MARCELLUS HALL

Can We Increase Our Commercial Income?

By Howard Schechter

YOU COULD LOSE as much as $58,000 if you don't get on the escalator. The tax escalator, that is. Want to know more? Read on.

Some lucky cooperatives and condominiums have commercial space that belongs to the building. They lease out the space to commercial tenants; and the rent they collect subsidizes the operation of the building, holding maintenance charges down. Like other commercial landlords, these buildings seek to get the highest rents they can for the space and to limit as much as possible the expenses they must pay. Typically, commercial leases extend for five, ten, or fifteen years – or even longer, raising special concerns when negotiating the leases. A major concern is to assure that the profit generated by the rent does not go down over time because of increased expenses or inflation. One strategy for accomplishing this is to step the rent up every year or two to keep pace with inflation.

Another is to make the commercial tenant responsible for unpredictable expenses, such as

A porter's wage adjustment can earn you money – even if you don't have a porter

By Edward T. Braverman

There are basically two types of escalators currently in use in the New York metropolitan area: cost-of-living adjustments and porter wage adjustments. Each has only a tangential relationship to operating a building in the New York metropolitan area; basically, both are designed to increase profitability.

Cost-of-Living Adjustments. To utilize cost-of-living adjustments (COLA), you need a yardstick to measure increases. In the New York metropolitan area, the yardstick is usually the Consumer Price Index (CPI). To put this escalator into effect, an owner must establish a base amount against which future amounts will be compared. This will create a percentage by which the established base rent will change. Most owners try and fix the month immediately preceding the execution of the lease as the base against which future increases are measured. Changes are then measured and applied annually or semi-annually. Most owner-crafted COLA lease provisions work in one direction only (up) with the contractual provision that the base rent will not be reduced should the CPI take a negative turn.

Porter Wage Adjustments. Like COLA, the porter wage escalator must have a yardstick to measure increases. That yardstick is the "porter wage" category of the union contract. This index has little relationship to an owner's cost of operating its building. In fact, neither the building nor the commercial space need be serviced by a porter, nor does the building need to be a union building. Utilizing this type of increase, an owner must establish: the union contract to reference; the employee line whose wages will establish the base amount against which future measurements will be made (i.e., porter, superintendent, handyman, other); and the base date against which future increases will be calculated.

In selecting these criteria, an owner should take into consideration that the local union contract is negotiated on a calendar-year basis, running from January 1 of each year to December 31 of some future year, with yearly increases usually taking effect on January 1 of each calendar year (and some times at mid-year). A lease starting on November 1, for instance, with a base date for porter wage adjustment of December 31 of that same year, will increase rent on January 1 – a mere two months after the lease begins. The owner must also be careful to maximize the increase by insisting on the inclusion of fringe benefits in the calculations (i.e., pension, healthcare, vacation, and comp time).

Once the index and base date are established it becomes a relatively simple task to measure the increase in terms of a percentage; that percentage is then applied to the tenant's base rent to determine the new and increased annual rent. When applying this escalator to tenancies rented by the square foot, the most common increase is "penny-for-penny": the rent per square foot will be increased by a cent for each cent by which the stated union worker's wages and benefits are increased. **H**

repairs in the space as well as cleaning, waste removal, decorating and other maintenance expenses, water and utility costs, hot water, and even heat. Once these items have been accounted for, the remaining big variable expense is the real estate tax. Since this is based on the assessed value of the building and the commercial space is part of that value, a portion of the tax bill is attributable to the commercial space; and unless the board, as the landlord, protects the property, the value of its rental stream can go down each time the real estate tax goes up. When New York City imposed double-digit increases in real estate taxes a few years ago, landlords who had not protected their properties experienced big losses in their net rental income.

Santa Clause Keeps On Giving

The solution to this problem is the tax escalation clause, a provision in the lease that makes the commercial tenant responsible for paying the portion of the increase in taxes that is attributable to the commercial space. Including such a clause in all its commercial leases can result in large returns for the boards that include them.

Tax escalation clauses consist of several components. Generally, the tenants agree to pay their portions of the increases in real estate taxes over the life of the lease. A well-drawn clause must carefully define the term "real estate tax" to assure that all impositions by the authorities are included, must then fix the amount of the taxes over which the increases will be calculated (sometimes called the "base taxes"), and must state the percentage of the increase in taxes for the whole building that will be the responsibility of the commercial tenants. The base taxes are fixed as the taxes payable during an initial year (typically, the year in which the lease is written is called the "base year"). If the taxes in any year after the base year are higher than the base taxes, then the tenants are responsible for paying their proportionate share of the increase.

Commercial income is not only rent. Savvy boards include tax escalation clauses that over time prove bountiful.

For example, if the base taxes are $250,000, by the next year they will be $300,000 with the tenant's share at five percent, meaning he would be required to pay $2,500 ($250,000 subtracted from $300,000 equals $50,000, which is multiplied by five percent to end up with $2,500). The true value of these clauses is seen in the later years of the lease when the taxes have increased the most. In the example, the taxes five years later could be $400,000. In that case, the tenant's share would be $7,500. Since the tax escalation clause produces additional income each year, over time the amounts can become quite substantial.

One issue that has recently arisen concerning the definition of real estate taxes concerns the co-op abatement allowed by New York City during the last several years. The abatement program is designed to compensate owners of cooperative apartments for the higher rates of real estate

taxes their buildings pay compared to one-family homeowners. Under the law, the cooperatives are required to give the abatements they receive from the city back to the shareholders penny-for-penny.

In one instance, a Manhattan cooperative had a commercial tenant under a lease written before the co-op abatements began. When it calculated the amount the tenant was required to pay under a real estate tax escalation clause, the board, reasoning that it was not the building's money but the shareholders', charged the tenant for the increased taxes without reducing them for the amount of the abatement. The appellate division, New York's second highest court, ruled that this was wrong: the cooperative had to use the taxes reduced by the abatement in calculating the amount the tenant had to pay. As a result, the cooperative lost almost $21,000 in income for three years.

Boards that are in the process of negotiating new commercial leases are sometimes lax about the details of the tax escalation clause. They should not be, since it can make a big difference in the rent collected over the life of the lease. For example, if a lease is to be negotiated in August 2008, the most appropriate base year would be July 1, 2008, through June 30, 2009. The tenant might ask for the base year to be 2009 to 2010 instead. But if the board agrees to this, it will reduce the income each year for the life of the lease, not just in the first year. In the example given earlier, that would amount to $2,500 per year for the life of the lease. Over ten years, that's a great deal of money.

The percentage that the tenant must pay is also worth attention. Typically, it is calculated based on the percentage of the total square footage of the building that the commercial space represents. If this has not been measured out correctly, it can also result in too little being collected from the tenant. Boards with commercial space should review how the percentage for each tenant was arrived at and make corrections, if needed.

The tax escalation should be specifically called "additional rent" in the lease. That way, if it is not paid, the tenant can be evicted. Without this language, the board may be limited to suing the tenant for the money, and if the lease ends before a tax year is complete or the tenant has paid the tax escalation, the obligation to pay will continue and be adjusted when the numbers are determined.

Remember: the best-written tax escalation clause is worthless if the rent is not collected. A cooperative client of ours recently changed managing agents. In reviewing the commercial lease to determine how much to bill the commercial tenant, the new manager noticed the tax escalation clause. After its initial 20-year term had expired, the lease had been renewed for 15 years. There had been a big dispute about the rent during the renewal period. After the arbitration, the previous managing agent had billed the new rent determined by the arbitrator but did not include the tax escalation. As it turned out, the base year for the tax escalation was the year at the beginning of the first 20-year term. The tax escalation rent that had not been billed for the first five years of the renewal period totalled over $58,000! The moral of the story: be vigilant and review commercial leases. Otherwise, you could be missing out on a fortune. **H**

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