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Tenant Allowances
—When Are Construction-Related Payments Included in Income?

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One income tax issue that has given rise to much confusion and some litigation over the years is the treatment of amounts, often referred to as tenant allowances, that are paid by a landlord to a tenant to finance the construction and "build-out" of facilities by the tenant for its use.

Background

Generally, if tenant allowances are provided to fund the construction of improvements that will be owned by the landlord, the amounts are not includible in the tenant's income and are included in the landlord's investment in the property subject to depreciation. Conversely, if funds paid by a landlord to a tenant in connection with entering into a lease are unrestricted as to use, or are required to be used by the tenant to construct improvements or acquire fixtures that will be owned *by the tenant*, those amounts are generally includible in the tenant's income. However, determining the true owner of property for tax purposes is often not a simple task.

The United States Bankruptcy Court for the Southern District of Ohio recently had occasion to address some of these distinctions. The court ultimately denied an Internal Revenue Service claim against a debtor in bankruptcy that was premised on the assertion that approximately $39 million of tenant allowances paid to the debtor were required to be included in its income (*In re The Elder-Beerman Stores Corp.*, 207 Bankr. 548, 79 AFTR2d 2076 (1997)).

Elder-Beerman Stores

The Elder-Beerman Stores Corporation ("E-B") was a retail department store chain which opened "anchor" stores in many shopping centers. E-B did not have sufficient capital to finance the construction of its own stores, and therefore opened its stores in buildings that were leased from the developers of shopping center projects.

Prior to 1990, developers would generally build, at their cost, the building shell of each store. E-B would then bear the cost of completing the interior build-out.

Beginning in 1991 and throughout the tax years before the court (1992-1995), E-B entered into arrangements with developers pursuant to which E-B agreed to construct the entire store for its use. E-B received payments from developers to fund the costs of construction and fixtures. This arrangement, as compared to E-B's prior practice, permitted stores to be constructed more quickly and at lower cost, through the supervision of construction by E-B personnel and the use of contractors familiar with E-B's requirements who followed E-B from store to store.

Tenant allowances were negotiated by E-B by reference to budgets prepared by E-B for each project. The tenant allowances did not, however, fully cover the costs of completing the building shell and interior build-out.

Payment of the tenant allowances was typically tied to the completion of a stage in the construction process. Generally, E-B was required to submit each claim to a developer for payment on an AIA form entitled "Application and Certificate for Payment," on which form E-B would be identified as the contractor and the developer would be identified as the owner of the building being constructed. Title to each building was held by the developer.

The leases to E-B reflecting these arrangements each provided for an initial lease term of a fixed period, generally 20 years, with renewal options. The leases required E-B to make fixed and percentage rent payments and, usually, to pay a share of the developers' common area maintenance costs, real estate taxes and insurance costs. The developers could use the buildings as collateral for a loan, and could sell or transfer title to the buildings.

During the years at issue, E-B received from developers $44 million in tenant allowances relating to new and expanded stores at 13 locations. Of that amount, $37 million was expended on the construction of stores and $7 million on related fixtures, furniture and equipment (FF&E). Before the case was decided, E-B had included in its income $4.5 million of the tenant allowances received in prior tax years for the acquisition of FF&E.

E-B filed for bankruptcy in October, 1995, and the IRS thereafter filed a claim for taxes due based on the portion of the tenant allowances that had not been reported by E-B as income. The IRS argued that the transactions were shams structured by E-B to hide income; that the payments were made to induce E-B to locate its stores in the shopping centers; that the transactions lacked economic substance; that E-B had the benefits and burdens of ownership and therefore owned the stores for tax purposes; and that, accordingly, E-B must include the payments in its income.

E-B objected to the claim, arguing (i) that the tenant allowances were received as reimbursement for E-B's construction of stores on behalf of the developers which E-B then leased, and therefore were not includible in E-B's income; and (ii) that, even if E-B were deemed to own the stores for tax purposes, the allowances were excludible from its income as capital contributions under section 118 of the Internal Revenue Code.

The court concluded that, under the seminal case of *Frank Lyon Co. v. United States* (435 U.S. 561 (1978)) and its progeny, including the Tax Court decision in *Grodt & McKay Realty* (77 T.C. 1221 (1981)) cited by the IRS in support of its claim, the form of the transactions as leases of buildings owned by the developers should be respected because the developers were, in substance as well as in form, the owners of the buildings and improvements funded through the tenant allowances.

With respect to the factors that the case law indicates are relevant to this analysis, the court noted that the developers had title to the land and buildings; that E-B had no equity interest or right to acquire an equity interest in the buildings leased to it; that the developers would be entitled to any gain realized upon the sale of a store; and that the developers were required to insure the stores and bore the ultimate risk of loss or damage to the stores.

E-B did have some rights and obligations generally associated with the ownership of real property, specifically, the right to possession (not surprisingly) and the contractual obligation under the lease to pay to the lessors property taxes and insurance premiums relating to the stores and to perform general repairs and maintenance.

The court properly concluded, however, that these rights and obligations were typical of a commercial net lease arrangement, and therefore did not justify a conclusion that the lease transactions ought to be recharacterized or that E-B should otherwise be viewed as owning improvements paid for through the tenant allowances. Rather than being the owner of the properties, the court found that E-B "was merely a conduit for the developers' money."

A footnote in the opinion states that, even if E-B were found to own the improvements funded with the tenant allowances, those allowances would be contributions to capital excludible from its income under Code section 118, citing (among other cases) *Federated Department Stores v. Commissioner* (426 F.2d 417 (6th Cir. 1970)). In light, however, of the conclusions elsewhere in the opinion that the form of the transactions should be respected and that the developers (and not E-B) owned the improvements, this alternative characterization of the payments as capital contributions (which would be inconsistent with other conclusions in the opinion) should probably be viewed as mere dictum.

Observations

The court appears to have reached a sensible result under the circumstances described in the decision. In a nutshell, the developer providing the funds (from its own resources or from borrowings) was treated as the owner of the property constructed or otherwise acquired with those funds. The court apparently viewed E-B as a conduit or agent for the developers in constructing the improvements.

It appears that the court did not consider at length an assertion by the IRS, apparently as a fall-back position, that E-B should be treated as the owner of property funded with the tenant allowances at least to the extent of the interior build-out and FF&E. Most if not all of the FF&E and interior build-out probably had an economic useful life of not more than the typical 20-year term of the leases, a fact which would tend to support a conclusion that the developer did not have the benefits of ownership of such property and therefore, perhaps, should not be treated as owning it for tax purposes. (This is not to suggest, however, that useful life should be the sole criterion for determining ownership in this context.)

One may speculate as to why the IRS chose to litigate this issue in this case. In a nonbankruptcy tax audit, such an issue would more likely be resolved by settlement or other disposition through the administrative process. It also appears, however, that the IRS had previously prevailed in compelling E-B to include some tenant allowance amounts in income, "based on certain language in a lease." That victory may have caused the IRS to become overly confident of winning its case with respect to the claim litigated here.