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It is important to understand how real estate taxes are addressed in a commercial lease



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An important component of any commercial lease is a provision which addresses to what extent a landlord and tenant will share payment of real estate taxes and how those payments will be paid. This issue appears to be simple. Either the landlord pays in full, the tenant pays in full, or the taxes are apportioned between the two. That simple analysis belies the complexities that are beneath the surface of this seemingly straightforward concept.

First, "real estate taxes" must be precisely defined. A landlord typically wants to include all current taxes, assessments, charges or levies that are related to or arise from the use or ownership of real property as well as all future categories of charges which a municipality may impose. A tenant on the other hand wants to be sure that "real estate taxes" do not and never will include charges, levies, etc. which are not real estate based (such as franchise taxes, income taxes, business taxes and the like). In short, a landlord will seek to be more inclusive, while a tenant will seek specificity.

Second, it is crucial that the tenant accurately determine the current tax status of the property to be leased. This is so whether the tenant is paying gross taxes or only tax escalations over a "base year." Typically, the "base year" is the year in which the tenant takes occupancy of the premises.

Special circumstances can affect the current taxable status of real property. For example, if the property is subject to an industrial development agency financing through the local municipality (IDA Financing), then the property owner is making "payments in lieu of taxes" (PILOT payments). The property is not assessed at its full value. Rather, the assessed value is phased-in. Consequently, the PILOT payments do not equal the full taxable amounts that would otherwise be paid as real estate taxes but are also phased-in over that same period of time. At the end of the phase-in period, an unsuspecting tenant would see the real estate taxes increase dramatically.

The same issues present themselves if the property is the beneficiary of a partial real estate exemption pursuant to New York Real Property Tax Law Section 485-b as a result of new construction (New Construction Abatement). While the genesis of this application of a partial transitional exemption is different, the end result is similar to that of an IDA Financing on a property. Again, the parties must determine how to treat the partial exemption so that the allocation of real estate taxes reflects the true nature of the agreement intended by the parties.

A related issue is determining which party will have the right to file a tax reduction proceeding on the property with the relevant municipality. Often, if an entire building or parcel of land is leased by a tenant, that right is ceded by the landlord to the tenant. However, where there are multiple tenants on a property, the landlord often reserves that right to itself. If a tax reduction proceeding is successfully prosecuted and a tax refund is procured, the lease should address to whom that refund is paid and in what manner. A tenant will argue that it should receive that portion of the refund which relates to that portion of the taxes which have been paid by the tenant. Landlords will sometimes prefer to apply a credit against rent for any refund due to a tenant rather than making a cash payment of the refund to that tenant. In these instances a tenant must be sure to address how that refund will be obtained if it is procured after the lease term is over. Conversely, a landlord will want to be sure that the refund, to the extent payable to the tenant, is net of any costs incurred by the landlord in obtaining the refund. Since tax reduction proceedings often occur over a span of years, it is important to address whether or not that refund will be payable to the tenant, if obtained after the expiration of the lease.

How real estate taxes are addressed in a commercial lease is extremely important. Landlords and tenants that fail to give the issue thorough consideration do so at their peril as a mistake and its unanticipated consequences can be very costly.

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