannot be split into a current expense for lease termination.

Facts

Union Carbide leased a specialized vessel, the Chemical Pioneer, in 1983 through a series of arrangements involving a trust and a partnership. By 1993, the lease became burdensome, and Union Carbide could either terminate the lease for a scheduled amount or purchase the vessel. It chose to acquire the vessel for $107,748,925, which was about 20% less than the termination cost. The agreed value of the vessel, excluding the lease, was $13,865,000. Union Carbide sought to allocate the difference between the purchase price and the vessel's value as a business expense for terminating the lease.

Procedural History

The Commissioner of Internal Revenue moved for partial summary judgment on the legal issue of whether I. R. C. § 167(c)(2) applied to Union Carbide's acquisition of the vessel. The Tax Court granted the motion, holding that the entire acquisition cost must be allocated to the vessel's basis, with no portion deductible as an expense for terminating the lease.

Issue(s)

1. Whether I. R. C. § 167(c)(2) applies to a lessee's acquisition of a leased asset when the purpose is to terminate the lease?
2. Whether a lessee who acquires a leased asset can allocate a portion of the acquisition cost to a current business expense for terminating a burdensome lease?

Holding

1. Yes, because I. R. C. § 167(c)(2) applies to any property acquired subject to a lease, irrespective of whether the lease continues post-acquisition.
2. No, because the entire acquisition cost must be allocated to the leased asset's basis and cannot be split into a current business expense for lease termination, as

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per I. R. C. § 167(c)(2) and existing case law.

Court’s Reasoning

The court interpreted I. R. C. § 167(c)(2) to mean that when property is acquired subject to a lease, no portion of the acquisition cost can be allocated to the leasehold interest. The court rejected Union Carbide’s argument that the statute only applies if the lease continues post-acquisition, finding that the statute’s language and legislative intent support its application to any leased asset acquisition. The court also relied on pre-existing case law, particularly *Millinery Ctr. Bldg. Corp. v. Commissioner*, which supported the allocation of the entire cost to the asset’s basis. The court noted that allowing a lessee to bifurcate the cost would create an unfair advantage over non-lessees, contrary to the statute’s purpose of uniform treatment.

Practical Implications

This decision clarifies that lessees cannot claim a current deduction for terminating a burdensome lease when they acquire the leased asset. It reinforces the principle that the entire cost of acquiring a leased asset must be allocated to the asset’s basis, to be depreciated over its useful life. Practitioners should advise clients to consider this ruling when structuring lease termination or asset acquisition transactions. The decision may impact businesses that frequently lease assets and later consider purchasing them to avoid ongoing lease obligations. Subsequent cases have followed this ruling, maintaining the integrity of I. R. C. § 167(c)(2) and its application to leased asset acquisitions.

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