

A basis for worry

How tax pass-throughs create costly surprises for business tenants **Interviewed by Paul R. Harvey**

Prior to 1978, buildings and property in California were assessed each year based upon their fair market value. Proposition 13 stopped that.

Approved in June 1978 by 65 percent of the California voters, Proposition 13 enacted Section 2 of Article XIII A of the California Constitution and provided for a property acquisition value assessment system.

Under the revised system, property values are assessed when acquired through a change of ownership or by new construction. Thereafter, the taxable value of property can increase annually by no more than the rate of inflation or 2 percent, or whichever is less. The current tax rate fluctuates statewide between 1 percent and 1.2 percent.

"The biggest injustice of Proposition 13 to office market tenants is the real estate tax pass-through," says Craig A. Irving, principal, Irving Hughes. "If your company moves into a building with a low tax basis and that building sells at market, you're exposing the company to a potentially huge increase in occupancy costs."

Smart Business asked Irving to illustrate some of the facts about real estate tax pass-throughs and the devastating effects they could potentially have on office space lessees.

How are lease costs determined?

Typically a tenant signs a lease for a defined period of time — three-, five- and 10-year leases are most common. The first year of the tenant's occupancy determines the base year for the operating expense pass-throughs the landlord pays, and each subsequent year, the tenant pays additional rent for any increases in expenses over the base year aggregate.

So as the cost of supplies, janitorial contracts, electricity and other maintenance expenses rise, the landlord passes those increases directly to the tenant. This is an inflationary hedge by the landlord. Never mind that a landlord likely collects 3 to 4 percent increases each year in the base rent and possibly parking revenue.



Craig A. Irving
Principal
Irving Hughes

What is causing a large area of exposure for office tenants?

We represent tenants in office leasing and protect them in as many financial areas as possible. Rent and tenant improvements are the primary areas of focus for most tenants and brokers, but financial pitfalls lurk in many other areas of a lease transaction. None is more dangerous and unfair than the real estate tax pass-through.

How does real estate tax pass-through come into play?

Tenants pay rent and provide landlords the revenue to pay expenses, the mortgage and, in most cases, a return on their investment. Tenants, and the rent they pay, create the value in the buildings they occupy. The real estate tax pass-through creates a huge exposure for tenants because under Proposition 13, every time a building is sold, it is reassessed for real estate tax purposes. The new value, and the new tax base, gets passed directly through to the tenants. With buildings selling for higher and higher prices these days, tenants are getting hammered with significant real estate tax pass-throughs.

Can these pass-throughs cripple an organization?

Here's an example: Let's assume a tenant signs a 10-year lease in 1999 for 20,000 square feet. The tenant receives a 1999 base year for operating expenses that totals \$10 per foot per year in costs to operate the building, including property taxes of \$1.80 per year based on an assessed building value of \$150 per square foot. The fact that this tenant signed a lease for 10 years increases the value of the building and, five years into the lease, the landlord gets an offer to sell the building for \$400 per foot. The seller makes a fortune and never looks back.

The new assessed property tax value after the sale is \$4.80 and the difference between the base year assessed value and the new value is \$3 per year, or 25 cents per square foot per month. This difference is now passed on to all the tenants in the building. In our example, the tenant will have to start paying an additional \$60,000 per year for the remaining five years on the lease. This significant impact on the tenant's bottom line was probably never anticipated or expected and is wholly unfair.

What can be done about this?

Almost nothing. Proposition 13 tax protection is rarely available unless a tenant has a lot of leverage from occupying a significant portion of a building or is in a tenant favorable market. When weighing different options in the market, it's important that tenants understand the cost basis of each building they are considering. Cost basis varies from building to building and submarket to submarket. A contingency must be considered if, on the surface, two buildings offer the same economic package, but one building has half the basis as another and Proposition 13 protection is not available. Tenants must understand the potential downside cost in the event their building is sold out from under them.

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