

## TAX TREATMENT OF REDEEMABLE GROUND RENTS

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Mr. BYRD of Virginia, from the Committee on Finance, submitted the following

### REPORT

[To accompany H.R. 1597]

The Committee on Finance, to whom was referred the bill (H.R. 1597) to amend the Internal Revenue Code of 1954 to provide a deduction for payment of redeemable ground rents, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

#### I. SUMMARY OF BILL

H.R. 1597, as amended, in effect deals with the tax treatment in Maryland of both the buyer of a home subject to a redeemable ground rent and the person selling this real property subject to the redeemable ground rent. For the home buyer the ground rent paid is treated as a mortgage interest payment and, therefore, is deductible by him for tax purposes. The seller of the real property subject to the redeemable ground rent is treated as if he had sold the property subject to a mortgage in a face amount equal to the redemption price of the redeemable ground rent. As a result, the redeemable ground rent is taken into account in determining his sale price for the property and, therefore, is reflected in any gain (or loss) recognized to him. Under the bill, as amended, the deduction of the ground rent, as the equivalent of a mortgage interest payment, is available for 1962 and subsequent years. In the case of the seller of the property, however, the new treatment in general applies only in the case of transactions occurring after the date of enactment of the bill.

The Treasury Department has indicated that it favors the enactment of the bill as amended by your committee.

## II. GENERAL STATEMENT

In Maryland private homes have often been sold subject to so-called ground rents. A ground rent is an obligation assumed by the home buyer to pay a fixed amount per year on the property. Under Maryland law, 5 years after the creation of a ground rent any holder of the property may redeem the ground rent by paying an amount computed by capitalizing the rental payment at a 6-percent rate. From 1921 until the decision in the *Welsh* case (cited below) Treasury Department rules and regulations treated ground rents as mortgages in every respect. Accordingly, the annual rents were deductible as interest by the home buyer, and the seller of the home included the redemption price of the ground rent in his sale price in the same manner as the face amount of a purchase money mortgage.<sup>1</sup>

In 1956, the Court of Appeals for the Fourth Circuit held in *Estate of Ralph W. Simmers* (231 F. 2d 909, affirming 23 T.C. 869) that a person retaining a Maryland ground rent is the actual owner of the property (i.e., the lessor) and, therefore, that a builder who sold houses subject to such rents would not have to include the capitalized value of these rents in his sales price to determine gain (or loss) in the manner in which mortgages are included. The same general principle was followed in *Welsh Homes, Inc. v. Commissioner* (32 T.C. 239, affirmed 279 F. 2d 391). The amount of gain not included in current income is somewhat different in the two cases although under both decisions additional gain would be taken into account on redemption of the ground rent.<sup>2</sup>

With these two decisions that the person retaining the ground rent was the owner of the property, the Treasury Department could no longer maintain its position that the payment of the ground rent was deductible interest payment rather than a nondeductible rental payment. Therefore, effective as of January 1, 1962, the Treasury Department changed its regulations to conform with the principles of the two court cases, both as to the home buyer and as to the seller.

Your committee believes, without regard to the formal legal theory involved, that the result obtained under the court decisions in practice is the wrong result. It sees no reason why the home buyers in Maryland should receive smaller deductions for tax purposes with respect to payments made on their homes than is true of taxpayers elsewhere with respect to similar payments made on their homes.

<sup>1</sup> The Treasury position is apparent from G.C.M. 2042; O.B. VI-2, 182 (1921); and I.T. 2879, O.B. XII-1, 103 (1933).

<sup>2</sup> Assume a purchaser pays \$12,000 for a home subject to an annual ground rent of \$120. Capitalizing this at 6 percent indicates a value for the ground rent of \$2,000. Thus, the total value of the property is \$14,000. Assume the land cost \$500 and the house \$10,000, a total cost of \$10,500. The gain on the transaction under the two cases and under the bills is as follows:

	Cost or basis	Sale price	Gain
Bill.....	\$10,500	\$14,000	\$3,500
<i>Simmers</i> case.....	10,000	12,000	2,000
<i>Welsh</i> case.....	9,000	12,000	3,000

The bill determines the gain as the difference between the total sales price and the total cost or basis. Under the *Simmers* case the gain is computed as the difference between the sales price and the cost or other basis of the house alone. Under the *Welsh* case the sales price is the same as in the *Simmers* case. However under the *Welsh* case the basis of the interest transferred bears the same ratio to the total basis of the house and land as the sales price bears to the sum of the redemption price of the ground rent plus such sales price.

On the other hand, there also appears to be no justification in permitting the seller of the property in these cases to reduce the gain at the time of his sale below that which would be realized in other States merely by making use of the redeemable ground rent device available in Maryland, rather than a purchase money mortgage which generally would be used in most other States to achieve substantially the same results.

In view of these considerations, your committee's bill, as amended, restores the old rules and regulations of the Treasury Department. First, the code is amended to provide that annual or periodic rentals under a redeemable ground rent (except the amounts paid in redemption of this rent) are to be treated as interest paid on a mortgage indebtedness. Second, the special rules of the code dealing with gain or loss on the disposition of property are amended to treat a redeemable ground rent as a mortgage and to provide that real property held subject to liabilities under a ground rent is to be treated as being held subject to liabilities under a mortgage.

The bill provides different effective dates for the deduction of ground rents by home buyers and the determination of the price received by the seller of property. In addition, the bill also provides transition rules to deal with those situations where homes have been sold in earlier years.

First, for the homeowner, ground rents are to be deductible in the case of rents paid or accrued on or after January 1, 1962. This is the same date existing regulations denying such a deduction were to become effective (sec. 1.163-1(b) of the regulations). By making this change, Congress will be assuring the uninterrupted continuation of the allowance of ground rent as a deduction.

Second, the basis adjustments, made to treat the capitalized value of ground rents in the same manner as mortgages, in general are effective on the day after the date of enactment of this bill. After that date, regardless of when the property was acquired, both in determining the basis and sales price of property held subject to a ground rent, the capitalized value of the ground rent is to be taken into account in the same manner as a mortgage. Thus, the sales price would be increased by such an amount and the basis of the property would be increased by this amount if the property was transferred subject to a ground rental.

Third, rules are provided for the builder or other person who before the date of enactment of this section sold real property retaining a redeemable ground rent, for determining the basis of the redeemable ground rent itself when it, after the date of enactment, is sold or redeemed. If he took the redeemable ground rent into account for tax purposes in the past in determining his sales price for the real property, then there will be included in the basis of the ground rent in his hands this same amount in the case of a subsequent redemption or sale. If he did not in the past take the redeemable ground rent into account for tax purposes in determining the sales price of the property, then he may not take this value into account as part of the basis of the redeemable ground rent when it is sold or redeemed.

Your committee's amendments changed the bill, as passed by the House, so that it will add to the Internal Revenue Code a new section 1055(c) which will define a redeemable ground rent. Your committee feels that this definition will make the effect of the bill considerably clearer.

The "redeemable ground rents" which constitute the arrangements to which the term as used in the bill refers, are agreements in the form of freely assignable leases, as to which there is a statutory right to redeem upon payment of the capitalized value of the rentals reserved in the agreement at a rate not in excess of that fixed by statute. These leases are usually renewable and are for very long terms. In Maryland, in order to have a statutory right of redemption the term (including renewals) must be for at least 15 years and is frequently for 99 years. These arrangements are used primarily as vehicles in the financing of the purchase of real property. An essential characteristic is that in actuality the "tenant" has the equivalence of fee simple ownership in the land, and the "landlord" has only a security interest in the property to protect the rental payments to which he is entitled. The landlord does not have the usual liabilities of a landowner for taxes on the property, nor in tort. Upon ejection of the "tenant" for nonpayment of the ground rent, the "tenant" has certain rights to redeem his property by curing his default within a limited period of time (similar to the remedy of a mortgagor with an equity of redemption).

The term "redeemable ground rent," as used in the bill, refers to an arrangement in the form of an assignable lease as to which a right to redeem upon payment of a determined or determinable amount exists by virtue of State or local law and not because of any private agreement or privately created condition. Thus, the bill does not alter the existing law applicable to a lease joined with an option to purchase. Accordingly, in any case in which the "tenant" has a right to extinguish the reversionary interest, which right was created by action of the landowner, this arrangement will be treated as a true lease or as a mortgage, as the case may be, in the same manner as if this bill had not been enacted. This will, of course, also be true even if the right to extinguish the reversionary interest was originally created by an earlier landlord for the benefit of a former "tenant."

Of course redeemable ground rents not of the type referred to by the bill, but which are still the substantial equivalent of mortgages bearing interest and to which the *Simmers* and *Welsh Homes* decisions do not apply, would continue to be treated in accordance with current Treasury practice. For example, there would be no change in the treatment of Pennsylvania redeemable ground rents created as separate charges at the same time as the owner of the real property conveyed a fee simple estate.

### III. DETAILED EXPLANATION OF THE BILL

Subsection (a) of the first section of the bill, as reported, amends section 163 of the Internal Revenue Code of 1954 (relating to deduction for interest) to provide that the annual or periodic rental payments under a redeemable ground rent is to be treated as interest on an indebtedness secured by a mortgage. This does not apply to amounts paid in redemption of the ground rent.

Thus, it will be clear that a homeowner will be able to deduct rental payments as interest in the same manner as has been done from 1921 through 1961 under the Treasury practice. Also, ground rent payments will be treated as interest for all other purposes of the income tax. Thus, for example, it will be clear that ground rents are not to

be treated as "rents" for purposes of the first sentence of section 543(a)(7) of the Internal Revenue Code of 1954 (relating to personal holding company income). However, these payments will be treated as rents for purposes of that subsection to the same extent as ordinary mortgage interest is so treated in the special case described therein (interest payments on purchase money mortgages received by a corporation selling real property held primarily for sale to customers in the ordinary course of business). Accordingly if a corporation is owned by two individuals and is not engaged in the building business, it is a personal holding company if 80 percent of its gross income is from ground rents. On the other hand, if a corporation is engaged in the building business and sells houses, reporting the gain from such sales as ordinary gain, the interest produced by the ground rents reserved on the sale of such houses is treated as rent income, so that even if 80 percent of its gross income is from this source, it is not a personal holding company.

Subsection (b) of the first section of the bill inserts a new section 1055, in the Internal Revenue Code of 1954 (old sec. 1055 being renumbered as sec. 1056). Subsection (a) of this new section provides that a redeemable ground rent is to be treated as being in the nature of a mortgage and that real property held subject to liabilities under a ground rent is to be treated as being held subject to a mortgage. Thus, under this section it will be clear that the transfer of property subject to a redeemable ground rent has the same effect as the transfer of property subject to a mortgage; that the acquisition of property subject to a redeemable ground rent is to be treated the same as the acquisition of property subject to a mortgage, and that the holding of property subject to a redeemable ground rent is to be treated in the same manner as the holding of property subject to a mortgage.

Paragraph (1) of subsection (b) of new section 1055 provides that subsection (a) shall take effect on the day after the date of enactment of this section and shall apply with respect to taxable years ending after such date of enactment.

Paragraph (2) of subsection (b) of new section 1055 provides that in determining the basis of real property held subject to a redeemable ground rent subsection (a) is to apply whether the real property was acquired before or after the enactment of this section. In other words, if a homeowner paid \$10,000 in cash for a house subject to a ground rent redeemable for \$2,000, his basis for the house is \$12,000 whether he acquired it before or after the date of enactment of the bill. Similarly, if on the date of the enactment of the bill property is owned with a carryover basis (because of a tax-free transaction), the basis of the present owner's predecessor in interest is to be determined by treating a redeemable ground rent as a mortgage. Thus, for example, if in 1962 a corporation acquired a house subject to a redeemable ground rent in a transfer to which section 351 applied, the basis of the transferor of the property is to be determined by treating any redeemable ground rent to which it was subject in such transferor's hands as a mortgage.

Paragraph (3) of subsection (b) of new section 1055 provides transitional rules for persons who reserved or created a ground rent on or before the date of enactment of the bill. Under these rules, a person who transferred the right to hold real property reserving a redeemable ground rent and who did not take the ground rent into account for

income tax purposes at the time of the transfer, will not have any greater basis than his cost for such ground rent.

This may be illustrated by some simple examples. Assume in all cases that a builder purchased land for \$500 and erected a house thereon for \$10,000. Thereafter he sold the house for \$12,000, reserving a ground rent redeemable for \$2,000 (\$120 a year)—

(1) In the first case, the builder reported a \$2,000 gain on the sale of the house, treating the sale price as \$12,000 and his cost as \$10,000. Since the builder did not take the ground rent into account at all on the prior sale of property, his basis for the ground rent is not more than \$500 (the cost of the land not offset against the sale price of the house). Thus, if he sells the ground rent for \$2,000, he has a gain of \$1,500.

(2) In the second case, the builder reported a gain of \$3,000 on the sale of the house, treating the sale price received by him as \$12,000 but treating his cost allocable to the house and leasehold as  $12,000/14,000$ ths of his total \$10,500 cost, or \$9,000. In the case of this builder, since he still has remaining \$1,500 of unallocated cost, his basis for the ground rent is \$1,500. Thus, if he sells it for \$2,000, his gain is \$500.

(3) In the third case, the builder reported \$3,500 gain. He obtained this result by treating his receipts on the sale as \$14,000 (\$12,000 cash plus a ground rent redeemable for \$2,000), and computing his costs as \$10,000 for the house and \$500 for the land. Since this builder took the entire amount of the ground rent into account in computing his gain, his basis for the ground rent is \$2,000. Thus, if he sells the ground rent for \$2,000, he has no gain and no loss on the transaction.

Subsection (c) of the new code section 1055 sets forth a definition of a redeemable ground rent. Under this definition, a redeemable ground rent is a ground rent payable under a lease assignable by the lessee without the consent of the lessor which (including possible renewal periods) is for a term in excess of 15 years. The definition also provides that the leaseholder must have a present or future right to acquire the entire interest of the lessor by payment of a determined or determinable amount and that this right must exist by virtue of State or local law and not because of any private agreement or any privately created condition. Finally, the definition provides that the lessor's interest must be primarily a security interest to protect the rental payments to which he is entitled.

Subsection (d) of the new code section 1055 adds a cross-reference to section 163(c) relating to treatment of rentals under redeemable ground rents as interest.

Subsection (c) of the first section of the bill adds to section 163 a cross-reference to the new section 1055.

Subsection (d) of the first section of the bill makes a conforming amendment to the table of sections for part IV of subchapter O of chapter 1.

Under section 2 of the bill, the amendments made by subsection (a) of the first section of the bill are to take effect as of January 1, 1962, and are to apply with respect to taxable years ending on or after such date. The amendments made by subsection (b) of the first section of the bill are to take effect on the day after the date of enactment of this bill and are to apply with respect to taxable years ending after such date of enactment.

## IV. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

## INTERNAL REVENUE CODE

## SEC. 163. INTEREST

(a) **GENERAL RULE.**—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(b) **INSTALLMENT PURCHASES WHERE INTEREST CHARGE IS NOT SEPARATELY STATED.**—

(1) **GENERAL RULE.**—If personal property is purchased under a contract—

(A) which provides that payment of part or all of the purchase price is to be made in installments, and

(B) in which carrying charges are separately stated but the interest charge cannot be ascertained,

then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is in the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

(2) **LIMITATION.**—In the case of any contract to which paragraph (1) applies, the amount treated as interest for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

(c) **REDEEMABLE GROUND RENTS.**—*For purposes of this subtitle, any annual or periodic rental under a redeemable ground rent (excluding amounts in redemption thereof) shall be treated as interest on an indebtedness secured by a mortgage.*

[(c)] (d) **CROSS REFERENCES.**—

(1) For disallowance of certain amounts paid in connection with insurance, endowment, or annuity contracts, see section 264.

(2) For disallowance of deduction for interest relating to tax-exempt income, see section 265(2).

(3) For disallowance of deduction for carrying charges chargeable to capital account, see section 266.

(4) For disallowance of interest with respect to transactions between related taxpayers, see section 267.

(5) *For treatment of redeemable ground rents and real property held subject to liabilities under redeemable ground rents, see section 1055.*

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## PART IV—SPECIAL RULES

- Sec. 1051. Property acquired during affiliation.  
 Sec. 1052. Basis established by the Revenue Act of 1932 or 1934 or by the Internal Revenue Code of 1939.  
 Sec. 1053. Property acquired before March 1, 1913.  
 Sec. 1054. Certain stock of Federal National Mortgage Association.  
 Sec. 1055 Redeemable ground rents.  
 Sec. [1055]. 1056. Cross references.

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**SEC. 1055. REDEEMABLE GROUND RENTS.—**

- (a) **CHARACTER.**—*For purposes of this subtitle—*
- (1) *a redeemable ground rent shall be treated as being in the nature of a mortgage, and*
  - (2) *real property held subject to liabilities under a redeemable ground rent shall be treated as held subject to liabilities under a mortgage.*
- (b) **APPLICATION OF SUBSECTION (a).**—
- (1) **IN GENERAL.**—*Subsection (a) shall take effect on the day after the date of the enactment of this section and shall apply with respect to taxable years ending after such date of enactment.*
  - (2) **BASIS OF HOLDER.**—*In determining the basis of real property held subject to liabilities under a redeemable ground rent, subsection (a) shall apply whether such real property was acquired before or after the enactment of this section.*
  - (3) **BASIS OF RESERVED REDEEMABLE GROUND RENT.**—*In the case of a redeemable ground rent reserved or created on or before the date of enactment of this section in connection with a transfer of the right to hold real property subject to liabilities under such ground rent, the basis of such ground rent after such date in the hands of the person who reserved or created the ground rent shall be the amount taken into account in respect of such ground rent for Federal income tax purposes as consideration for the disposition of such real property. If no such amount was taken into account, such basis shall be determined as if this section had not been enacted.*
- (c) **REDEEMABLE GROUND RENT DEFINED.**—*For purposes of this subtitle, the term "redeemable ground rent" means only a ground rent with respect to which—*
- (1) *there is a lease of land which is assignable by the lessee without the consent of the lessor and which (together with periods for which the lease may be renewed at the option of the lessee) is for a term in excess of 15 years;*
  - (2) *the leaseholder has a present or future right to terminate, and to acquire the entire interest of the lessor in the land, by payment of a determined or determinable amount, which right exists by virtue of State or local law and not because of any private agreement or privately created condition, and*
  - (3) *the lessor's interest in the land is primarily a security interest to protect the rental payments to which the lessor is entitled under the lease.*
- (d) **CROSS REFERENCE.**—
- For treatment of rentals under redeemable ground rents as interest, see section 163(c).*



**SEC. [1055] 1056. CROSS REFERENCES.**

(1) For nonrecognition of gain in connection with the transfer of obsolete vessels to the Maritime Administration under section 510 of the Merchant Marine Act, 1936, see subsection (e) of that section, as amended August 4, 1939 (46 U.S.C. 1160).

(2) For recognition of gain or loss in connection with the construction of new vessels, see section 511 of such Act, as amended (46 U.S.C. 1161).

(3) For nonrecognition of gain in connection with vessels exchanged with the Maritime Administration under section 8 of the Merchant Ship Sales Act of 1946, see subsection (a) of that section (50 U.S.C. App. 1741).

