

Tax Advantages of Leasing

by Robert L. Nessen

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For more than thirty years, businesses “in-the-know” have turned to net leasing as the best alternative for managing the costs and risks of buildings and real estate necessary to commercial success. In a newly uncertain world, with unsettled markets, the benefits of net leasing are clearer than ever. The net lease alternative is often associated with its favorable accounting treatment and its positive effect on a company’s balance sheet. Not to be overlooked however, are the equally compelling benefits of net leasing’s favorable tax treatment.

The tax impact of a real estate transaction can vary substantially depending upon the choice of financing strategy. Net leasing is almost always the best strategy, providing lower after-tax cost and greater savings than any alternative form of financing. This result stems from the fact that when a company leases property, it can deduct 100% of the lease payments against its taxable income.

Using the following assumptions, let’s compare the tax benefits of three basic forms of real estate financing: 100% cash equity investment, mortgage financing, and net leasing.

ASSUMPTIONS

Property Cost	\$10 million
Cost of Land	\$3 million
Cost of Building and Improvements	\$7 million
Term of Transaction	20 years
Company’s Cost of 20-year Funds	8.5%
Company’s Tax Rate	40% (tax inclusive)

ALL-CASH ALTERNATIVE - EXTREMELY LOW TAX BENEFITS OR COST SAVINGS

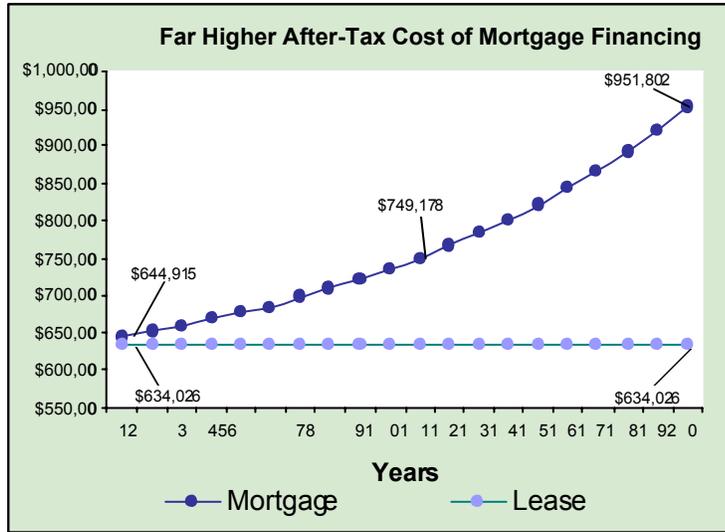
If a company has the liquidity and the desire to fund the cost of its real estate with its own cash, the company’s tax benefits are limited to depreciation of the building and improvements.

Since \$7 million is the cost of the depreciable assets (i.e. the building and other improvements), the amount of the annual depreciation will be \$179,487 (\$7 million divided by thirty-nine years). At the company’s tax rate of 40%, the value of the annual depreciation deduction is \$71,795 (\$179,487 multiplied by 40% tax rate).

MORTGAGE FINANCING ALTERNATIVE - LOW AND DIMINISHING TAX BENEFITS

Under the mortgage financing alternative, the company will look to a third-party source to fund most of the cost of the property. Mortgage financing is usually up to 80% of cost, with the company putting up at least 20% equity. However, for illustrative purposes, assume that the company can obtain 100% mortgage financing (or \$10 million) at an interest rate of 8.5% and 100% amortization over twenty years. The annual debt service under the mortgage will be \$1,056,710.

Under the tax laws, the interest portion of the debt service will be deductible, but the principal payment will not. In addition, the company will be able to deduct depreciation at the annual rate of \$179,487 (as calculated under the description of the all-cash alternative). Therefore, as the accompanying charts show, the value of the total annual deductions under this alternative diminishes over time, starting at \$411,795 and decreasing to \$104,900 by year 20. The after-tax cost to grows over time and by year 20 it is 48% higher than in the first year.

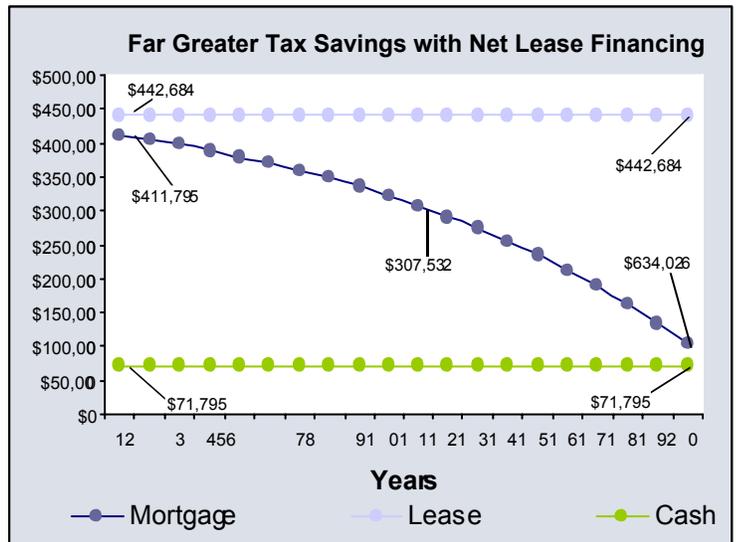


NET LEASING - THE MOST COST EFFECTIVE ALTERNATIVE

Under the leasing alternative, assume the annual rent will be \$1,056,710, the same as the debt service on the mortgage financing. However, unlike debt service on the mortgage, 100% of the rent payment is deductible. At a 40% tax rate, the value of the annual rent deduction is \$422,684 (\$1,056,710 multiplied by 40%), and the after-tax cost of the rent each year is \$634,026. Over the twenty year term in this example, the after-tax cost of net lease financing is over \$2.5 million less than the cost of mortgage financing.

TAX BENEFITS - NO COMPARISON

The annual tax benefit from the all-cash alternative is only \$71,794.87, making this is one of many reasons why this is not a sensible alternative for business. With Comparing the mortgage and lease alternatives, left it is evident (from the charts above) that the leasing alternative delivers a much lower after tax cost and a far greater tax savings.



CONCLUSION

The case for net leasing is simple. The rent deductions with net leasing will almost always be greater than the interest and depreciation deductions under mortgage financing, making net leasing the best alternative for managing the costs and risks of buildings and real estate necessary to commercial success. ●

Robert L. Nessen, the Chairman of CRIC₂ Funds, LLC, has specialized in corporate and net lease financing since beginning his career in 1958. He is nationally-recognized for the work he has done in creating and implementing new financing techniques for real estate.