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Tenant Inducements: Know the Tax Implications

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In today's challenging real estate market, it's common for commercial property owners to offer a variety of inducements – such as rent holidays, cash payments, and build-out allowances – to attract tenants. Different types of inducements have different tax consequences, so it's important to understand the tax impact and to draft lease provisions carefully to ensure the desired outcome.

Rent Holidays

From a landlord's perspective, offering tenants a period of free rent is often the most effective incentive. Unlike cash payments and build-out allowances, the costs of which are generally amortized over time, foregoing rent immediately reduces the landlord's rental income while providing the tenant with a cash flow boost.

But watch out for Internal Revenue Code Sec. 467. At one time, it was possible for a cash-basis landlord to defer rental income until it was actually paid, while its accrual-basis tenant deducted rent as it accrued. To prevent this "mismatching" of income and deductions, Congress added Sec. 467, which applies to certain leases for which the total rent exceeds \$250,000. It provides that if rent is deferred for more than one year – or if rent increases or decreases over time – both parties must recognize constant rent over the lease term (as well as imputed interest on deferred payments), unless they can prove there was no tax avoidance motive.

There are several exceptions to this "rent leveling" rule, including "reasonable rent holidays" (in accordance with local practice), rent adjustments tied to a price index, and rent based on a percentage of tenant sales.

Cash Payments

Unrestricted cash payments to a tenant generally are amortizable by the landlord over the lease term (including reasonably certain renewals). For the tenant, however, these payments are immediately taxable in the year they're received. If the tenant uses the funds for deductible business expenses – such as moving costs, equipment or furniture – it may be able to offset some or all of the taxable income.

If the tenant uses the money to make leasehold improvements, different rules may apply (see below).

Build-Out Allowances

The tax treatment of leasehold improvements generally depends on which party pays for and owns the improvements. If the landlord owns the improvements, it capitalizes the cost and depreciates it over 39 years (or less, as discussed below) and there would be no tax impact on the tenant. If the tenant owns the improvements, then it would claim the depreciation deductions. In either case, if the improvements have no continuing value at the end of the lease term, the party that owns them can write off the balance. Ownership of leasehold improvements depends on several factors, including the terms of the lease, which party owns the improvements upon expiration of the lease, which party bears the risk of loss, and which party insures and maintains the improvements.

If a landlord provides a tenant with a build-out allowance used for improvements owned by the tenant, the landlord generally treats the allowance as a lease acquisition cost, amortizing it over the lease term. The tenant includes the allowance in taxable income and depreciates the cost of leasehold improvements over time.

There's an exception, however, for certain short-term (15 years or less) retail leases. If the tenant applies the allowance exclusively toward leasehold improvements used in its retail business, then the allowance is excluded from the tenant's income and the landlord must treat the allowance as an investment in depreciable property.

Keep in mind that "qualified leasehold improvements" placed in service by the end of 2011 qualify for accelerated depreciation – over 15, rather than 39, years. Also, in some cases, qualified leasehold improvements are eligible for Sec. 179 expensing or for 50% or 100% bonus depreciation. Qualified leasehold improvements are improvements to nonresidential buildings (provided the building is more than three years old) if the improvements:

- Are made pursuant to a lease between unrelated parties;
- Are made to an interior portion of the building exclusively occupied by the tenant; and
- Consist of real, rather than personal, property.

Certain improvements are ineligible, including internal structural framework, elevators and escalators, and structural components that benefit common areas.

Lease Language is Critical

Landlords and tenants should pay close attention to the language of their leases, which can have a significant impact on the tax consequences. Suppose, for example, that a landlord provides a tenant with a one-year rent holiday. If the lease indicates that the tenant is obligated to make leasehold improvements in lieu of rent, the landlord may have to include the cost of those improvements in income and depreciate the cost over time.

To avoid unintended tax consequences, be sure to have lease provisions regarding (or affecting) tenant inducements reviewed by your tax advisors.