

Alstores Realty Corporation v. Commissioner
46 T.C. 363 (1966)

Hoyt, Judge.

Respondent determined a deficiency in income tax against petitioner in the amount of \$120,429.60 for petitioner's taxable year ended January 31, 1958. Respondent's disallowance of a portion of petitioner's claimed deduction for accrued taxes has not been challenged. Hence, the only issues remaining for decision are: (1) Whether petitioner realized \$253,090.75 of rent income as a result of a transaction in which it purchased a warehouse property for \$750,000 cash plus a simultaneous agreement to permit the seller to retain occupancy of a portion of the building rent free for 2 1/2 years, and (2) if petitioner did realize rent income as determined by respondent, is it entitled to increase its cost basis in the property by the amount so realized, and accordingly increase its annual depreciation of the building?

FINDINGS OF FACT

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Steinway's original asking price for the subject premises was \$1,250,000; this was later lowered to \$1 million. However, because Steinway at the time of these negotiations was not yet prepared to remove its manufacturing operations from the subject building, it would not at that time have agreed to a sale unless an arrangement could be made permitting it to retain possession of a portion of the building until its new plant would be ready for occupancy. Eventually, in 1956, the parties agreed to a transaction under which petitioner (Alstores) would pay \$750,000 cash for title to the building and Steinway would retain occupancy of a portion of the building for 2 1/2 years from the date of conveyance, without further payment of rent.

After this arrangement had been agreed upon, Steinway's attorney prepared a single written document to effectuate the contract. This document provided for sale of the subject premises with a contemporaneous lease of portions of the premises by the purchaser back to Steinway. The petitioner's attorney, however, requested that the single contract be split into two separate contracts.

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ULTIMATE FINDINGS OF FACT

The fair market value as of February 1, 1957, of Steinway's rights of occupancy under the space-occupancy agreement was \$253,090.75. The fair market value of the subject premises on February 1, 1957, was \$1,003,090.75, and petitioner's cost basis in the property was \$1,003,090.75, the total purchase price paid when the cash consideration of \$750,000 is added to the fair market value of the leaseback to Steinway. Petitioner received rental income of \$253,090.75 on February 1, 1957, when the transaction was closed and the subject property was deeded to it by Steinway & Sons.

OPINION

It is respondent's contention that petitioner realized taxable rent income as a result of the transaction described in our findings. Petitioner contends simply that Steinway's occupancy was expressly made

rent free and that petitioner never received any rent payments from Steinway for occupancy of the subject premises in the taxable year in question or any other year.

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There are two approaches to analyzing the transaction here involved. One approach is to say that there was a purchase by petitioner of the entire fee interest in the subject premises and at the same time a lease of a portion of the premises back to the seller for a 2 1/2-year term. This is the approach taken by the respondent herein.

Petitioner contends that even if the space-occupancy agreement should be regarded as a lease, there was, nonetheless, no income produced to the "lessor" since the "lease" was rent free. While it may be true that no rent was due or to be paid after Steinway's occupancy was to begin as petitioner's tenant, the agreement of the parties recognizes that it was because prepayment had been made by Steinway....

The alternative analysis of the situation looks to the substance of the transaction. Petitioner here argues that, although in form there may have been a sale and leaseback, in substance there was a conveyance of a future interest with Steinway reserving to itself, or carving out, a term of 2 1/2 years in a portion of the property. Hence, Steinway in substance retained its right to occupancy not as a lessee of petitioner, but as a legal owner of a reserved term for years....

Although at first blush petitioner's argument is an appealing one, we conclude that it must be rejected.... Steinway did not in form or substance reserve an estate for years.

An analogous situation was presented in *McCulley Ashlock, 18 T.C. 405 (1952)*. There the building in question was subject to a lease to a third party at the time it was purchased by the taxpayer. The contract of sale provided that the buyer would pay \$40,000 cash but the seller was to retain "possession" of the premises and all the rights to the rental income from the lessee until the expiration of the primary term of the existing lease (about 28 months from date of the sale contract). The Commissioner determined that the rent received by the seller subsequent to conveyance of title to the taxpayer purchaser was really taxable income to the taxpayer purchaser. We rejected the Commissioner's approach in that case, holding that the seller had reserved an ownership interest in the property (an estate for years) and that the rents received were income to the seller for occupancy of what was still his property -- not income to the purchaser, who did not then have a present legal ownership interest but only a future interest. The essence of our reasoning in the *Ashlock* case was as follows (pp. 411-412).

Here, the trustees [the sellers of the property] not only retained the rents legally but they also retained control and benefits of ownership. Under the contract of sale on April 18, 1945, the trustees specifically agreed to pay property taxes, insurance premiums, and "all normal maintenance items and expenses," so that the property would be delivered to . . . [the buyer] in the present condition except for normal wear and tear. Furthermore, the June 11, 1945, agreement stated that in the event that the property was damaged or destroyed, and loss of income during the period of repair or reconstruction would be the trustees' loss. It further provided that insurance proceeds would be devoted to restore and repair the property, except in the event of total destruction petitioner would have the option of rebuilding the premises or compensating the trustees for unpaid rent. Thus the trustee bore the risks of ownership of the rents and managed the property. Larger expenses or a cessation of rents were risks incurred by the trustees....

The same factors which we looked to in *Ashlock* in deciding in favor of the purchaser, analyzed in the factual posture of the instant case, dictate the opposite result here. Petitioner, the buyer, assumed control of the premises and the benefits of ownership. Petitioner, the buyer, specifically agreed to pay for and supply to Steinway, the seller, heat, electricity, and water. The space-occupancy agreement stated that in the event the property was damaged or destroyed and Steinway's occupancy was thereby destroyed or impaired the burden of loss would be upon petitioner (with petitioner agreeing to pay Steinway 6 1/4 cents per square foot per month for space so affected). It is clear in the instant case that the buyer bore the risks and burdens of ownership during the term of the space-occupancy agreement. . . .

Furthermore, the rights of Steinway, the seller, as occupant were not those of a holder of a legal estate for years but were specifically limited to those of a lessee. The standard terms and conditions of a New York Real Estate Board form lease were imposed. For example, Steinway could not alter or improve the building nor sublet or assign its interest without the consent of petitioner.

Of key significance in this case is the fact that petitioner was required to pay to Steinway 6 1/4 cents per square foot per month for space which Steinway was entitled to occupy but which it may have been unable to occupy by reason of an act of God or the fault of petitioner, or which it may have elected to vacate during the last one-half year of the space occupancy agreement. This arrangement is entirely inconsistent with the theory that Steinway had a reserved estate for years; why would petitioner, the alleged remainderman, be required to make payments to Steinway, the alleged owner of an estate for years, as a result of nonoccupancy by the latter? What we really have here is a provision for reimbursement of prepaid rent in the event the tenant is denied (or, during the last one-half year of the term, elects abandonment of) its right of unfettered occupancy, the prepaid rent being in the form of the value of the property received by petitioner in excess of the \$750,000 cash paid therefor.

Petitioner emphasizes the fact that it received no cash rental payments at any time; it merely purchased real estate for cash. This is partly true, but one need not receive cash to have received income. . . .

Possibly the result in the instant case would be different if the parties had in fact *intended* to carve out a reserved term for years in Steinway and had structured their transaction in that form. We do not agree with petitioner, however, that to hold that there was a sale of the fee and a simultaneous leaseback here is to exalt form over substance. The so-called space-occupancy agreement placed the two parties' rights, obligations, and risks as they would be allocated in a typical lease arrangement. Hence, the arrangement was a lease in substance as well as in form.

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