

TAX SAVINGS STRATEGIES FOR LANDLORDS

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In these trying times, many real estate owners and some developers are holding commercial real estate longer than originally planned, so the owner has leased the real estate to businesses. Due to our struggling economy many of tenants have gone out of business and have left the premises.

Any original structural costs that were made in entering the lease are just sitting there literally and financially – and there may be a tax savings hidden there. Let me explain - for income tax purposes, these tenant improvements are being depreciated over 39 years even though the lease was for a shorter term. So these improvements are being depreciated even though the property is vacant or renovated to a new tenant. This leads to double tax depreciation for the landlord on the vacant improvements as well as improvements for the new tenant.

Several years ago, tax laws were changed as Congress felt that the costs that relate to the leasing of property should not be recovered beyond the term of the lease to the extent those costs do not provide a future benefit beyond such term. Thus landlords can write off any improvements they paid for when the improvements are abandoned – even if the disposed items are structural i.e. fit up costs. In order to take advantage of this deduction, then the landlord must be able to account for those costs that are fit out costs from the other structural costs.

Now a new tenant is looking at leasing the space that needs improvements and the tenant is requiring the landlord to spend money to make such improvements. Those costs are built into the new rent as higher rent. If certain conditions are met, then the owner can expense all these costs this year. For 2011, eligible property can be depreciated all in 2011 under the bonus depreciation rules. Eligible property includes Qualified Leasehold Improvements “QLI”. To qualify as QLI, the improvements must be made under a lease agreement, the improvements must be made to the interior of the space (not common area), the building must be at least 3 years old and the tenant cannot be related with the building owner. Further, the space needs to be occupied by year end to qualify for the 100% bonus depreciation. If the tenant occupies the space in 2012, the bonus depreciation decreases to 50% with the balance depreciated over 15 years. It should be noted that there is talk in Congress to retain 100% bonus depreciation in 2012 as well. It should be noted that tenants are eligible to take advantage of bonus depreciation as well for QLIs. Be careful, building owners that make improvements to the building to attract tenants are not QLI as they are not costs pursuant to a lease. Those costs are depreciated over 39 years!

One interesting play on bonus depreciation is eligible property can be financed. Therefore, the landlord can finance the costs of the tenant fix up costs and the fix up costs can still qualify as QLIs and bonus depreciation. With the low interest rates, this can further enhance yields to building owners.

Further, certain tenants may wish to fix up their space and have the landlord pay for the fix up costs. These landlord payments may qualify as QLIs and bonus depreciation provided for conditions are met. Under the tax rules, there is a safe harbor that the IRS issued and if met, then the landlord payment to the tenant can qualify as QLIs. Under the safe harbor, the lease term cannot be great than 15 years, the tenant uses the money to construct or improve the real estate for use in the tenant's business at that location and the allowance is documented in the lease before the payment is made. If the safe harbor is not satisfied, then the landlord will be required to amortize the costs of this payment as opposed to expensing it in 2011.

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