

Office of Chief Counsel
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Memorandum

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subject: Construction Allowances for Short Term Leases of Retail Space Not Subject to § 110

This memorandum responds to your request for advice regarding construction allowances that are paid by a lessor to a lessee of retail space under a short-term lease and that are not excluded from the lessee's gross income by § 110 of the Internal Revenue Code. This document should not be used or cited as precedent.

ISSUE

Whether the amount of a construction allowance paid by a lessor to a lessee that exceeds the lessee's cost of constructing or improving qualified long-term real property within the meaning of § 110 is gross income to the lessee under § 61 under the facts described below, and if so, whether the excess amount of the construction allowance is a nonshareholder contribution to capital excluded from the lessee's gross income under § 118.

CONCLUSION

The excess amount of a construction allowance over the lessee's cost of constructing or improving qualified long-term real property within the meaning of § 110 is gross income to the lessee under § 61 and is not a nonshareholder contribution to capital excluded from the lessee's gross income under § 118.

FACTS

A lessee and lessor enter into a lease of retail space as defined in § 110(c)(3) and § 1.110-1(b)(2)(iii) of the Income Tax Regulations. The lease is a short-term lease as defined in § 110(c)(2) and § 1.110-1(b)(2)(ii). In compliance with § 1.110-1(b)(3), the lease agreement expressly provides that the lessor will give the lessee a \$70,000 construction allowance for the purpose of constructing or improving qualified long-term real property for use in the lessee's trade or business at the retail space. Pursuant to the lease agreement, the lessor gives the lessee a \$70,000 construction allowance. In the same taxable year that the lessee receives the \$70,000 construction allowance, the lessee expends \$100,000 for construction or improvement of the retail space ("build-out costs"): \$60,000 for qualified long-term real property as defined in § 110(c)(1) and § 1.110-1(b)(2)(i); and \$40,000 for property owned by the lessee. The lessee notified the lessor that only \$60,000 of the \$70,000 construction allowance was expended on qualified long-term real property. The lessee reported the transaction without including any portion of the \$70,000 construction allowance in its gross income in the taxable year received. Instead, the lessee uses one of the following two methods:

Method #1: The lessee nets the \$70,000 construction allowance against its \$100,000 build-out costs. First, the lessee applies the \$70,000 construction allowance against its \$60,000 cost of the qualified long-term real property. Then, the lessee applies the remaining \$10,000 of the construction allowance ($\$70,000 - \$60,000 = \$10,000$) against its \$40,000 cost of the property owned by the lessee. The lessee takes a \$0 tax basis in the qualified long-term real property and a \$30,000 tax basis in the property owned by the lessee.

Method #2: The lessee treats the \$70,000 construction allowance as an asset, deferred rent, and amortizes it into income as an offset to rent expense over the lease term using the straight-line method. The lessee takes a \$60,000 tax basis in the qualified long-term real property and a \$40,000 tax basis in the property owned by the lessee.

Based on the law and analysis below, we conclude that neither of the foregoing methods is correct for federal income tax purposes. The lessee must include \$10,000 in its gross income in the taxable year it receives the \$70,000 construction allowance (that is, the excess of the \$70,000 construction allowance over the \$60,000 cost of the qualified long-term real property). The lessee has no tax basis in the qualified long-term real property, which is owned by the lessor (§ 110(b)), and a \$40,000 tax basis in the property owned by the lessee (§ 1012) owned by the lessee.

LAW AND ANALYSIS

Section 110(a) provides that gross income of a lessee does not include any amount received in cash (or treated as a rent reduction) by a lessee from a lessor under a short-term lease of retail space and for the purpose of the lessee's constructing or improving qualified long-term real property for use in the lessee's trade or business at the retail

space, but only to the extent that such amount does not exceed the amount expended by the lessee for such construction or improvement.

Section 110(b) provides that qualified long-term real property constructed or improved in connection with any amount excluded from a lessee's income by § 110(a) shall be treated as nonresidential real property of the lessor (including for purposes of § 168(i)(8)(B)).

Section 110(c)(1) defines "qualified long-term real property" as nonresidential real property that is part of, or otherwise present at, the retail space and that reverts to the lessor at the termination of the lease.

Section 110(c)(2) defines "short-term lease" as a lease (or other agreement for occupancy or use) of retail space for 15 years or less (as determined under the rules of § 168(i)(3)).

Section 110(c)(3) defines "retail space" as real property leased, occupied, or otherwise used by a lessee in its trade or business of selling tangible personal property or services to the general public.

Section 1.110-1(a) provides that amounts provided to a lessee by a lessor for property to be constructed and used by the lessee pursuant to a lease are not includible in the lessee's gross income if the amount is a qualified lessee construction allowance.

Section 1.110-1(b)(1) defines a "qualified lessee construction allowance" as any amount received in cash (or treated as a rent reduction) by a lessee from a lessor (i) under a short term lease of retail space; (ii) for the purpose of constructing or improving qualified long-term real property for use in the lessee's trade or business at that retail space; and (iii) to the extent the amount is expended by the lessee in the taxable year received on the construction or improvement of qualified long-term real property for use in the lessee's trade or business at that retail space.

Section 1.110-1(b)(2)(i) defines "qualified long-term real property" as nonresidential real property under § 168(e)(2)(B) that is part of, or otherwise present at, the retail space referred to in § 1.110-1(b)(1)(i) and that reverts to the lessor at the termination of the lease. Thus, qualified long-term real property does not include property qualifying as § 1245 property under § 1245(a)(3).

Section 1.110-1(b)(2)(ii) defines "short term lease" as a lease (or other agreement for occupancy or use) of retail space for 15 years or less (as determined pursuant to § 168(i)(3)).

Section 1.110-1(b)(2)(iii) defines "retail space" as nonresidential real property under § 168(e)(2)(B) that is leased, occupied, or otherwise used by the lessee in its trade or business of selling tangible personal property or services to the general public.

Section 1.110-1(b)(3) provides that an amount will meet the requirement of § 1.110-1(b)(1)(ii) only to the extent that the lease agreement for the retail space expressly provides that the construction allowance is for the purpose of constructing or improving qualified long-term real property for use in the lessee's trade or business at the retail space.

Section 1.110-1(b)(4) provides that expenditures referred to in § 1.110-1(b)(1)(iii) may be treated as being made first from the lessee's construction allowance. Tracing of the construction allowance to the actual lessee expenditures for the construction or improvement of qualified long-term real property is not required.

Section 1.110-1(b)(5) provides that the lessor must treat the construction allowance as fully expended in the construction or improvement of qualified long-term real property for use in the lessee's trade or business at the retail space unless the lessor is notified by the lessee in writing to the contrary.

The Conference Report for the Taxpayer Relief Act of 1997, H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 657 (1997), states the following:

A coordinated issue paper issued by the Internal Revenue Service ("IRS") on October 7, 1996, states the IRS position that construction allowances should generally be included in income in the year received. However, the paper does recognize that amounts received by a lessee from a lessor and expended by the lessee on assets owned by the lessor were not includible in the lessee's income. The issue paper provides that tax ownership is determined by applying a "benefits and burdens of ownership" test that includes an examination of several factors.

The House Report, H.R. Rep. No. 148, 105th Cong., 1st Sess. 423 (1997), and the Senate Report, S. Rep. 33, 105th Cong., 1st Sess. 232 (1997), list the following factors in determining whether a taxpayer has the benefits and burdens of ownership of leased property:

(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 present obligations on the seller to execute and deliver a deed and on the buyer to make payments; (5) whether the right of possession is vested; (6) who pays property taxes; (7) who bears the risk of loss or damage to the property; (8) who receives the profits from the operation and sale of the property; (9) who carries insurance with respect to the property; (10) who is responsible for replacing the property; and (11) who has the benefits of any remainder interests in the property.

The Conference Report, at 658-59, states the following:

In addition, the conferees wish to emphasize that no inference is intended as to the treatment of amounts that are not subject to the provision [§ 110], and that the provisions of the IRS issue paper and present law (including case law) will continue to apply where applicable.

Section 61(a) provides that gross income means "all income from whatever source derived" except as otherwise provided in subtitle A of the Code. Construing similar language in the 1939 Code, the United States Supreme Court in Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), held that the statutory language evidenced Congress's intent to tax all gains except those specifically exempted. Id. at 430. The court concluded that recoveries of certain punitive damages were taxable gains, because they constitute "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Id. at 431.

Consistent with the legislative history of § 110, to the extent a lessee holds the benefits and burdens of ownership of leasehold improvements, the lessee has an accession to wealth. Compare In re Elder-Beerman, 207 BR 548 (Bankr. S.D. Ohio 1997) (property purchased with tenant allowances granted to debtor by developers, pursuant to lease agreements, deemed to be owned by developers). Unless some provision of the Code excludes these payments, they fall within the § 61(a) definition of gross income.

Section 118(a) provides that, in the case of a corporation, gross income does not include any contributions to the capital of the taxpayer. Section 1.118-1 of the Income Tax Regulations recognizes that contributions to capital may be made by shareholders and nonshareholders, and cites as examples of nonshareholder contributions those made by governmental units and civic groups.

The term "contribution to capital" is not defined in the Code or regulations. However, the legislative history indicates that § 118 was intended to be a codification of existing case law. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18-19 (1954). The legislative history also indicates that a capital contribution lies somewhere on a continuum between a gift and compensation. The contribution cannot be called a gift because the contributor expects to derive indirect benefits. Yet, anticipated future benefits are so speculative and intangible that it would be inappropriate to treat the contribution as a payment for future services. Consistent with congressional intent, the regulations provide that the exclusion does not apply to transfers of cash or property to a corporation in exchange for goods or services to be rendered by that corporation.

Three pre-1954 Supreme Court cases are relevant to a determination of the scope of the term "contribution to capital." See Edwards v. Cuba Railroad Company, 268 U.S. 628 (1925); Detroit Edison v. Commissioner, 319 U.S. 98 (1943); and, Brown Shoe v. Commissioner, 339 U.S. 583 (1950). A post-1954 Supreme Court opinion, United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973), is also

relevant to this inquiry. There are also two cases that apply a § 118(a) analysis to inducements paid by developers to anchor stores in order to facilitate the success of shopping centers. See Federated Department Stores v. Commissioner, 51 T.C. 500 (1968), aff'd, 426 F.2d 417 (6th Cir. 1970), nonacq., 1971-2 C.B. 4; and The May Department Stores Company v. Commissioner, T.C. Memo. 1974-253, aff'd per curiam, 519 F.2d 1154 (8th Cir. 1975). The final case relevant to the scope of § 118(a) is John B. White, Inc. v. Commissioner, 55 T.C. 729 (1971), aff'd per curiam, 458 F.2d 989 (3d Cir.), cert. denied, 409 U.S. 876 (1972).

In Cuba Railroad Company, the Supreme Court held that cash subsidies paid by the Republic of Cuba to induce construction and operation of a railroad did not constitute taxable income within the meaning of the Sixteenth Amendment. The Court rested its decision on two grounds. First, it recognized that the subsidies were made with the desire of achieving a broad public benefit since the payments were made to induce the construction and operation of a railroad for the service of the public. Second, it held that the subsidies arose not out of the daily operations of the railroad, but were instead received as additions to the taxpayer's operating assets to be used in the taxpayer's business. This opinion has been credited with establishing an objective, functional use test to determine whether a subsidy constitutes a contribution to capital.

In Detroit Edison, a utility company charged prospective customers for the cost of constructing power line extensions. The issue before the Supreme Court concerned the appropriate method for calculating the depreciable basis of the power lines. The Court concluded that the payments in question were not contributions to capital but rather the price of service. In so holding, the Court narrowed and refined its earlier definition of a "capital contribution". It focused on the motivation behind the contribution rather than on the function of the payment. The Detroit Edison decision has been recognized as replacing the functional use test established by the Cuba Railroad opinion with a subjective contributor motivation test.

In Brown Shoe, the Supreme Court utilized the contributor motivation test as its benchmark. There, community groups contributed cash and property to a manufacturing company to induce the company to locate new, or expand existing, facilities in the communities. The Court held that where the contributor is a community group that is driven by a desire to improve the general well-being of the community, rather than motivated by a desire to obtain a direct benefit for itself, its donations are capital contributions. The Brown Shoe Court distinguished Detroit Edison because the contributors in Detroit Edison, unlike the contributors in Brown Shoe, were future customers of the transferee. The Court further held that since the transferors were motivated by a desire to increase the working capital of the company, the payments were capital contributions.

In Federated Department Stores, a land developer contributed cash and other property to a retail store operator to induce it to construct and operate an anchor store in the developer's shopping center. The Service argued that since the contributor's primary

motive was to increase the value of its property, the contribution was outside the purview of § 118(a). The Tax Court held that the contribution was a § 118(a) capital contribution. In affirming, the Sixth Circuit recognized that the motive behind the developer's contribution was to enhance the value of its property. However, the Sixth Circuit decided that the payor's expectation of future benefit was of such a speculative and intangible nature that any benefit was "indirect" and thus not a payment for future services.

The Sixth Circuit further opined that for a contribution to be considered a payment for future goods and services, the contribution had to have a reasonable nexus to the services normally performed by the recipient corporation. Finally, the Sixth Circuit rejected the argument that a nonshareholder capital contribution can be made only by a governmental or civic group.

May Department Stores involved a shopping center developer's conveyance of land to May, a retail store operator, in return for May's agreement to build and maintain an anchor store in the shopping center. The facts in May roughly paralleled those in Federated and the Tax Court decision did little more than reiterate the conclusions of the Federated court. The court held that because the benefits anticipated by the developer were so speculative and intangible they did not rise to the level of a payment for goods and services. The court refused to limit the meaning of "indirect benefits" to those enjoyed by a contributor solely as a result of its being a member of the community at large. Thus, despite the fact that the overriding and dominant motive of the contributor was to secure a financial benefit for itself, the transfer was accorded capital contribution status.

In John B. White, the Tax Court concluded that § 118(a) was inapplicable to the subject transaction. In John B. White, Ford Motor Company made payments to a Ford dealership to induce it to relocate to a "better" neighborhood. Ford Motor Company anticipated that the move would increase the sales of Ford Motor Company products and enhance the Ford image. Thus, Ford expected to derive a direct benefit from its payment.

In denying § 118(a) treatment, the court distinguished its case from Federated on the basis of the relationship between the payment and the business venture of the recipient corporation. In John B. White, the benefit anticipated by the contributor (increased sales of Ford products and enhancement of the Ford image) had a reasonable nexus with the business the recipient corporation customarily provided (the sale of Ford products). Accordingly, the John B. White court held that the payment was not a capital contribution.

The Supreme Court revisited the nonshareholder capital contribution question in Chicago, Burlington & Quincy Railroad Co. (CB&Q). There, various governmental units donated funds to reimburse a railroad for the cost of constructing railroad crossings that were designed to expedite traffic and improve public safety. Reflecting on its earlier

capital contribution cases, the Court reconciled Brown Shoe and Detroit Edison on the basis of the motivation underlying the respective transfers. When a transferor is motivated by a desire to obtain a direct, specific, and certain benefit for itself, the Court reiterated that capital contribution status is inappropriate.

In CB&Q, each transferor's motive was to benefit the community at large (through improved public safety measures). Accordingly, the payments may well have been classified as capital contributions. However, unlike the Brown Shoe and Detroit Edison decisions, the CB&Q decision identified five characteristics of a nonshareholder contribution to capital: (1) it must become a permanent part of the transferee's working capital structure; (2) it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee; (3) it must be bargained for; (4) the asset transferred must foreseeably result in benefit to the transferee in an amount commensurate with its value; and (5) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect. Because the Court concluded that the recipient corporation failed to satisfy three of these five criteria, the payment was denied capital contribution status. This resulted even though the payor's motivation may well have supported a finding of capital contribution status. (See also Rev. Rul. 93-16, 1993-1 C.B. 16, in which the Service applied the Detroit Edison and Brown Shoe subjective motivation test and the CB&Q five characteristics to determine that an FAA grant to a corporate airport operator was a nonshareholder contribution to capital under § 118(a).)

In light of the above cases, a transfer of money does not qualify as a nonshareholder contribution to capital under § 118 if the transferor is motivated by a desire to obtain specific, quantifiable benefits. If the transferor expects to receive only vague, uncertain, or incidental benefits, the transfer is likely a § 118(a) contribution to capital, provided it satisfies the factors in CB&Q. A transfer in furtherance of the transferor's goal of benefiting the community at large, as described in Brown Shoe, is an example of the classic § 118(a) contribution to capital.

A construction allowance provided by a lessor to a lessee is motivated by the lessor's desire to have the lessee operate a retail store in the lessee's retail property. The lessor is receiving rent. The existence of a lease under which rent is payable to the lessor is a sufficient direct benefit to take a construction allowance outside the scope of § 118(a).

Furthermore, the Federated and May decisions are distinguishable from the facts of this advice and may only be good law prior to 1976. See, e.g., 4 Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, p. 91-53, n.9 (3rd ed. 2003), who cite Federated and May and conclude that under pre-1976 law, courts construed § 118 to exclude contributions by real estate developers to induce corporations to locate portions of their businesses in a development (e.g., a shopping center). In any event, the facts of those cases are distinguishable because rent under a lease provides direct and nonspeculative annual benefits to the lessor. The Federated and May decisions do

not support treating any portion of the construction allowance provided under a lease agreement as excludible from income under § 118(a).

Applying the foregoing law to the facts presented in the request for advice, we conclude that neither method #1 nor method #2 is correct for federal income tax purposes. The lessee must include \$10,000 in its gross income in the taxable year it receives the \$70,000 construction allowance (that is, the excess of the \$70,000 construction allowance over the \$60,000 cost of the qualified long-term real property). The lessee has no tax basis in the qualified long-term real property, which is owned by the lessor (§ 110(b)), and a \$40,000 tax basis in the property owned by the lessee (§ 1012).

Accordingly, we conclude that to the extent a construction allowance paid by a lessor to a lessee exceeds the cost of constructing or improving qualified long-term real property within the meaning of § 110, the allowance is gross income under § 61 and is not excluded from gross income under § 118.

Please call me at (202) 622-3000 or Paul Handleman at (202) 622-3040 if you have any further questions about this matter.

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