

TO: LANDLORDS AND REAL ESTATE PROFESSIONALS

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HOW TO MAXIMIZE YOUR TAX BENEFITS UNDER REAL ESTATE LEASES

You can maximize tax benefits under real estate leases by accelerating deductions, making land costs deductible, and not recognizing income on monies and stock rights received from a tenant. These tax planning techniques are discussed below.

1. INCREASE YOUR DEDUCTIONS FOR TENANT IMPROVEMENTS BY FASTER AMORTIZATION WRITEOFFS.

Deductions for tenant improvements can be increased by classifying the improvements as "personal property," and then writing the improvements off over five to seven years using the double declining method.¹ In other words, certain improvements do not have to be written off over the straight-line 39 or 27½ years. Thus, cabinetry, specialized lighting, exhaust systems, specialized equipment, electrical and plumbing items for specialized equipment, loading door levelers, emergency generators, computer floors and wiring, store improvements, refrigeration equipment, and other specialized tenant improvements can be classified as "personal property" and written off over shorter lives.²

¹See Rev. Proc. 87-56, 1987-2 C.B. 674; and Rev. Proc. 88-22, 1988-1 C.B. 784.

²Such a componentization has been approved by the United States Tax Court in *Hospital Corp. of America*, 109 TC 21 (1997).

Classifying items as personal property, however, can cause deductions to be recaptured as

Much of this personal property can be written off over five or seven years using the double declining method, and switching to straight-line at the time to maximize tax deductions. The IRS has stated that appliances, carpeting and furniture in rental real estate can be recovered over a five-year period.³ Additionally, sidewalks, roads, driveways, parking areas, fencing, drainage, sewers, underground utilities, landscaping, irrigation, and other land improvements can be amortized over a 15-year period utilizing the 150% declining balance method.⁴ These increased deductions require that a cost segregation study be performed to segregate the personal property and land improvements.

2. UTILIZE THE NEW 2002 TAX LAW'S 30 PERCENT FIRST-YEAR "BONUS" DEPRECIATION.

The 2002 tax law's new "bonus" 30% first year depreciation applies to qualifying property acquired after September 10, 2001 and before September 11, 2004.⁵ The improvements must also meet either one of two qualifying tests. The first alternative qualifying test is for the tenant improvements to be "personal property" (such as cabinetry, carpeting and specialized tenant HVAC systems) or "land improvements" (such as irrigation systems, roads, parking areas and hardscape), and thus have a recovery period of less than 20 years. The second alternative qualifying test is for the improvements to be "qualified leasehold improvement" property. "Qualified leasehold improvement" property must, among its other requirements, not be tenant improvements in new buildings, but rather the improvements must be placed in service more than three years after the building was first placed in service.⁶ Additionally, "qualified leasehold improvement" property includes only certain interior portions of the building, and excludes such items as elevators and structural framework.

3. CHOOSE WHETHER YOU OR YOUR TENANT WILL DEDUCT THE TENANT IMPROVEMENTS' COSTS.

ordinary income on the property's sale under §1245. Additionally, upon a §1031 exchange, in order for property to be "like-kind," it will have to be exchanged for similar personal property. Finally, landlords that are REITs must be careful that rental income attributable to personal property does not violate the gross income test under §856.

³Ann. 99-82, 1999-32 IRB 44.

⁴See §168(b)(2).

⁵See §168(k). The basis of the property is then reduced to reflect this 30% first-year depreciation.

⁶Qualified leasehold improvements can include electrical, plumbing and HVAC systems.

The party that "owns" the tenant improvements is entitled to the amortization and depreciation deduction. The "ownership" will not only be based on legal title, but is also based on who the lease states is the owner, and which party paid for the tenant improvements. For example, if you, as the landlord, pay for the tenant improvements and intend to amortize same, then have the lease specify that the tenant improvements are your property.

4. EVEN IF YOUR TENANT PAYS FOR TENANT IMPROVEMENTS WHICH BECOME YOUR PROPERTY ON THE LEASE'S TERMINATION, YOU STILL HAVE NO INCOME.

On the lease's termination, you can receive tenant improvements which are paid for by the tenant tax free.⁷ Thus, you can receive tax free HVAC systems, lighting fixtures, and plumbing fixtures paid for by your tenant. Additionally, at the end of a ground lease, you can receive tax free an entire building paid for by your tenant. The lease must not state that the tenant's obligation to make these improvements is an offset against rent.

5. SECURITY DEPOSITS WHICH YOU RECEIVE ARE NOT INCLUDED IN YOUR INCOME.

Security deposits are not taxable to you until you apply the deposits to the tenant's obligations under the lease. In order to be sure that the "security deposit" is not classified as taxable rent, the lease should identify the payment as a security deposit and require that the security deposit be returned to the tenant (less your use of the deposit) upon the lease's termination.

6. YOU CAN RECEIVE TAX FREE A TENANT'S STOCK WARRANTS AND STOCK OPTIONS AS PART OF THE LEASE TRANSACTION.

During the "dot-com" frenzy, many landlords received tenants' warrants and stock options in exchange for leasing space to high-risk "dot-com" tenants. Some landlords mistakenly assumed that the receipt of these options or warrants were nontaxable events under the Internal Revenue Code sections which applied to employee stock options.⁸ In most cases, however, it was unlikely that these employee stock option rules applied to

⁷See §109 which states that gross income of the landlord does not include property reverting to the landlord on the lease termination. Section 1019 prevents a lessor from increasing its tax basis in the tenant improvements by this excluded income.

⁸See §83 and Regulations thereunder.

landlords. Instead, landlords can avoid recognition of income upon the receipt of options or warrants by structuring these rights as not having an ascertainable value. However, if the stock options' and warrants' gain is deferred, gain could be recognized upon the expiration of the options' or warrants' restrictions.⁹

7. INCREASE YOUR CASH FLOW BY GIVING TENANT A PARTNERSHIP PROFIT INTERESTS IN EXCHANGE FOR THAT TENANT ENTERING INTO A LONG-TERM LEASE.

Tenants can receive a partnership profit interest in a landlord tax free, in exchange for that tenant entering into a long-term lease. Such a long-term lease allows you to receive more loan proceeds on your financing of the leased property, and also permits you to negotiate a higher rental amount from the tenant. Tenants receiving only a partnership profits interest have no income upon receipt of that partnership interest.¹⁰ Instead, the tenant recognizes income as the tenant receives distributions from the partnership.

8. USE A GROUND LEASE TO CREATE TAX DEDUCTIONS.

Your land purchase costs are not deductible. However, instead of purchasing the land, you could lease the land (under a ground lease) where the ground lease payments are tax deductible. A long-term ground lease is especially attractive to tax-exempt landlords such as universities that own land in urban areas, since received ground lease rents are exempt from taxation. As an example, Columbia University leases to Rockefeller Center on a long-term ground lease much of the Center's land in New York City.

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⁹If the warrants or options have no ascertainable value because their value is speculative or certain contingencies prevent their exercise, income is not recognized on the options' and warrants' receipt. However, when these contingencies or restrictions expire, ordinary income can result.

¹⁰This result is supported by the tax authorities of *Campbell*, 943 F2d 815 (8th Cir. 1991); and Rev. Proc. 93-27, 1993-2 CB 343.

This newsletter contains general information on real estate tax issues. Because each person's tax and factual situation is unique, nothing in this newsletter should be deemed advice on a specific situation. For specific tax or legal advice, please contact Robert A. Briskin at rbriskin@bflegal.com.