SHOULD THE LANDLORD PAY FOR THE FIT-OUT?

BY MARTIN H. ABO, CPA/AB/CVA/CFF JUNE 20, 2014

There are many inequities in the tax law, and one of these pertains to the write-off of leasehold improvements a tenant makes to a landlord's property. Under the tax law, the owner is required to depreciate residential property over a 27.5 year life and commercial property over a 39 year life. Usually a tenant's lease is 10 years or less, a considerably shorter period than the property's depreciable life. Nevertheless, if a tenant makes leasehold improvements, for tax purposes the cost is required to be written off over the same period as the property life, starting with the year in which the improvements are first placed in service, regardless of the fact that the term of the lease is much shorter. Thus, even though a commercial property may have already been depreciated by the landlord or the lease is for a short duration, the tenant improvements are required to be written off over 39 years. Of course, if the tenant's lease expires and is not renewed, and the tenant leaves the leasehold improvements, a loss deduction can be taken for the undepreciated portion of the cost of the improvements. If the tenant reimburses the landlord for improvements, the cost is considered advance rent, which is at least deductible over the remaining lease term. If the remaining lease term is shorter than the regular depreciation recovery period (i.e. 39 years), it may be advantageous for the tenant to reimburse the landlord for the cost of the improvements, rather than making the improvements directly. One further consideration is a business' ability to preserve vital capital by having the landlord pay for the actual fit out and merely increase the rent to the tenant proportionately, including an interest factor. This will not only preserve cash and resulting working capital but will effectively accelerate tax deductions (i.e. as increased and currently deductible rent expense) versus writing off the fit out over a 39 year period.

These and other tax issues come up regularly with clients with regard to real estate matters. Besides clarifying the tax rules, it's suggested conferring with your CPA who can often recommend tax reducing strategies that enhance cash flow.

FOR MORE INFORMATION:

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