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# TAXATION - INCOME TAX - IMPROVEMENTS MADE BY LESSEE AS INCOME TO LESSOR

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TAXATION — INCOME TAX — IMPROVEMENTS MADE BY LESSEE AS INCOME TO LESSOR — The recent decision of the Supreme Court of the United Stattes in *M. E. Blatt Co. v. United States*[1] has fairly settled the conflict that has ranged for over twenty years between the Commissioner of Internal Revenue and the Board of Tax Appeals on one side, and the courts on the other. The commissioner's contention that improvements made by a lessee should be taxed as income to the lessor was denied, and by dictum the Court approved the reasoning of Judge Learned Hand in *Hewitt Realty Co. v. Commissioner*,[2]

[1] 305 U. S. 267, 59 S. Ct. 186 (1938), reversing (Ct. Cl. 1938) 23 F. Supp. 461.

[2] (C. C. A. 5th, 1935) 76 F. (2d) 880, 98 A. L. R. 1201 at 1207.

wherein he said that the judicial concept of "income" did not include improvements erected by a lessee. Justice Stone concurred in the result but did not join in the opinion on the point of whether or not such improvements would be taxable if they resulted in an increase in the market value of the lessor's land in the tax year.

The lessee under a ten-year lease of a theatre agreed to make certain improvements and install equipment, to become the property of the lessor at the expiration or earlier termination of the lease. The commissioner ruled that these improvements and equipment were income to the lessor in the year of completion to the extent of their value at the termination of the lease. As provided by an option in the Treasury Department's regulations then in force, still substantially unchanged,[3] one-tenth of the "estimated depreciated value" of the improvements at the end of the term was treated as taxable income to the lessor. Lessor sued for tax refund on the theory of the *Hewitt* case, but the Court of Claims dismissed the action, distinguishing the *Hewitt* case on its facts and ruling that the improvements "constitute compensation paid by the lessee as additional rent for the use of the leased premises."[4] On certiorari, the Court of Claims was reversed on the ground that the facts did not support the finding that "the making of improvements by lessee was payment of rent." Justice Butler, who wrote the opinion, said:[5]

> "Even when required, improvements by lessee will not be deemed rent unless intention that they shall be is plainly disclosed. Rent is 'a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property' . . . it does not include payments, uncertain both as to amount and time, made for the cost of improvements. . . ."

Having eliminated the possibility of the amount in question being treated as "rent," the Court argued that the findings did not afford any other basis of value for computing taxable income. Clearly the "estimated depreciated value" based on cost to lessee would not repre-

[3] TREAS. REG. 77, art. 63, promulgated under the Revenue Act of 1932. REG. 101, art. 22 (a)-13, promulgated under the Revenue Act of 1938, provides:

"If buildings are erected or improvements made by a lessee and such buildings or improvements immediately become the property of the lessor, as, for instance, if they are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon any one of the following bases: . . .

"(c) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof."

[4] (Ct. Cl. 1938) 23 F. Supp. 461 at 463.

[5] 305 U. S. 267 at 277, 59 S. Ct. 186 (1938), quoting Duffy v. Central R. R., 268 U. S. 55 at 63, 45 S. Ct. 429 (1925).

sent the value of the improvements if removed, for the findings did not indicate that as salvage there would be this or any value at all. Likewise the Court condemns the commissioner's computation when interpreted on the theory that it represents the enhanced value of the leased premises:

> "But present or future value, however ascertained, is single in substance; it cannot be arrived at by mere summation of actual or estimated cost of constituent elements, new or depreciated. The addition to value of the leased premises resulting from the lessee's improvements may not be arrived at by formula or arithmetically by merely setting against each item or element its cost less depreciation estimated to accrue during the term of the lease. The amount included in the total value of the structure reasonably to be attributed to the improvements after use for ten years is not ascertainable by the simple calculations employed by the commissioner."[6]

The opinion made clear that the case is not a decision on "whether under any lease or in any circumstances, income is received by lessor by reason of improvements made by lessee," but that it is merely a ruling that on the facts before it the improvements did not constitute such income. However, the profession is most likely to be interested in the dicta of the Court tacitly approving the *Hewitt* case, and disapproving the dictum of the earliest case on the subject, *Miller v. Gearin*,[7] upon which the regulations of the Treasury Department have been based.

I.

The revenue laws have never spelled out in terms that improvements made by a lessee are to be regarded as income to the lessor. The Revenue Act of 1938 defines "gross income" in section 22 (a) as including "gains, profits, and income derived from . . . rent . . . or gains or profits and income derived from any source whatever."[8] The provisions of all the prior revenue acts have been substantially the same.[9] The first ruling of the Treasury Department on the question was in 1917, to the effect that at the end of the term the lessor realizes income

[6] Ibid., 305 U. S. at 278-279.

[7] (C. C. A. 9th, 1919) 258 F. 225, cert. den. 250 U. S. 667, 40 S. Ct. 13 (1919).

[8] 52 Stat. L. 457 (1938), 26 U. S. C. (Supp. 1938), § 22a.

[9] Revenue Act of 1913, § IIB, 38 Stat. L. 167; Act of 1916, § 2(a), 39 Stat. L. 757; Act of 1918, § 213(a), 40 Stat. L. 1065; Act of 1921, § 213(a), 42 Stat. L. 238; Act of 1924, § 213(a), 43 Stat. L. 267; Act of 1926, § 213(a), 44 Stat. L. 23; Act of 1932, § 22(a), 47 Stat. L. 178; Act of 1934, § 22(a), 48 Stat. L. 686; Act of 1936, § 22(a), 49 Stat. L. 1657.

to the extent of the cost of the improvements minus the allowable depreciation while the lessee was in possession.[10] But in *Miller v. Gearin*,[11] the Circuit Court of Appeals for the Ninth Circuit held that no income was realized at termination of the lease, and to this extent the regulations would not be followed. In that case the lessee under a twenty-three-year lease erected a valuable building in 1907, but in 1916 there was default in rent payments and the lessors terminated the lease, acquiring possession of a seven-story brick building which had cost the lessee $140,000. From the time of acquisition of possession to the time of litigation, the rentals were insufficient to pay the expenses of maintenance, management, and taxes, but nevertheless the commissioner included as income for the year of forfeiture (1916) the value of the building. Answering the contention of the collector, the court said:

> "The lessor acquired nothing in 1916 save the possession of that which for many years had been her own. The possession so acquired was not income. It was, not a gain, but was a loss."[12]

Thus, the court found that the acquisition of possession was valueless to the lessor, and even involved losses from operation. By way of dictum the court went on to say:

> "Assuming that the building was income derived from the use of the property, we think it clear that the time when it was 'derived' was the time when the completed building was added to the real estate and enhanced its value. At that time it represented a prepayment to the lessor of a portion of the rental, distributable over a period of 23 years. The lease provided that the ownership of the buildings or improvements put upon the premises was to vest in the lessor immediately upon the construction of the same, subject to the provisions of the lease."[13]

The regulations were again held invalid nine months later in *Cryan v. Wardell*[14] on almost identical facts, but without any reference to the *Miller* case.

[10] T. D. 2442, Feb. 6, 1917. The substance of this ruling was the basis of TREAS. REG. 33 (revised), art. 4, par. 50 (1916 Act as amended by Act of Oct. 3, 1917) and art. 48 of REG. 45 (1918 Act).

[11] (C. C. A. 9th, 1919) 258 F. 225, cert. den. 250 U. S. 667, 40 S. Ct. 13 (1919).

[12] Ibid., 258 F. at 226.

[13] Ibid., 258 F. at 226.

[14] (D. C. Cal. 1920) 263 F. 248 at 249. The court said: "The terms of the lease clearly disclose that the erection of the building was a part of the consideration for the lease, and that it was provided for and taken into consideration in the rent reserved. It therefore became, upon its completion, a part and parcel of plaintiff's

Regarding the dicta in these decisions as controlling law, the commissioner abandoned his theory that the improvements were income at the end of the term, and promulgated new regulations providing that income is to be computed at the time the improvements are completed.[15] Regulations 62, article 48, under the 1921 act gave the taxpayer the option of recognizing the entire gain during the year of completion, or of spreading the gain out over the term of the lease and reporting an aliquot part as gain for each year.[16] There are dicta upholding this view in two cases,[17] and the regulations were actually followed in one other decision in which the opinion was very brief and without any examination of authorities.[18] Up to the decision in the *Hewitt* case, the Board of Tax Appeals had consistently followed the regulations, apparently with no misgivings as to their validity, though there were occasional dissents without opinion.[19] In the *Hewitt* case, the regulations were held unconstitutional because any gain to lessor from such improvements is not "realized" at time of completion, not "derived" from capital, from labor, or from both combined, within the definition of "income" laid down in *Eisner v. Macomber*.[20] In the concurring opinion Judge Learned Hand wrote:[21]

> "Just when it in fact is 'realized' is not always easy to say. We concede that in a situation like that at bar a lessor need not receive

income-bearing property, and was subject to taxation in her as of that date. . . . The regulation of the Treasury Department cannot be applied to such a state of facts; if so intended, it must give way, as the department has no power to abrogate a substantive rule of law. . . . It results that whatever accession of value resulted to plaintiff's property from the erection of the building in question accrued and became vested in 1910 [year of completion], and not upon the termination of the lease."

[15] T. D. 3062 (3 C. B., 109), Sept. 1, 1920: "When buildings are erected or improvements are made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor receives income at the time such buildings or improvements are completed, to the extent of the fair market price or value of such buildings or improvements subject to the lease." See also Mim. 2714, 4 C. B. 90.

[16] Practically unchanged are the corresponding provisions of later regulations: Art. 48 of TREAS. REG. 65 (1924 Act) and REG. 69 (1926 Act); Art. 63 of REG. 74 (1928 Act) and REG. 77 (1932 Act). The same general idea is carried out in Art. 22 (a)-13 of REG. 86 (1934 Act), REG. 94 (1936 Act) and REG. 101 (1938 Act), though technically three options are available to the taxpayer.

[17] United States v. Boston & Providence R. R., (C. C. A. 1st, 1930) 37 F. (2d) 670; Crane v. Commissioner, (C. C. A. 1st, 1934) 68 F. (2d) 640.

[18] Kentucky Block Coal Co. v. Lucas, (D. C. Ky. 1933) 4 F. Supp. 266.

[19] Butler's Appeal, 4 B. T. A. 756 (1926); Scott v. Commr., 9 B. T. A. 1219 (1918); Alexander v. Commr., 13 B. T. A. 1169 (1928); Cataract Ice Co. v. Commr., 23 B. T. A. 654 (1931); Martin v. Commr., 24 B. T. A. 813 (1931).

[20] 252 U. S. 189, 40 S. Ct. 189 (1920).

[21] Hewitt Realty Co. v. Commr., (C. C. A. 2d, 1935) 76 F. (2d) 880 at 884.

money to be taxable; if improvements to land be portable—detachable machinery, for example, which he can take off and sell as separate chattels—he receives income either when the lease is made, or when the term ends; for present purposes we need not say which. On the other hand, if the lease requires the lessee to drain the land, or set out shade trees, or pave it, or grade it, or build a golf course, or a race track on it, we can see no difference between the resulting increase in its value and that arising from the growth of the surrounding neighborhood, or the increase in value of a share of stock. The question as we view it is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away."

The Treasury Department did not appeal the decision, but nevertheless refused to acquiesce in it, and until the *Blatt* decision was handed down the Board of Tax Appeals followed the regulations.[22] During the period intervening between the *Hewitt* and *Blatt* cases the lower federal courts were in sharp conflict: the *Hewitt* case was followed in the second, third and fourth circuits,[23] while the Court of Claims and the District Court for the Territory of Hawaii insisted upon following the regulations.[24]

The language in the opinion of the *Blatt* case makes it clear that the Court rejects the dictum of *Miller v. Gearin* wherein the circuit court of appeals was of the opinion that gain is derived when the completed building is added to the real estate. However, its rejection of

[22] Slack v. Commr., 35 B. T. A. 271 (1937); Morphy v. Commr., 35 B. T. A. 289 (1937); Sloan v. Commr., 36 B. T. A. 370 (1937); Hart v. Commr., 37 B. T. A. 360 (No. 54) (1938). In the Sloan case, supra, the board said, 36 B. T. A. at 376: "In the recent case of *Emma C. Morphy* . . . we gave careful consideration to the decision in *Hewitt Realty Co. v. Commissioner* . . . and, relying upon the cases of *Miller v. Gearin* . . . and *Cryan v. Wardell* . . . came to the conclusion that, since no other court had adopted the theory of the *Hewitt Realty Co.* case, we should adhere to our former opinion and again sustain the validity of the contested regulations." The board no longer follows the regulations. See Cleveland Trust Co. v. Commr., 39 B. T. A., No. 18 (Jan. 17, 1939); Merkra Holding Co. v. Commr., 39 B. T. A., No. 19 (Jan. 17, 1939).

[23] Hilgenberg v. United States, (D. C. Md. 1937) 21 F. Supp. 453; English v. Bitgood, (D. C. Conn. 1938) 21 F. Supp. 641. Followed but adversely criticized in Dominick v. United States, (D. C. N. Y. 1938) 24 F. Supp. 829; Staples v. United States, (D. C. Pa. 1937) 21 F. Supp. 737.

[24] Campbell v. United States, (D. C. Haw. 1938) 4 CCH FEDERAL TAX SERVICE, ¶ 9408 (1938); M. E. Blatt Co. v. United States, (Ct. Cl. 1938) 23 F. Supp. 461, reversed 305 U. S. 267, 59 S. Ct. 186 (1938).

this view is based not on the constitutional ground as reasoned in the *Hewitt* case, but on the Court's interpretation of the statute:

> "It may be assumed that, subject to the lease, lessor became owner of the improvements at the time they were made. But it had no right to use or dispose of them during the term. Mere acquisition of that sort did not amount to contemporaneous realization of gain within the meaning of the statute."[25]

Thus, strictly speaking, the Supreme Court has not expressed itself even by way of dictum upon the question of the constitutional power of Congress expressly to include such improvements as income.

2.

The arguments for and against treating the improvements as rent are fairly well stated in the opinions of Judge Learned Hand and Judge Chase in the *Hewitt* case. Judge Chase's concept of the "rent" received by the lessor was that "In part it was payable in money and in part payable in additions to value, if any," in case the lessee erected any improvements. Consequently, if the new building, title to which immediately passed to the lessor subject to the lease, had any present value in the year such title was acquired, "that value was a gain to the lessor growing out of the use of its land by the lessee." Certainly the receipt of property is income,[26] and it has been held that a conveyance of other realty by a lessee in consideration of the lease is income to the lessor during the year of transfer.[27] Therefore, logically one could say that the lessor "derived" income even if he received only a future interest in realty other than that which he already owned. So it is argued that the present acquisition of the reversionary right to the building erected by the lessee should be taxable income to the lessor.

In opposition, Judge Hand insists that income is "derived" only from the receipt of "something separately disposable," not the acquisition of something "so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away." Consequently, the lessor is not to be taxed until he sells his interest in the land. This is certainly the simplest, most workable method to administer. The uncertainties of depreciation tables and interest rates which would have to be used in determining the present value of the future interest would almost of necessity lead to arbitrariness. Where the lease contains a provision for renewal at lessee's option, which would make the time of reversion uncertain, any

[25] 305 U. S. 267 at 280, 59 S. Ct. 186 (1938).
[26] Peabody v. Eisner, 247 U. S. 347, 38 S. Ct. 546 (1918).
[27] Pembroke v. Helvering, (App. D. C. 1934) 70 F. (2d) 850.

hope for an accurate determination of present value must vanish. While the rule laid down means deferring the collection of the tax, it will most likely result in greater revenue to the government from the transaction. Currently the lessor pays tax only on the rent he receives. When he repossesses the land, any increased value from the building will likely mean increased rental value, and a correspondingly higher tax. When the fee is ultimately disposed of, capital gain is recognized as the differential between the sale price and the original cost of the unimproved land,[28] which would include any value contributed by the lessee's improvements. The possibility of increased revenue to the government comes from deferring tax assessment during a period marked by a tendency to increase tax rates per dollar of income. Despite this likely greater tax cost to the lessor, he is not going to complain. Taxes must be paid with cash, and cash is most likely to be in the hands of the owner when he disposes of the entire property. If he must pay the tax before sale, it is conceivable that he would have to borrow funds to pay the tax on the anticipated realization of income from the building. In the case of installment sales, Congress has been cognizant of the hardship of presently taxing gains which are not yet cash in the hand, even though they be "derived" within the meaning of the Constitution.[29] There is no doubt that Congress could tax the entire anticipated cash profit at the time an installment sale is made, but for some time the statutes have given the taxpayer the option of recognizing the gain only as the cash payments come in. Similarly, but to a lesser extent, the commissioner had sought to alleviate the hardship of immediate cash payment in the very regulations which the Court struck down in the *Blatt* case, for it was provided that the taxpayer had the option of spreading over the term of the lease the recognition of gain on completion of improvements. Furthermore, the Court might have appreciated the artificiality of presently taxing something which in itself has no separate market value for cash conversion purposes, but has value only when connected with and made a part of the capital asset, the land. The value of the improvements, like one of Siamese twins, cannot withstand severance.

3.

The accountants have contributed very little to the solution of the specific problem at hand. An examination of several leading texts has not revealed any analysis of the situation or any method of entering the transactions in the lessor's books, although some writers refer to

[28] Revenue Act of 1938, § 111(a), 52 Stat. L. 484, 26 U. S. C. (Supp. 1938), § 111(a).

[29] Revenue Act of 1938, § 44, 52 Stat. L. 473, 26 U. S. C. (Supp. 1938), § 44.

the Treasury Department's regulations, leaving the implication that the methods there suggested are generally satisfactory for bookkeeping purposes.[30] One writer,[31] without analysis or explanation, states the rule of practice to be that the lessor makes no entry to record the value of the improvement when completed, but treats as profit any value that the building may have at the time the lease expires. This was the procedure prescribed in the very first treasury regulations, but it was soon changed because of the dictum of the court in *Miller v. Gearin*[32] that on termination of the lease the lessor acquired nothing "save the possession of that which for many years had been her own."

In determining value, the accountant often must count chickens before they are hatched, but he does not count all that are even hatched and hopping, for he knows that some will die before maturity. So with improvements made by the lessee. When the term is short and reasonable foresight indicates that the lessor is likely to acquire possession in the future of something of real value, something can be said for treating the acquisition of the present right as the income-determining event, and recording the present discounted value thereof. For example, in the *Blatt* case, a modern theatre costing $140,000 was to revert to the lessor in ten years. The reversionary interest of the lessor must have an enhanced value at the present time because of the improvement. It would seem that the proper measure of income is the difference between the value of the reversion of the improved land and the value unimproved. The regulations have never provided such a measure, but have looked only to the value or cost of the building erected. This was the specific reason given by the Court in the *Blatt* case for objecting to the computation of income in that case. The Court expressly did not decide that the erection of the buildings could in no case be deemed the income event.

Some of the uncertainty can be avoided by delaying the tax event until the lessor actually gets possession, to go back to the view suggested by Eggleston.[33] The factors of depreciation and interest rate are eliminated from the computation of present value, and it is at this time that we can know whether the lessor can really count on the improvements as being of any value at all to him. Nevertheless, the valuation problem is a difficult one, for the worth of old buildings apart from the land on which they are situated cannot be determined by any

[30] HATFIELD, ACCOUNTING (1928); KESTER, ADVANCED ACCOUNTING 352 (1933); MONTGOMERY, AUDITING THEORY AND PRACTICE, 5th ed. (1937); 1 FINNEY, PRINCIPLES OF ACCOUNTING (1934); PATON, ESSENTIALS OF ACCOUNTING (1938); PATON, ACCOUNTANT'S HANDBOOK, 2d ed., 539 (1936).

[31] 1 EGGLESTON, MODERN ACCOUNTING THEORY AND PRACTICE 236 (1930).

[32] (C. C. A. 9th, 1919) 258 F. 225.

[33] See note 30, supra.

of the ordinary methods of proof. Basing the tax on figures so uncertain might well be considered objectionable.

For practicality of administration, perhaps the best view is that expressed by Judge Hand in the *Hewitt* case, namely, deferring recognition of any gain whatsoever, except for rental income, until the lessor's interest is sold. Accountants do not in general favor writing up land accounts to reflect changes in value not attributable to the owner's expenditures.[34] Of late there has been some shift toward recognizing increased values in the accounts, but the increment is treated with suspicion.[35] Those advocating recognition of increased values still recommend retaining the cost figure as separate and distinct from the value increment in the accounts or balance sheet. According to this view the write-up is not credited to surplus, but to a special reserve ear-marked to indicate that it is not available for dividends. No complicated guesses need be made when the property is actually sold. It is far easier to depend on history than foresight to determine how many eggs become marketable birds, and the taxpayer deserves this consideration because the doubts of tax administrators are likely to be resolved against him. In the end, the government will get a larger share of the gain, if any there be, because tax rates will likely be higher when the time comes to assess the deferred gain.[36]

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[34] PATON, ACCOUNTANT'S HANDBOOK, 2d ed., 477 (1934); HATFIELD, ACCOUNTING 77 (1928).

[35] PATON AND STEVENSON, PRINCIPLES OF ACCOUNTING, c. 20 (1928); 1 FINNEY, PRINCIPLES OF ACCOUNTING 288 (1934); DICKINSON, ACCOUNTING PRACTICE AND PROCEDURE, 2d ed., 81-82 (1919).

[36] A possible method of tax avoidance is suggested by a strict adherence to Judge Hand's view that improvements "so merged in the land as to become financially a part of it" do not constitute income. Logically, no gain would be recognized if a building were erected on the taxpayer's land in consideration of goods or personal services.