



Make Best Tax Use of Construction Allowances For Short-Term Leases

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Tax planning and minimization strategies are frequently at the forefront of major business transactions, as tax practitioners and attorneys are consulted to help taxpayers achieve the best overall results. Often, entering into a new lease agreement is seen more as a routine business decision rather than a tax-saving opportunity, but this could prove costly to a lessee that is unaware of the potential tax implications. As an enticement to a new tenant, a lessor may offer a construction allowance to help offset the lessee's cost of moving into a new space and fitting it to the lessee's needs. The allowance could be paid:

- *As a reimbursement.*
- *In cash up front.*
- *In the form of rent reductions.*

For a lease with a term of 15 years or less,¹ special tax treatment may apply.

Financial reporting vs. tax treatment

For financial reporting purposes, GAAP requires that the allowance used for the purchase or improvement of the property be capitalized and amortized over the life of the lease. The allowance is also recorded as a deferred rent liability and prorated over the life of the lease.² Therefore, for book purposes, the lessee is the owner of the improvements.

If this were to apply also for tax purposes, the lessee would be required to use the proper tax life for nonresidential real property of 39 years (alternatively, 15 years if meeting the definition of qualified leasehold improvement property, as defined in Section 168(k)(3)). Moreover, the lessee would also have to recognize the full allowance in gross income when received. It is more advantageous for the lessee (from a tax perspective) to have the lessor own the improvements.

Prior to 1997, ownership for tax purposes was determined (and therefore the question of whether the lessee had to recognize the allowance as income) by relying on an IRS

Coordinated Issue Paper (CIP) titled "Tenant Allowances to Retail Store Operators," issued 10/7/96, which was based on established case law.⁴ The standard established was a "benefits and burdens of ownership" test, which laid out eight criteria that could help determine who truly owned the improvements.⁵ These included the following:

- (1) Whether legal title passes.
- (2) How the parties treat the transaction.
- (3) Whether an equity interest was acquired in the property.
- (4) Whether the contract creates a present obligation on the purchaser to make payments.
- (5) Whether the right of possession is vested in the purchaser.
- (6) Which party pays the property taxes.
- (7) Which party bears the risk of loss or damage to the property.
- (8) Which party receives the profits from the operation and sale of the property.

Congress made the issue simpler with the passage of the Taxpayer Relief Act of 1997, which established Section 110. This section lays out what is essentially a safe-harbor provision.

¹ Reg. 1.110-1(b)(2)(ii).

² FASB Codification 840-20-25.

³ Barranca, "Gross Income-Lessee Construction Allowances" AICPA.org.

⁴ 77 TC 1221 (1981).

⁵ IRS Coordinated Issue Paper, "Tenant Allowances to Retail Store Operators," 10/7/96; Grodt and McKay Realty, Inc., *supra* note 4.



For leases entered into after 8/5/97, the lessee does not need to include in gross income any amount received in cash or treated as a rent reduction from a lessor under a short-term lease for retail space that is used for constructing or improving qualified long-term real property.⁶ Although disclosure is required in the taxpayer's timely filed return (including extensions), if the criteria of the section are met the exclusion of income is automatic.⁷ Unless notified by the lessee in writing to the contrary, the lessor must capitalize the improvements for tax purposes and depreciate them over 39 years (or 15 years, if applicable). The Service guidance still applies to those situations that do not fall under the purview of Section 110.⁸

Scope of tax rules

The application of the Code and subsequent regulations is far reaching. Retail space is broadly defined as nonresidential real property that is used by the lessee in its trade or business of selling tangible personal property or services to the general public.⁹ The space includes both the location where the sales are made and areas supporting the sales, such as administrative offices. Using these criteria, not only would a clothing retailer in a mall qualify as having retail space, but also that business' headquarters comprised of the finance and marketing divisions. Additionally, service businesses such as law or accounting firms would meet the definition outlined in the regulations.

Short-term leases include any lease spanning up to 15 years.¹⁰ This includes options to renew unless meeting the exception to renew at fair market value as outlined in Section 168(i)(3)(B).¹¹ Qualified long-term real property is defined as nonresidential real property under Section 168(e)(2)(B) that reverts to the lessor at the end of the lease and is not Section 1245 property.¹² Most constructed improvements or attached fixtures would meet this definition.

⁶ Section 110(a).

⁷ Reg. 1.110-1(b)(5).

⁸ H. Rep't No. 105-220, 105th Cong., 1st Sess. (1997).

⁹ Reg. 1.110-1(b)(2)(iii).

¹⁰ Reg. 1.110-1(b)(2)(ii).

¹¹ Section 168(i)(3)(B).

¹² Reg. 1.110-1(b)(2).

¹³ Section 1245.

Example 1. ABC Corp., a landscaping design firm, leases space from XYZ Corp. beginning January 2009. The lease expires December 2018. As an incentive to ABC, XYZ includes in the lease an agreement to cover \$1 million of improvements that ABC will make to the leased space within the first year of the lease. The lease specifies that at least some portion of the allowance will be used to improve long-term real property, and notes that any portion not used can be applied by ABC against rent payments within the year. ABC uses \$800,000 of the allowance, \$750,000 of which is spent on Section 1250 property and \$50,000 on Section 1245 property. ABC applies the remainder against its December 2009 rent.

On its 2009 federal income tax return, ABC would capitalize and depreciate the \$50,000 of the allowance to purchase tangible personal property.¹³ The company would also recognize \$250,000 of gross income on its return for the \$200,000 applied against the December rent payment and the \$50,000 capitalized. However, the \$750,000 would not be treated as income or as a capital asset on ABC's return. According to Section 110, XYZ would treat this amount as an asset and depreciate it on its return, unless ABC agrees in writing to a different treatment. Both ABC and XYZ would attach a statement to their timely filed returns pursuant to the regulations.

Planning strategy

When negotiating and executing the lease, the lessee should be aware of this Code section and specify that at least some portion of the allowance will be used for the purpose of constructing or improving qualified long-term real property in order to meet the purpose requirement in Reg. 1.110-1(b)(3). If this provision was missed in the master agreement, an ancillary agreement executed either with the



lease or during the term of the lease is also acceptable.¹⁴ Rev. Rul. 2001-20¹⁵ clarifies that although the lease agreement does not need to require the entire allowance be used for this purpose, only the amount actually expended on qualified long-term real property will qualify under Section 110.

Example 2. The facts are the same as in Example 1, except the lease did not specify that any portion would need to be spent improving real property. In this instance, the treatment by ABC and XYZ should still be the same, but because there could be an issue under examination as to whether the purpose requirement was met, an ancillary agreement should be drawn up to cover this point.

Excess allowance

Any portion of the allowance that exceeds the lessee's cost of constructing or improving qualified long-term property, including amounts used to acquire tangible personal property (Section 1245 property), not expended by the lessee within 8 1/2 months after the close of the tax year in which the amount was received, or applied as a rent reduction would not be included under Section 110 and would be recognized as gross income.¹⁶

Example 3. The facts are the same as in Example 1, except the original lease agreement calls for XYZ to pay the \$1 million up front to ABC for ABC to use as it chooses, provided a portion is used for qualifying long-term real property. ABC Corp. spends \$650,000 in 2009 on qualifying Section 1250 property and the remainder in December 2010, also on qualifying Section 1250 property.

In this scenario, ABC would recognize \$350,000 of gross income on its 2009 federal income tax return despite using the entirety of the allowance on qualifying property. Since only \$650,000 was spent by 9/15/10 (8 1/2 months after the year in which the proceeds were received), the remainder no longer qualifies under Section 110. Lessees should be wary of this clause to be sure

intended improvements are made within the proper time frame.

Qualified improvements

As noted above, the lessor may be entitled to use the shorter life of 15 years for some leasehold improvements they are required to depreciate under Section 110. As outlined in Section 168(k)(3), improvements to interior portions of buildings are considered qualified leasehold improvements, provided:

- The lessor and lessee are not related parties.
- The leased space is occupied exclusively by the lessee.
- The building has been placed in service for more than three years.

The allowance in this case could *not* be used to:

- Enlarge the building.
- Install an elevator or escalator.
- Involve a structural component in a common area.
- Alter internal structural framework.

Additionally, under Section 168(i)(8), the lessor may be entitled to write off the balance of the capitalized allowance at the termination of the lease if the improvements made pursuant to the lease are fully disposed of or abandoned by the lessor.

Reporting requirement

Both the lessee and the lessor are required under Section 110 to attach a statement to their timely filed (including extensions) federal income tax returns¹⁷ generally providing details of the parties to the lease agreement and details surrounding the allowance. For the lessee, this includes:

- The lessor's name, address, and EIN.
- The location of the retail space.
- The amount of the allowance.

¹⁴ IRM 4.43.1.11.6.5 (7/23/09).

¹⁵ 2001-1 CB 1143.

¹⁶ IRS Advice Memorandum 2007-003, 4/16/07.

¹⁷ Reg. 1.110-1(c).



- The amount of the allowance that is a qualified lessee construction allowance as defined in the regulations.¹⁸

Given the detailed information required in the statement, it would be best to request this from the lessor at the time the agreement is signed. The lessor is required to report the same information regarding the location and allowance, but would need the name, address, and EIN of the lessee.¹⁹

Conclusion

Lessees should keep Section 110 in mind when negotiating a lease for a new space. Careful documentation in the lease regarding a construction allowance and awareness of the necessary terms of the safe-harbor provision can save lessees tax dollars and the surprise of additional income on their annual income tax returns.

Should you want more information about this topic, please contact Meredith Pilaro, Tax Manager, Argy, Wiltse & Robinson, P.C. at 703.770.6357 or Joyce Robinson, Tax Partner, Argy, Wiltse & Robinson, P.C. at 703.770.6311.

Note: This article was also published as the cover article in the December 2009 issue of Practical Tax Strategies, a Thomson Reuters monthly tax publication.

¹⁸ Reg. 1.110-1(c)(3)(ii).

¹⁹ Reg. 1.110-(c)(3)(i).