Private Letter Ruling 8118023

This is in reference to a letter dated September 16, 1980, and subsequent communications submitted on behalf of the above named taxpayers requesting rulings under sections 162, 1031, 61, and 109 of the Internal Revenue Code.

Lessor is the legal owner of certain unimproved real estate (henceforth referred to as the `premises') that is to be leased to Lessees. Lessor is the trustee of a trust whose beneficiaries are F, R, M, J, and C. Lessor exercises no discretion with regard to the ownership, management, or control of the premises. Rather, the beneficiaries of the trust exercise control over the premises by performing the obligations of ownership themselves or by issuing directions to be carried out by Lessor.

Upon signing the lease the Lessees will deliver a security deposit of $y to the Lessor. If the Lessees fail to perform any of their obligations during the term of the lease, the Lessor may apply all or part of the security deposit in order to cure Lessees' failure. The Lessor will return Lessees' security deposit, with interest, upon the earlier of (1) the end of the term of the lease, or (2) the date upon which the Lessees complete improvements to the premises costing at least $y. The security deposit will be invested by the Lessor in an interest bearing account, or U.S. Treasury bills, notes, or bonds.

The lease provides that the Lessees may make certain improvements to the premises. Under the terms of the lease, the improvements are not to be deemed as or constitute rent. The improvements are to be the property of the Lessees during the term of the lease, and the property of the Lessor thereafter.

Lessees are not obligated to pay any rent during an initial period beginning on the date the term of the lease commences and ending on the earlier to occur of the date the premises are opened for business and the 270th day after the date of commencement of the term of the lease. Immediately after this initial period the monthly rent will be $ .125y per month. During a later period the rent will be increased to $ .2y per month, and during a final period ending on May 31, 2001, the rent will be further increased to $ .3y per month.

Lessees are given the option to purchase the premises for $ 16.5y in accordance with the provisions of a real estate sales contract (henceforth referred to as the `sales contract'). The sales contract provides that there shall be no set off or deduction of any kind or nature by Lessees against the purchase price of $ 16.5y. All of the provisions of the lease, including the obligation to pay rent, continue until the closing date of the sale.

Assuming Lessees exercise their option to purchase the premises, Lessor will have the right to convert the sales contract into an exchange contract at any time prior to the closing date by specifying one or more parcels of real estate which Lessor desires Lessees to purchase

(henceforth referred to as the `exchange property'). The exchange is intended to qualify for nonrecognition treatment to Lessor under section 1031 of the Code. Upon acquisition by Lessees of title to the exchange property, Lessees shall immediately convey such title to Lessor, and Lessor shall simultaneously convey Lessor's interest in the premises to Lessees in exchange for title to the exchange property. The instruments of conveyance of title to the exchange property from Lessees to Lessor and of Lessor's interest in the premises from Lessor to Lessees shall be recorded simultaneously.

The lease agreement and the sales contract will be amended in several material respects as follows:

(1) A new paragraph will be added to the lease representing that the stated monthly rent and the stated purchase price of $ 16.5y are each the result of arms-length negotiations between unrelated parties as Lessor and Lessees, that the monthly rent is the fair market monthly rent for the premises as of the date of the signing of the lease, and that the purchase price is the fair market sales price of the premises.

(2) The lease will be amended to provide that the option to purchase may only be exercised during the month of July, 1982, and the sales contract will be amended to provide that the closing date will be on the last day of the sixth month after the month in which the option is exercised.

(3) The lease will be amended to contain a representation that the period between the exercise of the option to purchase the premises and the closing date is for the sole purpose of facilitating the transaction by allowing Lessees time to obtain (i) financing for the purchase of the premises or (ii) like-kind property (acceptable to Lessor) for an exchange pursuant to section 1031 of the Code.

The determination of whether a particular transaction is a lease or a financing transaction (a sale or a loan) is to be made by reference to the relative distribution between the parties of the relative burdens and benefits of ownership. Helvering v. Lazarus & Co., 308 U.S. 252, 84 L. Ed. 226, 60 S. Ct. 209, 1939-2 C.B. 208 (1939), 1939-2 C.B. 208; Sun Oil Co. v. Commissioner, 562 F. 2d 258 (3rd Cir. 1977), cert. denied 436 U.S. 944 (1978). In Lazarus, the Supreme Court said that `In the field of taxation, administrators of laws, and the courts, are concerned with substance and realities and formal written documents are not rigidly binding.' 308 U.S. at 255, 1939-2 C.B. at 209.

Based solely on the facts and representations as stated above, we conclude that the lease agreement is a true lease rather than a sale of the premises.

Section 61(a) of the Internal Revenue Code provides that gross income means all income from whatever source derived, including rents. Section 1.61-8(b) of the Income Tax Regulations provides that gross income includes advance rentals which must be included in income in the year of receipt. However, an amount deposited with a lessor merely as security for the lessee's performance under the lease agreement where the lessor is strictly accountable for and required to return the deposit will not be treated as rental income. See John Mantell v. Commissioner, 17 T.C. 1143 (1952), acq., 1952-1 C.B. 3; Rev. Rul. 72-519, 1972-1 C.B. 32.

In the present case, the security deposit is delivered to Lessor in order to secure Lessees' performance under the lease. The Lessor may use the Lessees' deposit in order to cure Lessees' nonperformance, otherwise the deposit must be returned to Lessees upon the occurrence of either one of two events. Therefore, the security deposit does not constitute rental income.

Section 109 of the Code provides that gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee. Additionally, a lessor does not recognize taxable income because of the increased value of the real property on the date the improvements are made. See Blatt Co. v. U.S., 305 U.S. 267, 83 L. Ed. 167, 59 S. Ct. 186, 87 Ct. Cl. 747, 193-1 C.B. 221 (part 1) (1938) .

Section 1.109-1(a) of the Income Tax Regulations provides that the section 109 exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

Under the lease agreement, the improvements are not to be construed as the payment of rent by Lessees. Therefore the value of the improvements are not includible in gross income.

Based upon the lease agreement and the citations of authority above, we conclude that the security deposit and the value of the improvements on the date the improvements are made or when the lease is terminated are not includible in gross income.

Section 162(a)(3) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Section 1.162-11 of the regulations provides, in part, that taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter.

Accordingly, we conclude that the monthly rent paid by Lessees pursuant to paragraph 15 of the lease and any real estate taxes paid by Lessees pursuant to paragraph 24 are deductible by Lessees under section 162 of the Code, provided such amounts are ordinary and necessary expenses paid or incurred in carrying on any trade or business.

Section 1031(a) of the Code provides that no gain or loss will be recognized upon the exchange of property held for productive use in a trade or business, or for investment, for property of a like kind to be held either for productive use in a trade or business or for investment. This rule does not apply to stock in trade or other property held primarily for sale, or stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidence of indebtedness or interest.

A prearranged transfer is not, per se, prohibited from meeting the requirements of section 1031 and the regulations. A taxpayer may agree to transfer his property to a third party on the condition that the third party obtain some particular property to be exchanged for the taxpayer's property, and meet the requirements for nonrecognition of gain or loss under section 1031. Rev. Rul. 75-291, 1975-2 C.B. 332; Rev. Rul. 77-297, 1977-2 C.B. 304; but cf. Rev. Rul. 77-337, 1977-2 C.B. 305 (prearranged transfer that did not meet the requirements of section 1031).

Based upon the lease agreement and the facts as stated above, we conclude that Lessor is not precluded from nonrecognition treatment under section 1031 of the Code merely because the Lessees will have possession of the premises prior to the exchange. This possessory interest does not constitute ownership for tax purposes. Therefore, a true simultaneous exchange of the premises for the exchange property will occur as described above.

In addition, we conclude that Lessor is not precluded from nonrecognition treatment under section 1031 of the Code merely because Lessees will be acquiring property specifically to complete the exchange. See Rev. Rul. 75-291 and Rev. Rul. 77-297. However, no opinion is expressed as to whether Lessees will be acquiring the exchange property on their own behalf (rather than as Lessor's agent), as required by Rev. Rul. 75-291 and Rev. Rul. 77-297, since this question is one of fact. In addition, since the specific exchange property to be acquired by Lessees has not been identified, no opinion is expressed as to whether such property will be `like-kind' property under section 1031 of the Code.

Therefore, we conclude that the transaction described above will qualify for nonrecognition treatment under section 1031 of the Code, provided the following requirements are satisfied:

(a) the premises and the exchange property are of a like kind,

(b) Lessees acquire the exchange property on their own behalf rather than as Lessor's agent, and

(c) the premises and the exchange property are each held for investment or for productive use in trade or business

Except as specifically ruled above, no opinion is expressed as to the federal income tax consequences of the transaction described above under any other sections of the Code. Also, no opinion is expressed as to the classification of the trust for federal income tax purposes. See Rev. Rul. 64-220, 1964-2 C.B. 235, reclassifying a purported trust as a partnership.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the income tax returns filed by Lessor, F, R, M, J and C for the year in which the transaction occurs.

Anthony Manzanares, Jr.

Chief, Individual Income Tax Branch