OPERATING EXPENSE ISSUES FOR THE MODERN TEXAS LANDLORD

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Beware of little expenses. A small leak will sink a great ship.
- Benjamin Franklin

Aside from rent, operating expenses are one of the few aspects of the landlord-tenant relationship that can drastically alter the "bottom line". During lease negotiation, both sides negotiate and debate which operating expenses landlord must pay, and which operating expenses tenant must pay. We all know how the game is played: the landlord begins by defining operating expenses as broadly as possible. Conversely, tenant wants to funnel down the landlord's operating expenses as much as possible.

Many authors and commentators stress the importance of scrutinizing the lease language and focusing on such things such as capital expenses inclusions/exclusions, audits, and methods of calculating expenses. But many of the other important operating-expenses concepts get very little attention, especially since Texas law puts a few wrinkles into the issue. This article will bring some of those concepts to forefront.

Certain Charges are Not Allowed Regardless of The Lease Language

Many lease forms – especially those prepared by out-of-state lawyers and landlords – typically include broad "catch all" language that says, essentially, the landlord can impose "reasonable charges or fees". However, these overly broad provisions might not be enforceable because the Texas Property Code says that, except for rent or physical damage to the space, a landlord may not assess a charge unless the amount of the charge, or the method of calculating it, is stated in the lease. This law permits such charges if they are "rent", however, instead of leaving the determination of the charge solely to landlord, the language should include some type of flat fee, or a method (such as a formula) to arrive at the charge.

Margin Tax

In 2006, Texas modified the way franchise taxes are determined and applied. This modified tax is typically referred to as the "margin" tax and, subject to exceptions and various other twists and turns under Texas tax law, is a tax equal to 1% of a taxpayer's "gross receipts", including the landlord's gross receipts. In addition to changing the law, the legislature also mandated a reduction in local school property taxes so that more school funding would come from the state via the new margin tax.

Landlords were obviously not happy about this change, especially since a landlord's gross receipts consist of rent, proceeds from the sale of real property, and operating expense reimbursements. In an attempt to mitigate some of the increased tax liability, many landlords took the approach that since property taxes were going down due to the new margin tax, then tenants should pay the corresponding "margin tax". From the landlord's perspective, this would not result in any net change to the tenant's operating expenses.

On the other hand, tenants argue that margin taxes are clearly franchise taxes, not property taxes, and are treated as income taxes for accounting purposes because they are based on revenue and not property value. Thus, margin taxes quickly became a hotly contested point. Due to Texas law that requires each lease to spell out all charges (discussed above), the margin-tax issue should be clearly addressed in the lease, because tenants will not be responsible for the landlord's margin taxes unless the lease allows it.

Some landlords add express language requiring tenants to pay the margin tax, and others try to hide it by stating that the tenant must pay all ad valorem taxes and any other charges that replace or supplement ad valorem taxes. But the latter approach often leads to disputes since it is not always clear how much and to what extent the margin tax "replaces" ad valorem taxes.

Even if the parties agree to pass through the margin tax, there are a lot of issues to consider in the lease. To begin, the margin tax applies to all similar businesses in the same ownership group as the landlord. So, if the property contains multiple units, or the landlord owns multiple properties, then the lease will have to allocate relevant margin tax expenses to the applicable tenant. Some leases require the landlord to determine the tenant's share of the margin tax as if the building were the only applicable building (thus ignoring any other entities or assets owned by the landlord it its affiliates). Additionally, if the landlord were to sell the asset, the proceeds from the sale are subject to the 1% margin tax, which may or may not be passed through to the tenant.

Going Green

Texans place a high value on environmental protection and sustainability. As the emphasis on sustainability increases, so will the prevalence of "green" provisions in commercial leases. As a result, negotiation and dispute about who pays for the cost of "going green" is a red-hot topic.

Many standard operating expenses charged to tenants already include certain "greenery", such as fluorescent lights and recycling. However, bulbs and recycling are only the tip of the iceberg – given the developing technology and zeal for green buildings (and the often higher rents they can fetch), landlords will want to expand the range of costs associated with seeking or maintaining a certain sustainability rating. Few tenants balk at these costs if the building is already certified, but inclusion of these costs as part of operating expenses can be contentious where the landlord is attempting to retrofit a building for environmental certification and to pass through such costs to existing tenants. In those situations, even the most environmentally conscious tenants may argue that because the building was not certified at the time of lease execution, these retrofit costs are improper; and are akin to the cost of remediating pre-existing environmental contamination or ADA noncompliance. As a result, there are a few points to keep in mind, especially if you are the tenant:

➔ Many tenants will want the landlord to amortize the cost of initial certification, or any attempts to update or re-commission the property.
➔ What if the landlord installs various energy-efficient measures and the resulting cost does not reduce expenses? In that regard, the tenant will probably want to seek some "cost neutrality" concept in their lease.
➔ A tenant may wish to require a "cap" so that the cost to sustain the rating does not exceed a certain percentage of the total operating expenses.

➔ A tenant with a "base year" concept in their lease can negotiate for increases in the categories of base year expenses if a new sustainability-related cost is incurred after the lease is signed.

Mixed-Use Mix-Ups

As Texas becomes more transit-oriented, mixed-use developments will become more important. Users love the "something for everyone approach", however, this approach can also create issues with operating expenses. In order to keep the peace (and attract the best tenants), multi-use or mixed-use landlords may elect to segregate how expenses area allocated. For example, consider the following:

➔ Excluding the floor area of non-retail areas from the calculation of taxes and insurance.
➔ For those non-restaurant tenants, exclude from CAM expenses the costs related to operating eating areas.
➔ Varying the parking charges for high density tenants vs low density tenants.

The key for landlords in these situations is to remember to allow for "cost pooling", whereby the landlord retains the right to allocate certain operating expenses only among those tenants of the mixed or multi-use development benefiting from the applicable expense. Otherwise, the landlord risks not being able to fully recapture the cost of these items.

Conclusion

Ben Franklin was right – beware of little expenses. They can mean big bucks. Since everything is bigger in Texas, Landlords and tenants must pay particular attention to these details in the Lone Star State.