LESSEE-ERECTED IMPROVEMENTS SECURING LONG-TERM LEASES: AN OVERLOOKED DEPRECIATION DEDUCTION FOR THE LANDLORD*

LEASES often require the lessee to construct an improvement on leased property, with title to this addition passing immediately to the lessor.[1] Where the lease term is at least as long as the building's estimated life, the lessee can recover the improvement's entire cost through federal income tax depreciation deductions.[2] Such deductions are denied the lessor because the lessee pays for the improvement, and thereby acquires the requisite depreciation basis.[3]

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*Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 74 Sup. Ct. 637 (1954).

1. This provision in long-term leases is common. MCMICHAEL, LEASES: PERCENTAGE, SHORT AND LONG TERM 123-165 (4th ed. 1947). For an example of such a lease stipulation, see *id.* at 164-65.

2. See, *e.g.*, Duffy v. Central R.R., 268 U.S. 55 (1925); Edwin C. May, P-H 1944 TC MEM. DEC. ¶ 44,243 (1944); INT. REV. CODE § 23(1). When the term is shorter than the building's life, the lessee may recover his entire cost through amortization. U.S. Treas. Reg. 118, § 39.23(a)-10 (1953). On forfeiture the lessee may deduct as a loss the undepreciated cost of the improvement. See Geo. H. Bowman Co., 7 B.T.A. 399 (1927), *aff'd*, 32 F.2d 404 (D.C. Cir. 1929). See, generally, 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.01 *et seq.* (1942). For methods of computing the deduction, see U.S. Treas. Reg. 118, § 39.23(1)-5 (1953).

The purpose of the deduction, which is a matter of legislative grace, Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943), is stated as follows in U.S. Treas. Reg. 118, § 39.23(1)-1 (1953): "The proper allowance for . . . depreciation is that amount which should be set aside for the taxable year . . . whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property. . . ."

The deduction is allowed on property which is subject to "exhaustion, wear and tear, and obsolescence" which lead to the end of the "useful life of the depreciable property." U.S. Treas. Reg. 118, § 39.23(1)-1 (1953). The term "useful life" has been judicially construed to mean the life of the property during which it may be reasonably useful to the possessor. Adda, Inc., 9 T.C. 199 (1947); First National Corp. v. Jones, 36 F. Supp. 682 (W.D. Okla. 1941). And the deduction may be taken on either tangible or intangible property. U.S. Treas. Reg. 118, §§ 39.23(1)-2, 39.23(1)-3 (1953).

The burden of proving the existence of a tax basis, without which depreciation deductions cannot be taken, is on the taxpayer. *E.g.*, Clinton Cotton Mills v. Commissioner, 78 F.2d 292 (4th Cir. 1935); Kaufmann v. Commissioner, 44 F.2d 144 (3d Cir. 1930).

3. *E.g.*, Reisinger v. Commissioner, 144 F.2d 475 (2d Cir. 1944); Edwin C. May, P-H 1944 TC MEM. DEC. ¶ 44,243 (1944). The basis of property on which depreciation deductions are allowed is, with certain exceptions and adjustments, the cost of the property. See INT. REV. CODE §§ 23(n), 114, 113(b), and 113(a). Since the *Reisinger* case held that the cost to the lessor of an improvement built and paid for by the lessee was zero, the basis for the lessor's depreciation was zero.

A lessor is allowed depreciation deductions on improvements built by himself. *E.g.*, Gulf, Mobile & Northern R.R. v. Commissioner, 83 F.2d 788 (5th Cir.), *cert. denied*, 299 U.S. 574 (1936); Terminal Realty Corp., 32 B.T.A. 623 (1935).

However, the Tax Court has held that the lessor's successor by inheritance also has such a basis, and therefore may depreciate a lessee-erected improvement.[4] That basis is the fair market value of his inherited interest in the improvement.[5] The Tax Court has established this value as that of the improvement itself, ignoring the reduction in value of the heir's interest due to the long-term lease's grant of sole possessory rights to the lessee.[6] Recent judicial recognition of this value diminution due to a long-term lease,[7] while

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4. Charles Bertram Currier, 7 T.C. 980 (1946), *acq.*, 1947-1 CUM. BULL. 2, *nonacq.*, 1950-2 CUM. BULL. 5. J. Charles Pearson, Jr., 13 T.C. 851 (1949), *rev'd on other grounds*, 188 F.2d 72 (5th Cir.), *cert. denied*, 342 U.S. 861 (1951). Mary Young Moore, 15 T.C. 906, (1950), *rev'd*, 207 F.2d 265 (9th Cir. 1953). See Notes, 37 CORNELL L.Q. 323 (1952); 3 UTAH L. REV. 130 (1952).

5. INT. REV. CODE § 113(a)(5). Related Code provisions make the fair market value of the property at the time of the heir's acquisition his basis for its depreciation. INT. REV. CODE §§ 23(1), 23(n), 114, 113(b), and 113(a). See also U.S. Treas. Reg. 118, § 39.23(1)-4 (1953). Because of INT. REV. CODE § 113(a)(5), total depreciation deductions on a single piece of property may far exceed its original cost. If price levels have risen by the time of inheritance, the fair market basis of the property will usually be more than the cost of the building still not recovered through depreciation. And if the original owner has over-deducted for depreciation, the same result will follow. Conversely, the original cost of the property may never be recovered if price levels have fallen or the original owner has under-deducted. There is some pressure on aged owners of property to deduct more each year for depreciation than realities warrant in order to recover as much of their basis as possible before death. Therefore, excessive depreciation is more probable than inadequate depreciation. INT. REV. CODE § 113(a)(5) has been criticized for bringing about such consequences. See Tannenbaum, *Basis of Property Transmitted at Death—Need for Revision*, 3 TAX L. REV. 166 (1948) and sources cited therein.

6. See cases cited in note 4 *supra*; but *see* Charles Bertram Currier, 7 T.C. 980 (1946) (dissenting opinion); J. Charles Pearson, Jr., 13 T.C. 851 (1949) (dissenting opinion). See also First National Bank of Kansas City v. Nee, 85 F. Supp. 842 (W.D. Mo. 1949), where the effect of the long-term lease was considered irrelevant, since, under state law, title to the improvement did not vest in the lessor until a lessee breach. This fact is usually immaterial, however, since depreciation allowances do not depend on legal title. Helvering v. F. & R. Lazarus & Co., 308 U.S. 252 (1939); 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 23.04 (1942). The *Nee* judgment was affirmed on broader grounds, 190 F.2d 61 (8th Cir. 1951), the court concluding that no basis for the property existed, since no valuation had been placed upon it in assessing the lessor's estate for taxation. In effect, the court held that a federal estate tax valuation was a *sine qua non* for the establishment of a fair market value basis for depreciation by a lessor's successor.

The stress which the court in Commissioner v. Moore, 207 F.2d 265, 270 (9th Cir. 1953), placed upon the fact that petitioners did not prove that an estate valuation had been placed on the improvement supports this rule. These cases were apparently based on U.S. Treas. Reg. 118, § 39.113(a)(5)-1(c) (1953), which states that the value of the property as appraised for the purpose of the federal estate tax "shall be deemed to be its fair market value at the time of the acquisition." It is believed that this regulation should be considered precatory; if mandatory, it prevents both the Bureau and the taxpayer from later correcting appraisal errors. See Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 HARV. L. REV. 1134, 1153 (1952) and cases collected therein at note 58.

7. Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), *cert. denied*, 74 Sup. Ct. 637 (1954).

imperiling the Tax Court doctrine, may give support to the hitherto untested argument that depreciation be allowed the lessor or his successor by inheritance or purchase on the value of the improvement as an asset securing lease performance.[8] Such value, if any, stems from the lessee's desire to avoid breach because its consequence is forfeiture of possessory rights in the improvement.[9]

The Ninth Circuit, in *Commissioner v. Moore*,[10] recently overruled the Tax Court doctrine, basing its holding on the effect of a long-term lease upon a successor's interest in a lessee-erected improvement.[11] Taxpayer inherited a lessor's title to a leasehold and to a lessee-erected improvement with an estimated life shorter than the lease term. She claimed depreciation deductions on her inherited share in the structure. She also requested depreciation deductions on the value of the difference between the rents required by the lease and the allegedly lower rents the lot would command at market rates prevailing at the lessor's death.[12] While allowing this second claim, the Court denied the first by distinguishing between the improvement, which is clearly depreciable, and the taxpayer's interest in the improvement, which was viewed as merely her right to possess it at the end of the term.[13] This interest, it was held, did not meet any of the three Code requirements for depreciation deductions.[14] The Court reasoned first that the taxpayer's interest lacked a basis. It had no fair market value because presumably it would not entitle her to possess the structure until it was worthless.[15] Secondly, the Court declared that such a possessory right is not subject to economic exhaustion.[16] Finally, the Court stated that the taxpayer did not hold her interest to produce income,[17] since the lease gave her a constant rental income regardless of the improvement's existence.[18]

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8. See text beginning at note 19 *infra*.

9. See text at note 20 *infra*.

10. 207 F.2d 265 (9th Cir. 1953), *reversing* Mary Young Moore, 15 T.C. 906 (1950).

11. Commissioner v. Moore, 207 F.2d 265, 268 (9th Cir. 1953).

12. *Id.* at 273.

13. *Id.* at 268.

14. INT. REV. CODE §§ 23(1), 23(n). Section 23(1) permits depreciation deductions on property which is subject to wear and tear, exhaustion, or obsolescence *and* which is used in the taxpayer's trade or business or held for the production of income. Section 23(n) limits total deductions to the taxpayer's basis. A taxpayer must meet all three requirements before he is allowed deductions.

15. Commissioner v. Moore, 207 F.2d 265, 271 (9th Cir. 1953).

16. *Id.* at 269.

17. *Id.* at 271. See INT. REV. CODE § 23(1)(2).

The conclusion that such a taxpayer does not hold the property directly for the production of income for himself, and hence does not comply with § 23(1)(2) was first enunciated in First National Bank of Kansas City v. Nee, 190 F.2d 61 (8th Cir. 1951). This principle is questionable because depreciation deductions may also be taken under § 23(1)(1) on property used in trade or business. And under the broad judicial interpretation given the term "trade or business," the petitioner was clearly in the real estate business and the property was used in that business. See, *e.g.*, Fackler v. Commissioner, While the Court rightly denied petitioner's claim to depreciate her share in the building as if unencumbered by the lease, its view of her interest as solely the right of future possession is unrealistic. The fair market value of a leasehold will vary with the potential buyer's estimate of the likelihood of lessee performance. Therefore a long-term leasehold providing for rentals at least equal to market rates [19] and under which the lessee has built a valuable structure subject to forfeiture on his material breach is generally more valuable than a leasehold without such a deterrent to non-performance.[20] This

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133 F.2d 509 (6th Cir. 1943); Commissioner v. Boeing, 106 F.2d 305 (9th Cir.), *cert. denied*, 308 U.S. 619 (1939). And the court's belief that the property itself did not produce income for the petitioner does not require a finding that it was not used in his business. See, *e.g.*, Commissioner v. Dougherty Co., 159 F.2d 269 (4th Cir. 1946); Wittredge v. Commissioner, 88 F.2d 632 (2d Cir. 1937).

18. While *Moore* dealt only with a lessee-erected improvement in the hands of the lessor's successor, the rationale of its holding would deny depreciation deductions to both a lessor and his successor on lessor-erected improvements. The interest of both lessor and successor in the building—the right to possess it at the expiration of the lease—is not subject to exhaustion during the term. And, unless the lease guarantees the existence of the building, the right of the lessor and his successor to the rental income for the term will be unaffected by the destruction of the building; hence it is not held for the production of income. See note 17 *supra*. Furthermore, if the lease term is longer than the estimated life of the improvement, possessory rights are restricted so that the basis to the successor is zero. And even though the lessor does have a basis—the cost of the building—his failure to meet the exhaustibility requirement will bar the deduction.

However, both parties may be able to recover at least part of the cost of a lessor-erected building in another manner. The lessor could amortize this cost over the lease term as a capital expenditure involved in obtaining the leasehold. And the successor could take depreciation deductions on part of the value of the leasehold. For he has inherited a leasehold the rents of which are based on the value of both the land and the improvement at the time of leasing. When the term expires the building will be worthless and the rents will fall to an amount based on the value of the land alone. Thus the portion of the leasehold's value attributable to the rents derived from the improvement is subject to exhaustion. The leasehold has a basis under INT. REV. CODE § 113(a)(5), a limited life, and is held for the production of income to the successor. Therefore, depreciation deductions should be allowed on the exhaustible value of the leasehold.

While the above analysis runs counter to the present case law, see cases cited note 2 *supra* and in the last paragraph of note 3 *supra*, it is believed that this approach is not only theoretically sound but that it also leads to more equitable results. For under these circumstances it is the value of the leasehold which provides income to lessor and successor. The value of the building itself has no economic effect on either party.

19. The improvement generally will have a security value even if the lease rents are the current market rents; for a breach may cause the lessor both litigation and renovation costs, and will probably cause him to expend money in obtaining a new lessee. And if the lease rents are higher than the market, a breach will further cost the lessor the difference between the lease rents and the lower market rents he will receive from the new lessee.

20. See MCMICHAEL, LEASES: PERCENTAGE, SHORT AND LONG TERM 159 (4th ed. 1947).

The leasehold will be more valuable to the lessor or his successor regardless of who, other than the lessee, owns the right to possess the building on forfeiture, for it is the difference in value must be attributed to the presence of the improvement as a security. In this role, the improvement may have a substantial fair market value and hence a tax basis for the lessor's successor by inheritance.[21] And a leasehold purchaser may have a basis if part of his cost can be properly allocated to the security.[22] Furthermore, if a portion of the security value is taxed to the lessor as ordinary income received in lieu of rent, he may also have a cost basis.[23]

Not only does the security value of the improvement usually meet the Code's requirement of a basis for depreciation,[24] but it may also fulfill the prerequisite of being subject to exhaustion over a limited period if the improvement's life is shorter than the lease term.[25] As the worth of the building declines through deterioration, the tenant has less to lose by a material breach; hence the building has a reduced security value to the lessor or his successor. But at the same time the total expected future rental under the lease also decreases, and the landlord needs less security. If the building and the lease both have the same life, the building's worth and the amount of future lease rents will

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potential loss of the building that deters the lessee from breaching. If, however, the lessee has an excellent financial rating, a good business reputation, and a business with good prospects, the value of the leasehold will not change substantially if he further provides an improvement as security. But in most situations involving long-term leases such factors are likely to be highly unpredictable. In such cases the security does add value to the leasehold.

21. The basis of a successor by purchase is the cost of the property. INT. REV. CODE § 113(a).

22. See note 3 *supra*.

23. Before 1942, the value of a lessee-erected building was taxed to the lessor when it was received by him on lease termination. Helvering v. Bruun, 309 U.S. 461 (1940). But the lessor was permitted to apportion such income over the lease term. See *id.* at 464-6; U.S. Treas. Reg. 118, § 39.113(c)-1 (1953). In 1942 Congress enacted INT. REV. CODE § 22(b)(11), which excludes such gain from gross taxable income unless it is considered part of the rent. I.T. 4009, 1950-1 CUM. BULL. 13. This may indicate a general congressional intent to tax all gains derived from lessee-erected improvements and taking the place of rent. Therefore a lessor who takes less rent on the stipulation that the tenant erect an improvement which, although its life is shorter than the term, adds security value to the leasehold, may be taxed on the amount of rent reduction. If the security value is not construed as rent, it will probably be considered unrealized appreciation and not taxed to the lessor. See Roehner, *Realization: Administrative Convenience or Constitutional Requirement?*, 8 TAX L. REV. 173 (1953). But see Bittker, *Charitable Gifts of Income and the Internal Revenue Code: Another View*, 65 HARV. L. REV. 1375 (1952).

If the amount of rent reduction is taxed to the lessor, it may provide him with a cost basis for depreciation of the security. A lessor may have a basis for a lessee-erected building received by him upon lease termination. This basis is the amount he reported as income derived from the future receipt of the building. See INT. REV. CODE § 113(c); U.S. Treas. Reg. 118, § 39.113(c)-1 (1953). The determining factor in a lessor's acquisition of a basis, therefore, has apparently been his reporting the value received from a lessee-erected building as taxable income.

24. INT. REV. CODE § 23(n).

25. INT. REV. CODE § 23(l); U.S. Treas. Reg. 118, § 39.23(l)-1 (1953).

decline at approximately the same rate.[26] Thus a constant ratio of security value to value secured is maintained, and the landlord's economic position remains unchanged. If, however, the lease will outlive the improvement, the improvement's worth will diminish faster than the value of the future rental, and the lessor or his successor will have proportionately less security each year for the value of the future rental he wishes secured.[27] Since the structure will be worthless before the term ends, its security value is subject to exhaustion over the improvement's life.

Finally, the security satisfies the Code's third requirement that the asset be "held for the production of income" or be "used in the trade or business."[28] The landlord holds the security to produce income, inasmuch as its sole function is to cause the lessee to pay the rent. Moreover, it is clearly used in his "trade or business" under the broad meaning judicially given these terms.[29]

The only substantial barrier to allowing depreciation deductions on the improvement's security value is the "incident-to-fee" test.[30] Under this doctrine, the value of a subsidiary interest in property, such as a leasehold, is considered to be part of the overall value of fee simple ownership. Therefore, since the value of fee ownership is non-depreciable, the inferior interests cannot be depreciated either.[31] Applying this rule, courts have refused to allow a purchaser of land subject to a lease providing for rentals higher than the current market rate to depreciate that portion of the purchase price specifically attributable to this premium feature of the leasehold.[32] Thus, this test does not recognize that interests in land may have a value distinct from the value of the

26. For example, assume that initially the improvement is worth $10,000 as security for total future rentals of $1,000,000. When one-half of the lease term has expired, the security will have depreciated, presumably on a straight-line decline, to $5,000, but the total future rentals that it secures also will have been reduced by half.

27. For example, assume that initially the improvement is worth $10,000 as security for total future rentals of $1,000,000. The lease term is 100 years and the life of the improvement is 50 years. At the beginning of the term, the ratio of security to total future rentals is 1:100; at the end of 25 years, the ratio will have fallen, security-wise, to 1:150; and at the end of 50 years there will be no security.

28. INT. REV. CODE §§ 23(1) (2), 23(1) (1); see note 17 *supra.*

29. See note 17 *supra.*

30. See, *e.g.*, Martha R. Peters, 4 T.C. 1236 (1945); Milton H. Friend, 40 B.T.A. 768 (1939), *aff'd on other grounds*, 119 F.2d 959 (7th Cir.), *cert. denied*, 314 U.S. 673 (1941). The test first appeared in tax law in William Robert Farmer, 1 B.T.A. 711 (1925). For criticism of the doctrine, see Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 HARV. L. REV. 1134 (1952).

31. The "incident-to-fee" test is usually enunciated in property law terminology. *E.g.*, "In a fee simple title all lesser estates, rights, titles and interests merge." Milton H. Friend, 40 B.T.A. 768, 771 (1939). Rubin, *supra* note 30, at 1139 n.23, criticizes the arbitrary application of the rule. While no broad description of the rule can account logically for the exceptions made to it, it is believed that interpreting the rule in terms of value rather than of property interests is more understandable.

32. Mary Young Moore, 15 T.C. 906 (1950), *rev'd*, 207 F.2d 265 (9th Cir. 1953). *Accord*, The Annex Corp., P-H 1943 TC MEM. DEC. ¶ 43,256 (1943).

fee title itself.[33] And if a leasehold cannot be depreciated, neither can an improvement as security, since its value is simply included in the value of the leasehold. The *Moore* decision, in allowing the taxpayer to depreciate the premium rental value of her leasehold, discarded the "incident-to-fee" test.[34] The demise of this doctrine should enable a lessor or his successor to depreciate the security value of a lessee-erected improvement under a long-term lease.[35]

The *Moore* holding may also have important estate tax consequences. Under the Code, a lessor's gross estate is appraised at its fair market value.[36] To date, the Bureau has valued the lessor's interest in a lessee-erected improvement subject to a long-term lease as if it were unencumbered by such a restriction.[37] *Moore*, however, decided that the fair market value of such a holding is zero.[38] Even though the *Moore* finding pertained to depreciation basis under the Code's income tax provisions,[39] the fair market value of an asset should not vary with the application of different Code titles.[40] If the *Moore* determination is correct, therefore, no estate tax value should be attributed to

33. See Rubin, *supra* note 30, at 1136-7.

34. See 67 HARV. L. REV. 894 (1954) for a critical view of the holding on premium rentals.

35. The fact that the fair market value of the security may often be difficult to prove should not prevent the courts from allowing the taxpayer an opportunity to make the claim. Speculative evidence has often been relied upon in assessing value for tax purposes. See, *e.g.*, Plymouth Coal Mining Co., 3 B.T.A. 1023 (1926); Clark & Co., 4 B.T.A. 356 (1926).

The security value of the improvement might be proved by a two-step computation based on the testimony of expert appraisers. First, the difference would be determined between fair market value of the leasehold and the fair market value of another leasehold of the same term covering substantially identical but unimproved land. This difference may be attributed not only to the security value of the improvement, but also to the price a speculator might pay for the right to possess the building on a lessee breach. Therefore the value of this latter right should be deducted from the difference in value of the two leaseholds to give the value of the security.

It might be argued that an allowance of depreciation deductions on the building as security will amount to double depreciation on the same asset by both the lessor or his successor and the lessee, with a resulting over-depreciation of the building. See Note, 37 CORNELL L.Q. 323 (1952); Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953). This contention is unsound, however, for depreciation is being taken on two assets, each with a different basis. And total deductions by both parties will not exceed the total of the two bases.

36. INT. REV. CODE § 811; U.S. Treas. Reg. 105, § 81.10 (1942).

37. See Charles Bertram Currier, 7 T.C. 980 (1946) and Mary Young Moore, 15 T.C. 906 (1950). In both these cases, the Tax Court accepted petitioners' allegation that such an estate tax valuation had been placed on the lease-encumbered property. And the argument of the court in reversing the latter case, Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), proved at most that petitioners had not sustained the burden of proof.

38. *Id.* at 269-71.

39. INT. REV. CODE § 113(a)(5).

40. There is no complete interrelationship between the various chapters of the Code. Hence the same word or phrase may be interpreted quite differently in different parts of

the lessor's interest in the improvement. Since, however, this interest may have worth as security, this security value should be added to the decedent's gross estate. Such an appraisal, together with a depreciation allowance on the security, would recognize at least some of the economic implications of long-term leases.

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the Code, if policy considerations warrant. But here the primary consideration is whether the lessor's estate should be taxed on the same value basis as that upon which his successor will be allowed depreciation deductions. No reason is apparent to justify a discrepancy between the two values, in the face of identical language. Furthermore, the Regulations indicate that the estate tax and income tax provisions in this area are interrelated. U.S. Treas. Reg. 118, § 39.113(a)(5)-1(c) (1953).