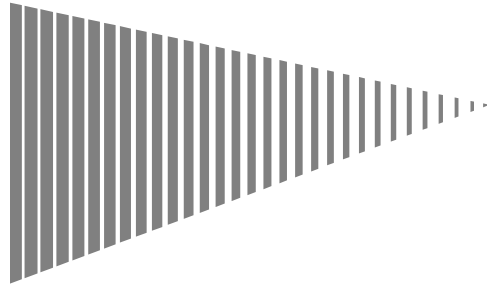


# New York State Bar Association Real Estate Committee

Tax Implications of Lease Provisions

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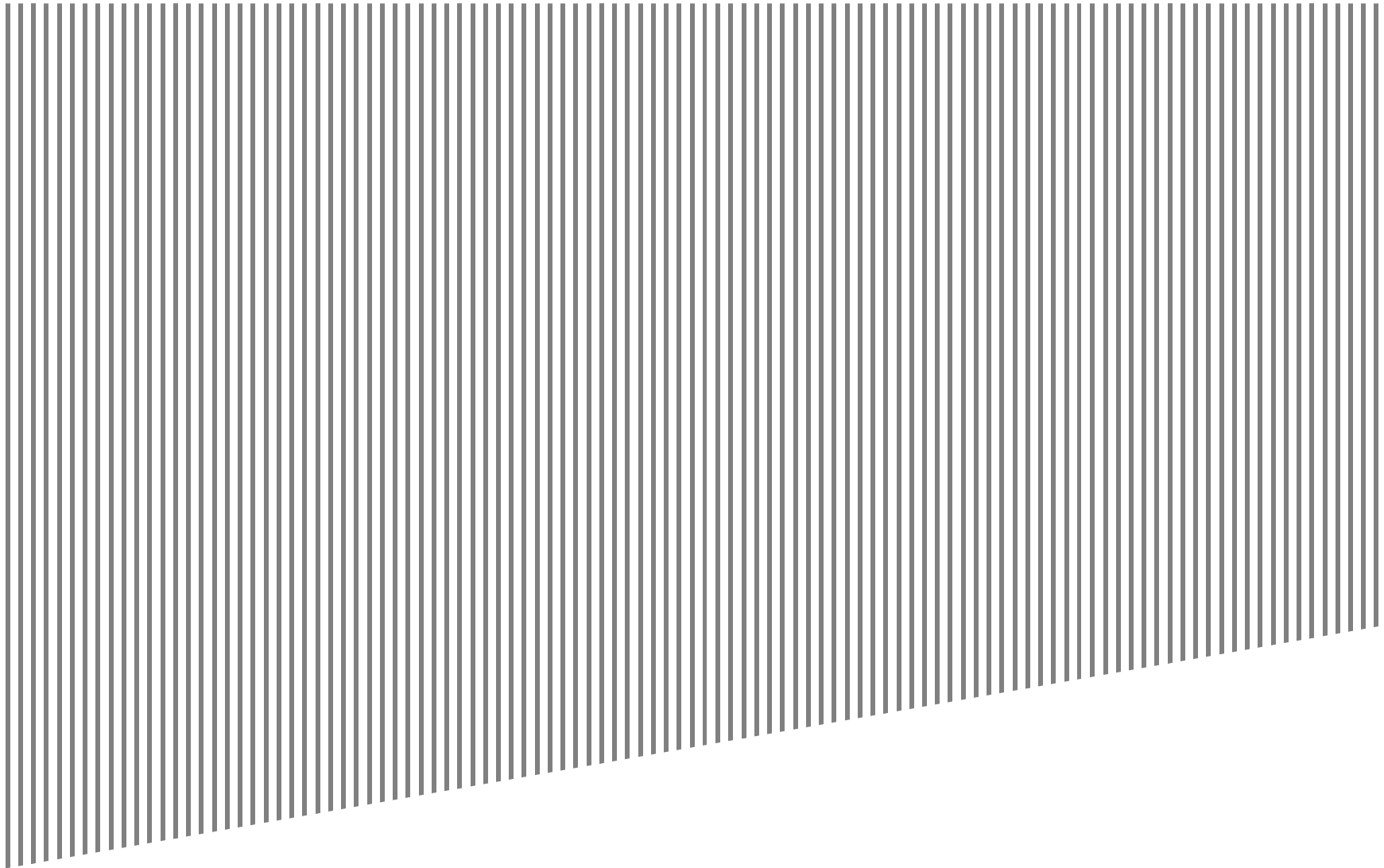
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# Agenda

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- ▶ Lease characterization
  - ▶ Lease v. sale/financing
  - ▶ Lease v. management contract
  - ▶ Other characterizations
- ▶ Rent structures and section 467
- ▶ Landlord tenant issues
  - ▶ Tenant inducements
  - ▶ Tenant funded leasehold improvements
  - ▶ Security Deposits
- ▶ Lease disposition and acquisition
- ▶ Lease termination payments

# True Lease Characterization



# Lease vs. Sale/Financing

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- ▶ *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).
- ▶ Benefits and Burdens Inquiry: Factors
  - ▶ The parties' treatment
  - ▶ Present obligation
  - ▶ Whether purchaser/lessor acquires equity

# Lease vs. Sale/Financing

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- ▶ Benefits and Burdens Inquiry: Factors (cont'd)
  - ▶ Whether the purchase price is FMV
  - ▶ Who bears risk of loss (beyond required insurance)
  - ▶ Residual life/value of property after term
  - ▶ Who receives profits from ultimate sale of property
  - ▶ Existence of purchase options for less than FMV
  - ▶ Are rentals for any renewal term at the fair market rental value?
  - ▶ Reasonable possibility for recoup of investment through rentals and/or residual value?
- ▶ Facts and circumstances (no one factor is determinative)

# Rent Credit Toward Purchase Options

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- ▶ If a “lessee” is acquiring ownership, the payments labeled as rent may be recharacterized as (non-deductible) purchase payments
  - ▶ This can apply where there is a bargain purchase option (see e.g., *Chicago Stoker Corp. v. Comr.*, 14 T.C. 44 (1950); *Franklin Est. v. Comr.*, 64 T.C. 752 (1975)) or when the purchase option is otherwise certain to be exercised
- ▶ The facts and circumstances will still control on the ultimate determination, and there isn’t any hard and fast rule
- ▶ The intent and conduct of the parties is important in making the determination

# Lease vs. Service Contract

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- ▶ Section 7701(e)(1) – a contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease, taking into account all relevant factors including whether or not:
  - ▶ the service recipient is in physical possession of the property
  - ▶ the service recipient controls the property
  - ▶ the service recipient has a significant economic or possessory interest in the property
  - ▶ the service provider does not bear any risk of diminished receipts/increased expenditures for nonperformance
  - ▶ the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient
  - ▶ the total contract price does not substantially exceed the rental value of the property for the contract period.

# Lease vs. Management Contract

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- ▶ Lease vs. management contract applies where the purported lessee may be providing services to the owner.
- ▶ REIT-TRS and unrelated business taxable income/UBTI-sensitive owner leases of operating assets, e.g., hotels, assisted living, etc.
- ▶ Two most important factors in case law:
  - ▶ whether the purported lessee controls the venture
  - ▶ whether the purported lessee bears the risk of loss associated with operating the property

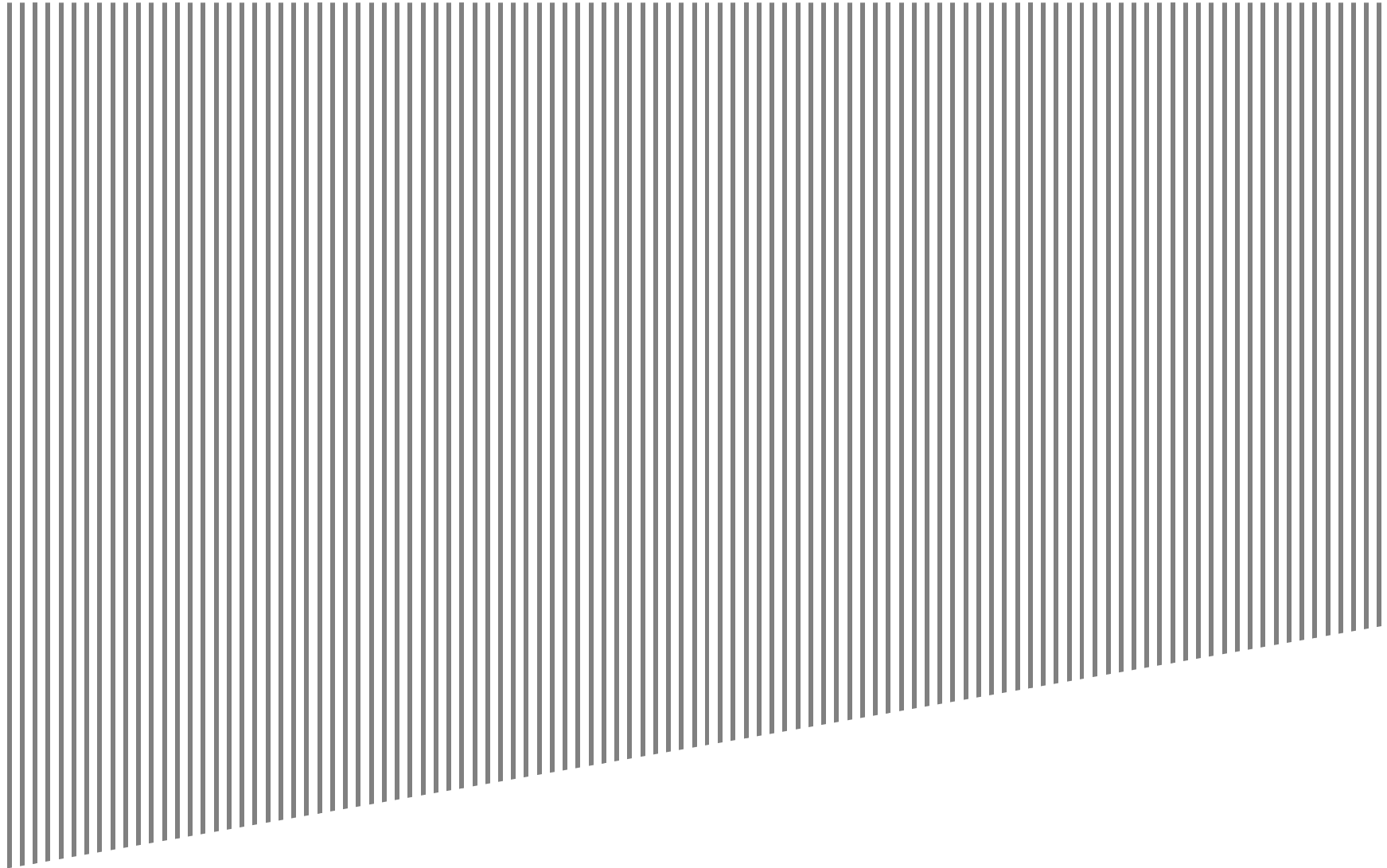


# Lease vs. Partnership

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- ▶ Statutory definitions of tax partnership
  - ▶ Section 761(a) and 7701(a)(2).
- ▶ Case law generally considers whether the parties pool capital to carry on a business together and share net profits to examine whether an arrangement is a lease or a tax partnership.

# Section 467: Uneven Rental Payments



# Section 467

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- ▶ Intent
  - ▶ Added to Code in 1984
  - ▶ Regulations Finalized in 1999
  - ▶ Putting certain lessors and lessees on an accrual basis to avoid timing mismatches between cash and accrual basis taxpayers.
- ▶ When is Section 467 applicable?
  - ▶ Leases of tangible property – including real estate.
  - ▶ > \$250,000 in total rents
  - ▶ 467 Rental Agreement if:
    - ▶ Increasing or decreasing rent
    - ▶ Prepaid or deferred rent

# Section 467

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- ▶ Exceptions to Increasing or Decreasing Rent
  - ▶ Rent Holiday
  - ▶ Certain Contingent Rent
    - ▶ Qualified percentage rent
    - ▶ Adjustments based on reasonable price index
    - ▶ Third-party costs or late payment charges
    - ▶ Loss payment provision
    - ▶ Others

# Section 467

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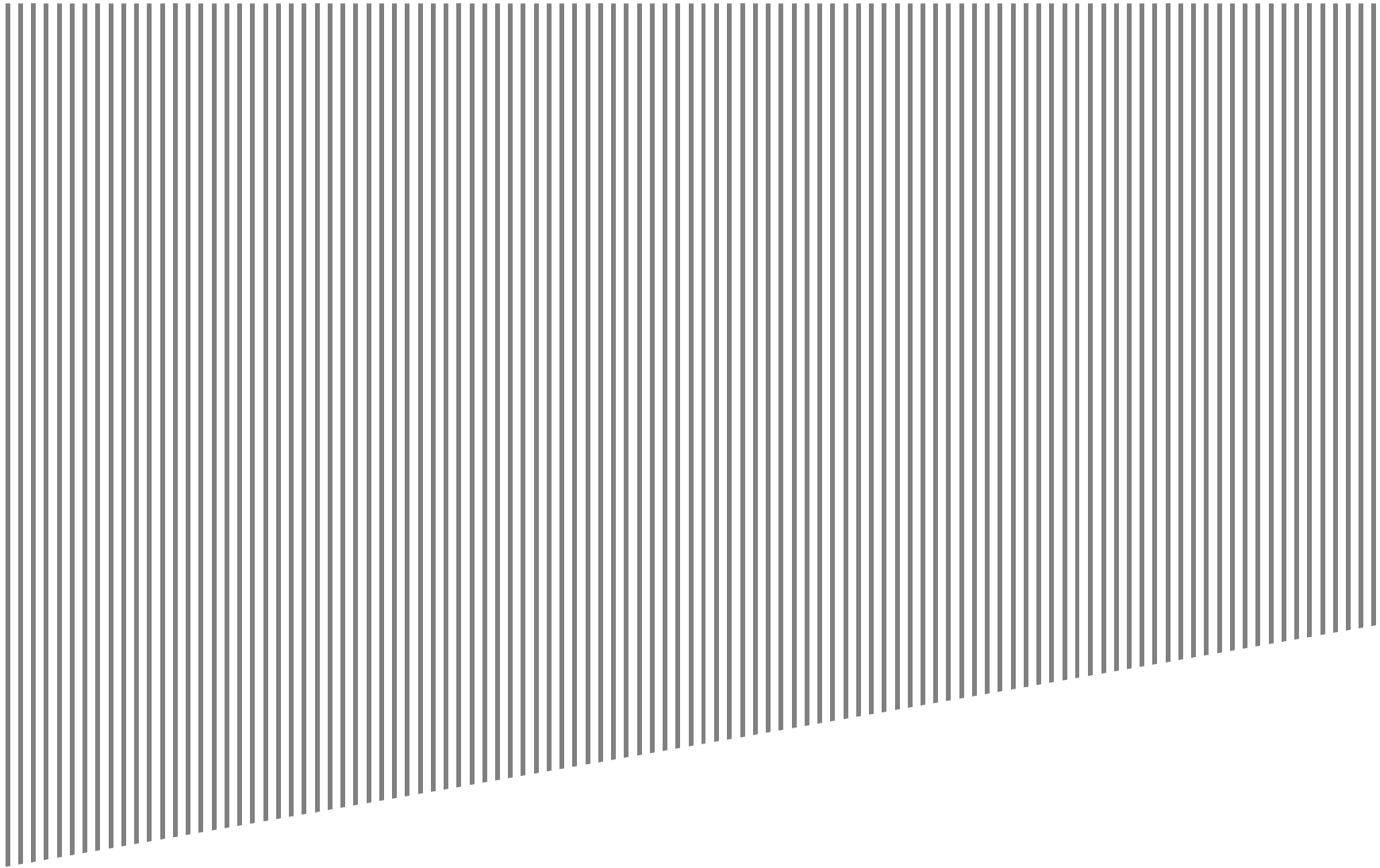
- ▶ Rental Accrual Methods
  - ▶ Proportional Rental Accrual
    - ▶ Prepaid or deferred rent
    - ▶ Allocation schedule that is different than payment schedule
    - ▶ If no interest component, creates Section 467 loan
  - ▶ Constant Rental Accrual
    - ▶ Increasing or decreasing rent
    - ▶ Long-term agreement or leaseback
    - ▶ Only Commissioner can apply

# Section 467

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- ▶ Rental Accrual Methods (cont'd)
  - ▶ Constant Rental Accrual (cont'd)
    - ▶ Safe Harbors
      - ▶ 15% variance uneven rent safe harbor
      - ▶ Rent holiday
      - ▶ Contingent rent
    - ▶ Rental Agreement Accrual
      - ▶ Follow accrual/payment schedule in rental agreement
  
- ▶ Planning Opportunities
  - ▶ Proportional rental accrual for increasing rents
  - ▶ Prepaid Leases for build-outs or dispositions

# Landlord/Tenant Issues



# Tenant Inducements

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## ▶ General Rules

- ▶ Section 61(a): gross income includes all income from whatever source derived.
- ▶ Frank Lyon Co. v. United States, 435 U.S. 561 (1978): Substance over form doctrine
- ▶ Purpose and Intent test: Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956); Sun Microsystems, Inc. v. Commissioner, T.C. Memo 1993-467.



# Background

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- ▶ Various cases consider the taxability of inducement payments.
- ▶ Major department store operators generally have prevailed against IRS efforts to tax them on payments made to induce them to build and operate anchor stores at shopping centers under development.
- ▶ Other retailers have not fared as well. See, e.g., John B. White, Inc., 55 T.C. 729 (1971), aff'd per curiam 458 F.2d 989 (3d Cir. 1971) (IRS upheld in taxing a dealership on payment made to it by Ford to induce it to relocate).

# ISP Paper

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- ▶ An IRS position paper issued in 1996 (“ISP Paper”) specifically considers the taxability of tenant allowances paid to retail store operators.
- ▶ IRS position taken is that tenant allowances are presumptively taxable unless expended on property belonging to the landlord.
- ▶ Accordingly, the tenant has the burden of proving that, under the usual “benefits and burdens of ownership” test (discussed previously), the landlord is the owner for tax purposes of the improvements constructed with the allowance.

# Non-Section 110 Requirements

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## ▶ ISP Paper

- ▶ IRS concluded that the cash payments received by tenant were accessions to wealth and must be included in gross income to the extent that the tenant owned the leasehold improvements for tax purposes.
- ▶ IRS applied Benefits and Burdens of ownership analysis (generally the first 8 factors discussed previously).
- ▶ ISP Paper Adds Four Additional Factors:
  - ▶ Whether the tenant carries personal property/liability insurance on the leasehold improvements
  - ▶ Whether the tenant is the beneficiary under such insurance
  - ▶ Whether the tenant is responsible for replacing leasehold improvements
  - ▶ Whether the tenant enjoys any remainder interest in the improvements.

# Section 110

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- ▶ Provides a safe harbor for construction allowances in order to reduce controversies between IRS and taxpayers.
- ▶ Assures that landlords and tenants consistently treat improvements constructed out of § 110 allowances as property owned by the landlord.
- ▶ Assures consistent tax treatment of landlords and tenants in comparable circumstances, e.g., where the landlord constructs retail space to the tenant's specifications or where the landlord provides the tenant with a construction allowance to build out retail space.

# Section 110 Requirements

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- ▶ Does the lease qualify
  - ▶ Lease term cannot exceed 15 years
  - ▶ Renewal options are included in term unless the rent is to be set at a market rate determined at the time of renewal.
  - ▶ Property must be used by a lessee in its trade or business of selling tangible personal property or services to the public
  - ▶ Allowance must be for purpose of constructing or improving the retail space
  - ▶ Allowance must be spent on improvements, not personalty within a certain timeframe
  - ▶ Lessor and lessee must both file statement with tax return
  - ▶ Have the documents trace the section 110 requirements

# Capitalization Requirements

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- ▶ Subject to a few exceptions, a taxpayer must capitalize:
  - ▶ An amount paid to acquire an intangible
  - ▶ An amount paid to create an intangible
    - ▶ Prepaid expenses
    - ▶ Contract rights (amounts paid to create, originate, enter into, renew, or renegotiate)
  - ▶ An amount paid to facilitate the acquisition or creation of an intangible
    - ▶ E.g., amounts to investigate or otherwise pursue a transaction

# Tenant Funded Leasehold Improvements

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## ▶ General Rules

- ▶ Section 109 – No inclusion in landlord’s gross income
- ▶ Section 1019 – Not added to landlord’s basis
- ▶ Tenant has a depreciable interest as owner under benefits and burdens analysis or under section 168(i)(8)
- ▶ Must not be intended to be “in lieu of rent”
  - ▶ *Hopkins Partners, Cleveland Airport Hotel Limited Partnership, Tax Matters Partners, et. al. v. Commissioner*
  - ▶ Leasehold improvement or rent

# Security Deposits

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- ▶ A security deposit is a deposit made to insure the lessee's performance over the term of the lease
- ▶ Indianapolis Power & Light v. Cmr.
- ▶ If the deposit is merely an advanced rental payment – taxable income on receipt
- ▶ If the lessor lacks “complete dominion” over the amount – probably not income on receipt

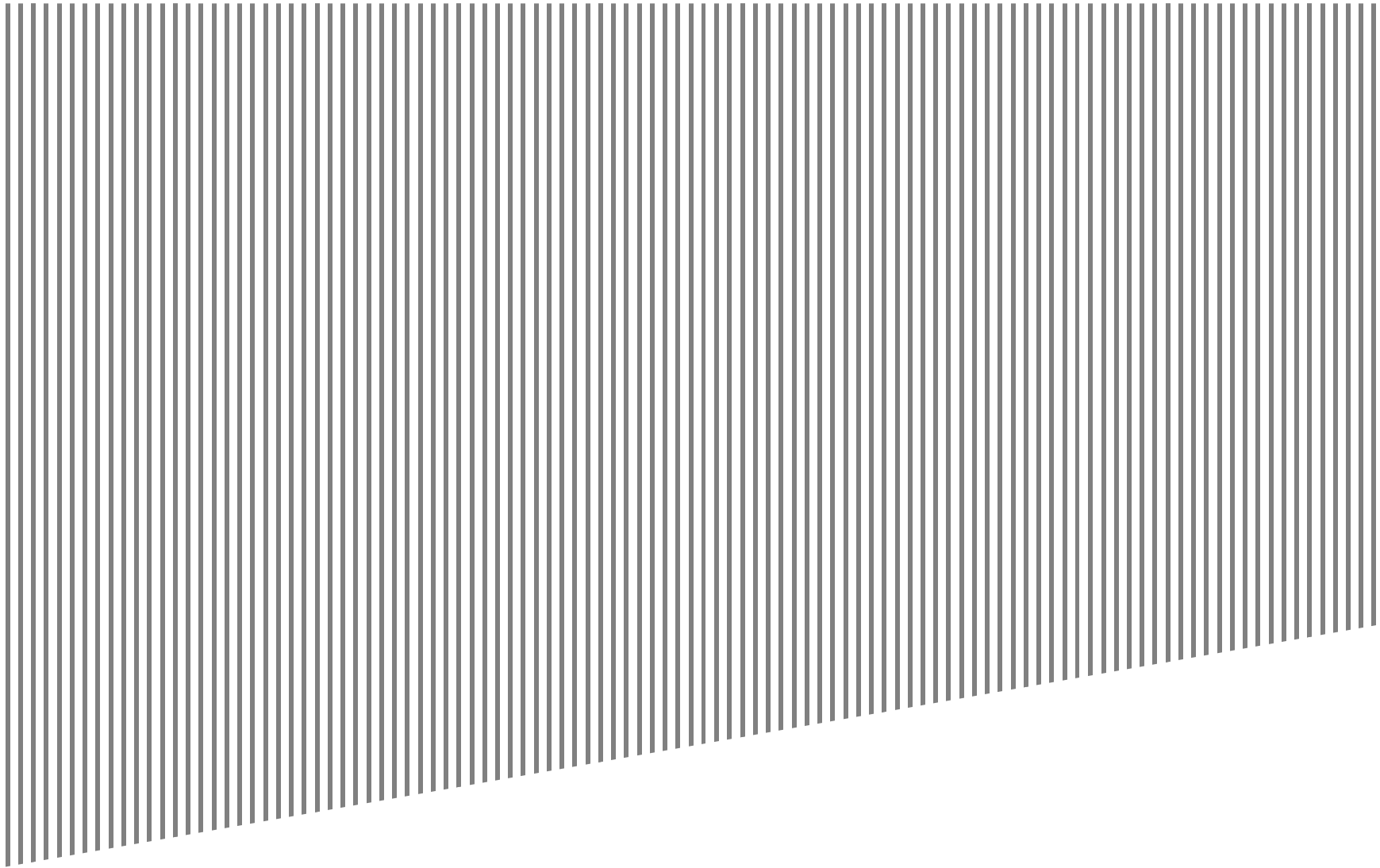


# Foreign Lessor

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- ▶ Generally, payments of rent to a foreign person are considered “fixed or determinable annual or periodic,” FDAP, subject to 30% withholding tax (or lower applicable tax treaty rate and production of form W-8 BEN)
- ▶ If the foreign lessor is considered to be in a US trade or business or has made a §871(d) or 882(d) election to be taxed on a “net” basis as effectively connected income (ECI), no withholding is required (require proof of form W-8 ECI)

# Lease Disposition/Acquisition Issues



# Landlord Transfer of Lease Interest

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- ▶ Sale of property with above market or below market existing leases
  - ▶ Allocation of purchase price among land / lease
    - ▶ Seller perspective – little support to bifurcate sale price
    - ▶ Buyer perspective – post August 13, 1993, Section 167(c) bars any allocation to a leasehold interest acquired at the same time as underlying property
  - ▶ Allocation of prorated rent
    - ▶ Generally must be economically allocated pursuant to the parties' accounting method (special rules where Section 467 applies)
    - ▶ May result in challenge from IRS absent economic allocation

# Tenant Transfer of Lease Interest

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## ▶ Assignment vs. Sublease

### ▶ General rule

- ▶ Assignment - no interest nor reversionary interest is retained by the grantor or assignor

- ▶ Retention of contingent liability for rent does not necessarily bar sale treatment – must look at all the facts and circumstances

- ▶ Sublease – grant of interest in premises for less than tenant’s own, or where tenant reserves a reversionary interest in the term

### ▶ Character of gain/loss (non-dealers)

- ▶ If the lessee transfers all of its interest in the leasehold, the IRS has applied capital gains treatment (see e.g., Rev. Rul. 72-85)

- ▶ If the leasehold is a “section 1231” asset used in the lessee’s trade or business, section 1231 treatment should apply

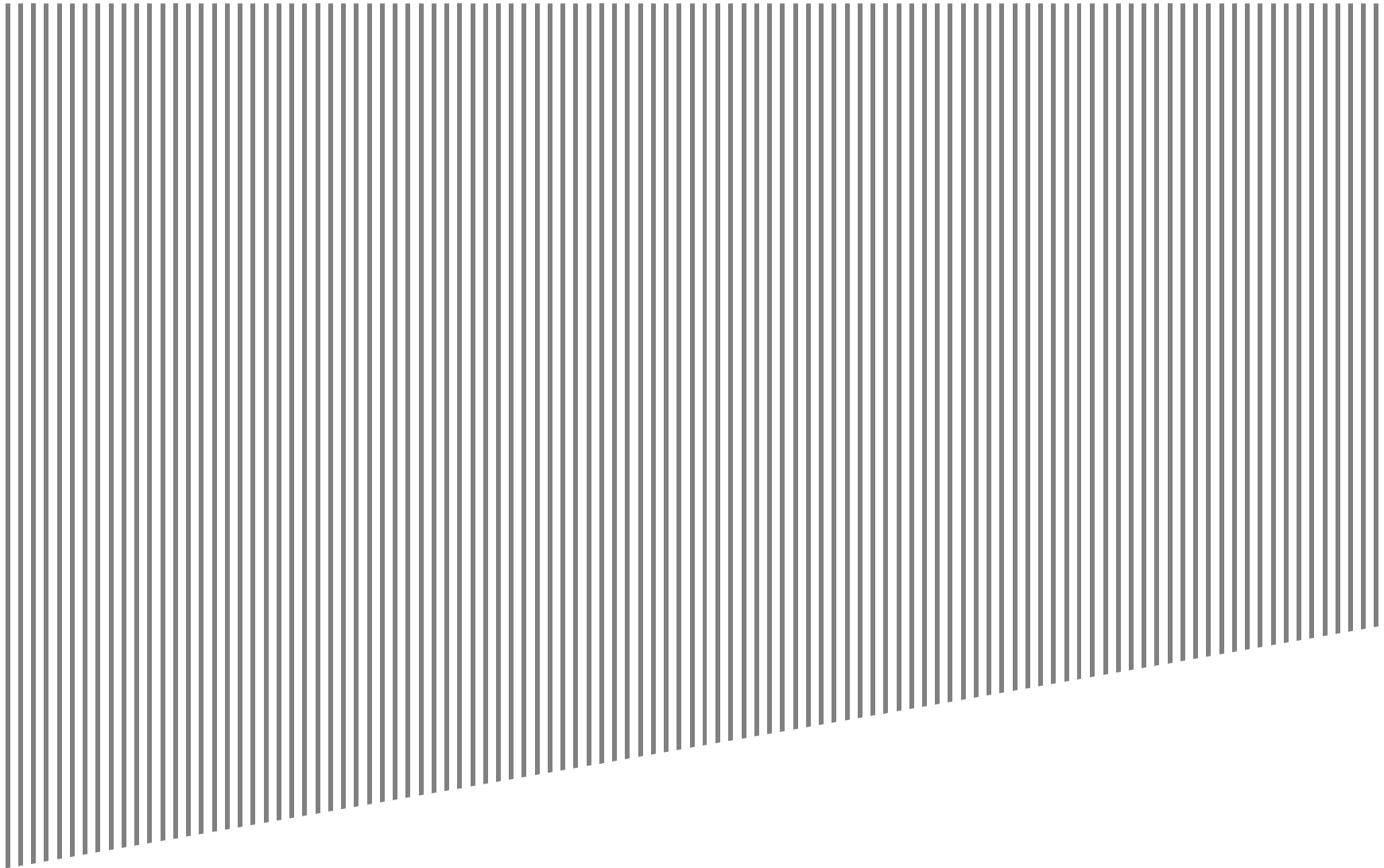
- ▶ Amortization of leasehold acquisition costs – section 178

# Disposition of US Real Property Interests

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- ▶ Foreign Investment in Real Property Tax Act 1980
  - ▶ Disposition by foreign person of US real property interest is deemed US source ECI (i.e., taxed on a “net” basis)
    - ▶ Buyer is required to withhold 10% of gross amount realized
    - ▶ Applies to dispositions of real estate, including options and leasehold interests in real property
    - ▶ Excludes loans, mortgages (interest solely as a creditor)
    - ▶ FIRPTA regulations have specific rules on valuing a leasehold interest in real property
      - ▶ Reg. § 1.897-1(o)(3) (basically, any premium is taxable)
  - ▶ Purchase and sale agreements
    - ▶ Typically require rep to non-foreign status
    - ▶ Require production of forms W-9, W-8 ECI, etc.
    - ▶ Reduced withholding certification from IRS (Reg. § 1.1445-3)

# Lease Termination Payments



# Lease Termination Payments

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- ▶ Tenant pays Landlord to vacate early
  - ▶ Regulation section 1.61-8 - currently includable by landlord
  - ▶ Generally, currently deductible by tenant, unless connected with a renewal or extension
    - ▶ Same Landlord under the new lease or new landlord?
- ▶ Landlord pays Tenant to vacate early
  - ▶ Tenant treated as having a “sale or exchange” of leasehold under section 1241.
    - ▶ Must satisfy definition of capital asset or 1231 asset
    - ▶ Can apply to reductions in premises or term
  - ▶ Capitalized by landlord– but over what period, remaining term of old lease or over term of new lease?

# Questions and Discussion

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- ▶ Please feel free to contact us to discuss any questions or thoughts you may have at:

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- ▶ Thank you for listening!