

Make Each Tenant Pay Higher Taxes Resulting from Its Lavish Improvement

“Tenants don’t want to subsidize another tenant’s Taj Mahal,” says Susan Fowler McNally, an attorney at the Santa Monica, California, law firm of Gilchrist & Rutter. But big tenants often worry that they’ll get stuck doing just that. They plan to lease most of your building and make “plain vanilla” improvements, but they’re concerned that a small tenant will come in and do something lavish.

What’s the tenant’s worry? The small tenant’s lavish improvements could inflate the property’s tax assessment and with it the property tax bill. Since standard leases usually prorate taxes among all tenants according to the amount of space each occupies, a big tenant will wind up paying the bulk of the higher tax caused by a small tenant.

To soothe a big tenant’s fears, McNally suggests that you offer to change the way your standard lease allocates property tax to tenants. As tenants renew or new tenants come in, use a lease that makes each tenant pay for any tax allocable to its lavish improvement. Knowing that eventually all of your tenants will have signed a lease like this should make a big prospective tenant happier.

Tenant Pays Tax Increase for ‘Overstandard’ Improvement

McNally says this lease change will work in an office building or shopping center. And it will work whether tenants pay a prorated share of the total property tax, or a prorated share of the amount the property tax has increased over a base year.

To make the change, include a clause in each new or renewal lease that makes the tenant pay for any tax allocable to its “overstandard” improvements—that is, those improvements costing more than a certain amount per square foot (see Model Lease Clause, p. 2). Now, subtract this amount from the amount of tax that all the center’s tenants must pay. Then, divide the remainder of the tax up among all the tenants on a prorated basis.

Tenants generally will accept this lease clause, McNally has found. Although the clause raises the ante for

a tenant that makes an expensive improvement, it protects that same tenant from an unfair tax burden caused by another tenant’s improvement. All tenants like to be protected from another tenant’s extravagance.

How the Clause Works

Set improvement cost floor. First, you need to define when a tenant must pay the increased property tax for its improvement. Do this by setting an improvement cost floor. Consider any improvement costs above the floor as overstandard—that is, they’ll trigger the tenant’s responsibility for the improvement-related tax [Clause, par. a].

Your property taxes needn’t actually rise overall. The clause can be triggered when property taxes go down, but the taxes would have been even lower if the tenant hadn’t made the extravagant improvements.

How high should the floor be? That depends on your property’s location and age, and on the average construction costs in your area. Figure out the cost of building-standard tenant improvements per square foot of usable space in your building. These are the total bare-bones improvement costs that each tenant will incur—for instance, for interior partitions, paint, inexpensive carpeting, lighting, and so on. Anything above that amount will be overstandard. In the Los Angeles area, for example, the improvement cost floor could range from \$15 to \$30 per square foot in older buildings and \$30 to \$40 per square foot in newer buildings, McNally says.

Include the same floor in all leases in your building, warns McNally. Otherwise, those tenants with higher cost floors will be forced to absorb an unfair amount of improvements made by other tenants.

Even if average improvement costs rise above the floor, the lease clause will continue to work, says McNally, as long as every tenant has the same floor. Every tenant will pay the same overstandard share of its own costs—in effect, prorating these costs to the extent that all tenant improvements exceed the floor.

State how much tax the tenant must pay. Once your tenant's overstandard improvements trigger the clause, you'll need to determine how much of the property tax increase that tenant must pay. Tax assessments vary widely when it comes to giving the reasons for an assessment increase. Some will itemize the factors behind an increase whereas others won't give any details. Make sure your lease clause lets you calculate the tenant's tax increase responsibility in either situation.

► *Follow itemized assessment.* Some assessments list the factors the assessor considered when valuing the property. If the assessment indicates what portion of the tax resulted from the tenant's improvement, it's easy. That's what the tenant pays [Clause, par. b].

EXAMPLE: A tenant spends \$30 per square foot putting in marble floors. The assessor says that \$2,300 of the owner's next annual property tax bill is a result of the marble floors. The tenant must pay the \$2,300. The owner subtracts the \$2,300 from the total property tax bill and prorates the remainder among all tenants. So, the tenant that put in the marble floors must pay \$2,300 plus its share of the remainder.

► *Use formula when itemization unclear.* But some tax authorities don't itemize or explain their valuations. So, it's tough to tell if the improvement was a factor in the tax assessment—and, if so, how much of a factor. In these situations, you'll need an alternative method to calculate the tenant's tax responsibility.

McNally says that you can use a formula that requires the tenant to pay a portion of the total property tax. With this formula, you multiply the tax rate for the building—a rate assigned to area properties by the tax authority—by the total overstandard costs of the tenant's improvements. The result is the tenant's additional tax responsibility [Clause, par. c].

EXAMPLE: A tenant rents 8,000 square feet—7,120 square feet of it usable—in an 80,000 square foot building. The overstandard improvement floor is \$20 per square foot of usable space. The owner gives the tenant a tenant improvement allowance of \$20 per usable square foot ($\$20 \times 7,120 = \$142,400$). The tenant spends an additional \$30 per usable square foot of its own money for improvements ($\$30 \times 7,120 = \$213,600$).

The total assessed value of the 80,000-square-foot building is \$15,125,000 and the tax rate for the property is 1.06 percent. The owner pays annual property taxes of \$160,325 on the building ($\$15,125,000 \times 1.06\%$).

Multiply the overstandard amount, \$213,600, by the property's tax rate, 1.06 percent. The tenant's share of the tax resulting from its overstandard improvements would be \$2,264.16. So, the tenant would have to pay the \$2,264.16, plus its prorated share of the rest of the property tax.

Tenants commonly accept—and sometimes ask for—this mechanism in their leases, says McNally. But McNally

MODEL LEASE CLAUSE

Change Tax Rules for Overstandard Tenant Improvement

The following lease clause requires that a tenant making extraordinary improvements to its space pay for any portion of the property tax resulting from that improvement. The

clause was drafted by Santa Monica, California, attorney Susan Fowler McNally.

COLLECT TAX ON OVERSTANDARD IMPROVEMENT

- a. **Tax on Overstandard Leasehold Improvements.** Tenant shall pay Landlord, within ten (10) days after Tenant's receipt of a written demand from Landlord, such portion of all real estate taxes levied or assessed against Landlord which are attributable to the value of the leasehold improvements installed in the Premises (either before or after the Commencement Date and whether installed and/or paid for by Landlord or Tenant) in excess of _____ Dollars (\$_____) per square foot of Usable Area in the Premises.
- b. **Assessor Allocates Specific Value to Improvement.** If the assessing authority allocates a specific value to said leasehold improvements of Tenant, the amount payable by Tenant shall be the tax attributable to such specific value.
- c. **Assessor Doesn't Allocate Specific Value to Improvement.** If the assessing authority does not allocate a specific value to said leasehold improvements of Tenant, the amount payable by Tenant pursuant to this Section ____ shall be the amount determined by multiplying the total cost of the leasehold improvements installed in the Premises in excess of _____ Dollars (\$_____) per square foot of Usable Area in the Premises by the Building's full assessed rate, as determined by the applicable assessing authority.

ly has seen an initially agreeable tenant later object to the extra amount it's required to pay. In response to these objections, says McNally, she's shown the tenant how the formula has produced the amount the tenant must pay and stressed that this is what the tenant agreed to in the lease. But if a tenant is still unhappy with the clause's application, you can always negotiate a settlement or arbitrate.

Put Clause in All Leases

Make sure to put this clause in all new and renewal leases, so that all tenants have a level playing field, says McNally. That will take time, and for awhile you'll probably have some tenants with older leases that don't contain the clause.

If these tenants make any overstandard improvements during the remainder of their lease terms, consider requiring them to agree to pay any additional tax as a condition to your consent to their improvements. Otherwise, you may get stuck paying the extra tax yourself. A tenant without the lease clause will argue that its lease doesn't require it to pay any extra tax for the overstandard improvement. And tenants with the lease clause won't want to absorb another tenant's overstandard tax amount when they're forced to pay their own. You may have to pick up the slack to placate them. ▲