Income Tax Issues for Lessors and Lessees (Slides)

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Income Tax Issues for Lessors and Lessees

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True Lease Classification
True Lease Classification

• No Definition in Statute or Regulations
  – Section 7701(e) treats a service contract or other arrangement as a lease if “properly treated as a lease”

• Judicial analysis
  – Benefits & burdens of ownership
    • Who has the upside and downside potential?
    • Look through indemnities and other arrangements to true economics
  – Substance over form
    • More than just transfer of legal title
    • Greater scrutiny for leases between related parties
  – Cases
    • Frank Lyon
    • Torres
    • Grodt & McKay Realty, Inc.
    • Estate of Thomas
True Lease Classification
Recast for Tax Purposes

- Alternatives for recast of a lease for tax purposes
  - Sale
  - Financing
  - Service contract
  - Partnership
  - Agency agreement
  - Service agreement
True Lease Classification

- Higher standard required for taxpayer to disavow its own form
  - Coleman & Danielson decisions
  - Synthetic leases
    - Also known as “off-balance sheet financing”
    - Treated as a lease for GAAP but mere financing for income tax purposes
      - Approved by IRS in:
        - PLR 9307002 and
        - FSA 199920003
      - Widely used until GAAP rules changed in 2005
  - Cross border leases
True Lease Classification
Safe Harbor

• Revenue Procedure 2001-28
  – Safe harbor provides “requirements” necessary to receive an advanced letter ruling
    • Requirements for form
    • 20% equity
    • No lessee financing
    • Lease term not in excess of 80% of useful life
    • 20% anticipated uninalled residual value
    • Limited use restriction
    • Fair rental value
    • Limited lessee improvements – severable v nonseverable
    • No fixed price lessee purchase option
  – Meeting the safe harbor requirements
    • Reduces tax risk
    • Increases level of comfort
True Lease Classification
Non Safe Harbor

• Non safe harbor true lease analysis
  – Requires analysis of judicial factors
  – Some private letter rulings have been issued despite not meeting all of the safe-harbor requirements
  – Some practitioners question whether the safe harbor applies only to leveraged leases of personal property
• Safe harbor factors are still worth reviewing for real property leases
Tenant Improvement Allowances
Tenant Improvement Allowances
Outside the Section 110 Safe Harbor

• General treatment
  – Tenant may be required to include improvement allowance payments as income under §61
  – Cost of tenant improvements paid by the tenant is generally depreciated over asset recovery period, up to 39 years
  – Some court cases have permitted exclusion of improvement allowances under §118
    – Federated Department Stores
Tenant Improvement Allowances
Outside the Section 110 Safe Harbor

- IRS Coordinated Issue Paper (October 1996)
  - Tenant must include in income payments from landlord used to pay for leasehold improvements of which the tenant is the "tax owner," i.e., the owner for federal income tax purposes
  - Cash payments received by tenant are not included in income to the extent paid for improvements of which the landlord is the tax owner
  - Tax ownership is determined based on the burdens and benefits of ownership test, outlined above (see Grodt & McKay Realty Inc.)
Tenant Improvement Allowances
Section 110 Safe Harbor

- Section 110 enacted in 1997
  - Qualifying cash (or rent reduction amount) received by a retail tenant is excluded from gross income if used for qualifying construction of real property leasehold improvements
    - Short-term lease, no more than 15 years, including renewals
    - Retail space
    - Amounts expended for qualifying costs in taxable year received
      - Or within 8½ months after close of taxable year
    - Lease agreement must contain specific language
      - Reg. §1.110-1(b)(3) requires that “lease agreement . . . expressly provides that the construction allowance is for the purpose of constructing or improving qualified long-term real property for use in the lessee’s trade or business at the retail space.”
    - Consistent treatment by lessor
    - Information required in statement attached to return
Tenant Improvement Allowances

Section 110 Safe Harbor

• Section 110 provides very broad definition of “retail space”
  – Administrative support space
  – Retail services, e.g.
    • Hair stylists
    • Accountants
    • Tailors
    • Financial service providers
Depreciation, Demolition and Disposition of Tenant Improvements
Tenant Improvements
Depreciation of Landlord Owned Improvements

- Landlord owned improvements
  - Residential real property
    - 27.5 years
    - Straight line method
  - Nonresidential real property
    - Generally 39 years
    - Special 15 year recovery for certain tenant improvements
      - Placed in service after October 22, 2004 and before January 1, 2006
    - Other special rules
      - E.g., Liberty zone
    - Straight line method
  - “Tangible personal property” improvements
    - Shorter lives and accelerated methods available
Tenant Improvements
Demolition of Landlord Owned Improvements

• Prior law
  – Landlords could deduct demolition losses provided the property was not purchased with an intent to demolish

• Section 280B
  – Enacted in 1976
    • Originally applied only to certified historic structures
    • Extended to all structures in 1984
  – Taxpayers may not deduct losses attributable to undepreciated basis and for related demolition expenses of any “structure”
    • Such costs must be capitalized and added to land basis
  – Section 280B trumps other disposition provisions
Tenant Improvements
Disposition of Landlord Owned Improvements

• In some cases, courts have permitted a landlord to deduct the remaining basis in improvements where their usefulness suddenly terminates
  – Tenant terminates occupancy (see Gorman)
  – Property abandonment four months before sudden decision to demolish the building (see De Cou)

• Section 168(i)(8)(B) allows a landlord to deduct remaining basis in tenant improvements upon lease termination
  – Improvements must be irrevocably disposed of or abandoned by the lessor at the termination of the lease
Tenant Improvements
Depreciation of Tenant Owned Improvements

• Residential real property
  – 27.5 years
  – Straight line method
• Nonresidential real property
  – Generally 39 years
  – Other special rules
    • E.g., Liberty zone
  – Straight line method
• “Tangible personal property” improvements
  – Shorter lives and accelerated methods available
Tenant Improvements
Disposition of Tenant Owned Improvements

• Lease termination
  – Generally, the lessee is entitled to deduct its remaining adjusted basis in the leasehold improvements that are not retained by the lessee upon lease termination
  • Presumably, the deduction is permitted under §165 or Reg. §1.167(a)-8, depending on whether or not the property was depreciable

• Disposition other than lease termination
  – In events other than a lease termination, e.g., lessee sublets the space, the tenant is generally not entitled to write off the unrecovered costs of the improvements
Bonus Depreciation
30% Bonus Depreciation

- Section 168(k) enacted in 2001, generally allowed if
  - Certain property acquired after September 10, 2001 and before September 11, 2004
  - Recovery period of 20 years or less
  - Original use after September 10, 2001 and
  - Placed in service before January 1, 2005
50% Bonus Depreciation

• Section 168(k) amended in 2003, generally allowed if
  – Certain property acquired after May 5, 2003 and before January 1, 2005
  – Recovery period of 20 years or less
  – Original use after May 5, 2003 and
  – Placed in service before January 1, 2005

• May elect 30%, in lieu of 50%, if eligible
Bonus Depreciation
Special Rules

- Property bought and sold within same taxable year is not eligible
- May elect out of bonus depreciation
- If subject to AMT and bonus applies, use MACRS depreciation
  - If elect out of bonus, AMT applies
Section 467 Leases
Section 467
General Treatment

- Section 467 Treatment
  - Addresses accrual and payment of rent for leases of tangible property
  - Applies when rents are increasing or prepaid and when rents are decreasing or deferred
  - Aimed at perceived abuses resulting from mismatching of income and deductions by lessors and lessees on differing tax accrual methods
  - Puts both lessor and lessee on an accrual method for “§467 rental agreements”
  - Uses “time value of money” concepts to address allocations of rent that do not coincide with payments of rent or increasing or decreasing rents
    - Deemed §467 loan concept
Section 467
Rent Leveling

• Constant rental accrual
  – Rents are “leveled” in the case of “tax avoidance” notwithstanding the parties’ allocation and payment of rent
    • Level rent has the same present value as actual lease rent
  – Only the IRS, and not taxpayer, can invoke rent leveling
    • Same effect can be achieved through level rent accrual
  – Requires either
    • Disqualified leaseback or
    • Long-term lease (75% of 19-year real property “statutory recovery period”)
  – Applies if “federal income tax avoidance” is a “principal purpose”
    • Special scrutiny if either party is legally or functionally tax-exempt
    • 10% variance safe harbor to avoid “constant rental accrual”
    • 15% safe harbor for real property
      – E.g., safe harbor applies if annual rent for each year is not less than 85% or more than 115% of average annual rent
Lease Acquisition, Transfer, Modification and Termination
Lease Acquisition and Transfer by Landlord

- Costs to enter into a new lease are capitalized
  - E.g., inducement payments and professional fees
  - Landlord generally amortizes "leasehold acquisition" costs over lease term
  - Rent holiday permissible under §467

- Upon sale of leased property by landlord, both the seller and purchaser generally must treat the lease as a part of the property being sold
  - Deemed §467 loan
  - Section 467(c) recapture

- Tenant’s tax position is generally not affected by transfer of the leased property by landlord
Lease Acquisition and Transfer by Tenant

- Upon entering into a new lease, tenant generally amortizes “leasehold acquisition” costs over lease term
  - Section 178

- Tenant sale of leased property used in tenant’s trade or business is generally treated as a sale of §1231 property
  - Deemed §467 loan

- Purchaser of tenant’s interest in lease generally must amortize the cost over the remaining term of the lease

- Landlord’s tax position is generally not affected by transfer of the tenant’s interest in the leased property
Lease Modification
Landlord Perspective

• Costs to modify a lease, e.g., inducement payments and professional fees, should be capitalized
  – Added to any unrecovered costs from the initial lease
  – Amortized over resulting term of the modified lease

• Payments received by landlord from a tenant for agreeing to modify a lease are ordinary income
  under the landlord’s general accounting method
Lease Modification
Tenant Perspective

• Payments received from a landlord for agreeing to modify a lease
  – Generally ordinary income
  – Reported under the tenant’s general accounting method

• Payments made to the landlord in exchange for modification to a lease
  – Generally treated as capital expenditures
    • Not currently deductible
  – Expenditures will benefit future periods
    • Amortized over the remaining term of the revised lease
      – Similar to lease acquisition costs
Lease Modification
Section 467 Rental Agreements

• Substantial modifications
  – Require parties to analyze agreement anew for §467 purposes
  – IRS may collapse the initial lease and subsequent modification if a principal purpose of the modification is to avoid the intent of §467
Lease Termination
Landlord Perspective

• Payments received by landlord from the tenant for termination of the lease
  – Generally ordinary income
  – Reported under landlord’s method of accounting
    • Installment sale method questionable

• Payments made to the tenant in exchange for termination of the lease
  – Generally treated as capital expenditure
    • Not currently deductible
  – Expenditures will benefit future periods, i.e., term of new lease
    • Amortized over the remaining term of the old lease v term of new lease, depending on the facts
      – Similar to lease acquisition costs if amortized over term of new lease
  – See Norwest decision (TC 1998)
Lease Termination
Tenant Perspective

• Payments received by tenant from the landlord for termination of the lease
  – Generally capital gain under §1241
  – Reported under tenant’s method of accounting
    • May qualify for installment sale method

• Payments made to the landlord in exchange for termination of the lease
  – Generally deductible currently
  – Under tenant’s method of accounting
  – But capitalization required if new lease of same property
Section 467 Lease Termination
Landlord and Tenant Perspectives

- If there is a deemed §467 loan:
  - Bifurcate consideration
    - Deemed §467 loan
    - Balance allocated to lease
  - Treatment of deemed §467 loan
    - Worthlessness deduction under §165?
    - Cancellation of indebtedness income?
Like-Kind Exchanges
Like-Kind Exchanges

- Section 1031 permits tax deferral for a “like-kind exchange”
  - Definition of “like kind”
    - Broad definition of real estate
    - 30-year lease is of like kind to fee simple ownership
      - Lease renewals count toward 30 years
    - Short-term lease for short-term lease
      - Rev. Rul. 76-301
    - Long-term lease for short-term lease?
      - Many requirements for a like-kind exchange
At Risk Limitations
At Risk Limitations

• Section 465 enacted in 1976
  – Generally limits deduction of losses to the taxpayer’s “amount at risk”
  – Generally applies only to individuals, estates and trusts, and certain closely held C corporations
    • Does not apply at partnership or S corporation level
  – Originally applied only to five specified activities
    • Did not apply to the holding of real property
At Risk Limitations

- In 1986, at risk limitations were extended to the holding of real property
  - Section 465(b)(6) permits amount at risk for “qualified nonrecourse financing”
    - Borrowed with respect to activity of holding real property
      - Includes personal property and services “incidental to making real property available as living accommodations”
    - Borrowed from a qualified person
      - Generally includes any lender “actively and regularly engaged in the business of lending money”
      - Unrelated to taxpayer and to seller
        - Exception for certain “commercially reasonable” financing
      - Does not earn fee relating to taxpayer’s investment
    - Alternatively, loan can be made or guaranteed by Federal, State or local government
  - Except as provided in regs, no person is personally liable
  - Not convertible debt
    - Grandfather relief permitted for pre-1987 real estate investments
Passive Activity Limitations.
Passive Activity Limitations

- Section 469 enacted in 1986
  - Losses from a passive activity can be deducted only
    - Against net income from another passive activity or
    - Upon a fully taxable disposition of all or substantially all of the
taxpayer's interest in the activity to an unrelated transferee
    - Suspended losses are carried forward and deducted under
      same limitations in future years
  - Generally applies only to individuals, estates and
    trusts, and certain closely held C corporations
    - Does not apply at partnership or S corporation level
  - Many complex and detailed rules and exceptions
Passive Activity Limitations

• Passive Activity
  – Trade or business activity in which taxpayer does not materially participate
  – Any rental activity, regardless of participation
    • Exception for “qualifying real estate professional”
      – Discussed below
  – “Activity” and “materially participation” are defined under complex and detailed rules and exceptions
Passive Activity Limitations

• Rental Activity
  – Generally includes
    • Payments for the use of tangible property
  – Exceptions
    • Average period of customer use is seven days or less
    • Average period of customer use is 30 days or less and significant personal services are rendered
    • Extraordinary personal services are rendered
    • Rental is incidental to nonrental activity
    • Customarily available for nonexclusive use
    • Used in nonrental activity of flow-through entity
  – Many more complex and detailed rules and exceptions
Passive Activity Relief

• Section 469(c)(7) enacted in 1993
  – Permits qualifying real estate professional to treat rental income and loss as nonpassive
  – Qualifying real estate professional
    • Materially participates in the rental activity and
    • Spends more than 750 hours and more than 50% of working time in real property trades or businesses in which the taxpayer materially participates
  – Special rules
    • Disregard participation as employee
      – Exception for more than 5% owner
    • Closely held C corporations – 50% gross receipts test
  – Many more complex and detailed rules and exceptions
Passive Activity Relief

- Application of Section 469(c)(7)
  - No election to be treated as a qualifying real estate professional
  - Requires review of all activities to determine activity grouping
  - Can apply in some years in not in others
  - Passive loss "relief" is not necessarily beneficial
    - E.g., net income from rental real estate and net losses from other passive activities
  - Election to aggregate all rental activities
    - All or nothing
  - Many more complex and detailed rules and exceptions
Tax-Exempt Leasing
New Section 470
Tax-Exempt Leasing  
New Code Section 470

- Enacted in American Jobs Creation Act of 2004 to prevent "SILO" and "SILO-like" transactions
- Seeks to prevent acceleration of deductions associated with leases to tax-exempt parties
- Disallows any net loss for the year from a lease of "tax-exempt use property"
  - Cross reference to definition in §168(h)
  - Applies on a lease-by-lease basis
  - Disallowed losses are suspended and carried forward
  - Losses are freed up under rules based on passive activity rules
Tax-Exempt Leasing
New Code Section 470

- Other adverse consequences
  - Limitations on like-kind exchanges of certain tax-exempt use property
- Tax-exempt use property
  - Includes property leased to a tax-exempt entity
    - Tax-exempt entity includes foreign entities
- Generally effective for leases entered into after March 12, 2004
Tax-Exempt Leasing
New Code Section 470

- Exceptions to tax-exempt use property
  - Nonresidential real property under §168(h)(1)(B) if less than 35% of property is leased under "disqualified leases," defined as:
    - Tax-exempt financing in which the exempt lessee participated
    - Exempt lessee has fixed or determinable price purchase option
    - Lease term, including renewals, exceeds 20 years or
    - Lease is a part of a sale-leaseback to exempt lessee or affiliate
  - Certain qualifying leases under §470(d)
    - Availability of funds
    - Substantial equity investment or
    - More than minimal risk of loss
Tax-Exempt Leasing
New Code Section 470

- Definition of tax-exempt use property is broad
  - Includes property owned by a partnership with both taxable and tax-exempt partners
    - Even if there is no lease of any partnership asset
    - Narrow exception for "qualified allocations"
      - Must be straight up and down, with no preferred return or special allocations
    - Application is complex and unclear
      - Apparently applies separately to each individual property
      - Apparently applies to nondepreciable property
      - Losses are fully or partially suspended while income is fully taxable
      - Special rule for tax-exempt controlled entities, e.g., UBTI blockers
      - Unclear application to tiered entities
      - Unclear what other types of entities, e.g., REITs, are subject to section 470
- Notice 2005-29 provides a moratorium for 2004
- Legislative action is being considered for 2005 and thereafter