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The commercial classroom: Should your client lease or buy a building?

February 10, 2014 - Front Section

This column is offered to help educate agents new to commercial and investment brokerage and serve as a review of basics for existing practitioners.

Should you client lease space or buy a building?

To answer this requires several considerations; status of their business; market conditions; and financial cost and benefits.

Are their business space requirements stable; or will they need more or less space in the future? This may be solved by leasing more space than they need now and sub-letting out the surplus. Buying a larger building and renting excess space until they need it may be another solution.

Owning eliminates the possibility of landlord issues, eliminates rules, hours open restrictions, you may modify the space as you choose. With ownership however, comes responsibility for repairs and maintenance, concerns for the condition of the roof, the heating and air conditioning systems, the parking lot etc. In a lease generally the landlord is responsible for these structural type expenses.

Buying a building gives you a fairly predictable cash flow, the mortgage costs and operating expenses are known. Leases typically escalate each year and at the end of the lease, a large rent increase from the landlord could cause the tenant to move, creating an interruption in their business and significant moving expenses.

Where is the market? Typically when rents go up so does the value of a building. Real estate tends to appreciate in value over time, meanwhile ones mortgage is being paid down increasing equity. Eventually the property could be sold at a profit. But in this comparison market trends need to be projected into the future, where will prices be five or ten years from now?

Which makes more financial sense to rent or buy? Today buying could require a down payment of 30% of the sale price, what kind of return does one get on that investment? Leasing requires no major down payment.

From a tax perspective when leasing one can deduct the cost of rent and operating expenses. Ownership deductions include: real estate taxes, operating expenses, depreciation and mortgage interest. But when the building is sold there will be capital gains taxes on appreciation of value and depreciation recapture.

There are several methods to compare each situation. Generally the lease term is compared to owning the building for the same length of time. The clients tax bracket also needs to be considered. The two most common methods of comparison are the Present Value method or Internal Rate of Return (IRR). In the Present Value method we look to compare the net cost after taxes, the opportunity with the lowest net cost is most favorable. The IRR is a similar analysis showing the Net Present Value using a discount rate.

As agents we can speak about the pros and cons of both situations, but your client should be referred to their accountant or tax advisor to have a complete financial comparison done.

Edward Smith, Jr., CREI, ITI, CIC, RECS, GREEN, MICP is the northeast regional director of Coldwell Banker Commercial NRT, Syosset, N.Y.