

The Savvy Tenant and a Sharp Pencil: Reflections On Bonus Depreciation and Funding Tenant Improvements



January 1st deadline looms for funding improvements and taking bonus depreciation

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"Tenant Improvement Bonus Depreciation," a part of the larger "**Tax Relief Reconciliation Act of 2003**" may not be on the radar of most commercial real estate brokers and their tenants, but it certainly deserves to be. Tenants have less than six months to take advantage of substantial tax breaks for improving their leased premises.

I was reminded of this cut-off date after reading an informative article by Scott Skinner, certified public accountant with Scott Skinner & Associates Inc., in the March 29, 2004 issue of **California Real Estate Journal** entitled "**Tenant Improvement Allowances: Bonus Depreciation Tax Incentives are Available to Landlords**," which emphasized the importance of these lucrative tax benefits when funding leasehold tenant improvements.

As a "tenant rep" broker, I always appreciate a lucid explanation of arcane legislation which contains "hidden" benefits for my clients. This Tax Relief Act certainly qualifies: either side—tenant or landlord--is eligible for the tax break because bonus or accelerated depreciation can be used by whichever party pays for allowed improvements. While landlords may be more aware of such regulations, as well they should be since their normal course of business involves improving their properties, it is not too late for tenants to understand how they, too, can take full advantage of the ruling.

Caveat: Although the following examples, numbers, and comments have been verified, each situation calls for appropriate verification and due diligence. Since other key issues attendant to construction and alterations will also need resolution, do make sure to use a tax attorney who specializes in real estate or a real estate attorney who specializes in taxation in order to analyze the numbers, determine alternatives, and fine-tune lease language.

Specifically, the law is entitled "**Jobs Growth Tax Relief Reconciliation Act of 2003**" and provides for, among many other changes, a 50 per cent bonus depreciation for tenant improvements put in place after May 5, 2003 and before January 1, 2005. This tax break applies to items that meet the following criteria:

- Be interior space which is leased;
- Occupied exclusively by the tenant;
- Not to be used (normally) for structural elements;
- Placed in service more than three years after the building was available for lease -----this last one means that owners of and tenants in new buildings don't qualify.

Example: Consider a law firm leasing 15,000 square feet for a ten-year term at \$31.00 per foot per year fully serviced in a class A downtown high rise, with estimated costs of \$75.00/square foot for the buildout. Of that amount, \$45.00 will be provided by the landlord as a tenant improvement allowance, while the additional \$30.00 must either come out of the tenant's pocket or be paid by the landlord, amortized over the term.

If the landlord amortizes all \$450,000.00 of the overage t.i. amount at 7.5% interest for additional rent of \$5,308.00 per month, gross rental income would increase to \$35.25/year. For purposes of this example, let's take a conservative 39 years of depreciation for everything (\$75.00 X 15,000 sf ÷ 39 yrs), or \$28,846.00 regular depreciation allowed under the old law for the first and each successive year. Under the 2003 Tax Relief Law, these same leasehold improvements would generate 50% bonus depreciation PLUS (one half) regular depreciation, which

equals an impressive \$576,923.00 ($50\% \times \$75.00 \times 15,000 = \$562,500.00 + \$14,423.00$). Notice the really big-g-g difference between first-year regular depreciation of \$28,846.00 and first-year bonus depreciation of \$576,923.00.

Other than taking a significant windfall writeoff against taxable income, how else might the ownership profit from this generous regulation? The over-standard space might help retain the tenant for another few years at the end of the lease or if not, might re-lease better to a new company if improvements withstand the test of time, although tenant turnover and obsolescence reduce the useful life of leasehold improvements to fewer years than what may be mandated for depreciating the item, especially those 39 year ones.

Too, any spread between the interest rate charged to the tenant and what the ownership actually borrows at becomes profit, even if the difference is as low as 1 or 2 per cent. Most importantly, as Skinner pointed out in his article, net operating income on the building increases, which typically makes it easier to position the building for sale at a higher price or obtain new financing at better terms.

Now let's look at this from a tenant's viewpoint. If the company funds any part of its tenant improvements, it too gets both the 50% bonus and 39 year (or whatever time period) regular depreciation PLUS a lump sum write-off at the end of the lease when these improvements are "abandoned" — when the lease or sublease terminates and/or the tenant vacates its premises. So, in this case, the remaining 39 year's worth of unused depreciation would go straight to the bottom line. And interestingly, the landlord cannot take the same end of lease lump-sum writeoff unless the tenant improvements are actually demolished!

This law does not only benefit the million-dollar construction budget. In fact it may be especially applicable to smaller direct deals and subleases where a tenant must contribute its own money toward all or part of the alterations because a landlord or sublessor will not or cannot put any more money into improving the premises.

For example, consider a 10,000 square foot tenant who finds a "steal" in rent for a short-term sublease (use 3 years) but must otherwise fund any alteration costs itself (use \$6.00/square foot). This company should take a strong second look at the deal instead of heading back into the market, as it might be preferable to pay for the construction work at \$60,000.00 ($10,000\text{sf} \times \6.00) rather than search for another place. It is entirely possible that such tenants who choose to or have to divert funds for their own tenant improvements could inadvertently be better off having done so as a result of these unsung, quite remarkable tax benefits. This is, of course, in addition to occupying new space whose design actually works for the company. In this particular instance, qualified tenant improvements would have bonus depreciation of \$30,769.00 in year 1; \$769.00 in year 2; and in year 3, \$769.00 plus the lump sum amount of \$27,693.00, or \$28,462 upon moving out--- for a grand total of, yep, \$60,000.

Certainly not many tenants are going to fund multi-million dollar tenant improvement packages in total, but it is likely that good negotiators, recognizing value to the other side, will be able to parlay their precise situation into an improved overall transaction even if it seems impossible--for whatever reason--to take advantage of bonus depreciation. But with this tax break still available, even more incentive exists to put dollars toward improvements in conjunction with, or instead of, the building's ownership. One can envision various scenarios where borrowing from another source other than the landlord, even at a slightly higher interest rate, might be a savvy decision. Or perhaps a concession of additional free rent from the landlord in return for tenant-paid improvements (with bonus depreciation, of course) might be just the ticket to seal an otherwise thorny negotiation.

From May 5, 2003 through January 1, 2005, by which time the law currently stipulates that the improvements must be in place, all tenants who already qualify and those seeking to relocate to a new facility or renegotiate in their current one would be remiss not to investigate how to take advantage of this little-known tax benefit for their tenant improvement work.