
Section 61.—Gross Income Defined

26 CFR 1.61-1: Gross income.

Must a lease agreement provide that an entire construction allowance is for the purpose of constructing or improving qualified long-term real

property to satisfy the purpose requirement under § 1.110-1(b)(3) of the Income Tax Regulations? See Rev. Rul. 2001-20, beginning on this page.

Section 110.—Qualified Lessee Construction Allowances for Short-Term Leases

26 CFR 1.110-1: Qualified lessee construction allowances. (Also § 61; 1.61-1.)

Qualified lessee construction allowances for short-term leases. The

purpose requirement under section 1.110-1(b)(3) of the Income Tax Regulations does not require a lease agreement to provide that the entire construction allowance is for the purpose of constructing or improving qualified long-term real property. However, only the portion of the construction allowance actually expended on qualified long-term real property for use in the lessee's trade or business at the retail space may qualify as a qualified lessee construction allowance.

Rev. Rul. 2001-20

ISSUE

Must a lease agreement provide that an entire construction allowance is for the purpose of constructing or improving qualified long-term real property to satisfy the purpose requirement under § 1.110-1(b)(3) of the Income Tax Regulations?

FACTS

X is in the business of selling tangible personal property to the general public. On February 5, 2001, X and Y sign a 10-year agreement for the lease by X of retail space located in Y's newly constructed shopping center. The 10-year lease term starts March 1, 2001. A provision of the lease agreement provides that Y will provide X with a construction allowance in the amount of \$1 million for the retail space. The lease agreement provides that, to the extent the \$1 million construction allowance is spent on qualified long-term real property, it is for the purpose of constructing or improving qualified long-term real property for use in X's business at the retail space located at Y's shopping center.

During X's 2001 taxable year, X receives the \$1 million construction allowance and spends \$800,000 on qualified long-term real property and \$100,000 on section 1245 property for the leased retail space located in Y's shopping center. X is permitted to retain any excess over the amount it actually spends improving the retail space.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that gross income means "all income from whatever source derived" except as otherwise provided in subtitle A of the Code.

Section 110(a) provides a safe harbor excluding from gross income 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, 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 the amount does not exceed the amount expended by the lessee for the construction or improvement (a qualified lessee construction allowance).

Section 110(c)(1) defines the term "qualified long-term real property" as nonresidential real property which is part of, or otherwise present at, the retail space referred to in § 110(a) and which reverts to the lessor at the termination of the lease. Section 1.110-1(b)(2)(i) further defines qualified long-term real property as not including property qualifying as section 1245 property under section 1245(a)(3).

Section 110(c)(2) defines the term "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 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.

Under the purpose requirement in § 1.110-1(b)(3), an amount is excluded from gross income under § 110(a) 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.

The intent of the purpose requirement in § 1.110-1(b)(3), which requires the lease agreement expressly provide that the construction allowance is for the purpose of constructing or improving qualified long-term real property, is to ensure that the lessor and the lessee take consistent tax positions. The requisite provision in the lease agreement serves as an acknowledgment by the lessor and the lessee that, to the extent the construction allowance is spent on qualified long-term real property, the improved or constructed property will be treated as owned by the lessor. The

purpose requirement in § 1.110-1(b)(3) does not require a lease agreement to provide that the entire construction allowance is for the purpose of constructing or improving qualified long-term real property. However, only the portion of the construction allowance actually spent on qualified long-term real property may qualify as a qualified lessee construction allowance. Accordingly, of the \$1 million construction allowance provided by Y to X, \$800,000 qualifies as a qualified lessee construction allowance that may be excluded from income under § 110(a).

HOLDING

The purpose requirement under § 1.110-1(b)(3) does not require a lease agreement to provide that the entire construction allowance is for the purpose of constructing or improving qualified long-term real property. However, only the portion of the construction allowance actually expended on qualified long-term real property for use in the lessee's trade or business at the retail space may qualify as a qualified lessee construction allowance.

DRAFTING INFORMATION

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