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Leasing Real Estate: Some Income Tax Aspects¹

Zolman Cavitch

THE LANDLORD-TENANT relationship usually presents a variety of income tax problems. Some of those problems have clear, unequivocal answers; some can be answered with a large measure of what one famous jurist called the "visceral" approach. All of them have this one characteristic in common — they are problems which the attorney faces many

times in his practice. The purpose of this article is to review briefly the income tax pitfalls and opportunities in three selected areas of real estate leasing.

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A. PROPER TAX TREATMENT OF ADVANCE RENTALS, SECURITY DEPOSITS, AND OTHER PREPAYMENTS.

Ordinarily, in the negotiation of a real estate lease, the lessor will require that the lessee make some sort of prepayment, a payment over and above the current rent. The particular characterization of that prepayment may make a considerable difference in the tax treatment to the parties, particularly in the tax treatment of the lessor, and it is therefore important that the attorney be aware of the varying tax impact.

1. *Advance Rental Payments*

If the prepayment is an advance rental payment — for example, a payment which, by the terms of the lease, is to be applied in payment of the last year's rent — then it is clear that the payment is immediately taxable as income to the lessor. A long line of cases so holds.²

A common sense approach would seem to require that since the lessor is immediately taxable on the receipt of advance rent, the lessee must concurrently obtain a rent reduction. That is probably not so, however.

1. The substance of this article is derived from a presentation by the author at the Cleveland Regional Tax Institute, September, 1958, sponsored by the Cleveland Bar Association.

2. *Commissioner v. Lyon*, 97 F.2d 70 (9th Cir. 1938); *Astor Holding Co. v. Commissioner*, 135 F.2d 47 (5th Cir. 1943); *Detroit Consolidated Theatres v. Commissioner*, 133 F.2d 200 (6th Cir. 1942); *Gilken Corp. v. Commissioner*, 176 F.2d 141 (6th Cir. 1949).

It is fairly well established that the lessee — even a cash basis lessee — may deduct an advance rent payment only in the year to which it *relates* — in our example, only in the year corresponding to the last year of the lease.³ Accordingly, a characterization of the prepayment as advance rent affords the lessee no tax benefit, but it does result in the lessor receiving a tax *disadvantage*.

2. Security Deposits

Suppose, however, the prepayment is not referred to in the lease as advance rent, and is not to be applied as future rent. Instead, it is in fact a deposit to secure all of the various covenants of the lessee. If the prepayment is in fact a security deposit, then it is not immediately taxable to the lessor.⁴ The lessee, of course, will get no immediate deduction, but in that respect he is no worse off than if the payment were advance rent.

3. Security Deposits vs. Advance Rental: Solving the Problem of Characterization

It is easy to conclude that from a tax standpoint the lessor will ordinarily be better off if the pre-payment is characterized as a security deposit than if it were characterized as advance rent, and that the lessee is not significantly affected by whichever characterization is made. The problem is made immeasurably more difficult than that, however, by the fact that *ordinarily* the parties will want the prepayment to do double duty. The lessor will indeed ordinarily want the prepayment to serve as a security deposit for the lessee's performance, and the lessee will ordinarily want the security deposit in effect returned to him by way of application on future rent.

Where, as is usually the case, the prepayment is intended to serve a double duty, the difficult question is presented as to whether the prepayment is intended *primarily* as a security deposit or *primarily* as an advance rent payment. Although there are many cases involving that determination from the tax standpoint,⁵ perhaps the most helpful case to the draftsman of the lease is the Tax Court decision in *John Mantell*.⁶

3. See Reg. § 1.162-11 and *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3d Cir. 1931). Some doubt is cast on this unfavorable conclusion by the case of *Waldheim Realty and Investment Company v. Commissioner*, 245 F.2d 823 (8th Cir. 1957), in which the Court of Appeals for the Eighth Circuit held that prepaid insurance premiums were deductible by the cash basis insured in the year of payment.

4. *George E. Barker*, 13 B.T.A. 562 (1928), acq. VIII-1 CUM. BULL. 3; *Warren Service Corp. v. Commissioner*, 110 F.2d 723 (2d Cir. 1940).

5. *Commissioner v. Lyon*, 97 F.2d 70 (9th Cir. 1938); *Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968 (5th Cir. 1942); *Astor Holding Company v. Commissioner*, 135 F.2d 47 (5th Cir. 1943).

6. 17 T.C. 1143 (1952); Acq. 1952-1 CUM. BULL. 3.

In *Mantell*, a ten-year lease required the lessee to deposit \$43,000 as security for the performance by the lessee of many substantial covenants. The lessor was not obligated to keep that deposit in a separate account or to pay interest to the lessee. The lease specifically stated that the deposit was not to be applied as rent. However, \$33,000 of that security deposit was to be returned to the lessee during the last year of the lease on five prescribed dates which were only four or five days after the prescribed dates for rental payments in the last year, and in exactly the same amounts as those installments of rent. The \$10,000 balance of the deposit was to be returned when the premises were surrendered by the lessee in accordance with the lease. On these facts, the Tax Court held that the \$43,000 was a security deposit, not advance rent, and therefore not taxable to the lessor in the year of receipt. One of the most interesting aspects of the case is that it was formally acquiesced in by the Commissioner.⁷

Particularly in view of that acquiescence, a lessor's counsel who is faced with a situation where an advance payment must do double duty should extract these lessons from the *Mantell* case:

1. The prepayment should secure substantial covenants to be performed by the lessee.⁸
2. The lease should nowhere refer to the prepayment as "advance rent." This is, of course, an easy precaution to observe, but it is surprising how often the cases come up in which the prepayment has been referred to both as a security deposit and as advance rent.⁹
3. The lessor should have no right to apply the prepayment on rent for any future period.
4. If at all possible, the lessor should not be obligated to return the deposit until the termination of the lease. If the lessee will not agree to such a provision, then the obligation to return the deposit should specify a return date or dates which do not coincide with the rental payment dates.

7. 1952-1 CUM. BULL. 3.

8. The opinion in the *Mantell* case provides a helpful check list in this connection. The prepayment involved in the *Mantell* case secured the following covenants of the lessee, among others: the return of the property in good condition at the end of the term, payment of the current rentals, replacement of all broken, damaged and missing personal property included in the inventory attached to the original lease, payment of all utility charges, keeping in good condition the interior of the premises, the indemnification of the lessor against any claim of any kind that might be brought against the lessor in connection with the lessee's operation of the premises, the assignment to the lessor as additional security for the payment of rent all personalty brought into the leased premises.

9. See cases cited Note 5 *supra*.

In short, there is no reason why the lessor's counsel should not be able, with careful drafting, to rely on the acquiesced *Mantell* decision in order to obtain for his client a postponement of tax liability on the prepayment.

4. *Bonus Payments by Lessee to Obtain or Modify a Lease*

Occasionally, a lessee will pay a sum in addition to the first year's rent in order to obtain a lease, or after the lease has commenced, will pay an additional sum to obtain a modification of a lease. Such payments, from both the lessor's and lessee's standpoints, fall into substantially the same pigeonhole as advance rents. That is, the lessee may not take an immediate deduction, but must instead amortize the payment ratably over the remaining term of the lease.¹⁰ The lessor, on the other hand, must include the full amount in income in the year received.¹¹

An interesting question arises as to the period over which a *lessee* must amortize such a "bonus" payment when the lease contains an option in the lessee to renew the lease. New Section 178 of the Internal Revenue Code, recently enacted by Congress in 1958, contains an interesting new rule, namely: where the value of the original term of the lease is less than 75% of the cost of acquiring the lease *and* the option to renew (a situation which indicates that the lessee was paying a substantial sum for the right to renew) then the lessee must amortize the cost over the extended period. He may still have an out, however. New Section 178 of the Code also provides that if at the end of a particular lease year, the lessee proves that it is more probable that he will not renew the lease than that he will renew it, then the previously unamortized cost may be deducted ratably over the remaining original term. Where the value of the original term of the lease is 75% or more of the total bonus payment, then the lessee may amortize the bonus over the original term, unless the lease has in fact been renewed or at the end of the particular year the facts show with reasonable certainty that it will be renewed.

5. *Bonus Payments to Terminate a Lease*

The cases are not entirely clear as to deductibility by a lessor of a payment made by him to his lessee to induce him to vacate. When a lessor pays off his present lessee in order to enter into a more favorable lease with a third party, common sense would seem to dictate one of two tax results: (1) either an immediate deduction to the lessor as ordinary

10. Reg. § 1.162-11; *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3d Cir. 1931); *Pig & Whistle Co.*, 9 B.T.A. 668 (1927).

11. See *Renwick v. United States*, 87 F.2d 123 (7th Cir. 1936).

and necessary business expense, or (2) the amortization of the payment over the term of the *new* lease, treating the payment as a cost of acquiring that new lease. The cases, however, seem to hold that the lessor may treat the payment in neither of those ways. Instead, he must amortize the payment over the remaining term of the old lease.¹² On the other hand, if the payment is made in order to clear the building, so that the lessor might demolish it and erect a new building, then there is authority for the more sensible rule that the payment must be added to the cost of the new building and recovered through depreciation deductions.¹³ Those two lines of cases are seemingly irreconcilable; in all probability, the last word has not yet been written on this point.

From the lessee's standpoint, the payment received by him to induce him to vacate gives rise to capital gain, to the extent of the gain realized by him, under the clear authority of the Internal Revenue Code.¹⁴

When the lessee pays the lessor in order to get out of his lease, the general rules are somewhat easier to reconcile. The lessee may ordinarily deduct the payment in its entirety in the year of termination.¹⁵ The lessor, the Supreme Court has held, must report as ordinary income in the year received a lessee's payment to terminate the lease.¹⁶ This ordinary income treatment by the lessor on receipt of a lessee's payment must be contrasted with the capital gain treatment accorded a lessee when he receives a similar payment from his lessor.

By way of summary of the prepayments discussion:

1. Advance rents are immediately taxable to the lessor but not deductible to the lessee until the year they are applied. Security deposits are not immediately taxable to the lessor and are not deductible by the lessee unless and until applied. Where a prepayment is intended to serve a double duty, careful reliance upon the *Mantell* case makes possible an advantageous characterization for the lessor.
2. Bonus payments by a lessee must be amortized over the period of the lease and in some situations over the lease period plus any renewal periods. Such payments are immediately taxable to the lessor.
3. Payments by a lessor to terminate a lease must ordinarily be amortized by the lessor over the remaining period of the old

12. *Henry B. Miller*, 10 B.T.A. 383 (1928); *Harriet B. Borland*, 27 B.T.A. 538 (1933).

13. *Business Real Estate Trust of Boston*, 25 B.T.A. 191 (1932); non-acq. XI-1 CUM. BULL. 8.

14. § 1241.

15. *Cassatt v. Commissioner*, 137 F.2d 745 (3d Cir. 1943).

16. *Hort v. Commissioner*, 313 U.S. 28 (1941).

lease; gain realized by the lessee is taxed at the favorable capital gain tax rates. Payments by a lessee to terminate a lease are ordinarily deductible immediately by the lessee and includable immediately as ordinary income by the lessor.

B. AVOIDING TAX TO LESSOR ON IMPROVEMENTS MADE BY LESSEE

Where a lease requires the lessee to make capital improvements to the land, which improvements will revert to the lessor at the end of the term, the Commissioner has attempted to impose a tax on the lessor either in the year such improvements are made, or in the year the lease terminates. The Commissioner's attempts have been predicated on the fact that such improvements made by the lessee will enrich the lessor, either at the time the improvements are made, or at the time the lease terminates, and that such enrichment should occasion a tax payment by the lessor. The cases and statutes make fairly clear that, with care, the Commissioner's attempts can be frustrated at both points.

Let us consider first the possibility of income to the lessor in the year in which the improvements are made. In *Blatt v. United States*,¹⁷ the lessee under a ten-year lease was obligated to pay a certain stipulated rent and in addition, to make substantial improvements to the land. The Supreme Court held that the improvements did not constitute additional rent, in whole or in part, in the year made. The Court stated that the improvements which were required to be made by the lessee would not be deemed to be additional rent to the lessor unless the intention that they be such is "plainly disclosed."

In *Brown v. Commissioner*,¹⁸ the improvements made by the lessee were expressly stated to be a credit on a certain portion of the rent payable by the lessee, and the Court of Appeals for the Seventh Circuit held that the lessor realized income in that amount — that is, the amount of the stated credit — in the year the improvements were made. Under the terms of this particular lease, stated the court, the improvements were clearly intended as rent, were therefore within the dictum in the *Blatt* case, and would be treated as taxable income to the lessor.

The moral of those two cases appears clear. If the lessee is to be obligated to make improvements to the land, the lease should not expressly relate those improvements to the payment of rent. The improvements should not be stated to be in lieu of rent,¹⁹ nor should the dollar rental be stated at a particular gross figure with a credit, or cutback, on account of the improvements.

17. 305 U.S. 267 (1938).

18. 220 F.2d 12 (7th Cir. 1955).

19. I.T. 4009, 1950-1 CUM. BULL. 13.

Suppose, however, that the lease calls for no dollar rental, or an extremely nominal dollar rent, and the lessee is obligated to make improvements which are not *stated* to be in lieu of rent. In such a situation it would seem that even though the intention is not expressly stated that the improvements are to be considered rent, the lack of any realistic dollar rental obligation makes clear that the improvement is intended as rent within the dictum of the *Blatt* case. Substantial doubt, however, is cast on this unfavorable conclusion by the recent case of *Commissioner v. Cunningham*.²⁰ In the *Cunningham* case, where the lessor on a five-year lease received no rent whatever, and the lessee erected \$20,000 of improvements on the land, both the Tax Court and the Appellate Court held that the lessor did not realize taxable income either in the year the improvement was made or in the year of termination of the lease, there being no indication that the improvement was intended as rent. Aside from being a borderline case, the *Cunningham* decision is perhaps distinguishable from the more typical kind of situation. In *Cunningham*, the lessor was the dominant shareholder in the corporate lessee. It is conceivable that the improvements were indeed not intended as being compensatory to the lessor but that on the other hand the shareholder-lessor intended to donate the use of the land to her corporation.²¹ If the lessor and lessee are unrelated, such a donative intent is not likely.

As a practical matter, whether or not the lessor and lessee are related, for the lessor to be relatively safe, the lessor should receive some significant dollar rent, in addition to the lessee's obligation to improve. In all probability, however, that dollar rent need not be equivalent to the fair rental value of the land, so long as it is substantial and is not grossly disproportionate to that fair rental value. Similarly, the fact that the improvements will have a useful life longer than the period of the lease is probably immaterial so long as the lease term is not flagrantly shorter than the useful life.²²

The Commissioner has also attempted to tax to the lessor in the year in which the lease terminates the value of improvements made by the

20. 58-2 U.S.T.C., ¶ 9771 (9th Cir. 1958).

21. It seems that the Commissioner might have argued just the converse intent; that is, that the corporation intended by erecting a building on the stockholder's land to make a donative (dividend) payment to the lessor, in the amount of the fair value of the premises to the lessor at the time of the ultimate termination of the lease. One factor weighing against such a result, and perhaps the factor which prevented this possibility from being raised in argument, is that the lessee corporation continued to rent the premises on a nominal basis after the expiration of the original term of the lease.

22. Where the lessee's improvements have a useful life longer than the period of the lease, the question might arise as to the period over which the lessee can write off the improvements for tax purposes. See the discussion in the text beginning at page 197 *infra*.

lessee. Indeed, he succeeded in that attempt in *Helvering v. Bruun*, decided by the Supreme Court in 1940.²³ Congress, however, promptly overruled the *Bruun* case by adopting section 109 of the Internal Revenue Code which expressly precludes, with one exception, the realization of income by a lessor *on the termination of a lease* on account of improvements made by a lessee. That exception is simply where such improvements constitute "rent" or as stated in the words of the statute "Gross income does not include income (other than rent). . . ." The *Brown* case²⁴ and the Internal Revenue Service's own ruling²⁵ hold that the lessor realizes income in the year that the improvements are *made* when the lease states that the improvements are in lieu of rent or when an express cut-back or credit on rent is provided. It is believed that those authorities are within the dictum in the earlier *Blatt*²⁶ case where the Supreme Court stated that the lessor will not be treated as in receipt of additional rent on account of the lessee's improvements, unless the intention that it be rent is plainly disclosed. If that intention is plainly disclosed the lessor would presumably realize income in the year the improvements are made; if the intention is not plainly disclosed, then it would seem that the improvements are not rent in *any* year. It may be that the only vitality to that exception in § 109 would exist in the rare situation where the intention that the improvements be deemed rent is plainly disclosed, and in addition the improvements are made in the very year the lease is terminated. Diluted down to that relatively rare situation, the parenthetical exception to the favorable exclusion in § 109 makes obviously good sense. Surely, if the making of the improvement in a particular year would have constituted rental income to the lessor in that year because it was plainly intended as such, it should not escape taxation simply because the lease happened to terminate in that same year. As a practical matter, it would seem that a situation calling for the application of that "rent" exception could exist only when a lease terminated through repossession.²⁷

By way of brief summary: If the lease requires the lessee to make improvements to the land, lessor's counsel should bear in mind the following caveats:

23. 309 U.S. 461 (1940).

24. 220 F.2d 12 (7th Cir. 1955).

25. I.T. 4009, 1950-1 CUM. BULL. 13.

26. 305 U.S. 267 (1938).

27. The Treasury Regulations under § 109 indicate that the "rent" exception relates to the situation where the improvements represent in whole or in part a liquidation in kind of lease rentals, presumably a situation where the lease reserves to the lessee the ownership of any improvements but where the lessee transfers that ownership to the lessor in payment of back rent. Reg. § 1.109-1 (1956).

1. The lease should not contain an express credit to a dollar rent payment or an express cutback in rent on account of the lessee's improvements.
2. The lease should not refer to the improvements as being in lieu of rent.
3. The dollar rent should not be merely nominal in amount.
4. The lease period should not be flagrantly shorter than the useful life of the building.

C. DEPRECIATING LEASEHOLD IMPROVEMENTS

1. *Depreciation by the Lessor*

Improvements made by a lessor may normally be depreciated over the economically useful life of those improvements.²⁸ One important and sometimes overlooked exception to that rule bears mention. If the lease obligates the lessee not only to keep the premises in good repair, but also to restore and replace the premises at the end of the term in as good condition as they were in at the beginning, the lessor may lose the depreciation deduction.²⁹ A nice question is presented as to whether the lessor would not at least be entitled to an obsolescence deduction, but no point would be served by dwelling on that question. The clear moral is that the lessee's obligation to maintain the premises should always except ordinary wear and tear, unless the parties do indeed intend that the lessee shall rebuild the premises at the end of the term.

2. *Depreciation by the Lessee*

More difficulty is encountered with the rules relating to depreciation by the lessee. Where the lessee makes improvements on his leasehold — and those improvements are not treated as ordinary income to the lessor³⁰ — the lessee is entitled to write off the cost of those improvements. Where the term of the lease is longer than the estimated life of the improvement, the lessee must depreciate the improvement over its life.³¹ Where, however, the term of the lease is shorter than the life of the improvement, so that the lessee is not likely to derive any benefit from

28. § 167; Reg. § 1.167 (a) (4).

29. *Georgia Railway & Electric Company v. Commissioner*, 77 F.2d 897 (5th Cir. 1935); *Commissioner v. Terre Haute Electric Company*, 67 F.2d 697 (7th Cir. 1933); G.C.M. 11933, XII-2 CUM. BULL. 52. But *cf.* *The North Carolina Midland Railway Company v. United States*, 58-2 U.S. T.C., ¶ 9701 (Ct. Cl. 1958).

30. If the lessee's improvements, when made, constitute income to the lessor, the lessee's tax treatment would presumably be governed by the rules relating to prepayments by lessees. See discussion beginning at page 189 *supra*.

31. Reg. § 1.167 (a) (4).

the improvement for a period beyond the lease term, he may amortize the improvement over the shorter lease term.³² It should be borne in mind, however, that amortization over the lease period, as distinguished from depreciation over the life of the improvement, *must* be made ratably in each year of the lease. The rapid depreciation methods of the 1954 Internal Revenue Code, whereby a disproportionate amount of the depreciation may be claimed in the earlier years, are clearly not available for *amortization*.³³

The big question over the years has not centered about the general rules just discussed, but rather over the subsidiary question of what is the applicable period of write-off by the lessee when he has an option to renew the lease or is related in some fashion to the lessor. On this difficult point let us take a quick look at the regulation, the cases, and new Section 178 recently added to the Internal Revenue Code. The regulations, surprisingly enough, after citing the renewal option and relationship factors, take the seemingly liberal view that unless the facts show with *reasonable certainty* that the lease will be renewed, the lessee may write off the improvement without taking into account any right of renewal.³⁴

The Tax Court, however, has done better by the Government than has the Commissioner.³⁵ The Tax Court, it seems, will be satisfied that there is a reasonable certainty that the lease will be renewed *unless* the lessee can prove a *reasonable probability* that it will *not* be renewed, a test substantially less liberal than the one seemingly set forth in the regulations.

That brings us to new Section 178 of the Internal Revenue Code. Under that new provision, certain specified relationships between the lessor and lessee will preclude amortization of improvements over a lease period shorter than the life of the improvement in every instance.³⁶ That new rule is categorical and has at least the virtue of eliminating debate.

Where the parties are not closely related, but the lessee has an option to renew, then Section 178 provides that if the unexpired initial term of the lease at the time the improvement is completed is shorter than 60% of the estimated life of the improvement, then the lessee may amortize over the remaining years in the original term only when he can establish

32. See Note 31, *supra*.

33. Reg. § 1.167(a)(4).

34. Reg. § 1.162-11.

35. Alamo Broadcasting Company, Inc., 15 T.C. 534 (1950); Acq. 1951-1 CUM. BULL. 1; Aiken Drive-In Theatre Corp., 15 G.C.M. 684 (1956); Kerr-Cochran, 30 T.C. --- (1958).

36. The specified relationships for this purpose are, with one slight modification, the relationships set forth in Internal Revenue Code § 267(b).

that as of the close of the particular year it is *more probable* that the lease will *not* be renewed than that the lease *will* be renewed. Suppose, by way of example, that the lessee completes an improvement to his leasehold interest at a time when the initial term of the lease has ten years to run. The lease gives lessee the right to renew for an additional ten-year term after the expiration of the initial term. The estimated life of the improvement is twenty years. Since the unexpired initial term of the lease is only 50% of the estimated life of the improvement, the lessee will have to write off the cost of the improvement over the full twenty-year period, unless he can establish at the end of a particular tax year that it is more probable that the lease will not be renewed than that the lease will be renewed. This new test of "greater probability" is not far different from the approach currently taken by the Tax Court and is not likely to put an end to litigation on this troublesome question.

If the unfavorable 60% test is not met, then the lessee may amortize over the initial term of the lease unless the lease has in fact been renewed or the facts show with reasonable certainty that it will be renewed. Suppose, by way of example, that in our previous illustration the estimated life of the improvement is fifteen years rather than twenty years. Since the unexpired initial term of the lease (ten years) is more than 60% of the estimated life of the improvement (fifteen years), the lessee will be able to amortize the improvement over the shorter ten year initial term of the lease, unless at the end of the particular tax year the lease has in fact been renewed or the facts show with reasonable certainty that it will be renewed.

The depreciation discussion may be summarized as follows:

1. Improvements made by a lessor may normally be depreciated over the useful life of the improvement. Beware, however, a lease provision which obligates the lessee to restore the premises at the end of the term without excepting ordinary wear and tear.
2. Improvements made by a lessee may normally be written off over the life of the improvement or the term of the lease, whichever is shorter. Where, however, the lessor and lessee are closely related, Section 178 of the Internal Revenue Code will preclude any write-off over a period shorter than the life of the improvement. Where the parties are not related, but the lessee has an option to renew, he must brace himself for the possibility of litigation if he attempts to write off an improvement over an initial term of the lease which is substantially shorter than the life of the improvement.