Rent and Lease deductions for US Tax explained

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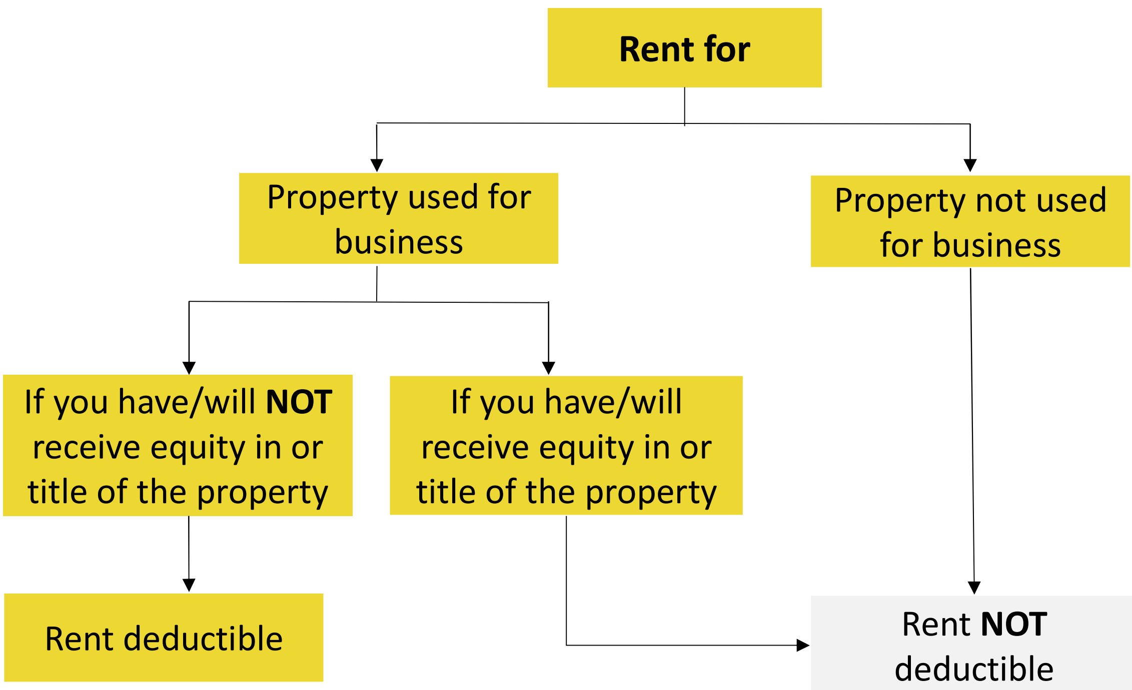
Rent

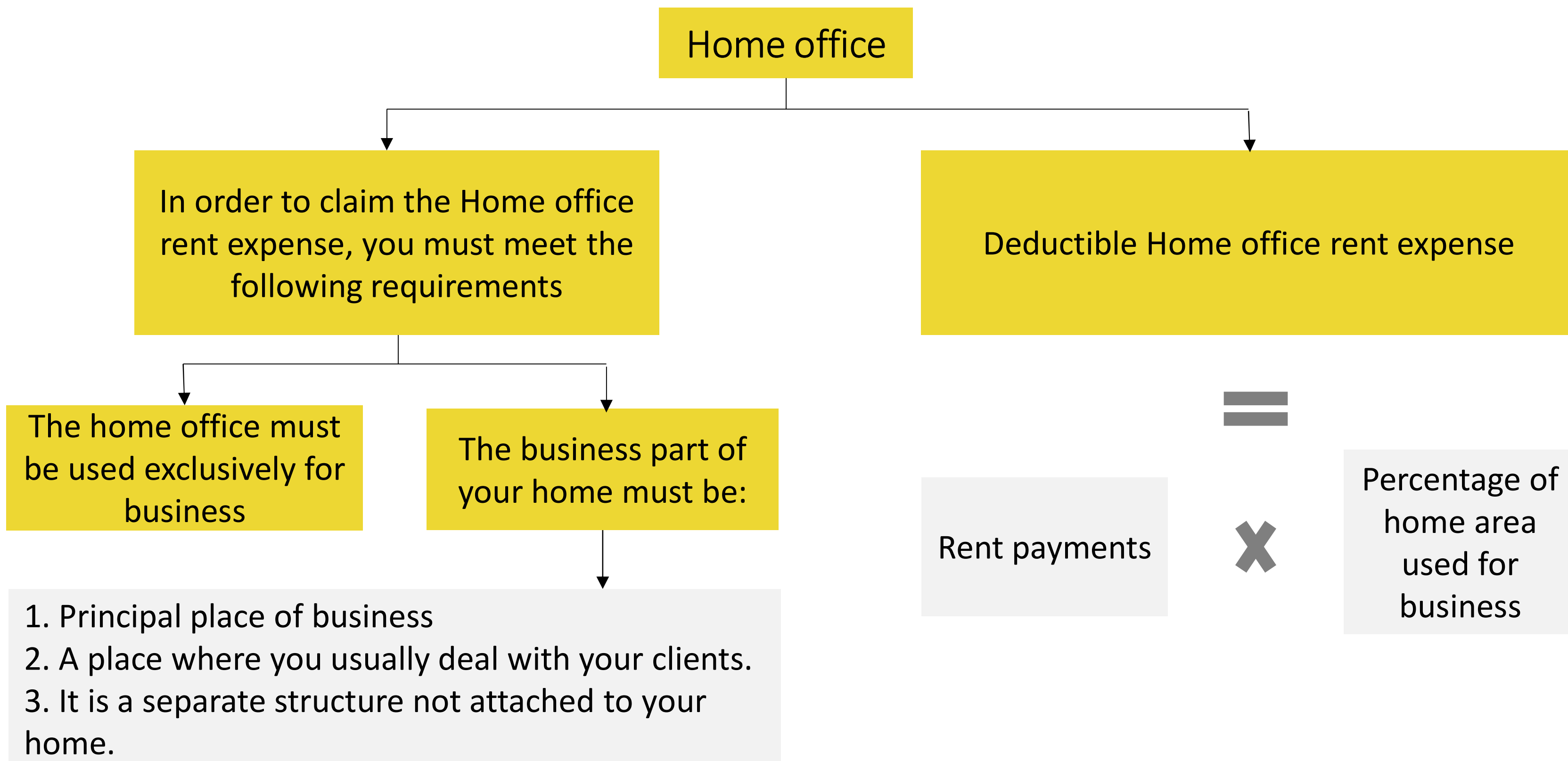
Rent is the payment you make for the property you do not own. If you rent a building/land for business purposes, you can deduct the rental payments as a business expense.



In order to be deductible, rents must be reasonable. This rule only applies where the lessor and the lessee are related. They can be related through family or business.

Home Office Rent Expense

If you make rent payments for your home and you have a home office. You might be able to deduct rent payments which are proportionate to the percentage of area used as Home office.



Prepaid Rent under different accounting methods

Prepaid Rent

If you use accrual method and pay rent in advance

You can only deduct the amount that pertains to use of property during the tax year. You can deduct rest of the amount over the period to which it applies.

If you use cash method and pay rent in advance

You might be able to deduct the entire amount of rent you paid in advance in the current tax year.

Under the **special 12-month** rule, corporations can deduct a prepaid expense when its benefit does not extend beyond the earlier of:

(1) 12 months after the first date on which the corporation realizes a benefit from the expenses, or
(2) the end of the tax year following the tax year in which the payment is made.

Prepaid Rent Example

Let's assume you are an **accrual method** taxpayer.

You pay monthly rent of **$1,200** for a building you use for business purpose.

The monthly rental starts from **October 1, 2020**.

You pay an advance rent of **$7,200** for October, 2020 to March, 2021.

For 2020	You can deduct only **$3,600** in your tax return as rent expense for the right to use the property.
For 2021	You will deduct the remaining amount of **$3,600** in your tax return.

Lease

Lease include rental payments along with other associated costs, such as utilities, insurance and property taxes.

Purchasing a lease

The cost of purchasing a lease is deductible over the period of lease term.

Cancelling a lease

The cost to cancel a lease is generally deductible. However, if cancellation is for obtaining a new lease from the same lessor, in this case, the costs will be deductible over the new lease period

Renewal

If renewal option is available for the lease, then the terms of renewal period will be included in the amortization period. However, this is applicable only if less than 75% of the cost is for the lease period before the renewal.

Taxes on leased property

If you pay real estate taxes to or on behalf of the lessor, you can deduct these taxes as an additional rent.

Conditional sales contract

A **conditional sales contract** allows the taxpayer to acquire either equity or title in the property . Any rent payments that will lead to ownership or equity are not deductible.

Conditional Sales or Lease?

Refer to the Contract

You can refer to the contract to determine whether an agreement is a lease or conditional sales contract.

Determine basis Intent

If it not clear from the contract, then basis of intent is another determining factor. This can be checked from any of these factors.

1. A part of each payment is applied towards equity interest
2. The agreement provides an option to buy the property at nominal price which is less than the usual price
3. The title of property will be transferred after making certain payments.
4. The payments made for lease exceed the fair market value of rent.
5. The total of all the payment is more than the cost of property

Improvements to Property

Improvements to property made by lessee

Permanent improvements made by lessee

Cost of improvement is depreciated with the Modified Accelerated Cost Recovery System (MACRS)**. The cost is depreciated over the recovery period and not the remaining term of the lease

Property improvements through assignment of lease*

Improvements which are made to a lease acquired through assignment are capitalized. Part of the capital investment is allocated to increased rental value which is amortized over the remaining term of lease. Another part of capital investment is allocated to permanent improvements. This portion depreciated over the recovery period of property.

Assignment of lease
It is a title document where all the rights of lessee are transferred to a third party. This usually happens when tenant wants to get out before the end of lease term.

***MACRS** *is a tax depreciation system that allows larger deductions in the early years of an asset's life, and lower deductions in later years.*

Leveraged Leases – Tax Treatment

Tax treatment of leveraged lease

NOT deductible

If IRS considers the **lessee** as the **owner** of the property, then the payments made for lease are **NOT deductible**. This happens mostly in case of **limited use property i.e.,** property not expected to be useful to the lessor at the end of lease term.

Deductible

A taxpayer who wants to use a leveraged lease should get an advance ruling from the IRS, which will be based on guidelines provided in **'Revenue Procedure 2001-28,**

In order to be deductible, the leveraged lease must satisfy these requirements

For the lessee:

1. Does not invest in the property.
2. Does not lend money nor guarantees a loan used by lessor to buy the property.
3. Has no contractual right to buy the property at less than Fair Market Value at the end of the lease term.

For the lessor:

1. Must maintain 20% at risk equity investment in the property.
2. Expects to receive a profit i.e., the lease is not for only the tax deductions, credits, allowances, and other tax attributes.

Special Rules

For Leases Exceeding $250,000

Special rules **don't apply** when:

You pay fixed amount of rent each month and all the rent payments are due in the year to which the rent relates.

Special rules apply when:

Any of the following is true:

- Rents **increase** or **decrease** during the lease
- Rents are **deferred** (payable after the calendar year) or **prepaid** (related to future calendar year)

If the special rules apply you must use accrual method of accounting for rental expenses irrespective of which method use otherwise

Thank You.

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