Leasing Insights:

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Texas does not have a state income tax for individuals, but it does tax the profits of business entities pursuant to the franchise tax which is set out in Chapter 171 of the Texas Tax Code. The franchise tax originally applied only to corporations and limited liability companies—it did not apply to limited partnerships. Accordingly, the majority of commercial real estate in Texas was owned and leased by limited partnerships with a view towards avoiding the franchise tax. In 2006, however, the Texas legislature replaced the franchise tax with a revised business franchise tax—the so-called "margin tax"—in order to extend application of the franchise tax to limited partnerships, general partnerships, and joint ventures which have at least one partner that is not a natural person, and to accomplish various other objectives. Although it has been several years, landlords and tenants are still dealing with the implications of this revision and negotiating (or arguing over) lease language in order to determine which party is or should be ultimately responsible for the payment of the margin tax assessed against the landlord.

In particular, landlords want the margin tax to be included in the definition of operating expenses that are to be passed through to and reimbursed by their tenants; while tenants, conversely, believe that the margin tax assessed against their landlord should be excluded from operating expenses. Both parties manage to see aspects of the margin tax which support their respective views.

That being said, one of two situations will typically exist with respect to margin taxes in the context of commercial leases: (1) Leases that were entered into prior to the enactment of said legislation typically don't specifically address the margin tax, and although the landlord will frequently attempt to amend the lease to address said issue in their favor, an argument will likely be had between landlord and tenant as to whether or not the margin tax can be passed through to tenant under the existing terms of the lease; and (2) Landlords and tenants entering into new leases typically tend to (and no doubt should) specifically address the margin tax and how it will be treated in the written lease agreement, often beginning as early as the letter of intent stage. Some of the more common arguments and positions asserted by landlords and tenants when discussing the margin tax are set forth below. However, notwithstanding the multitude of potential arguments and positions, in the context of new leases (at least more so than in the context of interpreting existing leases) the reality is that the pass through of the margin tax assessed against the landlord is ultimately a business decision, not a legal issue, and (as with other business decisions) the result typically turns on the negotiating strength of the respective parties.

Common arguments from the landlord's perspective:

- The margin tax was enacted in conjunction with a reduction in certain *ad valorem* taxes, and is therefore a substitute for *ad valorem* taxes which are typically passed through to tenants. This argument is particularly persuasive when the lease specifically and expressly provides that taxes imposed in lieu of property/*ad valorem* taxes or in replacement or substitution of property/*ad valorem* taxes are includable in operating expenses to be passed through to the tenant.
- The margin tax is essentially a tax on rents, which are typically included in operating expenses and/or taxes passed through to tenants. This argument is supported by the idea that the margin tax is arguably just another expense payable by the landlord, in that this particular tax arises solely as a result of the leasing and operation of the property, and is thus like any other expense incurred in connection therewith.
- If the landlord's tax liability can change year-to-year based on a change in operating expenses or insurance costs, a net lease that does not allow the landlord to pass through margin taxes begins to look less like a dependable stream of income and more like a gross lease.
- The legislation enacting the margin tax specifically provided that the tax imposed by Chapter 171 of the Texas Tax Code, as amended by the act "is not an income tax . . ."

Common arguments from the tenant's perspective:

- The margin tax is essentially an income tax, not an operating expense. This argument is arguably stronger if the lease specifically and expressly excludes from operating expenses and/or taxes which are passed through to the tenant items such as "income taxes" or "franchise taxes."
- The margin tax is the same as the "franchise tax" which is commonly excluded from operating expenses.

Often times landlords and tenants will negotiate on the issue and will come up with some compromise whereby neither landlord nor tenant bears the burden of the entire margin tax. Some of the more common compromises are set forth in general terms below:

- Rather than passing though the entire margin tax assessed against the landlord to the tenants, the tenants pay their proportionate share of only the portion of the margin tax that represents an actual reduction in applicable school district maintenance and operations taxes (i.e., the amount equal to (a) the amount that such school district maintenance and operations tax expenses would have been if calculated based upon the applicable school district maintenance and operations tax rates for 2006, minus (b) the actual amount of school district maintenance and operations tax expenses that are assessed for such lease year).
- Rather than passing though the entire margin tax assessed against the landlord to the tenants, the tenants pay a stipulated sum based on current tax rates and typically determined by applying said tax rates to a portion of the base and any additional rent to be paid by the tenants pursuant to the terms of the lease.
- Rather than passing though the entire margin tax assessed against the landlord to the tenants, the tenants pay a stipulated percentage of the margin tax assessed against the landlord.
- The tenant will require that any portion of the margin tax attributable to the landlord's sale or other conveyance of the property be excluded from the operating expenses and/or taxes passed through to the tenant.

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