Tax Considerations Affecting Construction Allowances and Disposition of Leasehold Improvements

Although construction allowances in leases are common, consideration of their tax consequences is, sadly, not so common.

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THE NEGOTIATION OF THE CONSTRUCTION ALLOWANCE is a major part of any lease transaction; however, those negotiations rarely, if ever, consider the resulting tax consequences. This article examines the tax consequences of certain forms of construction allowances and suggests how to negotiate tax-beneficial terms for these allowances.

In structuring construction allowances, tenants and landlords must consider two fundamental tax principles. First, income received is taxable in the year in which it is received. Second, the owner of a leasehold improvement must depreciate the improvement ratably over 39 years. The interplay of these two principles creates different and conflicting tax objectives for landlords and tenants. Tenants do not want construction allowances characterized as income, and landlords do not want to “write off” the construction allowances over 39 years. But a tenant can only avoid “income” if the landlord owns the leasehold improvements, while a landlord can only avoid a 39-year depreciation period and “write off” the construction allowance over the shorter lease term if the tenant owns the improvements. Put simply, to maximize tax benefits, each party must foist ownership of the improvements onto the other.

TAX TREATMENT OF CONSTRUCTION ALLOWANCES
What are the tax consequences of tenants receiving cash and “free rent” allowances? What special tax treatment is afforded anchor department stores?

Construction Allowances Disbursed from the Landlord Directly to the Tenant
To finance leasehold improvements, a landlord can disburse a cash allowance directly to the tenant or give the tenant rent credits. The tax treatment of allowances and credits is generally determined by who owns the improvements constructed with the allowance or credit. Ownership dictates who depreciates the improvements, what the depreciation period is, and whether the allowance constitutes income.

Landlord-Owned Improvements
Under current law, when cash is given to a tenant to construct leasehold improvements that the landlord will own, the tax treatment is straightforward. The landlord must depreciate the improvements over the statutory 39-year depreciation period for nonresidential real property, even if the lease is for a term of less than 39 years, except for those exceptions created by the Small Business Job Protection Act of 1996. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, Sec. 1120, 110 Stat. 1766 (1996); §168(i)(8). Although the tenant receives cash from the landlord, this cash is not treated as income to the tenant. The tenant is treated as a conduit for the landlord’s cash. In re Elder-Beerman, 97-1 U.S.T.C. ¶50, 391, p. 87, 939, 207 B.R. 548 (Bankr. S. Dist. W. Div. OH).

1 As this article will further discuss, a bill was recently introduced in the Senate and House of Representatives that would provide a shorter recovery period for the depreciation of certain leasehold improvements. S. 576, 108th Cong. (2003); H.R. 1634, 108th Cong. (2003). The bill would allow building owners to depreciate specified building improvements using a 10-year depreciable life rather than the 39 years required by current law.
2 The Small Business Job Protection Act of 1996 amended Internal Revenue Code section 168(I)(8), stating that a landlord may accelerate its leasehold improvement depreciation if the improvements are “irrevocably disposed of” or “abandoned”.
3 All section references are to the Internal Revenue Code (“IRC”), unless otherwise indicated.
Tenant-Owned Improvements

When the landlord does not own the improvements, the landlord is not required to use the 39-year depreciation schedule and, therefore, can “write off” the allowance ratably over the lease term. *Bonwit Teller & Co. v. Commissioner*, 17 B.T.A. 1019, 1026 (1929), rev’d, 53 F.2d 381 (1931). 4 If the lease includes option periods, the allowance is “written off” over the initial term plus option periods if “reasonable certainty” exists at the time of lease execution that the option will be exercised. *Joseph Neel Co. v. Commissioner*, 22 T.C. 1083, 1091 (1954); *Westinghouse Broadcasting Co. v. Commissioner*, 36 T.C. 912 (1961). Determination of whether “reasonable certainty” exists is dependent upon a facts and circumstances analysis that examines whether the economic terms of the lease make the exercise of the option likely. *Joseph Neel Co.*, 22 T.C. at 1091; *Westinghouse Broadcasting Co.*, 36 T.C. at 918. Because most options are exercisable at market rates, option terms are rarely added to the period over which the allowance is written off.

When cash is given to a tenant to construct leasehold improvements and the tenant owns the improvements, the cash received by the tenant is income in the year received because it “enhances” a tenant’s wealth by enabling it to acquire or construct suitable facilities. *John B. White v. Commissioner*, 55 T.C. 729 (1971). Further, because the tenant owns the improvements it must depreciate the improvements constructed with the allowance over 39 years.

Recent legislative development; proposed changes affecting the recovery period of certain leasehold improvements

A bill was recently introduced in the Senate and House of Representatives that would allow building owners to depreciate specified building improvements using a 10-year depreciable life, rather than the 39 years required by current law. H.R. 1634, 108th Cong. (2003), S. 576, 108th Cong. (2003). A shorter depreciable life would more closely match the expenses incurred to construct the improvements with the income the improvements generate under the lease. The bill would amend subparagraph (D) of section 168(e)(3) of the Internal Revenue Code of 1986 by adding “any qualified leasehold improvement property” to be classified as 10-year property. The term “qualified leasehold improvement property” means any improvement to an interior portion of a building which is nonresidential real property if i) such improvement is made under or pursuant to a lease (I) by the lessee (or any sublessee) of such portion, or (II) by the lessor of such portion; ii) such portion is to be occupied exclusively by the lessee (or any sublessee) of such portion, and iii) such improvement is placed in service more than 3 years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. Section (D) requires that if an improvement is

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4 On Appeal, the court clarified that a landlord may not “write off” an allowance for improvements beyond the end of the lease term which was valued. 53 F.2d at 383-84. In *Bonwit Teller & Co.*, the property in question was a leasehold having nineteen years to run, and containing an option to renew for twenty-one years at a rental to be determined by the appraisal of the property to be made at the time of the renewal. The appellate court stated that the existence or exercise of such an option does not change the period during which the lease will become exhausted. *Id.* But see *Joseph Neel Co.*, 22 T.C. at 1091.
made by the person who was the lessor of the improvement when the improvement was placed in service, the improvement will be qualified leasehold improvement property (if at all) only so long as the improvement is held by such a person. *Id.*

**Strategies Employed by Tenants and Landlords To Avoid Construction Allowance Income**

Many tenants treat construction allowances in a manner that is inconsistent with case law. For example, even though they otherwise treat the improvements as tenant-owned, some tenants neither declare these allowances as income nor include the allowance in the basis of the improvements.

Some tenants and landlords use a disbursement mechanism called a “New York Escrow” whereby the landlord places the construction allowance in an escrow account. Subject to landlord approval, disbursements are made from the escrow to pay the construction costs for the tenant improvements. Treating sums disbursed from the escrow as a lease inducement, landlords write off the construction allowance over the lease term and tenants do not report the construction allowance as income under the theory that the tenant neither receives the cash nor includes the amount of the allowance in the basis of the leasehold improvements. This treatment is flawed. The physical receipt of cash is not the touchstone for determining whether a taxpayer has income; rather, the tax laws look to whether the tenant has “enhanced” its wealth and who owns the improvements. Thus, if the tenant owns the improvements, the New York Escrow does not avoid the tenant’s tax liability for a construction allowance.

Another technique used by tenants and landlords to avoid having an allowance treated as income to the tenant is to convert the allowance to a loan repayable by the tenant over the lease term. A loan is not income to the tenant. Although preferable to receiving income, a loan has some negative tax consequences for tenants. A portion of the monthly loan payments to the landlord constitutes principal repayment and, therefore, unlike rent payments, is not deductible by the tenant. The reduced rent deduction is only partially offset by the tenant’s depreciation (on a 39-year schedule) of the improvements. A loan may be beneficial to the landlord because the landlord does not own the improvements and can effectively “write off” the loan/allowance over the lease term. Use of the loan structure may include an unexpected price; that is, loss of some lease remedies in some jurisdictions.

**Ownership Tests for Leasehold Improvements.**

As noted above, the determining factor in the tax treatment of allowances and improvements is the “tax ownership” of the leasehold improvements. “Tax Ownership” is distinct from legal ownership. It is not based on whether a person or entity holds title to a particular property but, rather, is based on a broad analysis of a person’s economic relationship to that property. Courts have applied this concept of ownership in a variety of contexts, such as the sale-leaseback. Only recently have the IRS, Congress, and the courts begun to develop tests and guidelines for determining who owns leasehold improvements constructed with tenant allowances. The following section sets forth the tests and guidelines that have been applied in determining ownership of leasehold improvements.

**The IRS Ownership Test: A Modified Version of the Benefits and Burdens Test**

The Internal Revenue Service (“IRS”) has published an “Issue Paper” on construction allowances as part of its Industry Specialization Program, a program designed to ensure the uniform application of the Federal tax laws. *See IRS Position Paper, Industry Specialization Program, Retail Industry Coordinated Issue Paper on Tenant Allowances, Tenant Allowances to Retail Store Operators, October 8, 1996 [hereinafter Issue Paper].* In the Issue Paper, the IRS