INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-127287-09

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer
A
B

ISSUE(S):

1. Whether the Taxpayer's transfers of retail buildings in Ground Owned transactions and in Ground Leased transactions qualify as sales under § 1001 of the Internal Revenue Code so that Taxpayer recognizes gain or loss.

2. Whether the Taxpayer held certain retail buildings primarily for sale to customers in the ordinary course of its trade or business under § 1221(a)(1) so that sale of the retail buildings resulted in ordinary, not capital, gain or loss.

CONCLUSION(S):

1. The Taxpayer's transfers of retail buildings in Ground Owned transactions qualify as sales under § 1001 and result in gain or loss. The Taxpayer's transfers of

retail buildings in Ground Leased transactions do not qualify as sales. Instead, the tenant improvement allowances received by Taxpayer from landlords in these transactions represent reimbursements for costs incurred by Taxpayer for leasehold improvements to be owned by the landlords. To the extent Taxpayer has incurred costs that exceed the tenant improvement allowance received from a landlord for a particular retail building, Taxpayer has a depreciable interest in the retail building.

2. Taxpayer held the retail buildings sold in Ground Owned transactions primarily for sale to customers in the ordinary course of its trade or business under § 1221(a)(1), and the sale of these retail buildings resulted in ordinary, not capital, gain or loss.

FACTS:

Taxpayer is a specialty retailer of consumer electronics, home office products, entertainment software and related services. Taxpayer operates retail stores throughout the United States. The majority of Taxpayer's retail stores are self-constructed in either a “Ground Owned” or “Ground Leased” transaction. Four representative transactions were submitted to the national office for review. Three transactions are Ground Leased transactions and one is a Ground Owned transaction.

Ground Owned Transactions

In a Ground Owned transaction, Taxpayer owns the land upon which it constructs a building. Following construction and an appraisal, Taxpayer transfers title to the land and the building to an institutional investor for cash consideration. Taxpayer then leases back the property, generally for a term of 22 years, with two ten-year renewal periods at Taxpayer’s option. Rent for the renewal terms is pre-determined and substantial.

Ground Leased Transactions

In a Ground Leased transaction, Taxpayer leases land from a landlord (typically a shopping center developer) and constructs a building to be used by Taxpayer as a retail store (“the leasehold improvement” or “retail building”). Upon completion of the leasehold improvement, the landlord is obligated to pay Taxpayer a “Tenant Improvement Allowance” ("TIA"). Following construction of the leasehold improvements, the landlord leases the land and leasehold improvements to Taxpayer for a term substantially similar to those common under the Ground Owned scenario.

The amount of the TIA is negotiated by Taxpayer and the landlord prior to construction of the leasehold improvement. While the amounts paid Taxpayer in Ground Owned transactions were based on independent third-party appraisals, no appraisals were

performed as part of the Ground Leased transactions. Rather, the amount of the TIA in these transactions reflected the relative bargaining strengths of Taxpayer and its landlord, with the projected cost of leasehold improvements providing a starting point for negotiation.

The TIA generally is paid to Taxpayer after the leasehold improvements are constructed, title to the improvements is transferred to the landlord, and the Taxpayer provides proof that all contractors have been paid. If a landlord fails to pay any portion of the TIA, the lease agreement permits Taxpayer to withhold or reduce rent until the full amount of the TIA is paid. Generally, the amount of the TIA in Ground Leased transactions is less than the amount expended by Taxpayer to construct the leasehold improvements.

LAW AND ANALYSIS:

Issue One

Whether the Taxpayer's transfers of retail buildings in Ground Owned transactions and in Ground Leased transactions qualify as sales under § 1001 so that Taxpayer recognizes gain or loss.

Ground Owned Transactions

In the case of Ground Owned transactions, Examination's position is that the sale-leaseback transactions are in substance financings, not sales, because the term of the leaseback to Taxpayer exceeds the useful life of the property.

In applying the doctrine of substance over form, courts look to the objective economic realities of a transaction rather than to the particular form the parties may have employed. Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978). Within the field of taxation, the courts are concerned with "substance and realities, and formal written documents are not rigidly binding." Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939).

A lease agreement that transfers all of the benefits of ownership of personal property to the lessee for substantially the entire useful life of the property is considered a sale (i.e., the transfer of equitable ownership). See, e.g., Rev. Rul. 55-540, 1955-2 C.B. 39; Rev. Rul. 55-541, 1955-2 C.B. 19. Where the transaction involves a sale-leaseback, support exists for recharacterizing the transaction as a financing. See, e.g., Rev. Rul. 72-543, 1972-2 C.B. 87 (transfer of title to a vessel followed by 21-year charter back to seller for rent sufficient to repay acquisition and reconstruction costs plus accrued interest recharacterized as a financing arrangement.)

Where real property is subject to a sale and leaseback, courts have sometimes recast the transaction as a financing arrangement. However, in such cases, a comparison of the length of the lease term to the estimated useful life of the real property is only one of a number of factors considered in making the determination of whether or not to respect the form of the transaction. See, e.g., Helvering v. Lazarus, supra (Court recharacterized purported transfer of ownership and 99-year leaseback as a mortgage and noted that lease obligations of taxpayer were structured to repay amount advanced to taxpayer.).

In the case of Ground Owned transactions, the facts do not support Examination's position that the leaseback term exceeds the useful life of the leasehold improvements. The sale-leaseback transactions here entail both land and leasehold improvements. Land, however, does not have finite useful life. Further, the lease agreements generally provide for two ten-year renewal terms following an initial 22-year term. Rents for the renewal terms are predetermined but substantial. If Taxpayer does not exercise its renewal rights, the leasehold improvements revert to the landlord, who has certain remarketing rights. These facts evidence that the useful life of the property extends beyond the initial lease term. We are not aware of any other facts that would support treating the Ground Owned transactions as financing arrangements. Accordingly, we conclude that the Ground Owned transactions are sales for Federal income tax purposes.

Ground Leased Transactions

In the Ground Leased transactions, Examination's position is that Taxpayer may depreciate its unreimbursed leasehold improvement costs over the specified recovery period of the improvements. Taxpayer's position is that it may deduct these costs in full under § 165 in the year the improvements are transferred to a landlord. Taxpayer's theory is that it sold the leasehold improvements to developers in exchange for the TIAs, and that the leasehold improvements had a basis equal to the total cost of the improvements (including both costs reimbursed through the TIA and Taxpayer's unreimbursed costs). Taxpayer concludes that it realizes gain (or loss) to the extent a TIA is more (or less) than the total cost of the improvements.

General rules regarding depreciation of leasehold improvement costs

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the taxpayer's trade or business. Section 1.167(a)-4 of the Income Tax Regulations provides that capital expenditures made by a lessee for the erection of buildings or the construction of other permanent improvements on leased property are recoverable through allowances for depreciation or amortization.

The depreciation deduction for tangible property placed in service after 1986 generally is determined under § 168. Section 168(i)(8)(A) provides that buildings erected (or improvements made) on leased property are determined under the provisions of § 168. A commercial building generally is classified as nonresidential real property under § 168(e)(2) and is depreciated using the straight-line method of depreciation, mid-month convention and a 39-year recovery period under § 168(b).

Case law both supports this general principal that a lessee depreciates leasehold improvements and clarifies that the party entitled to depreciate property is not necessarily the party with title to the property but rather the party who has invested in the property and thereby acquired a depreciable interest. See Gladding Dry Goods Co. v. Commissioner, 2 B.T.A. 336, 338 (1925) (the right to take a depreciation deduction for leasehold improvements is based on the capital investment in the property and not on legal title); Hopkins Partners v. Commissioner, T.C. Memo. 2009-107 (legal title and the right of possession are not determinative).

If a lessor makes improvements at the lessor's own expense, the lessor is entitled to depreciation deductions even though the lessee has the use of the improvements. Gladding Dry Goods, 2 B.T.A. at 338-339.

Leasehold improvement costs and tenant improvement allowances

Case law addresses how the foregoing rules regarding recovery of leasehold improvement costs apply when a lessor pays a lessee a tenant improvement allowance. In re: Elder-Beerman Stores, Corp., 207 B.R. 548 (S.D. Ohio 1997), is a bankruptcy court decision involving transactions similar to those at issue here. Taxpayer, a retailer, had agreed to contract for the construction of leasehold improvements, and a shopping center developer, as lessor, had agreed to pay a tenant improvement allowance. Taxpayer and the developer had "mutual rights of approval" over construction plans. The amount of the tenant improvement allowance was the result of negotiation, but the taxpayer based its negotiations on the construction budget. "[P]ayment of each tenant allowance was tied to the completion of the entire store or to the completion of different stages of the construction process." Id. at 553. Prior to payment, developers wanted "clean" title and required "lien waivers" from contractors.

The court held that the tenant improvement allowances were reimbursements by the developers for improvements the developers would own as lessors: "[T]he transactions will be respected as structured by the parties. Elder-Beerman and the developers unambiguously entered into lease agreements in which Elder-Beerman constructed the stores for the developers. The tenant allowances were basically reimbursements of those construction costs." Id. at 557.[1] The court further noted that to the extent the

[1] The Elder-Beerman court noted that its conclusion is consistent with the position taken by the Service in a Coordinated Issue Paper on Tenant Allowances to Retail Store Operators (issued October 8, 1996 (the "ISP Paper") and reprinted at Daily Tax Reporter No. 196 (BNA)). The ISP paper addresses the tax

retailer was not fully reimbursed, it had a depreciable interest: "To the extent the tenant allowances did not provide a complete store, Elder-Beerman had to invest its own capital in the stores. Regardless of which party might be considered to legally own such additional property, Elder-Beerman is deemed to own the property, for tax purposes." Id. at 557. "When Elder-Beerman did commit its capital to the store, it rightfully depreciated those amounts representing the consumption of that capital. See Treas. Reg. § 1.167(a)-4." Id. at 556.

Congress also has addressed the proper tax treatment of tenant improvement allowances. The Taxpayer Relief Act of 1997 (the Act) added a safe harbor in § 110 of the Code whereby it is assumed that a construction allowance is used to construct or improve lessor property (and is properly excludable by the lessee) when long-lived property is constructed or improved and used pursuant to a short-term lease. The Act provides a reporting requirement to ensure that the lessee and the lessor consistently treat the property funded with the construction allowance as nonresidential real property owned by the lessor. H.R. Rep. No. 148, 105th Cong., 1st Sess. 423, 424 (1997) (House Report); S. Rep. No. 33, 105th Cong., 1st Sess. 232-33 (1997) (Senate Report).

The legislative history of the Act states that no inference is intended as to the treatment of amounts that are not subject to the safe harbor provision. In such cases, the provisions of the ISP paper and present law (including case law) will continue to apply. H.R. Conf. Rep. No. 220, 105th Cong.,1st Sess. 658-59 (1997). The legislative history also contains the following statement:

> The [Senate] committee [on finance] understands that it is common industry practice for a lessor to custom improve retail space for the use by a lessee pursuant to a lease. Such leasehold improvements may be provided by the lessor directly constructing the improvements to the lessee's specifications. Alternatively, the lessee may receive a

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consequences to an anchor store upon its receipt of a cash tenant allowance from a shopping center developer in conjunction with entering into a lease. The ISP Paper concludes that if the anchor store can be found to own the leasehold improvements funded with the tenant allowances under the ownership test set forth in Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981), then the anchor store has an accession to wealth and the cash received from the developer is includible in its gross income. The ISP paper recognizes that any amounts received from the landlord and expended by the tenant on assets owned by the landlord cannot be characterized as income to the tenant.

See also John B. White, Inc. v. Commissioner, 55 T.C. 729, 735 (T.C. 1971):

White's contention that the incentive payment is not income rests upon an analogy which it has attempted to draw between the facts of this case and situations where a lessee has been reimbursed or has a right of reimbursement against a lessor for expenses which the lessee has incurred for improvements made upon the leased property. In such cases, it has been held that since the lessor is ultimately liable for the expenditures in question, the expenditures are not deductible or depreciable by the lessee. See, e.g., Levy v. Commissioner, 212 F. 2d 552 (C.A. 5), affirming a Memorandum Opinion of this Court; 379 Madison Ave., Inc., 23 B.T.A. 29, 41-42, rev'd on other grounds, 60 F. 2d 68 (C.A. 2).

> construction allowance from the lessor pursuant to the lease in order for the lessee to build or improve the property. The [Senate] committee [on finance] believes that the tax treatment of lessors and lessees in either case should be the same.

S. Rep. No. 33 at 232. The "tax treatment" that Congress sought to preserve in the case of tenant improvement allowances is for the lessor to depreciate its investment (whether made directly or in the form of a tenant improvement allowance) and for the lessee to depreciate its unreimbursed costs.

The Ground Leased Transactions are not Sales

Taxpayer's proposed recast of the Ground Leased transactions frustrates the purpose of § 168(i)(8)(A) and § 1.167(a)-4, implies a tax treatment inconsistent with Congressional intent underlying § 110, and conflicts with applicable case law (including Elder-Beerman). These authorities contemplate that a lessee recovers its unreimbursed leasehold improvement costs through depreciation deductions, not as a loss under the theory that improvements have been "sold" immediately upon completion for less than their cost.

While we are not prepared to conclude that there could never be a case in which the law would respect a purported sale of leasehold improvements, in this case neither in form nor in substance did Taxpayer sell leasehold improvements. The operative documents refer to the TIAs as "reimbursements," and in at least some cases amounts were paid as Taxpayer obtained lien waivers from its contractors by paying construction costs. This is consistent with characterizing the TIAs as reimbursements to Taxpayer for the costs of landlord-owned property.

Furthermore, the lease provisions governing early terminations by the landlord and condemnations of the leased property provide for payment to Taxpayer of the "unamortized cost of leasehold improvements." This indicates that Taxpayer had a continuing investment in the leasehold improvements. These provisions, which require that Taxpayer be compensated for the cost of leasehold improvements upon the occurrence of specified events, are impossible to reconcile with Taxpayer's theory that it sold the improvements to its lessors and is entitled to loss deductions for its unreimbursed costs.

The Taxpayer cites the factors from Grodt & McKay Realty as support for its view that tax ownership of the leasehold improvements transferred from Taxpayer to the landlord in return for its payment of the TIA. However, as the court in Elder-Beerman pointed out, in the context of tenant improvement allowances, these factors are used for determining which party owns the leasehold improvements, not for whether a "sale" of the leasehold improvements has taken place.

We conclude that the Ground Leased transactions are not sales. Rather, Taxpayer and Taxpayer's landlords, pursuant to § 168(i)(8)(A), must depreciate their respective investments in the leasehold improvements. Where the landlord paid Taxpayer a TIA that partially reimbursed Taxpayer for its leasehold improvement costs, Taxpayer has a depreciable interest in the leasehold improvements in an amount equal to the difference between Taxpayer's costs and the amount of the TIA. Landlord has a depreciable interest in the leasehold improvements in an amount equal to the TIA paid to Taxpayer.

Issue Two

The second issue is whether Taxpayer held certain retail buildings primarily for sale to customers in the ordinary course of its trade or business under § 1221(a)(1) so that the character of any gain or loss on their disposition is ordinary rather than capital. Because we have concluded that the Ground Leased transactions are not sales, the following discussion applies only to the Ground Owned transactions, which we have found to be sale-leasebacks.

Section 1221(a) provides that the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business) except in eight specified situations. The specified exception at issue is:

> (1) Stock in trade of the taxpayer . . . or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Whether the Ground Owned stores were held by Taxpayer primarily for sale to customers in the ordinary course of its business is primarily a question of fact. The determination must depend upon a consideration of all the factors and circumstances surrounding the relevant transaction in relation to the conduct of Taxpayer's business. See Lawyers Title Company of Missouri v. Commissioner, 14 T.C. 1221 (1950), acq., 1950-2 C.B. 3.

Congress intended that capital asset treatment be an exception to the normal requirements of the Internal Revenue Code and that the profits generated by everyday business operations be ordinary income. The Supreme Court in Arkansas Best Corporation v. Commissioner, 485 U.S. 212 (1988), held that the general definition of the term "capital asset" encompasses all property not within the exclusions of §§ 1221(1)-(5). Further, the courts have given the statutory exceptions to capital asset treatment a broad interpretation and narrowed the capital asset classification. Guardian Industries Corp. v. Commissioner, 97 T.C. 308, 315-16 (1991), aff'd, 73 A.F.T.R.2d (RIA) 1903 (6th Cir. 1994).

The controlling factor in determining the character of the gain or loss from the Ground Owned transactions is the purpose for which the stores were held, determined as of the time of sale. This determination is based on the Taxpayer's method of operation and

the standards customary in its line of business. Guardian Industries, supra at 316. In order for a sale of property to be classified as ordinary, sale to customers in the ordinary course of business must be of first importance or the principal reason that property is held. Malat v. Riddell, 383 U.S. 569, 572 (1966)

Taxpayer represents that its primary business was the sale of electronics. The construction details of Taxpayer's stores (and the locations of those stores) were critical to its retail electronics business. In its business judgment, Taxpayer needed a store that was configured in a certain fashion and that had certain features designed to facilitate the sale of electronics. To meet these needs, Taxpayer adopted the following business model: select a location, construct the store, find a purchaser for the store, and sell the store with a lease back. It constructed and sold with a lease-back approximately A stores per year. While these stores were sold for their appraised value, Taxpayer sold approximately B% of the stores at a loss. The stores were sold at a loss because of increased costs due to rapidly constructing the stores, store features that were of value to Taxpayer but not necessarily to other retailers, and the rapid sale and lease back of the stores. In Taxpayer's judgment, this business model kept capital free to continue to select locations and build stores, rather than having capital tied up in existing stores.

Based on all the facts and circumstances, we conclude that the sale-leaseback of Ground-Owned stores was a necessary incident to the conduct of Taxpayer's business and that the stores were held primarily for sale to customers in the ordinary course of Taxpayer's business. Accordingly, the resulting gains and losses are ordinary, not capital.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.