Lowndes

“Grossing-Up” Operating Expenses in Commercial Leases

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In triple net office leases, tenants are required to reimburse landlords for a portion of the building’s overall operating expenses. These expenses cover the costs of operating and maintaining a commercial property. Operating expenses are particularly important in multi-tenant buildings where each tenant pays a proportionate share based on the size of their lease relative to the total square footage of the building.

Fixed operating expenses, such as property taxes and insurance, remain the same regardless of occupancy. On the other hand, variable operating expenses, like janitorial services, utilities, and landscaping, vary directly in proportion to the number of tenants using them.

To deal with operating expenses when a building is not at full occupancy, a landlord can incorporate a “gross-up” provision in the lease. This allows the landlord to estimate the variable operating expenses as if the building were at 95%-100% occupancy. Instead of charging tenants their pro-rata share based on the current, low occupancy, landlords can charge them based on the operating costs at 95%-100% occupancy.

By “grossing up” the variable operating costs and charging tenants their pro-rata share of an estimated full occupancy operating expense, landlords are able to cover the actual costs to operate the property even without full occupancy.

For example:

> The landlord owns a 10-story office building, with each floor covering 10,000 square feet, resulting in a total area of 100,000 square feet. Currently, there are five different tenants, each occupying one floor, which means each tenant’s proportionate share of operating expenses is 1/10 of the building, or 10%. The total annual operating expenses for the building with those five tenants amounts to $100,000, with $75,000 for fixed expenses and $25,000 for variable operating expenses.

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Without Gross-Up Provision**:**

Each tenant would pay its pro-rata share of the total operating expenses, which is $10,000 ($7,500 for fixed expenses and $2,500 for variable operating expenses). However, not having a gross-up provision poses an issue. The landlord would only receive $12,500 for the variable operating expenses ($2,500 from each of the five tenants), which is only half of the total variable operating expenses of $25,000 that the landlord actually incurred with five tenants occupying the building. This leaves landlord with a $12,500 shortfall to cover out of pocket.

With Gross-Up Provision:

The landlord could estimate the variable operating costs at full occupancy. At 50% occupancy, the variable operating costs are $25,000, so at 100% occupancy, the landlord can estimate the variable operating costs would total $50,000. With variable operating expenses at $50,000, and fixed operating costs still at $75,000, each tenant will pay $12,500 ($7,500 for fixed expenses and $5,000 for variable expenses). At this “gross-up” rate, the landlord is paid the full $25,000 of variable operating expenses ($5,000 from each of the five tenants).

Gross-up provisions are meant to protect both landlords and tenants of commercial triple net leases. For landlords, these provisions are beneficial because they help landlords control their income stream by ensuring tenants cover the actual operating costs even during periods of low occupancy. Gross-up provisions guarantee tenants will pay the actual amount incurred to operate their space within the building. Additionally, these provisions help landlords cover the fixed operating expenses landlords when the building is not at full occupancy.

Tenants benefit from gross-up provisions because they provide a predictable budget. If a lease lacks a gross-up provision, operating expenses could fluctuate each year based on occupancy changes, making it difficult for tenants to predict their annual real estate expenses. Tenants also benefit if the operating expenses are based on a base year since a gross-up provision can protect them from a big and sudden increase in their share of operating expenses.

For example, if a tenant moves into a new building with low occupancy and uses a lease with no gross-up provision and a base year for operating expenses, the base year expenses would be low due to the building’s low occupancy. But, when the new building becomes fully occupied, the tenant’s pro-rata share of operating expenses will jump significantly higher because of the increase in variable operating expenses for a full-occupancy building. In contrast, a gross-up provision would protect the tenant from such a big spike in expenses because it would keep the tenant paying variable operating expenses based on the previously grossed-up base year.

When dealing with a lease that has a gross-up provision, two terms within the gross-up provision can be negotiated. First, landlords and tenants may negotiate at what occupancy the gross-up provision can be enforced. Typically, this provision kicks in when the average occupancy for the year falls below a certain percentage, like 95% or 100%. Second, landlords and tenants may negotiate what occupancy rate the expenses can be grossed up to, which typically ranges from 95% to 100%.

If you are entering into a commercial triple net lease, pay close attention to the gross-up provision concerning the payment of variable operating expenses. Remember that this provision is there to protect both landlords and tenants from unpredictable expenses.