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Reviewing rules for landlords to understand and take advantage of tax benefits

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At one time, owning property provided landlords with a steady income stream. However, in these trying times, many real estate owners and developers are holding commercial real estate longer than they had originally planned. They have had to lease the property to a business, but due to our struggling economy, many of these tenants have gone out of business and vacated the premises.

Any original structural costs that were made in entering the lease are just sitting there, literally and financially, and there may be hidden tax savings. 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 has been 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, the landlord must be able to account for those costs that are fit out costs from the other structural costs.

New Tenant, New Renovations

Now a new tenant is looking at leasing a space that needs improvements and they are requiring the landlord to spend money to make such improvements. Those renovation costs are built into the new rent in the form of higher rent. If certain conditions are met, the owner can expense all these costs this year. For 2011, eligible property can be fully depreciated 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 to the building owner. The space also 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 also be noted that tenants are eligible to take advantage of bonus depreciation for building owner QLIs. Building owners that make improvements to attract tenants are not QLI since they are not costs pursuant to a lease. Those costs are depreciated over 39 years!

Financing QLI Property

One interesting play on bonus depreciation is that eligible property can be financed. 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.

Tenant Allowances

Certain tenants may also wish to fix up their space and have the landlord pay for the costs. These landlord payments may qualify as QLIs and bonus depreciation provided certain conditions are met. Under the tax rules, there is a safe harbor that the IRS issued, and if met, the landlord payment to the tenant can qualify as QLIs. Under the safe harbor, the lease term cannot be greater than 15 years, the tenant must use the money to construct or improve the real estate for use in the tenant's business at that location, and the allowance must be 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 allowance as opposed to expensing it in 2011.

Building owners that enter into new leases should review these rules to understand and take advantage of the tax benefits.

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