

## Structuring the Complex Commercial Real Estate Lease - Government Incentives, Real Estate Tax Exemptions, Condominium Conversions, Financial Reporting Considerations, Intervening Leases, Tax Considerations and Unintended Consequences

By Stuart Mass<sup>1</sup>, Steven Monteforte<sup>2</sup> and Noah Shapiro<sup>3</sup>

Competition for tenants of substantial commercial real estate leases will often require the successful landlord to agree to complex lease structures, or even the re-structuring of the underlying real estate. Tenants making a substantial, long-term investment in a lease of real property will be best served by a team of professionals with expertise in the various components of an optimal structure, taking into account all relevant circumstances and the potential availability of government incentives and/or "as of right" real estate tax exemptions.

State and local government programs designed to lure tenants to designated locations, or to prevent their relocation to competing cities or states with a corresponding loss of jobs, are often dependent upon some form of relief from real estate taxes and/or sales taxes relating to the construction of leasehold improvements. This relief from taxation has sometimes required a transfer of actual or deemed ownership of all or a portion of a parcel of real property or a building to a tax-exempt development agency. In some cases, this involves the conversion of the underlying real estate to the condominium form of ownership, the transfer (for minimal consideration) of condominium units to a tax-exempt development agency, a series of leases and subleases to re-create the original landlord/tenant relationship contemplated by the parties, and a mechanism for ownership of the affected condominium units to revert back to the landlord upon the expiration of the originally contemplated lease (again, for minimal consideration). In other cases, more simple structures may be available, whereby a ground lease to a tax-exempt development agency will suffice without the need to create a condominium, or whereby the need to pass indicia of ownership to a tax-exempt development agency is not required. An alternate form of tax relief may come in the form of an abatement of a portion of the real estate taxes payable by the landlord for the entire building, with the amount of that abatement being expressly earmarked by the taxing authority for the benefit of a particular tenant that has relocated to a targeted area, expended a threshold dollar amount on leasehold improvements, and/or created a minimum number of permanent jobs. In the case of sales tax exemptions, it may be necessary for the ownership of building materials to pass to a tax-exempt development agency or quasi-governmental agency immediately upon their purchase.

Government incentives may also come in the form of direct monetary grants based, for example, on a finding by the applicable state or local agency that there is a monetary gap between the total cost of renovating and equipping a structure to meet the needs of a tenant that will relocate jobs from another state, and the aggregate amount of money that the tenant and the prospective landlord are reasonably willing to spend to accomplish that renovation in the context of market conditions and any competing offers from the tenant's home state. Additional benefits offered by government incentive programs may involve the ability of the qualifying tenant to purchase electricity at a discounted rate. A tenant considering

<sup>1</sup> Stuart Mass is a partner in the New York, NY office of the law firm of Haynes and Boone, LLP. His practice emphasizes commercial real estate leasing. He may be reached at [stuart.mass@haynesboone.com](mailto:stuart.mass@haynesboone.com) or 212.918.8977.

<sup>2</sup> Steven Monteforte is a partner in the New York, NY office of the law firm of Haynes and Boone, LLP. His practice emphasizes commercial real estate leasing. He may be reached at [steven.monteforte@haynesboone.com](mailto:steven.monteforte@haynesboone.com) or 212.918.8982.

<sup>3</sup> Noah Shapiro is a partner in the New York, NY office of the law firm of Haynes and Boone, LLP. His practice emphasizes commercial real estate leasing. He may be reached at [noah.shapiro@haynesboone.com](mailto:noah.shapiro@haynesboone.com) or 212.918.8991.

locations for a substantial lease should be aware that government incentive programs to encourage development and job creation are constantly being tweaked, supplemented and replaced. Current, expert advice on these matters can be crucial to making a well-informed and economically beneficial decision.

A lease from a prospective landlord to certain tenants organized and operated exclusively for tax-exempt purposes set forth in Section 501(c)(3) of the Internal Revenue Code (charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals) may qualify for an exemption from real estate taxes in a particular jurisdiction without the need to resort to incentive programs. A simple, short-term space lease may not, however, meet the exemption requirements of the local taxing authority. It may be necessary to demonstrate indicia of ownership in the 501(c)(3) entity, while the prospective landlord may not be interested in a full-fledged sale of its real property. In some cases, "ownership" in the 501(c)(3) entity may be established to the satisfaction of a taxing authority through a space lease for a specified minimum number of years. In other cases, recognition of "ownership" by the taxing authority may be accomplished by the conveyance of a ground lease position in the real property to the 501(c)(3) entity or, if it was not the intention of the parties to lease the entire property to the 501(c)(3) entity, the creation of a leasehold condominium and the sale of a condominium unit to the 501(c)(3) entity. In either case, the term of the ground lease or the duration of the leasehold estate of the leasehold condominium would be set to mirror the term of the space lease originally contemplated by the parties. The concept of an installment sale might be used to approximate the stream of rent anticipated under the originally contemplated lease. In any event, the parties should take whatever steps they can to confirm that the desired real estate tax exemption will be granted (which might include requesting a non-binding advisory opinion from applicable taxing authorities), failing which, they should have an agreement upon the allocation of the risk of failure.

In 2013, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) hope to conclude their project of issuing regulations to require the reporting of real estate leases with a term of more than one year on a company's balance sheet for the purpose of calculating the expenses to be reported in the company's income statement. They seem to have settled on a two-method approach in which lease expenses will be amortized on either (i) a straight-line basis over the term of the lease, in the case of a lease term for an insignificant portion of the useful life of the leased property or where the present value of the rents is insignificant in relation to the fair market value of the real property, or (ii) a front-loaded basis (including actual or imputed interest on the rent liability), in the case of a lease for a major part of the useful life of the leased property or where the fixed lease rents equal substantially all of the fair market value of the real property, thus front loading the reported expenses of a lease in its early years. Hopefully, the final standards will provide adequate guidance for determining the correct category for each particular lease. Financial reporting requirements and standards may influence a tenant's decision whether to lease or own (thereby creating potential pressure on landlords to create condominiums or leasehold condominiums), the length of term of a lease, and whether to delay the commencement date of a lease by requiring the landlord to prepare the tenant's initial leasehold improvements.

For prospective tenants interested in large blocks of contiguous floors, it may be necessary to relocate existing tenants of a building, or to negotiate the early surrender of existing leases to accommodate the prospective tenant's space requirements. In some cases, the prospective tenant may already occupy space in the building as a subtenant of an existing tenant, or may have entered into preliminary negotiations to sublease space from an existing tenant of the building. Often, the existing tenant does not have enough space or remaining length of lease term to satisfy the requirements of the prospective

tenant. This may lead to tri-party negotiations among the landlord, the existing tenant and the prospective tenant that could proceed in multiple directions.

One method of proceeding would be for the prospective tenant to enter into a sublease for the balance of the existing tenant's lease term, together with a direct lease between the landlord and the prospective tenant for the immediate leasing of additional space in the building for a longer term with renewal options, and the consolidation of the subleased space into the direct lease upon the expiration of the existing tenant's lease term. This method might be preferred where the existing tenant's rent exceeds the sublease rent the prospective tenant is willing to pay and/or in those cases where it would be hard to justify releasing the existing tenant from liability by doing a leasehold surrender. In other cases, such as where a high-credit prospective tenant willing to lease a large portion of a building insists upon a direct lease for the immediate delivery of its entire space requirement to qualify for government incentives, accepting a surrender of the existing tenant's leasehold may be the only viable solution. If the rents that would otherwise have been payable by the existing tenant to the landlord exceed the new rents that will be paid under the direct lease with the prospective tenant, the leasehold surrender agreement may require the existing tenant to make a one-time payment equal to the net present value of the shortfall over what would have been the remaining term of the existing tenant's lease.

Somewhat related to financial reporting issues are questions about the income tax considerations that may affect the structuring of complex leases. What are the respective tax ramifications on the landlord and the tenant of changing a deal that was initially structured for the delivery of unimproved space with a tenant improvement allowance and a free rent period for construction time, to the delivery of space constructed to the tenant's specifications with little or no improvement allowance or free rent? Should the tenant be permitted to convert any unused portion of the tenant improvement allowance to additional free rent? Will these answers vary if the landlord is a Real Estate Investment Trust? Will they depend upon variables that change from time to time?

In structuring a complex commercial real estate lease, decisions are often made and revised within tight time frames. Careful thought must be given to avoid unintended consequences. Take, for example, the conversion of a mature office building with multiple tenants to the condominium form of ownership to obtain a real estate tax exemption or abatement for a new tenant that is qualified under a government incentive program or as a 501(c)(3) entity. What do the other leases in the building say about the obligations of the tenants to pay real estate tax and operating expense escalations? Do the leases contain provisions addressing the right of the landlord to convert to the condominium form of ownership? Does the landlord need to enter into an agreement with the taxing authority that the building will continue to be assessed and taxed as if it were a single tax lot, and not taxed differently for each condominium unit based on variances in their assessed valuations due to differences in rents received by the landlord for different condominium units? The risk of unintended consequences reinforces the need for landlords and tenants embarking on complex leases to have in place a team of experts who are ready to respond with comprehensive advice on short notice.