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Should You Lease or Purchase Your Next Office Space?

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You have a growing business in need of more space. Perhaps you have a burgeoning not-for-profit organization that wants to establish itself in a new location, or your company is looking to relocate to New York City, or your current office lease is expiring. You need more room. So, what should you do?

There is a growing marketplace recently for commercial condominiums that provide users of less-than-an-entire building to acquire their office space as opposed to leasing. Several variables to contemplate when reviewing the options include price, cash outlay, cash flow impact, flexibility, investment alternatives and, of course, the tax effects.

As you approach the decision, consider the following pros and cons:

Potential Benefits of Owning

- *Equity* - When you purchase property with an amortizing mortgage and make loan payments, you increase your investment. Assuming the value of the commercial condominium stays the same or increases, you build equity.
- *Borrowing costs can remain relatively steady* - If you can obtain a fixed-rate loan, loan payments will remain constant.
- *Depreciation* - The portion of the purchase price of the unit allocable to the building is depreciable over a period of 39 years.
- *Not-for-profit organization real estate tax exemption* - Eligible tax exempt organizations that use the space for their exempt purposes may be exempt from real estate taxes, regardless of whether the unit was financed or purchased outright.
- *Section 1031 – like-kind exchange eligibility* - Commercial condominiums are real property and would be eligible for like kind exchange treatment under Internal Revenue Code Section 1031.
- *Mortgage interest is currently tax deductible*
- *Excess space may be sublet without approval* - Not-for-profit organizations may be subject to tax on rental income, so it is important to consult a qualified tax advisor to determine rental income taxability.
- *Owners are not subject to NYC commercial rent tax* - Commercial rent tax is charged to tenants who occupy a property for commercial activity in Manhattan south of 96th Street when the annual gross rent paid is at least $250,000.

Potential Downsides to Owning

- *Down payment* - Significant cash is needed upfront for financing the purchase – typically 20% to 30% of the purchase price.
- *Responsible for repairs and maintenance* - Owners must pay to maintain their property, including their proportionate share of structural repair and improvements to the building.
- *Obstacles to moving* -The resale market for commercial condominiums is currently not very large, which could impact the unit's pricing and marketability. Flexibility may be impaired by the inability to sell when you are planning a relocation. The unit's resale price depends on a variety of conditions, including the overall real estate market, the resale market for commercial condominiums, and the location.

Potential Benefits of Leasing

- *No down payment needed, other than a security deposit* - Less cash is needed upfront, and a lease security deposit is significantly less than a down payment on a purchase.
- *Lease payments are deductible* - Rent is tax deductible.
- *The landlord is typically responsible for most repairs* - The tenant has less uncertainty of future repair expenses; however, most commercial leases have escalation clauses that can pass certain costs through to the tenants as additional rent.
- *More flexibility* - There are fewer obstacles to moving in the future, other than the expiration of the lease term.
- *Tax benefits of leasehold improvements* - Eligible leasehold improvements can be depreciated over a period of 15 years, instead of the 39-year life for buildings. Eligible leasehold improvements may also qualify for immediate bonus depreciation and expensing elections.

Potential Downsides to Leasing

- *Limited appreciation in value* - The only time the tenants can benefit from an increase in the value of their space is to sell the leasehold interests prior to the expiration of the lease, assuming their rent becomes below the current market rents.
- *Rent increases* - Typically, leases include rent escalations over the course of the lease. These escalations can reflect market-based indexes, such as the consumer price index, stepped increase to base rent, a pass through of increases in operating expenses, or a combination of the above.
- *Limits on expansions and modifications* - A lease agreement may limit your options to modify the space. Leasehold improvements often revert back to the landlord after you vacate the space.
- *Lessees are subject to NYC commercial rent tax* - Tenants who occupy or use a property for commercial activity in Manhattan south of 96th Street when the annual gross rent paid is at least $250,000 are subject to a commercial rent tax.
- *New lease accounting rules* - Newly released GAAP accounting standards will require lessees to reflect almost all long-term leases on their balance sheets.The new accounting standard impacts financial statement presentation under GAAP. Financial metrics under certain other contracts, many of which relate directly to debt covenants and performance indicators, may be impacted by these rules.

To illustrate the implications of leasing versus owning, here is an example illustrating typical costs:

Purchase	
Purchase Price	10,000,000
Down payment - 30%	3,000,000
SBA loan amount	7,000,000
Interest Rate	4.5%
Loan term	25 years
Monthly loan payment	38,900
Real estate taxes per sq. foot	8

Leasing	
Price per square foot	60
Square footage of space	10,000
Monthly rent expense	50,000
CAM charge / sq. foot	6.80
Yearly rent and CAM increases	3%
Months of free rent	10

10 Years of Ownership	
Total mortgage payments	4,669,000
Total real estate taxes	800,000
Down payment	3,000,000
Total cash outflow - 10 years	8,469,000

10 Years of Leasing	
Total rent expense	6,378,300
Total CAM charges	777,800
Security deposit - 6 months rent	300,000
NYC commercial rent tax	234,000
Total cash outflow - 10 years	7,690,100

10 Years - Owner Tax Deductions	
Loan interest	2,755,100
Total real estate taxes	800,000
Depreciation **	2,307,700
Total tax deductions - 10 years	5,862,800

10 Years - Leasing Tax Deductions	
Total rent	6,378,300
Total CAM charges	777,800
NYC commercial rent tax	234,000
Total tax deductions - 10 years	7,390,100

Financial Position After 10 Years	
Total cash outflow - 10 years	8,469,000
Cash benefit of tax deductions	(2,931,400)
Net cash out of pocket	5,537,600
Equity in real estate *	(4,913,900)
Opportunity cost on down payment ***	1,231,600
Financial position after 10 years	(1,855,300)

Financial Position After 10 Years	
Total cash outflow - 10 years	7,690,100
Cash benefit of tax deductions	(3,695,000)
Net cash out of pocket	3,995,100
Security deposit	(300,000)
Opportunity cost on security deposit ***	123,200
Financial position after 10 years	(3,818,300)

*Assuming no appreciation or depreciation in the property value for the purposes of this illustration
**The property is depreciated over 39 years, with a 10% allocation of purchase price to land, which is not depreciable
***An assumed opportunity cost with a rate of return of 3.5% over 10 years
Generally there is a nominal difference in utilities and repairs expense between renting and owning, therefore it is not included in this illustration.

All numbers used in the illustration above are estimates and are likely to change.

When looking at the above analysis for an eligible not-for-profit organization, the benefit of ownership can be even greater due to the real estate tax exemption it is eligible to receive.

Each option has its own distinct advantages, and your decision to lease or buy will hinge on a combination of financial, tax, and personal issues. As you explore the decision, bring in trusted advisors and professionals to help you understand the option that works best for your situation.