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Tips on Reviewing Your Annual Expense and Tax Reconciliation

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For tenants with net leases, the annual expense reconciliation bill from your landlord will arrive soon. While sometimes tenants receive a credit, often they receive an invoice to pay. In either case, your company should carefully review the expenses passed on to you by your landlord for the prior year. This is especially important given the impacts of Covid-19, which caused much lower actual occupancy for most building types.

Expense audit clauses contain specialized lease language. Many leases require that your company hire a CPA if you wish to conduct an official audit of the landlord's books and records. Other leases don't grant a tenant's right to audit, so your landlord might not share any operating expense details with you. Most landlords will provide some detail to tenants which you can then compare against your prior year expenses. Real estate tax costs can be found online since they are public record, so you can confirm your tax costs without input from your landlord.

If you do an official audit, you or your CPA will check for errors or overcharges, and for things that shouldn't have been charged as an operating expense at all. Keep in mind that most leases contain language about what can or cannot be charged to tenants as a building operating expense, so this should be clear cut. However, there are some leases that are vague about what can be charged. Landlords tend to structure leases to their advantage so that they can pass through as many expenses as possible to the building's tenants.

Many office and industrial buildings today are adding building amenities such as fitness centers, training rooms, food service, conference rooms, lounges, bike storage, etc. How did your landlord pay to create these amenity spaces and packages? How did they pay for the tables, chairs, or equipment in these areas? These are questions that a tenant can ask their property manager without conducting a full-scale audit and then compare what they say against what is written in their lease.

Another related area of concern surrounding these new amenity spaces pertains to the ongoing cost for these spaces. In most buildings, the space used to create the new fitness center or training room was formerly occupied by a tenant paying rent, CAM, and taxes. Is the landlord absorbing the cost of the CAM and taxes for these amenity spaces, or is the landlord adding these costs to the rest of the building expenses for the remaining tenants to pay? These are questions worth asking.

Other expense items that tenants should review pertain to how the landlord is charging for the management fees along with any building staff dedicated to the property. In some buildings, there is a percentage fee charged as a management fee. In other situations, especially larger properties, there is a management fee plus the cost of onsite employees that manage the building. Is the landlord charging these costs correctly and in compliance with your lease? Is your landlord charging any costs for employees that don't work on your building or that are executives of the management company? Ask these questions.

As you review your operating expenses and tax pass-throughs, don't just look at the total amount. It's important to compare segments of expenses and taxes against each other year-to-year. By doing this, you will recognize significant changes in certain expense categories year-to-year. Then you can inquire accordingly about what changed or why things changed.

With the pandemic, it is important to compare your 2020 total actual expenses versus 2019. Occupancy sensitive expenses such as utilities, janitorial services, and trash removal should be far less. That said, many buildings have implemented additional cleaning procedures that will ultimately increase a tenant's janitorial cost. Also review any gross up calculations if your building lost tenants during the 2020 calendar year.

One final word of advice: review your annual expense and tax reconciliation even if you are receiving a credit. Just because the total amount of building expenses was less than what you were charged does not mean that everything you were charged was consistent with the terms of your lease. Operating expenses and tax costs can be a significant part of your total occupancy cost, so it is worth reviewing your reconciliation every year. If you contact your property manager each year and inquire about expenses and the budget, they will be less likely to charge expenses that are not allowed in your lease because they know you are watching.