Funding Your Office Renovation, Relocation or Remodel

Presented by
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Karen Leastman, CLFP

FM21
5/4/2018
10:30 AM
Funding Your Office Renovation, Relocation, or Remodel

Presented by: Christina Floyd & Karen Leastman

Objectives

• Examine funding options available for expenses, including landlord’s TI allowance

• Analyze accounting and tax considerations when financing office projects

• Outline the impact of terms and conditions to better negotiate lease and finance contracts

• Discuss industry-specific case studies
Funding Option 1

Tenant Improvement (TI) Allowance

**PRO:**

- In some situations, landlords will add a TI allowance to the rental agreement to sweeten the deal.

- Expressed as a lump sum or per-square-foot amount, it can be used to renovate or retrofit the leased space.

**CON:**

- The TI allowance is often not sufficient to cover all of the build-out expenses.

- The allowance may be stipulated for certain project costs such as construction, but not furniture.
Funding Option 2

Cash

PRO:
- Immediate ownership
- Eliminates the need for an additional contract
- Provides firm with depreciation benefit for tax purposes

CON:
- Depletes working capital
- Can cause year-over-year swings in distributions
- Today’s partners shoulder the entire cost of the buildout when benefits are realized over time
Funding Option 3

Bank Loan or Line of Credit

**PRO:**
- Using an existing bank line – already in place and set up
- Allows the firm to reciprocate business if the bank is a client
- Spreads expense over time, provides for long-term ownership
- Provides depreciation benefit

**CON:**
- Banks ability to loan against soft costs
- Using a line of credit
- Rate may be variable/floating
- May require fees, partner guarantees, more collateral, or financial performance covenants
Funding Option 4

Landlord Financing

PRO:
- Convenient
- Spreads the cost over the life of the office lease
- Buildout costs expensed with office lease rental payments
- Even partner share of costs over the life of the office lease

CON:
- Costly
- Financing will not match the useful life of the asset
- There may be fees or a letter of credit
Funding Option 5

Lease

Why Lease?

For many firms, a lease line of credit can solve many of the issues with traditional bank financing and TI allowances, including:

- Ability to finance 100% of the project’s costs
- Reduction in the tax burden
- Diversification of funding sources
- Distribution of costs overtime
- Prevention of accelerated write offs
Lease

**PRO:**
- Preserves cash and spread payments out over time
- Limits bank exposure and won’t trigger bank covenants
- Easier, more expedient and potentially better than a bank loan
- Less restrictions on collateral
- Flexible tax benefits
- Flexible ownership options

**CON:**
- Requires financial disclosure
- Requires a contract to be put in place
- Covenants or personal guarantees may be needed for 6+ year term lengths

Lease Line of Credit

Use a lease line of credit for the next 12-36 months for a variety of asset types—all in one

- Furniture
- AV Equipment
- Security Equipment
- LED Retrofits
- Movable/Modular Walls
- Kitchen Ware / Reception
- IT Equipment
- Server room outfitting
- Design Fees
- Artwork
- Flooring
- Construction/Buildout Costs

100% Project Financing
No under- or non-utilization fees
Rate lock options for up to 24 months
Bundle costs from multiple vendors and contractors
Underlying schedules customizable with different terms and lease structures
Lease Structures

OPERATING LEASE - FMV

- Promotes Refresh
- Lowest Monthly Payment
- Expense Rental Payment

For assets with <5 year life cycle
Cheaper to pay for “use” versus “ownership”
Firm gets to expense 100% of the rental payments

Operating Lease

Financial Statement Impact

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>No Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Off Balance Sheet)</td>
<td>(straight-line)</td>
</tr>
</tbody>
</table>

New accounting changes to operating leases - only affect GAAP accounting and not IRS tax accounting.
Lease Structures

CAPITAL LEASE - $1 BUYOUT

Distribute Costs Over Time
100% Financing
Depreciation Benefits

Lease Term

$1 Buyout

For assets with >5 year life cycle
Fixed rate, no fees
3-7 year term lengths
Furniture, Construction, Buildout costs, etc.

Capital Lease

Financial Statement Impact

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Record Asset and Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement</td>
<td>Depreciation Expense Interest Expense</td>
</tr>
</tbody>
</table>

A capital lease, like using cash or a bank loan, allows you to take the ownership benefits of depreciation.
Lease Structures

TAX LEASE - DEFINED FMV

100% Financing
Low Monthly Payment
Expense Rental Payment
Known Cost of Ownership Option

Lease Term

Defined Purchase
Renew
FMV

Tax Lease

Financial Statement Impact

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>No Impact (Off Balance Sheet)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Statement</td>
<td>Lease Expense (straight-line)</td>
</tr>
</tbody>
</table>
Complementary Options

- Landlord Allowance: 40%
- Lease: 20%
- Loan: 20%
- Cash: 20%

Accounting & Tax Considerations
Depreciation

**PRO:**
- Allows firms to claim higher expenses and lower short term taxable income—partners pay less taxes
- Allows for a guaranteed deduction you can count on for set period of time

**CON:**
- Utilizing accelerated depreciation provides a greater tax shield for partners in only 1 calendar year
- Has the potential to cause phantom income
- If moving out of space before 39.5 years, firm's have to accelerate remaining DEPR in one calendar year

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Tax Accounting Dilemma

Long-term tax depreciation (15 or 39 years) + Shorter-term office leases (7 or 10 years) = Accelerated write offs when moving
### Tax Lease Solution

#### Financial Statement Impact

<table>
<thead>
<tr>
<th></th>
<th>Depreciation Expense</th>
<th>V.</th>
<th>Lease Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DEPRECIATION (15 YEARS)</td>
<td>TAX SHIELD (39% RATE)</td>
<td>RENT EXPENSE</td>
</tr>
<tr>
<td>YEAR 1</td>
<td>$66,667</td>
<td>$26,000</td>
<td>YEAR 1</td>
</tr>
<tr>
<td>YEAR 2</td>
<td>$66,667</td>
<td>$26,000</td>
<td>YEAR 2</td>
</tr>
<tr>
<td>YEAR 3</td>
<td>$66,667</td>
<td>$26,000</td>
<td>YEAR 3</td>
</tr>
<tr>
<td>YEAR 4</td>
<td>$66,667</td>
<td>$26,000</td>
<td>YEAR 4</td>
</tr>
<tr>
<td>YEAR 5</td>
<td>$66,667</td>
<td>$26,000</td>
<td>YEAR 5</td>
</tr>
<tr>
<td>YEAR 6</td>
<td>$66,667</td>
<td>$26,000</td>
<td>YEAR 6</td>
</tr>
<tr>
<td>YEAR 7</td>
<td>$66,667</td>
<td>$26,000</td>
<td>YEAR 7</td>
</tr>
<tr>
<td><strong>TOTAL TAX SAVINGS</strong></td>
<td><strong>$182,000</strong></td>
<td><strong>TOTAL TAX SAVINGS</strong></td>
<td><strong>$414,742</strong></td>
</tr>
</tbody>
</table>
20 Attorney Firm

$2 Million
Office Move/Renovation

- 7 year tax lease
- Lower interest expense than Landlord Loan

AmLaw 100 Firm

$8.4 Million
Construction of new office

- Construction services on a 8 year lease term
- Tied IT hardware to the project on a 3 year FMV lease term
**AmLaw 100 Firm**

$4.5 Million
Administration office buildout

+ Bank not willing to finance whole project
+ Our financing solution included soft costs:
  + Carpentry
  + Construction Expenses
  + Software

**60 Attorney Firm**

$3 Million
Buildout of new office space

+ Bundling with 1 finance provider
+ Advanced funding into 3 takedowns
+ Long term rate lock during installation period
**Flexibility Features**

Installation Period Financing
- Reduced Rate financing
- Pay as you go or build into lease

Rate Locks
- 5 basis points for every 30 days
- More competitive for longer term locks

Customized Billing Options
CustomerConnect™

**Lease Language**
Relevant Lease Terms

- Lease Commencement
  - immediate, monthly, quarterly, fixed at 45 days
- Lease Deposit
- Lease Rate Factor
- Fees
- Notice requirement for end of term intentions
- Renewal periods
- End of term options

Lease Rate Factor

A lease rate factor is not an interest rate, but rather a multiplier used to determine the Lessee’s rental payment.

Example:

<table>
<thead>
<tr>
<th>Lease Rate Factor</th>
<th>0.02650</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment Cost</td>
<td>$100,000.00</td>
</tr>
<tr>
<td>Monthly Rental Payment</td>
<td>$2,650.00</td>
</tr>
</tbody>
</table>
Commencement, Deposits, Fees

Lease Terms

Lease Commencement Types:  Lease Deposits:

• Immediate
• Monthly
• Quarterly
• Fixed at 45 days

• Be sure the lease proposal specifies how the deposit will be applied
• Be sure the lease documentation is consistent on this provision

Fees:

• Some equipment Lessors require legal fees, executory fees, UCC filing fees, documentation fees or restocking fees
• Top firms offer no fee contracts

Deposits that are extra fees

Lease Terms

Many Lessors require a deposit (one month’s rent) before final documentation is sent

If it does not specifically state which payment the deposit is applied to, it will be in addition to all the others payments under the lease

Deposit to:

• "first open invoice" means nothing (does not state which payment)
• "equipment cost" means nothing
• "cost" means nothing (does not state which payment)
**Notice Requirements and Renewals**

**Lease Terms**

**Advance Notice Requirement**
- Purchase for Fair Market Value
- Return Equipment
- Extend Lease

**Notice Requirement:**
- A lease requires Lessees give notice of end of term intentions
- Top firms require notice 90 days prior to the end of term
- Other contracts could require notice much farther in advance

**Renewal Periods:**
- If the Lessee does not give notice, the lease will automatically renew
- Top firms offer 3-month renewals; other contracts can be longer

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**Complicated Notice Requirements**

**Lease Terms**

The Lessor requires notice within a certain “window”
- If notice window is missed, lease extends
- After lease extends once, the “notice window” re-sets, making it difficult to track

**Sample Language**

Advance notice accepted within this time frame
- Purchase for Fair Market Value
- Return Equipment
- Extend Lease

Window Missed
Default Option
Thank you for your time.

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Your opinion matters!

Please take a moment now to complete the evaluation.

Thank You!