T.C. Memo. 1958-2

Improvements made by a lessee to a lessor's property are not considered taxable income to the lessor, either at the time of construction or upon lease termination, unless such improvements are intended to constitute rent.

Summary

In this case, the Tax Court addressed whether improvements made by American Manufacturing Company (lessee) on property owned by Grace H. Cunningham (lessor) constituted taxable income for Cunningham. Cunningham leased property to her company, which made significant improvements. The lease stipulated no cash rent, but the improvements would revert to Cunningham at lease end. The IRS argued the improvements were income to Cunningham either in the year of construction or at lease termination. The court held that based on the intent of the parties, the improvements were not intended as rent and thus not taxable income to Cunningham in either year.

Facts

Grace H. Cunningham owned lots adjacent to American Manufacturing Company, Inc., a company she substantially owned and managed. In 1946, Cunningham leased lots 8-12 to American Manufacturing for six years. The written lease stated the consideration was the lessee paying property taxes and transferring ownership of a building constructed by the lessee on the property at the lease's end. American Manufacturing constructed improvements valued at approximately $21,904.33 during the lease term. The company capitalized these costs and took depreciation deductions. No cash rent was paid during the lease term, and both parties indicated the improvements were not intended as rent but to provide necessary business space for the company.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Grace H. Cunningham's income tax for 1946 and 1952, arguing that the value of the lessee-constructed improvements constituted taxable income to her as the lessor. Cunningham contested this determination in Tax Court.

Issue(s)

1. Whether improvements constructed by a lessee on a lessor's property during the lease term constitute taxable income to the lessor in the year of construction.
2. Whether the value of improvements reverting to the lessor upon termination of the lease constitutes taxable income to the lessor at the time of lease termination.
3. Whether, in either case, the improvements should be considered rent.

Holding

1. No, improvements constructed by a lessee do not automatically constitute taxable income to the lessor in the year of construction.
2. No, the value of improvements reverting to the lessor at lease termination does not automatically constitute taxable income at that time.
3. No, in this case, the improvements were not intended as rent because the parties' intent and surrounding circumstances indicated the improvements were for the lessee's business needs and not a substitute for rental payments.

Court's Reasoning

The court reviewed relevant tax code sections and case law, including *M. E. Blatt Co. v. United States* and *Helvering v. Bruun*. It emphasized that while *Bruun* initially suggested lessor income upon lease termination due to lessee improvements, subsequent legislation (Section 22(b)(11) of the 1939 Code) and regulations modified this, excluding such income unless it represents rent. Citing *Blatt*, the court stressed that lessee improvements are not deemed rent unless the intention for them to be rent is plainly disclosed. The court found that despite lease language mentioning transfer of the building as consideration, the contemporaneous minutes and testimony revealed the parties' intent was for no rent to be paid. The lessee treated the improvements as capital expenditures, not rent. The lessor testified the improvements were specialized for the company's needs and not intended as rent. The court concluded, "We are satisfied from this testimony and from the acts of the parties to the lease that they did not intend that the value of the improvements should constitute rent either at the time of construction or at the termination of the lease."

Practical Implications

Cunningham v. Commissioner highlights the critical role of intent in determining whether lessee improvements constitute taxable income for the lessor. It underscores that not all benefits a lessor receives from lessee improvements are automatically taxed. Legal professionals should carefully analyze lease agreements and surrounding circumstances to ascertain the true intent of the parties regarding improvements. If improvements are clearly intended as rent, they will be taxable income. However, if improvements serve the lessee's business needs and are not a substitute for rent, they may be excluded from the lessor's gross income, especially under the exception provided by Section 22(b)(11) and its successors. This case provides a practical example of how the "intent" standard is applied in tax law and emphasizes the importance of documenting the parties' intentions clearly in lease agreements and related corporate records.

