



The lease option and the potential tax issues presented if the IRS decides to recharacterize

November 06, 2009 - Financial Digest

A lease with an option to buy—commonly referred to as a "lease option"—offers several potential advantages for buyers and sellers of commercial real estate, particularly in a down market.

A lessor/seller, for example, can expand the pool of potential buyers and generate more cash-flow than with a straight lease. And for a lessee/buyer, it provides an opportunity to acquire property for a smaller upfront investment, to tie down property while putting together traditional financing, or to "test-drive" property during the option period with no commitment to buy.

Determining whether a lease option is right for you depends on a variety of economic, financial, and tax factors. The purpose of this article, however, is not to discuss the relative pros and cons of a lease option versus an outright sale. Rather, we'll look at the factors the IRS considers in deciding whether to recharacterize a lease option as a sale. If recharacterized by the IRS, there can be some unpleasant tax surprises for both parties.

Economic Reality Check

To avoid an IRS challenge, it's important to structure a lease option carefully to be sure that it has "economic reality." If the IRS concludes that the arrangement is, in economic reality, a sale, then it may recharacterize it as such, triggering the tax consequences discussed below.

In the typical lease option transaction, the parties enter into a lease agreement for the property and, at the same time, the lessee/buyer purchases an option to buy the property for a specified price at the end of the lease term or possibly sooner.

To determine whether an arrangement is a lease-option or a sale, the IRS examines all of the facts and circumstances surrounding the transaction. Circumstances that suggest a sale include:

- * The arrangement calls for above-market rent and a below-market option exercise price. This indicates that the lessee/buyer is, in effect, acquiring equity in the property because it wouldn't make economic sense not to exercise the option.
- * The lease requires the lessee/buyer to make substantial improvements to the property. Again, it wouldn't make economic sense to forgo the option, because exercising it is the only way the lessee/buyer can recoup his or her investment.
- * Total lease payments plus the exercise price are approximately equal to the property's fair market value. A bargain price by itself doesn't convert a lease option into a sale. But if the exercise price plus the total lease payments are approximately equal to the property's value, the arrangement looks suspiciously like a sale.
- * The option price and lease payments are credited toward the exercise price. Even if the rent and exercise price are set at fair market value, this arrangement may look more like an installment sale with a balloon payment. But the lessee/buyer may be able to support lease option treatment by demonstrating that at the time the transaction was consummated, a cash sale would not have been

economically feasible.

Keep in mind that no single factor is determinative, and that additional factors not listed above may also influence the result.

Even if the evidence suggests a sale, the parties can overcome this by showing that at the time they entered into the transaction, they believed in good faith that the rent and the exercise price reflected fair market value. Practically speaking, though, subjective intent is very difficult to prove, especially when the facts appear to contradict it.

Tax Implications

If the IRS recharacterizes a lease option as a sale, it's treated for tax purposes as an installment sale consummated on the date the parties entered into the transaction. The option payment is treated as the down payment and the lease payments are treated as part principal and part interest according to the imputed interest rules.

The lessee/buyer loses the ability to deduct the lease payments as a business expense, although this is partially offset by a tax deduction for imputed mortgage interest. Also, since the lessee/buyer is now treated as the owner, he or she is entitled to deduct depreciation and operating expenses. The portion of the lease payments that are treated as loan principal are added to the purchase price and increase the lessee/buyer's tax basis in the property.

The lessor/seller will be required to use the installment method to report the sale for tax purposes, in most cases treating a portion of the lease payments as a taxable capital gain. Although this may result in a lower tax rate, the lessor/seller also loses the ability to deduct depreciation and operating expenses.

Substance Over Form

Just because you characterize a transaction as a lease option doesn't necessarily mean that the IRS will agree. The best way ensure that a lease option withstands IRS scrutiny is to work with qualified appraisers to set the lease payments and exercise price at fair market value and to avoid crediting lease payments or option payments toward the exercise price.

Robert Gilman, CPA is a partner at Anchin, Block & Anchin, LLP, New York, N.Y.

New York Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540