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THE FEDERAL INCOME TAX CONSEQUENCES
OF COMMERCIAL CONVEYANCES OF RIGHTS IN
AIRSPACE

MARK H. ALLEN

AIR RIGHTS ARE FREQUENTLY the most valuable
rights connected with the ownership of commercial land since the value of such property consists principally of the
owner's right to erect buildings in the airspace. Four factors
in society contribute to make airspace rights increasingly im-
portant today. The first factor is the goal of achieving the
optimum use of property in highly urbanized commercial ar-
eas. The second factor is the development of aviation and the
related problems of providing the necessary air highways to
accommodate air travel. The third factor, involving the hous-
ing industry, concerns the attempt to combine the benefits of
multi-unit structures with the advantages and appeal of indi-
vidual ownership. The fourth factor is the desire to preserve
open space by means of "scenic" or "open space" easements.
This fourth factor is actually a factor of non-development
rather than a means of achieving fuller utilization of available

1 G. ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE ¶ 15.03 (1980)
[hereinafter cited as G. ROBINSON].
2 Id.
3 Bernard, Airspace in Urban Development: Emergent Concepts, 46 URB. LAND
INST. TECH. BULL. 7 (1963) [hereinafter cited as Bernard]. See R. WRIGHT, THE LAW
OF AIRSPACE 150 (1968) [hereinafter cited as R. WRIGHT]; Comment, Leasing of Air-
space Above Public Buildings—The Public Use Doctrine and Other Problems, 28 U.
PITT. L. REV. 661 (1967) [hereinafter cited as Leasing of Airspace].
4 Bernard, supra note 3, at 7; R. WRIGHT, supra note 3, at 101-209.
5 Id.
6 Bernard, supra note 3, at 7.
7 Id. at 7, 12; G. ROBINSON, supra note 1, at ¶ 15-16, 15-17.
airspace. This comment will concentrate on conveyances of airspace that are motivated by a desire to achieve a more commercially efficient use of airspace, and on the income tax effects of such conveyances.  

The commercial conveyances of airspace occur for a variety of purposes. There are many indications that airspace development will increase in the future as society discovers the multitude of needs that can be satisfied through this type of development.  

Because greater numbers of conveyances of airspace are likely to occur in the future, there is a need for attorneys to understand what the conveyances can accomplish and what the possible income tax effects of these conveyances will be.

I. THE HISTORICAL DEVELOPMENT OF COMMERCIAL CONVEYANCES OF AIRSPACE

The development of large American urban centers and the high concentration of the population and business community into compact areas have placed a premium on real property located within commercial regions. Real estate developers and other entrepreneurs seized the opportunity to capitalize

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* These types of conveyances primarily arise in commercial settings and deal with the development of airspace. See R. Wright, supra note 3, at 261-71. Undeniably, conveyances of airspace for purposes of multi-unit housing are usually commercial in nature, but there is already an ample amount of scholarly research devoted to condominiums and cooperative housing arrangements. See Rohan and Reskin, Condominium Law and Practice (1980), which is a multi-volume service with subscription updating. See also Kehoe, Cooperatives and Condominiums (1974); Clurman & Hebardi, Condominiums and Cooperatives (1970).

* Some of these purposes are:

   (1) For the construction of a restaurant above an interstate highway or tollroad. Bernard, supra note 3, at 18.

   (2) For the construction of an apartment building above a railroad yard. Bernard, supra note 3, at 16.


   (4) For the construction of a tennis court over the city reservoir. R. Wright, supra note 3, at 268.

* See note 9 supra.

* Leasing of Airspace, supra note 3; Bernard, supra note 2, at 7.
on the need for housing and office space in these areas by expanding construction capabilities to the point that skyscrapers could be built. Subterranean development also occurred, as subways and underground walkways were constructed to further meet the needs of the growing commercial centers.

The economic premium for property in the downtown areas of the large urban centers prompted utilization of all space that feasibly could be developed to meet the increasing growth and expansion. Once the downtown areas became moderately developed, alternatives to demolition of existing structures and reconstruction of new buildings were sought to meet the need for more efficient uses of property. Demolition and reconstruction were not favored because of the high costs and the safety risks involved with demolition in a crowded commercial area.

One fairly recent alternative to demolition is the utilization of airspace above existing surface development. An example of early airspace development is the utilization of the space above railroad tracks in the center of a metropolitan area. Years ago, for development of airspace to be economically feasible, it had to occur in a highly concentrated urban center where the high costs of construction would be offset by the premium paid for the additional space, or where the construction would be publicly subsidized. Today, this development of airspace has expanded to areas above virtually every type of surface structure including highways, bridge approaches,

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12 See generally R. WRIGHT, supra note 3, at 2-3.
13 See Bernard, supra note 3, at 12.
14 Leasing of Airspace, supra note 3; Bernard, supra note 2, at 7.
16 Id.
17 There are at least three orthodox developments of airspace; these are the developments of:
(1) Airspace over buildings.
(2) Airspace over and below highways.
(3) Airspace above railroads.
See Polikoff, Orthodox or Conventional Air Rights, in AIR RIGHTS 9 (D. Siskind ed. 1974)[hereinafter cited as Polikoff].
18 Nelson, Appraisal of Air Rights, 23 APPRAISAL J. 495, 497 (1965); Bernard, supra note 3, at 7, 9.
19 R. WRIGHT, supra note 3, at 310.
existing buildings, and city streets. It now appears that development of airspace is limited only by the requirements of local zoning ordinances, construction capabilities and costs, and the imaginations of entrepreneurs.

The meaning of the term "airspace" is still not uniformly established, but practically all of the modern definitions have developed from the common law maxim *cujus est solum, ejus est usque ad coelum et ad inferos* ("To whosoever the land belongs, he owns also to the sky and the depths"). Blackstone commented that the word "land," as used in the maxim, included not only the face of the earth but also everything under it or over it. However, to set the common law maxim in perspective, it must be observed that no judicial decision has ever really held that the ownership of airspace extended infinitely upward. While the maxim and its interpretation were consistent with the circumstances from which it arose, the advent of improved construction techniques and the use of the airspace by aviators made it apparent that the common law rule was inadequate to serve the needs of the modern world.

In *United States v. Causby*, the United States Supreme Court recognized that Congress had previously declared the air to be a public highway and that this realization necessarily

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20 Id. at 381.
21 See generally R. Wright, supra note 3, at 9.
24 R. Wright, supra note 3, at 102; Manion, Law of the Air 2 (1950).
25 When the maxim developed, there were no tall buildings or aviation so the question of airspace ownership was addressed on theoretical grounds. See R. Wright, supra note 3, at 12.
26 In a famous case on taxation, Justice Jackson limited the air rights ownership question:

> Today the landowner no more possesses a vertical control of all of the air above him than a shore owner possesses horizontal control of all the sea before him. The air is too precious an open highway to permit it to be "owned" to the exclusion or embarrassment of air navigation by surface landlords who could put it to little real use.

27 United States v. Causby, 328 U.S. 256, 261 (1946).
limited the common law maxim. Even though the common law principle which provided infinite ownership of airspace to the surface owner was eventually so limited as to be effectively renounced, it has served the important purpose of classifying airspace as a real property interest. This interest has been described by the Supreme Court as the amount of space above the ground that the owner can occupy or use in connection with the land.

Although there has yet to be unanimous agreement upon the extent of the property owner’s rights in airspace, two generally employed definitions of airspace rights will suffice for the purposes of this article. The more comprehensive definition is provided by Section 2 of the Model Airspace Act:

For purposes of this Act, airspace is defined as that space which extends from the surface of the earth upward and which is either occupied or utilized or is reasonably subject to being occupied or utilized or is otherwise necessary for the reasonable enjoyment and use of the land surface and any structures thereon by the surface owner or owners, his or their heirs, successors or assigns. The airspace owned by a surface owner or owners is that which lies within the vertical upward extension of his or their surface boundaries.

The second and less complex definition describes air rights as an independent unit of real property, created through the horizontal subdivision of real estate, which may be defined simply as “the right to occupy the space above a specified plane over, on or beneath a designated tract of land.”

Selection of a proper definition is only the beginning of the legal problems encountered with air rights. A wide spectrum of problems ranging from title description and recordation to the tax status of airspace for real property taxation purposes

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28 Id.
29 Id. at 256, 261.
30 Id. at 264.
32 Id. at 355.
34 Pedowitz, Transfers of Air Rights and Development Rights, 9 REAL PROP.,
await the parties conveying airspace. Yet, despite these difficulties, conveyances of airspace are occurring with increasing frequency. New and creative uses of airspace have fueled this trend towards increased development of airspace.35

II. FEDERAL INCOME TAXATION PROBLEMS WITH THE CONVEYANCE OF AIRSPACE

No specific provisions for special treatment of the conveyance of airspace are found in the Internal Revenue Code or in other official regulations or pronouncements.36 In fact, the concept of rights in airspace has seldom appeared in tax related cases or publications.37 This is not to say, however, that the problems encountered in a conveyance of airspace will be the same as those encountered in a conveyance of other types of real property, and, in those situations where the problems are similar, unique solutions are often required to solve the dilemma when it involves a conveyance of airspace.38

Except where airspace is leased, the determination of the tax basis39 of the airspace conveyed and of the basis of the property conveyed for support structures is an important

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Note 9 supra.

But see I.R.C. § 170(f). This section, in part, deals with nondeductibility of charitable contributions of scenic easements.

The conveyance of airspace has appeared in federal income tax cases under the following circumstances:

1. Where an easement in the airspace was granted under the threat of governmental condemnation. Rev. Rul. 54-575, 1954-3 C.B. 145.
2. Where the grantor made a charitable contribution of the airspace above an existing building along with the right to construct additional floors. The gift of the airspace was held to be deductible at its fair market value. Mattie Fair v. Commissioner, 27 T.C. 866 (1957).

The suggestions in this comment are based upon the premise that current principles of taxation of real property will be extended to the conveyance of airspace by the Internal Revenue Service and by the courts.

Basis is the tax "cost" of the property to the taxpayer. This may be his actual cost, fair market value, or a substituted basis, depending primarily on the manner in which the property was acquired. The basis is cost if the property was acquired by purchase. G. Robinson, supra note 1, at ¶ 11.02. See I.R.C. §§ 1001-1024.
problem common to all of the methods of conveyance. In each instance, the basis of the property must be determined in order to ascertain whether the tax effect of the transaction will be a gain, a loss, or a reduction of the basis of the property retained. The determination of basis can be difficult when only a portion of the property is sold, because the basis must be apportioned between the rights or property conveyed and those retained.

As in the subdivision of real estate, the grantor of airspace must allocate the basis of the entire property between the specific portions conveyed and the specific portions retained. A valid allocation is one that will reasonably identify the costs of property with the revenue from the sale of portions of that property. The method of allocation must be "an equitable apportionment" and not be purely ratable. It must be based on the fair market values of the rights as of the time of the purchase, not merely on such mathematical criteria as size, acreage, or flat percentage allocation according to area, unless there is no intrinsic difference in the value except in

40 The problem of the determination of the tax basis may well apply even to the leasing of airspace if the lease has a provision for easements for support structures, which is often the case. See R. Wright, supra note 3, at 346; Polikoff, supra note 17, at 24.

41 The determination of when a gain or loss or reduction of the basis is incurred will be explained in the subsequent discussion in this comment. For a good discussion of the character of the gain or loss (whether capital or ordinary) and of the real property classifications (ordinary assets, capital assets, and Section 1231 assets), see G. Robinson, supra note 1, at ¶ 11.06.

42 G. Robinson, supra note 1, at ¶ 11.02.

43 Id.


47 See cases cited in note 46 supra. Although the Tax Court has required that the allocation be made at the time of the purchase, a taxpayer may be able to sustain an allocation made at the time of the sub-division of the property if the allocation is carefully supported by the facts and circumstances. Schwieters & Warnick, supra note 44, at ¶ 11.02 [3][a]. See Ayling v. Commissioner, 32 T.C. 704 (1959); Treas. Reg. § 1.61-6(a) (1956).
terms of quantity. Furthermore, the grantor must be able to prove that his method of allocation is fair and equitable, or the Internal Revenue Service (IRS) has the authority to make an allocation for him.

The determination of the fair market values of the various rights, as a method of allocating the basis, will be much more likely to pass the scrutiny of the Internal Revenue Service if prepared by a qualified expert in appraising real estate. The fact that it is not usually practical to develop airspace except in urban centers and where high property values exist also tends to emphasize the need for appraisal by qualified experts, because large sums of money are typically involved and the tax effects may be substantially different if the Internal Revenue Service exercises its authority to make its own allocation. Although the fair market values will be determined by independent appraisers in most instances, it is still important for attorneys to understand the appraisal process. In this way they can better serve their clients during the planning of an airspace conveyance, when drafting the conveyance documents, and when preparing the client's tax return and handling any subsequent Internal Revenue Service examinations of that tax return.

Normally, when the owner of a tract of land is going to sell a portion of it, the owner is aware that all of the land has some value, even though he may attach little worth to some of it in his own mind. If the owner of the tract is going to sell

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50 Kanawhe Banking & Trust Co. v. Commissioner, 29 B.T.A. 376 (1933); See generally Heiner v. Gwinner, 114 F.2d 723 (3d Cir.), cert. denied, 311 U.S. 714 (1940).
51 R. Wright, supra note 3, at 310.
52 See Schwieters & Warnick, supra note 44, at ¶ 11.02[1].
53 See R. Wright, supra note 3, at 305.
54 Id.
55 Although a portion of a tract of land may be unmarketable or unusable for the taxpayer's purposes, it is very rare that none of the basis should be allocated to a portion of the tract. One reason for this is that it is questionable if any real benefit can be derived from showing that the portion of land is worthless. If the portion is worthless, then no basis should be allocated to it so it would not generate a deduction for worthless property. Of course, if no basis is allocated to a portion of the tract, the
half of his land and the land is of equal value, he merely allocates one half of his tax basis in the whole property to the half sold to determine whether or not he realizes a gain or a loss on the sale. This allocation becomes much more difficult when the land is not of uniform value, as is the case when, for example, the tract contains farm land, a pond, and a swamp, all of which are obviously worth different sums even though they may occupy equal amounts of the total tract. As noted previously, the owner then has to allocate the basis of the entire tract between the portions conveyed and the portion retained on the basis of respective fair market values. Although this sort of allocation is much more complicated than the first simple example, tax cases and IRS pronouncements establish a number of reasonable allocation methods for the subdivision of land.

The allocation of basis is much more difficult when airspace is the subject matter of the conveyance because it is highly unlikely that a separate value has been assigned to these rights or that the owner, or anyone else, has considered the airspace a portion of property capable of being conveyed separately. The IRS pronouncements and tax cases are of less help to the owner when he is trying to allocate the basis of his property because there are no precedents allowing or disallowing the various methods of allocation with regard to the conveyance of airspace. Indeed, some of the methods plainly could not be applied to a conveyance of airspace. For example, the allocation of basis by area method would be impossible

basis of the other property in the tract is higher. This situation decreases any gain on the sale of the other property, but the taxpayer is left in possession of a piece of property with no basis. If the piece is sold, the fact that it has no basis is likely to invite careful examination by the Internal Revenue Service, and the taxpayer's entire allocation may be disturbed. See generally, Schwieters & Warnick, supra note 44, at ¶ 11.02[4][b].

Treas. Reg. § 1.61-6(a) (1956).

Some of the various allocation methods are: equitable apportionment, acreage (or area) method, relative-value method, gross-profit method, selling-price method, and the units-per-lot method. For a discussion of these methods, see Schwieters & Warnick, supra note 44, at ¶ 11.02[3].

See generally Schwieters & Warnick, supra note 44, at ¶ 11.02.

See note 57 supra.
to apply due to the indefinite upper boundary of the airspace.\textsuperscript{60} The problem is further complicated by the fact that a portion of the basis may also have to be assigned to parts of the surface that are to be utilized for structural support related to the development of the airspace.\textsuperscript{61} Stated quite simply, a two dimensional problem becomes three dimensional, and instead of dealing with the conveyance of a flat surface lot, the parties are contemplating the conveyance of a three dimensional tract.

III. The Application of the Laws of Federal Income Taxation to the Methods of Conveyance of Airspace

Generally, there are five methods of conveying rights in airspace as contemplated in this article: the lease method, the grant of an easement, the conveyance of fee with reservation of an easement, the conveyance of fee above a certain level with an easement for supporting structure, and the conveyance in fee of both the airspace and the surface required for supporting structures.\textsuperscript{62} Each of these methods may have different tax consequences. For this reason, it may be very advantageous for the grantor to seek professional advice as to the tax implications before he agrees to make a particular kind of conveyance. The following discussion presents tax factors that should be considered when evaluating the various methods of conveyance.

A. The Lease Method

In many respects, the lease method is the simplest form of

\textsuperscript{60} Although the decision in United States v. Causby, 328 U.S. 256 (1946) stated that the upper boundary of real estate is the level beyond practical use in connection with the land, the determination of exactly where the “practical use in connection with the land” extends cannot be calculated with any certainty.

\textsuperscript{61} See notes 115-21 supra and accompanying text.

\textsuperscript{62} R. Wright, supra note 3, at 344-68; Polikoff, supra note 17, at 14-15. Some writers would include a sixth method, that is, the conveyance of the entire fee to a parcel of airspace as in the condominium situation. Technically, this is probably correct, but, as previously mentioned, this type of conveyance is excluded from treatment in this comment.
transferring rights in airspace. A fee estate in the specified airspace is usually leased for a limited amount of time, and often, the lease is coupled with options to renew or with an option to purchase which can be exercised at a later date. Frequently, the lease is combined with either easements for supporting structures or for the surface needed to accommodate supporting structures.

The lease method is also probably the simplest method when considering income tax consequences because allocation of basis problems are not present when no sale or exchange of the property occurs. Generally, as long as the lease is for a business purpose and between unrelated parties, the total lease payment is deductible by the lessee as rental expense and is included in the lessor's income as rental income. In order for the rentals paid to qualify as a business deduction, the rent must be paid for "property to which the taxpayer has not taken or is not taking title, or in which he has no equity." The requirement that the lessee not acquire title distinguishes a lease from a purchase, as well as from a use of property that is already owned in part by the taxpayer. The rent payments for the lease may take many forms, with the manner of the payment determining the period in which the rent deduction should be taken.

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65 R. WRIGHT, supra note 3, at 345-46.
66 Polikoff, supra note 17, at 16; R. WRIGHT, supra note 3, at 346-47.
67 R. WRIGHT, supra note 3, at 346-47.
68 This is because the entire rent payment is deductible. The lessee does not depreciate the cost of the lease and no allocation of basis is necessary. See I.R.C. § 162.
70 I.R.C. § 162(a)(3).
71 I.R.C. § 162.
72 The more common forms of payment are those listed below or a combination of them:

1. **Fixed Periodic payments**—these payments are deductible by a cash basis taxpayer when paid and by an accrual basis taxpayer as the rent accrues and becomes due for each month without regard to the actual date of payment. See I.R.C. § 162(a); Treas. Reg. § 1.446-1(c) (1956).
2. **Lump Sum payment**—The taxpayer must allocate the prepaid rent over the term of the lease and only take a deduction for a pro rata share of the lump sum, even if he is on a cash basis. See generally Treas. Reg. § 1.461-1(a)(1); Treas. Reg. § 1.461-1(a)(2) and (2) (1956).
The law does not limit the deduction for rent to "a reasonable allowance," as long as the expense is ordinary and necessary in carrying on any trade or business. This flexibility is particularly helpful in the leasing of airspace where the determination of a reasonable allowance would be a difficult problem in itself. A problem with leasing in general exists, however, when the amount claimed to be deductible as rent is, in fact, a disguised payment for some other purpose. Normally, under a simple lease arrangement, parties conveying airspace should encounter few income tax problems.

When the lease agreement contains an option to purchase, the question arises as to whether the transaction should be treated as a lease until the option is exercised, or whether the transaction should be treated as an installment sale for tax purposes. The Internal Revenue Service and the Tax Court apply an "economic reality" or "intent to purchase" test to determine the proper treatment. Whether an agreement, which is in form a lease, is in substance a conditional sales contract depends upon the intent of both of the parties as evidenced by "the provisions of the agreement, read in light of the facts and circumstances existing at the time the agree-

(3) Variable payments based on the lessee's income—a cash basis taxpayer may deduct rent payments that are computed as a percentage of income when that payment is actually paid. An accrual basis taxpayer may deduct this payment for the year to which the percentage is applied to determine the amount, as long as it is paid within two and one-half months of the close of the taxpayer's year. See I.R.C. § 267(a)(2).

72 I.R.C. § 162(a).

73 Levinson & Klein, Inc. v. Commissioner, 67 T.C. 694 (1977). See generally Consolidated Apparel Co. v. Commissioner, 207 F.2d 580 (7th Cir. 1953), rev'g, 17 T.C. 1570 (1952); Place v. Commissioner, 199 F.2d 373 (6th Cir. 1952), aff'g, 17 T.C. (1951), cert. denied, 344 U.S. 927 (1953). This problem will not ordinarily arise except between related landlords and tenants.
74 Holzwarth v. Commissioner, 24 T.C.M. (CCH) 1676 (1965).
76 Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956); M & W Gear Co. v. Commissioner, 54 T.C. 385 (1970), aff'd on this issue, 446 F.2d 841 (7th Cir. 1971).
There is no one test that can be applied to determine when a taxpayer might be required to treat a lease with a purchase option as an installment sales contract; even so, when the lessee is to acquire title upon the payment of a stated amount of rentals which he is required to make by the "lease" agreement, or when the agreed "rentals" materially exceed the current fair rental value, the taxpayer will most likely be required to treat his purchase option lease as an installment sales contract. There are many other conditions that may require sales treatment, unless an intention of the parties of a contrary purpose can be persuasively demonstrated.

78 See Frank Lyon Co. v. United States, 435 U.S. 561, 577 (1978). It should be noted that the Economic Recovery Tax Act of 1981 has added a safe harbor provision for certain leverage leasing arrangements to insure that the agreement is treated as a lease for federal income tax purposes. See I.R.C. § 168(f)(8).
79 Taft v. Commissioner, 27 B.T.A. 808 (1933); See generally Bowen v. Commissioner, 12 T.C. 446 (1949).
80 See McWaters v. Commissioner, 9 T.C.M. (CCH) 507 (1950).
81 Other conditions that will likely lead to the treatment of a lease with a purchase option as an installment sale exist when:
(a) portions of the periodic payments are made specifically applicable to an equity interest to be acquired by the lessee. See Bowen v. Commissioner, 12 T.C. 446 (1949).
(b) the total amount which the lessee is required to pay for a relatively short period of use constitutes an inordinately large portion of the total sum required to be paid to secure the transfer of the titles. Id.
(c) the airspace may be acquired under a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared to the total payments which are required to be made; Rev. Rul. 55-540, 1955-2 C.B. 39. But see Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952).
(d) some portion of the periodic payments is specifically designated as interest or is otherwise recognizable as the equivalent of interest. Judson Mills v. Commissioner, 11 T.C. 25 (1948).
(e) the agreement provides for a declining option price which is substantially less than the value of the leased property. Alexander v. Commissioner, 17 T.C.M. (CCH) 221 (1958).
(f) the lessee agrees to exercise the option by a specified date, a portion of the deductions for rentals may be disallowed or the agreement may be held to be a sale and not a lease with an option. Smith v. Commissioner, 51 T.C. 429 (1968).
(g) there is economic compulsion to indicate a sale as where the lessee
If a taxpayer is required to treat a lease with a purchase option as an installment sale, the tax consequences can be materially different. The lessee may be required in such cases to treat his rent payments as purchase payments, and then only the portion of these payments found to represent interest are deductible. However, if any depreciable property exists in the leasehold, the "lessee" is allowed to take a depreciation deduction if he is required to treat the transaction as a purchase. Unfortunately there is no depreciation deduction for real property (except for physical developments or improvements upon it); thus, apparently, there can be no depreciation of the purchased airspace. The treatment of the lease as an installment sale significantly affects any tax planning on the part of the lessee. Consequently, a lease agreement that contains a purchase option should be carefully drafted so as not to result in a transaction which the Internal Revenue Service could recharacterize.

B. Aerial Easements

Aerial easements are used primarily as supplements to other methods of conveyance and in connection with highways. When easements are granted, particularly in connection with highways, the grant is used both for the purpose of accommodating a need for an elevated highway and for the purpose of transferring the airspace above or below the high-
An aerial easement is often granted when a ramp is needed to rise gradually in approach to a large bridge or to another highway. In addition, an aerial easement above city streets is often granted so that a walkway can be constructed connecting two buildings above the ground level.

If a perpetual easement is granted and it is attached to a specific portion of property, it will be treated as a sale of that portion of the property and recognition of gain or loss on the sale is required. If a limited (non-perpetual) easement is granted to a specific portion of the property, the grant is treated as the sale of an interest in real property. When limited easements are granted, the proceeds should be applied to reduce the basis of the property affected, with any excess of proceeds over the amount of the basis treated as a gain. There can be no loss recognized on the granting of a limited easement, only a reduction of the basis. Thus, normally the granting of a perpetual easement is treated as a sale of a specific piece of real property, while a limited easement is treated as a sale of some of the rights to the use of the property.

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88 Id.
89 Id.
90 An example of one of these walkways may be observed in downtown Dallas, Texas, where an aerial walkway connects the second floor of an office building, One Dallas Centre, to the third floor of a parking garage across a city street. Actually, such walkways are common in many cities.
91 A perpetual easement is often referred to as an easement in perpetuity. J. CARTWRIGHT, GLOSSARY OF REAL ESTATE LAW 695 (1972). "Perpetual" is defined as "never ceasing; continuous; enduring; lasting; unlimited in respect of time." BLACK'S LAW DICTIONARY 1298 (4th ed. 1951).
92 This treatment can be visualized in a situation in which a perpetual easement is granted across a specific portion of a tract of land, such as a path used by adjacent landowners. The grant will be treated for tax purposes as a sale of the strip of land constituting the path because of the permanent nature of the easement. If the easement were not perpetual, the grant would not be treated as a sale of the strip of land but as a sale of the interest in the property that is less than the total of the rights associated with the property.
93 See Rev. Rul. 72-255, 1972-1 C.B. 221. Also, if the grantor retains nothing more than bare, legal title to the property by granting an easement, he will be required to treat the grant as a sale. Rev. Rul. 59-121, 1959-1 C.B. 212.
94 See note 91 supra.
96 Id.
When an aerial easement is granted over an entire tract of land and it is impossible or impracticable to ascertain a specific portion of the property affected by the easement, the consideration is applied to reduce the total basis of the property while any excess over the cost or other basis is treated as taxable income. As a general rule, the Internal Revenue Service and the courts have refused to find apportionment impossible or impracticable in real estate cases, but none of the cases have dealt with the granting of an aerial easement. Due to the very nature of an aerial easement, it is unlikely that courts will hold such an easement to be attached to a specific portion of the property, unless the conveyance agreement specifies the exact area the easement is to occupy. It would be more difficult for a court to identify an easement with a specific portion of the property if the easement occupies an unspecified, three-dimensional portion of airspace as occurs, for example, where an aerial easement is granted for an elevated highway ramp with the grantee retaining the right to change the location of the ramp to suit future needs.

These facts may allow the grantor of an aerial easement to engage in some effective tax planning before he grants the aerial easement. If the circumstances provide the needed flexibility, such as when neither the grantor nor the grantee is concerned with whether the easement is provided over a specific portion of the tract, the grantor can compare the tax consequences of making the grant over a specific area with the consequences of not specifying the area. The grantor can determine the tax effect of specifically identifying the portion of property to be affected by the aerial easement by making the allocation of the basis to that specified tract, and by then comparing the basis with the proceeds that he expects to receive. If the basis is greater than the proceeds, the grantor can incur a loss by a specific grant of a perpetual easement because it will be treated as a sale. If a limited easement is

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granted, the proceeds will only result in a reduction of the basis of the specific tract of property; proceeds that are in excess of the basis of the specifically identified portion of property will result in a taxable gain, whether the easement is perpetual or limited.\textsuperscript{101}

When the proceeds from the grant of the easement exceed the basis of the specific portion of the property affected, careful planning may allow the grantor to make the grant in such a way that it probably will not be identified with a specific portion of the land. If the grantor can do this, the proceeds will be applied to the basis of the entire property and gain will be recognized only if the proceeds exceed the entire basis of the grantor's property.\textsuperscript{102} The best way for the owner to avoid a finding that the easement is identified with a specific tract of land is for the owner to retain as many beneficial interests in the property conveyed as possible.\textsuperscript{103}

There are some specific measures that can be taken when drafting the easement document that might help insure a finding that it is impossible or impracticable to ascertain whether a specific portion of the property is affected by the easement. One such measure is to avoid specifically identifying the air through which the easement will run.\textsuperscript{104} Of course, the grantor may want other provisions in the document to insure that the grantee does not abuse such a grant, but this type of grant provides the parties with needed flexibility in the use of the airspace and in the construction of support structures.\textsuperscript{105} A second measure that can be taken to help insure a favorable finding on this issue is to include a provision that allows the grantee to change the location of the easement with the grantor's permission.\textsuperscript{106} A third provision that might

\begin{itemize}
\item \textsuperscript{103} G. Robinson, supra note 1, at ¶ 17.02.
\item \textsuperscript{104} This would help rebut an assertion that the easement was identified with a specific tract of land in the granting easement.
\item \textsuperscript{105} See Note, Conveyance and Taxation of Air Rights, 64 Colum. L. Rev. 33 (1964). Brennan, supra note 33, at 27.
\item \textsuperscript{106} This would rebut an assertion that although the location of the easement was
\end{itemize}
be included in the conveyance document, if the situation permits, is a provision for the grantor to retain rights of ingress and egress, and also to retain a reversionary interest in case the grantee abandons the easement.\textsuperscript{107} Since the retention of beneficial rights by the grantor will help insure that the easement will not be deemed attached to a specific portion of land,\textsuperscript{108} a reversionary interest is an excellent method of establishing these beneficial rights.\textsuperscript{109}

C. \textit{Conveyance of the Entire Fee with a Reservation to the Grantor of An Easement}

A conveyance of the entire fee with a reservation of an easement to the grantor is probably the method preferred by most grantees because they acquire the highest estate possible while still allowing the grantor to continue his operations.\textsuperscript{110} The conveyance is of the entire fee estate except facilities necessary for the grantor's business, which are reserved to the grantor by means of an easement.\textsuperscript{111} The grantee is generally conveyed a permanent easement for access through the area reserved to the grantor.\textsuperscript{112} Alternatively, the grantor may merely reserve an access easement rather than an easement

\textsuperscript{107} This provision has already been successfully litigated in the granting of a right of way; the reversionary interest seems particularly appropriate to the granting of an easement in airspace. \textit{See} Conway v. United States, 73-1 U.S.T.C. 80,686 (W.D. Ky. 1973).

\textsuperscript{108} G. Robinson, \textit{supra} note 1, at \textsuperscript{109}17.02.

\textsuperscript{109} An example of a situation in which these provisions might help the grantor avoid a taxable gain and also serve a practical purpose would be the grant of an aerial easement for an elevated highway ramp. There may be a need for the ramp to be moved in the future if the highway is enlarged; the second provision will serve a practical purpose if this occurs. Also, the easement certainly will no longer be needed if the highway is abandoned and this fact increases the grantor's chance of including a provision for a reversionary interest. Without these provisions, it is very likely that the ramp will be held to be identified with the specific portion of the property upon which it is constructed. \textit{See}, \textit{e.g.}, Rev. Rul. 72-255, 1972-1 C.B. 221.

\textsuperscript{110} "From an air right purchaser's viewpoint, it is an ideal arrangement, not only because of the flexibility, but because the entire property is owned outright by the purchaser." Horack \& Nolan, \textit{Land Use Controls} 118-19 (1955). \textit{See} Polikoff, \textit{supra} note 17, at 16.

\textsuperscript{111} Polikoff, \textit{supra} note 17, at 17.

\textsuperscript{112} \textit{Id.}
for the full operation of his business;¹¹⁸ the choice between these options depends upon the particular needs of the grantor.¹¹⁴

The principle tax problem encountered with this method of conveying airspace is basically the same as that encountered with the granting of an aerial easement, that is, the determination of the basis which should be allocated to the easement.¹¹⁶ When this method is used, the grantor sells everything but the easement reserved for his purposes.¹¹⁸ The question as to whether the grantor has retained more than the naked legal title to the property, as is required for an easement not to be treated as a sale,¹¹⁷ is no longer pertinent; the grantor has deeded the title to the grantee and retains the rights that he has reserved.¹¹⁸ Unless the easement is specifically identifiable with a particular portion of the property so that an allocation might be made based on the area of the surface burdened, or unless an allocation can be made by some other accepted method, the grantor will have to utilize a new method to allocate the basis of the entire property to the rights conveyed and to the rights retained in a fair and equitable manner.¹¹⁹ In the usual case the grantor will want to allocate as much of his basis as is possible to the rights conveyed; so that his taxable gain will be minimized or his taxable loss increased.¹²⁰ If the proceeds from the conveyance are agreed on, the amount of basis allocated to the property conveyed will determine the amount of gain or loss from the sale.¹²¹

When allocation of the basis is being made, it is helpful to

¹¹³ R. Wright, supra note 3, at 354.
¹¹⁴ Id.
¹¹⁵ See notes 70-72 supra and accompanying text.
¹¹⁶ See R. Wright, supra note 3, at 353.
¹¹⁷ See note 93 supra.
¹¹⁸ Polikoff, supra note 17, at 16-17.
¹¹⁹ See note 34 supra.
¹²⁰ This will have the effect of minimizing the grantor's tax liability for the current year, which is the objective of most taxpayers. See W. Andrews, Basic Federal Income Taxation 450 (2d ed. 1979).
¹²¹ See generally I.R.C. § 1001.
think of the property rights as existing in three tiers: the rights in airspace; surface rights; and subsurface and recoverable mineral rights. Out of this trio of rights conveyed must be subtracted the rights retained by the grantor. The fair market value of the airspace can be estimated by determining the present value of the future rent payments or the sales price of a platform constructed at some height above that surface. The cost of the platform should include the cost of acquiring rights to construct support structures and the cost of acquiring rights of ingress and egress. The platform should be thought of as a base for construction or for other intended use through which the airspace can be developed. After the fair market value of such a platform is determined, it must be adjusted for the estimated cost of constructing the platform. The fair market value of the surface rights can be determined by calculating the present value of future rentals of the surface area under such a platform, taking into consideration the fact that the surface will be burdened by the structural supports needed for the platform. Finally, the subsurface and mineral rights will have to be appraised to determine the fair market value of these rights, including the value of possible recoverable minerals and the present value of the property for future subsurface development. Once these fair market values have been estimated, a fair market value must be placed on the rights retained by the grantor, which may span into all three levels. This process can be clarified by visualizing a

122 See generally R. Wright, supra note 3, at 307-18.
123 See Bernard, supra note 3, at 12, 17.
124 See note 34 supra.
125 The platform for the airspace structure replaces the land surface in providing the base on which the building stands. In most instances it will constitute the most expensive additional element of cost involved. Machen, Air Rights Development, 34 Appraisal J. 288, 292 (1966). See also Nelson, Appraisal of Air Rights, 23 Appraisal J. 495, 505, 507 (1955).
126 Id.
127 Id.
128 Id.
129 See generally R. Wright, supra note 3, at 312.
130 Id. The fair market value of these subsurface rights may be zero if no known mineral deposits exist and if subsurface development is not foreseeable.
131 See generally R. Wright, supra note 3, at 312.
situation in which the grantor is a railroad, that conveys the fee for construction of a building above its tracks and reserves an easement for the operation of the railroad.\textsuperscript{132}

A sale and leaseback\textsuperscript{133} is similar to the sale of the fee estate with a reservation of an easement by the grantor.\textsuperscript{134} The grantor only leases back the portion of the property that he needs for his purposes and leaves the grantee free to develop the airspace.\textsuperscript{135} Such arrangements often include multiple renewal options or an option to repurchase. A sale and leaseback allows the grantor to shift the title to the property (and may allow him to shift the maintenance burden and other risks of ownership to the grantee) while the grantor gets the proceeds from the sale.\textsuperscript{136} Indeed, since proceeds may be in excess of the amount of financing available through a mortgage,\textsuperscript{137} the grantor who needs additional cash for his business may find this possibility especially attractive. Furthermore, the grantor is allowed a deduction for the full amount of his rental payment\textsuperscript{138} instead of only being allowed a deduction for the portion of his mortgage payment which represents interest.\textsuperscript{139} By using the sale and leaseback, the grantor is able to continue use of the property as required for the operation of his business, and the grantee obtains the highest estate in the prop-

\textsuperscript{132} This situation occurred in Chicago where the East Apartments were constructed upon the air rights above the Illinois Central Railroad Yard. See Bernard, \textit{supra} note 3, at 16.

\textsuperscript{133} This type of agreement results in the owner of the property selling his entire interest subject to a lease of which he is the lessee. See F. Roege, \textit{Sale and Leaseback Financing 2d} (1972).

The sale and leaseback arrangement is not usually discussed as a method of conveying rights in airspace but this arrangement appears to be a practical and beneficial alternative in many situations where the grantor desires to retain some type of right in the property conveyed.

\textsuperscript{134} In both of these types of conveyances, a fee is conveyed and the grantor retains the property needed for the operation of his business, either by easement or by lease. See Polikoff, \textit{supra} note 17, at 17.

\textsuperscript{135} Id.


\textsuperscript{137} Powell, \textit{supra} note 136, 'at ¶ 242[4].

\textsuperscript{138} I.R.C. § 61(a)(5).

\textsuperscript{139} I.R.C. § 163.
However, transactions such as the sale and leaseback must have true economic substance, and must not be shaped solely by tax avoidance features, to be given effect by the courts. Also, if the lease period is greater than thirty years, the Service may assert that a like-kind exchange has occurred. Should this position prevail, no gain or loss would be recognized and the rent deduction would be disallowed while a depreciation deduction would be allowed for the grantor.

D. Conveyance of Airspace in Fee Above a Certain Height with an Easement to the Grantee for Supporting Structures

A conveyance of airspace in fee above a certain height, with easements to the grantee for supporting structures, results in adjoining fee estates that are horizontally contiguous. The owner of the upper estate has an easement through the lower estate. The developer receives title to airspace above a designated plane and an easement for supporting structures which extends down from the fee of airspace to the grantor’s structure, or to the surface area of the property that is still owned by the grantor. Special provisions are often included in this type of conveyance that allow for a change in the location of support structures when necessary and for other alterations in arrangements which help to insure that needed flexibility is retained.

The tax problems in a conveyance of this type are basically a combination of those discussed in the conveyance of aerial easements and in the conveyance of the entire estate with a reservation of an easement in the grantor. Again, it is help-
ful to think of the property as stratified into three layers: the subsurface and mineral rights, the surface rights, and the airspace rights. In this method of conveyance, the airspace rights are divided at a certain height, with the lower division treated as incident to the surface rights. The grantor must determine the basis of the airspace above that certain height and he must also account for the basis that will be allocated to the easements for support structures. For this determination, an appraisal by a qualified expert as to the fair market values of the levels of the property is probably the best manner by which the allocation of the tax basis could be made. As with the granting of an aerial easement, there is the possibility that a carefully drafted document can result in a separate conveyance of the easements for support structures, without causing the grantor to recognize gain on the grant of the easements. Although the grantors must recognize a gain or loss on the conveyance of the airspace above the specified height (much as would be required if the transaction was a subdivision of real estate lots in a newly developed neighborhood), it appears possible that conveyance of the easements for support structures may take the form of a separate transaction so that the easements burden the entire tract of property remaining and are not identified with a specific portion of the grantor's property. If this technique is employed; the provisions mentioned in the discussion concerning the granting of aerial easements should be included in the document, that is, the location of the support structure easements should not be specifically identified. Instead, there should be a provision allowing for the change in the location of the support

147 See note 122 supra.
148 See R. Wright, supra note 3, at 354-60.
149 See G. Robinson, supra note 1, at ¶ 11.02.
151 See notes 87-109 supra and accompanying text.
152 See generally Schwieters & Warnick, supra note 44, at ¶ 12.05.
153 Since the easements are incident to the lower lot retained by the grantor, it appears possible for the grantor to convey the easements as attached to the entire tract of land and not as attached to any specific portion of the land. See generally Rev. Rul. 54-575, 1954-2 C.B. 145, as modified by Rev. Rul. 72-433, 1972-2 C.B. 470.
structures if the grantor approves, and a provision for a reversion can be included.\textsuperscript{154}

Whether or not this attempt to reduce the grantor's recognizable gain will be successful is a question not yet contemplated by any rulings or decisions. It would appear that the rights in real property must be recognized as separable and that once separability is established, a conveyance of the fee in airspace and then of the easements needed for support structures is possible.\textsuperscript{155} However, any separate conveyances of airspace and of easements should not be made solely for the purpose of tax avoidance without first considering that the IRS will likely challenge the transactions on a step transaction theory and may attempt to treat both conveyances as one sale.\textsuperscript{156}

E. The Conveyance in Fee of Both the Airspace and the Ground Required for Supporting Structures

The conveyance in fee of both the airspace and of the ground required for supporting structures involves the conveyance of a fee simple absolute. This method is theoretically designed to include full ownership of everything that the airspace structure will require,\textsuperscript{157} and, thus, provides the purchaser a degree of ownership approaching fee ownership of the entire property. One of the major problems with the method is that it requires a high degree of accuracy in locating support structures within the exact boundaries of the property conveyed;\textsuperscript{158} construction errors can cause many problems when such a high degree of accuracy is needed.\textsuperscript{159} This problem can be alleviated by providing for new conveyances or for easements if such problems are encountered, and by providing for a liberal amount of surface property and airspace that can be used for supporting structures.\textsuperscript{160}

\textsuperscript{154} See notes 87-109 supra.
\textsuperscript{155} See generally Treas. Reg. § 1.61-6(a) (1956).
\textsuperscript{156} See MERTENS, LAW OF FEDERAL INCOME TAXATION ¶ 20.161 (1977).
\textsuperscript{157} R. WRIGHT, supra note 3, at 361.
\textsuperscript{158} Id.; Polikoff, supra note 17, at 18.
\textsuperscript{159} R. WRIGHT, supra note 3, at 361.
\textsuperscript{160} Id. at 368.
The tax problems encountered with this method of conveying air rights are variations of the problems encountered with other methods of conveyance. When using this method, the grantor can no longer try to make a general grant of the areas needed for support structures, as he could if aerial easements or easements for support structures were being granted, because the property needed for the support structures is being sold to the grantee. In other words, the grantor has to determine the basis of the airspace above a certain height, the basis of the surface area used by the support structures, and probably even of the mineral and subsurface rights below those areas of the surface. There is no question as to the specific portion of the tract conveyed, since the surface areas are identified by complete legal descriptions. Because this method deals entirely with the transfer of a fee estate, there are no unique tax problems other than those previously mentioned in regard to other methods in which the granting of the fee was a portion of the conveyance.

IV. Conclusion

The federal income tax consequences of commercial conveyances of airspace, for the most part, have not yet been determined. When dealing with these conveyances, attorneys can only proceed cautiously under the assumption that current federal income taxation principles regarding other types of real property will be extended to rights in airspace. By keeping this assumption in mind, attorneys may be able to favorably influence their clients' income tax consequences through careful planning of the conveyance, through selection of the most appropriate method of conveyance, and by artfully drafting the instrument of conveyance to result in the most

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161 Id. at 361-65.  
162 See generally Bernard, supra note 2, at 12, 17.  
163 Bell, Air Rights, 23 ILLINOIS L. REV. 250 (1928); R. Wright, supra note 3, at 364.  
164 See notes 110-56 supra and accompanying text.  
165 See notes 100-12 supra and accompanying text.  
166 See R. Wright, supra note 3, at 344-68; Polikoff, supra note 17, at 14-15.
beneficial tax consequences for the client. An appraisal by a qualified expert will generally be helpful in sustaining valuations upon which allocations are made, and thus should not be overlooked when the attorney is engaged in the planning of an airspace conveyance. Once the appraisal has been made and method of conveyance has been selected, the attorney should remember that the allocation method must be reasonable and must fairly allocate the basis of the entire property to the rights transferred and to those retained. Reasonableness of the allocation is judged in light of the circumstances existing at the time of the sale, and should not be subject to successful challenge because of events occurring after the sale is completed.

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167 See notes 104-12 supra.
168 See generally R. Wright, supra note 3, at 305.
169 See notes 34-40 supra.
170 See generally Schwieters & Warnick, supra note 44, at ¶ 11.02[2].
171 Id.