The Taxation of Maryland Ground Rents

H. H. Walker Lewis
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By H. H. Walker Lewis*

Few intricacies of the law are more diabolically designed to baffle and befuddle than the Maryland system of ground rents. The writer, for one, long labored under the impression that they popped out of the ground in the spring only to dash back in terror of their own shadow. If so they are not the only ones who have suffered frustration, and it is the possible confusion of some of our tax masters¹ that forms the chief justification for this paper.

One must live with a ground rent and become acclimated to its habitat to know its qualities. Recourse to the legal encyclopedias is almost hopeless² and the only thorough text on the subject³ has become so rare as to require a lock and key to preserve it in the Baltimore bar library.

Fortunately the nature of ground rents in Maryland and of the instruments creating them has changed very little since their inception⁴ and in this paper all references are intended to be to the estates created by the usual form of lease for 99 years, renewable forever. The estates thus created consist of (1) a tenancy for 99 years renewable forever and (2) a reversionary interest carrying with it the right to collect the rent specified. For the purposes of this paper the person in the position of the lessor will be referred to as the owner of the rent or reversion and the person in the position of the lessee will be referred to as the owner of the leasehold.


¹ As a loyal Baltimorean I am happy to report that most of the confusion has been with regard to Federal taxes.

² The encyclopedias fail adequately to distinguish the Maryland variety of ground rents from their cousins in Pennsylvania and elsewhere and are replete with generalities and citations which prove erroneous when applied to our own local product. In addition they employ so much obsolete (although possibly essential) verbiage that one is left staggering in a plethora of such terms as emphyteusis, subinfeudation, terre-tenant, rents seck, feoffers and lords paramount.

³ Lewis Mayer, Ground Rents in Maryland (1883).

⁴ Mayer (at page 49) states that the first leases of this type were created in about 1750.
The estates resulting from the type of lease under discussion are subject to a variety of different taxes, both State and Federal, and it will facilitate consideration of the subject to treat each of such taxes separately.

A. Taxes Imposed by the State of Maryland

(1) Real Estate Taxes

The chief interest with regard to real estate taxes on land subject to ground rent lies in their historical development and the application of such taxes as between the parties interested in such land.

(a) Historical development. Historically the transition has been from (1) a tax imposed entirely on the owner of the rent or reversion, to (2) the separate assessment and taxation of the interests of the owner of the rent and of the owner of the leasehold, to (3) the assessment of the real estate to the owner of the leasehold. The detail of this development in the Maryland Session laws has been as follows:

(1) Entire tax on owner of rent or reversion
   May, 1756, Chapter 5
   February, 1777, Chapter 21
   March, 1778, Chapter 7, Sec. 23

(2) Separate assessment of the reversionary and leasehold interests:
   October, 1778, Chapter 7, Secs. 27-28
   November, 1779, Chapter 35, Secs. 29-30
   October, 1780, Chapter 25, Sec. 25
   November, 1781, Chapter 4, Sec. 26
   November, 1782, Chapter 6, Sec. 24

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5 This Act imposed the first real estate taxes in Maryland, but they were based on acreage and not on value (1 shilling an acre to non-Catholics, 2 shillings an acre to papists and reputed papists). The taxes were extended by Chapter 9 of the Acts of 1760 but expired on November 27, 1763. The entire tax under this statute was on the freehold estate, but in the case of lands leased by the Lord Proprietary of the Province it was to be paid in the first instance by the tenants and deducted by them from the rent.

6 The first Maryland statute taxing property on the basis of valuation.

7 For a summary and discussion of the statutes in this category see William's Case, 3 Bland's Ch. 186, 260-263 (1831). One of the Acts cited below (Ch. 71 of the Acts of November, 1792) makes no specific provision for the separate assessment of the leasehold and the reversion, but it is reasonable to assume that the same result was contemplated.
Assessment of entire value of real estate to the leasehold owner.\(^8\)

Most of the annual assessment Acts in the second of the above periods made specific provision for the payment by the leasehold owner of not only (1) the tax on the leasehold but also (2) the tax on the reversion or ground rent. They further provided, however, that the leasehold owner could deduct from the rent the amount of the tax assessed against the reversion, the later Acts containing the proviso “unless otherwise agreed between the lessor and lessee”. It is safe to guess that it soon came to be otherwise agreed upon in every case and that the statutes of this period originated the now universal covenant in ground rent leases.

\(^8\) It is not possible to find in the general State law any statutory line of demarcation from the second stage to the third. It should be noted, however, that the Act of 1812 was the last general assessment act until 1841 and during the intervening period assessments were effected pursuant to local acts applicable to the various counties individually. While the writer has not attempted an examination of all the local assessment acts thus adopted, special note should be made of Chapter 148 of the Laws of 1817, applicable to Baltimore City. In Section 4 of this Act it was provided that “tenants in possession shall be liable to the payment of taxes imposed upon premises occupied by them, without its operating, however, to alter the nature of contracts between landlords and tenants”. As the great bulk of Maryland ground rents cover property in the City of Baltimore, this provision is of particular interest and we may accept it as marking the end, for practical purposes at least, of the separate assessment of the reversionary and leasehold interests in property subject to ground rent.

In connection with the above it should be noted that the case of Hughes v. Young, 5 G. & J. 67 (1832) purports to hold that in the absence of any tax covenant in a ground rent lease the liability for the entire tax rests on the leasehold owner, as between such owner and the owner of the rent. Except for the headnote the case is confusing and it seems possible, if not probable, that it was misreported. As to this it is interesting to note that it is cited in a contemporaneous opinion (William's Case, 3 Bl. Ch., 186, 263, which seems from the report to actually antedate Hughes v. Young) for the proposition that “if a tenant should pay the public the sum valued for the estate of any landlord, he might have his action against the lessor for the sum so paid, or deduct it out of the rent reserved, unless otherwise agreed between the lessor and lessee,” which is directly contrary to the headnote to Hughes v. Young. Even if this explanation of the case is incorrect, it at least does not seem good law on the general proposition stated in the headnote, as to which see P. W. & B. R. Co. v. Appeal Tax Court, 50 Md. 397 (1879).
requiring that the rent be paid without deduction for taxes assessed on either the leasehold or the reversion.

Just as the form of tax covenant in ground rent leases patterned itself on the system of taxation, the law and practice in turn changed to fit the situation created by such tax covenants. It is obviously easier for the taxing authorities to assess the entire value of real estate to the person in possession of it. Consequently, after it became the universal practice for ground rent leases to require payment of all real estate taxes by the leasehold owner, there was no longer any reason to assess the ground rent separately from the leasehold. The third phase therefore represents a simplification in the tax system made possible by the use of lease forms throwing the burden of all real estate taxes on the leasehold owner, and it is important to view it in this light rather than as a substantive change in the basis of taxation. Until 1929, at least, the law did not attempt to change the relative liability of the parties concerned for the payment of taxes on real estate; it merely took advantage, for collection purposes, of the tax covenants which had come to be included in ground rent leases.

Although the entire value of real estate has for a long time been assessed to the leasehold owner, statutory recognition has always been given to the possibility of a right over against the owner of the reversion. The language, however, has varied and it is important to consider whether the revisions have effected changes in substance or merely changes in form or procedure.

In the Act of 1812 it was recognized that in the absence of an agreement to the contrary the leasehold owner was entitled to reimbursement for taxes paid on the reversion. The language was changed in 1874 so as to give the leasehold owner a right to recover "taxes levied on the demised premises" but the important point is that in both the 1812 and 1874 Acts it was recognized that the leasehold owner

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9 Laws of 1812, Ch. 191, Sec. 36, codified as Art. 81, Sec. 77 of the Annotated Code of Maryland (1924 Edition).
10 Laws of 1874, Ch. 483, Sec. 65.
had the right to recover or offset the taxes “unless otherwise agreed between the lessor and the lessee”.

In 1929 this provision\(^\text{11}\) was restated in such a way as to place the burden of taxes on the leasehold owner “with such right to indemnity from other persons as may be provided for by private contract, expressed or implied, in fact or in law”. In its report the Tax Revision Commission made the following comment with respect to this change:

“So far as tenants for years are concerned, it (i. e. Section 3 (c) of Art. 81) is a recodification with amendments of Code, Art. 71, Sec. 77 . . . The express provision for a remedy over by the tenant against the landlord has been eliminated as surplusage or worse, as the matter of a remedy over should be one of a fair construction of the language in each case . . .”

It seems reasonably clear that the 1929 revision of this provision was not intended by the Tax Revision Commission to effect a shift in the ultimate burden of taxes on ground rent properties. The effect, however, is far from clear and the language taken literally would seem opposed to the idea that the leasehold and reversion are separate property interests for tax purposes and that the assessment of the entire value of the real estate to the leasehold owner is merely a rule of convenience justified by the universal use in ground rent leases of tax covenants throwing the burden of taxes upon the owner of the leasehold. The distinction becomes of practical importance when we consider the application of exemptions to such interests.

(b) Application of exemptions. Under the practice which is now followed and which has prevailed for a long period, the entire value of real estate subject to ground rent is assessed to the leasehold owner, no separate assessment being made of the reversion. However, the treatment of exemptions makes it clear that at least until the 1929 revision the law still recognized the essential separation of the two interests and regarded the reversion and the leasehold as two distinct subjects of taxation.

\(^{11}\) Now Sec. 3 (c) of Art. 81 (1935 Supplement), as enacted by Ch. 226 of the Laws of 1929.
In *P. W. & B. R. R. Co. v. Appeal Tax Court*,\(^{11a}\) the railroad had leased certain property from the City of Baltimore for 99 years renewable forever and the question before the court was whether the railroad was liable for taxes on the entire value of the real estate or only for taxes on its leasehold interest therein. It was clear that City property was exempt from taxation and that the reversion would not be taxable if assessed separately from the leasehold, but it was argued that the law required the entire value to be assessed to the leasehold owner. The court held that the railroad was taxable only on its leasehold interest and not on the full value of the real estate.

This decision made it clear that the reversion and the leasehold should be treated separately for tax purposes in cases in which a separation was material and that the assessment of the entire value of the real estate to the leasehold owner was merely a rule of convenience for the purpose of facilitating the collection of taxes. In other words, the tax assessed against the leasehold owner was in reality two taxes, i.e.:

1. a tax on the leasehold, chargeable to the owner thereof.
2. a tax on the reversion, legally chargeable against the owner of the rent but collected from the owner of the leasehold as a matter of convenience.

The rule of the above case is still followed by the Bureau of Assessment of Baltimore City with regard to properties leased from the City on renewable 99 year leases, such properties being assessed at only their leasehold value rather than the full value of the real estate, and it is assumed that the same practice prevails with other assessing authorities who are faced with the same situation.

An interesting question arises as to the reverse of the situation which was before the Court of Appeals in *P. W. & B. R. R. Co. v. Appeal Tax Court*, namely where the lease-

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\(^{11a}\) 50 Md. 397 (1879). See also Appeal Tax Court v. Western Maryland R. R. Co., 50 Md. 274 (1879).
hold is owned by a tax exempt person and the reversion by one who is not exempt. Here the leasehold as such is not taxable, but there seems no reason why the reversion should not be taxed, especially where the exemption is based upon the fact of ownership by an exempt person. It is true that the effect of taxing the reversion would be to require payment to that extent by the leasehold owner, due to the usual covenants of the lease, but this should make no difference legally as the leasehold owner would not be paying a tax as such but would merely be performing a contractual obligation with a third party.\footnote{See in this connection H. Oliver Thompson v. Commissioner of Int. Rev., 17 B. T. A. 987 (1929).}

A distinction should probably be drawn between exemptions which are based partly or entirely on ownership, such as the exemption of property owned by the B. & O. Railroad, agencies of the Federal Government, the various fraternal orders, the American Legion, etc., and exemptions which are based solely on the use to which property is put, as for example the exemption of houses and buildings used exclusively for public worship. Where the question is one of ownership it seems clearly improper to exempt the reversion, which is not owned by the exempt person, merely because the leasehold is so owned. Where the question is solely one of use, the issue is harder to define, but even here it would seem that the use really extends only to the leasehold and should not operate to shield the reversion. If the two were assessed and taxed separately so that the owner of the rent paid his own taxes thereon, there would seem no legal reason for favoring the owner of a rent covering a church property as against the owner of a similar rent covering other property, any more than a mortgage on a church should be treated differently for tax purposes than a mortgage on any other property.

It has apparently not been the practice of the taxing authorities to make any assessment of the reversion where the leasehold is held by an exempt person. It would appear, however, that at least prior to 1929 such property was
subject to taxation and that the fact it escaped was due to reasons other than the law.\textsuperscript{13}

In this situation it becomes important to determine whether the 1929 revision changed the substance of the prior law which regarded the reversion and the leasehold under a ground rent lease as separate taxable interests. Prior to 1929 the leasehold owner was required to pay the full tax but was given a right over against the owner of the rent "unless otherwise agreed". Now the right of the leasehold owner to reimbursement from the owner of the rent is recognized \textit{only} to the extent agreed. Reading the language literally, the present law seems opposed to the theory of separate taxable interests, but the history of the provision makes it clear that no such fundamental change was intended. In addition the practice with regard to the assessment of property subject to an exempt rent is the same now as prior to 1929, namely to assess only the value of the leasehold and not the full value of the real estate, showing that the assessing authorities do not consider the law to have been changed in this respect.

(c) \textit{Rights and liabilities of successors in interest with respect to taxes.} The covenant to pay taxes which is universally included in ground rent leases is a covenant which runs with the land.\textsuperscript{14} It is binding not only upon the original lessee (by privity of covenant) but also upon succeeding owners of the leasehold (by privity of estate), and inures to the benefit of succeeding owners of the reversion. Only the original lessor remains liable on the covenant after he disposes of the leasehold (and for this reason nearly all ground rent leases are originally executed to straw men).

\textsuperscript{13}It is interesting to compare this situation with that existing when part of a property owned by a tax exempt person is used for a non-exempt purpose, as where a fraternal order uses the upper floors of a building for its own exclusive purposes and rents the lower floor for use as a public restaurant. In this situation the exemption is held not to extend to the rented portion of the building, as see: Appeal Tax Court v. Grand Lodge, 50 Md. 421 (1879). Here the question is solely one of use and it does not furnish an accurate analogy in the situation discussed above at least to the extent that the argument against exemption is based on the fact that the exempt person does not own the reversionary interest in the property.

\textsuperscript{14}Lester v. Hardesty, 29 Md. 50 (1868).
and succeeding owners of the leasehold are liable only for taxes becoming due during the period of their ownership.\textsuperscript{15}

Where the covenant to pay taxes is violated by one still in possession of the property, the owner of the rent may pay the taxes and bring an action at law to recover the amount paid.\textsuperscript{16} Where, however, the person breaching the covenant no longer owns the leasehold, equity, and only equity, may entertain a suit to recover the taxes paid by the owner of the rent.\textsuperscript{17}

Perhaps the most interesting aspect of the liability of successors in interest is with respect to the liability of mortgagees of the leasehold. Under the Maryland law a mortgage conveys title to the mortgagee and it is normally provided that the mortgagee shall be entitled to possession of the property upon any default under the terms of the mortgage. It is also a standard covenant of leasehold mortgages that the mortgagor shall pay taxes and rents due on the property. Under these provisions the occurrence of a default under the mortgage (which default may consist of a failure to pay rents or taxes on the mortgaged property) automatically puts the mortgagee in privity of estate with the owner of the rent and makes him liable to such owner for the payment of rents and taxes thereafter becoming due.\textsuperscript{18} The extent of such liability and the rules for its enforcement are substantially the same as in the case of other assignees of the leasehold.

It is startling to find that one who lends money on the security of a leasehold mortgage becomes personally liable for the payment of rents and taxes on the mortgaged property, and the rule has met with just criticism.\textsuperscript{19} Some of

\textsuperscript{15} Hintze v. Thomas, 7 Md. 346 (1855); Donelson v. Polk, 64 Md. 501, 2 Atl. 824 (1886).
\textsuperscript{16} Mayhew v. Hardesty, 8 Md. 479 (1855).
\textsuperscript{17} Hintze v. Thomas, 7 Md. 346 (1855); Donelson v. Polk, 64 Md. 501, 2 Atl. 824 (1886).
\textsuperscript{18} Hintze v. Thomas, 7 Md. 346 (1855); Mayhew v. Hardesty, 8 Md. 479 (1855); Lester v. Hardesty, 29 Md. 50 (1868); Commercial Bldg. & Loan Assn. v. Robinson, 90 Md. 615, 45 Atl. 449 (1900); Gibbs v. Didier, 125 Md. 486, 94 Atl. 100, A. C. 1916 B 833 (1915); Williams v. Safe Dep. & Tr. Co., 167 Md. 499, 175 Atl. 331 (1934); Hart v. HOLC, 169 Md. 446, 182 Atl. 322 (1936); Jones v. Burgess, 4 Atl. (2d) 473 (Md., 1939).
\textsuperscript{19} See opinion of Judge O'Dunne in Safe Deposit & Tr. Co. v. Williams, in the Circuit Court No. 2 of Baltimore City, published in The Daily Record of February 23, 1934.
the Federal lending agencies were particularly jolted to find that by refinancing countless bad mortgages in Baltimore they had become benefactors to the owners of ground rents, and it is interesting to note the efforts which have been made by the HOLC to avert similar trouble on its future mortgages.  

Attempts have been made to legislate away future liability on the part of leasehold mortgagors for ground rents and taxes. So far, however, all such attempts have been blocked and mortgagors of leasehold properties still remain in the position of guarantors of the rent and taxes on the property.

(2) State Income Tax

Under Chapter 277 of the Laws of 1939, rents from 99 year leases perpetually renewable are included within the classification of investment income (Sec. 215 (n)) and subject to tax to individuals at the rate of 6% (Sec. 223). The reason for including income from ground rents in this category was principally because mortgage interest was included therein and it was felt that it would be unfair to the holders of mortgages to place a higher tax on income from that type of security than on income from ground rents.

(a) Constitutionality. The Maryland Court of Appeals has already held one income tax on ground rents unconstitutional and it is not at all impossible that an attack will be made on the 1939 Act insofar as it applies thereto. For this reason this phase of the law is of particular interest at the present time.

Under Chapters 325 and 329 of the Laws of 1841, as amended by Chapter 294 of the Laws of 1842, a tax was imposed on the income from ground rents without any deduction by the taxpayer with respect to such income. This tax was later held unconstitutional but the decision of the

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21 As see House Bill 61 introduced at the 1937 session of the General Assembly.
22 Passed March 10, 1842.
23 Passed March 10, 1843.
Court of Appeals was not reported and the only knowledge which we have of it is through a resolution of the General Assembly of 1847 directing the Treasurer to refund all sums theretofore paid under the laws imposing a tax on ground rents "which laws have been pronounced unconstitutional by the Court of Appeals". The reason for the decision is not known but it has been suggested by Mr. Machen that this was probably on the ground that "the tax on the rent amounted to unconstitutional double taxation". The tax in question was peculiarly susceptible to attack on this ground as it was graduated in accordance with the worth of the reversion and was in effect a tax on the principal rather than a tax on income.

As previously outlined, a property tax is already imposed on the reversion under ground rent leases and question may therefore be raised as to whether the subjection of the rent to an income tax will amount to double taxation. It seems clear under both the Federal and State constitutions that it is proper to impose a net income tax on rents from property that is already subject to property tax. It is at least questionable, however, whether the same can be said for a gross income tax and there may be grave doubts as to the constitutionality of the 1939 Act if it must be considered in this light.

It will be noted that the 1939 income tax on individuals is imposed at the rate of 6% on "investment income" (in-
cluding income from ground rents) and at the rate of 2\(\frac{1}{2}\)% on ordinary income. No deductions as such are permitted against either class of income but a tax credit is allowed in the amount of 2\(\frac{1}{2}\)% of the sum of the personal exemption and deductible items of the taxpayer. In other words the tax is first computed on a gross basis on both investment and ordinary income, and a tax credit is then allowed computed on the personal exemption and deductible items at the same percentage as the tax on ordinary income.

In the case of an individual taxpayer having net ordinary income in excess of the amount of his personal exemption, the effect in dollars is the same as if a gross income tax had been imposed on investment income (which is defined to include income from ground rents). On the other hand a taxpayer having investment income but not having net ordinary income equal to the amount of his personal exemption would be allowed the advantage of offsetting his deductible items and personal exemption on a limited basis against the investment income. In this situation the effect in dollars is more favorable to the taxpayer than a computation of the tax on his gross investment income. It is obvious that this is coming very close to the line but the Act is, nevertheless, drawn in such a way as to justify the contention that it imposes a net rather than a gross income tax and it is believed that the constitutionality of the Act will be sustained against attack on the ground of double taxation.29

(b) Out-of-State Ground Rents. Apparently the only other jurisdiction in which ground rents flourish is the State of Pennsylvania, but, as will be discussed later, the Pennsylvania type of rent is quite different from our Maryland variety and it is very doubtful whether ground rents from Pennsylvania real estate would be included within the definition of "ground rents" as set out in Section 215 (k) of the Maryland law. If ground rents on out-of-state properties should be held to be included in "investment income"

29 The question of constitutionality on this and other grounds is not free from doubt, as see for example Redfield v. Fisher, 135 Ore. 180, 292 Pac. 813, 295 Pac. 461, 73 A. L. R. 721 (1930), cert. den. 284 U. S. 617, 76 L. Ed. 526, 52 Sup. Ct. 6 (1931).
within the meaning of the 1939 Act, the question of whether the law could be constitutionally applied to them would seem to be substantially the same as the question discussed above. If the tax is a net income tax there seems no constitutional objection to the inclusion of rents from out-of-state properties.\(^\text{30}\) If, however, it should be considered a gross income tax there might be substantial doubt as to whether it could be constitutionally applied to such income.

In this connection it may be interesting to note that the Pennsylvania law treating ground rents as intangible personal property and taxing them as such\(^\text{31}\) has recently been held unconstitutional by one of the lower courts of that State on the ground that such rents are real estate and that the State of Pennsylvania cannot impose a property tax on real estate outside of its boundaries.\(^\text{32}\) It should also be noted that certain other provisions of our 1939 income tax law definitely indicate that ground rents are to be treated as having a situs for taxation in Maryland.\(^\text{33}\)

(c) Effect on Sub-rents. Many of the old leases creating ground rents cover tracts of land which have since been sub-divided and the general practice has been to create sub-leases and sub-rents on the parcels carved out of the original tract. Sub-leases have also been created in Maryland in other situations and they are quite common on the older and larger downtown properties in the City of Baltimore.

In some cases where sub-leases are created the total of the sub-rents exceeds the amount of the original rent, as for example where John Smith owning a leasehold subject to an annual rent of $120 subdivides the tract into three parcels and creates sub-leases subjecting each third to an annual rent of $50. In this situation the owner of the sub-rents collects more than he is himself required to pay over

\(^{30}\) New York ex rel Cohn v. Graves, 300 U. S. 308, 81 L. Ed. 666, 57 Sup. Ct. 466 (1937).


\(^{32}\) In re Girard Trust Co. Executor (and three other cases which were covered in the same opinion) in the Philadelphia Court of Common Pleas, March 15, 1939.

\(^{33}\) See for example Md. Code, Art. 81, Sec. 246, as enacted by Chap. 277 of the Laws of 1939.
to the owner of the original rent. In most cases, however, the total of the sub-rents equals the amount of the original rent.

It will be noted that the 1939 income tax law defines ground rents to mean rents reserved under 99 year renewable "leases or sub-leases" and there would seem to be no question but that the owner of a sub-rent is required under the Act to include the sub-rent in the investment income which he returns for taxation. He is also permitted to treat as a deductible item any ground rents which he himself pays but this is a hollow right as the sub-rent which he collects will be taxable at the rate of 6% whereas the rent which he pays will be deductible only at the rate of 2½%.

It is to be doubted whether any one contemplated this situation at the time the 1939 income tax law was prepared and passed. The effect of the law as written would, however, seem to be to take a heavy toll out of the owners of sub-rents, whether or not the owner of the sub-rent derives any net income from the arrangement, and it is to be anticipated that there will be a scramble to eliminate sub-rents wherever possible as well as to change the law in this respect at the next session of the legislature.\(^{34}\)

(d) Liability of leasehold owner for payment of income tax. It has already been noted that all ground rent leases contain covenants requiring the leasehold owner to pay taxes on the property in question, the usual covenant being to pay "the rent or yearly sum of $\ldots$ over and above all deductions for taxes and assessments of every kind, levied or assessed, or hereafter to be levied or assessed, on said demised premises, or the rent issuing therefrom \ldots and to pay the aforesaid rent, taxes and assessments when legally demandable". There are undoubtedly variations from this type of covenant, but it is used in the form of ground rent lease which is in current use, and it is substan-

\(^{34}\)In cases where the arrangement does not involve any intermediate profit to the sub-rent owner, it is legally very simple to effect an apportionment of the original rent and an elimination of the sub-rents if the owner of the original rent will consent thereto. As a practical matter, however, this is often undesirable from the standpoint of the owner of the original rent as it involves splitting up and possibly weakening the security for the rent.
tially the same as that appearing in Carey’s Forms and in Mayer on Ground Rents.

Question was raised during the consideration of the Act by the General Assembly as to whether the income tax to be imposed on ground rents could be shifted to the owner of the leasehold under the covenants of the lease. The Attorney General in a ruling dated March 17, 1939 and addressed to John S. White, Chairman of the Ways and Means Committee of the House of Delegates, expressed the opinion that under the usual form of lease the owner of the leasehold could not be held liable for the payment of any part of the proposed income tax chargeable against the owner of the rent. The opinion treated the matter exhaustively and it is believed that the Court of Appeals will reach the same conclusion if the question is placed before it.

To make assurance doubly sure the legislature amended the income tax law so as to include the following provision:

"223 (c). No tax imposed under the provisions of this sub-title on any person with respect to ground rent received by him, shall be collected from the lessee by the lessor, and any agreement, expressed or implied, entered into by a lessor and a lessee providing for the payment of such tax by the lessee shall be void."

The sweeping nature of the language used may scare off claims by owners of ground rents, as well as provisions in future leases specifically requiring leasehold owners to pay income taxes on the rent, and may therefore have some effect as a practical matter. As a matter of law, however, it seems reasonably clear that this provision is unconstitutional as to any existing leases which actually require the leasehold owner to bear the burden of income taxes on the rent, and it also seems exceedingly difficult to find any constitutional justification for a restriction of this nature on leases executed in the future.

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25 Published in The Daily Record of March 29, 1939.
26 Note, however, that a contrary result has been reached as to Pennsylvania ground rent leases in which the tax covenant is similar to ours. Ehrlich v. Brogan, 262 Pa. 362, 105 Atl. 511 (1918).
(3) State Inheritance Taxes

There is not much of legal interest in the treatment of ground rents for the purpose of the three types of inheritance tax now enforced in Maryland, i.e. (1) the collateral inheritance tax, (2) the estate tax, and (3) the tax on commissions of executors and administrators, and it would seem sufficient for the purposes of this paper to note that the rent or reversion is treated as real estate for the purpose of such taxes and that the leasehold is treated as personal property. Since a sub-rent is a leasehold it is also treated as personal property.

The State inheritance tax does not apply to real estate outside of the State of Maryland, even if there is an equitable conversion of such real estate pursuant to the terms of the will of the testator, and for this reason ground rents issuing from the property situated outside of Maryland would not be subject to Maryland inheritance taxes. Ground rents issuing out of real estate located in Maryland are subject to Maryland inheritance taxes even although the owner of the rent was domiciled outside of the State, and this rule also is not altered by the equitable conversion of the property under the will of the testator.

(4) State Recordation Tax

The Relief Tax Act of 1937 made provision for a recordation tax on various instruments recorded or offered for record, including leases and instruments conveying title to real or personal property. This tax was imposed at the rate of 10¢ for each $100 or fractional part thereof of the actual consideration paid or to be paid in the case of instruments conveying title, and in addition to the tax thus imposed the Clerks of Court were required to collect a charge of 50¢ for each instrument recorded or offered for record.

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38 State v. Fusting, 134 Md. 349, 106 Atl. 690 (1919).
41 Codified as Md. Code, Art. 81, Secs. 213, 214.
In an opinion dated June 12, 1937\(^2\) the Attorney General ruled that ground rent leases were subject to the recordation tax as well as to the 50¢ recordation fee and further ruled that in the absence of better evidence as to the consideration passing between the parties, such might properly be determined by calculating or estimating the total rent payable during the life of the lease. This opinion was amended and enlarged in a later opinion dated July 2, 1937,\(^3\) the final conclusion being that the amount of tax to be collected upon the creation of a ground rent lease should be based upon the actual consideration paid for the leasehold, without including amounts representing rents to be paid in the future. It was also ruled that where a ground rent is created by lease to a straw man, the leasehold then being assigned to the real purchaser, the tax is not payable on the lease to the straw man but must be paid on the assignment of the leasehold to the real party in interest.

The provisions of the law in this respect were changed by the 1939 Act under which leases creating perpetually renewable ground rents are taxed on the basis of the capitalization of the annual rent at 6% plus the actual consideration (other than the rent) paid or to be paid for the leasehold. The tax is imposed at the same rate as in 1937 and the 50¢ recordation charge payable to the Clerk has been continued. A recordation tax and fee is also payable upon assignment of leaseholds and deeds of ground rents.

The 1939 Act makes a substantial change in the law as applied to perpetually renewable leases and has assimilated the creation of ground rents to the creation of mortgages for purposes of the recordation tax.\(^4\) For example, if a property were sold for $5,000 on terms of $2,000 cash and a $3,000 purchase money mortgage, the tax would be $5 (exclusive of the 50¢ fee), being payable on the full $5,000. Similarly if the transaction involved the payment of $2,000 in cash and the creation of a $180 ground rent (which, cap-

\(^{22}\) 22 Ops. A. G. 699 (1937).


\(^{4}\) Note, however, that assignments of mortgages are not subject to the recordation tax although deeds of ground rents and assignments of leaseholds are taxed.
italicized at 6%, would amount to $3,000), the tax would amount to $5, being computed on the consideration paid plus the capitalization of the rent at 6%. Under the prior law, however, the tax in the latter type of transaction would have been only $2, based on the consideration paid for the leasehold, although an additional $3 would be payable upon the redemption of the rent.

The new Act seems entirely reasonable in placing ground rents upon the same basis as mortgages for this purpose. It would seem necessary, however, to carry through the analogy so as to eliminate any further tax at the time of the redemption of rents so taxed. The law contains no provision on this point but it will doubtless be ruled in due course that when the tax has originally been computed and paid on both (a) the consideration for the leasehold and (b) the capitalization of the rent, no additional tax will be payable upon the redemption of the rent. This will, of course, make it necessary to treat differently the redemption of rents taxed under the 1939 Act at the time of their creation and the redemption of other ground rents.

(5) Miscellaneous

Ground rents and Maryland taxes have rubbed noses judicially in certain other connections which it may be of interest to mention, as follows:

For the purpose of the share tax, which for a long period was the most important of our corporate taxes, it was held that under the procedure established by the law ground rents could not be deducted in determining the value of the corporation's shares, even although a separate tax was paid on the real estate out of which such rents issued.45

On the other hand, it was held at one time that the tax on savings bank deposits was in effect a tax on the property in which such deposits were invested,46 and that such deposits were not subject to tax to the extent that they were

45 Baltimore v. Canton Co., 63 Md. 218 (1885).
invested in ground rents since such would involve double taxation.\textsuperscript{47}

Under the law relating to the valuation of corporate shares for tax purposes, fire insurance companies and life insurance companies have been permitted to deduct mortgages on Maryland real estate. This has been ruled by the Attorney General to permit the deduction of ground rents which were regarded for this purpose as being "in the nature of mortgages".\textsuperscript{48}

\section*{B. Federal Taxes}

\textbf{(1) Income Taxes}

\textit{(a) Deductibility of rents.} Sums received as ground rents are, of course, taxable as income to the owner of the rent. An interesting question arises, however, as to whether such sums are deductible by the leasehold owner.

In the case of a residential property it is clear that sums paid as ordinary house rent are not deductible for Federal income tax purposes. On the other hand sums paid as mortgage interest on residential property are deductible. From a practical standpoint there is very little difference between a mortgage and a redeemable ground rent and it is quite possible to prepare a mortgage which will be substantially identical in effect. For this reason the Bureau of Internal Revenue has ruled that sums paid by way of redeemable ground rents are deductible for Federal income tax purposes in the same way that mortgage interest is deductible.\textsuperscript{49} The Bureau, however, has drawn a distinction in this regard between redeemable and irredeemable ground rents and does not permit the deduction of irredeemable ground rents except to the extent that such are a business expense.

\textsuperscript{47} State v. Central Savings Bank, 67 Md. 290, 10 Atl. 290 (1887).
\textsuperscript{48} 21 Ops. A. G. 760 (1936).
\textsuperscript{49} IT 2679, C. B. XII-I, p. 103 (1933). But see H. Oliver Thompson v. Commissioner, 17 B. T. A. 987 (1929) in which the Board held that ground rent collected from the City of Baltimore as the owner of the leasehold was not exempt as interest upon the obligation of a political sub-division of the State.
This ruling of the Bureau of Internal Revenue is very fair to the owners of residential property subject to redeemable ground rents (and the great bulk of ground rents on residential property are redeemable). Unfortunately, however, the Treasury Department has not carried its fairness in this regard to the extent of apprising the general public of its position in the matter and the regulations which it issues fail to make any distinction between redeemable and irredeemable ground rents and fail to indicate that sums paid under redeemable ground rents may be deducted, the regulation being as follows:

Reg. 101, Art. 23 (b): "... Payments made for Maryland or Pennsylvania ground rents are not deductible as interest but may, if a proper business expense, be deducted as rent".

This regulation and the prior regulations of the Treasury Department, which are substantially similar, are distinctly misleading in view of the fact that taxpayers are actually allowed to deduct redeemable ground rents on non-business properties as well as on business properties.

(b) Determination of gain or loss. It was at one time ruled that where Maryland land was conveyed for (1) cash, plus (2) a ground rent, the transaction did not constitute a sale and did not result in a closed transaction resulting in gain or loss prior to the redemption of the ground rent.50 This was, of course, a splendid thing for those selling real estate who did not wish to show a taxable gain or loss on a transaction, but with all due respect to our peers in Washington it was a ridiculous ruling. It was so considered by the Board of Tax Appeals also when the question ultimately came before it and both the Board and the Federal courts have since held that such a transaction is closed for tax purposes when the deed or lease creating the ground rent is made.51 The former ruling has, therefore, been revoked and term sales of property on which the deferred payment

50 O. D. 1089, C. B. 5, p. 98 (1921).
is represented by a ground rent are now treated in the same manner as term sales in which the deferred payment is represented by a purchase money mortgage. The cases and rulings in this regard (other than the original ruling) involve Pennsylvania ground rents but they seem to be equally applicable to Maryland ground rents and have been treated as such in practice.

It is interesting to note that the Bureau of Internal Revenue later attempted to collect back income taxes on taxable gains realized in such sales but not reported due to the old ruling. By the time the old ruling had been reversed, however, the Statute of Limitations had run as to many of these cases and where this had occurred the Board of Tax Appeals held that it was no longer possible for the government to go back at the taxpayer for the gain which he actually made in such transactions. The Bureau of Internal Revenue filed a non-acquiescence as to this decision but no appeal was taken and it would appear that it has not and will not be able to reopen such of these old transactions as were closed beyond the period of limitations.

(2) *Stamp Taxes.*

The Federal stamp tax on conveyances applies only to deeds, instruments or writings whereby

"... lands, tenements or other realty sold shall be granted, assigned, transferred or otherwise conveyed to or vested in the purchaser or purchasers . . .".

It seems clear that the stamp tax applies only to instruments conveying *realty* and that it does not apply to instruments conveying personal property. This is recognized by the Regulations which have been promulgated by the Bureau of Internal Revenue pursuant to the Statute, and one of these Regulations provides as follows:

*Regulations 71, Art. 64. "(a) What constitutes 'lands, tenements, or other realty' is determinable by the law of the State in which the property is situated."*

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It is also stated by the Regulations (Art. 108) that "leases of real property are not subject to the tax".

It has been ruled by the Bureau of Internal Revenue that a deed creating a Pennsylvania ground rent is subject to tax and that later assignments by the tenant or by the owner of the rent of their respective interests in the property are also subject to the stamp tax. This ruling has been applied to Maryland ground rents and it is accordingly the present practice in this State to affix Federal stamps on the following instruments executed in connection with properties subject to ground rents:

(a) Lease creating the rent
(b) Assignment of the leasehold
(c) Deed of the rent
(d) Deed from the owner of the rent to the owner of the leasehold upon a redemption of the rent
(e) Assignments of sub-rents and sub-leaseholds, as well as redemptions of sub-rents.

It is important to note that the Pennsylvania form of ground rent is a thoroughly different animal from that indigenous to Maryland. In Pennsylvania ground rents are created by deed (rather than by lease, as in Maryland) and it is clear under the Pennsylvania law that the estate of one holding land subject to ground rent is a freehold or estate of inheritance. As a consequence it is clear that land subject to ground rent in Pennsylvania is realty and is squarely within the language of the Federal statute imposing a stamp tax on conveyances of realty.

In Maryland, however, the situation is the reverse. Ground rents here are created by lease and, while the property interests created thereby are subject to some of the

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rules applicable to realty, it is abundantly clear under our law that property subject to ground rent is personalty and not realty. Thus it has been held that the leasehold interest created by a ground rent lease (a) is not subject to dower, (b) may be transferred by a will which has not been executed with the formalities required to devise real estate, although valid as a will of personalty, and (c) is personal property rather than real estate for the purpose of rules governing inheritance.

The ruling of the Bureau of Internal Revenue referred to above seems correct as applied to the Pennsylvania form of ground rent. The Maryland ground rent system, however, presents a different situation and it is difficult to escape the conclusion that the leasehold estate created under our system, being personal property, is not subject to the Federal stamp tax. On this basis the requirement and practice of affixing Federal stamps to ground rent leases and to the assignments of leaseholds, sub-rents and sub-leaseholds, does not seem warranted by the wording of the Federal Act.

It is easy to see how a mistake could have been made in paying such taxes and the amount involved in any one transaction is ordinarily too small to be worth squabbling about, especially in view of the fact that the parties to any such transaction normally have their attention concentrated on getting the sale closed rather than on such incidental matters as the payment of stamp taxes. Nevertheless, it would appear that the requirements of the Federal authorities with respect to stamp taxes in this situation go much further than is justified by the statute.

See Bratt v. Bratt, 21 Md. 578 (1864).
Spangler v. Stanler, 1 Md. Ch. 36 (1847).
Allender v. Sussan, 33 Md. 11; 3 A. R. 171 (1870); Dumfries v. Abercrombie, 46 Md. 172 (1877); Taylor v. Taylor, 47 Md. 295 (1877); Merryman v. Long, 49 Md. 540 (1878); Arthur v. Cole, 56 Md. 100, 40 A. R. 409 (1881); Culbreth v. Smith, 69 Md. 450, 16 Atl. 112, 1 L. R. A. 538 (1888); Craig v. Craig, 140 Md. 322, 117 Atl. 756 (1922).
C. Summary

For the sake of completeness it may be desirable (although certainly not necessary) to point out that there are at least two schools of thought on the subject discussed in this paper. One is my own. The other has been more succinctly expressed by an able commentator as follows:

I can't imagine duller facts
Than those about an income tax,
Or see a particle of sense
In delving into old ground rents.
Of knowledge there may be a store,
But as for me it's all a bore.

My wife, who especially participated in the arduous but as yet fruitless hunt for the decision invalidating the 1841-2 income tax on ground rents.