LARGE AND MID-SIZE
BUSINESS DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR INDUSTRY DIRECTORS
DIRECTORS, FIELD OPERATIONS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR, PRE-FILING AND TECHNICAL GUIDANCE

FROM: /s/ Robert E. Brazzil
Director, Retailers, Food, Pharmaceuticals & Healthcare Industry

SUBJECT: LMSB Directive on the Planning & Examination of Construction "Tenant" Allowances for Leases Greater Than 15 Years.

Introduction

This memorandum provides guidelines for the efficient use of audit time and resources devoted to the examination of payments, commonly called "tenant allowances," made by developers to retail lessees with respect to long- term leases. This Memorandum only applies to those taxpayers with leases that do not meet the short-term lease definition of Internal Revenue Code Section 110(c)(2) and 168(i)(3), and its related Regulations. Whether payments received with respect to leases with terms exceeding 15 years are treated as income to the retailer (lessee) will turn on whether the lessee or the lessor is treated as the owner of the property constructed with the construction or "tenant allowance."

This LMSB Directive is not an official pronouncement of the law or the position of the Service and cannot be used, cited or relied upon as such.

Background

In the typical situation presented herein, the retailer (lessee) owns some leasehold improvements, and the landlord owns others. Any amounts received from the landlord and expended by the retailer on assets that are owned by the landlord cannot be characterized as income to the retailer. The retailer bears the burden of showing the extent to which monies received from the landlord were expended on leasehold improvements owned by the landlord.

However, amounts received from the landlord as lease inducements and expended by the retailer as it sees fit or on specific leasehold improvements that are owned by the retailer are includible in gross income unless excludible by some section of the Internal Revenue Code. Thus, in cases in which the

tenant holds the benefits and burdens or ownership of the leasehold improvements, the tenant has current income.

Current Tax Controversy

Whether cash transferred to a retailer as a tenant or construction allowance is includible in gross income under Section 61(a). Specifically, (1) whether the cash payments are accessions to wealth and, if so, (2) whether the retailer may exclude the cash payments from gross income under Section 118 or some other provision of the Code.

The difficulty in development of these issues lies in the determination of ownership. Ownership for federal tax purposes is determined by applying the benefits and burdens of ownership tests to the facts and circumstances surrounding the transaction. The Tax Court has set forth 8 separate tests to determine ownership for tax purposes. See, for example, Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981), and Coleman v. Commissioner, T.C. Memo 1987-195, aff'd, 16 F. 3d 821 (7th Cir. 1994). Ownership for tax purposes ultimately is determined using these well-recognized tests. However, there is no assurance that symmetry exists between the landlord and the retailer. Unless the planning technique recommended herein is employed, the potential for whipsaws and inconsistent treatment can be eliminated only by examining both the lessee and lessor.

Discussion

Tenant construction allowances in general are cash payments made either to encourage a retailer to enter a mall in the first instance, or as an incentive for a retailer to continue to operate its store in the developer's mall. In each case the payments are made as part of a contractual agreement.

Typically, under the terms of the leases, each developer/landlord is responsible for the completion of the gross structure of the shopping center. The retailer is responsible for the build out or finishing work of the interior space it will occupy, as well as other tenant work, such as opening for business, operating the business and advertising. The leases typically require the interior space to conform to certain conditions. Sometimes the landlord must approve the construction plan and completed work. A substantial portion of the build out and other tenant work is of the nature that its economic life will not extend beyond the lease term. As an inducement to enter the lease, developers agree to make lump sum payments, usually payable when the build out is completed or portions thereof are completed.

In many of these situations, the developer and the retailer will specify in the lease itself, or in an ancillary agreement, who is to be considered the owner of the improvements. Such a provision may be couched in terms of who bears the benefits and burdens of ownership.

Planning and Examination Guidance

Examination should focus on the contract language to the extent possible. When agreement of the parties is clear from the contract language, and both parties are reporting the payment on a basis consistent with the agreement, the treatment of such payments should be treated as a very low risk item in planning and executing the examination plan. Verifying treatment by the developer need not require a full-scale examination of the return. Rather, it can be handled as a check on a reference return. Examiners are encouraged to exercise discretion and judgment as to the extent of such verification.

If you have any questions, please contact Gregory W. Pierce, Senior Program Analyst, Retailers, Food, Pharmaceuticals & Healthcare, at 630-493-5934 or David Moser, Technical Advisor, Retail at 636-940-6226.

cc: Commissioner and Deputy Commissioner, LMSB
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