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Can Leasehold Improvements by a Lessee Be Treated as Rent?

-by Neil E. Harl

In theory, the cost of investments in a leasehold should be recovered over the life of the improvement except where more rapid recovery is allowed for purposes of stimulating the economy or a slower rate of cost recovery is intended to reduce inflationary pressures. While the costs of leasehold improvements are ordinarily recovered by the lessor or the lessee, depending upon who provided the funds for the improvement, a 2009 Tax Court case has focused on another possibility – deducting the cost of the improvement made by the lessee as additional rent. The critical factor is whether there is a clear showing of intent that the cost of the improvements are to be treated as rent.

History of the conventional approach

Before 1987, capital expenditures made by a tenant (lessee) could be depreciated under the Accelerated Cost Recovery System (ACRS) if the eligibility requirements were met. If the recovery period was equal to or shorter than the term of the lease, regular ACRS depreciation could be claimed. In the event the recovery period was longer than the lease term, through 1986 the depreciation deduction was determined by dividing the unrecovered cost of the expenditures by the years remaining under the lease. In other words, the cost of an improvement could be depreciated over the term of the lease.

After 1986, the cost of improvements is recovered without regard to the lease term under rules generally applicable to other taxpayers for that type of property. Thus, with a lease of a farm building, the building is depreciated as 20-year property. Upon termination of a lease, if the lessee does not retain the improvements, the lessee computes gain or loss relative to the adjusted basis of the improvement at that time.

Improvements to a leasehold

In a 2009 Tax Court decision, a partnership facing losses on hotel partnership property negotiated an arrangement with the city to make specified improvements to the hotel property to improve the level of rentals in exchange for rent credits. The partnership was allowed to credit the cost of certain improvements against the annual rent in excess of a specified minimum amount.

The Tax Court noted that a taxpayer’s entitlement to depreciation deductions for leasehold improvements hinges, not on a legal title, but on a recognized investment in the property. The court stated that if a lessor makes improvements at the lessor’s own expense, the lessor is entitled to depreciation deductions on the property even though...
the lessee has the use and enjoyment of the improvements.\textsuperscript{12} If the lessee makes the improvements, even though the title vests immediately in the lessor, the lessee is not precluded from recovering the lessee’s investment through depreciation deductions.\textsuperscript{13}

The Tax Court explained that generally, where a lessee makes improvements to property leased by the lessee, the lessee is entitled to depreciation deductions rather than through a current business expense deduction.\textsuperscript{14} However, as the court noted, there is an exception where a lessee places improvements on real estate \textit{that constitute a substitute for rent}.\textsuperscript{15} In that case, the regulations\textsuperscript{16} provide that the cost of the improvements made in lieu of rent is rental income to the lessor.\textsuperscript{17} The regulations also make it clear that improvements in lieu of rent are a currently deductible business expense as rents paid.\textsuperscript{18} The court reasoned that, where improvements are in lieu of rent, the cost of the improvements is actually borne by the lessor (through the rent credits) and the lessee has no capital investment to depreciate.\textsuperscript{19}

The court emphasized that whether the cost of the improvements constitutes rent turns upon the intent of the parties to the lease.\textsuperscript{20} To ascertain whether the parties intended the amounts to be considered rent, the court examined the various lease documents and the surrounding circumstances. The Tax Court concluded that the partnership consistently treated the eligible improvements, both on its books and in its tax returns, as a deductible rent expense in the year that it obtained a rent credit for the cost of the eligible improvements. Moreover, the court indicated that was consistent with the express language of the lease documents which indicated that the eligible improvements were intended by the parties to the lease agreements to be in lieu of rent.\textsuperscript{21}

The court held that the partnership appropriately deducted the cost of the eligible improvements as rent expense in the year in which the eligible improvement was credited against rent.\textsuperscript{22}

\textbf{ENDNOTES}

\textsuperscript{1} The Economic Recovery Tax Act of 1981 arguably was such an exception. See Pub. L. No. 97-34, 95 Stat. 172 (1981). The 1981 Act recites, in the preamble, that the purpose of the legislation was “... to encourage economic growth through reduction of tax rates for individual taxpayers, acceleration of capital recovery of investment in plant, equipment, and real property, and incentives for savings, and for other purposes.” 95 Stat. 172 (1981).

\textsuperscript{2} I.R.C. § 168(i)(6), (8). See Prop. Treas. Reg. § 1.168-5(d). See generally 4 Harl, \textit{Agricultural Law} § 28.04(b) (Matthew Bender 2009); Harl, \textit{Farm Income Tax Manual} § 3.06 (Matthew Bender 2009 ed.).


\textsuperscript{4} Id.


\textsuperscript{7} I.R.C. § 168(i)(6), (8). See Nelson v. Comm’r, T.C. Memo. 2000-212 (could not depreciate assets over 10-years just because lease term was 10-years).

\textsuperscript{8} I.R.C. § 168(e)(1).

\textsuperscript{9} I.R.C. § 168(i)(8)(B).

\textsuperscript{10} Hopkins Partners, Cleveland Airport Hotel Limited Partnership, et al. v. Comm’r, T.C. Memo. 2009-107, hereinafter cited as Hopkins Partners.


\textsuperscript{12} Hopkins Partners, note 10 supra.

\textsuperscript{13} Id.

\textsuperscript{14} Treas. Reg. § 1.162-11(b).

\textsuperscript{15} Hopkins Partners, note 10 supra.

\textsuperscript{16} Treas. Reg. § 1.61-8(c).

\textsuperscript{17} Id.

\textsuperscript{18} Id. See McGrath v. Comm’r, T.C. Memo. 2002-231, \textit{aff’d in unpub. op.}, 2003-2 U.S. Tax. Cas. (CCH) ¶ 50,663 (5th Cir. 2003); Your Health Club, Inc. v. Comm’r, 4 T.C. 385, 390 (1944).

\textsuperscript{19} Hopkins Partners, note 10 supra.

\textsuperscript{20} Id.

\textsuperscript{21} Id.

\textsuperscript{22} Id.