Cassidy Turley BT Commercial

Before the Build-Out

Assess tax consequences prior to leasehold improvements.

By Daniel Rowe, CPA, and John Vandaveer, CPA, CVA

In today's competitive leasing market, build-outs or other capital improvements are good ways for property owners to retain current tenants or attract new ones. Creating more open floor plans or providing additional capacity for new technologies can adapt older office buildings to fit the changing needs of the occupants. The same is true for retail and industrial properties where new build-outs can attract new types of tenants to the space.

After deciding to make improvements, property owners must figure how to fund the construction costs. Three common methods provide funding for tenant improvements: a direct investment in the improvements by the property owner, a cash payment to the tenant to then make improvements, or a rent holiday for the tenant.

For landlords and tenants, the tax consequences vary based on the method, or combination of methods, used to fund improvements. Additionally, the intent of the parties and the specific language used in their agreements will directly affect the tax treatment of leasehold improvements. In all cases, both parties should consider the potential tax consequences when agreeing on how to provide for improvements to leased property.

Direct Investment

In a direct investment in the leasehold improvements, the property owner pays all of the construction costs, using its own money or borrowed funds. Retaining ownership of the improvements, the owner records them as assets on its books and receives a deduction for depreciation of the assets over their useful lives. There is no tax effect on the tenant as a result of a direct investment by the property owner.

Tenant Payment

When a property owner makes a payment directly to the tenant, the nature of the payment, as determined by the parties' intent and the lease agreement, will influence the tax consequences. If the payment is considered a cash incentive for signing the lease, it will be treated as taxable income to the tenant and will be deducted by the landlord over the lease term. For example, if a $50,000 incentive is provided for a five-year lease, the tenant will have $50,000 of income in year one and the owner will deduct $10,000 of expense in each of years one through five. Once the tenant uses the money to make improvements, it will be able to depreciate them for tax purposes.

Contrast this with a payment that is considered to be a construction allowance. In this case, whether or not the tenant has income is based in large part on the lease agreement. If the lease is for retail space, is for 15 years or less, and the lease agreement expressly provides that the allowance is for the purpose of constructing or improving qualified long-term real property (not personal property), then the payment is not considered income to the tenant. The property owner would treat it as a direct investment, to be depreciated over 39 years. If the tenant does not use the allowance to pay for qualified real property, or the property does not revert to the owner at the termination of the lease, the tenant must consider construction allowance payments as taxable income. Therefore it is important to clearly establish what the allowance is to be used for and who retains the property at lease-end. Additionally if the lease is for nonretail space or the lease term exceeds 15 years, then the allowance is considered taxable income to the tenant.

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Rent Holiday

Free rent is often the most tax-effective way for a property owner to adjust to market conditions and entice tenants to rent a property. The tenant is given a rent holiday for an agreed-upon number of months, with or without the holiday being explicitly tied to the tenant's actual expenditures on improvements. The tenant then uses the money saved on rent to make any necessary improvements.

It is important for the lease agreement to state the terms of the rent holiday. The tax treatment of the transaction will be determined based on whether or not the improvements made by the tenant are considered to be in lieu of rent.

If the rent holiday explicitly is tied to tenant improvements or the improvements are considered a substitute for rent, the landlord will have both taxable income and depreciable assets (the improvements). For example, the agreement stipulates the tenant is to make $50,000 worth of improvements for the owner instead of paying rent. Then the owner would report $50,000 of taxable income despite not having received the rent. The owner would have $50,000 of assets to depreciate over their useful lives and the tenant would have a rent expense of $50,000.

On the other hand, if the rent holiday is not explicitly tied to improvements or the improvements are not made in lieu of rent, the owner should not have to recognize taxable income to the extent of the improvements made. The downside of this situation is that the owner has no tax basis in the assets. The tenant will have the tax basis and depreciation expense until the termination of the lease, at which time the tenant can write off any remaining assets.

Necessary building updates should not lead to unnecessary tax burdens. To fully examine the tax treatment of a specific situation, it is important establish who owns the improvements during the term of the lease and what happens to the property upon termination of the lease. The specific language of the lease agreement and examination of the facts and circumstances are also critical to establishing tax consequences. Owners and tenants should work with their tax advisers to ensure the intended results are achieved.

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