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BASIC AND NON-BASIC TAX TIPS FOR LEASING LAWYERS

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I. INTRODUCTION

Leases raise several tax issues. Attorneys advising landlords and tenants should be aware of the general tax aspects that affect leases. This paper covers federal income tax issues that attorneys should be aware of as they assist clients with negotiating and entering into leases. The topics range from basic tax treatment of rent payments to more complex tax accounting for prepaid and deferred rent payments to issues that arise in specific leasing and transactional contexts.

II. TAX BASICS OF LEASING

A lease is an arrangement that requires payment for the use of property. As such, the owner of property (lessor) grants another party (lessee) the right to use the property in exchange for consideration. Those respective transfers of value create tax consequences to both the lessor and the lessee. The general tax treatment of lease payments does not apply in the case of section 467 lease, as discussed below.

A. General Tax Treatment of Lessor

Rent is ordinary income to the lessor, when the lessor receives the rental payments. I.R.C. §§ 61(a)(5), 451. Therefore, a lessor must pay tax on rent received at ordinary income rates.

B. General Tax Treatment of Lessee

Lessees can deduct rental payments as an ordinary and necessary cost of doing business against ordinary income. I.R.C. § 162(a)(3). Lessees cannot, however, deduct prepaid rent currently. Instead, they must capitalize prepaid rent. I.R.C. § 263; Treas. Reg. § 1.263(a)-4. That means they cannot deduct prepaid rent currently. Instead, a lessee would deduct a portion of prepaid rent over the life of the lease. Treas. Reg. § 1.162-11 (providing that the purchaser of a leasehold may deduct an aliquot share of purchase price of lease each year over life of lease).

C. Asymmetry and Tax Treatment Mismatch

Because the general tax rules require the lessor to recognize income upon receipt of rent payments and require the lessee to capitalize prepaid rent and deduct it over the life of the lease, the general tax rules create asymmetry, or

a reporting mismatch. That mismatch generally benefits the government with respect to prepaid rent because the government currently receives tax on rental income reported by the lessor, but the lessee deducts the rent expense over the life of the lease. The following table illustrates the potential tax-treatment mismatch of prepaid rent.

General Tax Treatment of Prepaid Rent

	Year 1	Year 2	Year 3	Year 4	Year 5
Payment	$900,000	$0	$0	$0	$0
Lessor Gross Income	$900,000	$0	$0	$0	$0
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

If the lessor and lessee use different accounting methods, deferred rent can also create asymmetry and mismatch. For instance, a lessee who uses the accrual method of accounting deducts rent over the life of the lease, regardless of when the rent is paid. A cash method lessee would, however, generally only recognize rental income when the rent is paid. Thus, the lessee may have current deductions under the accrual method, while the lessor defers rental income until rent is paid, in the case of deferred rent. The following table shows the potential tax-treatment mismatch that results from deferred rent.

General Tax Treatment of Deferred Rent

	Year 1	Year 2	Year 3	Year 4	Year 5
Payment	$0	$0	$0	$0	$900,000
Lessor Gross Income	$0	$0	$0	$0	$900,000
Lessee Deduction	$180,000	$180,000	$180,000	$180,000	$180,000

The mismatch that results from the general tax treatment of rent payments can create tension between the lessee and lessor. The lessee would like to have a current deduction, but the lessor would prefer to defer income recognition. If both lessor and lessee are accrual method taxpayers, then they should both report the accrual of rents at the same time. In such situations, the tension would relate to timing of the payment. The lessee would prefer to receive payments as the rental income accrues, and the lessor would prefer to defer payment as long as possible. Congress recognizes this tension exists between lessors and lessees and created a tax regime to leverage that tension to create a self-policing system that allows lessors and lessees to work together to develop rental accrual schedules. The regime also provides the IRS authority to determine accrual schedules if it finds that the accrual schedule used by the lessor and lessee is designed to avoid taxes.

III. SECTION 467 LEASES

Congress enacted section 467 to eliminate tax-reporting mismatches caused by tax accounting rules and to harness tax-avoidance schemes that took advantage of that mismatch. Section 467 uses rental accrual rules to match when a lessee deducts rent payments with when lessor recognizes income. The application of section 467 to two

types of lease arrangements could be deemed by the lessor or lessee to be punitive, but outside those two types of arrangements, and within certain regulatory parameters, section 467 provides an opportunity for lessor and lessee to negotiate the timing of the rental deductions and income.

In the section 467 legislative history, Congress recognized that the mismatch of income recognition and deductions provided opportunities for lessors and lessees to time payments to defer income recognition and advance rental deductions. Congress particularly identified leases with "backloaded" or "stepped" rents. With such leases, an accrual method lessee could deduct rents as they accrued over the life of the lease, while a cash method lessor deferred income recognition until receipt of payment at the end of the lease. If the tax situation of the lessor and lessee differed significantly, they could time lease payments and accrual to minimize the overall tax effect of the lease. For instance, if the lessor had significant current and carryover operating losses, the lessor would be amenable to recognizing rental income currently. Thus, the lessor might agree to a prepaid or frontloaded rent. The lessee would still have to capitalize and amortize any prepaid or frontloaded rental payments but would be happy with earlier deductions.

In enacting section 467, Congress provided the IRS with a tool to challenge and recharacterize leases that were designed to avoid federal income tax or did not provide for adequate interest payments. It also includes a self-policing mechanism that draws upon the tension that exists between lessors and lessees. Under that self-policing mechanism, lessors and lessees self-police tax reporting. For instance, a lessor and lessee may create rental accrual schedule that does not necessarily track rental payments. The catch is that the lessor and lessee must include adequate interest on fixed rent and recognize tax aspects of rent payments at the same time, so the lessor recognizes rental income at the same time the lessee takes a rental deduction.

The self-policing mechanism breaks down if the parties' tax situations differ. For instance, a tax-exempt lessor would not worry about front-loaded rental accrual, but a lessee with significant current taxable income would favor front-loaded rental accrual. Alternatively, a lessee may have considerable current losses and not need the current deduction and agree with a lessor that has significant current income to backloaded rental accrual. Congress recognized these possibilities and provides a mechanism for the IRS to curtail such arrangements.

The self-policing mechanism of section 467 provides generally that if section 467 applies, the lessor and lessee must treat rents in the same manner, i.e., recognize the income and take the deductions at the same time. Additionally, the lessor and lessee must use the accrual method of accounting, regardless of their overall methods of accounting.

A. Applicability of Section 467

Section 467 only applies to "section 467 rental agreements." I.R.C. § 467(a); Treas. Reg. § 1.467-1(a)(2). The definition of section 467 rental agreement has two elements:

1. The agreement is for the use of tangible property, and
2. The agreement provides for
    a. Uneven (increasing or decreasing) rents, or
    b. Prepaid or deferred rent.

I.R.C. § 467(d)(1); Treas. Reg. § 1.467-1(c)(1). Agreements that provide for aggregate rents of less than $250,000 are excluded from the definition of section 467 rental agreements. I.R.C. § 467(d)(2); Treas. Reg. § 1.467-1(a)(2).

If section 467 applies, one of the section 467 rental accrual methods determines the amount of the lessor's rental income and the lessee's rental deduction for any taxable year. The section 467 accrual methods are:

1. The constant accrual method, Treas. Reg. § 1.467-1(d)(2)(i), -3,
2. The proportional accrual method, Treas. Reg. § 1.467-1(d)(2)(ii), -2, and

3. Rental agreement accrual method, Treas. Reg. § 1.467-1(d)(2)(iii).

The methods are mutually exclusive, so only one method will apply to a section 467 lease agreement. The applicable method determines the amount of fixed rent for each period of a lease, which becomes part of the section 467 rent that the lessor and lessee must account for in a given accrual period. Treas. Reg. § 1.467-1(b), -1(d)(1). Thus, in analyzing the different accrual methods, the focus is on which method applies to a particular section 467 rental agreement and determining the result of applying a particular method to an agreement.

B. Constant Rental Accrual Method

The constant rental accrual method applies to disqualified leasebacks and long-term agreements that do not provide for permissible accruals. I.R.C. § 467(b)(2), (3); Treas. Reg. § 1.467-1(d)(2)(i). Only the IRS can determine if the lease is disqualified, so only the IRS can apply the constant rental accrual method. Stough v. Commissioner, 144 T.C. 306 (2015); Treas. Reg. § 1.467-3(a). A section 467 rental agreement is disqualified if it: (1) is either a leaseback or a long-term agreement; (2) the principal purpose of increasing or decreasing rents is the avoidance of federal income tax; and (3) the IRS determines the leaseback or long-term agreement should be disqualified. I.R.C. § 467(b)(4); Treas. Reg. § 1.467-3(b)(1).

1. Leaseback or Long-Term Lease

A rental agreement is a leaseback if the lessee had any interest in the property at any time during the two-year period that ends on the date of the agreement. Treas. Reg. § 1.467-3(b)(2). A rental agreement is long-term if the lease term exceeds 75 percent of the property's statutory recovery period. I.R.C. § 467(b)(4)(A); Treas. Reg. § 1.467-3(b)(3)(i). The statutory recovery period of most real property, including land (which does not qualify for the depreciation deduction), is 19 years. Treas. Reg. § 1.467-3(b)(3)(ii). Thus, a rental agreement of real property is long-term if it runs for more than 14.25 years (19 × 75 percent).

2. Tax-Avoidance Purpose

The IRS will apply a facts and circumstances test to determine whether increasing or decreasing rents in an agreement have the principal purpose of avoidance of federal income tax. Treas. Reg. § 1.467-3(c)(1). The regulations provide safe harbors that show tax avoidance is not a principal purpose for increasing or decreasing rents, but failure to come within one of the safe harbors does not, by itself, indicate the agreement had a principal tax avoidance purpose. Id. The IRS will closely scrutinize any arrangement if the marginal tax rates of the lessor and lessee can reasonably be expected at some time during the lease term to be significantly different. Treas. Reg. § 1.467-3(c)(2)(i). The difference in marginal rates is significant if, in the case of an agreement with increasing rents, the lessor's marginal tax rate is expected to exceed the lessee's marginal tax rate by 10 percentage points during the lease term. Treas. Reg. § 1.467-3(c)(2)(ii)(A). In the case of a lease agreement with decreasing rents, the difference in marginal tax rates is significant if the lessor's marginal tax rate is expected to be more than 10 percentage points greater than the lessee's. Treas. Reg. § 1.467-3(c)(2)(ii)(B). In such situations, the lessor or lessee under scrutiny will have to show by clear and convincing evidence that the rental agreement did not have tax avoidance as a principal purpose. Treas. Reg. § 1.467-3(c)(2)(i). The following are examples of when the difference between the lessor's and lessee's marginal tax rates might be significant.

The lessor is a tax-exempt entity, the taxable lessee has significant income, and the rental agreement provides for decreasing rents. In such a situation, the lessor does not pay tax on prepaid rent, and the lessee benefits from current deductions.

The lessee has current and projected operating losses, the lessor has significant income, and the rental agreement provides for increasing rents. In such situation, the lessor benefits from deferral of income recognition, and the lessee is indifferent about not getting deductions currently

Increasing or decreasing rents in these situations would appear to be in a rental agreement for the principal purpose of avoiding federal income tax, and the IRS would most likely scrutinize such arrangements.

3. Non-Avoidance Safe Harbors

The following situations come within the non-avoidance safe harbors. I.R.C. § 467(b)(5); Treas. Reg. § 1.467-3(b)(3). Under the safe harbor, tax avoidance is not a principal purpose if increasing or decreasing rents meet the uneven rent test. Treas. Reg. § 1.467-3(c)(3)(i). Rents meet the uneven rent test if the amount of rent allocated to each calendar year is within 10 percent of the average rent for all calendar years. Treas. Reg. § 1.467-3(c)(4). An agreement also comes within the safe harbor if an increase or decrease in rent is wholly attributable to one or more of the following: (1) a contingent rent provision; or (2) a single rent holiday allowing reduced rent for one consecutive period of the lease for less than three months or for a commercially reasonable period that cannot be in excess of the lesser of 24 months and 10 percent of the lease term. Treas. Reg. § .1467-3(b)(3)(ii).

4. IRS Application of the Constant Rental Accrual Method

If the IRS determines that the constant rental accrual method applies, the constant rental amount equals the amount that provides a present value of rental amounts equal to the present value of all amounts payable under the lease. Treas. Reg. § 1.467-3(d)(1). The IRS deploys a three-step process to compute a constant rental amount:

Step 1: determine present value of amounts payable under disqualified lease;

Step 2: determine present value of $1 to be received at end of each rental period; and

Step 3: divide Step 1 amount by Step 2 amount.

Treas. Reg. § 1.467-3(d)(3). The result of the process is the fixed rent for each accrual period of the lease. Treas. Reg. § 1.467-1(d)(2)(i). Example 1 illustrates the application of the steps to determine the constant rental amount.

EXAMPLE 1

Application of the Constant Rental Accrual Method

The IRS determines that a rental agreement is a disqualified sale-leaseback. The rental agreement provides for deferred rent, and the lessor's marginal tax rate exceeds the lessee's marginal tax rate by a significant amount. The lease agreement includes the following payment schedule for year-end payments:

Schedule of Rent Payments due under Agreement					
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Rent	$0	$0	$0	$17,500,000	$17,500,000

The IRS would deploy the three-step process to determine the constant rental amount.

Step 1: Determine the present value of rent payments (assumes a 12 percent applicable rate).

$$\$21{,}051{,}536 = \frac{\$0}{(1.12)^1} + \frac{\$0}{(1.12)^2} + \frac{\$0}{(1.12)^3} + \frac{\$17{,}5000{,}000}{(1.12)^4} + \frac{\$17{,}5000{,}000}{(1.12)^5}$$

Step 2: Determine the present value of $1 received at end of each rental period.

$$\$3.6047762 = \frac{\$1}{(1.12)^1} + \frac{\$1}{(1.12)^2} + \frac{\$1}{(1.12)^3} + \frac{\$1}{(1.12)^4} + \frac{\$1}{(1.12)^5}$$

Step 3: Determine the constant rental amount by dividing the Step 1 amount by the Step 2 amount.

$$\mathbf{\$5{,}839{,}910} = \frac{\$21{,}051{,}536}{\$3.6047762}$$

Because $5,839,910 is the constant rental amount, the lessor must report $5,839,901 as gross income for each year of the lease, and the lessee may deduct the same amount as rent expense for each year of lease. Treas. Reg. § 1.467-3(e), Ex. 6.

The application of the constant rental accrual method also results in a section 467 loan. The discussion below illustrates how to compute the loan amount and the interest imputed under a section 467 loan. A section 467 loan is a deemed loan, and it can be from either the lessor or the lessee. In this situation, because the rent payments are deferred, the lessor will be deemed to loan the money to the lessee and will have interest income over the life of the lease.

C. Section 467 Proportional Rental Accrual Method

The proportional rental accrual method can only apply if a section 467 rental agreement is not subject to the constant rental accrual method. Treas. Reg. § 1.467-1(d)(2)(ii). Thus, the proportional rental accrual method cannot apply to a section 467 rental agreement that the IRS determines is a disqualified leaseback or long-term agreement. Treas. Reg. § 1.467-2(a)(1). The rental agreement also must fail to provide for adequate interest on fixed rent. Treas. Reg. § 1.467-2(a)(2). The proportional rental accrual method would generally apply only if the payment schedule under the rental agreement differs from the accrual schedule in the rental agreement.

After determining that a rental agreement is not a disqualified leaseback or long-term lease, the next step in applying the proportional rental accrual method is to determine whether the rental agreement provides for adequate interest on fixed rent. If not, the parties must compute the proportional rental amount.

1. Adequate Interest on Fixed Rent

A section 467 rental agreement fails to provide for adequate interest on fixed rent, if it does not satisfy one of the definitions of adequate interest on fixed rent. A rental agreement provides for adequate interest on fixed rent if it has no deferred or prepaid rent. Treas. Reg. § 1.467-2(b)(1)(i). Other agreements can provide for adequate interest on fixed rent in one of multiple different ways, depending upon the type of rent provided for in the rental agreement.

A section 467 rental agreement with deferred or prepaid rent provides adequate interest on the fixed rent if the rental agreement provides for interest on deferred or prepaid rent at a single rate, includes a stated rate of interest that is no lower than 110 percent of Applicable Federal Rate (AFR), adjusts the amount of deferred and prepaid fixed rent at least annually to reflect amounts paid and owing, and requires interest to be paid or compounded at least annually. Treas. Reg. § 1.467-2(b)(1)(ii).

A section 467 rental agreement with deferred, but not prepaid, rent provides for adequate interest on fixed rent if the sum of the present value of all amounts payable by the lessee as fixed rent and interest is greater than or equal to the sum of the present value of the fixed rent allocated to each rental period. Treas. Reg. § 1.467-2(b)(1)(iii).

A section 467 rental agreement with prepaid, but not deferred, rent provides for adequate interest on fixed rent if the sum of the present value of all amounts payable by the lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is less than or equal to the sum of the present value of fixed rent allocated to each rental period. Treas. Reg. § 1.467-2(b)(1)(iv).

A section 467 agreements with variable interest must use fixed rate substitutes to determine if it provides for fixed rates of interest. Treas. Reg. § 1.467-2(b)(2).

A section 467 agreement with both deferred and prepaid rent provides for adequate interest if the agreement satisfies the requirements of a rental agreement with deferred or prepaid rent, has a single fixed rate of interest on deferred rent, and has a single fixed rate of interest on prepaid rent. The rates of interest on prepaid and deferred rent can differ. Treas. Reg. § 1.467-2(b)(3).

2. Computation of Proportional Rental Amount

If a section 467 rental agreement is not a disqualified leaseback or long-term lease and does not provide for adequate interest, the proportional rental amount is determined by multiplying the rent allocated to a rental income or payments period by the following fraction:

$$\frac{\textit{present value of amounts payable + interest}}{\textit{present values of fixed rents allocated to each period}}$$

Treas. Reg. § 1.467-2(c)(1).

3. Application of Proportional Rental Accrual Method

Example 2 illustrates the application of the proportional rental accrual method.

EXAMPLE 2

Application of the Proportional Rental Accrual Method

A rental agreement that does not provide for an interest rate at a fixed rate has the following schedule of rent payments and allocations of rent:

Schedule of Rent Allocated Payments due under Agreement			
	Year 1	Year 2	Year 3
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000

This agreement provides for deferred rent (rent paid only in Year 3), but not prepaid rent. Thus, it will have adequate interest if the sum of the present values of all amounts payable are greater than the sum of the present values of the fixed rent allocated to each rental period. Because the total rent allocated to each period equals the rent payable and some of the rent is allocated to Year 1 and Year 2, the sum of the present values of the rent allocated will exceed the present value of the rent payable. The computation of the present value proves out that conclusion. Assuming an applicable rate of 8.5 percent.

$$\textit{present value of amount payable} = \$2{,}348{,}724 = \frac{\$3{,}000{,}000}{(1.085)^3}$$

$$\textit{present value of allocated rent} = \$2{,}526{,}272 = \frac{\$3{,}000{,}000}{(1.085)^3}$$

Notice that $2,526,272 present value of the allocated rent is greater than the $2,348,724 of present value of rent payables. Thus, the following fraction would apply in determining the rent allocated to each period to compute the proportional rental amount for each rental period.

$$\textit{Fraction} = \mathbf{.9297294} = \frac{\$2{,}348{,}724}{\$2{,}536{,}272}$$

The proportional rental amount for each rental period equals the rent allocated to each period multiplied by that fraction.

Year 1: $800,000 × .9297294 = $743,776

Year 2: $1,000,000 × .9297294 = $929,729

Year 3: $1,200,000 × .9297294 = $1,115,663

Treas. Reg. § 1.467-2(f), Ex. 3.

As with the constant rental accrual method, the proportional rental accrual method results in a section 467 loan.

D. Section 467 Loans

The section 467 loan rules apply to rental agreements that are subject to either constant rental accrual method or proportional rental accrual method. Treas. Reg. § 1.467-4(a)(2), (3). A section 467 loan exists if, as of the first day of the rental period, the amount of fixed rent stated in the agreement differs from the amount determined under one of those methods. Treas. Reg. § 1.467-4(a)(1).

1. Principal Balance and Effect of Section 467 Loan

A section 467 loan can have either a positive principal balance or negative principal balance. Treas. Reg. § 1.467-4(a)(1). If a section 467 loan has a positive principal balance, it is a loan from lessor to lessee, so the lessor is deemed to be lending the lessee accrued unpaid rent. Under such a situation, the lessor has interest income, and the lessee has interest expense. Treas. Reg. § 1.467-1(e)(3). If a section 467 loan has a negative principal balance, the loan is deemed to be from lessee to lessor, so the lessee is deemed to be lending the lessor prepaid rent. Under such a situation, the lessee has interest income, and the lessor has interest expense. Treas. Reg. § 1.467-1(e)(3).

2. Computation of Section 467 Loan Principal Balance

The principal balance of a section 467 loan at the beginning of a rental period is determined using the following formula: fixed rent accrued in preceding years + (lessor's interest income for preceding years + interest payable to lessor on or before first day) – (lessee's interest income on prepaid fixed rent for prior rental periods + amount payable to lessor before first day as interest). Treas. Reg. § 1.467-4(b). Example 3 draws upon the facts in Example 2 to illustrate how to determine the amount of a section 467 loan.

EXAMPLE 3

Computation of Section 467 Loan and Interest

A rental agreement that does not provide for an interest rate at a fixed rate has the following schedule of rent payments and allocations of rent:

Schedule of Rent Allocated Payments due under Agreement			
	Year 1	**Year 2**	**Year 3**
Rent Allocation	$800,000	$1,000,000	$1,200,000
Rent Payment	$0	$0	$3,000,000
467 Rent	$743,776	$929,729	$1,115,663

Using this information, the parties can determine the amount of section 467 loan outstanding at the beginning of each rental period and the amount of interest that will accrue on that loan. At the beginning of Year 1, no rent had accrued because the Year 1 rent accrues at the end of the year. At the beginning of Year 2, the accrued rent will equal $743,776. Assuming an 8.5 percent yield, the lessor will have interest income of $63,221 in Year 2, and the lessee will have an interest expense in the same year.

At the beginning of Year 3, the $1,736,726 outstanding balance will include the $743,776 of Year 1 rent, the $63,221 of Year 2 interest, and the $929,729 of Year 2 rent. The Year 3 interest on that amount will be $147,622. The outstanding balance increases by that amount of interest and the $1,115,663 of Year 3 rent to $3,000,000, as summarized in the following table.

Amount of 467 Loan + Interest (assume 8.5 percent yield)			
	Year 1	**Year 2**	**Year 3**
Accrued Fixed Rent (beginning)	$0	$743,776	$1,736,726
Lessor's Interest Inc.	$0	$63,221	$147,622
Interest Payable to Lessor	$0	$0	$0
Lessee's Interest	$0	$0	$0
Amount Payable to Lessor	$0	$0	$0
Outstanding Loan Balance (end)	$0	$806,997	$1,884,348
Ending Loan Balance	$0	$0	$3,000,000

Because the loan has a positive principal balance, its from the lessor to the lessee. The lessor therefore has $63,221 of interest income in Year 2 and $147,622 of interest income in Year 3, and the lessee has the same amounts of interest expense in those years. The rules thus treat the lessor as lending the amount of section 467 rent to the lessee, treats the lessee as paying the rent to the lessor, and, at the end of the rental agreement, the lessee pays the principal and outstanding balance of the loan to the lessor.

E. Section 467 Rental Agreement Accrual Method

The section 467 rental agreement accrual method only applies if the lease is not subject to constant rental accrual method or proportional rental accrual. Treas. Reg. § 1.467-1(d)(2)(iii). Thus, the rental agreement must provide adequate interest on fixed rent, and the rental agreement cannot be a disqualified leaseback or long-term lease. If a section 467 lease agreement qualifies for the rental agreement accrual method, tax law will follow an accrual schedule in rental agreement. I.R.C. § 467(b)(1). A rental agreement specifically allocates fixed rent to a rental period if it unambiguously specifies a fixed amount of rent for which the lessee becomes liable for use of the property during the period, and the total amount of fixed rent specified equals the total amount of fixed rent payable under the lease. Treas. Reg. § 1.467-1(c)(2)(ii)(A)(*2*). If there is no specific allocation, the amount of rent allocated to a rental period is the amount of fixed rent payable during that rental period. Treas. Reg. § 1.467-1(c)(2)(ii)(B).

This method allows parties to a section 467 rental agreement to create the rental accrual schedule. They could frontload rent payments and backload accrual or backload payments and frontload accrual. If the structure does not have tax avoidance as the principal purpose, then the IRS would not be able to apply the constant rental accrual method. If the agreement had adequate interest on fixed rent, then the constant rental accrual method would not apply. Thus, the parties must take into account their respective preferences for recognizing income and taking deductions, compare their tax rates, and account for the time value of money of scheduled payments and rent accruals. These factors create some parameters, but do not prohibit the parties from allocating rents in values that differ from payments of rents. This fact is manifest in Example 2, which applies the constant rental accrual method. The parties to the rental agreement in that example should have been able to use the resulting accrual schedule to allocate rents, and the agreement should have had adequate interest on fixed rent. The parties would, of course, have to account for the interest as well as the rent with such a schedule.

IV. TAX TREATMENT OF IMPROVEMENTS TO LEASED PROPERTY

Improved leased property raises tax issues related to depreciation deductions of the property and to tax treatment of tenant improvements that revert to the lessee on termination of the lease.

A. Depreciation Deductions

Depreciation deductions are valuable because they reduce taxable income without affecting operating cash flow. As a general matter, the owner of property gets depreciation deductions. Therefore, the lessor typically gets depreciation deductions for improvements the lessor constructs on leased property. The lessee typically gets depreciation deductions for tenant improvements. In determining who gets the deprecation deductions, courts look to which party invested capital in the improvements. Hopkins Partners v. Commissioner, 97 T.C.M. (CCH) 1560 (2009).

B. Lessee Improvements

Generally, lease improvements are excluded from the lessor's income upon lease termination when improvements revert to the lessor. I.R.C. § 109. The lessor takes a zero basis in such reverted improvements, deferring gain recognition until the lessor later sells the property. I.R.C. § 1019.

A lessee must capitalize the cost of lessee improvements. I.R.C. § 263. Regardless of who qualifies for the depreciation deductions, the paying party must capitalize the cost of improvements and depreciate the cost over applicable MACRS recovery period—not life of lease. I.R.C. § 168(i)(8)(A). Thus, if a lease has 25 years remaining, but the recovery period of property the lessee constructs is 39 years, a lessee must compute depreciation deductions related to tenant improvements over 39 years. The lessee should be able to deduct any remaining basis in lessee improvements when a lease terminates. See I.R.C. § 165; Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, at 108 (1987).

Tenant improvements can be a substitute for rent, in which case, the improvements give rise to lessor as ordinary rental income. The lessee can deduct the cost of rent-substitute improvements currently against ordinary income, if the substitute improvements are for current rent. Hopkins Partners v. Commissioner, 97 T.C.M. (CCH) 1560 (2009); Treas. Reg. § 1.109-1.

V. TAX CLASSIFICATION OF LEASES

Leases are leases are leases . . . unless tax law classifies them as something else. Such reclassification is possible when an arrangement that is labeled a lease is substantively something different from a lease for tax purposes. Consider two possible reclassifications of leases—a reclassification to a sale or financing and a reclassification to a partnership.

A. Lease vs. Sale/Financing

A lease is a finance transaction. A lease provides the lessee the right to use property in exchange for making payments. As the discussion of section 467 illustrates, a lease with prepaid or deferred rent can create a loan with interest, at least for tax purposes. A lease also provides an asset and liability for each party to the lease. The lessor has a right to rental payments, and the lessee has a right to use the property. The lessor has an obligation to make the property available to the lessee, and the lessee has an obligation to pay rent. Sophisticated lessees and lessors will also recognize that deferred and prepaid rent have time-value-of-money implications. Thus, leases have attributes of many finance arrangements.

An arrangement that is labeled a lease may lack the attributes that make it a lease and begin to look like a sale from the lessor to the lessee or a financing arrangement with the lessor providing financing for the lessee to purchase the property. The structure of the former transaction would include the lessor leasing the property to the lessee, but the form may reflect a seller-financed transfer of the property. The structure of the latter transaction would represent the lessor acquiring property and leasing it to the lessee. In substance, such a transaction may be nothing more than the lessee providing financing for the lessee to acquire the property.

If the transaction is a seller-financed transfer, the "lessor" would realize gain at the inception of the arrangement (and most likely recognize the gain as payments are made under the installment method), and the "lessee" would take a basis in the property equal to its purchase price. Regular "lease" payments would be treated as debt service. Tax law looks at the substance of transactions to determine their proper classification.

Tax law generally recognizes that the party that holds the benefits and burdens of a property is the tax owner of the property. Courts consider the following several factors in determining who holds the benefits and burdens.

- How do the parties treat the transaction?
  - Rent payments or debt service and interest?
  - Lessor recognizes gain upon entering into the lease?
  - Which party is claiming depreciation deductions?
- Does the lessor have an equity interest in the property?
- Will the property have any economic value at the end of the lease term?
  - If the lessee consumes all of the property's economic value during the lease term, the lease looks more like a sale
- Does lessee have option to purchase at below market at end of lease term?
  - If the exercise price of the option is well below market, the rational lessee will exercise the option and acquire the property. The lessee may turn around and sell it immediately, but a low exercise price transfers benefits to the lessee.

- Does the lessor have a present obligation to transfer title to the property?
- Who bears the risk of loss?
- Who owns the upside?

Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Torres v. Commissioner, 88 T.C. 702, 720-722 (1987); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237-1238 (1981); Estate of Thomas v. Commissioner, 84 T.C. 412, 433-436 (1985).

B. Lease vs. Partnership

The IRS could also find that something that the parties call a lease is actually a partnership. State law provides that a partnership is "an association of two or more persons to carry on as co-owners a business for profit." If rent is based upon the lessee's profits, the IRS may scrutinize the arrangement more closely. To avoid the risk of that scrutiny, the parties may prefer to base rent on gross receipts. The parties should also consider the ultimate disposition of the property, which relates to ownership and co-ownership. The question of whether a partnership exists is one of the most difficult questions in partnership tax, if a situation raises the question. See Bradley T. Borden, The Federal Definition of Tax Partnership, 43 Hous. L. Rev. 925 (2006). The question is also a matter of federal tax law, so state law classification is not determinative.

VI. SYNTHETIC LEASES

Synthetic leases have been a popular finance structure for many years, but changes in GAAP may be dampening their attractiveness. The essence of a synthetic lease is that the user is treated as the owner of the property for tax purposes. For GAAP purposes, the arrangement is an operating lease, so the parties do not have to report liabilities in their financial statements. Synthetic leases are typically used for assets such as corporate headquarters, other real estate projects, or corporate aircraft. They are only relevant for parties who provide GAAP financial statements.

A. Financing structure

The lease documents of a synthetic lease typically provide for a short-term lease (less than 10 years, including renewal options). The lease uses purchase options and rights of termination to shift the benefits and burdens of ownership to the lessee. For GAAP purposes the user is deemed to enter into an operating lease with the "lender."

VII. REITS AND RENTS

REIT income tests require that 95 percent (passive type income) and 75 percent (income from real property) of the REIT's gross income derive from specific sources, including Rents from real property. I.R.C. § 856(c)(2), (3). For payments to come within the definition of rents from real property they must be for the use of real property. I.R.C. § 856(d)(2). Numerous cases and rulings and recent regulations address the definition of real property. See Bradley T. Borden, "Reforming REIT Taxation (or Not)," 53 Hous. L. Rev. 1 (2015); Treas. Reg. § 1.856-10.

For REIT purposes, rent excludes payment for services provided to tenants, other than customary services. I.R.C. § 856(d)(1). Non-customary services can be provided to tenants of REIT property by independent contractors and taxable REIT subsidiaries. I.R.C. § 856(d)(2)(C), (7).

VIII. TAX TREATMENT OF LEASE TERMINATION PAYMENTS

A lease termination fee paid from a lessee to a lessor is ordinary income to the lessor. Hort v. Commissioner, 313 U.S. 28 (1941); Treas. Reg. § 1.61-8(b). The lessee should be able to deduct such a termination fee currently. Cassatt v. Commissioner, 137 F.2d 745 (3d Cir. 1943).

A lessor must capitalize a termination fee paid to a lessee. Treas. Reg. § 1.263(a)-4(d)(7)(i)(A). The lessor either adds the fee to the basis of the property, recovers it over the unexpired term of the terminated lease, or recovers it over another lease the lessor enters into in a transaction related to the termination. Handlery Hotels, Inc. v. United States,

663 F.2d 892 (9th Cir. 1981). The lessee treats the receipt of such a payment as an amount received in exchange for selling the lease. I.R.C. § 1241. The lessee's tax treatment will therefore depend upon whether the lease is a capital asset or business-use property for the lessee, which would result in capital gains or losses, or another type of asset, which would result in ordinary income.

IX. USE OF LEASES IN LAND-BUILDING SPLITS

With land-building splits, the owner of improved property transfers title to a building on land and retains the land. The purchaser of the building uses the lease to obtain access to the land on which the building stands. Several cases have considered whether attempts to split buildings from land have been successful.

A. Unsuccessful Splits

Courts have provided a list of Indicia of lease, but no transfer of building in attempted land-building splits:

- Lessee required to restore destroyed building;
- Lessee must post bond equal to demolition and construction costs to replace existing building;
- Lessee required to insure building;
- Recovery from loss of building paid to lessor;
- Lessee must maintain the building in good condition;
- Title to building reverts to lessor when lease terminates; and
- Lessee is not permitted to sever or remove the buildings.

Gates v. Helvering, 69 F.2d 277 (8th Cir. 1934); Lindley's Trust No. 1 v. Commissioner, 120 F.2d 998 (8th Cir. 1941); Crile v. Commissioner, 55 F.2d 804 (6th Cir. 1932); Estate of Budd Frankenfield v. Commissioner, 17 T.C. 1304 (1952); Minneapolis Syndicate v. Commissioner, 13 B.T.A. 1303 (1928).

B. Successful Land-Building Splits

Perhaps the most common example of a land-building split is a condominium sale. The IRS has ruled that a land-building split was successful with respect to a condominium sale, in which the lessee had the right to remove the condominium at end of the ground lease, the lessor had to acquire units that were not removed at end of the lease, and the owner of the improvements would receive proceeds from condemnation. Rev. Rul. 70-607, 1970-2 C.B. 9. The tax court has held that the right to remove building is strong indication of split. Waldrep v. Commissioner, 52 T.C. 640 (1969). A federal district court has held that the right to remove building and a right to insurance proceeds are indicia of a split. Bratton v. Rountree, 37 A.F.T.R.2d 76-762 (M.D. Tenn. 1976).

One way to approach the land-building split question is to consider whether the building will have any value and remaining useful life at the end of the lease term. If it does, and it will revert to the land owner, then the lessee would not appear to own the building. If the lessee will consume the useful life and value of the building, then it is more likely that the lessee owns the building. Some buildings retain useful life for decades, so they may have remaining useful life even after a 99-year lease expires.

X. EXCHANGING LEASES UNDER NEW SECTION 1031

Leases appear to qualify for like-kind exchange treatment under section 1031. Section 1031 requires relinquished and replacement property to be real property and like kind. I.R.C. § 1031(a). Leasehold of a fee with 30 years or more to run is like kind to real estate. Treas. Reg. § 1.1031(a)-1(c)(2).

The real-property requirement in section 1031 became part of the law with the enactment of the Tax Cuts and Jobs Act of 2017 at the end of 2017. That new requirement raises the question of whether a leasehold in real property comes within the definition of real property under section 1031. Tax law recognizes that leases are intangible personal property for capitalization rules. Treas. Reg. § 1.263(a)-4(c)(1)(vi), -4(d)(3). But definitions of real property in other areas of tax law include leases. I.R.C. § 897(c)(6); Treas. Reg. § 1.1250-1(e)(3)(i); Treas. Reg. § 1.263A-8(c)(1).

Even if a lease comes within the definition of real property, it must be like-kind to the exchange property to qualify for section 1031 tax-free treatment. The regulations provide that a leasehold in real property of at least 30 years is like kind to general interests in real property (i.e., land and improvements), but a leasehold in real property of less than 30 years probably is not like kind to general interests in real property. Standard Envelope Manufacturing Co. v. Commissioner, 15 T.C. 41 (1950); Capri, Inc. v. Commissioner, 65 T.C. 162 (1975). Such leases could, however, be like kind to other leases of similar length. Rev. Rul. 76-301, 1976-2 C.B. 241.

XI. LEASEHOLD IMPROVEMENT SITUATION

The leasehold improvement exchange is one of the most creative and useful exchange structures. Yet, many people are not aware of its availability. Such exchanges make sense when a property owner would like to sell property tax free and use the sale proceeds to construct improvements on other raw land the property owner holds. To qualify for section 1031 tax-free treatment, the transaction must be an exchange and the property acquired must be real property that is like-kind to the transferred property. The transaction must also properly address the related-party rules, if relevant.

Property that a property owner already owns is not eligible for a leasehold improvement exchange. An exchange requires a reciprocal transfer of property. Treas. Reg. § 1.1002-1(d). Therefore, a person cannot acquire already-owned property as part of an exchange, transfer of the property to an accommodation titleholder, and thereby cleanse the pre-owned status. Rev. Proc. 2004-51, 2004-2 C.B. 294. Another party, including a related party, must own the property for at least 180 days prior to the exchange to cleanse pre-owned status, but beware of the related party exchange rules.

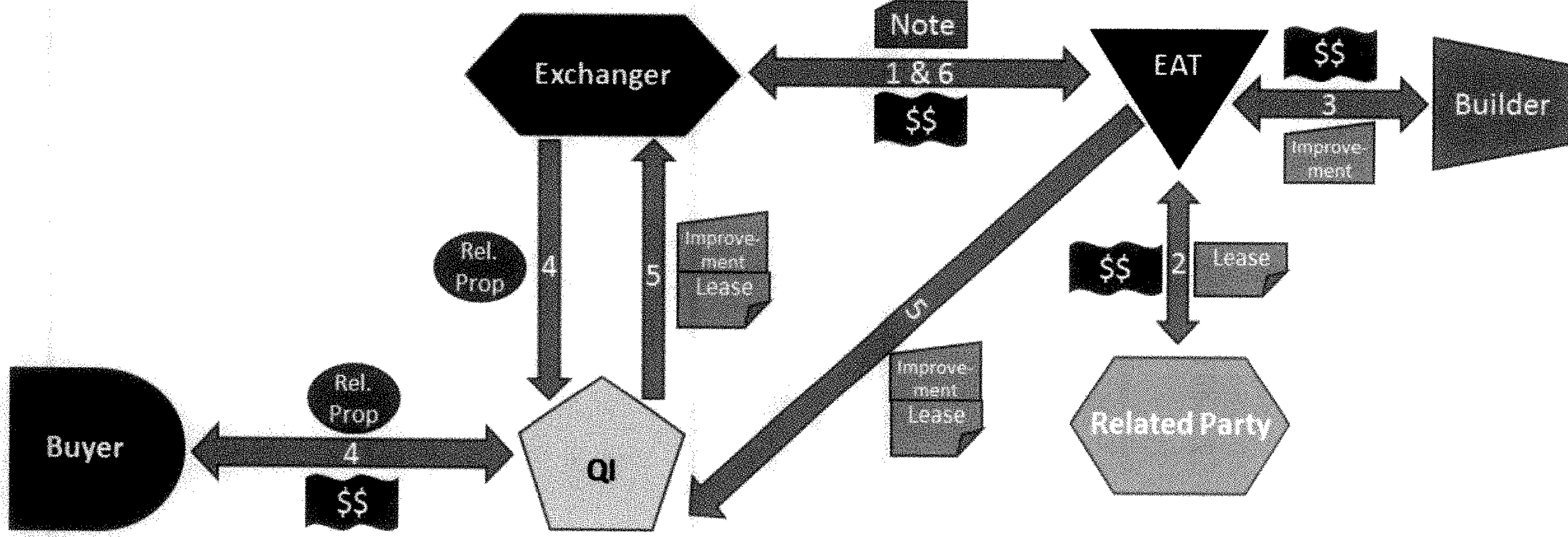
With those hurdles in mind, a property owner may try a leasehold improvements exchange. The property owner avoids building on its property by causing a related party to lease the raw land to an accommodation titleholder. While the accommodation titleholder is the lessee, the property owner directs the accommodation titleholder to construct improvements. Once the improvements are constructed, the accommodation titleholder transfers the leasehold to the property owner to complete the exchange. The IRS approved a leasehold improvement exchange in PLR 200251008, and it approved a similar structure in PLR 200329021. The diagram illustrates the leasehold improvements exchange.

XII. USE OF LEASES IN TICS AND DSTS (LEASE AS "BLOCKER")

Tenancy-in-common arrangements (TICs) and Delaware statutory trusts (DSTs) find use in the section area because property owners desire to directly own interests in real property instead of owning interests in a partnership. For members of TICs and DSTs to be treated as owning direct interests in the property, the TIC or DST cannot be classified as a partnership for tax purposes. The question of whether a TIC or DST is a tax partnership generally is a challenging question. To steer clear of partnership classification, TICs and DSTs must refrain from conducting business activity. Many such structures use master-lease arrangements to pass the management activities down to the master lessee and limit activity at the TIC and DST level to interacting with the master-lessee. The following diagrams illustrate the difference between a TIC with direct management of the property and one with a master-lessee.

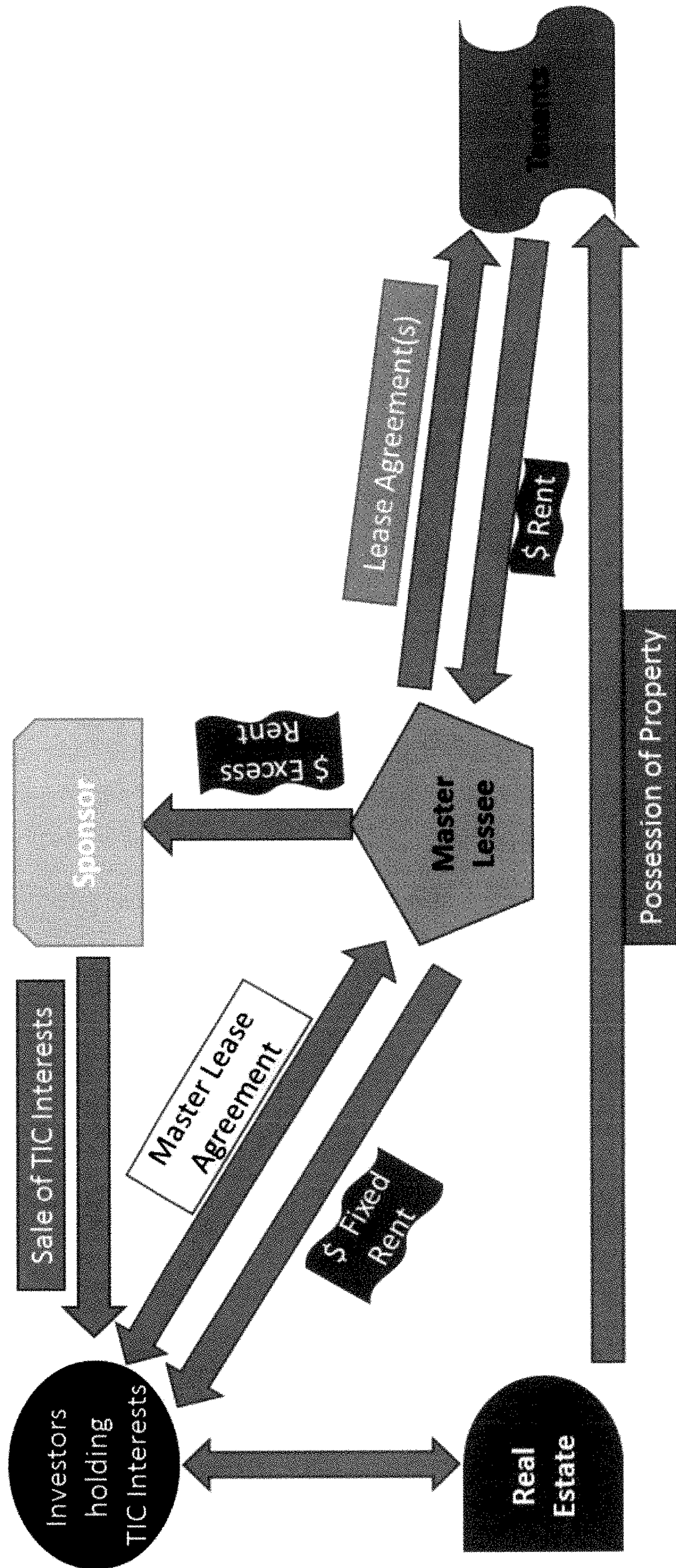
The lease in the master-lease structure becomes a "blocker," blocking the activities associated with managing the property and working with tenants from being attributed to the TIC owners, if structured properly.

LEASHOLD IMPROVEMENTS EXCHANGE



1. Exchanger lends funds to EAT.
2. Related Party grants an arms-length 32-year leasehold in raw land to EAT.
3. EAT constructs improvements on the leased raw land, and Exchanger identifies Rel. Prop. within 45 days.
4. Exchanger transfers Rel. Prop., and QI is treated as selling Rel. Prop. to Buyer, and QI receives exchange proceeds.
5. QI uses exchange proceeds to purchase improved Rep. Prop. leasehold from EAT and transfer it to Exchanger.
6. EAT pays off construction loan.

TIC MASTER-LEASE STRUCTURE



TIC PROPERTY-MANAGEMENT STRUCTURE