

income. However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

(b) The provisions of this section may be illustrated by the following example:

Example. The A Corporation leased in 1945 for a period of 50 years unimproved real property to the B Corporation under a lease providing that the B Corporation erect on the leased premises an office building costing \$500,000, in addition to paying the A Corporation a lease rental of \$10,000 per annum beginning on the date of completion of the improvements, the sum of \$100,000 being placed in escrow for the payment of the rental. The building was completed on January 1, 1950. The lease provided that all improvements made by the lessee on the leased property would become the absolute property of the A Corporation on the termination of the lease by forfeiture or otherwise and that the lessor would become entitled on such termination to the remainder of the sum, if any, remaining in the escrow fund. The B Corporation forfeited its lease on January 1, 1955, when the improvements had a value of \$100,000. Under the provisions of section 109, the \$100,000 is excluded from gross income. The amount of \$50,000 representing the remainder in the escrow fund is forfeited to the A Corporation and is included in the gross income of that taxpayer. As to the basis of the property in the hands of the A Corporation, see § 1.1019-1.

§ 1.110-1 Qualified lessee construction allowances.

(a) *Overview.* Amounts provided to a lessee by a lessor for property to be

constructed and used by the lessee pursuant to a lease are not includible in the lessee's gross income if the amount is a qualified lessee construction allowance under paragraph (b) of this section.

(b) *Qualified lessee construction allowance—(1) In general.* A qualified lessee construction allowance means any amount received in cash (or treated as a rent reduction) by a lessee from a lessor—

(i) Under a short-term lease of retail space;

(ii) For the purpose of constructing or improving qualified long-term real property for use in the lessee's trade or business at that retail space; and

(iii) To the extent the amount is expended by the lessee in the taxable year received on the construction or improvement of qualified long-term real property for use in the lessee's trade or business at that retail space.

(2) *Definitions—(i) Qualified long-term real property* is nonresidential real property under section 168(e)(2)(B) that is part of, or otherwise present at, the retail space referred to in paragraph (b)(1)(i) of this section and which reverts to the lessor at the termination of the lease. Thus, qualified long-term real property does not include property qualifying as section 1245 property under section 1245(a)(3).

(ii) *Short-term lease* is a lease (or other agreement for occupancy or use) of retail space for 15 years or less (as determined pursuant to section 168(i)(3)).

(iii) *Retail space* is nonresidential real property under section 168(e)(2)(B) that is leased, occupied, or otherwise used by the lessee in its trade or business of selling tangible personal property or services to the general public. The term *retail space* includes not only the space where the retail sales are made, but also space where activities supporting the retail activity are performed (such as an administrative office, a storage area, and employee lounge). Examples of services typically sold to the general public include services provided by hair stylists, tailors,

shoe repairmen, doctors, lawyers, accountants, insurance agents, stock brokers, securities dealers (including dealers who sell securities out of inventory), financial advisors and bankers. For purposes of this paragraph (b)(2)(iii), a taxpayer is selling to the general public if the products or services for sale are made available to the general public, even if the product or service is targeted to certain customers or clients.

(3) *Purpose requirement.* An amount will meet the requirement in paragraph (b)(1)(ii) of this section 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. An ancillary agreement between the lessor and the lessee providing for a construction allowance, executed contemporaneously with the lease or during the term of the lease, is considered a provision of the lease agreement for purposes of the preceding sentence, provided the agreement is executed before payment of the construction allowance.

(4) *Expenditure requirement—(i) In general.* Expenditures referred to in paragraph (b)(1)(iii) of this section may be treated as being made first from the lessee's construction allowance. Tracing of the construction allowance to the actual lessee expenditures for the construction or improvement of qualified long-term real property is not required. However, the lessee should maintain accurate records of the amount of the qualified lessee construction allowance received and the expenditures made for qualified long-term real property.

(ii) *Time when expenditures deemed made.* For purposes of paragraph (b)(1)(iii) of this section, an amount is deemed to have been expended by a lessee in the taxable year in which the construction allowance was received by the lessee if—

(A) The amount is expended by the lessee within 8½ months after the close of the taxable year in which the amount was received; or

(B) The amount is a reimbursement from the lessor for amounts expended

by the lessee in a prior year and for which the lessee has not claimed any depreciation deductions.

(5) *Consistent treatment by lessor.* Qualified long-term real property constructed or improved with any amount excluded from a lessee's gross income by reason of paragraph (a) of this section must be treated as nonresidential real property owned by the lessor for purposes of depreciation under 168(e)(2)(B) and determining gain or loss under section 168(i)(8)(B)). For purposes of the preceding sentence, the lessor must treat the construction allowance as fully expended in the manner required by paragraph (b)(1)(iii) of this section unless the lessor is notified by the lessee in writing to the contrary. General tax principles apply for purposes of determining when the lessor may begin depreciation of its nonresidential real property. The lessee's exclusion from gross income under paragraph (a) of this section, however, is not dependent upon the lessor's treatment of the property as nonresidential real property.

(c) *Information required to be furnished—(1) In general.* The lessor and the lessee described in paragraph (b) of this section who are paying and receiving a qualified lessee construction allowance, respectively, must furnish the information described in paragraph (c)(3) of this section in the time and manner prescribed in paragraph (c)(2) of this section.

(2) *Time and manner for furnishing information.* The requirement to furnish information under paragraph (c)(1) of this section is met by attaching a statement with the information described in paragraph (c)(3) of this section to the lessor's or the lessee's, as applicable, timely filed (including extensions) Federal income tax return for the taxable year in which the construction allowance was paid by the lessor or received by the lessee (either in cash or treated as a rent reduction), as applicable. A lessor or a lessee may report the required information for several qualified lessee construction allowances on a combined statement. However, a lessor's or a lessee's failure to provide information with respect to each lease will be treated as a separate

failure to provide information for purposes of paragraph (c)(4) of this section.

(3) *Information required*—(i) *Lessor*. The statement provided by the lessor must contain the lessor's name (and, in the case of a consolidated group, the parent's name), employer identification number, taxable year and the following information for each lease:

(A) The lessee's name (in the case of a consolidated group, the parent's name).

(B) The address of the lessee.

(C) The employer identification number of the lessee.

(D) The location of the retail space (including mall or strip center name, if applicable, and store name).

(E) The amount of the construction allowance.

(F) The amount of the construction allowance treated by the lessor as non-residential real property owned by the lessor.

(ii) *Lessee*. The statement provided by the lessee must contain the lessee's name (and, in the case of a consolidated group, the parent's name), employer identification number, taxable year and the following information for each lease:

(A) The lessor's name (in the case of a consolidated group, the parent's name).

(B) The address of the lessor.

(C) The employer identification number of the lessor.

(D) The location of the retail space (including mall or strip center name, if applicable, and store name).

(E) The amount of the construction allowance.

(F) The amount of the construction allowance that is a qualified lessee construction allowance under paragraph (b) of this section.

(4) *Failure to furnish information*. A lessor or a lessee that fails to furnish the information required in this paragraph (c) may be subject to a penalty under section 6721.

(d) *Effective date*. This section is applicable to leases entered into on or after October 5, 2000.

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§ 1.111-1 Recovery of certain items previously deducted or credited.

(a) *General*. Section 111 provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. The term "recovery exclusion" as used in this section means an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 111), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939).

(1) *Section 111 items*. The term "section 111 items" as used in this section means bad debts, prior taxes, delinquency amounts, and all other items subject to the rule of exclusion, for which a deduction or credit was allowed for a prior taxable year. If a bad debt was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts, it was not deducted, and it is therefore not considered a section 111 item. Bad debts, prior taxes, and delinquency amounts are defined in section 111(b) (1), (2), and (3), respectively. An example of a delinquency amount is interest on delinquent taxes. An example of the other items not expressly referred to in section 111 but nevertheless subject to the rule of exclusion is a loss sustained