Income Tax Issues for Lessors and Lessees

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INCOME TAX ISSUES
FOR LESSORS AND LESSEES

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I. ACQUISITION OF LEASE AND INDUCEMENTS.

A. Leasehold Acquisition Expenses of Landlord.

1. In General. Both the landlord and the tenant incur a number of costs when entering into a lease. Generally, commissions and expenses, including attorney's fees, paid by the landlord in obtaining the lease are not deductible when paid, but must be capitalized and amortized over the life of the lease. See Rev Rul 70-408, 1970-2 CB 68 (broker's commission); and Rev Rul 73-421, 1973-2 CB 33 (attorney's fees, lease signing bonuses, and appraisal costs). Lease acquisition expenses must be capitalized, regardless of the accounting method used by the landlord and even when the tenant fails to pay rent on a regular and continuous basis. See Tonningsen v. Com., 61 F2d 199 (9th Cir. 1932) (cash basis taxpayer); and Godson v. Com., 5 TCM (CCH) 648 (1946) (lessee failed to pay rent after 11 months on 99-year lease).

2. Unsuccessful Lease Negotiations. If lease negotiations are unsuccessful and the proposed lease falls through, the fees and expenses should be deductible in full when paid or incurred. See Davidson v. Com., 27 BTA 158 (1932). However, where the improvements are not yet ready for service or use, IRC § 195 may block deductibility. See Richmond Television Corp. v. U.S., 345 F2d 901 (4th Cir. 1965).

3. Lease Premium. Prior to 1993, the courts were in conflict as to whether the purchaser of real property encumbered by a lease providing for rents in excess of the current fair market rental rate could amortize the premium value of such lease over the remaining lease term. A vast majority of the cases have held that the premium value of the lease may not be treated as an asset separate and distinct from the fee interest in the property; in other words, the value of the lease (whether favorable or otherwise) is reflected in the value of the property it encumbers. See, e.g., Midler Court Realty, Inc. v. Com., 61 TC 590 (1974), aff'd, 521 F.2d 767 (3rd Cir. 1975); and Com. v. Moore, 207 F2d 265 (9th Cir. 1953). However, for property placed in service after August 10, 1993, where such property is acquired subject to a lease, IRC §167(c) provides that the premium value of the lease is not treated as a separate asset, but rather is part of the adjusted basis of the fee interest in the property and taken into account in determining the depreciation deduction with respect to the property subject to the lease. See also IRC §197(e)(5) (excluding any interest under any existing lease of tangible property from the definition of an “intangible” eligible for the 15-year amortization deduction).

4. Tenant Forfeiture. If a tenant abandons or forfeits the lease, or the lease is cancelled, any remaining unamortized lease costs are deductible in full. See Oliver Iron Mining Co. v. Com., 13 T.C. 416, 418, n. 4 (1949) (unrecovered cost of a lease deductible as a loss when lease is terminated).

5. Sale or Exchange. If the landlord sells the property, any unamortized costs are added to basis. See Post v. Com., 109 F2d 135 (2nd Cir. 1940). Similarly, if the landlord exchanges property in a like-kind exchange, any unamortized
costs are added to the landlord's basis for the property received in the exchange. See Plaza Inv. Co. v. Com., 5 T.C. 1295 (1945).

B. Leasehold Acquisition Expenses of Tenant.

1. **In General.** Commissions and other costs paid by the tenant in entering into a lease are amortizable over the life of the lease. See King Amusement Co. v. Com., 44 F.2d 709 (9th Cir. 1930), cert. denied, 282 U.S. 900 (1931) (fees paid to guarantors of rent); and Nusbaum v. Com., 10 BTA 664 (1928) (fees paid to geologist to examine land that was subsequently leased). Likewise, the cost of purchasing a lease from another tenant is amortizable over the remaining term of the lease. See Treas. Reg. §1.162-11(a). See also Cooper Foundation v. O'Malley, 221 F.2d 279 (8th Cir. 1955).

2. **Renewal Option.** IRC §178(a), applicable to property placed in service after December 31, 1986, clarifies when renewal options are included in the lease period for purposes of determining the amount of the lessee's deduction. If less than 75% of the lease acquisition cost is attributable to the remaining portion of the original lease, the lease term is treated as including all renewal options (and any other period for which the parties reasonably expect the lease to be renewed), with the exception of a renewal option that is exercisable by the lessee. See IRC §178(b). Prior to the 1986 amendment of IRC §178, the renewal period was not included in the lease term if the tenant could establish that it was more probable than not that the lease option would not be renewed.

3. **Prior Tenant Improvements.** When a tenant purchases a lease from an existing tenant, a portion of the payment may be allocable to improvements made by the previous tenant on the leased property. Although the portion of the payment allocable to the cost of the lease is amortized over the lease term, the portion allocable to the cost of such improvements can only be recovered under the accelerated cost recovery rules of IRC §168, regardless of the lease term. IRC §168(i)(3) and (8), applicable to property placed in service after December 31, 1986. See Grinalds v. Com., 65 TCM (CCH) 1971 (1993). Previously, the tenant was allowed to recover the cost of improvements over the shorter of the lease term or the life of the improvement. See, e.g., 1220 Realty Co. v. Com., 322 F.2d 495 (6th Cir. 1963). See also Rev. Rul. 61-217, 1961-2 C.B. 49.

4. **Effect of Lease Extension.** Where a lease is extended or renewed prior to expiration, any unamortized costs are amortized over the entire remaining term of the lease (including the extension or renewal period). See Pig & Whistle Co. v. Com., 9 BTA 668, 670 (1927); and U.S. Bancorp v. Com., 111 T.C. 231.

5. **Effect of Early Termination.** Where a lease is terminated early, any unamortized costs of the tenant are deductible in full in the year of termination. See Guelph Hotel Corp. v. Com., 7 BTA 1043 (1927). However, if the early termination is due to the purchase of the fee by the tenant, then any unamortized costs are added to the basis of the property. See Boos v. Com., 30 BTA 882 (1934).
C. **Bonus Paid by Tenant for Lease.**

1. **Treatment by Landlord.** A bonus received by a landlord for a lease is reportable as rental income when received. Treas. Reg. §1.61-8(b) provides that advance rentals are included in income when received, except as provided in IRC §467 (discussed below) or except as provided in administrative guidance allowing deferral to a taxable year other than the year of receipt. See also *Jennings Co. v. Com.*, 59 F.2d 32 (9th Cir. 1932); *Renwick v. Com.*, 87 F.2d 123 (7th Cir. 1936); and *New Capital Hotel, Inc. v. Com.*, 28 T.C. 706 (1957), aff'd per curiam, 261 F.2d 437 (6th Cir. 1958).

2. **Treatment by Tenant.** Treas. Reg. §1.162-11(a) allows the tenant to deduct a proportionate amount of leasehold costs, including a bonus paid to the landlord, based on the number of years the lease has to run. See *Southwestern Hotel Co. v. U.S.*, 115 F.2d 686 (5th Cir. 1940); *Kohler-Campbell Corp. v. U.S.*, 298 F.2d 911 (4th Cir. 1962). This rule also applies where the bonus is paid to obtain an extension, modification or renewal of a lease. See, e.g., *Phil Gluckenstern's Inc. v. Com.*, 15 TCM (CCH) 41 (1956). Furthermore, if a lease is extended or renewed before its expiration, any remaining unamortized costs from the prior term are amortized over the entire remaining term of the lease (including the extension or renewal period). See *Pig & Whistle Co. v. Com.*, 9 BTA 668 (1927); and *U.S. Bancorp v. Com.*, 111 T.C. 231 (1998).

D. **Concessions and Inducements to Tenant.**

1. **In General.** A landlord may offer cash amounts to a new or renewing tenant to be used by the tenant without restriction, or for specific purposes, such as allowances for expenses, build-out or purchase of furnishings. With the exception of certain payments for the build-out of improvements owned by the landlord (discussed below), basic income taxation principles concerning accessions to wealth require that such incentive payments be recognized as income by the tenant, and capitalized by the landlord and amortized over the term of the lease. See *John B. White, Inc. v. Com.*, 55 T.C. 729 (1971), aff'd per curiam, 458 F.2d 989 (3rd Cir.), cert denied, 409 U.S. 876 (1972). This treatment would apply, regardless of whether the payment is made directly to the tenant, to a vendor on behalf of the tenant or otherwise reimbursed to the tenant.

2. **Build-out Allowances.**

   a. **In General.** Amounts received by (or reimbursed to) a tenant from a landlord and expended by the tenant on improvements owned by the landlord are not includible in the tenant's income. See *In re The Elder Beerman Stores Inc.*, 97-1 USTC ¶ 50,391 (Bankr SD Ohio 1997). See also FSA 1997-27 (Aug. 4, 1997) (predating the effective date of IRC § 110), wherein the IRS concluded that a build-out allowance was income to a lessee where the lessee assumed the benefits and burdens of ownership of the improvements.

   b. **IRC §110 Safe Harbor Exclusion from Tenant Income.** IRC §110, enacted as part of the Taxpayer Relief Act of 1997, provides a safe harbor for
the exclusion from a tenant's gross income of any amount (1) received in cash (or treated as a rent reduction) from a landlord under a "short-term lease" of "retail space" and (2) for the purpose of the tenant constructing or improving "qualified long-term real property," for use in the tenant's trade or business at the retail space. The exclusion is limited to the amount expended by the tenant for the construction or improvement. IRC §110, effective for leases entered into after August 5, 1997, contains no inference as to the treatment of non-safe harbor amounts.

c. IRC §110 Additional Requirements. For leases entered into after October 4, 2000, a payment will qualify for the safe harbor only if the following regulatory requirements are satisfied.

(1) **Timing.** The amounts received by the lessee must be expended in the taxable year received on the construction or improvement of qualified long-term real property for use in the lessee's trade or business at the retail space that is the subject of the lease. See Treas. Reg. §1.110-1(b)(1)(iii). Amounts will be treated as expended in the taxable year in which the construction allowance was received if (i) either the amounts are expended within eight-and-one-half months from the close of the taxable year in which the construction allowance was received; or (ii) the construction allowance is a reimbursement from the lessor for amounts expended by the lessee in a prior year and for which the lessee has not claimed any depreciation deduction. See Treas. Reg. §1.110-1(b)(4)(ii).

(2) **Express Provisions.** In addition, the lease must "expressly" provide that the construction allowance is for constructing or improving qualified long-term real property for use in the lessee's trade or business at the retail space. However, an ancillary agreement, whether executed contemporaneously with the lease or during the term of the lease, can be considered a provision of the lease agreement for this purpose, provided that the ancillary agreement is executed before payment of the construction allowance. See Treas. Reg. §1.110-1(b)(3).

(3) **Consistent Treatment.** IRC §110(b) requires consistent treatment, so that all "qualified long-term real property" is treated as nonresidential real property of the landlord and subject to depreciation in accordance with IRC §168. See also Treas. Reg. §1.110-1(b)(5).

(4) **Reporting.** The lessor and the lessee must attach a statement to their respective Federal income tax returns with the following information: (i) name (and, in the case of a consolidated group, the parent's name), address and employer identification number of the opposite party; (ii) the location of the retail space (including mall or strip center name, if applicable, and store name); and (iii) the amount of the construction allowance and the amount expended on nonresidential real property owned by the lessor. See Treas. Reg. §1.110-1(c)(3).
d. IRC §110 Definitions.

(1) Short-Term Lease. The term “short-term lease” means a lease (or other agreement for occupancy or use) of retail space for 15 years or less (as determined under IRC §168(i)(3)). IRC §110(c)(2); and Treas. Reg. §1.110-1(b)(2)(ii). IRC §168(i)(3) provides that the period during which any option to renew will run shall be treated as part of the original lease term, unless the option is to renew at fair market value determined at the time of renewal. See Frydland, Michael, Qualified Construction Allowances for Short-Term Leases, 15 THE PRACTICAL TAX LAWYER 37-43 (Spring 2001).

(2) Retail Space. The term “retail space” means real property used by a tenant in its trade or business of selling tangible personal property or services to the general public. Retail space includes not only the space where retail sales are made, but also space where activities supporting the retail activities are performed, such as an administrative office, storage area or employee lounge (in other words, “back office” space). IRC §110(c)(3); and Treas. Reg. §1.110-1(b)(2)(iii).

(3) Qualified Long-Term Real Property. The term “qualified long-term real property” means nonresidential real property which is part of, or otherwise present at, such retail space and which reverts to the landlord at the expiration of the lease. IRC §110(c)(1); and Treas. Reg. §1.110-1(b)(2)(i).

3. Equity Participation Agreements.

a. As an alternative to offering cash payments, rent holidays or other incentives to induce a lessee to enter into a lease, a landlord may offer the tenant an equitable interest in the property. This may be accomplished, directly, by granting the lessee a purchase option or a percentage of future cash flow/sales proceeds or, indirectly, by providing the lessee with an interest in the partnership that owns and operates the property.

b. When a tenant receives a partnership interest in exchange for entering into a long term lease of the partnership property, an issue arises as to whether the tenant has transferred “property” in exchange for the partnership interest within the meaning of IRC §721(a). If the tenant's obligation to lease a portion of the partnership's building constitutes “property” for purposes of IRC 721(a), then the transfer of the partnership interest to the tenant in exchange for the “contribution” of the lease to the partnership should qualify as a nontaxable event. However, if the tenant's lease obligation is not considered “property” for this purpose, then the transfer will fail to qualify for nonrecognition treatment, and the tenant will recognize as ordinary income its percentage interest in the fair market value of the partnership assets at the time of the transfer.

c. Even if the lease obligation is not characterized as “property” for purposes of IRC §721, a lessee may receive a “restricted” partnership
interest without recognizing income on the exchange. For example, the receipt by the lessee of a partnership interest that grants the lessee an interest in the lease property’s future appreciation in excess of its fair market value at the time of transfer should not be taxable to the lessee. See *St. John v. U.S.*, 53 AFTR2d 84-718 (CD Ill 1983)(receipt of subordinated partnership interest in exchange for performance of services). Unlike the receipt of a current profits or cash flow interest in a partnership, which has an ascertainable value and may result in income recognition, the transfer of a partnership interest that is limited to the future participation in the partnership’s operations and asset appreciation should be considered to have little or no current value at the time of the exchange. Consequently, a lessee receiving a “restricted” partnership interest should not incur any adverse tax consequences until such time as the leased property is disposed of and the fair market value of the tenant’s equity interest in the partnership can be objectively determined. For a detailed discussion of equity participation, see Faggen & Prescott, Tax Consequences of Lease Inducements Can Vary Widely Both for the Landlord and the Tenant, 18 TAXATION FOR LAWYERS 116 (1989).

E. **Bonus Depreciation.**

1. **15-Year Useful Life for Leasehold Improvements In General.** The 15-year recovery period applies to any “qualified leasehold improvement property” or any “qualified restaurant property” placed in service after October 22, 2004 and before January 1, 2006. Section 168(e)(3)(E). The taxpayer is restricted to straight line depreciation. (Under prior law, such property was treated as non-residential real property generally subject to a 39-year MACRS recovery period.)

2. **Qualified Leasehold Improvement Property.** In determining what is “qualified leasehold improvement property” for purposes of the reduced recovery period, it is immaterial whether the landlord or the tenant makes the improvements. However, new Section 168(e)(6), as added by AJCA 2004, expressly states that if a lessor makes a leasehold improvement that qualifies for the 15-year recovery period, a subsequent owner of the leasehold improvement property may not depreciate the leasehold improvement over the reduced recovery period.

3. **Qualified Restaurant Property.** New Section 168(e)(7) defines “qualified restaurant property” as any Section 1250 improvement to a building if (i) the improvement is placed in service more than three years after the date the building was first placed in service and (ii) more than 50% of the building’s square footage is devoted to the preparation, seating and consumption of prepared meals.
II. RENT AND RELATED PAYMENTS.

A. Rental Payments In General.

1. Form of Rental Payment. Rental payments entitle the tenant to use and occupy property. Rent may be in the form of cash or in kind and may be based on a fixed amount or prorated in accordance with a specific percentage of the tenant's gross or net income. See *M.E. Blatt Co. v. U.S.*, 305 U.S. 267 (1938). Rent is not considered compensation subject to self-employment tax under IRC §1402. See *Wuebker v. Com.*, 110 T.C. 431 (1998) (payments described as rentals under a 10-year contract between an Ohio farmer and the U.S. Agriculture Department); and *McNamara v. Com.*, 236 F.3d 410 (8th Cir. 2000). See also *Raby & Raby, Farm Rentals and the Self-Employment Tax*, 91 TAX NOTES 1297 (2001). Rent often is not paid directly to the landlord, but rather consists of payments by the tenant of landlord expenses in connection with ownership of the property. Payments made on behalf of the landlord may include, without limitation, income and real estate taxes, principal and interest on mortgage indebtedness, insurance, maintenance and repairs and construction of improvements. It should be noted, however, that the form, timing and method of computation of rental payments all affect their tax treatment.

2. Landlord Tax Treatment. Rental payments constitute taxable income to the landlord under IRC §61(a)(5) and are reported in the year received or accrued, depending on the method of accounting used. See IRC §451; and Treas. Reg. §1.451-1(a). Unless IRC §467 governs, advance rentals are generally includible in the landlord's income upon receipt, regardless of the accounting method used. Treas. Reg. §1.61-8(b) specifically provides that advance rentals are included in income when received, except as provided in IRC §467 (discussed below) or except as provided in administrative guidance allowing deferral to a taxable year other than the year of receipt. If a rental agreement falls within the meaning of IRC §467, that section will control the timing of the landlord's income.

3. Tenant Tax Treatment. IRC §162(a)(3) provides that a tenant may deduct “rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the [tenant] has not taken or is not taking title or in which he has no equity.” See *Hunt & Sons, Inc. v. Com.*, 83 TCM (CCH) 1345 (2002)(rental deductions disallowed to the extent in excess of the fair market rental value of properties leased by the taxpayer). IRC §212(1) further provides that a tenant can deduct rent as an expense of producing income. However, rent paid on account of personal, living or family reasons is not deductible. See IRC §262. See also Rev Rul 68-12, 1968-1 C.B. 96. Rental payments are deductible by the tenant in the year paid or accrued, depending on the method of accounting used. See IRC §461(a); and Treas. Reg. §1.461-1(a). Unless IRC §467 governs, the tenant must generally amortize advance rentals over the life of the lease, regardless of the accounting method used, although rent prepaid by a cash-basis taxpayer for a period of less than 12 months is deductible in full in the year paid. See Treas. Reg. §1.162-11(a). The tenant, like the
landlord, is governed by IRC §467 when the rental agreement falls within the meaning of that section.

B. Advance Rentals.

1. Income to Landlord.

a. Income Inclusion upon Receipt Unless Excepted. The lessor must include payments of advance rentals in gross income under IRC §61(a)(1) and (5). Such advance rental payments must be included in income for the year of receipt regardless of the period or the method of accounting employed unless a specific exception applies. Treas. Reg. §1.61-8(b) provides that advance rentals are included in income when received, except as provided in IRC §467 (discussed below) or except as provided in administrative guidance allowing deferral to a taxable year other than the year of receipt. Even if the lease allows for the advance rents to be returned in certain events, the payment is still taxable upon receipt if the landlord has free and unrestricted use of the funds. See Lazarus v. Com., 58 T.C. 854 (1972), aff’d, 513 F.2d 824 (9th Cir. 1975); and New Capital Hotel, Inc. v. Com., 28 T.C. 706 (1957), aff’d 261 F.2d 437 (6th Cir. 1958).

b. Alternative Characterization. Because of the required inclusion in income upon receipt, lessors who receive advance payments from lessees typically try to argue that the amounts are loans or security deposits, rather than advance rentals.

c. Rent versus Loan. With respect to the issue of whether monies from a lessee are a loan, Blue Flame Gas Co. v. Com., 54 T.C. 584 (1970), held that the purported loan was an advance rental payment based on the following factors: (a) the intention of the parties; (b) the treatment of the funds for bookkeeping purposes; (c) the treatment of the funds for book and tax purposes; (d) the handling of the transaction, including the presence of a note, a repayment date, provision for interest, giving of security and presence of formal restrictions on use of money; and (e) the interdependence of the purported loan and lease arrangement. See also SPA Bldg. Co. v. Com., 33 TCM (CCH) 179 (1974). The Service has used these factors in determining whether entry fees paid to retirement communities by tenants are advance rentals or loans. See, e.g., PLR 9307007 (Oct. 28, 1992)(1/3 advance rental; 2/3 loan); and PLR 9246006 (Jul. 28, 1992)(entire amount advance rental).

2. Deduction to Tenant.

a. Tax Year Concept. Rent prepaid for a period of 12 months or more (beyond the taxable year) historically has not been deductible in the year in which paid. Rather, such rent is required to be amortized over the lease term. In the case of a cash-basis taxpayer, however, rent prepaid for a period of less than 12 months is deductible in full in the year paid. See Zaninovich v. Com., 616 F.2d 429 (9th Cir. 1980), rev’g, 69 T.C. 605 (1978).
b. Limitations on Use of Cash Method. The prepayment exception for cash method taxpayers has been steadily narrowed by excluding certain types of taxpayers from being on the cash method basis. IRC §448(a)(2), as enacted in 1986, has now narrowed the exception to exclude all tax shelters and certain other types of taxpayers from using the cash method of accounting.

C. IRC §467 Rental Agreements

1. In General. IRC §467, as enacted by the Deficit Reduction Act of 1984 and effective for agreements entered into after June 8, 1984, was designed to eliminate the mismatching in deferred and stepped rental transactions.

   a. Prior Law. Prior to the enactment of IRC §467, tax-shelter benefits could be derived in certain instances by deferring rental payments. A cash basis landlord who deferred all payments until the end of the rental period would not have to report income until received, whereas an accrual method tenant was allowed a proportionate deduction each year, even though no payment was required until the end of the rental term. See Explanation of the Senate Finance Committee, Deficit Reduction Tax Act of 1984, 98th Cong., 2d Sess. 260 (1984). See also Allison, New Rules Increase Exposure of Lessors to Tax on Rents That Will Not Be Received Until Later, 64 J TAX'N 8 (1986).

   b. IRC §467 Required Accrual. Under IRC §467, lessors and lessees under certain rental agreements must take into account their income and expenses arising out of such agreements by applying statutory accrual-basis and present-value principles, regardless of the actual accounting method used. Income accrual may also apply to agreements for services under IRC §467(g). The prescribed treatment, in effect, is an extension of the original issue discount rules.

   c. Effective Dates. Treasury Regulations addressing the required rent and interest accrual under IRC §467 are effective for rental agreements entered into after May 18, 1999, unless such agreements are disqualified leasebacks or long-term agreements, as to which case the regulations apply after June 3, 1996. See Treas. Reg. §1.467-9(a). See Melone, Final Section 467 Regulations Expand and Clarify Proposed Rules, 27 J Real Est Tax'n 65 (2001). Revisions to the initial Treasury Regulations were issued in 2001. The revised regulations eliminate the $2 million exception from the constant rental accrual for IRC §467 rental agreements entered into on or after July 18, 1999. Although the other amendments apply to rental agreements entered into after March 6, 2001, taxpayers are permitted to elect to apply the amendments to rental agreements entered into on or before March 6, 2001.

2. Regulations Effective On or Before May 18, 1999.

   a. “IRC §467 Rental Agreement.” For disqualified leasebacks or long-term agreements, as defined in Treas. Reg. §1.467-3(b), entered into before June 3, 1996, and other rental agreements entered into on or before May 18, 1999, IRC §467
applies only to a rental agreement classified as an "IRC §467 rental agreement". An "IRC §467 rental agreement" means any rental agreement for tangible property under which there is at least one rental payment allocable to the use of property during a calendar year that is to be paid after the close of the calendar year to which such payment is allocable. IRC §467(d)(1)(A). An "IRC §467 rental agreement" also includes an agreement in which there are "stepped rents" or increases in the amount of rent to be paid under the agreement. IRC §467(d)(1)(B). "IRC §467 rental agreements" do not encompass rental agreements in which the sum of the amounts to be paid is $250,000 or less. IRC §467(d)(2). Although not entirely clear, it would appear that improvements, if not income, should not constitute "payments received as consideration" in determining whether the rent exceeds $250,000.

b. Tax Treatment In General. When an IRC §467 rental agreement exists, the landlord and tenant, regardless of the accounting method used, must take into account for the taxable year (i) the sum of the accrued rental payments pursuant to IRC §467(a)(1), and (ii) any interest on amounts that were taken into account in prior years and remain unpaid, such as accrued but unpaid rent and interest, pursuant to IRC §467(a)(2). Both parties are effectively put on the economic accrual method of accounting. The amount of rent that is considered accrued each year may be calculated under either the "allocation of the agreement" approach or the "constant rental amount" approach.

c. Allocation of the Agreement Approach. If the IRC §467 rental agreement allocates rent and does not involve "stepped rent" for tax avoidance purposes, the deferred rent accrual rules or "allocation of the agreement" approach under IRC §467(b)(1) applies. Under this approach, rents are determined under any IRC §467 rental agreement by allocating rents in accordance with the agreement and by taking into account rent paid after the close of a period according to present value concepts.

(1) Description of Method. Using this method to determine the accrued rental amount, rents are allocated in accordance with the agreement. To determine the total amount of rent accrued under IRC §467(b)(1)(A) and (B), the present value of any rent allocated to the taxable year, the payment of which is deferred to a different taxable year, is added to allocated rents that are paid in the current taxable year.

(2) Present Value. Present value is computed based on a rate, compounded semiannually, of 110% of the applicable Federal rate (AFR) in effect at the time the agreement is entered into for debt instruments with a maturity as long as that of the IRC §467 rental agreement. IRC §467(e)(4).

(3) Example. A leases a building from B for two years. Rent is payable $175,000 in the first year, $150,000 in the second year and $25,000 in the third year. The lease allocates the rent $175,000 to each of the two years. In Year 1, lessor B recognizes $175,000 income and lessee A recognizes $175,000 expense. In Year 2, the amount accrued under the lease will be $150,000 plus the present value of
$25,000 (based on 110% of the short-term AFR in effect on the day the lease was signed). The difference between $25,000 and its present value will be interest income and expense to the parties in Year 3.

(4) For example, in TAM 9352002 (Sept. 14, 1993), the lessee was required to pay a specified level of rent per year with the yearly amount increasing at periodic intervals. One-twelfth of each year's total lease payment was due and payable on the first of each month. The lease contained no other provisions that otherwise specifically allocated rent to lease periods. The taxpayer, probably was seeking to accelerate deductions in excess of cash outlay, argued affirmatively that the lease was an IRC §467 rental agreement. See Holthouse & Williamson, An Illustration of the Affirmative Use of § 467 Rental Agreements, Found in the Workpapers of Suwalsky, 47-5th Tax Mgmt, Real Estate Leases and Improvements. Although the Service recognized that the statute and the legislative history suggested that the payment of rent could differ from its allocation, the Joint Committee on Taxation explanation of the Section suggests they are the same. The Service bolstered this conclusion by noting there was no evidence to suggest that Congress expected that a lease must contain rental allocation schedules separate from payment schedules and that in this situation the rent was to be paid in intervals of less than a year.

(5) One court has addressed the issue. In Piccadilly Cafeterias, Inc. v. U.S., 78 AFTR2d 96-5294 (Ct. Cl. 1996), where rent payment schedules in the lease actually specified rent for each year of the lease (and further defined monthly rent as one-twelfth of the annual rental amount), the Court held that such schedules constituted "allocations" of rent to a given year. The Court noted, however, that a rent payment schedule will not constitute an allocation provision in all circumstances, and specifically where rent is to be paid in a lump sum at the beginning or end of a multi-year lease period.

(6) If the rent holidays (zero rent periods) are reasonable within the meaning of IRC §467(b)(5)(C), then the payment schedules in the leases should be respected as an allocation of rent for purposes of IRC §467(b)(1)(A). See, e.g., PLR 9406003 (Oct. 28, 1993).

d. Constant Rental Approach. Certain IRC §467 rental agreements require a leveling of rents. The constant rental amount rules apply if either the rental agreement fails to allocate rents over the rental period (IRC §467(b)(3)(B)) or the lease is part of a disqualified leaseback or long-term agreement (IRC §467(b)(3)(A)).

(1) Leaseback. A "leaseback" transaction for this purpose is one that involves a leaseback of property to any person (or to a related person) who had an interest in such property at any time within the two-year period before such leaseback. IRC §467(c)(2). A "related person" under IRC §467(e)(5) is defined by IRC §465(b)(3)(C), which refers to the rules of IRC §267(b) and IRC §707(b)(1), with certain modifications.
(2) **Long-term Agreement.** A “long-term agreement” refers to a term in excess of 75% of the statutory recovery period for the property. IRC §467(b)(4).

(3) **Disqualified Tax Avoidance Principal Purpose.** In order for these lease agreements to be “disqualified” and subject to constant rental accrual, the lease must call for the uneven payment of rents and the principal purpose of the payment schedule must be tax-avoidance. IRC §467(b)(4)(B). IRC §467(b)(5) provides a list of reasons, which if applicable to a lease, will ensure that the lease was not structured for a tax-avoidance purpose. The enumerated circumstances include:

(i) Changes in amounts paid determined by reference to price indexes (such as the Consumer Price Index);

(ii) Rents based on a fixed percentage of lessee receipts or similar amounts;

(iii) Reasonable rent holidays (as to which legislative history permits one year, or, under exceptional circumstances, up to two years);[FN86] [FN86] See Republic Plaza Properties Partnership v. Comm., 107 TC 94 (1996) (holding that 11.5 months of zero rent at the inception of the lease was a reasonable rent holiday in accordance with local commercial practice);

(iv) Changes in amounts paid to unrelated third parties.[FN87] [FN87] IRC § 467(b)(5). By analogy, it should also be noted that with respect to rent fluctuations in the cases of leases involving personal (but not real) property, the IRS has taken the position that a 10% fluctuation above or below the average rent is permissible. Rev Proc 75-21, 1975-1 CB 715, § 5, modified by Rev Proc 79-48, 1979-2 CB 529, and Rev Proc 81-71, 1981-2 CB 731.

(4) **Facts and circumstances suggesting that the lease was structured for tax-avoidance purposes include the following:**

(i) a difference in the relative tax brackets of the lessor and lessee at the inception of the lease and in later years (this would include lessees which are tax-exempt entities or those with substantial net operating losses);

(ii) the structure of a lease as a “sandwich lease”; or

(iii) a lease option which allows renewal at a rental amount significantly less than the rental amounts payable during the later years of the original lease term.

A “sandwich lease” is a set of tiered leases, at the top of which is the property owner, an accrual method taxpayer, who leases the property (with rising rents over the lease term but no stated rent allocation) to a cash method partnership, which in turn subleases the property to an accrual method taxpayer on terms identical to the upper-tier lease, with the exception that rent accrues ratably; though the partnership does nothing but collect the rent and pass it onto the property owner, its insertion in the deal enables the property owner to obtain significant deferral while the actual tenant does not lose the benefit of any deduction. See Staff of the Joint Committee on Taxation, General Explanation of the

(5) **Constant Rental Amount.** If the lease is disqualified, then each year the landlord and tenant both report a constant rental amount, which is equivalent to the amount that, if paid as of the close of each lease period under the agreement, would result in an aggregate present value equal to the present value of the aggregate payments required under the agreement. IRC §467(e)(1); Treas. Reg. §1.467-3(d).

(6) **On or After July 19, 1999.** Final regulations, issued on January 5, 2001, removed the $2 million or less exception to constant rental accrual for IRC §467 rental agreements entered into on or after July 19, 1999. See Treas. Reg. §1.467-3(b)(1)(iii). Prior to the effective date of these final regulations, constant rental accrual applied to leasebacks or long-term agreements with total rental payments and other consideration which exceeded $2 million.

(7) **Recapture.** IRC §467 also provides for a recapture provision applicable in situations in which property subject to a long-term agreement or leaseback is disposed of and the lease has not been subject to rent leveling.

(i) When the property is sold at a point when the amount of annual rent payable is below the average annual rent over the lease term, the purchase price would reflect the excess rent to be paid in later years. In such a situation, any gains realized on the disposition of the property, ordinarily taxed at capital gains rates, is taxed as ordinary income to the extent of the recapture amount. The recapture amount is the excess of the amount realized on disposition (or, if not a sale, exchange or involuntary conversion, the property's fair market value) over the adjusted basis, less any amount treated as ordinary income under any other Code provision (such as depreciation recapture), but in any event the recapture amount is not more than the aggregate prior understated rent inclusions determined under the constant rent accrual concept. IRC §467(c)(2).

(ii) Regulations are to be promulgated under IRC §467(c)(5) providing that exceptions similar to the exceptions provided under IRC §§1245 and 1250 are to apply for purposes of the rent recapture provision, and under which the ordinary income taint on the property will be preserved in cases where the property is transferred and the transferor's basis in the property carries over to the transferee.

(iii) Since recapture only occurs upon a disposition of the subject property within a specific period of time during the lease, it is advisable to be aware of the amount of the recapture early in the planning of the sale. IRC §467 rental agreements should be avoided, if possible, by landlords who do not wish to accelerate their income. Careful drafting of the lease in order to avoid unintentional recapture and unintended application of the constant rental amount is clearly important.
See generally Allison, New Rules Increase Exposure of Lessors to Tax on Rents That Will Not Be Received Until Later, 64 J TAX’N 8 (1986); Reeves, Section 467: Its Application to and Effect on Leases Containing Stepped or Deferred Rents, 13 J REAL EST TAX’N 346 (1986); Cocanower, Drafting Section 467 Rental Agreements, 20 TAX’N FOR LAWYERS 252 (1992); Suwalsky, Structuring Lease Inducements in a Soft Market, 7 TAX MGT REAL EST J 247 (Dec. 4, 1991); Frydland, Deferred Payment Leases Can be More Tax Beneficial than Rent Holidays, 73 J TAX’N 356 (1990). Faggen & Prescott, Tax Consequences of Lease Inducements Can Vary Widely Both for Landlord and the Tenant, 18 TAX’N FOR LAW 116 (1989).


a. For disqualified leasebacks or long-term agreements entered into after June 3, 1996 and other rental agreements entered into after May 18, 1999, an “IRC §467 rental agreement” is defined as a rental agreement of tangible property having (1) increasing or decreasing rents or (2) prepaid or deferred rents. Treas. Reg. §1.467-1(c)(1). See generally, Sperka and Gordon, Calculating Rent and Interest Under the Final Regulations, 40 TAX MGMT MEMO 219 (1999); and Reynolds, IRS Finalizes Regulations Governing Accruals of Uneven Rent, 91 J TAX’N 86 (1999).

b. In making these determinations, if a rental agreement unambiguously specifies, for a period no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during such period, and the total amount of fixed rent specified is equal to the total amount of fixed rent payable under the lease, the amount of fixed rent allocated to each rental period is the amount of fixed rent allocated to such period by the rental agreement. If a rental agreement does not provide for this specific allocation of fixed rent, the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during such rental period. Treas. Reg. §1.467-1(c)(2)(ii).

c. A rental agreement has increasing or decreasing rent if the annualized fixed rent allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term. Treas. Reg. §1.467-1(c)(2)(i)(A). For this purpose, rent holidays at the beginning of the lease term which do not exceed three months will be disregarded. Treas. Reg. §1.467-1(c)(2)(i)(B).

d. In addition, a rental agreement will have increasing or decreasing rent if it requires the payment of contingent rent, unless such contingent rent is contingent solely as a result of: (i) a provision pursuant to which the rent is equal to a percentage of the lessee's receipts (but only if the percentage does not vary throughout the term of the lease); (ii) an adjustment based on a reasonable price index; (iii) a provision requiring the lessee to pay third-party costs (including real estate taxes, insurance premiums and maintenance costs) not within the control of the lessor or lessee or any related person; or (iv) a provision requiring the payment of late payment charges, a loss payment provision, a qualified TRAC provision, a residual condition provision, a tax
indemnity provision or a variable interest rate provision. Treas. Reg. §1.467-1(c)(2)(iii). Treas. Reg. §1.467-1(h) further defines these listed safe harbors.

Example 1. A and B enter into a rental agreement that provides for the lease of property to begin on January 1, 2000 and end on December 31, 2003. The rental agreement provides that rent of $100,000 accrues during each year of the lease term. Under the rental agreement, no rent is payable during calendar year 2000, a payment of $100,000 is to be made on each of December 31, 2001 and December 31, 2002, and a payment of $200,000 is to be made on December 31, 2003. Because the amount of rent allocated to each rental period is $100,000, the rental agreement does not have increasing or decreasing rent. See Treas. Reg. §1.467-1(c)(3)(iv), Example 1(i).

f. A rental agreement has deferred rent if the amount of rent allocated to a calendar year, when added to the rent allocated to all preceding calendar years, exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year. Treas. Reg. §1.467-1(c)(3)(i). A rental agreement has prepaid rent if the amount of rent allocated to a calendar year, when added to the rent allocated to all preceding calendar years, is less than the cumulative amount of rent payable before the beginning of the preceding calendar year. Treas. Reg. §1.467-1(c)(3)(ii).

Example 2. Using the same facts from Example 1 above, the rent allocated to 2000 ($100,000) does not exceed the cumulative rent payable as of December 31, 2001 ($100,000); the rent allocated to 2001 and preceding years ($200,000) does not exceed the cumulative rent payable as of December 31, 2002 ($200,000); the rent allocated to 2002 and preceding years ($300,000) does not exceed the cumulative rent payable as of December 31, 2003 ($400,000); and the rent allocated to 2003 and preceding years ($400,000) does not exceed the cumulative rent payable as of December 31, 2004 ($400,000). Therefore, the rental agreement does not have prepaid or deferred rent. Treas. Reg. §1.467-1(c)(3)(iv), Example 1(ii).

g. Notwithstanding the foregoing rules, the Regulations do not apply to a rental agreement if the aggregate amount of rental payments over the lease term is not reasonably expected, as of the execution of the lease, to exceed $250,000. In determining whether the total rent is reasonably expected to exceed $250,000, the following rules apply:

(1) Stated interest on deferred rent is not taken into account;

(2) Non-cash consideration is taken into account at its fair market value;

(3) All leases that are part of the same transaction or series of related transactions are treated as a single lease;
(4) Any increase or decrease in rent payable solely as the result of an adjustment based on a reasonable price index is not taken into account;

(5) Where the agreement provides for a variable interest rate provision, fixed rate substitutes, determined in the same manner as under Treas. Reg. §1.1275-5(c), must be used in this calculation; and

(6) Contingent rent arising from third-party costs is not taken into account. Treas. Reg. §1.467-1(c)(4).

h. If, based on the foregoing criteria, the rental agreement is an IRC §467 rental agreement, the lessor and lessee must each take into account for any taxable year (1) the IRC §467 rent for the taxable year and (2) the IRC §467 interest for the taxable year. Treas. Reg. §1.467-1(b).

(1) The IRC §467 rent for a taxable year is the sum of (a) the fixed rent for any rental period that begins and ends in the taxable year; (b) a ratable portion of the fixed rent for any other rental period beginning or ending in the taxable year; and (c) the contingent rent, if any, that accrues during the taxable year. Treas. Reg. §1.467-1(d)(1).

(2) With two exceptions, the fixed rent for any such taxable period is the amount of fixed rent allocated to the rental period under the rental agreement. Treas. Reg. §1.467-1(d)(2)(iii).

(a) The first exception applies with respect to disqualified leasebacks or long-term agreements, in either of which cases the fixed rent is the constant rental amount. Treas. Reg. §1.467-1(d)(2)(i). The constant rental amount is defined as the amount that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the agreement as rent and interest. Treas. Reg. §1.467-3(d)(1). A leaseback or a long-term agreement is disqualified only if (i) the total rent exceeds $2,000,000; (ii) a principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax; and (iii) the Commissioner determines that it is appropriate to treat the agreement as a disqualified leaseback or long-term agreement. Treas. Reg. §1.467-3(c)(1) and (2). The determination of whether tax avoidance is a principal purpose for providing increasing or decreasing rent is based on all of the facts and circumstances. However, if either the lessee or the lessor is not subject to Federal income tax on its income or is a tax-exempt entity, the agreement will be closely scrutinized and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent. Treas. Reg. §1.467-3(c)(1). Tax avoidance will not be considered a principal purpose for providing increasing or decreasing rent if (A) the rent allocated to a calendar year does not vary from the average rent allocated to all calendar years by more than 10% (15% for long-term agreements where at least 90% of the leased property consists of real property, based on fair market values), or (B) all of the increases
and decreases in rent are attributable to a contingent rent provision in the rent agreement which qualifies under Treas. Reg. §1.467-1(e)(2)(iii)(B) and/or allowing reduced rent (including no rent) for a period at the beginning of the lease term, but only if the duration of such rent holiday does not exceed the lesser of 24 months or 10% of the lease term. Treas. Reg. §1.467-3(c)(3).

(b) The second exception applies with respect to rental agreements which do not provide for adequate interest on prepaid or deferred rent, in which case the fixed rent for any rental period is the proportional rental amount. Treas. Reg. §1.467-1(d)(2)(ii). A rental agreement provides for adequate interest on fixed rent if, disregarding any contingent rent: (i) the rental agreement has no prepaid or deferred rent; (ii) the rental agreement has prepaid or deferred fixed rent, and the rental agreement provides for a stated rate of interest on such rent no lower than 110% of the AFR; (iii) the prepaid or deferred rent on which interest is charged is adjusted at least annually; and (iv) the rental agreement requires interest to be paid or compounded at least annually. Treas. Reg. §1.467-2(b)(1). The proportional rental amount for a rental period is the amount of fixed rent allocated to the rental period under the rental agreement multiplied by a fraction. The numerator of the fraction is the sum of the present values of the amounts payable under the terms of the agreement as fixed rent and interest. The denominator of the fraction is the sum of the present values of the fixed rent allocated to each rental period under the rental agreement. Treas. Reg. §1.467-2(c)(1).

i. The IRC §467 interest for a taxable year is the sum of (1) the interest on fixed rent for any rental period that begins and ends in the taxable year; (2) a ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year; and (3) if there is contingent rent, the amount of interest that accrues on the contingent rent during the taxable year. Treas. Reg. §1.467-1(e)(1). If the IRC §467 rental agreement provides for adequate interest and is not a disqualified leaseback or a long-term agreement, the interest on fixed rent for a rental period is the amount of interest provided for in the rental agreement for any such period. Treas. Reg. §1.467-1(e)(2)(ii). Otherwise, the interest on fixed rent for any rental period is equal to the product of the principal balance of the deemed loan (an IRC §467 loan) at the beginning of such rental period and the yield of the IRC §467 loan. Treas. Reg. §1.467-1(e)(2)(i). An IRC §467 loan exists if, as of the first day of a rental period, there is a difference between the amount of fixed rent payable under the rental agreement on, or before, the first day of such period, and the amount of fixed rent required to be accrued before the first day of such period. Treas. Reg. §1.467-4(a)(1). The principal balance of the IRC §467 loan at the beginning of a rental period equals the fixed rent accrued in preceding rental periods (A) increased by the interest on fixed rent includible in the gross income of the lessor for preceding rental periods and any amount payable by the lessor on, or before, the first day of the rental period as interest on prepaid fixed rent, and (B) decreased by the interest on prepaid fixed rent includible in the gross income of the lessee for preceding rental periods and any amount payable by the lessee on, or before, the first day of the rental period as fixed rent or interest thereon. Treas. Reg. §1.467-4(b)(1). If the principal balance is positive, the amount represents a loan from the lessor to the lessee, and, if the principal balance is negative, the amount represents a loan from the
lessee to the lessor. Treas. Reg. §1.467-4(a)(1). Hence, if the IRC §467 interest for a rental period is a positive amount, the lessor has interest income and the lessee has an interest expense. If the IRC §467 interest for a rental period is a negative amount, the lessee has interest income and the lessor has an interest expense. Treas. Reg. §1.467-1(e)(3).

Example 3. A and B enter into a rental agreement beginning on January 1, 2000 and ending on December 31, 2002. The rental agreement provides that rent of $400,000 is allocated to 2000, rent of $600,000 is allocated to 2001 and rent of $800,000 is allocated to 2002. The rental agreement requires a payment of $1,800,000 to be made on December 31, 2002, but does not provide for interest on deferred rent. Assume also that 110% of the AFR based on annual compounding is 10%. The proportional rental amounts for 2000, 2001 and 2002 are assumed to be $370,370.37, $555,555.56 and $740,740.74, respectively. A Section 467 loan in the amount of $370,370.37 arises at the beginning of the second rental period because the rent payable on or before that day (zero) is less than the fixed rent accrued in all preceding rental periods ($370,370.37). The interest on the fixed rent for the second rental period is $37,037.04 (.10 \times $370,370.37). The principal balance of the Section 467 loan at the beginning of the third rental period is equal to the fixed rent accrued during the first and second rental periods, plus the lessor's interest income on fixed rent for the second rental period ($962,962.97 = $370,370.37 + $555,555.56 + $37,037.04). The interest on fixed rent for the third rental period is $96,296.30 (.10 \times $962,962.97). Treas. Reg. §1.467-4(f), Example 1.

Under Treas. Reg. §1.467-7(a), a lessor disposing of property subject to certain applicable IRC §467 rental agreements is required to recapture a portion of the gain realized by the lessor as ordinary income. Recapture applies to any disposition of property subject to a leaseback or a long-term agreement which is not disqualified and which allocates to any rental period fixed rent that, when annualized, exceeds the annualized fixed rent allocated to any preceding rental period. The recapture amount for a disposition is the lesser of (1) the prior understated inclusions or (2) the IRC §467 gain. Treas. Reg. §1.467-7(b)(1). Prior understated inclusions are the excess (if any) of the aggregate amount of IRC §467 rent and interest for the period during which the lessor held the property, determined as if the IRC §467 rental agreement were a disqualified leaseback or long-term agreement, over the aggregate amount of IRC §467 rent and interest accrued by the lessor during such period. Treas. Reg. §1.467-7(b)(2). The IRC §467 gain is the excess (if any) of the amount realized from the disposition over the sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income other than by reason of IRC §467. Treas. Reg. §1.467-7(b)(3). The recapture rules do not apply to a disposition by gift or a disposition at death. Treas. Reg. §1.467-7(c)(1) and (2). In addition, there are limitations on the amount of recapture for certain tax-free exchanges, like-kind exchanges and involuntary conversions and installment sales. Treas. Reg. §1.467-7(c)(3), (5) and (6).
D. Related Party Limitations on Rent Deductibility.

1. Related Party Rules In General.

a. IRC §267. Special rules under IRC §267 apply when landlords and tenants are related taxpayers. IRC §267 applies to a leasing situation if two conditions are met. First, the landlord and tenant must be “related” taxpayers within the meaning of IRC §267(b). Second, the landlord must be on the cash method of accounting and the tenant on the accrual method. If these two conditions are present, IRC §267(a)(2) effectively places both taxpayers on the cash method. The tenant is not allowed a deduction for the rental payment until the taxable year in which the landlord includes the rental payment in income. The related-party relationships are set forth in IRC §267(b), subject to the constructive ownership rules of IRC §267(c), and include: (a) an individual and family members; (b) an individual and a corporation of which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for such individual; (c) two corporations that are members of the same controlled group; and (d) a grantor and fiduciary of a trust.

b. IRC §482. In the case of taxpayers under common control, IRC §482 can also require a reallocation among the parties. See, e.g., Sparks Nugget, Inc. v. Com., 458 F.2d 631 (9th Cir. 1972), cert. denied, 410 U.S. 928 (1973). But see Osterlund, Inc. v. Com., 52 TCM (CCH) 1451 (1987). See also PLR 200133030 (May 21, 2001)(no related party treatment for purposes of IRC §1239). Where property owned by one member of a group of controlled entities is leased to another member of the same group at less than an arms-length rental charge, the Service may make appropriate allocations to reflect an arms-length charge. See Treas. Reg. §1.482-2(c)(1). See, e.g., Procacci v. Com., 94 T.C. 397 (1990).

c. Excessive Rents. Courts have determined certain rents to be excessive or unreasonable, thereby disallowing the deductibility of the excessive amounts. The issue of excessive rents generally only arises in situations of rental agreements entered into between related parties. See, e.g., United Builders Supply, Inc. v. U.S., 41 AFTR2d 78-654 (SD Miss 1977); and Thorpe v. Com., 75 TCM (CCH) 2039 (1998).

2. Disguised Dividends. There are a number of situations where taxpayers, in an effort to derive tax benefits, will disguise certain transactions so as to resemble a typical landlord-tenant relationship. For example, a shareholder may lease property to a controlled corporation at an excessive rent in an attempt to disguise dividends. In these cases, the excessive portion of the rent will be disallowed as a deduction and reclassified as a dividend. See e.g., Limericks, Inc. v. Com., 7 T.C. 1129 (1946), aff’d, 165 F.2d 483 (5th Cir. 1948); Utter-McKinley Mortuaries v. Com., 225 F.2d 870 (9th Cir. 1955); Social Psychological Services, Inc. v. Com., 66 TCM 1458 (CCH) (1993). On the other hand, the deduction will be allowed, even when the parties are related, if the rents are not excessive. See Braum Family Partnership v. Com., 66 TCM (CCH) 780 (1993).
3. **Disguised Purchases.** The language of IRC §162(a)(3) states that rents are deductible only for “property as to which the taxpayer has not taken or is not taking title or in which he has no equity.” Hence, a lease payment that is really a form of consideration for the purchase of property will not be deductible. See, e.g., *Minneapolis Security Bldg. Corp. v. Com.*, 38 BTA 1220 (1938); *Oesterreich v. Com.*, 226 F2d 798 (9th 1955); *Home News Pub. Co. v. Com.*, 28 TCM (CCH) 834 (1969). See also PLR 9026033 (Mar. 28, 1990).

   a. **Facts and Circumstances Test.** Whether a transaction is a sale or a lease involves an examination of several factors at the initiation of the transaction, without the benefit of hindsight. See, e.g., *Lester v. Com.*, 32 T.C. 711 (1959); *Universal Drilling Co., Inc. v. U.S.*, 412 F. Supp. 1231 (ED La 1976); and *Benton v. Com.*, 197 F.2d 745 (5th Cir. 1952).


   c. **Rent in Relation to Value.** Second, courts look to the overall reasonableness of the rent, based on the fair market value of the property. Where the rent under the lease significantly exceeds the fair rental value of the property, the lease may be recharacterized as a sale. See, e.g., *Haggard v. Com.*, 241 F.2d 288 (7th Cir. 1956).

   d. **Purchase Option.** Third, if there is an option to purchase the property at some time during the lease term with some part (or even all) of the lease payments, the transaction will more likely resemble a sale. See, e.g., *Bowen v. Com.*, 12 T.C. 446 (1949)(sale recast where property title was to be transferred to tenant when monthly rental payments equaled the stated value of the property plus one percent, or, if otherwise, tenant had option to purchase). See also *Helser Machine & Marine Works, Inc. v. Com.*, 39 BTA 644 (1939). See generally, Barragato and Abatemarco, Purchase Options Can Turn Leases into Taxable Sales, 26 Tax'n For Lawyers 340 (1998). But see *Smith v. Com.*, 51 T.C. 429 (1968)(purchase option, in and of itself, does not conclusively indicate a sale). Certainly, no rent deduction will be allowed if, without further act or consideration, the tenant acquires title to the property after a certain number of lease payments. See *St. John v. Com.*, 29 TCM (CCH) 621 (1970); and *Chicago Stoker Corp. v. Com.*, 14 T.C. 441 (1950). By the same token, certain purported option arrangements may be recharacterized as a lease arrangement in substance. See, e.g., TAM 9129002 (Mar. 26, 1991)(focusing on level of control over and right of access to the “optioned” property and citing *Virginia Iron Coal & Coke Co. v. Com.*, 99 F.2d 919 (4th Cir. 1938), cert. denied, 307 U.S. 630 (1938); *Howlett v. Com.*, 56 T.C. 951 (1971)).
e. Interest Payment. Another issue is whether any part of the lease payment is either designated as interest or is equivalent to an interest payment. See, e.g., Judson Mills v. Com., 11 T.C. 25 (1948)(correspondence specified that amounts payable in monthly installments included 5% or 6% interest on the principal).

f. Significant Tenant Improvements. Finally, a sale rather than a lease will likely be found where the tenant makes significant improvements to the property, such as land improvement, and the tenant improvements are not recoverable through depreciation or amortization deductions or else can only be protected through the exercise of an option. See, e.g., M&W Gear Co. v. Com., 446 F.2d 841 (7th Cir. 1971); and Oesterreich v. Com., 226 F.2d 798 (9th Cir. 1955).

E. Gift/Leaseback.

1. In General. Employing a leaseback in either gift/leaseback form or the sale/leaseback form can affect the tax treatment of rental payments. The gift and leaseback is an effective means of shifting income to other family members who are the natural recipients of the donor's bounty. In a gift/leaseback situation, the donee typically receives property that is anticipated to grow in value over time, thereby shifting a part of the donor's estate. The donee, in the capacity of a landlord, receives rent income, which may well be taxed at a lower tax bracket than the donor's income. If the gift/leaseback is properly calculated, the donor, in the capacity of tenant, receives a rent deduction that offsets his income. The gift/leaseback enables the higher bracket donor to shift dollars to a taxpayer in a lower bracket on a deductible basis. It should be noted that the ability to generate tax savings through intra-family transfers of income-producing property by taxing has been substantially reduced, since the net unearned income of a child under 14 years of age is taxed to the child at the top rate of the parents, regardless of the source of the assets. IRC §1(g)(child's unearned income added to parents' taxable income to determine applicable rate).

2. Facts and Circumstances Test. In determining whether the donor-tenant may receive the preferential rent deduction in a gift/leaseback situation, the courts have focused on four factors.

3. Bona Fide Business Purpose. First, the courts determine whether the leaseback is pursuant to a bona fide business purpose. There is a split in the Circuits on this issue. The Fifth and Eleventh Circuits, accepting the Service position, hold that the entire transaction (that is, both the gift and the leaseback) must meet the business purpose criterion. For example, in Van Zandt v. Com., 341 F.2d 440 (5th Cir. 1965), cert. denied, 382 U.S. 814 (1965) (deduction denied, because simultaneous execution of sale and leaseback was viewed as single transaction in which entire trust principal was irrevocably committed to possession of donor when trust was created). See also Mathews v. Com., 520 F.2d 323 (5th Cir. 1975), reh. denied 524 F.2d 240 (5th Cir. 1975), cert. denied, 424 U.S. 967 (1976). The Third, Seventh and Ninth Circuits tend to focus solely on the leaseback itself and whether it is bona fide and done on a business basis. See, e.g., Skemp v. Com., 168 F.2d 598 (7th Cir. 1948)(taxpayer allowed to deduct rent to trust
created for his wife and children because building was conveyed to a trust to which he was in no way connected and independent trustee was bound by fiduciary duty to collect payments). See also Brown v. Com., 180 F.2d 926 (3rd Cir. 1950); Brooke v. U.S., 468 F.2d 1155 (9th Cir. 1972); and May v. Com., 723 F.2d 1434 (9th Cir. 1984). See generally, Note, Tax Court Again Allows Rent Deduction in Trust-Leaseback Arrangement, 50 J Tax’n 107 (1979).

4. **Bona Fide Transfer versus Retention of Control.** The second factor the courts consider in determining whether the donor/tenant may receive the preferential rent deduction in a gift and leaseback situation is whether the donor has retained substantially the same control over the property, or has made a bona fide transfer to an independent trustee or other party. See, e.g., Perry v. U.S., 520 F.2d 235 (4th Cir. 1975), cert. denied, 423 U.S. 1052 (1976)(bank, as trustee, had no function save to hold legal title and to remit rent).

5. **Retained Equity Interest.** A third factor examined by the courts is whether the donor has retained an equity interest in the property. See, e.g., Quinlivan v. U.S., 599 F.2d 269 (8th Cir. 1979), aff’d, 37 TCM (CCH) 346 (1978) (upholding rent payments to Clifford trust landlord, despite reversion at end of trust term).

6. **Fair Market Rental.** The final factor considered by the courts is whether the donor has paid a reasonable rent, based on a fair market rental. See, e.g., Brown v. Com., 180 F.2d 926 (3rd Cir. 1950); Skemp v. Com., 168 F.2d 598 (7th Cir. 1948); and Engel v. U.S., 400 F.Supp. 5 (WD Pa 1975).

**F. Sale/Leaseback.**

1. **Categories.** The sale/leaseback may be categorized as one of the three following and quite different types of transactions: (i) a financing transaction, which is effectively equivalent to a deferred or subordinate mortgage; (ii) a like-kind exchange, or (iii) a true sale/leaseback.

2. **Sale/Leaseback In Substance a Financing Transaction.**

   a. **In General.** The sale/leaseback as a form of financing transaction grew out of the desire to avoid usury laws and to obtain higher loan-to-value ratios from regulated lenders. See generally, Marcus, Real Estate Purchase-Leasebacks as Secured Loans, 2 Real Estate Law J 664 (1973); Kaster, Tax Criteria for Structuring Sale-Leasebacks, 9 Real Estate Rev 39 (1979). For example, rent will be disallowed if there is a sale at a low price and a leaseback at a high rental between a corporation and a controlling shareholder. See, e.g., W.H. Armston Co., Inc. v. Com., 12 T.C. 539 (1949), aff’d, 188 F.2d 531 (5th Cir. 1951). These transactions, if unchallenged, would enable the selling corporation to remove the property without dividend treatment, transforming nondeductible dividends into deductible rents.
b. **Purchase Option.** The sine qua non of the financing transaction is the option of the seller/tenant to repurchase the property. See *Helvering v. F.&R. Lazarus Co.*, 308 U.S. 252 (1939) (sale/leaseback considered a mortgage). However, existence of an option to repurchase, alone, does not assure a financing transaction. See, e.g., *Belz Inv. Co., Inc. v. Com.*, 72 T.C. 1029 (1979), aff'd, 661 F.2d 76 (6th Cir. 1981) (upholding sale/leaseback based on lack of tax avoidance motive and fact that the transaction was economically reasonable and bargained for at arms' length). See also *Desert Lawn Memorial Park, Inc. v. Com.*, 19 TCM (CCH) 32 (1960). Furthermore, the courts also have not viewed an option price at or below the fair market value of the property (at least as of the date of the sale and leaseback) as determinative of a financing transaction. See, e.g., *Comtel Corp. v. Com.*, 67-1 USTC ¶9433, aff'd, 376 F.2d 791 (2nd Cir. 1967), cert. denied, 389 U.S. 929 (1967); *Frenzel v. Com.*, 22 TCM (CCH) 1391 (1963); and *Shillito Corp. v. U.S.*, 42-2 USTC ¶9712 (SD Ohio 1942).

c. **Facts and Circumstances Test.** In *Sun Oil Co. c. Com.*, 562 F.2d 258 (3rd Cir. 1977), rev'd, 35 TCM (CCH) 173 (1976), cert. denied, 436 U.S. 944 (1978), the sale/leaseback was recharacterized as a financing arrangement based on the following factors: (1) All of the economic benefits and burdens fell on the seller/lessee; (2) the lease was a net lease; (3) there would be no compensation through rent if a casualty occurred; (4) the seller/lessee had the benefit of any appreciation in the property; (5) the rentals did not reflect the fair market value of the property, but were at below market rates; and (6) the repurchase price under the option was equal to the present value of future rents under the lease. See generally Strum, *Sale-Leasebacks: Protection for Accelerated Depreciation Deduction and Clear Title*, 7 REAL PROP, PROB & TR J 785 (1972).

d. **Other Indicia of Financing Transaction.** The courts also look at such other factors as (1) which party pays the real estate taxes, maintenance costs and insurance costs, and (2) whether the seller/tenant has resorted to the sale/leaseback as an escape from prior difficulties in obtaining financing. See *Frenzel v. Comm.*, 22 TCM (CCH) 1391 (1963).

3. **Sale/Leaseback In Substance a Like-Kind Exchange.**

a. **In General.** The Service typically recharacterizes the sale/leaseback as a like-kind exchange in order to prevent the seller/tenant from deducting a loss on the sale of the property. (If there were gain, the taxpayer might well cast the sale/leaseback as a financing transaction.)

(1) Under IRC §1031, gain or loss is not recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like-kind to be held either for productive use in a trade or business or for investment. See also IRC §1031(c), providing that no loss from the exchange is recognized if the exchange would be within IRC §1035(a), 1036(a) or 1037(a) if it were not for the fact that the property received in exchange consists not only
of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money.

(2) An IRC §1031(a) exchange in which loss cannot be recognized under IRC §1031(c) occurs if the transfers of the like-kind property are reciprocal, even if the exchanged interests are in the same property. See Rev. Rul. 61-119, 1961-1 C.B. 395. See, e.g., Treas. Reg. §1.1031(a)-1(e)(2)(exchange of improved real estate for unimproved real estate as illustrative example of like-kind exchange). See also Koch v. Com., 71 T.C. 54 (1978), acq., 1979-2 C.B. 2. See generally, Morris, Sale-Leaseback Transactions of Real Property—A Proposal, 30 TAX LAW 701 (1977); and Del Cotto, Sale and Leaseback: A Hollow Sound When Tapped?, 37 TAX L REV (1981). Another example of a like-kind exchange is urban real estate exchanged for a ranch or farm. Treas. Reg. §1.1031(a)-1(c)(2). See also Braley v. Com., 14 BTA 1153 (1929). See also PLR 8609012 (Nov. 26, 1985). A third illustration of a like-kind exchange is a leasehold interest with 30 years or more to run in exchange for a fee interest in real estate. Treas. Reg. §1.1031(a)-1(c)(2). See Rev. Rul. 60-43, 1960-1 C.B. 687; and Rev. Rul. 76-301, 1976-2 C.B. 241. See also PLR 8304022 (Oct. 22, 1982).

(3) If a transaction is a like-kind exchange under the mandatory (nonelective) rules of IRC §1031, then no loss will be recognized on the transaction. See IRC §1031(c). See generally Massey, Sale-Leaseback Transactions: Loss Realization--The Neglected Issue, 6 J REAL EST TAX'N 308 (1979).

(4) A transfer of a fee simple interest in real estate for a leasehold interest in real estate with 30 years or more to run, regardless of whether in the same real estate or in other, like-kind real estate, is considered a like-kind exchange. See Treas. Reg. §1.1031(a)-1(c). This is so whether or not boot is involved. IRC §1031(a) and (c). The transaction is treated as a like-kind exchange whether or not there is any value in the leasehold received in the exchange. See, e.g., Rev. Rul. 76-301, 1976-2 C.B. 241. See also Rev. Rul. 60-43, 1960-1 C.B. 687.

(5) A transaction that is in form an exchange may be deemed a sale. See Carlton v. U.S., 385 F.2d 238 (5th Cir. 1967). On the other hand, the transaction that is in form two sales may be treated as an exchange. See e.g., Allegheny County Auto Mart, Inc. v. Com., 12 TCM (CCH) 427 (1953), aff'd, 208 F.2d 693 (3rd Cir. 1953). See also Rev. Rul. 61-119, 1961-1 C.B. 395.

b. Like-Kind Exchange Recast. The like-kind exchange concept may be applied to what purports to be two separate transactions—a sale and purchase or a sale and leaseback.

(1) In Rev. Rul. 76-301, 1976-2 C.B. 241, for example, the taxpayer exchanged a long-term leasehold interest in a building (a portion of which was used for retail operations and the remainder of which was sublet as office space) for an identical leasehold interest in the retail space and a payment of cash. The taxpayer sought to deduct a loss on the exchange, measured by the excess of (a) its adjusted basis
the nonretail space leasehold interest and improvements, over (b) the cash payment made by the transferee, as determined by the value of the nonretail space leasehold and improvements at the time of the exchange. The Service treated the transaction as a like-kind exchange under IRC §1031(a) and denied the loss. See also Rev. Rul. 61-119, 1961-1 C.B. 395.

(2) In applying the like-kind exchange concept to the sale/leaseback, reference should first be made to Century Electric Co. v. Com., 192 F.2d 155 (8th Cir. 1951), cert. denied, 342 U.S. 954 (1952), in which the taxpayer transferred land, a building and appurtenances with an adjusted basis of $530,000 for $150,000 cash and a 95-year leaseback. The taxpayer sought to deduct a loss, but the Eighth Circuit, affirming the Tax Court, found that the transaction was a like-kind exchange and that any loss was, accordingly, not deductible. Especially where a leaseback includes renewal options, the Service may contend, and prevail in its contention, that such renewal options must be considered as part of the term in determining the period of the leaseback. See, e.g., Century Elec. Co. v. Com., supra; and Missouri Pac. R. Co. v. U.S., 32 AFTR2d 73-5816 (Ct. Cl. 1973), adopted, 497 F.2d 1386 (Ct. Cl. 1974).

(3) Almost every other case has found against the Service, however. See, e.g., Standard Envelope Mfg. Co. v. Com., 15 T.C. 41 (1950)(loss permitted on sale where leaseback was for 25 years, including both the initial term of one year and the renewal term of 24 years, but there was no repurchase option or further renewal option). Even where the leaseback is for 30 years or more, virtually all cases since Century Electric have held against the Service. The Century Electric decision is distinguished on the grounds that the cash received was the full equivalent of the value of the fee conveyed to the vendee-lessee. See Jordan Marsh Co. v. Com., 269 F.2d 453 (2nd Cir. 1959). But see Rev. Rul. 60-43, 1960-1 C.B. 687 (nonacq.) in which the Service continues to maintain that a sale and leaseback under the circumstances here present constituted, in substance, a single integrated transaction under which there was an exchange of property of like kind with cash as boot. See also City Inv. Co. v. Com., 38 T.C. 1 (1962)(leaseback had no separate value that could properly be viewed as a part of the consideration paid or exchanged, because fair annual net rental for land was not in excess of agreed rental under the leaseback, and its fair market value on date of transfer was not in excess of amount paid); Leslie Co. v. Com., 64 T.C. 247 (1975), aff'd, 539 F.2d 943 (3rd Cir. 1976); and Crowley, Milner & Co. v. Com., 76 T.C. 1030 (1981), aff'd, 689 F.2d 635 (6th Cir. 1982). But note the specter raised by Judge Tannenwald's dissent in Leslie Co. v. Com., supra, 64 TC at 257 n. 4, which may come back to haunt taxpayers—the taxpayer simply acted as an agent in constructing the building and was simply a conduit for the formal transfer of the property because of its ownership of the land. See generally, Weinstein, Realizing a Loss through a Sale-Leaseback, 10 REAL EST LAW J 247 (1982).

4. True Sale/Leaseback. If the sale/leaseback is neither a financing transaction nor a like-kind exchange, a true sale and leaseback should be found to exist. When there is an otherwise recognizable loss, and the taxpayer (the seller/tenant) wants to be certain that the loss will be allowed, notwithstanding Treas. Reg. §1.1031(a)-1(c),
the taxpayer should make certain that the term of the leaseback is clearly less than 30 years. Alternatively, though a somewhat riskier (but, in light of the case law, clearly viable) argument, based on a showing that the leaseback has no fair market value (because the rental under the lease is at going rates), the taxpayer could contend that the transaction is not an exchange, because nothing of severable value (other than money) was received by reason of the leaseback.

G. Additional Rent.

1. In General. Whenever a tenant pays expenses of the landlord, a question arises as to whether these payments constitute rent for tax purposes. Expenses that a tenant may pay for the benefit of the landlord include income and real estate taxes, principal and interest payments on an outstanding mortgage, insurance premiums and other expenses. The cost of improvements made by the tenant on the landlord's property may also be classified as additional rent. Treas. Reg. §1.61-8(c) provides, "As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor. If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor."

2. Landlord's Taxes. Income taxes of the landlord that are paid by the tenant constitute gross income to the landlord and, if otherwise allowable, will be deductible as rent by the tenant. See Treas. Reg. §1.61-8(c). Similarly, real estate taxes that are paid to or on behalf of the landlord for business property are deductible as rent by the tenant and constitute income to the landlord. See Treas. Reg. §1.162-11(a). See also Rev. Rul. 75-301, 1975-2 C.B. 66. However, an accrual basis tenant that pays the real estate taxes directly to the taxing authority cannot deduct the real estate taxes until they are fixed and payable. Thus if real estate taxes accrue on the tax rolls on January 1, but are not due and payable until June 1, there is no accrual until June 1. See Rev. Rul. 74-244, 1974-1 C.B. 118. On the other hand, if the tenant is liable to the landlord for such taxes on January 1, as additional rent payable to the landlord, then it may accrue the deduction on January 1. See Rev. Rul. 76-474, 1976-2 C.B. 135. See also PLR 9227007 (March 24, 1992) (taxpayer corporations ineligible for recurring item exception for additional rent representing real property taxes because such items were material and accrual did not result in more proper matching of expenses and income). The landlord may likewise deduct the real estate taxes when paid or properly accrued. Treas. Reg. §1.162-11(a). See Evans v. Com., 42 BTA 246 (1940).

3. Landlord's Mortgage and Miscellaneous Expenses. Other expenses of the landlord, such as insurance premiums, operating costs and principal and interest payments on a mortgage, which are paid or reimbursed by the tenant are taxable income to the landlord and are deductible by the tenant. See Treas. Reg. §1.61-8(c). See also Old Colony Trust Co. v. Com., 279 U.S. 716 (1929); and Wentz v. Gentsch, 40-2 USTC ¶ 9666 (ND Ohio 1940). With respect to mortgage payments, no distinction is made as to whether or not the landlord is personally liable on the mortgage. See Amey v.
Com., 22 T.C. 756 (1954) (tenant payments in reduction of outstanding mortgage was income to landlord, even though landlord was not personally liable).

4. Payments in Lieu of Repair Obligations. A tenant may opt to make payments to the landlord rather than enter into an obligation under the lease to make repairs to the premises. Such payments are deductible as rent by the tenant. IRC §162(a). See, e.g., Frank & Seder Co. v. Com., 44 F.2d 147 (3rd Cir. 1930). If the payments are for ordinary and necessary repairs, the landlord includes the payments as ordinary income and then may deduct the repair expenses. See Treas. Reg. §1.162-4, providing that “[t]he cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production, or the gain or loss basis of the taxpayer’s plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures.” See also Sirbo Holdings, Inc. v. Com., 509 F.2d 1220 (2nd Cir. 1975), aff’d, 61 T.C. 723 (1974). See generally, Salter & McGowan, Tax Treatment of Payment to Lessor in Lieu of Restoration: What Sirbo Holdings, Inc. Will Decide, 1 J REAL ESTAT'N 145 (1974). If, however, the payments offset the tenant’s obligation to replace damaged or removed property, then the landlord may either have a return of capital or be treated as having made a sale of the damaged or removed property. But see, Washington Fireproof Bldg. Co. v. Com., 31 BTA 824 (1934)(ordinary income to landlord). Compare Waggoner v. Com., 15 T.C. 496 (1950).

5. Tenant Improvements on Landlord’s Property. Permanent improvements made by the tenant to the leased premises can be characterized as rent.

a. Parties’ Intent. Generally, in determining whether improvements made by a tenant on the landlord’s property constitute rent, it does not matter whether the improvements increase the value of the landlord’s property and will remain on the property upon expiration of the lease. Treas. Reg. §1.61-8(c) provides that the classification of improvements as rent “depends upon the intention of the parties, which may be indicated either by the terms of the lease or by the surrounding circumstances.” See also Treas. Reg. §1.109-1. See generally, Burford, Tax Treatment of Tenant-Added Leasehold Improvements, 1964 SO CALIF TAX INST 183 (1964). Where the lease provides that the cost of improvements is to be credited to the rent, then any improvements will be treated as rent. See, e.g., Your Health Club, Inc. v. Com., 4 T.C. 385 (1944); Hilldan Corp. v. Com., 26 TCM (CCH) 1035 (1967), aff’d, 408 F.2d 1117 (2nd Cir. 1969); and Martin v. Com., 11 BTA 850 (1928). But see M.E. Blatt Co. v. U.S., 305 U.S. 267 (1938)(holding that improvements were not rent because no clear intention to that effect). See also Cunningham v. Com., 28 T.C. 670 (1957), aff’d, 258 F.2d 231 (9th Cir. 1958).

b. Capital Expenditure to Tenant. If a tenant makes a permanent improvement on the leased premises and it is not characterized as rent, such improvement will be considered a capital expenditure to the tenant. Although it is not allowed a rental expense deduction, the tenant will be able to take depreciation
deductions over the applicable recovery period, writing off any remaining basis that has not been depreciated upon expiration of the lease. IRC §168(i)(8). Commentators have suggested that when leasing space to a tenant, the tenant should be in charge of the construction of the improvements to take advantage potentially of the shorter write-off period due to the loss deduction upon lease termination. However, lessors should be cognizant that if they decrease the rent payable based on the tenant's improvements, they may not have decreased their rental income. See Robinson, 22 REAL ESTATE TAX IDEAS 1 (July 1993); Raby, Tenant Improvements have not Improved Under TRA '86, 60 TAX NOTES 207 (1993).

c. Improvements Upon Lease Expiration under IRC §109. Upon the expiration of the lease, the improvements do not become income to the landlord.

(1) IRC §109 provides a specific exclusion for the value of any property attributable to buildings erected or other improvements made by the lessee upon termination of a lease. See also Treas. Reg. §1.109-1(a) stating that "income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income.

(2) However, the exclusion from gross income does not apply to the extent that the buildings or improvements represent in whole or in part a liquidation in kind of lease rentals. As provided in Treas. Reg. §1.1019-1(a), IRC §109 does not apply to: (i) rental income during the lease term derived from tenant-made improvements; (ii) income (such as forfeited security deposits) realized on termination of the lease but not attributable to the value of the improvements; or (iii) income derived after the termination of the lease that is incident to the ownership of such improvements.

(3) Where the improvements are not considered to be income to the landlord on the expiration of the lease, they neither add to nor reduce the landlord's basis in its real property. See Treas. Reg. §1.1019-1.

d. Tenant Short-term Lease Rent Reduction Exclusion under IRC §110. IRC §110, as added by the Taxpayer Relief Act of 1997, offers relief to lessees in the form of an exclusion from income for any amount received in cash or rent reduction from a lessor under a "short-term lease" of retail space to the extent the amount is used to construct or improve "qualified long-term real property" used in the lessee's trade or business at such retail space.

(1) "Qualified long-term real property" is defined by IRC §110(c)(1) to mean nonresidential real property that is part of the retail space and that reverts back to the lessor at the termination of the lease.
(2) For purposes of this provision, a "short-term lease" as defined by IRC §110(c)(2) means a lease of retail space for 15 years or less. Leases that run for more than 15 years and other lease fact patterns that do not fit within the statutory safe harbor must be analyzed under the IRS Industry Specialization Program Coordinated Issue Paper—Tenant Allowances (Oct. 7, 1996) and existing case law precedent. See Federated Department Stores v. Com., 51 T.C. 500 (1968), aff'd, 426 F.2d 417 (6th Cir. 1970), nonacq., 1971-2 C.B. 4; May Dept. Stores Co. v. Com., 33 TCM (CCH) 1128, aff'd per curiam, 519 F.2d 1154 (8th Cir. 1975); and In re The Elder Beerman Stores, Inc., 97-1 USTC ¶ 50,391 (Bankr SD Ohio 1997). See generally, Jenks and Purnell, IRS Loses Test Case on Tenant Allowances, 38 TAX MGMT MEMO 184 (1997); and Jacobson and Law, Code §110(a): The Fall and Rise of the "Exclusion" from Gross Income of "Tenant Allowances," 14 TAX’N MGMT RE J 107 (1998).

(3) "Retail space" is defined under IRC §110(c)(3) as real property leased, occupied, or otherwise used by a lessee in its trade or business of selling tangible personal property or services to the public.

(4) IRC §110(d) contemplates that regulations will be promulgated to require the lessor and lessee to provide to the Service information concerning amounts received (or treated as a rent reduction) and expended as well as any other information deemed necessary.

6. Inadvertent Additional Rent from Sale/Leaseback. In a sale/leaseback transaction, the seller/tenant may obtain a waiver of rent or a below-market rental from the purchaser/landlord for a period of time. In that case, it is essential from the purchaser/landlord's point of view that the seller/tenant couch its waiver of rent period as a reserved estate for years or months, rather than merely as a waiver or abatement of rent. See Ashlock v. Com., 18 T.C. 405 (1952). See also Rev. Rul. 77-413, 1977-2 C.B. 298 (amount realized from sale of real property did not include value of 20-year promissory interest retained in part of the property). Otherwise, the purchaser/landlord will be treated as receiving prepaid rental income. This was the result in two cases involving adverse sides of the same transaction. See Alstores Realty Corp. v. Com., 46 TC 363, 373 (1966) (so-called space-occupancy agreement where purchaser/landlord assumed both control and risks of ownership was in form and substance a typical lease arrangement). acq., 1967-2 C.B. 1; and Steinway & Sons v. Com., 46 T.C. 375 (1966). See also Ellison v. Com., 80 T.C. 378 (1983).


a. A security deposit is an amount placed into a deposit account, either with the landlord or with an independent escrow agent, in order to assure the landlord of the tenant's performance of its obligations under the lease. Security deposits can be used to secure the rent obligations, the return of the leased property in acceptable condition to the landlord, or compliance with other of the tenant's lease obligations. The landlord returns the security deposit to the tenant upon satisfaction of the obligations for which the security deposit was made.
b. A true security deposit is not income to the landlord when deposited. In *Com. v. Indianapolis Power & Light*, 493 U.S. 203 (1990), the Supreme Court held that security deposits of utility customers were not advance payments, which would be income to the utility, but were instead nontaxable loans. The Court specifically noted that this decision was consistent with earlier cases dealing with security deposits received by landlords. See *Clinton Hotel Realty Corp. v. Com.*, 128 F.2d 968 (5th Cir. 1943) (landlord has no present right or claim of full ownership of security deposit); and *Mantell v. Com.*, 17 T.C. 1143 (1952).

c. Rev. Rul. 72-519, 1972-2 C.B. 32, states that an amount intended primarily to secure only payments of rent due, rather than other covenants, should be considered advance rent. See *e.g.*, *Astor Holding Co. v. Com.*, 135 F.2d 47 (5th Cir. 1943); and *August v. Com.*, 17 T.C. 1165 (1952); and *Com. v. Riss*, 374 F.2d 161 (8th Cir. 1967). See also Rev. Rul. 67-47, 1967-1 C.B. 9 (true security deposit was not income).

d. A true security deposit is not deductible by the tenant when so deposited, thereby matching the tax treatment by the landlord. See *Minneapolis Security Bldg. Corp. v. Com.*, 38 BTA 1220 (1938) (taxpayer not allowed to deduct deposit placed into depreciation fund required by lease). The tenant is allowed to deduct the security deposit as rent only in the year in which the landlord's obligation to return the deposit ends. Rev. Rul. 67-47, 1967-1 C.B. 9. This applies even though the landlord, having had unrestricted use of the deposit, which was made solely to secure rent payments, was determined to have income on receipt of the deposit. In any event, the ability of the tenant to deduct the deposit when made or when the landlord takes it into income is subject to the advance rent rules (discussed above).

e. A security deposit originally treated as such may be subsequently forfeited by the tenant as a result of breaching the lease. If the security deposit is credited to the tenant's rent, the sum is income to the landlord as rent in the year in which it is so credited. See *Fifteen Hundred Walnut St. Corp. v. Com.*, 237 F.2d 933 (3rd Cir. 1956). If, however, the security deposit constitutes reimbursement by the tenant for any injury to the leased premises, then the landlord may be considered to have received a return of basis. See *Hamilton & Main v. Com.*, 25 T.C. 878 (1956) (payment at end of lease by lessee to taxpayer in lieu of repairs of leased premises constituted return of capital, not ordinary income). When a tenant defaults and/or cancels the lease, which ends the contingent obligation of the landlord to return the security deposit, the deposit is income to the landlord in the year such obligation to return ends. See Rev. Rul. 67-47, 1967-1 C.B. 9. Furthermore, the landlord is not allowed to claim an offsetting loss attributable to the loss of anticipated rents. See *Warren Service Corp. v. Com.*, 110 F.2d 723 (2nd 1940).
III. LEASE TRANSFER, MODIFICATION AND TERMINATION.

A. Bonus Paid by Landlord for Cancellation of Lease.

1. Amortization Over Remaining Lease Term. Any payment made by a landlord for the cancellation of a lease is amortized over the remaining term of the cancelled lease. By the payment to the lessee, the lessor acquires an asset, namely, the right to lease or use the premises for his own purpose for the remaining term of the lease period. *Burwig v. Com.*, TC Memo Op. Dkt. No. 37227 (1953). See also *Borland v. Com.*, 27 BTA 538 (1933).

2. Other Situations. In certain situations, however, the landlord will not be allowed to amortize cancellation payments. For example, where a lease was cancelled so that the landlord could construct new improvements on the property, the lease cancellation payments by the landlord must be added to the basis of the new building. *Keiler v. U.S.*, 285 F Supp 520 (WD Ky 1966), aff'd per curiam, 395 F.2d 991 (6th Cir. 1968). See also *Latter v. Com.*, 20 TCM (CCH) 336 (1961). Amortization is not permitted even when the remaining period of the cancelled lease is shorter than the life of the new building. See *American Spring & Wire Specialty Co. v. Com.*, 20 TCM (CCH) 116 (1961). This rule contrasts with the treatment of acquisition costs when a tenant purchases an existing leasehold and is permitted to amortize the leasehold costs over the leasehold term.

3. Demolition Expense. IRC §280B provides that any amount expended for the demolition of a structure must be capitalized and added to the basis of the land. Hence, a bonus payment for the cancellation of a lease in order to demolish a building must be capitalized as a cost of the land. Previously, a taxpayer was allowed, under certain circumstances, to amortize the cancellation payment over the life of the new improvements that replaced the demolished buildings. See *Houston Chronicle Pub. Co. v. U.S.*, 339 F. Supp. 1314 (SD Tex 1972), aff'd, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974).

4. Sale of Property versus New Lease. Similarly, if a lease is cancelled as a means of effectuating the sale of the property, the landlord's payment is added to the basis for the property. See *Shirley Hill Coal Co. v. Com.*, 6 BTA 935 (1927). By comparison, if the lease is cancelled so that the landlord may enter into a new lease for the property, the cancellation payment generally must be amortized over the period of the new lease. *Wells Fargo Bank & Union Trust Co. v. Com.*, 163 F.2d 521 (9th Cir. 1947). See also *Peerless Weighing & Vending Mach. Corp. v. Com.*, 52 TC 850 (1969).

5. Tenant Tax Treatment. IRC §1241 provides that any amount received by a tenant for the cancellation of a lease is treated as a gain or loss on the exchange of a lease. See generally Thompson, Some Tax Problems on Mid-Stream Modifications and Terminations of Leases, 4 J REAL EST TAX'N 214 (1977). See also *Stotis v. Comm.*, 72 TCM 704 (1996) (holding that taxpayer's legal expenses incurred in
connection with surrender of his lease were capital expenditures that offset the capital gain realized by taxpayer in connection therewith).

a. **Character as Capital Gain.** It should be noted that IRC §1241 does not determine whether or not a lease is a capital asset, even though its cancellation qualifies as an exchange thereunder. See Treas. Reg. §1.1241-1(a)(1). The applicable provision for determining whether or not a lease qualifies as a capital asset is IRC 1231, pursuant to which sales of property used in the trade or business produce capital gain or ordinary loss.

b. **Ordinary Income Character.** However, certain provisions override IRC §1231 treatment. In the case of a sale or exchange of property between certain related persons, IRC §1239 will override IRC §1241. In the case of a lease exchange between related persons, the gain must be treated as ordinary income. IRC §1239(a); and Treas. Reg. §1.1239-1(a). For the definition of related persons, see IRC §§1239(b), (c), and (d) and the regulations thereunder. See, e.g., *McEnery v. Com.*, 26 TCM (CCH) 1060 (1967). Moreover, where the tenant has taken depreciation on its leasehold interest, IRC §1245 will override IRC §1241 and cause any capital gain to be subject to recapture. See, e.g., *Kingsbury v. Com.*, 65 TC 1068 (1976).

c. **Partial Cancellation.** When there is a partial cancellation of a lease, IRC §1241 is also applicable. On the other hand, IRC §1241 will not apply to lease modifications. IRC §1241 applies only if the cancellation relates to a severable economic unit, such as a portion of the premises covered by a lease or a reduction in the unexpired term of a lease. See Treas. Reg. §1.1241-1(b). See also *Billy Rose’s Diamond Horseshoe, Inc. v. U.S.*, 322 F.Supp. 76 (SD NY 1971), aff’d, 448 F.2d 549 (2nd Cir. 1971).

d. **Lease Modification.** Merely because IRC §1241 is inapplicable, a tenant is not precluded from treating a landlord payment as a sale or exchange. See Treas. Reg. §1.1241-1(a). For example, a tenant realized capital gain upon the receipt of a cancellation fee for giving up a restrictive covenant. See *Com. v. Ray*, 210 F.2d 390 (5th Cir. 1954), cert denied, 348 U.S. 829 (1954).

**B. Bonus Paid by Tenant for Cancellation of Lease.**

1. **Advance Rental.** Generally, any amount paid by the tenant for the cancellation of a lease is ordinary income to the landlord in the year received, whether the landlord is on the cash method or an accrual method of reporting, on the theory that the cancellation payment is in lieu of future rents. See Treas. Reg. §1.61-8(b), providing that advance rentals are included in income when received, except as provided in IRC §467 or except as provided in administrative guidance allowing deferral to a taxable year other than the year of receipt. See, e.g., *Hort v. Com.*, 313 U.S. 28 (1941); and *1969 Corp. v. Com.*, 52 TCM (CCH) 226 (1986).

2. **Release of Obligation to Repay Security Deposit.** In Rev. Rul. 68-19, 1968-1 C.B. 42, the Service ruled that when a lessee releases a landlord from the landlord's obligation to
repay a security deposit as consideration for the cancellation of a lease, the entire amount realized by the landlord from the release is ordinary income in the year received. However, there is contrary case authority. In the cases of Bradford Hotel Operating Co. v. Com., 244 F.2d 876 (1st Cir. 1957), rev’d, 26 T.C. 454 (1956), and Warren Service Corp. v. Com., 110 F.2d 723 (2nd Cir. 1940), nonacq., Rev. Rul. 68-19, supra, the lessors had the right to the general use of the security deposits throughout the leases and did not have to repay the security deposits as consideration for the cancellation of the lease. In each case, the Court held that because the lessor was deprived of the right to use the security deposit (that is, earn interest thereon) for the remaining lease term, the amount of the security deposit included in income by the lessor in the year of the lease cancellation was to be discounted by the value of the loss of the right to earn interest on the deposit.

3. Tenant Tax Treatment. Generally, where the tenant makes a lease cancellation payment solely to secure relief from an unprofitable contract, such bonus payment will be deductible in the year of cancellation. See Cassatt v. Com., 137 F.2d 745 (3rd Cir. 1943). In contrast, a lease termination payment made in order to facilitate the acquisition of new property is considered a capital expenditure, and not a deductible expense. See PLR 9607016 (Nov. 20, 1995). If, however, the tenant makes a payment for the acquisition of a fee interest in the realty rather than a lease-cancellation bonus, the tenant receives no deduction, even though the lease is cancelled upon purchase. Such a payment may be apportioned between the land and so-called “additional rights” in the building. These additional rights in the building are depreciable over the remaining useful life of the building. See Millinery Center Bldg. Corp. v. Com., 21 T.C. 817 (1954), rev’d on other issues, 221 F.2d 322 (2nd Cir. 1955), aff’d, 350 U.S. 456 (1956). See also PLR 200048002 (May 22, 2000) (corporation that transferred lease interest as part of a sale could not take an ordinary loss deduction under IRC §165(a) for the abandonment of the lease).

IV. MISCELLANEOUS ISSUES.

A. Like-Kind Exchanges.

1. Transfer of Leasehold Interest. A leasehold interest in real estate with 30 years or more to run can be exchanged for a fee simple interest in real estate under IRC §1031(a). See, e.g., Treas. Reg. §1.1031(a)-1(c). This is the case whether or not boot is involved. IRC §1031(a) and (c). This is also the case whether or not there is any value in the leasehold received in the exchange. See, e.g., Rev. Rul. 76-301, 1976-2 C.B. 241.

2. Example. Rev. Rul. 76-301, 1976-2 C.B. 241: Corporation X sought to deduct its loss on the following transaction with unrelated corporation Z. Since 1940, X corporation had leased an entire 20-story building in which it had operated a retail clothing store located in the first 5 stories and basement. Z acquired X’s entire leasehold interest and all of X’s leasehold improvements, except those that only benefited the retail store, for $1,000x. The agreement also provided that Z would sublease the first 5 floors and basement of the building to X for the full term of the underlying lease. X sought to deduct a loss on the exchange, measured by the excess of (1) its adjusted basis in the nonretail space leasehold interest and improvements, over (2) the cash
payment made by the transferee, as determined by the value of the nonretail space leasehold and improvements at the time of the exchange. The Service concluded that the transfer of a long-term leasehold interest in a building in return for an identical leasehold interest in another portion of same building was an IRC §1031(a) like-kind exchange in which no loss could be recognized under IRC §1031(c).

B. Tax-Exempt Leasing.

1. In General. IRC §470, as enacted by AJCA 2004, was intended to prevent partnerships from being used in synthetic sale-in, lease-out (SILO) transactions. IRC §470 prohibits a partnership from deducting losses related to “tax-exempt use property” in excess of the income or gain from that property. Losses related to “tax-exempt use property” include depreciation, amortization, taxes, maintenance and other expenses. IRC §470 applies to leases entered into after March 12, 2004.

2. Tax-Exempt Use Property.

   a. “Tax-exempt use property” is defined by reference to the cost recovery rules of IRC §168(h) with certain modifications.

   b. “Tax-exempt use property” includes tangible property leased to a tax-exempt entity. As a modification, “tax-exempt use property” adds certain specified intangibles, such as IRC §197 intangibles.

   c. “Tax-exempt use property” also includes any property (whether or not leased) owned by a partnership (1) which has as partners both taxable persons and tax-exempt entities (including foreign persons), and (2) which makes allocations to the tax-exempt partners that are not “qualified allocations.” As a result, even if the partnership does not lease any property to a tax-exempt entity, a partnership with a tax-exempt or foreign partner is potentially subject to IRC §470, and an amount equal to the tax-exempt entity’s proportionate share of the non-qualified allocation is treated as “tax-exempt use property”. An allocation of a partnership item to a tax-exempt entity is a “qualified allocation” if (i) the allocation is straight-up allocation and non-varying, and (ii) the allocation has “substantial economic effect” within the meaning of IRC §704(b)(2), without taking into account items allocated under IRC §704(c). See IRC §168(h)(6).

3. Broad Scope.

   a. Because certain taxable entities “controlled” by tax-exempt entities are considered tax-exempt entities under IRC §168(h)(6)(F), IRC 470 can apply even if a tax-exempt entity (other than a foreign person) holds its partnership interest indirectly through a corporate “blocker” entity.
b. IRC §470 also applies to pass-through entities other than partnerships by reason of IRC §168(h)(6)(E), but it is unclear whether REITs are included, since "pass-through entity" is not a defined term.

4. Application. IRC §470 applies on a property-to-property basis. Any deduction disallowed under IRC §470 is treated as a deduction with respect to "tax-exempt use property" in the next year. When a taxpayer disposes of its entire interest in the tax-exempt property, any suspended or disallowed losses will become available under rules similar to those under IRC §469 for passive activity losses.

5. Leasing Transaction Exception. The disallowance provision of Section 470 will not apply, however, if a leasing transaction satisfies the following four requirements.

a. The lessee may not monetize its lease obligations, by means of, for example, a defeasance arrangement or sinking fund arrangement, in an amount that exceeds 20% of the lessor's adjusted basis in the property at the time the lease is entered into.

b. For any lease with a lease term of more than five years, the lessor must have unconditional at-risk equity investment in the property of at least 20 percent of its adjusted basis in the property at the inception of the lease and all throughout the lease term.

c. For any lease with a lease term of more than five years, the lessee may not bear (a) any portion of the loss that would occur if the fair market value of the leased property were 25% less than its reasonably expected fair market value at the time the lease is terminated, or (b) more than 50% of the loss that would occur if the fair market value of the leased property at the time the lease is terminated were zero.

d. With respect to property with a class life of more than seven years, if the lease includes an option for the lessee to purchase the property, the purchase price under the option must be for the fair market value of the property at the time of exercise of the option.

6. 2004 Moratorium under Notice 2005-29, 13 I.R.B. 796. This Notice provides transition relief under new IRC §470 to partnerships and other pass-through entities that are treated as holding tax-exempt use property as a result of IRC §168(h)(6). In the case of partnerships and pass-through entities described in IRC §168(h)(6)(E), for taxable years that begin before January 1, 2005, the Service will not apply IRC §470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of IRC §168(h)(6).

C. At Risk Limitations.

D. Passive Activity Limitations.