LEASE PROVISIONS:

What Happens When You End a Lease Early for a Nonprofitable Location

By Aric Wong, CPA, MBT | Senior *Manager - Tax*

The pandemic has caused many restaurants to close due to a loss of revenue. Even after the reopening of dine-in restaurants in California, many anticipate significantly reduced revenues for a long time. Rent payments are such a big component of the fixed costs that they strongly influence a restaurant's ability to survive. For restaurants with multiple locations, it may be decided to terminate a lease early for locations that have not been historically profitable and/or may not ever be profitable now that the pandemic is in place for years to come.

NEGOTIATING YOUR LEASE TERMS

A restaurant may want to consider negotiating your existing lease terms with the landlord before deciding to terminate the lease completely. A good point of contention is that the landlord allows you to pay a reduced percentage of the rent rather than them being stuck with a vacancy for an unknown period. If negotiations fall through or a restaurant's financial health would not allow any lease payments to continue, the only option is to move out and pay the lease termination fees. Many tax considerations need to be analyzed and understood when this situation is contemplated.

LEASE TERMINATION PAYMENTS

Any amounts paid towards lease cancellation to a landlord are generally considered deductible in full in the year paid since it is essentially considered a substitute for rental payments. Since it is an ordinary deduction, this will lower the restaurant's taxable income (or increase the loss).

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However, an exception would apply if the lease termination payment was made to acquire a new property. The IRS privately ruled[1] that a lease termination payment made by a tenant couldn't be deducted when paid because it was made as part of an overall plan to acquire another site and relocate there. The payment has to be capitalized as part of the cost of acquiring the new lease. Under the termination agreement with the landlord of the original site, the tenant's right to terminate was expressly conditioned upon acquisition of the new location and commencement of construction there. The lease payment wasn't considered damages in relief of an uneconomic contract; thus, it wasn't deductible but rather capitalized and amortized over the new lease term.

LEASE TERMINATION AGREEMENTS

Many times in a lease termination agreement, the restaurant tenant would leave behind the equipment, furniture, and fixtures as partial consideration of the lease termination fees as well as the leasehold improvements attached to the building. All of these items that are not retained would be considered abandoned thus eligible for Sec. 1231 loss treatment by reference to the remaining tax basis in these assets. If the restaurant is set up as a pass-through entity for tax purposes, such as an S corporation, partnership, or LLC, then the Sec. 1231 loss would flow through to the owners on their Schedule K-1 to be used on their personal tax returns.

Since these losses are done under Section 1231 of the Internal Revenue Code, they are not subject to the usual capital loss limitation of $3,000 per individual return. Still, they can be favorably offset against other ordinary income (other business income, etc.).

It is essential that a lease agreement is carefully analyzed for any requirements of a tenant to repair or replace property at lease termination because the components of any lease termination payment need to be understood.

KROST Restaurant Accountants & Consultants can help you navigate through your lease agreement to avoid lease termination. Contact us today. ■

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[1] *IRS Private Letter Ruling 9607016*