

# SOME ECONOMIC AND LEGAL ASPECTS OF THE PURCHASE AND LEASE OF REAL ESTATE BY LIFE INSURANCE COMPANIES \*

By JOHN W. McPHERSON †

The increasing need of life insurance companies for a broadening and modernization of their investment powers has resulted during the past few years in the passage of state statutes permitting insurance companies to invest, to a limited extent, in certain types of real estate. The need for new fields of investment was due to several factors—one of which was the stupendous increase in the assets of life insurance companies during the past decade. Ten years ago the assets of life insurance companies in the United States totaled about twenty-six and a quarter billion dollars; by 1947 this figure had increased to fifty-one billions and was still growing.<sup>1</sup> Although the war afforded the life insurance companies the opportunity to invest large sums in the various government issues, the return of peace brought an immediate need for a revision of the investment sections of the state statutes if the life insurance industry was to keep its growing assets productive.

## STATUTORY AUTHORITY

Since the companies have long been permitted to hold foreclosed real estate pending resale, it was only natural that amendments to the investment sections of many state statutes should include legislation permitting the companies to make direct investments in real estate or interests in real estate acquired for the purpose of producing income, apart from any investment power relating specifically to housing projects—often referred to as “income real estate.” The legislatures for many years have provided for investment in real estate to a limited extent—namely, in home office properties and foreclosed real estate and housing. That such investment is necessary and proper in the conduct of the legitimate business of a life insurance company has not been questioned. The expansion of this power to include investment in income real estate is merely an extension of the field within which the inherent investment power of a life insurance company may be exercised.<sup>2</sup>

---

\* This article is based on a paper read before the Association of Life Insurance Counsel, Dec. 7, 1948.

† A.B., 1929, LL.B., 1932, Harvard University. Assistant Counsel, The Penn Mutual Life Insurance Company. Member of the Pennsylvania Bar.

1. See INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 46 (1948).  
2. Metropolitan Life Insurance Co. v. Whitestone Management Co., 77 F. 2d 255 (7 Cir. 1935); Prudential v. Richman, 292 Ill. App. 261, 11 N. E. 2d 126 (1937); Lewis v. New York Life Insurance Co., 358 Pa. 57, 55 A. 2d 801 (1947).

An examination of the investment sections of the state insurance laws reveals that income real estate is permitted in some form for either domestic or foreign companies or for both in 45 jurisdictions, including the District of Columbia.<sup>3</sup> That the development is recent is illustrated by the fact that of the 36 statutes giving specific authorization to the companies to make such investments in one form or another, 4 were adopted in 1948, 21 in 1947, 3 in 1946, 7 in 1945 and 1 in 1942.

Life insurance counsel should have little difficulty in determining the application of the law of a particular state to domestic companies. In the majority of states permitting domestic companies to invest in income real estate, a general authorization to invest in real estate for the purpose of producing income is provided with some restrictions as to type and amount of assets which may be placed in income real estate. The statutes of other states are fairly restrictive in requiring a specific leasing arrangement as a condition, while some permit such investment under a general power to invest a limited portion of assets in investments of a kind not specifically authorized or permitted. Finally, other states permit such investment merely by the absence of any restriction.<sup>4</sup>

However, there is more room for uncertainty in determining what effect, if any, the laws of other states may have on an insurance company's exercise of the power to purchase income real estate given it by its state of domicile when it seeks to exercise the power in other states or when it merely does business there. The problem is not new. The consideration of the possible application of domestic company investment restrictions in a state in which the foreign company does business has always been present where the investment requirements for insurance companies of the two states have differed. The determination of the possible conflict between the investment requirements of two states, in so far as such requirements relate to the purchase of income real estate by domestic and foreign companies, gives rise to the application of certain well defined principles, including, *inter alia*, the sovereignty of a state over its real estate, the rule of

---

3. The scope of this article is limited to the provisions of the leases agreements and certain legal problems which arise in its preparation. The general subject of life insurance investments in income real estate would not be properly covered without some mention of the power of a given company to purchase income real estate in states other than its state of domicile. See Satterthwaite, *Investments by Life Insurance Companies in Real Estate*, [1947] *INS. L. J.* 771. For analyses of pertinent statutes and constitutional provisions, see LIFE INSURANCE ASSOCIATION OF AMERICA, *ANALYSIS OF STATE LAWS AFFECTING INVESTMENT IN REAL ESTATE BY LIFE INSURANCE COMPANIES* (1947).

4. For a chart summarizing the various state statutes and constitutional provisions, see Satterthwaite, *supra* note 3, at 776.

comity between states, the right of a state to impose an investment standard on foreign companies, and the principal that investment is a necessary and proper function of a life insurance company.<sup>5</sup> These principles when applied to the statutory, as well as the constitutional, provisions of any given state will assist counsel in determining whether his company should take advantage of this new field of investment in such state.

#### THE ECONOMIC ASPECTS OF A PURCHASE-LEASE TO A TENANT

The acquisition of income real estate by insurance companies normally involves the purchase of properties from business concerns and the simultaneous lease of such properties to them.<sup>6</sup> In some instances, the insurance company may transfer to its income real estate account properties which it has acquired through foreclosure and lease such properties to business concerns on a net lease basis, in which case the date of the transfer from the foreclosed real estate account to the income real estate account is usually considered the date of acquisition for valuation or for annual write-down purposes.<sup>7</sup>

What then are the reasons given by corporations for a purchase-and-lease transaction? In the first place, many corporations prefer to concentrate their attention upon merchandising and avoid the responsibilities of real estate ownership and management.<sup>8</sup> The result is a supply of cash which can be turned over in business operations instead of being tied up in real estate. In some businesses it is desirable to keep as small as possible an investment in fixed assets so as to have greater funds available in working capital for merchandising operations and to meet the opportunities offered by a favorable market. One statistician has estimated that working capital today brings a return of 20%. On this hypothesis it has been computed that a corporation which owns a \$320,000 plant and makes a profit before taxes and depreciation of \$125,000 can increase its net profit from \$71,000 to \$101,000 by effecting a purchase-lease of its plant. The increase is determined by including in gross profits the amount which can be earned with the \$320,000 used as working capital.<sup>9</sup>

---

5. For a helpful text on the admissibility of foreign corporations, see HENDERSON, *THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW* (1918).

6. The entire transaction has received a number of short titles, *e. g.*, "purchase-lease," "leaseback," "net lease," "buy-build-sell-lease," and facetiously, "lend-lease."

7. *Cf.* PA. STAT. ANN., tit. 40, § 506.1(i) (Purdon, Supp. 1947).

8. Levy, *The Trend of Corporations to Sell Their Real Estate to Institutional Investors*, *THE MORTGAGE BANKER* (Nov. 1947).

9. Allsopp, *Industrial Financing by Purchase Lease*, 16 *THE APPRAISAL J.* 156, 160 (1948).

There is, of course, the corporation which desires to retire its long-term indebtedness or to prepay a mortgage loan secured by its plant. The company can sell its plant and apply the proceeds of sale to the retirement of its debt.

There is, in addition, the controversial subject of tax savings, which all corporations are eager to secure and which will be discussed more fully later.<sup>10</sup> Although the operating expenses of corporations are not necessarily less under a lease than under outright ownership, eventual savings may result in future years when and if the corporation elects one or more of the renewal periods of the lease, in which event the rentals will in all probability be considerably less than the rentals paid during the basic or original lease term.<sup>11</sup>

Incident to the availability of sufficient working capital are the expansion opportunities presented by lease arrangements. This feature, in fact, may be the most important single reason for many purchase-lease arrangements.<sup>12</sup> Expansion programs usually involve working capital problems, and by means of appropriate lease arrangements corporations may increase their facilities without sacrificing their working capital. In some leases, the lessee is permitted to select the architect (who shall meet with the approval of the lessor) to prepare the plans and specifications for its new building, and so long as these plans and specifications meet with the lessor's approval, the lessee is in the position of having the new structure designed and constructed substantially to its own liking. In some leases, the actual construction of the building will be done by a contractor selected by the lessee and approved by the lessor, and all contracts for the purchase of materials and the performance of the construction work will be in the lessee's name. As the work progresses, the lessor reimburses the lessee at stated intervals for the actual cost of construction, and these advances may be capitalized and returned to the lessor as rent during the basic term of the lease. When the building is completed the lessee has a warehouse or store built to its own specifications in a location which it has selected. It has made no outlay of cash, its working capital is intact, nor has it borrowed any money. Its books show no liability except the rent due for the current period, and its credit position is in nowise affected by the transaction. The process may be repeated, in theory, at least, any number of times.<sup>13</sup>

---

10. See text at notes 20-32 and 63-71 *infra*.

11. MACDONALD, *EQUITY INVESTMENT IN MERCANTILE AND INDUSTRIAL REAL ESTATE BY LIFE INSURANCE COMPANIES* (unpublished thesis in Univ. of Pa. Library, 1948).

12. *Ibid.*

13. MORROW, *Some Economic and Legal Aspects of Lease-Back Transactions*, 34 VA. L. REV. 686, 687 (1948).

The purchase-lease arrangement also offers certain accounting advantages to corporations. Of course, if a purchase-lease arrangement were not available, corporations would not necessarily have to finance their expansion programs by exhausting their surplus or their working capital. They could either mortgage their new plants, or obtain bank loans or issue new securities. But if they secure a mortgage loan, such an obligation must be carried in their financial statements as a liability and thus may adversely affect their credit standing. Bank loans also appear as debts upon a corporation's balance sheet and are usually for a shorter term than a lease arrangement. The issuance of new securities may alter the present ownership of the corporation, aside from the problem of marketing such securities, the costs of such an undertaking and the timing of the new issue.<sup>14</sup>

In a purchase-lease arrangement the corporation's statement will merely show the annual rental payments made by the lessee corporation during the period for which the statement is rendered as a cost of operation. The corporation-lessee has divested its balance sheet of one of the fixed assets and long-term fixed obligations. One accountant has posed the question whether such balance sheets "fairly present the position" of such corporations.<sup>15</sup> The credit behind a purchase-lease transaction is obviously that of the tenant, but no hint of the obligation appears in any liability account in the tenant's books. It would appear that it is not yet accepted accounting practice to mention in published audit reports the existence of long-term non-cancellable net leases, nor is attention generally directed to the possible future liabilities connected therewith. It has been suggested that if present accounting conventions are inadequate to disclose long-term lease obligations and real or contingent liabilities connected therewith, and the effect thereof on credit or net worth, the lessee's balance sheet might show the leasehold as a fixed asset subject to amortization and the rent obligation as a fixed liability. Until a more satisfactory device is worked out, accountants will probably fall back on the over-worked device of the footnote to set out the facts as to these fixed obligations unrelated to any present balance sheet fixed asset or funded debt. This method of informing the reader concerning such commitments would seem to be the least that should be done if the lessee's statements are to "fairly present" the real financial condition of the company.<sup>16</sup>

---

14. MACDONALD, *op. cit. supra* note 11.

15. Cannon, *Danger Signals to Accountants in "Net Lease" Financing*, 85 J. OF ACCOUNTANCY 312 (1948).

16. *Ibid.*

Still another advantage of a purchase-lease transaction is its absence of restrictive covenants upon company financing which are so common in term loan agreements and bond indentures. A corporation in need of working capital or funds for expansion may be subjected to severe restrictions if it seeks such funds through the issuance of preferred stock or by private placement with the customary term loan agreement. The impact of the so-called affirmative and negative covenants of a term loan agreement, requiring, *inter alia*, the debtor corporation to maintain a certain debt ratio and a net working capital at an agreed figure, limiting additional indebtedness and the amount of dividends distributable from earned surplus, may be sufficient reason to cause a corporation to elect a purchase-lease transaction rather than a debt financing program.

#### THE LEASE

As has been previously stated, the normal purchase-lease transaction involves the acquisition of real estate from a business corporation and the simultaneous lease of such property to the corporation. The transaction may be initiated by real estate brokers or the offer to sell to the insurance company with a leaseback may be made directly by the corporation. When the negotiations are completed and the terms agreed upon, the assistance of counsel will be required to prepare the necessary instruments to complete the transaction. Generally speaking, counsel will be interested in the forms of agreements of sale, deed and lease in income real estate investments. The first two instruments—the agreement of sale and deed—require no special treatment in this paper. They will normally be drawn in accordance with accepted standards of conveyancing customarily used in the jurisdiction where the real property is situated. One satisfactory method is to utilize an agreement of sale only where the property is being acquired from a third party. Where the property is being acquired from and leased back to the prospective tenant, the acceptance by the tenant of the commitment letter which includes all the basic terms and conditions of the transaction, will normally serve as a satisfactory agreement of sale.

The lease agreement will require careful preparation. The type of lease which is utilized in income real estate transactions by reason of its very nature is substantially different in many important provisions from lease forms ordinarily used in the leasing of similar properties. Although most life insurance companies which have taken advantage of this new field of investment have by this time prepared a basic lease form for use in transactions of this type, experience has

shown that in most cases it is generally necessary to make some changes in order to adapt the form to the circumstances of each particular transaction. Each lease agreement is tailor-made to some extent, and requires the utmost care in preparation. No effort will be made here to analyze all of the provisions of a normal lease of income real estate, but some of the more unusual clauses which are common to most purchase-lease transactions will be treated.

*The Term.* The basic term of the lease, or what is sometimes called the "primary term," is largely dependent upon the financial responsibility of the tenant and the location of the property.<sup>17</sup> During this period the rentals should be sufficient to provide for the complete amortization of the investment, as well as the return agreed upon by the parties. Although the annual rental charges during the basic term of most leases are constant, in a few leases rentals are reduced after each five-year period.<sup>18</sup> If the purchase-lease arrangement contemplates the construction of a new building for the tenant, the lease may also provide for a "preliminary term" during which period the building will be erected and the lessor will be advancing construction costs. In some leases the tenant is required to pay as rental during such construction period an amount equivalent to interest charges on the lessor's advances (including advances made by the lessor in acquiring the land) until final completion of the improvements, at which time the basic term commences and the regular rental payments become due and payable. The basic term may range from 15 to 40 years, with 20 to 25-year periods most often stipulated.

*Renewal Options.* The majority of leases of the type under consideration grant the tenant the option to extend the lease beyond its basic term. The successive renewal periods may be for 5 or 10 years each, and when combined with the basic term may permit the tenant to occupy the property for a total of 100 years. The liberality of the renewal options depends in part upon the age of the building and in part upon the flexibility of the use to which the structure may be put over a long term of years. Because the rentals during the renewal options are substantially lower than the rentals during the basic term the average tenant ordinarily seeks options granting numerous extension periods. The rentals payable during the extension periods may be as low as one, two or three per cent of the insurance company's original investment. The extremely low rentals during the renewal

---

17. Address by Henry Verdelin, *Commercial Income Producing Real Estate for Investment*, June 19, 1948.

18. MACDONALD, *op. cit. supra* note 11, at 39.

periods may result in a tax problem for the tenant. Because such rentals would normally be attractive to a tenant as compared with the higher rentals of the basic term, it may be asserted by the Bureau of Internal Revenue that, other things being equal, the renewal options were at all times intended to be exercised by the tenant and that therefore the deductions for the larger rental payments claimed by the tenant during the basic term of the lease should be prorated over the option periods. There are no cases directly in point, but the decisions dealing with deductions for a purchased leasehold are closely analogous.<sup>18a</sup>

*The "Net" Lease Provisions.* The "net" lease feature is common to all lease transactions of income real estate. Although the establishment of this net basis is usually covered by several sections of the lease, its result is to assure the lessor an absolute net return on its investment during the basic term of the lease. These sections provide, respectively, that the tenant shall pay all taxes, assessments, and other public charges, as well as all fire and extended coverage insurance, and shall deposit such policies with the lessor; shall provide for the lessor's benefit comprehensive general liability insurance in companies and amounts satisfactory to the lessor; and shall pay for all charges for water, gas, electricity and other utility services. A broad "hold harmless" clause is usually added to indemnify the lessor from all types of suits arising out of injury or damage to persons or property in any manner growing out of the tenant's use of the premises, streets or sidewalks.

*Repurchase Options.* Because of the controversial tax questions which are presented by the use of repurchase options, their use in lease transactions has been the subject of much discussion among corporation attorneys. The options which are found in most leases are of one of two types, or, in some cases, both. The first type is the granting to the tenant of an absolute right to purchase the leased premises at any time after the lease has been in force for a specified number of years, *e. g.*, 5 years, at a price equivalent to the lessor's unamortized investment in the leased premises, plus a premium, which may vary from 1% to 5% of the lessor's total original investment, depending upon the portion of the lease term which has expired at the time of the exercise of the option. The second type of repurchase option, which

---

18a. *Bonwit Teller & Co. v. Commissioner*, 53 F. 2d 381 (2d Cir. 1931); *Commissioner v. Pittsburgh Union Stock Yards Co.*, 46 F. 2d 646 (3d Cir. 1931); *Two Ninety-Two Flatbush Ave. Corp.*, 3 B. T. A. 830 (1926); *Strand Amusement Co.*, 3 B. T. A. 770 (1926); see also Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1, 19 (1948).



is frequently termed the "rejectable offer", permits the tenant after a specified number of lease years to request cancellation of the lease, provided at the same time it offers to purchase the property at a price equivalent to the lessor's unamortized investment in the leased premises, plus a premium of a specified percentage of the lessor's original investment. The lessor has the option of accepting or rejecting the offer, but, whether or not the lessor accepts it, the lease terminates upon the date specified in the tenant's notice of cancellation which is normally required to be at the end of the then current lease year.<sup>19</sup> The rejectable offer affords a tenant a method of cancelling the lease but at the risk of buying the property, if by reason of changed conditions the continued tenancy is not economically justified. As might be expected, the rejectable offer has become the more acceptable implement of lease cancellation and repurchase and not without reason.

When a vendor-lessee has entered into a purchase-lease transaction, it is interested in claiming that "rentals" paid under its lease are deductible expenses for income tax purposes throughout the term of the lease. Had such vendor not sold its property, it would have enjoyed a yearly deduction for depreciation of the building;<sup>20</sup> and if the building was security for a mortgaged loan of the vendor, it could also have enjoyed a yearly deduction equal to the amount of interest paid the mortgagee on such loan.<sup>21</sup> The vendor-lessee is, therefore, vitally interested in claiming that the "rentals" paid under its lease qualify as deductible expenses for income tax purposes in carrying on its trade or business and that in making such rental payments it is not acquiring an equity in the leased premises.<sup>22</sup> If the lessee is held to be acquiring an equity in the premises, its tax deduction will be limited to the interest factor in its so-called rental payments, in that the transaction for tax purposes is a purchase and not a lease.<sup>23</sup> Although an absolute purchase option in favor of the lessee will not normally of itself be sufficient to convert a landlord and tenant rela-

---

19. Some forms permit the tenant the option either to terminate or continue the lease if the lessor rejects the tenant's offer to purchase.

20. INT. REV. CODE § 23(1).

21. *Id.* § 23(b).

22. *Id.* § 23(a)(1) provides, in part, as follows:

"In computing net income there shall be allowed as deductions:

(a) Expenses—

(1) Trade or business expenses—

(A) In General—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying out any trade or business, including . . . rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

23. *Judson Mills v. Commissioner*, 11 T. C. 25 (1948).

tionship into one of vendor and vendee, the few decided cases on this point indicate that the form of the option is of real significance in determining the real intention of the parties. It should be noted in passing that many of the cases referred to hereinafter are cases involving personal rather than real property, but it is submitted that the principles involved are precisely the same.

It has been repeatedly held that the form of the instrument under which payments are made will not alone determine the nature of the transaction.<sup>24</sup> "The question . . . as to what constitutes taxable income is one of fact and cannot be determined alone by a mere regard to the form of the instrument under which it was collected. It is the character of the transaction which produced the funds collected, as governed by the intent of the parties in carrying it out, that must determine the character of such funds in the hands of the taxpayer."<sup>25</sup> This same Tax Court decision contains a helpful statement which indicates the approach which the Tax Court might well take today to a purchase-lease transaction:

" . . . if the parties to the lease-option contracts, by their acts, intended in each instance to effect nothing more than a lease of the properties described to the lessee named for the period designated, with no thought of committing themselves to a sale, except as provided for in the option feature of the contract, then their relationship throughout was one of landlord and tenant and the payments were rent under the lease. If, however, . . . a verbal agreement of sale of the property involved preceded the execution of each of these contracts, and the parties in so executing and carrying them out at all times intended to accomplish a sale of the property described in the lease from the lessor to the lessee, and the lessor and lessees intended that the payments made by the latter to the former under the rental provisions of the leases should be credited upon the purchase price of such property, then such payments must be regarded as purchase-price payments. . . ." <sup>26</sup>

Where the parties to the transaction have entered into a lease for the express purpose of avoiding the unfavorable redemption laws of a particular state, which a deed and mortgage would entail,<sup>27</sup> or because a sale would meet with the disapproval of an administrative tribunal

---

24. *Heryford v. David*, 102 U. S. 235 (1880); *Watson v. Commissioner*, 62 F. 2d 35 (9th Cir. 1932); *Jefferson Gas Coal Co. v. Commissioner*, 52 F. 2d 120 (3d Cir. 1931).

25. *Robertson v. Commissioner*, 19 B. T. A. 534, 538 (1930).

26. *Id.* at 539.

27. *Robertson v. Commissioner*, 19 B. T. A. 534 (1930); cf. *Haverstick v. Commissioner*, 13 B. T. A. 837 (1928).

having jurisdiction over the subject matter of the transaction,<sup>28</sup> the courts will disregard the form of the contract and will look to the substance, to the actual intent of the parties as gathered from the facts, and will call the transaction what it in fact is, a sale. Where, too, the total "rentals" to be paid under the lease agreement before title to the property is to pass to the lessor, in the event that he exercised the option to purchase, approximate the value of the property, the Tax Court will regard the transaction as a sale for tax purposes, since "it is inconceivable that the petitioner is not acquiring something of value, that is, a certain equity in the machines, with each payment made in accordance with the agreement."<sup>29</sup> In a similar situation, when commenting on the lessee's option to purchase the property, the Tax Court pointed out that "a right to take title to the property" is in itself sufficient to defeat the lessee's contention that the monthly payments were rentals and that it was, therefore, entitled to a deduction for the amounts so paid.<sup>30</sup> Where, however, in the event of the exercise of the option, no part of the rent reserved in the lease is allocable to the purchase price of the land, and the rent, as such, is solely for the use of the premises during the term of the lease, the tenant may properly claim the rental payments as deductions.<sup>31</sup>

No cases have been found involving a typical purchase-lease transaction which a life insurance company has negotiated under its right to own income real estate. But it would seem advisable when preparing such leases to advise the prospective tenant against the use of an absolute option to purchase if the tenant is to be secure in its position in claiming all rental payments as a necessary expense of conducting its business. This advice would appear to be particularly appropriate in purchase-lease transactions where the sale is made at cost of the land and the new building, and the rentals, which will be paid throughout the basic term of the lease, are equal to the purchase price of the land and improvements plus a return comparable to a secured investment.<sup>32</sup>

Between the two poles—a lease without any form of option and a lease containing an absolute option to purchase—is the lease with the rejectable offer. This form has become the more acceptable pro-

---

28. *Watson v. Commissioner*, 62 F. 2d 35 (9th Cir. 1932).

29. *Holeproof Hosiery Co. v. Commissioner*, 11 B. T. A. 547, 556 (1928). See *Taft v. Commissioner*, 27 B. T. A. 808 (1933); *Smith v. Commissioner*, 20 B. T. A. 27 (1930).

30. *Judson Mills v. Commissioner*, 11 T. C. 25 (1948); *Helser Machine and Marine Works v. Commissioner*, 39 B. T. A. 644 (1939).

31. *Leatherbee v. Commissioner*, 34 B. T. A. 196 (1936).

32. Stone, *Some Legal Problems Involved in the Sale of Real Estate by Insurance Companies*, VI ASSOCIATION OF LIFE INSURANCE COUNSEL PROCEEDINGS 287, 311-314 (1935).

cedure of lease cancellation and purchase, and although it does not assure a tenant the right to reacquire its property, it places such tenant in the position of cancelling its lease if by reason of changed conditions the continuation of the tenancy is not economically justified. There are no known decisions construing such a provision, but it is submitted that the rejectable offer clause defeats any claim that may be made by the Internal Revenue Department that the tenant under such a lease is acquiring an equity in the leased premises, in that the lessor is always in the position of being able to reject the offer and suffer a cancellation of the lease. In other words, it assures the lessor a real ownership status in the property and helps to create a *bona fide* relationship of landlord and tenant.

*Default Clause.* The default clause of the normal lease follows a generally uniform pattern. The usual contingencies which may permit the landlord either to re-enter the premises and declare the term ended, or without re-entering or terminating the lease to sue for all rents, including damages, which have accrued or which may accrue to the end of the basic term of the lease, are the following:

- (a) Non-payment of rent or any other sum required to be paid by the tenant.
- (b) Non-performance of other covenants or conditions to be performed by the tenant.
- (c) If the tenant without further possibility of appeal
  - (i) is adjudicated a bankrupt or insolvent, or
  - (ii) has a receiver appointed for its assets or business,or
  - (iii) has a trustee appointed for it after a petition has been filed for the tenant's reorganization under the Chandler Act,<sup>33</sup> or
  - (iv) shall make an assignment for the benefit of its creditors.

It is not the purpose of this article to discuss the rights and liabilities of a landlord and tenant when a default occurs under the provisions of the lease by either party. However, in view of the corporate character of the tenants with which life insurance companies are negotiating long-term lease agreements, it seems worth-while to include in this discussion a brief resume of a landlord's rights in case his tenant goes into bankruptcy or petitions for reorganization under the Chandler Act.

---

33. 52 STAT. 840 (1938), 11 U. S. C. § 501 (1946).

If the tenant is adjudicated a bankrupt, Section 70b of the present Bankruptcy Act provides that the trustee, within sixty days after the adjudication, shall assume or reject any executory contract, including any unexpired leases of real property, and if no action is taken within that time, the lease shall be deemed to be rejected.<sup>34</sup> The same section also provides that a general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the lease and subsequently assigning it, although an express covenant in the lease that an assignment by operation of law or the bankruptcy of the lessee shall terminate the lease shall be enforceable.

If the trustee assumes the lease, he is, of course, liable under all the covenants of the lease.<sup>35</sup>

If the trustee rejects the lease, the claim of the landlord, under Section 63a (9) of the Bankruptcy Act, can in no event be allowed in an amount exceeding the rent reserved by the lease, without acceleration, for the year next succeeding the date of the surrender of the premises to the landlord or the date of re-entry of the landlord, whichever first occurs, whether before or after bankruptcy, plus an amount equal to the unpaid rent accrued to beginning of such next succeeding year.<sup>36</sup> Section 63 (c) provides that notwithstanding any state law to the contrary, the rejection of an unexpired lease shall constitute a breach of such lease as of the date of the filing of the petition in bankruptcy.<sup>37</sup>

If, however, the tenant petitions for reorganization under the Chandler Act, the trustee or debtor in possession has a reasonable time within which to decide whether to petition the court to adopt or reject the lease;<sup>38</sup> and the adoption or rejection takes place only upon order of the court,<sup>39</sup> but until adoption or rejection of the lease, the trustee or the debtor in possession is liable only for the reasonable value of the use and occupancy of the premises.<sup>40</sup> Such value may be, but is not necessarily, fixed at the rent reserved in the lease.<sup>41</sup>

34. 52 STAT. 880 (1938), 11 U. S. C. § 110(b) (1946); 4 COLLIER, BANKRUPTCY ¶ 70.44 (14th ed. 1942).

35. *In re Barnhardt Coal and Limestone Co.*, 265 Fed. 385 (N. D. Ohio 1919); 4 COLLIER, BANKRUPTCY ¶ 70.44.

36. 30 STAT. 562 (1898), as amended, 11 U. S. C. § 103 (1946); 3 COLLIER, BANKRUPTCY ¶ 63.33.

37. 30 STAT. 562 (1898), as amended, 11 U. S. C. § 103 (1946); 3 COLLIER, BANKRUPTCY ¶ 63.35.

38. *Philadelphia Co. v. Dipple*, 312 U. S. 168 (1940); 6 COLLIER, BANKRUPTCY ¶ 3.23(7).

39. 52 STAT. 884 (1938), 11 U. S. C. § 516 (1946); 6 COLLIER, BANKRUPTCY ¶ 3.23.

40. *Philadelphia Co. v. Dipple*, 312 U. S. 168 (1940); 6 COLLIER, BANKRUPTCY ¶ 3.23(8).

41. *Ibid.*

If the court approves the assumption of the lease by the trustee, the debtor's estate becomes bound by all the liabilities, terms and conditions of the contract.<sup>42</sup>

If, however, the trustee, with the approval of the court, rejects the lease, the claim of the landlord for damages cannot exceed the rent reserved "for the three years next succeeding the date of the surrender of the premises to the landlord or the date of re-entry of the landlord, whichever first occurs, whether before or after the filing of the petition, plus unpaid accrued rent, without acceleration, up to such date of surrender or re-entry."<sup>43</sup>

*Other Provisions.* The usual lease agreement also contains many of the standard lease provisions, including clauses respecting fire damage and condemnation, repairs, assignment and subletting, and a section on arbitration.

In order to assure an uninterrupted flow of rental payments to the landlord throughout the basic term of the lease, the fire clause usually provides that damage or destruction of any portion or all of the building on the leased premises by fire, the elements or by any other cause whatsoever shall not terminate the lease or entitle the tenant to surrender the leased premises or to any abatement in rent. In case of loss, the proceeds of fire and extended coverage insurance are expected to restore the improvements to their original condition, but if they are insufficient, the tenant is required to pay the difference. Only in case of partial condemnation will there normally be a reduction in rent. If the condemnation is complete, the lease terminates, and if the total award is not sufficient to permit payment to the landlord of the total of the monthly instalments of rental from the date of the taking to the end of the basic term of the lease, the tenant is required to pay such difference to the landlord. Fire and condemnation clauses are frequently the most provocative sections of any lease, and there are as many forms and variations of such clauses as there are leases in existence.

The repair clause places upon the tenant the duty to make all ordinary and structural repairs and to maintain the premises in good order and condition. The lease may require the landlord's prior approval to any alterations or additions costing in excess of a named dollar figure, and if the improvements are substantial, the lease may provide that the landlord will bear the cost thereof with a correspond-

---

42. *Johnson v. Kurn*, 95 F. 2d 629 (8th Cir. 1938); 6 COLLIER, BANKRUPTCY ¶ 3.24(3).

43. 52 STAT. 893 (1938), 11 U. S. C. § 602 (1946); 6 COLLIER, BANKRUPTCY ¶ 9.20(3).

ing increase in rental in an amount that will amortize the cost of such improvements with a fixed return thereon over the remaining years of the basic term of the lease.

The inclusion of a "construction of building" section in the lease will in large part depend upon the nature of the transaction. It will be included if the transaction contemplates the erection of a new building for the tenant, and may also be inserted in a lease which covers an existing building but contemplates a possible new addition during the term. One preferred method is to have the construction of the improvements undertaken and supervised by the tenant, subject to the landlord's approval of the work, but if the contract is let and the work supervised by the landlord himself, he should be entitled to a small allowance to cover unusual overhead expenses, such allowance to be capitalized and included in his total investment. In the average situation, where advances are made for new improvements, rent in an amount equivalent to interest on such advances is paid monthly by the tenant prior to final completion of the work, at which time the basic term commences and the regular rental payments, sufficient to amortize fully the landlord's total investment within the basic term at the determined interest rate, become due and payable.

#### PURCHASE-LEASES AND MORTGAGES <sup>44</sup>

Purchase-lease transactions have been criticised by some lending institutions as not sales at all but just another form of financing,<sup>45</sup> while others have termed such transactions as the making of 100% mortgage loans.<sup>46</sup> From an economic point of view the purchase-lease and mortgage accomplish for the borrowing corporation almost identical results. In each case the corporation uses its real estate and its credit as a means to obtain immediate cash. If the mortgage method is employed, the balance sheet of the corporation will immediately reflect the loan. But, if the purchase-lease mode is employed, the balance sheet of the vendor-lessee may not even show the transaction or at least, may merely contain a footnote reference to the lease. In either case an obligation has been incurred by the corporation, whether it be a mortgagor or a lessee.

From the default angle, the vendor-lessee may suffer more severe penalties than his counterpart mortgagor. If the mortgagor defaults

---

44. In the discussion which follows, I am indebted for the economic and legal similarities between purchase-leases and mortgages to George E. Morrow, Associate Editor of the *Virginia Law Review*, whose Note in the August, 1948 issue of that Review shows a keen analysis of the "lease-back" mode of financing. See note 13 *supra*.

45. Levy, *supra* note 8, at 13.

46. Allsopp, *supra* note 9, at 164.

in the payment of its principal or interest instalments or other mortgage covenants, it may lose the property entirely or, in those states which afford the mortgagor an equity of redemption, recover the property within the redemption period. A foreclosure may even bring about a deficiency judgment. In the case of a lessee, however, a default in the payment of rent or of other lease covenants may result in a complete loss of the use of the property with no redemption period within which it may correct the defaults and thereby recover possession. In addition the default clauses of a lease may permit the vendee-lessor to recover damages for breach of the lease, which is similar in form to the deficiency judgment to which the mortgagor may be subjected. As one writer on the subject has said: "It thus appears that the vendor corporation in a leaseback transaction is in reality merely trading economic advantages for accounting benefits."<sup>47</sup>

From the economic similarities of purchase-lease and mortgage transactions, let us examine briefly the legal implications of the two methods of financing.

A mortgage has been defined as a conveyance of land as security.<sup>48</sup> It is also well established that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money.<sup>49</sup> Where the deed is accompanied by an agreement to reconvey, it is generally held that whether the transaction shall be regarded as a mortgage or a conditional sale depends entirely upon the intention of the parties;<sup>50</sup> and such intention may be gathered from the instruments themselves, and from extrinsic evidence of previous and subsequent acts or declarations of the parties in so far as they are relevant to the inquiry of intention at the time of the execution of the contract. In some states the mere fact that an agreement to reconvey accompanies a deed is alone sufficient to constitute it a mortgage or presumptively a mortgage.<sup>51</sup> In Pennsylvania such a situation raises a conclusive presumption that the deed is a mortgage,<sup>52</sup> but in the majority of the states, the question is one of fact to be decided after considering the intention of the parties and all of the

---

47. Morrow, *supra* note 13, at 691.

48. 1 JONES, MORTGAGES § 17 (8th ed. 1928).

49. Peugh v. Davis, 96 U. S. 332 (1877). See Note, 79 A. L. R. 937 (1931).

50. Conway v. Alexander, 7 Cranch 218 (U. S. 1812); 1 JONES, MORTGAGES § 309 (8th ed. 1928).

51. 1 WILTSIE, MORTGAGES § 25 (5th ed. 1939). See Note, 79 A. L. R. 937, 938 (1931).

52. Herman v. Pepper, 311 Pa. 104, 166 Atl. 587 (1933); Safe Deposit & Title Guaranty Company of Kittanning v. Linton, 213 Pa. 105, 62 Atl. 566 (1905); Appeal of William L. Lance, 112 Pa. 456 (1886); Pennsylvania Company for Insurances on Lives and Granting Annuities v. Austin, 42 Pa. 257 (1862); Wilson v. Shoemberger's Executors, 31 Pa. 295 (1858); Stoeber v. Stoeber, 9 S. & R. 434 (Pa. 1823).



circumstances surrounding the transaction.<sup>53</sup> Among the elements of a transaction which will influence a court in holding that the deed and the separate agreement to reconvey constitute a mortgage are: the ratio of the price to the actual value of the property;<sup>54</sup> whether or not there is a continuing obligation on the part of the grantor to pay a sum equivalent to interest payments;<sup>55</sup> retention of possession and control of the property by the grantor;<sup>56</sup> subsequent payment of taxes by the grantor;<sup>57</sup> prior negotiations for a loan from the grantee of approximately the amount paid by him;<sup>58</sup> the financial plight and character of the grantor at the time of the transaction.<sup>59</sup>

When a purchase-lease transaction with an absolute option to purchase is compared with above situations, it is apparent that it meets many of the tests of a mortgage. It is difficult to believe, however, that a court in passing upon the pure title aspects of the situation would construe a purchase-lease with an absolute option to purchase as a mortgage where the vendee-lessor is a life insurance company with statutory power to invest in income real estate. The legislative intent has been so clearly expressed in the several state statutes that insurance companies may now invest a portion of their assets in certain types of real estate and lease such real property for the production of income that to construe a purchase-lease transaction as a mortgage would be in direct conflict with the intention of the parties, the pole-star of judicial construction of the transaction.<sup>60</sup> Although the transaction may have passed legal title under state law this would not prevent the federal courts from treating the vendor-lessee as the owner of the property for income tax purposes.<sup>61</sup> Because of the tax aspects of the situation, it is again submitted that the lease should not contain an absolute option to purchase.<sup>62</sup>

53. 1 JONES, MORTGAGES § 309 (8th ed. 1928).

54. *Wilson v. Giem*, 90 Colo. 27, 5 P. 2d 880 (1931). See Note, 155 A. L. R. 1104, 1109 (1945). 1 WILTSIE, MORTGAGES § 18(2) (5th ed. 1939).

55. *Corey v. Roberts*, 82 Utah 445, 25 P. 2d 940 (1933); 1 WILTSIE, MORTGAGES § 18(4) (5th ed. 1939).

56. *Guilford-Chester Water Co. v. Guilford*, 107 Conn. 519, 141 Atl. 880 (1928); 1 WILTSIE, MORTGAGES § 18(3) (5th ed. 1939).

57. *In re Euclid Doan Co.*, 104 F. 2d 712 (6th Cir. 1939); 1 WILTSIE, MORTGAGES § 18(4) (5th ed. 1939).

58. See *Farley v. Forester*, 96 W. Va. 652, 659, 123 S. E. 599, 601 (1924); 1 WILTSIE, MORTGAGES § 18(5) (5th ed. 1939).

59. *In re Euclid Doan Co.*, 104 F. 2d 712 (6th Cir. 1939); 1 WILTSIE, MORTGAGES § 18(6) (5th ed. 1939).

60. 1 WILTSIE, MORTGAGES § 21 (5th ed. 1939).

61. *Higgins v. Smith*, 308 U. S. 473 (1940); *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252 (1939); *Commissioner v. H. F. Neighbors Realty Co.*, 81 F. 2d 173 (6th Cir. 1936).

62. See text at notes 23-31 *supra*.

It is difficult to discuss any phase of purchase-lease transactions without coming face to face with the tax aspects of a leaseback. This becomes apparent when the purchase-lease is compared with mortgage financing.<sup>63</sup>

There are certain basic rules of income tax law which explain the reason why purchase-leases are attractive to only a limited group of investors. In the first place, money received as rent is taxable to the recipient as income;<sup>64</sup> and secondly, money received as payment of a debt to the recipient is regarded as a return of capital and is not income for tax purposes.<sup>65</sup> Tax exempt investors—educational institutions and charitable corporations—are free to regard rental payments as either income in their entirety or as part income and part a return of capital.<sup>66</sup> Although life insurance companies must report all rental payments as “income” for income tax purposes, their gross income is so reduced by a deduction, appropriately authorized by the Revenue Act, to permit them to maintain their reserves,<sup>67</sup> that the impact of the corporate tax rates upon their rental income is less severe than in the case of ordinary business corporations.

However, when these same basic rules of income tax law are applied to the average taxpayer, it is apparent that if he invested in a purchase-lease he would be faced with heavier income tax liability than if he invested the same amount of money in a mortgage. A recent discussion illustrates this proposition in the following manner:

Let us assume a mortgage loan of \$1,000,000, the principal of which is to be repaid in twenty yearly installments of \$50,000 plus 3 per cent interest on the declining balance. The payment for the first year will be \$80,000. Of this amount, \$50,000 is a return of capital and is not included in gross income. The \$30,000 interest is all the investor is required to pay income taxes on. If the transaction had been a lease-back, in which the building was sold was \$1,000,000 and leased back at a diminishing rental which in twenty years would amortize the investment and provide a 3 per cent return, then the first year's payment would be the same—\$80,000. In this case, however, the entire amount would be taxable as rental income to the lessor. His gross receipts for the year would be identical with the mortgagee's, but his taxable income would be \$50,000 greater. He would however get his depreciation allowance, possibly on some basis other than the straight line method to reflect more accurately his income.

---

63. See text at notes 44-59 *supra*.

64. INT. REV. CODE § 22(a).

65. *Cf. Eisner v. Macomber*, 252 U. S. 189 (1919).

66. INT. REV. CODE § 101(6).

67. INT. REV. CODE § 202.

At the other end of the transaction, the vendor-lessee is in a correspondingly advantageous tax position in relation to his counterpart, the mortgagor. The mortgagor, who pays \$80,000 on the mortgage, is entitled to deduct from gross income only the \$30,000 interest as a business expense. The payment of the other \$50,000, being a repayment of a loan, is not counted as an expense. But the lessee who pays \$80,000 in rent can deduct the entire amount as an ordinary and necessary business expense. Thus, though their expenditures are matched dollar for dollar, the lessee enjoys each year a \$50,000 greater deduction from taxable income than does the mortgagor.<sup>68</sup>

Which one—the mortgagor or the vendor-lessee—is in a more advantageous position? The mortgagor enjoys certain benefits in his position as the owner of the property—he can take an annual depreciation on his property; this depreciation can normally be spread over forty or fifty years depending upon the age and construction of the buildings; he can take a deduction for interest paid on his loan and for taxes assessed on the mortgaged premises; and when the loan is paid in full the mortgagor retains the ownership of the premises. On the other hand, although the vendor-lessee loses its deductions for depreciation on its buildings, such loss is more than offset by the lessee's opportunity to write off, within a specified period, the whole property, including the land which may not be depreciated under the present tax laws; the lessee by appropriate lease provisions can arrange to make higher rental payments (and thereby obtain larger deductions from gross income) for the next few years when large profits are anticipated and then pay a lower rental in low income periods; the lessee may continue to claim as a deduction the real estate taxes which it now pays pursuant to its lease as additional rent to the landlord;<sup>68a</sup> if the lessee elects to renew the lease at the end of the basic term, it will not only be freed from its heavier rental payments but may benefit by lower income tax rates then in force; on the other hand, if the lessee elects not to renew the lease and the lessor rejects its offer to purchase, the lessee will be without a building. But the real advantage enjoyed by a vendor-lessee is its ability to take all its deductions on the building during the basic term of the lease rather than have them spread over the life of the building which its counterpart mortgagor would be required to do. What the lessee is in effect doing is squeez-

---

68. Morrow, note 13 *supra*, at 695.

68a. Although taxes paid by a tenant to or for a landlord for business property are additional rental and constitute a deductible item to the tenant and taxable income to the landlord, the amount of such taxes may be deducted by the landlord in its income tax return: see INT. REV. CODE § 23(a)(1); C. C. H., Standard Federal Tax Reporter, Vol. 1, Par. 165.

ing the depreciation into twenty years rather than spreading it over forty or fifty years. It follows, therefore, that the tax advantage to the lessee relates to time rather than to amount.

### CONCLUSION

The foregoing observations represent some of the economic and legal problems with which life insurance counsel will be faced as the industry takes advantage of this new field of investment. The field is so new that from the tax aspects of the device no cases have been found involving the construction of leases made by life insurance companies under their legislative authority to invest in income real estate. It is anticipated that the Treasury Department will soon take steps to fill this vacuum. It has already been alleged that the purchase-lease is a scheme based on tax evasion.<sup>69</sup> Educational institutions have been attacked in congressional hearings for capitalizing on their tax exemption when investing in purchase-leases,<sup>70</sup> and the Treasury Department has added a question to its form of information return made by certain tax exempt institutions regarding income from purchase-leases made by such institutions.<sup>71</sup> It seems probable that leases with absolute options will be the first to come under attack. Certainly greater security can be found for the tenant in the lease containing the rejectable offer.

The purchase-lease for the life insurance industry is still in its infancy, but with the need for new investment outlets which the stupendous increase in the industry's assets has made necessary, income real estate promises to be an attractive means to keep these assets productive.

---

69. *Hearings before Committee on Ways and Means on Revenue Revisions, 1947-1948*, 80th Cong., 1st Sess. 3411 (1948).

70. *Id.* at 3410-3412.

71. Form 990, Int. Rev. Dept.