

Real Estate Advisor

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Landlords and Tenants Alike Should Consider the Tax Ramifications of Tenant Inducements

Tenant inducements play an increasingly vital role in today's competitive real estate market. In the scramble to maintain occupancy rates, property managers offer prospective and current tenants a wide variety of perks. Rent holidays, stepped rent, lump-sum payments and leasehold improvements top the list of popular tenant incentives at the higher end of the cost scale. When structured properly, these inducement packages do more than just attract and retain tenants; they yield the best possible tax results for both the lessor and the tenant. To develop the most advantageous inducement packages, property managers must understand the tax angles of various tenant incentives. Those who ignore these tax angles risk incurring hidden costs as well as unpleasant tax results.

Rent Holidays

A "rent holiday" or free rent period is one of the most popular tenant inducements. While the tenant experiences a cash flow boost, the lessor's cash flow is negatively affected. The lessor does, however, receive a tax benefit for granting the rent holiday; namely, a reduction in income during the time rent is not received because lessor recognizes no rental income during the rent holiday. In terms of timing, the tax benefit associated with a rent holiday is more beneficial than those associated with other inducements as the reduction in income is reflected immediately during the period in which it occurs. Tax benefits from many other forms of lease inducements are spread over much longer periods.

Stepped Rents

Stepped-rent agreements are characterized by deeply discounted rates, which generally continue during the first year of the lease. After the initial low-rate period, the lease agreement calls for a rent increase for the remaining term. One advantage of stepped-rent agreements is the higher starting point in renewal negotiations, since the lease amount is at its peak by the end of the lease term. For example, if office space is leased for five years at an average of \$18 per square foot but the final year of the lease agreement calls for \$20 per square foot, the lessor can start renewal negotiations at \$20 per square foot or more. Under a stepped-rent agreement, a reduced-rent period is allowed. By receiving reduced rental payments, the lessor avoids the cash flow strain that accompanies rent holidays. The lessor also receives the tax benefit of a reduction of income during the initial phase of a stepped rent agreement, except, possibly, where Internal Revenue Code Section 467 applies. Stepped-rent agreements offer

the same timing benefit as rent holidays — the tax benefit is received during rather than after the inducement period.

Lump-Sum Payments

Lump-sum payments are inducements where the lessor pays the lessee direction, usually to:

- Cover the tenant's moving expense,
- Buy out an existing lease,
- Cover furniture and equipment costs, and
- Provide a true cash bonus.

Lump-sum payments made to the tenant (to the extent not attributable to leasehold improvements) must be capitalized by the lessor and amortized over the term of the lease. For example, if a lessor makes a lump-sum cash payment of \$50,000 to a tenant for signing a new 10-year lease, the lessor would capitalize the payment and deduct \$5,000 annually during each year of the lease.

When the lessor makes a cash payment directly to the tenant, the tenant will have taxable income for the tax period during which the payment is received. (except when the payment is characterized as a reimbursement for leasehold improvements owned by the landlord). If the tenant then uses the money to pay moving or other expenses, the tenant will also have an offsetting deduction. If the allowance the tenant receives exceeds the amount actually spent, the excess amount would be income.

A lump-sum payment to buy out an existing lease is not always a practical tenant inducement. Sometimes it makes more sense for the new lessor to sublease the tenant's former space. Subletting, however, can create tax problems for some tenants if it results in undesirable passive income or a loss. In such cases, one option would be to quantify the value of the lease buyout and convert that value into another type of inducement, such as a rent holiday.

Lump-sum payments for furniture and equipment purchased by tenants must be depreciated over the life of the furniture or equipment. In many ways, the tax treatment of lump-sum payments for furniture and equipment would be the same as for leasehold improvements. For tax purposes, a rent holiday is generally more advantageous for the tenant and the lessor than a lump-sum payment.

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Designing the New Green Hospitality Market

The Evolution of LEED

Since its launch in 2000, the U.S. Green Building Council's (USGBC) LEED green building program has been an instrumental tool in the transformation of the built environment towards sustainable building practices. The LEED program's greatest strength lies in its consensus-based, transparent, ongoing development cycle. The ability to be flexible allows LEED to evolve, taking advantage of new technologies and advancements in building science while prioritizing energy efficiency and CO₂ emissions reductions. The latest version of the rating system, LEED 2009, introduced major technical advancements to the LEED credits and points. This update included all rating systems that address commercial buildings, including LEED for New Construction and LEED for Existing Buildings, two systems that are increasingly being used in the hospitality industry.

Through enhancements to the technical requirements to LEED, a closer connection to the carbon footprint of a building, and scalable certification processes and infrastructure, LEED brings together the most relevant and appropriate tools for the commercial real estate industry for developing high-performance, sustainable buildings. In its ten year history, the driving force behind LEED has been transforming the way we design, build, and operate our real estate. The system has evolved to ensure continued progress towards our common goals—a fiscally sound and environmentally responsible real estate market.

LEED and Hospitality

LEED is designed to work across different space types, including offices, schools, retail, and hotels and resorts. While these building types differ in the strategies they employ, their environmental impacts are fundamentally the same. LEED addresses sustainable site development, water savings, energy efficiency, materials and resources selection, and indoor environmental quality, providing critical measurement and verification tools to all properties seeking to minimize their environmental impact. USGBC is actively working with a group of hospitality industry representatives to provide alternative compliance paths for certain LEED credits. This will better fit the rating system to hotel and resort development and management. The resulting technical changes from this industry-led effort will be available for use in late 2010.

Discovering and Institutionalizing Green Design

Although green design concepts are increasingly used across the building industry, the hospitality market has been slower to embrace the concept holistically.

Currently there are 900 hotels seeking certification (registered projects), and 35 LEED certified hotels. The hospitality industry is catching up quickly. For example, hotel chain Starwood plans to certify every Element hotel, Marriott has announced plans to offer a LEED precertified prototype for its Courtyard brand, and individual properties such as The Nines in Portland, Proximity Hotel in Greensboro, North Carolina and The Westin in Avon, Colorado have shown the industry that green design and operations can enhance guest experiences. CityCenter in Las Vegas recently received six LEED certifications, one for each open hotel in the new massive development by MGM MIRAGE. These properties demonstrate the business case for green building, both in terms of operating costs and the increased marketability of their hotels.

Additionally, environmental building strategies are being built into brand standards and hotel designs. In an American Hotel & Lodging Association (AH&LA) survey conducted in 2008, 20% of the 10,000 surveyed properties were incorporating elements of LEED and an additional 21% planned to incorporate LEED within the coming 12 months. Through brands and ownership, there is tremendous opportunity to scale the implementation of LEED across all hotels in their portfolio. USGBC has been working with leading retailers and real estate, which will quickly lead to hundreds of additional certified banks, coffee shops, commercial office buildings, and even hotels. Several hotel companies are working towards integrating LEED into their prototype design for economy and mid-scale properties, while simultaneously updating brand standards for all properties, including for higher-end brands.

Market Momentum

Hospitality has always been a design-forward industry and green design aligns well with forward-thinking design. The Sustainable Suite Design Competition, recently hosted by USGBC, the American Society of Interior Designers (ASID) and The Hospitality Industry Network (NEWH), captured some of the most innovative thinking in green hospitality design – pushing the market to think beyond current strategies for energy and water conservation, indoor air quality, and sustainable materials. The competition winner, destination design firm WATG, will showcase their design at the HDEXpo in May 2010. To learn more about the Sustainable Suite Design Competition and view the winning entries, visit www.usgbc.org/sustainablesuite.

By Marc Heisterkamp

Ten Opportunities to Reduce your Property Tax Burden

Real estate and business personal property taxes are unavoidable. Together they are one of the largest generators of state and local tax revenue. Unlike income taxes, however, property taxes are not tied to a company's profitability. Every year, companies unknowingly pay more than their fair share of property taxes. Bottom line: Companies must be more proactive in managing their property tax liabilities.

Here are ten often missed opportunities to lower your real and personal property tax liabilities.

1. Land classification

Conservation easements, excessive waterfront property, swamp land, agricultural land, and other land classifications hold lower market values than standard market transactions. Classification of land rights can be valued at a fee simple interest, all rights, or a level with one or more rights removed. Land over and above an area "standard" should be valued at a lower level per square foot.

2. Know your property's value

Properties increase and decrease in value depending on market conditions. Each market and type of property does not change at the same rates. Apartments, office, manufacturing, retail and residential properties within a market may be stable, increasing, or decreasing independent of each other. To obtain a copy of your assessment, review the assessor's website or visit the assessor's office. Most mid-sized and larger jurisdictions have a wealth of information available online, including comparable sales and other relevant information. Remember, market value is an opinion of value at a specific point in time. By reviewing the information underlying the assessor's opinion, you may be able to find appropriate areas to challenge.

3. Understand areas of impairment

There are three general areas of value depreciation: physical, functional and economic.

Physical depreciation is tied to the age of the property. If the typical life for a specific structure is 50 years and the structure is 5 years old, it is physically 10% impaired, or 90% good.

Functional obsolescence is inherent in the property itself, such as extra walls from expansion, remodels or upgrades to electrical or HVAC, or any other quantifiable attribute that would not be included if a new, state-of-the-art facility were to be constructed.

Economic obsolescence is impairment outside of the property. Production reductions from market loss, bankruptcy of supply chain vendors, tenant vacancy, natural disasters, or decay of surrounding properties are quantifiable events impairing value of the subject property.

4. Exemptions

States often provide exemptions for real and personal property in order to assist the property owners in operating

within a state. Some states exempt assets physically used in manufacturing, others exempt assets used to protect the environment through a pollution control exemption, and several states taxing inventory provide a Freeport exemption for goods to be shipped out of state within a specified amount of time. Each state's rules vary, so be sure to review each states opportunities.

5. This is not my property

Errors do occur. Review the property record card from the assessing jurisdiction annually, especially after expansion, demolition, remodeling, or renovation. The assessor's property record card is only as accurate as the information they were able to obtain. Errors in square footage, incorrect property, type of foundation, floor, age, electrical circuitry, or interior finish can make a significant impact on value.

6. Quantify and verify

Once you have determined your property is overvalued, you must be able to quantify the overvalued components. As the owner, you know better than anyone else what issues surround the property. Discuss these with the assessor. Many assessors will work with your information and assist you in quantification. If this approach is not successful, a qualified property appraiser can provide an independent market value appraisal quantifying each of the three approaches to value. In addition, a qualified property tax consultant may assist you with quantifying and negotiating value, exemptions, and formal or informal appeals.

7. Changing at the pace of technology

Computers and peripheral equipment are often taxed as business personal property using an accelerated life, compared to furniture or equipment. Often the pace of technology outpaces guidance used for valuing these pieces of equipment.

8. Haunted by ghost assets

Personal property is filed based upon fixed asset records. Often assets that have been disposed of, depreciated, idled, or removed from service remain on the record long after their departure. These "ghost" assets continue to be taxed at a floor of 10% to 15% of original cost until they are removed.

9. Hey, that is not my lease

Leased equipment is often taxable, but the question is, to whom? Each state is different, some require the lessor to file, others require the lessee, while some states like Wisconsin require both and reconcile.

10. Are your vehicles taxable?

Vehicles, aircraft, watercraft, and other property may be subject to property tax. Consider where each taxed item is typically located. Tagged vehicles may be exempt, or the state may not tax vehicles registered in other states where the property is typically housed.

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Leasehold Improvement Allowances

Lessors frequently offer allowances for leasehold improvements as another form of tenant inducement. Tax treatment of leasehold improvements hinges on which party retains ownership of the leasehold improvement. In most cases, the lessor receives tax benefits of the cost of leasehold improvements more quickly by making a lump-sum payment to the tenant for the improvement costs rather than paying for and retaining ownership of the improvements and receiving tax benefits through depreciation.

When the tenant retains ownership of the improvements, the cash payment from the lessor is recognized as income to the tenant. The tenant then depreciates the leasehold improvement over its statutory life, which is currently 39 years. The lessor capitalizes the cash amount paid to the tenant, amortizing it over its statutory life.

When the lessor retains ownership of leasehold improvements, the tenant is not entitled to depreciation even if the expenditures pass through the tenant's books. In other words, the tenant's taxes are not affected. The lessor, on the other hand, capitalizes the amount paid for leasehold improvements and, rather than amortizing them over the life of the lease, depreciates the amount over the statutory life, with any undepreciated balance being written off at the end of the lease if the improvements are abandoned by the lessor on termination of the lease.

If the tenant owns the improvements, but turns them over to the lessor upon vacating the property, the lessor is generally not required to recognize income. Nor does the lessor receive a depreciable basis in the improvements. But if the lessor receives the improvements in lieu of rent, the lessor may have to recognize income and have a depreciable basis in the improvements.

The lessor receives the tax benefit of tenant inducements, except where Section 467 takes effect.

Rent-Leveling Provisions

In the past, postponement of rental income and expense through stepped rent and rent holidays offered an ideal opportunity for deferring taxes. A cash-basis lessor could defer recognizing income until rent was actually received, while an accrual-basis tenant could take a current tax deduction for accrued rent, even though that rent would not be paid until a later year.

To do away with the perceived abuse of this provision, the Internal Revenue Code Section 467 attempts to smooth out the recognition of rental income that otherwise would have been deferred through rent holidays or stepped rent. Through its "rent-leveling" provisions, Section 467 requires rent charged in certain deferred arrangements to be leveled over the length of the agreement.

Section 467 applies to lease agreements for the tangible property (real or personal) when:

- Total payments over the lease term (cash plus fair market value) exceed \$250,000,
- Rent is postponed for more than one year, and the lease agreement allocates the rent to a specific calendar year,
- Rent is increasing (or decreasing),
- The lease term exceeds 75% of the recovery period of the leased property, and
- The principal purpose of the agreement is tax avoidance.

The tax courts determine tax avoidance on a case-by-case basis and take into consideration the size of the gap between tax brackets of the lessor and tenant, whether an option exists for the tenant to renew at rents significantly less than the amounts in the original lease's later years, and whether the lease involves a tax-exempt organization placed between two taxable parties.

In the following situations or safe harbors, rent holidays or stepped-rent agreements will not be considered to have a tax avoidance purpose:

- Rent increases are linked to a price index, such as the consumer price index,
- Rents are based on a fixed percentage of tenant's gross receipts
- Reasonable rent holidays were given at the beginning of the lease term based on the current rental real estate market,
- Rent increased due to escalations in amounts paid to unrelated third parties, such as insurance, taxes or maintenance costs.

If a lease agreement does come under the rent leveling provisions of Section 467, both the lessor and the tenant must allocate an equal amount of rent to each period under the lease.

The rent amount is determined by taking the present value of all payments that are to be made under the lease terms. This rent accrual is treated the same as any other debt owed by an accrual-basis taxpayer. Thus, both lessors and tenants will be subject to the rules governing bad debt deductions, discharge of indebtedness and the tax benefit rule. Interest must be imputed on any of the leveled rent amount that is not paid currently, and the total amount of rent and interest recognized for the entire lease term should equal the total amount of payments under the lease.

When possible, lessors should structure lease agreements to address the provisions of Section 467. All proposed lease agreements should be reviewed with tax advantages and disadvantages in mind before granting any significant rent holidays or stepped-rent concessions.

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