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IMPROVEMENTS, COST — INSTALLED BY TENANTS ON PROPERTY LEASED UNDER SHORT TERM LEASES — WHEN CARRIED ON ACCOUNTING RECORDS OF TENANT — DEFERRED ITEMS — DESIGNATED “LEASEHOLDS” OR “LEASEHOLD IMPROVEMENTS” — TO BE AMORTIZED OVER DURATION OF LEASE — SUCH ITEMS “PREPAID ITEMS” — SECTION 5327 G. C.

SYLLABUS:

When the cost of improvements installed by tenants on property leased under short term leases is carried on the accounting records of the tenant as deferred items under the designation of "leaseholds" or "leasehold improvements" to be amortized over the duration of the lease, such items constitute "prepaid items" within the meaning of that term as used in Section 5327 of the General Code.

Columbus, Ohio, January 13, 1944

Hon. William S. Evatt, Tax Commissioner
Columbus, Ohio

Dear Sir:

Your request for my opinion reads as follows:

"In auditing personal property tax returns of persons engaged in business, this department is frequently confronted with the question of the taxability of certain items set forth in the balance sheets of such taxpayers which are usually designated as 'leaseholds' or 'leasehold improvements'. Such balance sheet items result from improvements having been made by the lessee to the leased real estate. The amounts so expended by the lessee for such improvements may be either amortized over the period of the lease, or, immediately charged off within the year, depending upon the method of accounting used, Your opinion is respectfully requested as to whether, in either of the above cases, such item or items constitute 'prepaid' items within the term 'credits' as defined in Section 5327, General Code.

Attention is directed to an opinion of one of your predecessors appearing in Opinions of the Attorney General for 1935, Volume III, page 1599."

For the purposes of this opinion, I am assuming that the leases referred to in your inquiry are those popularly referred to as "short term leases" rather than "long term" or "perpetual leaseholds" and that the leasehold improvements therein referred to are the installations of equipment, partitions, lighting fixtures, shelving or other equipment constructed or installed for the purpose of making the leased premises more suitable to the business of the lessee, which items at the termination of the lease will either belong to the landlord by reason of the covenants contained in the lease, or which, if removed at the end of the lease, would be of little value to the lessee and that they do not con-

sist of buildings or structures erected upon vacant lands leased under a long term leasehold.

Your inquiry arises by reason of the definition of "credits" contained in Section 5327 of the General Code which reads:

"The term 'credits' as so used, means the excess of the sum of all current accounts receivable and prepaid items (used) in business when added together estimating every such account and item at its true value in money, over and above the sum of current accounts payable of the business, other than taxes and assessments. 'Current accounts' includes items receivable or payable on demand or within one year from the date of inception, however evidenced. 'Prepaid items' does not include tangible property. In making up the sum of such current accounts payable there shall not be taken into account an acknowledgment of indebtedness, unless founded on some consideration actually received, and believed at the time of making such acknowledgment to be a full consideration therefor; nor an acknowledgment for the purpose of diminishing the amount of credits to be listed for taxation."

The syllabus of the opinion of one of my predecessors referred to in your inquiry which defines "prepaid items", reads: (Opinions of the Attorney General for 1935, No. 4969, Vol. III, page 1599)

"The term 'prepaid items' as the same is used in section 5327, General Code, defining the term 'credits' for purposes of taxation, includes all items of prepayment made by the taxpayer in the conduct of his business by which rights accrue to the taxpayer over the period of time covered by such prepayment, which, by recognized and proper accounting practice, may be set up as prepaid items as an asset of the taxpayer, and which on tax listing day have an actual value in money amortized as of said date."

In arriving at such conclusion my predecessor in office made the following observations:

"Two views are suggested as to the meaning of the term 'prepaid items' as used in the section of the General Code above quoted. The first view limits the meaning of this term to such prepayments as, when the same are made, create an actual or potential account receivable in favor of the corporation or other person making prepayment of the item in question. Thus, prepayment of premiums on certain kinds of insurance creates a right in the insured which may on cancellation of the insurance policy result in an account receivable in favor of such insured person. The other view which is suggested with respect to the meaning of this term is based upon a supposed

recognition by the legislature of recognized accounting practice in setting up certain items as prepaid items on the asset side of the balance sheet of persons engaged in business, and leads to the conclusion that this term as used in the section of the General Code above quoted is intended to include all such items as according to recognized and proper accounting practice are set up as assets of the taxpayer. Looking to the theory upon which prepaid items in this view are made taxable, it is to be recognized, for example, that although a prepayment of rent for an extended period of time such as a year or more would not ordinarily result in an account receivable to the taxpayer making such prepayment in case of his removal from the leased premises before the expiration of the term of his prepaid lease, such taxpayer but for such prepayment of rent would thereafter have in possession in the form of money, bank deposits or inventory, property or wealth of some kind which would be taxable. And in this view, it seems but right and just that the right thus accruing to the taxpayer by reason of such prepayment should be taxed at the amortized true value which such right may have on the day as of which the same is listed for taxation. This in my opinion is the purpose and legislative intent indicated by the inclusion in the term 'credits' of the rights of the taxpayer therein designated as 'prepaid items'.

This view with respect to the meaning of this term as the same is used in section 5327, General Code, is supported to some extent by certain provisions contained in section 5328-2, General Code, which section, among other things, allocates to this state for purposes of taxation certain classes of intangible property accruing in the conduct of business in this State by non-residents and which but for the provisions of this section and of section 5328-1, General Code, might be taxable only in the state where the owner of such intangible property resides. Section 5328-2, General Code, in so far as the same is pertinent to the question here presented, provides:

'Property of the kinds and classes herein mentioned, when used in business, shall be considered to arise out of business transacted in a state other than that in which the owner thereof resides in the cases and under the circumstances following: * * *

In the case of prepaid items, when the right acquired thereby relates exclusively to the business to be transacted in such other state, or to property used in such business.'

The above quoted language of section 5328-2, General Code, lends color to the view that the term, 'prepaid items' includes all continuing rights created by a prepayment made in the course of business conducted by such taxpayer and relating to such business."

In "Accounting in Law Practice", by Graham & Katz, at page 72,

the authors define for accounting purposes what is properly referred to as "prepaid items", as follows:

"A deferred or prepaid expense is an asset which represents an amount paid but not yet consumed."

Again on page 21 such authors, in discussing subdivisions of a balance sheet, describe such items as follows:

"The *current assets* section includes those items which in the ordinary course of the business would be converted into cash in a relatively short period of time, perhaps six months or a year. The second division, *prepaid expenses*, includes items for which expenditures have been made but which have not yet been consumed and will be consumed in a relatively short period, perhaps a year."

In Paton's "Accountants' Handbook", Second Edition, pages 300 to 305, the author describes the types of items which are usually regarded as "prepaid expense" and includes insurance premiums which usually pay in advance the premium on the insurance for from one to three years, rent which is often prepaid for a period of a month or more, transportation charges, prepaid wages and salaries, office supplies, drawing accounts, royalties and prepaid interest. On page 303 of such work such author states as follows:

"Rent is often prepaid from month to month and in some cases for much longer periods. Rent arises most commonly in connection with the use of land and buildings, but there are also many cases in which movable equipment, such as railway cars and motor vehicles, are leased, and more or less rare examples can be found of the hire of almost every kind of tangible asset. The right of the lessee, assuming payment has been made in advance, consists in a valid claim to the use of the property, under agreed conditions, for the period covered by the payment. The amount of any such prepayment is undoubtedly a legitimate asset, to the payor, and in the event that more than one period is covered by the particular payment it is necessary at the close of each period to determine the amount expired and set up the new asset balance.

Long-term prepayments of rent are sometimes made. In one type of leasehold a single lump-sum payment is made for the right to use the property throughout the period of the contract; in other cases an initial special payment (or 'bonus') is made and an annual rental in addition. In both situations the amount of the initial payment should be systematically apportioned over the life of the contract as a rental cost, periodic unexpired balances being treated as a type of

asset. * * *”

I am informed that in the leasing of office, store and shop space in some cases the alterations to make the space suitable for the tenant are made by the landlord or lessor and the rental reserved under the lease is a charge for the space as modified to suit the needs of the tenant, but that in other cases the space is leased to the tenant in the condition in which it exists at the time the indenture of lease is executed and that the tenant is authorized to make such alterations as will make the space suitable for his particular needs and that under such type of lease modern accounting practices amortize the expense of such alterations over the life of the lease when the occupant keeps his accounting records on an accrual basis or system.

The only other method, I am advised, by which the business could account for such expense would be to charge it entirely to operation expense at the time of the expenditure, even though such installations were to be used by the tenant during the period of the lease.

It further appears to be modern practice that when taxes are paid in advance, as in the case of personal property taxes which are payable in March and September, such items are also included as prepaid items and amortized during the year; that is, one-twelfth of the annual taxes is taken as an expense during each month. Such has been accepted accounting practice over a long period of time. It would appear that under accepted accounting practice prepaid insurance, prepaid rental, prepaid taxes and other similar items are all included as prepaid items. It is, therefore, somewhat difficult to perceive that if the tenant assumes the obligation of preparing leased office space to his particular business needs, rather than having such space so adapted by the landlord and paying the rental over the period of the lease, that it would come in any different category than if the rental were paid in advance since the rental which would be otherwise payable over the life of the lease is to a like extent diminished.

When we look at the facts from which your inquiry arises from the lessee's view point, it would appear that rental paid for business quarters is but the cost of acquiring suitable space in which to transact his business during the term of the lease. If he has paid the rental for the entire term in advance, such prepayment of rent is in ordinary

accounting practice prepaid business expense and would be reflected upon his books of account as an asset and be amortized over the period of the lease. If such be true, let us suppose that such tenant could acquire more suitable or efficient space in which to transact his business by making certain improvements, as by installing better lighting equipment, more efficient elevators, refinishing certain space so as to change it from storage space to salesrooms or offices, or painting salesrooms to make the same more attractive to customers. Such alterations, so made by the tenant, would presumably be useful for and beneficial to the tenant's business for a more or less extended period of time. If so, the same reasons which exist for amortizing prepaid rent, which is the cost of the leasehold estate over the life of the lease, as a prepaid expense would apply with equal force to the treating of the additional expense of acquiring improved business space as an asset to be amortized over the life of the lease.

While it is not controlling in the decision of your inquiry, it may be pertinent to note that under the regulations promulgated by the Federal Treasury Department (Reg. 111, Sec. 29.23 (a)-10), a lessee who has made improvements to the leasehold premises is not permitted to deduct the cost thereof as a business expense, but must capitalize the item and charge the same off to expense during the life of the improvement or the life of the lease, whichever is the shorter.

From the nature of the estate held under a lease and the installation of improvements on a leased premises, it is evident that the ownership of such improvements, after installation, is in the lessor and that the only interest which the lessee has therein is the intangible right of enjoyment thereof during the life of the lease. It is such right which is evidenced on the books of account of the tenant as "improvements to leased property", "leaseholds", "leasehold improvements" or "prepaid expense". It would thus seem that the commonly accepted meaning of the term "prepaid items" or "prepaid expense", as used by accountants in the Federal Government in the administration of the income tax law, includes the cost of acquiring a leasehold estate to the extent that it has been paid in advance whether as prepayment of rent, advancement of taxes or an improvement of the leased premises where the improvements are to be enjoyed or consumed over a period of time after installation.

It will be observed that Section 5327 of the General Code, above quoted, does not purport to define the exact nature of "prepaid items" which are to be included in the computation of "credits" for purposes of taxation. Such term, as we have above pointed out, is one used by accountants or business men and, as so used, has a commonly accepted meaning.

It has been held on numerous occasions that when a word in common use is used in a statute, it is to be construed in its ordinary accepted meaning and significance. See *Eastman v. State*, 131 O. S. 1; *Keifer v. State*, 106 O. S. 285, 289; *Woolford Realty Company, Inc. v. Rose*, 268 U. S. 568; *Maillard v. Lawrence*, 16 How. (U. S.) 251, 261; *Old Colony R. R. Co. v. Commissioner of Internal Revenue*, 284 U. S. 552, 560.

In view of the commonly accepted meaning of "prepaid items and expense", as in common use, I am unable to form the conclusion that the expense of leasehold improvements installed by the tenant and carried on his accounting records as "prepaid expense" does not constitute "prepaid items" within the meaning of that term as used in Section 5327 of the General Code, especially in view of the fact that the Legislature did not define such term.

In specific answer to your inquiry, it is my opinion that when the cost of improvements installed by tenants on property leased under short term leases is carried on the accounting records of the tenant as deferred items under the designation of "leaseholds" or "leasehold improvements" to be amortized over the duration of the lease, such items constitute "prepaid items" within the meaning of that term as used in Section 5327 of the General Code.

Respectfully,

THOMAS J. HERBERT
Attorney General