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Tax Problems Incident To the Management of Acquired Real Estate

I

PROBLEMS OF RENT

Norman A. Sugarman

RULES GENERALLY APPLICABLE TO RENT

Ordinarily, the payment or receipt of rent for the use of real property would seem to be a subject that should not give rise to any complicated tax problems. However, as in many other situations under the tax law, the determination of the tax treatment of rent is simple or complicated depending upon whether the factual situation is simple or complicated.

General Rules

In general, as to the lessor, rent is income in the year received (actually or constructively) if the lessor is on a cash basis, or in the year of accrual (but not later than the year received) if the lessor is on an accrual basis.¹ As to the lessee, in determining the deduction for rent, the treat-

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ment may be somewhat different depending upon whether the lessee is an individual or a corporation. In the case of an individual (including a partnership) lessee, rent is deductible for the period to which the rent relates in computing adjusted gross income if the rent is for property used in the lessee's trade or business.² The same rule applies in computing taxable income if the rent is for property held for the production of income.³ Where a corporation is the lessee, rent is ordinarily presumed to be a business expense and, hence, is deductible in computing taxable income of the corporation for the period to which the rent relates.⁴

1. INT. REV. CODE OF 1954, §§ 61(a)(5), 212; Treas. Reg. §§ 1.61-8(a) (1957), 1.212-1 (1957).

2. INT. REV. CODE OF 1954, § 162.

3. INT. REV. CODE OF 1954, § 212.

4. INT. REV. CODE OF 1954, § 162.

Indirect Payments

The treatment of rent becomes more complicated where there are indirect payments. The familiar principle of "constructive receipt" applies to expenditures by a lessee which are in discharge of the obligations of the lessor. Thus, the lessor cannot avoid being taxed on rent where the lessee makes payments to the lessor's assignee of rental payments.⁵ Attempts to shift income within members of the lessor's family will fail where there is a mere assignment of the right to rents;⁶ but a leasehold may be assigned by the lessor and will be effective to shift income to the recipient where the assignment is a transfer of rights in the property itself.⁷ In general, however, the lessor does not avoid tax on rent by having rent paid in discharge of his mortgage or by payments to the lessor's creditors,⁸ nor by having the payments made direct to the lessor's stockholders.⁹

A familiar form of lease which involves the principles of constructive receipt is the "net lease." In the case of such a lease, technically the lessee's payment of items such as taxes, insurance, interest, and repair bills, pursuant to the terms of the lease, are "rent" and deductible as such by the lessee and includible in income as such by the lessor; and the lessor should deduct such items as taxes, insurance, interest, and repair bills, as if constructively paid by him.¹⁰ While ordinarily these items "wash" and, therefore, it is immaterial how such clearly deductible items are treated as between lessee and lessor, nevertheless, in some cases it may be important. Thus, if rent is not deductible by the lessee (for example, by reason of the fact that it is not a business expense) and the lessee makes capital improvements in lieu of a portion of the rent, the cost of which is not reported by the lessor as income, then the actual effect to the lessor is a deduction of the cost of such improvements. If, however, this cost had actually been paid by the lessor or if it had been constructively treated as income and reported by him as rent, it would not be deductible, but would have to be added to the capital account of the property and depreciated over the useful life of the improvement.

Likewise, under certain provisions of the law it is particularly important to know the precise amount of rent. For example, a corporation may be saved from the additional tax on a personal holding company if its gross rental income constitutes 50% or more of its gross

5. *Treas. Reg.* § 1.61-8(c) (1957); *Galt v. Commissioner*, 216 F.2d 41 (7th Cir. 1954), *cert. denied*, 348 U.S. 951 (1954).

6. *United States v. Shafto*, 246 F.2d 338 (4th Cir. 1957); *Rev. Rul.* 337, 1958-2 CUM. BULL. 13.

7. *Lum v. Commissioner*, 147 F.2d 356 (3d Cir. 1945).

8. *Brockman Building Corp. v. Commissioner*, 231 F.2d 145 (9th Cir. 1955), *cert. denied*, 350 U.S. 936 (1956).

9. *United States v. Joliet & Chicago R.R.*, 315 U.S. 44 (1942).

10. *Cf. Your Health Club*, 4 T.C. 385 (1944); *Rev. Rul.* 600, 1954-2 CUM. BULL. 164.

income.¹¹ Conversely, too much "rent" may deprive a corporation of the benefits of Subchapter S of the code, since they are not available if more than 20% of the gross receipts are from rents and certain personal holding company types of income.¹² An individual who has attained the age of sixty-five, and is entitled to the credit against tax for "retirement income" can include in such retirement income rents unreduced by depreciation or other expenses.¹³

A particular problem to watch for in cases in which a lessee pays expenses of the lessor is the pyramiding effect where the lessee pays the lessor's income tax. It has long been established that the payment by the lessee of the lessor's income tax is additional income to the lessor.¹⁴ In such cases, since the payment of the tax itself produces additional income, unless the lessee's obligation is limited to the first payment, the lessee will be required to pay the tax on the additional income created by the first tax payment and so on, with each additional tax payment building up a corresponding additional income and additional tax. It is the position of the Service that pyramiding, which can be a trap for the unwary unless the covenant for payment of tax is limited as to the number of such payments, results in additional taxable income to the lessor.¹⁵

Improvements made by a lessee may present certain factual problems from a tax viewpoint. The principle has been established by a United States Supreme Court decision¹⁶ that generally leasehold improvements are not "rent" at the time of construction unless clearly intended to be so. The problem can and should be avoided if no credit is given for improvements in lieu of rent.¹⁷

TIMING OF RENT AS INCOME OR DEDUCTION

Timing is an item of great importance in the tax treatment of rent. Here, the rules are not consistent as between the lessor and the lessee.

General Rules

As previously stated, rent is taxable to the lessor not later than when received, regardless of the lessor's method of accounting.¹⁸

11. INT. REV. CODE OF 1954, § 543(a) (7).

12. INT. REV. CODE OF 1954, § 1372(e) (5).

13. INT. REV. CODE OF 1954, § 37; Treas. Reg. § 1.37-3(a) (2) (1956).

14. *United States v. Boston & Me. R.R.*, 279 U.S. 732 (1929).

15. Rev. Rul. 13798, 1952-1 CUM. BULL. 8, *modified in* Rev. Rul. 13953, 1952-2 CUM. BULL. 65. There is an exception for certain pre-1954 leases — payment of tax is not income to lessor nor deductible by lessee if both are corporations, INT. REV. CODE OF 1954, § 110.

16. *Blatt v. United States*, 305 U.S. 267 (1938).

17. See *Brown v. Commissioner*, 220 F.2d 12 (7th Cir. 1955); Treas. Reg. § 1.61-8(c) (1957). For a detailed discussion of this subject see note 12, p. 188 and accompanying text.

18. Treas. Reg. § 1.61-8(b) (1957); *Astor Holding Co. v. Commissioner*, 135 F.2d 47 (5th Cir. 1943).

However, in the case of the lessee, the general rule is that the rent deduction is spread over, or applied to, the period to which it relates, regardless of when paid.¹⁹ This treatment is typical of that developed under the tax laws in the interest of revenue collection, namely, that items of income are taxed immediately whereas deductions are deferred.

Advance Rent, Security Deposits Distinguished

Before applying the rule to the lessor that rent is always immediately income, it is necessary in some cases to determine whether a particular payment is "rent." Thus, if a payment is a "security deposit," instead of "advance rent," then it is not income to the lessor at the time of receipt.²⁰ The problem is to determine when a payment is a "security deposit" instead of "advance rent." From the lessor's viewpoint careful drafting of the lease and control of the surrounding facts can be very important in protecting the lessor's right to treat a payment as a security deposit. The courts have indicated that the following facts will support the position that a payment is a "security deposit":

- (a) the payment is described as a security deposit, not rent;
- (b) the payment is intended as security for specific performance by the lessee;
- (c) the payment is to be accounted for by the lessor to the lessee;
- (d) it is helpful if interest is paid by the lessor;
- (e) the amount is to be repaid to the lessee and not automatically applied on rent (but it may be used by the lessee to exercise his option to purchase).²¹

Of course, if the lessor desires to protect his position that a payment is a "security deposit" he should see to it that the lessee takes the same position and does not seek to deduct the amount of the payment as "advance rent." Inasmuch as there is the previously described inconsistency between the timing rules for income and deductions, the deduction of advance rental by the lessee, which must be spread over or applied to the period of the lease to which it relates, probably will not benefit the lessee enough in most cases to overcome the cost to the lessor of having to report the entire amount of such payment as income in the year received. If the payment is in fact a

19. Treas. Reg. § 1.162-11 (1958); *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3d Cir. 1931), *cert. denied*, 284 U.S. 674 (1931).

20. *Warren Service Corp. v. Commissioner*, 110 F.2d 723 (2d Cir. 1940); *Estate of George E. Baker*, 13 B.T.A. 562 (1928), *acq.*, VIII-1 CUM. BULL. 3 (1929).

21. *Clinton Hotel Realty Corp. v. Commissioner*, 128 F.2d 968 (5th Cir. 1942); *Harcum v. United States*, 164 F. Supp. 650 (E.D. Va. 1958); *Greentree v. Fahs* (S.D. Fla. 1956); *John Mantell*, 17 T.C. 1143 (1952), *acq.*, 1952-1 CUM. BULL. 3. Compare—held rent: *Gilken Corp. v. Commissioner*, 176 F.2d 141 (6th Cir. 1949); *Hirsch Improvement Co. v. Commissioner*, 143 F.2d 912 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1944); *Astor Holding Co. v. Commissioner*, 135 F.2d 47 (5th Cir. 1943).

security deposit and is subsequently applied by the lessee against rent, then it will be deductible by the lessee when released by him to the lessor, or when applied by the lessee to rent.

"Security deposits" must be distinguished from "the last month's" rent, if the latter is merely advance rent or a bonus payment to the lessor. Such advance rentals or bonus payments constitute immediate income to the lessor.²²

Timing of Deductions: Lessee's Problems

The situation with respect to the deduction by the lessee is more complicated. The question in each case is whether a payment is rent for the period in which paid or is for the purchase of an asset, the cost of which is to be amortized over a period of time. Generally, advance rentals and bonus payments are required to be spread over the term of the lease.²³ It is not unusual, however, for a lease to provide for unequal rental payments. The question in such a case is whether the rent must be deducted evenly on a pro rata basis over the remaining term regardless of the uneven payments. Generally, the Internal Revenue Service has no hesitancy in "remaking" the lease to provide for the even deduction of the rent over the remaining term.²⁴ However, the mere fact that rental payments are uneven does not mean that they *must* be spread, because proof may be presented that the payments for a particular year are based upon the circumstances of that year and are unrelated to any other period, as in the case of a rent based upon a percentage of sales.²⁵

Under a new provision of the law, special attention must be given to the write off by the lessee of any bonus paid for acquiring a lease containing an option to renew.²⁶ Under this provision, if less than 75% of the cost of acquiring a lease is attributable to the portion of the term of the lease (excluding any period for which the lease may be subsequently renewed, extended, or continued pursuant to an option exercisable by the lessee) remaining on the date of its acquisition, then the period for amortizing and deducting the cost of acquiring the lease is to include any period for which the lease may be renewed, extended, or continued pursuant to such an option, unless the lessee establishes that (as of the close of the taxable year) it is more probable than not that the lease will not be renewed, extended, or con-

22. *Pembroke v. Commissioner*, 70 F.2d 850 (D.C. Cir. 1934); Rev. Rul. 537, 1957-2 CUM. BULL. 52.

23. *Baton Coal Co. v. Commissioner*, 51 F.2d 469 (3d Cir. 1931), *cert. denied*, 284 U.S. 674 (1931); *Home Trust Co. v. Commissioner*, 65 F.2d 532 (8th Cir. 1933).

24. *Galatoire Bros. v. Lines*, 11 F.2d 878 (5th Cir. 1928); *Cf.* Rev. Rul. 170, 1953-2 CUM. BULL. 141.

25. *Cf.* Rev. Rul. 136, 1956-1 CUM. BULL. 32.

26. INT. REV. CODE OF 1954, § 178. For a discussion of the rule concerning the treatment of the write-off of a building erected, or other improvements made, see note 19, p. 190 and accompanying text.

tinued for such period. Even if a lease does not contain an option to renew (the general rule being that the amortization is to be made only with reference to the term of the lease), the term is to include an extension if the facts show with reasonable certainty that the lease will in fact be renewed, continued, or extended.²⁷

Where the lessor and lessee are related parties, special attention must be given to the timing of rental payments in order for the lessee to protect his right to the deduction of rent. Under an express statutory provision, an accrual basis lessee, accruing rent, will be denied the deduction if the related lessor is on a cash basis and the rent is not paid within two and one-half months after the close of the lessee's taxable year.²⁸ Related taxpayers who come within the purview of this provision are defined in this same statutory provision.

PAYMENTS ON TERMINATION OF LEASE

Payments for termination of a lease also present special problems. Where the lessee makes a final payment to secure cancellation of a lease, the amount is treated the same as rent and since the period ends with the cancellation of the lease, the payment is immediately deductible as a business expense in the year paid or incurred.²⁹ Consistent with the general treatment of rent to the lessor, such a payment is immediate income to the lessor.³⁰

A more difficult problem arises when the lessee purchases the fee. The Supreme Court, in *Millinery Center Building Corporation v. Commissioner*,³¹ held that the entire amount of the payment by the lessee is to be treated as the cost of property and in the nature of a capital expenditure. However, in the earlier case of *Cleveland Allerton Hotel, Incorporated v. Commissioner*,³² the Court of Appeals for the Sixth Circuit had held that where the taxpayer could establish that an excess amount over the value of the fee was paid to escape the burdensome lease, such excess was deductible as a business expense. The Supreme Court in the *Millinery Center* case indicated, without expressly saying so, that the facts before it were different from those in the *Cleveland Allerton Hotel* case. Therefore, it appears that the *Cleveland Allerton Hotel* case is still good law. This is particularly important because the result reached by the Supreme Court is harsh in that the purchase price paid by the lessee allocable to the land cannot be amortized or depreciated, although the portion allocable to the building can be deducted through depreciation, over the remain-

27. INT. REV. CODE OF 1954, § 178 (c).

28. INT. REV. CODE OF 1954, § 267. For a discussion of the amount allowable for amortization deduction, see note 22, p. 192 and accompanying text.

29. Alexander J. Cassatt, 47 B.T.A. 400 (1942), *aff'd*, 137 F.2d 745 (3d Cir. 1943).

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

31. 350 U.S. 456 (1956). See also Henry Boos, 30 B.T.A. 882 (1934).

32. 166 F.2d 805 (6th Cir. 1948).

ing useful life of the building. The Supreme Court denied the taxpayer the right to deduct any portion of its payment over the shorter unexpired term of the lease.

When payments are made by a lessor for termination of a lease, a different set of rules applies. Under an express statutory provision, amounts received by a lessee for the cancellation of a lease are considered as amounts received for the sale of the leasehold by the lessee and, hence, are long-term capital gain to the lessee, if the lease has been held for more than six months.³³ A lessor who makes payment to secure the cancellation of a lease is generally considered to have acquired the leasehold and, therefore, amortizes the cost over the remaining life of the lease.³⁴ This is a peculiar rule based upon the apparent fiction that the lessor has acquired a leasehold, when, in fact, the leasehold disappears into the fee. The rule would appear to be justified only in those cases where the lessor purchases a lease to acquire or make a new lease, or pays off the lessee in order to erect a building; in such cases it would seem appropriate that the lessor's cost be amortized over the life of the new lease or the building which he erects.³⁵

LEASES TREATED AS INSTALLMENT PURCHASES

An area of growing importance is the treatment of rental payments under leases which have some of the features of installment sales. This problem commonly arises under lease-purchase arrangements. In a sense every lease is a method by which a lessee may "finance" the use of property over a period of time; but there is a substantial tax difference between being the lessee who merely rents the property, and being the owner of it who finances his purchase under an installment sale. The tax difference lies in the fact that if the transaction is a purchase, the "lessee" is not entitled to a rental deduction, but only to a depreciation deduction for the cost of the depreciable property over its useful life, which is frequently a lesser annual deduction than the rent called for. On the other hand, from the lessor's viewpoint, if the "lease" is a "sale," then the lessor does not have rental income, offset in whole or in part by depreciation deductions, but rather has capital gain (or in some cases ordinary income) on the sale.

It is obvious that if the parties embark upon a "lease" arrangement which they desire to have recognized as a lease, then they must act consistently in their tax returns; by the same token, should the Internal Revenue Service challenge the lessee's right to the rental deduction, the lessor should be prepared to protect himself by a claim

33. INT. REV. CODE OF 1954, § 1241.

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

35. Wells Fargo Bank & Union Trust Co. v. Commissioner, 163 F.2d 521 (9th Cir. 1947); Business Real Estate Trust of Boston, 25 B.T.A. 191 (1932).

for refund which is likely to give him more favorable tax treatment if the transaction is in fact determined to be a sale.

One of the most difficult problems for the lessor when filing his tax return is deciding whether the transaction is a lease rather than an installment sale. In order for a taxpayer to report a sale on the installment method of accounting, *i.e.*, reporting only a proportionate part of the profit as each payment is received, the taxpayer must indicate in his income tax return the adoption of the installment method in the first taxable year in which he makes the installment sale.³⁶ If the taxpayer does not make a timely election to use the installment method, then the Internal Revenue Service may contend that the value of the purchaser's obligation is immediately reportable, in the year of the sale, as gain or income.³⁷ Obviously, advice cannot be given in a vacuum as to the matter of whether the lessor should include a statement in his return electing the installment method with respect to a transaction which may or may not be deemed to constitute a sale. A careful analysis of the danger of exposure to installment sale treatment is obviously the first requisite.

The Internal Revenue Service has indicated certain criteria which it will apply in determining whether a "lease" is an installment sale.³⁸ The position of the Service is that a sale is indicated by some or all of the following:

- (a) if the lessee acquires an equity in the property;
- (b) where the rental payments are more than "reasonable rent";
- (c) if the lessee has an option to purchase and the purchase price is nominal or small, relative to "rental" payments or to fair market value at the option date;
- (d) where the rental payments are equivalent to a financing cost for the purchase of the property with a reasonable interest rate.³⁹

These tests are obviously quite indefinite. It is particularly significant to note that the position of the Service, although somewhat questionable, envisions treatment of a lease as a sale where the lessee acquires an "equity" in the property, even though there is no option

36. Treas. Reg. § 1.453-8 (1958).

37. But see cases holding that where the sale is on a contract without a note, income is reportable only in the year of receipt of payments: Estate of Clarence W. Ennis, 23 T.C. 799 (1955); Nona B. Wood, 24 P-H Tax Ct. Mem. 969 (1955); Nina J. Ennis, 17 T.C. 465 (1951). But see George L. Castner Co., 30 T.C. 1061 (1958), holding the rule not to be applicable to an accrual basis taxpayer. See also Colborn, Fleming, Katcher, & Merritt, *Buying and Selling a Corporate Business: A Survey of Tax and Non-Tax Implications*, 10 WEST. RES. L. REV. 123, 136-37 (1959), and articles therein cited.

38. Rev. Rul. 540, 1955-2 CUM. BULL. 39.

39. A recent ruling with possibly broad implications is Rev. Rul. 59-345, 1959 INT. REV. BULL. NO. 42, at 9, in which a three party arrangement for construction of a building to be leased to the government was considered. It held the builder (who sold to the investor-lessor) had ordinary income as a construction profit; the investor-lessor was not entitled to depreciation; and the lessee (the Government) was, in effect, the real owner of the property. As to a similar holding on the builder's profit see George K. Heebner, Jr., 32 T.C. No. 109 (Sept. 10, 1959).

to purchase. On the other hand, the rules developed by the courts have not been appreciably more definite. Thus, there are court decisions which recognize transactions as leases, against the charges of the Internal Revenue Service that the arrangement was an installment sale; in such cases, the courts apply the test of whether there was an "intent to purchase."⁴⁰ Nevertheless, the Tax Court has recognized, in a decision in which the Commissioner acquiesced, that an option to purchase does not in itself disqualify a lease.⁴¹ It may also be of some comfort to know that in some cases the Service will give advance rulings that a lease will be recognized as a lease and not as a sale. However, it is probably useless to apply for a ruling unless one can make out a clear-cut case for a lease.

SPECIAL PROBLEMS OF RENT WHERE PARTIES ARE RELATED

A discussion of rental problems in connection with leases would not be complete without a final reference to problems that arise where the lessor and lessee are related. The matter of timing of the lessee's deductions has already been referred to.⁴² In addition, the amount of the rent is a matter requiring particular consideration where the parties are related, because the Service may contend that a claimed rental deduction is "unreasonable." Under the statute,⁴³ a deduction is allowed for "rent" and there is no requirement, as there is in the case of compensation, that the amount must be "reasonable" in order to be an allowable deduction. Nevertheless, where the Service believes that an amount is in excess of a "reasonable rent" it may attack part of the payment as being something different in character than rent, such as a dividend (where the lessor is a stockholder), or a gift (where the lessor is a member of the family), or as compensation (which may be disallowed in whole or in part as unreasonable compensation where the lessor is an officer or employee). Thus, in preparing a lease between related parties, it is necessary to buttress the rental provision with evidence that the terms of the lease providing for rent are reasonable under the circumstances existing at the time the lease is entered into. The courts have indicated that where the amount of the rent is arrived at on an arm's-length basis or is reasonable by objective standards, the rent will be recognized as such regardless of the relationship between the parties.⁴⁴

40. *Breece Veneer & Panel Co. v. Commissioner*, 232 F.2d 319 (7th Cir. 1956); *WBSR, Inc.*, 30 T.C. 747 (1958). But "leases" were held sales in: *Haggard v. Commissioner*, 241 F.2d 288 (9th Cir. 1957); *Ersel H. Beus*, 28 T.C. 1133 (1957). For a general discussion of leasing techniques see GREENFIELD & GRIESINGER, *SALE-LEASEBACKS AND LEASING IN REAL ESTATE AND EQUIPMENT TRANSACTIONS* (1958).

41. *Cf. Edward E. Haverstick*, 13 B.T.A. 837 (1928), *acq.*, VIII-1 CUM. BULL. 19 (1929).

42. See note 28 *supra* and accompanying text. For a discussion of the amortization of leasehold improvements where the lessee and lessor are related see note 22, p. 192.

43. INT. REV. CODE OF 1954, § 62.

44. *Southern Ford Tractor Co.*, 29 T.C. 833 (1958), *acq.*, 1958-2 CUM. BULL. 7.