7 T.C. 1061 (1946)

A lessor who contributes to the cost of a building erected by a lessee on the leased property is entitled to a depreciation deduction on that capital investment over the building's useful life, provided the lessee is not obligated to restore the building's value at the lease's termination.

Summary

Revere Land Company, as lessor, entered into a ground lease requiring the lessee to erect a building costing at least $3,000,000, with Revere contributing $1,026,227.50. The lessee was not required to repay this contribution, only to maintain the building. The lease term exceeded the building's useful life. The Tax Court held that Revere had a capital investment in the building equal to its contribution and was entitled to depreciation deductions over the building's useful life. This decision distinguishes situations where a lessor has no such investment or where the lessee is obligated to maintain the property's value.

Facts

Revere Land Company (lessor) acquired three parcels of land in Pittsburgh. Revere agreed to lease the land to Strasswill Corporation, who assigned the rights to Grant Building, Inc. (lessee), contingent on the lessee constructing an office and garage building costing at least $3,000,000. Revere was obligated to contribute $1,030,877.95 towards the building's construction. The lease required the lessee to pay taxes and insurance, replace the building if destroyed, and maintain the building in good repair. Upon termination, the lessee was to return the land with the structures. Revere contributed $1,026,227.50 towards the building's cost. The building had a useful life of 50 years, shorter than the lease term.

Procedural History

The Commissioner of Internal Revenue disallowed Revere's depreciation deductions related to its contribution towards the building's cost. Revere contested this disallowance, arguing it was entitled to depreciation on its capital investment. The Tax Court reviewed the Commissioner's determination.

Issue(s)

Whether the lessor, having contributed to the cost of a building erected by the lessee on its land, is entitled to a depreciation deduction on that contribution over the useful life of the building.

Holding

Yes, because the lessor made a capital investment in the building, and the lessee was not obligated to restore the building's value at the lease's termination, allowing

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the lessor to deduct depreciation expenses.

Court's Reasoning

The court reasoned that, unlike situations where a lessee constructs improvements at its own expense, Revere made a direct capital investment in the building. This investment would not be returned unless through depreciation deductions since the lease term exceeded the building's useful life, and the lessee's obligation to maintain the building did not equate to an obligation to restore its value. The court rejected the Commissioner's argument that Revere's payment was merely additional cost for the land, finding the land acquisition and the building contribution were distinct transactions. The court distinguished cases where the lessee is obligated to return the property in the same condition, which would preclude the lessor's depreciation deduction. Here, the lease only required the lessee to "keep in good order and repair," which would not prevent depreciation or obsolescence. The court also dismissed the argument that the lessee's option to replace obsolete buildings ensured against loss, emphasizing that it was merely an option, not an obligation. The Court cited *Wilhelm v. Commissioner* to support their position.

Practical Implications

This case clarifies that a lessor making a capital contribution to a lessee's building project can claim depreciation deductions, provided the lessee is not obligated to restore the building's value at the end of the lease. When drafting leases involving lessor contributions, the lease should explicitly state whether the lessee has an obligation to compensate the lessor for depreciation. If the lessee bears the risk of depreciation, the lessor cannot take depreciation deductions. This ruling impacts tax planning for real estate transactions, influencing how lessors structure lease agreements to maximize potential tax benefits. Subsequent cases distinguish *Revere Land Co.* by focusing on the specific language of lease agreements regarding the lessee's obligations to maintain or restore the property's value.

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