***Warren v. Commissioner*, 22 T.C. 136 (1954)**

Mortgage amortization payments made by a lessee on behalf of the lessor are considered rental income to the lessor, regardless of whether the lessor is personally liable on the mortgage.

Summary

In *Warren v. Commissioner*, the Tax Court addressed whether mortgage amortization payments made by a lessee directly to the mortgagee should be considered ordinary income to the lessor. The court held that such payments, which were part of the consideration for the lease, constituted rental income to the lessor, even though the lessor was not personally obligated on the mortgages. This decision emphasized that the substance of the transaction, where the lessee effectively paid the lessor's obligations, controlled over the form. The court found that the lessor benefited from the increased equity in the property due to the amortization payments, thereby realizing income.

Facts

The petitioner, Warren, owned a 50% interest in an apartment hotel, subject to a long-term lease. Under the lease agreement, the lessee was required to pay cash rentals and also to make payments towards the amortization of two substantial mortgages on the hotel property. In 1944, the lessee paid approximately $29,385 to the Greenwich Savings Bank for mortgage amortization. The lease specifically stated that these amortization payments were considered "additional rent." The value of the property always exceeded the mortgage amount.

Procedural History

The Commissioner of Internal Revenue included Warren's portion of the amortization payments as part of her taxable income for 1944. Warren challenged this in the Tax Court, arguing that the payments should not be considered as income. The Tax Court sided with the Commissioner, leading to this appeal.

Issue(s)

Whether mortgage amortization payments made by a lessee directly to the mortgagee on property owned by the lessor constitute taxable income to the lessor, even if the lessor is not personally liable for the mortgage.

Holding

Yes, the court held that the mortgage amortization payments made by the lessee were indeed taxable income to Warren because they were considered rental income.

Court's Reasoning

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The court's reasoning hinged on the economic substance of the transaction. The court cited *Crane v. Commissioner*, emphasizing that an owner must treat mortgage obligations as personal, and that the lease clearly indicated that the executors of the estate, acting on behalf of the petitioner, were treating the mortgages as obligations of the estate. The court reasoned that the lessee's payments discharged an obligation of the lessor, increasing the lessor's equity in the property. It determined that the amortization payments represented a form of rental income, regardless of the fact that the lessor did not directly receive the funds. The court highlighted that the lease specifically defined these payments as "additional rent," which further supported its conclusion.

The court referred to the U.S. District Court case of *Wentz v. Gentsch*, which held that similar amortization payments are taxable income to the lessor. The court found that the lack of personal obligation of the lessee did not warrant a different result. The court held that a lessor should not be allowed to avoid tax liability by having the lessee divert rental payments to a third party. The court noted, "…a lessor may not avoid or even postpone his tax liability by the expedient of requiring the lessee to divert a portion of the rental payments to amortization of mortgages on the leased premises…"

Practical Implications

This case has several important practical implications for tax planning in real estate transactions. First, it underscores the importance of looking beyond the form of a transaction to its economic substance. Attorneys should advise clients that structures that aim to divert income to third parties without tax consequences will be closely scrutinized. Second, it reinforces the principle that payments made by a lessee on behalf of a lessor, which satisfy the lessor's obligations, are likely to be treated as income to the lessor. Lawyers must consider the tax implications of lease provisions that require lessees to make payments to third parties on behalf of lessors.

Third, this case suggests that even if a lessor is not personally liable on a mortgage, the amortization payments made by the lessee will still be considered part of the income of the lessor. Finally, the holding in this case continues to be applied in similar cases today.

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