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Depreciation Of Tenant-Erected Building By Purchaser Of Fee

*World Publishing Co. v. Commissioner of Internal Revenue*¹

Pursuant to the terms of a fifty year lease of realty, the lessee erected a six story building at a cost of more than \$250,000. The lease provided that at its expiration all buildings and improvements put upon the land by the lessee were to pass to the lessor. Subsequently, the lessor sold his entire interest in the property to the petitioner. After the petitioner purchased the lessor's interest, he began claiming a deduction for depreciation of the building by writing off, over the remaining twenty eight years of the lease, that portion of the purchase price applicable to the building.² The depreciation deductions claimed by the taxpayer were disallowed by the Commissioner of Internal Revenue and this ruling was upheld by the Tax Court.³ The Tax Court concluded that depreciation⁴ was not allowable in this instance since the petitioner's interest in the building was such that he would not suffer an economic loss by its physical exhaustion. On appeal the Circuit Court reversed the Tax Court decision. It held that the taxpayer could write off that portion of the purchase price allocable to the tenant erected building by periodic depreciation deductions. The Court pointed out a number of cases that have denied depreciation on the tenant built improvement where the taxpayer acquired the fee interest by devise or inheritance, but distinguished those cases from an acquisition by purchase.⁵

¹ 299 F. 2d 614 (8th Cir. 1962).

² Petitioner paid \$700,000 for the property. The land was appraised at \$400,000 and the building at \$300,000. The rent over the fifty year lease averaged \$28,500 per year.

³ 35 T.C. 7 (1961).

⁴ 26 U.S.C.A. (IRC 1954) § 167(a). The 1954 Code is referred to throughout the note since sections of the 1939 Code applicable to discussion were not materially changed by the 1954 Code.

⁵ *Supra*, n. 1, 618-621.

While the instant case deals with a purchase situation, the great majority of cases dealing with the problem of depreciation of a tenant-built improvement by the owner of the fee have been confined to the situation where the taxpayer acquired the fee by devise or inheritance. These cases have been decided on their particular facts, but their history demonstrates an early conflict between the Tax Court and the United States Circuit Courts of Appeal. This conflict has been resolved so as to deny depreciation to the owner of the fee.

The early Tax Court cases allowed the heir or devisee to depreciate a tenant-erected building when it was included in valuing the decedent's estate for estate tax purposes.⁶ The rationale of these cases was that a depreciable basis was acquired by the devisee as an incidence of the estate tax which was paid on the value of the improved property.

The Tax Court was subsequently overruled in several instances. The 5th Circuit reversed the Tax Court when the evidence indicated that the property valued for estate tax purposes was not the tenant erected building, but the cash ground rental value of the land.⁷ The 9th Circuit, in the case of *Moore v. Commissioner of Internal Revenue*,⁸ where the lease was one that would not expire until the year 2023, again overruled the Tax Court. The Court reasoned that no basis existed for allowing the taxpayer to depreciate a building he would not possess until after the building's useful life had terminated and its value had been exhausted. In an 8th Circuit decision,⁹ the executor of the lessor's estate was disallowed depreciation where it was not proved that the building was held "for the production of income,"¹⁰ and where under state law title to the building would not vest in the lessor until after the expiration of the lease.

The Court of Appeals' reversal of the Tax Court in the death situation led the Tax Court to reverse its position and disallow depreciation on the tenant erected improvement. In so doing, the Tax Court in one instance denied

⁶ *Moore v. Commissioner of Internal Revenue*, 15 T.C. 906 (1950); *Pearson v. Commissioner of Internal Revenue*, 13 T.C. 851 (1949); *Currier v. Commissioner of Internal Revenue*, 7 T.C. 980 (1946).

⁷ *Pearson v. Commissioner of Internal Revenue*, 188 F. 2d 72 (5th Cir. 1951).

⁸ 207 F. 2d 265 (9th Cir. 1953); Note, *Lessee-Erected Improvements Securing Long Term Leases: An Overlooked Depreciation Deduction For The Landlord*, 63 Yale L.J. 872 (1954).

⁹ *First National Bank of Kansas City v. Nee*, 190 F. 2d 61 (8th Cir. 1951); Anno., 40 A.L.R. 2d 423 (1955).

¹⁰ 26 U.S.C.A. (IRC 1954) § 167(a)(2).

depreciation on the basis that the taxpayer was only receiving rental income from the ground alone and therefore had no interest in the building.¹¹

Depreciation was similarly denied by the Tax Court in the one case prior to the instant case where a purchase situation was involved. In disallowing depreciation in *Bernstein v. Commissioner of Internal Revenue*,¹² the Tax Court concluded that the taxpayer had purchased only a reversionary interest in the building or a right to possess the improvements upon the termination of the lease. The Court cited the opinion of the 9th Circuit in the *Moore* case as precedent and recognized the principle that there is no difference with respect to depreciation of a tenant built improvement on property acquired by purchase and property acquired by inheritance.¹³ On appeal the Tax Court decision was sustained by the 2nd Circuit primarily on the grounds that the facts showed the taxpayer's entire cost of the property was less than the fair market value of the land alone.¹⁴ Thus, because of the facts in the *Bernstein* case, the question of a purchaser's right to depreciate a tenant-erected building had never been squarely presented until the instant case.

While the 8th Circuit decision in the instant case allowing the depreciation deduction seems to create a distinction between the purchase and death situations, precedent for such a distinction does not appear to come from the case law or from the Internal Revenue Code. The Code only makes a distinction between the two situations in the measure of the basis.¹⁵ Where property is acquired by devise or inheritance fair market value is the basis,¹⁶ while cost becomes the depreciable basis when property is purchased.¹⁷

The practical economic effect of allowing depreciation to the fee owner is to allow two taxpayers, the tenant and the lessor, to depreciate the same wasting asset at the same

¹¹ *Rowan v. Commissioner of Internal Revenue*, 22 T.C. 865 (1954).

¹² 22 T.C. 1146 (1954).

¹³ On the theory that no distinction exists between a purchase and death situation see generally: Lurie, *Depreciating Structures Bought Under Long Term Lease: An Adventure in Blunderland*, New York University 18th Annual Institute on Federal Taxation (1960) p. 43; Rubin, *Depreciation of Property Purchased Subject To A Lease*, 65 Harv. L. Rev. 1134 (1952).

¹⁴ *Bernstein v. Commissioner of Internal Revenue*, 230 F. 2d 603 (2d Cir. 1956).

¹⁵ 26 U.S.C.A. (IRC 1954) § 167(f) provides the basis of depreciation as being the basis for determining gain from a sale.

¹⁶ 26 U.S.C.A. (IRC 1954) §§ 1011, 1014 dealing with basis of property acquired by devise or inheritance.

¹⁷ 26 U.S.C.A. (IRC 1954) § 1012 dealing with basis of property acquired by purchase.

time. Clearly the tenant who erected the building has a depreciable basis in the property so as to enable him to recover his costs through depreciation.¹⁸ But on what theory can a purchaser of the lessor's interest in such property justify a depreciation deduction?¹⁹ He purchased a right which in the hands of his transferor was not depreciable. How can he acquire a greater interest in the tenant erected building than his transferor had?²⁰ Even if the consideration paid for the lessor's interest in the property is in excess of the fair market value of the land alone, how can this excess be justified as the cost of the building when at the date of purchase the remaining useful life of the building is less than the remaining term of the lease?

In the instant case the Court reasoned that the purchaser bought a capital asset, over and above the land itself, which was said to be separate and distinct from the lessee's interest in the building. Therefore, in allowing each to recover their capital expenditures, the Court saw no duplication. An analogous situation was said to exist where the tenant, after having fully recovered the cost of the building by depreciation, purchased his lessor's interest in the fee.²¹ Are these situations really analogous? Two taxpayers are not depreciating the same capital asset at the same time as in the main case and the tenant is only writing off the actual cost of the building to himself.

Rather than allow double depreciation as the instant case has done, it might be better to construe the purchase of the lessor's interest in the property as a purchase of the land only, a purchase of a contract right to receive rentals under the lease, or as a purchase of the reversionary interest in the building, or a combination of all three, none of which should give rise to a depreciation deduction.

While the primary issue involved in the purchase and death situations has been depreciation, another issue which has arisen in these cases is that of amortization. The argument has been made that as an alternative to depreciation on the tenant-erected building, the taxpayer who has ac-

¹⁸ Federal Tax Regulation, U.S.C.C., A.N. (1961) § 1-167(a)-4.

¹⁹ One author who discusses the double depreciation problem, has taken the position that the purchaser and tenant will only be recovering their own costs. However he recognizes that one method by which recovery of costs would be realized would be "in the form of a basis to offset against the amount realized upon sale or exchange." Rubin, *Depreciation of Property Purchased Subject To A Lease*, 65 Harv. L. Rev. 1134, 1148 (1952).

²⁰ Value of the tenant erected building is not included in the landlord's income upon termination of the lease. 26 U.S.C.A. (IRC 1954) § 109.

²¹ 221 F. 2d 322 (2d Cir. 1955).

quired the fee should be allowed an amortization deduction where a favorable lease is involved.²²

The Tax Court, however, has rejected the claim that where the total rentals payable under the unexpired term of a long term lease are greater than the fair rental value for a like term, the taxpayer should be allowed to write off this difference through amortization.²³ In denying amortization the Tax Court reasoned that the right to receive rentals under a favorable lease was merely incident to the fee and that the favorable lease was not a separate exhaustible asset.

The 9th Circuit in the *Moore* case²⁴ overruled the Tax Court on the amortization issue and allowed the taxpayer who acquired the property by inheritance to amortize the favorable aspects of the lease over the remaining term of the lease. In order to justify its conclusion that the claimed amortization deduction was proper, the Court set up a hypothetical purchase situation. The Court reasoned that if a purchaser had paid an amount greater than the fair market value of the land alone in order to acquire the right to receive favorable rentals under a long term lease, he could recover the premium paid for the favorable lease under the Internal Revenue Code.²⁵ The Court then concluded that since the Code makes no distinction between a purchase or death situation, the taxpayer who acquires similar property by inheritance may amortize the value of the property he received to the extent that it was greater than the fair market value of the land alone.²⁶

The decision of the 9th Circuit in the *Moore* case, however, is in conflict with an earlier decision in the 7th Circuit in *Friend v. Commissioner of Internal Revenue*,²⁷ another inheritance situation. The Court in the *Friend* case would not construe the Code so as to place the executor of the estate of a decedent in the position of a purchaser and thus enable him to amortize the right to receive rent under a favorable lease. The Court concluded that the Internal Revenue Code did not give a successor of the decedent a

²² A favorable lease is one in which the rentals under the lease are greater than the market rental value of the same property at the date of acquisition of the lessor's interest in the property. See, Rubin, *Depreciation of Property Purchased Subject To A Lease*, 65 Harv. L. Rev. 1134 (1952).

²³ *Moore v. Commissioner of Internal Revenue*, 15 T.C. 906 (1950); *Peters v. Commissioner of Internal Revenue*, 4 T.C. 1236 (1945).

²⁴ 207 F. 2d 265 (9th Cir. 1953).

²⁵ 26 U.S.C.A. (IRC 1954) § 167 (a).

²⁶ *Supra*, n. 24, 275-277.

²⁷ 119 F. 2d 959 (7th Cir. 1941).

basis for amortization, but only a basis for determining gain or loss.²⁸

The direct conflict raised by the *Moore* and *Friend* cases was again brought to light in a more recent death situation in the 4th Circuit.²⁹ While depreciation was denied on authority of the *Moore* case, in that the taxpayer was held to have acquired only such interest as the decedent had at the time of his death, the same authority was not used to decide the question of amortization. An irreconcilable conflict on the amortization issue was said to exist. The Court, however, reasoned that the view presented in the 7th Circuit was preferable to that of the 9th Circuit in that it eliminated the possibility of speculation in the courts in determining rental values. They therefore denied amortization.

While the conflict among the 9th, 4th, and 7th Circuits on amortization of a favorable lease has not been clearly presented in a purchase situation, it might be concluded that a purchaser would be allowed to amortize a favorable lease. Clearly the 9th Circuit indicated such a result in its reasoning in allowing amortization to the taxpayer who acquired the fee by inheritance. Dictum in the 7th Circuit *Friend* case also indicates that the decision in that Court might have been in favor of the taxpayer had he been a purchaser. In the instant case the favorable lease argument was not raised and amortization in the *Bernstein*³⁰ case was denied on the basis of insufficient proof.

By making a distinction between the purchase and death situations in order to allow the taxpayer to depreciate the tenant erected building, the instant case has made a distinction where none appears to exist in the case law or in the Internal Revenue Code. Rather than make such a distinction, might not the better view be to deny depreciation to the purchaser of the fee, but to allow amortization if it can be shown that a favorable lease exists? Thereby double depreciation of the same physical property is avoided.

JULES R. WILLEN

²⁸ 26 U.S.C.A. (IRC 1954) § 1014.

²⁹ *Schubert v. Commissioner of Internal Revenue*, 286 F. 2d 573 (4th Cir. 1961).

³⁰ *Supra*, n. 14.