Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:MAN:TL-N-7047-98
SDTillem

date:

to: District Director, Manhattan District
Examination Division, Branch 2, Group 1246
Attn: Ellis Rosenblatt, Manager
Valary Arthur, Revenue Agent

from: District Counsel, Manhattan District, New York

subject: [redacted]
EIN: [redacted]
Tax Year: [redacted]
Amortization of Leasehold Improvements
Statute of Limitations for [redacted] expires: [redacted] (Form 872)
Uniform Issue List # 162.09-03

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

We contacted John L. Trevey, Jr. of the National Office (CC:DOM:FS:IT&A) regarding this issue and confirmed that this advice is subject to 10 day post review by the National Office. Accordingly, we request that you do not act on this advice until we inform you of the National Office's comments, if any, about

this advice.

The statute of limitations on assessment for the [redacted] taxable year is currently set to expire on [redacted] pursuant to an executed Form 872.

This memorandum is in response to your request for advice concerning the proper period over which [redacted] should amortize the cost of leasehold improvements. This advice assumes that the facts are as represented herein.

Issue

Whether [redacted] should amortize $[redacted] of leasehold improvements over ten years based on the initial ten year term of its lease or over twenty years based on the initial term of its lease plus a ten year renewal term.

Conclusion

[redacted] should amortize its $[redacted] of leasehold improvements over twenty years because there is a reasonable certainty that its initial ten year lease will be renewed for an additional renewal period of ten years.

Facts

[redacted] is a limited partnership that operates a [redacted] and [redacted] complex located on the [redacted] which includes a [redacted], [redacted], [redacted] and [redacted]. [redacted] leases the [redacted] from [redacted] pursuant to a lease dated [redacted]. The lease provides for an initial ten year term expiring on [redacted], and a renewal option that allows [redacted] the right to offer to extend the lease for ten additional years. [redacted]'s offer to renew the lease is subject to a number of factors, including "impact on the community" and the "public interest." See Lease § 2.2.

Under the lease [redacted] (the lessee) agreed to pay a base rent of $[redacted] per year to [redacted] (the lessor) and to undertake $[redacted] in improvements to the leased property. The $[redacted] dollars of leasehold improvements is considered "additional rent" allocated pro rata over the ten year period of the lease pursuant to §§ 3.1(a) and (c) of the lease.

[redacted] was obligated under the lease to complete construction of [redacted] facilities, and [redacted], [redacted] and

[redacted] by [redacted]. See Lease [redacted] If [redacted] failed to use at least [redacted]% of the premises for its operations within sixty days of completing construction, [redacted] as the lessor had the right to take over the facilities. See Lease [redacted], [redacted], and [redacted]. As of [redacted], [redacted] completed the $[redacted] of the required leasehold improvements.

The lease also provides that [redacted] will pay [redacted] liquidated damages if [redacted] does not offer [redacted] the ten year renewal of the lease. The liquidated damages would be calculated by using the actual construction costs of the leasehold improvements less depreciation determined on a straight line or an accelerated depreciation basis, in each case utilizing useful life periods prescribed by I.R.C. § 168(i)(8). See Lease [redacted].

[redacted] and [redacted] amended the lease on [redacted], (the "[redacted] Amendment"). The [redacted] Amendment provides [redacted] additional renewal periods each for ten years. [redacted] has the unilateral right to offer the lessee an option to renew for each ten year period.

[redacted] refinanced its debts by executing a mortgage note with [redacted] on [redacted]. Pursuant to the refinancing agreement [redacted] advanced [redacted] $[redacted] under a first mortgage note with a maturity date of [redacted].

[redacted] deducted as a rent expense $[redacted] dollars on its U.S. Partnership Tax Return (Form 1065) for taxable year [redacted]. The $[redacted] dollar deduction was calculated using the cost of the $[redacted] dollars in leasehold improvements amortized over the initial term of the lease of ten years. The Service proposed amortizing the $[redacted] of leasehold improvements over twenty years based on the ten year lease plus the ten year renewal period under the lease dated [redacted]. The proposed adjustment decreases the rent expense by $[redacted] dollars in [redacted] (equaling the difference between the $[redacted] rent expense deducted by the taxpayer less the $[redacted] rent expense proposed by the Service). The leasehold improvements have a useful life in excess of twenty years.

Discussion

If improvements made by a lessee are a substitute for rent, the lessee's deduction takes the form of a deduction for rent. Your Health Club v. Commissioner, 4 T.C. 385 (1944). As a general rule, the rent deduction equals the cost of the leasehold

improvements spread over the term of the lease plus the renewal period if there is a reasonable certainty that the lease will be renewed. Treas. Reg. § 1-162-11. The question of whether the renewal period should be included in calculating the amortization period is a factual one. See, e.g., Hens & Kelly, Inc. v. Commissioner, 19 T.C. 305, 325 (1952)(for federal income tax purposes whether lease renewal periods should be taken into account is an intensely factual one.); Morris v. Commissioner, 38 T.C. 279 (1962) (the term of a lease for tax purposes depends on the court's assessment of all the facts concerning whether the lessor and lessee will renew the lease.)

In Jos. N. Neel Co. v. Commissioner, 22 T.C. 1083 (1954), the Tax Court found that the taxpayer/lessee was entitled to amortize rent paid in the form of improvements over the initial lease term plus one renewal term. Under the terms of the lease, the lessee had an option to renew the initial seven year and eight month term for two ten year terms. In addition to a base rent, the lease required the lessee to spend $250,000 for improvements to the leasehold property during the initial term of the lease. The lessee argued that only the initial seven year and eight month term of the lease should be used for amortization purposes. The court rejected the lessee's position and found that the facts show with a reasonable degree that the lease will be renewed for at least the first ten year renewal period. Accordingly, the court held that the proper period over which amortization should be spread is 17 years 8 months. In making its findings the court considered the relationship of the lessee and lessor and the cost of the leasehold improvements.

In determining whether there is a reasonable certainty that a lease will be renewed courts have also considered the following factors:

1. Damages if the lease is not renewed. Commissioner v. Philadelphia Coke Co., 130 F.2d 87 (3d Cir. 1942);

2. Economic conditions. Hens & Kelly, Inc. v. Commissioner, 19 T.C. 305 (1952); and

3. Taxpayer's failure to prove that nonrenewal was more probable than renewal. Spritzer v. Commissioner, 55 T.C. Memo. 1988-463.

In the instant case, we believe there is a reasonable degree of certainty that the lease will be renewed for the ten year term primarily because [redacted] as the lessor will be subject to liquidated damages if it does not exercise the ten year renewal option. See Lease § 2.2(b). Accordingly, it is likely that [redacted]

[redacted] will renew the lease to avoid paying the liquidated damages. [redacted] has no right to any liquidated damages from [redacted] if the lease is not renewed beyond the twentieth year. See Lease § 22.1. Hence, there is less certainty that the lease will be renewed beyond twenty years pursuant to the [redacted] Amendment of the lease.

As of [redacted], [redacted] has been current with its rental payments and completed extensive capital improvements. Over the first ten years of the lease [redacted] will have paid $[redacted] in rent ($[redacted] in rent a year for ten years) plus have made leasehold improvements in excess of $[redacted]. [redacted] stated that if [redacted] offers to renew the lease it will accept the offer. Such additional factors enhance the probability that the lease will be renewed for the ten year renewal term.

[redacted] argues that the fact that [redacted] would only refinance its debt with a ten year mortgage note as opposed to a twenty year note, indicates that it is unlikely the lease would be renewed beyond ten years. However, it is conceivable that [redacted] requested a ten year mortgage period as opposed to a longer term so that it would incur less in interest expense. In fact, [redacted] only undertook the refinancing after [redacted] amended its lease to include additional renewal periods. Accordingly, [redacted] would probably not be able to refinance its debts at all, if it did not have a reasonable chance of renewing its lease. In addition, it is also probable that [redacted] initially persuaded investors to become limited partners by convincing them that the lease would be renewed.

We also find unpersuasive [redacted] argument that [redacted] could succumb to public opposition to [redacted] and refuse to renew the lease. [redacted] is a viable rent paying business and has presented no convincing evidence that the public has pressured [redacted] to shut them down.

In summary, if improvements made by a lessee are a substitute for rent, the lessee's deduction takes the form of a deduction for rent. Your Health Club v. Commissioner, 4 T.C. 385 (1944). Such deduction equals the cost of the improvements spread over the term of the lease plus the renewal term if there is a reasonable certainty that the lease will be renewed. Treas. Reg. § 1-162-11. The question of whether a lease renewal term should be taken into account in calculating the amortization period of leasehold improvements is a factual one. Morris v. Commissioner, 38 T.C. 279 (1962). In the instant case, it appears there is a reasonable certainty that the lease will be

renewed for the additional ten year term based on the following facts:

1. [redacted] as lessor will have to pay a substantial sum in liquidated damages to [redacted] if the lease is not renewed for the additional ten year term.

2. [redacted] has made extensive capital improvements to the leased property and has stated it would renew its lease if [redacted] offers the renewal option.

3. [redacted] is in compliance with its lease and has presented no substantial reason why [redacted] would not offer the ten year renewal term.

For the foregoing reasons, we conclude that [redacted] should amortize its $[redacted] dollars of leasehold improvements over twenty years as opposed to ten years.

If you have any questions regarding this memorandum please contact Attorney Steven Tillem at (212) 264-5473 or Attorney Isaac Malul at (212) 264-1595.

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