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# Clarifying Unit of Properties for Leaseholds

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– David McGuire
Director
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The new repair regulations have brought up many questions. Inquiries have included clarification on the optimal time to capitalize a roof, a more detailed definition of refresh, and further explanations of how to calculate a partial disposition. Furthermore, one of the most frequent and largest issues we have seen come up is the capitalization of Leasehold Improvements.

Leasehold improvements have been a contentious issue under the new regulations, attributable to the definition of Unit of Property (UOP) as it relates to leasehold improvements. By the letter of the law, the UOP for leaseholds relates to the area subject to the lease for the lessee, and the entire building for the lessor. This has led many practitioners to conclude that most tenant improvements for landlords are not significant portions of the UOP and can, therefore, be expensed. This is a dangerous position and needs to be examined more closely.

While it is true that the landlord can look at the entire building as it relates to the UOP the IRS also points out that Section 110 applies, and in some cases may trump the new rules. Under 1.263(a)-3(3) the new tangible property regulations are explored further.

(3) Lessor improvements—(i) Requirement to capitalize. A taxpayer lessor must capitalize the related amounts (see paragraph (g)(3) of this section) that it pays directly, or indirectly through a construction allowance to the lessee, to improve (as defined in paragraph (d) of this section) a leased property when the lessor is the owner of the improvement or to the extent that section 110 applies to the construction allowance. A lessor must also capitalize the related amounts that the lessee pays to improve a leased property (as defined in paragraph (e) of this section) when the lessee’s improvement constitutes a substitute for rent. See §1.61-8(c) for treatment of expenditures by lessees that constitute a substitute for rent. Amounts capitalized by the lessor under this paragraph (f)(3)(i) may not be capitalized by the lessee. If a lessor improvement is comprised of an entire building erected on leased property, then the amount paid for the building is treated as an amount paid by the lessor to acquire or produce a unit of property under §1.263(a)-2(d)(1). See paragraphs (e)(2) of this section for the unit of property for a building and paragraph (e)(3) of this section for the unit of property for real or personal property other than a building.

An important aspect of this portion of the regulation is that the IRS highlights Section 110.. While Section 110 is an older part of the tax code, it is important to understand how it relates to the new repair regulations. The IRS states that if Section 110 applies, a lessor must capitalize the improvements.

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As a reminder, Section 110 allows for a tenant to take an allowance for the buildout of retail space (broadly defined to include professional offices) without claiming the payment as income. A tenant that receives rent concessions or a buildout allowance to pay for improvements does not have to claim that as income on a short term lease (15 years or less). However, in order for the tenant to make this claim, the landlord must capitalize the property as non-residential real property.

Take for example a CPA firm moving into a space on a short term lease. If the landlord of the building provides a $50/sf buildout allowance, the CPA firm does not need to claim the allowance as income. However, the landlord must capitalize this cost as non-residential real property. The new tangible property regulations confirm this treatment. Keep in mind, the property may be eligible for a 15-year Qualified Leasehold Improvement treatment.

If we consider this as the rule, then the converse also has to be true. If a landlord provides a buildout allowance but does not capitalize the cost, the tenant must claim this amount as income. This confirms how significant it is for landlords to verify Section 110 does not apply prior to writing off tenant improvements.

In practice, we have seen many practitioners trying to write-off large amounts of Tenant Improvements under the Unit of Property tests. Carrying out these write-offs without checking the Section 110 tests is dangerous, as it can create a whipsaw effect and throw taxable income back on the tenant.

As with many areas relating to the new Tangible Property Regulations, this is a complicated discussion. Please feel free to contact your McGuire Sponsel representative with any questions.

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