

CAM AND TAXES IN SHOPPING CENTERS
BY ROSIE REES

PARTNER,
PIRCHER, NICHOLS AND MEEKS

I. INTRODUCTION

In a shopping center, in addition to requiring tenants to pay a fixed minimum rent, landlords also want to tenants to share in the landlord's expenses for real estate taxes and the operations of the shopping center. These additional costs are shared by the tenant with the other tenants in the shopping. The extent of the costs in which a tenant is willing to share, and the manner in which such tenant's share is determined, are the subject of substantial negotiation between the landlords and tenants.

II. DEFINING TERMS

1. Real Estate Taxes

Landlord will want to include a very broad definition of real estate taxes in the lease. It will include taxes assessed against the real property in the shopping center by any taxing authority of the state, county, or local governmental authorities. It will also include all assessments (both general and special), fees charged by special taxing units (like a water or sewer district), taxes imposed on rent and other receipts received by the landlord with respect to the shopping center, and taxes imposed on personal property used in the common areas. If the shopping center is part of a larger development, the shopping center may be part of a larger tax parcel and landlord will want to pass its share of those taxes on to tenants. Also, where the landlord has ground leased the land on which the shopping center is built, landlord may be paying ground rent in lieu of taxes, and landlord will want to include such payments in taxes as well.

2. Operational Costs

The operational costs generally include the costs of maintaining, repairing and replacing the areas of the shopping center that are used in common by all the tenants (called the "common areas"), insuring the common areas and the buildings against casualty and other hazards, insuring against liability arising from use of the common areas, managing the shopping center (including salaries, consulting fees, legal fees, brokerage fees, and the like), and promoting and advertising the shopping center. These costs are often called "common area maintenance" costs or, in shorthand, "CAM", because they are generally costs that arise from the maintenance of the common areas. This is somewhat of a misnomer, however, because landlord will

want to include costs that go beyond “maintenance”; i.e. all costs in operating the center. These could include music systems, landscaping, sprinkler systems, security systems, holiday decorations, and other non-maintenance items. Landlords will often include an administrative fee to cover landlord’s offsite overhead in managing the center (costs for a corporate office, salaries of personnel above the on-site manager and service employees, and the like). This fee is generally calculated as a percentage of the total operating expenses of which tenant pays its share, usually between 7% and 15%.

III. COMMON EXCLUSIONS FROM TAXES

Taxes will generally not include landlord’s federal or state income taxes, inheritance, succession or estate taxes, taxes on stock transactions, and the like.

In addition, tenants will want to exclude other costs they feel are not legitimately “real estate taxes”. The following are some of the most common exclusions requested by tenants.

1. Special Assessments.

Tenants will try to exclude special assessments, since they are often paid over periods of time that may not be part of the term of the lease.

Also, landlords will sometimes negotiate special taxing arrangements with a taxing body to assist the landlord in developing the shopping center. The taxing authority will provide financing for the development or redevelopment of the shopping center and then assess special taxes to the development to reimburse the governmental authority. Tenants often object to paying these special assessments, arguing that tenants should not have to contribute to the costs of initially developing or redeveloping the shopping center. Landlords will usually agree to exclude these assessments for major tenants (department stores, big box tenants, grocery stores).

2. Rent Taxes.

Tenants will often object to paying taxes on the rent that they pay, saying this should be the landlord’s cost. If by law the rent tax is imposed on the tenant, tenants are more likely to agree to pay it.

3. Tax Increases Due to Transfer of Center

Some states and local taxing bodies keep real estate taxes lower by not assessing tax increases until a property is sold. Tenants feel this could impose an unexpected additional tax burden and try to exclude any

increases in taxes based upon a transfer by the landlord of the shopping center.

Landlords argue that since the taxes have been kept artificially low prior to the tax increase, tenants have benefited from the lower taxes and should be willing to share in the increase. A common compromise is to limit the number of tax increases due to transfers in which the tenant will share. For instance, the parties may agree that a tenant's share will be increased not more often than once every 5 years due to a transfer of the shopping center.

IV. COMMON EXCLUSIONS FROM CAM

This often becomes one of the most disputed issues during lease negotiations. Tenants will try to keep the total amount of operating costs in which they are required to share as low, by excluding as many cost items as possible. Major tenants will often be successful in limiting the universe of operating costs to only those costs incurred for the actual maintenance of the common areas, excluding all general operational and management costs. Smaller tenants with less leverage will be able to negotiate only very specific exclusions.

The following are common exclusions from CAM:

1. Costs related to the development of the shopping center.

Landlords will generally agree to exclude costs such as debt service on mortgages and ground rent payments, depreciation and amortization of construction costs for initial development and expansions, or for repairing construction defects.

2. Costs related to other tenants in the shopping center.

Tenants will generally be able to exclude landlord's leasing commissions, advertising costs to lease space, costs for repairs and similar costs related to leased space, legal fees for disputes with tenants, or special services given to only certain tenants (for example, maintenance costs for a food court).

3. Capital expenditures.

Tenants often object to pay for improvements that will benefit the shopping center beyond the term of the tenant's lease; for instance, replacement of a parking lot, installation of a parking garage, roof replacement, upgrading of utility systems, costly equipment.

Landlords with leverage will insist on including capital costs. They may be willing to agree not to put the full cost into CAM in a single year, but instead to amortize these costs over a longer period of time. Tenants who agree to pay for capital expenditures will want them amortized over the useful life of the capital item. Landlords will try to amortize them over shorter periods (for instance, 7 years for parking lot improvements.)

4. Compliance with law.

Tenants will want to exclude any costs incurred by landlord to remediate hazardous materials, meet ADA requirements, and comply with any new laws imposed during the term of the lease. Landlords of older shopping centers will try to retain the ability to pass through costs of remediating hazardous materials if they are incidental to landlord's routine maintenance and repairs (like abating asbestos in order to repair utility systems).

5. Reserves.

Tenants do not want to be assessed for contingencies, like reserves for capital improvements, or for uninsured casualties. For tenants with leverage, landlords will usually agree to this exclusion.

6. Management fees.

Tenants who pay the administrative fee will object to paying an additional management fee to the landlord or a third party manager to manage the shopping center. The management fee is usually calculated as a percentage of the revenues landlord earns from the shopping center, usually between 1% to 5%. Tenants who agree to pay a share of the management fee will try to pay this in lieu of the administrative fee and require that the cost be similar to management fees payable at similar shopping centers in the local marketplace.

7. Costs Reimbursed Through Warranties, Insurance Proceeds and Other Tenants.

To the extent that the landlord is reimbursed by warranties or insurance proceeds for certain costs it incurs to maintain and repair the shopping center, tenants will expect those reimbursements to be deducted from operating expenses. Another tenant may also reimburse landlord directly for specific damage that tenant may have caused. Landlords will generally agree to deduct such receipts from CAM for purposes of calculating another tenant's share.

8. Corporate costs for the formation and maintenance of the landlord entity.

Such costs are seen by tenants as landlord's costs of doing business that are not directly related to the operation of the shopping center. Landlords will generally agree to exclude such costs.

V. COMPUTING A TENANT'S PROPORTIONATE SHARE

1. Gross Leasable Area.

Tenants will want their share of taxes and operational costs to be a proportional share based upon the amount of floor area they lease in relation to the total floor area in the shopping center for use by all tenants. The term commonly used for this floor area at the shopping center is the "gross leasable area" or "gla". This would exclude common areas, storage areas, landlord's management office, and the like.

2. Exclusions from GLA.

Because it is to the landlord's benefit to pass through as many costs as possible to the tenants, and because not all floor area available for lease will actually be occupied by tenants paying their full share of taxes and operating costs, landlords will try to exclude from the calculation of a particular tenant's share as much gla that is not occupied, or gla occupied by tenants who do not pay a full share of such costs, as possible.

- a. Unleased Space: The most obvious is unleased space. Since there is no tenant in such space to share in paying the costs, landlords will seek to deduct from a tenant's calculation the square footage of unleased space. For example, when a shopping center is only 80% occupied, instead of calculating a tenant's proportionate share based upon 100% of the gla, the landlord will determine the tenant's share as if the total gla equaled 80% of the actual gla, deducting any square footage that is not leased.

Tenants will argue that they should not have to subsidize the unleased space. They will say it is landlord's responsibility to lease the shopping center, and the landlord should make up the difference in the loss of revenue from the unleased space.

Major tenants will generally win this argument. Smaller tenants will not. But for smaller tenants, landlords will usually agree to a "gla floor": a minimum percentage of floor area that will be presumed to be occupied. For example, if 75% of the leasable square footage of the shopping center is occupied, and a tenant has an 80% gla floor, tenant's proportionate share will

be calculated as if the shopping center were at least 80% leased. Landlord will be responsible for the additional 5% shortfall in cost recovery.

Major tenants also raise concerns that the landlord might demolish or remove certain buildings from the shopping center, thereby reducing the total gla in the shopping center that shares in the costs. These tenants may insist on a minimum floor area upon which their proportionate share must be calculated, regardless of the ultimate total gla in the shopping center.

b. Tenants Not Paying Full Share: In any shopping center, some tenants will not pay their full share of CAM or taxes. Department stores in a regional enclosed mall usually do not pay CAM costs arising from the enclosed mall, and often pay only a fraction of their actual share of CAM for the exterior common areas. Because department stores bring a lot of customer traffic to the shopping center, they are generally entitled to get a break on these costs. Theaters and restaurants with no entrance onto the enclosed mall likewise will not pay enclosed mall CAM, since they do not benefit from enclosed mall traffic. Restaurants on outparcels with their own parking areas may only contribute to the maintenance of the ring road in a regional mall, but not for the other CAM costs arising from the exterior parking areas. Grocery stores and other big box tenants will negotiate to pay less than their full share of CAM costs, because they bring customers to the shopping center.

Since these tenants do not pay a full share of certain costs, landlords will want to exclude their square footage from the calculation of the other tenants' proportionate share. Landlords will generally agree to deduct the actual amounts these tenants pay towards certain costs from the total costs for which the other tenants pay their share, before calculating the other tenants' shares.

Tenants again will argue that they should not have to subsidize these tenants, especially if they believe they are not benefited by the presence of such tenants at the shopping center. They will want to define what the landlord considers a "department store" and be willing to deduct only the square footage of those tenants that are truly department stores. In regional malls, tenants with leverage will insist that a department store must have at least a minimum gla (for example, no less than 50,000 sq. ft.), must operate under a single trade name in contiguous square footage (e.g., 4 separate stores operated by Gap under different trade names would not be considered a department store). In lifestyle centers, power centers, or single anchored strip centers, a "major tenant" could be defined as any tenant occupying at least 15,000 square feet of gla.

c. Separate Tax and Maintenance Parcels.

Often larger tenants will have their ground leased or owned land parcel separately assessed for tax purposes, especially if a tenant has leased land which includes common area. The taxes on these parcels are not included in the taxes for the rest of the shopping center, and so the gla of these tenants is excluded for purposes of calculating the other tenants' proportionate shares of taxes.

Sometimes tenants that own or ground lease common area will elect to maintain or insure the common area on their parcel at their own cost, rather than paying landlord to do so. Since landlord does not incur the costs of maintenance and insurance for these common areas, landlord will exclude the gla of these tenants from the calculation of the other tenants' shares. Depending on the amount of common area that is maintained or insured by the large tenant and whether or not that tenant's customers will make use of other common area in the shopping center, landlord may still expect them to contribute something toward the upkeep of the remaining common area. Any such contribution would be deducted before calculating the other tenants' shares.

Sophisticated tenants also try to protect themselves from increases in taxes due to construction of additional improvements in the shopping center by prohibiting their share of taxes from increasing disproportionately due to such improvements.

VI. BILLING, AUDITS, CAPS

1. **Billing:** Landlords generally prefer a tenant to pay for taxes and CAM monthly with minimum rent, based upon landlord's estimates of what the costs will be in the upcoming year. Landlord will notify the tenant of its estimated annual proportionate share in terms of a dollar amount per square foot of leasable space in the premises. This annual amount will be payable by the tenant in equal monthly installments. Landlords usually reserve the right to revise the estimates during the year, based on new information landlord has received regarding its anticipated costs. Tenants usually try to limit the number of times the landlord can revise its estimates during the year to no more than twice per year.

At the end of the year, landlord will determine, and send the tenant a statement showing, landlord's actual costs for CAM and taxes and tenant's actual proportionate share for the prior year, and bill tenant for any shortfall or reimburse tenant for any overpayment. Tenants usually want to receive such statements within 3-6 months after the end of the year, and will want landlords to forfeit reimbursements for a shortfall if landlord has not sent the statement within one to two years after the year to which it applies.

2. Audit: Tenants often will request the right to audit the landlord's books and records for CAM and taxes on an annual basis. In lieu of a right to audit taxes, landlords generally prefer to give tenants a copy of the tax bills. Audit rights for CAM costs are more commonly granted, though landlords try to limit the frequency, place and manner of such audits. Often tenants must request to audit a particular statement no later than 90 days to one year after the statement is issued, or lose their right to audit such statement. Landlords particularly try to avoid audits by contingency fee auditors who may represent a large number of tenants at the shopping center and troll for general billing errors by the landlord.

3. Caps: Tenants will want landlord's estimates to be reasonable and to be based upon the actual costs incurred by landlord in the prior year. In newly developed centers where the landlord has no prior experience with taxes or CAM costs, tenants may insist on a cap on the increase in estimates for the first year, so that its costs don't exceed its initial pro forma. Caps on CAM for the initial year of a new shopping center usually range from 3% to 7%. Caps on taxes are much less common, since landlords generally cannot control increases in taxes.

Tenants will often request caps on annual increases in their proportionate share of CAM during the term of the lease, again to control their costs. Landlords are reluctant to agree to on-going caps, because they cannot easily predict how much costs will escalate during the term. However, caps of 5% to 10% are not uncommon. Generally landlords will negotiate exclusions from the caps for costs they deem to be particularly beyond their control. The "uncontrollable costs" generally excluded are insurance, utilities, security, and snow removal.

Some landlords, to prevent the inevitable negotiation with tenants over exclusions to CAM, tenant's proportionate share, and CAM caps, and to avoid the intrusion and squabbling over CAM audits, are agreeing to fixed CAM arrangements. In a fixed CAM arrangement, Landlord determines a standard per square foot amount for CAM for the first year of a tenant's term. Then, that amount is automatically increased by a certain percentage in each subsequent year of the term, generally between 3% and 7%. Uncontrollable costs are generally excluded from fixed CAM, and tenants still pay for these costs based upon estimates that are adjusted at the end of each year.

VII. SPECAIL CONCERNS IN MIXED USE PROJECTS

Recently there has been a proliferation of lifestyle centers with substantial non-retail components. Hotels, residential units, office buildings, and entertainment are an integrated part of the center. No longer is the development just a "shopping center". It is a "project," with shopping only

one activity among many. This complicates the negotiation of the CAM and taxes provisions of the retail tenant's lease.

Since the non-retail components do not utilize the common areas to the same extent or in the same manner as the retail component, landlords may allocate the costs among these various components differently. Thus, landlords may cluster like uses in separate groups and allocate costs based on anticipated usage. Often, because of the greater usage of common areas by the retail component, larger portion of the overall costs are imposed on the retail component.

Where retail is primarily on the ground level and the residential and office will be above ground, a retail tenant's share of CAM and taxes may be calculated based upon all ground level gla. Where retail is located throughout the project, a "retail area" may be defined, and the retail tenant's share based on the gla in the retail area. The retail area may be defined by deducting all non-retail gla in the project; for instance, hotel, residential, and general office. In the alternative, rather than define the retail area by what is excluded, it may be defined by what is included: all space in the center available for lease for retail, service, and restaurant uses.

Sophisticated tenants object to subsidizing the non-retail tenants. Landlords argue that these non-retail components bring customers to the retail tenants, much like the department stores or other big box tenants, and should be similarly excluded. Tenants fear that too much non-retail detracts from the nature of the project as a shopping center. They may insist that the retail area never contain less than a minimum amount of gla. They may try to limit the total amount of non-retail space that can be deducted in calculating their share, either by setting a maximum amount of gla that may be excluded or requiring a gla floor for non-retail; so that their share is calculated as if retail were a certain minimum proportion of the total gla (for example, at least 60%). Solutions to this thorny problem are still evolving.