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Practice Area: Retail Real Estate

Property, internet sales, capital gains, income, estate – it seems there is a constant buzz about taxes. In an economic environment of shrinking tax bases and increasing municipal expenditures, the commercial rent tax remains a relatively untapped source of revenue for cash-strapped state and local governments. While Florida currently holds the dubious distinction of being the only jurisdiction in the country that imposes a state-wide tax on commercial rents, several other jurisdictions, including Arizona, Hawaii and New York, impose some form of local or county tax on commercial rents.

Location, location, location. In some jurisdictions, the distance of a few city blocks can determine whether commercial rents are taxable and at what rate. For example, in Florida, each county has the discretion to add up to an additional 1% to the state-wide 6% base tax on commercial rents. In Arizona each county may impose taxes on commercial rents and rates can range from 0% to 4% depending on the county. Further still, in New York City, certain boroughs impose taxes and others do not. These variations within a single market add another important economic variable to the already complex matter of portfolio development and site selection.

Who, what, when and where? Depending on the jurisdiction, taxes on commercial rents may be payable to the local municipality, the county or the state. Even in states that do not impose state-wide taxes, some counties defer collection to the state department of revenue. In addition, different jurisdictions have different rules for which party is ultimately liable for the payment of taxes. In Florida, tenants are ultimately responsible for the payment but landlords are generally required to act as agent to collect and remit the tax. In contrast, tenants in New York City are responsible for paying the tax directly to the collecting authority. The complexities of how taxes on commercial rents are collected and paid often results in unpaid taxes, costly audits and disputes between landlords, tenants and taxing authorities.

What is taxable? What constitutes rent for the purposes of commercial rent tax also varies greatly from one jurisdiction to another. In most jurisdictions, taxable rent includes base rent, additional rent and common area maintenance charges. Florida broadly defines taxable rent as any payment required to be paid as a condition of occupancy under a commercial lease. In New York City amounts not actually paid may also constitute taxable rent. For example, rent credits provided to a tenant that are tied directly to improvements are treated as rent paid and therefore part of the taxable rent. However, free rent not tied to a particular expense and accomplishing a similar result will generally not be treated as foregone taxable rent. Separately metered utilities paid by a tenant directly to a utility provider are generally exempt from commercial rent tax. Other lease-related payments such as lease termination payments may be treated as taxable rent if they are booked as rental income and rental expenses. Lastly, it is worth noting that rental agreements between related parties (i.e., parent/subsidiary) are also taxable. The varying rules regarding what constitutes taxable rent present opportunities for the astute and pitfalls for the unwary.

Drafting and Other Considerations.

- Consider the economic impact of taxes on commercial rent during site selection process.
- Separately itemize rent tax amounts and clearly define which party is responsible for the collection and/or payment of rent taxes.
- Include indemnification for failure to remit taxes to the appropriate taxing authority.
- To the extent possible, separately meter utilities and structure the lease so that Tenant makes payments directly to the utility provider.
- Utilize free rent and other adjustments rather than rent credits tied to specific expenses.
- Do not record termination payments as rental income or rental expenses.
- In the event a lease is assigned, clarify responsibility for rent taxes between the assignor and assignee and incorporate appropriate indemnification provisions.

Recent Developments. Critics of the commercial rent tax contend that the tax, when combined with traditional property tax, amounts to an improper double taxation of property. Opponents also believe that these taxes have a chilling effect on economic development and ultimately result in a reduction of overall revenue. On the other hand, proponents view the commercial rent tax as a critical source of revenue in an unstable economic environment. In Florida, these concerns have led to the recent introduction of legislation that would gradually reduce, and eventually eliminate, the commercial rent tax.

Regardless of the outcome of the commercial rent tax in Florida, the heated national debates surrounding the Marketplace Fairness Act and the taxing of internet sales will likely cause local governments to reevaluate taxes on commercial rents as a source of additional revenue. Stay tuned.

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