

Basic and Non-Basic Tax Tips for Leasing Lawyers

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Presentation Overview

- Tax basics of leasing
- Section 467 leases
- Tax treatment of tenant improvement costs
- Identifying the party entitled to depreciation deductions in a ground lease of improved property
- When is a lease a sale and vice versa?
- End of synthetic leases?
- REIT rents problems
- Tax treatment of lease termination payments
- Use of leases in land-building splits
- Exchanging leases under new Section 1031
- Leasehold improvements exchanges
- Lease arrangements in TICs and DSTs

Tax Basics of Leasing

- Lessor has income when rent payment received
 - Rent is ordinary income
 - I.R.C. § 61(a)(5)/451
 - Rent qualifies for section 199A 20% deduction if recognized by a qualified trade or business (see below)
- Lessee cannot deduct prepaid rent currently
 - Must capitalize and deduct over life of lease
 - Rent is deductible against ordinary income (assuming property is used in trade or business)
 - I.R.C. § 263/Treas. Reg. § 1.263(a)-4
 - Treas. Reg. § 1.162-11 (aliquot share of purchase price of lease each year over life of lease)

Scenario: Lease or Sale?

- Situation:
 - Family Partnership owns Hotel. Some family members are old, so family wants them to hold Hotel until death to get basis step-up.
 - Buyer is ready to purchase Hotel and will structure acquisition to accommodate Family Partnership.

Lease v. Sale Alternatives

- Lease with option to purchase following death of family members.
 - Rent payments are ordinary income to Family Partnership
 - Will lease be recast as a current sale (see below)?
- Installment sale with payments that track the lease payments
 - Installment method—gain when payments received
 - Installment payments—basis recovery, capital gain
 - Character—long-term capital gain
 - Basis of note upon death
 - If decedent holds note, no basis step-up
 - If partnership holds note
 - If 754 election in effect, basis step-up upon death
 - If no 754 election, basis step-up upon distribution of note

Tax Asymmetry in Leasing

- Rules create asymmetry
 - Lessor has income when rent payments received
 - Lessee must defer deductions
- Lessor-lessee tension
 - Lessee wants current deduction
 - Lessor wants to defer income recognition
- Consider accounting method
 - Accrual—deductions for lessee over life of lease
 - Cash—Lessor has income when payments received

Scenario: Lessor-Lessee Tax Tension

- Cash-poor landowner wishes to lease property and receive as much cash as possible currently while deferring recognition of income
- Potential lessee is flush with cash and would like to front-load lease payments to obtain the tax benefit of a tax deduction currently
- If they both can't get their wishes, can they find an arrangement that optimizes their preferences?

Examples of Lessor-Lessee Tax-Reporting Mismatch and Tension

General Tax Treatment of Prepaid Rent					
	Year 1	Year 2	Year 3	Year 4	Year 5
Payment (prepaid)	\$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

General Tax Treatment of Deferred Rent					
	Year 1	Year 2	Year 3	Year 4	Year 5
Payment (deferred)	\$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

Section 467

- Section 467 designed to eliminate mismatch caused by tax accounting rules
 - Require/allow lessee to deduct rent payments when lessor recognizes income
 - Enacted to help prevent abuse
 - Lease with “backloaded” or “stepped” rents
 - Accrual method lessee gets current deductions
 - Cash method lessor defers income recognition until later in lease
- Congress leverages lessor-lessee tension
 - Lessor and lessee self-police tax reporting
 - Lessor and lessee create rental accrual schedule that does not necessarily track payments of rent
 - Lessor and lessee must recognize tax aspects of rent payments at the same time
 - Lessor recognizes rental income at same time lessee takes deduction
- Self-policing mechanism breaks down if the parties’ tax situations differ
 - Tax-exempt lessor (doesn’t worry about front-loaded rent)
 - Lessee with considerable current losses (doesn’t need current deduction)
- If section 467 applies
 - Lessor and lessee must treat rents consistently
 - Lessor and lessee must use accrual method of accounting, regardless of overall method of accounting

Applicability of Section 467

- Applies to “section 467 rental agreements”
 - Lease of tangible property
and
 - Rental terms
 - Uneven rents (increasing or decreasing)
or
 - Prepaid or deferred rent
 - Provides for total rent of more than \$250,000
- 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

Section 467 Rental Accrual Methods

- Constant rental accrual method
 - Treas. Reg. § 1.467-1(e)(2)(i), -3
- Proportional rental accrual
 - Treas. Reg. § 1.467-1(e)(2)(ii), -2
- Rental agreement accrual
 - Treas. Reg. § 1.467-1(e)(2)(iii)

Section 467 Constant Rental Accrual Method

- Disqualified long-term agreement or leaseback
 - Leaseback if lessee held interest in property within two years prior to lease
 - Long-term lease if lease term exceeds 75% of the property's statutory recovery period
 - Real estate has a recovery period of 19 years for section 467
 - $19 \times 75\% = 14.25$
 - All leases with terms exceeding 14.25 years are long-term under this definition
- Disqualified
 - Principal purpose for providing increasing or decreasing rent is the avoidance of federal income tax
 - IRS Commissioner determines the lease should be disqualified because of the tax avoidance purpose
 - Only IRS Commissioner can apply
 - Enforcement sword
 - Not a shield for taxpayers
- Creates a section 467 loan

Application of Constant Rental Accrual Method

- Tax avoidance
 - Reasonable expectation of significant difference between the marginal tax rates of the lessor and lessee at some time during lease term
 - Leads to close scrutiny of agreement
 - Need clear and convincing evidence to show tax avoidance not a principal purpose
- If IRS finds tax avoidance, it uses 3-step method to determine 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
 - Step 3: divide Step 1 amount by Step 2 amount

Reasonable Expectation of Significant Difference in Marginal Tax Rates

- Rental agreement has increasing rents
 - Lessors marginal tax rate is expected to be greater than
 - Lessee's marginal tax rate + 10 percentage points
- Rental agreement has decreasing rents
 - Lessee's marginal tax rate is expected to be greater than
 - Lessor's marginal tax rate + 10 percentage points

Examples of Possible Significant Difference in Marginal Tax Rates

- Lessor is tax-exempt entity, taxable lessee has significant income
 - Lease provides for decreasing rents
 - Lessor does not pay tax on prepaid rent
 - Lessee benefits from current deductions
- Lessee has current and projected operating losses, lessor has significant income
 - Lease provides for increasing rents
 - Lessor benefits from deferral of income recognition
 - Lessee is indifferent about not getting deductions currently

Computation of Constant Rental Amount

- Disqualified sale-leaseback (lessor has higher tax rate)

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

- Step 1: present value of rent payments = \$21,051,536
 - Assumption: 12% discount rate
- Step 2: present value of \$1 received at end of each rental period = \$3.6047762
- Step 3: $\frac{\$21,051,536}{\$3.6047762} = \mathbf{\$5,839,901}$ (fixed rent for each rental period)
- Lessor must report \$5,839,901 as gross income for each year of lease
- Lessee may deduct \$5,839,901 as rent expense for each year of lease

Safe Harbor from Constant Rental Amount

- Tax avoidance not a principal purpose for increasing or decreasing rents if
 - Meet uneven rent test
 - Amount of rent allocated to each calendar year is within 10 percent of the average rent for all calendar years
 - Increase or decrease in rent is wholly attributable to one or more of the following
 - A contingent rent provision
 - A single rent holiday allowing reduced rent for one consecutive period of the lease
 - For three months or less
 - Reasonable, as determined by reference to commercial practice
 - Does not exceed lesser of 24 months and 10 percent of lease term

Section 467 Proportional Rental Accrual Method

- Only applies if rental agreement is not subject to constant rental accrual method
 - Section 467 rental agreement is not a disqualified leaseback or long-term agreement
- Rental agreement provides for
 - Does not provide for adequate interest
- Generally, applied if payment schedule under the lease is different from the accrual schedule
- Creates a section 467 loan

Adequate Interest on Rent

- Adequate interest on fixed rent
 - No deferred or prepaid rent
 - Deferred or prepaid rent, and
 - Rental agreement provides for interest on deferred or prepaid rent at a single rate
 - Stated rate of interest is no lower than 110% of AFR
 - Amount of deferred and prepaid fixed rent adjusted at least annually to reflect amounts paid and owing
 - Rental agreement requires interest to be paid or compounded at least annually
 - Other agreements
 - Deferred, but no prepaid, rent
 - Sum of present value of all amounts payable by lessee as fixed rent is greater than or equal to the sum of the present value of the fixed rent allocated to each rental period
 - Prepaid, but no deferred, rent
 - Sum of present value of all amounts payable by 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
- Section 467 rental agreements with variable interest
 - Use fixed rate substitutes
- Agreement with both deferred and prepaid rent
 - Satisfy the requirements of a rental agreement with deferred or prepaid rent
 - Single fixed rate of interest on deferred rent
 - Single fixed rate of interest on prepaid rent
 - Rates of interest can differ

Computation of Proportional Rental Amount

- For rental agreements that are not disqualified and do not provide for adequate interest the proportional rental amount is the amount of rent allocated to rental period multiplied by the following fraction:

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

Application of Proportional Rental Accrual Method

- Rent schedule in agreement

Schedule of Rent Allocated and 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

- Agreement does not state adequate interest
 - Has deferred rent
 - Does not provide for interest at a fixed rate
 - Present value of payments not greater than or equal to present value of allocated rents (assuming 8.5% discount rate)
 - Present value of amounts payable = \$2,348,724
 - Present value of allocated rents = \$2,526,272
- Fraction = $\$2,348,724 / \$2,526,27 = .9297294$
- Section 467 rent for each year
 - Year 1: $\$800,000 \times .9297194 = \$743,776$
 - Year 2: $\$1,000,000 \times .9297194 = \$929,729$
 - Year 3: $\$1,200,000 \times .9297194 = \$1,115,663$
- Parties must also account for interest on the section 467 loan

Section 467 Loans

- Section 467 loan exists if rent is determined using either constant rental accrual method or proportional rental accrual method
 - I.e., the amount of fixed rent stated in the agreement differs from the amount determined under one of those methods
- Positive section 467 principal balance
 - Loan from lessor to lessee
 - Lessor is lending lessee accrued unpaid rent
 - Lessor has interest income
 - Lessee has interest deduction
- Negative section 467 principal balance
 - Loan from lessee to lessor
 - Lessee is lending lessor prepaid rent
 - Lessee has interest income
 - Lessor has interest deduction

Computation of Section 467 Loan

Amount of 467 loan = 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 in income on prepaid fixed rent for prior rental periods + amount payable to lessor before first day as interest)

- Example from proportion accrual method

Schedule of Rent Allocated and 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

Amount of 467 Loan + Interest (assume 8.5% 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	\$0	\$806,997	\$1,884,348
Ending Loan Balance			\$3,000,000

Section 467 Rental Agreement Accrual Method

- Only applies if lease not subject to constant rental accrual method or proportional rental accrual
- Follow accrual schedule in rental agreement
- If there is no specific allocation, the amount of rental allocated to a rental period is the amount of fixed rent payable during that rental period

Scenario: Improvements on Leased Property

- Lessee would like to improve leased property.
- Both lessee and lessor would like to take the depreciation deductions related to the new construction
- Lessee would like to be reimbursed for any value that goes to lessor for improvements
 - Effect on value of property leased by other tenants
 - Reduced rent, if lessee pays for improvements?
 - Ownership of improvements when lease terminates
 - Offset rents, if lessee pays for improvements?

Tax Treatment of Tenant Improvements

- General rule: owner of property gets depreciation deductions
 - Lessor typically gets depreciation deductions for improvements lessor constructs on leased property
 - Lessee typically gets depreciation deductions for tenant improvements
 - Look to who invested capital in the improvements
- Lessee improvements
 - Lessee improvements excluded from lessor's income upon lease termination
 - I.R.C. §§ 109, 1019
 - Lessee must capitalize cost of lessee improvements
 - I.R.C. § 263
 - Lessee or lessor capitalizes and depreciates cost of improvements over applicable MACRS recovery period—not life of lease
 - I.R.C. § 168(i)(8)(A)
 - Lessee should be able to deduct any remaining basis upon termination of lease
 - I.R.C. § 165
- Tenant improvements as substitute for rent
 - Lessee improvements are in lessor's income, if a substitute for rent
 - Lessee can deduct cost of rent-substitute improvements currently
 - Hopkins Partners v. Comm'r, 97 T.C.M. (CCH) 1560 (2009); Treas. Reg. § 1.109-1

Scenario: Transfer Interest as Part of Section 1031 Exchange

- Rancher owns ranch land and leases a portion to the owner of a cell tower.
- Rancher would like to sell ranch land.
- Owner of cell tower wishes to lock in use of land for cell tower and prefers a lease.
- Can land owner use proceeds from right of transfer to do a section 1031 exchange?
 - Entering into a lease as a landowner does not qualify for section 1031 treatment (see below)
 - If arrangement with cell tower owner is called a lease, can it qualify for section 1031 treatment?

Lease vs. Sale/Financing

- Tax law can disregard the form of a transaction
 - Transaction cast as a lease can be a seller-financed sale from the lessor to the lessee in substance
 - Transaction cast as a debt-financed purchase by the user could be recast as a purchase by the “lender” and lease to user
- Party that holds the benefits and burdens is the tax owner
 - Factors
 - How do the parties treat the transaction?
 - Rent payments or debt service and interest?
 - Lessor recognize 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?
 - Does lessee have option to purchase at below market at end of lease term?
 - 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)

Lease vs. Sale/Finance

- Lease (Weiss v. Wiener, 279 U.S. 333 (1929); Butler v. Comm'r, 19 BTA 718 (1930))
 - Initial term of 99 years
 - Unlimited options to renew for 99 years
 - Flat rental amount
 - Fixed-price purchase options to purchase after some period of time
- Sale (Oesterreich v. Comm'r, 226 F.2d 798 (9th Cir. 1995))
 - Option to purchase for a nominal fixed price (\$10) at the termination of a lease (no renewal)
 - Reasoning that the purchaser would undoubtedly exercise the purchase option
 - Parties negotiated sale, but changed to lease structure

Relevance of Classification

- Tax accounting
 - Installment sale vs. lease payments
- Rights transferred
 - Carve-out vs. transfer of tax ownership
 - Can exchange tax ownership; cannot exchange carve-out

Lease vs. Partnership

- Partnership under state law: “an association of two or more persons to carry on as co-owners a business for profit”
 - Is “rent” based upon lessee’s profits?
 - Different if gross receipts?
 - Who controls the ultimate disposition of the property?
- Question of whether a partnership exists is one of the most difficult questions in partnership tax, if a situation raises the question
- Question is matter of federal tax law, so state law classification is not determinative

Situation: Owner of Portfolio of Leased Property

- Taxpayer is transferring out of relinquished property and wants to acquire multiple NNN properties
 - Will the income from the NNN properties qualify for the section 199A 20% deduction?
 - Is owning one or more NNN properties a qualified trade or business?

Section 199A Deduction and Leasing

- Section 199A Deduction
 - 20% of qualified business income
 - Qualified business income
 - Is Not
 - SSTB (i.e., law, accounting, medical practice)
 - Services as an employee
 - Is a trade or business under section 162
 - Question for owners of rental property (no active management)
 - Holding property for rental is use in trade or business
 - Hazard v. Comm'r, 7 T.C. 372 (1946)
 - Holding property for rental is NOT trade or business
 - Grier v. U.S., 120 F.Supp. 395 (D. Conn. 1954)

Effect of Section 199A Deduction

Marginal Tax Rates Before and After Section 199A Deduction	
Marginal Income Tax Rate <u>Before</u> 199A Deduction	Marginal Income Tax Rate <u>After</u> 199A Deduction
10%	8.0%
12%	9.6%
22%	17.6%
24%	19.2%
32%	25.6%
35%	28%
37%	29.6%

Notice 2019-07 (Jan. 18, 2019) (Rules of Application)

- Rental real estate enterprise treated as a trade or business for purposes of section 199A if
 - Real estate enterprise
 - Real property held for production of rents
 - May consist of interests in multiple properties
 - Individual or RPE (relevant passthrough entity)
 - Must hold the interest directly or through disregarded entity
 - Enterprise
 - Each property as separate enterprise
 - Similar properties held for production of rents as a single enterprise
 - Commercial and residential cannot be part of same enterprise

Notice 2019-07 (Safe Harbor)

- Rental real estate enterprise (RREE) treated as trade or business if following requirements satisfied
 - Separate books and records for each RREE
 - Prior to Jan. 1, 2023
 - At least 250 hours of rental services per year with respect to RREE
 - After Dec. 31, 2022
 - In any 3 of 5 years, at least 250 hours of rental services with respect to RREE
 - Contemporaneous records
 - Hours of all services performed
 - Description of services
 - Dates on which services performed
 - Who performed services

Notice 2019-07 (Rental Services)

- Included Services
 - Advertising to rent or lease the real estate
 - Negotiating and executing leases
 - Verifying information contained in prospective tenant applications
 - Collection of rent
 - Daily operation, maintenance, and repair of the property
 - Management of the real estate
 - Purchase materials
 - Supervision of employees and independent contractors
- Performance by owners, employees, agents, contractors

Notice 2019-07 (Rental Services)

- Excluded Services
 - Financial or investment management activities
 - Arranging financing
 - Procuring property
 - Studying and reviewing financial information
 - Planning, managing, or constructing long-term capital improvements
 - Hours spent traveling to and from the real estate

Notice 2019-07 (Rental Services)

- Excluded Arrangements
 - Real estate used by the taxpayer as a residence for any part of the year under section 280A
 - NNN property
 - Lease agreement that requires the tenant or lessee to
 - Pay taxes
 - Pay fees
 - Pay insurance
 - Be responsible for maintenance activities for a property in addition to rent and utilities
- Disclosure Requirement
 - Include statement attached to return claiming section 199A deduction

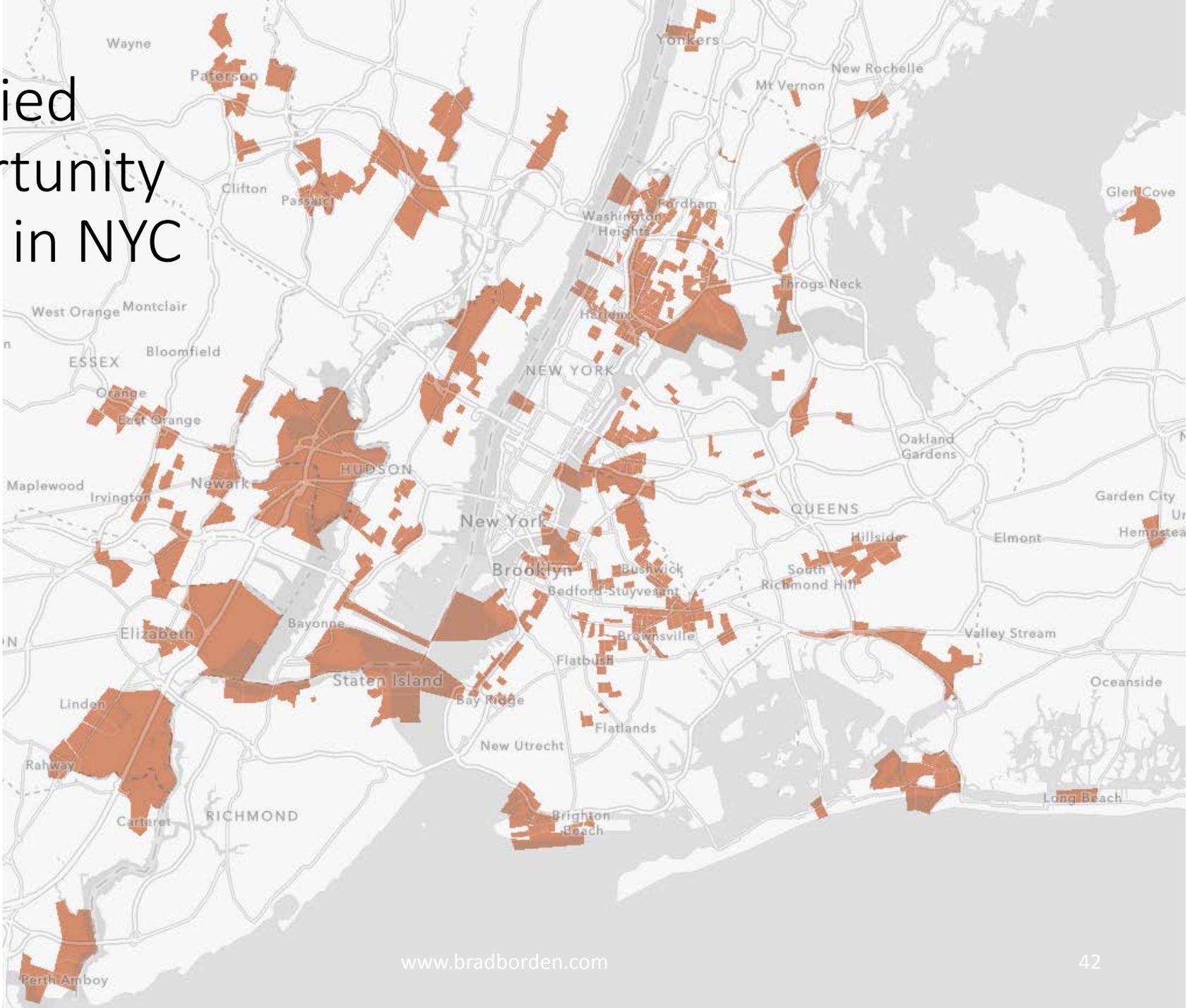
Return to Scenario

- Landlord wants zero to low management responsibility
- NNN properties do not come within the Notice 2019-07 proposed safe harbor
 - Could portfolio be a trade or business outside the safe harbor
- Will credit tenants negotiate a double-net (NN) lease?
 - What activities should the landlord accept?
 - What are the consequences of breach?
 - Can tenant provide those services as agent of the landlord?

Leases and OppZones

- Qualified Opportunity Fund (QOF) Rules. I.R.C. § 1400Z-2
 - Capital gain invested in a QOF is deferred
 - After 5 years 10% of gain excluded
 - After 7 years 5% of gain excluded
 - On Dec. 31, 2026, remaining 85% recognized
 - Post-investment gain can be excluded
 - If held for 10 years, post-investment gain is excluded
- QOF Qualification
 - 90% of QOF assets must be qualified opportunity zone property
 - Qualified opportunity zone stock
 - Qualified opportunity zone partnership interest
 - Qualified opportunity zone business property

Qualified Opportunity Zones in NYC Area



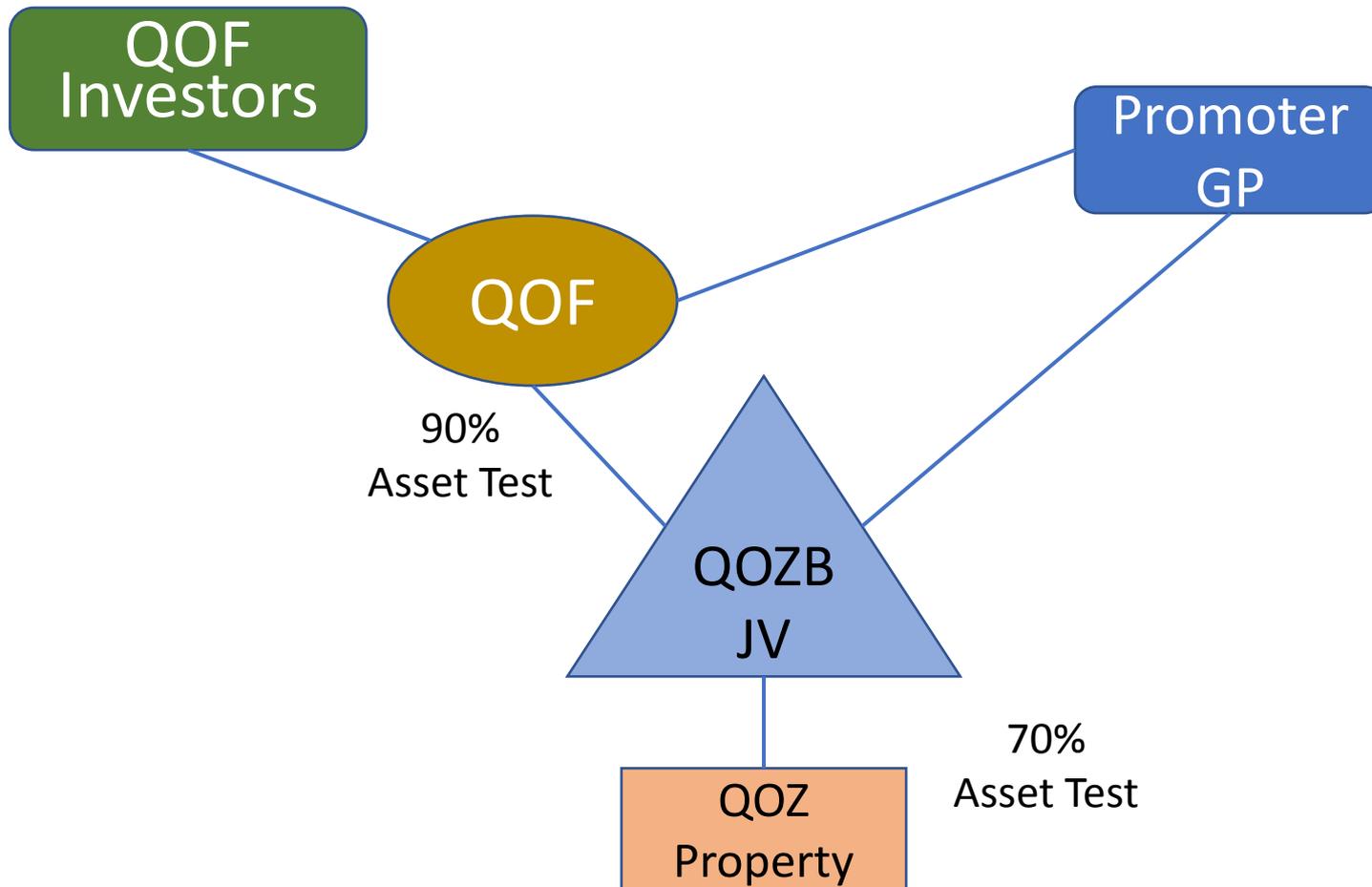
Qualified Opportunity Zone Business Property

- QOZBP
 - Tangible property
 - Used in a trade or business of the QOF
 - Acquired by QOF by purchase
 - Original use of substantially improved
 - Substantially improved = double basis
 - Used in qualified opportunity zone

Qualified Opportunity Zone Business

- Partnership or corporation
- 70% of assets owned or leased is qualified opportunity zone business property

Typical Simple QOF Structure



Leases in Qualified Opportunity Zone Business

- Does leased property have to be located in OppZone for lease to be qualified property?
- If yes, what value counts for purposes of 70% test?
 - Value of leased property?
 - Value of lease?
- If value of lease,
 - Value = \$0, if for fair market rent
 - Zero-value lease would not adversely affect the 70% test
 - Can long-term lease of property outside zone affect value of QOF?
 - E.g., QOZB leases land outside zone as parking for building in QOZB

Synthetic Leases

- Financing structure
 - Short-term lease (<10 years, including renewal options)
 - Purchase options
 - Rights of termination
 - Relevant to taxpayers who prepare GAAP financial statements
 - Used for assets such as corporate headquarters or real estate projects, or corporate aircraft
- For tax purposes, the user is deemed to borrow and buy property
 - User has the benefits and burdens
 - User gets the depreciation deductions
- For GAAP purposes the user is deemed to enter into an operating lease with the “lender”
 - Operating lease keeps the obligation for rent payments off the balance sheet
- Recent accounting changes will require lessees to record a lease liability for synthetic leases, so benefit of off-balance sheet finance will be lost
 - Popularity may diminish

REITs and Rents

- REIT income tests require that 95% (passive type income) and 75% (income from real property) of the REIT's gross income derive from specific sources, including
 - Rents from real property
 - Two components
 - Real property
 - Rents

REIT Definition Real Property

- Must be real property
 - Numerous rulings and recent regulations
 - Land
 - Water and air space superjacent to land
 - Unsevered natural products and deposits
 - Improvements to land
 - Inherently permanent structures
 - Permanently affixed building or other permanently affixed structure
 - Building
 - Encloses space within its walls and is covered by a roof
 - Structural components
 - Distinct asset that is a constituent part of an integrated into an inherently permanent structure

REIT Definition of Rents

- Cannot be from services provided to tenants, other than customary services
- Customary services
 - Furnishing heat and light
 - Cleaning public entrances, exits, stairways, and lobbies
 - Collecting trash
- Non-customary services
 - For the convenience of tenant
 - E.g., maid services
 - Tenants of REIT property can receive non-customary services from party other than the REIT
 - Independent contractors
 - Taxable REIT subsidiaries

Tax Treatment of Lease Termination Payments

- Treatment of termination fee paid from lessee to lessor
 - Ordinary income to lessor
 - Hort v. Comm'r, 313 U.S. 28 (1941)
 - Treas. Reg. § 1.61.8(b)
 - Lessee should be able to currently deduct fee
 - Cassatt v. Comm'r, 137 F.2d 745 (3d Cir. 1943)
- Treatment of termination fee paid from lessor to lessee
 - Lessor must capitalize fee, Treas. Reg. § 1.263(a)-4(d)(7)(i)(A)
 - Add to basis of the property
 - Recover over unexpired term, or
 - Recover over another lease the lessor enters into
 - Handlery Hotels, Inc. v. United States, 663 F.2d 892 (9th Cir. 1981)
 - Lessee treats payment as an amount received in exchange for selling the lease
 - I.R.C. § 1241

Use of Leases in Land-Building Splits

- Land-building split: owner of improved property transfers title to building and retains land
 - Purchaser of building uses lease for access to the land
- Unsuccessful Splits (indicia of lease, but no transfer of building)
 - 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
 - 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. Comm'r*, 120 F.2d 998 (8th Cir. 1941); *Crile v. Comm'r*, 55 F.2d 804 (6th Cir. 1932); *Estate of Budd Frankenfield v. Comm'r*, 17 T.C. 1304 (1952); *Minneapolis Syndicate v. Comm'r*, 13 B.T.A. 1303 (1928).

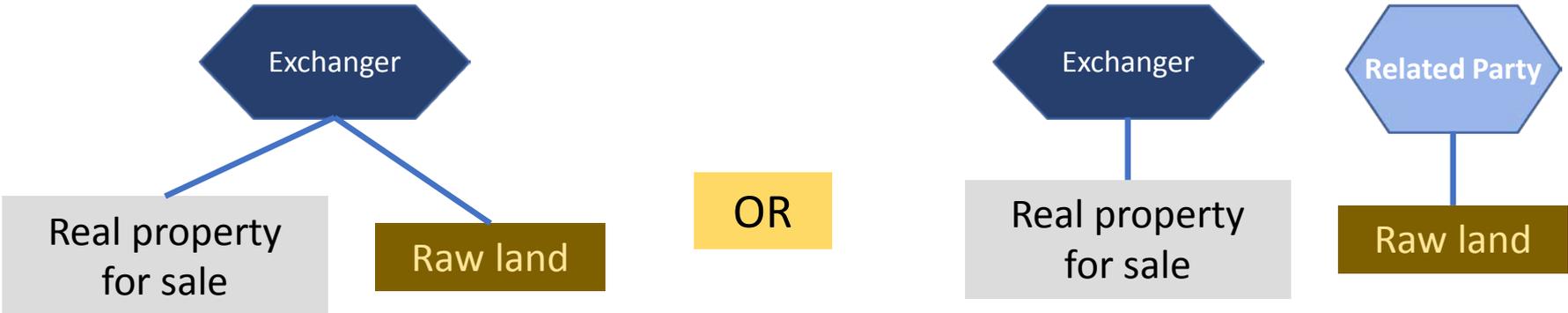
Successful land-building splits

- Condominium sales
 - Lessee has right to remove at end of ground lease
 - Lessor had to acquire units that were not removed at end of the lease
 - Owner of improvements would receive proceeds from condemnation
 - Rev. Ru. 70-607, 1970-2 C.B. 9
- Right to remove building strong indication of split
 - Waldrep v. Comm'r, 52 T.C. 640 (1969)
- Right to remove building and right to insurance proceeds indicia of split
 - Bratton v. Rountree, 37 A.F.T.R.2d 76-762 (M.D. Tenn. 1976)

Exchanging Leases under New Section 1031

- Section 1031 requires relinquished and replacement property to be real property and like kind
- 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)
- Is a leasehold in real property real property under section 1031?
 - Recognized as intangible personal property for capitalization rules
 - Treas. Reg. § 1.263(a)-4(c)(1)(vi), -4(d)(3)
 - Comes within definition of real property
 - I.R.C. § 897(c)(6); Treas. Reg. § 1.1250-1(e)(3)(i); Treas. Reg. § 1.263A-8(c)(1)
 - Treated as real property for like-kind requirement
- Leasehold in real property of less than 30 years
 - Probably not like kind to fee
 - Maybe like kind to other lease with similar length
 - Check definition of real property

Scenario: Exchanger wants to use Exchange Proceeds to Build on Other Land



Objective

- Exchanger would like to use the proceeds from the sale of its property to construct improvements on the raw land
- Exchanger wants 1031 nonrecognition

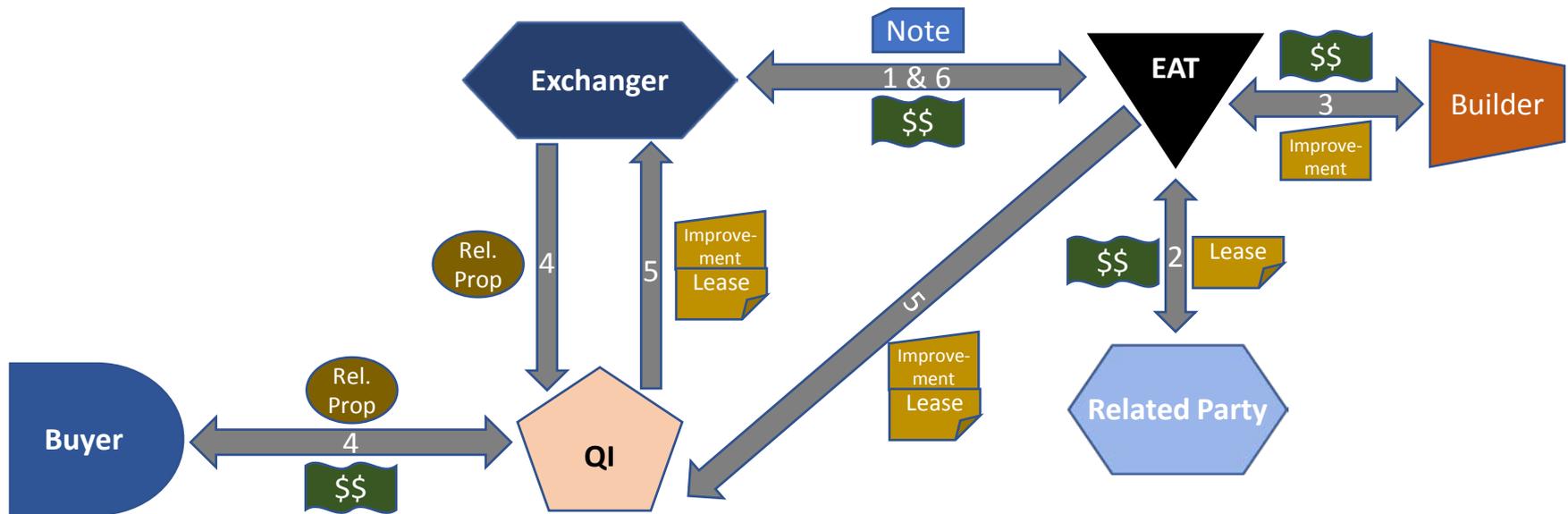
Relevant Section 1031 Elements

- Keys to improvement exchanges
 - Like Kind
 - Real Property
 - Exchange
- Related-Party Rules

Planning Strategy

- Avoid building on already-owned property
 - Use related party's property
- Avoid basis shifting and cashing out
 - Ensure that improvements, not already-owned property, are the replacement property

Leasehold 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.

I.R.S. Approved Leasehold Improvement Exchange

- IRS approved leasehold improvement exchange in PLR 200251008
 - Unrelated party owned fee
 - Related party had a 45 year ground sublease
 - Related party subleased property for 32 years to EAT to make improvements
 - Within 180 days EAT transferred leasehold and improvements to exchanger
- IRS approved similar structure in PLR 200329021
 - Related party owned long term lease of property
 - Related party assigned the lease to the EAT to make improvements
 - EAT assigned leasehold and improvements to exchanger
 - IRS approved, but required each party to hold for two years

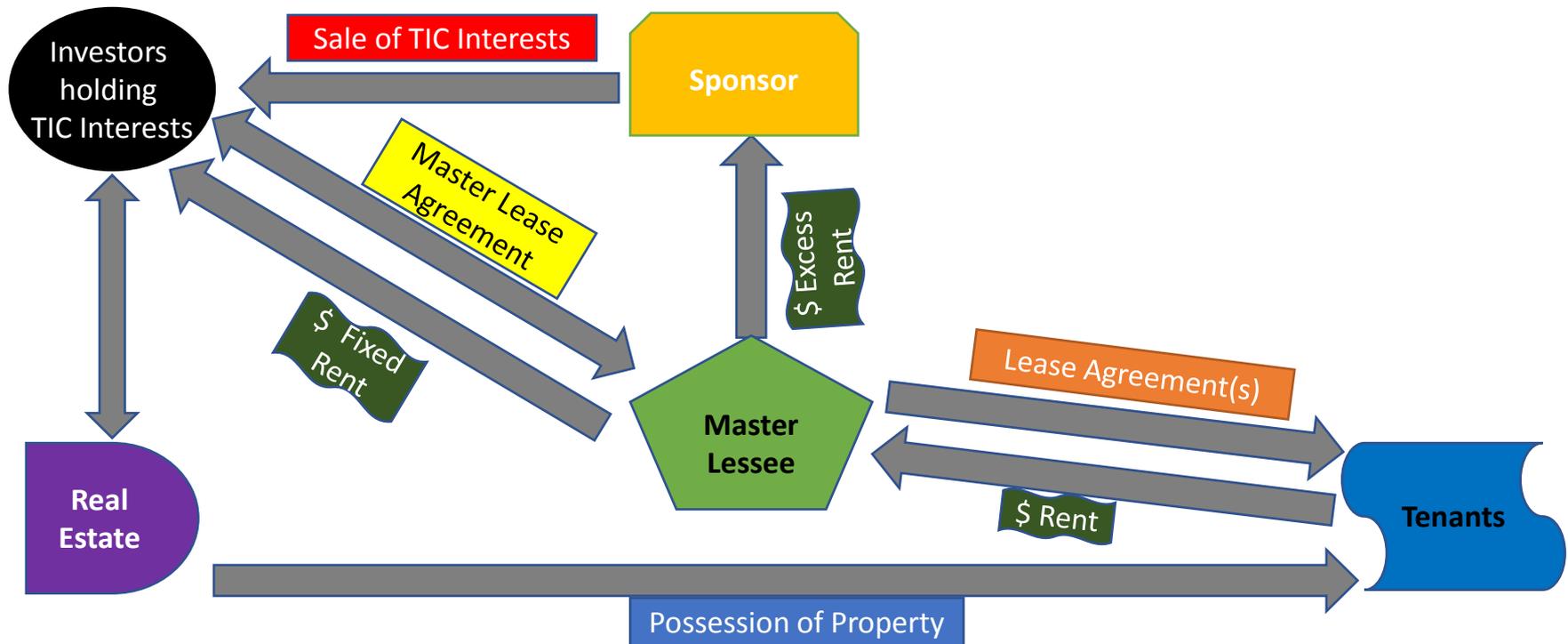
Scenario: Management of a DST or TIC

- Several parties wish to acquire interests in property as replacement property for their respective 1031 exchanges.
- They know they must hold the replacement property as a tenancy-in-common (TIC) or a Delaware Statutory Trust (DST)
- If owner involvement is too significant, they will lose TIC or DST classification
- Can they lease the property to a master tenant who then manage the property?

Use of Leases in TICs and DSTs

- Leases can help TICs and DSTs avoid being classified as tax partnerships

TIC Master-Lease Structure



TIC Property-Management Structure

