Typical Tax Aspects of Real Property Leases

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Landlords and tenants regularly negotiate for the use of real property. These negotiations focus on the economics of the present value of the rent payable and the other concessions to be made by one party or the other over the term of the proposed lease. The tax aspects of the rent payments and concessions can make a significant difference in the economics of the proposed transaction, and thus need to be understood by the parties. The purpose of this article is to provide a general overview and guide to the key tax issues typically encountered.

1. **Rent**. Business rents are deductible as business expense for the tenant (IRC § 162) and rents are income to the landlord. IRC § 61(a)(5). Timing of the income depends on the accounting method used. IRC § 451(a). Landlords may like accrual reporting because rents are generally payable in advance while mortgage interest is generally payable in arrears. Thus, accrual reporting may accelerate more expense than income. Rent income under the accrual method is reportable when all events have occurred to fix the right to receive the rent and when the amount can be determined with a reasonable degree of accuracy. This is usually when it falls due under the lease. See Regs. §§ 1.451-1(a) and 1.446-1(c)(1)(ii)(A). Prepaid rents are taxable when received.

When a landlord uses the cash accounting method, rent income is taxed when actually or constructively received. Regs. § 1.451-2. Constructive receipt may apply when a related tenant has the ability to pay but doesn't.

Also, despite the normal accounting methods of the parties, IRC § 467 may require earlier inclusion into income by landlord where total rents exceed $250,000 to avoid abusive mismatches such as equal rents payable under a master lease with a sublease providing for low rents in early years, and higher rents in later years. IRC § 467 applies to leases with rents back-end loaded beyond one year following the calendar year in which the use occurs or where there are increases in rents during the term. Rent is recognized on an accrual basis with an imputed interest factor for the deferred rent. However, since under this provision accruals are allocated pursuant to the lease (IRC § 467(b)(1)(A)), in many leases there is no difference in result with or without IRC § 467 because payment schedules and period allocations are the same. See Regs. §§ 1.467-1(c)(2)(ii)(A)(2), 1.467-1(c)(2)(ii)(B), and 1.467-7(j)(4). Thus, absent tax avoidance (see IRC § 467(b)(4)(B)) in certain disqualified leaseback or long-term leases, transactions can generally be structured to avoid IRC § 467 treatment for accrual basis taxpayers by making payments and allocations the same. Also, specifying currently payable adequate interest generally avoids time value of money issues. See Reg. § 1.467-2(a) and (b) (110% of applicable federal rate). On the other hand, this provision, because it overrides normal accounting methods, can allow law firms and other cash basis service firm tenants to accrue deductions prior to the

related payments sometimes with little tax cost to the landlord. The rules are quite complex, however.

Let's turn to the tenant's side of the transaction. Where the tenant uses the accrual method of accounting, the same fixed and determinable rule applies as with landlords, but economic performance is ratable with the use of the property, so the accrual of deductions usually can't be accelerated. Advance rents would generally be capitalized. Contingent rents (*e.g.*, based on sales) accrue as sales are made or the contingency is met. Regs. § 1.461-4(d)(3)(ii). Cost pass-throughs (*e.g.*, taxes, utilities, etc.), however, can be accrued monthly even if billed later by the landlord if the amount can be determined with reasonable accuracy.

Where the tenant uses the cash method of accounting, generally, the deduction is available when the rent is actually paid. If a prepayment has a useful life beyond one year, it must be capitalized and amortized. *Zaninovich v. Com'r*, 616 F.2d 429 (9th Cir. 1980) allowed a full deduction for a December prepayment for the following 12 months' rent. Rev. Rul. 80-70, 1980-1 CB. 104 holds the opposite and would allow a deduction only for rent attributable to the current taxable year.

Payments clearly designated as rent are usually simply rent, but not every transaction is that simple. What may be rent? Rents also include expenses of landlord's paid by tenants. Reg. § 1.162-11(a); *Lim v. Com'r*, TC Memo 1998-432; *Blunt v. Com'r*, TC Memo 1966-280. If the tenant pays the amount before the landlord pays or accrues the expense, income may be accelerated to the landlord as a form of prepaid rent. However, if the actual legal obligation is or becomes the tenant's, then the landlord may avoid accelerating income. This does not work if the landlord remains liable and the tenant pays the amount–this is rent as the tenant makes the payments. See *Wentz v. Gentsch*, 27AFTR 1128 (DC Ohio 1940); *Equity Planning Corp & Subsidiaries v. Com'r*, TC Memo 1983-57.

Treating advance rentals (whether through paying landlord expenses or just paying landlord money, or otherwise) as loans to avoid accelerating income generally does not work, particularly where poorly documented, without interest, between related parties, or directly tied to the lease. See *U.S. v. Williams*, 395 F.2d 508 (5th Cir. 1968); *New England Tank Ind. of N.H., Inc. v. Com'r*, 50 TC 771 (1968), *aff'd* 413 F.2d 1038 (1st Cir. 1969).

Payments to a landlord to cancel a lease may be rental income of the landlord in the year received (or in which liability to pay is certain). Regs § 1.61-8(b); *Hort v. Com'r*, 313 US 28 (1941) (substitute for rent). However, IRC § 1234A seems to change this rule after 1997 to make such payments capital gain. Under that section, any gain attributable to the cancellation or other termination of a right with respect to property which is a capital asset in the hands of the taxpayer is capital gain; this appears to apply to IRC § 1231 assets (property used in a trade or business), as well as capital assets. Congress disapproved of two cases holding that payments to release the lessee's obligation to restore premises were ordinary income, and decided that in the future similar payments were to be made subject to Code Sec. 1234A, and thus eligible for capital gain treatment. S. Rept. No. 105-33, 105th Cong., 1st Session, 134-135 (1997). Real property under IRC § 1221(a) will be a capital asset in the hands of a lessor unless it is "property

used in a trade or business." But capital gain treatment could apply even where the property is not a capital asset because the rental real estate in the cases disapproved by Congress was used in a trade or business, disqualifying it from the definition of capital asset and making it instead "§ 1231(b) property."

Security deposits to secure the landlord against property damage and other such matters and returnable at lease termination but not segregated in the meantime, are not rents. See *Indianapolis Power & Light Co. v. Com'r.*, 493 US 203 (1990). If, however, the deposit is only to secure rents and is not segregated, it is more likely a rent advance payment because the tenant is obligated to pay the rent, in any event. Also, if a segregated deposit or a deposit which covers a range of possible tenant obligations is used to pay the last month's rent, it is likely rent at that time. Where, however, the landlord receives prepaid amounts for rent applicable to a later period, then sells the property and the price is reduced for those prepaid amounts, the prepaid amounts are rental income to the buyer, not the seller. *Hyde Park Realty, Inc. v. Com'r*, 211 F.2d 462 (2d Cir. 1954), *aff'g* 20 TC 43 (1953).

2. **Expenses**. Landlords, on the cash basis of tax accounting, deduct expenses when paid. Under the accrual basis of tax accounting, landlords take expense deductions when fixed, reasonably determinable, and also upon economic performance. IRC § 461(h).

For real estate taxes, accrual is generally as they are paid, not on the assessment date. There is an exception to the general economic performance accrual rule for nonmaterial recurring tax items where paid within the shorter of a reasonable period or 8 ½ months after year end. IRC § 461(h)(3). The use of this exception requires an election in first taxable year such real estate taxes are payable. Reg. § 1.461-5(d)(1).

There is also an exception to the general economic performance rule allowing the making of a ratable accrual method election for real property taxes relating to specific periods of time. IRC § 461(c). The election must be made in the first taxable year the landlord incurs the real property taxes.

Co-owners (not subject to partnership rules), generally get a deduction only for their own share of expenses, except for mortgage interest and property taxes, where the co-owner may need to pay the other owner's share to protect his or her interest in the property. See *Movius Estate v. Com'r*, 22 TC 391 (1954) (real estate taxes); Rev. Rul. 67-21, 1967-1 CB 45. In such cases, the personal liability of the paying co-owner, occupancy of the property, and a right to reimbursement under state law, help justify the deduction for the paying co-owner. See *Conroy v. Com'r*, TC Memo 1958-6.

3. **Special Tenant Benefits**. Leases often contain special benefits or concessions to attract or keep tenants. Tenant buildouts or allowances for tenant improvements, buyouts of prior leases, moving cost payments, sign rights, reductions in expense pass-throughs, etc., often raise concerns about the tax treatment they receive.

Cash or tangible benefits are income to the tenant. IRC § 61. Capital items received (*i.e.*, in lieu of cash) are taxable but under some circumstances might be deducted (*e.g.*, through depreciation, or abandonment) in later years by the tenant. Such benefits are not likely to be treated as nontaxable rent rebates.

The landlord's assumption (not a payoff) of a prior lease may not create taxable income because the income generally would be offset by a corresponding deduction. *Cassatt v. Com'r*, 137 F.2d 745 (3d Cir. 1943); Rev. Rul. 69-511, 1969-2 C.B. 23.

It is possible for the tenant to just take the value of concessions by landlord as lower rent over the lease term. However, to the extent the concession is not just a true rent reduction, but takes some other form, the concession will be a cost of obtaining the lease, and the landlord amortizes the costs of obtaining the lease over the term of the lease; this includes the cost of special tenant incentives (<u>see</u> Regs. §§ 1.263(a)-2(a) and 1.461-1(a)(1)), as well as legal fees, brokerage commissions, and similar costs (Rev. Rul. 73-421, 1973-2 C.B. 33).

Options held by the tenant to acquire some or all of an interest in the real property fee title create special issues. Under IRC § 162 the rent deduction does not apply where the tenant is taking title or equity. Nominal option payments at the end of a lease will create a purchase rather than a true lease. Rev. Rul. 55-540, 1955-2 C.B. 39. Favorable options, however, do not alone transform a lease into a sale unless they are almost certain to be exercised. <u>See</u> generally, *Beaudry v. Com'r*, TC Memo 1972-214.

Options to buy a fee interest under the lease where rents are set in the lease at amounts in excess of market rents at the time of leasing generally will make the excess a payment for the option, not for the use of the property; however, if other factors indicating a sale are present (*e.g.*, a very low price payable on exercise of the option), the excess payments may indicate a present sale which should trigger the recognition of gain or loss and prevent the so-called "rents" from in effect becoming deductible purchase price. Rev. Rul. 55-540, 1955-2 C.B. 39. If the transaction is not treated as an immediate sale, the excess amounts where an option is present and which are treated as payments for the option itself, would add to the basis of the fee interest if the option is exercised, or be written off if the option is allowed to lapse. Where the option is real and not a disguised sale, actual rents (either where there is no excess payment or to the extent the rents are not treated as essentially a payment for acquisition of the option itself) paid before option exercise are still treated as rents even if the price is reduced in some part by them, and only amounts paid after exercise are for purchase price. *Indian Creek Coal and Coke Co.*, 23 BTA 950 (1931).

4. **<u>Lease Acquisition or Modification Costs</u>**. Landlord and Tenant both must capitalize the cost of obtaining the lease. For the landlord, costs of acquisition of the lease include tenant incentives as well as ordinary transaction costs. <u>See</u> *Strouth v. Com'r*, TC Memo 1987-552 (landlord's payments to third party for acquiring tenants and management services capitalized); *Seahill Co. v. Com'r*, TC Memo 1964-56 (commissions capitalized). For the tenant, ordinary transaction costs, such as commissions, attorney and other professional fees, or the cost of purchasing a leasehold estate, or the costs of modifying a lease, all need to be amortized over

the term of the lease. IRC §178 generally allows the lease costs to be deducted over the life of the lease even if there is an expectation the lease may renew for a longer term. (As discussed below, the same is not true for leasehold improvements which are deductible under IRC § 168 over their recovery periods even if longer than the lease term.) However, if less than 75% of the costs are allocable to the main term, then the tenant must include any explicit or implicit renewal option periods in the amortization period. IRC § 178(a) and (b); Regs. § 1.178-1(b)(5). If 25% or more of the costs are allocable to the renewal term option periods, tenant must assume the options will be exercised in calculating the amortization period. IRC § 178 provides for a straightline amortization. Unamortized balances are deductible at the time any option expires unexercised. If the option period was not earlier taken into account in setting the amortization period, any remaining unamortized costs at the time of an exercise of the option need to be reamortized over the extended term beginning in the year of exercise. *Dalton v. Com'r*, 21 TCM 435 (1962).

Landlord costs to purchase the cancellation of a lease need to be capitalized. IRC § 263; *Peerless Weighing and Vending Machine Corp. v. Com'r*, 52 T.C. 850 (1969). Rev. Rul. 71-283, 1971-2 C.B. 168 required the amortization over the remaining term of the canceled lease. Or, if the payment is to obtain possession in order to re-lease, it may be more appropriate to amortize it over the term of the new lease as an acquisition of lease cost. Landlords must capitalize costs paid to modify a lease, as well.

For the tenant, the receipt of funds in a cancellation payment transaction is a sale or exchange which may provide capital gain treatment. IRC §§ 1221, 1222, 1231. This is not the case with payments to the tenant to modify the lease, however, which will be ordinary income to the tenant. Payments by the tenant to cancel or modify a lease are treated as rent paid by the tenant (and generally deductible by tenant) to the landlord (or as gain for the landlord under IRC § 1234A, discussed above as to rents), and the landlord's income is not deferred even if the tenant enters into a new lease with the landlord. IRC § 461. However, if there is such a new lease, the tenant may be required to capitalize the payment over the term of the new lease rather than deduct it. See *U.S. Bancorp & Consol. Subsid. v. Com'r*, 111 TC 231 (1998); Ltr. Rul. 9607016.

5. **Tenant Improvements**. Without a depreciable interest in property, there can be no depreciation deduction. A capitalized lease can be such property. The real estate fee and reversion can be such property. Between the two, each asset involved should be depreciable by one of the parties.

The proper party to depreciate an item is determined by a recognized interest in the property. *Mayerson v. Com'r*, 47 T.C. 340 (1966). An economic reality test is used. Rev. Rul. 55-25, 1955-1 C.B. 283. Legal title is a factor, but not itself determinative. Other factors include how the benefits and burdens are allocated (*e.g.*, tax, insurance), who has the right to possession, who paid for the improvements, and what the parties intended. See IRS Industry Specialization Paper 162, Retail Industry. Tenant Allowances (Oct. 5, 1996).

Parties can (and probably should) negotiate who is to pay for which items, and thus potentially create net tax savings. To the extent a payment, even one denominated "rent," is for costs of improvements to be owned by tenant, it is essentially a purchase and must be capitalized and amortized by tenant over the recovery period of the improvement, even if longer than the lease term. IRC § 168(c). If landlord pays some of the cost, say up to a dollar cap, with tenant paying the rest, both parties would have a depreciable interest. Landlord would not have income by reason of tenant paying for some of, or some part of, the tenant improvements. Landlord might, however, grant a rent concession expressly tied to the specific tenant expenditure; this may create income to the landlord as disguised rent. Without a showing that the improvements were intended as a substitute for rent, however, landlord does not receive income. Regs § 1.61-8(c); *M.E. Blatt & Co. v. U.S.*, 305 U.S. 267 (1938).

Landlord may also do one of these three things: it may grant a rent holiday or reduced rate period not expressly tied to the specific tenant expenditure, resulting in the immediate reduction in landlord's taxable income, it may pay the tenant to make the improvements and will generally amortize the payments over the lease term, while the payments will be taxable to the tenant and the improvements will be depreciated by tenant, or it may itself make the improvements and amortize the cost over the assets' applicable recovery periods (for example, straightline 27.5 years for residential and 39 years for nonresidential property under IRC § 168(c) ; but shorter MACRS periods or accelerated methods may be available for tangible personal property). Of these, the first choice is generally best for landlord, the second choice is bad for the tenant, and the third choice is not too bad and is often used.

Payments to tenants for concessions, whether called signup bonuses, or otherwise, generally are taxable to tenants even if used to build out the space. The improvements would then be depreciated by tenant. A specific allowance may be granted if not paid to tenant, without creating such income. For example, landlord will pay to contractors $10 per square foot, tenant will pay any excess.

Construction period interest generally ceases to be capitalized and becomes immediately deductible under IRC § 163 on obtaining a certificate of occupancy. IRC § 263A (uniform capitalization rules). Deductible interest may, nevertheless, still be subject to passive loss and at-risk limitations.

Landlord may at the termination of the lease deduct any unamortized leasehold improvements it paid for, at least if no other tenant can use them. IRC § 168(i)(8)(B). Landlords need to separately account for improvements for each tenant, and use proper cost accounting and capitalization when landlord's own staff does the improvement work. Tenants also take the adjusted basis of leasehold improvements into account in determining gain a loss at the termination of a lease (subleasing to another is not sufficient). IRC § 165 or Regs § 1.167(a)-8, depending on whether the property was depreciable. S. Report No. 281, 104th Cong. 2d Sess. 17 (1996).

Asset write-offs on abandonment under IRC § 168(i)(8) and Regs §§ 1.165-2 and 1.167(a)-8 will not be available for a structure being demolished, rather IRC § 280B disallows

any losses attributable to undepreciated basis and demolition costs, but requires them to be capitalized on the underlying land. IRC § 280B(a)(2) and Regs. § 1.280B-1(a). This rule applies to tenants, too. (How does a tenant do this when it does not own the land? Does tenant take the deduction on termination of the lease?) If possible, the landlord will want to take abandonment deductions before committing to demolition.

IRC § 109 specifically prevents income to landlord on taking over tenant paid improvements on termination of the lease. Cash payments related to the condition of the premises are not so excluded, however. IRC § 1019 prevents landlord from including such tenant-paid improvements in landlord's basis. However, the IRC § 109 exclusion will not apply where the facts disclose that buildings and improvements represent, in whole or in part, a liquidation in-kind of lease rentals. Regs § 109-1(a).

On the other hand, IRC § 110 provides for certain retail tenants (which can include service providers like lawyers and accountants) an exclusion for cash paid to them by landlords for qualifying construction and long-term real property lease improvements which revert to landlord under a short-term lease (not to exceed 15 years). IRC § 110 is a safe harbor; outside the safe harbor payments to tenants may or may not be taxable under other applicable (but not clearly understood) rules.

Under the IRC § 179 certain items up to $100,000 can be expensed rather than depreciated. Leasehold improvements can obtain the benefit of IRC § 179.

Also, qualified leasehold improvements can receive the benefit of special bonus depreciation (after reduction for any § 179 expensing). IRC § 168(k)(2)(A)(i). Original use must commence with the taxpayer, acquisition must be after December 31, 2007, and before January 1, 2010, and the improvements must be placed in service before January 1, 2010. (Note: these dates may not apply if under pending legislation the bonus depreciation is made permanent. See S. 233, 111th Cong.) The qualified leasehold improvements are improvements to the interior portion of a nonresidential building (whether or not depreciated under MACRS rules) made by the lessor or the lessee under or pursuant to a lease. The interior must be occupied exclusively by the lessor or its sublessee. Improvements to new buildings do not qualify; rather, the improvement must be placed in service more than three years after the building was placed in service. If the lessor and lessee are related, the bonus depreciation will not be available. IRC § 168(k)(3)(C)(ii). Also, certain improvements do not get the benefit of the bonus depreciation including: enlargement of the building, an elevator or escalator, structural components benefitting common areas (*i.e.*, stairways, hallways, lobbies, loading docks, etc.), or the internal structural framework of the building.

6. **Lease Transfers**. When a landlord sells property subject to a lease, the landlord's value in the real estate will generally be determined by the lease income stream. If below-market rents are being received, the value will be lower, affecting gain or loss on the transaction. If above-market rents are being received, value will increase. Rather than recapture depreciation (see IRC § 1250), the landlord may try to argue for separate asset treatment for the premium on the above-market leases. As to a buyer, however, courts were split on the issue until IRC §

167(c) removed the possibility of separate basis in leaseholds where the entire property is purchased. IRC § 197 also does not provide for amortization of leasehold intangibles.

Where a buyer pays more than land value it may be able to allocate basis to improvements paid for by the tenant but cannot take depreciation until after the tenant's lease expires. *Geneva Drive in Theatre, Inc. v. Com'r*, 67 T.C. 764 (1977).

The tenant's leasehold may be assignable by the tenant. If the assignment transfers the tenant's entire interest and does not in effect create a sublease, then under IRC § 1001 such a sale or exchange could generate capital gain or loss treatment. *Clodfelter v. Com'r.*, 48 T.C. 694 (1967). But <u>see</u> Rev. Rul. 57-537, 1957-2 C.B. 52 (amount paid by assignee for the assignment of a lease is in the nature of an advance rental payment, where the facts indicate the relationship between the parties to be that of lessor-lessee; the assignor retained an option to buy the property).

The sale of the real estate (or other assets) without the associated lease income stream (known as rent or lease stripping), which might be attempted in a number of ways, direct or indirect, has been found to be abusive and may be subject to attack under a number of code sections and tax principles, such as IRC §§ 165 (loss allowances) 269 (acquisitions to obtain tax benefit), 382 (corporate ownership change limitations on net operating losses and built-in losses), 446(b) (method of accounting not clearly reflect income), 482 (allocation among taxpayers), 701 (partnership taxation), 704 (reallocation of partnership items without economic effect), assignment of income, step transaction, business purpose, sham transaction, and recharacterization of lease as a financing. It may be possible to impute an obligation like a note from buyer to seller and require buyer to take rents into income even if the lease rental stream is retained by seller in the transaction. This is similar to IRC § 467 treatment. <u>See</u> the equipment-lease stripping tax shelter cases, such as *Nicole Rose Corp. (f/k/a Quintron Corp) v. Com'*r, 117 TC 328, *aff'd* 320 F.3d 282 (2d Cir. 2003); *CMA Consolidated, Inc. v. Com'r*, TC Memo 2005-16. <u>See</u> also Notice 2003-55, 2003-34 IRB 395.

7. **<u>Sales-Leaseback Transactions</u>**. Where a property is sold and immediately leased back to the seller, the issue will be whether the transaction should be characterized as a true sale with a true lease or whether the transaction is actually something else, such as a financing mechanism or even a like-kind exchange. If characterized as a true sale with a true lease, the seller is taxed as with real estate sales generally (capital gain, recapture of depreciation, etc.) and is treated as a lessee under the general lease rules described above. The benefit to the seller is to extract cash from a property while retaining its use and to do so without the usual limits on proportion of net equity typical in loan transactions. Rent is deductible to the seller-lessee but principal payments on acquisition or loan indebtedness would not be deductible. Future appreciation will not, however, accrue to the seller-lessee but will accrue to the buyer-lessor instead.

If, on the other hand, the sale leaseback is not characterized as a true sale with a true lease but is characterized as a refinancing, the result is loan treatment. "Rent" payments are treated as interest and principal, with only the interest portion deductible for the seller-lessee. The buyer-

lessor receives interest income rather than rental income. Rev. Rul. 72-543, 1972-2 C.B. 87. If the buyer-lessor ends up with ownership at the end of the transaction, there will be sale treatment at that time.

The characterization of the sale-leaseback depends on all the facts and circumstances. *Frank Lyon Co. v. U.S.*, 435 U.S. 561 (1978), *rev'g* 536 F.2d 746 (8th Cir. 1976); *International Minerals and Chemical Corp.*, TC Memo 1984-47. Some of the key factors to analyze include: If there is an option to repurchase property, is the option price too low (indicating a refinancing) or is it fair (indicating a true sale)? For example, is the option price only equal to the present value of future rents? How are risks allocated as to condemnation or casualty? Is the rent set at fair market rates? Has the opportunity or risk for appreciation or depreciation in value moved to the buyer-lessor? The following pronouncements by the Internal Revenue Service provide some helpful guidance on factors to consider: Rev. Rul. 55-540, 1955-2 C.B. 39 (equipment leases); Rev. Proc. 2001-28, 2001-1 C.B. 1156 (ruling guidelines on leveraged leases); Ltr. Rul. 9748005; IRS Examination Tax Shelters Handbook, IRM 4236, Ch. 300 at 3(20) Real Estate Tax Shelters; FSA 199917039 (attacks on sales-leasebacks).

If the lease term is over 30 years, a like-kind exchange under IRC § 1031 (rather than a loan) may be involved. See Regs. §1.1031(a)-1(c). This could deny the "seller" a loss on the property. Again, this depends on all the facts and circumstances. *Century Electric Co. v. Com'r*, 15 T.C. 581 (1950) *aff'd* 192 F.2d 155 (8th Cir. 1951) *cert. denied*, 342 U.S. 954 (1952); *Missouri Pacific R.R. Co. v. U. S.*, 497 F.2d 1386 (Ct. Cl. 1974) (lists factors).

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