

COMMERCIAL LEASE INDUCEMENTS AND TAX TREATMENT

Often with commercial leases a tenant will seek or be offered a form of inducement for its lease of premises, generally to allow for tenant improvements to the space. There are three common types of inducements: a cash payment; a rent holiday or free rent period; or a build-out or construction allowance to be paid by landlord to the tenant. Each of these types of lease inducements are treated differently for tax purposes, and the structuring of the inducement package can impact its tax treatment for both parties to the lease. With respect to any form of inducement, the parties' treatment of the inducement should be clearly set forth in the lease, and should be treated consistently between the landlord and tenant for tax purposes.

Cash Payments: A cash payment, unrestricted as to its use after receipt by the tenant, will generally have to be declared as taxable income by the tenant in the year received. If the tenant were to use such cash for tenant improvements to real property, the tenant would be able to depreciate the improvement costs over a 39 year period (39 years is the current recovery period for commercial real property improvements under IRC §168(c))¹. Generally in the event of such a cash payment, the landlord would treat the payment as a cost of acquiring the lease, and amortize the cost over the term of the lease under IRC §178. The IRS has carved out an exception for a cash payment made for the purpose of, and restricted for the purpose of, a construction allowance for retail tenant improvements to real property, which is addressed below.

Free Rent Periods: Rent holidays or free rent periods can be favorable for the landlord, as a landlord will not be required to report rental income during the rent free period, and will not have to depreciate the cost of tenant improvements to the building over time. Tax treatment of a free rent form of inducement may be less favorable to the tenant, as tenants receiving a free rent inducement would not be able to report a rent expense during the free rent period. Many commercial leases also provide for a graduated rent rate, with a lower rent during the initial years, which improves tenant cash flow during the beginning of the term.

Leases having a free rent period or a graduated rent increase may be subject to I.R.C. §467 which sets forth deferred rent agreement rules (copy attached). Section 467 applies to leases providing for payments of \$250,000 or more, and its purpose is to prevent tax avoidance and deferral, and to provide for consistent reporting by landlords and

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Under current law, if a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement is depreciated using the straight-line method over a 39-year recovery period.

The Job Creations Act signed in 2004 provided a temporary statutory 15-year recovery period for qualified leasehold improvement property placed in service before January 1, 2006. It requires that qualified leasehold improvement property be recovered using the straight-line method. Legislators continue to seek a reduction in the 39-year recovery period for leasehold improvements.

tenants. A simplified summary of the application of §467 is that rent shall be reported by both landlord and tenant and allocated to the periods of time specified in the lease, unless leveling is required for long term leases and disqualified lease-back arrangements. A 'long term lease' is defined as a lease for a term in excess of 75 percent of the statutory recovery period for the property². Leveling of the rent for reporting purposes is not required where the free rent period is for a 'reasonable period' (generally 12 months or less, dependent upon custom, and the commentary states free rent can be for up to 24 months in certain instances); the rent allocable to a taxable year can be determined by the terms of the lease; and there is not a purpose of avoiding taxes. Section 467 also provides exceptions for rent increases based on price indexes, percentages of sales, and increases in payments to third parties.

Retail Tenant Construction Allowances: Generally, the tax treatment of payment of a construction allowance depends upon ownership of the improvements. If the tenant is deemed to be the owner, then the allowance is treated as income to the tenant, and the tenant must depreciate the costs of the improvements over a 39 year period. Landlord would amortize the allowance expense over the lease term. If landlord is the owner of the improvements, then the allowance (assuming is it all applied to costs of the real estate improvements) would not be treated as income to the tenant, and landlord would depreciate the cost of the improvements over a 39 year period. Ownership would be determined by multiple factors, including: which party insures the improvements, which party maintains and replaces the improvements, which party owns the improvements after lease expiration, how the lease addresses ownership, and which party bears the risk of loss. The treatment of lease inducements should be clearly set forth in the lease agreement to avoid confusion as to tax treatment.

The IRS has provided a safe harbor for retail tenants receiving construction allowances for qualified long term real property improvements in connection with a short-term lease, subject to the guidelines in IRC §110, Treasury Regulation Section 1.110 et seq and Rev Ruling 2001-20 (copies attached). Under §110, such an allowance would not be considered income to the tenant. The landlord must own the tenant improvements upon expiration of the lease, and landlord will be required to amortize the cost, paid in the form of the allowance, over a 39-year period. Only that portion of the allowance actually applied to qualified long term real property improvements by the tenant would be protected by the safe harbor, and any other funds received would be treated as income by the tenant. Section 110(c)(1) defines qualified long term real property as nonresidential real property which is part of, or otherwise present at, the retail space and which reverts to lessor at the termination of the lease. Under the Ruling, the tenant must have expended the allowance within 8 ½ months after the end of the taxable year in which the amount was received, or the amount must be in the form of a reimbursement from landlord for amounts spent by the tenant during a prior year, for which the tenant has not claimed and depreciation or deductions.

² 39 years under IRC §168, 19 years under §407(e)(3)(A), and a temporary provision at 15 years for qualified leasehold improvements if placed in service before December 31, 2005 pursuant to the 2004 Jobs Creation Act.

Capital Contributions to Anchor Tenants. It is sometimes the case, in connection with a shopping center or multi-tenant development, that a major or anchor retail tenant will be offered numerous inducements by the landlord, including grants of land, construction of a building at the expense of landlord, or extensive free rent periods, in return for the intangible benefit the major tenant renders to the center. Section 118 of the Code provides a means for such an anchor tenant to exclude intangible inducements from reportable income. Any payment and receipt of rent in return for the inducement, however, including percentage rent, will disqualify this inducement treatment under §118.

Commercial leases providing for tenant inducements should be structured with clarity as to the form of any tenant inducements, and their tax treatment by both parties.³

³*IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that the federal tax advice (if any) contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code or promoting, marketing or recommending to another party any transaction or matter addressed herein.*