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Taxation of Build-Out Allowance

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In negotiating a build-out allowance from its landlord, does a tenant create income for itself? Unless the tenant has met the requirements of Internal Revenue Code Section 110, the answer is probably unclear. The crux of the analysis in determining whether a tenant has income from landlord-funded improvements is whether the tenant "owns" the improvements. If the tenant owns the improvements, then it has been enriched from the landlord-provided allowance and has realized income.

But what is "ownership" in this context? Outside of IRC 110, the IRS has determined ownership for these purposes by examining seven factors: (1) who has legal title, (2) how have the parties to the transaction treated it, (3) did the tenant acquire an equity interest in the property, (4) who has the right to possess the asset, (5) which party pays the property tax, (6) which party bears the risk of loss or damage to the property, and (7) which party receives the profits from the operation and sale of the property. While these seem reasonable, seven-factor tests from the IRS rarely produce consistent, reliable results.

Section 110 of the Internal Revenue Code is meant to provide consistency and reliability in determining the taxation of landlord-provided build-out allowances. If Section 110 applies to a build-out allowance, then it is not included in the gross income of the tenant (whether as cash or a rent reduction).

Section 110 has a few requirements:

1. **The lease must be a short-term lease of retail space.** Section 110 is only helpful for retail tenants. For purposes of Section 110, a retail tenant is any person that sells tangible personal property or services to the general public. A "short term lease" is a lease having a duration of fewer than 15 years
2. **The build-out allowance has to be for the purpose of constructing or improving qualified long-term real property for use in the tenant's trade or business at such retail space.** "Qualified long-term real property" means nonresidential real

property that is part of or present at the retail space of the tenant. The construction or improvements must revert to the landlord at the end of the lease.

3. **The lease agreement must expressly state that the build-out allowance is for the purposes of constructing the improvements.** It is crucial that the lease agreement not simply provide a discounted rent to allow the tenant additional funds to complete the build-out.
4. **The build-out allowance must be noted in a statement attached to the tenant's and landlord's income tax returns.**

By complying with Section 110, a retail tenant can ensure its treatment of a build-out allowance for tax purposes is respected by the IRS.