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# Knowing your potential tenant for leasing

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Getting to know your potential tenant before negotiating the tenant improvement allowance provisions of the lease can lead to a much better answer for a landlord. This knowledge goes beyond the normal credit worthiness and ability to pay the monthly rent and charges. A deeper knowledge of your potential tenant can produce a better overall cash flow through reduced cash requirements and tax savings.

Tax Status/Position of the Tenant

The tax status/position of the potential tenant is very important during this aspect of the lease negotiations. The two key factors to find out is whether the tenant is a tax-exempt entity and, if the tenant is a taxable entity, does it have any net operating losses or other similar tax attributes. If the tenant is a tax-exempt entity or a taxable entity with net operating losses, a lease inducement payment can be used instead of a tenant allowance. The benefit of using a lease inducement payment for the landlord is that the costs may be expensed over a much shorter life (the life of the lease) than a typical tenant improvement allowance (39 years) resulting in a much quicker tax deduction. For the tenant, the lease inducement payment is considered taxable income when received. Typically, a tax-exempt entity or taxable entity with net operating losses is not worried about the income recognition since they are not subject to tax on the income or have tax attributes to offset the income.

The potential savings on the accelerated expenses can be huge. For example, if a tenant was given a 10 year lease with a lease inducement payment of $500,000, the landlord's annual tax deduction would be $50,000. If the same 10 year lease was negotiated with a $500,000 tenant improvement allowance, the landlord would only receive a $13,000 annual tax deduction. This is based on the current depreciation rules that require a 39 year life for the depreciation of tenant improvements.

Cash Position/Needs of the Tenant

Understanding the cash position and needs of your potential tenant are also very important. This knowledge can help you use free rent provisions and the tenant's available cash instead of tenant improvement allowances. Free rent provisions are very powerful as they allow the landlord an immediate tax benefit as they do not have to pick up rental income for the amount of the free rent. Free rent also allows the tenant to have available cash flow during the startup of their business. The free rent can be best used in situations where the space is in good condition and compatible with the tenant's business.

Allowing the tenant to use their own cash for tenant improvement allowances can be advantageous for both the landlord and tenant in the right situation. For the landlord, they do not have to come up with the cash to do the tenant improvements. If the property is cash strapped and has no access to additional capital, this works well. The tenant can benefit if they have access to capital that is cheaper than the increased rent that would be charged if the landlord did the tenant improvements.

When a tenant does decide to use their own cash, a careful analysis must be completed by the tenant. This can be very fruitful for a tenant if structured properly.

## Final Word

The ideas above must be contemplated early in the negotiations. Lease inducement payments and free rent periods in lieu of tenant improvement allowances can be deemed to be tenant improvement allowances if that was the intent and they are not negotiated correctly. Careful planning must be done to avoid this. Additionally, the ever changing tax law makes navigating this area very difficult. 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 scales in your favor.

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