REDEEMABLE GROUND RENTS

HEARING

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

EIGHTY-EIGHTH CONGRESS

FIRST SESSION

ON

H.R. 1597, S. 878

AN ACT RELATING TO THE TAX TREATMENT OF REDEEMABLE GROUND RENTS

MARCH 7, 1963

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STATEMENTS

REDEEMABLE GROUND RENTS

THURSDAY, MARCH 7, 1963

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:25 a.m., in room 2221, New Senate Office Building, Senator Harry F. Byrd (chairman) presiding.

Present: Senators Byrd of Virginia, Douglas, Talmadge, Hartke, Williams of Delaware and Morton.

Also present: Elizabeth B. Springer, chief clerk.

The CHAIRMAN. The committee will come to order.

The hearing this morning, is on the bill, H.R. 1597, relating to the tax treatment of redeemable ground rents.

(The bill and accompanying report are as follows:)

[H.R. 1597, 88th Cong., 1st sess.]

AN ACT Relating to the tax treatment of redeemable ground rents

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 163 of the Internal Revenue Code of 1954 (relating to deduction for interest) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(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."

(b) Part IV of subchapter O of chapter 1 of such Code (relating to special rules for determining gain or loss on disposition of property) is amended by redesignating section 1055 as section 1056 and by inserting after section 1054 the following new section:

"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 the 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) CROSS REFERENCE.—

"For treatment of rentals under redeemable ground rents as interest, see section 163(c)."

(c) Section 163(d) of such Code (as redesignated by subsection (a) of this section) is amended by adding at the end thereof the following new paragraph:

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

(d) The table of sections for part IV of subchapter O of chapter 1 of such Code is amended by striking out

"Sec. 1055. Cross references."

and inserting in lieu thereof the following:

"Sec. 1055. Redeemable ground rents.
"Sec. 1056. Cross references."

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

Passed the House of Representatives February 26, 1963.

Attest:

RALPH R. ROBERTS, *Clerk*.

The CHAIRMAN. The Chair recognizes Senator Beall.

STATEMENT OF HON. J. GLENN BEALL, A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator BEALL. Thank you very much, Mr. Chairman, for letting us come in.

I wish to thank you for scheduling early hearings on the ground rent bills. This is a matter which should be resolved prior to April 15, the last day for filing 1962 tax returns.

I appear to support enactment of S. 878, which I cosponsored with my colleague, Senator Brewster. H.R. 1597, which passed the House, and is also before the committee, was introduced in a form identical to S. 878. The House committee, however, amended the bill prior to passage. I urge this committee to reject the House amendments.

S. 878 states that annual or periodic payments, with respect to a redeemable ground rent, shall be treated, with respect to the payer, as interest. This bill would, in effect, set aside the Treasury Department regulations which would have denied home purchasers the right to deduct ground rent payments.

Two questions are presented by the House bill:

First, How shall we treat, for tax purposes, the buyer of a home subject to a redeemable ground rent? and

Second, How shall we treat the seller of real property subject to redeemable ground rent?

I concur with the reasoning of the House Ways and Means Committee insofar as it applies to home purchasers. That committee, in its report, states as follows:

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.

As to the seller, I believe the House amendment is without legal basis.

The House bill adopts the fiction that the ground rent transaction is a mortgage. Such is not the case. I am even more concerned that the House bill establishes a tax liability where there is no taxable event.

It seems to me that the House amendment rejects the sound legal thinking expressed in the *Simmers & Welsh* cases to impose uniformity on the State of Maryland. With all due respect, I believe this approach is discriminatory.

Mr. Chairman, I shall leave the development of the legal arguments to the representative of the Maryland homebuilders. I should add, however, that I full endorse the position of the Maryland homebuilders.

Mr. Chairman, ground rents have provided a beneficial system to Maryland homebuilders and purchasers for almost 200 years. This system should be preserved. I urge the committee to approve S. 878 without amendment.

The CHAIRMAN. Thank you very much, Senator Beall. We hope we will have you before the committee again soon.

Our next witness is Senator Brewster, of Maryland.

Senator, take a seat. We are very happy to have you with us.

STATEMENT OF SENATOR DANIEL B. BREWSTER, A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator BREWSTER. I am happy to be here, Mr. Chairman.

I sincerely appreciate the opportunity to appear before this committee to present may views on the legislation which is before you, and which keenly affects many hundreds of thousands of homeowners in Maryland.

Maryland's ground rent system dates back to 1772, and was designed to help the average citizen to buy a home without paying for the land. The effect of the ground rent is to reduce the downpayment and the mortgage installments. This system has enabled those who live in metropolitan areas in Maryland to become one of the largest per capita homeowning groups in the entire United States. From its earliest days, the Maryland ground rents system has been tailored to meet the financing needs of the average Maryland home buyer. It has represented a sound investment in land, and a system of securing a loan, the interest upon which is paid in the form of an annual ground rent of 6 percent.

There are hundreds of thousands of citizens in Maryland who have purchased their homes with the clear understanding that ground rents would be deductible for income tax purposes. To change this regulation will mean that these Maryland homeowners will not be permitted to take deductions of up to $200 per year on their Federal income taxes. There is no doubt that many of these homeowners cannot afford the additional burden. To exact this penalty from the thousands of owners in Maryland who are already bound to long-term ground rent payments is unjust. There is no reason why home buyers in Maryland, and also in other States, should receive smaller deductions for tax purposes with respect to payments made on their homes than is true of homeowners in other States.

Because relief to the homeowners of the same type permitted in other States is desired, it does not follow that we should require the drastic change which would result if ground rents are treated for all purposes as sales subject to a mortgage. This is what the Treasury Department seeks in the amendment made to H.R. 1597, in the House Ways and Means Committee.

The legislation, as introduced by Congressman Friedel, and S. 878, introduced by Senator Beall and myself, is intended to correct the inequity of the recent Treasury Department ruling with respect to the payer of the ground rent, but is not intended to alter in any way the status of the builder or the seller, respecting tax liabilities for ground rents, which was established in the decisions in the *Simmers & Welsh Homes* cases. The amendment made to H.R. 1597 by the House Ways and Means Committee, and urged here today by representatives of the Treasury Department, would change the rule established by Judge Soper in these two decisions.

We do not wish to upset long established real estate practice in Maryland. Nor do we wish to cause damage to homebuilders and to persons who hold ground rents as investments at the same time that we bring relief to the homeowners.

Let me make it clear that the legislation which Senator Beall and I have introduced, and which was introduced by Congressman Friedel in the House, is not an effort to provide Marylanders, either homeowners or homebuilders, with any new tax deductions. In the case of the homeowner, it is simply intended to bring about a return to an arrangement which has been acceptable to the Treasury Department since 1927. In the case of the homebuilder, no tax is lost either. The builder or seller will be required to pay his tax, under income or capital gains provisions of the Revenue Code, at such time as the ground rent in question is either sold or redeemed, and the value of the ground rent actually realized. To require the builder to pay this tax at an earlier time, based on a theoretical increase in value at a future time, does not seem to me proper.

I sincerely appreciate the cooperation of this committee in its scheduling of early hearings on this important matter, and thank you for this opportunity to present my views.

Mr. Chairman, I thank you and the other members of the committee for allowing me to testify on this subject this morning.

The CHAIRMAN. We are certainly glad to have you, Senator Brewster, and we hope you will come again soon.

The next witness is Congressman Friedel from the Seventh District of Maryland.

Will you take a seat and proceed.

STATEMENT OF HON. SAMUEL N. FRIEDEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Congressman FRIEDEL. I want to thank you for having such a prompt hearing on my bill H.R. 1577. I mailed a letter to each member of the committee explaining the ground rent rule. I won't be repetitious and read it, but I would like to have it inserted in the record.

(The material referred to is as follows:)

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., February 27, 1963.

DEAR SENATOR: On February 26, the House passed my bill, H.R. 1597, to amend the Internal Revenue Act to insure that ground rents paid in the State of Maryland will continue to be deductible for income tax purposes. I will appreciate early consideration of this measure by the Senate Finance Committee and will be grateful for your support.

I realize that most people are not familiar with ground rent arrangements. As a matter of fact, only five States in the country have such arrangements. Therefore, I am taking this opportunity to give you some information concerning this matter and I trust it will be helpful to you in considering my bill.

First, let me make it clear that my bill will not give the Maryland taxpayers any new tax deductions, and ground rent is not a recent innovation. Maryland's ground rent system goes back to 1772, and was designed to help the average citizen to buy a home without paying for the land. In effect, this reduces the downpayment and the mortgage installments. This system has enabled those who live in metropolitan areas of Maryland to become one of the largest, if not the largest, per capita homeowning population in the entire United States.

From its earliest days, the Maryland ground rent has represented nothing more than a sound investment in land much like a mortgage. It has been tailored to meet the financing needs of the average Maryland home buyer and is frequently described and referred to as a common and ordinary form of securing a loan of money, the interest thereon being paid in the form of an annual ground rent of 6 percent.

Since ground rent is, in effect, a mortgage, the Treasury Department has permitted such payments to be deducted for income tax purposes since 1927. However, last year the Internal Revenue Service ruled that ground rents paid in Maryland could no longer be deducted for income tax purposes. At this point let me stress that this new regulation affects only the citizens of Maryland.

Internal Revenue has stated that it was basing its new regulation on the U.S. court of appeals decision in the cases of *Commissioner* v. *Simmers Est.* and *Welsh Homes, Inc.* v. *Commissioner*. I cannot see how the Internal Revenue Service can support their position either factually or legally, since the cases referred to above did not involve the question of deduction of ground rent and taxes by the purchaser. It is also interesting to note that Internal Revenue did not take their present position until 5 years after the *Simmers* decision was rendered.

There are thousands of citizens in Maryland who have purchased their homes with the clear understanding that ground rents would be deductible for income tax purposes. To change this regulation now will mean that hundreds of thousands of Maryland homeowners will have to pay up to $250 a year in additional taxes, and there is no doubt that many of them cannot afford this burden. To exact this penalty from the thousands of innocent home buyers who are already bound to long-term ground rent payments is unjust.

I do not feel there is any justification for changing the traditional regulation permitting ground rent deductions for income tax purposes. Therefore, I would consider it a personal favor if you will support my bill, H.R. 1597, to specifically authorize such deductions by law.

Thanking you in advance, and with warmest personal regards, I am,

Sincerely,

SAMUEL N. FRIEDEL,
Member of Congress.

Congressman FRIEDEL. I also submit for the record a copy of a letter that I received from Stanley S. Surrey on November 2, 1962, in response to a letter I wrote on October 15 with respect to the effective date of the Treasury regulation which prohibits the homeowners from deducting their ground rent.

(The material referred to is as follows:)

TREASURY DEPARTMENT,
ASSISTANT SECRETARY,
Washington, November 2, 1962.

HON. SAMUEL N. FRIEDEL,
Representative in Congress,
Post Office Building, Baltimore, Md.

DEAR MR. FRIEDEL: Thank you for your letter of October 15, 1962, requesting a postponement of the effective date of the Treasury regulation dealing with the tax treatment of Maryland ground rent payments. We regret that under existing case law the Treasury has no authority to defer the effective date of the regulation, which has already been promulgated. This is recognized by Mr. Mills in his statement which you enclosed with your letter. Mr. Mills states that if the legislation can be enacted promptly, its application could be retroactive. The assumption underlying this statement by Mr. Mills is that a change in the Treasury regulation can be made only by legislation and can be made effective for 1962 only by retroactive legislation. Otherwise prompt enactment would not be necessary.

The Treasury Department, however, will be very glad to cooperate with you to press for the early enactment of legislation which will assure deductibility to Maryland homeowners of their ground rent payments. This can be done by the enactment of legislation similar to H.R. 8754 as it passed the House, applying retroactively with respect to homeowners. We have every reason to hope and believe that this legislation can be passed before Apirl 15, 1963. In that case, in accordance with Mr. Mills' pledge, it will take effect so that Maryland taxpayers will be able to claim deductions on their 1962 tax returns before the filing date. We believe you may want to advise your Maryland taxpayers, as a matter of convenience, that they should not file their tax returns for 1962 before April 15 so that they will be in a position to take advantage of the congressional action on this subject without having to file a refund claim.

Sincerely yours,

STANLEY S. SURREY.

Congressman FRIEDEL. I think this point is of interest. Ground rent comes before a first mortgage, and it is one of the oldest arrangements we have in Maryland. We have more individual homeowners per capita than anywhere in the United States, because of the ground rent law. I just recently noticed that California wants to adopt the ground rent system because land is so expensive that they couldn't finance it as a $20,000 loan. The land would cost around $20,000, and under the ground rent system they could finance it much easier.

I want to thank you, Mr. Chairman, for the early hearing. And I hope we can have my bill passed real soon, because of the tax deadline of April 15.

Thank you very much.

The CHAIRMAN. Thank you very much, Congressman Friedel.

The next witness is Mr. Donald C. Lubick, tax legislative counsel of the Treasury Department.

STATEMENT OF DONALD C. LUBICK, TAX LEGISLATIVE COUNSEL TO THE TREASURY

Mr. LUBICK. Mr. Chairman and members of the committee, thank you for the opportunity to appear in support of H.R. 1597.

This bill deals with the tax treatment of redeemable ground rents. It treats a redeemable ground rent as essentially equivalent to a mortgage. It thereby entitles a homeowner whose property is subject to a redeemable ground rent to an interest deduction in the same manner as if his ground rent payments were interest payments on a mortgage. Additionally it treats the seller of property subject to a redeemable ground rent as if he had sold the property and received

as part of the sales price a mortgage in face amount equal to the fair market value of the redeemable ground rent.

The bill is necessary because of two recent court decisions which treat redeemable ground rents in the State of Maryland as leases rather than as mortgages.[1]

These decisions are contrary to over 30 years of administrative practice by the Treasury Department, in regulations and published rulings, which equated Maryland ground rents to mortgages.[2]

In order to understand the use of the Maryland ground rent as a financing device for the purchase of residential real property, it will help to compare it with a purchase under traditional mortgage financing.

In footnote 4 in my statement I have a tabular summary of the examples which I am going to read now.

Suppose a real estate developer acquires a residential lot for $1,000 and builds a house on it at a cost of $8,000. In a State other than Maryland, he sells house and lot for $11,600. He conveys the property outright to the buyer, or as lawyers put it, in "fee simple." The buyer secures a conventional 25-year mortgage at 6 percent with 25 percent down. This requires a downpayment of $2,900 and a mortgage of $8,700. The buyer makes monthly payments of $56.06 and the interest element in each monthly payment is deductible under section 163 of the Internal Revenue Code of 1954.

The same transaction in Maryland might be financed in part by a redeemable ground rent. In that case the real estate developer would create a lease of the lot for 99 years, renewable forever, subject to an annual ground rent of say, $96. He would sell the house (subject to the ground rent) for $10,000.[3]

Under Maryland law the homeowner may redeem the ground rent and acquire outright ownership, that is, a fee simple, at any time after 5 years upon payment of its capitalized value at 6 percent—in this case $1,600. The ground rent worth $1,600 plus the $10,000 paid equal the $11,600 purchase price of outright ownership. By the ground rent the tenant has, in effect, a permanent mortgage for $1,600 at a 6-percent interest rate as to which he does not amortize any principal but which he can retire at any time after 5 years.

The purchaser thus acquires in legal terminology and form only an interest as a tenant in the property. Since his tenancy is renewable forever so long as the annual ground rent is paid, however, he has the equivalent of outright ownership. Further he can redeem the ground rent after 5 years for $1,600 and become in deed as well as fact, the full outright owner.

To finance the $10,000 purchase price immediately payable for his house, however, suppose he obtains the same 25-year conventional 6-percent mortgage as his brother outside Maryland, with a 25-percent downpayment. The downpayment for him is $2,500 instead of $2,900 and his mortgage is $7,500 instead of $8,700. He makes monthly

[1] *Estate of Ralph W. Summers*, 23 T.C. 869, aff'd 231 F. 2d 909 (4th Cir. 1956); *Welch Homes, Inc.*, 32 T.C. 239, aff'd 279 F. 2d 931 (4th Cir. 1960).

[2] Treasury Regulation 118, sec. 39.23 (b)-1 (b); T.D. 6223 (1957); G.C.M. 2042, VI-2 C.B. 182 (1921); I.T. 2679, XII-1 C.B. 103 (1933).

[3] Actually the lease would be to a dummy corporation, which would assign the lease to the homeowner to relieve him of any personal obligation to pay the ground rent after he subsequently sold his home, but this detail is not material here.

payments on the mortgage of $48.33 and his ground rent is $8 a month.[4]

In effect he has financed the purchase of his home for $2,500 down with a $7,500 mortgage and a ground rent worth $1,600—a total of $9,100 financing. His interest payments on the $7,500 mortgage are deductible, but because of the recent cases his ground rents are not. The court has characterized them as rentals under a lease so they cannot qualify as interest on a house mortgage. Yet the redeemable ground rent is in substance simply a financing device like a mortgage, which in some cases permits a smaller downpayment.

The Treasury, as I have stated, had treated Maryland ground rents as mortgages for over 30 years and allowed interest deductions to the owner of property subject to the redeemable Maryland ground rent. It thus equalized the Maryland home purchaser with persons similarly situated in other States whose financing is exclusively by means of mortgages, be they first, second, or third. As a result of these court decisions, the Treasury has had no alternative but to change its regulations, effective for 1962, to conform to the court decisions. The Treasury has joined Maryland homeowners last year and this to secure legislation to restore the former situation.

H.R. 1597 would thus overrule the court decisions, restore time-honored practice, treat the redeemable ground rent payments as mortgage interest and allow the homeowner to deduct them in the same manner. It would apply to the calendar year 1962 in accordance with the statement of the chairman of the House Ways and Means Committee last October [5] when it appeared that a similar bill, H.R. 8754, passed the House too near the close of the 87th Congress to be reached for Senate action. Thus there is some urgency to secure passage of this bill as soon as possible to enable Maryland homeowners to file their 1962 returns by April 15, 1963, and claim the deduction of their 1962 ground rents as they have done for all previous years.

It is easy to demonstrate that the redeemable Maryland ground rent is in substance a mortgage arrangement and does not embody the landlord-tenant relationship under a lease as that relationship is customarily understood.

First of all, it is used, represented, and justified as a financing device to enable purchasers to acquire homes with lower downpayments and lower monthly payments. Literature of Maryland lending institutions expressly characterizes the ground rent as a home financing device.

[4] See the following:

TABULAR SUMMARY

Fee simple purchase		*Ground rent financing*	
Purchase price	$11,600.00	Cash payment	$10,000.00
		Value of $96 ground rent	1,600.00
		Total	11,600.00
Downpayment	2,900.00	Downpayment	2,500.00
Mortgage (6 percent, 25 years)	8,700.00	Mortgage (6 percent, 25 years)	7,500.00
12 monthly payments per year	672.72	12 monthly payments per year	579.96
		Plus ground rent	96.00
Total	672.72	Total	675.96

[5] Congressional Record, Oct. 13, 1962, p. 22237: "This is a problem that has been unsettled for several years. It is my hope that legislation similar to H.R. 8754 as it passed the House this year can be enacted by Congress early next year. If it can be enacted promptly we will be able to make its application to homeowners retroactive. The application to sellers would, of course, be prospective."

Second, the fact that the Maryland ground lease is usually perpetual and, if the term exceeds 15 years, is by statute redeemable just as a mortgage is dischargeable indicates that the true owner of the property is the purchaser. He would not pay for the valuable house if he were only a tenant for a fixed term; on the other hand the person entitled to the ground rent has only a technical estate in the land without the usual liabilities of a landlord for real estate taxes, for maintenance of the property or in tort.

Third, if there is a default in payment of ground rents, Maryland law provides protection similar to that on a mortgage foreclosure. Even after the owner of the ground rent obligation takes over the property, the ejected tenant may recover back his property within a certain period of time by curing his defaults. This is a remedy typical of a mortgagor, but not a tenant.

The highest Maryland Court has said that—in practical effect the relation of the lessee to the property is that of owner of the land and improvements thereon, subject to the payment of the annual rent and all taxes on the property.[6]

Thus, the economic realities of the situation are clear. The redeemable ground rent is like a mortgage pure and simple, not like a conventional lease. What the so-called tenant pays as ground rents is interest on an indebtedness used to acquire his house. It should be deductible as such.

If the Maryland ground rent is to be treated as a matter of economic substance as a mortgage and not a lease, the homeowners should be able to deduct their ground rent payments as interest on a mortgage. This means, however, that the ground rent obligation should be treated as a mortgage, as it is in economic substance, on the other side of the transaction too. H.R. 1597 rightly provides that the sale of property subject to a redeemable ground rent is to be treated as a sale where the purchase price is partially paid by a mortgage obligation. Since this may change the tax effect on sellers who have already consummated transactions on a different basis, its application is prospective only in this respect.

The consequences to the seller of property may be illustrated by our earlier example of the lot and building which sold for $11,600 under traditional financing on the one hand or $10,000 plus a $96 redeemable ground rent (worth $1,600) under ground rent financing. The seller had paid $1,000 for the lot and had built the house for $8,000. His total profit was thus $2,600 in either case.

Under traditional financing, he would sell the property for $11,600 and be taxable on the $2,600 profit. Usually the buyer would pay him the $2,900 down, and turn over to him the proceeds of his $8,700 mortgage; all done simultaneously with conveyance of fee simple title. The seller could, however, finance all or part of the purchase price, through taking back a purchase-money mortgage himself. Suppose the purchaser turned over $10,000 in cash to the seller, which he raised from his own funds, or partly from his own funds and partly second mortgage or other financing, and, in addition, gave the seller a 6-percent purchase-money first mortgage for the $1,600 balance—thus securing the $1,600 balance by a first lien on the property.

The seller is taxable on his full $2,600 of profit, even though part of the purchase price—$1,600—was received in the form of a mortgage rather than cash, so long as the fair market value of the $1,600 mort-

[6] *Moran v. Hammerle*, 183 Md. 378, 381, 52 A. 2d 727, 728 (1947).

gage was $1,600. This is because the mortgage is a property interest with a fair market value and is the equivalance of cash. It would be sold at any time for $1,600. The gain has been realized the same as if the seller had taken his full $11,600 in cash, or in marketable stocks, or $11,600 worth of typewriters.

There is one exception to this: if the seller elects the installment method of accounting. In that case, if his downpayment received in the year of sale do not exceed 30 percent of the total purchase price, he can defer tax on the gain attributable to the installment obligations—including indebtedness secured by a mortgage—until collected. But, in this case, he received more than 30 percent of the price at the time of sale; so, the full amount of gain is taxable on sale.

The rule that gain realized includes the value of a mortgage on property sold is traditional, and has governed real estate transactions in every State since the first income tax.

Under ground rent financing, the seller is in the same situation. He has gotten $10,000 in cash and he has a 6-percent obligation worth $1,600, which is a first lien on the property—exactly the same as a mortgage in economic effect. The ground rent is as salable as a mortgage, or, if anything, more so. On June 30, 1962, the savings and loan industry in Maryland alone held $14,650,000 of ground rents acquired as such investments. One savings and loan institution says: [7]

> From the point of view of the individual investor, ground rents offer an ideal field for investment. They afford a large measure of security, a good "yield" on the money invested, and have a ready market if the owner desires to dispose of them.

Thus, H.R. 1597 properly provides that a redeemable ground rent is to be treated as a mortgage. When a developer sells a house for $10,000 subject to a $96 ground rent worth $1,600, he has realized $11,600, and is taxable on his profit the same as if he had received $10,000 in cash and taken a mortgage for $1,600. As far as the Internal Revenue Service was able to maintain uniformly, this was the practice before the *Simmers* case; it is still the practice in Pennsylvania, where the technicalities of the ground rent used to finance take a somewhat different form. This treatment is the only way to treat developers in all States the same, regardless of the technical method of financing employed. It recognizes the substance of the transaction. The fact that reliance on technical interpretations, by Maryland courts of Maryland real property law in nontax situations, persuaded the court that it should follow the Maryland characterization of a ground rent as a lease and should not preclude the proper result from being reached in tax legislation.

If a redeemable ground rent obligation is a mortgage so that the homeowner can deduct his rental payments as interest, then it is a mortgage for all purposes. The real estate developer argued in the *Simmers* case that the ground rent there was a lease, and therefore there was no tax on its value until sold or redeemed. If it is a lease, the rent is not deductible as interest by the tenant. It cannot be played both ways. The true economic reality—the basis of the use in commerce of the redeemable ground rent—is as a mortgage. H.R. 1597 rightly treats it as such, in accordance with longstanding practice in the administration of our revenue laws. This will permit all tax-

[7] "The Maryland Ground Rent System," Wyman Park Federal Savings & Loan Association (Baltimore, 1962).

payers in Maryland living in their houses the opportunity to continue to take deductions which would otherwise be lost for the first time. The bill should be reported by this committee in the form passed by the House.

There is no basis for treating statutorily redeemable ground rents as a lease for one purpose and a mortgage for another. The consequent whipsawing of the Treasury would give an unwarranted preference to one method of financing over all others which are in substance the same. Developers in Maryland should not be preferred over those in the other 49 States.

Unless H.R. 1597 is passed in the form of the House bill, there will be a strong tax impetus to encourage a change in State laws on property in favor of the statutorily redeemable ground rent system simply as a method of tax avoidance for builders. The tax laws ought not to be used to influence the States in determining the shape of their laws of real property.

Thank you, Mr. Chairman, for the opportunity to present the views of the Treasury on H.R. 1597.

The CHAIRMAN. Thank you, Mr. Lubick. Do I understand your position to be that, under this bill, a ground rent will be treated exactly the same as a mortgage?

Mr. LUBICK. Mr. Chairman, that would be true if it were a redeemable ground rent, one which by statute the occupier of the property has a right to pay off and get a fee simple ownership by paying—for example, the capitalized value of his ground rent, yes; not a ground rent where you don't have a right of redemption, however.

The CHAIRMAN. In other words, the builder's basis would be that what he paid for the land, plus the cost of the house, and the selling price will be the value of the ground rent obtained, plus cash and all other considerations?

Mr. LUBICK. Yes, sir.

The CHAIRMAN. And under this bill the builders in Maryland would be treated exactly as the builders in the other States?

Mr. LUBICK. Yes, where the builders in the other States took back purchase money mortgages.

The CHAIRMAN. Thus this bill would bring back the law as it was before the ruling in the *Simmers* case in 1956?

Mr. LUBICK. Yes, sir.

The CHAIRMAN. Any questions? Senator Brewster, would you care to ask any questions?

Senator BREWSTER. No.

The CHAIRMAN. Congressman Friedel?

Contressman FRIEDEL. No.

The CHAIRMAN. Senator Morton?

Senator MORTON. If we had put this 5 percent floor in it when we got the message from the President a few days ago, this thing would be academic, wouldn't it?

Mr. LUBICK. I don't think so, Senator Morton; because, in Maryland today, the homeowner can deduct the interest on his mortgage. In the illustration I gave, in footnote 4, he is paying interest on a mortgage of $7,500. Now, if the Congress should pass the 5 percent floor, it would penalize Maryland homeowners more than it would those in other States; because they would have a smaller amount of interest to eat up the 5 percent floor before the total amount all be-

comes deductible along with their taxes and casualty losses, and medical expenses and charitable contributions.

So that while the enactment of the 5 percent floor would not make it academic, it would in effect, if this bill is not passed, put the Maryland homeowner in a much more adverse situation than those in the other 49 States.

Senator MORTON. Yes, assuming that his interest would exceed the 5 percent, or his deductions would exceed the 5 percent. I can see that.

I won't belabor that point, we will be dealing with that in August or September.

Senator WILLIAMS. If you think you will get it in August or September, you are an optimist.

Senator MORTON. Well, in October, then.

That is all.

The CHAIRMAN. Thank you very much.

The next witness is Mr. Charles Atwater, of the Home Builders Association of Maryland.

STATEMENT OF CHARLES C. ATWATER, ATTORNEY, REPRESENTING HOME BUILDERS ASSOCIATION OF MARYLAND

Mr. ATWATER. Mr. Chairman and members of the committee, I have filed a written statement which basically outlines the position of the Home Builders Association of Maryland.

(The statement referred to is as follows:)

MEMORANDUM SUBMITTED ON BEHALF OF THE HOME BUILDERS ASSOCIATION OF MARYLAND

Testimony will be presented by Charles C. W. Atwater. He is a member of the bar of the State of Maryland, admitted to practice in 1941, and engaged in the practice of law as a member of the firm of Mylander & Atwater, 1213 Fidelity Building, Baltimore 1, Md. The practice of this firm is primarily in the field of litigated problems relating to real property law. The firm represents and handles trial work for the Title Guarantee Co., the home office of which is located in Baltimore, Md.

Original H.R. 1597 to amend section 163 of the Internal Revenue Code

The industry agrees with the purpose of H.R. 1597 as originally introduced to permit Maryland homeowners to deduct annual ground rents in a manner similar to the deduction of interest on a first mortgage. From the point of view of the homeowner who holds a leasehold title to his home subject to a 99-year lease made redeemable by statute, the payments are similar to interest payments on the amount of a lien. The capitalized value of the ground rent is not literally a debt because it does not have to be paid, but the rent itself is a charge on the land, and for nonpayment he can be dispossessed. The State legislature has relaxed the common-law rule and gives him a right to purchase the fee title at a price based upon the rent capitalized at 6 percent. Congress in the tax law should permit him to deduct his payments so that he will be accorded similar economic and tax treatment to that of homeowners in other States

Amended H.R. 1597 to add new section 1055

The enactment of H.R. 1597, as amended, for the purposes set forth in the report of the Committee on Ways and Means of the House of Representatives, is not advisable. The act as now written would result in harsh inequities, would violate established legal principles of real property law, tax law, and constitutional law, and would create uncertainty in tax law not only with reference to Maryland ground rents, but also with reference to leases in all parts of the United States.

The Commissioner argues for logical consistency and that if the homeowner is allowed the deduction of section 163, then the lease should be treated as a sale and mortgage for all purposes. *Simmer* and *Welsh* should be reversed by legislation. The proposed amendment would add a new section 1055 to the Internal

Revenue Code of 1954 so as to tax the execution of a lease of real property which reserves an annual ground rent as if there had been a sale subject to a mortgage. The section as drafted would require the treatment of all redeemable ground rent leases as if they were conveyances of the fee simple title, in exchange for a purchase money mortgage. This could have unforeseen tax effect throughout the United States as well as in the State of Maryland. It would create a legal fiction contrary to the express holding of the U.S. Court of Appeals of the Fourth Circuit in the *Simmers* and in the *Welsh* cases. It would impose a tax upon unrealized appreciation in contrary to the basic concepts of the tax law and contrary to the constitutional limitations of the power given Congress by the 16th amendment to impose a tax on income. The result would be confusion, inequity, and the imposition of an unconstitutional tax.

Necessity for definition of "redeemable ground rent"

There is no definition in the act of the term "redeemable ground rent." The committee report states that it refers to Maryland ground rents. Even the Court of Appeals of Maryland has stated that this term is so indefinite that its use in a contract of sale without definition makes the contract so indefinite that it is not specifically enforceable (*Ward* v. *Newbold*, 115 Md. 689, 81 A–793, Ann. Cas. 1913 A-919: *Moran* v. *Hammersla*, 188 Md. 378, 52 A 2d 727).

The only definition of "ground rents" in the Maryland law is contained in section 279(k) of Article 81: Maryland Code (1957), which defines ground rents for purposes of Maryland income tax. It includes the historical ground rent of colonial days and rents made redeemable by sections 103, 104, and 108 of article 21. It should be noted the redeemable rents of sections 103, 104, and 108 are not even referred to in the statutory definition as "ground" rents but only as "rents."

Ground rent leases have been used in Maryland since colonial days, and are based upon English common law. Attached for the information of the committee is a form of ground rent lease generally used by lawyers in Maryland. Attention is called to the fact that this is a lease which provides for distraint and for reentry for nonpayment of rent. This form is very little changed from the original ground rent leases used by Thomas Fell while Maryland was a colony, when houses were first built on Fell's Point in "Baltimore Town." [1] All such leases were irredeemable; the estate of the lessee was and still is personal property; the estate of the lessor was and still is a reversionary fee simple title, subject to the rights of the tenant under the terms of the lease, all in accordance with basic landlord and tenant law. The principles applicable thereto are well stated by the Honorable Morris Soper, an eminent jurist trained in Maryland law, chief judge of the U.S. Court of Appeals for the Fourth Circuit, in the *Simmers* case.

The first redemption statute was passed in 1884 and was applicable to leases executed thereafter. A second statute was passed in 1888 changing the terms for redemption. These two statutes are presently found in the Annotated Code of Maryland, (1957 ed.), article 21, section 103. In 1900 the Legislature of Maryland passed a new redemption statute which is still in effect, applicable to leases created since that date, found in article 21, section 104. This statute provides as follows:

"All rents reserved by leases or subleases of land hereafter made in this State for a longer period than 15 years shall be redeemable at any time after expiration of 5 years from date of such leases or subleases, at the option of the tenant, after a notice of 1 month to the landlord, for a sum of money equal to the capitalization of the rent reserved at a rate not exceeding 6 percent."

The committee's attention is called to the fact that this covers leases for any period longer than 15 years, and is not restricted to 99-year leases. It has been applied to a lease for 6 years with a right of renewal for 8 years and a further right of renewal for 10 years, even though the initial term was less than 15 years (*Maryland Theatrical Corp.* v. *Manayunk Trust Co.*, 157 Md. 602, 146A805). The right of redemption under this statute was held applicable to commercial leases as well as residential leases, and in 1922 the Maryland Legislature enacted what is now section 108, article 21, of the Maryland Code to provide that the redemption statutes would not apply to "leases or subleases of property leased exclusively for business, commercial, manufacturing, mercantile, or industrial purposes, as distinguished from residential purposes, where the term of such leases or subleases, including all renewals provided for therein, shall not exceed 99 years."

[1] (See: Kaufman, "The Maryland Ground Rent—Mysterious But Beneficial," 5 Maryland Law Review 1.)

It is, therefore, clear that even under the Maryland law it is necessary to define the term "redeemable ground rent," at least with reference to the term of the lease and whether it is for commercial or residential purposes. Even commercial leases if they exceed 99 years, with all renewal terms, are "redeemable ground rent" leases.

The present statute could be applied to any commercial land lease. Modern practice in the development of shopping centers and in the construction of apartment houses and office buildings often includes a land lease. Obviously, Congress does not intend to apply the provisions of H.R. 1597 to such commercial leases.

The redemption statute is equivalent to a covenant or right written into a lease, and a lease with an option to purchase would literally be a "redeemable" ground rent lease. The effect of the proposed statute could be to tax all such leases containing an option, wherever executed in the United States, as sales with mortgages back. This would be a dangerous statute, and the unintended result could be the entrapment of parties negotiating commercial transactions who have no knowledge of the pendency of this bill, and if they did have knowledge, would not be interested because of its apparent application only to Maryland residential ground rent leases.

The act applies to all leases executed after the time of enactment. This would cause extreme hardship upon persons who have entered into contracts to execute such leases. We have personal knowledge of one contract to execute a commercial lease for $60,000 a year, which, because of renewal terms, under the Maryland statute (art. 21, sec. 108) would be a redeemable ground lease. The result of this statute would be that the execution of such lease would result in a taxable gain of $1 million although the lessor only has a right to receive rent of $60,000 a year. The tenant has the right, but is under no obligation, to pay the sum of $1 million for the fee simple title. Whether he exercises that statutory option to purchase (or redeem) or not, the proposed act would require the owner to sell his property in order to pay the tax.

The act does not state whether or not a ground lease arrangement would be a sale within the installment sale provisions of the Internal Revenue Code. Even if sec. 453 of the Internal Revenue Code as to installment sales were applied, it would be of no benefit to the builder who sells the leasehold estate during the first year at a price well in excess of 30 percent of the total of the capitalized value of the rent and the sale price of the leasehold.

New section 1055 begins "for the purposes of this subtitle," but the committee report indicated that it will have the effect under section 543(a)7 of reclassifying ground rents as interest rather than rents, for the purposes of the personal holding company tax. This, again, could have unintended effects upon corporations holding ground leases both within and without the State of Maryland.

The act imposes a tax upon unrealized gains

The basis for the decision by Judge Soper in the *Simmers* case was that the transaction involved a lease and not a sale of the land. He held that the lessor, on the construction of improvements upon the property leased by him, was not taxable because "mere enhancement in value does not involve a taxable gain." The real distinction from the lessor's point of view between a ground lease and a sale with a mortgage was pointed out by Judge Soper in the *Welsh* case, "the purchaser of the leasehold interest cannot be compelled to redeem the ground rent, and hence the builder does not realize a taxable gain on the reserved ground rent until it is sold or redeemed by the lessee."

The *Welsh* case involved factually a building corporation which purchased land in fee simple and then, after creation of its rent and its building of houses, transferred the leasehold interest to the home buyer. Judge Soper adopted the rule 50 computation of the Tax Court upon the theory that when the builder leased the property and sold the leasehold interest, the total cost of land and improvements should be allocated at the time of the execution of the lease to both the leasehold estate and the reserved fee simple estate of the lessor.

Another quite common factual situation occurs when the building corporation never has the fee simple title but only acquires the leasehold title before constructing improvements. The only cost which can be allocated in this situation at the time of the execution of the lease is the land cost. The leasehold interest at that point has no cost, and it acquires a basis as improvements are erected equal to the cost of the construction of such improvements by the builder. The landowner who thus leases land to a builder has not realized any gain at the time of the lease, does not realize any gain when the leasehold is sold by the builder, and does not even receive the benefit of the enhancement in value of the leasehold estate until the improvements are subsequently constructed. The reserved title or ground rent is not even salable until the improvements are constructed.

Realization of gain is the taxable event under the income tax amendment of the Constitution of the United States. The 16th amendment reads as follows:

"The Congress shall have power to lay and collect taxes on income, from whatever sources derived, without apportionment among the several States, and without regard to any census or enumeration."

The Supreme Court gave this power a broad interpretation, but still limited it to a tax upon income as a gain which had been derived (*Eisher* v. *Macomber*, 252 U.S. 189).

The principle has long been established in income tax law that a landlord does not realize any taxable gain when improvements are constructed by his tenant upon the leased property. Thus, as pointed out by Judge Soper in the *Simmers* and *Welsh* cases, "mere increment in value" is not a realized taxable gain.

The Maryland ground rent is not an artificial device

The committee report refers to the "redeemable ground rent device available in Maryland." The Maryland ground rent lease was not a device created to avoid income tax. It grew out of feudal theories of tenure and was adapted for use in Maryland. The use by Thomas Fell was directly for the purpose of making land owned by him income producing. It was leased to a builder at a rent based upon a fair return upon the market value of the land, and the builder then erected houses and sold the leasehold estate to the home buyer. The economic advantage of this system in Maryland is that the homeowner has been granted by statute the right to pay off the redemption price of the ground lease, but can never be required to do so. He therefore does not have to amortize the capitalized value of his rent and is able to purchase a home out of less income than would otherwise be required if he had executed a first mortgage, which would require amortization of the mortgage debt.

This practice was thoroughly established long before the Income Tax Act of 1913. In fact, it had been so thoroughly established that the legislature on three occasions had written redemption statutes so as to permit homeowners who might wish to terminate the annual rent to redeem and buy in the outstanding fee simple interest of the lessor.

Taxation of the interest of the ground rent owner under Simmers and Welsh does not result in any tax loss

The method of taxation under *Simmers* and *Welsh* of the gain of the lessor is to tax that gain when it is realized. Ground rents have been favored investments under the trust rules of the State courts in Maryland for trustees, guardians, and other fiduciaries, also with financial institutions and other persons who wish a stable, secure income. The market price of such rents depends upon the money market because it is a fixed-return investment. Many of the life insurance companies have invested heavily in ground rents because of this stable reutrn. Large purchases are made from builders each year, and, of course, the tax on the gain realized from such sales is payable under present law by the builders.

In any event, the gain in value of the land does not escape taxation—the tax is only postponed. The typical builder does not retain for any length of time the ground rents created, and under *Simmers* and *Welsh* he is taxed upon his realized gain as soon as he sells the rents. The only effect of those decisions is to give effect to the legal relationship of the parties and to permit the builder to postpone paying all of the tax until he makes such a sale and realizes a profit.

Exact figures are not available, but in the opinion of individuals in the business of financing builders, a very small percentage of ground rents created by builders are retained. The proposed section 1055 would therefore result in no new tax and in very little anticipation of tax payment by the builders, but would affect in a drastic manner the landowner who leases his land to a builder in order to make the land income producing.

The arguments for logical consistency is not valid

The Internal Revenue Service has continued to argue since the decision in *Morris Lipsitz*, 21 T.C. 917 (1954), regardless of the decisions in *Simmers* and *Welsh* in the U.S. Court of Appeals for the Fourth Circuit, that when a leasehold estate is sold in Maryland, subject to the payment of a ground rent, that there has been a sale of the land. This, as clearly explained by Judge Soper, just is not true. The fee simple title is retained by the owner, who executes a lease for a term of years, renewable forever, for a specified annual rent. If at the time of the lease the house has been built, then the total cost of land and improvements (under the *Welsh* case) shall be allocated according to value to the leasehold estate sold and the fee title (or reversion, or ground rent) retained. The fee title owner thus has

a fixed annual rental receivable as the income from his land. The title law as to this fee title owner has not changed since the Maryland Court of Appeals construed Fells Point leases dated 1772 in *Myers* v. *Siljacks*, 58 Md. 319 (1882), and in *Banks* v. *Haskie*, 45 Md. 207 (1876).

The interest of the homeowner, however, has been changed greatly by statute. All leases since 1884 are now redeemable "at the option of the tenant" after 5 years. From his point of view it is similar to a first mortgage without a due date which he can pay but is not required to pay. His monthly payments to the mortgagee who financed his home consist of one-twelfth of the annual taxes, ground rent, and insurance, plus the principal and interest on the amount borrowed. The ground rent to him is economically like a first mortgage in another State, except that the principal does not have to be amortized. Many homeowners, when money is available at less than 6 percent, borrow money to buy the fee title.

The proposal to permit the deduction of ground rent by the payor so that it shall be "treated as interest" for the purposes of section 163(a) of the Internal Revenue Code, is simply a recognition by Congress of the inequity of this annual charge not being interest and, therefore, putting him on a par with other taxpayers in other States.

The argument that, if this is done, the ground rent leases should for all purposes be treated as sales subject to a purchase-money mortgage, ignores the established legal rules of real property law which are still in effect as to the landlord who owns the "ground rent." His rights have already been limited—not extended—by Maryland statutes. He realizes no gain until and unless his tenant decides to exercise his statutory option to purchase, and his position is precisely that of a landowner who executes a lease containing an option to purchase to a tenant who constructs improvements on the leased land. The tax on the gain should be paid when the gain is realized, not when there is merely an "unrealized increment in value."

MARYLAND STATUTES REFERRED TO: ANNOTATED CODE OF MARYLAND (1957 EDITION)

Article 21: Section 103

All leases or subleases of land made in this State between the 8th day of April, 1884, and the 5th day of April, 1888, for a longer period than fifteen years, shall be redeemable at any time after the expiration of fifteen years, at the option of the tenant, for a sum of money equal to the capitalization of the rent reserved at the rate of six per centum in gold coin of the United States, or its equivalent, unless some other sum not exceeding four per cent capitalization of said rent in said coin shall be specified in said lease, in which event said rent shall be redeemable for the sum fixed in said lease or sublease. All rents reserved by leases or subleases of land made in this State, after April 5th, 1888, for a longer period than fifteen years shall be redeemable at any time after the expiration of ten years from the date of such lease or sublease, at the option of the tenant, after a notice of six months to the landlord, for a sum of money equal to the capitalization of the rent reserved at a rate not to exceed six per centum.

Article 21: Section 104

All rents reserved by leases or subleases of land hereafter made in this State, for a longer period than fifteen years shall be redeemable at any time after expiration of five years from date of such leases or subleases, at the option of the tenant, after a notice of one month to the landlord, for a sum of money equal to the capitalization of the rent reserved at a rate not exceeding six per centum.

Article 21: Section 108

The provisions of Chapter 485 of the Acts of 1884 of the General Assembly of Maryland, and the provisions of Chapter 395 of the Acts of 1888 of the General Assembly of Maryland, and the provisions of Chapter 207 of the Acts of 1900 of the General Assembly of Maryland, were not intended to apply and do not apply to leases or subleases of property leased exclusively for business, commercial, manufacturing, mercantile, or industrial purposes, as distinguished from residence purposes, where the term of such lease or subleases, including all renewals provided for therein, shall not exceed ninety-nine years.

Article 81: Section 279 (k)

"Ground rents" means all rents reserved under ninety-nine year leases or subleases, perpetually renewable, and also rents which are redeemable, at the option of the lessee, under the provisions of Sec. 103, 104, and 108 of Article 21.

LEASE FOR NINETY-NINE YEARS—CODE CITY OR COUNTY—86

This Lease, *Made this* *day of*

in the year one thousand nine hundred and *between*

of *of the first part, and*

of

of the *part*

WITNESSETH, That the said

in consideration of the rent hereinafter expressed to be paid, do *lease unto the said*

executors, administrators and assigns, all that lot of ground and

premises, situate, lying and being in the *aforesaid, and described*

as follows, to wit: Beginning for the same

TOGETHER with all improvements, thereon made, lanes, alleys, ways, waters, easements, emoluments and advantages to the said ground belonging or in anywise appertaining.

To be held by the said lessee

executors, administrators and assigns, for the term of ninety-nine years,

beginning on the day of the date of these presents he the said lessee

executors, administrators or assigns, yielding and paying unto the said lessor

heirs or assigns,

the rent or yearly sum of *dollars,*
and that in even and equal half-yearly instalments, accounting from the
day of *one thousand nine hundred and*
over and above all deductions for taxes and assessments of every kind, levied or assessed, or hereafter to be levied or assessed, on said demised premises, or the rent issuing therefrom. Provided, that if the said rent shall be in arrear, in whole or in part, at any time, then it shall be lawful for the said lessor *heirs or assigns, to make distress therefor.*

AND provided also that, if the said rent shall be in arrear, in whole or in part, for sixty days, then it shall be lawful for the said lessor

heirs or assigns, to re-enter upon the hereby demised premises, and hold the same, until all the arrearages of rent thereon, and all expenses incurred by reason of such non-payment, shall be fully paid.

AND provided further, that if said rent shall be in arrears for six months, then the said

lessor

heirs or assigns, may re-enter upon the premises hereby demised, and hold the same as if this lease had never been made.

And the said lessee *for* *h* *sel* *heirs, executors, administrators and assigns, covenants with the said lessor* *h* *heirs and assigns, to pay the aforesaid rent, taxes and assessments when legally demandable.*

AND the said lessor *for* *h* *sel* *heirs, executors, administrators and assigns, do* *hereby covenant with the said lessee* *h* *executors, administrators and assigns, that on payment by the said Lessee* *h* *heirs, executors, administrators and assigns, of said rent, and performance of all covenants herein on* *part to be paid and performed,* *he* *the said lessor* *heirs, executors, administrators and assigns, will warrant the property hereby leased from all claims thereon, under or by said lessor or any person claiming by, from or under* *h*

ALSO, that at any time during this demise the said lessor *h* *heirs or assigns, shall on payment to* *them of Ten Dollars as renewal fine, execute and deliver or cause to be executed and delivered, to the said lessee* *executors, administrators or assigns at* *their request and cost, a new lease of the above described property for another term of ninety-nine years, to commence on the expiration of this, subject to the same rent, and with the same covenants, so that the demise hereby created may be renewable and renewed, from time to time, forever.*

Witness the hands and seals of the parties hereto

TEST:

.....

.....[SEAL]

.....[SEAL]

.....[SEAL]

.....[SEAL]

STATE OF MARYLAND, , TO WIT:

I Hereby Certify, that on this day of in the year one thousand nine hundred and before me, the subscriber, of the State of Maryland, in and for aforesaid, personally appeared

and severally acknowledged the foregoing Lease to act.

AS WITNESS my hand and Notarial Seal.

.....

Notary Public

LEASE

FROM

.....

.....

TO

.....

.....

.....

BLOCK NO.....

Received for Record.....19.....,
at.....o'clock.....M. Same day recorded
in Liber..... No..... Folio..... &c.,
one of the Land Records of .....
..... and examined per
....., Clerk.

Cost of Record, $.....

The Daily Record Company, Baltimore, Md.

Mr. ATWATER. However, I would like to supplement that with an oral statement, and emphasize some of the points that I think are not obvious in this bill.

The bill, as originally introduced in the Senate and in the House, was simply to permit the Maryland ground rent payer—the homeowner—to deduct as interest the ground rent, which he had always been permitted to deduct as interest, in a manner similar to a first-mortgage interest deduction. The amendments by the Treasury Department—or at the request of the Treasury Department—are so-called in the interest of logical consistency. However, that is not necessarily true. We favor the permitting of a deduction of the ground rent to the homeowner because, from his piont of view—and I emphasize "from his point of view"—it is very similar to a first mortgage. He looks on it as a method of financing. It is like a first mortgage, but with this essential difference: He has the right to pay it by statute. But the owner of the ground rent never has the right to require that the principal amount of that obligation, capitalized at 6 percent, be paid. So, we do have two different situations: the homeowner and the owner of the ground rent.

Now, when we say it is exactly like a mortgage, we are ignoring what the lease instrument is. The Maryland ground rent lease—I have attached a copy of the standard form granted by the Daily Record Co., in Maryland—generally used in Maryland—which is attached to the statement. The basis of that lease form is very similar to the ones used by Thomas Fell in—at least—1772 for the development of Baltimore City. It was not a device for the advoidance of income tax; it was a method for the development of the city. And the method he used then is still used. He owned land and he wanted to get a return. He decided that if houses were built on that land he could get rental income. So, he leased the land in lots to a builder, and he inserted in his lease a covenant that the builder would build houses on those lots. The lease was for 99 years, renewable forever. That is the lease used in Maryland today, except that normally now we do not insert the covenant. However, I have run across leases executed in Maryland this year, by a landowner to a builder, which included the covenant that Thomas Fell put in in 1772, requiring the builder to build houses in order to secure the rental payments from the land.

That is what the animal actually is. It is not a mysterious device; it is a ground lease started for the purpose of permitting a person to buy and own a house on a leasehold estate. He has the security that, as long as he pays his annual ground rent—we will use the $96 figure used by the Treasury Department—as long as he pays that $96 he has possession of that land and the buildings on it forever. But the legislature in 1884 first passed the redemption statute in Maryland, permitting the ground rent payer—the homeowner—to redeem, by paying either the capitalized value fixed in the lease or 4 percent—not in excess of 4 percent. So, an 1884 lease—one between 1884 and 1888—the redeemable ground rent may be a 4-percent capitalized value—not even a 6-percent capitalized value—according to the terms of the lease. And, in this bill, I don't see how you could distinguish as to what is the value on the transfer, at 4 or 6 percent.

One difficulty with this bill, is that it uses the phrase "redeemable ground rent." There is no definition in the law of the State of Mary-

land of redeemable ground rent. I do not know what that term is, and I have been practicing in the real property field for 22 years. And our firm specializes a great deal in litigated real property matters. I don't know what that term means. In the last two cases before the court of appeals in Maryland, which are cited in our brief, in which the contracts were subject to a ground rent to be created, the court of appeals said the term is too indefinite to make the contract enforcible. A redeemable ground rent would be any lease whereby the tenant has the right to buy in the reversion. That is the right of redemption. If you take it as a strict legal term, that would be, in any State in the United States, not only Maryland, but any of the other 49 as well, where a tenant has the right to buy in the reversion. A lease with an option to purchase, that would be a redeemable ground rent, and would be taxable in the same way as the Treasury says would apply to Maryland ground rent in this case. That is one of the dangers in this case. The report says it applies only to Maryland ground rents. But the law applies in all taxing jurisdictions in the United States. The land-lease device is used in commercial transactions in many States now. If those land leases contain an option to purchase, the land-lease amount is a redeemable ground rent. And the owner of the ground who leases it for commercial purposes is subject to realizing immediately the full gain on a capitalization at 6 percent of the rent received.

To apply that to one case we have in the office right now, we have a commercial client who leased a valuable piece of commercial real estate for $60,000. He made it on a 99-year lease. Under the Maryland law a commercial lease for in excess of 99 years is redeemable. This with an option to renew in it in means that that lease is a redeemable ground rent in Maryland. That is a contract now pending. When that lease is executed, this landowner is going to have a gain under the Treasury's theory of $1 million, the taxable event they say is a $1 million gain the instant that lease is executed. And that will be true anywhere in the United States where a lease with an option to purchase is executed under this Treasury Department amendment. It is dangerous. People in Maryland are familiar with this; we can see the possible effects. But nobody outside of Maryland has paid any attention to this bill, and it could have incalculable effects in other States. That is one of the hidden dangers in this bill.

As far as the phrase used in the Treasury Department's statement, that the ground rent is a way of "avoiding" tax, no tax is loss. If section 1055 as proposed is not passed, not one nickel of tax revenue is loss to the Government. In some cases it is postponed for a few years until the gain is actually realized.

Building is done in two ways. One, the builder buys the land in fee simple, leases it, and because the lessee is liable on the convenant personally, he leases it to a straw party. And then he conveys that leasehold estate, which is exactly what it is, subject to the payment of the rent to the home buyer.

Now, that was the situation in *Welsh*. And the rule 50 computation worked out by the tax court was adopted by Judge Soper in the *Welsh* decision. We say it is a fair method of taxing the gain realized at that time by the builder. And that is the only gain in that situation, is the percentage allocation at the time the lease is executed of total cost.

Now, take the other situaton to which this would also apply, the landowner like Thomas Fell, who leases land to a builder subject to ground rents. At that moment under the Treasury Department decision he realizes a taxable gain as a taxable event, the capitalized value of those rents. The builder owns only the leasehold estate. He builds the houses and sells them, and he sells all the title he owns, which is the leasehold estate, to the home buyer, who pays this ground rent under it.

Now, how can that owner who—all he has done is lease the land to someone who is going to build on it—be taxed on gain as if it were realized at that time? We don't tax any other landlord who leases to commercial tenants who are going to construct improvements on them. And that is exactly the situation that this is, except that by statute Maryland has given the homeowner who has this rental the right to redeem it as if there were a clause in the lease giving him an option to purchase.

So from the point of view of the person living in the house who owns the leasehold estate, it is similar for him to paying interest, and he can pay off the principal. But from the ground owner's point of view, the person who owns the land and leases it out, he can never demand that capitalized value of the rent, the only thing he has a right to demand is the $96 a year. And unless he sells the very land that he has leased in order to get an income, he won't have the money even to pay the tax on the gain which the Treasury Department would tax him on.

Now, Judge Soper is an eminent jurist. He has been a judge of the Circuit Court for the Fourth Circuit for many, many years. I don't know quite how long it has been, but he was appointed by President Hoover. He was an eminent Maryland lawyer prior to that time. He recently celebrated his 90th birthday, and is one of the most wide-awake, alive men around today. His decisions in the *Simmers* and in the *Welsh* cases held that as a reality no gain had been realized at the time the lease was executed. There was no taxable event. The Treasury says for consistency we should impose a tax even though no profit has been realized and even though it may require the person who has leased his property, in order to get an income, to sell that property, because you are taxing him on unrealized profit. I haven't seen it argued in many a year that a tax statute was unconstitutional. But the *Macomber* case which originally interpreted the 16th amendment says that the Congress has the power to levy taxes on income, which means any realized gain. In this case we have the decision of the highest Court, which has interpreted this transaction as being on unrealized gain. So we have for the first time, to my knowledge, an effort to tax an unrealized gain which has a constitutional question as well as the inequitable problem of imposing a tax before a gain is actually realized.

The first mortgagee, on the logical consistency argument of the Treasury, has the right on demand payment of the principal amount of the mortgage in accordance with its terms. But the ground-rent owner never can require payment of that principal. It is not a debt due to him, all he has the right to do is collect the rent itself. That is a very sharp distinction between a mortgage and a ground rent from the point of view of the ground-rent owner.

The installment sales provisions were referred to as possibly applying to leasehold transactions of this kind. To do that we will have to redefine what a sale is in the installment sales provision, because I do not think—and while I am not a tax specialist, we do have to deal in tax matters constantly in the real estate field—I do not think that this would be an installment sale. The highest courts have said it is not a sale; it is a lease. So to call it a sale on installments would be violating the basic law of the State. It would be doing what the Treasury Department says it doesn't want to do, which is to influence the States in determining the shape of their real property law by a tax law.

In the personal-holding-company section they say that the ground rent will be treated as interest under section 543(a)7, as interest on a purchase obligation. But it is not interest on a purchase obligation; there is no sale. So that the ground rent would be personal-holding-company income.

There are investments in many fields other than simply builders. This tax would not only hit builders, it would hit anybody with a lease, with an option to purchase, with a ground rent as an investment, even though the tax on the gain is paid as soon as the ground rent is sold, or as soon as that fee simple interest is disposed of. It is not lost, it is only postponed, and under *Welsh*, in the builder's case it is only partially postponed at that.

So our position is that from the homeowner's point of view this is to him exactly similar in economic effect to a first mortgage which he can pay off. The system is so beneficial that the section added by the Treasury Department, we feel, would do damage to a system which has permitted home buyers in Maryland to purchase homes and has permitted a landowner to develop income from his property in a way that has created a city of homeowners to a high percentage. The taxing act proposed by the Treasury Department, including the amendment, will affect that in an inequitable way, and possibly an unconstitutional way. And further, this statute will have an effect throughout the other 49 States in ways that tax lawyers and real estate lawyers in other States do not have the slightest conception of yet.

Thank you, Mr. Chairman and members of the committee.

The CHAIRMAN. I want to clarify your position. You favor the House bill as originally introduced by Congressman Friedel; is that correct?

Mr. ATWATER. Yes. The House bill as originally introduced by Congressman Friedel, and Senate bill S. 878 introduced by Senators Beall and Brewster.

The CHAIRMAN. You oppose the amendment that was put on by the Ways and Means Committee?

Mr. ATWATER. Yes, sir; that is our position.

The bill as originally introduced would simply permit Maryland homeowners the same privilege accorded homeowners in every other State to pay an interest on what to them is a financing method on their house.

The CHAIRMAN. Is one of your main objections that the owner can never demand redemption?

Mr. ATWATER. The ground rent owner as opposed to the homeowner, the person who has the right to receive the rent, can never require that the capitalized value be paid. If there is a ground rent

of $96, to capitalize that value at 6 percent, which is what would be taxed under the Treasury amendment, the ground rent can never demand anything more than $96.

The CHAIRMAN. It is a very complicated subject, and it has been before the committee for a long time. I think Senator Butler introduced a similar bill.

Mr. ATWATER. Yes, there was a bill introduced by Senator Butler when he was a member of this body.

The CHAIRMAN. I just want to get it clear exactly what you want done. You favor the House bill as originally introduced?

Mr. ATWATER. We favor the House bill as introduced by Congressman Friedel.

The CHAIRMAN. But you oppose the amendment?

Mr. ATWATER. We oppose the amendment on both equitable and legal principles, and because we feel it is dangerous.

The CHAIRMAN. Your remarks today were directed in opposition to the amendment?

Mr. ATWATER. Yes, we are very strongly in opposition to the amendment.

The CHAIRMAN. Because we are considering the House bill, you know, we are not considering the Senate bill.

Mr. ATWATER. Yes, this is the House bill as amended that is now before this committee, I understand, yes, sir.

The CHAIRMAN. Thank you very much.

Any questions?

Senator MORTON. Senator Brewster, is your position similar to the position of the witness?

Senator BREWSTER. Senator Beall's position and my position would be precisely the same as Mr. Atwater's. We favor the House bill as originally introduced, but we oppose the Treasury's amendment.

Senator MORTON. And the effect of this amendment, Mr. Atwater, is that it has no effect on the homeowner; I mean both the bill as amended and the bill as originally introduced take care of the $96 or whatever it is, that permits him to deduct that from his gross income for figuring his income tax?

Mr. ATWATER. Yes, Senator, that is correct.

Senator MORTON. But where the amendment hits and what you are against is that the owner of the land has to take a gain even though it is not realized?

Mr. ATWATER. Exactly.

Senator MORTON. And that is the effect of the amendment which the Committee on Ways and Means, at the request of the Treasury Department, I believe, put into the original Friedel bill; is that correct?

Mr. ATWATER. That is correct, sir. They say that instead of this being a lease it is a sale, an absolute sale with a mortgage back——

Senator MORTON. But the measure as originally introduced as well as the measure as amended does give the necessary relief to the homeowner in permitting him to expense this interest item?

Mr. ATWATER. Yes, sir.

Senator MORTON. Rather than to treat it as rent?

Mr. ATWATER. Exactly.

The CHAIRMAN. Have you given consideration to a modification of the House amendment?

Mr. ATWATER. Senator, I haven't figured a way to really modify this amendment to clarify it even, much less remove some of the things I think were inequitable. As a bill, if it is the policy, if it is going to be the policy of Congress to treat ground rent leases as sales and mortgages, if that policy should be adopted, which I feel would be a mistake, but if it were adopted, this bill is an improper one to pass, and requires further study on that amendment, because there is no definition in this of a redeemable ground rent, and the Maryland law has no definition. A redemption is literally a purchase by a tenant of the reversionary interest of the landlord. So that anything which by contract or statute gave the tenant the right to buy the reversionary interest of the landlord would be a redeemable ground lease. The effect of that is far outside of Maryland's statutory right of redemption.

The CHAIRMAN. I would like to ask Senator Brewster a question.

Have you conferred with the Treasury Department in an effort to modify the House amendment.

Senator BREWSTER. Mr. Chairman, we have asked the Treasury Department to withdraw from their position and strike their amendments, and they have refused to do it. We argue, Mr. Chairman, that the original bill goes to a very simple proposition, purely and simply, it gives tax relief to the little fellow that pays the $96 a year. And we don't even want to get into the wide question the Treasury Department wants to put us in and reconstruct Maryland's law. But they have been adamant, as I understand it, in their adherence to the amendment as proposed.

The CHAIRMAN. You are opposed to it in toto, the House amendment?

Senator MORTON. The amendment is a new bill.

The CHAIRMAN. Senator Douglas, do you have any questions?

Senator DOUGLAS. Mr. Chairman, I regret that I was delayed in coming here. This is a somewhat unfamiliar subject due to the fact that the Maryland situation, as I understand it, approximates the English situation much more than any other situation. This difference is that, under the English system, interest payments on homes are deductible, but payments of rents are not; isn't that true?

Mr. ATWATER. That is true.

Senator DOUGLAS. And what you have here is a situation in which these longtime leases were very similar to the English system; isn't that true?

Mr. ATWATER. They started to go back to the English system—or possibly the Irish land leases are about the closest we could get.

Senator DOUGLAS. They are essentially 99-year leases. And the question then comes up; are they payments of rent or payments of interest?

Mr. ATWATER. That is the question. And in Maryland before the act of 1884 they were clearly rent. The tenant could never buy in the reversion. And many of those old rent arrangements are still in Baltimore City. Some of the department stores downtown still have them.

Then in 1884 the statute passed the legislature as to any new created rents after that date, any new leases for 99 years, the tenant would have the right to purchase the landlord's interest, his reversion, originally at the capitalized value to be fixed in the lease not in excess of 4 percent. And finally in 1900 it was amended to its present form,

whereby any lease for more than 15 years, the tenant has the right to pay the capitalized value at 6 percent of the amount of the ground lease. It was found that applied to commercial property as well as residential, and they had to pass an amendment, which is now section 108, to provide that as far as redeemable features of commercial leases, any commercial lease for more than 99 years shall be redeemable at 6 percent, as differentiated from a 15-year term for a noncommercial lease. So the effect of those statutes is to give the tenant the right to redeem, which places him in the position whereby he can pay off the obligation, but never has to. So from his point of view it now is very similar to a first mortgage. But from the lessor's point of view the law is still unchanged, he has no additional rights to what he had under common law.

Did I answer the question?

Senator DOUGLAS. You increased my perplexity.

The CHAIRMAN. I would like to ask one more question.

This legislation applies to Maryland only?

Mr. ATWATER. No, sir. The term of this statute simply says "redeemable ground rent," it doesn't say "Maryland ground rent."

The CHAIRMAN. I understand it doesn't say "Maryland ground rent." But from a practical standpoint it applies to Maryland, doesn't it, chiefly? There may be some instances in Hawaii——

Mr. ATWATER. I understand that California and Hawaii have a number of them now. Actually if you say that the phrase "redeemable ground rent" used in this bill shall be interpreted to mean a ground rent redeemable by statute as defined in the Maryland statutory law, then you do restrict it to Maryland. But if you leave it undefined, it could apply to any lease with an option to purchase in any other State.

And that is where I say the danger is in this second amendment or in this amendment. The danger has not occurred to people in other States outside of Maryland, they think this applies only to Maryland. But a tax statute can't apply only to Maryland, it has to apply to the whole country.

The CHAIRMAN. The Chair fully understands that. But from a practical standpoint it applies principally to Maryland, doesn't it? For instance, I as chairman have received no complaint or expressions of approval from any State other than Maryland.

Mr. ATWATER. That would be two things. One, the Maryland ground rent system is the basis for this bill, so that Marylanders are familiar with it. And the committee report referred specifically to Maryland ground rents.

The CHAIRMAN. I am not against Maryland asking for relief; I am just asking as a matter of information whether this law would not apply entirely to Maryland.

Mr. ATWATER. As a matter of fact, its application would be primarily to Maryland. Its effect in other States we do not know.

The CHAIRMAN. Would this House amendment satisfy you, to amend the House amendment and say "shall apply only the ground rents of residential property for a term in excess of 15 years as to which the owner of the leasehold has a statutory right to redeem the ground rent by payment of the stated value, and to receive outright ownership of the land"? I am informed by Mr. Lubick that the Treasury would agree to it.

Mr. ATWATER. That would cure some of the lack of definition. I would like to really think about the effects of that just a little bit before I gave it my full approval.

The CHAIRMAN. I realize that Maryland has a different situation with respect to redeemable ground rents; but my experience has been that when legislation of this character is opposed by the Treasury Department, it nearly always is vetoed by the President. I have no idea what he will do in this instance, but I know that in many other cases where the application is more or less to one State, if the Treasury opposes the bill, the President will veto it. And if we can we should pass a bill in the form that the Treasury will approve. I understand from Mr. Lubick that he thinks that this language I just read will remove some of the objections to the Ways and Means Committee amendment.

We will have another difficulty in going to conference. If the Ways and Means Committee members insist upon this amendment, then it is doubtful that we can enact legislation.

Do I make myself clear?

Mr. ATWATER. Yes.

I would never pronounce an opinion as to what the President might do on this.

The CHAIRMAN. I am not giving an opinion. But I would like you to take this suggested modification of the amendment of the Ways and Means Committee and see if agreement can be worked out.

Mr. ATWATER. That wouldn't solve the problem that this is a tax on unrealized gain.

The CHAIRMAN. I would like Senator Brewster or Congressman Friedel to comment on that.

Congressman FRIEDEL. Senator, when I originally introduced the bill, I introduced the bill to protect individual homeowners, the ones which we describe as payers of the $96 ground rent. The Treasury Department would not recommend the passage of that bill unless the bill was amended. And 250,000 individual homeowners will be affected if we don't pass this bill, they will not be able to deduct that as interest. On the other hand, you are speaking of home-builders. I am sorry, I have sympathy for you, but I am not going to sacrifice 250,000 homeowners for that.

And besides, this is something that applies to the people of all States.

Mr. ATWATER. Congressman, I don't want to sacrifice the homeowners either. I think they should have the right to make this deduction.

Congressman FRIEDEL. If we don't pass this bill we won't be able to get it.

Mr. ATWATER. But as to the practical method of how the Senate or the House could work together, or how a conference committee could work, this is not within my experience at all, so that I would hesitate to say. I would hope that there would be some method of giving the homeowner this relief from a tax which really does treat him differently from homeowners in other States, but which still will not so basically affect the Maryland law and the established principles which Judge Soper reviewed so thoroughly in the *Simmers* and *Welsh* cases. The effect of taxing this gain is going to require immediate sale of ground rents in many, many cases whereby people otherwise would hold them as investments. And if they are required

to realize the gain as soon as they execute the lease, they are going to have to sell in order to pay the tax. Now, that is just basically inequitable, that the man hasn't made the money yet, hasn't realized his profit, but is taxed on it, so that he has to sell in order to pay it.

The CHAIRMAN. The Chair is anxious to get quick action. We are supposed to take this bill up in executive session next week. If some modification can be approved by the Treasury, I think we will stand a much better chance of getting the legislation finally enacted. That is the proposal that is made by the Treasury. There is no necessity of giving an answer this morning.

Mr. ATWATER. I would be interested to give this a little consideration as to how this would affect it and whether this would cure at least some of the problems. Of course, the basic problem is one that can't be cured as long as the purpose is in the law.

The CHAIRMAN. You know, in a matter of legislation we never get all that we want; I have found that out. There has to be a compromise, and a compromise of principles sometimes.

Mr. ATWATER. Of course, the Treasury Department has been fighting this since the Tax Court decision that required a similar—they have been questioning this ground rent system.

The CHAIRMAN. Do you think the modification of the Ways and Means Committee is a long step toward solving the problem?

Mr. ATWATER. This would make it more definite—well, for a term in excess of 15 years. The Maryland law actually is in 1 case whereby there was a lease for 2 years and 50 options for renewal, which would carry it beyond 15 years, and they said that was a redeemable ground rent under Maryland law.

The CHAIRMAN. Congressman Friedel said that you had different interests to look after. He has to look after the homeowner.

Mr. ATWATER. I can appreciate that, I know that that is something that is justifiable as Congressman Friedel's interest in this. But by the same token, I don't think that logical consistency requires, on the other side of the coin, that the owner of the ground rent should have his entire method of taxing changed and be required to pay a tax before he has actually realized a gain. He is going to pay the tax sometime, he is not going to get out of it, as soon as he realized the gain he is going to pay it.

The CHAIRMAN. The Chair is merely trying to be helpful, and, of course, in the final analysis, the Chair will give special consideration to the views expressed by the two Senators from Maryland, since this is a bill that applies in the main to the State of Maryland.

So I would like to ask the two Senators to consider that suggestion and try to work out some agreement and let the Chair know whether you want final action taken on the bill next week, or whether you need additional time for final negotiations with the Treasury in the hope of getting agreement.

Senator BREWSTER. I will so advise the Chairman.

The CHAIRMAN. Is that satisfactory to you?

Congressman FRIEDEL. Yes, sir.

Senator DOUGLAS. May I ask the witness a question.

The CHAIRMAN. Yes, sir.

Senator DOUGLAS. I am trying to understand this. Do I understand you to agree that the payment of the ground rent by the tenant should be charged as an expense and should not be subject to taxation; do you agree with that?

Mr. ATWATER. I agree that that deduction is a proper one, the permitting of that deduction.

Senator DOUGLAS. Now, do I understand you to be saying in effect that the ground rents received by the owner should not be charged as income to him, but that he should only be taxed on any increase in value on the final sale of the property? Have I misunderstood you?

Mr. ATWATER. Of course, the ground rent payment would be income to the person who receives them, there is no question but that they would be income in any event.

Senator DOUGLAS. Then what are you contending?

Mr. ATWATER. The question I have is that if the owner leases his land for $96 a year—to take a simple case, say $60 a year which, capitalized at 6 percent would be $1,000—when he executes that lease at $60 a year under that amendemnt, the proposed section 1055, he would realize a gain of $1,000, or at least he would realize a gain equal to a sale price of $1,000, so that if his land costs were $600, as soon as he executes the lease for a $60-a-year rent, he would have to pick up a gain on the difference between his land cost and the capitalized value of that rent. So that he would in theory be taxable upon a gain based upon a sale at $1,000, whereas actually he can never require that tenant to pay him the thousand dollars; all he can require is that the tenant pay the $60 a year.

So to pay the tax on his gain, the only thing he could do, if he doesn't have other assets out of which to pay it, would be to sell it and realize his $1,000, and at that point pay the tax. But this would tax him before he realizes that $1,000. And that is where we feel it is basically inequitable. He is taxable, of course, on the income of $60 a year, that is ordinary income.

Senator DOUGLAS. If he sold at $1,000, the difference between the $600 and the $1,000 would be a capital gain, would it not?

Mr. ATWATER. If he is in the building business, it is going to be ordinary income.

As a matter of fact, there is another problem here. A great many of the smaller builders can't hold on to—I would say the majority of builders do not even keep their rents, they create the rents and then sell them to private investors as investments, to insurance companies—I know at one time the insurance companies were very interested in these because they were good, safe 6 percent investments, and as soon as the builder created the Maryland ground rents and built the houses, the builders would sell the rents to the insurance company. Of course, as soon as the builder sells if for a $1,000, he has realized his gain and he pays his tax. But our objection is that unless he does sell it we don't think he has realized the $1,000 and doesn't have to pay a tax on it.

The CHAIRMAN. Thank you very much.

Mr. ATWATER. Thank you. I appreciate this opportunity for full presentation.

The CHAIRMAN. I would like to ask Senator Douglas to take the Chair.

(Senator Douglas now presiding.)

Senator DOUGLAS. The next witness is Mr. William B. Guy, Jr., Real Estate Board of Greater Baltimore.

STATEMENT OF WILLIAM B. GUY, JR., PRESIDENT OF THE REAL ESTATE BOARD OF GREATER BALTIMORE; ACCOMPANIED BY HENRY M. DEKKER, JR., COUNSEL

Mr. GUY. Mr. Chairman and gentlemen, I am William B. Guy, Jr., of Baltimore, president of the Real Estate Board of Greater Baltimore, Inc., an organization of nearly 2,000 members devoted to the interests of all real estate owners and homeowners in the Greater Baltimore area.

The purpose of my appearance is to voice the vigorous support of my organization, and, I feel, of many thousands of homeowners in the Greater Baltimore area, to H.R. 1597, under the provisions of which Maryland ground rent payments will continue to be deductible as interest for Federal income tax purposes where, as is the usual case in Maryland, the ground rent is redeemable at the option of the leasehold owner.

While ground rents exist in other cities and States, the most extensive use of ground rents in the financing of the sale of real estate, and particularly residential real estate, has been in the Greater Baltimore area. It has been said that the fact that Baltimore has always been a city of homeowners, rather than renters, is due in large measure to the Maryland ground rent system. This is because the effect of the ground rent system has been to bring many small, individual investors into participation in the financing of residential purchases, through use of the ground rent, whereas in other places the home-financing field is occupied almost entirely by mortgage lending institutions.

We have been unable to discover any reliable figures to indicate the number of ground rents existing in Maryland, or in Baltimore; but it is safe to say, I feel, that by far the majority of the homes in the Greater Baltimore area, with a population of over a million and three-quarters, are subject to ground rents.

Since 1927, these thousands of homeowners in Maryland, and many homeowners in other States, have been permitted, under Treasury Department regulations, to deduct as interest, for Federal income tax purposes, the amounts which they have paid as ground rent. Now, after this long-continued and well-established administrative interpretation of the law has played a persuasive role in encouraging a multitude of Maryland home buyers to purchase their homes subject to ground rents, the Internal Revenue Service has changed the rules of the game by denying the deductibility, for income tax purposes, of such ground rent payments.

It might be contended that these homeowners have not prejudiced their position in relying upon the past interpretation of the law by the Treasury Department, since, under Maryland law, they will now have the right to redeem the ground rents to which their properties are subject. But, gentlemen, you must remember that many of these homeowners are people of low income, without any substantial financial reserve, who will be unable to obtain the $1,500, $2,000, or $3,000 in the lump sum necessary in order to effect a redemption of their ground rents.

Moreover, the amended regulation of the Internal Revenue Service could not be more discriminatory, in that its impact, because of highly technical reasons, is to be felt only by the residents of the State of Maryland. Homeowners in Pennsylvania who pay ground rent—

and that's what it is called in Pennsylvania, as I understand it, "ground rent"—these homeowners in Pennsylvania who pay ground rent will continue to be able to deduct their payments as interest, while homeowners in Maryland who pay ground rent will not be able to so deduct their payments, because it is said to be technically rent and and not interest.

Perhaps the legal staff of the Internal Revenue Service, and others skilled in the field of law and statutory construction, understand clearly the technical legal distinctions underlying this anomalous situation; but, gentlemen, no one will ever be able to explain to the people—the small, homeowning, citizens of Maryland—the legal subtleties which permit a Pennsylvania homeowner to deduct his ground rent payments for income tax purposes but which deny this privilege to Marylanders.

To the average citizen of Maryland, the situation as it now exists under the Treasury Department's amended regulation is clearly discriminatory and grossly unfair.

The passage of the bill under consideration today by this Committee, however, would correct the inequities resulting from the Treasury Department's action.

I am not a lawyer and, therefore, I would not have the temerity to attempt to discuss with you the legal technicalities which are said to underlie the Treasury Department's recent change in its regulations.

However, Marylanders always have understood that a ground rent is to be regarded as a mortgage, and that ground rent payments are, in practical effect, payments of interest. Actually, the amount of the ground rent on any given property depends entirely upon the whim of the person creating the ground rent. The amount of the ground rent depends upon how much money the person creating it wishes—in effect—to "lend" at 6 percent interest. It is my understanding that the Maryland Court of Appeals—the highest court in the State of Maryland—has said in its opinions more than once that a redeemable Maryland ground rent—and I quote:

> has most of the essential features of, and is practically nothing more than, a mortgage to secure a principal sum, the interest of which is placed in the form of an annual rent (*Posner* v. *Bayless*, 59 Md. 56, 60).

Moreover, the Internal Revenue Service itself, for more than 30 years, permitted the deduction of Maryland ground rent payments, where the rent was redeemable, because of the realization that such payments were, to all practical intents and purposes, payments of interest on a loan.

Because of this realization that a Maryland ground rent in practical effect is nothing more than a mortgage, the Internal Revenue Service, back in 1956, attempted to persuade the United States Court of Appeals for the Fourth Circuit, in the *Simmers* case, that a builder should be charged with a realized gain at the time he creates a ground rent, just as though the ground rent were a mortgage. The United States Court of Appeals—or at least two judges of the three-judge court—held at that time, in 1956, that the Maryland ground rent was not, technically, a mortgage, and that the builder's gain, therefore, was not realized until the rent was sold or redeemed.

More recently, in the *Welsh* case, in 1960, I am informed, the Internal Revenue Service gained a substantial—although not complete—victory in the same court under a theory of gain computation, ap-

proved by the court, which reduced considerably the amount of gain which a builder could postpone under the *Simmers* case. But the court again refused to permit the Internal Revenue Service to tax the full amount of the gain at the time of the creation of the ground rent, the court holding again—as it did in the *Simmers* case—that, technically, a Maryland ground rent is not a mortgage.

I might point out in passing that the courts have never held that homeowners may not deduct their ground rent payments for Federal income tax purposes.

But, because of these decisions in 1956 and 1960 in cases involving builders, the Internal Revenue Service ruled that, effective January 1, 1962, it would no longer permit Maryland homeowners to deduct ground rent payments for Federal income tax purposes. Pennsylvania homeowners may continue, however, to deduct their ground rent payments, because of highly technical and finely drawn legal distinctions in the State laws.

Unless the bill under consideration today by this committee is enacted, most homeowners in the Greater Baltimore area will lose income tax deductions in amounts ranging from $60 to $200 a year, and more. This is a very serious thing to a great many people in Maryland—people who have relied on an interpretation of the law which has been in effect for many years—and I respectfully urge that this long-continued and basically fair interpretation of the law should be continued. The passage of H.R. 1597 would accomplish this.

At the request of the Internal Revenue Service, as I understand it, provisions have been included in H.R. 1597 which would have the effect of nullifying the decisions in the *Simmers* and *Welsh* cases. These provisions would require a builder or a developer to treat a ground rent created by him as a mortgage, and the entire amount of any gain would be taxable to such builder or developer immediately. Under the *Welsh* case, the taxation of a portion of the gain may now be deferred until the ground rent is sold or redeemed. I have been told that the Internal Revenue Service insists that such provisions be included in any bill permitting the deduction of ground rent payments by homeowners.

Whether such provisions are required for the purposes of legal consistency, I am not prepared to say. It has been brought to my attention that some of these provisions are likely to work a hardship upon some builders and developers in Maryland.

Nevertheless, I am convinced that a harsh and unfair situation is about to be imposed upon many thousands of Maryland homeowners unless that portion of the bill is promptly enacted which permits the deduction of ground rent payments for income tax purposes.

Because of what I regard as the great and immediate necessity for this aspect of the bill, I respectfully urge that this committee approve H.R. 1597 in its present form in time for the Maryland homeowner to take the deductions on his 1962 tax return.

Now, the amendment that was recently proposed, several minutes ago here by the Treasury Department, to meet the objections of the homebuilders, I feel on the advice of my counsel, who is here to explain that particular aspect of it, is unnecessary. We feel that the important thing about this bill is to get the deduction for the homeowners. And we do not feel this amendment is necessary. And also we are

worried and concerned about the possibility of the bill not passing if it gets any amendment at all.

If I may, I will let Mr. Henry Dekker, of Baltimore, explain this particular point, and also on the matter of definition of ground rents.

Senator DOUGLAS. Thank you very much.

Mr. Dekker.

Mr. DEKKER. Mr. Chairman, I have known Mr. Atwater for a great many years, and I have the highest respect for his legal ability. I do not necessarily take issue with him, but I am not sure that I understood clearly what he said, and perhaps the committee did not understand clearly what he said. But the substance of his discussion was that the term "redeemable ground rent" needed a more precise definition in the act. He based this opinion upon the fact that the Court of Appeals of Maryland supposedly said that it, the highest court in the State of Maryland, did not know what a redeemable ground rent was.

Well, it is true that the court said something like this, but in a peculiar context. The cases to which Mr. Atwater referred were cases involving contracts of sale, involving suits for specific performance of a contract of sale, where a property was sold, let us say, subject to a $96 ground rent. An effort was made by the seller to enforce this contract. And it is true that the court of appeals said, "We do not know what a $96 ground rent is." Under Maryland law it might be a 16-year lease, it might be a 40-year lease, or it might be a perpetually renewable 99-year lease. We do not know what the parties had in mind. But for the purposes of this act, certainly anyone in Maryland would know what a renewable ground rent is. It is any lease for residential purposes of more than 15 years or a commercial lease for more than 99 years. I could not feel that the act needs any more precise definition. And I think the Treasury Department was caught unaware by Mr. Atwater's remarks, and under those circumstances proposed this amendment, which I do not feel is necessary.

Senator DOUGLAS. On residential property, the Treasury Department is proposing the same definition that you propose, is it not; namely, that redeemable ground rent apply to the ground rents of residential property for a term in excess of 15 years? Wasn't that your definition?

Mr. DEKKER. This is the definition that is established by statute in the State of Maryland. This is what a redeemable ground rent is.

Senator DOUGLAS. What is your objection to including this language, the fear that this will get caught in conference?

Mr. DEKKER. Yes, sir. And we feel it is unnecessary.

If you will refer to the appendix to Mr. Atwater's statement, you will see the applicable Maryland statutes which define "redeemable ground rent."

Senator DOUGLAS. Thank you.

Mr. DEKKER. Thank you, Mr. Chairman.

Senator DOUGLAS. Mr. Walter C. Mylander.

STATEMENT OF WALTER C. MYLANDER, JR., HOME BUILDERS OF HOWARD COUNTY, MD.

Mr. MYLANDER. Mr. Chairman, thank you very much for the opportunity to appear.

I have no prepared statement.

My position is precisely like that of Mr. Atwater. I am heartily in favor of the House bill as offered. And I agree with all of the witnesses who seem to be in accord in their opinion that from the standpoint of the homeowner, the payment of Maryland ground rent is substantially equivalent, from his point of view, to interest on borrowed money, and that it should therefore be made deductible as it always has been.

I am strongly against, however, the Treasury amendment being the inclusion of section 1055. In the present form of the bill my objection is substantially that any legislation, whether tax legislation or substantive law, which unwittingly or unintentionally goes beyond its original purpose into unexplored fields, is undesirable, if not actually dangerous.

Now, the intention, the original intention of the Treasury in proposing its amendment was to overcome the rule of the *Simmers* and the *Welsh* cases. The language used to accomplish this was broad. We must recognize the fact that the *Welsh* and *Simmers* situation is only a small part of the field that is covered by this proposed amendment, whether or not it is modified in accordance with the suggestion which was circulated here today.

The *Welsh* situation factually—the *Simmers* also—was that an owner of a parcel of land, who was a builder, built houses upon it, and then created the ground rent as a financing device and sold the leaseholds subject to these reserved ground rents.

Judge Soper in both cases said that as to the value of the retained land, no taxable event occurred. In *Simmers* the builder was taxed only on the difference between the cost of his improvements and the sale price of the leasehold which incorporated or included the improvements. In *Welsh*, the cost basis of the leasehold was apportioned differently, but that is not material to my comment on this bill.

But normally and historically ground rents were not created by builders, ground rents were created by landowners who wanted to make their land productive, and so they leased it to others.

Mr. Atwater referred to Thomas Fell, who was one of the earliest Marylanders to utilize the device generally. He owned a tract of land at Fells Point in Baltimore Town. Instead of selling it to people who wanted to build houses, he leased it to them. He charged them nothing for the leasehold, he just entered into an agreement in exactly the same form that is used today, with only the most minor changes, such as the use of——

Senator DOUGLAS. May I ask a question, Mr. Mylander?

Mr. MYLANDER. Yes, indeed.

Senator DOUGLAS. Take the builders whom you represent, when they buy land, is that subject to a leasehold, or do they buy it outright and then impose a leasehold upon the people who buy the house from them?

Mr. MYLANDER. Specifically with reference to my particular client in Howard County, I can't answer you, Senator. I can say that at

large, and throughout the State, both methods occur. An owner of land will sometimes lease it to a builder or to an owner to build a house on it. In other instances the builder will buy a tract in fee simple and create and retain the rents himself. In other instances he will create the ground rents before he builds. So that you might have a situation where John Jones, builder, buys 10 acres of land and creates 40 ground rents on the subdivided lots within those 10 acres. Not until the next year or so does he build his houses and sell the leaseholds. Does he realize a taxable event when he creates the rents but sells nothing? Under this bill he does, under the Treasury amendment he does. But more important than the technical, legal objection to taxing an event in which no money is realized is the fact that this language is broad, it says "redeemable ground rents."

Now, I sharply differ with Mr. Dekker. We do think we know what Maryland ground rents are. Generally they are the 99-year leases renewal forever, which under the act of 1900, are redeemable at the rent capitalized at the rate of 6 percent. That is ture, but this is a generic concept. Ground rents mean, can mean, many things. And the Maryland court of appeals in *Ward* v. *Newbold* and *Moran* against *Hammersla*, two Maryland cases—and I would like to cite them, since the transcript contains reference to them—*Ward* against *Newbold* (115 Md. 689); *Moran* against *Hammersla* (188 Md. 378). Our court said that the term "ground rent" was not sufficiently definite to permit specific performance of a contract which defined what was sold by just that term.

Now, it is answered by Mr. Dekker that our redemption act, article XXI, section 104 of the Maryland Code, provides that all residential leases for more than 15 years are redeemable at the capitalization of the rent reserved at 6 percent, and that all leases whether residential or not are redeemable if the term is for more than 99 years.

Now, that is not a definition of a ground rent which the courts in North Dakota or in Kansas or in California are going to adopt in construing this amendment. A ground rent can be in Maryland any lease for more than 15 years which is redeemable in the sense that the lessee can buy out the reversion. We talked of redeemable ground rents before our redemption statute. Some ground rents even before 1884 were redeemable by a clause of the lease, which provided that they should be redeemable.

Now, the language which is used in this Treasury amendment would clearly make any lease of the ground—any long-term lease of the ground and improvements—with an option to purchase, come within the scope of this tax act. The result—and there is not any doubt about this—the result is that every commercial lease made in Pennsylvania or made in New York or made in Massachusetts or any other State, where the ground was leased and the lessee had an option to purchase, would be involved by this Treasury amendment. The mere signing of the lease would be a taxable event giving rise to liability for income tax based on the capitalization of the reserved rental, even though that sum may never be received by the lessor.

Thousands of these exist with reference to shopping centers, with reference to commercial institutions. And unwittingly, unintentionally, if this amendment is passed, it will give rise to questions, legal

questions and tax questions, throughout the breadth of the country that are not anticipated and not intended.

Now, the additional amendment that is offered by the Treasury and which was circulated here today helps only one of my objections. It would eliminate the question as to the commercial leases. But it still would cover apartment houses. More important, however, it would still leave taxable the mere signing of leases where no gain was realized. And for the reasons expressed by Mr. Atwater, this would be unconstitutional, and it would be contrary to all previous tax policy.

If one is taxed because he has created an unrealized increment of value, but he has no money with which to pay the tax, we are doing great injustice to the tax structure.

Now, my conclusion is that House bill 1597 as originally offered should be passed. Section 163 is proper and in accordance with previous Treasury standards. The proposed section 1055 is dangerous, firstly because it fails to define "redeemable ground rent," secondly, because it unwittingly and unintentionally taxes many events that occur within the framework of the system that we call Maryland ground rents, even though no gain has been realized, and in some cases will not be realized for a considerable length of time.

And thirdly, because it involves unwittingly and unintentionally, situations in each of the other 49 States the people of which have no idea that they are being subjected to the dangers that are inherent in this Treasury amendment.

Thank you very much.

Senator DOUGLAS. Thank you very much.

May I ask a factual question. Is there a brisk market in the purchase and sale of these ground rents?

Mr. MYLANDER. Senator, there is a ready market. It is no longer as brisk as it once was. At one time it could be said that any well-secured ground rent, that is, any rent reserved on a house where the fee simple interest was 4 to 6 times the amount of the capitalization of the rent, that such a rent could be sold almost across the counter. There is a strong market for these creatures. The brokers in Baltimore City will have a buyer to match a seller. A contract can usually be made simply by a call to a broker's office.

A few years ago there was a brisk market. Today, while it is not as brisk, there is still a steady market. There are ready buyers in the person of the insurance companies, investment trusts, private trusts, and private investors. The ground rent system is stated in a very competent law review article in the Maryland Law Review by Frank Kaufman to be beneficial. "Mysterious but Beneficial," is part of the title. It is beneficial both to the leaseholder, that is, the homeowner, and to the investor, that is, the reversion owner.

Senator DOUGLAS. Do I understand that one of the objections of the homebuilders to section 1055 is that it might hasten the process of sale by the builder of the ground rent for a figure less than he might realize if he held on to it for sometime.

Mr. MYLANDER. No; I think that is an extrapolation. It would hasten the sale, but not at a less figure. I think if he were forced to sell he could realize the current market price for it even if he had to sell this week or next, to pay his tax bill.

Senator DOUGLAS. But he would give up the prospect of an increased future market price for it; isn't that true?

Mr. MYLANDER. The more that is being done to ground rents the more the market is harmed. The ground rents are no longer the favored investment that they once were. This is due not only to the taxes on the Federal level, but to unfavorable tax treatment at the State level, strangely enough.

Senator DOUGLAS. Thank you very much.

I think that concludes the witnesses. And thank you all for coming.

(Whereupon, at 12:15 p.m., the committee adjourned, subject to the call of the chair.)