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LEASES AND FEDERAL TAXATION†

HIRAM H. LESAR*

With federal income tax rates beginning at 20 percent, there are few transactions that can safely be entered into without giving some consideration to tax effects. Leases are no exception. For the most part the problems involved relate to what receipts are income, when income is taxable, deductions and the treatment of leases between related taxpayers. The problems are discussed in this order in the sections which follow.¹

I. WHAT RECEIPTS ARE INCOME

Rent. Any amount received by the lessor as rent is ordinary income to him. This includes amounts paid in satisfaction of the lessor's obligations, such as payment of dividends to a corporate lessor's shareholders,² of the lessor's taxes, including income taxes,³ and of insurance premiums.⁴ The cost of improvements required to be made by the tenant may be treated as rent under the lease,⁵ and an amount loaned by the tenant to the lessor

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1. The discussion herein is not, of course, exhaustive. For further discussion, see MERTENS, FEDERAL INCOME TAXATION, Chapters 8, 11, 12; RABKIN AND JOHNSON, FEDERAL TAXATION, Chapters 11, 41, 42, 45.

2. U.S. v. Joliet & Chicago R.R., 315 U.S. 44, 62 Sup. Ct. 442 (1942). Cf. Denholm & McKay Realty Co. v. Commissioner, 139 F.2d 545 (1st Cir. 1944), where the payment was in discharge of a guaranty which the court held was not consideration for the lease.

3. Mim. 6779, 1952-1 Cum. Bull. 8, as modified by IR-Mim. 51, 1952-2 Cum. Bull. 65. But see I.R.C. § 110 (1954), which provides that as to pre-1954 leases, a corporate lessor's tax paid by corporate tenant is not income to landlord and not deductible by the tenant. See also Kades, *Phantom Income: Net Leases and the Clark Case*, 5 SYRACUSE L. REV. 18 (1953).

4. The lessor can also deduct these items: See U.S. Treas. Reg. 39.23(a)-10 (1954).

In Ethel S. Amey, 22 T.C. 756 (1954), payments by the tenant to the mortgagee were held income to the lessor where required by the lease, although the lessor was not personally liable on the mortgage.

5. Your Health Club, Inc., 4 T.C. 385 (1944). For further discussion of improvements, see Part III *infra*.

to finance construction has been treated as advance rental where the agreement provided that it would be credited against the rent.⁶ Although subject to a depletion allowance, royalties from mineral leases also are ordinary income.⁷

Payments under Leases with Option to Purchase. The question in these cases, where the original transaction is held to be a lease, is whether certain advance payments made by the tenant with provision for later credit on the purchase price upon exercise of the option to purchase are ordinary income to the lessor or proceeds of a sale of property. On the tenant's side, the question is whether he may deduct these payments as an expense or must capitalize them and recover by way of depreciation. Where the payment is treated in the lease as rent or "bonus," it has been held to be ordinary income to the lessor in the year received,⁸ even though the purchase price first agreed upon was reduced in the lease to reflect the payment.⁹ Yet, in another case where the payment was expressly stated to be consideration for the option to purchase, but with a provision for credit on the purchase price, it was held that the true nature of the item could not be ascertained until the option was exercised or had expired, although the lessor intended to use the fund to liquidate a mortgage.¹⁰ The difference between this and the previous cases would seem to be one of form.¹¹

If a prepayment is intended as rent when made but is credited on the purchase price at the time the option is exercised in a later year, it becomes

6. *Acer Realty Co. v. Commissioner*, 132 F. 2d 512 (8th Cir. 1942). This result could have been avoided by putting the loan in the form of a note with fixed maturity date. See Young, *Tax Aspects of Real Estate Loans*, 1952 U. of Ill. L. Forum 601, 604.

7. See 2 AMERICAN LAW OF PROPERTY § 10.124 (1952) for discussion of these provisions; see also *Jefferson Lake Sulphur Co. v. Lambert*, 133 F. Supp. 197 (E.D. La. 1955); *Arthur S. Barker*, 24 T.C. No. 132 (Oct. 1955).

8. *Estate of Mary G. Gordon*, 17 T.C. 427 (1951), *aff'd*, 201 F. 2d 171 (6th Cir. 1952) (agreement was for 25 year lease with option to purchase for \$125,000, but lease required \$25,000 payment, rent equal to 4½% on \$100,000 and option to purchase at \$100,000); *Gilken Corp. v. Commissioner*, 176 F. 2d 141 (6th Cir. 1949).

9. *Estate of Mary G. Gordon*, 17 T.C. 427 (1951), *aff'd*, 201 F. 2d 171 (6th Cir. 1952).

10. *C.V.L. Corporation*, 17 T.C. 812 (1951) (\$120,000 paid for execution of 99 year lease, to be credited on a purchase price of \$500,000 if option exercised. Lessor carried item on books as "Option to Purchase." Not taxable until option either exercised or expired).

11. See also *Minneapolis Security Building Corp.*, 38 B.T.A. 1220 (1938) where the fund could be applied either to rent or on the purchase price and the court reached the same conclusion; cases cited n. 18, *infra*.

income to the lessee-purchaser on the closing date, rather than being treated as a reduction in the price.¹²

In many cases the transaction may be cast in the form of a lease-purchase agreement for some particular reason¹³ when actually a sale was intended from the beginning. In that case the tenant must capitalize the payments he makes and can take depreciation upon taking possession,¹⁴ while the lessor must treat the payments as the proceeds of a sale.¹⁵ Whether the latter's gain or loss will be considered as ordinary income or capital gain or loss will depend upon whether he was holding the property primarily for sale to customers, in which case it will be ordinary income, or whether the property was a capital asset or depreciable business property held for more than six months, in either of which cases the gain will receive capital gains treatment.¹⁶

Even if the gain is capital gain, it generally will all accrue in one year unless the lessor elects to report the periodic payments on an installment basis.¹⁷

There has been considerable controversy concerning the test to be applied in determining whether the transaction initially is a sale or a lease with an option to purchase. If the agreement provides for the payment of "rent" over a term and that title is to vest in the lessee at the end, or that the lessor is to convey title then or one of these upon the payment of a non-

12. *Hyde Park Realty, Inc. v. Commissioner*, 211 F. 2d 462 (C.A. 2d, 1954), *aff'g* 20 T.C. 43. See also *Abramson v. U.S.*, 133 F. Supp. 677 (S.D. Ia. 1955).

13. *E.g.* to facilitate repossession. For a listing of many reasons, see Blumenthal and Harrison, *The Tax Treatment of the Lease with an Option to Purchase*, 32 *Tax. L. Rev.* 839 (1954). Conversely, a lease may be cast in the form of a sale. See *Arthur S. Barker*, 24 T.C. No. 132 (Oct. 1955) ("royalties" from "sale" of sand and gravel were ordinary income, subject to depletion); *Gates v. Helvering*, 69 F. 2d 277 (8th Cir. 1934) (lease of land and sale of building construed as one transaction, a lease).

14. *Robert A. Taft*, 27 B.T.A. 808 (1933).

15. *Alexander W. Smith, Jr.*, 20 B.T.A. 27 (1930).

16. If the gains from all such transactions exceed the losses in the latter case. See I.R.C. § 1231 (1950), replacing I.R.C. § 117(g) (1939). See also *McGah v. Commissioner*, 210 F. 2d 769 (9th Cir. 1954). Whether the property was held for sale in the ordinary course of trade or business is a question of fact. *Cohen v. Commissioner*, 226 F. 2d 22 (9th Cir. 1955).

17. See I.R.C. § 453 (1954). On what constitutes an installment sale, see *Williams v. U.S.*, 219 F. 2d 523 (5th Cir. 1955) (not where entire purchase price placed in escrow with restrictions only on withdrawals); *Young, Principal Tax Considerations in the Sale of Real Estate*, 17 *Mo. L. Rev.* 117, 122 (1952).

inal consideration, the transaction is a sale.¹⁸ The case that causes difficulty is where the agreement provides for the payment of rent and the acquisition of title during or at the end of the term after payment of a substantial option price.¹⁹ The Tax Court has applied the so-called objective economic test in this situation.²⁰ This test is variously stated, but it is based on the relation between the size of the rental, the option price and the value of the property.²¹ If the "rent" is in excess of the rental value and exercise of the option is practically certain because it is less than the value of the property, then the transaction is a sale.²² The Fifth Circuit has adopted an intention test.²³ It has been suggested that these transactions realistically are both sales and leases and should be treated accordingly, although such treatment would require legislation.²⁴

Many of these cases have involved "leases" of equipment²⁵ where the

18. *Watson v. Commissioner*, 62 F. 2d 35 (9th Cir. 1932); *Oesterreich v. Commissioner*, 226 F. 2d 798 (9th Cir. 1955). See Note, *Tax Treatment of "Lessors" and "Lessees" under Lease-Purchase Agreements*, 62 *Yale L. J.* 273 (1953).

19. See Johnson, *Lease Improvements to Lease Property and Options to Purchase*, N.Y.U. 12th Ann. Inst. of Fed. Tax. 75, 90 (1954).

20. *Ibid.* The test stems from *Judson Mills*, 11 T.C. 25 (1948). Earlier B.T.A. cases used the intention test. *E. G. Robertson v. Commissioner*, 19 B.T.A. 534 (1930). See also n. 16, *infra*.

The Internal Revenue Service has issued a statement of guides to be used in determining the tax treatment of equipment leases. Rev. Rul. 55-540, I.R.B. No. 35, p. 9 (1955). See also Rev. Rul. 55-541, I.R.B. No. 35, p. 6 (1955) and Rev. Rul. 55-542, *Id.* at 14.

21. See Johnson, *supra* n. 12.

22. See *Truman Bowen*, 12 T.C. 446 (1949); *Chicago Stoker Corporation*, 14 T.C. 441 (1950); also, see n. 11, *supra*.

23. *Benton v. Commissioner*, 197 F. 2d 745 (5th Cir. 1952). See also *Barker*, 1955 T.C. Memo 145, where the transaction was in the form of a sale but the court held the owner retained an "economic interest" and the transaction was a lease.

The placing of deeds in escrow indicates a sale: *Alexander W. Smith, Jr.*, 20 B.T.A. 27 (1930); *Joe W. Scales*, 18 T.C. 1263 (1952), *reversed on other grounds*, 211 F.2d 133 (4th Cir. 1954); See also: *E. G. Robertson*, 19 B.T.A. 534 (1930), where there was an oral contract of sale; *Parklawn Corp. v. Glenn*, 118 F. Supp. 37 (W.D. Ky. 1954) (language of sale).

24. Johnson, *supra* n. 19, at 96. Cf. *Blumenthal and Harrison, The Tax Treatment of the Lease with an Option to Purchase*, 32 *TEX. L. REV.* 834 (1954), suggesting instead an addition to the regulations defining rental income and deductions under Internal Revenue Code §§ 61, 162 (1954), and permitting allocation.

25. See *e.g.* *Estate of Clarence B. Eaton*, 10 T.C. 869 (1948) (selling price to be difference between value of property on one hand and 1 per cent per month for period used plus rent paid on the other, amount received before purchase held rent); *Truman Bowen*, 12 T.C. 446 (title to pass when "rent" paid should equal value plus freight to site plus 1 percent per month used).

tax interest of the ultimate buyer and seller conflict. Under the 1954 Code,²⁶ however, much of the advantage which theretofore accrued to the buyer from a rental deduction can be obtained through the new stepped-up methods of depreciation under a transaction which is treated from the beginning as a sale.

Payments on Cancellation or Assignment. In an ordinary tenancy the lease is either a capital asset or property used in trade or business. Gain from an assignment of the lease to a third person is therefore to be treated as capital gain if the property has been held for six months.²⁷ Where the lessee surrenders to the lessor, there generally is a merger of the leasehold in the fee,²⁸ and it was quite properly held that there is a sale of property so that amounts received by the lessee may qualify for capital gain treatment.²⁹ Any doubts concerning the matter have been removed by Section 1241 of the Internal Revenue Code of 1954, which provides that amounts received by the lessee on cancellation are to be considered as amounts received in exchange for the lease.

Where the lessee had subtenants, however, which the lessor took over, it was ruled in the Treasury that the amount paid the lessee by the lessor was ordinary income, a substitute for rent.³⁰ An analogy was drawn to *Hort v. Commissioner*.³¹ That case involved a cancellation payment made by the lessee to the lessor. The court properly held this to be ordinary income. It could not be a capital receipt for the capital was the property and that was returned to the lessor. But the *Hort* case does not furnish an apt analogy where the payment is made to the lessee. The lessor does not pay him rent, and he has nothing left after the cancellation.³²

Payments made by the lessee to the lessor on cancellation are, of course,

26. See I.R.C. § 167(b) (1954).

27. Walter H. Sutliff, 46 B.T.A. 446 (1942).

28. See 1 AMERICAN LAW OF PROPERTY § 3.100 (1952).

29. Commissioner v. McCue Bros. & Drummond, Inc., 210 F. 2d 752 (2d Cir. 1954), *aff'g* 19 T.C. 667 (although lease had expired and tenant was holding under emergency rent laws); Commissioner v. Galonsky, 200 F. 2d 72 (C.A. 3d 1952), *aff'g* 16 T.C. 1450 (1951); Note, 10 TAX L. REV. 257 (1954) (criticizing McCue Bros. case on the facts). *Cf.* Forrest Hotel Corp. v. Fly, 112 F. Supp. 782 (S.D. Miss. 1953).

30. Rev. Rul. 129, 1953-2 Cum. Bull. 97.

31. *Hort v. Commissioner*, 31 U.S. 28, 61 Sup. Ct. 757 (1941).

32. Schan, *Problems of Negotiation and Surrender of Leaseholds*, NYU 12th ANN. INST. ON FED. TAX. 99, 106 (1954).

ordinary income to the latter.³³ Insurance proceeds received by the lessor upon destruction of an improvement, on the other hand, are subject to the capital gains provisions and are not income from a lease cancellation even though the lessee elects to terminate the lease under an option, instead of requiring restoration of the premises.³⁴

II. WHEN INCOME IS TAXABLE

Income is taxable when received.³⁵ This rule applies to both cash and accrual³⁶ basis taxpayers. As to an accrual basis taxpayer, an item also is income when it accrues although not received.³⁷

The chief difficulty in applying these rules to lease income has been in connection with payments by the lessee to the lessor as security where the lease provides that the sum will or may be applied toward rent due at a future date. If the item is treated as advance rental, then it must be included in the lessor's income when received even though it is for rent to accrue during the last year of the lease.³⁸ It is not always easy to distinguish between a security deposit and an advance payment of rental,³⁹ but the payment is more likely to be construed as a deposit if the lessor has a specified obligation to pay interest or otherwise account⁴⁰ and where the lease refers to it as a deposit.⁴¹

33. See Spencer Thorpe, 42 B.T.A. 654 (1940), *appeal dismissed*, 121 F. 2d 458 (9th Cir. 1941) (release of covenant).

34. Owen Meredith, 12 T.C. 344 (1949).

35. *Gilken Corp. v. Commissioner*, 176 F. 2d 141 (6th Cir. 1949); *Hirsch Improvement Co. v. Commissioner*, 143 F.2d 912 (2d Cir. 1944); *Renwich v. U.S.*, 87 F.2d 123 (7th Cir. 1936). The doctrine of constructive receipt applies: See *Baker v. Commissioner*, 81 F.2d 741 (3d Cir. 1936). See also Charles F. Kahler, 18 T.C. 31 (1952) (check received last day of year, although too late to cash or deposit, treated as receipt of cash).

Loans by the lessee to the lessor may be held to be advance rent: See *Acer Realty Co. v. Commissioner*, 132 F.2d 512 (8th Cir. 1942), *supra* n. 6.

36. *South Dade Farms v. Commissioner*, 138 F.2d 818 (5th Cir. 1943).

37. *Heer-Andres Investment Co.*, 17 T.C. 786, 787 (1951) (percentage rental based on sales of year income to accrual basis lessor in year of sales although not payable until 10 days after end of year); *Lab Estates, Inc.*, 13 T.C. 811 (1949) (forgiveness of accrued rent may result in deduction for lessor for was income when accrued).

38. *Astor Holding Co. v. Commissioner*, 135 F. 2d 47 (5th Cir. 1942).

39. See 1 *AMERICAN LAW OF PROPERTY* § 3.73 (1952).

40. *Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968 (5th Cir. 1942) (lessor to pay interest); see *Warren Service Corp. v. Commissioner*, 110 F.2d 723 (2d Cir. 1940) (specific obligation to refund).

41. *John Mantell*, 17 T.C. 1143 (1952) (even though repayment matched rent payments). In *Jack August*, 17 T.C. 1165 (1952), the amount was referred to as rent in the lease and it was held to be rent.

A holding that a substantial payment in advance rental may be very disadvantageous, taxwise, to the lessor. It can be avoided, while attaining the security feature, by placing the amount in escrow.⁴²

It is worth noting that although advance rental is income to the lessor, the lessee cannot deduct it when made but must treat the payment as a capital expenditure.⁴³

Crop Shares Under Farm Leases (Including Inherited Property). Where the lessor reserves a share of the crop as rent, the share does not enter into the lessee's return either as income or a deduction. The lessor reports the value of the share, or the proceeds of its sale if sold, as income in the year in which the crop is harvested if he is on the accrual or inventory basis. But, contrary to the usual rule that income in kind is reported when received,⁴⁴ a strictly cash basis lessor reports the income only when the crop is sold.⁴⁵ This gives such a lessor an opportunity to shift his income from one year to another.⁴⁶

Where the lessor under a crop share lease dies, there arise problems both of time and taxability. First, assume that the crop, say grain, has been harvested and the lessor's share is on the land. If the lessor was on an accrual basis, the share is included in the inventory on his final income tax return. When a subsequent sale is made by the personal representative, gain or loss is calculated on the date of death value.⁴⁷ If the lessor is on a cash basis, the share is not income to him, and the question is whether it is income to the heir or devisee. Apparently the Bureau of Internal Revenue treats the crop as "property" and not income.⁴⁸ Therefore, it escapes the income tax, to the extent of the date of death value.

42. See *McLaughlin v. Commissioner*, 113 F.2d 611 (7th Cir. 1940). If rent notes are given directly to the lessor, they would seem to be cash to the extent of their fair market value by analogy to treatment under U.S. Treas. Regs. § 39.22 (a)-4 of notes given in sales. Young, *Tax Aspects of Real Estate Leases*, 1952 U. of Ill. L. Forum 601, 606-7.

43. *Main & McKinney Building Co. v. Commissioner*, 113 F.2d 81 (5th Cir. 1940), *cert. den.* 311 U.S. 688, 61 Sup. Ct. 66 (1940); *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3d Cir. 1931), *cert. den.* 284 U.S. 674, 52 Sup. Ct. 129 (1931).

44. U.S. Treas. Regs. 111, § 39.22 (a)-1 (1954).

45. *Id.* § 39.22(a)-7.

46. A contract for sale could be made in one year, with payment and delivery to take place the following year. See J.D. Amend, 13 T.C. 178 (1949).

47. See Young, *Tax Aspects of Real Estate Leases*, 1952 U. OF ILL. FORUM 601, 624.

48. *Id.* at 625. The author suggests that if the crop goes to a devisee, as distinguished from a legatee or the personal representative, he may be taxed

Second, assume that the crop is unharvested. Then it is not included in the decedent lessor's final income tax return, whether he was on the cash or accrual basis, but the growing crop is included and valued separately in the estate tax return.⁴⁹ This value would become the basis of the successor, to be subtracted, with other expenses, from the amount for which he sells the crop shares. The difference is taxable as ordinary income.

III. DEDUCTIONS

In General. Either party, lessor or lessee, who incurs the expense may deduct from his income such items as taxes on the leased property, repairs, maintenance and insurance.⁵⁰ Where the lessor has reported accrued but unpaid rent as income, he may take a business expense or loss deduction if he forgives the amount for business reasons,⁵¹ but cancellation of a lease and re-letting at a lower rental does not result in a loss.⁵²

When the expenditure is for an asset that will be useful for a period substantially longer than a year, the amount cannot be deducted all in one year but must be capitalized and recovered by way of depreciation or amortization over the useful life of the asset.⁵³ This rule applies to special assessments⁵⁴ and to bonuses, commissions and legal costs in procuring the lease. It has also been applied to insurance premiums, even though it is customary to pay these for three years at a time.⁵⁵ The treatment of payments made by the lessor to the lessee to secure cancellation of the lease depends on the lessor's purpose. If it is to enable the lessor to give a new lease, then the amount is amortized over the life of the new lease.⁵⁶ If the

for the gain as ordinary income, but notes that generally there will be no gain, the estate tax value corresponding to the sale price. At any rate, the date of death value is untaxed as income. *Id.* n. 110.

49. *W. S. Peebles v. Commissioner*, 5 B.T.A. 386 (1926).

50. As to insurance see *Commissioner v. Boylston Market Ass'n.*, 131 F.2d 966 (1st Cir. 1942), *infra* n. 55.

A tenant-stockholder in a cooperative housing corporation may deduct a proportionate share of taxes and interest paid by the corporation. I.R.C. § 216 (1954).

51. *Lab Estates, Inc.*, 13 T.C. 811 (1949) (tenants were negotiating for other stores to lease but gave promise to continue leases with taxpayer).

52. *Warren Service Corp. v. Commissioner*, 110 F.2d 723 (2d Cir. 1940).

53. See U.S. Treas. Regs. 118, § 39.24(a)-2 (1953).

54. I.T. 2164, IV-1 Cum. Bull. 34 (1925).

55. *Commissioner v. Boylston Market Ass'n.*, 131 F.2d 966 (1st Cir. 1942).

56. *Wells Fargo Bank & Tr. Co. v. Commissioner*, 163 F.2d 521 (9th Cir. 1947), *reversing* 7 T.C. 556 (1946), *Cf. Manhattan Life Ins. Co.*, 28 B.T.A. 129 (1933), *rev'd on other grounds*, 71 F. 2d 292 (2d Cir. 1934).

purpose is to acquire the use of the property for the lessor's business, the payment is amortized over the balance of the term of the cancelled lease.⁵⁷ If the purpose is to erect a new building or sell the property, the amount is added to the cost of the building⁵⁸ or the land.⁵⁹ In the former case it would be recovered by way of depreciation, in the latter it serves to reduce gain or increase loss on subsequent sale.

A lessee of business property can, of course, deduct rent,⁶⁰ but advance rental must be capitalized.⁶¹ Where the lessee exercises an option to purchase and pays more than the fair market value of the property, he has been permitted to deduct the difference as a business expense,⁶² but this decision is questionable.⁶³ A payment to the lessor to secure cancellation of the lease

57. Harriet B. Borland, 27 B.T.A. 538 (1933).

58. Business Real Estate Trust of Boston, 25 B.T.A. 191 (1932).

59. Shirley Hill Coal Co., 6 B.T.A. 935 (1927).

60. In *Commissioner v. Doyle*, 231 F. 2d 635 (7th Cir. 1956), the majority of the court permitted the deduction of rent and wages paid in conducting an illegal enterprise (bookmaking), on the ground that the Code does not specify that expenses must be legal and lawfulness not being an element of taxable income should not be an element of allowable expenses.

61. *Southwestern Hotel Co. v. U.S.*, 115 F.2d 686 (5th Cir. 1940), *cert. den.* 312 U.S. 703, 61 Sup. Ct. 807 (1941); *Main & McKinney Bldg. Co. v. Commissioner*, 113 F.2d 81 (5th Cir. 1940), *cert. den.* 311 U.S. 688, 61 Sup. Ct. 66 (1940); *Barton Coal Co. v. Commissioner*, 51 F.2d 469 (3d Cir. 1931), *cert. den.* 284 U.S. 674, 52 Sup. Ct. 129 (1931); U.S. Treas. Regs. 118, § 39.23(a)-10; "If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has run." *Cf. Jefferson Lake Sulphur Co. v. Lambert*, 133 F. Supp. 197 (E.D. La. 1955) (sulphur lease for \$300,000 consideration, payable \$7500 per year, annual payment deductible as advance royalty).

62. *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (C.C.A. 6th, 1948), *reversing* 6 T.C.M. 498 (1947) (deduction of that portion of purchase price attributable to excessive rent).

63. *Contra: Millinery Center Corp.*, 21 T.C. 92 (1954). The court in the *Cleveland Allerton* case, *supra* n. 12, relied on cancellation cases. But the court in the *Millinery* case suggests that these cases are not applicable because possession is given there, while here there is no change of possession.

In the *Millinery* case the lessee had erected a building on the premises during its first term and fully depreciated the cost. The option to purchase was exercised during a renewal period. The price paid was \$2,100,000. The Tax Court found the value of the land to be \$660,000, but refused to let the lessee-purchaser depreciate the remaining portion of the purchase price because the taxpayer had depreciated it while a lessee. The Second Circuit reversed on this point, holding the purchaser could depreciate that part of the purchase price allocable to the building over its remaining useful life. *Millinery Center Building Corp. v. Commissioner*, 221 F.2d 322 (1955). The Supreme Court granted certiorari because of the "apparent conflict" between this case and the *Cleveland Allerton Hotel* case. *Millinery Center Building Corp. v. Commissioner*, 76 Sup. Ct. 493, 495 (1956). The Court affirmed the decision below, holding that the lessee-purchaser could not recover that part of the purchase price allocable to the building over the remaining life of the renewal term of the lease (21 years). (The Government did not appeal the allowance of depreciation over the useful life

is also deductible by the lessee.⁶⁴

Depreciation of Improvements by the Lessor; Rights of Heirs. The lessor is entitled to take depreciation⁶⁵ on improvements which he has bought or erected. He cannot take depreciation on improvements erected by the lessee at the latter's expense or where the lessee has covenanted to restore the premises in as good condition as when received.⁶⁶ The deduction is spread over the life of the improvement although the lease is for a larger period.⁶⁷ This rule also applies to a life tenant who is a lessor, he being treated as a fee owner for this purpose.⁶⁸

Where an old building or other improvement is demolished, the owner may be able to take the amount of the remaining undepreciated basis as a loss.⁶⁹ Normally, however, the particular facts where there is a lease will require some other method of handling the transaction. (1) If the property was bought for the purpose of demolishing existing structures in order to use the land alone or to erect new structures, then no loss is allowed, but the demolition cost is added to the purchase price and capitalized as the cost of the land.⁷⁰ (2) If, after buying property, an owner decides to tear

of the building.) But the Court did not decide the issue on excess purchase price. It found that the plaintiff had presented no evidence of such, saying "Whatever possible merit petitioner's contention might have were there proof of excessive purchase price can await such a case." *Id.*: at 496.

A stranger could not deduct that part of the purchase price allocable to a favorable lease. See McCulley Ashlock, 18 T.C. 405 (1952).

64. Cassatt v. Commissioner, 137 F.2d 745 (3d Cir. 1943). *Cf.* Millinery Center Corp., 21 T.C. 92 (1954), *supra* n. 63, where the lessee purchased the fee.

As to losses between related taxpayers, see Part IV *infra*.

65. See Note, 40 A.L.R.2d 440 (1955).

66. Commissioner v. Revere Land Co., 169 F.2d 469 (3d Cir. 1948) (lessee erected improvement); Commissioner v. Terre Haute Elec. Co., 67 F.2d 677 (7th Cir. 1933), *cert. den.* 292 U.S. 624 (1934) (covenant to restore); Appeal of A. Wilhelm Co., 6 B.T.A. 1 (1927) (same). There is a tendency to construe covenants as not binding the tenant to restore. See St. Paul Union Depot Co. v. Commissioner, 123 F.2d 235 (8th Cir. 1941).

For the rule as to the lessor's heirs, see notes 77-80, *infra*.

67. Lamson Bldg. Co. v. Commissioner, 141 F.2d 408 (6th Cir. 1944).

68. Penn v. Commissioner, 199 F.2d 210 (8th Cir. 1952) (life tenant had life expectancy of 7.26 years, the improvement a life of 50 years); I.R.C. § 167(g) (1954).

The result of the life tenant erecting an improvement is that he makes a taxable gift to the remainderman of the present value of the remainder interest in the improvement. Smith v. Shaughnessy, 318 U.S. 176, 63 Sup. Ct. 545 (1945). Then, since this is a gift reserving a life estate, the value of the improvement at the life tenant's death is included in his estate under I.R.C. § 2036 (1954).

69. See U.S. Treas. Regs. 118, § 39.23(e)-2 (1953); Union Bed & Spring Co. v. Commissioner, 39 F.2d 383 (7th Cir. 1930).

70. *Ibid.*

down a structure and erect a new one, the undepreciated cost of the old improvement and the demolition cost are capitalized as part of the cost of the new improvement.⁷¹ (3) Where, in order to secure a tenant, the lessor authorizes the tenant to remove an existing structure and erect a new one, the undepreciated cost of the old one is part of the cost of acquiring the lease and the lessor must amortize it over the term of the lease.⁷²

When leased property is inherited by the lessor's heirs, it is included in the lessor's estate at the fair market value and this becomes the basis in the hands of the heirs.⁷³ This has given rise to two problems. First, suppose that the lease is an advantageous one which enhances the value of the land. Since the enhanced value presumably will not survive the lease, may the heirs amortize this amount over the period of the lease? On the ground that the heirs have no interest apart from the fee, it has been held that they may not,⁷⁴ but there is recent authority to the contrary.⁷⁵ The situation of the heirs of the lessee must, of course, be distinguished.⁷⁶

Secondly, can the heirs depreciate improvements erected and paid for by the tenant? The cases are in conflict. The lessor could not, and the lessee does, take such depreciation. Two circuit court decisions have denied the deduction. One stressed the double deduction,⁷⁷ while the other denied

71. *Commissioner v. Appleby's Estate*, 123 F.2d 700 (2d Cir. 1941). The court, distinguishing § 39.23(e)-2, *supra* n. 5, states that if an owner razes a building intending to erect a new one, it is not a closed transaction until he erects the building.

72. *Young v. Commissioner*, 59 F.2d 691 (9th Cir. 1932), *cert. den.* 287 U.S. 652, 53 Sup. Ct. 116 (1932); *Anahma Realty Corp. v. Commissioner*, 42 F.2d 128 (2d Cir. 1930), *cert. den.* 282 U.S. 854, 51 Sup. Ct. 31 (1930); *Laurence Walker Berber*, 7 T.C. 1339 (1946).

73. I.R.C. § 1014 (1954). The valuation is at the date of death or the alternate valuation date. *Id.* § 2032.

74. *Friend v. Commissioner*, 119 F.2d 959 (7th Cir. 1941), *cert. den.* 314 U.S. 673, 62 Sup. Ct. 136 (1941); *Mary Young Moore*, 15 T.C. 906 (1950), *reversed* 207 F.2d 267 (9th Cir. 1953).

75. See *Commissioner v. Moore*, 207 F.2d 267 (9th Cir. 1953), *reversing* 15 T.C. 906 (1950), *supra* n. 74. The Tax Court decision was reversed for allowing depreciation. See text, *infra* at n. 77. But the court said that there was evidence of a premium value which could be amortized. This was allowed by the Tax Court in the proceedings on remand. See *Mary Young Moore*, P-H 1955 TC Memo. 55-219.

A provision that the lessee can recover the cost of improvements by credits against future rent does not decrease the date of death value of the property. *Harriet M. Bryant Trust*, 11 T.C. 374 (1949).

76. They can amortize the value. See n. 101, *infra*.

77. *Commissioner v. Moore*, 207 F.2d 267 (9th Cir. 1953) *reversing* 15 T.C. 906 (1950). But the circuit court permitted amortization of premium value. See n. 75 *supra*.

depreciation on the ground that the lease would outlast the improvement.⁷⁸ The Tax Court, on the other hand, has allowed depreciation,⁷⁹ the court quite properly pointing out that the heirs must take as their tax basis the date of death value which includes the value of improvements.⁸⁰ While the Tax Court has been reversed on this point, it is significant that the reversing court permitted amortization of premium value.⁸¹

Improvements by the Lessee. At one time the Supreme Court held that the fair market value of improvements erected by the lessee was income to the lessor on the date the lease terminated.⁸² While the decision was logically correct, it worked a hardship on the lessor. Congress therefore amended the code so as to exclude such value from income⁸³ and from the lessor's basis for the property.⁸⁴ The result is that taxation of this value to the lessor is deferred until he sells the property.

Of course, the improvement may be intended as payment of rent in kind. Then it is income to the lessor when made⁸⁵ and a payment of advance rent by the lessee to be amortized over the life of the lease.⁸⁶ It is not uncommon to specifically provide that the lessee recoup all or part of the cost of improvements by credits against rental payments. In such cases, the lessor receives income but also makes a contribution to the cost of the improvements which can be depreciated.⁸⁷ Generally, it would seem that im-

78. *First Nat. Bank of Kansas City v. Nee*, 190 F.2d 61, 40 A.L.R.2d 423 (8th Cir. 1951), 37 CORN. L. Q. 323 (1952). This was also true in *Commissioner v. Moore*, n. 77, *supra*.

79. *Mary Young Moore*, 15 T.C. 906 (1950), *reversed sub. nom. Commissioner v. Moore*, 207 F.2d 267 (9th Cir. 1953); *J. Charles Pearson, Jr.*, 13 T.C. 85 (1949) *reversed for inadequate proof sub. nom., Commissioner v. Pearson*, 188 F.2d 72 (5th Cir. 1951), *cert. den.* 342 U.S. 861, 72 Sup. Ct. 88 (1951).

80. See *Harriet M. Bryant Trust*, 11 T.C. 374 (1949), n. 75, *supra*.

The *Nee* case is criticized in Young, *Tax Aspects of Real Estate Leases*, 1952 U. OF ILL. L. FORUM 601, 620.

81. See *Commissioner v. Moore*, n. 77 *supra*.

82. *Helvering v. Brunn*, 309 U.S. 461, 60 Sup. Ct. 631 (1940).

83. I.R.C. § 22(b)(11) (1939), now I.R.C. § 1019 (1954).

84. I.R.C. § 113(c) (1939), now I.R.C. § 1019 (1954).

85. I.T. 4009, 1950-4 CUM. BULL. 13, I.R.C. § 109 (1954) (excluding "income (other than rent)" from improvements). See U.S. Treas. Regs. 118, § 39.22(b)(11)-1 (1953); *Your Health Club, Inc.*, 4 T.C. 385 (1944) (lessee can deduct as rent).

86. See *supra* n. 74.

87. Suppose the lessee under a 10-year lease erects an improvement costing \$15,000 and having a life of 20 years, the lease providing for \$5000 annual rental and permitting a credit of \$1000 per year for improvements. The first year the lessor gets \$4000 cash and \$10,000 income from the improvements (the total credits over the whole term). He has contributed \$10,000 to the improvement and can depreciate this over 20 years (5% each year). The lessee has paid an

improvements required under flat rental leases without provision for recoupment are not rental, but they could be if the rent reserved is much below prevailing rents.⁸⁸

To the extent that the lessee makes or contributes to the cost of capital⁸⁹ improvements used in trade or business, he is entitled to depreciation.⁹⁰ The general rule is that depreciation is to be taken over the useful life of the property or the term of the lease, whichever is shorter.⁹¹ Should the lessee abandon the property or secure cancellation of the lease, he can deduct the undepreciated cost as a loss.⁹² If he buys the fee, the undepreciated cost of improvements becomes part of the cost of the fee, recoverable over the life of the improvement.⁹³ This likewise is true where the lessee is to retain ownership of the improvement.⁹⁴

Where there is a renewal provision in the lease the improvement, if it has a longer life, should be depreciated over the original term and the renewal period if the facts indicate that the lease is reasonably certain to be renewed.⁹⁵ Some of the cases raise a presumption that the lease will be renewed.⁹⁶ Since the taxpayer has the burden of sustaining the deduction,

additional \$5000 in the improvement. He can amortize both amounts over the term of the lease. See Young, *Tax Aspects of Real Estate Leases*, 1952 U. of Ill. L. Forum 601, 615. This situation could arise in a percentage rent lease, with the credit limited to rent in excess of a certain amount if it were certain that amount would be reached. *Ibid.*

88. *Ibid.*

89. On what is a capital improvement as distinguished from repairs, see *Hotel Kingkade v. Commissioner*, 180 F.2d 310 (10th Cir. 1950).

90. The lessee, of course, cannot depreciate improvements if he did not contribute to the cost. *Weiss v. Wiener*, 279 U.S. 333, 49 Sup. Ct. 337 (1929).

On depreciable property, see *Claire A. Pekras*, P-H 1943 TC Memo. Dec. ¶ 43, 258 (1948), *aff'd per curiam* 139 F.2d 699 (6th Cir. 1943), *cert. den.* 322 U.S. 739, 64 Sup. Ct. 1056 (1944).

91. U.S. Treas. Regs. 118, § 39.23(a)-10(b).

92. *Cassatt v. Commissioner*, 137 F.2d 745 (3d Cir. 1943); *Emma C. McIlwaine*, 11 T.C.M. 964 (1952); *Fisher Brown*, 9 T.C.M. 1054 (1950); U.S. Treas. Regs. 118, § 39.23(e)-3.

93. *Citizens Nat. Bank of Kirksville, Mo. v. Commissioner*, 122 F.2d 1011 (8th Cir. 1941); *Leonard Refineries*, 11 T.C. 1000 (1948); *Henry Boos*, 30 B.T.A. 882 (1934).

94. *Repplier Coal Co.*, P-H 1942 T.C. Mem. Dec. ¶ 42, 621, *reversed on another issue*, 140 F.2d 554 (3d Cir. 1944).

95. *Fisher Brown*, 9 T.C.M. 1054 (1950); *Hens & Kelly, Inc.*, 19 T.C. 305 (1952); U.S. Treas. Regs. 118, § 39.23(a)-10 (1953).

96. *Union Electric Co. v. Commissioner*, 177 F.2d 269 (8th Cir. 1949); *Alamo Broadcasting Co.*, 15 T.C. 534 (1950). *Cf. Bonwit Teller & Co. v. Commissioner*, 53 F.2d 381 (2d Cir. 1931), *cert. den.* 284 U.S. 690 (1932); RABKIN AND JOHNSON, *FEDERAL TAXATION* § 59.02(4).

the presumption is a logical one. If renewal is uncertain but later the lease is actually renewed, the remaining undepreciated amount is spread over the renewal period.⁹⁷

Where the tenancy is indefinite, for example a month-to-month tenancy requiring notice to terminate,⁹⁸ the depreciation is taken over the life of the property.⁹⁹ In one case the court applied this rule to a short term lease where the parties were related and the improvements were substantial.¹⁰⁰

An heir who inherits a lease can amortize its value over the remaining portion of the term.¹⁰¹

If the lease requires the lessee to restore the property to its original condition, the cost of complying with the covenant may be deducted as an expense in the year incurred.¹⁰²

Sale and Leaseback. The sale and leaseback has become a popular method of financing growing businesses. Taxwise, the main effect to the business (the vendor-lessee) is to substitute a rent deduction for depreciation.¹⁰³ Charities and other tax exempt organizations frequently are the purchaser-lessors, and initially borrow much of the purchase price. To prevent what was considered an abuse of the device in such cases, Congress provided that a portion of the rental from business leases equal to the ratio of the indebtedness to the tax basis shall be taxed to the exempt organization as unrelated business income.¹⁰⁴ If the transaction is between related taxpayers there is also the possibility that deductions will be disallowed or the transaction be otherwise disregarded.¹⁰⁵

97. *East Kansai Water Co., Ltd.*, 11 T.C. 1014 (1949). This assumes that the asset will last that long.

98. See 1 AMERICAN LAW OF PROPERTY § 3.23 (1952).

99. *Ehrlich v. Commissioner*, 198 F.2d 158 (1st Cir. 1952); *Emma C. McIlwaine*, 11 T.C.M. 964 (1952).

100. *George E. Thurner*, 11 T.C.M. 42 (1952). *Cf.* *Halsum Products Co.*, 11 T.C.M. 87 (1952), where although the parties were related, business reasons made it unlikely the lease would be renewed.

101. *Estate of Hobbs*, 16 T.C. 1259 (1951) (taxpayer inherited leased property and 1/5 interest in reversion; he could amortize 4/5 of value of leasehold at decedent's death over remaining life of lease).

102. See *Frank & Seder Co. v. Commissioner*, 44 F.2d 147 (3d Cir. 1930) (even though obligation discharged by payment of cash). As to the effect of such a covenant on the lessor's depreciation, see n. 66, *supra*.

103. See Cary, *Corporate Financing Through the Sale and Leaseback of Property; Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1 (1948). On tax questions, see Note, 26 A.L.R.2d 703 (1952).

104. I.R.C. § 514 (1954).

105. See Part IV, *infra*.

In *Century Electric Co. v. Commissioner*,¹⁰⁶ the vendor-lessee sought to claim a loss on the transaction. The Regulations, however, provide that no gain or loss is recognized if the taxpayer who is not a dealer in real estate exchanges "a leasehold of a fee with 30 years or more to run for real estate."¹⁰⁷ The court applied this section to deny a loss.¹⁰⁸ Losses have been allowed where the sale was found to be bona fide and the lease was for less than thirty years.¹⁰⁹

IV. LEASES BETWEEN RELATED TAXPAYERS

Leases between related taxpayers—*e.g.* husband and wife, officer or stockholder and corporation—are subject to close scrutiny.¹¹⁰ This may result in denial of a loss,¹¹¹ a limiting of depreciation¹¹² or the denial to the tenant of a deduction for all or a part of the rental.¹¹³ In one case where a corporate lessee subleased to shareholders of a family corporation for a nominal rental, the court taxed the sublease earnings to the corporation and then to the shareholders as a dividend.¹¹⁴

Attempts to split income among members of a family by gifts of property interests are successful if the gifts are absolute and the interests sub-

106. *Century Electric Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), *aff'g.* 15 T.C. 581 (1950), *cert. den.* 342 U.S. 954, 72 Sup. Ct. 625 (1952).

107. U.S. Treas. Regs. 39.112(b)(1)-1 (1953).

108. The court held that the basis of the fee transferred in the foundry building minus the cash received on the sale became the tax basis for the leasehold, amortizable over its term (95 years).

109. *May Dept. Stores*, 16 T.C. 547 (1951); see Note, 26 A.L.R.2d 703, 722 (1952).

110. *Roland P. Place*, 17 T.C. 199 (1951).

111. See *Cooper Foundation v. O'Malley*, 121 F. Supp. 438 (D. Neb. 1954), where the court found the transaction was one in which gain or loss is not recognized, but commented that the transaction appeared to be an evasion scheme.

112. As by holding a lease would be renewed and therefore depreciation is to be spread over the renewal period or, if indefinite, over the life of the improvement. See *George E. Thurner*, 11 T.C.M. 42 (1952). *Cf.* *Halsum Products Co.*, 11 T.C.M. 87 (1952).

113. *Roland P. Place*, 17 T.C. 199 (1951) (no deduction for rent increases in lease between husband and wife). For cases involving stockholders, see notes 120-121, *infra*.

114. *58th St. Plaza Theatre, Inc. v. Commissioner*, 195 F.2d 724 (2d Cir. 1952). One judge dissented on the ground that the property was operated by the subleases and the profit was from the operation. *Cf.* *Consolidated Apparel Co.*, 17 T.C. 1570 (1953), where the lease was held to have a business purpose and the rental to be reasonable.

stantial. This rule has been applied to an assignment of the reversion on a leasehold.¹¹⁵

Income splitting transactions also take the form of a gift of the property with a leaseback to the grantor, a member of the family. In two cases where the conveyance was made to a trustee, for the benefit of minor children in one case and of the wife and minor children in the other, the court upheld the deduction of rent.¹¹⁶ In *Kirchenmann v. Westover*,¹¹⁷ however, share crop rental paid to the donee-lessor was taxed to the donor-tenant. This case has been criticized,¹¹⁸ and it would seem that where the conveyance is absolute and the lease one which would meet the standards of the market place and the terms of which are observed by the parties, the transaction should be effective for tax purposes.¹¹⁹ The same rule should be applicable to leases by a corporation to a stockholder¹²⁰ or a partnership of stock-

115. *Lum v. Commissioner*, 147 F.2d 356 (3d Cir. 1945) (assignment of rents alone not effective; assignment of all rights as landlord effective). Cf. *Bing v. Bowers*, 22 F.2d 450 (S.D. N.Y. 1927). Also note that the Clifford Rules, now I.R.C. §§ 671 *et. seq.* (1954), which tax income to a grantor if the property will return to him in 10 years, apply only to transfers in trust.

116. *Brown v. Commissioner*, 180 F.2d 926 (3d Cir. 1950), *cert. den.* 340 U.S. 814, 71 Sup. Ct. 42 (1950) [*reversing* 12 T.C. 1095 (1949)]; *Skemp v. Commissioner*, 168 F.2d 598 (7th Cir. 1948) [*reversing* 8 T.C. 415 (1947)]. See also I.T. 3901, 1948-1 CUM. BUL. 30.

117. 5 CCH 1953 Fed. Tax 9126, 44 A.F.T.R. 1271 (S.D. Cal. 1952), *aff'd*, 225 F.2d 69 (9th Cir. 1955). The affirmance was based on an application of the "business purpose" test, but the court also stated that the rental was unreasonable under the circumstances. See also *White v. Fitzpatrick*, 193 F.2d 398 (2d Cir. 1951) (patent royalties nondeductible by lessee); *Riverpoint Lace Works*, TC Memo No. 39 (1954).

118. Young, *Tax Aspects of Real Estate Leases*, 1952 U. OF ILL. L. FORUM 601, 628. Cf. Cary, *Current Tax Problems in Sale, or Gift, and Leaseback Transactions*, NYU NINTH ANNUAL INST. FED. TAX. 959 (1951), repr. 29 TAXES 662; Smith, *Shifting Income Within the Family Group*, 30 TAXES 995, 1000 (1952).

119. In the *Kirchenmann* case, *supra* n. 117, the lease was a standard farm lease. Of course, if the rental is unreasonable or the parties do not observe the terms of the lease, the original owner continuing to treat the property as his, the transaction should not be effective. See *Riverpoint Lace Works*, T.C. Memo, No. 39 (1954).

120. *J. H. Robinson Truck Lines v. Commissioner*, 183 F.2d 1739 (5th Cir. 1950) (rent reasonable and deductible); *Utter-McKinley Mortuaries v. Commissioner*, 225 F.2d 870 (9th Cir. 1955) (rent paid by sole stockholder excessive and disallowed as to all over \$2400 per year); *Limericks, Inc.*, 7 T.C. 1129 (1946), *aff'd*, 165 F.2d 483 (5th Cir. 1948) (excessive rent paid to husband, who with wife owned all but qualifying shares of lessee corporation, treated as dividend).

In *Curran Realty Co.*, 15 T.C. 341 (1950), the lessor-stockholder repaid the excessive rent to the lessee-corporation during the tax year and was permitted to exclude the amount from his tax return.

holders.¹²¹ If the lease involves dividing up a business, however, there must be a proper division of functions.¹²² Otherwise, the lease may be disregarded.¹²³

121. *Twin Oaks v. Commissioner*, 183 F.2d 385 (9th Cir. 1950).

In *Stanley Imerman*, 7 T.C. 1030 (1946), rent paid by a partnership of brothers to their mother was held deductible.

122. See *Twin Oaks v. Commissioner*, 183 F.2d 385 (9th Cir. 1950).

123. See Burnett, *Reduction of Corporate Income Taxes by the Use of Separate Partnerships or Individual Proprietorships*, 15 Mo. L. REV. 138 (1950).