Overlooking the relationship between lease abstracts and cost segregation can impact the bottom line

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The bottom-line value of any commercial real estate asset is typically found in its retail, office or industrial leases. Thus, a thorough understanding of those leases is essential for profitable acquisitions and successful property management. That's why real estate investors should demand meticulous, exhaustive and up-to-date lease abstracts before making any purchasing decisions. Failure to review all of the complex details contained in a lease portfolio can lead to potentially disastrous financial and legal consequences.

When evaluating the data extracted from a property's leases, investors often focus on cash flow and revenue generating potential. Yet, they all too often fail to analyze leases for cost segregation purposes and overlook the significant tax implications of the tenant improvement clauses. The tenant improvement clauses determine whether the landlord or the tenant has legal ownership of any tenant improvements. The question of legal ownership is important because the owner of the improvements may be able to benefit from an IRS-approved cost segregation study, whereby eligible assets are identified and reclassified for accelerated depreciation.

In general, buildings can be depreciated over either a 27.5-year or a 39-year period, but certain categories of fixed assets within a building can be depreciated more quickly, over five, seven or 15 years. Cost segregation studies identify and reclassify these eligible fixed assets to shorter recovery periods in order to reduce the owner's tax liability and improve cash flow. A general rule - approximately $150,000 to $200,000 in net present value tax savings can be generated for each $1 million of reclassified assets.

Eligible assets generally include fixtures or related elements that are either unnecessary for the operation of the building itself, or are temporary structures. They can include:

* Redundant HVAC systems
* Decorative lighting, moldings and millwork
* Floor coverings, wall coverings and window treatments
* Sidewalks, parking lots and curbing
* Landscaping, swimming pools, fencing and outdoor lighting
* Storm water drainage systems
* Hospitality fixtures
* Communication systems, distribution panels and wiring
* Specialized vents, exhaust systems and specialized air filtration
* Security access and monitoring systems
* Computer data and power.

The list of eligible assets includes many items that commonly fall into the category of tenant improvements. Indeed, landlords often offer rent abatements to tenants who add them to the property. The key for cost segregation purposes is to specify who legally owns the improvement (whether it is carpeting and cabinetry or sidewalks).

Although lease abstracting is routinely performed before properties are purchased, it's important for landlords to insist on a thorough review of the leases during the feasibility phase of a cost segregation study. If the firm doing the cost segregation study fails to separate tenant-owned items from landlord-owned items, the initial evaluation may include assets that do not, in fact, belong to the landlord, resulting in misleading estimates.

When the tenant improvements clauses are fully and accurately abstracted, landlords may discover that they own improvements that they can include in the study. Or, they may find that they own only the building shell and the land it rests on, along with any common areas that may exist, but that everything else is owned by the tenants. To avoid this and gain the most accurate measurement of a property's true value, tenant improvement ownership needs to be included in all lease abstracts, regardless of the purpose or timing of the review. This permits the owner or potential purchaser to determine whether the considerable benefits of a cost segregation study can be added to the plus side of the property's balance sheet. Failure to include tenant ownership in the lease abstracts means that the benefits remain unexplored, hidden in plain sight.

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