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Federal Income Taxation -- Leases -- Amortization of Ground Rents

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For closed years, if any are involved, it would seem that the husband's possibility of redress is only that available through mitigation of the statute of limitations.  

While *Lester* creates some problems of hardship, the benefits of simplicity of interpretation and certainty of tax consequences are much to be desired in applying the federal revenue laws. The decision has also settled a confusing conflict of circuit court authority in construing property settlement agreements containing contingent reduction provisions in the event of death or remarriage of the wife, death of the husband, or because minor children become of age, die, or marry. These factors may justify the triumph of form over substance *in this instance*, but no extension of that approach is advocated, either in the federal tax field or other branches of the law.

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**Federal Income Taxation—Leases—Amortization of Ground Rents**

Not infrequently a taxpayer will purchase real property subject to an outstanding lease. In many instances the lessee will have erected improvements on the leased land. By virtue of having made a capital investment in those improvements and avowedly retaining ownership of them until the termination of the lease, the lessee is entitled to an annual depreciation deduction. In cases where both these fac-

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85 In cases where the parties are "related taxpayers" under the statute, for instance when the wife is beneficiary under an alimony trust, there appear to be possibilities of mitigation. Eleanor B. Burton, 1 T.C. 1198 (1943); Katharine C. Ketcham, 2 T.C. 159 (1943); aff'd, 142 F.2d 996 (2d Cir. 1944); Int. Rev. Code of 1954, §§ 1311-1314. See generally 2 MERTENS, FEDERAL INCOME TAXATION ch. 14 (rev. 1961); Scheifly, *The Operation of Sections 1311-1314*, 13 U. So. Cal. 1961 Tax Inst. 509; Annot., 54 A.L.R.2d 538 (1957).


No cases have been found construing the applicable North Carolina statutes. However, since the laws are extremely similar, especially in the provisions relating to deductibility of child support payments, the need for clarity, certainty, and conformity in the construction and application of revenue laws, both state and federal, should lead the courts of North Carolina to adopt the rule in *Lester*. See N.C. Gen. Stat. §§ 105-141(a), -141.2, -147(1) (1958).

1 Duffy v. Central R.R. of N.J., 268 U.S. 55 (1925); Hotel Kingkade v. Commissioner, 180 F.2d 310 (10th Cir. 1950).
tors are present the purchase price, which is unavoidably determined to some extent by the ground rent\(^2\) yielded by the outstanding lease, may well reflect a premium over what would be paid for a similar tract of land without a favorable lease.\(^3\) Has the purchaser in such event acquired only non-depreciable land, or has he acquired in addition a wasting asset\(^4\) in the right to receive future ground rent? If the wasting asset is part of his investment will he be able to amortize, over the unexpired term of the lease, that portion of the purchase price attributable to this right?

In *World Publishing Co. v. Commissioner*\(^5\) the Eighth Circuit held that the taxpayer acquired a wasting asset in these ground rents, and would be allowed to amortize, over the remaining life of the lease, that portion of the purchase price allocable to this wasting asset. There the taxpayer bought land which the vendor-lessee had leased for a term of fifty years for an annual rental of $28,500. At the time of the purchase there were twenty-eight years remaining in the term. The purchaser paid $700,000 for the land and outstanding lease. He contended that the difference between the total purchase price and the fair market value of the land was paid for the right to receive future rentals;\(^6\) since this was a wasting asset, he should be allowed

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\(^2\) The phrase 'ground rent' or 'ground rentals' means the money received under a lease for the use of the land alone. This term as used in this note is to be distinguished from the term ground rent as used in Maryland, Pennsylvania, and Michigan meaning an interest in land. A typical example of a Maryland, Pennsylvania, or Michigan ground rent is where A conveys to B and his heirs and assigns in fee simple, with the provision that B and his heirs and assigns pay annual rent forever to the grantor, his heirs and assigns. *Pronzato v. Guerrina*, 400 Pa. 521, 524 n.1, 163 A.2d 297, 298 n.1 (1960). Ground rent, as an interest in land, is distinct and separate from the land out of which it issues. *Marburg v. Mercantile Bldg. Co.*, 154 Md. 438, 442, 140 Atl. 836, 838-39 (1928).

\(^3\) A favorable lease is one in which the reserved rentals are greater than the rentals which could be obtained currently on the same premises. Conversely, in an unfavorable lease the reserved rentals are less than the rentals which could have been obtained if the purchaser were in a position to lease the property to another in the current market. See *Rubin, Depreciation of Property Purchased Subject to a Lease*, 65 Harv. L. Rev. 1134 (1952).

\(^4\) A wasting asset is intangible property, as compared with depreciable, tangible property, which is characterized by a progressive loss of value extending over a series of taxable years. Due to the passage of time, a wasting asset will eventually become worthless, either because it stops producing income, as does a patent, or the very thing ceases to exist, as does the right to receive rent in the principal case. See *512 W. Fifty-Sixth St. Corp. v. Commissioner*, 151 F.2d 942, 944 (2d Cir. 1945).

\(^5\) 299 F.2d 614 (8th Cir. 1962).

\(^6\) Here the fair market value of the land was $400,000. The difference of $300,000 is the amount attributable to the right to receive ground rents.
to amortize or depreciate the difference over the remaining life of the lease.

The question of whether one, who acquired land subject to an outstanding lease, had the right to amortize, first arose where the taxpayer was an heir or devisee of the lessor. In such a situation the courts have repeatedly denied the heir or devisee the right to amortize or depreciate. The courts reasoned that since neither the devisor nor devisee had any capital investment in the leasehold, there was no depreciable interest which could be acquired by the devisee.

Commissioner v. Moore, involving a devise of property subject to an outstanding lease, was the first case to allow amortization of

While depreciation and amortization are basically the same, there is the distinction that the former applies to tangible property and the latter to intangible property. Since rentals are intangible, amortization is the proper designation for the deduction allowance. It should be noted that throughout the opinion in World Publishing, the court makes no distinction between amortization and depreciation. While both are methods which enable the taxpayer to recover his investment, depreciation allows a more rapid write-off in the earlier years. Amortization over the life of the property is in effect a form of depreciation known as the straight line method. That is, the same amount is deducted each year. See Treas. Regs. § 1.167(b)-1 (1962). But there is another method of depreciation called the declining balance which allows for the first year a 150% deduction of the applicable straight line rate. See Treas. Regs. § 1.167(b)-2 (1962). For example, under the straight line method, if the first year's deduction was $100 for property with an adjusted basis of $1000 and a useful life of 10 years, then the deduction under the declining balance method for the first year would be $150. In three years the deduction allowed under the former method would be (3 x $100) = $300, while under the latter method it would be $385.88. This allowance of 150% of the straight line rate is applicable to new or used property acquired after December 31, 1953. Rev. Rul. 60-8, 1960-1 CUM. BULL. 113; Rev. Rul. 57-352, 1957-2 CUM. BULL. 150.

INT. REV. CODE OF 1954, § 167(a) provides as a depreciation deduction, an allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence of property held for the production of income.) See, e.g., Schubert v. Commissioner, 286 F.2d 573 (4th Cir.), cert. denied, 366 U.S. 960 (1961); Goelet v. United States, 265 F.2d 881 (2d Cir. 1959); First Nat'l Bank v. Nee, 190 F.2d 61 (8th Cir. 1951); Commissioner v. Pearson, 188 F.2d 72 (5th Cir. 1951); Friend v. Commissioner, 119 F.2d 959 (7th Cir.), cert. denied, 314 U.S. 673 (1941).

The general situation with the heir or devisee was that he acquired the real property or an interest in it which was subject to an outstanding lease. He contended that since the estate tax valuation of the property and lease operated to furnish a new basis for determining gain or loss from the sale or other disposition of the property, and to the extent that depreciable property entered into it, for the depreciation of the property, then he should be allowed a basis for depreciation of the property he acquired. The court rejected this reasoning by saying unless the property is depreciable, the statutory provisions providing a basis for depreciation are irrelevant. These provisions only provide a basis upon which depreciation is to be computed and does not create or amplify depreciable. First National Bank v. Nee, supra note 9, at 64; Schubert v. Commissioner, supra note 9, at 579.

207 F.2d 265 (9th Cir. 1953), cert. denied, 347 U.S. 942 (1954).
the right to receive ground rents—limited, however, to the premium. In Moore the court's decision reflected the true contentions of the taxpayer; that is, he was not trying to depreciate or amortize the improvements built by the lessee, but rather his interest in the rentals. In World Publishing there is the factual difference, which Friend v. Commissioner intimated might result in allowing the taxpayer to amortize, that the taxpayer invested money in what he considered to be income producing property.

The commissioner based his attack on the fact that the purchaser in World Publishing acquired only what the original lessor had, and this had not included any depreciable interest in the lessee-constructed building. In support of this argument he relied on the inheritance approach and the valuation approach used in the principal case. Using the valuation approach, the taxpayer is allowed to amortize the difference between the total purchase price and the fair market value of the land. With the premium approach the amortizable deduction is that amount, in excess of the value of the land, which a purchaser would be willing to pay to get a return equal to the amount of the existing rentals.

Under the valuation approach, the amount to be amortized is easily ascertained by subtracting the fair market value of the land from the total purchase price. That figure is $300,000. Since he paid $700,000 to get a return of $28,500 a year, the rate of return is about 4%. Since the premium could be calculated by comparing the capitalized value of the future rentals for the remaining years under the lease, as it existed when the heir or devisee acquired the property, with the capitalized value of an identical lease made presently, the question is what amount in addition to the value of the land would a purchaser pay to receive $28,500 annually? Based on a 4% return, this can be calculated as follows: 4% \times \text{Total Price} = $28,500. This figure is again $700,000. Since the value of the land was $400,000, the additional amount is what the purchaser would pay, and is the amount allowed to be amortized.

The taxpayer in Friend v. Commissioner, 119 F.2d 959 (7th Cir. 1941), made the same contention. But there the court said to be entitled to depreciation or amortization the taxpayer must have made an investment in the leasehold, and, since the taxpayer denied that there had been any cost to the estate in the acquisition of these leases, there can be no loss to be recovered by amortization or depreciation.

The right to receive rent for twenty-eight years in World Publishing is analogous to patents or copyrights. With a patent which has a finite life of seventeen years, a taxpayer, should he buy the patent, would enjoy the income it produces for all seventeen years. In Buckwalter v. Commissioner, 61 F.2d 571 (6th Cir. 1932), it was held that a patent is a wasting asset which may be amortized over its life where it is used in the taxpayer's trade or business or when it is held for the production of income. After this time the patent would be worthless. In World Publishing, assuming the value of the land remained stable, at the end of the lease the property would only be worth $400,000. Here the passage of time not only eliminates further income—it reduces the value of the investment.

The lower courts properly agreed with the commissioner that the heir or devisee had no present depreciable interest in the building or other im-

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12 There is no real difference in the premium approach and the valuation approach used in the principal case. Using the valuation approach, the taxpayer is allowed to amortize the difference between the total purchase price and the fair market value of the land. With the premium approach the amortizable deduction is that amount, in excess of the value of the land, which a purchaser would be willing to pay to get a return equal to the amount of the existing rentals.

14 119 F.2d 959 (7th Cir. 1941).
cases which held that neither the decedent nor his successor has any interest in the leasehold. In *Schubert v. Commissioner*, it was held that an heir or devisee cannot acquire a larger interest than that of the decedent. The court in *World Publishing* rejected this argument on grounds that it is illogical to allow a purchaser to depreciate where the vendor-lessee is the builder, but to deny the purchaser the deduction where the lessee is the builder. This approach may result in further confusion, because the purchaser is not trying to depreciate the improvements themselves, but is instead, seeking to amortize his investment made for the future ground rentals. Where the building or other improvements are erected by the lessee who retains the title until the termination or default of the lease, notwithstanding the decision in the principal case, the rule remains that the purchaser (or heir) is not entitled to depreciate these improvements. Since the purchaser or heir acquired no interest in the improvements, he is not concerned with their useful life. The building could be destroyed or condemned long before the expiration of the lease and still the lessee would have to pay the annual rent for the full term. Likewise, had there been no improvements made by the lessee, the result in *World Publishing* would have been the same.

In arriving at the amount which the taxpayer is allowed to amortize there is an additional factor to be considered. Should the useful life of the building exceed or be shorter than the unexpired term of the lease, the fair market value of the building at the time of the improvements made by the lessee, but were in error when they concluded that the devisee had no interest that could be depreciated or amortized. When the estate was evaluated for estate tax purposes, the capitalized value of the future rentals was included in the gross estate. The devisee had an interest in the right to receive the rentals.

16 286 F.2d 573 (4th Cir. 1961).
17 Since the taxpayer is amortizing his investment in the right to receive rentals, and not the improvements made by the lessee, the right to depreciate them is left to the lessee. In the principal case, the court said: "What is significant is that each taxpayer . . . meets the statutory requirements for depreciation. To allow each to recover his own, and separate, investment is not, as is suggested, to permit duplication at the expense of the revenues and is not to permit one taxpayer to depreciate another's investment. That each is concerned with the same building is of no relevance." 299 F.2d at 622.
18 Useful life is that period of time during which the depreciable property will be reasonably useful to the particular taxpayer in his trade or business. Treas. Regs. § 1.167(a)-1(b) (1962).
19 The lessor's interest in the building on the date of surrender is the fair market value of the building and not its adjusted base. This is especially true in the case where the life of the lease exceeds the useful life of the building, because the adjusted base may vary according to the method of depreciation the lessee employs. See note 8 supra. The determination of the
termination of the lease must be figured in the total purchase price in order that the amount to be amortized can be computed. In the principal case the parties stipulated that the useful life of the building did not exceed the remaining term of the lease. Since the taxpayer is trying to arrive at an estimated value of the building for the purpose of computing the amount to be amortized, the fair market value of the building at the end of the lease will not be sufficient for his present needs. A building worth so much in the future will not be worth the same at the present time. To arrive at the correct amount, it is necessary to know what a building would be worth to a buyer today when he would be unable to enjoy possession until a later date. This would be the discount value, and is the amount one would pay presently for the future right of possession. It is suggested that the decision should be limited to the extent that the maximum amount allowed to be amortized should not be greater than the difference between the total price and the fair market value of the land increased by the discount value of the building.

The decision in the principal case may affect another issue which was not raised. If amortization of the wasting asset is correct when the purchaser buys and retains the ground subject to a lease, what are the results should he sell or exchange his right to receive future rentals? In *Hort v. Commissioner* a devisee acquired land subject to an outstanding lease. During a period of depression, he and the lessee agreed that for a stipulated sum the lessee could surrender the lease. The Court held that this payment was a substitute for future rentals, and, as such, was a recognized gain. As a result of the principal case, if the taxpayer is allowed to amortize that portion of the purchase price allocable to the right to receive future rentals, it would seem that he could treat the amount received on the sale of this right, to the extent of its then adjusted basis, as a return of capital and not as gain of any character. Any amount received in excess of the adjusted basis would be recognized gain.

Should the Supreme Court of the United States eventually ap-
amount of the lessor's interest is necessary in order to compute how much he will be able to amortize. This is not to be confused with what the lessor's basis would be, or whether such improvements would be considered as income or not. Int. Rev. Code of 1954, § 1019 provides that the basis of the lessor's real property shall not be increased or diminished by reason of his acquiring the lessee-made improvements on the termination of the lease.

313 U.S. 28 (1941).

The adjusted basis for the lessor would be cost of the building minus depreciation deductions allowed to the lessee. See Treas. Regs. § 1.1011-1 (1962).
prove the ruling in the principal case, its holding would permanently lay to rest the commissioner's contention, suggested by Schubert, that one cannot obtain more rights than one's devisor or vendor had. As pointed out in World Publishing the problem should be analyzed on the basis of what the taxpayer has rather than what a prior lessor may have had. From this point of view World Publishing and Moore are in accord.

Borden R. Hallowes

Insane Persons—Involuntary Commitment Procedures—Due Process

North Carolina's statutory commitment procedure has been put together in a piecemeal manner and does not readily conform to any pattern of laws applicable in other jurisdictions. The General Assembly, recognizing the special problems concerning care of the mentally ill, has constantly striven to modernize the old law. In what has appeared to be cognizance of this endeavor, the court has taken judicial notice of the fact that commitment of a mentally ill person involves a procedure unlike any other.

For example, in the case of In re Harris, the court overruled previous decisions and enlarged the writ of habeas corpus to the

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2 For graphic comparisons of all state procedures see Lindman & McIntyre, The Mentally Disabled and the Law 44-106 (1961); Ross, Commitment of the Mentally Ill; Problems of Law and Policy, 57 Mich. L. Rev. 945, 1008-16 (1959). Nonconformity by North Carolina is not in itself damning, for there is little conformity between the states as to any type of commitment procedure. See Lindman & McIntyre, supra; Ross, supra. An attempt to gain uniformity was made in 1950 by the preparation of a "Draft Act" which was sent to all the state governors as a working model to be adapted to local needs and conditions. National Institute of Mental Health, Federal Security Agency, A Draft Act Governing Hospitalization of the Mentally Ill (Public Health Service Pub. No. 51, 1951). Approximately ten states have adopted the Draft Act in whole or in part. Slovenko & Super, Commitment Procedures in Louisiana, 35 Tul. L. Rev. 705 n.2 (1961).


4 Involuntary commitment proceedings are, strictly speaking, neither a civil action nor a special proceeding. In re Cook, 218 N.C. 384, 11 S.E.2d 142 (1940). This "creates a problem only in the minds of those who are not familiar with the distinction between a hospitalization proceeding and a criminal or civil trial." Whitmore, Comments on a Draft Act for the Hospitalization of the Mentally Ill, 19 Geo. Wash. L. Rev. 512, 524-25 (1951).

241 N.C. 179, 84 S.E.2d 808 (1954).

* E.g., In re Chase, 193 N.C. 450, 137 S.E. 305 (1927).