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## The Valuation of Leasehold Improvements

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Normally, the valuation of leasehold improvements is not a major issue in business valuations. Recently, however, I testified as an expert where it was one of the main issues. Judge Richard Denner presided over the trial and his perceptive question to the other valuation expert is the focus of this article.

Leasehold improvements are the costs spent in remodeling the premises that a business is leasing. In a law firm, they would include all tenant improvements that were not paid by the landlord, such as special flooring. In a restaurant, they would include changes to the plumbing and the installation of special exhaust systems, as well as the installation and configuration of electrical and gas lines for the various appliances used in the kitchen. This article assumes that the leasehold improvements cannot be transferred to another location, which is usually the case. The special electrical work, the specially created walls, the plumbing, etc. all becomes worthless to the tenant when that tenant moves from the leased space.

The accounting for leasehold improvements is very similar to that of fixed assets. Fixed assets, such as buildings, trucks, machinery and equipment, are depreciated over the life of the asset. For federal tax purposes for example, office furniture would usually have a life of seven years<sup>1</sup>. Thus (putting aside the more complicated aspects of the depreciation rules), after the date of purchase one seventh of the furniture cost could be deducted for each of the seven years after purchase. Leasehold improvements are generally depreciated over the life of commercial real estate 39 years<sup>2</sup>.

The enormously long period of a 39-year life period dictated by the Internal Revenue Code for leasehold improvements often causes a distortion between the true economic value of the leasehold improvements and the book value as dictated by federal law. A small law firm that invests \$25,000 to improve their leased offices may have no dream of being in that location for the next 39 years. And their five-year lease may not even have an option to renew. Despite this, for the next five years, the law firm would be allowed to expense only 1/39th, not one fifth, of the \$25,000 leasehold improvements. Since 80% of the economic value was used by the end of four years, the economic value

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<sup>1</sup> Internal Revenue Code Section 168(e)(1)

<sup>2</sup> IRC 168(i)(8)(A)

of the improvements is only \$5,000. The book value for tax purposes, however, is approximately 90% of the original cost or \$22,500.

In divorce cases, one tries to arrive at the real economic value of all of the assets. For most of the machinery and equipment, the tax returns are frequently the starting point for the determination of value. As we see above, however, when considering leasehold improvements the tax returns do not provide meaningful results.

In the case before Judge Denner, the issue was the value of a plastic surgeon's practice. The leasehold improvements consisted primarily of a full operating room and recovery suite located in an office building. Part of the raw office space was converted into an operating room with its special plumbing and electrical needs. The rest of the raw office space was converted into a recovery room designed to look like a beautiful hotel suite. The total cost for the doctor's leasehold improvements were approximately \$250,000.

The lease itself was for six years, with two options to renew for five years each, both at the prevailing market rates. The court used a valuation date three months after the initial lease had expired. The doctor had not exercised his option to renew the lease but, instead, was renting the premises on a month-to-month basis at the last rate under the lease. This monthly rate translated to \$2.35 a square foot. The market rate at the valuation date was \$1.50 per square foot. Despite his paying much more than the market rate, I assumed the doctor was not going to sign a new lease until the divorce was completed. Landlords are usually more interested in obtaining tenants bound to a lease rather than tenants under a month-to-month relationship. There is no reason why this wasn't true with this plastic surgeon. I further assumed that since the office building in which the doctor's business was located was approximately one-third vacant, the doctor could easily obtain a new lease for the same space that he was occupying at the prevailing market rate of \$1.50 per square foot. Accordingly, I concluded that the leasehold improvements should be valued as if (1) the lease was never terminated or (2) that a new lease could easily be obtained.

If the landlord were issuing new leases for ten years with two options of five years each, then the leasehold improvements should be amortized over the past life (beginning from the date of acquisition) plus an additional twenty years, or some other reasonable long life. However, I discounted the value of the leasehold improvements because, in reality, there was no lease in effect and an absence of a lease creates more risk in the continued existence of the improvements. That is, without a lease, there is always the possibility of being evicted from the building, which would create a total loss in value for the leasehold improvements.

Based on all of this, I valued the leasehold improvements using the original cost amortized over a twenty-year life, less an overall 20% discount for being month-to-month. A twenty-year life was based on the life a reasonable doctor would expect his leasehold improvements to last when he invested the funds to install those improvements.

The opposing expert argued that since the lease had expired and the options had not been exercised, the leasehold improvements were worthless. This expert added no value to the practice for the leasehold improvements even though the doctor was still continuing to practice in that office, rented month-to-month, and showed no intention to relocate.

Facing these contradictory opinions, Judge Denner asked a telling question of the

other expert: "Assume that a tenant was renting offices on a month-to-month basis, and that tenant had just spent \$100,000 on leasehold improvements. What is the value of those improvements to the business?" At least the expert was consistent - he answered that the improvements had zero value because there was no lease.

In his ruling Judge Denner found that the leasehold improvements should be valued using the cost of the improvements amortized over a twenty-year life, less an overall 20% discount due to the month-to-month tenancy - just as I opined!

We must be careful in taking any generalizations from this particular fact situation. That is, as we all know, evaluations must be done on a case-to-case basis. As an example, assume a business with significant leasehold improvements and a lease that is soon to expire. Assume further that the current market rates for leases are dramatically higher than what the business is paying under its current lease. In this case, the evaluator must exercise judgment in determining the likelihood of the business relocating. If the high market rates of leases would normally force the business to relocate, the evaluator should deflate the leasehold improvements to reflect their becoming worthless shortly. If the evaluator decides the business will move in six months, then the leasehold improvements will have a remaining life of only six months, and probably have a much smaller market value than what might appear on the business' financial statements. Keep these points in mind the next time you see "leasehold improvements" on one of the schedules of a business evaluation.

In summary, unlike almost all of the other assets of a typical business, leasehold improvements cannot be transferred if the business relocates. The valuation of those improvements depends on the circumstances specific to that business. And most importantly, their value depends on a key exercise of judgment by the appraisers - the likelihood of the business remaining in the same location and, if so, for how long.

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