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Margin Taxes and Leases: Who Should Pay?

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What Is The Margin Tax?

In May 2006, the Texas Legislature significantly changed the Texas Franchise Tax. Prior to the change, the tax was largely optional for most landlords, as it did not apply to limited partnerships and most landlords chose that form of ownership. But in 2006, Texas was struggling with equitable funding for local school districts and the Legislature did two things to generate tax income. First, it broadened the state's tax base by expanding the franchise tax to cover virtually all types of entities that enjoyed some form of liability protection, including limited partnerships. Second, the Legislature changed the formula for the tax from one based solely on the income of the entity paying it, to one based on gross receipts, or margin, allowing for certain deductions. As a result, some entities could owe tax even if they did not earn any income. At the same time these two changes to the franchise tax were made, Texas mandated a reduction in local school property taxes so that more school funding would come from the state. For many real property leases in Texas which provided that tenant would be responsible for taxes on the leased property, the changes created considerable uncertainty.

Who Should Pay The Margin Tax?

Many commercial real property leases provide for the tenant to pay certain property expenses including property, or ad valorem, taxes. Landlords have argued that the new margin tax was a replacement for local property taxes and should also be passed on to their tenants. Existing leases do not clearly allow that result, and many tenants have pushed back at landlord attempts to incorporate a margin tax pass-through in new or renewal leases because tenants historically did not pay landlord franchise taxes or income taxes. Tenants argue that margin taxes are clearly franchise taxes, not property taxes, and are treated as income taxes for accounting purposes because they are based on revenue and not on the value of the underlying property.

As in most landlord/tenant lease issues, margin taxes are a negotiated provision of the lease, and while there is no right answer the margin tax issue should be clearly addressed in the lease. Tenants will not be responsible for the landlord's margin taxes absent a provision in the lease providing for the pass-through of taxes, so if the landlord intends for the tenant to pay the tax it must add such a provision. Some landlords have specifically added language to their form leases explicitly allowing the landlord to pass-through margin taxes to tenants. Other landlords have tried to disguise the pass-through by providing that the landlord can pass through ad valorem taxes and taxes that replace ad valorem taxes. I do not recommend the latter approach as many arguments can be made that margin taxes are not a replacement for ad valorem taxes. Because the margin tax is now a known cost, the best practice, and the one least likely to result in a later dispute, is to explicitly allocate it between the landlord and the tenant just like any other cost addressed in the lease.

What Other Issues Apply?

If the landlord and tenant do agree to pass through the margin tax to the tenant there are several issues to consider when drafting the lease provision, especially from the tenant's perspective. First of all, the margin tax is a unitary tax applying to all similar businesses in the same ownership group as landlord. If the property contains multiple units, or the landlord owns multiple properties, the landlord may have to allocate exemptions and expenses in calculating the tax applicable to tenant. One approach may be for the lease to provide that the margin tax be calculated as though the leased property is the only property owned by landlord. Second, if the landlord were to sell the property during the term of the lease the proceeds from the sale of the property could be included in the calculation of margin tax for landlord. A tenant would expect these gross receipts to be excluded from the margin tax passed through to it. Third, the Texas legislature could amend or terminate the law mandating a reduction in local school taxes, thereby increasing those taxes to what they were before the 2006 changes. The tenant may want to provide for a limit on passing through the margin tax if ad valorem taxes are raised past a certain level. Fourth, margin taxes are deductible by the landlord and the tenant may want to take the benefit of such deduction into account when determining the pass-through. Clearly, drafting and administering a margin tax pass-through to a tenant is complex.

Is There A Standard Approach?

Even though the margin tax has been with us for a number of years, the above issues linger in negotiations between landlords and tenants and there is not yet a commercial standard for addressing them. Knowledgeable landlords and tenants, however, can negotiate lease provisions that specifically address the above issues and result in what the parties believe to be a fair allocation of landlord's costs. In any lease where some taxes are to be passed through to the tenant, landlord and tenant should carefully consider relevant issues and clearly draft the lease to resolve those issues.