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# Taxation - Federal Income Tax - Lessor's Right to Depreciation Allowances Under Long Term-Lease

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TAXATION—FEDERAL INCOME TAX—LESSOR'S RIGHT TO DEPRECIATION ALLOWANCES UNDER LONG-TERM LEASE—Plaintiff corporation leased its entire railroad property under a long-term lease subject to termination at the election of either party, or by breach of the lessee. The lessee agreed to preserve, replace, renew and maintain the property during the term and to return it upon termination "in at least as good condition as at the beginning of the term." Plaintiff, on the other hand, agreed to reimburse the lessee for all additions and betterments to the property which passed to him upon termination. The government disallowed plaintiff's claim for a tax refund based on its right to allow for depreciation, because plaintiff's "property would be as valuable at the end of the term as it was at the beginning and, therefore, will not depreciate from the standpoint of its owner." In a refund proceeding, *held,* plaintiff will suffer loss from obsolescence and depreciation regardless of lessee's covenant. The agreement to return in as good condition implies no more than to maintain in good condition, which does not mean restoring the value of the property at the end of the term. *North Carolina Midland Railway Co. v. United States,* (Ct. Cl. 1958) 163 F. Supp. 610.

When an investor leases his property the lessee may, by undertaking various obligations relating to the maintenance or restoration of the property, reduce or eliminate losses falling upon the lessor due to wear and tear and obsolescence.[1] Hence a lessor's right to a depreciation deduc-

[1] See Atlantic Coast Line v. Commissioner, (4th Cir. 1936) 81 F. (2d) 309, cert. den. 298 U.S. 656 (1936), rehearing den. 298 U.S. 691 (1936), note, 46 YALE L.J. 172 (1936).

tion is ultimately determined by the interpretation given to the lessee's obligations under the lease agreement.[2] The courts have not been uniform in construing many fairly standard lease covenants, when a tax question is presented. It seems settled that covenants for the maintenance and repair of the property do not preclude the lessor from taking a depreciation deduction[3] and, conversely, covenants obligating the lessee to restore the value or equivalent of the property to the lessor clearly do prevent him from claiming a deduction.[4] Between these extremes are covenants which typically require the lessee to renew and replace the property and to return it at the end of the lease in as good condition as it was at the beginning of the lease.[5] It is in these cases that the courts have taken different courses. In one line of cases, the courts have denied the lessor a deduction on the theory that since the lessee is to return the property in virtually the same condition as when he received it the lessor cannot be said to have suffered any economic loss on his investment through depreciation.[6] This reasoning may be justified if cognizance is taken of the relationship between the life of the property and the life of the lease.[7] Where the lease is longer than the estimated life of the property it is reasonable to suppose that the lessee's obligation to renew and replace will come into play and thereby prevent any depreciation losses on existing property from falling on the lessor.[8] This would not preclude a deduction for obsolescence on such property that has an estimated life of greater duration than the lease, nor on replacement property that becomes obsolete to an extent which causes the lessor a loss. In the principal case the court rejects this approach by construing the lessee's obligations to include no more than a duty to make "necessary" renewals and to "maintain" the property in good condition.[9] This seems to be an unwarranted

[2] For an extensive discussion and collection of cases on the lessor's right to deduct for depreciation, see 40 A.L.R. (2d) 440 (1955). See also 153 A.L.R. 906 (1944).

[3] Terminal R. Assn. of St. Louis v. Commissioner, 33 B.T.A. 906 at 909 (1936), affd. sub nom. Helvering v. Terminal R. Assn. of St. Louis, (8th Cir. 1937) 89 F. (2d) 739. Cases are collected in 40 A.L.R. (2d) 440 at 460.

[4] Commissioner v. Terre Haute Electric Co., (7th Cir. 1933) 67 F. (2d) 697 at 698, cert. den. 292 U.S. 624 (1934). See also 40 A.L.R. (2d) 440 at 468.

[5] E.g., principal case at 611; Georgia Ry. & Electric Co. v. Commissioner, (5th Cir. 1935) 77 F. (2d) 897, cert. den. 296 U.S. 601 (1935); Commissioner v. Terre Haute Electric Co., note 4 supra.

[6] Georgia Ry. & Electric Co. v. Commissioner, note 5 supra; Cincinnati Gas & Electric Co. v. Commissioner, 36 B.T.A. 1122 (1937). See Atlantic Coast Line v. Commissioner, note 1 supra. See also note, 43 GEO. L.J. 529 at 531 (1955).

[7] Cincinnati Gas & Electric Co. v. Commissioner, note 6 supra, at 1127.

[8] Ibid.

[9] Principal case at 614. "Surely it is an immaterial difference that in some cases the lessee covenanted to maintain the property in good condition, whereas in the instant case he undertook to return it in as good condition as it was in the beginning of the term. The difference in the phraseology of the two clauses is only in the degree of emphasis, rather than in their meaning."

dilution of the lease language, achieved by comparing it with other cases in which the covenants involved are distinguishable.[10] Yet there may be some justification for this interpretation since the lease contained a thirty-day termination clause which made its duration uncertain and thus precluded a comparison of the life expectancies of the property and the lease such as suggested above. Furthermore, it is true that such covenants are usually construed in the manner most favorable to the lessee.[11] The lack of uniformity on the part of the courts in dealing with this problem might be easily explained and justified if those courts used state law to determine the obligations of the parties to the lease and then applied tax rules accordingly. However, the courts have looked to other tax cases, regardless of locus, to find the proper construction for the lease covenants. Long-term leases have become commonplace and almost without exception contain covenants concerning the lessee's duty for the care of the property. The tax consequences of such lease covenants undoubtedly play an important part in the making of leases; consequently, some degree of uniformity in the interpretation of these covenants for tax purposes is a worthwhile goal. This uniformity might be achieved in either of two ways: (1) the tax code might be amended to provide in the future for a standard interpretation of such typical lease covenants as found in the principal case, or (2) the courts might interpret the lease covenants under the law of the state where the property is located. The latter course is preferable because it would avoid forcing prospective lessors and lessees to draft leases with an eye to conflicting interpretations of their covenants by the state courts on one hand and the federal courts, for tax purposes, on the other.

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[10] The court in the principal case at 613 cites Helvering v. Terminal R. Assn. of St. Louis, note 3 supra, in support of its holding. But the court in that case stated at 742 that their ". . . conclusion is much fortified by the limitation of the renewals to 'necessary' renewals." The court also cites Alaska Realty Co. v. Commissioner, (6th Cir. 1944) 141 F. (2d) 675 as support, but in that case the court emphasized, at 676, the "obligation to repair and replace . . . *whenever necessary* . . ." and also distinguished cases involving railroad equipment.

[11] E.g., Hollywood Bldg. Corp. v. Greenview Amusement Co., 315 Ill. App. 658 at 661, 43 N.E. (2d) 566 (1942); Lehmeyer v. Moses, 69 Misc. 476 at 482, 127 N.Y. S. 253 (1910). See also 45 A.L.R. 12 at 30 (1926).