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7 TAX ASPECTS OF TENANT IMPROVEMENTS

One of the often-overlooked but crucial aspects of a lease negotiation for commercial real estate is the tax impact of how tenant improvements (TIs) are funded, whether by the landlord or the tenant. The examples, which follow, illustrate some of the alternative approaches to funding tenant improvements and the resulting federal income tax consequences. As the examples demonstrate, although the tax considerations may not drive a deal, they can have a material effect on the bottom line of the landlord and tenant.

These examples assume that the tenant requires $1 million of tenant improvements; the term of the lease is 10 years; and the tenant improvements are considered real property depreciable on a straight-line basis over 39 years under applicable federal income tax laws.

1. The landlord could pay for and own the tenant improvements for tax purposes. From a tax perspective, this approach is the least favorable to the landlord because the landlord can only recover its $1 million cash outlay ratably over 39 years as deductions for depreciation. This arrangement produces no tax consequences for the tenant, unless the tenant also contributes to the improvements.

2. The landlord could provide the tenant with a $1 million improvement allowance and the tenant would be the owner of the tenant improvements for tax purposes. Under this approach, the landlord can amortize its $1 million cash outlay ratably over the 10-year lease term as a leasehold acquisition cost. The landlord's ability to recover its $1 million over 10 years, rather than over 39 years, makes this approach substantially more attractive to the landlord than the first example. However, because the $1 million improvement allowance is fully taxable to the tenant, many tenants may be reluctant to agree. As the tax owner of the improvements, the tenant (as with the landlord in the first example) can only recoup the taxes attributable to the $1 million over 39 years (unless the tenant vacates the leased premises at the end of the 10-year lease term, in which case the undepreciated balance can be written off by the tenant). The reversion of the tenant improvements is not a taxable event for the landlord.

Although many tenants may not want to incur the $1 million of taxable income, if the tenant has a large net operating loss carry forward for federal income tax purposes, the tenant may be more concerned about cash flow than tax consequences. As a result, the tenant may be willing to absorb the income associated with a $1 million improvement allowance from the landlord in exchange for receiving the cash flow.

3. Instead of an improvement allowance, the landlord could provide the tenant with $1 million of free rent at the beginning of the lease term. This approach has the effect of allowing the landlord to recover its $1 million contribution to the tenant for its improvements immediately for tax purposes through the absence of any taxable rental income from the tenant during the free rent period. Not only does the tenant have $1 million of lost rental deductions during the initial period of the lease, but the tenant must then use its own funds or borrow funds in order to finance the $1 million of needed tenant improvements. And, as noted earlier, the tenant (as the tax owner of the improvements) would only be able to recover its $1 million outlay ratably over 39 years until the end of the term, at which point the tenant may deduct the remaining undepreciated basis in the improvements.

4. The tenant could pay for and own the tenant improvements. The tenant then would be entitled to recover its $1 million cash outlay ratably over 39 years. However, if the tenant abandoned the tenant improvements at the end of the 10-year lease term, the tenant could then deduct its remaining unamortized basis in the improvements. This alternative has no tax consequences for the landlord.

> If a landlord could provide a tenant with $1 million of free rent at the beginning of the lease term, the landlord should be able to recover the $1 million contribution immediately for tax purposes through the absence of any taxable rental income from the tenant during the free rent period. From the tenant's perspective, however, this approach may be the least desirable for tax purposes.

5. The tenant could pay for the tenant improvements and, upon their completion, convey them to the landlord, who would become the tax owner of the improvements. This often occurs inadvertently when leases provide that all improvements or alterations become the landlord's property immediately upon completion. In this scenario, the tenant can amortize the full cost of the improvements over the 10-year lease term as a leasehold acquisition cost, but the landlord would correspondingly have $1 million of taxable income upon receipt of the tenant improvements (without receiving cash to pay the associated liability) and would only be able to depreciate the property over 39 years.

6. The landlord could, with borrowed funds, pay for and own the tenant improvements. In order to shift the economic cost of the improvements to the tenant, however, the tenant's

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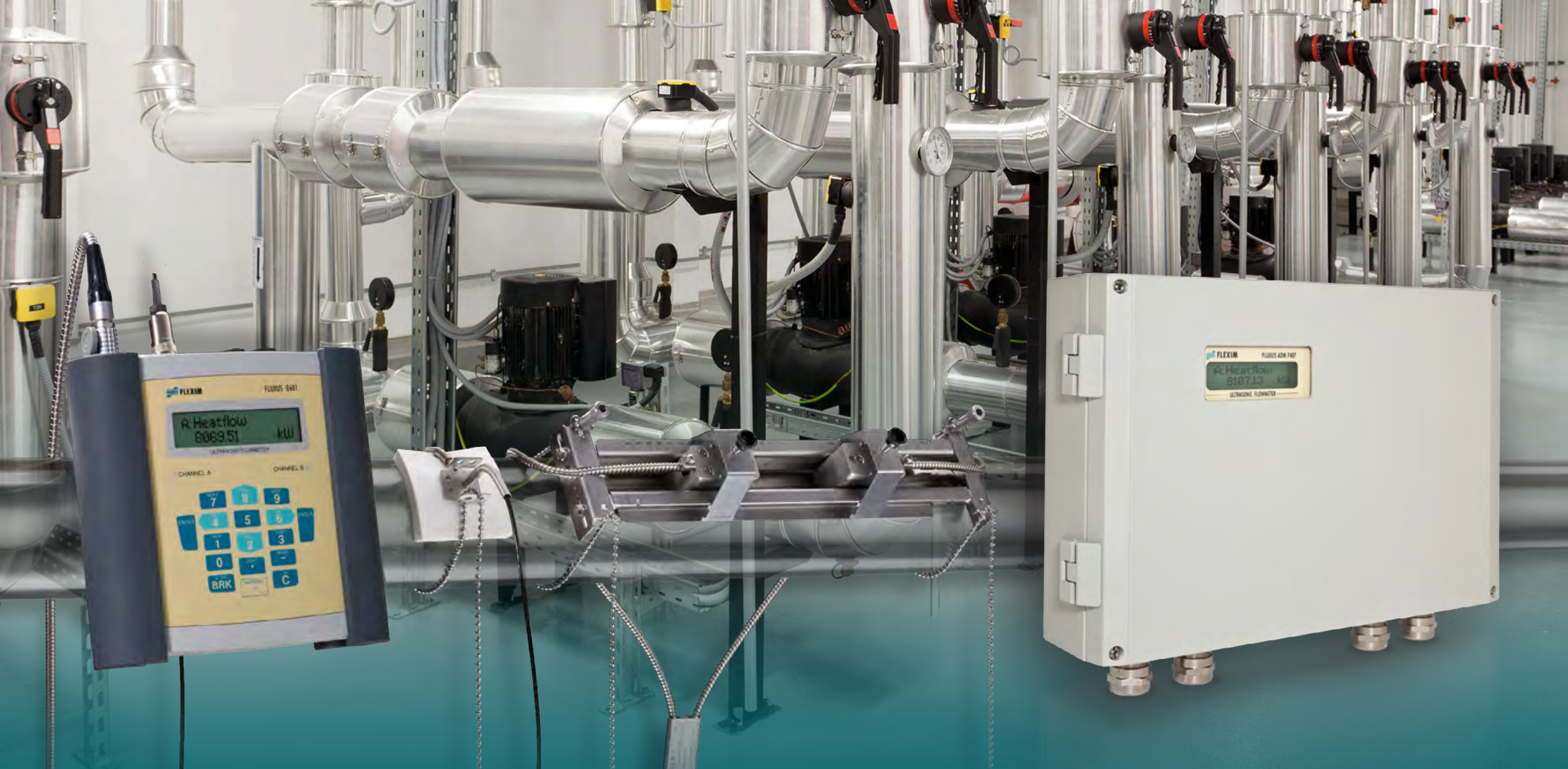

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rent would be increased in an amount sufficient to make all debt service payments on the loan obtained by the landlord. This approach avoids having the landlord recognize $1 million of income at the commencement of the lease term. While the landlord would have to include in taxable income the increased rental payments from the tenant, that income would be offset somewhat by the landlord's deductions for interest payments on the $1 million loan and depreciation on the tenant improvements. From the tenant's perspective, this approach effectively allows the tenant to recover the cost of the $1 million of tenant improvements ratably over the 10-year lease term through increased rental deductions.

7. As a variation on the previous example, the landlord could loan the tenant $1 million and the tenant would then pay for and own the improvements. To increase the likelihood that the Internal Revenue Service would respect the form of this transaction, the loan would be evidenced by a promissory note that probably would mature at the end of the lease term. This structure allows the tenant to avoid recognition of $1 million of income, albeit at the cost of having to repay the loan with interest. The tenant would be able to (i) recover the cost of the improvements ratably over 39 years; (ii) claim an abandonment loss once the tenant vacated the leased premises; and (iii) deduct the interest. As noted earlier, the reversion of the tenant improvements to the landlord is not a taxable event for the landlord.

> The landlord could, with borrowed funds, pay for and own the tenant improvements. In order to shift the economic cost of the improvements to the tenant, however, the tenant's rent would be increased in an amount sufficient to make all debt service payments on the loan obtained by the landlord.

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