# Office CONDOS:

## Should Your Business Rent or Own its Space?

By Dean Morehouse

**ONE OF THE MOST PRESSING ISSUES FOR BUSINESSES TODAY IS WHETHER TO RENT OR TO OWN THE COMMERCIAL SPACE YOU NEED. WHETHER THAT SPACE IS CONVENTIONAL OFFICE SPACE FOR RUNNING DAY-TO-DAY ACTIVITIES, WAREHOUSE SPACE FOR STORING MATERIALS OR FLEX SPACE FOR MULTIPLE PURPOSES, HOW TO HANDLE THE FINANCES OF THE SPACE YOU OCCUPY IS SOMETHING THAT SHOULD BE CAREFULLY EVALUATED.**

The overwhelming majority of commercial space occupied in the United States is leased. Yet some of the same issues that people face in deciding whether to own or rent their homes can be applied to analyzing whether to own or rent the spaces where you operate your business. It's just that companies need to sit down and take the time to go over the many financial considerations, and they need to view the decision over the long haul. That decision also can be made on many levels since most businesses need space for multiple purposes.

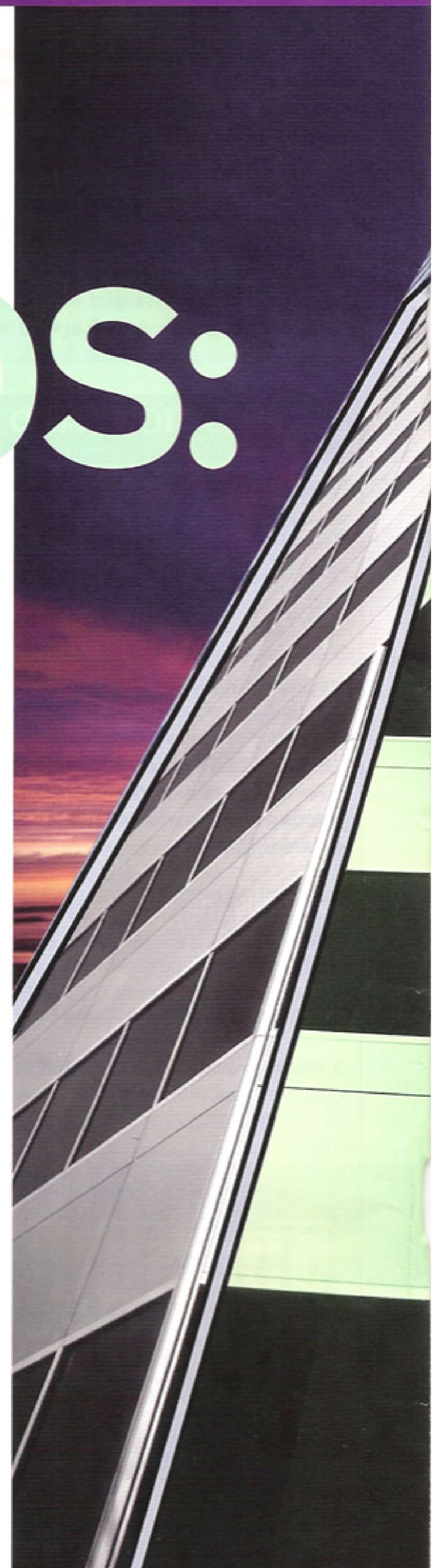
For many businesses, ownership comes in the form of a condominium where space is not individually subdivided so you share in common area expenses with other occupants of the building. Common area expenses may include water, electricity, landscaping and snow removal, trash removal, janitorial services, property management, insurance and real estate taxes. The next level of ownership, however, can be in owning the entire building.

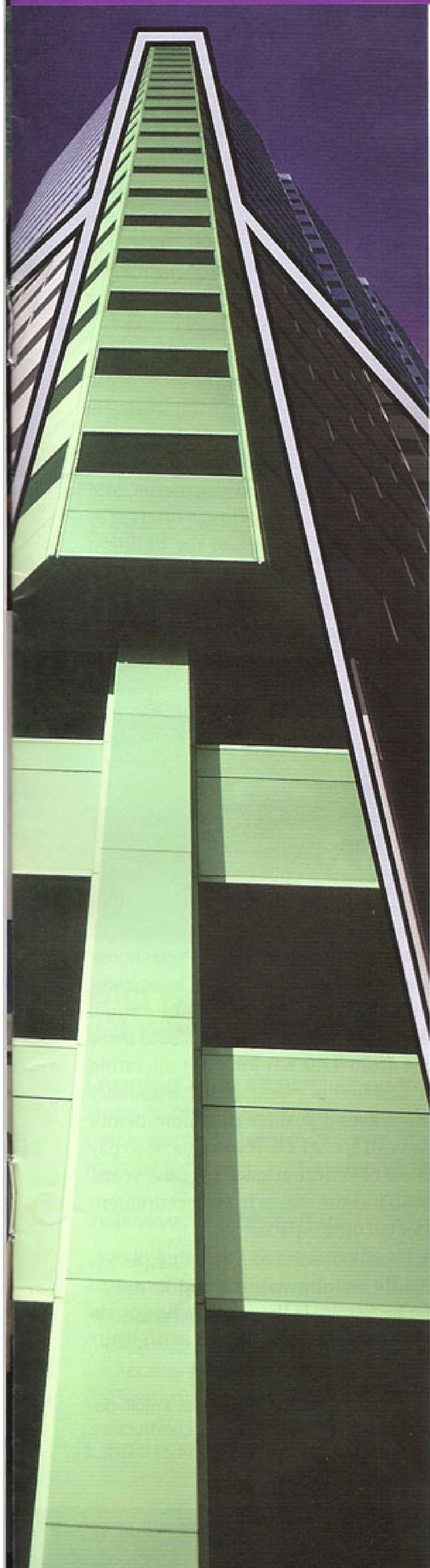
Some pros and cons of ownership versus leasing your space are as follows:

### Leasing

Pros:

- *Flexibility in terms.* Arrangements range from month-to-month rentals to 20-year-plus leases with options to renew.
- *Ease of expansion or reduction in size.* You can expand or contract as your operations dictate depending on what you negotiate in your lease agreement.
- *Taxes.* Lease payments are tax deductible.
- *Flexibility in location.* You can easily move at the end of the lease term or before if your lease allows you to sub-





lease your space to another user).

- *Ease of operation.* There is no need to "manage" your business' environment; third party contractors who perform services for the building, such as landscaping, repairs and janitorial services, are hired by the landlord.

Cons:

- *No return on investment.* There is no build up of equity through amortization of your mortgage payments.
- *No deductions.* You don't receive a depreciation or mortgage interest deductions for tax purposes.
- *Less control of environment.* The flip-side of not managing your property is that you have little control over your environment; you are dependent on your property management company to do a good job.

## Ownership

Pros:

- *Return on investment.* You build up equity through the amortization of your mortgage payments.
- *Increase in value.* There is potential for price appreciation in the value of the real estate improvement.
- *Taxes.* You receive depreciation deductions, cost segregation deductions and mortgage interest deductions.
- *Rent backs.* There is potential to lease the space back to your own operating unit. If you are a C-Corporation, you can own the building personally and rent out space to your operating company (as long as it is a market-rate deal and an arms length transaction). You also can rent out portions of the space your operating business is not actually utilizing.

Cons:

- *Difficulty in expansion.* There is little flexibility if the need arises to expand your operation.
- *No control of location.* If the area around you decays, there is little you can do about it.
- *Possibility of dropping value.* In a bad market, there is potential for price deflation.

## Crunching the Numbers

Sometimes the decision comes down to what happens when you sit down and put the numbers into a calculating tool. Let's take a look at a case study for a typical office user—we'll call the company Builder, LLC.

Builder LLC is a 4,000-square-foot office tenant that has the option of leasing space in a Class B office building for 10 years at a rate of $23.50 per square foot. The building is full service (meaning all operating expenses are part of the rent and paid by the landlord) and the base rent escalates by three percent each year. The first year of the lease term is called the base year. This is important because all future operating expenses above the first base year will be paid by Builder, LLC on a prorated share of the total building area Builder, LLC occupies.

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In our example, the office building is 100,000 square feet (sf) and Builder, LLC occupies four percent of the building. In addition, the builder will have a "core factor" added to its useable square footage for purposes of allocating public areas of the building to each individual occupant (elevators, stairwells, restrooms and lobby areas represent most of the "core" area). This core factor is usually between 10 percent and 15 percent.

In our example, Builder, LLC has 4,000 rentable square feet based on a useable square footage of 3,571 to which the landlord has added a 12 percent core factor to arrive at 4,000 rentable square feet. The landlord will prepare the space to meet the specifications of Builder, LLC (walls, electrical/computer outlets, paint, carpet, etc.). Here are the numbers:

### Builder, LLC Office Lease Summary:

| | |
|---|---|
| Useable square footage: | 3,571 |
| Core factor: | 12.0% |
| Rentable square footage: | 4,000 |
| Rental rate (full service): | $23.50 (1st year) |
| Annual base lease payment: | $94,000 (1st year) |
| Base rental escalation: | 3.0% |
| Base year: | 2006 |
| Operating expenses: | $7.00 (1st year) |

For the purposes of this example we will assume that operating expenses increase by 3 percent year per year over the term of the 10-year lease:

| | |
|---|---|
| Total base rent paid over 10 years: | $1,077,605 |
| Total operating expense pass-throughs paid: | $ 40,989 |
| Total rental obligation paid over 10 years: | $1,118,594 |
| Average total rent per square foot over 10 years: | $27.96 |
| Average annual base lease payment: | $107,760.50 (or $26.94/sf) |

Alternatively Builder, LLC could buy a condominium office space, also in a class B office building directly across the street. Market pricing indicates that Builder, LLC could purchase a like-kind building with 4,000 square feet of office space (3,571 that is useable) for $250 a square foot, which would include a building standard build-out of the space by the developer. Let's look at the numbers:

### Builder, LLC Office Purchase Summary:

Acquisition price (4,000 sf x $250/sf): $1,000,000

Financing (assume 100% financing for simplicity of comparison)

| | |
|---|---|
| Interest Rate: | 6.75% |
| Term | 25 years or 300 payments |
| Annual Principal & Interest | $82,909.38 |

The key comparison is the annual principal and interest payments ($82,909) as compared to the average annual base rental payments ($107,760). The differential is $24,851 per year times 10 years, or $248,510. (For purposes of this example, assume operating expenses are approximately the same.)

Looking down the road, ten years go by, and the builder decides to sell the business or retire. Let's see the equity that builder may have built up over the 10 years of ownership.

The initial price was $1,000,000 for the condominium. If the average annual appreciation over the 10 years was three percent, the value of the office condominium would be $1,343,916 and the principal balance on the loan would now be $780,770. Assuming a four percent cost of sale, the equity in the condo upon its sale would be $509,390. If you add that to the $248,510 saved in monthly rental payments, you get a total savings of $757,900. And this does not include the tax benefits the owner has had in that time.

Typically, a business would purchase the property with a Limited Liability Corporation (LLC) to keep the asset separate from the operating business. The operating business could then pay rent to the LLC, thereby potentially creating passive income not subject to payroll taxes. Deductions for the operating business would be the lease payments, and deductions for the LLC would include mortgage interest as well as depreciation deductions. The cost of the building divided by 39.5 years equals the annual depreciable amount. Depreciation expense covers most of the principal (25 years vs. 39.5 years).

As I explained in the pros, another opportunity would be to own the building as a C-Corporation. In such a case, you could own your building (or your space) personally and lease it back to your operating company, which would be a further tax benefit (and assuming it was a market rate deal and an arms length transaction).

As one can see from the example presented, ownership can be extremely advantageous over leasing. In fact, if set up right, ownership may represent another income stream in your retirement years, either from the asset sale itself or by leasing the asset to a third party.

Using the example noted above, if after 10 years you choose to vacate your space and lease to a third party, lease rates could be $31.58/sf, full service (at three percent annual increases). Operating expenses could be $9.41/sf (also at three percent annual increases from $7.00/sf) for a net operating income of $22.17/sf or $88,680 per year less the $82,909 annual debt service. This leaves a positive cash flow, before positive tax considerations, of $5,771.00. If you choose to pay down the principal balance of your mortgage over the years, you could have an $88,680 income steam in your retirement from just 4,000 square feet of office space.

Still, rent does have its advantages as I've listed above, and every company has its own limitations and issues to consider. The wise thing to do here is the same thing you do for all your financial considerations: check with your accountant about your individual situation. ■

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