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June 1, 2008 Volume 18, Number 8  
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**LEASEHOLD IMPROVEMENTS**

One of the largest expenditures that many businesses make as they enter the business growth phase is improvements to a building. For reasons of time constraints as well as maintaining a location known by customers, many businesses would rather stay in a location that they have used rather than move to a new location. As a result, improvements to the existing location will be made to make it more useful and productive. These improvements are referred to in tax law as “leasehold improvements” if the improvements are made to a building leased by the business. How does a business deduct these improvements?

The basic rules for deducting leasehold improvements are as follows:

- A. The cost of improvements made by lessors (the “lessor” is the landlord) are depreciated over 39 years in the case of commercial property – regardless of the term of the lease. This rule also applies where the improvements are made to the tenant’s specifications so that they may not be suitable for the next tenant.
- B. The cost of improvements made by lessee (the “lessee” is the tenant) are depreciated over 39 years in the case of commercial property – regardless of the term of the lease. Thus, the lessee is treated as any other owner-taxpayer for purposes of determining depreciation.

What happens when the lease ends but the improvements have not been completely depreciated:

- A. Where the lease ends or terminates before the end of the depreciation period of the improvement and the lessee doesn't retain the improvement, the lessee can deduct the undepreciated cost of the improvement in the year the lease ends. If the lease is renewed, the depreciation of the improvement continues as if the lease never ended and the new one started.
- B. Where a leasehold improvement is irrevocably disposed of or abandoned by the lessor at the termination of the lease by the lessee, and the improvement was made by the lessor for the lessee, the improvement is treated as disposed of by the lessor at the time of the disposition or abandonment. Thus, the undepreciated cost of the improvement made for the lessee is fully deducted in that year the lessee terminates the lease.

Suppose you find a great location, but it is already occupied by some other business. You then decide the location is “so good” that you would like to buy the remaining term of the lease from the occupant. How do you deduct that money paid – the cost of acquiring the lease? Answer: The cost of acquiring an assignment of a lease must be allocated between (a) the amount paid for the assignment of the lease;

and (b) the amount paid for the leasehold improvements. The amount paid for assignment of the lease is deducted over the term of the lease. The amount paid for the leasehold improvements is depreciated over 39 years.

Suppose a tenant simply outgrows a space and needs to move. The tenant and landlord work out an agreement on settlement of the lease that calls for the tenant to pay for example \$5,000 to the landlord for cancellation of the lease. The payment would be an immediate deductible expense for the tenant, but is a capital gain payment to the landlord. The treatment of the lease cancellation payment is a significant planning opportunity for the landlord since the payment can be used to off-set capital losses from other sources.

**SALES TAX AND LEASES**

The State of Florida imposes sales tax on the payment of commercial rent. Suppose Joe owns a building, and a corporation 100% owned by Joe occupies that building. Joe charges rent to the corporation or has

the corporation pay the debt to the bank on the building. The rent is subject to sales tax, and the debt payment to the bank is imputed rent also subject to sales tax. As a planning note, it is possible to structure payments from Joe’s corporation to Joe without incurring sales tax. It is also possible to structure payments to a corporation that owns the building without incurring sales tax. Please call us if you have any interest in the structure.

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*When one door closes another door opens; but we so often look so long and so regretfully upon the closed door, that we do not see the ones which open for us.*

*Imagination is more important than knowledge.*

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