

Tax Court Levels Taxpayer's Weak Theories in Rent Accrual Case

By David K. Burton

Reprinted from *Tax Notes*, September 28, 2015, p. 1521

Tax Court Levels Taxpayer's Weak Theories in Rent Accrual Case

By David K. Burton



David K. Burton

David K. Burton is a partner with Akin Gump Strauss Hauer & Feld LLP. He thanks Anne Levin-Nussbaum of Akin Gump for her helpful comments during the drafting of this article.

In this article, Burton analyzes a decision in which the Tax Court rejected a taxpayer's attempts to defer recognizing taxable income for a \$1 million lease payment that was made at the option of the lessee and resulted in a reduction in subsequent rents. Burton endorses the Tax Court's conclusion and describes how, with appropriate lease drafting, the taxpayer could have used section 467 and related regulations to achieve its desired result.

The Tax Court's recent decision in *Stough v. Commissioner*¹ illustrates the traps for the unwary taxpayer in structuring commercial leases and the consequences of failing to review a tax return prepared by a professional tax adviser.

The taxpayer in *Stough* was a commercial real estate developer and landlord. The taxpayer entered into a 10-year lease of commercial real estate in North Carolina that was constructed for and at the direction of the lessee. Rent payments were calculated according to a formula based on the taxpayer's construction costs. The lease gave the lessee an option to reduce its rent payments over the 10-year lease term by making an upfront payment of part of the property's construction cost.

Exercising that option, the lessee made an upfront payment of \$1 million shortly after occupying the premises. The Tax Court agreed with the IRS that the entire \$1 million was taxable income in the year of receipt. The taxpayer could have avoided that result through proper structuring under section

467, spreading out his income from the \$1 million payment over the 10-year term — and without changing the timing or amount of the rent payments.

On December 15, 2006, the lessee and the taxpayer's wholly owned S corporation (the landlord) entered into a development agreement that included the lessee's requirements for the construction of the property. The proposed form of lease was included as an exhibit to the development agreement. The landlord obtained a commercial loan from PNC Bank to fund the construction.

The landlord received a certificate of occupancy for the newly constructed building on February 19, 2008, and the lessee moved in on an unspecified date in February. The lessee commenced paying rent on March 1, 2008. On April 17, 2008, the lessee exercised its option to make a prepayment to the landlord to reduce future rent payments. The form of lease under which the lessee made the payment did not specify a minimum or maximum payment amount.² The lessee opted to pay \$1 million, which was deemed to reduce the landlord's construction costs. Because the rents were based on a formula applied to the landlord's construction costs, the payment would reduce the amount of rent the lessee owed over the remaining lease term.³

The lease's most relevant characteristic was that it merely referred to when and in what amount the rent was payable, with no reference to how to allocate the rent. Thus, the lease is similar to most leases signed in the United States.

The taxpayer used the full \$1 million prepayment from the lessee to repay part of a commercial loan from PNC Bank. The lessee issued the landlord a Form 1099-MISC that included the \$1 million option payment as rent in and for 2008. The taxpayer's CPA prepared its 2008 tax return claiming a \$1

²The only requirement regarding the timing of the payment connected with the option was that it had to be before the "commencement date." The Tax Court's opinion does not include a definition of the commencement date. However, because the payment was made after the lessee occupied the property but before the execution of the definitive lease, it would appear that "commencement date" referred to the date the definitive lease was executed.

³The lease was actually executed by the parties on June 6, 2008; however, the \$1 million prepayment option in the "form of a lease" that was included as an exhibit to the development agreement was unchanged in the executed lease.

¹144 T.C. No. 16 (2015).

million “contribution to construct” expense and including the \$1 million payment from the lessee as rent.

The IRS began auditing the taxpayer’s 2008 tax return on April 16, 2010. On November 18, 2010, the landlord’s chief operating officer wrote the lessee requesting a reissuance of the Form 1099-MISC for 2008 to report the \$1 million “as a buy-down reimbursement” of construction costs (as opposed to how it was originally reported, which was as rent). The lessee reissued the 2008 Form 1099-MISC, as requested.

In 2011 the IRS issued a notice of proposed deficiency that disallowed the \$1 million principal repayment as a deductible expense but that increased the basis in the commercial real estate by \$1 million, resulting in \$87,868 of additional depreciation in 2008.

Analysis of Lease Tax Issues

The taxpayer before the Tax Court made three weak assertions for not including the \$1 million option payment in his 2008 taxable income.

First, the taxpayer argued that the \$1 million was a leasehold improvement that wasn’t subject to current taxation. However, for that to be true, first the \$1 million would need to have been for an “improvement” and not a cash payment to the landlord; and second, it would need to have been the parties’ intent that the improvement was not meant to be in lieu of rent.⁴

This rule is demonstrated by the following simple examples:

1. Tenant offers to remodel the kitchen if the landlord waives the payment of rent for four months.
2. Tenant on its own initiative remodels the kitchen with no reduction in rent.

In the first example, the fair market value of the remodeling is considered to be “rent” and is taxable to the lessor in the year the remodeling occurs.

In the second example, the value of the kitchen remodeling is not currently includable in the landlord’s taxable income. The theory is that the landlord receives no value from the remodel until the expiry of the lease, and at that time, the landlord would have taxable income from being able to sell or rent the property for more due to whatever value remained from the remodel.

In *Stough*, it was apparent that the parties intended for the \$1 million to be treated as rent, given that the payment resulted in a formulaic reduction in the amount of rent due over the 10-year term and

⁴See reg. section 1.61-8(c).

was provided for in the “rent” section of the lease. Also, the original Form 1099-MISC characterized it as a payment of rent, and the taxpayer originally reported it that way on his tax return.

After losing on that front, the taxpayer sought to invoke section 467 for his own benefit. This argument had two avenues under which the taxpayer could have achieved his desired result. First, the taxpayer invoked the urban legend that taxpayers may voluntarily “levelize” their accrual of rent using the constant rental accrual method in section 467. If successful, the taxpayer, rather than accruing the full \$1 million in 2008, would have accrued a constant or level amount in each of the 10 years of the lease. The annual level amount would have been determined so that when the amount was discounted at 110 percent of the applicable federal rate⁵ that was in effect on the lease’s effective date, its present value would have been \$1 million.⁶

Congress enacted section 467 to provide the IRS a weapon for when a taxpayer structures specific types of leases with lower rents in the early years and higher rents in the later years to create a tax deferral benefit for the lessor. Because the constant rental accrual rule is a tool to combat tax avoidance, it may only be invoked by the IRS based on its determination that the rental pattern in the lease is a function of tax avoidance.⁷ Thus, the court ruled that the taxpayer could not invoke it and debunked the myth that a taxpayer may invoke levelization of a lease.

Further, even if the IRS had wanted to invoke the constant rental accrual method for the taxpayer’s lease, section 467 would not have permitted it to do so.

Section 467 provides that the constant rental accrual method applies only to a “disqualified leaseback or long-term agreement.”⁸ The taxpayer’s lease was neither. It was not a disqualified leaseback because the lessee did not have an ownership interest in the leased property before the transaction,⁹ and it was not a long-term agreement because the 10-year term was less than 75 percent of the 19-year statutory recovery period for real estate.¹⁰

Next, the taxpayer tried to invoke the proportional rental accrual rules.¹¹ However, the taxpayer’s analysis was flawed because the lease was

⁵An interest rate published monthly by the IRS.

⁶See reg. section 1.467-3(d).

⁷Reg. section 1.467-3(a) (“may not be used in the absence of a determination by the Commissioner”).

⁸Section 467(b)(3)(A), reg. section 1.467-3(a).

⁹Section 467(e)(2).

¹⁰Section 467(e)(3)(A).

¹¹See reg. section 1.467-2.

outside the purview of the proportional rental rules (and it is unclear how the rules would have been applied to the rent).

To understand the proportional rental accrual rules, one must start with the premise that the section 467 regulations permit a properly drafted lease to divorce the payment of rent from the allocation (that is, the accrual) of rent. For instance, rent could be paid and allocated as follows:

Years	Rent Allocation	Rent Payment
1	\$90	\$500
2	\$90	
3	\$100	
4	\$110	
5	\$110	
Total	\$500	\$500

In this example, \$500 is payable as rent in the first year, but only \$90 of rent accrues for income tax purposes in that year.

The section 467 regulations permit this gamesmanship to a degree, but after a point require a deemed interest charge for income tax purposes to reflect the time-value benefit of such structuring.

In the example above, the interest charge that would accrue after the first year¹² would be \$8.20 (that is, \$500 less \$90, or \$410) which is the section 467 loan balance, multiplied by 110 percent of the midterm (for a five-year lease) applicable federal rate for August 2015 or 2 percent (110 percent of 1.82 percent).¹³

Because the lessor has \$410 more in cash than allocated rent, the lessor is economically considered a borrower. Therefore, the interest would be a deductible expense to the lessor and an item of income to the lessee.¹⁴

That allocation yields a particularly attractive result for the lessor in the first year of the lease — that is, \$500 of cash, but only \$90 of taxable rental income. In the second year, the taxpayer would also be entitled to a deduction of \$8.20 for the interest on

the deemed loan. Also, the taxpayer would be entitled to a deemed interest deduction in each subsequent year based on the principal balance of the deemed loan.

The problem for the taxpayer was that his lease did not separate the rent allocation from the rent payment because it only referred to the timing and amount of the rent payment.

When a lease refers only to the timing and amount of payments (not allocations), the allocation is deemed to be the same as the payment.¹⁵ Thus, there is no divorcing of allocations and payment in such leases, and they escape the proportional rental rules and related deemed interest concepts.¹⁶

Further, it is not clear how the proportional rental rules would have applied to this lease. The lease had no allocation of rent, so what amount would have been taxable income to the lessor in the first year if not the \$1 million from the option payment, plus the other rent payable?

How the Lease Should Have Been Structured

If the taxpayer had been properly advised and the lessee was willing to be flexible with its pattern of rental deductions, the taxpayer could have deferred the \$1 million payment plus other rents and benefited from a deemed interest deduction.

Here are the steps:

1. Have separate payment and allocation schedules for rent, with each party agreeing that the allocation schedule provides for the rent that accrues for income tax purposes. The two schedules must have the same total.¹⁷
2. Reach an agreement with the lessee about the allocation of rent, which is distinct from the payment of rent. The lessor is best served by allocating as much rent as possible as late in the lease as possible. The taxpayer's lease is not a "disqualified leaseback or long-term agreement,"¹⁸ but if this hypothetically optimized lease were a disqualified leaseback or long-term agreement, the allocation schedule would need to meet a safe harbor in order to avoid the risk of the IRS "levelizing" the annual allocation and causing the lessor to

¹²Reg. section 1.467-1(e)(2)(i)(A).

¹³Note, if the lessee were a tax-exempt entity (or a "tax-exempt controlled entity") within the meaning of section 168(h), the applicability of the section 470 loss trapping rules would have to be evaluated. Among other reasons, in such a lease if the maximum section 467 "loan balance" during the term (*i.e.*, \$410) is in excess of 20 percent of the basis of the leased property as of the inception of the lease, the section 470 loss trapping would apply. *See* section 470(c)(2), (d)(1)(C). Section 470 operates much like the passive activity loss rules of section 469: trapping deductions that exceed taxable income until the taxpayer sells the leased property (or it ceases to be leased to a tax-exempt entity), at which time the trapped losses are released. *See* section 470(a), (b), and (e).

¹⁴*See* reg. section 1.467-1(e).

¹⁵Reg. section 1.467-1(c)(2)(ii).

¹⁶Just because a lease avoids the "proportional rental" rules does not mean the lease would escape the "constant rental accrual" rules (*i.e.*, levelization). As explained above, levelization can only be imposed by the IRS. The proportional rental rules are formulaic and apply even in the absence of an audit. *See* reg. section 1.467-2(a), -3(b)(1)(ii).

¹⁷*See* reg. section 1.467-1(c)(ii)(2) ("the total amount of fixed rent [allocated] is equal to the total amount of fixed rent payable under the lease").

¹⁸*See* reg. section 1.467-1(d)(2)(i), -3(b).

have taxable income earlier than it otherwise would. In real estate, the safe harbor is that the average annual allocated rents are at least 85 percent and no more than 115 percent of the average annual allocated rents during the first half of the lease.¹⁹

3. In the lease in *Stough*, the taxpayer could have effectively had a rent holiday for the first nine years with all of the rent allocated to the last year because it is not a disqualified leaseback or long-term agreement. However, if the hypothetical optimized lease were a disqualified leaseback or long-term agreement, the taxpayer could have still structured the lease with a one-year rent holiday.²⁰ Although in common parlance the term “rent holiday” refers to a period when rent does not have to be paid, the section 467 regulations permit a holiday from the allocation of rent²¹ (even if rent is still payable during the holiday period).

4. Then the parties would have needed to include in the lease an interest charge for income tax purposes on the prepaid rent.²² The interest charge would have had to be at least 110 percent²³ of the long-term²⁴ applicable federal rate for the month the lease is binding.²⁵

5. The hypothetical lease would have to be executed on or before the date the lessee occupies the property, so that the amount and timing of rental allocations and payments

were clearly determined and agreed upon as of the “agreement date”²⁶ and the “lease date.”²⁷ That execution of the lease addresses two issues. First, the lack of a definitive executed agreement either could mean there is no schedule of allocated rent or could similarly raise the question whether the purported allocated rent in the unexecuted agreement meets the requirement of being rent “for which the lessee becomes liable on account of the use of the property.”²⁸ Second, the later execution of the definitive agreement could raise the question whether the execution was a “substantial modification”²⁹ requiring recomputation of the tax attributes as discussed below.

6. In the hypothetical lease, if the lessee wanted to retain optionality for a voluntary payment that reduces future rents, the optional payment should be characterized as a unilateral option for purposes of the section 467 regulations. Then the regulations require the parties to have initially determined their tax treatment based on the more likely to occur as of the date the lease is binding — whether the lessee exercises the prepayment option or not.³⁰ Unlike the lease in *Stough*, one would hope the lessee would at least agree to fix the amount and date of the payment for the option.

If the parties determined that the optional payment was the more likely scenario, their tax computations for the lease would include the payment and the resulting reduction in subsequent rents. Then if lessee did not exercise the option, it would be a modification³¹ of the lease for section 467 purposes that would likely be substantial.³² Alternatively, if they determined the likely outcome was that the option would not be exercised, their tax computations for the lease would exclude the option payment. And if the lessee exercised the option, that election would be a modification of the lease for section 467 purposes that would likely be substantial.

The section 467 regulations treat a substantial modification as if the parties have entered into a new lease. The consequences of that treatment

¹⁹See reg. section 1.467-3(c)(4)(ii). If the leased property were not real estate, the allocation percentages would have been 90 percent and 110 percent. Reg. section 1.467-3(c)(4)(i). Moreover, the transaction is not a leaseback or long-term agreement. Therefore, the taxpayer’s lease is not technically subject to the 90/110 (for personal property) and 85/115 (for real property) safe harbors, and in theory all the rent could have been allocated to the 10th year (the last year). However, the lessee would have been paying rent without a tax deduction until the last year.

²⁰Reg. section 1.467-3(c)(4)(ii). The holiday would have been limited to three months, if the property was not real estate.

²¹Reg. section 1.467-3(c)(4)(iii)(c) (“an initial rent holiday period and any rent[s] [or lack thereof] allocated to such period are disregarded for purposes of” the 85/115 (real estate) or 90/110 (personal property) safe harbors).

²²Alternatively, the taxpayer could have relied on the deemed interest charge rules of reg. section 1.467-1(d)(2)(ii), -2(c), -4(a)(1), -4(b), -4(c)(2). In that case, the interest rate would have been 110 percent of the applicable federal rate as of the outset of the lease. See reg. section 1.467-2(e).

²³Reg. section 1.467-2(b)(1)(ii)(B).

²⁴Reg. section 1.467-2(e)(1)(ii). The short-term rate applies to leases of three years or less; the midterm rate applies to leases over three years but less than nine years; and the long-term rate applies to leases over nine years. The “term” includes lessor “put” renewal options and any option the lessee is expected to exercise. Reg. section 1.467-1(h)(6).

²⁵Reg. section 1.467-2(e)(1).

²⁶See reg. section 1.467-1(h)(1) (the agreement date is the date there is a “binding written contract” or other agreement that substantially sets forth the terms).

²⁷See reg. section 1.467-1(h)(5) (the lease date is the date the lessee has the right to use the property).

²⁸Reg. section 1.467-1(c)(2)(ii)(A)(2).

²⁹See reg. section 1.467-1(h)(5).

³⁰See reg. section 1.467-1(h)(3)(v).

³¹Reg. section 1.467-1(f)(5)(i).

³²Reg. section 1.467-1(f)(5)(ii).

include updating the interest rate to 110 percent of the applicable federal rate in effect for the date of the substantial modification and for a true-up adjustment.³³ A substantial modification can be a headache from a tax computational perspective. The preamble to the section 467 regulations describes the consequences of a substantial modification as:

the lessor and lessee must take pre-modification items (generally, rent for periods before the modification, interest thereon, and payments allocable thereto (whether made before or after the modification)) into account under the method of accounting used before the modification. In computing section 467 rent, section 467 interest, and the amount of the section 467 loan with respect to post-modification items, only post-modification items are taken into account. In addition, the parties to the agreement are required to take into account adjustments necessary to prevent duplications and omissions resulting from the modification.³⁴

However, as the lessee in *Stough* exercised the option within two months of occupying the property (and in this hypothetical transaction involving an optimally structured lease, during the holiday

from the allocation of rent), it suggests either that the election of the optional \$1 million payment was the more likely scenario (so it is not a modification) or that the computational requirements would be lessened because the lease had only been in effect a short time before the election.

Penalty and Tax Return Review

The taxpayer was apparently poorly advised in structuring the lease, and according to his own testimony, he only briefly reviewed the 2008 tax return prepared by his CPA. Therefore, despite a finding that he relied on a qualified accountant to prepare the return, the court determined the taxpayer did not have reasonable cause³⁵ regarding his tax return positions, and it imposed an accuracy-related penalty of 20 percent.³⁶

Thus, if a taxpayer has a tax professional prepare his return to be able to assert that he reasonably relied on a qualified professional and should not be subject to penalties,³⁷ he should take the time to review the return in detail and document that review. One way to do this would be to schedule a conference call with the professional to review the return before it is filed and retain a record of when the call occurred and its duration.

³³See generally reg. section 1.467-1(f).

³⁴T.D. 8820.

³⁵See section 6664(c)(1).

³⁶Section 6662(a).

³⁷See section 6664(c)(1).

SUBMISSIONS TO TAX NOTES

Tax Notes welcomes submissions of commentary and analysis pieces on federal tax matters that may be of interest to the nation's tax policymakers, academics, and practitioners. To be considered for publication,

articles should be sent to the editor's attention at tax.notes@taxanalysts.org. Submission guidelines and FAQs are available at taxanalysts.com/submissions.