



Crowe Soberman | Canada

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Overheard at Crowe Soberman | Real Estate 101 Part Two: Commercial Rental Properties

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overheard

— AT CROWE SOBERMAN —

The purchase, sale, and leasing of commercial property involves many business issues, from financing to portfolio management, from leasing to

cost-sharing, from tax to insurance. In the second part of our Real Estate 101 series, we join Audit & Advisory Partner and Real Estate & Construction industry expert, Chandor Gauthier, for a deeper dive into the complex nature of commercial rental properties.

What are the different ways to own and finance a commercial rental property?

There are business and tax advantages/disadvantages depending on which structuring option you decide to use. Refer to our **Residential Real Estate article** for more information. There will be a subsequent article in this series that covers structuring in more detail.

Do I need insurance?

There are several different types of insurance you will want to consider. Our **Residential Real Estate article** covers the various types of insurance you should discuss with your insurance provider.

What are Anchor Tenants?

Chances are, if you're renting out sections of a larger commercial building, you're going to have (and want) "anchor tenants". These are tenants who will lease a large portion of space and will tend to have more sway with regards to how their lease is structured, what landlord's work and tenant inducements they will ask for, and likely a template lease agreement they will want to use. Make sure your lawyer is involved in this process and that the lease covers lease cancellation payments, conditions for payment of a lease inducement, recoverable annual costs (like utilities and realty taxes), extraordinary costs which may be recoverable from the

tenant (like roof repairs), and any caps on these types of amounts. Speak with your accounting professional to go over the tax treatment of these items.

Can I increase the rent and how is the income reported?

Commercial leases tend to run for a much longer period of time, with no regulated limit on the annual rent increases which you see with a typical year-to-year residential lease. Instead, long-term commercial leases can include free rent periods, fixturing periods, and incremental increases in rent (such as an increase of \$0.75 per square foot every five years). If you are going to have audited or reviewed financial statements under the

accounting standards for private enterprises, rental income will be reported in those financial statements on a straight-line basis. This means that all free rent periods, fixturing periods, and any incremental step-ups in rent will be included in calculating the smoothed out annual rental income. This adjustment is for accounting purposes only and owners may choose to report rental income based on the actual rental payments received/receivable each year. Since this is a departure from the accounting requirements, the audit or review report attached to the financial statements by your accounting professional would then include a qualification for this departure. This should be discussed with your accounting professional in advance of their year-end work.

Can I deduct tenant inducements as an expense?

Tenant inducements are common with commercial leases and can come in a variety of forms – rent-free periods (including fixturing periods), cash payments, reimbursement for leasehold improvements, enhanced landlord's work, etc. For example, in one lease agreement a tenant receives a cash payment of \$1 per square foot on signing of the lease whereas in another version of the same lease agreement a tenant receives a payment of \$1 per square foot to help pay for specific leasehold improvements undertaken by the tenant. For the landlord, the tax treatment of each of these

tenant inducements may vary even though the inducement amount is the same. In some instances, the amount paid to a tenant could be tax deductible in the year paid. In other instances, it could be deductible over the term of the lease. If the lease is 20 years, that's a long time to fully utilize the tax benefit when the cash outlay occurred at the onset of the lease. Whether you are the landlord or the tenant, it would be wise to discuss each of the tenant inducements you are considering with your accounting professional.

Can I deduct landlord's work as an expense?

Commercial leases usually include sections covering what work in the leased space will be done by landlord and what work will be done by the tenant to prepare the space for that tenant's occupancy. To the extent a landlord must perform work, consider whether the amounts to be incurred will be additions to the cost of the rental property, leasehold improvements that are tenant specific, or repairs and maintenance. The tax and accounting treatment of each of these categories will be different. Where there is uncertainty as to the tax and accounting treatment, speak to your accounting professional.

What are recoverable operating expenses?

A landlord wants to maximize recoverability of expenses like utilities, landscaping, snow clearing, garbage collection,

property taxes, etc. It's imperative to ensure that the leasable area and recoverable costs are clearly spelled out in each of the lease agreements. If there are any spaces in the building structure that are not directly connected to a tenant space, consider what portion, if any, of annual operating costs will not be recoverable from tenants as a result of this unused (and possibly unusable) space.

What about HST?

As a landlord of a commercial rental space, you will be required to charge HST on the rent and operating cost recovery amounts from tenants and remit the HST collected to the Canada Revenue Agency (CRA). HST will be charged as well on some tenant inducement amounts, long-term tenant receivables, possibly the property tax recoveries, etc. You will be able to claim HST input tax credits (HST ITCs) on many of the costs you incur. HST will be covered in more detail in a subsequent article in this series. Stay tuned!

Specific professional advice should be obtained prior to the implementation of any suggestion contained in this article. Contact your Crowe Soberman advisor for more information.

Connect with the Author

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A reputation for warmth and good humour with a proven track record advising clients on strategic decisions, how to develop and grow their business, and how to maximize their family wealth. Chandor holds an extraordinary blend of strong technical expertise with a flair for collaborating with a wide range of clients and their team of external advisors. Connect with Chandor via email at chandor.gauthier@crowesoberman.com or call 416 963 7220.

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Our core services are in Audit, Tax, and Advisory. Along with these, we have professionals who specialize in Business Valuation, Claims Valuation, Corporate Recovery & Turnaround, Forensics, Estates & Trusts, Global Mobility Services, HR Consulting, Commodity Tax (HST), International Transactions & Consulting, International Tax, Litigation Support, M&A Transactions, Management Services, Personal Insolvency and Succession Planning. Members of our various specialty services groups are available when required as a technical resource to assist the client service team.

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