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COVID-19 and Distressed Leases

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Given the current economic climate with the arrival of COVID-19, many taxpayers with real estate ventures may be encountering tenants who are having troubling paying their rents and are considering entering into forbearance agreements or modifications with respect to their leases. It is paramount for landlords to understand the tax implications of these distressed leases, and in particular, any requirements to continue to recognize rental income even when payments are not actually being made.

This article highlights the considerations that may arise and discusses potential ways to avoid any unwanted dry income pickups by a landlord.

With many businesses forced to close their doors (at least temporarily) as a result of the spread of COVID-19, tenants may be unable to continue to timely pay their rent under their current lease arrangements. As a result, landlords may need to evaluate the impact of doubtful collectability of rents on their tax accounting method for rent. They also may be considering how to provide relief to tenants, and so will want to understand the implications of temporarily waiving payment of rent and whether lease modifications could be considered that could result in allowing the deferral of reporting rental income. The requirement for a landlord to continue to recognize rental income for tax purposes will be

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dependent in part on the type of lease (either as a section 467¹ rental agreement or a section 451 rental agreement), the facts and circumstances around the tenant's ability to pay rents, and the type of relief provided.

Background on Accrual of Rental Income

To the extent a lease is not a section 467 rental agreement (as discussed below), the lease is governed by the rules under section 451. Section 451 and the regulations thereunder generally provide that rents payable under a lease are an income item, to be taken into account by the landlord when required under the landlord's method of accounting. For the timing of income from rents, an accrual method landlord is generally required to include rents in income in the year that all events have occurred that fix the right to receive such rents and the amount of such rents can be determined with reasonable accuracy (the "all-events test"). Under the all-events test, a landlord's right to receive income from rents becomes fixed on the earlier of the date that:

- Payment is earned through performance
- Payment is due, or
- Payment is actually received.

As part of the Tax Cuts and Jobs Act ("TCJA"), new section 451(b) was added to provide that an accrual basis landlord will generally take into account rental income on the earlier date that the rent is taken into account on the landlord's audited financial statements, or the all-events test,² but this rule does not apply to special methods of accounting.

Section 467 is a special method of accounting that is excepted under the general recognition rules provided under section 451 and applies only to section 467 rental agreements. These agreements may be written or oral, but must be for the use of tangible property and must be treated as "true leases" for U.S. federal income tax purposes. Additionally, a section 467 rental agreement must have "increasing" or "decreasing" rents, or "deferred" or "prepaid" rents. However, a section 467 rental agreement does not include:

- A rental agreement that provides for total rents of \$250,000 or less
- A rental agreement that solely provides for a rent holiday of three months or less at the beginning of a lease term, and

¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

² See section 451(b). As section 451(b) does not change the extent to which income has been realized within the meaning of section 61, rental income that has not been earned through the use of the property during the period would not be considered subject to the income inclusion rule in section 451(b)(1)(A).

- A rental agreement that has adjusting rents solely based on a reasonable price index that reflects inflation or deflation over the lease term, such as the Consumer Price Index.³

If a lease is a section 467 rental agreement, absent a separate rent allocation schedule⁴ or a determination by the IRS that the rent patterns have a principal purpose of tax avoidance,⁵ the landlord (and tenant) is required to take the rents into account in accordance with the rent payment schedule, notwithstanding when payment of such rents is actually made and received.⁶ Thus, for each tax year, the landlord generally includes the rents payable for each rental period that begins and ends in that tax year, and a ratable portion of the rents payable for each rental period that begins or ends in that tax year.⁷

In more structured transactions involving a separate rent allocation schedule that differs from the rent payment schedule, a section 467 rental agreement may have prepaid or deferred rent (subject to certain exceptions) that results in the application of the “proportional rental accrual method” under which a loan is deemed to be made between the landlord and tenant.⁸ If there is a separate rent allocation schedule, but no deferred or prepaid rents within the meaning of section 467,⁹ the taxpayer generally takes rents into account in accordance with the separate rent allocation schedule.¹⁰

Distressed Tenant Scenarios

As discussed above, given the current economic climate, and the spread of COVID-19 that has required many businesses to shut their doors (at least temporarily), tenants may be in a situation where they are unable to pay rent. The requirement to continue to accrue rent and recognize rental income for tax purposes will depend on the facts and circumstances of the tenant, as well as any relief provided by the landlord.

Doubtful Collectability and Nonaccrual of Rents

Generally, an accrual method landlord has to continue to accrue rental income unless the facts and circumstances are sufficient to demonstrate that there is no reasonable expectation of payment of the rent. The “reasonable expectancy of payment” exception to income accrual is strictly construed. And so for income accrual to be prevented, uncertainty as to collection must be substantial and not merely

³ For additional background on section 467 leases, see Kevin Juran and Sam Chen, “Transfers and Assignments Related to Section 467 Leases,” *What’s News in Tax* (Apr. 23, 2012).

⁴ See sections 1.467-1(d)(2)(ii), 1.467-1(c)(2)(ii)(A), and 1.467-2.

⁵ See sections 1.467-1(d)(2)(i) and 1.467-3.

⁶ See sections 1.467-1(c)(2)(ii)(B) and 1.467-1(d)(2)(iii).

⁷ *Id.*

⁸ Sections 1.467-2 and 1.467-4.

⁹ A rental agreement has deferred rent if the cumulative amount of rent allocated as of the close of a calendar year exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year. Section 1.467-1(c)(3)(i). Similarly, a rental agreement has prepaid rent if the cumulative amount of rent payable as of the close of a calendar year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year. Section 1.467-1(c)(3)(ii).

¹⁰ See sections 1.467-2(b)(1)(i) and 1.467-1(d)(2)(iii).

technical in nature. As a consequence, to treat an item of income as non-accruable, the cases generally have applied a “doubtful collectability” standard, which despite its name, requires a relatively high bar to be met. Missed payments, postponements of payments, and temporary financial difficulties may not suffice to support nonaccrual.

Generally, whether rent is considered to be of doubtful collectability is a facts and circumstances test and likely requires an identifiable event, such as the tenant becoming insolvent without further hope of future profitability or going into bankruptcy. This test is similar to what is required for nonaccrual of interest with respect to a loan or claiming a partially or wholly worthless bad debt deduction under section 166, in that the test is based on the presence of serious doubt about ultimate collectability and not just temporary hardship. Considerations to be taken into account include a tenant’s history, financial status, and ability to pay, as could any changes in a tenant’s facts and circumstances as a result of COVID-19.¹¹

Thus, until there is substantial evidence to support doubtful collectability, an accrual method landlord must continue to accrue rent and recognize rental income for tax purposes, despite the tenant not paying. This is true for both leases subject to section 451 and section 467. This is a particularly bad answer for real estate investment trusts (REITs), which may be required to make distributions based on the accrual of the rental income, but may not have the cash to support those distributions.

In the event the landlord has accrued a rent receivable and it is later determined there is not a reasonable expectation of payment from the tenant, any rent receivable from that tenant would be eligible for a bad debt deduction under section 166.

Lease Modifications as an Alternative to Nonaccrual

While a landlord may not be able to stop accruing rents that are not being paid but are otherwise due, a landlord may agree to a lease modification with the tenant to provide that rents do not accrue and are not required to be paid for a period of time. If a lease is modified such that rents do not legally accrue and are not required to be paid for a period of time (the “rent holiday period”), then the landlord is not required to take those rents into account for tax purposes during that time.

Importantly, however, a temporary forbearance that merely provides for a temporary waiver of payment without modifying the amount of rent that is earned for such period generally is not treated as a modification of a lease.¹² Thus, rent still would accrue and the landlord would recognize rental income subject to the rules discussed above under section 451 for section 451 rental agreements and the relevant method under section 467 for section 467 rental agreements (absent meeting the “no reasonable expectancy” standard discussed above).

¹¹ See, e.g., *European Am. Bank & Trust Co. v. United States*, 20 Cl. Ct. 594 (1990), *aff’d per curiam*, 940 F.2d 677 (Fed Cir. 1991); *Jones Lumber Co. v. Commissioner*, 404 F.2d 764 (6th Cir. 1968); *Koehring Co. v. United States*, 421 F.2d 715 (Ct. Cl. 1970); Rev. Rul. 80-161.

¹² Cf. section 1.1001-3(c)(4)(ii) (providing that a holder’s temporary forbearance of up to two years is not treated as a modification of a debt instrument).

Rather, there must be a legal modification of the lease that provides the tenant with the use of the property for a period of time for free, such that no rent legally accrues or is required to be paid for that period. Rent for future periods may be increased, or the lease may be extended as consideration for providing the rent-free period.

It is also important that the lease modification specifies that any increases in rent for subsequent rental periods that are intended to be an economic offset for the lack of rents during the rent holiday period are legally for the use of the leased property for those subsequent rental periods rather than for the rent holiday period. The modification should not refer to the payments made in the subsequent rental periods as deferred payments relating to the use of the property for the rent holiday period.

This is the case whether the accrual of rental income is governed by section 451 or section 467. As discussed above, section 451 generally requires that rental income be taken into account upon the earlier of when it is earned, due, or received. Thus, subsequent rent increases must not be viewed as relating to the use of the property for the rent holiday period, or the increases may be treated as earned for the rent holiday period and required to be taken into income during the rent holiday period.

The same concept applies to leases governed by section 467. The modification should provide that no payments are due for the rent holiday period and that additional subsequent rent payments are for the use of the leased property for those subsequent rental periods. Otherwise, the original rent payment schedule may be viewed as a separate rent “allocation” schedule. In that case, section 467 may require the landlord to continue to take rents into account in accordance with the original rent allocation schedule. If the modified payment schedule differs sufficiently from the original rent allocation schedule, application of the proportional rental accrual method may be required.

Another consideration is that a modification could result in the modified lease being treated as a new lease for tax purposes; therefore, analysis will need to be undertaken regarding whether the new lease qualifies as a section 467 rental agreement or is subject to section 451 (including section 451(b)). In certain situations, the status of the lease as a true lease may need to be confirmed.

In addition, for section 467 rental agreements subject to the proportional rental accrual method, a modification to both the payment schedule and the allocation schedule will be needed in order for the landlord to be able to stop taking rents into account during the rent holiday period. Just changing the payment schedule is insufficient because the landlord's rental income is calculated based on the rent allocation schedule.¹³ Note that for leases with respect to which the proportional rental accrual method applies, a modification will result in a re-calculation of the section 467 rents and interest amounts.¹⁴ Although the landlord may no longer need to pick up rental income during the rent-free period, the landlord may need to pick up some income as a result of the modification itself.¹⁵

¹³ Section 1.467-2(c).

¹⁴ Sections 1.467-2(c) and 1.467-4.

¹⁵ Sections 1.467-7(g)(1)(iii) and -7(g)(2)(ii).

Conclusion

These are trying times for many landlords and tenants. As the parties work together to renegotiate leases, they should do so with an eye towards the potential tax consequences. By understanding and keeping in mind the potential tax pitfalls of lease modifications, the parties can structure them in a manner that mitigates potential adverse tax consequences and better aligns the tax treatment with the economic impact of the transactions.

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