

## PROPOSAL A OF 1994 AND LEASES: OWNER, TENANT AND BUYER BEWARE

by David E. Nykanen\*

### I. INTRODUCTION

This article analyzes the relationship between the General Property Tax Act's<sup>1</sup> cap on the increase in taxable value of real estate, and real property tax provisions in commercial leases.<sup>2</sup> In particular, the article considers the impact of the cap on tax increases in a gross lease, capped increase lease, net lease and base year lease.

On March 15, 1994, Michigan voters adopted "Proposal A," which imposed a cap on increases in the taxable values of real estate assessments, and concurrently increased Michigan's sales and use tax from four percent to six percent.<sup>3</sup> As a result of the enactment of Proposal A of 1994, assessment notices now contain a "taxable value," and a "state equalized value."<sup>4</sup> The General Property Tax Act caps the annual increase of taxable value to the lesser of: (a) five percent; or (b) the inflation rate.<sup>5</sup> However, the state equalized value increases without a cap, and is to represent fifty percent of the property's

true cash value.<sup>6</sup> When a transfer of ownership<sup>7</sup> occurs, the cap on the taxable value is lifted and the taxable value is raised to the state equalized value.

The "lifting of the cap" can have a significant impact on commercial real estate leases. For example, an office building in the Troy or Farmington Hills real estate markets could easily have a year 2000 state equalized value that exceeds the property's taxable value by 50%, assuming no transfers have occurred since 1994.<sup>8</sup> Thus, when the taxable value of the real estate is "uncapped" upon a transfer, the taxes on the property will increase dramatically. The purpose of this article is to identify issues that may arise when the taxable value is uncapped, and to propose negotiating points for attorneys representing parties in lease transactions. In order to properly address the impact of the potentially dramatic tax increase on real estate leases, a working definition of gross, capped increase, net and base year leases is necessary.

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\* David E. Nykanen is an attorney with Steinhardt Pesick & Cohen, Professional Corporation, in Southfield, Michigan, where he practices in the areas of real estate and business transactions. Mr. Nykanen is a *magna cum laude* graduate of Oakland University, and a *cum laude* graduate of Wayne State University Law School, where he served as the Managing Editor of *The Wayne Law Review*.

## A. GROSS LEASE

A gross lease is a lease in which the rental payment paid by the tenant does not change based upon changes in taxes, operating expenses, or insurance costs. The rental payment may, pursuant to the lease, increase through the term of the lease. For the purposes of this article, the only element that is essential is that the rental payments under a gross lease do not *directly* change due to a change in the taxes on the real estate.<sup>9</sup>

## B. CAPPED INCREASE LEASE

A capped increase lease refers to a lease wherein the tenant is responsible for some, and perhaps all, of the operating expenses, taxes and insurance costs relating to the property up to a certain point, and the landlord is responsible for costs exceeding that point. For example, an expense stop lease may impose a 5% annual cap on the tenant's responsibility for expense increases.<sup>10</sup> Once the cap on expense increases is reached, this type of lease becomes, for all practical purposes, a gross lease.<sup>11</sup>

## C. NET LEASE

A net lease is a rental agreement in which the tenant agrees to pay a base rental payment, plus a percentage of the total operating expenses equal to the percentage of the leasable portion of the building occupied by the tenant. In this type of lease, the landlord receives the base rental paid for use of the property, without the requirement to pay expenses out of the base rental payments. Instead, expenses are paid out of operating expense payments made by the tenants. Thus, the base rental payment is "net" of expenses.<sup>12</sup>

## D. BASE YEAR LEASE

A base year lease is a type of lease which will, for the purposes of this article, be considered in conjunction with the net lease. A base year lease renders the tenant responsible for all increases in expenses, taxes and insurance costs in excess of a base year sum (the base year from which the sum is calculated is negotiated by the parties at the time the lease is signed). The base year lease is a variation on the net lease.<sup>13</sup>

## II. THE LANDLORD'S PERSPECTIVE

### A. GROSS LEASE AND CAPPED INCREASE LEASE

Ordinarily, a landlord in a gross lease situation factors into the base rent the expected increases in taxes. In that

respect, Proposal A makes planning much easier, because the increase in taxes is capped. However, Proposal A does raise two significant concerns for the landlord in a gross lease situation.

First, a potential buyer of the landlord's property may weigh the large increase in taxes when performing purchase price due diligence. For example, if the property's net operating income for the previous twelve months is \$100,000, and the tax increase resulting from the "uncapping" of taxes would be approximately \$10,000, the potential buyer may deduct that tax increase from the net operating income when applying a capitalization rate to determine an appropriate purchase price.<sup>14</sup> The consequences can be dramatic: assuming a potential buyer is applying a 10% capitalization rate<sup>15</sup>, the deduction of increased taxes could lead to a purchase price reduction of \$100,000:

$\$100,000 / .10 =$	\$1,000,000
$(\$100,000 - \$10,000) / .10 =$	<u>\$ 900,000</u> <sup>16</sup>
Reduction	\$ 100,000

Second, a landlord may *inadvertently* uncap the taxable value by transferring an interest within the landlord's own entity. A transfer of more than 50% of interests in the landlord's entity constitutes a transfer of ownership.<sup>17</sup> Many entities make "internal" transfers for a variety of reasons. Consider the example of a limited liability company in which an aging entrepreneur, who is the sole member, annually transfers membership interests to the entrepreneur's children for estate planning purposes. The State Tax Commission has taken the position that, when these transfers aggregate more than 50% of the outstanding membership interests, a "transfer of ownership" has occurred.<sup>18</sup>

At that point, the cap on the taxable value is lifted, and the taxable value will be increased to the state equalized value. Of course, the property taxes will increase accordingly, but the tenant's lease payments will not change. Therefore, the net operating income will decrease dollar for dollar with the increase in taxes, taking money out of the pockets of the landlord's members, who were intended to benefit from the purportedly prudent estate planning.

A clever attorney may note that "transfers" are reported to the municipal assessor on a voluntary basis, through the filing of a Property Transfer Affidavit. Therefore, if the "phantom" transfer is never reported, the taxable value will

not be “uncapped” until a true sale occurs. But the potential downside of such a course of action (or omission to act) is significant. If a transfer of ownership remains unreported, and is later discovered by the assessor, the assessor may levy: (a) additional taxes that would have been due from the date of the transfer forward; (b) interest and penalties on the unpaid taxes, retroactive to the date of transfer; and (c) a penalty of up to \$200 for failure to file.<sup>19</sup> If an unreported transfer of ownership is discovered years later, the retroactive taxes, penalties and interest could have a devastating impact on the owner.

The issues in a capped increase lease are substantially similar to the gross lease. A landlord should ensure that the cap on the expense increases is high enough so that the cap increases are greater than the increases of taxes under Proposal A. The discussion above regarding potential purchase price reductions applies to the capped increase lease, as the landlord will remain responsible for tax increases beyond the expense cap.

## **B. NET LEASE AND BASE YEAR LEASE**

Ordinarily, a true net lease includes a pass-through of all taxes to the tenant (or tenants in a multi-tenant setting.) However, as a result of Proposal A, and as will be discussed below, a shrewd tenant may propose an annual “cap” on its exposure to tax increases. The sophisticated landlord should resist such a proposal. In the event a building is sold, or the taxable value is otherwise uncapped,<sup>20</sup> the taxes that ordinarily would have been passed through to the tenant will instead be deducted from the landlord’s net operating income. As discussed above, any deduction from net operating income could have a direct, negative effect on the potential purchase price of the building.

The issues in a base year lease are virtually identical to those in a net lease as they relate to the landlord. For all relevant purposes, a base year lease becomes a net lease to the landlord after the base year. Therefore, the issues discussed in the above paragraph apply equally here.

## **III. THE TENANT’S PERSPECTIVE**

### **A. GROSS LEASE AND CAPPED INCREASE LEASE**

A tenant with a gross or capped increase lease may believe that Proposal A will not affect the tenant, because

increased taxes are borne by the landlord. In most cases, that belief is correct. However, when the landlord sells the building, the tenant will be impacted by the increase in taxes when negotiating the next term of the lease. The new owner will attempt to recover the increased tax expense by increasing the base rent. Therefore, a tenant may wish to consider negotiating early extensions of the lease term if the building is, or is expected to be, marketed for sale. By negotiating an extension before the sale is consummated, a tenant may be able to secure a lower lease rate, before the seller or purchaser recognizes the extent of the impending tax increase resulting from the uncapping of taxable value.

Although outside the scope of this article, a tenant’s attorney should note that a landlord in a gross lease situation will receive all of the benefit of a decrease in taxes if the assessed value of the property is challenged and lowered.

## **B. NET LEASE AND BASE YEAR LEASE**

In a net lease situation, the tenant is truly exposed to an unexpected increase in taxes, due solely to the acts of the landlord. Because the acts of the landlord alone cause the tax increase, a tenant should address this issue in lease negotiations. A tenant should refuse to pay any tax increase arising out of the sale or transfer of the leased property.<sup>21</sup> As a fall-back position, a tenant should attempt to negotiate a cap on the increase in taxes. A reasonable cap would be equal to the cap on the increase in taxable value under Proposal A. The rationale in these two positions, of course, is that the tenant should not be harmed by the landlord’s act of selling the building, or otherwise uncapping the taxable value. As discussed above in Section II B, the landlord should, from its perspective, attempt to reject a cap on increases in taxes.

In the event the tenant has occupied the building since 1994, the landlord can construct a very compelling argument that the tenant has enjoyed the benefits of the annual cap on taxable value on an annual basis since the enactment of Proposal A, and therefore the tenant should now share in the pain of “uncapping” the taxable value. Of course, the parties’ relative bargaining power will resolve this issue.

As discussed in the Landlord’s Perspective (Section II) of this article, the issues in a base year lease are virtually identical to that of a net lease as they relate to the tenant.

#### IV. THE POTENTIAL BUYER'S PERSPECTIVE

##### A. GROSS LEASE AND CAPPED INCREASE LEASE

The party most affected by Proposal A in the gross lease or capped increase lease situation is the potential buyer of a building. Most buyers determine the maximum purchase price they are willing to pay by capitalizing the net operating income.<sup>22</sup> When calculating net operating income on a *pro forma* basis, the buyer must be certain to include a charge for taxes, which is calculated based upon the purchase price (which will presumably become the basis of the state equalized value), and not calculated based upon the then-current taxable value. This increased tax expense will undoubtedly reduce net operating income. The reduction in net operating income will, in turn, affect the maximum purchase price that the potential buyer would be willing to pay, when the lower net operating income is capitalized.

##### B. NET LEASE AND BASE YEAR LEASE

A potential purchaser of a building where the tenants have signed net leases or base year leases should ordinarily be unaffected by the uncapping of taxable value. The increased tax expense should be passed through to the tenants.

However, when performing due diligence, the potential buyer and its counsel should confirm that the leases do not contain a cap on the increase in taxes. A prudent attorney should consider including a seller's representation in the purchase agreement that no lease on the property contains a cap on the increase in taxes. Obviously, the existence of such a cap in any lease should be considered when calculating a maximum purchase price.

#### V. CONCLUSION

Although the existence of Proposal A will primarily affect buyers of buildings with tenants who have executed gross or capped increase leases, all parties, and their attorneys, should be conscious of the possible impact of Proposal A on the economics of any particular transaction. As 1994 fades further into the past, Proposal A's impact will continue to grow, as the potential for large spreads between taxable value and state equalized value will continually increase.

#### ENDNOTES

1. MCL 211.1 *et seq.*; MSA 7.1 *et seq.*

2. For an elementary discussion of the tax problem in leases, see *Friedman on Leases*, 4th Edition, Volume 1, p. 158 (1997).
3. See Goodin, "Assessments Up; Prop A Keeps Tax Rates Level," *Crain's Detroit Business*, May 1, 1995, at p. 19.
4. Technically, assessment notices contain a capped value, a state equalized value, and a taxable value. The taxable value is the lesser of the capped value and the state equalized value. Since Michigan real estate values have increased each year since the enactment of Proposal A at a rate greater than the rate of inflation, the taxable value has been almost without exception equal to the capped value. See State Tax Commission Bulletin No. 16 "Transfers of Ownership," September 20, 1985.
5. MCL 211.27a(2)(a); MSA 7.27(1)(2)(a). The statute also allows for inclusion of "additions" and subtraction of "losses." For further discussion of these issues, see Rhoades and Itnyre, "Property Tax Cap and Transfer Taxes," 27 *Mich Real Prop Rev* 63 (Summer 2000).
6. MCL 211.27(1); MSA 7.27(1); MCL 211.27a(1); MCL 7.27(1)(1).
7. MCL 211.27a(6); MSA 7.27(1)(6) defines "transfer of ownership."
8. For example, from 1994 to 1995, the "gap" between the taxable and state equalized value for One Detroit Center, a high-rise office building located in the central business district of the City of Detroit, was \$3,700,000, an amount equal to 9.8% of the property's taxable value. Goodin, "Assessments Up; Prop A Keeps Tax Rates Level," *Crain's Detroit Business*, May 1, 1995 at p. 19. This disparity will only grow as we pull further away from 1994, so long as the real estate valuations increase faster than the inflation rate. If the 1990s real estate boom slows down, these disparities could shrink.
9. Rent could increase throughout the term of the lease for various reasons. However, so long as the rent does not increase as a direct result of a tax increase, such a lease shall be referred to in this article as a "gross lease." *Black's Law Dictionary* defines a "gross lease" as a: "Lease in which lessee pays a flat sum for rent and of which the lessor is required to pay all expenses such as taxes, water, utilities, etc." *Black's Law Dictionary* p. 889 (6th ed. 1990).
10. This type of lease is an attempt to allocate the risk for increased operating expenses between the landlord and tenant.
11. This lease may, for all other purposes, be more closely related to a net lease.
12. Again, the *Black's Law Dictionary* definition of "net lease" is a: "Lease in which provision is made for the lessee to pay, in addition to rent, such additional expenses as the taxes, insurance and maintenance charges." *Black's Law Dictionary* 1040 (6th ed. 1990).

13. *Black's Law Dictionary* uses the term "graduated lease" to refer to these types of leases. According to *Black's Law Dictionary*, such a lease "takes into consideration future increases in operating expenses. In a graduated lease there must be a base year on which an increase is judged. With inflation and continuing increase in taxes, energy costs, and other expenses, this type of lease has become more popular than the fixed-straight [gross] lease." *Black's Law Dictionary* 889 (6th ed. 1990).
14. In fact, a deduction of additional tax expenses is specifically discussed in appraisal treatises. See Appraisal Institute, *The Appraisal of Real Estate* 499 (11th ed. 1996).
15. A capitalization rate is used to determine the maximum purchase price a buyer could pay while earning a specified rate of return on the capital investment. See Appraisal Institute, *The Appraisal of Real Estate* 455-461 (11th ed. 1996).
16. See generally Appraisal Institute, *The Appraisal of Real Estate*.
17. MCL 211.27a(6)(h); MSA 7.27(1)(6)(h).
18. State Tax Commission Bulletin No. 16, "Transfers of Ownership," September 20, 1995. For further discussion of this issue, see Wolford, "Transfer of Ownership": Uncapping Taxable Value for Property Tax Assessments," 75 Mich Bar J. 302 (1996).
19. MCL 211.27b; MSA 7.27(2).
20. See discussion of inadvertent uncapping by internal transfers in Section II A of this article.
21. In addition to the increase in assessed value, a landlord may attempt to pass-through transfer taxes paid at closing.
22. See discussion of capitalization in Section II A of this article.