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The Income Tax Treatment of Interests Acquired from a Ground Lessor

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THE INCOME TAX TREATMENT OF INTERESTS ACQUIRED FROM A GROUND LESSOR

NORTON L. STEUBEN*

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I. INTRODUCTION

In 1993, Congress enacted Internal Revenue Code section 197, permitting the amortization of certain intangible assets, in an effort to simplify the law and reduce the number of controversies with respect to the federal income tax treatment of intangibles.¹ While section 197 is of benefit to many industries, it is unduly harsh to the real estate industry. Congress, in its enactment of section 197, adopted the position of the Internal Revenue Service that a purchaser or heir can acquire nothing more from a seller or a decedent lessor than an interest in land and improvements.² Section 197 provides that no portion of the acquisition cost of an interest in

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1. See I.R.C. § 197; H.R. CONF. REP. NO. 213, 103d Cong., 1st Sess. 672-73 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1361-62. All citations to sections of the Internal Revenue Code in this Article are to the Internal Revenue Code of 1986, as amended before June 1996.

2. See *infra* notes 20-33 and accompanying text.

real property³ or an interest under an existing lease of tangible property⁴ is subject to amortization under that section.⁵

In addition, consistent with the Internal Revenue Service's position, Congress expressly provided that when property is acquired subject to a lease, no portion of the adjusted basis may be allocated to the leasehold interest.⁶ The entire adjusted basis must be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease.⁷ This position, particularly in the case of an acquisition from a ground lessor, may result in a substantial distortion of the acquiring party's income. The Conference Committee Report contains an example of the operation of the rule against separate allocation to the leasehold interest. The Report states that

if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, the portion (if any) of the purchase price of the shopping center that is attributable to the favorable attributes of the leases is to be taken into account as a part of the basis of the shopping center and is to be taken into account in determining the depreciation deduction allowed with respect to the shopping center.⁸

The position adopted by Congress forces the heir of, or purchaser from, a lessor of improved real property to treat the cost of any interests acquired from the lessor in addition to the lessor's interests in land and improvements as part of the cost of the land and improvements. At best, this requires the heir or purchaser to depreciate the cost of any additional interests over the remaining life of the improvements rather than amortizing it over fifteen years as permitted under section 197(a).

But, what is allowed to one purchasing or inheriting from a ground lessor?⁹ With the exception of the ground lessor's interests in improvements,¹⁰ the cost of any other interests acquired from a ground lessor must be added to the cost of the land.¹¹ If these interests were amortizable or

3. See I.R.C. §§ 197(e)(2), (f)(3).

4. See *id.* § 197(e)(5)(A).

5. The effect of these provisions is explained in the Conference Committee Report in the following manner:

[N]o good will, going concern value or other Section 197 intangible is to arise in connection with the acquisition of . . . real property. . . . Instead, the entire cost of acquiring such real property is to be included in the basis of the real property and is to be recovered under the principles of present law applicable to such property.

H.R. CONF. REP. NO. 213, *supra* note 1, at 688, *reprinted in* 1993 U.S.C.C.A.N. at 1377.

6. See I.R.C. § 167(c)(2).

7. *Id.* § 167(c)(2).

8. H.R. CONF. REP. NO. 213, *supra* note 1, at 681-82, *reprinted in* 1993 U.S.C.C.A.N. at 1370-71.

9. A ground lessor is the owner and lessor of unimproved real property.

10. For example, the ground lessor's residuary interest, if any, in improvements constructed by the lessee.

11. This is because the only other asset that the ground lessor "owns," in an income tax sense, is the land.

depreciable before the enactment of section 197, sections 167(c)(2), 197(e)(5), and 197(f)(8) now prohibit such amortization or depreciation.¹² As a result, the cost of interests acquired from a ground lessor, other than land, cannot be recovered until the sale of the land unless one or more of these interests can be treated as an interest in improvements since improvements are depreciable.¹³ If the interest is not an interest in the improvements but does contribute to the realization of current rental income, the fact that its cost cannot be recovered until the sale of the land will result in a substantial distortion of the purchaser's or heir's income.

I will demonstrate in this Article that a purchaser or heir can acquire from a ground lessor a number of interests in addition to the lessor's interest in the land. In addition, I will show how some of those interests can be depreciated or amortized despite the provisions of sections 167(a)(2) and 197. Finally, to the extent that some of these interests cannot be amortized or depreciated, there occurs a material distortion of the acquiring party's income. I suggest that sections 167(a)(2) and 197 should be revised to permit amortization or depreciation of these interests so that the material distortion of income does not arise. Part II of this Article describes a hypothetical situation to illustrate how this problem arises. Interests that can be acquired from a ground lessor, other than land, are described in part III. Part IV briefly describes the position of the Internal Revenue Service with respect to the acquisition of interests, other than land, from a ground lessor. The analysis of authorities contained in part V demonstrates that interests, other than land, can be acquired from a ground lessor. Finally, part VI concludes with a discussion of the present treatment of interests, other than land, acquired from a ground lessor.

II. HOW THE VALUE OF LAND CAN EXCEED ITS VALUE AS AN UNENCUMBERED FEE

Landowner owned a vacant two-acre lot (the land) in a fashionable, primarily residential area. Developer approached Landowner to inquire whether the land was available for the development of an executive suite hotel. This type of development was permitted under the zoning of the land then in effect. Landowner indicated that the land was available but that she preferred not to sell the land at this time. Developer stated that Landowner's reluctance to sell the land did not concern him. He would simply lease the land from Landowner, build an executive suite hotel on it, and then sublease the land and the hotel to the financially sound, leading operator of executive hotels. Landowner liked this approach and negotiated the terms of a ground lease with Developer.

12. See I.R.C. §§ 167(c)(2), 197(e)(5), 197(f)(8).

13. See *id.* § 167(a).

Landowner asked for an annual rent that was at the top of the fair rental range for similar land. Landowner requested an annual increase in the rent equal to the dollar equivalent of any increase in the cost-of-living index. In addition to the above increase, Landowner wanted the annual rent increased every five years by a percentage of the previously paid annual rent. The burden of paying the “carrying costs” of the land, such as real estate taxes, was to be placed on Developer. Landowner proposed that the lease have a reasonably long term and that Developer’s obligations under the lease be guaranteed by the hotel operator. Finally, Developer was required to agree to maintain and repair the hotel and, upon termination of the lease, deliver to Landowner possession of the hotel in good condition and repair, with ordinary wear and tear excepted. Developer agreed to all of these requests. The lease was prepared and executed. Developer then constructed an elegant executive suite hotel.

The executive suite hotel was a success. Landowner was pleased with the development and the use of her land. Unfortunately, after approximately one-quarter of the lease term had passed, Landowner encountered some financial difficulties and decided to sell her interest in the land. She calculated the value of her interest as an unencumbered fee.¹⁴

Prior to setting a sale price for the land, Landowner asked the opinion of her financial adviser. After careful thought and analysis, the financial adviser suggested a sale price in excess of the value of Landowner’s land as an unencumbered fee. Landowner trusted the financial adviser and, as a result, asked for the price suggested by the financial adviser. To Landowner’s great surprise, within just a few days, an investment group agreed to purchase her interest for the asking price. After the sale was closed, Landowner asked the financial adviser why anyone would place a higher value on—and pay more for—an interest in land subject to a ground lease than the value of the land as an unencumbered fee. She further inquired whether her interest would have had the same value in her estate had she died prior to selling the land. In addition, Landowner was curious about how the purchaser or an heir would treat, for income tax purposes, the portion of the purchase price paid for, or the valuation of, the land that exceeded its value as an unencumbered fee.

III. REASONS FOR THE VALUATION AND/OR PURCHASE OF THE LAND AT A VALUE IN EXCESS OF THE LAND’S VALUE AS AN UNENCUMBERED FEE

The excess value can be attributed to independent factors impacting the value of the land. For example, it is possible that rents derived from real

14. In simple terms, for the purposes of this Article, the value of the land as an unencumbered fee is determined by ascertaining the rental that the land would produce free from the ground lease and the improvements made by the lessee under the ground lease and capitalizing that income with a multiplier that reflects the return expected for similar real estate.

estate similar to the land exceed the return that could be earned on other available investments having similar risks. As a result, an investor, in order to obtain an investment in real estate, may pay somewhat more than the unencumbered value of the land since, even after paying the increased value, the investor would earn a return greater than the return on other investments having similar risks. The excess value may also result from changes in zoning or land use regulations or development that may limit, in the future, the amount of real estate that could be put to uses similar to those to which the land in question could be put. While these changes may not currently affect the rent that can be obtained, perhaps an investor who foresees these changes will pay more for the land than its present unencumbered value.

The value in excess of the land's unencumbered value may also be attributed to the ground lease. For example, the rent paid under the lease may exceed the rent that is currently paid for unencumbered real estate similar to the land. The excess rent may be attributable to the negotiating skills of the ground lessor and his or her ability to achieve a rental return in excess of that available for similar parcels of land. Or, it may be that the rent available for similar parcels has declined since the execution of the ground lease and, as a result, the rent being paid under the lease is greater than that which can currently be obtained for similar parcels.¹⁵

Four possibilities exist with respect to the duration of the excess rent. First, the excess rent may be attributable solely to the existing ground lease and, upon termination of the ground lease, the then-available rent may decline to the rent that can be obtained from similar real estate. Second, the rent that can be obtained from similar real estate may increase over the remaining term of the lease so that the rent obtainable from the land after termination of the lease will be equal to, or in excess of, the rent paid under the lease. Third, the excess rent may be consideration for renewal or purchase options or the purchase of the leased land pursuant to a purchase option, or it may be compensated for by low rent during renewal periods. Finally, the excess value may be attributable to the presence of a strong and desirable tenant. An investor may pay more for the

15. See, e.g., *Moore v. Commissioner*, 15 T.C. 906 (1950), *rev'd*, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954), *on remand*, 14 T.C.M. (CCH) 869 (1955); W. Reed Quilliam, Jr., *Depreciation of Property Acquired Subject to a Lease: Premium Lease Rentals as a Wasting Asset*, 4 VAL. U. L. REV. 261, 272 (1970); Raymond Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 HARV. L. REV. 1134, 1135 (1952); Note, *World Publishing Co. v. Commissioner*, 76 HARV. L. REV. 1303 (1963) [hereinafter *Harvard Note*]; Jules R. Willen, Note, *Depreciation of Tenant-Erected Building by Purchaser of Fee*, 23 MD. L. REV. 353, 357 (1963) [hereinafter *Maryland Note*]; Note, *Purchaser's Depreciation Rights in Property Subject to a Lease*, 82 MICH. L. REV. 572, 573, 588-89 (1983) [hereinafter *Michigan Note*]; Note, *Depreciation Disallowed on Inherited Leased Property*, 3 UTAH L. REV. 130, 131-32 (1952) [hereinafter *Utah Note*]; Irwin W. Feldman, Note, *Taxation Depreciation of Tenant Erected Improvements by Purchaser-Lessor*, 1963 WIS. L. REV. 484, 485, 489, 491 (1963) [hereinafter *Wisconsin Note*].

land and, as a result, obtain a lower return because the tenant under the ground lease (or the subtenant) is a desirable tenant and is financially strong, presenting little or no risk of default.¹⁶

The excess value of the land may additionally be attributed to factors resulting from improvements made to the land. For example, the economic life of a building constructed on the land by the lessee may exceed the term of the ground lease. The lessor's reversion in the building accounts for the excess value.¹⁷ An investor also may pay more than the unencumbered value of the land because a substantial improvement erected by the lessee, even though the improvement's economic useful life is less than the remaining term of the lease, provides security for the lessee's performance of the lease and makes the land more leasable in the event of the lessee's breach.¹⁸ In addition, an investor may ascribe a value to the ground lessor's ability to use a lessee-constructed improvement as security for a loan to the ground lessor.¹⁹ Finally, the excess value may be based on a combination of the foregoing reasons.

IV. THE INTERNAL REVENUE SERVICE TREATS THE EXCESS VALUE OR PRICE OF THE LAND AS PART OF THE BASIS OF THE LAND

When the excess value is due to factors directly impacting the land, it should be treated as part of the purchaser's or heir's basis in the land. The purchaser or heir has acquired nothing but the land. However, when the excess value is derived from the ground lease or the "security value" of the improvements, the Internal Revenue Service and many courts still treat the excess value as part of the basis of the land. It is sometimes said that one cannot split an investment between land and a subdivided part of the land, such as a lease of the land. The excess value, since it is incident to the fee, merges into the fee.²⁰ If the excess value is attributable to the

16. See, e.g., Quilliam, *supra* note 15, at 266; Note, *Lessee-Erected Improvements Securing Long-Term Leases: An Overlooked Depreciation Deduction for the Landlord*, 63 YALE L.J. 872, 875 (1954) [hereinafter Yale Note].

17. See, e.g., Alvin D. Lurie, *Depreciating Structures Bought Under Long Leases: An Adventure in Blunderland*, 18 N.Y.U. INST. FED. TAX'N 43, 56 (1960); Quilliam, *supra* note 15, at 264; Mikel M. Rollyson, *Long Waiting Line at Geneva Drive-In*, 4 J. REAL EST. TAX'N 364, 368 (1977); Michigan Note, *supra* note 15, at 586.

18. See, e.g., Lurie, *supra* note 17, at 48; Quilliam, *supra* note 15, at 264, 266; Rollyson, *supra* note 17, at 368; Rubin, *supra* note 15, at 1144, 1147; Wisconsin Note, *supra* note 15, at 487; Yale Note, *supra* note 16, at 874-75, 877.

19. As used in this Article, the "security value" of lessee-constructed improvements is the value the ground lessor derives from the improvements' (1) acting as security for the performance of the lessee's obligations under the ground lease; (2) making the real estate more leasable on termination of the existing lease; and (3) being available to serve as security for a loan to the ground lessor.

20. See, e.g., *Midler Court Realty, Inc. v. Commissioner*, 61 T.C. 590 (1974), *aff'd*, 521 F.2d 767 (3d Cir. 1975); *Schubert v. Commissioner*, 33 T.C. 1048 (1960), *aff'd*, 286 F.2d 573 (4th Cir. 1961), *cert. denied*, 366 U.S. 960 (1961); *Peters v. Commissioner*, 4 T.C. 1236 (1945); *Friend v. Commissioner*, 40 B.T.A. 768 (1939), *aff'd*, 119 F.2d 959 (7th Cir.

rent paid pursuant to the lease's being in excess of the rent that could be derived from the land at the time of its acquisition, but not in excess of the rent that could be derived following the termination of the lease, it has been asserted that the holder of the lease will suffer no loss through exhaustion since the same rent will be available after termination of the lease.²¹ Alternatively, it is said that the excess rent is really the consideration for renewal options, purchase options, or the purchase of the leased land, or that it is made up for by lower rents during the renewal periods.²² Finally, at the present time, sections 167(c) and 197(e)(5) require, in some cases, that the excess value be added to the basis of the land.²³

Another way of rationalizing the position that excess value arising from the ground lease or leasehold improvement should be added to the basis of the land is that a devisee or purchaser cannot acquire an interest greater than that owned by the decedent or seller. If a seller or decedent had no economic interest in the lease or in a leasehold improvement, a purchaser or devisee cannot acquire one.²⁴ This position is correct if what is meant is that the purchaser or devisee takes the land as the seller or decedent held it—subject to the ground lease. The position is not correct if what is meant is that since the seller or decedent had no basis in the lease or improvement, the purchaser or devisee cannot acquire one.

When the excess value is derived through a leasehold improvement, a number of reasons have been given for treating that value as part of the basis of the land. For example, it is asserted that there cannot be more than one taxpayer depreciating the same building at the same time.²⁵ In instances in which the ground lessor does not acquire title to the improve-

1941), *cert. denied*, 314 U.S. 673 (1941); Lurie, *supra* note 17, at 52-53; Quilliam, *supra* note 15, at 266; Maryland Note, *supra* note 15, at 354, 357; Wisconsin Note, *supra* note 15, at 492; Yale Note, *supra* note 16, at 877.

21. See, e.g., Moore v. Commissioner, 207 F.2d 265 (9th Cir. 1953), *rev'g* 15 T.C. 906 (1950), *cert. denied*, 347 U.S. 942 (1954); Friend, 40 B.T.A. at 771; Quilliam, *supra* note 15, at 272, 275; Wisconsin Note, *supra* note 15, at 492.

22. See, e.g., Fieland v. Commissioner, 73 T.C. 743 (1980); Midler Court Realty, 61 T.C. at 596.

23. See I.R.C. §§ 167(c)(2), 197(e)(5).

24. See, e.g., M. DeMatteo Constr. Co. v. United States, 310 F. Supp. 1313 (D. Mass. 1970), *aff'd*, 433 F.2d 1263 (1st Cir. 1970); Barnes v. United States, 222 F. Supp. 960 (D. Mass. 1963), *aff'd sub nom.* Buzzell v. United States, 326 F.2d 825 (1st Cir. 1964); Goelet v. United States, 161 F. Supp. 305 (S.D.N.Y. 1958), *aff'd*, 266 F.2d 881 (2d Cir. 1959); Schubert, 33 T.C. at 1054; Rollyson, *supra* note 17, at 366; James V. Heffernan, Note, *Depreciation Allowable on Lessee-Constructed Property Subject to Long-Term Lease*, 37 CORNELL L.Q. 323, 326 (1952) [hereinafter Cornell Note]; Maryland Note, *supra* note 15, at 356; Wisconsin Note, *supra* note 15, at 487.

25. See, e.g., Moore, 207 F.2d at 272; Lurie, *supra* note 17, at 57; Rollyson, *supra* note 17, at 366; Rubin, *supra* note 15, at 1147; Cornell Note, *supra* note 24, at 325; Maryland Note, *supra* note 15, at 356; Yale Note, *supra* note 16, at 878.

ment until the termination of the lease, a few courts have attempted to tie the ability to depreciate to the ownership of the improvement.²⁶

Another reason given for prohibiting a ground lessor's devisee or purchaser from adding the excess value to the leasehold improvement and depreciating it is that the leasehold improvement is said not to be used in the trade or business or for the production of income by the purchaser or devisee.²⁷ It is the land that produces the rent. Therefore, neither the purchaser nor the devisee can depreciate the improvement.²⁸ While it is undoubtedly true that the land is the source of the rent, this position does not recognize that the improvement can have a direct impact on the quality and predictability of that rent.²⁹

The economic life of a leasehold improvement made by the lessee affects whether the excess value will be treated as part of the basis of the improvement or of the land. For example, if the economic life of a leasehold improvement is less than the term of the ground lease, it is reasoned that a purchaser or devisee from the ground lessor cannot have acquired an interest in the improvement, since the improvement will be "used up" by the time the lease terminates.³⁰ On the other hand, if the economic life of the improvement exceeds the term of the lease, the excess value can be attributed to the lessor's reversion in the improvements on termination of the lease. The reversion, however, is not subject to exhaustion until termination of the ground lease and, therefore, is not depreciable until that time. In this instance, once the ground lease terminates, the devisee or

26. See, e.g., *First National Bank of Kansas City v. Nee*, 85 F. Supp. 840, 842-43 (W.D. Mo. 1949), *motion for new trial overruled* 92 F. Supp. 328 (W.D. Mo. 1950), *aff'd*, 190 F.2d 61 (8th Cir. 1951); Lurie, *supra* note 17, at 46; Rollyson, *supra* note 17, at 366; Cornell Note, *supra* note 24, at 327; Maryland Note, *supra* note 15, at 354.

27. See, e.g., *Schubert v. Commissioner*, 33 T.C. 1048 (1960), *aff'd*, 286 F.2d 573 (4th Cir. 1961), *cert. denied*, 366 U.S. 960 (1961); *Goelet*, 161 F. Supp. at 310-11; *First National Bank of Kansas City*, 85 F. Supp. at 842-43; *Geneva Drive-In Theatre, Inc. v. Commissioner*, 67 T.C. 764, 772 (1977), *aff'd*, 622 F.2d 995 (9th Cir. 1980); Quilliam, *supra* note 15, at 263, 279; Rollyson, *supra* note 17, at 365-66, 368-69; Cornell Note, *supra* note 24, at 330; Maryland Note, *supra* note 15, at 354; Michigan Note, *supra* note 15, at 582, 584; Utah Note, *supra* note 15, at 131; Wisconsin Note, *supra* note 15, at 486, 489.

28. See *supra* note 27.

29. See, e.g., *World Publishing Co. v. Commissioner*, 299 F.2d 614 (8th Cir. 1962), *rev'g* 35 T.C. 7 (1960); *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 805 (6th Cir. 1948), *rev'g* 6 T.C.M. (CCH) 498 (1947); *First National Bank of Kansas City*, 85 F. Supp. at 840; *Geneva Drive-In Theatre*, 67 T.C. at 764; *Millinery Ctr. Bldg. Corp. v. Commissioner*, 21 T.C. 817 (1954), *aff'd in part, rev'd in part*, 221 F.2d 322 (2d Cir. 1955), *cert. granted*, 350 U.S. 820 (1955), *aff'd*, 350 U.S. 456 (1956).

30. See, e.g., *Moore v. Commissioner*, 207 F.2d 265 (9th Cir. 1953), *rev'g* 15 T.C. 906 (1950), *cert. denied*, 347 U.S. 942 (1954), *on remand*, 14 T.C.M. 869 (1955); *Commissioner v. Pearson*, 188 F.2d 72 (5th Cir. 1951), *rev'g* 13 T.C. 851 (1949), *cert. denied*, 342 U.S. 861 (1951); *M. DeMatteo Constr. Co. v. United States*, 310 F. Supp. 1313 (D. Mass. 1970), *aff'd*, 433 F.2d 1263 (1st Cir. 1970); *Rowan v. Commissioner*, 22 T.C. 865 (1954); Quilliam, *supra* note 15, at 263, 276; Rollyson, *supra* note 17, at 366; Rubin, *supra* note 15, at 1147; Cornell Note, *supra* note 24, at 325; Maryland Note, *supra* note 15, at 354, 356; Utah Note, *supra* note 15, at 130-31; Wisconsin Note, *supra* note 15, at 487.

purchaser will be able to depreciate the excess value attributable to the reversion.³¹

It may be, in the case of excess value allegedly attributable to either the lease or the improvement, that the taxpayer will fail to carry the burden of proof in demonstrating the allocation of the excess value among the leasehold improvement, lease, and land. If this burden is not met, a court will determine that the excess value must be treated as part of the basis of the land.³² It may also be asserted that the appraisal or the purchase price was simply too high, that the appraiser was wrong, or that the purchaser paid too much for the land and, since the excess value resulted from an error, it is simply added to the basis of the land.³³

V. AN ANALYSIS AND CRITIQUE OF CASES INVOLVING ACQUISITIONS FROM A GROUND LESSOR

A. *Mistake in Valuation and Failure To Carry the Burden of Proof*

While there have been a number of cases in the Tax Court, district courts, circuit courts of appeal, and at least one case in the Supreme Court dealing with acquisitions from a ground lessor, several of these cases establish questionable precedents. Some of the cases, when properly analyzed, do not actually address the problem.³⁴ Other cases that do address the problem do not contribute to its resolution because the taxpayer failed to prove the existence of an interest beyond the interest in land acquired from the ground lessor.³⁵

A number of cases arise from a mistake in the valuation of the ground lessor's interest for estate tax purposes.³⁶ In some cases, the value of a lessee-constructed improvement, which had no "security value" and in which the decedent ground lessor had no reversionary interest, was included in the ground lessor's estate.³⁷ Typically, in these cases, the value of a lessee-

31. See, e.g., *Geneva Drive-In Theatre*, 67 T.C. at 764; *Schubert*, 33 T.C. at 1048; *Quilliam*, *supra* note 15, at 284; *Rollyson*, *supra* note 17, at 365; *Maryland Note*, *supra* note 15, at 357; *Michigan Note*, *supra* note 15, at 586; *Utah Note*, *supra* note 15, at 131; *Wisconsin Note*, *supra* note 15, at 486-87.

32. See, e.g., *Midler Court Realty, Inc. v. Commissioner*, 61 T.C. 590 (1974), *aff'd*, 521 F.2d 767 (3d Cir. 1975); *Bernstein v. Commissioner*, 22 T.C. 1146 (1954), *aff'd*, 230 F.2d 603 (2d Cir. 1956); *Peters v. Commissioner*, 4 T.C. 1236 (1945); *May v. Commissioner*, 3 T.C.M. (CCH) 733 (1944); *Annex Corp. v. Commissioner*, 2 T.C.M. (CCH) 167 (1943); *Wisconsin Note*, *supra* note 15, at 493.

33. See, e.g., *Moore*, 207 F.2d at 265; *Wisconsin Note*, *supra* note 15, at 489, 491.

34. See *infra* notes 36-42 and accompanying text.

35. See *infra* notes 43-48 and accompanying text.

36. See *infra* notes 37-38 and accompanying text.

37. See, e.g., *Buzzell v. Commissioner*, 326 F.2d 825 (1st Cir. 1964); *Barnes v. United States*, 222 F. Supp. 960 (D. Mass. 1963), *aff'd sub nom. Buzzell v. Commissioner*, 326 F.2d 825 (1st Cir. 1964); *Goellet v. United States*, 161 F. Supp. 305 (S.D.N.Y. 1958), *aff'd*, 266 F.2d 881 (2d Cir. 1959); *Bueltermann v. United States*, 61 F. Supp. 451 (E.D. Mo. 1945),

constructed improvement was included in the lessor's estate because the ground lessor had title to both the land and the improvement.³⁸

One would expect a purchaser from a ground lessor not to allocate any part of the purchase price to a lessee-constructed improvement when the term of the lease is longer than the economic life of the improvement and the improvement does not appear to provide any "security value." There are, however, several cases in which a part of the purchase price was so allocated.³⁹ In several cases, the taxpayers recognized the error in allocating part of the purchase price to the lessee-constructed improvement and argued that they had actually acquired the "security value" of the improvement or the ground lessor's interest in a premium lease.⁴⁰

While these cases discuss the possibility of the acquisition from the ground lessor of interests other than the interest in land, they constitute doubtful precedents. With the exception of *World Publishing Co. v. Commissioner*,⁴¹ all that was actually acquired from the ground lessor in any of these cases was the interest in land and, probably, an essentially valueless reversionary interest in the improvement.⁴²

In a number of cases, the proponent of the acquisition from the ground lessor of an interest in addition to the land failed to carry the burden of proof in showing that the additional interest existed.⁴³ All of these cases involve the alleged acquisition of premium rentals and the amortization of the value or acquisition cost over the remaining term of the ground lease.⁴⁴

The courts agree on the facts that the taxpayer must prove to show the existence of an additional interest. For example, the Tax Court in *May v.*

rev'd, 155 F.2d 597 (8th Cir. 1946); *Currier v. Commissioner*, 51 T.C. 488 (1968); *Rowan*, 22 T.C. at 865; *Pearson v. Commissioner*, 13 T.C. 851 (1949), *rev'd*, 188 F.2d 72 (5th Cir. 1951), *cert. denied*, 342 U.S. 861 (1951); *Currier v. Commissioner*, 7 T.C. 980 (1946).

38. See, e.g., *Buzzell*, 326 F.2d at 825; *Goelet*, 161 F. Supp. at 305; *Pearson*, 13 T.C. at 851.

39. See, e.g., *M. DeMatteo Constr. Co. v. United States*, 310 F. Supp. 1313 (D. Mass. 1970), *aff'd*, 433 F.2d 1263 (1st Cir. 1970); *Fieland v. Commissioner*, 73 T.C. 743 (1980).

40. See, e.g., *M. DeMatteo Constr.*, 310 F. Supp. at 1313; *World Publishing Co. v. Commissioner*, 35 T.C. 7 (1960), *rev'd*, 299 F.2d 614 (8th Cir. 1962). The Eighth Circuit Court of Appeals reversed the Tax Court in *World Publishing Co. v. Commissioner* and, apparently, permitted the purchaser to depreciate the improvement. While depreciating the improvement was the wrong answer, the right answer might have allowed the purchaser to depreciate or amortize the amount that had been allocated to the improvement partly as the cost of the "security value" of the improvement and partly as a payment for premium rentals.

41. 35 T.C. 7 (1960), *rev'd*, 299 F.2d 614 (8th Cir. 1962).

42. See, e.g., *Buzzell v. Commissioner*, 326 F.2d 825 (1st Cir. 1964); *M. DeMatteo Constr.*, 310 F. Supp. at 1313; *Barnes v. United States*, 222 F. Supp. 960 (Mass. 1963), *aff'd sub nom. Buzzell v. Commissioner*, 326 F.2d 825 (1st Cir. 1964); *Fieland*, 73 T.C. at 743; *Currier v. Commissioner*, 51 T.C. 488 (1968); *Rowan v. Commissioner*, 22 T.C. 865 (1954); *Pearson v. Commissioner*, 13 T.C. 851 (1949), *rev'd*, 188 F.2d 72 (5th Cir. 1951), *cert. denied*, 342 U.S. 861 (1951); *Currier v. Commissioner*, 7 T.C. 980 (1946).

43. See *infra* notes 47-48 and accompanying text.

44. See *infra* notes 47-48 and accompanying text.

*Commissioner*⁴⁵ described the facts that must be established by the taxpayer:

The independent value of a leasehold, to a lessor, at any given time, is the present worth of the excess of the rentals payable during the remaining term of the lease over the present worth of the rentals that might be obtained under a similar new lease for a like period. That is to say, the value of a lease is its bonus value.

The value, if any, of the leasehold in question in the hands of the . . . [taxpayer], independently of the land, was not the capitalized value of the rentals to be received, but was the capitalized value of such rentals over the capitalized value of the rentals that might have been obtained under a new lease of like kind. The evidence affords no basis for determining that nor does it indicate that there was any such value.⁴⁶

In reaching a determination that the taxpayer failed to satisfy the burden of proof, courts are strongly influenced by the taxpayer's failure to show that the claimed interest was separately valued in the decedent ground lessor's estate, or that the claimed interest was acquired separately from the land and that the purchase price was partially allocated to it.⁴⁷

A number of courts have imposed additional burdens on the taxpayer. If the taxpayer claimed an interest in premium rents, the taxpayer was obligated to demonstrate both that the excess rent over the fair rental value was not consideration for an option to renew the lease, an option to purchase the land, or part of the purchase price of the land, and that it was not made up for by below-market rents in renewal terms of the lease.⁴⁸

Finally, the decisions in *Cleveland Allerton Hotel, Inc. v. Commissioner*⁴⁹ and *Millinery Center Building Corp. v. Commissioner*⁵⁰ present an interesting contrast in the treatment of the taxpayer's burden of proof and represent a significant affirmative step in the treatment of an interest in premium rents as a separate interest that can be acquired from a ground lessor. Both cases involved situations in which the lessee, who had constructed a building on the leased land, purchased title to the land from the lessor in order to avoid paying a higher-than-fair-market rent for the land. In each case, the lessee, after completing the purchase, attempted to alb-

45. 3 T.C.M. (CCH) 733 (1944).

46. *Id.* at 738 (citations omitted).

47. See, e.g., *Midler Court Realty, Inc. v. Commissioner*, 61 T.C. 590 (1974), *aff'd*, 521 F.2d 767 (3d Cir. 1975); *Bernstein v. Commissioner*, 22 T.C. 1146 (1954), *aff'd*, 230 F.2d 603 (2d Cir. 1956); *Cleveland Allerton Hotel, Inc. v. Commissioner*, 6 T.C.M. (CCH) 498 (1947), *rev'd*, 166 F.2d 805 (6th Cir. 1948); *Peters v. Commissioner*, 4 T.C. 1236 (1945); *Annex Corp. v. Commissioner*, 2 T.C.M. (CCH) 167 (1943).

48. See, e.g., *Fieland v. Commissioner*, 73 T.C. 743 (1980); *Midler Court Realty*, 61 T.C. at 590.

49. 6 T.C.M. (CCH) 498 (1947), *rev'd*, 166 F.2d 805 (6th Cir. 1948).

50. 21 T.C. 817 (1954), *aff'd in part, rev'd in part*, 221 F.2d 322 (2d Cir. 1955), *cert. denied*, 350 U.S. 820 (1955), *aff'd*, 350 U.S. 456 (1956).

cate part of the purchase price to the acquisition of relief from the high rent.

The Tax Court, in *Cleveland Allerton Hotel*, refused to permit the allocation because it was not made at the time of the sale and the transaction did not provide for the separate acquisition of the leasehold estate.⁵¹ The Tax Court was reversed by the Sixth Circuit Court of Appeals:

[The taxpayer] could not, it says, have merely secured escape from a burdensome lease and . . . [left] the premises because it owned a valuable building thereon. It had no need for the fee simple title because it already had full possession and use of the land by the provisions of the lease for its unexpired term. Uncontradicted testimony supports the petitioner's assertion of its purpose and the necessity for buying the land⁵²

The Supreme Court, however, in *Millinery Center Building*, refused to permit a similarly situated taxpayer to treat part of the purchase price as the consideration for freedom from the lease.⁵³ The Court stated:

Petitioner introduced evidence to show that the rent it was paying under the lease was greatly in excess of the fair rental value of the land as vacant, unimproved land. Petitioner contends that it already owned the building and that therefore the purchase agreement was entered into for the purpose of avoiding the excessive rentals of the lease. . . . Petitioner's claim that it "owned" the building is based on a loose and misleading use of "owned." . . . It could make use of the building for the remainder of its economic life, but only on payment of the stated rent. Petitioner's evidence with respect to the rental value of the land as unimproved is irrelevant. It was using the land as improved by the building; it was paying rent for the land as improved by the building. Petitioner tendered no evidence that it was paying excessive rent for what it was actually leasing.⁵⁴

One might question the analysis of the Supreme Court. When the taxpayer claimed it "owned" the building, it really was saying that it had constructed the building, made the investment in the building, and that the lessor had no investment in the building. As a result, the lessor was not entitled to a return from the building. The lessor's sole investment was in the land, and the lessor obtained its return from the land through the rent paid pursuant to the ground lease. Therefore, the lessee's evidence showing that the rent it was paying under the ground lease was greatly in excess of the fair rental value of the land as vacant, unimproved land was entirely relevant with respect to the matter being litigated.

The cases involving the taxpayer's failure to carry the burden of proof, as well as the cases involving an error in the determination of the estate

51. 6 T.C.M. (CCH) at 498.

52. *Cleveland Allerton Hotel, Inc. v. Commissioner*, 166 F.2d 806, 806 (6th Cir. 1948).

53. 350 U.S. 456, 461 (1956).

54. *Id.* at 495-96.

tax value or the purchase price, are of questionable value in determining whether interests other than an interest in land can be acquired from a ground lessor. A number of the cases, however, suggest that had the taxpayer satisfied the burden of proof, the court would have found that an interest in addition to that in the land itself had been acquired.⁵⁵ In addition, although its impact is leavened by a bit of doubt arising from the Supreme Court's decision in *Millinery Center Building*,⁵⁶ the Sixth Circuit Court of Appeals in *Cleveland Allerton Hotel* held that a lessee acquiring the ground lessor's interest can, upon appropriate proof, deduct the cost of getting out of a burdensome ground lease.⁵⁷ If a lessee, acquiring the lessor's interest, can deduct the cost of getting out of a burdensome lease, certainly a taxpayer ought to be able to amortize the cost of acquiring a beneficial lease.

B. Acquisition of the Ground Lessor's Residuary Interest in an Improvement

If a purchaser acquires, or an heir inherits, the residuary interest of the ground lessor in an improvement constructed by the lessee, the purchaser,⁵⁸ or the heir⁵⁹ can claim a basis in the acquired residuary interest apart from the interest in the land.⁶⁰ While there have been assertions that the heir's basis, acquired pursuant to section 1014 of the Internal Revenue Code of 1986, as amended, may be used solely for determining gain and loss,⁶¹ the acquired basis can be depreciated.⁶² The question is when depreciation can be claimed. Since the purchaser's or heir's basis in the residuary interest in the improvement is not subject to exhaustion and is not used in the trade or business of, or the production of income for, the purchaser or heir until the end of the term of the ground lease, depreciation cannot be claimed until the termination of the ground lease.⁶³ Following the termination of the ground lease, the heir or purchaser may depreciate the basis acquired in the residuary interest.⁶⁴

55. See, e.g., *Fieland v. Commissioner*, 73 T.C. 743 (1980); *Peters v. Commissioner*, 4 T.C. 1236 (1945); *May v. Commissioner*, 3 T.C.M. (CCH) 733 (1944).

56. 350 U.S. 456, 461 (1956).

57. 166 F.2d 805, 807 (6th Cir. 1948).

58. See Rev. Rul. 60-180, 1960-1 C.B. 114; *Millinery Ctr. Bldg. Corp. v. Commissioner*, 221 F.2d 322 (2d Cir. 1955), *aff'd*, 350 U.S. 456 (1956).

59. See *Williams v. Commissioner*, 37 T.C. 1099 (1962); *Schubert v. Commissioner*, 33 T.C. 1048 (1960), *aff'd*, 286 F.2d 573 (4th Cir. 1961).

60. See *infra* notes 61-64 and accompanying text.

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

62. See *Williams*, 37 T.C. at 1099; *Schubert*, 33 T.C. at 1048.

63. See *Goelet*, 161 F. Supp. at 305; *Williams*, 37 T.C. at 1099; *Schubert*, 33 T.C. at 1048.

64. See *Geneva Drive-In Theatre, Inc. v. Commissioner*, 67 T.C. 764, 770 (1977), *aff'd*, 622 F.2d 995 (9th Cir. 1980); *Williams*, 37 T.C. at 1099; *Schubert*, 33 T.C. at 1048.

Two issues are generally present in cases dealing with the allocation of the purchase price, or the allocation of value for estate tax purposes, to the lessor's residuary interest in the improvement. The first is whether the economic life of the lessee-constructed improvement is greater than the term of the lease, and the second is whether the purchaser or heir can depreciate the interest prior to the termination of the ground lease.⁶⁵

*Geneva Drive-In Theatre, Inc. v. Commissioner*⁶⁶ provides a good example of an appropriate analysis of the acquisition of a lessor's residuary interest in a lessee-constructed improvement. First, it was demonstrated that the economic life of the improvement was greater than the term of the ground lease. The Tax Court stated that "[p]etitioners acquired . . . the right to have the land and theater improvements revert to them, as provided in the lease, upon its termination;"⁶⁷ this statement implied that the improvement would have some economic life remaining upon reversion. The taxpayers attempted to depreciate the residuary interest prior to the termination of the lease. In denying the depreciation, the Ninth Circuit Court of Appeals reasoned that

[p]rior to termination of the lease, the taxpayers did not hold the improvements for the production of income. . . . Second, the taxpayers' investment in the improvements did not erode prior [to the termination of the lease]. They did not suffer economic loss from obsolescence or use, and so did not qualify for the deduction.⁶⁸

Once the lease terminated, however, and

the theater improvements reverted to [the taxpayers], their interest ripened into a depreciable one. They then became entitled to annual depreciation deductions in such amounts as to enable them to recover over the improvements' remaining useful lives the \$200,000 of the purchase price allocable to [the residuary interest].⁶⁹

Thus, one interest that can be acquired from a ground lessor, in addition to the land, is the ground lessor's residuary interest, if any, in lessee-constructed improvements. The basis in this interest, however, cannot be depreciated until the ground lease ends.

65. See, e.g., *Geneva Drive-In Theatre*, 67 T.C. at 764; *Williams*, 37 T.C. at 1099; *Schubert*, 33 T.C. at 1048.

66. 67 T.C. at 764.

67. *Id.* at 770.

68. *Geneva Drive-In Theatre, Inc. v. Commissioner*, 622 F.2d 995, 996 (9th Cir. 1980).

69. 67 T.C. at 771-72.

C. *Acquisition from a Ground Lessor of a Currently Depreciable Interest in Lessee-Constructed Improvements*

1. *In General*

Generally, the heir of, or a purchaser from, a ground lessor cannot acquire a currently depreciable interest in a lessee-constructed improvement. An exception to this rule occurs when a recently constructed substantial improvement serves as a form of security for the lessee's performance of the ground lease or can be used as security for a loan to be made to the ground lessor.⁷⁰ It is sometimes said that the presence of the improvement simply makes the lease more valuable. The improvement, however, inhibits the lessee's breach of the lease, makes the premises easier to lease on termination of the ground lease, and may serve as security for a loan to the lessor. Therefore, for the ground lessor, the improvement has a "security value" that the heir or the purchaser can acquire.⁷¹

The Tax Court resolved in favor of the taxpayers the first three cases to question whether an heir or purchaser could acquire a currently depreciable interest in a lessee-constructed improvement.⁷² In each of these cases, the improvement's economic life was less than the term of the lease, the improvement had been constructed well before the taxpayer's acquisition, and the improvement had no security value.⁷³ It appears, however, that the improvement may have been valued in the estate of the decedent lessor.⁷⁴

In short order, the Tax Court was reversed by the Fifth Circuit Court of Appeals, in *Commissioner v. Pearson*,⁷⁵ and the Ninth Circuit Court of Appeals, in *Moore v. Commissioner*.⁷⁶ Subsequently, the Tax Court, in *Rowan v. Commissioner*,⁷⁷ reached the conclusion that the Fifth Circuit and the Ninth Circuit were correct in their views of this issue. Following *Rowan*, the courts consistently denied the heir or purchaser a currently depreciable interest in a lessee-constructed improvement when the in-

70. See *supra* note 18 and accompanying text; *infra* notes 109-19 and accompanying text.

71. Another possible item of value to the ground lessor, and one that a purchaser or heir might acquire, is the value associated with a desirable and creditworthy tenant. This item standing alone, however, should not have a great impact on the purchase price or estate tax value. Therefore, this value is primarily helpful in demonstrating that premium rentals, or an interest in a lessee-constructed improvement having security value, have been acquired.

72. See *Moore v. Commissioner*, 15 T.C. 906 (1950), *rev'd*, 207 F.2d 265 (9th Cir. 1953), *reh'g granted*, 14 T.C.M. (CCH) 869 (1955); *Pearson v. Commissioner*, 13 T.C. 851 (1949), *rev'd*, 188 F.2d 72 (5th Cir. 1951); *Currier v. Commissioner*, 7 T.C. 980 (1946).

73. See *supra* note 72.

74. See *supra* note 72.

75. 188 F.2d 72 (5th Cir. 1951).

76. 207 F.2d 265 (9th Cir. 1953).

77. 22 T.C. 865 (1954).

provement had no security value.⁷⁸ This trend persisted until the Eighth Circuit Court of Appeals' decision in *World Publishing Co. v. Commissioner*.⁷⁹

While the courts, with the exception of the Eighth Circuit, uniformly chose to deny the heir or the purchaser a currently depreciable interest, the reasons for the denials were many and varied. Some courts distinguished between an heir and a purchaser and found that an heir, unlike a purchaser, does not acquire a depreciable interest or, put affirmatively, acquires an unchanging basis.⁸⁰ This analysis is faulty. The courts recognized early that there was no distinction between the basis, and the use of the basis, of an heir vis-à-vis a purchaser.⁸¹

Other courts reasoned that if a decedent or a seller-lessor does not have an interest that can be depreciated, an heir or purchaser from such a lessor cannot acquire one.⁸² This analysis also is faulty unless what is meant is that an interest having no value to a ground lessor has no value to an heir of, or a purchaser from, the ground lessor. As stated by the court in *Pearson*:

[T]here is no necessary inconsistency in the holding that, though an ancestor, lessor, having no cost basis, does not have a depreciable interest in a building erected by a lessee, an heir may, as an incidence of estate taxation, and, under [Section 1014] I.R.C., have a basis for depreciation and an interest to depreciate.⁸³

It has been suggested that "[a] construction of the law to permit not only the lessee (who has a real economic interest) but also [a purchaser or heir] to take depreciation on the same building would be somewhat anomalous."⁸⁴ This result, however, would be no more anomalous than permitting each of two co-tenants, who both provide funds to construct a real estate improvement, to depreciate the same improvement, or permitting a lessee, who finishes out rough space, to depreciate the lessee's cost of the improvement while the lessor is depreciating the cost of the improvement incurred by the lessor.

78. See *infra* text accompanying notes 80-88.

79. 299 F.2d 614 (8th Cir. 1962).

80. See, e.g., *Goelet v. United States*, 161 F. Supp. 305 (S.D.N.Y. 1958), *aff'd*, 266 F.2d 881 (2nd Cir. 1959); *First National Bank of Kansas City v. Nee*, 85 F. Supp. 840 (W.D. Mo. 1949), *motion for new trial*, 92 F. Supp. 328 (W.D. Mo. 1950), *aff'd*, 190 F.2d 61 (8th Cir. 1951); *Bueltermann v. United States*, 61 F. Supp. 451 (E.D. Mo. 1945), *rev'd*, 155 F.2d 597 (8th Cir. 1946); *Friend v. Commissioner*, 40 B.T.A. 768 (1939), *aff'd*, 119 F.2d 959 (7th Cir. 1941).

81. *Moore v. Commissioner*, 207 F.2d 265, 274-75 (9th Cir. 1953).

82. See, e.g., *M. DeMatteo Constr. Co. v. United States*, 310 F. Supp. 1313 (D. Mass. 1970), *aff'd*, 433 F.2d 1263 (1st Cir. 1970); *Currier v. Commissioner*, 51 T.C. 488 (1968); *Schubert v. Commissioner*, 33 T.C. 1048 (1960), *aff'd*, 286 F.2d 573 (4th Cir. 1961).

83. 188 F.2d 72, 74 (5th Cir. 1951), *rev'g* 13 T.C. 851 (1949).

84. *Moore*, 207 F.2d at 272.

It is properly asserted that a purchaser or heir cannot depreciate a lessee-constructed improvement when that improvement is not currently used in the trade or business of, or for the production of income by, the heir or purchaser and when the interest in the improvement is not subject to the loss of value during the term of the ground lease.⁸⁵ This analysis is applicable if the heir or purchaser acquires only a residuary interest in the improvement from the ground lessor, but it would not be applicable if the security value of the improvement is also acquired, since the security value is subject to exhaustion during the term of the lease.⁸⁶

Finally, some courts properly point out that if the lessee-constructed improvement is subject to a ground lease with a term longer than the economic life of the improvement and the improvement has no security value, the improvement has no value to the ground lessor and, as a result, no value to a purchaser from, or heir of, the ground lessor.⁸⁷ The Tax Court, in *Rowan*, described the heir's position in the following terms:

[I]n situations such as we have here where the term of the lease extended beyond the useful life of the building and where the taxpayer would not sustain any economic loss as the building wore out and could not sell her interest in the building apart from the land or the rentals, the value of her interest in the building was zero and she could not take depreciation on the building.⁸⁸

In general, therefore, a purchaser from, or an heir of, a ground lessor can acquire a depreciable interest in a lessee-constructed improvement only under two circumstances: when the term of the ground lease is shorter than the economic life of the lessee-constructed improvement, or when a recent improvement acts as security for the lessee's performance of its obligations under the lease or for a loan to the ground lessor. The Eighth Circuit in *World Publishing*, however, held that a purchaser from a ground lessor acquired a depreciable interest in a lessee-constructed improvement even though it appeared that the term of the ground lease was longer than the life of the improvement and the improvement might have had no security value.⁸⁹ Some courts have indicated their belief that the Eighth Circuit Court of Appeals is simply wrong.⁹⁰ Other courts have in-

85. See, e.g., Rev. Rul. 55-89, 1955-1 C.B. 284; *First National Bank of Kansas City v. Nee*, 190 F.2d 61 (8th Cir. 1951); *Goelet v. United States*, 161 F. Supp. 305 (S.D.N.Y. 1958), *aff'd*, 266 F.2d 881 (2d Cir. 1959); *Geneva Drive-In Theatre, Inc. v. Commissioner*, 67 T.C. 764 (1977), *aff'd*, 622 F.2d 995 (9th Cir. 1980).

86. See *supra* notes 18-19 and accompanying text; *infra* notes 109-12 and accompanying text.

87. See, e.g., *Moore v. Commissioner*, 207 F.2d 265, 265 (9th Cir. 1953), *reh'g granted*, 14 T.C.M. (CCH) 869 (1955); *Commissioner v. Pearson*, 188 F.2d 72 (5th Cir. 1951); *Rowan v. Commissioner*, 22 T.C. 865 (1954).

88. 22 T.C. at 873.

89. 299 F.2d 614, 623 (8th Cir. 1962), *rev'g* 35 T.C. 7 (1960).

90. See, e.g., *M. DeMatteo Constr. Co. v. United States*, 433 F.2d 1263 (1st Cir. 1970).

dictated that the Eighth Circuit reached the right result because the court was really dealing with premium rentals and, therefore, could permit the amortization of the purchaser's cost of the premium rentals over the remaining term of the lease.⁹¹

The *World Publishing* court explained why it believed that the purchaser was currently entitled to depreciate an interest in a lessee-constructed improvement:

A. The taxpayer-purchaser by his purchase of the property has made an investment. He is not concerned with the identity, as between his vendor-lessor and the tenant, of the builder of the building. From this point of view, if he is entitled to the deduction where his vendor-lessor was the builder, he is entitled to a deduction where the tenant was the builder.

B. To allow the purchaser to depreciate in one situation and to deny him depreciation in the other, especially where, as here, title to the building is in the lessor and then in the purchaser, seems to be illogical, to emphasize a historical fact not participated in or caused by the purchaser and not of any other considered economic consequence to him, and to exalt form over substance.

C. It is no answer to say that the lease rentals . . . constitute only ground rent. We are concerned here not with depreciation of rentals, but with depreciation of a portion of this taxpayer's investment in the income producing property he purchased.⁹²

The reasoning of the court is faulty. When a purchaser or heir steps into the shoes of the ground lessor, the purchaser's or heir's return from the property is derived through the ground lease. The rents paid pursuant to the ground lease are solely a return on the ground lessor's interest in the land, which is the only investment of the ground lessor. If the term of the ground lease is longer than the remaining economic life of the lessee-constructed improvement and the improvement has no security value, the value of the improvement to the lessor must be zero. On the other hand, when the ground lessor constructs the improvement, the ground lessor has made an investment in the improvement and, presumably, it is of value to the ground lessor. This interest of the ground lessor in the improvement is part of what the purchaser or heir acquires. It is far from illogical to permit the purchaser or heir to depreciate an interest in an improvement when the interest was purchased from a lessor who constructed the improvement and to whom the improvement had value, and to deny depreciation when the purchaser or heir could not acquire a valuable interest in a lessee-constructed improvement because the improvement had no value to the ground lessor.

91. See, e.g., *Geneva Drive-In Theatre, Inc. v. Commissioner*, 67 T.C. 764 (1977), *aff'd*, 622 F.2d 995 (9th Cir. 1980).

92. 299 F.2d at 621-22.

2. *Can a Currently Depreciable Interest in a Lessee-Constructed Improvement Ever Be Acquired from a Ground Lessor?*

If the ground lessor has a valuable interest in the lessee-constructed improvement, a purchaser or an heir can acquire that interest. A ground lessor may have a valuable interest in a lessee-constructed improvement when the improvement acts as security for the lessee's performance of the ground lease or improves the lessor's ability to lease the land if the ground lease is terminated.⁹³ While the improvement actually makes the ground lease and land more valuable, the value derived is dependent on, and is lost with, the aging of the lessee-constructed improvement. Therefore, it can be said that the lessor has a valuable interest in the lessee-constructed improvement—an interest that a purchaser or heir can acquire.

The security value of the lessee-constructed improvement is not affected by whether the lessee financed the construction of the improvement if the lessee is personally liable for the financing. If, however, the construction of the improvement is highly leveraged and the lessee is not personally liable, the value to the lessor is substantially less since the lessee may have little or nothing at stake in whether it loses the improvement. Even if the lessee has a substantial amount at stake (through investment in the improvement or personal liability for the financing), the value of this interest to the ground lessor will decrease as the improvement ages. The lessee, presumably, will recover the investment and a reasonable return on that investment from the use of the improvement as it ages.

The ground lessor also has a valuable interest in a lessee-constructed improvement if the ground lessor can use the improvement as security for its own borrowings. The use of the improvement as security can result in the lessor's being able to borrow more money or secure a lower interest rate on a secured loan. It is probably the rare case in which a ground lessor can use a lessee-constructed improvement as security for a loan. The lessor may not acquire title to the improvement until termination of the lease and, in most cases, the construction of the improvement will be financed by the lessee using the improvement as security for the financing. As a result, there will be a first mortgage on the improvement and the ground lessor's ability to use the improvement as security for borrowing will be limited, if not nonexistent. The value to the ground lessor of the right to use the improvement as security for a loan will increase as any lessee-incurred financing secured by the improvement is paid off. On the other hand, as the improvement grows older, the value to the lessor of the right to pledge the improvement as security for a loan diminishes.

The security value of a lessee-constructed improvement, as the concept has been used in this Article, has been defined as one or a combination of

93. See *supra* note 18 and accompanying text; *infra* notes 95-108 and accompanying text.

the following: (1) the lessor's ability to use the improvement as security for a loan; (2) the use of the improvement as security for the ground lessee's performance of the ground lease; or (3) the presence of the improvement in facilitating the ground lessor's leasing of the property on termination of the lease.⁹⁴ Do any or all of these interests rise to the level of a currently depreciable interest in the improvement in the hands of a purchaser from, or an heir of, the ground lessor?

The Eight Circuit Court of Appeals' opinion in *World Publishing* is useful in addressing the lessor's use of an improvement as security for a loan made to the lessor. As will be remembered from the prior discussion of this case, the Eighth Circuit held that the taxpayer had a currently depreciable interest in lessee-constructed improvements.⁹⁵ The decision has been criticized in this Article⁹⁶ and by the First Circuit Court of Appeals in *M. DeMatteo Construction Co. v. United States*.⁹⁷ In addition, the Tax Court suggested in *Geneva Drive-In Theatre* that the Eighth Circuit in *World Publishing*, had really held that the \$300,000 of the purchase price that the taxpayer was permitted to amortize was a payment for premium rentals.⁹⁸ This position does not appear to offer a satisfactory explanation of the case since the Eighth Circuit did consider the premium rentals argument and had dismissed it by stating that "it [was] not particularly urged by the taxpayer on [the] appeal."⁹⁹

It is clear, however, that in *World Publishing*, the lessor could have used the lessee-constructed improvement as security for a loan to the ground lessor and that, in the event such a loan had been made, the mortgage securing the loan would have had priority over the lease.¹⁰⁰ This valuable interest, possibly in conjunction with other elements of security value in the improvement and the premium rentals, would logically explain the court's decision in *World Publishing*.¹⁰¹ If this interpretation is correct, then at least one court has recognized as a valuable interest the right of the lessor to use a lessee-constructed improvement as security for a loan. This right can be purchased and inherited and, therefore, can result in a currently depreciable interest in the improvement in the hands of the purchaser or heir.

The security value of a lessee-constructed improvement, other than its value as security for a loan to the lessor, has been recognized by a number of courts as a valuable interest of the ground lessor. For example, in determining the value of a ground lease, the Sixth Circuit Court of Appeals, in

94. See *supra* note 19 and accompanying text.

95. 299 F.2d at 622.

96. See *supra* note 92 and accompanying text.

97. 433 F.2d 1263, 1265 (1st Cir 1970).

98. *Geneva Drive-In Theatre*, 67 T.C. at 773.

99. 299 F.2d at 620.

100. *Id.* at 617.

101. See *id.* at 614.

1220 Realty Co. v. Commissioner,¹⁰² set out with approval the following testimony of an appraiser:

[T]he land is worth around \$700,000.00, and that \$41,000.00 a year ground rental would be equal to around 5.8% [o]n the \$700,000.00. And, as of 1952 or 1953, . . . a ground rental of that type would have been listed lower if it had been secured by a building, a good building.¹⁰³

In *Cleveland Allerton Hotel*, a lessee chose to buy the ground lessor's interest rather than buy its way out of a ground lease.¹⁰⁴ The Sixth Circuit Court of Appeals impliedly recognized the value of a lessee-constructed improvement that secured the lessee's performance of the ground lease in describing the position of the lessee in the following manner:

It could not, it says, have merely secured escape from a burdensome lease and [left] the premises because it owned a valuable building thereon The lease was a liability which it sought to extinguish. It was impossible to do merely by buying acquittance and giving up possession of the premises. It had thereupon a valuable hotel building which it could not take away with it.¹⁰⁵

While the Eighth Circuit Court of Appeals, in *First National Bank of Kansas City v. Nee*,¹⁰⁶ did not permit the heir of the ground lessor to depreciate currently the lessee-constructed improvement, it did recognize the value of the lessee-constructed improvement to the ground lessor. The court stated: "It [the lessee-constructed improvement] stands primarily as security for the lessee's performance of its covenants; therefore, belongs to the lessee subject to that pledge."¹⁰⁷ Finally, in *Geneva Drive-In Theatre*, the Tax Court, while finding against the purchaser's claim to current depreciation on the facts of this case, indicated that it might have reached a different decision on different facts:

There may be situations where lessee-constructed improvements enhance the value of real property acquired subject to a lease. Such improvements, for example, may provide added assurance that the land rent to which the purchaser becomes entitled will be collectible. In that sense the deterioration or obsolescence of the improvements prior to the expiration of the lease may tend to cause the purchaser's investment to depreciate.¹⁰⁸

102. 322 F.2d 495 (6th Cir. 1963).

103. *Id.* at 497.

104. 166 F.2d 805, 807 (6th Cir. 1948).

105. *Id.* at 806.

106. 190 F.2d 61 (8th Cir. 1951).

107. *Id.* at 71.

108. 67 T.C. 764, 772 (1977), *aff'd*, 622 F.2d 995 (9th Cir. 1980).

Once it has been determined that the purchaser or heir has acquired a present interest in the lessee-constructed improvement through the acquisition of the security value, it must be determined whether the purchaser or heir can depreciate the "cost" of that interest. In order to depreciate the interest, the purchaser or heir must use the interest in trade or business or for the production of income and the investment in the interest must erode over time.¹⁰⁹ The purchaser's or heir's investment in the security value of the lessee-constructed improvement will erode over time. As the improvement ages, its value as "security" will go down and the purchaser or heir will suffer an economic loss. Whether this interest is used in trade or business or for the production of income is a more difficult question. Since the used-in-trade-or-business test can be met by devoting the interest to trade or business,¹¹⁰ and an interest does not have to produce income in order to be devoted to use in trade or business,¹¹¹ the use of the lessee-constructed improvement as security for the lessee's performance of the ground lease should qualify as being used in trade or business. It is more difficult to argue that the availability of the lessee-constructed improvement as security for a loan to the ground lessor amounts to being devoted to use in trade or business. Use in trade or business, however, includes interests that are available but not yet actually used in trade or business.¹¹² Therefore, the purchaser and the heir should be able to meet the requirements for current depreciation of the security value of the lessee-constructed improvement.

*D. Acquisition from a Ground Lessor of an Interest in Premium Rents—
The Advantageous Aspects of the Ground Lease*

If the rent paid pursuant to a ground lease is greater than the rent that could be obtained from the land unencumbered by the ground lease, the ground lessor possesses a valuable interest in the ground lease in addition to the lessor's interest in the land. This interest is derived from the advantageous portions of the ground lease, particularly the rental, and is independent of the land subject to the ground lease.¹¹³ The value is not inherent in the land but, instead, is derived through the ground lease.

While there have been few decisions that have expressly permitted a purchaser from, or an heir of, a ground lessor to claim a basis in the lease

109. 622 F.2d at 996.

110. See, e.g., *P. Dougherty Co. v. Commissioner*, 159 F.2d 269 (4th Cir. 1946); *Alamo Broadcasting Co., Inc. v. Commissioner*, 15 T.C. 534 (1950).

111. See, e.g., *Commissioner v. Smith*, 397 F.2d 804 (9th Cir. 1968).

112. See *P. Dougherty Co.*, 159 F.2d at 269. If the ground lessor borrowed funds against the security of the lessee-constructed improvement and used those funds in the operation of the real estate, the use-in-trade-or-business test presumably would be met.

113. Another potentially advantageous and significant aspect of the ground lease involves the lessee. The desirability and creditworthiness of the lessee may represent a valuable interest of the ground lessor—an interest that can be purchased or inherited.

as a result of premium rents and amortize that basis over the term of the ground lease, a number of courts have recognized the concept of premium rents. For example, the Third Circuit Court of Appeals, in *Midler Court Realty, Inc. v. Commissioner*,¹¹⁴ defined the concept of premium rent in the following terms:

For purposes of discussion, we shall treat two possible definitions of "premium" rentals whose applicability might be proven in a case such as this one:

1) The amount, determined as of the dates the . . . leases were executed, by which the rent provided under the leases exceeded the rent which could have been obtained in the open market under similar leases.

2) The amount by which the rent provided under the leases in fact exceeded the fair rental value of the premises over the unexpired lease terms, determined at the time . . . the property [was purchased or inherited] subject to the leaseholds. . . . The existence of "premium" rentals along the lines of the first definition is inherently suspect in an arm's length transaction, especially in a transaction involving substantial rentals payable over a long period of time.

. . .

The second possible definition of "premium" rent is similar to the first, except that the appropriateness of the rent specified in the lease is evaluated as of the date on which the purchaser [or heir] acquires the fee subject to a leasehold. "Premium" rent under this definition is the amount by which the fair rental value of the premises at the time the lease was executed exceeds the fair rental value over the remaining term of the lease. Thus, in the present case, the "premium" represents a decrease in the fair rental value of the leased premises between the execution dates of the leases and the date of purchase [or death of the ground lessor] . . .¹¹⁵

The amount paid for, or the value of, the premium rents (the amount of rent in excess of the rent that, at the time of acquisition, could be derived from the unencumbered land) will constitute the purchaser's, or the heir's, basis in the ground lease. This amount has not been paid for the land and is not part of the value of the land since the inherent value of the land is its unencumbered value. It is only when the ground lease is combined with the land that the value of the premium rents is present. The purchaser, or the heir, uses the lease in trade or business, or for the production of income, and the advantageous portions of the lease will be exhausted on termination of the lease. Therefore, at a minimum, the purchaser or heir should be entitled to amortize the basis in the lease over the term of the lease. Looking again to the opinion of the Third Circuit Court of Appeals in *Midler Court Realty*:

114. 521 F.2d 767 (3d Cir. 1975).

115. *Id.* at 769.

[The purchaser] contends that a portion of the purchase price paid to the . . . [ground lessor] for the fee is attributable to the right to receive rent in excess of the amount for which . . . [the purchaser] could have leased the premises on the date of purchase. It claims that the fee, as encumbered by favorable leases, cost it more than the unencumbered fee would have, and that therefore it should be entitled, for purposes of reporting its taxable income, to offset its investment in the "premium" rentals against the "premium" rent income. This would permit [the purchaser] to amortize its cost of receiving "premium" rentals over the terms of the leases under which the "premium" rentals are due.¹¹⁶

The *Midler Court Realty* court, however, did not permit the purchaser to claim a basis in the advantageous leases and to amortize this basis over the term of the leases.¹¹⁷ The court rested its refusal on a finding that the taxpayer had not met its burden of proving that premium rents were present.¹¹⁸

In *Moore v. Commissioner*,¹¹⁹ the Ninth Circuit Court of Appeals reached a different conclusion. The *Moore* court found that the taxpayer, who was the heir of a ground lessor, had demonstrated that the rents received under a ground lease at the time of the heir's acquisition of the property were greater than the rents that might have been obtained for the unencumbered land at the time of acquisition and were not offset by any other terms of the lease. The court determined that the application of section 1014 resulted in a basis to the heir in the premium rentals (the ground lease) equal to the value of those premium rentals at the time of the death of the ground lessor.¹²⁰ In addition, the court determined that the favorable aspects of the ground lease were used in the trade or business of, or for the production of income by, the heir.¹²¹ Finally, the court held that if the heir's interest in the premium rentals were exhausted over time, the heir's basis in the premium rentals could be amortized under regulation 1.167(a)-3.¹²²

Regulation 1.167(a)-3 permits the depreciation or amortization of an intangible asset if it is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy. The

116. *Id.* at 769-70.

117. *Id.* at 770.

118. *Id.* The taxpayer failed to demonstrate that rent payments, which were higher than the rent that could be obtained for the land at the time of acquisition (1) were not made up for by lower rentals during the renewal terms of the lease; (2) were not consideration for the options to renew and to purchase; and (3) were not part of the purchase price if the lessee exercised the option to purchase. *Id.* The Tax Court, in *Fieland*, also used these considerations to hold that the purchaser had failed to demonstrate the presence of premium rentals. See also *Turner Outdoor Advertising, Ltd. v. Commissioner*, 69 T.C.M. (CCH) 2692 (1995).

119. 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954).

120. *Id.* at 274-75.

121. *Id.* at 274.

122. *Id.* at 277.

Ninth Circuit remanded *Moore* to the Tax Court for a determination of whether the premium rentals were subject to exhaustion.¹²³ The Ninth Circuit felt, erroneously, that if the land subject to the ground lease could be rented after termination of the ground lease at rents equal to, or higher than, the rents provided under the ground lease, then the heir's interest in the premium rentals was not subject to exhaustion.¹²⁴ The position of the Ninth Circuit was shared by other courts. For example, in *Schubert v. Commissioner*,¹²⁵ the Fourth Circuit indicated that

to the extent of these excess or premium rentals . . . [the taxpayer] has acquired, and is holding, as capital or principal, for the production of income, an asset wasting by lapse of time since, upon and after the termination of the lease, the land will yield only its lesser fair rental value; and at that time the premium rentals will have been exhausted and will vanish.¹²⁶

In addition, the United States Board of Tax Appeals (now the Tax Court), in *Friend v. Commissioner*,¹²⁷ denied a taxpayer amortization with respect to the cost of the alleged premium rents; the court stated that “[t]here is no showing that the rental value of the premises at the expiration of the leases will be any less than it was upon the dates of the execution of the leases.”¹²⁸

On remand from the Ninth Circuit, the Tax Court in *Moore* permitted both parties to introduce evidence of the rental value of the land upon termination of the ground lease in 2023.¹²⁹ Although none of the expert witnesses could estimate the rental value of the land in 2023, or even in 1975 or 1960,¹³⁰ the court held that the taxpayer could amortize the basis in her interest in the premium rentals.¹³¹ The Tax Court justified its conclusion by noting that the taxpayer, as the heir of the ground lessor, acquired the premium rent *required by the ground lease*.¹³² This interest had to be exhausted by the time of the termination of the lease regardless of whether the land subject to the ground lease subsequently could be rented for the same rent, or even a higher rent.¹³³ The Tax Court stated:

In addition to the land, what the petitioner must be regarded as having purchased, and did in fact acquire . . . [,] was a contract calling for the

123. *Id.*

124. *Id.*

125. 286 F.2d 573 (4th Cir. 1961), *aff'g* 33 T.C. 1048, *cert. denied*, 366 U.S. 960 (1961).

126. *Id.* at 580.

127. 40 B.T.A. 768 (1939), *aff'd*, 119 F.2d 959 (7th Cir. 1941), *cert. denied*, 314 U.S. 673 (1941).

128. *Id.* at 771-72.

129. 14 T.C.M. (CCH) 869, 872 (1955).

130. *Id.*

131. *Id.* at 873.

132. *Id.*

133. *Id.*

payment of fixed rentals above the then current rental value of the property for a period of years extending to the year 2023. The contract is a depreciable capital asset having a limited and determinable existence. Exhaustion of her rights under the lease will be complete in the year 2023 because, in that year, her right to the *rentals fixed by the lease* will terminate. Fluctuation in the rental value of the property during the term of the lease and the rental obtainable thereafter have no relation to the rights acquired by a purchaser of the lease. The . . . price paid for the premium value should properly be amortizable to permit petitioner to recover the "cost of her investments" without being taxed thereon. . . . The purchaser of the lease is not required to show that it cannot be renewed on as favorable terms upon its termination, since the amount paid for this lease was meant to secure a favorable rental for a determinate period of time; hence, it is amortizable during this period of time.¹³⁴

The Tax Court's holding on remand of *Moore* is the only decision that clearly grants to the party acquiring the ground lessor's interest in premium rentals the ability to amortize the interest over the term of the lease.¹³⁵ This concept, however, has been viewed favorably by a number of courts. For example, in both *Midler Court Realty*¹³⁶ and *Fieland v. Commissioner*,¹³⁷ the courts indicated that, had the taxpayers been able to prove the existence of premium rentals, the courts might have recognized that the interest in premium rentals could be acquired, a basis therein established, and, upon a demonstration that the interest was subject to exhaustion, the court might have recognized that the basis could be amortized over the term of the lease.¹³⁸ Both the Fourth Circuit Court of Appeals, in *Schubert*, and the First Circuit Court of Appeals, in *M. DeMatteo Construction*, affirmatively recognized the existence of the premium rental concept.¹³⁹ Finally, as interpreted by the Tax Court in *Geneva Drive-In Theatre*, the Eighth Circuit Court of Appeals in *World Publishing* not only accepted the premium rental concept but, in fact, permitted the taxpayer to amortize its basis in the interest in premium rents acquired from the ground lessor.¹⁴⁰ The Tax Court, considering in *Geneva Drive-In Theatre* the Eighth Circuit's decision in *World Publishing*, stated:

134. *Id.* (emphasis added).

135. *Id.*

136. 61 T.C. 590 (1974), *aff'd*, 521 F.2d 767 (3d Cir. 1975).

137. 73 T.C. 743 (1980).

138. *Midler Court Realty, Inc. v. Commissioner*, 521 F.2d 767, 769-70 (3d Cir. 1975); *Fieland*, 73 T.C. at 755-56. In addition, in *Turner Outdoor Advertising, Ltd. v. Commissioner*, 69 T.C.M. (CCH) 2692 (1995), the Commissioner conceded the validity of this concept.

139. 433 F.2d 1263, 1265 (1st Cir. 1970); *Schubert v. Commissioner*, 286 F.2d 573, 583 (4th Cir. 1961), *aff'g* 33 T.C. 1048, *cert. denied*, 366 U.S. 960 (1961).

140. See *Geneva Drive-In Theatre, Inc. v. Commissioner*, 67 T.C. 764, 773 (1977), *aff'd*, 622 F.2d 995 (9th Cir. 1980).

The *World Publishing Co.* opinion holds that the \$300,000 was amortizable as a premium paid by the taxpayer for the favorable aspects of the lease and not as depreciation of the building. It is almost inconceivable that the taxpayer in that case would have paid \$300,000 for a building which, as such, would provide it with no income and would have no value when the lease was terminated. In fact, the opinion enumerates 11 provisions of the lease which, in addition to rentals averaging \$28,000 per year over the remaining 28 years of the lease term, conferred various benefits and rights upon the lessor and, as a result of the purchase, upon the taxpayer. While portions of the opinion could be interpreted to refer to the building as a wasting asset, the holding was . . . that: "The taxpayer's spreading of the wasting portion of its purchase price over the entire remaining lease term by the straight-line method approximated the minimal deduction for the taxpayer."¹⁴¹

The courts that have denied the existence of, or the amortization of the interest in, premium rentals have followed one or more of the following lines of reasoning. First, it is asserted that the taxpayer has not proven the existence of the acquisition of premium rentals if the taxpayer failed to show that the higher rentals were not consideration for renewal options, purchase options, or lower purchase prices and were not compensated for by lower renewal rentals.¹⁴² Second, it is argued that the interest in premium rentals will not be exhausted and, therefore, amortization is not available if the rentals that can be obtained from the land after the termination of the ground lease will be equal to, or greater than, the rentals payable under the ground lease or if the amount of such future rentals cannot be determined.¹⁴³ This second assertion, however, was convincingly answered by the Tax Court on remand in *Moore*.¹⁴⁴

Other courts simply have taken the position that the premium rental concept has no validity. The approach taken by these courts is that upon acquisition of the fee interest in real estate, any lesser interest is merged with the fee and merely contributes to the value of the fee.¹⁴⁵ It is true that the purchaser or heir of a fee interest that is not subject to a lease cannot divide that fee interest into a right of use and a remainder and then amortize the right of use.¹⁴⁶ However, when a purchaser or heir acquires a fee

141. *Id.* (quoting 299 F.2d at 617).

142. See *Midler Court Realty, Inc. v. Commissioner*, 521 F.2d 767 (3d Cir. 1975); *Fieland v. Commissioner*, 73 T.C. 743 (1980).

143. See *Schubert v. Commissioner*, 286 F.2d 573, 583 (4th Cir. 1961), *cert. denied*, 366 U.S. 960 (1961); *Moore v. Commissioner*, 207 F.2d 265, 277-78 (9th Cir. 1953); *Friend v. Commissioner*, 40 B.T.A. 768 (1939), *aff'd*, 119 F.2d 959 (7th Cir. 1941).

144. 14 T.C.M. (CCH) 869, 873 (1955); see *supra* notes 11-27 and accompanying text.

145. See, e.g., *Moore v. Commissioner*, 69 T.C.M. (CCH) 1797 (1995); *Schubert v. Commissioner*, 33 T.C. 1048 (1960), *aff'd*, 286 F.2d 573 (4th Cir. 1961), *cert. denied*, 366 U.S. 960 (1961); *Moore v. Commissioner*, 15 T.C. 906 (1950), *rev'd*, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954); *Peters v. Commissioner*, 4 T.C. 1236 (1945); *Friend*, 40 B.T.A. at 770-72.

146. *Cf. Michaelis v. Commissioner*, 54 T.C. 1175 (1970).

interest subject to a ground lease, the fee and leasehold interests exist independent of any act by the purchaser or heir. These interests each have a separate existence and do not merge; both the fee and the leasehold still exist after acquisition. If the rent paid under the lease is equal to, or less than, the rent that could be derived from the unencumbered fee, the lease has no value apart from the fee. On the other hand, if premium rents are present, the acquiring party can divide the acquisition into an acquisition of the fee and an acquisition of the premium rents (the favorable aspects of the lease) because each interest has a separate value. Each interest makes its own contribution to the overall value. It is incorrect to say that the lease merely adds value to the land. The value of the land is what it can earn as an unencumbered fee. Any additional value is the result of the existence of the lease and this value erodes over the term of the lease. The Ninth Circuit Court of Appeals, in *Moore*, summarized the concept in the following terms:

Now, if we were dealing with a taxpayer who . . . purchased [an] . . . interest in the . . . property . . . and if it appeared that at that time the rents being paid were in excess of the fair market rentals of the property, and if the price paid took this latter fact into consideration, it must have included a bonus or premium for the acquisition of the "favorable" features of the lease.¹⁴⁷

Therefore, it is undeniable that a ground lease can have a value separate and apart from the value of the land subject to the ground lease. This valuable interest can be acquired from the ground lessor by an heir or purchaser. It can then be amortized over the remaining term of the ground lease.

VI. CONCLUSION

The ground lessor may possess a number of valuable interests in addition to the interest in land subject to a ground lease. These interests should be included in a decedent ground lessor's estate, and they can be acquired by a purchaser or an heir. Such valuable interests may include

- a) a residuary interest in a lessee-constructed improvement;
- b) a present interest in a lessee-constructed improvement that can be used as security for borrowings by the ground lessor;
- c) a present interest in a lessee-constructed improvement that acts as security for the lessee's performance of its obligations under the ground lease and makes the land more leasable in the event of the termination of the ground lease; and, finally,
- d) a present interest in the favorable aspects of the ground lease, including premium rentals and, possibly, the presence of a creditworthy and desirable lessee.

147. 207 F.2d 265, 274 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954).

What is necessary to persuade a court that a purchaser or heir has acquired one or more of these valuable interests and is entitled to a basis in it that can be amortized or depreciated at some point in time? In order to get a foot in the door, the value of the ground lessor's interests for estate tax purposes should be allocated, in preparing the estate tax return, among the valuable interests the ground lessor possesses. Similarly, the purchase price of the interests of a ground lessor should be allocated, in the purchase agreement, among the interests. These allocations, while getting the heir or purchaser off to a good start, do not appear to have any negative effects on the decedent ground lessor's estate or on the seller lessor. None of these interests should be regarded as income in respect of a decedent. All of these interests should be treated as either capital assets or real property used in trade or business or held for profit upon their sale.¹⁴⁸

The purchaser from, or the heir of, a ground lessor should realize that an attempt to demonstrate a depreciable or amortizable basis in each of the interests described above requires a discrete analysis and presents particular proof problems. For example, if the interest at issue is the ground lessor's residuary interest, the heir or purchaser must demonstrate that the economic useful life of the lessee-constructed improvement exceeds the term of the ground lease.¹⁴⁹ The lessee should be obligated to deliver the lessee-constructed improvement to the lessor at the termination of the lease, and the lessee, at the minimum, should be obligated to maintain the improvement in good condition and repair, with normal wear and tear excepted.¹⁵⁰ Finally, the value of the residuary interest would be the value of the lessee-constructed improvement as of the termination of the lease and discounted to present value at the time of the heir's or purchaser's acquisition. The heir's or purchaser's basis in the residuary interest acquired from the ground lessor is, after termination of the ground lease, depreciable over the remaining useful life of the improvement. Neither section 167(c)(2) nor section 197(e)(5) presents a problem since it is the improvement that is being depreciated.

If the lessee-constructed improvement is to have value to the ground lessor as a result of the lessor's ability to use the improvement as security for its own borrowings, it is clear that the ground lessor must acquire title

148. *But see Schubert*, 33 T.C. at 1053-54. In addition, section 167(c)(2) may present a problem in connection with the classification of the interest in the favorable aspects of the ground lease as section 1231 property. Since section 167(c)(2) prevents the amortization and depreciation of the interest in the ground lease, it would have to be classified as real property used in trade or business or held for profit in order to be treated as section 1231 property. See I.R.C § 1231(b). While a lessor's sale of the rent to become due pursuant to a ground lease almost certainly would be treated as an anticipatory assignment of income, a sale of all the lessor's rights and obligations under a ground lease, especially in conjunction with a sale of the fee simple, should be treated as a conveyance of real property used in trade or business or held for profit. *Cf. Heim v. Fitzpatrick*, 262 F.2d 887 (2d Cir. 1959).

149. See *supra* notes 65-68 and accompanying text.

150. See *supra* notes 60-68 and accompanying text.

to the lessee-constructed improvement upon its construction. In addition, it may be necessary to have the lessee's agreement that the ground lease can be subordinated to a security interest in the improvement that secures a loan to the lessor. This interest will increase in value as the lessee pays off any financing and will decrease in value as the lessee-constructed improvement ages.

Valuation of this interest is difficult, but not impossible. Conceptually, it is the value to the ground lessor, including an heir or purchaser, of the ability to give a lender an interest in the improvement as security for a loan to the lessor. The increased borrowing capacity and reduced interest rate that the ground lessor acquires as a result of having this security to give to a lender are important factors in valuing the interest. For example, one can calculate the ground lessor's return on borrowed money as applied to the additional borrowing capacity. The interest charged on the additional borrowing is then subtracted and the difference capitalized. If the additional security results in an interest rate reduction, the reduction in the interest rate can be capitalized. The purchaser or heir can depreciate this interest over the remaining useful life of the improvement. Since it is the improvement that is depreciated, neither section 167(c)(2) nor section 197(e)(5) presents any problems.

The ground lessor has a potentially valuable interest in a lessee-constructed improvement if the improvement acts as security for the lessee's performance of its obligations pursuant to the ground lease.¹⁵¹ While it can be asserted that this value is embedded in the lease, the lessee-constructed improvement is necessary to create this value. The erosion of the value of the improvement reduces the value of this interest. The value is present only in conjunction with the lease, but it is determined by the improvement.

In order to demonstrate the existence of this interest, it must be shown that the nature of the lessee-constructed improvement and the lessee's investment therein are such that the lessee would be reluctant to lose them.¹⁵² As a result, it would be unlikely that the lessee would breach the lease or try to buy out of the lease. If this is the case, the lessee-constructed improvement can be said to contribute substantially to the dependability of the rental stream under the ground lease.¹⁵³

The financing of the lessee-constructed improvement is important in making the above demonstration. For example, if the lessee used no financing and paid the entire cost of a substantial lessee-constructed improvement or was personally liable for the financing thereof, the lessee

151. In addition to being security for the lessee's performance of the ground lease, the lessee-constructed improvement will have value to the ground lessor if the improvement makes it easier to lease the premises should the lessee default and/or the ground lease terminate.

152. See *supra* notes 93-112 and accompanying text.

153. It may also aid in securing a new rental stream should the lessee breach the lease.

would be hesitant to take the chance of losing it. On the other hand, if the lessee financed 100% of the cost of the improvement using a nonrecourse mortgage, the lessee would be much less reluctant to lose the improvement. Thus, the lessee's equity in the improvement and the lessee's personal liability for the financing of the improvement are significant in determining the value of this interest.

In general, the value of this interest to the ground lessor can be said to be the capitalized value of the reduction in rental return that a ground lessor will accept as a result of the increased dependability of the rental stream resulting from the lessee-constructed improvement. This interest will lose value as the lessee-constructed improvement grows older but, possibly, will gain some value as the lessee acquires more equity in the improvement. Since this interest loses value as the improvement ages, the heir or purchaser should be able to depreciate its basis over the remaining useful life of the improvement. Sections 167(c)(2) and 197(e)(5) should have no effect because it is the improvement that is being depreciated. It may be urged that the cost of this interest should be amortized over the remaining term of the ground lease. If this position is accepted, sections 167(c)(2) and 197(e)(5) will prevent the amortization. This interest, however, is better considered as an interest in the improvement because it is a result of the construction of the improvement and erodes as the improvement ages. Since this is so, the taxpayer should be able to depreciate the basis of the interest over the remaining life of the improvement. At least, this should be the case if the improvement is considered *subject to the lease* under section 167(c)(2).¹⁵⁴ Since the seller or decedent ground lessor holds this valuable interest, it would certainly seem to be subject to the lease.

To establish that the ground lessor has a valuable interest in premium rents (the advantageous aspects of the ground lease),¹⁵⁵ an heir or a purchaser must demonstrate that the rent currently payable under the ground lease is greater than the rent that could be obtained from the land unencumbered by the ground lease.¹⁵⁶ In addition, it must be shown that the excess rent is not consideration for a renewal or purchase option or for the purchase of the land and that is not compensated for by lower rents during renewal periods.¹⁵⁷ The reason for the excess rent should be demonstrated. For example, it may be that the ground lessor was an excellent negotiator and obtained rent which was in excess of the rent that the land subject to the ground lease would normally produce.¹⁵⁸ The other, and more common,

154. See I.R.C. § 167(c)(2).

155. The premium rentals, and possibly the creditworthiness and desirability of the lessee, add to the value of the ground lease.

156. See *supra* notes 113-22 and accompanying text.

157. See *supra* note 48 and accompanying text.

158. However, the Third Circuit in *Midler* questioned such an argument:

explanation for the excess rent is that the land unencumbered by the ground lease will produce less rent than that provided under the ground lease at the time of the acquisition of the ground lessor's interest because there has been a decrease in the fair rental value of similar land since the execution of the lease.¹⁵⁹

The rent that the land will produce after termination of the ground lease should not be relevant to whether premium rents exist.¹⁶⁰ Enough courts, however, have thought this fact relevant¹⁶¹ that, if possible, it should be demonstrated that the rent the land will produce after termination of the ground lease will be below the rent payable pursuant to the lease. On the other hand, if the rent after termination will not be less than the current rent, or if the determination of such rent is entirely too speculative, the taxpayer should argue that the rent after termination is not relevant to whether premium rents exist.¹⁶² The assets that the heir or purchaser acquires are the premium rents produced by, and the other positive aspects of, the ground lease to which the land is subject. These assets erode in value as the ground lease approaches termination, regardless of the amount of rent the unencumbered land would then produce.

As mentioned above, the value of this interest is determined by the difference between the rent payable under the ground lease and the rent that could be obtained from the unencumbered fee at the time of the acquisition of the ground lessor's interest. The difference should be capitalized to produce the value of the premium rents. The basis of this interest should be amortized over the term of the lease since the erosion of the value of this interest is measured by, at best, the term of the lease. If this amortization is permitted, both the income (the excess rental) and the expense of producing the income (the cost of acquiring the premium rental)

The existence of "premium" rentals . . . [as a result of skillful negotiation by the ground lessor] is inherently suspect in an arm's length transaction, especially in a transaction involving substantial rentals payable over a long period of time. In the absence of evidence to the contrary, we assume that . . . [a ground lessee] agreed to pay the . . . [ground lessor] the minimum rental for which it thought it could obtain the premises. Thus, any "premium" rent would have resulted from an error by . . . [the ground lessee] in judging the lowest obtainable rent or from some imperfection in the market. We are unwilling to burden the tax collection process with speculative inquiries into the relative fortunes of lessors and lessees at the bargaining table. We doubt that after-the-fact administrative and judicial proceedings will lead to a more precise determination of fair rental value than that upon which the parties to a lease agree in arm's length negotiations.

Midler Court Realty, Inc. v. Commissioner, 521 F.2d 767, 769 (3d Cir. 1975).

159. See *supra* notes 113-15 and accompanying text.

160. See Moore v. Commissioner, 14 T.C.M. (CCH) 869 (1955).

161. See, e.g., Schubert v. Commissioner, 286 F.2d 573 (4th Cir. 1961), *cert. denied*, 366 U.S. 960 (1961); Moore v. Commissioner, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 347 U.S. 942 (1954); Friend v. Commissioner, 40 B.T.A. 768 (1939), *aff'd*, 119 F.2d 959 (7th Cir. 1941), *cert. denied*, 314 U.S. 673 (1941).

162. See Moore, 14 T.C.M. (CCH) at 873.

are matched. Sections 167(c)(2) and 197(e)(5), however, prevent the matching of income and expense by prohibiting the amortization or depreciation of the leasehold. While this distortion of income might not be of great concern if the cost of the interest could be amortized over the remaining life of an improvement, in this case it is the land rather than an improvement that is subject to the lease. As a result, not only is the rental income not reduced by an expense of producing it, but this expense can be recovered only by reducing sale proceeds, which may be received many years after the rental income is earned. Consequently, sections 167(c)(2) and 197(e)(5) should be amended to permit a purchaser or heir to acquire a basis in a ground lease and, subsequently, the amortization of that basis.