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Volume 30 | Issue 2

Article 3

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1976

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## Recommended Citation

J. Scott Morris, *Taxation of Leases: Profits and Pitfalls*, 30 Sw L.J. 435 (1976)  
<https://scholar.smu.edu/smulr/vol30/iss2/3>

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# TAXATION OF LEASES: PROFITS AND PITFALLS

by

J. Scott Morris\*

A lease is usually thought of as a contractual arrangement whereby one owning land or other property, or holding the right to possession and use of land or other property, gives over its possession and use to another for a limited period of time in return for a consideration. A sale is generally considered to be the transfer of title to property for a consideration. For tax purposes, however, the line of demarcation between sales and leases is not always so easily drawn.

## I. LEASES

Rental payments are the consideration given for the use of land or other property, but for tax purposes rentals are deductible only if the taxpayer has not taken title to the property, is not taking title to the property, and has no equity in the property.<sup>1</sup> Taking title to the "leased" property is the same as acquiring an equity in it for purposes of the section 162(a)(3) test.<sup>2</sup> There are of course a number of incentives for one who is actually purchasing property to have his purchase treated as a lease instead of a purchase for tax purposes. Rentals qualifying under section 162(a)(3) are fully deductible; of mortgage payments, only the interest factor is deductible. The 1969 amendments to the depreciation statute greatly reduced the deductions that once were available.<sup>3</sup> The fastest write-offs allowed by the new ADR (asset depreciation range) rules in 1971 are not available in the case of realty.<sup>4</sup> Also, the recapture of depreciation rules were made more severe in 1969.<sup>5</sup>

What then is a lease for tax purposes as opposed to a sale? A primary consideration is whether the consideration for the lease is actually equal to the real fair market value of the property, this of course being one indication of a sale.<sup>6</sup> Another important consideration is whether the rentals are uniform over the term of the lease. If they are not uniform, then it must be asked whether they increase or decrease according to changes in the fair rental value of the property.<sup>7</sup> If the total of the rentals approximates the amount that would be reached by payments of principal and interest, then it must be determined whether the purported lessee can obtain title at the

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1. INT. REV. CODE OF 1954, § 162(a)(3).

2. *Oesterrich v. Commissioner*, 226 F.2d 798, 802 (9th Cir. 1955).

3. INT. REV. CODE OF 1954, § 167(j).

4. *Id.* § 167(m).

5. *Id.* §§ 1245, 1250, as amended in 1969.

6. *Robinson v. Elliot*, 262 F.2d 383, 386 (9th Cir. 1958).

7. *Oesterrich v. Commissioner*, 226 F.2d 798, 803 (9th Cir. 1955).

termination of the lease period by the payment of a merely nominal sum.<sup>8</sup> The same presumption that the property is actually a sale rather than a lease is reached if the lease agreement is silent as to ownership at the end of the lease period, but the improvements are tailor-made for the lessee and will be valueless to the lessor at the end of the lease.<sup>9</sup> In a true lease, of course, the burdens of ownership such as taxes and assessments remain the obligations of the owner. Thus, it is pertinent to ask whether in a purported lease the taxes and similar burdens are being paid by the lessor or by the purported lessee.<sup>10</sup> These same criteria are used in distinguishing leases from management contracts.<sup>11</sup>

One of the most recent adaptations of the usual lease transaction is the "leveraged lease." In such a transaction the lessor buys the asset on an installment plan and leases it for a term equal to all or a substantial part of the asset's expected useful life on a net basis, so as to cover the debt service to the lender. The Internal Revenue Service has, for ruling purposes, established criteria by which it will determine whether a purported lease is to be treated as a lease for tax purposes. Revenue Procedure 75-21<sup>12</sup> sets out the criteria used and Revenue Procedure 75-28<sup>13</sup> sets forth the information required of parties requesting rulings under Revenue Procedure 75-21.

There must be a minimum unconditional equity investment by the lessor of at least twenty percent of the section 1012 total acquisition cost.<sup>14</sup> Only actual consideration paid and personal liability incurred count as unconditional investment. The minimum investment must be equal to at least twenty percent of the cost of the property at all times throughout the lease.<sup>15</sup> An amount equal to at least twenty percent of the original cost of the property must be the estimated remaining fair market value at the end of the lease term.<sup>16</sup> The lease term includes all renewal or extension periods except those exercisable by the lessee at fair rental value.<sup>17</sup> The lessee may not have a contractual right to purchase the property for less than its fair market value and the lessor may not, when the property is first placed in service or use by the lessee, have a contractual right to cause any party to purchase the property. The lessor must also not have any present intention at that time to acquire such a contractual right.<sup>18</sup> The lessee may make ordinary repairs and incur ordinary maintenance,<sup>19</sup> and may make higher rental payments to cover cost overruns,<sup>20</sup> but may not furnish any part of

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8. *Id.* at 802; *M & W Gear Co. v. Commissioner*, 446 F.2d 841, 845 (7th Cir. 1971).

9. *Estate of Starr v. Commissioner*, 274 F.2d 294, 295 (9th Cir. 1959).

10. *Robinson v. Elliot*, 262 F.2d 383, 385 (9th Cir. 1958).

11. *State Nat'l Bank v. United States*, 509 F.2d 832 (5th Cir. 1975).

12. 1975-1 CUM. BULL. 715.

13. 1975-1 CUM. BULL. 752.

14. *Rev. Proc. 75-21*, § 4(1)(A), 1975-1 CUM. BULL. 715.

15. *Id.* § 4(1)(B).

16. *Id.* § 4(1)(C).

17. *Id.* § 4(2), at 716.

18. *Id.* § 4(3).

19. *Id.* § 4(4)(B).

20. *Id.* § 4(4)(A).

the cost of the property or make any improvements that are not readily removable at the end of the lease term.<sup>21</sup>

The lessee may not lend the lessor any of the funds necessary to purchase the property, and may not guarantee any of the lessor's acquisition indebtedness.<sup>22</sup> The lessor must demonstrate that it expects to make a profit apart from the tax write-offs,<sup>23</sup> and must furnish evidence that it will have a positive cash flow from the lease.<sup>24</sup>

Even though a lease meets all these criteria, uneven rental payments may be considered to be prepaid or deferred rentals. Ordinarily, uneven rentals are acceptable to the Internal Revenue Service if they are no more than ten percent above or below the average per-year rentals payable over the lease term.<sup>25</sup> In the alternative, in the first two-thirds of a lease term the yearly rentals may vary as much as ten percent above or below the average yearly rentals for the initial term if, in addition, yearly rentals in the remaining one-third of the term do not exceed the highest yearly rent paid during the first two-thirds of the term and are no less than fifty percent of the average annual rent paid in the first two-thirds of the term.<sup>26</sup>

The taxpayer must indicate whether, at the end of the lease term, the property will be useful or usable by the lessor or by anyone other than the lessee.<sup>27</sup> The Internal Revenue Service, however, has not decided that it will or will not issue rulings in those situations where the property will not, at the end of the lease term, be useful to or usable by anyone other than the lessee.<sup>28</sup>

## II. TAXATION OF LESSORS

### A. Rental Income

As discussed in the preceding materials on differentiating leases from sales,<sup>29</sup> rents are paid for the possession and use of property, whereas payments are made pursuant to a sale or for the purpose of obtaining title or for building an equity in the property.<sup>30</sup> Section 61(a)(5) includes rents in gross income. The regulations include in rent any amount received by a lessor from his lessee in consideration of canceling a lease.<sup>31</sup> The regulations further stipulate that if a lessee pays any of the expenses of his lessor, such payments are to be considered additional rental income of the lessor.<sup>32</sup>

*Lessee Improvements.* Lessee improvements, included in gross income by the regulations<sup>33</sup> if the parties intended them to be substituted for rent, have

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21. *Id.* § 4(4).

22. *Id.* § 4(5).

23. *Id.* § 4(6).

24. Rev. Proc. 75-28, § 4.07, 1975-1 CUM. BULL. 752.

25. Rev. Proc. 75-21, § 5.01, 1975-1 CUM. BULL. 715, 716.

26. *Id.*

27. Rev. Proc. 75-28, § 4.09, 1975-1 CUM. BULL. 752, 754.

28. Rev. Proc. 75-21, § 5.02, 1975-1 CUM. BULL. 715, 717.

29. See text accompanying notes 6-11 *supra*.

30. INT. REV. CODE OF 1954, § 162(a)(3).

31. Treas. Reg. § 1.61-8(b) (1957).

32. *Id.* § 1.61-8(c).

33. *Id.*

been the subject of considerable litigation. If the parties do not intend that the lessee improvements be rent substitutes, the lessor's gross income does not include any value attributable on the termination of a lease to buildings or other improvements made by lessee during the term of his lease.<sup>34</sup> This rule applies only to income that may be realized upon the termination of a lease. It does not apply to income not attributable to lessee improvements nor to income realized incident to such improvements but after the lease has terminated.<sup>35</sup>

The exclusion from income dictated by section 109 neither requires nor allows any adjustments to the lessor's adjusted basis in the property.<sup>36</sup> If any amount was so included in income before January 1, 1942 (the effective date of the predecessor to section 109), then the property basis is increased accordingly under section 1019.<sup>37</sup> The mandatory operation of sections 109 and 1019 should be compared with the elective provisions of sections 108 and 1017, whereby a taxpayer may exclude from gross income amounts realized by the forgiveness of debt provided that the taxpayer reduces the basis of his property subject to the debt under section 1017.<sup>38</sup> Section 109's history is summarized in the accompanying footnote.<sup>39</sup> It is important to note that lessor and lessee, either deliberately or inadvertently, can characterize lessee improvements as rent. In such a case they will be taxed to the lessor as rent.<sup>40</sup>

*Substitution of Money for Lessee Improvements.* The substitution by the lessee of cash in lieu of buildings or other agreed upon lessee improvements is a different question. In the leading case, *Boston Fish Market Corp.*,<sup>41</sup> the lessee had contracted to return a leased building to the lessor restored to its original condition.<sup>42</sup> Instead, as the end of the lease drew near the parties contracted for a cash payment in lieu of the restoration.<sup>43</sup> The lessor did not report this cash as income, but reduced its basis in the leased property.<sup>44</sup> The Tax Court held that this arrangement did not come within section 109 and the cash was income to the recipient lessor.<sup>45</sup> The court treated the transaction as a sale of the leasehold improvements that had been destroyed

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34. INT. REV. CODE OF 1954, § 109.

35. Treas. Reg. § 1.109-1(a) (1956).

36. INT. REV. CODE OF 1954, § 1019.

37. Treas. Reg. § 1.1019-1 (1957).

38. INT. REV. CODE OF 1954, §§ 108, 1017; Treas. Reg. §§ 1.108(a)-1, -2, 1.1017-1(a) (1956).

39. *M.E. Blatt Co. v. United States*, 305 U.S. 267, 276, 279 (1938), held that lessee improvements are additions to capital and not realized income to the lessor, but that if the parties intend them to be rent substitutes they are taxed as rent. *Helvering v. Bruun*, 309 U.S. 461 (1940), held that lessee improvements are income to the lessor at the termination of a lease if the lessor acquires lessee-erected improvements at that time. Congress responded by adding § 22(b)(11) to the 1949 Code, Revenue Act of 1942, § 115(a), 56 Stat. (pt. 1) 812. The exclusionary rule of § 22(b)(11) was continued as INT. REV. CODE OF 1954, § 109. The accompanying basis rules, originally found in INT. REV. CODE OF 1939, § 113(c), were continued in INT. REV. CODE OF 1954, § 1019.

40. *Brown v. Commissioner*, 220 F.2d 12 (7th Cir. 1955).

41. 57 T.C. 884 (1972).

42. *Id.* at 885.

43. *Id.*

44. *Id.* at 886.

45. *Id.* at 887.

or removed by the lessee. The lessor's total basis was allocated among these improvements and the cash received in excess of the basis of improvements was treated as section 1231 capital gain.<sup>46</sup>

An almost identical fact situation gave rise to *Sirbo Holdings, Inc. v. Commissioner*.<sup>47</sup> The Tax Court had held that the cash paid by the lessee in lieu of its agreement to restore the leasehold improvements at the lease's end was ordinary income to the lessor.<sup>48</sup> The Second Circuit vacated and remanded the Tax Court opinion for reconsideration in light of the Tax Court opinion in *Boston Fish Market Corp.* The Tax Court, following what it believed was required under the *Golsen*<sup>49</sup> doctrine, had attempted to follow dicta in some other Second Circuit opinions. On remand the Tax Court held that there was no sale or exchange and, thus, no section 1231 gain.<sup>50</sup> It distinguished its prior decision in *Boston Fish Market* on grounds that the Commissioner had not challenged the taxpayer on the section 1231 issue in that case.<sup>51</sup>

*Insurance Proceeds.* In some instances insurance proceeds may be taxed to the lessor as rent. Fire insurance proceeds paid for the loss of machinery and other fixtures installed by the lessee, which fixtures are to become the property of the lessor at the end of the lease, are taxed to the lessor as long-term capital gains. The entire amount is treated as a long-term capital gain because the taxpayer has a zero basis in the destroyed property.<sup>52</sup> On the other hand, insurance proceeds paid for engineering fees, tools, supplies, spare parts, and clean-up and salvage activities are not reimbursements for destroyed property. These are not "other improvements made by the lessee." Therefore, these payments to the taxpayer are deemed a constructive dividend from the lessee corporation of which he is the controlling shareholder.<sup>53</sup>

The most important recent development in this area is *Central Tablet Manufacturing Co. v. United States*.<sup>54</sup> In this case the taxpayer's manufacturing plant and equipment were destroyed by an accidental fire. Fire insurance proceeds were collected and the taxpayer never again engaged in the manufacturing business.<sup>55</sup> Eight months after the fire the shareholders adopted a plan of liquidation, collected the insurance proceeds, and liquidated, claiming that no gain or loss was recognized by it, pursuant to section 337(a).<sup>56</sup> The Eighth Circuit, acting on a very similar fact situation (save for the fact that its taxpayer was on the cash rather than the accrual basis), had held that section 337 treatment was permissible.<sup>57</sup> In *Central Tablet*

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46. *Id.* at 889.

47. 476 F.2d 981 (2d Cir. 1973).

48. 57 T.C. 530 (1972).

49. Jack E. Golsen, 54 T.C. 742 (1970).

50. 61 T.C. 723, 724, 725 (1974).

51. *Id.* at 726.

52. See Max N. Tobias, 40 T.C. 84, 94-96 (1963).

53. *Id.* at 95.

54. 417 U.S. 673 (1974).

55. *Id.* at 675.

56. *Id.* at 675, 676.

57. *United States v. Morton*, 387 F.2d 441 (8th Cir. 1968).

*Manufacturing Co.* the Sixth Circuit had held that section 337 treatment was not available.<sup>58</sup> The Supreme Court affirmed the Sixth Circuit, holding that the sale or exchange took place on the date of the involuntary conversion, not on the later date when the taxpayer became entitled to its insurance proceeds.<sup>59</sup> The Supreme Court did note that the taxpayer could have reinvested its insurance proceeds in property similar or related in service or use and escaped tax under section 1033(a)(3) and then at a later date could have resorted to a section 337 liquidation.<sup>60</sup> The Court held, however, that the existence of this possibility was not grounds for disregarding the plain language of Code section 337(a).<sup>61</sup>

*Condemnation Proceeds.* Where possible, the consideration paid for property taken must be separated from severance damages to the land or property not taken. Severance damages are not taxable; they are applied to a reduction of the taxpayer's adjusted basis in the property not condemned.<sup>62</sup>

Condemnation is an involuntary conversion. If the property condemned is a section 1221 asset or a section 1231 asset and has been held for over six months, gain is figured as in the case of any other sale or exchange of a capital asset. If there is a net loss, it is deductible under sections 165(c)(1) or (2). There may, of course, be recapture of depreciation under sections 1245 or 1250. The taxpayer may elect to utilize section 1033. To do so he must reinvest the condemnation proceeds either (1) in the case of real property held for investment or for use in trade or business, into property "of a like kind"<sup>63</sup> or, (2) in the case of other property, into "property similar or related in service or use" or stock in the acquisition of control of a corporation owning such other property.<sup>64</sup> Reinvestment must occur within a period ending two years after the close of the taxable year in which the conversion gain is realized.<sup>65</sup> If such reinvestment is made, the gain is not recognized; any conversion proceeds not so reinvested will cause recognition.

A lessee whose leasehold terminates when the property subject to the lease is condemned may reinvest his share of the condemnation award in a purchase of property similar or related in service or use and qualify for

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58. 481 F.2d 954 (6th Cir. 1973).

59. 417 U.S. at 687-89.

60. *Id.* at 690.

61. *Id.*

62. *Pioneer Real Estate Co.*, 47 B.T.A. 886 (1942), *acquiesced in*, 1943 CUM. BULL. 18; Rev. Rul. 68-37, 1968-1 CUM. BULL. 359; Rev. Rul. 64-183, 1964-1 CUM. BULL. 297.

63. INT. REV. CODE OF 1954, § 1033(g)(1). The purchase of an outstanding leasehold on taxpayer's own realty of at least 30 years, following the condemnation of the taxpayer's other realty, qualified under § 1033(g). Rev. Rul. 68-394, 1968-2 CUM. BULL. 338. However, the acquisition of a new personal residence via a long-term lease does not qualify for non-recognition of gain in the sale of a residence under INT. REV. CODE OF 1954, § 1034. *Richard E. Boesel, Jr.*, 65 T.C. No. 32 (Nov. 24, 1975), *approving* Rev. Rul. 72-266, 1972-1 CUM. BULL. 227.

64. INT. REV. CODE OF 1954, § 1033(a)(3)(A); *Hofer v. United States*, 74-2 U.S. Tax Cas. ¶ 9690 (D. Ore. 1974). Tenants-in-common can use § 1033 if their aggregate control is 80% even though no single taxpayer meets § 1033(a)(3)(A).

65. INT. REV. CODE OF 1954, § 1033(a)(3)(B). The time period begins to run when the money is received, not when the condemnation award becomes final. *Casalina Corp. v. Commissioner*, 511 F.2d 1162 (4th Cir. 1975). If a taxpayer accepts § 1033 relief, he may later make a timely revocation of his election on the basis of new information only if no replacement has in fact been undertaken. Treas. Reg. § 1.1033(a)-2(c)(2) (1957). *See also* *John McShain*, 65 T.C. No. 61 (Jan. 7, 1976).

nonrecognition under section 1033(a).<sup>66</sup> The same rule should apply to reinvestments in like kind property under section 1033(g). If a property owner is faced with condemnation and leases his property to the condemning authority for a period of time preceding the taking, the rentals paid do not count as a part of the condemnation award.<sup>67</sup>

Careful consideration must be given to the definition of "similar or related in service or use." This definition, used in section 1033(a)(1), is supposed to be a more narrow definition than the "of like kind" test utilized in section 1033(g).<sup>68</sup> In the early years of the 1954 Code the Internal Revenue Service and the Tax Court defined "similar or related in service or use" to mean that the end use of replacement property had to be substantially the same as that of the property replaced.<sup>69</sup> Courts other than the Tax Court used a variety of different tests.<sup>70</sup> The Internal Revenue Service and the Tax Court abandoned the "functional use test" in cases involving investor-lessors.<sup>71</sup> The new test looks at the relationship of the taxpayer to the service or use of the new property. The functional use test, however, continues in owner-operator cases.<sup>72</sup>

Consideration must be given to the overlap of sections 1033(a) and 1033(g). A failure to qualify under section 1033(g) does not necessarily preclude the taxpayer from qualifying for section 1033(a) treatment under the test of Revenue Ruling 64-237.<sup>73</sup> Under either section 1033(a) or section 1033(g) it is necessary to allocate basis when replacement property is bought as a unit. That part of the section 1012 cost basis of replacement property which must be allocated to non-qualified property does not come under the protection of section 1033.<sup>74</sup> The rest of the proceeds, that part allocable to property qualifying under either section 1033(a) or section 1033(g), qualifies for nonrecognition treatment.

*Advance Rents; Additional Rents.* Advance rents are those paid in consideration for something other than current use and occupancy. Higher-than-average rents paid in the early years of a lease are not necessarily advance rentals.<sup>75</sup> A cash basis taxpayer must include advance rents or additional rents in income for the taxable year in which they are actually or constructively received.<sup>76</sup> An accrual basis taxpayer includes such amounts in

66. *Davis Regulator Co.*, 36 B.T.A. 437 (1937), *acquiesced in*, 1937-2 CUM. BULL. 7; Rev. Rul. 71-519, 1971-2 CUM. BULL. 309.

67. Rev. Rul. 57-261, 1957-1 CUM. BULL. 262.

68. S. REP. No. 1983, 85th Cong., 2d Sess. 72, 73, 202 (1958). *See also* Rev. Rul. 71-41, 1971-1 CUM. BULL. 223.

69. *McCaffrey v. Commissioner*, 275 F.2d 27 (3d Cir.), *cert. denied*, 363 U.S. 828 (1960), *aff'g* 31 T.C. 505 (1958). This is a 1939 Code case, but its definition carried over into and dominated Tax Court opinions in the early 1954 Code years.

70. *See, e.g., Loco Realty Co. v. Commissioner*, 306 F.2d 207 (8th Cir. 1962).

71. *Harvey J. Johnson*, 43 T.C. 736 (1965), *acquiesced in*, 1965-2 CUM. BULL. 5; Rev. Rul. 64-237, 1964-2 CUM. BULL. 319.

72. *Fred Maloof*, 65 T.C. No. 23 (Nov. 10, 1975); Rev. Rul. 64-237, 1964-2 CUM. BULL. 319; Rev. Rul. 67-254, 1967-2 CUM. BULL. 269.

73. Rev. Rul. 71-41, 1971-1 CUM. BULL. 223.

74. Rev. Rul. 70-405, 1970-2 CUM. BULL. 162.

75. *Bellingham Cold Storage Co.*, 64 T.C. No. 5 (Apr. 16, 1975).

76. Treas. Reg. §§ 1.451-1(a), -2(a) (1957).



income as they are earned.<sup>77</sup> The deferral methods allowed for building and construction contracts<sup>78</sup> and for advance payment for goods<sup>79</sup> are not applicable to rents. The lessee may deduct additional rentals (the premium paid to obtain a favorable lease or consideration paid for a release from future obligations) ratably over the term of the lease.<sup>80</sup>

### B. Depreciation of Leased Property and of Lessee Improvements

If a lessor erects a building and then leases the property he gets the depreciation deduction. The lessee may deduct rent paid, but gets no depreciation deduction.<sup>81</sup> If the property is leased unimproved and the lessee erects a building or other improvement, if lessor and lessee are not related parties under section 178(b), and if the remaining term is less than sixty percent of the useful life of the building or other improvement, then the renewal terms of the lease are added to its initial term unless the lessee establishes that it is more probable that the lease will not be renewed than that it will be renewed.<sup>82</sup> If the remaining term of the lease is greater than or equal to the useful life of the building or other improvement, the lessee takes depreciation. If the remaining term of the lease is less than the useful life of the building or other improvement, the lessee amortizes his investment over the remaining term of the lease.

If a lessor erects a building or other improvement, leases the property, and then sells it subject to the lease, the purchaser may take depreciation to the extent that he can allocate his purchase price to the building or other improvement. If the building or other improvement is erected by the lessee and then the property is sold subject to the lease, both the buyer and the lessee may take depreciation (or amortization) deductions. Each has a separate wasting asset meeting the requirements for depreciation set out in *World Publishing Co. v. Commissioner*.<sup>83</sup> A more recent case<sup>84</sup> reaches the opposite result, and a third case,<sup>85</sup> decided on a different but similar issue, distinguishes the *World Publishing Co.* decision while holding that the depreciation deduction may be taken only by the party bearing the risk of loss.<sup>86</sup>

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77. *Id.* § 1.451-1(a).

78. *Id.* § 1.451-3.

79. *Id.* § 1.451-5 (1971), T.D. 7103, 1971-1 CUM. BULL. 138.

80. *Main & McKinney Bldg. Co. v. Commissioner*, 113 F.2d 81 (5th Cir. 1940); Rev. Rul. 73-176, 1973-1 CUM. BULL. 146; cf. *Schutler v. United States*, 470 F.2d 1143 (10th Cir. 1972). See also Rev. Proc. 75-21, 1975-1 CUM. BULL. 715. For the taxation of a lessor who pays a lessee to give up his lease, see *The Montgomery Co.*, 54 T.C. 986 (1970).

81. This assumes that the lessee is using the rental building in his trade or business. INT. REV. CODE OF 1954, § 162(a)(3).

82. *Id.* § 178(a).

83. 299 F.2d 614 (8th Cir. 1962).

84. *M. De Matteo Constr. Co. v. United States*, 433 F.2d 1263 (1st Cir. 1970). This opinion says in dictum that the purchaser has an amortizable cost basis in the lease because it is the lease and not the building that is his income-producing asset. *Id.* at 1265.

85. *Kem v. Commissioner*, 432 F.2d 961 (9th Cir. 1970).

86. *Id.* at 963, 964. This decision distinguishes the holding of *World Publishing Co.* on the basis that there the value of the leased property was properly anticipated to be less at the end of the term than at its beginning. *Id.* at 964.

### C. Demolition of Leased Property

No deduction is allowed if the demolition is "pursuant to the requirements of a lease." The basis of the building or other improvement demolished is considered to be a part of the cost of the lease and is amortized over its term.<sup>87</sup> The same result obtains when a landowner demolishes an existing building to induce someone else to lease the land.<sup>88</sup>

There are two lines of cases differing on the meaning of "pursuant to the requirements of a lease." The first line holds that "pursuant to" means "required to." Unless the lease requires demolition the deduction is to be allowed.<sup>89</sup> Even under these decisions, however, if the lessee may demolish the building or other improvement but is required to replace the demolished improvements with new ones, no deduction is allowed.<sup>90</sup> In the other line of cases "pursuant to" means "having the right to." If the lessee may demolish or has the right to demolish the building or other improvement, no deduction is allowed.<sup>91</sup> A proposed amendment to the regulation in question would deny a loss deduction either for permissive or for mandatory demolitions.<sup>92</sup> In either event a building may be so old as to have no basis apart from the land on which it stands.<sup>93</sup>

If the intent to demolish buildings or other improvements is present at the time the lease is executed, no loss deduction is allowed.<sup>94</sup> The entire basis of the property, both building or other improvement and land, shall be allocated to the land only.<sup>95</sup> If realty with an existing building is sold and the land leased back, the building having been demolished by the purchaser-lessee, the purchaser-lessee could be considered as having demolished the building as agent for the seller-lessee. In such a case no loss deduction would be allowed.<sup>96</sup>

### D. Abandonment or Obsolescence of Lease Property

Deductions may be taken for an obsolescence adjustment to remaining useful life,<sup>97</sup> a permanent retirement from use,<sup>98</sup> or an abandonment.<sup>99</sup> The

87. Treas. Reg. § 1.165-3(b)(2) (1960).

88. *Yates Motor Co.*, 75 P-H Tax Ct. Mem. 285 (1975).

89. *Hightower v. United States*, 463 F.2d 182 (5th Cir. 1972); *Feldman v. Wood*, 335 F.2d 264, 266 (9th Cir. 1964). The IRS will *not* follow *Feldman*. Rev. Rul. 67-410, 1967-2 CUM. BULL. 93.

90. *Holder v. United States*, 444 F.2d 1297, 1300 (5th Cir. 1971). *Hightower* distinguishes the Fifth Circuit's earlier *Holder* opinion. 463 F.2d at 183.

91. *Foltz v. United States*, 458 F.2d 600 (8th Cir. 1972); *Landerman v. Commissioner*, 454 F.2d 338 (7th Cir. 1971), *cert. denied*, 406 U.S. 967 (1972) (note that the parties had an intent to demolish at the time the lease was executed, *id.* at 341).

92. Proposed Treas. Reg. § 1.165-3(b)(2), 37 Fed. Reg. 7891 (1972).

93. *Barry v. United States*, 501 F.2d 578 (6th Cir. 1974), *cert. denied*, 420 U.S. 925 (1975).

94. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974); *Bender v. United States*, 383 F.2d 656 (6th Cir. 1967), *cert. denied*, 390 U.S. 958 (1968); Treas. Reg. § 1.165-3(a) (1960).

95. Treas. Reg. § 1.165-3(a)(1) (1960).

96. *Id.* §§ 1.165-3(a)(1), -3(b)(2).

97. *Id.* § 1.167(a)-9, T.D. 6445, 1960-1 CUM. BULL. 93, 111.

98. Treas. Reg. § 1.167(a)-8(a)(3) (1956).

99. *Id.* § 1.167(a)-8(a)(4).

retirement from use in trade or business or from use in production of income must be "abnormal" to be deductible.<sup>100</sup> That is, it must be due to a cause not foreseen in setting the useful life and depreciation rate. The taxpayer can sell obsolete or abandoned property without losing the deduction if the obsolescence or abandonment preceded the sale and not vice versa.<sup>101</sup>

If property is purchased with an intention to demolish any part of it or to abandon it, no loss deduction is allowed.<sup>102</sup> The leasehold acquisition cost is amortized over the useful life of any new buildings erected,<sup>103</sup> or, if no new building or other improvement is erected, over the life of the lease to the user.<sup>104</sup> Of course, it may be that no separate basis can be established for a demolished building.<sup>105</sup>

### III. TAXATION OF LESSEES

#### A. *In What Year is Rent Deductible?*

A lessee may deduct additional rentals, the premium paid to obtain a favorable lease, ratably over the remaining term of the lease.<sup>106</sup> A lump sum payment as damages for cancellation of a lease, equal to the rentals owing for the unexpired term, is deductible under section 162.<sup>107</sup> That portion of rental payment withheld during the early years of the lease and to be paid to the lessor ratably in later years is deductible by an accrual method lessee in the year in which he withholds them.<sup>108</sup>

#### B. *When Is Rent Not Deductible?*

*Grantor Trust and Leaseback.* In instances where grantors transfer property to trusts for the benefit of their children or grandchildren and lease back the property a significant line of cases denies the rental deduction. Perhaps the most powerful rationale available to the Commissioner is the single transaction doctrine. Under this doctrine a gift and leaseback is analyzed not as two separate transactions, but rather as a single or unitary transaction. Thus, the test of section 162(a)(3) must be met for the transaction as a whole rather than being applied piecemeal to the various elements of the transaction. Application of this doctrine, established in *Van Zandt v. Commissioner*,<sup>109</sup> results in a finding that the rentals are not "necessary" un-

100. *Id.* § 1.167(a)-8(b).

101. *Tanforan Co. v. United States*, 313 F. Supp. 796 (N.D. Cal. 1970), *aff'd*, 462 F.2d 605 (9th Cir. 1972) (per curiam).

102. Treas. Reg. § 1.165-3(a) (1960).

103. *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1261 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974).

104. *Bender v. United States*, 383 F.2d 656 (6th Cir. 1967).

105. *Barry v. United States*, 501 F.2d 578 (6th Cir. 1974), *cert. denied*, 420 U.S. 925 (1975).

106. *Main & McKinney Bldg. Co. v. Commissioner*, 113 F.2d 81 (5th Cir.), *cert. denied*, 311 U.S. 688 (1940); Rev. Rul. 73-176, 1973-1 CUM. BULL. 146.

107. Rev. Rul. 69-511, 1969-2 CUM. BULL. 24.

108. Rev. Rul. 70-119, 1970-1 CUM. BULL. 120.

109. *Van Zandt v. Commissioner*, 341 F.2d 440, 443 (5th Cir. 1965). *See also Mathews v. Commissioner*, 520 F.2d 323 (5th Cir. 1975), *petition for cert. filed*, 44 U.S.L.W. 3343 (U.S. Jan. 9, 1976) and *Perry v. United States*, 520 F.2d 235 (4th Cir. 1975), *cert. denied*, 96 S. Ct. 782 (1976), both following *Van Zandt*.

der section 162(a)(3) because the grantor formerly had both title to and possession of the property and it is not necessary for him to make the gift and lease back the property in order to have continued possession. A recent Tax Court opinion, *Jack Wiles*,<sup>110</sup> while not possessing the analytical clarity of *Van Zandt*, does set out a number of indicia of nondeductibility. Like *Van Zandt*, *Wiles* holds that the rent is not required.<sup>111</sup> *Wiles* also holds that the presence of other, unrelated tenants in the leasebacked building is of no significance.<sup>112</sup> The absence of a reversionary interest in the grantor is held unimportant.<sup>113</sup> The absence of an independent trustee may have been of importance, but the point is not emphasized.<sup>114</sup> In *Wiles* the property was transferred to the trust subject to its purchase money mortgage. The court held that the trust's payment of the mortgage was income to the grantor.<sup>115</sup>

In *Samuel Yanow*<sup>116</sup> the taxpayer leased three buildings to three controlled corporations for a rental equal to the ad valorem taxes on two of the buildings and equal to these taxes and interest on an improvement loan in the case of the third building. The Tax Court held that he was not entitled to deduct depreciation on the buildings, either as property used in the trade or business<sup>117</sup> or as property held for the production of income,<sup>118</sup> because there was no profit motive in the transfer.<sup>119</sup> The same reasoning could easily be applied in the instance of grantor trusts and leasebacks.

There is a line of cases allowing the rental deduction or other benefit to the grantor-lessee. *Alden B. Oakes*<sup>120</sup> allowed the deduction, distinguishing *Van Zandt* on the grounds that the trustee was independent<sup>121</sup> and that the taxpayer had reserved no reversionary interest.<sup>122</sup> In *Brooke v. United States*<sup>123</sup> the Internal Revenue Service sought to attribute trust income to the grantor under section 677(b). The trust income had been spent on private schools, automobiles for the beneficiary minors, and for vacation trips to Europe, all of which items went beyond the local law requirements of support and maintenance.<sup>124</sup> The court held for the taxpayer, citing the Internal Revenue Service to its own position taken at Revenue Ruling 56-484<sup>125</sup> that the amount of income includable under section 677(b) is limited to the extent of legal obligations under local law. The Ninth Circuit held that, measured by Idaho law, the trust in question clearly was not for

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110. 59 T.C. 289 (1972), *aff'd*, 491 F.2d 1406 (5th Cir. 1974) (per curiam).

111. 59 T.C. at 298.

112. *Id.* at 299.

113. *Id.*

114. *Id.* at 298, 299.

115. *Id.* at 300, 301.

116. 44 T.C. 444 (1965), *aff'd*, 358 F.2d 743 (3d Cir. 1966).

117. INT. REV. CODE OF 1954, § 167(a)(1).

118. *Id.* § 167(a)(2).

119. 44 T.C. at 451, 452.

120. 44 T.C. 524 (1965).

121. *Id.* at 532.

122. *Id.* at 531.

123. 468 F.2d 1155 (9th Cir. 1972), *aff'g* 300 F. Supp. 465 (D. Mont. 1969).

124. 300 F. Supp. at 466.

125. 1956-2 CUM. BULL. 23.

support and, therefore, the income was not taxable to the grantor under section 677(b).<sup>126</sup>

*C. James Mathews*<sup>127</sup> is an important case. Here there was an independent trustee and the Tax Court held for the taxpayer on three tests: First, the court found that the grantor had not retained substantially the same control over the property that he had before making the gift.<sup>128</sup> Second, the leaseback was in writing and the rentals were set at a fair and reasonable amount.<sup>129</sup> Third, the leaseback was held to have a bona fide business purpose.<sup>130</sup> It is interesting to note that, unlike *Van Zandt*, the Tax Court reviewed the leaseback separately from the transfer and gift.<sup>131</sup> The court further held that a reversionary interest is not an equity disqualifying the grantor's deduction under section 162(a)(3).<sup>132</sup> The Fifth Circuit reversed the Tax Court,<sup>133</sup> holding that the existence of an independent trustee was irrelevant, that the transaction was an economic nullity, that the single transaction could not be divided into separate parts, and that *Van Zandt* was controlling.<sup>134</sup> The Fourth Circuit, in *Perry v. United States*,<sup>135</sup> also holds that *Van Zandt* is controlling. The Tax Court, therefore, is now following<sup>136</sup> *Van Zandt* via *Mathews* and *Perry*.

*Grantor Trust and Leasebacks: Estate Tax Problems.* If a taxpayer dies during the term of a lease there is a serious question as to whether the leased property is includable in the taxpayer's estate under section 2036(a)(1) because of his retention of possession. One old Supreme Court decision indicates it would not be included,<sup>137</sup> but more recent authorities suggest that it may be includable.<sup>138</sup> One recent case, *Estate of William du Pont*,<sup>139</sup> concerns a decedent who had conveyed all but eighteen acres of his 260-acre estate to his wholly-owned corporation and leased it back from the corporation at a rental based upon no more than one-fourth to one-third of the property's fair market value for a ten-year initial term with an option to renew for successive ten-year terms. The rentals were based on the use of the property as a horse farm, although the highest and best use of the property was for residential and commercial development. Decedent had transferred all of the corporation's stock to an irrevocable trust in which he retained no interest. He died approximately four years after the conveyance. The Court held that the series of steps, taken together, comprised a

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126. 468 F.2d at 1158.

127. 61 T.C. 12 (1973), *rev'd*, 520 F.2d 323 (5th Cir. 1975).

128. *Id.* at 18, 19.

129. *Id.* at 19.

130. *Id.*

131. *Id.* at 19, 21.

132. *Id.* at 23.

133. *Mathews v. Commissioner*, 520 F.2d 323 (5th Cir. 1975), *petition for cert. filed*, 44 U.S.L.W. 3443 (U.S. Jan. 9, 1976).

134. *Id.* at 325.

135. 520 F.2d 235 (4th Cir. 1975), *cert. denied*, 96 S. Ct. 782 (1976).

136. Frank L. Butler, 65 T.C. No. 28 (Nov. 20, 1975).

137. *Nichols v. Coolidge*, 274 U.S. 531 (1927).

138. *O'Malley v. United States*, 220 F. Supp. 30 (N.D. Ill. 1963), *rev'd on other grounds*, 383 U.S. 627 (1966).

139. 63 T.C. 746 (1975).

single device by which the decedent had attempted to divest himself of title to the property without relinquishing his possession or enjoyment thereof.<sup>140</sup> The rentals, based upon use of the property as a horse farm, were substantially lower than those that could have been obtained had the property been put to its highest and best use. This factor, combined with the fact that no independent owner would have leased the property for such a long term at such low rentals, showed that the decedent had not relinquished his possession or enjoyment of the property as required by section 2036(a)(1).<sup>141</sup>

On the other hand, a second transaction by the same decedent was held not to come under section 2036. A wholly-owned subsidiary of a corporation wholly owned by the decedent had purchased real property from an outside party and then leased it to the decedent for a term of ten years with an option to renew for a successive ten-year term. The rental was set at a fair rental based upon the true fair market value of the property. The decedent thereafter acquired all of the subsidiary's stock from its parent corporation and transferred this stock to an irrevocable trust in which he had no interest. The Tax Court held that section 2036 did not apply to this transaction on the grounds that the lease was at a fair rental value and that the decedent had had no connection with the property prior to its purchase by the subsidiary corporation.<sup>142</sup>

### C. *Sale and Leaseback*

The sale and leaseback is a device utilized to allow continued use of one's premises or manufacturing facilities while realizing the capital tied up in them. The sale may produce a loss which offsets gains from other sources and which, if a section 1231 loss, will offset ordinary income. The gain, except on a sale to a spouse or to an eighty-percent-owned corporation, will often be capital gain.<sup>143</sup> The rent deduction under the lease ordinarily is larger than the depreciation deduction formerly allowed. The economic risks are minimal: the purchaser's bankruptcy (the seller has a purchase money first mortgage), and the possibility that an improperly drafted lease will not be an attractive security to lenders. Frequently, owners will sell and lease back their land, which is a non-depreciable asset, while retaining title and possession to their buildings, especially pre-1969 buildings which carry a rate of depreciation not now available. A sufficiently long leaseback on the land is necessary so that it can be possible to depreciate the buildings and other assets fully.

*Recharacterization as a Tax-Free Exchange.* The most detrimental tax treatment is characterization as an exchange of like-kind properties. The Internal Revenue Service often seeks to treat sales and leasebacks as section 1031 exchanges of like-kind property, thereby disallowing any loss on the sale and possibly disallowing the rental deduction. A leasehold with thirty

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140. *Id.* at 763-64.

141. *Id.* at 765.

142. *Id.* at 767.

143. INT. REV. CODE OF 1954, § 1239(a).

years or more left to run is treated as like-kind property with a fee.<sup>144</sup> Neither section 1031 nor the regulations thereunder state whether renewal terms are counted as a part of the thirty years.

It is generally thought that section 178(c) should be used to determine if the renewal terms are counted as a part of the thirty-year period.<sup>145</sup> The relationship between lessor and lessee is a significant factor in determining whether, under the "reasonable certainty" test, the lease will be renewed so that the renewal term can be counted with the initial term<sup>146</sup> to meet the thirty-year period of the regulations under section 1031.<sup>147</sup> In contrast to the reasonable certainty test of section 178(c), the recent *Missouri Pacific Railroad Co. v. United States*<sup>148</sup> case states that the test is the number of years available to the lessee as a matter of right.<sup>149</sup>

*Recharacterization as a Mortgage.* The other possible recharacterization that will deny the benefits of recognizing loss and deducting rental payments is treatment as a mortgage. If the leaseback is not for a sufficiently long term for the purchaser-lessor to amortize his investment, or if the seller-lessee may repurchase the property at less than fair market value, or both, there is a very substantial chance that the transaction will be recharacterized as a mortgage for tax purposes. Renewal options, exercisable at less than fair rental value, also are strong evidence that the transaction is a mortgage.<sup>150</sup> Other tax problems are disallowance of loss recognition if the sale is to a related party,<sup>151</sup> realization of ordinary income if gains are from a sale of depreciable property to related parties,<sup>152</sup> and the recharacterization of a part of the sale price as payments of advance rents if the leaseback is at less than fair rental value.<sup>153</sup> It is possible that a sale of property on the section 453 installment method coupled with a leaseback in which the lessor-seller has an option to reacquire title may result in characterization of the leaseback as a leveraged lease.<sup>154</sup>

In *Century Electric Co. v. Commissioner*<sup>155</sup> a sale and leaseback for a period of over thirty years was treated as a tax free exchange and the loss

144. *Id.* § 1031(c); Treas. Reg. § 1.1031(c)-1, T.D. 6935, 1967-2 CUM. BULL. 278; Treas. Reg. § 1.1031(a)-1(c) (1956).

145. INT. REV. CODE OF 1954, § 178(c) includes the renewal terms if the facts show "with reasonable certainty" that the lease will be renewed or extended.

146. Treas. Reg. § 1.178-3(b) (1960).

147. *Id.* § 1.1031(a)-1(c) (1956).

148. 497 F.2d 1386 (Ct. Cl. 1974); see notes 164-66 *infra* and accompanying text.

149. 497 F.2d at 1391 n.6.

150. See generally Agar, *Sale and Lease-Backs*, 18 (pt. 2) ABA TAXATION SECTION 61 (1965).

151. INT. REV. CODE OF 1954, § 267 (sale to a family member or a related party as defined in § 267(b)); *id.* § 707(b) (sale to a 50% owned partnership or sales between commonly-owned partnerships).

152. *Id.* § 1239(a).

153. *Alstores Realty Corp.*, 46 T.C. 363 (1966); Rev. Rul. 66-209, 1966-2 CUM. BULL. 299, citing *Century Electric Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), *aff'g* 15 T.C. 581 (1950), and *Pembroke v. Commissioner*, 70 F.2d 850 (D.C. Cir. 1934). *Alstores* also holds that the "advance rent" is a part of the purchaser's cost basis and must be allocated between land and improvements in the same way as is the rest of the consideration paid. 46 T.C. at 374.

154. See notes 12-28 *supra* and accompanying text.

155. 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), *aff'g* 15 T.C. 581 (1950).

realized on the sale was not recognized. The leaseback may have been at less than full fair rental value.<sup>156</sup> The lease was assigned a basis to be depreciated over its term.<sup>157</sup> In *Jordan Marsh Co. v. Commissioner*,<sup>158</sup> however, a building and the land upon which it stood were sold and leased back for a period of thirty years and three days with an option to renew the lease for another thirty years if the lessee erected certain specified new buildings.<sup>159</sup> The rentals were at a full fair rental value and the sales price was at a full fair market value.<sup>160</sup> Sales treatment was upheld and the loss allowed.<sup>161</sup> The *Century Electric* decision was distinguished on the differing facts in the two cases.<sup>162</sup> In *Jordan Marsh* the court held that the taxpayer clearly was closing out a losing investment and, therefore, was entitled to sales treatment.<sup>163</sup>

In *Missouri Pacific Railroad Co. v. United States*<sup>164</sup> the taxpayer's building was sold and leased back for an initial term of twenty-nine years and eleven months. There were four renewal options of five years each. The taxpayer also had a right to repurchase the property at any time after the lapse of five years. The repurchase option plus the total lease term of over thirty years resulted in the transaction being characterized as a like-kind exchange despite the fact that the sale was at fair market value and the leaseback was at fair rental value. The court held that the repurchase option alone was sufficient grounds to deny sales status upon which loss could be recognized.<sup>165</sup> The court further held that the unrecognized loss was amortizable over the period of the lease—the initial term and all the renewal options. If the property were repurchased, the unamortized part of the loss would be added to the new cost basis in the property.<sup>166</sup>

Finally, in *Hudspeth v. Commissioner*<sup>167</sup> the taxpayer's parents owned more farm land under irrigation than was allowable under Bureau of Reclamation standards. The parents sold a part of the excess acreage to their children and leased it back from them for a twelve-year term. The parents gave the children a sufficient amount of money to make up the excess of the mortgage payments on the land, both principal and interest, over the rentals received from the parents for the use of the land. The taxpayers reported the rental income, but also deducted the interest they paid on the mortgage. The court disallowed the section 163 interest deduction to the extent of the excess over the rental payments received.<sup>168</sup> It is interesting to note that the decision is restricted to disallowance of the

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156. 15 T.C. at 583, 585. See also *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 456-57 (2d Cir. 1959).

157. 192 F.2d at 160.

158. 269 F.2d 453 (2d Cir. 1959).

159. *Id.* at 454.

160. *Id.*

161. *Id.* at 455, 458.

162. *Id.* at 456, 457.

163. *Id.* at 456.

164. 497 F.2d 1386 (Ct. Cl. 1974).

165. *Id.* at 1393.

166. *Id.* at 1394.

167. 509 F.2d 1224 (9th Cir. 1975).

168. *Id.* at 1227.



interest deduction. The validity of the sale and leaseback is specifically upheld,<sup>169</sup> and there is no attempt to disallow the rental deductions, as might have been done under the authority of *Van Zandt* and the cases following it<sup>170</sup> save for the fact that the sale was occasioned by business reasons.

#### D. Lease Cancellations

Section 1241 provides that amounts received by a lessee for cancellation of a lease are treated as received in sale or exchange for it. The character of gain or loss depends upon how the lease has been held,<sup>171</sup> and, as a lease is a depreciable asset, a lessee's release of a lease to its controlled corporation will cause recognition of ordinary income under section 1239(a).<sup>172</sup> Cancellation is defined as a termination of all the lessee's contractual rights in the lease.<sup>173</sup>

The few cases and rulings on lease cancellations are not always consistent. *Metropolitan Building Co. v. Commissioner*<sup>174</sup> holds that section 1241 applies to amounts received by a lessee from a sublessee in return for the lessee's releasing its rights in the leased property so that the sublessee could deal directly with the lessor. Revenue Ruling 72-85<sup>175</sup> holds that a lessee's sale of a leasehold used in his trade or business is the sale of a section 1231(b) asset, with possible application of sections 1245 and 1250 to the gain.

#### IV. CONCLUSION

Uses and abuses of our tax laws stem from the types of businesses and investments most widely used. The choice of investment, or of business enterprise, depends largely upon both the status of the economy and the combination of available capital and margin of profit in different sectors of the economy. Thus, in the late 1950's and early 1960's relatively low interest rates and the uncertainty of capital appreciation caused by the Berlin Crisis and the Cuban Missile Crisis caused many businessmen to prefer leasing to investment. The tax laws then in effect, principally the high rates of depreciation and weaker section 1250 recapture rules, induced some taxpayers to invest capital despite the alleged non-tax benefits of leasing.

Today's tighter money supply and higher interest rates have again shifted many businesses toward leasing rather than buying. Recent changes in the tax laws have accelerated this change. The heavy use of accelerated depreciation, coupled with investors' willingness to sell investments once the greater part of depreciation had been taken, led to the tightening-up of sections 167 and 1250 by the Tax Reform Act of 1969.<sup>176</sup> These changes, along with a tighter money supply and a general lowering of expectations as

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169. *Id.*

170. See notes 109-36 *supra* and accompanying text.

171. Treas. Reg. § 1.1241-1(a) (1957).

172. J.P. McEnery, 26 CCH Tax Ct. Mem. 1060 (1967).

173. Treas. Reg. § 1.1241-1(b) (1957).

174. 282 F.2d 593 (9th Cir. 1960).

175. 1972-1 CUM. BULL. 234.

176. Pub. L. No. 91-172, § 521 (Dec. 30, 1969).

to the future strength of our economy,<sup>177</sup> have produced today's interest in leasing.

Naturally, many taxpayers have tried to combine leasing's tax advantage, the full deductibility of rent, with devices which preserve some of the capital appreciation advantages of investment. The tax laws will, therefore, be changed to meet these new devices and prevent revenue losses. The new leveraged lease rules are an example.<sup>178</sup> Rental costs, if truly rent, cannot shelter income from taxation because they, unlike depreciation deductions, are out-of-pocket expenses. For this reason we can expect to see fewer legislative changes of the tax law applicable to leases than may occur with respect to investments.<sup>179</sup> Nevertheless, there remains a need to develop criteria by which to decide what is a lease and what is a purchase. Such distinctions, however, should be drawn in the context of the present Internal Revenue Code by case law and administrative interpretations. The Code already is unwieldy; there is no pressing need for new statutes on the taxation of leases.

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177. Jones, *Why Business Must Seek Tax Reform*, 53 HARV. BUS. REV. 49 (1975); Loomis, *The New Questions About the U.S. Economy*, 89 FORTUNE 69 (1974); Wallich & Wallich, *Profits Aren't as Good as They Look*, 89 FORTUNE 126 (1974).

178. See the materials on leveraged leases, notes 12-28 *supra* and accompanying text.

179. Tax Equity Act of 1975, H.R. 10612, 94th Cong., 1st Sess. (1975).

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VOLUME 30

SPRING 1976

NUMBER 2

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