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World Publishing Company v. Commissioner, 299 F.2d 614 (8th Cir. 1962)

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Cover Page Footnote

World Publishing Company v. Commissioner

RECENT DECISIONS

PURCHASER OF LEASED PROPERTY MAY DEPRECIATE COST ALLOCABLE TO BUILDING CONSTRUCTED BY LESSEE.—Lessee-corporation leased two lots located in a metropolitan area, the lease taking effect on July 1, 1928, for a term of fifty years with annual rentals averaging \$28,500. As required by the provisions of the lease, lessee-corporation constructed a building on the property at a cost in excess of \$250,000.¹ In 1950 taxpayer purchased the entire interest of the lessor in the two lots, including the right to receive rentals from the outstanding lease. In each of the years 1952, 1953, and 1954 taxpayer deducted \$10,547.92 for depreciation and amortization. The deductions were computed by dividing the number of years remaining in the term of the lease into \$300,000, the portion of the purchase price which taxpayer claimed was allocable to the building. The Commissioner disallowed the deductions and the United States Tax Court upheld the Commissioner's decision.² On appeal to the U.S. Court of Appeals for the 8th Circuit, *held*, reversed.³ The purchaser of leased property on which the lessee has constructed a building may deduct, as depreciation, the amount of his investment allocable to the building. *World Publishing Company v. Commissioner*, 299 F.2d 614 (8th Cir. 1962).

A taxpayer who acquires an asset which decreases in value may depreciate its value through deductions from his federal income tax.⁴ The amount of the depreciation deductible depends in part upon the basis of the asset. The basis is either the cost of the asset to the taxpayer or the fair market value of the asset when it was acquired.⁵ If, under the Internal Revenue Code, the asset may be depreciated, the taxpayer is allowed to re-

¹The lease also provided that upon its termination all buildings erected upon the premises were to become a part of the realty and the property of the lessor. The lessor had the right to subject the land and the improvements to mortgage liens; to amend or reject plans and specifications for the building; to be protected by adequate insurance at the expense of the lessee, the lessor being named as the insured; and to inspect the building at any time with the lessee bearing the cost of maintenance. The lessee was to pay all taxes and assessments upon the land and improvements, or "which the Lessor shall be required to pay by reason of or on account of its interest in said land or improvements, or its interest in or under this lease, except estate, inheritance, and income taxes."

²35 T.C. 7 (1960).

³The court remanded to the Tax Court with directions to recompute the taxpayer's deficiencies in accord with the views expressed.

⁴"General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

"(1) of property used in the trade or business, or

"(2) of property held for the production of income." INT. REV. CODE OF 1954, § 167(a). Section 23(1) of the 1939 INT. REV. CODE is the section applicable to the tax years involved.

⁵"Basis of property—Cost. The basis of property shall be the cost of such property . . ." INT. REV. CODE OF 1954, § 1012. Compare INT. REV. CODE OF 1954, § 1014:

"(a) In General.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent . . . shall . . . be the fair market value of the property at the date of the decedent's death. . . ." See, e.g., *Parsons v. United States*, 227 F.2d 437 (3rd Cir. 1955); *Detroit Edison Co. v. Comm'r*, 319 U.S. 98 (1943); *Reis v. Comm'r*, 142 F.2d 900 (6th Cir. 1944); *Oxford Paper Co. v. United States*, 86 F. Supp. 366 (D.C.N.Y. 1949).

cover the basis as depreciation occurs by taking periodic deductions from his income tax during the estimated useful life of the asset.⁶ If, however, depreciation is not allowed, the taxpayer may not recover any of his basis until final disposition of the asset.⁷

No prior cases have arisen where the taxpayer has purchased leased property upon which the lessee has constructed a building.⁸ However, an analogous situation arises where the property has been inherited by the taxpayer.⁹ The courts have held in these cases that: (1) the land is a non-depreciable asset; (2) the lease is also non-depreciable on the ground that the rights under it are merely an incident to the taxpayer-lessor's fee ownership of the land,¹⁰ and (3) the right to depreciate the building depends upon the character of the lease.¹¹ If the rents are greater than could be presently obtained on the same property, the lease is characterized as favorable;¹² if the rents are less than could be presently obtained on the same property, the lease is unfavorable;¹³ if the rents approximate what could currently be obtained on the same property, the lease is ordinary.¹⁴ When the lease is favorable, the courts have held that the basis of the property is its fair market value when acquired by the taxpayer,¹⁵ and the portion of this basis allocable to the building is depreciable if the building is used in the taxpayer's trade or business or is held by him for the production of income.¹⁶

When the lease is unfavorable, if the incident to the fee theory is applied, the portion of the total basis allocable to the non-depreciable asset, the land, would be reduced by the burden of the unfavorable lease. At the same time the building would be given its full market value as a depreciable asset. In economic reality, as the unfavorable lease expires, the land, relieved of its burden of the unfavorable lease, would appreciate and at the

⁶For the methods of computing depreciation allowance compare Treas. Reg. § 1.167(b)-0 (1960), as amended, T.D. 6500; Treas. Regs. §§ 1.167(b)-1 to (b)-4.

⁷INT. REV. CODE OF 1954, §§ 1011, 1016.

⁸Instant case at 621.

⁹First Nat'l Bank v. Nee, 190 F.2d 61 (8th Cir. 1951); Goelt v. United States, 266 F.2d 881 (2d Cir. 1959), *affirming* 161 F. Supp. 305 (S.D.N.Y. 1958); Schubert v. Comm'r, 286 F.2d 573 (4th Cir.), *cert. denied* 366 U.S. 960 (1961), *affirming* 33 T.C. 1043 (1960); Friend v. Comm'r, 119 F.2d 959 (7th Cir.) *cert. denied* 314 U.S. 673 (1941), *affirming* 40 B.T.A. 768 (1939).

¹⁰When a lease is an incident to the lessor's fee ownership of the land, its value and the value of the land are combined to determine the basis of the land. Both are non-depreciable. See, e.g., Martha R. Peters, 4 T.C. 1236 (1945); Milton H. Friend, 40 B.T.A. 768 (1939); Comm'r v. Pearson, 188 F.2d 72 (5th Cir.), *cert. denied* 342 U.S. 861 (1951), *reversing* 13 T.C. 851 (1949). An exception to these cases is Comm'r v. Moore, 207 F.2d 265 (9th Cir. 1953), *cert. denied* 347 U.S. 942 (1954), *reversing with directions* 15 T.C. 906 (1950), wherein the court allowed the lease to be depreciated.

¹¹Rubin, *Depreciation of Property Purchased Subject to a Lease*, 65 HARV. L. REV. 1134.

¹²See, e.g., Mary Young Moore, 15 T.C. 906, 910 (1950); Milton H. Friend, 40 B.T.A. 768, 771 (1939) (advantageously leased); Martha R. Peters, 4 T.C. 1236, 1240 (1945) (advantageously leased).

¹³See, e.g., First Nat'l Bank v. Nee, *supra* note 9; Comm'r v. Pearson, *supra* note 10.

¹⁴Rubin, *supra* note 11, at 1140.

¹⁵Comm'r v. Moore, *supra* note 10; Friend v. Comm'r, *supra* note 9.

¹⁶See *supra* note 4. The court in Comm'r v. Moore, *supra* note 10, did not allow the building to be depreciated because the term of the lease extended beyond the useful life of the building. It reasoned that there could be no depreciation because taxpayer did not acquire anything of value upon termination of the lease. It must be noted that the instant case also involved a lease whose term extended beyond the useful life of the building.

expiration of the lease the land would have a basis less than its true fair market value. To avoid this result, the courts have departed from the Internal Revenue Code and have held that the basis of property burdened by an unfavorable lease is not its fair market value when acquired by the taxpayer but its fair market value when leased by the decedent, taxpayer's predecessor in interest.¹⁷ The courts reason that the land when leased by the taxpayer's decedent was unimproved and its fair market value represented the value of (1) the land and (2) the lease which is considered to be incident to the fee of the land. Both of these assets are non-depreciable. Since the taxpayer can acquire no interest greater than that possessed by his decedent and inasmuch as his decedent had no depreciable interest in the property, the taxpayer can acquire no depreciable interest.¹⁸ Hence, the building is not allowed to be depreciated in the unfavorable lease situation but, as was previously noted, is allowed to be depreciated when the lease is favorable.

In the instant case the court relied upon the reasoning of *Millinery Center Building Corporation v. Commissioner*¹⁹ where a building was constructed upon land by the taxpayer-lessee in accordance with a lease which contained an option to renew. The lease also provided that upon its termination title to the building would pass to the lessor. During the life of the lease taxpayer fully depreciated the cost of the building. On his option to renew taxpayer purchased the fee in the property, including the building, and sought to deduct depreciation for the building based on the difference between his purchase price and the value of the land if it were unimproved. The Tax Court disallowed the deductions, six judges dissenting.²⁰ On appeal, the U.S. Court of Appeals reversed,²¹ reasoning that since a third-party purchaser of such a fee would be entitled to allocate, for depreciation purposes, part of its cost to the building, depreciation should be allowed in this case.²² The Supreme Court, on certiorari, affirmed.²³

Likewise in the instant case the court held that the total basis of the property was its cost to the taxpayer and allocated a portion of this basis to the land and the remainder to the building.²⁴ Based upon these allocations, the court held that depreciation for the building is allowable.²⁵ The court considered the cases in which ownership was acquired by inheritance and noted that in one of them, *Commissioner v. Moore*,²⁶ a taxpayer-devisee was allowed to depreciate a favorable lease. Although the court in the instant case was apparently confronted with an ordinary and not a favor-

¹⁷See *supra* note 13.

¹⁸First Nat'l Bank v. Nee, 190 F.2d 61, 67 (8th Cir. 1951); *Comm'r v. Pearson*, 188 F.2d 72, 74 (5th Cir. 1951). In the latter case the court recognized that the lessor's basis is not determinative of the taxpayer's basis and that this is the general view but, because of the unfavorable lease, held that the basis was the value to the lessor.

¹⁹221 F.2d 322 (2d Cir. 1955), *cert. granted* 350 U.S. 456 (1956), *reversing* 21 T.C. 817 (1954).

²⁰21 T.C. 817 (1954).

²¹221 F.2d 322 (2d Cir. 1955).

²²*Id.* at 324.

²³350 U.S. 456 (1956).

²⁴Instant case at 617.

²⁵*Ibid.* See *supra* note 4.

²⁶See *supra* note 10.

able lease,²⁷ its seeming approval of the *Moore* case, with respect to the lease, may indicate that it would have allowed taxpayer to depreciate the lease had it been favorable.²⁸

The court also held that the fair market value of the property when leased by taxpayer's predecessor in interest is not determinative of the right to depreciate²⁹ and thereby rejected the reasoning of the unfavorable lease cases. Taxpayer was concerned only with the depreciation that he would suffer from his investment in an asset which would decrease in value,³⁰ and the fact that his predecessor in interest had not invested in the building was immaterial.

The position of the court in the instant case is entirely consistent with the depreciation statutes of the Code³¹ and comparable sections of the Regulations.³² The fair market value of the property at the time of acquisition determines the basis of property acquired by inheritance or devise.³³ The taxpayer's cost determines the basis of property acquired by purchase.³⁴ The values assigned to the property when it is acquired are relevant only in determining basis and are thereafter immaterial.³⁵ A building is given a basis when it is acquired which may be depreciated without consideration of its value to the taxpayer after the expiration of its useful life.³⁶ Therefore, the fact that the lease term is longer than the useful life of the building and that theoretically taxpayer would suffer no loss if the building were constructed by another is immaterial. Since the basis is determined only by the value of the property acquired by the taxpayer, any consideration of the grantor's basis is also immaterial.³⁷

It is submitted that the instant case suggests that a consistent rationale can be developed in the leased property cases only if the courts will recognize that (1) the purpose of depreciation is to allow the taxpayer tax-free recovery of his cost and (2) that leases, favorable or unfavorable, do exhaust themselves over a period of time and, therefore, should be depre-

²⁷Instant case at 616. The lease provided for rentals which were to increase through the years.

²⁸"Moore demonstrates, however, that one circuit has afforded relief to a taxpayer who found himself with a newly acquired interest in property [speaking of the favorable lease] with a newly acquired basis which had no rational relationship to land value alone. . . . [T]here is an alternative argument [speaking again of Moore and of the depreciation of the favorable lease] which has borne fruit in at least one circuit." Instant case at 620-21.

²⁹"The taxpayer-purchaser by his purchase of the property has made an investment. He is not concerned with the identity, as between his vendor-lessor and the tenant, of the builder of the building." Instant case at 621.

³⁰*Ibid.* Compare instant case at 622-23, where the court recognized that the lessee was depreciating his cost of the building but found no anomaly in allowing taxpayer to also depreciate his interest in the asset. Both had made an investment in the asset which could be depreciated.

³¹See *supra* notes 4 and 5.

³²Treas. Reg. § 1.167 (1960); see *supra* note 6.

³³See *supra* note 5.

³⁴*Ibid.*

³⁵Rubin, *supra* note 11, at 1142.

³⁶*Ibid.*

³⁷See *supra* note 5. The statute defines basis only in its relation to the present taxpayer.

cial as intangible assets.⁸⁶ Only when the courts adopt this rationale will they reach results which will conform to the Internal Revenue Code and to economic reality.

HARRY A. HAINES

SCIENTER REQUIRED IN POST OFFICE CENSORSHIP PROCEEDING UNDER 18 U.S.C. § 1461.—Three publishing corporations, having a common president, brought suit in the United States District Court for the District of Columbia to enjoin a nonmailability order of the Postmaster General of the United States against certain of their magazines. The magazines, entitled *MANual*, *Trim*, and *Grecian Guild Pictorial*, consist of photographs of nude or semi-nude males, and advertisements by independent photographers offering photographs of male nudes for sale. The District Court denied injunctive relief and sustained nonmailability on the grounds that the magazines are obscene in themselves and that they contain information of where obscenity may be obtained. The Circuit Court of Appeals affirmed.¹ On certiorari to the Supreme Court of the United States, *held*, reversed. Mr. Justice Harlan, in announcing the judgment of the court, was of the view that the magazines do not affront the current community standards of decency and, hence, are not obscene in themselves. Secondly, without a showing of scienter on the part of the publisher the magazines cannot be removed from the mails on the grounds that they contain information of where obscenity may be obtained. Mr. Justice Stewart concurred. Mr. Chief Justice Warren, Mr. Justice Brennan, and Mr. Justice Douglas concurred in the reversal, but based their opinion on the ground that the Postmaster General has no legal authority to make nonmailability determinations under 18 U.S.C. § 1461 (1955). (Mr. Justice Black concurred in the result writing no opinion, and Mr. Justice Frankfurter and Mr. Justice White took no part in the decision. Mr. Justice Clark dissented against both of the separate majority opinions on the ground that the Postmaster General has authority to make nonmailability determinations under 18 U.S.C. § 1461 (1955), and further, that scienter is an immaterial element. *Manual Enterprises, Inc. v. Day*, 82 Sup. Ct. 1432 (1962).

The divergence of opinion among the justices makes it difficult to interpret the impact of the decision. Although the concept of a prior restraint seems crucial, it is not explicitly considered in any of the opinions. What can the Court be expected to do regarding future Post Office De-

⁸⁶Although all leases theoretically constitute depreciable assets, only the favorable lease could be depreciated because the rents received from it are greater than could currently be obtained on the same property. This excess value would exhaust itself whereas in the unfavorable and ordinary lease situations there would be no excess value to depreciate. Treas. Reg. § 1.167(a)-3 (1960): "Intangibles. If an intangible asset is known from experience or other facts to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance." Compare *Comm'r v. Moore*, 207 F.2d 285, 274, 276 (9th Cir. 1953).

¹*Manual Enterprises, Inc. v. Day*, 289 F.2d 455 (D.C. Cir. 1961).