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DEPRECIATION OF PROPERTY ACQUIRED SUBJECT TO A LEASE: PREMIUM LEASE RENTALS AS A WASTING ASSET

W. REED QUILLIAM, JR.*

INTRODUCTION

Pity the tax lawyer through the years
Who I'm certain must have been close to tears[1]
Representing a client who acquired a piece
Of real estate subject to an existing lease.

After *Friend*[2] I suppose he'd have had to plead
(Since the Code must not say what I can read)
That inheritance gives you a basis for trading
But nary a one for depreciating.

And that lucrative lease contract that you buy
That is melting away like pie in the sky
Is nothing, the Tax Court would have us to see
But merely an incident of the fee.

And so on . . . .

If the above represents a dismal effort at verse, it is scarcely more lamentable than the efforts of the courts have been in dealing with the tax consequences to the purchaser, heir or devisee of property acquired subject to a lease. If the foregoing rhyme is lacking in meter and style, it is ringing with truth.

Before inspecting the judicial treatment of such acquisitions, it is necessary to examine three hypothetical cases presenting facts similar to those typically dealt with by the courts. After contemplating the nature of the problem, the generally aberrant determination yielded by the courts can be examined in their proper perspective.

Unimproved Land

In hypothetical Case 1[3] C has purchased land which *if not leased*

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1. *See* notes 98-109 *supra* and accompanying text for the plight of the taxpayer's attorney in *Rowan v. Commissioner*, 22 T.C. 865 (1954).

2. Friend v. Commissioner, 119 F.2d 959 (7th Cir.), *cert. denied*, 314 U.S. 673 (1941).

3. See Appendix. The numbered cases referred to in the remainder of the article are listed in the Appendix. Factual assumptions and numerical calculations are provided for each hypothetical case.

would presently be worth $80,000 and which could be expected to bring a return of $4,800 annually at present market rates. But the property *is leased* for forty more years and will return $6,000 annually during this period. Assume that C is a prudent and experienced investor and prior to making the purchase assessed the worth of the land. He found the present value of expectant lease rentals, discounting them at a rate appropriate to the risk of the investment, to be $90,277. He evaluated the reversionary interest in the land, based upon its value at acquisition[4] and discounting at a rate appropriate to the risk, at $7,777. Thus, knowing the value of A's property to be $98,054 and recognizing A to be an equally skilled trader, C offers that amount to A and it is accepted.

Has C acquired any assets which should be depreciable under the Code?[5] Regarding the nature of the depreciation deduction the Supreme Court has said:

> The end and purpose of it all is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of its capital assets. For this purpose it is sound accounting practice annually to accrue as to each classification of depreciable property an amount which at the time is retired will with its salvage value replace the original investment therein.[6]

At the expiration of the lease C will have an asset—the unencumbered land—presumably worth $80,000.[7] Thus, his capital investment of $98,054 will decline in value by $18,054 during the lease term. The "wasting" should be reflected by an annual depreciation deduction from C's gross income during the term of the lease.

C is investing not only in land, including its natural attribute—the right to receive an annual fair rental value of $4,800—but he is also investing in the contractual right to receive an additional $1,200 per year

4. In determining the present value of the reversionary interest in the land, it seems clear that the land's fair market value at the time of acquisition should be assigned as the value of the land at the termination of the lease, without consideration of possible changes in the land values. This is in accord with common sense, since the current value presumably reflects the contingency of change, and is consistent with present tax policy which, in allocating basis in proportion to values, looks solely to present value without considering future fluctuations resulting from economic factors.

5. INT. REV. CODE of 1954, § 167(a):

(a) GENERAL RULE—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

6. Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943).

7. *See* note 4 *supra*.

in rentals. The latter asset, for which C is paying $18,054, will be exhausted during the lease term, and a depreciation deduction would simply represent a return of capital to C. It seems clear that of C's total basis of $98,054, $18,054 would be depreciable over the lease term. Since the Code[8] limits depreciation of intangible property to the straight line method, the amount should be amortized evenly throughout the lease's duration. Permitting depreciation of this contractual right is not unusual. In addition to the Regulations[9] specifically providing for the depreciation of intangibles, depreciation has consistently been allowed on a variety of exhaustible contract rights.

If C paid either more or less than the actual value of $98,054 for the assets, the depreciable portion of this purchase price should be determined in accordance with the Treasury Regulation[10] which establishes the formula for apportioning the basis between depreciable and nondepreciable assets.[11]

Improved Land—Improvements Built by Lessee

In Case 7[12] the existence of a lessee-built structure is of no economic significance to C. The building can not generate any rental income for C's benefit and since the useful life of the improvement is shorter than the lease term, C has no reversionary interest in the building. The rentals under the lease represent nothing more than ground rent to A, even after the improvements were constructed, and they remain ground rent in the hands of C. A had no economic interest in the building and neither does his purchaser.

Whether legal title to the building is in B or C is of no importance for tax purposes since the Code requires that the property be held "for the production of income"[13] in order to qualify for the depreciation deduction. Since the rentals are being paid for the land alone, the building clearly does not meet this criterion. What is C's investment? As in Case 1, he is buying land, including the right to receive the fair rental value thereof and the premium value provided by the lease contract over and above the fair rental value of the land. It is not reasonable to assume that

8. INT. REV. CODE of 1954, § 167(c).
9. Treas. Reg. § 1.167(a)-3 (1967).
10. Treas. Reg. § 1.167(a)-5 (1967) provides that the basis for the depreciable property

> cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time.

11. Several examples of allocation under Treas. Reg. 1.167(a)-5 (1967) are provided in Case 1, Columns G, H and I.
12. See Appendix.
13. INT. REV. CODE of 1954, § 167(a).

any portion of the purchase price is being paid for a building with a useful life[14] shorter than the lease term and which is not producing rentals during the term. The building represents nothing more than security for payment of the ground rent to C. Though the security may add value to the lease contract[15] it clearly does not qualify as a separate, depreciable item of acquisition.

Thus, the tax treatment of C should be the same in Case 7 as in Case 1. He should be permitted to amortize that portion of his basis allocable to the premium rentals—the exhausted fraction of his basis. Consequently, depreciation on the building should not be allowed.

Property Acquired from a Decedent

Case 6[16] presents facts similar to Case 1 except that C acquired the property from A by inheritance rather than by purchase. Thus, there is no purchase price by which to measure C's investment in the wasting asset. The Code[17] provides that the basis for depreciation shall be the same as that for determining gain or loss on the sale or other disposition of property. Section 1014[18] states that the basis of property acquired from a decedent shall be the fair market value of the property at the decedent's death.[19] Accordingly, the property acquires its basis by the incidence of the estate tax.[20] Assuming that the estate tax return correctly reflected a property value of $98,054,[21] C has manifestly acquired the decedent's basis in the property. A depreciation deduction will be allowed for that portion of the basis, $18,054, allocable to the wasting premium value of the lease.

It is apparent that the tax treatment of C in all three hypotheticals should be the same. The existence of lessee-built improvements, with a useful life shorter than the lease term, should not affect C's tax treatment because C has no economic interest in the depreciable improvements and does not hold them for the production of income. Regardless, C has a

14. It is the useful life of the building to C at the time of his purchase that should be measured, not the useful life allocated to the building by B. If the reasonably expected useful life at the time of purchase exceeds the remaining term of the lease, a portion of the purchase price is attributable to the building. *See* notes 126-28 *infra* and accompanying text.

15. *See* notes 58-61 *infra* and accompanying text.

16. See Appendix.

17. INT. REV. CODE of 1954, § 167(g).

18. *Id.* at § 1014.

19. "[I]n the case of an election under either section 2032 or section 811(j) . . . [the value will be that] prescribed under those sections." *Id.* at (a).

20. Currier v. Commissioner, 7 T.C. 980 (1946).

21. An interesting problem is presented where the decedent's estate tax return valued the property at either more or less than its actual fair market value as determined by the court in the proceedings pertaining to depreciation. This problem is discussed in notes 26-31 *infra* and accompanying text.

depreciable interest in the premium rentals. That C acquired his basis by inheritance rather than purchase is superfluous insofar as his right to depreciation is concerned, since the Code makes it clear that the basis for depreciation of property acquired from a decedent shall be the fair market value of the property at the date of the decedent's death.

JUDICIAL ERRANCY

The foregoing hypothetical cases were considered to illustrate that C's tax treatment should be the same whether the land is unimproved, improved by a lessee-built structure with a useful life shorter than the lease term or whether C's basis was acquired through purchase or inheritance. The majority of cases considered involve land subject to a lease extending beyond the life of a lessee-constructed building. The following discussion attempts to analyze the generally errant judicial treatment accorded the legal questions presented by these hypothetical cases.

Inherited Basis

An earlier obstacle to the proper disposition of inheritance cases was *Friend v. Commissioner,*[22] the first case directly dealing with the tax consequences accorded one acquiring lessee-improved property subject to a long term lease. Though the Board of Tax Appeals had denied amortization of lease rentals on other grounds,[23] the circuit court, in affirming, held that the taxpayer had acquired no depreciable basis by virtue of inheriting the property.[24] This obviously erroneous interpretation of the statute was ignored by the Tax Court. In *Currier v. Commissioner,*[25] however, the court observed:

> The basis of inherited property is not cost. . . . The basis of property acquired by devise is categorically fixed by statute as fair market value on the date of aquisition. . . . Having acquired a basis of the incidence of the estate tax, the gradually disappearing value of a wasting asset can not be replaced except by periodic depreciation deductions.[26]

Although *Currier* was not appealed, the Tax Court's diagnosis of

22. 119 F.2d 959 (7th Cir. 1941).
23. Friend v. Commissioner, 40 B.T.A. 768 (1939).
24. The court stated:

> It is plain from a reading of the statute that what is meant is to give the asset . . . a basis for . . . determining gain or loss. . . . The statute can not be construed . . . to place the petitioners in the position of a purchaser. . . .

Friend v. Commissioner, 119 F.2d 959, 961 (7th Cir. 1941).

25. 7 T.C. 980 (1946).
26. *Id.* at 984.

the problem was approved by the Fifth Circuit in *Commissioner v. Pearson,*[27] the next inheritance case presented. Subsequent decisions have denied depreciation on lessee-constructed improvements acquired by inheritance; however, they have not taken the *Friend* approach that a depreciable basis cannot be inherited. Rather, they are grounded in the concept that the property acquired by inheritance does not include, for tax purposes, the lessee-built structure in which neither the heir nor his ancestor had any economic interest. Regardless, it is not entirely clear that an heir and a purchaser will be accorded similar treatment by the courts. This peculiarity arises as a result of the Eighth Circuit's decision in *World Publishing Company v. Commissioner.*[28] In the face of an established line of inheritance cases denying depreciation of a lessee-constructed building with a life shorter than the lease, the court, in allowing such depreciation in a *purchase* case, stated:

> Whatever may be the proper result in the inheritance or devise situation . . . we are not now willing to extend the philosophy of those cases to the purchase situation of the present case.[29]

An interesting variable to the inheritance situation is suggested by the facts of *Pearson.* What if the valuation placed upon the property in the decedent's tax return does not accurately reflect the fair market value of the property as determined by the court in the proceedings concerning the claim for depreciation?

In a purchase situation, such as Case 1, if C pays $85,000 for property with a total value of $98,054, it is reasonable to assume that he got a "good buy" on both the land and the premium rentals and thus, he should be permitted to allocate his basis between them at the same ratio that each of them bears to total value. But in an inheritance case where C's basis is established solely by the imposition of the estate tax, there would seem to be some justification, in a proceeding to determine C's right to a depreciation deduction, for permitting C to allocate that amount to the wasting asset upon which estate tax was paid and which is in excess of the fair market value of the land, but not exceeding the

27. 188 F.2d 72 (5th Cir.), *cert. denied,* 342 U.S. 861 (1951).
28. 299 F.2d 614 (8th Cir. 1962).
29. *Id.* at 622. Though the court did not attempt to distinguish the purchase situation from the inheritance situation by questioning the statutory basis for depreciation accorded to an heir, there is no other reasonable basis for distinction and the quoted language at least raises the implication that the court finds some distinction to exist. As a result of this decision, the present state of the law is probably that a purchaser can depreciate the lessee-built structure, while an heir cannot. *See* 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.90 (1966).

total fair market value. The estate tax valuation in excess of the fair market value would be allocated in the normal manner. Thus, if the total fair market value in Case 6 was $98,054, but A's estate tax return reflected a value of $80,000—the value of the land alone—a depreciation deduction would not be permitted; if the valuation was $85,000, he would be allowed to allocate $5,000 to the wasting asset. If the estate tax valuation is in excess of its fair market value, for example, $105,000, the allocation to the wasting asset would be determined by assigning the same proportion to the valuation that the depreciable value bears to the total value, $19,320.[30] It would seem that the reduced allocations to the depreciable assets could be made under the Regulations[31] by virtue of the pronouncement therein that the depreciable basis *can not exceed* the amount provided by the formula. Of course, if the estate tax proceeding could be reopened and adjusted to reflect the true fair market value of the property, depreciation should be allowed on the depreciable portion of that value.

There should not be a distinction in the tax treatment accorded C whether he is a purchaser or an heir. The *World Publishing* decision is erroneous if it is to be construed as advocating a variance in treatment. The *Currier* approach should be followed except when the decedent's estate tax return does not reflect the true fair market value of the property as found by the court in the proceeding on the claim for depreciation.

"Incident to the Fee" Doctrine

A maxim initiated by the Board of Tax Appeals in *Friend* has been a consistent hindrance to the proper adjudication of these cases. In *Friend* the taxpayer had *inherited* property under facts approximating Case 7. In denying the taxpayer amortization of any portion of the lease rentals, the court adopted the position that the right to rentals was merely a feature of the fee simple title. The court stated: "In a fee simple title all lesser estates, rights, titles and interests merge."[32]

If the "incident to the fee" doctrine was conceived in *Friend,* it was injected into the terminology of these cases in *Peters v. Commissioner,*[33] when the Tax Court held:

> [The petitioner] did not acquire as a separate and distinct item of property the right to receive rental income; she

30. Alternate treatment of this type is parenthetically proposed in Case 6, Columns H and I.
31. Treas. Reg. § 1.167(a)-5 (1967).
32. Friend v. Commissioner, 40 B.T.A. 768, 771 (1939).
33. 4 T.C. 1236 (1945).

acquired this right as a part of the bundle of rights *incident to the ownership of the fee.*[34]

Since that decision the Tax Court has consistently denied depreciation or amortization of the premium value of lease rentals in these cases and, in all but one,[35] has based its denial on the "incident to the fee" doctrine.[36] Its last two decisions have denied recovery[37] despite circuit court reversals of two earlier Tax Court judgments.[38]

At least on occasion, however, the courts of appeal have challenged the Tax Court's dogmatism on this point. The first challenge occurred in *Cleveland Allerton Hotel, Inc. v. Commissioner*[39] where the lessee who built the improvements[40] purchased the fee to escape the excessive rentals. The building's useful life was shorter than the lease term. The value of the land was only $200,000, yet the taxpayer agreed to a purchase price of $441,250. Thus, he was apparently paying a substantial portion of the purchase price for the premium or excess rentals provided by the lease. The Tax Court denied a deduction based upon the "incident to the fee" doctrine. In reversing, the Sixth Circuit stated:

> If numerous admonitions that taxation is a practical matter, that taxing authorities may look through *form to substance, is not mere rhetoric where the taxpayer's interest is* involved, and a working formula only when it is of advantage to the Treasury, it would seem to be clear that *petitioner paid all over $200,000 to escape from a burdensome lease, and should be able to write that off as an expense of doing business.*[41]

Though the court weakens the force of its decision by observing that "[t]he status of petitioner does not approximate that of a third person

34. *Id.* at 1240 (emphasis added).

35. Bernstein v. Commissioner, 22 T.C. 1146 (1954). The Tax Court's denial of amortization was founded on a lack of proof that any premium values existed in the lease rentals.

36. World Publishing Co. v. Commissioner, 35 T.C. 7 (1960); Schubert v. Commissioner, 33 T.C. 1048 (1960); Moore v. Commissioner, 15 T.C. 906 (1950); Cleveland Allerton Hotel, Inc. v. Commissioner, 16 P-H Tax Ct. Mem. 435 (1947); Annex Corp. v. Commissioner, 2 CCH Tax Ct. Mem. 167 (1943).

37. World Publishing Co. v. Commissioner, 35 T.C. 7 (1960); Schubert v. Commissioner, 33 T.C. 1048 (1960).

38. Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954); Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805 (6th Cir. 1948).

39. 166 F.2d 805 (6th Cir. 1948).

40. The improvements were actually constructed by an assignee of the original lessee.

41. Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805, 807 (6th Cir. 1948) (emphasis added).

investor,"[42] this case is the first illuminating discourse on the matter. Few others have followed.

After the Tax Court had denied amortization of premium rentals in *Moore v. Commissioner*,[43] again on the "incident to the fee" doctrine, a well-reasoned analysis of the problem was presented.[44] The author argued that allocating the portion of lease rentals attributable to the fair market value of the land at the time of purchase—the fair rental value—fully satisfied the "incident to the fee" doctrine and that rentals in excess of that allocation should be fully depreciable as a wasting asset.

Perhaps influenced by this article, the Ninth Circuit reversed the Tax Court's decision in *Commissioner v. Moore*.[45] The opinion of Justice Pope remains the most enlightened judicial treatment of the subject.

In *Moore* the taxpayer had inherited a one-half interest in property subject to a lease with a remaining term of eighty-five years. The existing building had been constructed by the lessee, and its useful life was shorter than the lease term. Annual rentals attributed to C's half interest were $120,000, yet the fair market value of her interest in the land, unencumbered by the lease, was only $400,000 at the time of her acquisition and the fair rental value thereof was $24,000 per year. Thus, it would appear that the lease had an annual premium value of $96,000.[46]

At that time the Tax Court was in the midst of a series of cases[47]

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42. *Id.* at 806.

43. 15 T.C. 906 (1950).

44. Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 HARV. L. REV. 1134 (1952).

45. 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954), *on remand*, 24 P-H Tax Ct. Mem. 726 (1955).

46. In *Moore*, the Ninth Circuit explained the great difference in rental value of the property at periods in time only fourteen years apart:

> Some of the witnesses who testified as to the "favorable" character of the leases . . . attributed the falling off of rentals since the lease was made, to the movement of merchandising business away from downtown Los Angeles, and out into other sections of the city where trading centers had sprung up, where more room was available for parking facilities and where other types of store buildings could be erected.

207 F.2d at 277.

On remand, the Tax Court expanded on the cause of the decreased rentals:

> On October 1, 1924, when [the property was leased] . . . Los Angeles was in the midst of a real estate boom. There had been particular activity during 1923 and 1924 in the area where this property was located. It appeared, at that time, that this area would become the center of a higher class trade than the downtown Broadway section. However, the business depression affected this area more drastically than it did most of the downtown sections. Almost all of the fine shops moved out and the effort to establish it as an exclusive shopping area failed.

24 P-H Tax Ct. Mem. at 727.

47. *See* notes 89-92 *infra* and accompanying text.

allowing depreciation of the fair market value of buildings at the time of acquisition and denying depreciation or amortization of any portion of the lease contract. *Moore* was decided accordingly, and both the taxpayer and the Commissioner appealed. Regarding the amortization of the premium lease rentals, the court of appeals, in reversing both counts, stated:

> Now, if we were dealing with a taxpayer who . . . purchased . . . the . . . property . . . and if it appeared that at that time the rents being paid were in excess of the fair market rental of the property . . . it must have included a bonus or premium for the aquisition of the "favorable" features of the lease. . . . [S]o it may be possible to prove that the higher rents secured through the premium paid by such a purchaser would be exhausted and terminated when the lease ends . . . . The lease, or rather the portion thereof providing the above-normal rents, is an intangible asset with a definitely limited life. . . . In our hypothetical case of a . . . purchaser of this . . . interest, if the premium paid on account of the higher rents to be received under the lease may not be amortized by deductions over the period of the lease, his original investment will not be replaced as [the Code] contemplates. . . .
>
> Here, of course, the taxpayer is not a purchaser, but an heir. But the effect of . . . the Code is to put the heir in the same position as if he were a purchaser. . . .
>
> . . . .
>
> Thus we hold that if the lease was one whose favorable rentals are subject to ultimate exhaustion, that portion of the . . . [estate tax valuation of the property as a whole] attributable to what we . . . call, for want of a better term, its "premium" value, should be amortized through annual deductions allowable to the lessor.[48]

In remanding for the Tax Court's determination of the lease's premium value, the court issued these instructions:

> Should this be found to be a conclusion justified by the facts, the "premium", or sum representing the favorable features of the lease might be found to be the difference between the value of the land and the capitalized value of the rents reasonably to be expected under the lease.[49]

48. 207 F.2d at 274-76 (footnotes omitted).
49. *Id.* at 277 (footnotes omitted).

On remand the Tax Court found that the fair market value of the land at the time of the taxpayer's acquisition by inheritance was $400,000 and the premium value of lease rentals was $1,000,000. But, instead of applying the allocation formula provided by the Regulations[50] and permitting her to depreciate a portion of her basis,[51] the court simply permitted the taxpayer to depreciate the $1,000,000 fair market value of the premium rentals.[52] An important aspect in determining the premium value of the lease rentals was suggested by the circuit court in *Moore* and was apparently followed by the Tax Court on remand. An examination of additional hypothetical cases illustrates this point.

In Case 3[53] the market value of the land was $100,000 when the lease was executed ten years earlier and had not increased at the time of C's purchase. Because the annual rate of return on unimproved land has decreased from six percent to five percent, the rents to be received under the lease should be discounted at five percent to determine their present value since this is the rate of return that C could make in an investment of a similar risk. Thus, the lease rentals have a premium value because they provide a higher rate of return than would be obtainable from the unencumbered land at the time of purchase. Put another way, the lease provides $1,000 in annual rentals over and above the income that could be obtained from the property if it were unencumbered at the time of purchase.

As illustrated by Case 4,[54] if the market rate of return had risen to seven percent the lease would be unfavorable[55] and would have no premium value. Obviously, the lease is not a typical one that should be evaluated solely on the existing market return of unencumbered land.

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50. Treas. Reg. § 1.167(a)-5 (1967).

51. The portion of the taxpayer's basis which she attempted to depreciate bore the same ratio to the total basis as did the value of the depreciable property ($1,000,000) to the total value ($1,400,000). The taxpayer's one-half interest in the property had been valued in her ancestor's estate at $1,000,000.

52. In *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (6th Cir. 1948), that court also failed to apply the allocation formula provided by the Regulations. There it found the fair market value of the land at $200,000, and allowed taxpayer to deduct all of the purchase price ($441,250) in excess of that amount. It should have found the fair market value of the excess or premium rentals and permitted a deduction of that part of the $441,250 which bore the same ratio to total basis as the value of the depreciable property bore to total value.

In *Moore*, it would appear from the facts that the total value of the property acquired exceeded the valuation shown in decedent's estate tax return of $1,533,000. It is at least arguable that in such a situation the taxpayer-heir should be limited, in his allocation of basis to the wasting asset, to that amount upon which estate tax was paid which is in excess of the fair market value of the land at decedent's death.

53. See Appendix.

54. *Id.*

55. *See* notes 89-93 *infra* and accompanying text for a discussion of unfavorable leases.

Assume, for example, that the tenant is in a financially weak position or that the lease terms allow the tenant to sublet and terminate his obligations under the lease without the lessor's consent. Under such circumstances a lease should probably be evaluated at a greater discount than the current market rate.[56] Case 5[57] presents this situation. Though the market rate of return has dropped from six to five percent, the lease, made at six percent, should nonetheless contain premium value and be discounted at six percent since the lessor's position is financially weak and risky. Thus, the lease has no premium value because of its own peculiar characteristics. Of course, the opposite may be true. If the lease in question justifies a lower risk factor than the average market return on unencumbered land, the lease has premium value.

It was noted earlier[58] that the presence of lessee-built improvements with an expected useful life shorter than the lease term is only significant to C as security[59] for payment of the ground rents under the lease and that the security may add value to the lease contract. This situation is best illustrated by Case 8,[60] in which the market value of the land is $100,000, and the market rate of return on similar unimproved and unencumbered land is six percent. Neither the market value nor the rate of return has varied since the lease was executed. Thus, if the land were unimproved the lease would have no premium value. But the presence of a lessee-constructed building decreases the risk. It is unlikely that B will jeopardize his investment in the building by failing to pay the rentals due under the lease. Consequently, a lower rate of discount, five percent, is applied in measuring the value of C's investment and the existence of a premium value in the lease becomes apparent.

It should be noted that in Case 8 the useful life of the building at the time of C's purchase is thirty years. Since the lease term has forty years remaining, the risk involved during the last ten years of the term is probably greater. This can be reflected by assigning different risk factors

56. It is arguable that the lease, regardless of its below average strength, should not be discounted at more than the going market rate of return on unencumbered land, since presumably if the lease were broken by the lessee the land could be leased at the market rate of return. This argument, however, overlooks reality. A lease with a bad tenant may cause serious financial difficulties before repossession and reletting of the premises can be accomplished, e.g., irregular payments, legal expense incurred in ousting the tenant and loss of rent while ousting the old tenant and obtaining a new one.

57. See Appendix.

58. *See* note 15 *supra* and accompanying text.

59. *See First Nat'l Bank of Kansas City v. Nee*, 190 F.2d 61 (8th Cir. 1951), where the court stated that the building "stands primarily as security for the lessee's performance of covenants." *Id.* at 71.

60. See Appendix.

to the various periods of the lease[61] or, as in Case 8, by considering such factors in the overall rate applied.

Following the suggestion of the court of appeals, the Tax Court in *Moore* appeared to take varying risk factors[62] into consideration on remand. Despite the Ninth Circuit's incisive modification of the "incident to the fee" doctrine in *Moore,* the Tax Court persisted in its application, first by dodging the *Moore* opinion[63] and thereafter by flatly rejecting it.[64] Though the appellate courts have avoided ruling directly on the "incident to the fee" doctrine, since *Moore* they have consistently upheld the Tax Court's denial of amortization of the premium rentals and have shown great reluctance to accept the Ninth Circuit's view as articulated in *Moore.*

In *Schubert v. Commissioner*[65] the Fourth Circuit, in affirming the Tax Court's denial of amortization, apparently relied upon the "no exhaustion" doctrine.[66] However, the court took the position that in the fact situation presented any evidence introduced to establish premium value in the lease "could be founded on nothing more than guess, speculation and conjecture."[67]

The statement of the court is even more significant since the record apparently contained substantial evidence that the lease provided for annual premium rentals of approximately $3,000 to $4,000[68] during the remaining nineteen years of the term. In *Moore,* the circuit court admitted, perhaps as the result of a faulty hypothesis,[69] that allocations of

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61. For example, the investment can be discounted at 4 3/4 percent for the first thirty years and at 5 3/4 percent for the last ten years after the building's expected useful life has expired.

62. Some of the factors considered were the life of the building and the remaining life of the sub-lease from the lessee to the present occupant of the building.

63. Bernstein v. Commissioner, 22 T.C. 1146 (1954). The Tax Court's refusal to allow amortization of the value of premium rental was not proven and may well be justified under the facts of that case. The court of appeals affirmed the Tax Court's determination. 230 F.2d 603 (2d Cir. 1956).

64. World Publishing Co. v. Commissioner, 35 T.C. 7 (1960); Schubert v. Commissioner, 33 T.C. 1048 (1960). In *Schubert,* the Tax Court indicated its lack of appreciation of the capital nature of the premium rentals bought and paid for by the purchaser:

> If the purchaser would be entitled to isolate the lease from the fee and take deductions for the favorable portion of the lease, it would mean some of the rents reserved in the lease would escape ordinary income tax altogether.

33 T.C. at 1053. Of course, such rents would escape ordinary income tax only because they represent a return of capital to C.

65. 286 F.2d 573 (4th Cir.), *cert. denied,* 366 U.S. 906 (1961).

66. *See* notes 77-88 *infra* and accompanying text for a discussion of the "no exhaustion" doctrine.

67. 286 F.2d at 583.

68. The lease called for net rentals of $11,120 annually for the next 4 1/2 years and $11,870 annually for the following 15 years. The petitioner introduced evidence that the fair rental value of the land at the time of her inheritance was $7,700 per year.

69. In one of the few unsound comments in the opinion the circuit court said: "If

value to premium rentals may be speculative, but nevertheless reached the conclusion that the allocation should be made.[70] The *Schubert* decision, however, does not seem to involve much speculation and approaches the position that any attempt to allocate value to premium rentals is too conjectural. While the court in *World Publishing Co. v. Commissioner*[71] did not flatly repudiate *Moore,* it characterized the taxpayer's wasting asset as depreciation of the lessee-built improvements and affirmed the Tax Court's disallowance of a deduction for amortization of premium rentals. The court noted that the deduction was "not particularly urged"[72] by the taxpayer on appeal.

In the only other case involving a taxpayer's right to amortize premium rentals,[73] a district court and the court of appeals denied relief to the taxpayer. Both courts held that the question could not be considered, since the taxpayer did not indicate his grounds for a deduction when he filed a refund claim with the Commissioner.[74] *Moore,*[75] with minor exceptions, presents the proper tax treatment in these situations. On remand, however, the Tax Court failed to translate the value of the wasting asset into a proportion of the basis. To the extent that the value of the rentals provided under the lease contract exceed the value of the rentals obtainable from the land at the time of acquisition, they are not "incident to the fee" and should be depreciable as a wasting asset. Since they are intangible assets, the straight line basis of depreciation should be used.

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the terms of the lease could be renewed at any time on the same terms, there would be no exhaustion or wasting . . . and no occasion for depreciation or amortization." 207 F.2d at 277. Thus, the court hypothesized, even if the lease called for rentals over and above the present fair rental value of the land, if the fair rental value of the land at the *termination* of the lease would be as great as the lease rentals, there would be no wasting. It was primarily directed toward the difficulty of determining the fair rental value of the land at the *end of the term* that the court made its comment about the "speculative" nature of determining the value of the premium rentals. The court's quoted comment at the beginning of this footnote is an erroneous interpretation of the nature of the depreciation deduction, as the Tax Court pointed out on remand.

70. That such allocations are somewhat speculative does not prevent their being made. . . . As stated in Bryant v. Commissioner, 2 Cir., 76 F.2d 103, 105: "In such cases though it be impossible to reach a certain conclusion, it has been several times held that the Board should exercise a sound judgment, though taking all chances against the taxpayer. . . . We are quite aware that the result will be speculative but the Treasury will be protected and some relief is juster than the denial of all."

207 F.2d at 278.

71. 299 F.2d 614 (8th Cir. 1962).

72. *Id.* at 620.

73. Goelet v. United States, 161 F. Supp. 305 (S.D.N.Y. 1958), *aff'd per curiam,* 266 F.2d 881 (2d Cir. 1959).

74. Apparently the taxpayer, in his claim for a refund, relied entirely on depreciation of the lessee-constructed building.

75. 207 F.2d 265 (9th Cir. 1953), *cert. denied,* 347 U.S. 942 (1954), *on remand,* 24 P-H Tax Ct. Mem. 726 (1955).

"No Exhaustion" Doctrine

The "no exhaustion" doctrine is a first cousin of the "incident to the fee" doctrine, though the denial of amortization of premium rentals has been couched in the former terms less frequently. The doctrine was initially applied in *Friend v. Commissioner.*[76] The court stated:

> [A]n allowance for exhaustion obtains only where exhaustion actually exists. . . . There is no showing here that the [rental] value of the . . . premises . . . at the expiration of the leases will be any less than it was upon the dates of the execution of the leases.[77]

Even the court in *Moore* took the position that if the fair rental value at the end of the term would be equal to the value provided by the lease, there would be no exhaustion and no wasting premium value even though the rents obtainable when the taxpayer inherited the property were much lower.[78] The fallacy in this position was pointed out in Rubin's article.

> It is sometimes suggested that depreciation of a lease should be denied on the ground that, since it cannot be shown that the rent obtainable after the lease expires will be less than that paid under the lease, there is no certain or fixed loss caused by the gradual exhaustion of the lease. *This contention misconstrues the function of amortization or depreciation.* They are essentially methods of tax-free recovery of cost; although value may be relevant in determining basis, it is thereafter immaterial. Thus depreciation of a building is allowed to the full extent of its basis without regard to replacement cost or to whether the total value of the property will be any less after expiration of the useful life of the building. Likewise it is no objection to amortization of the cost of a contract that an equally favorable contract may be available after it expires.[79]

On remand in *Moore,* the Tax Court correctly took the position that although none of the witnesses could estimate the fair rental value of the property at the end of the lease, the premium value of the lease was nevertheless ascertainable. Noting that the rentals obtainable at at the end of the lease had no relation to the rights acquired by the taxpayer-heir, the court determined premium value with reference to the

76. 40 B.T.A. 768 (1939).
77. *Id.* at 771-72.
78. 207 F.2d at 277.
79. Rubin, *supra* note 44, at 1142 (emphasis added).

rents obtainable at the time of acquisition by the taxpayer.[80] But in *Schubert v. Commissioner*,[81] the Fourth Circuit favorably quoted *Moore* on this point,[82] and indicated that at the termination of the lease the taxpayer will have a rentable building on the property. Thus, the property will have, in all probability, a greater rental value than that provided by the lease.[83]

That rentals equalling those provided in the lease may be available at the end of the term, however, has no bearing on whether C's acquisition contains premium rentals which constitute a wasting asset. The position of the Tax Court on the *Moore* remand and that advocated by Rubin represent the correct posture on this question.

"Depreciation of Lessee-Constructed Building" Doctrine

As previously indicated,[84] when C purchases or inherits property with a lessee-constructed building having a useful life shorter than the lease term, there is no apparent justification for permitting C to depreciate the building. None of the lease rentals are attributable to the building. Even if legal title to the building is in C, he does not hold it "for the production of income," nor does he have an economic interest in the building.

This position is in no sense founded upon the possibility of allowing both the lessee and purchaser-lessor to depreciate the building simultaneously.[85] If each had made an *investment* in the building each would be entitled to depreciation. The decisive factor is that C has not invested in the building since it is not reasonable to assume that any part of the purchase price was paid for improvements which will not result in a

80. The Tax Court drew this parallel:

> The purchaser of a lease is not required to show that it cannot be renewed on as favorable terms upon its termination, since the amount paid for his lease was meant to secure a favorable rental *for a determinable period of time*; hence it is amortizable during this period of time. Similarly, the purchaser of a contract which entitles him to buy merchandise for a period of years at less than the market price at the time the contract was entered into has been permitted to amortize the cost of the contract over its term without a showing that such merchandise will not be available on as favorable prices upon expiration of the contract.

24 P-H Tax Ct. Mem. at 729 (emphasis added).

81. 286 F.2d 572 (4th Cir.), *cert. denied*, 366 U.S. 690 (1961).

82. *Id.*

83. *Id.* at 581. In *Schubert*, the useful life of the building extended beyond the lease term. The court, however, found that the taxpayer had acquired no depreciable basis in the building but seemed to take the position that such reversionary interest in the building offset any wasting aspects of the premium ground rentals provided in the lease.

84. *See* notes 59-61 *supra* and accompanying text.

85. *See* Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953); Goelet v. United States, 161 F. Supp. 305 (S.D.N.Y. 1958).

present return or a future reversion. C will have an economic interest in the building only if B forfeits his leasehold during the building's useful life. As pointed out in *First National Bank of Kansas City v. Nee,*[86] "[i]t is not ordinarily the policy of the law to measure the rights of parties to contracts upon the basis of a forfeiture, which, though contractually possible, has not occurred and is neither imminent nor probable."[87] Although certain eminent tax authorities[88] disagree with this position and believe that C has acquired a depreciable interest in the lessee-constructed building, the above analysis seems to be the best solution.

Regardless, the issue of whether the purchaser or heir should be permitted to depreciate the lessee-built improvements has played an important role in the courts' consideration of these cases and is largely responsible for obscuring the true nature of C's investment and the correct tax treatment to be accorded him.

The initial position of the Commissioner was to allow C to depreciate the lessee-built improvements if the useful life extended beyond the lease term[89] and to deny depreciation if the life of the improvements was shorter than the lease. However, in *Currier v. Commissioner,*[90] the first time the issue was presented, the Tax Court did not accept the Commissioner's position on the latter point. The Court held that "[b]y the end of the lease the property will be returned with a worthless building, and petitioner's capital will have been correspondingly reduced."[91] The Court failed to consider that none of the taxpayer's capital was invested in the building and that it produced none of the rents under the lease. The fallacy of this approach is revealed in *Pearson v. Commissioner*[92] where the taxpayer inherited property subject to an *unfavorable* lease.

In Case 2[93] the value of the land has risen from $100,000 when the

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86. 190 F.2d 61 (8th Cir. 1951), *aff'g* 92 F. Supp. 328 (W.D. Mo. 1950).

87. 190 F.2d at 71, citing Puerto Rico v. United States, 132 F.2d 220 (1st Cir. 1942) and Board of Commissioners of Mahoning County v. Young, 59 F. 96 (6th Cir. 1893).

88. *See* J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 45.09A (1954); Lurie, *Depreciating Structures Bought Under Long Leases: An Adventure in Blunderland,* N.Y.U. 18TH INST. ON FED. TAX. 43 (1960).

89. *See* Peters v. Commissioner, 4 T.C. 1236 (1945); Annex Corp. v. Commissioner, 2 CCH Tax Ct. Mem. 167 (1943). In these cases only the question of amortization of lease rentals was in issue, not depreciation of the improvements. The opinions reveal, however, that the Commissioner had agreed to deductions for depreciation of the buildings, apparently beginning immediately and at least in *Peters,* by using the full present fair market value of the building as the criterion for allocation of its basis.

90. 7 T.C. 980 (1946).

91. *Id.* at 984.

92. 13 T.C. 851 (1949).

93. See Appendix.

lease was executed to $120,000 at the date of C's acquisition. Thus, at a rate of six percent the unencumbered land would produce $7,200 annually while the lease yields only $6,000. The lease has no premium value since the present value of the land, if unencumbered by the lease, exceeds the value of the property with the lease. Consequently, C should not be entitled to a depreciation deduction, regardless of the price he paid, since he does not own a wasting asset. Another unfavorable lease situation is presented by Case 4 in which the rate of return on real estate has gone up since the lease was executed.

Of course a lessee-constructed building with a useful life shorter than the lease term should not affect[94] C's tax treatment. Yet, the Tax Court in *Pearson* allowed depreciation on the building even though the taxpayer's capital investment would actually *appreciate* as the lease-free reversion became more immediate.

While the Tax Court was allowing depreciation on the building in *Pearson,* a federal district court denied a depreciation deduction in a similar situation.[95] Though the decision adds little to this discussion since the Court's legal and factual analysis is questionable,[96] it does represent the first correct *result.*

After the Tax Court, on remand, allowed depreciation of the building in *Moore,* three circuit court decisions followed which involved lease terms that extended beyond the useful life of the lessee-built improvements. The decisions were progressively enlightening.

In reversing the Tax Court in *Pearson,* the court of appeals found that "the fair market value of the building alone, as distinguished from the . . . property as a whole, was, as to . . . the [taxpayer-heir,] zero,"[97] and that there was no proof that the decedent's estate tax return valuation included any interest in the building.[98]

However, the Eighth Circuit in *First National Bank of Kansas City*

94. The building may serve as security for the lessee's obligation to pay the lease rentals. *See* notes 58-59 *supra* and accompanying text.

95. First Nat'l Bank of Kansas City v. Nee, 85 F. Supp. 840 (W.D. Mo. 1949), *motion for amended judgment denied,* 92 F. Supp. 328 (1950), *aff'd,* 190 F.2d 61 (8th Cir. 1951).

96. The court: 1) held that under Missouri law all property strictly embraced within the leasehold would be chattels real and would belong to the lessee, a determination later challenged by the appellate court; 2) found, on the motion for amended judgment, that the lessee's position was like that of a life tenant, and that the lessee alone was thus entitled to depreciate the building; and 3) erroneously found that the terms of the lease required the tenant to yield up a building at the lease's termination in as good a condition as the building constructed by the lessee when new.

97. Commissioner v. Pearson, 188 F.2d 72, 74 (5th Cir. 1951), *rev'g* 13 T.C. 851 (1949).

98. *Id.* at 75.

v. Nee,[99] in affirming the result reached by the district court,[100] provided the first pithy rhetoric on the subject. The court found that the building was neither used by the taxpayer-heir in his trade or business nor held by him for the production of income and that consequently it did not qualify as depreciable property under the Code.[101] The Court stated:

> We consider that the expression "held for the production of income" must be understood as requiring for its applicability that property be held *by the taxpayer* for the production of income *for or to him.*[102]

Recognizing that property held for the production of income does not require that income actually accrue to the taxpayer during the years in question, the Court continued:

> What matters is the taxpayer's purpose to obtain income from it as the motive for his holding of it.
>
> . . . [I]t is demonstrable . . . that no income accrued to the lessor or was intended to accrue to her or her devisees or assigns from that structure. The lessor reserved and received, and her successors continue to receive, rent solely from the ground. . . .
>
> . . . .
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> The building unquestionably produces . . . income; but not for the lessor or her successors. . . .
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> . . . .
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> . . . [W]e need not . . . determine with finality the ownership of the legal title to the building presently upon the land, for that consideration is not alone decisive upon the right to claim depreciation on the score of its deterioration. . . . The controlling inquiry is whether, in the situation under review regardless of who technically owns the wasting improvement, the claimant of depreciation holds it for the production of income for the claimant's benefit and has in it a cost basis or . . . a substitute basis . . . .[103]

99. 190 F.2d 61 (8th Cir. 1951), *aff'g* 92 F. Supp. 328 (1950). Ironically, it is also the Eighth Circuit who most recently "muddied the water" on this matter in *World Publishing Co. v. Commissioner*, 299 F.2d 614 (8th Cir. 1962).

100. The court remarked: "It will be observed that our approach to, and emphasis upon, the grounds of decision depart in some respects from the reported reasoning of the trial judge. But we are entirely in agreement with his ruling in the action." 190 F.2d at 64.

101. INT. REV. CODE of 1954, § 167(a).

102. 190 F.2d at 66.

103. *Id.* at 66-68.

The *Moore* decision followed and was as edifying in its reversal of the Tax Court's allowance of depreciation for the building as it was in reversing the Court's denial of amortization of premium rentals under the lease. The Court stated:

> [T]he basis shall be the fair market value of such property at the time of such acquisition. But "such property" is not the . . . building . . . it is the taxpayer's *interest* in that property . . . .
>
> . . . .
>
> It is not the physical property itself, nor the title thereto, which alone entitles the owner to claim depreciation. The statutory allowance is available to him whose interest in the wasting asset is such that he would suffer an economic loss resulting from the deterioration and physical exhaustion as it takes place . . . . We think the Commissioner is right in his statement that "so far as the rights reserved by the lessors were concerned, the existence of the building and its depreciation were matters of economic indifference. Their right to receive the ground rentals and to have possession of the property at a future time when the building would no longer have value, was not diminished by the physical exhaustion of the building."[104]

The introductory verse[105] suggested that the reader consider the predicament of counsel for the petitioner in *Rowan v. Commissioner*[106] as he prepared for his appearance before the Tax Court. Rowan was an uncle of Mrs. Pearson, wife of the taxpayer in *Pearson*.[107] Rowan's inhertited interest was in the *same property* involved in *Pearson*. In three consecutive cases,[108] including *Pearson*, the Tax Court had held that an heir to leased property was entitled to depreciation deductions on a lessee-constructed building with a useful life shorter than the lease. It had also uniformly held[109] that the purchaser or heir of such property was not entitled to depreciate or amortize premium rentals obtained under

104. Commissioner v. Moore, 207 F.2d 265, 268-69 (9th Cir. 1953) (footnotes omitted).

105. *See* note 1 *supra* and accompanying text.

106. 22 T.C. 865 (1954).

107. 13 T.C. 851 (1949). In *Pearson*, it was an interest inherited by *Mrs*. Pearson that was under review, though the case was brought in her husband's name.

108. Moore v. Commissioner, 15 T.C. 906 (1950); Pearson v. Commissioner, 13 T.C. 851 (1949); Currier v. Commissioner, 7 T.C. 980 (1946).

109. Moore v. Commissioner, 15 T.C. 906 (1950); Cleveland Allerton Hotel, Inc. v. Commissioner, 16 P-H Tax Ct. Mem. 435 (1947); Peters v. Commissioner, 4 T.C. 1236 (1945); Annex Corp. v. Commissioner, 2 CCH Tax Ct. Mem. 1967 (1943); Friend v. Commissioner, 40 B.T.A. 768 (1939).

the lease because they were "incident to the fee." Although *Pearson* had been reversed by the circuit court,[110] the reversal was partially couched in terms of a failure to establish a basis in the building, and Rowan's attorney probably felt he had more complete evidence on this point. As counsel was preparing his brief, the Ninth Circuit had not as yet rendered the *Moore* decision.[111] Thus, *no* court had ever allowed depreciation or amortization of premium rentals.[112] Obviously, the most promising approach was to seek depreciation of the building and that was the path Rowan's attorney chose to follow.

After counsel's brief was filed, the appellate court decision in *Moore* was rendered. It must have come like a bombshell to the harried practitioner. Not only did the *Moore* court disallow depreciation of the building—what Rowan's counsel had sought—but it permitted amortization of premium rentals, relief he had not sought. Caught in this distressing position, counsel could do little more than stand agonizingly by while the Tax Court denied depreciation of the building.

If the Tax Court has refused to follow the Ninth Circuit and disallow amortization of premium rentals,[113] it has almost mechanically conformed to *Moore* in denying the depreciation of improvements to one who acquires property upon which there is a lessee-constructed building, regardless of whether the useful life of the improvements were shorter[114] or longer[115] than the lease term.

Goelet v. United States,[116] however, was the first case to apply the *Moore* rationale, although erroneously, to a situation where the life of the building extended beyond the term of the lease.[117]

In *World Publishing Co. v. Commissioner,*[118] A leased land to B for fifty years and B subsequently erected a building. When 28½ years

110. Commissioner v. Pearson, 188 F.2d 72 (5th Cir. 1951), *rev'g* 13 T.C. 851 (1949).

111. The Tax Court in *Rowan* noted the fact that *Moore* was not reversed until after the petitioner's brief had been filed. 22 T.C. at 872.

112. Though the Sixth Circuit reversed the Tax Court on the "incident to the fee" doctrine in *Cleveland Allerton Hotel, Inc. v. Commissioner,* 116 F.2d 805 (6th Cir. 1948), it allowed the *lessee-purchaser* in that case a business expense deduction in the *year of purchase.* The court also observed that the status of the *lessee-purchaser* did not approximate that of a third party purchaser.

113. *See* notes 62-64 *supra* and accompanying text.

114. *E.g.,* World Publishing Co. v. Commissioner, 35 T.C. 7 (1960); Bernstein v. Commissioner, 22 T.C. 1146 (1954).

115. *E.g.,* Schubert v. Commissioner, 33 T.C. 1048 (1960).

116. 161 F. Supp. 305 (S.D.N.Y. 1958), *aff'd per curiam,* 266 F.2d 881 (2d Cir. 1959).

117. *See* notes 135-36 *infra* and accompanying text.

118. 299 F.2d 614 (8th Cir. 1962).

remained on the lease A sold the property to C (World Publishing Co.)[119] for $700,000. It was stipulated that the remaining useful life of the building was not greater than the unexpired term of the lease and the court found that the fair market value of the land was $400,000 at the time of C's purchase.

In what must be regarded as an unusually iconoclastic opinion, the court remarked:

> On these facts, *uninfluenced by any decided lease cases,* it would seem clearly to follow that the taxpayer is entitled to a deduction . . . for depreciation of the $300,000 portion of its . . . purchase price allocable to the improvements. . . . The building, as well as the land, *was acquired and held by taxpayer "for the production of income"* . . . . [T]he building is a wasting asset and its complete exhaustion will have been effected before the end of the lease term. The taxpayer's spreading of the wasting portion of the purchase price over the entire remaining lease term by the straight-line method approximated the minimal deduction for the taxpayer.[120]

Although all of the rentals payable during the lease term throughout the building's useful life were for the land alone, the court did not clearly indicate in what manner C held the building "for the production of income." Apparently the court did not consider it illogical to assume that part of C's purchase price was paid for a structure in which he would never have an economic interest.

As indicated earlier,[121] the opinion implied that there might be some distinction between denying building depreciation in a purchase case, as opposed to an inheritance case. Additional precedent was distinguished because the lessor-purchaser held legal title to the building. These distinctions are unconvincing since the court did not offer any reasons why either variant should warrant differential treatment.

World Publishing has cast a new cloud of confusion over the proper tax treatment to be dispensed to the purchaser or heir of property acquired subject to a lease. Case 9[122] appears to be the proper solution to the situation presented in *World Publishing.* In the only subsequent decision which may be pertinent to this discussion,[123] *World Publishing*

119. The rentals remaining to be paid under the lease were: $30,000 per year for 8 1/2 years after the purchase, $32,500 annually for the following ten years and $27,500 for the last ten years of the term.

120. 299 F.2d at 617 (footnotes omitted).

121. *See* notes 27-28 *supra* and accompanying text.

122. See Appendix.

123. Wilshire Medical Properties, Inc. v. United States, 314 F.2d 333 (9th Cir.

was followed. It is clear, however, that the decision has not been extended and applied to inheritance cases,[124] so as to permit depreciation of lessee-built improvements to an heir of the lessor.

In the preceding sections the tax treatment accorded C involved the acquisition of property subject to a lease, which was either unimproved or improved by the presence of a lessee-constructed building with a useful life shorter than the lease term. A different analysis is called for when the lessee-built improvements have a life extending beyond the lease term. Still another approach is necessary where the improvements are built by the lessor prior to the execution of the lease. The purpose of this section is to suggest the correct tax treatment in these circumstances.

LESSEE-BUILT STRUCTURE SURVIVING LEASE TERM

At the time of C's purchase in Case 10[125] forty years remain on the lease. The expected useful life of the building is forty-five years. The building is economically insignificant to C during the lease since no rents are being produced. It will be of economic importance to him, however, at the expiration of the lease, because he can use it for the production of income during the five remaining years of its useful life. Thus, it is logical to assume that a portion of C's purchase price was paid for the reversionary right to the building when the lease expires.

In determining the value of the building at the end of the lease term it would appear reasonable to assign a value which, if depreciated at the time of C's purchase on a straight line basis, would equal the remaining value upon the expiration of the term. Thus, in case 9 the anticipated value of the building at the time of its reversion to C would be $40,000.[126] Accordingly, the present value of the reversionary interest in the building is $5,682.

The reversionary interest in the building effects an increase in the total value of C's purchase, since the value of the premium rentals,

1963). In a per curiam decision remanding the case to the district court, the Ninth Circuit stated:

> [W]e conclude that summary judgment is not the proper procedure to follow in this case; that the cause should be heard, and appellant be given the opportunity to prove, if it can, it is entitled for depreciation purposes to some allocation of the purchase price between the land and the building.

Id. at 333-34. Apparently the cause was settled before being heard on the remand, since there is no reported opinion of the district court.

124. Barnes v. United States, 222 F. Supp. 960 (D. Mass. 1963), *aff'd sub nom.* Buzzell v. United States, 326 F.2d 825 (1964); Currier v. Commissioner, 51 T.C. 488 (1968).

125. See Appendix.

126. A building worth $360,000 with a remaining useful life of 45 years would permit an $8,000 annual depreciation deduction. At the end of 40 years, on a straight line basis, its value [$360,000 - (40 x $8,000)] would be $40,000.

$17,159, and the value of the land, $100,000, remain unchanged by the reversion in the building. However, a lower percentage of basis is obviously being paid for the assets since a portion of the purchase price must be attributed to the reversionary right in the building. Allocation of basis among the various assets should be made in accordance with the formula provided by the Regulations.[127]

Since C's basis in the building will not begin to decrease until the end of the lease term, his depreciation of the basis allocated to that asset should be delayed until the reversion occurs. Meanwhile, his basis in the premium rentals should be amortized over the remaining years of the lease.

Lessor-Built Structures

It is not the purpose of this article to extensively explore the equitable tax treatment to be accorded C when he acquires *lessor-improved* property subject to a lease; however, the matter warrants some consideration at this point. Depreciation or amortization of premium rentals resulting from lessor-constructed buildings has received scant attention from the courts, presumably because the taxpayer, C, is permitted to depreciate his basis in the improvements. Further, in allocating his basis between land and improvements he is generally able to reflect any premium value of the lease in the value of the building. Under most circumstances C is adequately compensated by being permitted to depreciate the building at an accelerated rate.

In *World Publishing* the court stated that it was immaterial whether the improvements were constructed by the vendor-lessor or the tenant—if C is entitled to depreciation in one instance he should be in the other.[128] The presence of lessor-contructed improvements, however, results in an increase in income directly attributable to the improvements and a deduction is justified. The existence of lessee-constructed improvements does not increase the lessor's income and consequently, a depreciation deduction is unwarranted.

The Treasury policy of permitting C to depreciate the lessor-built improvements does not necessarily reflect the exhaustion of C's capital investment, since there may be a substantial amount of premium value in the lease which is not reflected in the deduction. That would be the result, for example, where there has been a decided decline in the value of unimproved land subsequent to the execution of the lease.[129] In such a

127. Treas. Reg. § 1.167(a)-5 (1967).

128. 35 T.C. 7 (1960).

129. Apparently this was the situation in *Peters v. Commissioner,* 4 T.C. 1236 (1945), where amortization of premium rentals was denied on the "incident to the fee" doctrine. The building in that case was lessor-constructed.

situation an approach similar to that outlined previously is recommended.[130]

No difficulty is encountered when the remaining useful life of the building coincides with the remaining term of the lease, as illustrated by Case 11.[131] The amount in excess of the land's value will be "wasting" over the identical forty year period and whether the depreciation is attributed to the building or is labeled as premium value of the lease is of little consequence except for C's right to accelerated depreciation.

When the remaining life of the building extends beyond the lease, the exhaustion of C's capital assets would seem to be properly reflected by assigning a value to the reversionary right in the building as discussed in Case 10. Thus, the depreciation of that portion of C's basis would be postponed until the reversion ripens, permitting the remainder of C's basis, in excess of that attributable to the land, to be depreciated over the remaining term of the lease. Again, it is immaterial, except for the right to accelerated depreciation, whether the asset exhausted during the lease is considered a structure or an intangible. The question of whether C should be allowed accelerated depreciation on the wasting asset has been rendered less important by the recapture provisions in the Code.[132] Difficulty is encountered, however, in allocating a basis for depreciation that will accurately reflect the exhaustion of C's investment where the remaining useful life of the building, at the time of C's purchase, falls short of the unexpired lease.

This result occurs because the allocation of basis formula uses the value of the expected lease rentals as an element of total value. The valuation of the lease rentals for the remaining term is inaccurate since it presupposes the existence of a building for the production of a portion of the rentals throughout the lease term. This, of course, is not the case since C theoretically will have to make an investment in another building when the useful life of the existing structure expires.

Without attempting to offer a final solution to this problem,[133] it is suggested that an inflated basis must be allocated to the wasting assets which will reflect not only C's present investment, but also the investment he will have to make at the end of the present building's useful life to produce rentals to the end of the lease term. Once the wasting basis is ascertained it would be allocated to the building in the same proportion that the present fair market value of the building bears to the value of the total rents to be received under the lease.

130. *See* notes 53-56 *supra* and accompanying text.
131. See Appendix.
132. INT. REV. CODE of 1954, § 1250.
133. This problem is one which has never arisen in the courts.

As previously noted,[134] in the decade between the *Moore* and *World Publishing* decisions, the courts consistently held that one who acquired lessee-improved property was not entitled to depreciate those improvements. Although *Moore* was directed at cases where the useful life of the improvements was shorter than the lease term, the courts applied the rule with equal vigor when the useful life exceeded the lease term. In *Goelet v. United States*[135] the useful life of the improvements at the time of the taxpayer's acquisition of the property extended eight years beyond the term of the lease. The district court did not mention this distinction in denying the depreciation deduction and the appellate court deemed the fact unimportant in its per curiam affirmance of the lower court's decision.[136]

In *Schubert,* both the Tax Court and the court of appeals followed *Goelet* without questioning the correctness of applying the *Moore* doctrine to improvements that would outlive the lease. After the taxpayer in *World Publishing* was permitted to depreciate improvements with a useful life "not in excess" of the lease term, the anomaly of existing law became clear—one who purchases or inherits leased property containing lessee-built improvements with a useful life *shorter* than the lease term may depreciate those improvements; one who acquires such property where the life of the improvements extend *beyond* the lease term may not depreciate the improvemnts.

Obviously, where the useful life of the building exceeds the lease term, the taxpayer should be permitted to assign a present value to the reversionary right in the building and allocate his basis to the land, the premium rentals and the reversion. The basis of the reversion should be depreciated over the remaining life of the building when the reversion ripens and the basis of the premium rentals should be amortized over the lease term.

The tax consequence to one who acquires leased property with lessor-constructed improvements has received scant attention by the courts. *Peters v. Commissioner*[137] is the only case where the taxpayer sought amortization of the premium rentals under such circumstances. Relying on the "incident to the fee" doctrine, the court incorrectly denied taxpayer's claim. Of course, in these circumstances the Commissioner

134. *See* notes 111-17 *supra* and accompanying text.
135. 266 F.2d 881 (2d Cir. 1959), *aff'g* 161 F. Supp. 305 (S.D.N.Y. 1958).
136. 266 F.2d at 882. In *Goelet* the taxpayer acquired the property by inheritance in 1941, when there were thirty-two years remaining on the lease term and the building had an unused life of forty years. In 1946, prior to the case being heard, the lease was extended for ten years. This, however, had no bearing on the nature of the taxpayer's "investment" at the time of her acquisition in 1941.
137. 4 T.C. 1236 (1945).

permits depreciation of the basis allocable to the building. The taxpayers have probably not sought to enlarge their depreciable basis to include premium rentals, since there may be a risk of losing the accelerated rate.

CONCLUSION

Where C purchases or inherits unimproved property subject to a lease or property having lessee-constructed improvements with an expected useful life shorter than the remaining lease term, he should be permitted to amortize that portion of his basis allocable to the premium rentals receivable under the lease—those rentals in excess of the fair rental value of the land, unencumbered by the lease at the time of acquisition. C should not be entitled to a depreciation deduction on a lessee-built structure that will not survive the lease term, since he does not hold it for the production of rental income during the lease term or have a reversionary interest in the building.

An equitable tax treatment of C has eluded the courts in these circumstances. The taxpayers and their counsel must share the responsibility for this situation with the judiciary.[138] They can scarcely be faulted for their approach, however, in view of the judicial precedents with which they were faced.

The court of appeals decision in *Moore* is the apex of judicial insight. Only the failure of the Tax Court to allocate a basis to the wasting asset in accordance with the formula provided by the Regulations prevented a proper result from being reached on remand. The steady regression to the earlier Tax Court view allowing depreciation of lessee-built structures and denying amortization of premium rentals culminated in the *World Publishing* decision in the Eighth Circuit. Recent decisions are even more perplexing. In *Goelet* and *Schubert* depreciation was not allowed on buildings that would survive the lease term, while in *World Publishing* depreciation was allowed on a structure with a useful life shorter than the remaining term of the lease.

It would appear that the only safe course for tax counsel to pursue in the present chaotic state of the law is alternative relief: amortization of the basis allocable to premium rentals and depreciation of the basis allocable to the reversion in the building, the latter to be taken when the reversion ripens; *or* depreciation of the basis allocable to the building, based upon the ratio of the present value of the building to total value. Where the expected useful life of the lessee-built structure exceeds the lease term, C should be required to allocate a portion of his basis to the

138. Typically the taxpayers sought only depreciation of the lessee-built improvements without seeking amortization of the premium rentals.

reversionary interest in the building and take a depreciation deduction on that portion of his basis when the reversion ripens. Meanwhile, the basis allocable to premium rentals should be depreciated during the lease term.

It is hoped that by these alternative positions counsel can faciltiate the development of an enlightened rationale in these cases while protecting his client's position regardless of which variegated precedent the court might choose to follow.

APPENDIX

(TABLE OF HYPOTHETICAL CASES)

	Present Value of Property Acquired by C								
Common Facts (to Cases 1-6) A buys land for $100,000 and leases to B for 50 years at $6,000 per year. At end of 10 years C purchases the property (in case 6, C inherits it) from A, subject to the lease.	A Present Value of Lease Rentals	B Present Value of Reversion[38] in land	C Total Value	D Value Allocable to Land, if Unencumbered	E Value Allocable to Premium Lease Rentals	F Ratio of Premium Rents Value to Total Value	G Various Assumed Total Bases	H Portion of Basis Allocable to Premium Rentals (Depreciable)	I Portion of Basis Allocable to Land (Not Depreciable)
Case 1 Additional Facts: Market value of the land is $80,000 at the time of C's purchase, and the market rate of return on unimproved land similarly situated is 6%. The lease is an average one.	(6%) 15.0462 x $6,000 = $90,277	(6%) $80,000 + 10.2857 = $7,777	$90,277 + $7,777 = $98,054	$80,000	$18,054	$18,054 / $98,054 = 18.4%	$98,054	$18,054	$80,000
							$105,000	$19,320	$85,680
							$85,000	$15,640	$69,360
Case 2 Additional Facts: Market value of the land is $120,000 at the time of C's purchase, and the market rate of return on improved land similarly situated is 6%. The lease is an average one.	(6%) 15.0462 x $6,000 = $90,277	(6%) $120,000 + 10.2857 = $11,667	$90,277 + $11,667 = $101,944	$120,000	0	0 / $101,944 = 0%	$101,944	0	$101,944
							$105,000	0	$105,000
							$85,000	0	$85,000
Case 3 Additional Facts: Market value of the land is $100,000 at the time of C's purchase, but the market rate of return on unimproved land similarly situated is now 5%. The lease is an average one.	(5%) 17.1590 x $6,000 = $102,954	(5%) $100,000 + 7.0399 = $14,205	$102,954 + $14,205 = $117,159	$100,000	$17,159	$17,159 / $117,159 = 14.6%	$117,159	$17,159	$100,000
							$130,000	$18,980	$111,020
							$100,000	$14,600	$85,400
Case 4 Additional Facts: Market value of the land is $100,000 at the time of C's purchase, but the market rate of return on unimproved land similarly situated is now 7%. The lease is an average one.	(7%) 13.3317 x $6,000 = $79,990	(7%) $100,000 + 14.9744 = $6,678	$79,990 + $6,678 = $86,668	$100,000	0	0 / $86,668 = 0%	$86,668	0	$86,668
							$100,000	0	$100,000
							$75,000	0	$75,000
Case 5 Additional Facts: Market value of the land is $100,000 at the time of C's purchase, the market rate of return on unimproved land similarly situated is 5%. However, the lease is weak and risky, requiring at least a 6% return to a prudent investor.	(6%) 15.0462 x $6,000 = $90,277	(6%) $100,000 + 10.2857 = $9,721	$90,277 + $9,722 = $100,000	$100,000	0	0 / $100,000 = 0%	$100,000	0	$100,000
							$110,000	0	$110,000
							$90,000	0	$90,000
Case 6 Additional Facts: Market value of the land is $80,000 at the time of C's acquisition, and the market rate of return on unimproved land similarly situated is 6%. The lease is an average one. C inherits the property from A.	15.0462 x $6,000 = $90,277	$80,000 + 10.2857 = $7,777	$90,277 + $7,777 = $98,054	$80,000	$18,054	$18,054 / $98,054 = 18.4%	$98,054	$18,054	$80,000
							$80,000	$14,720 (0)	$65,280 ($80,000)
							$85,000	$15,640 ($5,000)	$69,360 ($80,000)
							$105,000	$19,320	$85,680
							$70,000	$12,880 (0)	$57,120 ($70,000)

[TABLE OF HYPOTHETICAL CASES]

Common Facts (to Cases 7, 8 & 10)	Present Value of Property Acquired By C												
	A	B	C	D	E	F	G	H	I	J	K	L	M
A buys land and leases to B for 50 years at $6,000 per year. B builds a building thereon at a cost of $40,000. Ten years later A sells the property to C, subject to the lease.	Present Value of Lease Rentals to be Received	Present Value of Reversion in Land	Present Value of Reversion in Building	Total Value	Value Allocable to Land if unencumbered	Value Allocable to Reversion in Building	Value Allocable to Premium Lease Rentals	Ratio of Premium Rents Value to Total Value	Ratio of Building (Reversionary) Value to Total Value	Various Assumed Total Bases	Portion of Basis Allocable to Premium Rentals (Depreciable over Lease Term)	Portion of Basis Allocable to Reversion in Building (Depreciable When Reversion Ripens)	Portion of Basis Allocable to Land (Non-Depreciable)
Case 7 Additional Facts: Market value of the land is $80,000 at the time of C's purchase, and the market rate of return on unimproved land similarly situated is 6%. The lease is an average one despite the presence of the lessee-built building. The remaining useful life of the building at C's purchase is 30 years.	(5%) 15.0462 x $6,000 = $90,277	(6%) $80,000 ÷ 10.2857 = 7,777	0	$90,277 + 7,777 = $98,054	$80,000	0	$18,054	$18,054 / $98,054 = 18.4%	0 / $98,054 = 0%	$98,054 $105,000 $85,000	$18,054 $19,320 $15,640	0 0 0	$80,000 $85,680 $69,360
Case 8 Additional Facts: Market value of the land is $100,000 at the time of C's purchase, and the market rate of return on unimproved land similarly situated is 6%. The remaining useful life of the building at the time of C's purchase is 30 years. The lease is a strong one, largely because of the presence of the lessee constructed building.	(5%) 17.1590 x $6,000 = $102,954	(5%) $100,000 ÷ 7.0399 = $14,205	0	$102,954 + 14,205 = $117,159	$100,000	0	$17,159	$17,159 / $117,159 = 14.6%	0 / $114,318 = 0%	$117,159 $130,000 $100,000	$17,159 $18,980 $14,600	0 0 0	$100,000 $111,020 $85,400
Case 9 For the facts of World Publishing Co. v. Commissioner see notes 118-21 and accompanying text. Assume that the market rate of return on unimproved land similarly situated is 6%, but the presence of the lessee-constructed building here makes this lease a 5% risk.	(5%) 145 6.7855 x $30,000 = $203,565 (5%) 144 5.1019 x $32,500 = $165,812 (5%) 145 3.1321 x $27,500 = $86,132	(5%) $400,000 ÷ 4.0181 = 99,550	0	$203,565 + 165,812 + 86,132 99,550 $555,059	$400,000	0	$155,059	$155,059 / $555,059 = 28%	0 / $555,059 = 0%	$700,000	$196,000	0	$504,000
Case 10 Same facts as Case 8 (including the Common Facts) except that the remaining useful life of the building at the time of C's purchase is 45 years. The fair market value of the building at the time of C's purchase is $360,000.	(5%) 17.1590 x $6,000 = $102,954	(5%) $100,000 ÷ 7.0399 = 14,205	(5%) $40,000 ÷ 7.0399 = $5,682	$102,954 + 14,205 + 5,682 = $122,841	$100,000	$5,682	$17,159	$17,159 / $122,841 = 14%	$5,682 / $122,841 = 4.6%	$122,841 $130,000 $100,000	$17,841 $18,200 $14,000	$5,682 $5,980 $4,600	$100,000 $105,820 $81,400
Case 11 C buys land for $100,000, builds a building thereon costing $400,000 and leases to B for 50 years at $30,000 per year. Ten years later A sells the property to C. At such time the building has a remaining useful life of 40 years and a present fair market value of $360,000, the land has a present fair market value of $80,000, and the market rate of return on both improved and unimproved property is 6%. The lease is an average one.	(6%) 15.0462 x $30,000 = $451,386	(6%) $80,000 ÷ 10.2857 = $7,777	0	$451,386 + 7,777 = $459,163	$80,000	0	$379,163	$379,163 / $459,163 = 82.6%	0 / $459,163 = 0%	$459,163 $500,000 $400,000	$379,163 $413,000 $330,400	0 0 0	$80,000 $87,000 $69,600