

VALUE OF IMPROVEMENTS ERECTED BY A LESSEE
AS TAXABLE INCOME OF THE LESSOR FOR
THE YEAR IN WHICH THEY WERE
ERECTED.

The following regulation was promulgated by the Commissioner of Internal Revenue on September 2 last, viz.:

“Article 48. Rents and Royalties.—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 when 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. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements. If for any other reason than a *bona fide* purchase from the lessee by the lessor the lease is terminated, so that the lessor comes into possession and control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the fair market price or value thereof to him as determined when the same completed became part of the realty. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the termination of the lease, the lessor is entitled to deduct as a loss of the year when such destruction takes place the fair market price or value of such buildings or improvements subject to the lease as determined when the same, completed, became a part of the realty, or the value thereof subject to the lease on March 1st,

1913, less any salvage value subject to the lease to the extent of such loss was not compensated by insurance.”

This regulation supersedes Article 48, Regulation 45, which had been previously followed by the Internal Revenue Department, and which reads as follows:

“Rents and Royalties.—When improvements made by a lessee become part of the real estate, the value of such improvements upon the expiration (termination) of the existing term of the lease is income to the lessor. In general, sums paid by a tenant for the use of property, although to another than the landlord, are properly to be regarded as rent and constitute income of the landlord.”

The sections of the Act of Congress which it is claimed authorize these regulations and rules, are as follows:

“Section 213. That for the purposes of this title (except as otherwise provided in Section 233) the term ‘gross income,’ (a) includes gains, profits, and income derived from salaries, wages or compensation for personal service of whatever kind in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer unless, under methods of accounting permitted under subdivision (b) of Section 212, any such amounts are to be properly accounted for as of a different period.”

This new regulation of September 2, 1920, was no doubt adopted to meet the situation which arose from the decision in the case of *Cryan v. Wardell*, 263 Federal 248, in which it was held that the title to improvements erected on leased property by a lessee, which could not be removed at the termination of the lease, vested in the owner of the property im-

mediately upon their erection, and consequently that the regulations of the Internal Revenue Department, then in force, providing for the assessment of the increased value of the property caused by the erection of the improvements as *income at the termination of the lease*, were null and void because that income accrued as soon as the lessee erected the buildings. The opinion in that case, however, did not decide, or even consider, the more serious question whether the increased value of such leased property could be considered *taxable income* prior to an actual sale or some other disposition thereof by which the owner realized an actual profit in cash or its equivalent.

The Supreme Court of the United States, in construing the Revenue Act of 1867 in the case of *Gray v. Darlington*, 15 Wallace 63, used the following language:

“And again, the mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of a tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits and income specified by the statutes. It constitutes and can be treated merely as an increase of capital.”

This language was again cited with approval by the Supreme Court of the United States in the case of *Lynch v. Turrish*, 247 U. S. 221, in construing the present Revenue Act.

Again, in the case of *Eisner v. McComber* (the stock dividend case), the Supreme Court held that even Congress could not, by calling something “*income*” when in fact it was not income, make it taxable as such. And if Congress cannot do that, then “*a fortiori*” the Commissioner cannot.

It has generally been held by the Supreme Court that the word “*income*,” when used in an income tax law, means cash or its equivalent; that it does not mean choses in action or unrealized increments in the value of property. *United States v. Schillinger*, 14 Blatch. 71; *Gray v. Darlington*, 15 Wallace 63; *Baldwin Locomotive Works v. McCoach*, 221 Fed. 59.

In *Lynch v. Hornby*, 247 U. S. 329, the Supreme Court used the following language:

“It is evident that Congress intended to draw and did draw a distinction between a stockholder’s undivided share or interest in the gains and profits of a corporation, prior to the declaration of the dividend and his participation in the dividends declared and paid, treating the latter, in ordinary circumstances, as a part of his income for the purposes of the surtax, and not regarding the former as taxable income unless fraudulently accumulated for the purpose of evading the tax.”

This principle has always been recognized by the Revenue Department in taxing stocks, bonds and personal property generally. No matter how much the corporate stocks or bonds owned by an individual or corporation have enhanced in value, the owner cannot be taxed upon the increased value as income until there has been either a sale, an exchange or other disposition thereof. Any other rule, as applied to stocks which may fluctuate rapidly in value, would indeed be wholly impracticable. The same rule, we believe, must also be applied to real estate, and until the owner has sold or exchanged his real estate he cannot be taxed upon any increase in value as upon a *realized income*.

This brings us to the question whether the lease of property under an arrangement by which the lessee erects valuable improvements that he cannot remove at the termination of the lease is such a sale or exchange of the land as will subject the owner to a tax upon the increase in its value as upon so much realized income. It may be conceded that, from a legal standpoint, the legal title to the improvements vests in the lessor as soon as the tenant erects them. It may also be conceded that in executing a lease the lessor carves his fee estate into two estates, viz.: a leasehold estate which belongs to the lessee and a reversion which belongs to the lessor. But the lessee does not pay for his leasehold estate at the time the lease is executed; he pays by installments which extend through a period of years and upon each of which, as it is paid, the lessor is taxable *as income in the year in which it is received*.

To say that the improvements erected by the lessee, the

title to which vests in the lessor at once, is the equivalent of a payment of cash rent at that time equal to the increase the improvements may cause in the value of the land is to lose sight of the controlling fact that these improvements, as soon as erected, become merged in and are in law an integral part of the real estate itself, and do not constitute a separate estate or property apart from the land upon which they may be erected. They cannot be sold for any substantial sum separately from the real estate, because for mere removal purposes they have little or no value. The situation is similar to that of an owner of a vacant lot worth \$5,000.00 who erects improvements thereon costing \$10,000.00, and the improved property is then worth \$25,000.00. Here is a "paper profit" of \$10,000.00, but until the owner sells or exchanges the property it is not a "real profit" and does not become taxable income.

Moreover, it ignores entirely the character of the lessor's interest in such improvements, which is not a present estate, but merely one in reversion. Although the title to the improvements may vest in the lessor at once, the right to the occupation and enjoyment until the termination of the term of years—as much so as to such improvements as to the land independently of the improvements. The lessor in that case has merely a vested estate of future enjoyment, in either, unless, of course, he realizes the value of the improvements by making a sale of his reversion during the term.

If the principle embodied in this new regulation were once allowed and established, then under it the Commissioner of Internal Revenue could promulgate a rule by which all the property a man owns would be valued by Government clerks once a year and he could be forced to pay a cash tax upon the supposed increase in value whether he has in fact realized or received any profit or not.

This regulation, therefore, seems clearly invalid and unenforceable. We are confirmed in this opinion by a consideration of the hazards to which its enforcement would subject a lessor. He would be compelled to submit to a *guess or estimate* which some department employee would make as to the value of his property before the improvement was

erected and a like *guess or estimate* as to its value after the improvement and subject to the lease, and then immediately would have to pay a tax upon that estimated increase in value as if it were an actual cash income which he had received, notwithstanding that real estate has no recognized market value like stocks or bonds or corn or wheat, and that it is notoriously slow of sale, and the actual sale price when the owner sells may be far less than the estimated price. It is small satisfaction to say to the owner that when he is finally able to sell, if he sells at a less price than was estimated by the Government employee, he can sue the Collector for a refund of the tax, or some part of it. The fact that this rule or regulation, if enforced, would operate oppressively should be considered by the courts in passing upon its validity.

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