

T.D. 8901

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Qualified Lessee Construction Allowances for Short-Term Leases

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning an exclusion from gross income for qualified lessee construction allowances provided by a lessor to a lessee for the purpose of constructing long-lived property to be used by the lessee pursuant to a short-term lease. The final regulations affect a lessor and a lessee paying and receiving, respectively, qualified lessee construction allowances that are depreciated by a lessor as nonresidential real property and excluded from the lessee's gross income. The final regulations provide guidance on the exclusion, the information required to be furnished by the lessor and the lessee, and the time and manner for providing that information to the IRS.

DATES: *Effective Date:* These regulations are effective October 5, 2000.

Date of Applicability: For date of applicability of §1.110-1, see §1.110-1(d).

FOR FURTHER INFORMATION CONTACT: Paul Handleman, (202) 622-3040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of

1995 (44 U.S.C. 3507) under control number 1545-1661. Responses to these collections of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from .5 hours to 1.5 hours, depending on individual circumstances, with an estimated average of 1 hour.

Comments concerning the accuracy of these burden estimates and suggestions for reducing these burdens should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On September 20, 1999, the IRS published proposed regulations (REG-106010-98, 1999-40 I.R.B. 493) in the **Federal Register** (64 F.R. 50783) inviting comments under section 110. A public hearing was held January 19, 2000. Numerous comments have been received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision.

Public Comments

In accordance with section 110(a), the proposed regulations provided 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. The proposed regulations defined a qualified lessee construction allowance as 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, provided the purpose and expenditure requirements are met.

Expenditure Requirement

The proposed regulations required that a qualified lessee construction allowance be 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 the retail space. However, the proposed regulations deemed an amount to have been expended by a lessee in the taxable year in which the construction allowance was received by the lessee if the amount is expended within 8 1/2 months after the close of that taxable year.

Several commentators maintained that the proposed rule prescribing a time limit for making the expenditure is not required by the statute or the legislative history and should be eliminated. One commentator, for example, pointed out the absence of an explicit expenditure requirement in section 110 like the one found in section 118(c)(2)(B), which requires that an expenditure relating to a nontaxable contribution in aid of construction be made before the end of the second taxable year after the year in which such amount was received.

Section 110 does not provide an explicit expenditure time limit, but it also does not toll the statute of limitations until the taxpayer notifies the Secretary that the amount has been expended as does section 118. The lack of a statute of limitation tolling provision in section 110 would be troublesome if there was no limitation on the time period to make the qualified expenditure. In addition, section 110(a) provides that an amount may be excluded only to the extent that such amount does not exceed the amount expended by the lessee for the construction or improvement of qualified long-term real property.

The IRS and Treasury Department believe that the absence of an extension of the statute of limitations and use of the term "expended" in the past tense indicate that the amount must be expended by the end of the taxable year it is received. Ac-

Accordingly, the final regulations retain the expenditure time limitation. However, in recognition that a lessee may not be able to expend the amount in the same taxable year the lessee receives the construction allowance from the lessor, the final regulations also retain the 8 1/2 month rule provided in the proposed regulations. This 8 1/2 month rule, which grants the lessee an additional 8 1/2 months after the close of the taxable year in which the construction allowance was received to expend the amount, is consistent with the time period, including extensions, that a corporate taxpayer has to file its return for the taxable year in which the construction allowance is received.

Commentators requested that to the extent the final regulations retain the expenditure requirement, the requirement should be modified to include construction allowances used to reimburse lessee expenditures made in a prior year. In response to these comments, the final regulations clarify that, provided the lessee has not depreciated the expenditures, reimbursements received in a taxable year after the year in which the expenditures are made by the lessee are timely for purposes of the expenditure requirement.

Purpose Requirement

Consistent with section 110(a), the proposed regulations provided that a qualified lessee construction allowance must be under a short-term lease of retail space and 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. The proposed regulations required that the lease agreement for the retail space expressly provide 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 that retail space. The purpose requirement was intended to further Congressional intent of ensuring consistency in the treatment of the construction allowance by both the lessor and the lessee.

Commentators suggested deleting the requirement in the proposed regulations that the lease agreement "expressly provides" that a construction allowance be for the purpose of constructing or improving qualified long-term real property. Other commentators suggested changing

this language to "substantially provides" or using a standard that would lead a reasonable person to conclude that the purpose of the construction allowance amount is for the construction or improvement of qualified long-term real property. The final regulations do not adopt these suggestions. The IRS and the Treasury Department believe that this express language is consistent with the requirements of section 110(a) and is necessary to help ensure that the lessor and the lessee take consistent tax positions.

In addition, commentators noted that lease agreements do not necessarily address construction allowances. The construction allowance provisions may be contained in another document executed contemporaneously with the lease agreement or executed during the lease term. For example, the lessor may provide a construction allowance during the lease term for the remodeling of the retail space by the lessee. In response to these comments, the final regulations clarify that an ancillary agreement executed contemporaneously with the payment of a construction allowance, whether executed with the lease or during the term of the lease, is considered a provision of the lease agreement for this purpose.

Definition of Retail Space

Section 110(c)(3) defines the term "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. The proposed regulations specifically requested comments on whether the definition of "retail space" needs to be clarified.

In response to comments, the final regulations clarify that offices for hair stylists, tailors, shoe repairmen, doctors, lawyers, accountants, insurance agents, financial advisors, stock brokers, securities dealers (including dealers who sell securities out of inventory), and bankers are included in the definition of retail space. The final regulations also clarify that a taxpayer is selling to the general public if the products or services for sale are made available to everyone even though only certain customers or clients are targeted.

A commentator suggested that retail space should include back-office support functions that are contiguous to the retail

sales area and not be limited only to areas where customers purchase products and services. Section 110(c)(3) and the proposed regulations only require that the property be used "in the trade or business" of selling tangible personal property or services to the general public. In response to these comments, the final regulations state that the term "retail space" includes not only the space where the retail sales are made, but also space where activities supporting the retail activity are performed (such as an administrative office, a storage area, and an employee lounge).

Definition of Lease Term

Consistent with section 110(c)(2), the proposed regulations defined a 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 section 168(i)(3)). Section 168(i)(3) provides rules on determining when renewal options will be considered part of the lease term. Section 168(i)(3)(B) provides that, in the case of nonresidential real property or residential rental property, any option to renew at fair market value, determined at the time of renewal, is not taken into account for purposes of determining the lease term.

A commentator suggested that the final regulations stipulate that certain common renewal options will be considered to be at fair market value. For example, the commentator suggested that if a lease sets rent at a certain percentage of sales for the original lease term and uses that same percentage of sales for renewal options, the renewals should be considered to be at fair market value. As the comment relates to the determination of lease term under section 168 and would affect other provisions in addition to section 110 that reference section 168(i)(3), such as sections 142 and 280F, the comment is beyond the scope of this regulation. Accordingly, the final regulations do not adopt the suggested comment.

Information Requirement

The proposed regulations required qualified lessee construction allowance information to be furnished by the lessor and the lessee to the IRS, and described the time and manner for providing that information to the IRS. The proposed regulations also provided that a lessor or a

lessee that fails to furnish the required information may be subject to a penalty under section 6721.

A commentator suggested that the required information to be furnished should be the information that is current at the time the lease is executed. According to the commentator, it would not be unusual for a lease to be executed years prior to the payment and receipt of the construction allowance. One of the parties to the lease may have been acquired by another taxpayer or its name and address may have changed.

The final regulations do not adopt the suggestion. The purpose of the information reporting by the lessor and the lessee is to ensure consistent treatment of the construction allowance as nonresidential property owned by the lessor. Accordingly, it is imperative that the identity of the persons paying and receiving the construction allowance amount and relevant information provided be correct.

A commentator suggested that the information requirement should absolve the party filing the information statement from any penalty under section 6721 if the party relied upon incorrect information received from the other party or if the information cannot be obtained from the other party after reasonable efforts. Section 6724(a) provides that no penalty shall be imposed under section 6721 with respect to any failure if it is shown that such failure is due to reasonable cause and not willful neglect. Thus, no penalty under section 6721 will apply to a lessor (or a lessee) if the failure to furnish qualified lessee construction allowance information resulted from the lessee (or the lessor) providing incorrect information to the other party to the lease upon which the lessor (or the lessee) relied in good faith.

Another commentator suggested that the information to be furnished by a lessor is duplicative because the lessee is required to furnish the same information to the IRS. According to the commentator, the lessee should bear the entire burden of filing the required information because the lessee is the primary beneficiary of section 110. The final regulations do not adopt the commentator's suggestion. The information provided by the lessor is helpful in corroborating the information provided by the lessee and ensures that the lessor treats the amount as nonresidential real property on its return.

Moreover, the reporting requirement in section 110(d) specifically provides that both the lessor and the lessee should furnish information.

Effective Date

The proposed regulations proposed an effective date applicable to leases entered into on or after the date final regulations are published in the **Federal Register**. A commentator suggested delaying the effective date of the final regulations to allow businesses a short period to conform their business practices to the final regulations. The final regulations adopt this suggestion by making the regulations effective 30 days after the date the final regulations are published in the **Federal Register**.

Although the final regulations do not provide for an election to apply the regulations retroactively, taxpayers who comply with the rules set forth in the regulations for leases entered into after August 5, 1997, and prior to the effective date of the regulations (other than the reporting requirement) will be treated as meeting the requirements of section 110.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that any burden on taxpayers is minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Paul F. Handleman, Office of the Associ-

ate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.110-1 also issued under 26 U.S.C. 110(d); * * *

Par. 2. Section 1.110-1 is added to read as follows:

§1.110-1 Qualified lessee construction allowances.

(a) *Overview.* 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 under paragraph (b) of this section.

(b) *Qualified lessee construction allowance—(1) In general.* A qualified lessee construction allowance means 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.

(2) *Definitions—(i) Qualified long-term real property* is nonresidential real property under section 168(e)(2)(B) that is part of, or otherwise present at, the retail space referred to in paragraph (b)(1)(i) of this section and which reverts to the lessor at the termination of the lease. Thus, qualified long-term real property does not include property qualifying as section 1245 property under section 1245(a)(3).

(ii) *Short-term lease* is a lease (or other agreement for occupancy or use) of retail space for 15 years or less (as determined pursuant to section 168(i)(3)).

(iii) *Retail space* is nonresidential real property under section 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. The term *retail space* includes not only the space where the retail sales are made, but also space where activities supporting the retail activity are performed (such as an administrative office, a storage area, and employee lounge). Examples of services typically sold to the general public include services provided by hair stylists, tailors, shoe repairmen, doctors, lawyers, accountants, insurance agents, stock brokers, securities dealers (including dealers who sell securities out of inventory), financial advisors and bankers. For purposes of this paragraph (b)(2)(iii), a taxpayer is selling to the general public if the products or services for sale are made available to the general public, even if the product or service is targeted to certain customers or clients.

(3) *Purpose requirement.* An amount will meet the requirement in paragraph (b)(1)(ii) of this section 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. An ancillary agreement between the lessor and the lessee providing for a construction allowance, executed contemporaneously with the lease or during the term of the lease, is considered a provision of the lease agreement for purposes of the preceding sentence, provided the agreement is executed before payment of the construction allowance.

(4) *Expenditure requirement—(i) In general.* Expenditures referred to in paragraph (b)(1)(iii) of this section 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. However, the lessee should maintain accurate records of the amount of the qualified lessee con-

struction allowance received and the expenditures made for qualified long-term real property.

(ii) *Time when expenditures deemed made.* For purposes of paragraph (b)(1)(iii) of this section, an amount is deemed to have been expended by a lessee in the taxable year in which the construction allowance was received by the lessee if—

(A) The amount is expended by the lessee within 8 1/2 months after the close of the taxable year in which the amount was received; or

(B) The amount is a reimbursement from the lessor for amounts expended by the lessee in a prior year and for which the lessee has not claimed any depreciation deductions.

(5) *Consistent treatment by lessor.* Qualified long-term real property constructed or improved with any amount excluded from a lessee's gross income by reason of paragraph (a) of this section must be treated as nonresidential real property owned by the lessor (for purposes of depreciation under 168(e)(2)(B) and determining gain or loss under section 168(i)(8)(B)). For purposes of the preceding sentence, the lessor must treat the construction allowance as fully expended in the manner required by paragraph (b)(1)(iii) of this section unless the lessor is notified by the lessee in writing to the contrary. General tax principles apply for purposes of determining when the lessor may begin depreciation of its nonresidential real property. The lessee's exclusion from gross income under paragraph (a) of this section, however, is not dependent upon the lessor's treatment of the property as nonresidential real property.

(c) *Information required to be furnished—(1) In general.* The lessor and the lessee described in paragraph (b) of this section who are paying and receiving a qualified lessee construction allowance, respectively, must furnish the information described in paragraph (c)(3) of this section in the time and manner prescribed in paragraph (c)(2) of this section.

(2) *Time and manner for furnishing information.* The requirement to furnish information under paragraph (c)(1) of this section is met by attaching a statement with the information described in paragraph (c)(3) of this section to the lessor's

or the lessee's, as applicable, timely filed (including extensions) Federal income tax return for the taxable year in which the construction allowance was paid by the lessor or received by the lessee (either in cash or treated as a rent reduction), as applicable. A lessor or a lessee may report the required information for several qualified lessee construction allowances on a combined statement. However, a lessor's or a lessee's failure to provide information with respect to each lease will be treated as a separate failure to provide information for purposes of paragraph (c)(4) of this section.

(3) *Information required—(i) Lessor.* The statement provided by the lessor must contain the lessor's name (and, in the case of a consolidated group, the parent's name), employer identification number, taxable year and the following information for each lease:

(A) The lessee's name (in the case of a consolidated group, the parent's name).

(B) The address of the lessee.

(C) The employer identification number of the lessee.

(D) The location of the retail space (including mall or strip center name, if applicable, and store name).

(E) The amount of the construction allowance.

(F) The amount of the construction allowance treated by the lessor as nonresidential real property owned by the lessor.

(ii) *Lessee.* The statement provided by the lessee must contain the lessee's name (and, in the case of a consolidated group, the parent's name), employer identification number, taxable year and the following information for each lease:

(A) The lessor's name (in the case of a consolidated group, the parent's name).

(B) The address of the lessor.

(C) The employer identification number of the lessor.

(D) The location of the retail space (including mall or strip center name, if applicable, and store name).

(E) The amount of the construction allowance.

(F) The amount of the construction allowance that is a qualified lessee construction allowance under paragraph (b) of this section.

(4) *Failure to furnish information.* A lessor or a lessee that fails to furnish the information required in this paragraph (c)

may be subject to a penalty under section 6721.

(d) *Effective date.* This section is applicable to leases entered into on or after October 5, 2000.

PART 602—OMB CONTROL
NUMBERS UNDER THE
PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry for 1.110–1 to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

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(b) * * *

Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

Approved August 29, 2000.

Jonathan Talisman,
*Acting Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on September 1, 2000, 8:45 a.m., and published in the issue of the Federal Register for September 5, 2000, 65 F.R. 53584)