

Internal Revenue Service

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Department of the Treasury

P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:5 — PLR-104662-00
Date: 8-10-00

In re: Request for Private Letter Ruling under § 1241 of the Internal Revenue Code

Legend:

Taxpayer =

Premises =

Building =

Agency 1 =

Agency 2 =

Court =

Statute =

Corp =

City =

c =

d =

f =

g =

h =

j =

m =

n =

s =

t =

u =

v =

w =

Dear

This letter responds to a letter dated February 16, 2000, submitted on behalf of Taxpayer, requesting a private letter ruling regarding the application of § 1241 of the Internal Revenue Code to a payment to Taxpayer to terminate his rights in the Premises.

Taxpayer represents the following facts:

In c, Taxpayer entered into a g-year commercial lease, with Taxpayer as tenant, for the Premises (a rental unit in the Building). Taxpayer continued to renew the lease for d years until w (changing the named tenant on the lease to Corp, the name under which Taxpayer was doing business, in t).

On f, Taxpayer filed a rent overcharge complaint against the landlord with Agency 1, the agency formerly charged with enforcing City's rent control laws. In the complaint, Taxpayer claimed that during the course of Taxpayer's occupancy, the predominant use of the Premises had been residential, and that the Premises were, therefore, subject to the applicable rent control law. Taxpayer continued to occupy the Premises without a written lease.

After protracted proceedings, on h, Agency 2, the agency currently charged with the duty of administering the rent control program, issued a final order determining that the predominant use of the Premises had been residential, and that the Premises continuously had been subject to rent control law from the time Taxpayer took occupancy. This final order was upheld on j, by the Court.

City's rent control law gives a tenant the right to continued possession of a property and establishes the maximum rent that may be charged. This right of possession is for an indefinite time period. The landlord may evict such a tenant only under specific circumstances as listed in the Statute.

As a result of the determination that the Premises were subject to the rent control law, the landlord agreed to pay Taxpayer \$s in return for Taxpayer surrendering all lease and statutory rights to the Premises. This agreed sum represents \$m plus \$n to cover estimated taxes. The estimated tax amount was determined under the assumption that Taxpayer's gains from the transaction would be treated as capital

gains. Further, the landlord agreed to pay an additional amount, up to \$u, plus interest and penalties, if the Internal Revenue Service determines that the gain is ordinary. Finally, the landlord agreed to pay \$v to a law firm to cover Taxpayer's legal fees.

Section 61 provides that gross income includes all income from whatever source derived, except as otherwise provided by law. A taxpayer's § 61 gross income is not limited to the actual receipt of gain, but also includes the receipt of any economic benefit unless excluded by law. See Glenshaw Glass Co. v. Commissioner, 348 U.S. 426 (1955). A payment on behalf of a taxpayer generally would cause the taxpayer to be in receipt of an economic benefit, and thus § 61 gross income. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929). Payment by the purchaser of the seller's taxes and legal fees in connection with the sale of real property are included in the purchase price of the property. Rev. Rul. 57-565, 1957-2 C.B. 546.

Gain from the sale or exchange of an asset held for more than one year is treated as long-term capital gain if the asset disposed of is a capital asset as defined in § 1221. Section 1221 defines the term "capital asset" as property held by the taxpayer (whether or not connected with the taxpayer's trade or business), unless the property meets one of the listed exceptions. Section 1221 excludes the following five categories of property from the definition of capital asset: 1) inventory; 2) property of a character that is subject to the allowance for depreciation provided in § 167, or real property used in a trade or business; 3) certain intangible property; 4) accounts receivable acquired in the ordinary course of trade or business; and 5) certain publications received from the United States government.

Section 1222(3) defines long-term capital gain as gain from the sale or exchange of a capital asset held for more than one year.

Gain from property described in § 1221(2), *i.e.*, real property used in a trade or business, though excluded from capital asset treatment by § 1221, may still give rise to long-term capital gains treatment under § 1231. Section 1.1221-1(b) of the Income Tax Regulations specifically provides that gains or losses from the sale or exchange of property described in § 1221(2) are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in § 1231.

Section 1231 provides capital gain treatment for property used in a trade or business (provided § 1231 gains exceed § 1231 losses). Section 1231(b) defines "property used in the trade or business" as property used in a trade or business, of a character that is subject to the allowance for depreciation under § 167, held for more than 1 year, and real property used in the trade or business, held for more than one year, which is not: 1) inventory; 2) property held by the taxpayer primarily for sale to customers in the ordinary course of taxpayer's trade or business; 3) certain intangible property; or 4) certain publications received from the United States Government. None of these exceptions apply to this case.

We note that § 1231, rather than § 1221, may apply to the instant case because the facts indicate that Taxpayer's leasehold may have been used in part, or for a portion of the lease period, for the conduct of Taxpayer's business. Business use of real property precludes that property from receiving capital asset treatment under § 1221(2). However, we do not need to determine whether the leasehold is excluded under § 1221(2) because it will either be a § 1221 capital asset or a § 1231 asset. In either case, the gain recognized on the exchange of the leasehold will be capital, rather than ordinary.

In Rev. Rul. 72-85, 1972-1 C.B. 234, the Service determined that a leasehold of land used in a trade or business is § 1231 property, even if it is of indefinite duration. This revenue ruling clarified Rev. Rul. 56-531, 1956-2 C.B. 983, which holds, in part, that the Service acquiesces in McCue Bros. & Drummond, Inc. v. Commissioner, 19 T.C. 667 (1953), acq. 1956-2 C.B. 7, aff'd, 210 F.2d 752 (2d Cir. 1954), cert. denied, 348 U.S. 829 (1954).

The petitioner in McCue Bros. leased a hat shop in New York City. For a portion of his occupancy, the petitioner held the property under a written lease. However, after the lease expired, the petitioner continued to occupy the property under a "statutory tenancy" by virtue of the New York rent control laws that had taken effect shortly before the end of the written lease. In affirming the Tax Court in McCue Bros., the Second Circuit stated that it was immaterial whether the petitioner held the property under a lease or through the rent control laws. The court stated, "we think the right of possession under a lease or otherwise, is a... substantial property right which does not lose its existence when transferred. If it is sold by the tenant to a third person, the gain derived therefrom is a capital gain." 210 F. 2d at 753. The court further stated that the holding period began when the statutory right of possession attached. Id. At 754.

In Stotis v. Commissioner, T.C.Memo. 1996-431, the Tax Court came to a similar result in the case of a residential leasehold. Mr. Stotis, the petitioner, leased space in an apartment building that he used as a residence. The landlord, desiring to use the real estate for other purposes, entered into a surrender agreement with the petitioner whereby the petitioner exchanged his right in the property for a cash payment. The Tax Court held that the petitioner's leasehold interest in a residence was a capital asset, and that the petitioner's sale of the leasehold interest constituted a sale or exchange, taxable as capital gain.

The facts of this case are not clear as to whether the property in question is properly treated as real property used in the trade or business for purposes of §§ 1221 and 1231. If it is not real property used in the trade or business, the leasehold interest is a capital asset under § 1221. If it is real property used in the trade or business, any gain attributable to the sale or exchange of the leasehold interest is treated as long-term capital gain under § 1231. Taxpayer's holding period began with the vesting of the statutory right of occupancy on c. Therefore, Taxpayer held the property for more than one year. Additionally, Under Rev. Rul. 72-85, the fact that Taxpayer's leasehold interest under the rent control laws was for an indefinite period does not preclude

§ 1231 long-term capital gain treatment.

Under § 1241, amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), are considered as amounts received in exchange for such lease or agreement.

Based on the foregoing, we conclude that the amounts received by Taxpayer are considered amounts received in exchange for Taxpayer's leasehold interest in the Premises. Further, we conclude that Taxpayer realized long-term capital gain on the sale of the leasehold interest. Taxpayer's interest in the Premises is either a capital asset under § 1221 or real property used in the trade or business under § 1231. In either event, gain realized from the sale of the leasehold interest is treated as long-term capital gain. Payments of the legal fees and income taxes are part of the purchase price to the extent that such payments are given in exchange for Taxpayer's leasehold interest and not for Taxpayer abandoning some other legal right or property not related to the transaction in question.

According to the power of attorney on file with the ruling request, a copy of this letter was sent to Taxpayer.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,
Harold E. Burghart
Assistant to the Branch Chief, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

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