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# "Union Carbide"—Tax Consequences Upon the Purchase of Leased Property

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When property is acquired subject to a lease, section 167(c)(2) of the Internal Revenue Code (the "Code") provides that no portion of the property's adjusted basis (generally, its cost) may be allocated to the leasehold interest. Instead, the entire cost must be taken into account in determining the depreciable basis of the property subject to the lease.

Since the remaining term of such a lease is frequently much shorter than the applicable recovery period for the underlying property, the requirement that the entire cost be allocated to the property can have a substantial negative impact on the timing of deductions.

The Tax Court recently addressed whether section 167(c)(2), which was added to the Code in 1993, applies where property subject to a lease is purchased by the lessee and, as a result, the lease is terminated. The Tax Court held that section 167(c)(2) applies in these circumstances, such that the entire purchase price must be allocated to the property even if, as alleged by the petitioner, the value of the terminated lease to the lessor greatly exceeded the value of the underlying property itself. *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. No. 32 (2000).

## Facts

The transactions described in *Union Carbide* relate to a seagoing vessel completed in 1983 in accordance with the specifications of the petitioner (referred to in this article as "Carbide"). To prevent the vessel (and, presumably, associated debt obligations) from appearing on Carbide's balance sheet, the ship was acquired by a grantor trust created by Merrill Lynch Leasing, Inc. The trust leased the ship for 20 years, under a "Bareboat Charter," to a partnership comprised of an affiliate of Carbide and an unrelated entity.

The partnership then entered into a contract with Carbide under which Carbide was entitled to 75% of the ships capacity and was responsible for all of the payments due under the Bareboat Charter. The partnership also entered into agreements with affiliates of the unrelated partner to manage and operate the ship and to market ship capacity not used by Carbide.

The Bareboat Charter granted Carbide the right to terminate the lease, without acquiring the ship, through payment of a scheduled amount.

Carbide did not exercise the termination right. In December, 1993, however, Carbide purchased the interest of Merrill Lynch in the trust for approximately $107 million, about 20% less than the amount Carbide would have had to pay to terminate the lease without acquiring the ship.

Thereafter, no further payments were made under the Bareboat Charter. In June, 1994, the Bareboat Charter and various related contracts were canceled and Carbide acquired title to the ship from the trust.

The opinion does not state how these transactions were reflected on Carbide's tax returns. In the Tax Court proceedings, Carbide asserted that section 167(c)(2) by its terms did not apply; that the difference between (i) the amount paid for the ship and (ii) the value of the ship (alleged to be only $14 million) was allocable to the termination of a burdensome lease; and that the amount allocable to the termination of the lease was deductible in the year of acquisition because the lease was terminated.

The Commissioner's position was apparently that section 167(c)(2), as well as prior case law that would be controlling if section 167(c)(2) did not apply, required that the entire amount paid be included in the cost basis of the vessel, and the Commissioner moved for partial summary judgment on this issue.

For purposes of the summary judgment motion, the Commissioner conceded that the lease was burdensome from the lessee's perspective and that the value of the ship without regard to the lease was as alleged by Carbide. The court also accepted, for purposes of considering the motion, the petitioner's assertion that the lease terminated upon acquisition of the ship, rather than surviving the purchase and terminating thereafter.

Thus, the court said, it had to decide "whether a lessee of an asset who purchases that asset for the purpose of terminating the lease is subject to section 167(c)(2)."

## Applicability of Section 167(c)(2)

Section 167(c)(2) applies by its terms "[i]f any property is acquired subject to a lease." Carbide argued that the phrase "subject to a lease" modifies its immediate antecedent, the word "acquired," such that section 167(c)(2) applies only if an acquisition of property is made subject to a lease and the property, when acquired, remains subject to that lease.

The Commissioner argued, conversely, that "subject to a lease" effectively modifies the term "property" as well, such that the statutory provision should be read to apply so long as the property acquired is subject to a lease at the time the property is transferred.

The court concluded that neither of these interpretations of the statute was clearly more convincing than the other, and also found that the legislative history did not address this question specifically.

The court observed that section 167(c)(2) applies in the same manner whether a lease has a remaining term of 1 day or 10 years at the time of the purchase of the underlying property. This, in the court's view, made it difficult to accept Carbide's argument that section 167(c)(2) did not apply if the purchase had the effect of terminating the lease immediately.

The court also reasoned that, under Carbide's interpretation, the application of section 167(c)(2) might be easily avoided "merely by a simultaneous acquisition of tangible property, cancellation of the 'existing lease', and the renegotiation of a new lease." It is not clear to the authors exactly how a third party purchaser would, as a practical matter, effect a transaction such as the one described by the court.

The court also noted the statement in the legislative history to the effect that all costs incurred in connection with the acquisition of property subject to a lease, including those attributable to the acquisition of the lessor's interest under the lease, were to be capitalized as part of the depreciable cost of the real property. Carbide's interpretation of the provision would lead to a contrary result, at least where the property was being purchased by the lessee.

Taking all of the above into account, the court concluded that section 167(c)(2) was applicable and denied the immediate deduction sought by Carbide.

## Prior Case Law

The court further concluded that, even if section 167(c)(2) had not been enacted, the same result would have been reached under the case law.

Carbide's argument for an immediate deduction was supported by *Cleveland Allerton Hotel, Inc. v. Commissioner* (166 F.2d 805 (6th Cir. 1948)). In that case, the Court of Appeals for the Sixth Circuit, reversing the Tax Court, concluded that, where the owner of a hotel built on land subject to a ground lease acquired the land for a price well in excess of the unimproved value of the land, that excess could be deducted currently as a business expense incurred to extinguish the lease.

By contrast, in *Millinery Center Building Corp. v. Commissioner* (221 F.2d 322 (1956)), the Court of Appeals for the Second Circuit concluded, in circumstances that were similar to those in *Cleveland Allerton*, that the excess of the amount paid to acquire the land over the unimproved value of the land should be included in the cost of the building.

The Court of Appeals decision in *Millinery Center* was reviewed by the Supreme Court (350 U.S. 456 (1956)). After noting the apparent conflict between the Court of Appeals decisions in *Cleveland Allerton* and *Millinery Center*, the Supreme Court affirmed the decision of the Second Circuit to the effect that no immediate deduction was allowable. In doing so, however, the Court observed that the petitioner had failed to establish that it was paying excessive rent or that the purchase price represented anything more than the cost of acquiring the complete fee interest in the land and the building.

The Tax Court in *Union Carbide* concluded that, in light of *Millinery Center*, the vitality of the *Cleveland Allerton* decision was questionable, and also noted that any appeal of the Tax Court's decision would go to the Court of Appeals for the Second Circuit, which had rejected in *Millinery Center* the reasoning of the Sixth Circuit in *Cleveland Allerton*. Thus, *Millinery Center*would be controlling, and would preclude the result sought by Carbide, even if section 167(c)(2) were not applicable.

The Tax Court further observed that "it may also be fair to say that Congress was aware" of the Supreme Court's holding in *Millinery Center* when section 167(c)(2) was enacted in 1993. Thus, it seems likely that Congress would have made clear at that time any intention to alter the then prevailing rule regarding the allocation of purchase price where property is purchased by the lessee.

Finally, the Tax Court observed that it could not think of any reason to allow a lessee a more favorable result, through a current deduction, than would apply under section 167(c)(2) if a purchaser other than the lessee acquired the property.

## Observations

A strong argument can be made that the immediate deduction of any amount paid in excess of the value of the tangible property, as sought by Carbide, would provide a better match between the time of economic realization of a loss and the timing of the related tax deduction, since the excess amount paid in such circumstances is not attributable to any continuing asset of the lessee. It might also be argued that, if section 167(c)(2) does not apply, *Millinery Center* could be distinguished on the basis of facts alleged in *Union Carbide* that were not established in the earlier case.

The holding of *Union Carbide* does, however, appear to achieve the correct result under current law, either because section 167(c)(2) applies or, if it does not, because the case law discussed in the opinion prohibits the claimed deduction. The decision, therefore, seems likely to be sustained if it is appealed.

Section 197 and other reforms enacted in 1993, relating to the treatment of intangible property, were also intended, more generally, to reduce litigation of fact-dependent issues and the importance of sophisticated tax advice and the availability of experts to establish, for example, the expected life of an intangible asset or the value or economic burden of a contractual obligation; and to achieve greater predictability of tax results. Allowing Carbide to bifurcate the transaction, and to allocate a portion of the consideration to the lease that was terminated, would be inconsistent with some of these objectives.

*Union Carbide* is also a reminder of the importance of tax planning to achieve the most favorable possible result with respect to transactions involving the termination of a lease or other contract rights. Although perhaps not feasible as a business matter for the taxpayer in the *Union Carbide* case, in many circumstances a payment made to terminate an unfavorable lease of real or tangible personal property may result in a more immediate tax benefit to the payor if the termination is not associated with the acquisition of the underlying property.