

Negotiating Leases and Home-Based Business Issues

Commercial leases are full of negotiating opportunities most small business owners miss—and home-based businesses carry their own unique set of tax and legal considerations. This course covers practical strategies for securing favorable lease terms and addresses the compliance, deduction, and operational issues that come with running a business from home. If your clients include small business owners, startups, or sole proprietors, this course offers directly applicable guidance you can put to work right away.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the characteristics of various types of lease payments.
- Recall the IRS requirements for business use of a home.

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Chapter 1: NEGOTIATING A FAVORABLE LEASE

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the characteristics of various types of lease payments.

Many small businesses start out in leased premises and prefer to use leased space throughout their business lives. By leasing rather than owning, you avoid tying up valuable working capital. Also, it's easier to move to new quarters if your space needs change. This chapter looks at how to find the right place for your business and how to negotiate your lease.

FINDING A PLACE

Your first step is to find the right space. Begin by analyzing the specific needs of your business. Real estate professionals are fond of saying that the three most important factors in choosing a business space are location, location, and location. For certain types of retail stores and restaurants, this might be true. For example, a sandwich shop requires a location with a high volume of foot traffic. Or maybe you'll benefit if you're near other businesses that are similar to yours; restaurants often like to locate in a restaurant district.

But for many other businesses, where you're located doesn't matter much. For example, if you repair bathroom tile, run a computer-based information search business, import jewelry from Bali, or do any one of ten thousand other things, it won't help you to be in a high-visibility, high-rent district. Chances are your business can efficiently operate in a less pricey area, where you can negotiate a lower rent and the landlord is likely to be far more flexible on other lease terms as well.

After you've analyzed what you need, it's time to begin searching for the right spot. Go to the neighborhoods where you might like to locate; spend a day or two driving or walking the streets to see what might be available. Don't just look for vacant space. A store, office, studio, or workshop that's good for your business might be occupied by a tenant who is going out of business—or moving to larger quarters in a few months. There's a lot of turnover among small businesses, and you might get lucky.

Because some of the best opportunities come to light through word of mouth, ask friends, associates, and other businesspeople if they know of available space. Business owners—particularly those in the part of town that you're interested in—might know of businesses that are moving or going out of business long before these vacancies are announced. And if you get there early, the landlord, relieved to avoid a period of vacancy and uncertainty, could offer you a favorable lease.

For-rent ads in newspapers and online are an obvious place to look. If the selection is limited, call a real estate office that deals primarily with business space. The agent's fee—usually, a percentage of the rent that you'll be paying—is generally paid by the landlord. If your space needs are special, consider hiring an agent to search the market for you. But if you follow this somewhat unusual approach, you'll probably have to pay the agent's commission.

LEASES AND RENTAL AGREEMENTS: AN OVERVIEW

A “lease” is a contract between you and the landlord. A lease can be for a short term (as little as one month) or long term, and it can be written or oral—although a lease for more than a year must be in writing to be legally enforceable past the first year. Some people use the phrase “rental agreement” to describe a short or oral lease for which rent is typically paid once a month and the tenancy can be terminated on a 30-day written notice. (See “Short-Term Leases (Month-to-Month Rentals),” below, for more on short-term leases.) To avoid confusion, this course uses the word “lease.”

Terminology

Sometimes a written lease talks about the “lessor” and the “lessee.” The lessor is the landlord; the lessee is the tenant. If you have a choice in terminology, go with the plain English “landlord” and “tenant”; you'll reduce the risk of typos!

In theory, all terms of a lease are negotiable. Just how far you can negotiate, however, depends on economic conditions. If desirable properties are close to full occupancy in your city, landlords might not be willing to negotiate with you over price or other major lease terms.

On the other hand, in many parts of the country where commercial space has been overbuilt or where employees have transitioned to remote workspaces, landlords are eager to bargain with small businesses to fill empty units. Even in a tight market, you might come across some acceptable space that, for one reason or another, the landlord is anxious to fill, giving you greater bargaining power. This is often true with a new building or one under construction and the landlord needs cash. Also, if you're one of the first tenants in the building, you might get an especially attractive deal, because your presence could help the landlord attract other tenants.

If you find a landlord willing to negotiate, what should you ask for? After you read “Written Long-Term Leases,” below, you'll have a good understanding of the kinds of terms that usually go into a lease. Because you're not likely to get everything you want, it's important to get your priorities straight in your own mind and concentrate on achieving what's most important. What do you really care about? What would be nice to have but not essential? What benefits can you offer the landlord for things you really need?

A lower rent is likely to be high on everybody's bargaining list. But how about physical changes in the building? Would you want the landlord to redesign the entryway? Add some office space at the back of the warehouse? Customize the interior for your needs? More or better parking for your customers might be worth more than slightly lowered rent. Your priorities might be unique to your business, so think them through carefully before making proposals and counterproposals to the landlord.

Let's look at how you might approach the matter of rent. A landlord who is reluctant to lower the basic rent might be willing to make other adjustments—which could be even more valuable. The landlord might do this in order to be able to truthfully tell other prospective tenants that you're paying a high dollar amount per square foot. (It might sound silly, but some landlords do play this game.) For example, in a slack market, the landlord might be willing to give you a move-in allowance that you can use to fix up the space. Also, check out what the landlord is willing to do in paying for improvements (often called build-outs) to the space. (See "Improvements by the Landlord," later in this chapter.)

SHORT-TERM LEASES (MONTH-TO-MONTH RENTALS)

Once you've found the space you want, the next step, usually, is to sign a lease. Occasionally, a small business that's just starting out prefers an oral lease permitting the tenant to occupy the space from month to month. This approach might seem attractive if you just want to test the waters, have great uncertainty about the prospects for your business, and wouldn't mind leaving on short notice if the landlord terminated the lease. But even if you want to make only a very short-term commitment, it almost always makes far more sense to negotiate a written month-to-month lease or rental agreement. A written lease clarifies what's been agreed to and helps avoid disputes.

Whether oral or written, the key feature of a month-to-month lease is that you can move—or the landlord can require you to move—on short notice. You can negotiate how notice is required, but if you don't, the law in your state will dictate the amount of time.

In many states, the law requires 30 days' notice, although states don't always compute the time period in the same way. Some, such as California, allow either the landlord or tenant to give notice at any date during a month; the 30-day period runs from the notice date. Other states require that the notice be given at least 30 days before the first day of the next monthly rental period; furthermore, the termination date must coincide with the beginning of a new period.

Caution!

Notice requirements vary from state to state. For information about what's required in your state, you'll need to check the statutes or case law.

The clauses in a month-to-month lease, other than those dealing with the length of the tenancy, are much the same as those in any other written lease, so be sure to consult the following sections of this chapter.

WRITTEN LONG-TERM LEASES

Many small businesses and landlords prefer the protection of a written lease that lasts a year or more. But when you talk to the landlord, you'll probably be presented with a typed or printed lease prepared by the landlord or the landlord's lawyer. Because the terms typically favor the landlord, consider it as no more than the starting point. Chances are excellent that you'll be able to negotiate at least some significant improvements.

Keep in mind that you have two sometimes conflicting goals: to get a favorable lease and to have a good long-term relationship with your landlord. In the interest of long-term harmony, there are times when it makes sense not to fight for the last scrap of a concession as if you were a starving pit bull.

To eliminate a proposed lease's one-sidedness, ask for equal treatment for you and the landlord for all clauses where this is relevant. For example, if the lease requires you to cure your lease defaults within 10 days after you receive notice from the landlord, it should also require the landlord to cure defaults within 10 days after you give notice. Similarly, if you're required to pay for your landlord's attorneys' fees in enforcing the lease, the landlord should be required to pay for your attorneys' fees if you have to enforce the lease.

Now let's look at some common lease terms and how you might approach them.

Who Should Sign the Lease?

Leases begin by naming the landlord and the tenant. Make sure that the person, partnership, or corporation named as landlord is the owner of the property. A husband might not have legal authority to sign leases for space in a building owned solely by his wife. A management company or on-site manager might have only day-to-day management powers that fall short of the right to approve new leases. Or if they can sign a lease, they might be able to offer only specific terms and concessions. If you have any doubts about whom you're dealing with and what authority they have, ask to see a deed or title insurance policy to verify that the named landlord really owns the building. Here are the rules about who's authorized to sign a binding lease on behalf of the landlord:

- If a building is owned by an individual, that person (or an authorized agent) should sign the lease.
- If a building is owned by a general partnership, insist on the signature of one of the partners.

- If a building is owned by a limited partnership (not uncommon for rental properties), require the signature of a general (managing) partner; a limited partner usually lacks the power to bind the partnership.
- If a building is owned by a corporation, get the signature of a corporate officer or an executive with authority to sign leases.
- If a building is owned by an LLC, ask that the lease be signed by a member or manager of the LLC.
- If you're dealing with a rental agent who will be negotiating the lease and signing it on behalf of the owner, ask for written confirmation from the owner that the agent has that authority. Obviously, you need to worry less about this step if the rental agent is part of an established and respected real estate management company, but it never hurts to request documentation.

Who should be named as the tenant? Before you sign a lease as an individual or a partner, be aware that you'll be personally liable for the rent if your business runs into financial problems. If your business fails, the landlord can (and probably will) go after your personal assets such as your car, home, and bank account. To avoid this exposure, consider incorporating or forming an LLC. Then you can sign the lease as President of XYZ, Inc., or XYZ, LLC—and you're personally off the hook.

Caution!

Beware of personal guarantees. In addition to signing in your corporate capacity, you might be asked to personally guarantee the lease. Doing this makes you personally responsible for the rent and means that the corporation doesn't shield your personal assets. One approach is to offer to guarantee the lease only up to a maximum amount—say, three months' worth of rent. For even greater protection, see if the landlord is willing to release you from your personal guarantee if all rent is paid on time during the first year.

Defining the Space You're Leasing

The lease should identify the space that you'll be occupying. If you're leasing the whole building, that's easy: simply give the street address. If you're leasing less than the whole building, specify your space more precisely. One way is to refer to building or floor plan drawings. For example, you might say "Suite 2 of the Commerce Building as shown on the attached drawing" or "The south half of the first floor of the Entrepreneur Plaza."

In describing the space you'll be occupying, don't overlook the common areas—space you'll be sharing with other tenants. This often includes hallways, restrooms, elevators, storage space, and parking. Spell out in your lease that your business and your customers have the right to use these additional spaces and facilities.

If your business keeps unusual hours, remember to define when you have access to your space and the common spaces. You don't want to find yourself locked out some evening or weekend.

Because commercial space is often priced by the square foot, find out what method is used to compute square footage. Sometimes it's measured from the exterior of the walls or from the middle of the walls' thickness. If this is the case, you'll be paying for some space that's not really usable. This isn't necessarily bad. But you need to find out about it in advance, because it affects rent negotiations.

The square footage rate is usually stated in annual terms—\$20 a square foot means \$20 per square foot per year. However, it's sometimes stated by the month—\$0.60 a square foot means 60 cents per square foot per month. Obviously you need to know exactly what any numbers you're quoted mean.

Also find out if the quoted figure applies only to the space occupied by your business or whether you're expected to pay for a proportionate share of the common areas. If your rent is computed on the basis of dollars per square foot, and if you're asked to pay for a share of the common areas, it's reasonable to seek a lower square-footage rate for common areas.

If your landlord has agreed to set aside some parking spaces for your business or to let you use a storage building or another outbuilding, get it in writing in the lease. Also specify whether indoor storage space will be shared or is reserved exclusively for your use.

Starting Date of the Lease

Your lease should clearly state its starting date. This can sometimes be a problem, especially if you're renting space in a building that's still under construction or space currently occupied. If you sign a lease before ground has been broken or if the building is only partially complete, what happens if your space isn't ready by the time you need it? This, too, should be addressed in your lease. Otherwise, there might be little pressure on the landlord to meet deadlines.

One possibility is to negotiate a cutoff date by which you have the right to cancel the lease if the building (or your unit) isn't ready for occupancy. You might also be able to collect damages from the landlord if you suffer losses because your space isn't ready on time. But in negotiating such a clause, remember it's always hard to prove lost profits—particularly if you're just starting out in business—so it's better to negotiate a preset amount for your damages.

Also, with a building to be constructed or under construction, state in your lease that until local building officials have issued a certificate of occupancy for the building, no rent will be due. You might think that this is so obvious it doesn't need to be spelled out in your lease, but some landlords have actually tried to collect rent even before building officials have approved the building for occupancy.

In a slight variation on this problem, some leases call for the landlord to erect a shell building. Then you, the tenant, finish off your own space. Obviously, you want to avoid having to install improvements in a partially constructed building that might not be completed for many months. One good solution: a lease clause saying you don't have to start work on your space until the building is enclosed and the common areas—such as hallways and restrooms—are done.

The lease could also require the landlord to have the building and safety department make a preliminary inspection of your space before you start making improvements. The inspection would make sure the landlord has correctly installed the electrical and plumbing lines, and heating, ventilating, and air-conditioning facilities within your leased space. You don't want to risk the possibility that you'll have to rip out and redo your interior work because the landlord's contractor made a mistake.

With space that's currently vacant, ask the landlord to agree to let you have immediate access to decorate and install equipment. That way, you'll be ready to do business when you start paying rent. Spell this out in the lease.

Ending Date of the Lease

The lease should state its termination date, although you might have an option to renew. (See "An Option to Renew a Lease," below.) Some leases state that if the tenant remains in possession after the termination without exercising an option to renew, the tenancy is from month to month during the holdover period. (See the discussion above for information on month-to-month tenancies.)

An Option to Renew a Lease

When you first negotiate a lease, you can often bargain for a clause that gives you the right to renew or extend your lease when its term ends. Let's say you're negotiating a new two-year lease. You like the location, the rent is favorable, and you'd like the right to stay for an extended period if your business is doing well. But at the same time, you're nervous about signing a four-year lease in case your business doesn't prosper.

A two-year lease that includes an option to renew for two more years might be ideal. Typically, you exercise an option to stay by notifying your landlord in writing a set number of days or months before the lease expires. The amount of notice required is negotiable.

Getting the landlord to include an option in your lease might not be easy. Put yourself in the landlord's shoes. You might well go for a firm commitment from the tenant for eight years with adequate rent increases built in. You'd find it less attractive to grant a series of successive two-year options, which introduce an element of uncertainty—they allow the tenant the right to stay if the location turns out to be profitable but to leave if it's a dud. Not surprisingly, as a landlord, you'd look for some economic incentive to make the deal more attractive.