

Lease Option or Installment Sale?

Leasing

Determine the "Economic Realty" of Your Lease-Option Transactions--or the IRS Will.

By Donald J. Valachi, CCIM |

A lease with an option to purchase, also known as a "lease option," is a common real estate arrangement. The important income tax question in lease-option transactions is whether the tenant is leasing the property or, as an economic reality, an installment sale has occurred prior to the tenant exercising the purchase option.



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The answer to this question depends upon an analysis of all the surrounding factors, because no single factor determines whether or not a lease option is, in economic reality, a sale. As Gerald J. Robinson, a noted tax authority, observed in the Federal Income Taxation of Real Estate, a determination includes studying many factors, "including the terms of the lease, the surrounding economic circumstances, and the intent of the parties....A collection of telltale signs leads to the conclusion that exercise of the option was virtually certain from the outset, so that treating the entire transaction as a sale is warranted."

If a lease option is treated as a sale, there are two important tax implications:

- The timing of the transfer of ownership of the property is changed. With a "true" lease option, ownership transfers when the option is exercised. If the transaction is treated as a sale, then ownership transfers when the parties execute the original agreement. (For an examination of the tax consequences of a "true" lease option, see "Consider the Consequences of Your Options," CIREJ, Spring 1995, page 21.)
- The nature of the option payment and the rent payments during the lease period are changed.

Because the tax treatment of a purchase transaction is so different from a lease transaction, it is important to understand the factors that may lead the Internal Revenue Service (IRS) to characterize a lease-option transaction as a sale.

Lease Option or Sale?

As already noted, the basic tax question in lease-option transactions is whether or not the IRS will assume a sale occurred before the tenant actually exercises the option to purchase. In general, if all of the economic circumstances at the time the lease-option agreement is executed indicate a high probability that the tenant will exercise the option, the IRS will very likely characterize the lease option as a sale. If the tenant acquires equity in the property during the period of the lease, it increases the likelihood that he will exercise the option to purchase, because this is the only way to protect his "investment."

Lease Terms. Rent payments are deductible only for a property for which the tenant does not take title or hold equity interest. Two factors indicate that a tenant is acquiring an equity interest in a property:

- payment of rent in an amount that is substantially in excess of the actual fair market rental value of the property; and
- the sum of the rent payments and the option price approximate the fair market value of the property.

The linking of inflated rents and a below-market option price tends to corroborate that the tenant is acquiring an equity interest in the property. For example, assume that Adams agrees to lease an industrial building from Baker for two years at an annual rent of \$120,000. At the same time, Adams pays Baker \$20,000 for an option to purchase the property at the end of two years for \$240,000. At the time the lease-option agreement is executed, the fair market value of the property is \$500,000 and the annual fair rental is \$50,000.

Adams acquires \$70,000 of equity per year over the two-year lease period (\$120,000 annual rent payment - \$50,000 fair market rent). In addition, the total payments made by Adams equal the value of the property (\$20,000 option payment + \$120,000 rent payment [year #1] + \$120,000 rent payment [year #2] + \$240,000 option price = \$500,000 fair market value). Thus, the economic circumstances at the time the agreement is executed indicate that the lease option is, in economic reality, a sale and that the \$20,000 option payment is the down payment.

The lease-option transaction outlined in that example will be treated as a sale for tax purposes, because the rental amounts are so great that the tenant is economically

compelled to exercise the option. Moreover, the evidence in this case is even more compelling, because the inflated rents and the low option price add up to the approximate fair market value of the property.

However, the mere fact that the option price is a "bargain" price will not, by itself, result in the lease-option transaction being characterized as a sale. If the option price represents a substantial portion of the fair market value of the property, the rent approximates the actual fair market rental value, and the rent payments are not applied to the purchase price, the lease-option will not be characterized as a sale.

The IRS may come to the same conclusion in that example if the option price of the property is set at market value, but the rent and the option payments are applied to the option price. For example, assume the same facts as in the previous example, except that the option price is \$500,000 and the \$20,000 option payment and the two annual \$120,000 rent payments are to be applied to the option price. When Adams exercises the purchase option, he pays Baker \$240,000 ($\$500,000 \text{ option price} - \$20,000 \text{ option payment} - \$120,000 \text{ rent payment [year \#1]} - \$120,000 \text{ rent payment [year \#2]} = \$240,000$).

Other Economic Circumstances. In addition to the rental value and option price, other economic factors may be considered in determining whether a lease option should be characterized as a sale for tax purposes. In analyzing lease option transactions, each of the following factors has been considered evidence that indicates a sale:

- The lease requires that the tenant make substantial improvements to the property and the tenant can recoup his investment only by exercising the option.
- A portion of the rent payments can be identified as a substitute for loan interest.
- The agreement calls for the crediting of rent payments against the option price. This is true even when both the rental value and the option price are set at fair market value.

Regarding the situation in the third point, the tenant is paying no more in rent than would be the case in the absence of the option. Thus, the tenant is not acquiring equity during the lease period. However, if the rent may be applied to the option price, the lease option transaction has the appearance of an installment sale with a balloon payment. This is especially true when the rent payments approximate the amount of installment payments the tenant would make, given a loan amortization schedule with a market rate of interest.

However, there is no certainty that the tenant will exercise the option. Thus, if the tenant can demonstrate to the IRS that the reason for the lease option is that a sale was not

possible because of economic conditions, the lease option will likely be upheld. As Michael P. Sampson says in Tax Guide for Residential Real Estate: "...if you can demonstrate that the reason for the lease option is the impossibility of a cash sale because of economic conditions, the form of the transaction as a lease option will probably stand. This would be the case, for instance, where your purpose is to tie down the property during a tight money market, with the expectation that within the option period you can get institutional financing."

Intention of the Parties. In a number of cases, the court has ruled that the intentions of the parties determine whether a lease-option transaction is to be treated as a sale, instead of relying on the strictly economic tests already discussed. If the parties believed when they entered the transaction that the rent charged reflected fair market rents and that the option price reflected a good faith estimate of the future value of the property, the lease option will very likely be upheld.

Because the intention of the parties is subjective, an IRS agent or a judge would be expected to corroborate these intentions in the economic circumstances surrounding the transaction. As Tax Factors in Real Estate Operations suggests, "Although there is authority for giving effect to the intent of the parties, as a practical matter it will prove difficult for the parties to show a subjective intent that differs from the inference provided by the objective evidence." Accordingly, the economic factors discussed above will be relevant even where the intention of the parties is considered the controlling factor.

Tax Consequences to Tenant and Landlord

If the IRS characterizes the lease option as an installment sale for income tax purposes, the ownership of the property is assumed to have been transferred at the time the tenant gave the landlord the option payment and the lease commenced. This timing alters the tax consequences considerably for both the tenant and the landlord.

Tenant as Buyer. The tax consequences for the tenant-buyer are as follows:

- The tenant will not be allowed to deduct his rental payments as such.
- The tenant will be allowed to deduct depreciation, based on the portion of the presumed purchase price allocated to depreciable improvements. In addition, the tenant may also deduct other expenses associated with operating the property.
- A portion of the rental payments that the tenant makes will be recharacterized as interest payments and will be treated as deductible interest for income tax purposes. The amount of the interest deduction for the tenant will be calculated under the "imputed interest rules." The portion of the rental payments treated as

loan principal payments is considered part of the purchase price and, thus, is added to the tenant-buyer's tax basis for the property.

Landlord as Seller. For the landlord, the tax consequences of having the lease-option transaction characterized as a sale are as follows:

- The option payment is treated as a down payment. Since the landlord did not receive all cash for his equity, the installment method of reporting would be applicable to the transaction. Thus, the option payment will be treated as an initial payment received in the year of "sale" under the installment method.
- The rental payments received by the landlord-seller under the lease agreement are treated as part of the selling price. More specifically, part of each installment payment is taxable gain. Since no interest is stated in the rent payments, it must be imputed.
- The recharacterized rental payments will result in either long-term capital gain or ordinary loss. This assumes that the property was held for more than one year at the time the lease-option agreement was signed, and that the landlord-seller was not a "dealer" in real estate with respect to the property in question.
- Ordinary income (rental income) converts into capital gain (sale proceeds). As a result, the applicable tax rate could be lower. In addition, the amount of reportable income would be limited to the gain, if any, on the sale.
- The landlord would not be allowed to deduct an allowance for depreciation or other rental expenses, because the landlord is deemed to have disposed of the property. Instead, the tenant-buyer would be allowed to deduct depreciation and other operating expenses.

Although the lease option is a valuable strategy in many situations, it should be used with great care. There is always a threat that the IRS may view the lease-option transaction as a sale and the lease as merely a financing device. Rents that are significantly above fair market rents, when combined with a "bargain" option price, indicate that the transaction is likely to be characterized as a sale and that the rental payments are, in fact, installment payments on the purchase price. Thus, both the rental payments and the option price should be set by the parties with reference to going market values and rents for similar properties. And the parties should be prepared to justify their estimates of rent and purchase price if the transaction is later challenged by the IRS. Rental value and property value are best established through independent appraisal by experts.

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Example 1: Granting the Option. Susan buys a two-year option to purchase a small apartment building from John for \$500,000. Susan pays John \$15,000 for the option. The receipt of the \$15,000 option payment has no immediate tax consequences to either Susan (the optionee) or John (the optionor). The receipt of the option consideration is treated as a nontaxable open transaction. The transaction will remain open until Susan either exercises the option or allows it to expire.

Example 2: Exercising the Option. Six months later, Susan exercises the option and buys the apartment building for \$500,000. Susan's tax basis for the property is \$515,000 (\$500,000 + \$15,000). John's amount realized from the sale is also \$515,000.

Example 3: Selling the Option at a Gain. Instead of purchasing the building, after one year, Susan decides to sell the option for \$20,000. Since the apartment would have been §1231 property if Susan had acquired it, she reports a §1231 gain of \$5,000 (\$20,000 - \$15,000). Susan's sale of the option has no tax consequences for John.

Example 4: Selling the Option at a Loss. Assume in Example 3 that Susan sold the option for \$10,000 instead of \$20,000. Susan reports a §1231 loss of \$5,000 (\$10,000 - \$15,000). Again, the sale has no tax consequences for John.

Example 5: The Expired Option. Instead of selling the option, after two years, Susan fails to exercise the option and it expires. Since the apartment would have been §1231 property if Susan had acquired it, the \$15,000 forfeited option payment is treated as a §1231 loss. John reports the \$15,000 payment as ordinary, taxable income in the year the option expired.