

Maryland Ground Rents Not Realized Income on Sale of Leasehold - Commissioner of Internal Revenue v. Simmers' Estate

Ronald M. Smullian

Follow this and additional works at: <http://digitalcommons.law.umaryland.edu/mlr>



Part of the [Property Law and Real Estate Commons](#)

Recommended Citation

Ronald M. Smullian, *Maryland Ground Rents Not Realized Income on Sale of Leasehold - Commissioner of Internal Revenue v. Simmers' Estate*, 17 Md. L. Rev. 241 (1957)

Available at: <http://digitalcommons.law.umaryland.edu/mlr/vol17/iss3/6>

This Casenotes and Comments is brought to you for free and open access by the Academic Journals at DigitalCommons@UM Carey Law. It has been accepted for inclusion in Maryland Law Review by an authorized administrator of DigitalCommons@UM Carey Law. For more information, please contact smccarty@law.umaryland.edu.

Maryland Ground Rents Not Realized Income On Sale Of Leasehold

*Commissioner of Internal Revenue v. Simmers' Estate*¹

Taxpayer, as part of the real estate development business, bought land, built houses thereon, and created ground rents which he retained upon sale of the houses and transfer of the leasehold to the purchaser.² On his annual returns taxpayer reported as gross income the selling price of the leasehold interests. The Commissioner asserted a deficiency equal to the amount of the capitalized value of the ground rent (less basis for the land) contending that the retention of the ground rent or reversion was not a retention of an interest in the property but actually represented part of the purchase price.³ Taxpayer contended that he had merely created a leasehold estate out of the original fee simple, and that only the former had been granted, retaining in himself the reversion.

The Tax Court held that the ground rental arrangements were not taxable because they were mere leases.⁴ On appeal, the United States Court of Appeals for the 4th Circuit affirmed (2-1).⁵ For tax purposes, in this situation, a Maryland ground rent constitutes a lease and not a mortgage.

The majority rested its opinion on the historical concept of ground rents as followed in Maryland. Judge Soper said that, "The decisions of the Court of Appeals of Maryland and of Judge Chesnut make it perfectly clear that the relationship between the owner of the ground rent and the owner of the leasehold is historically and actually that of

¹ 231 F. 2d 909 (4th Cir., 1956).

² The buyer was required to make semi-annual payments to taxpayer of a prearranged amount. Failure to make these payments gave taxpayer a right of distraint which could be asserted against the entire property. This seems to be the usual form for a Maryland Ground Rent lease. Kaufman, *The Maryland Ground Rent — Mysterious But Beneficial*, 5 Md. L. Rev. 1, 14-16 (1940); see also Lewis, *The Taxation of Maryland Ground Rents*, 3 Md. L. Rev. 314 (1939). The leases were stated as being for 99 years, renewable forever which, by operation of law, made them redeemable within five years at the option of the lessee at a capitalized value of six per cent. Md. Code (1951), Art. 21, §§111, 112, 116.

³ In essence, the Commissioner asserted that the buyer had given cash and a first mortgage in the form of a ground rent in exchange for an absolute interest in the property and that the grantor (taxpayer) held title to the fee merely to secure payment of the mortgage.

⁴ Estate of Ralph W. Simmers, 23 T. C. 869 (1955).

⁵ *Supra*, n. 1.

lessor and lessee."⁶ Under this view, a taxpayer who retains the ground rent interest realizes no taxable gain until title to that interest is transferred either by voluntary sale to a third person or by redemption.⁷ In anticipation of Judge Parker's mortgage analogy, Judge Soper emphasized the fact that the purchaser of the leasehold can never be required to pay the alleged mortgage debt nor can the owner of the reversion ever demand redemption or threaten to foreclose.

In his dissent, Chief Judge Parker attempted to analyze the problem by relying on the practical economic effect of the Maryland ground rent. He stated that the beneficial interest in the property is in the hands of the owner of the leasehold while taxpayer has but the bare legal title.

" . . . it cannot reasonably be said that the seller, as the result of the sale to the purchaser, has not received rights under the ground rent contract as well as the cash and the notes secured by mortgage. He has completely parted with the fee simple title which he originally owned, receiving in return therefor, in addition to the cash and notes secured by mortgage, rights under a covenant requiring the payment of ground rents, a covenant which runs with the land, and which, so far as computing gain and profit on the transaction is concerned, cannot be distinguished from a mortgage indebtedness secured by the land."⁸

"No one would contend that the latter [mortgage notes] should not be considered as a part of the purchase price received by the taxpayer, although he receives nothing on them at the time of the sale."⁹

Maryland ground rents have frequently been compared with mortgages and in some instances have been called nothing more than a mortgage.¹⁰ It was evidently the Commissioner's opinion that the mere possibility of redemption¹¹ at the instance of one party (owner of leasehold)

⁶ *Ibid.*, 914.

⁷ *Ibid.*, 915, where the court said ". . . there is no realization of taxable gain until one or the other of these events occurs."

⁸ *Ibid.*, *dis. op.* 915.

⁹ *Ibid.*, 916.

¹⁰ *Posner v. Bayless*, 59 Md. 56, 60 (1882); *Kaufman*, *supra*, n. 2, 47 *et seq.*; but this conclusion seems to ignore the fact that even in a purchase money mortgage the grantor does not become the mortgagee until the instantaneous transfer of title becomes effectuated.

¹¹ Five years from the date of the lease. Md. Code, *supra*, n. 2.

makes the ground rent a mortgage.¹² In 1933, the Commissioner had issued a bulletin which allowed the annual rental on a redeemable ground rent to be deductible as interest on a mortgage.¹³ It was restated as Treasury Regulation, 111, Section 29.23(G-1), promulgated under the Internal Revenue Code of 1939.¹⁴ The Commissioner relied on this regulation in the principal case to show the consistent administrative policy of treating ground rents as mortgages.¹⁵

It should be noted that the above regulation deals with ground rent payments made by the lessee and their deductibility on his individual return as interest expenses. From the lessee's point of view there is a great similarity between a ground rent and a mortgage in that annual payments not in excess of the maximum legal rate of interest are required in order to prevent default and in each case there is a right of redemption held by the lessee to which he can, and usually does, avail himself.¹⁶ On the other hand, while the holder of the reversion is entitled to annual payments for the use of his property, he can never foreclose or require the leasehold owner to redeem the fee. From his point of view there is in existence an unlimited lease

¹² Government Bulletin No. 9, Vol. XII, 1933, I. T. 2679, XII-9-6047, 12 C. B. 103 (1933), (1933 CCH, par. 6128).

¹³ I. T. 2679, XII-9-6047, 12 C. B. 103 (1933).

¹⁴ Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

"Sec. 29.23(b) — 1. Interest . . .

"Payments of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but are treated as rent if the ground rent is irredeemable and in such case are deductible only to the extent they constitute a proper business expense."

¹⁵ But see *H. Oliver Thompson v. Commissioner*, 17 B. T. A. 987, 988 (1929), where it was argued that certain ground rent payments made by the City of Baltimore to taxpayer were in effect interest upon the obligations of a political subdivision of the State and hence exempt from taxation. The Board of Tax Appeals disagreed, holding:

"The lease itself designates the amount to be paid as rent and not interest, . . .

"Moreover, leases such as we have here are regarded by the Courts of Maryland as establishing the relation of landlord and tenant and the obligation of the lessee is spoken of as rent."

In other words in 1929 the Board of Tax Appeals by refusing to accept ground rent payments as interest (so as to enable taxpayer to exclude it from income) was not willing to treat a Maryland ground rent as a mortgage at least for purposes of the tax-exempt interest provisions.

¹⁶ The majority of the court in a portion of the opinion deleted upon rehearing, in referring to Treasury Regulation 111, *supra*, n. 14, stated:

"Doubtless this concession was made because most redeemable ground rents are actually redeemed in the course of time, and it seemed reasonable to treat the payments of rent prior to redemption like the interest payments on an outstanding mortgage."

The deleted portion of the opinion appears in the *Daily Record* of April 16, 1956.

option agreement under which the lessee has no obligation to buy in the fee. Until the option is exercised it cannot be said that a sale has been completed.¹⁷

However, there are distinctions between a ground rent and a lease plus option arrangement. For example, in the latter situation the lessee has only a possessory interest in the property, and by failing to make his rental payments or by allowing the option to lapse he loses only his right to occupancy. On the other hand, a ground rent lessee must either redeem or continue his annual payments indefinitely, for unless he does so he may be faced with the complete divestiture of a substantial proprietary interest: *i.e.*, the leasehold interest originally purchased. In a lease option arrangement the property will eventually return to the lessor if the lessee fails to exercise the option. Because of this, the lessor will take note of fluctuations in real estate values. However, Maryland ground rents are renewable forever. Unless a forfeiture for non-payment of rent occurs, the lessor will never again regain possession or the unlimited use of the property. The fluctuations in the value of a ground rent turn not on the basis of real estate transactions in the area but rather on changes in the interest rate. In an economic sense the holder of the reversion has exchanged something for his right to the ground rent. Prior to the transaction he held an unfettered interest in the land. As a result of the transfer however, he holds only a right to receive the ground rents.

Under Sections 111(a) and 111(b) of the Internal Revenue Code of 1939,¹⁸ the method of determining gain or loss from the sale of property is set out. It is the tendency of the courts to apply tax statutes uniformly throughout the country. Judge Chesnut has so indicated in *Jones v. Magruder* where he states: "And if the statute is susceptible of general uniform application, we must apply it without deference to the particularity of the Maryland view of the nature of the estate."¹⁹ In applying the Maryland property law, it might appear that the majority of the court abandoned the principle and departed from economic uniformity. It is generally recognized that the Maryland ground rent is unique as compared to other forms of

¹⁷ *Young, Tax Problems in Real Estate Transactions*, 1949 U. of Ill. L. Forum 473, 477.

¹⁸ 26 U. S. C. A. 111(a), 111(b) (1955). Determination of amount of, and recognition of, gain or loss.

¹⁹ 42 F. Supp. 193, 198 (D. C. Md., 1941). See also *Burnet v. Harmel*, 287 U. S. 103, 110 (1932); 10A MERTENS, LAW OF FEDERAL INCOME TAXATION (1948 Rev. Vol.), Sec. 61.09.

so called ground rents in that the fee simple title to the property held under the ground rent will not pass until such ground rent is sold or redeemed.²⁰ With this in mind it would follow that if a ground rent is found to be sufficiently different from a mortgage there would be no violation of this principle of uniform application of the tax laws. That such could be the case was indicated in *Morris Lipsitz v. Commissioner*,²¹ where the Tax Court said:

"In the case of the ground rents created by petitioners herein there was no evidence that any purchaser of a building made any downpayment on the land or in any way treated the transaction as one looking toward the acquisition of the land in such circumstances that the ground rent arrangement might be regarded as the equivalent of a purchase money mortgage. The ground rents here were nothing more than what they appeared to be, notwithstanding the Maryland law gave the lessee the right to 'redeem' after 5 years. We think that the so-called creation of ground rents in this case was no more than the execution of leases, which are productive of income only to the extent that rent is received. It was not proper to capitalize the rents and thus in effect charge the owner with realization of income in the year the leases were executed, as though the land had then been disposed of at a profit."²²

It is interesting to note that in the principal case the purchaser of the leasehold was apparently treated as the owner of the building while the holder of the reversion (the ground rent) was considered the owner of the land. This

²⁰ 42 F. Supp. 193, 198 (1941), *MAYER, GROUND RENTS IN MARYLAND* (1883). *Cf. Pennsylvania Co. etc. v. Commissioner of Internal Rev.*, 19 BTA 699, aff'd. 52 F. 2d 601 (3rd Cir., 1931), where a conveyance of realty for cash of \$500,000 plus a Pennsylvania ground rent of \$800,000 payable at the option of the grantee at any time within ten years was held properly includible in grantor's gross income. Note that full payment was required to be made within ten years. Note also that a man in the position of a Maryland leaseholder has in Pennsylvania a fee interest. Kaufman, *The Maryland Ground Rent — Mysterious But Beneficial*, 5 Md. L. Rev. 1, 28 (1940), n. 76; Lewis, *The Taxation of Maryland Ground Rents*, 3 Md. L. Rev. 314, 335 (1939).

²¹ 21 T. C. 917, 936 (1954). The court was determining taxable income by the use of the increase in net worth method.

²² *Ibid.* The Tax Court in the principal case cited the Lipsitz case in its opinion 23 T. C. 869, 877 (1955) — however it emphasized the fact that the decision was reached on the basis of the particular facts presented. It is submitted however that the creation of ground rents is a relatively uniform operation and leaves little room for distinction. For discussion of the form of a ground rent lease see Kaufman, *supra*, n. 20, 14.

is a common misconception of the property interest included in the Maryland ground rent, for the Maryland ground rent affords to its holder a partial interest in both the land and the building.²³ It is a partial interest in the entire property and is treated as the fee interest, yet both the reversion and the leasehold are the subject of mortgage and judgment liens.²⁴ Under the lease they are inseparable.²⁵ It is submitted, therefore, that the result in the principal case may be considered altered without reversing the decision of the Fourth Circuit simply by redetermining the cost basis of the leasehold and the reversion. There are two suggested methods of determining a cost basis in this situation.

A. Ignore the property rights included in the Maryland ground rent and distribute costs applicable to the land itself to the ground rent while building costs will refer to the leasehold interest. This was the method used in the *Simmers* case.²⁶

B. Affirm the property rights in Maryland ground rents and allocate the total cost on the basis of the fair market value of the component leasehold and reversion on the date of the creation of these separate interests.²⁷ Since the leasehold came into being as the result of a prospective sale, its fair market value should be easily determined as the selling price of the leasehold. The same is true for the reversion which can readily be sold for the capitalized value of the ground rent.

Assume that a builder has purchased a lot for \$200. In addition a home was constructed for \$9,800. The property is purchased for \$13,000 plus a \$120²⁸ annual ground rent. The capitalized value of the ground rent is \$2,000. The tax effect under each of the above methods is as follows:

²³ Kaufman, *ibid.*, 66; THOMPSON, MARYLAND GROUND RENTS AS VIEWED BY A TRUSTMAN (1947) 40 (thesis submitted to the Graduate School of Banking conducted by the American Bankers Association at Rutgers University).

²⁴ MAYER, *op. cit. supra*, n. 20, 69.

²⁵ THOMPSON, *loc. cit., supra*, n. 23.

²⁶ 231 F. 2d 909 (4th Cir., 1956).

²⁷ MERTENS, *op. cit., supra*, n. 19, §21.05, §21.23, Nathan Blum, 5 T. C. 702 (1945); C. D. Johnson Lumber Corporation, 12 T. C. 348 (1949); Oscar Bowman, 14 T. C. M. 46 (1955). See also L. M. Graves, 11 T. C. M. 467, 472 (1952), where the court stated: ". . . where consideration is paid for a mixed group of assets a cost basis is to be allocated to each asset based upon its relative value to the whole at the time of acquisition."

²⁸ Payable \$60 semi-annually.

	Method A	Method B ²⁹
Cost Basis of Building.....	\$ 9,800	\$ 8,667
Cost Basis of Land.....	200	1,333
	<u>10,000</u>	<u>10,000</u>
Selling Price of Leasehold.....	13,000	13,000
Less: Cost Basis.....	9,800	8,667
	<u>3,200</u>	<u>4,333</u>
Reportable Income on Sale of Leasehold	3,200	4,333
Selling Price of Reversion.....	2,000	2,000
Less: Cost Basis.....	200	1,333
	<u>1,800</u>	<u>667</u>
Reportable Income on Sale of Reversion	1,800	667

The Commissioner wished to have reported as income the entire profit (\$5,000) on the date of the sale of the leasehold. Reportable income is deferred until the reversion is either sold or redeemed to the amount of \$1,800 under Method A, but only \$667 under Method B. Method B would appear to be the more logical method since it gives full effect to the special attributes of a Maryland ground rent. Where the majority in the *Simmers* case has turned the result as to the "realization" issue on these same peculiarities of the Maryland ground rent, consistency would seem to require that the Commissioner be allowed to use Method B. By using Method B, the Commissioner would

²⁹ Basis of computation under Method B:

Fair market value of leasehold.....		\$13,000
Fair market value of reversion.....		2,000
		<u>\$15,000</u>
Fair market value of property in fee simple....		<u>\$10,000</u>
Total cost of property.....		\$10,000
Basis of leasehold:	13,000 x 10,000 =	8,667
	<u>15,000</u>	
Basis of reversion:	2,000 x 10,000 =	1,333
	<u>15,000</u>	
		<u>\$10,000</u>

be able to recoup most of the potential revenue loss that the *Simmers* case entails.³⁰

It is important to note that the Commissioner has issued a nonacquiescence to the decision in the *Simmers* case.³¹ However, certiorari was not authorized.³² Treasury Regulation 111, Section 29.23(G-1), promulgated under the Internal Revenue Code of 1939³³ is still in effect. The Fourth Circuit taxpayer is in a strong position in relying on the *Simmers* case; however, in view of the history of this problem and the Treasury non-acquiescence to the Tax Court decision, the taxpayer is not assured that he will be free from litigation on adopting the *Simmers* treatment.

RONALD M. SMULLIAN

³⁰ *Supra*, n. 26. Note that in the principal case *Simmers* had died. Therefore the basis of the ground rent to his estate was the fair market value of the asset at the time of death — §113(a)5 of the 1939 INT. REV. CODE, 26 U. S. C. A. §113 (1955), now §1014 of the 1954 INT. REV. CODE. In that event no income would be realized to the estate from the sale or redemption of the ground rent at its fair market value, and the appreciation in the value of the land resulting from the developer's activities would escape taxation entirely.

³¹ 1955-2 Cum. Bull. 11.

³² 1956 C. C. H. Vol. 5, 51, 143.

³³ *Supra*, n. 14.