Construction Allowances & Leasehold Improvements: Maximizing the Tax Benefits

Wednesday, May 18, 2016 — 11:30 am to 1:30 pm
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Tenant Improvements

The basic facts are as follows:

a) Landlord has a long-time tenant whose lease is coming due.

b) As part of the renegotiation of the new lease, tenant has requested that landlord spend $100,000 in new tenant improvements.
Tenant Improvements

The basic facts continued:

c) The Landlord proposes to “fund” these improvements as follows:

• Cash payment of $50,000 to tenant upon signing of the new lease

• A $5,000 per month reduction in rent over the next 10 months.
General Questions:

• What tax implications might this have for the Tenant?
• For the Landlord?
• What recommendations would you make to mitigate these tax consequences for the Tenant?
• For the Landlord?
• What do you recommend as a better alternative to this arrangement?
Issues:

1. Will the Tenant have taxable income?
TAX OWNERSHIP IS THE KEY

• If the Tenant owns the improvements, the Tenant will likely have income
  – Specifically, both the cash payment and the rent reduction (if tied to improvements) are taxable for the Tenant

• If the Landlord owns the improvements, the Tenant will not have income
Issues:

2. How do we determine who will own the improvements?
   a) The IRS Ownership Test: Modified “Benefits and Burdens”
   b) Elder-Beerman Test: “Substance Over Form”

Also, consider Section 110 of the Code, discussed later!
2(a) **IRS Modified Benefits and Burdens Test:**

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 seller to execute and deliver a deed and 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; and
8) Which party receives the profits from the operation and sale of the property

In the context of leasehold improvements, the IRS also considers certain additional factors which indicate the Tenant owns such improvements:

- The Tenant carries property and liability insurance on the leasehold improvements;
- The Tenant is the beneficiary under those policies;
- The Tenant is responsible for replacing the leasehold improvements if they wear out prior to the end of the lease term; and
- If the usefulness of the leasehold improvements extends beyond the lease term, the Tenant has the remainder interest in the improvements.

FSA 1997-27, August 4, 1997 *reprinted in* 2000 TNT 170-23; *See also* IRS Position Paper
2(b) Elder-Beerman. Bankruptcy Court, following *Frank Lyon*, decided the real issue was substance over form. Because the structure arose because of non-tax issues, it was respected.

No later court has ruled, either accepting or rejecting this rationale.

Tax Ownership of Tenant Improvements (continued)

- **Drafting tips?**
  - Tax ownership language
  - “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.”

LMSB Directive on the Planning & Examination of Construction "Tenant" Allowances for Leases Greater Than 15 Years, March 24, 2003
Issues:

“Qualified Lessee Construction Allowances”

3. Might the tenant qualify for relief under Section 110? What is required to qualify?
Section 110 allows Tenants who qualify to receive a TI allowance and not be treated as the owner. Must be an express provision in the lease. Side agreement OK.

1. Short term lease of retail space –15 years or less
   *Broad definition of “retail”—to the general public*
   *Options to renew generally taken into account*

2. To construct “qualified long-term real property” used in business
   *Nonresidential real property with a class life of more than 27.5 years*

3. Tracing not required. Expenses can first be charged to the allowance
   *Consistent treatment and reporting required; special disclosure on tax return*
More on “Qualified Lessee Construction Allowances”

• What happens if the Tenant does not spend the full amount on qualified improvements?
  Also note: 8½ month rule
• If qualifying under Section 110, Landlord is treated as the owner for tax purposes
  Landlord depreciates once placed in service
• Other drafting tips?
  – Agreement should provide the Landlord is the owner
  – Express language, detail tax treatment
  – Paid in installments?

See Rev. Rul. 2001-20
Issues:

4. If the Landlord owns the improvement, how is the cost recovered?
Landlord owned improvements are generally depreciated over 39 years, even if lease term is shorter. If abandoned at lease termination, full write-off of remaining basis.

Also consider Section 179 expensing for any personal property, cost segregation analyses, and special 15-year “Qualified Leasehold Improvements”/ “Qualified Restaurant Property”/”Qualified Retail Improvement Property” (and associated expensing/bonus depreciation)
Issues:

5. If Tenant owns the improvement, how is the cost recovered by the Tenant? What about the Landlord?
• Tenant owned improvements are also depreciated by the Tenant over 39 years. At the lease termination, the remaining basis is written off.
  – Remember, the Tenant has income upon receipt of the construction allowance!
  – Also consider accelerated depreciation and expensing again!
  – “Irrevocably disposed of” or “abandoned”

• The Landlord writes off the amount of the allowance over the lease term
  – Ratably
  – Term? What about options? “Reasonable certainty” test
Issues:

6. Does the landlord get a deduction for the $50K cash payment? How does Section 110 affect this?
No immediate deduction if the Tenant owns the improvements. Cost of lease acquisition and written off over lease term.

If the Landlord owns improvements, it depreciates them. A Section 110 allowance is treated as fully expended unless tenant notifies the Landlord otherwise.

(Again, consider the 8 ½ month rule)
Issues:

7. If the improvement reverts to the Landlord on termination of the lease, does the Landlord have taxable income? What result if the Landlord owns the improvement at lease-end?
Section 109 prevents the Landlord from having income.

– But no basis increase (so no depreciation and more potential gain on sale)

Any exceptions? “Rent”
Issues:

8. Does the Landlord have taxable income as a result of the rent reduction?
Unlikely. This gives the landlord the economic effect of a deduction but the Tenant owns the improvements and deducts the cost over 39 years. The IRS can re-characterize this according to economic reality.
Issues:

9. Would it be a better arrangement to simply loan $100K to the tenant with an interest rate equal to the Applicable Federal Rate?
Better than income but not perfect. Principal repayment is not deductible and the improvements are still deducted over 39 years with acceleration on lease termination.

Other structures? How about the Landlord builds the improvements and the Tenant has the option to reimburse the Landlord?

Stough v. Commissioner, 144 T.C. 16 (2015)