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Use smart leasing strategies to negotiate tenant improvements

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Given the current state of the real estate market, landlords need to consider all possible options related to lease negotiations. When entering into a lease, one of the most significant items, to negotiate can be tenant improvements. The most common approach has been a tenant improvement allowance negotiated in the lease agreement. Typically this is a non-taxable event to the tenant and the landlord would depreciate the improvements over lives ranging from 15-39 years. In the not so distant past, many landlords paid for the entire cost of the improvements. Now credit is tight and capital for improvements is scarce, so it is in the landlord's best interest to be strategic about these negotiations.

With the recent expiration of the "bonus" depreciation rules, the landlord no longer has the ability to deduct half of the costs of the improvements in the first year. Under President Obama's current budget proposal, bonus depreciation is to return through 2010. However, there is no guarantee that it will pass. These deductions were a great benefit to those who qualified for them. So what else can the landlord do to gain the best tax result for the dollars they plan on spending? Here are a few suggestions:

Amortize the Cost: One option available instead of a tenant improvement allowance is a lease inducement payment. A lease inducement payment is still specified in the lease. The benefit to the landlord is that the costs may be amortized over a much shorter life than a typical construction allowance. Consideration here should be given to the length of the lease. For example, a typical office lease is 5-7 years versus depreciating the same dollars spent on tenant improvements over 15 or 39 years. The downside is that the landlord has no control over how the dollars are spent by the tenant. Nor is the tenant required to spend the money on the improvements. However, depending on the property, this may be a viable option. Most tenant improvements are virtually worthless in terms of value by the time a typical commercial lease expires.

Share the Cost: In a situation where the tenant and landlord agree to share the cost of the improvements, there is potential for additional savings based on who pays for specific improvements. If there is certain equipment that needs to be installed in a bio-medical space, or a clean room, the landlord can identify those improvements and specifically pay for those. This determination should be negotiated into the lease so there is a clear distinction as to where the dollars will be spent, and who gets the deductions. There is then the possibility of depreciating those costs over shorter lives and accelerating the tax deductions. With proper planning, the tax savings can be significant. For example, if you are going to share the cost of improvements with the tenant and the total cost of the improvements will be $100,000 each. If you identify $50,000 that will need to be spent on equipment, or property that can be classified and depreciated over 5 or 7 years, include language in the lease that specifically identifies the property that your dollars will be spent on. You can then take advantage of the accelerated tax deductions.

Time the Cost: There are other options you can employ to offset the cost with tax savings, which may be time-sensitive. DGC recently assisted a client who was negotiating a moderate level of improvements with an existing tenant. By having the opportunity to assist before a final decision was made, DGC was able to save the client $35,000 in current tax dollars just by adjusting the timing of the completion of the improvements.

Leasing strategies are just one of the options available to landlords. The key is to get your advisor(s) involved early on in the process. Their expertise, especially with regard to tax law changes, can tip the scale in your favor.

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