The Business Journal (Minneapolis/St. Paul) - January 19, 2004
http://twincities.bizjournals.com/twincities/stories/2004/01/19/focus1.html

THE BUSINESS JOURNAL MINNEAPOLIS • ST. PAUL

IN DEPTH: COMMERCIAL REAL ESTATE

From the January 16, 2004 print edition

Tax bonus affects lease negotiations

Accelerated depreciation on tenant improvements can be used by lessee or landlord

Scott D. Smith
Staff reporter

Tenants are using a new depreciation tax break to bargain for the sleek new offices they want.

The U.S. Jobs and Growth Tax Relief Reconciliation Act of 2003, enacted in May, allows for accelerated depreciation of newly acquired equipment and tenant improvements in buildings more than 3 years old.

Under the benefit, some tenant improvements can be depreciated by a bonus 50 percent. That can mean significant tax savings for whoever paid for the improvements.

Tenants, landlords and tenant representatives are negotiating lease terms to take advantage of the tax bonus. Property transactions also are being affected, as buyers try to position themselves for increased depreciation. New construction also can benefit.

Restor Johnson, vice president and real estate consultant with the Minneapolis office of Jones Lang LaSalle, said he has recently changed his tenant-representative strategy in response to the new tax bonus. Rather than pushing a landlord to do more tenant improvements, Johnson sometimes seeks free rent or lower rent. That way the tenant can do the improvements and receive the tax break, he said.

During lease negotiations, the tax deduction can become a bargaining tool, depending on who may benefit more. For example, a profitable tenant with a large tax liability might pay for tenant improvements to get the tax relief. However, the bonus wouldn't benefit an unprofitable tenant. In that case, the tenant might give up the benefit to a landlord in exchange for something else.

As with any tax deduction, it only helps a profitable filer.

"Sophisticated landlords want to take advantage of it themselves," Johnson said.

The bonus allows a business to get a tax break right away rather than spreading that same tax break out over several years.

"I tell people it is an interest-free loan from the government," said Todd Phillips, senior associate real estate services, with the Bloomington office of Virchow, Krause & Co.

Tenant improvements that qualify must take place between May 5, 2003, and Jan. 1, 2005, in a building more than 3 years old. The deduction must be claimed on 2003 or 2004 tax filings. The improvements can't be part of the structural framework of a building or part of a common area.

Landlords and tenants are pushing for improvements with a greater sense of urgency to meet the deadline.

"We're seeing some projects accelerating from 2005 to 2004," Johnson said.

Buy in

The bonus depreciation can become a factor in new building sales.

Scott Frederiksen of Bloomington-based Welsh Cos. brokered the purchase of Creek Edge Business Center in Eden Prairie. A Welsh Cos. partnership recently bought the building from a New York investment group after Golf Galaxy agreed to lease 40,000 square feet. Frederiksen said that without the bonus depreciation, the Welsh partnership might have required the previous owner to fund the Golf Galaxy tenant improvements. Because of the bonus, the partnership agreed to take on the cost of retrofitting the space.

"If someone is buying a new building, they might prefer to do the improvements themselves," Frederiksen said.

The bonus also can offset moving costs. One of Johnson's Jones Lang LaSalle clients is a Fortune 100 company that is seriously considering relocating in part because of the bonus. Businesses generally spend between $20 to $60 a foot to move into a new space. The bonus depreciation would offset that cost enough to make moving feasible, he said.

New construction

Besides tenant improvements, those constructing new buildings can use the bonus depreciation to write down parts of the property expected to last less than 20 years, such as landscaping, carpet, accent lighting and other equipment.

The structure of a building doesn't qualify for the bonus. Buildings are considered to have a tax life of 39 years, which means their value depreciates at about 2.56 percent a year.

To take advantage of the bonus, businesses can do a cost-segregation analysis. During this process, experts go through a building to find assets with shorter lives that can be written off faster. This can include items such as plumbing and electrical systems.

Virchow Krause recently conducted a cost segregation for Applied Sales Inc., which owns seven warehouse buildings that include refrigeration systems. The analysis found that the refrigeration systems qualified for the accelerated depreciation, which resulted in tax savings, said Skip Lindblask, co-president of Applied Sales, Hudson, Wis.

Cost segregation can reclassify the tax lives of up to 40 percent of the building to 15 years or less, said Jim Lockhart, partner with Virchow Krause. For example, someone could purchase a new building for $1 million and instead of depreciating the entire cost over 39 years, write off $250,000 of the cost during the first year.

Tipping the scales

The U.S. Congress estimated that the bonus depreciation would cause the federal government to lose about $33 billion in revenue during 2004, though it would gain the money back in later years.

Ultimately, property owners are making decisions based on business fundamentals. But the tax break is encouraging some activity.

"My impression is that people are still making buy decisions based on the economics of a deal," said Stacy Rubsam, partner with the Minneapolis office of Grant Thornton. "But when it's a close call, [the bonus] pushes them over the edge."

Mike Wolf, chief financial officer for Golden Valley-based Knutson Construction Services Inc., said the bonus hasn't spurred new construction, but it has encouraged Knutson to buy new construction equipment.

Though he likes the benefit, he has a beef with the state of Minnesota, which has declined to offer it on state income taxes. That means businesses need to depreciate an asset under the standard rules for state income taxes. That also creates a little tax headache of keeping track of two different depreciation schedules, Wolf said.

ssmith@bizjournals.com | (612) 288-2107