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ASSET MANAGEMENT, INC.

# Capital - Can I Pass It Through?

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## UNRAVELING THE MYSTERIES OF THE ESCALATABILITY OF CAPITAL EXPENDITURES

What are capital expenditures, and how do they affect a commercial real estate property owner's financial reporting (e.g., to the state and to the IRS for income tax purposes) versus can they be passed on/through to their property's tenants (e.g., via "Operating Expense Escalations")? Are they the same thing, and are they handled the same way in both situations? This article explores the proper treatment of "Capital" as a potential cost to be possibly reimbursed by commercial real estate tenants to their landlords.

**Background**

One of the most frequent areas of disagreement between commercial real estate tenants and their landlords is the escalation of capital expenditures versus normal operating expenses. For a property's, or a company's, own internal, state, and federal reporting, under Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS") there are clear standards that every business owner, accountant, and asset manager and/or property owner must follow for properly identifying/recognizing and then recording their fixed assets (a.k.a. "capital expenditures") for tax accounting purposes, with such fixed assets accounted for on the entity's balance sheets. Although such entities may at times also establish a "threshold" for their internal and external recording and reporting (e.g., "any item under $50,000 will be 'expensed', while any item over that threshold will be 'capitalized'"), no such "threshold" actually exists in the GAAP and IFRS standards.

For "Operating Expense Escalations" relating to a property's commercial real estate tenant leases, however, there are yet other, and somewhat different, standards that must be adhered to (but many times are not) by property owners, not only because of reasons relating to an established contractual agreement, but also because of fairness. First, in the context of "Operating Expense Escalations", "capital" is not a loose term that one can define any which way one wants (e.g., labeling it as an "expense" to match what was done in the company's internal reporting even though accounting standards would clearly classify it as a "capital expenditure"). There is a reason that the accounting profession has two different terms called "expenses" and "capital" – it's because they are in fact different and not one in the same. "Operating Expenses" means "expenses", and "Capital" means "capital" – so it is one's duty to treat them as such when computing "Operating Expense Escalations", which affect other, entirely different and unrelated, parties – the property's tenants. Second, there is no leeway granted by a tenant lease in "re-classifying" "capital expenditures" to "expenses" via some you-can-decide-what-you-want-it-to-be dollar threshold because there are simply no thresholds allowed in Operating Expense Escalations unless specifically identified and agreed to by both parties in the particular tenant lease. Third, because a "capital expenditure" is by definition not an "expense", no "capital" can be escalated under the banner of "Operating Expenses", unless of course the lease specifically identifies and allows certain capital expenditures to be escalated – all of the others, however, *must* be excluded from escalation. Basically, commercial property owners and management companies must learn to recognize that fixed assets / capital expenditures are in fact to be treated differently pursuant to the terms of a tenant lease agreement than they are treated for their own company's/property's tax accounting purposes – i.e., the treatment an entity chooses to employ in a company's internal financial reporting has no bearing on how that same expenditure should be treated in the computation of Operating Expense Escalations, and visa versa. Simply because a property owner has chosen to treat a particular expenditure a certain way for its internal, or state and/or federal tax reporting purposes, doesn't mean they can treat it the same way for the Operating Expense Escalations process for their tenant leases.

**Shouldn't Tenants Pay Their Share of Capital Expenditures**

So why all the fuss? The tenants are leasing, and using, space in a landlord's building and have agreed to pay rent and their share of the building's "expenses", right? So why shouldn't they pay their share of these additional, and usually needed, building-related "expenditures" that will most likely benefit them too? Well, first it's a matter of what the definition of an "expense" is both per GAAP and per the specifically negotiated language in the tenant lease (a written contract), and second it's because both sides have separate and competing financial objectives. The following might help to better put all of this in perspective:

- ☐ **Tenant Perspective** – "The Base Rent that we pay was calculated to account for our use of the building and its systems, along with a depreciation of the property owner's investment, plus profit. When the investment's various assets/components are fully depreciated, the owner will be able to replace those items with the money they've already collected in rents from us and the other tenants. Having us pay these costs again as escalated Operating Expenses amounts to duplicate payments, so how is this "fair" and why should we agree to or be forced into paying this? In addition, fixed assets are the property owner's cost of doing business as a business entity, and we're not an owner of the business entity. After all, such improvements or replacements increase the value and marketability of the building, and enhance the value of the property owner's asset – a benefit that is not passed on to or shared with us – so why should we participate in the additional cost?"

- ☐ **Ownership Perspective** – "First, some of these capital expenditures result in cost savings, and the tenants will therefore be financially benefiting along with us as a result of reduced Operating Expense Escalations; so why shouldn't they share in such costs? It's only fair! Second, other expenditures are mandatory – required by law – and as such we have no control of them. We alone shouldn't be penalized when they (the tenants) get to have full use of our property; we should both share in such items. Third, when the market declines and monthly rental rates are lowered to a point close to the cost of doing business, there is no extra revenue built into the Base Rent for us to cover extraordinary expenditures needed to keep the property in a first-class condition; so, for fairness, the tenants, who also want to continue to use and work in a first-class facility, should share in such expenditures."

The two perspectives given above demonstrate viewpoints that are important to consider when *drafting* a lease clause. For the purposes of this discussion however – i.e., for the *administration* of an *existing* tenant lease's Operating Expense Escalation clauses – these perspectives become somewhat irrelevant (although they remain informative) because they have already been taken into account during long-ago lease negotiations that established just how "capital expenditures" are to be treated in the subject lease. Typically, such resulting negotiated clauses would contain something along the lines of:

- ☐ **Sample Lease Clause** – *"Operating Expenses shall not include … capital expenditures, as determined pursuant to generally accepted accounting principles, consistently applied, made in connection with the Building or Property or any equipment therein or thereon, except for those (i) required to comply with laws enacted after the date of this Lease, and (ii) made for the purpose of reducing Operating Expenses, to the extent of the savings realized; all amortized on a straight line basis over the useful life of the asset, with interest accruing on the unamortized portion equal to Landlord's then-applicable borrowing rate."*

The above example not only clearly identifies what constitutes an allowable/escalatable "capital expenditure" (i.e., nothing except that which meets criteria (i) or (ii) above), but it also indicates how the escalation of such allowable "capital expenditures" is to be computed (i.e., in this case, they are to be amortized). In the absence of such language, however, both the tenant and landlord may have legitimate concerns regarding whether the escalation of "capital expenditures" is allowable, but usually clues in the lease may still exist – for example, if the lease language indicates that escalatable "Operating Expenses" include costs incurred for the "operation, repair, and maintenance of the building", but doesn't use such words as "restoration" or "replacement", or if it mentions that escalatable expenses shall conform to GAAP, then "capital expenditures" are to be excluded. Furthermore, in the total absence of any direction whatsoever, the best and most fair and honest approach would be to either (a) imagine yourself on the other side and in the place of a tenant who personally owns his firm and is paying the bills, and then determine if you still think that the escalation of the expenditure to yourself is fair and per the intent of the lease, or (b) simply use your best judgment as if you were sitting across the table from your tenants and having to clearly and convincingly explain to them why they should share in paying for any such extraordinary expenditures. If either causes you to hesitate, then you have your answer – they shouldn't share in such expenditures. In general, nevertheless, a good rule of thumb is to simply follow GAAP (as is the industry standard practice for all business entities anyway, but “as written” and not as “re-interpreted”).

**Is it “Capital”?**

Which expenditures are considered to be “capital” then? While every project, and every lease, is different, unless otherwise specifically directed in the lease one should always apply the industry standard methodology in making the determination – that is, simply apply the rules of GAAP as written (not as “re-interpreted” to be in one side’s favor), but as supplemented by the specific terms of the tenant’s lease. Note first that GAAP requires that if at least one of the following criteria is met, then the expenditure must be classified as “capital”:

- ☐ The cost provides a benefit for a period of more than one year.

- ☐ The cost increases the item’s useful or productive life and/or capacity.

- ☐ The cost represents an extraordinary, non-recurring expenditure.

If the expenditure for some reason doesn’t clearly fall under any of those criteria, one then needs to apply the following further tests in order to determine how it is to be properly categorized (i.e., either as an “expense” or “capitalized”):

- ☐ All expenditures involved in acquiring an item as well as those incurred prior to using the item for its intended purpose (e.g., installing, testing, and commissioning the item) are to be capitalized. Costs incurred subsequently, however, for repairs, maintenance, betterments, or alterations are to be either expensed or capitalized depending on the type and purpose of such work.

- ☐ *Ordinary* expenditures for normal repairs and maintenance that are “**recurring and relatively small**” and relate to the routine or continual preservation of an item to keep it working properly without changing, replacing, or otherwise improving it, and without adding to its value or substantially prolonging its useful life, are considered by GAAP to be “expenses”. These are the typical, ongoing type of expenses a building would incur each year to ensure an item continues to work as intended, with regular check-ups/inspections, and with normal repairs if required.

- ☐ *Extraordinary* expenditures for repairs and maintenance that are infrequent or non-recurring and a “*relatively large expenditure*” are not considered by GAAP to be “expenses”, but are to be treated instead as “capital expenditures”. These also include any expenditure that increases the value, utility, or longevity of the item.

- ☐ Replacements” of items or major parts are also to be treated as “capital expenditures” inasmuch as the new item’s/part’s life extends what would have been the potential life of the already aged and now failed item/part. Also, keep in mind that while some “repairs” can involve the replacement of some of its parts, certain “repairs” can also be made without actual replacements. Such “non-replacement repair expenditures”, however, should still be treated as “capital” if it can be demonstrated that the life of the repaired item has been extended beyond its original useful life.

- ☐ “Additions” to any existing item that enlarges, expands, or simply “adds to” the item are also to be treated as a “capital expenditure”.

Fortunately, GAAP, on page 333 of the Wiley GAAP 2000 edition, has provided the following quite useful table that very clearly summarizes the above. Preparers of “Operating Expense Escalations” should refer constantly to it for guidance.

**Costs Subsequent to Acquisition of Property, Plant, and Equipment**

| | | Normal accounting treatment | | | |
|---|---|---|---|---|---|
| | | Expense when incurred | Capitalize: Charge to asset | Capitalize: Charge to accum. deprec. | Other |
| *Type of expenditure* | *Characteristics* | | | | |
| 1. Additions | • Extensions, enlargements, or expansions made to an existing asset | | x | | |
| 2. Repairs and maintenance | | | | | |
| a. Ordinary | • Recurring, relatively small expenditures<br>1. Maintain normal operating condition<br>2. Do not add materially to use value<br>3. Do not extend useful life | x<br>x<br>x | | | |
| b. Extraordinary (major) | • Not recurring, relatively large expenditures | | | | |
| | 1. Primarily increase the use value | | x | | |
| | 2. Primarily extend the useful life | | | x | |
| 3. Replacements and betterments | • Major component of asset is removed and replaced with the same type of component with comparable performance capabilities (replacement) or a different type of component having superior performance capabilities (betterment) | | | | |
| a. Book value of old component is known | | | | | • Remove old asset cost and accum. deprec.<br>• Recognize any loss (or gain) on old asset<br>• Charge asset for replacement component |
| b. Book value of old component is not known | 1. Primarily increase the use value | | x | | |
| | 2. Primarily extend the useful life | | | x | |
| 4. Reinstallations and rearrangements | • Provide greater efficiency in production or reduce production costs | | | | |
| | 1. Material costs incurred; benefits extend into future accounting periods | | x | | |
| | 2. No measurable future benefit | x | | | |

Fixed Assets

**<u>So it's "Capital", but can it be passed through?</u>**

The quick answer – only if the lease specifically permits it, and then only in the manner the lease specifically allows! As mentioned earlier, most commercial real estate tenant leases preclude *any* capital expenditures from being passed through to tenants except for certain exceptions as mentioned above such as capital expenditures that: (i) result in a reduction or savings in Operating Expenses; or (ii) are required by laws enacted subsequent to the lease commencement date.

- ☐ <u>Reduction or savings in Operating Expenses:</u>
  The reason that this type of capital expenditure is generally agreed by both parties to be escalatable / passed through to the tenant (typically at an amortized level) is that it's not fair for the property owner alone to foot the cost of something that benefits their tenants as much as or more than themselves. By adding the amortized cost into the escalatable Operating Expenses, both parties share fairly in the cost as well as in the "savings" that result directly from the cost. Interestingly, for the tenants the combination of the reduction/savings and amortized cost add-backs, of course, basically result in a "push" – i.e., there is essentially no "net" change reflected in the Operating Expense Escalations because the amortized cost add-back generally offsets the reduction/savings. The property owner, however, gets (i) a good portion of the expenditure paid back to them over time, plus interest, by/from the percentage of the property that is leased/occupied, (ii) receives "savings" for the portion of expenses that it solely absorbs (i.e., for the vacant portion of the property), and (iii) receives an "enhanced value" of their overall property which appraisals/valuations would compute because the actual reduction in Operating Expenses.

- ☐ <u>Required by laws enacted subsequent to the lease commencement date:</u>
  The reason that this type of capital expenditure is generally agreed by both parties to be escalated / passed through to the tenant (again typically at an amortized level) is that it's also not necessarily fair for the property owner to foot the entire bill by itself for something that neither they nor the tenant(s) have any control over. Although the landlord owns the property and is in fact solely responsible for the asset and its compliance with all laws, the tenant has been granted rights of use and enjoyment by the landlord, all of which benefit the tenant who should therefore share in certain unexpected costs that suddenly arise and affect both parties after the lease commences and that are thrust upon the facility both are using.

- ☐ If the tenant's lease permits the escalation of capital expenditures required by law but is silent with regard to the starting point of such expenditures, there may be nothing that prevents the landlord from escalating expenditures incurred after the lease commenced to correct legal or code issues that were subject to laws put in place prior to the tenant's lease commencement date, unless of course the landlord has exhibited negligence, willful deceit, or violated a specific law by not earlier performing such work.

The basic reason that all other capital expenditures are excluded from escalations and therefore from being "shared" with tenants is also one based on established contractual agreements (i.e., the tenant leases) as well as fairness. Capital expenditures are considered by GAAP and the accounting industry to be Fixed Assets, which are part of the hard asset and the value of the overall asset / property / plant / equipment. Hence when capital expenditures (i.e., "Capital Improvements", "Capital Replacements", "Capital Repairs", "Capital Additions", "Capital Betterments", "Capital Reinstallations / Rearrangements", etc.) are made/added to the property/asset, the Fixed Assets of the investment, and therefore its value, are increased and the property owner benefits (e.g., via an increased value of their property, taxable depreciation, etc.). Because only the property owner "owns" the property (and not the tenants) and is the only one who shares in the benefits of property ownership (e.g., the value increases, additional profits upon sale, ability to take money out of the asset, depreciation, tax deductions, collections of rental income, etc.), only they should share in a cost that results in an increase to their asset's/investment's value – stated another way, since tenants do not share in the benefits of ownership, they shouldn't be made to share in the expenditures made specifically to achieve those benefits. On the other hand, while tenants, as users of the property/asset, shouldn't have to share in the purchase/upgrades ("capital expenditures") of the asset they are only renting, they should share to some degree in the ongoing normal maintenance costs ("expenses") of the property/asset since they are enjoying many benefits of the property/asset by using it and are in fact at least a partial cause of most of the ongoing normal maintenance that is needed for the property/asset.

**So it's "Capital" and it can be passed through, now what?**

Now the tenants' lease provisions that state how much and how such allowable amounts are to be included in the tenants' Operating Expense Escalation computations must be followed. Usually, it's only in one of two ways – the allowable amounts are either escalated / passed through in the same year that the expenditure was incurred (rare), or amortized over the expenditure's useful life (industry standard). If a lease does allow a capital expenditure to be passed through in the same year as incurred, there may, however, also be a limiting threshold dollar amount (e.g., "up to $15,000 may be 'expensed', while anything exceeding this amount must be amortized over its useful life"). If the lease, however, calls for the capital expenditure to be amortized, it needs to be computed over the correct time period. Some leases call for capital expenditures to be amortized over their "useful life", while others call for them to be amortized over specified periods (e.g., "the greater of their useful life or ten years"; or "over 144 months" as is the preferred period in most AIREA leases). While "useful life" might be argumentative, either accepted accounting standards and known equipment life spans should be used instead of some other shorter periods that might be considered more favorable to the landlord.

**Conclusion**

Distinguishing between a *capital expenditure* and an *expense* is not always easy, and interpreting and adhering to the terms of a lease agreement can be confusing and quite complicated, especially if the manager or CPA is not familiar with the lease language. So just what must be done when preparing the Operating Expense Escalations for a building's tenants? The standard procedure should be to always read the lease agreements carefully and follow exactly what they each say/mandate – which is not necessarily what the entity might do for the same expenditure for its own tax reporting purposes!

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Mickey McClune is the President, Broker, and the Managing Principal of MKC Asset Management, Inc., a Long Beach-based commercial real estate property management firm. As President, Broker, and Managing Principal, Mickey is esponsible for all activities of the firm, including new business acquisition, oversight of all property management activities, and the performance of all of the firm's commercial real estate consulting services. He is an experienced commercial real estate property management, asset management, and leasing specialist with an extensive institutional owner and corporate user background.

Mickey began his career in commercial real estate in the early 1980's with the preeminent national real estate firm, LaSalle Partners (now Jones Lang LaSalle), as its General Manager for all of the office and industrial properties that it had acquired in the Los Angeles and Ventura County areas, and as its Asset Manager for various client portfolios in the Western U.S. While at LaSalle, he was recognized for numerous accomplishments both by the company and the commercial real estate industry. In 1993, he left LaSalle to form his own property management company, New America Asset Management Services, where he was the President and the senior partner of this Long Beach-based commercial real estate property management firm. In late 1997, LaSalle acquired NAAMS and its two million square foot management portfolio, and Mickey then served as LaSalle's Regional Vice President for the Southwestern U.S. In 1999, he joined EPS Solutions, a national corporate services consulting firm, as a Director of Real Estate Services. While at EPS Solutions he assisted property owners with their property acquisition due diligences, their properties' annual Operating Expense Escalations, and with the abstracting of their tenant leases, and he assisted tenants by performing over 50 CAM/OE Escalation Audits for them of their landlords' billed rent charges. In 2001, he again formed another commercial real estate property management firm, MKC Management Services, where he served as CEO and senior partner. Soon thereafter, MKC merged with New York City based Newmark & Company Real Estate and became its California-based Asset Management Group. In mid-2003, Mickey was instrumental in merging Newmark & Company's California-based Asset Management Group's operations into a new start-up entity that then became known as RiverRock Real Estate Group. At RiverRock, Mickey was its Senior Managing Director, where he established all of the firm's property management systems, oversaw selected property management teams, and was responsible for all of the firm's consulting business. In early 2006, Mickey left RiverRock to start MKC Asset Management.

Over the course of his 25+ year career in commercial real estate property management, Mickey has personally managed and leased well over 18 million square feet of commercial office, industrial, and retail space, abstracted over 5,000 leases, performed over 400 annual CAM/OE Escalations for landlords' buildings, saved clients well over $4 million in cash savings, received four (4) "Management Excellence Awards" from LaSalle Partners, was a LaSalle Partners' "Manager of the Year", and was awarded by BOMA of Greater Los Angeles four (4) "Building of the Year Awards" (in "100,000-250,000 SF" and "Over 500,000 SF" categories) and two (2) "Special Achievement Awards" including one for "Overall Design Improvement".

Prior to entering the real estate industry, Mickey was commissioned as an officer in the United States Air Force and spent 11 years in the USAF and private industry with Hughes Aircraft Company specializing in the business management of major aerospace industry programs.

Mickey has a California Real Estate Broker License, and is RPA and FMA certified by the Building Owners and Managers Institute. He is a past Chairman of the Board and past member of the Executive Committee and Board of Directors of BOMA of Greater Los Angeles, has served on BOMA Orange County's and BOMA California's Executive Committees and Boards of Directors, and on BOMA International's Board of Governors and Strategic Planning Task Force. Mickey graduated from the University of Southern California with a Bachelor of Science degree in Civil Engineering and a Master of Business Administration (MBA) degree.