Real Estate Tax Escalations For New Buildings Can Be Full Of Surprises

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Real estate taxes for new construction can create problems in leases, especially if those leases are misinterpreted.
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Commercial leases for occupancy often require the tenant to pay a percentage of increases in real estate taxes imposed on the owner's building, to the extent those taxes exceed the taxes in a base tax year. That base tax year is sometimes the tax year when the parties sign the lease, sometimes the next tax year, sometimes the tax year when the property owner delivers the leased space to the tenant, sometimes the tax year when the property becomes "stabilized," and sometimes a combination. It's a negotiation.

By helping to insulate the owner from increases in real estate taxes, a tax escalation clause helps the owner preserve its anticipated return from its real estate investment. That predictability appeals to lenders, allowing an owner to obtain maximum loan proceeds. Tenants agree to this arrangement as part of the horse trading that determines their initial

rent and other economic terms of their lease. They hope that as real estate taxes go up, so will their revenue. Sometimes tenants also negotiate for the right to share in the savings from tax abatements available to the owner.

When tenants negotiate tax escalation provisions, they want to try to have a somewhat predictable future expense. They want to know they'll only have to contribute to real estate taxes on a known and defined building, the one that the parties contemplated when they signed their lease. If the owner later expands the building beyond what the tenant expected, that would throw a wild card into the tenant's expense projections, because the larger building might have a much larger tax bill.

The tax escalation formula becomes particularly important in a new building. The owner might deliver the leased space to the tenant before the owner completes the rest of the building. At that point, real estate taxes will probably not have caught up with the value the owner created through its development project.

In a recent case, an extended development timeline coupled with a court's twisted and improper reading of the tax escalation clause in a retail lease resulted in an unpleasant surprise for the owner. The owner's project consisted of a multi-story rental apartment building in New York City, with retail space on the ground floor. The retail tenant signed a lease recognizing the mixed-use nature, size, and scope of the building to be constructed. The tenant agreed to pay a negotiated percentage of real estate taxes above the taxes for the building in the tax year when the owner delivered the retail space to the tenant. That tax year would become the base tax year for future tax escalations.

The lease also said the tenant didn't have to contribute at all to any incremental taxes that resulted from the owner's later expansion of the building as compared against the square footage of the building "existing" in the base tax year.

When the owner delivered the retail tenant's space, the real estate tax assessment didn't yet reflect a completed building, so the taxes were low. The owner had, nevertheless, finished the retail space to a point where the owner delivered it to the tenant. The base tax year occurred for the retail lease. At that point, the owner had also constructed the entire structure and much of the shell of the building, including all the upper floors that everyone knew would soon become residential apartments. The apartments themselves were well underway but not yet ready to be legally occupied or rented. That happened only a year or two later. The real estate taxes eventually went up to reflect the completed apartments.

The retail tenant refused to pay its share of any tax increase attributable to the completed apartments, arguing that the square footage they occupied was not "existing" in the base tax year. At that point the structure and shell of the building had already been built. The

incomplete building did already include the square footage that would soon become residential apartments. Those apartments just weren't completed or occupiable.

The court agreed with the tenant, finding that for purposes of the tax escalation clause the square footage that would become apartments—though already built in the base tax year—was not "existing" at all until that space could be legally occupied and the building's tax assessment took it into account. The apartments weren't "existing" in the base tax year because there was no certificate of occupancy for the apartment portion of the building, according to the court.

As a result, the tenant had to contribute only to increases in taxes attributable to the retail space in the building, which was taxed separately as a condominium unit. The tenant could ignore tax increases on the apartments because they were only partially complete – not "existing," according to the court – in the base tax year.

That made no sense, of course, given the business context and the other terms of the lease. The tenant had agreed to pay an agreed share of tax increases for the building as a whole above the base tax year. The lease made clear that the owner's building would include not just the retail space but also dozens of apartments. In the base tax year, the owner had reached completion of only part of the overall project, but the entire building—the mixed use building fully contemplated when the parties signed their lease—already existed.

Nothing in the lease said the entire building had to be fully completed, legally occupiable, or assessed for tax purposes. It just had to exist. It did. That's consistent with how landlords and tenants think about and negotiate tax escalation clauses every day. The court's decision was wholly at odds with the logic and purpose of the language in dispute.

The court also declared that it was against public policy for a tenant to contribute to real estate taxes attributable to residential space from which the tenant did not benefit. That declaration made no sense either. The tenant had agreed only to contribute a small percentage of the overall real estate taxes for the building as a whole, which included both residential and retail space. The retail tenant certainly benefitted from some percentage of the building. In recognition of that shared benefit, the tenant's low share of the overall taxes on the building—both the residential and the retail components—had been negotiated at arm's length.

The outcome of the case seems inconsistent with ordinary industry expectations about how tax escalations are typically negotiated and how they typically work. It seems odd for a court to decide that a chunk of a partly constructed building–steel and concrete and square footage in place consistent with the building the parties originally contemplated—does not

"exist" unless it has a certificate of occupancy and the tax assessment reflects it. That's especially true when the lease in question established no such requirement. The space just had to exist, which it did.

Sometimes words have strange meanings in New York. For example, in the infamous Stuyvesant Town ("Roberts") case, the state's highest court declared that even if a building is already subject to a particular government program, it can still "become" subject to that same program as the result of some later event. That's not normal English. Neither is the interpretation of "existing" in the litigation discussed above. In each case, the New York courts misinterpreted ordinary English words to the detriment of those in the real estate industry.

As a final note, now that the building discussed above is complete, occupiable, and fully assessed, the average real estate taxes on each of its apartments come out to around $1,500 per month. A monthly payment of $1,500 would, on its own, more than cover the rent on an average apartment in Houston. That little fact alone helps explain why new residential development is so difficult and "unaffordable" in New York City.

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