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The Operating Expense Gross-Up and Property Taxes as a Variable Expense

The troubled state of the commercial leasing market has compelled most landlords to navigate every available avenue in order to induce cash flow from their properties. Negative economic conditions, and measures taken by landlords to offset them, sometimes create opportunities for a landlord to enhance its bottom line. Property tax relief arising as a result of increased vacancy may enable a landlord to modify its approach to recovery of operating expenses from tenants. Because of the expanding availability of such relief and the increasing frequency in which it is pursued, real estate taxes are most appropriately characterized as a variable expense when passed through to tenants pursuant to a “gross-up” clause.

Before analyzing whether an expense is fixed or variable for this purpose of a gross-up, it is important to address the reasons for, and methods of, grossing up operating expenses. The gross-up of a tenant’s proportionate share of certain operating expenses that vary with occupancy is a longstanding convention in multi-tenant office leases. The principle behind this provision is based upon the desire of landlords to simulate an environment where the building is fully-leased with rent-paying tenants who are incurring all the variable expenses of the building. A landlord will prefer that its tenants absorb all of the variable expenses of the building so that the landlord isn’t paying the expenses for the vacant space. While some argue that this practice unfairly shifts the downside of vacancy to the tenants, it is customary in most office submarkets and as discussed in greater detail below, it is generally viewed among legal practitioners and businesspeople as equitable to both the landlord and the tenant.

Parties entering into a lease of space in a property with high vacancy bear a risk of and sudden increase in certain operating expenses as the occupancy rises. A building with depleted occupancy requires a reduced amount of building services and consumes less utility service than a fully occupied building. Many office leases provide that during each year of the lease, each tenant is responsible for paying its proportionate share of operating expenses in excess of a base year

amount of such expenses. The base year is usually deemed to be the calendar or fiscal year in which the lease commences. If the base year amount that is acutely low due to vacancy in the building (because the building is newly constructed or otherwise), as occupancy increases the year-to-year increase in the tenant’s liability may be especially dramatic.

To ameliorate the risk of such increases, parties to a lease containing an operating expense base year customarily agree that if the building is not fully-occupied as of the respective calculation date, the landlord will calculate the tenant’s proportionate share of operating expenses that vary with occupancy as if the building were fully occupied (or nearly fully occupied – 90-95% occupancy is often used as the standard). The following is an example of a typical gross-up clause:

In the event that during all or any portion of any year during the term, the Building is not fully rented and occupied, Landlord shall make an appropriate adjustment in expenses that vary with occupancy for such year for the purpose of avoiding distortion of the amount of such expenses to be attributed to Tenant by reason of variation in total occupancy of the Building, by employing consistent and sound accounting and management principles to determine the amount of such expenses that would have been paid or incurred by Landlord had the Building been at

least ninetyfive percent (95%) rented and occupied, and the amount so determined shall be deemed to have been such Expenses for such year.

Parties commonly agree to add to this provision (at the insistence of the tenant or its attorney) that in addition to the expenses passed through to the tenant in each lease year, the base year expenses should be grossed up as well. Hence, in the event of a sharp increase in occupancy from one year to the next, the tenant will see a benefit from the gross-up provision, as its liability for payment of variable expenses in excess of the base year amount will be minimized.

By way of example, consider a building that is only 45% occupied in a lease year, and suppose the increase (over the base year amount) in expenses that vary with occupancy in such year is \$80,000 in aggregate. To gross up the variable expenses, the landlord will increase such expenses to reflect a full (95%) occupancy, and will calculate tenants' share of such operating expenses using the resulting figure, \$168,888.89. The tenants in occupancy would then be obligated for \$76,000 in aggregate, which is 45% of the grossed-up amount.

Tenants will resist a gross-up of operating expenses under leases containing an expense stop (where tenants pay their proportionate share of expenses incurred above a negotiated amount), because the stop method does not bear any direct or indirect relation to the occupancy of the building. Still, just as the tenant under a base year lease will argue in favor of the gross up of the base year expenses, the tenant under a lease with an expense stop will argue in favor of an increased stop amount.

Even if parties to a lease agree to a gross-up, an expense-by expense analysis of items customarily subject to gross-up raises issues as to which expenses are truly "variable" or "fixed" for purposes of the underlying calculation. Most leases do not specifically define which expenses are deemed to vary with occupancy; however, such expenses generally are those that are reasonably likely to rise and fall in proportion with the occupying population of the property. These include costs of janitorial services, utilities, heating, ventilation and air conditioning service and repair and trash removal. In addition, property management fees based upon a percentage of gross income from the building are also considered in calculations of variable expenses.

Conversely, expenses generally understood to be fixed are those that will remain relatively constant

notwithstanding the occupancy of the property. These usually include insurance premiums, security expenses and landscaping costs, as well as property management fees based upon a fixed fee.

For purposes of the gross-up of operating expenses, real estate taxes have historically been considered to be a non-variable expense. However, upon examination of the means of assessment and the factors that apply to tax assessments from one year to the next, property taxes are more appropriately characterized as a variable expense. This recharacterization may have substantial economic impact upon the tenants' bottom line, particularly tenants under leases using a base year to calculate annual operating expense liability.

The variable nature of real estate taxes is most clearly manifested through the increasing number of taxing authorities offer rebates, reductions in assessments and other forms of relief to property owners based upon vacancy. Owners of multi-tenant office properties almost universally appeal their periodic property tax assessment as a matter of course. Assessment appeals are particularly critical in instances where the property owner is facing increased vacancy. In those instances, many jurisdictions will allow the taxpayer to apply for a tax rebate or reduction in appraised value based upon heightened vacancy. Tenants under leases which pass through property taxes commonly request that the landlord incur an affirmative lease obligation to appeal its property tax annually, or to use commercially reasonable efforts to minimize its tax liability, on the principle that since the tenants bear the burden of tax increase due to periodic reassessment, the landlord should pursue assessment relief so that that benefit is enjoyed proportionately by the tenants.

If the landlord and the tenant agree that property taxes are a variable operating expense and thus should be grossed up in the same way as janitorial costs, utilities and other variable expenses, then this raises another issue: By what method should the landlord calculate the gross-up? Determining the property taxes that would be payable if the building in question were fully-leased is easier said than done. As indicated in the sample provision above, the parties can agree that the grossed-up amount be calculated by the landlord using consistent and sound accounting principles, and such a broad set of parameters is usually sufficient in light of the fact that most variable expenses are reasonably predictable. Market rates for third-party services are

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ascertainable and estimates of utility usage can be based upon statistics gleaned from comparably-situated and populated properties.

But a gross-up of property taxes is much more difficult to calculate. Unlike other expenses, the components that make up the amounts that are ultimately payable by the taxpayer can be idiosyncratic and can vary greatly from jurisdiction to jurisdiction. In the current economic downturn, owners of commercial real estate are seeing great fluctuations in real estate taxes as states, counties and municipalities legislate measures designed to balance strained budgets and relieve burdens on constituencies. Therefore, even an estimate based upon the prior year's taxes is unreliable. In the end, the most prudent approach for the legal practitioner is to base any gross-up of property

taxes on a comprehensive examination of the component parts within the tax formula in the jurisdiction, utilizing the most current assessment information available from the taxing authority.

The factors underlying the nature of property taxes indicate that they are much closer to a variable expense than a fixed one. Landlords and tenants including property taxes as a variable expense for purposes of a gross-up provision should provide for a thorough and detailed accounting methodology to avoid disputes when those expenses are billed.

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