To Buy or To Rent Office Space

A TFPG CONSUMER REPORT

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Sooner or later, every business owner contemplates whether they're better off owning or leasing office space. From law firms to retailers to software developers, the decision varies, but here are some elements that most small businesses typically take into account.

The Cash Outlay Factor: Generally, you don't need to put out as much money upfront when you lease as you do when you buy. A quick example: a real-estate agent is looking to sell a $500,000 commercial property. Someone leasing the space might pay around $4,000 monthly in rent. Someone looking to buy the building would have to put about $175,000 down, as lenders will only finance 65% on commercial property. Then, there is the cost of an appraisal, building inspections, closing costs, etc.

The Fixed/Variable Cost Factor: Buy a building and you may have a good idea of what your costs are going to be year after year, especially if you have a fixed-rate loan on the property, but one must also add to this the uncertainty of how long the roof will last, HVAC equipment, etc. Lease and you can lock in your rates long term – even fluctuations in utility costs and other variable costs are usually within a safe range. Gross lease agreements further provide a level of certainty for 'total cost.'

The Growth Factor: Buying a building that's just the right size for you now may look attractive, but what will you do if your business and your space requirements grow over the next few years? Growing out of a place you own can involve more upheaval than growing out of a leased space. Sometimes a growing business can avoid the cost and hassle of moving by simply leasing more space in the building it occupies. That's not an option when you own a building unless you're only occupying part of it and can terminate the lease of another tenant.

The Landlording Factor: Buying a building puts you in a second business: real estate investing. Welcome to the world of tenant toilets, temperaments and temperature challenges! Did you know that in the average multi-person office there can be a 4 degree temperature preference difference whether in summer or winter! You must ask yourself, what businesses you are really in.

The Appreciation Factor: If you're in an area of appreciating land values, eventually you could sell it at a profit. But if you own a building with more space than your business needs, you'll probably end up renting to others, thus becoming a landlord. It can all be profitable, or, you could actually lose money, which is very easy to do in commercial real estate. The reality in Ontario right now is that the commercial property market is a flat to declining market from an investment point of view. Only Landlords with distinctive value are going to survive.

The Tax Factor: As usual, there are tax issues to consider. Businesses routinely can deduct the full amount they pay in rent. Owners of rental property can write off repairs immediately, but improvements to commercial real estate have to be deducted over 25 years. Depreciation on commercial buildings also is taken over 25 years. That means that if you buy a commercial property for $250,000 and the land is valued at $100,000, you can write off only $6,000 of the purchase price annually, regardless of the size of your down payment. You also can deduct interest on the purchase loan, property taxes and other qualifying expenses.

To Summarize

In general, leasing tends to appeal to business people who don't want to make the kind of large upfront investment required with a purchase, who aren't really sure how much space they'll ultimately need and who simply don't want to have to deal with the responsibilities of owning a piece of commercial property. Buying is going to make more sense for business people who are more established, who want to be in one location for several years and who have the financial resources to take on a significant real estate investment AND responsibility.

Some of the basics of comparing leasing to buying (trying to predict future price appreciation, considering cash-flow issues and factoring in the cost of a down payment on something you own versus rental payments that don't build any equity, for example) are similar to issues involved in deciding whether to lease or buy a house.

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