

Tax and Rent Prorations

Buyers and sellers often think of tax and rent prorations as insignificant boilerplate. But: as the numbers in a deal get bigger, so does the money that gets affected by proration clauses. Proration clauses in larger deals can result in swings of tens of thousands of dollars. That's a lot of dinners, even at [Ruth's Chris Steak House](#).

Here are some issues to consider in prorating taxes and rents.

1. **Property taxes.** Will use of a standard proration clause (for example, one based on last year's taxes, or one based on latest mill rate multiplied by the latest assessment) produce an abnormal result? In a year where property taxes dropped, we once saw a "latest mill rate times latest assessment" clause generate a \$15,000 windfall for the buyer. This was for a deal where the purchase price was in the low millions.

2. **Special assessments and other governmental charges.** In Wisconsin, the seller is generally charged for all special assessments that have been levied, assessed or for work commenced prior to the date of the purchase agreement. But there are now many other types of governmental charges other than real estate taxes and special assessments: utility connection fees, deferred assessments for sewage treatment plants, impact fees, park fees payable upon the issuance of building permits, tax penalties that result when agricultural property is converted to another use, and so forth. The well-drafted purchase agreement should address these charges so that the deal does not fall apart at closing.

3. **Rents.** Prorating current base rents is easy. But consider how to deal with the following:

1. **Delinquent rents.** The seller loses its ability to collect delinquent rents once the property is sold, because the seller sells the right to evict when it sells the property. If the tenant pays its post-closing rents on time, the buyer has no incentive to collect the delinquent rents. And yet, if the seller tries to have the post-closing rents applied first to delinquent rents, the buyer will rightfully say, "it's not my problem. I'm not the one who let the tenant get so far behind. Plus, when I agreed to buy your property, I didn't sign on to be your collection agent."

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2. Percentage rents. If a retail tenant pays a percentage of gross sales over a specified amount of base sales, and the closing takes place before the base sales for that calendar year have been reached, should the seller be credited for a portion of the percentage rents to be collected over the remainder of the calendar year? For example, suppose that the percentage rent is 1% in excess of base sales of \$1,000,000 for each calendar year. The closing takes place July 1. At that point there have only been \$990,000 in gross sales. Yet, it is likely there will be major percentage rents paid over the balance of the calendar year. If the purchase agreement simply lets the chips fall where they may as of the closing date, the buyer will receive a windfall.
3. Pass-through clauses for taxes and operating expenses. If tenants pay, in advance, estimated charges for taxes and operating expenses, what happens if the actual charges at year-end are less than the estimate? The tenants are entitled to a refund of the overpayments. Does the proration clause create a mechanism to make sure that seller is charged for refunds made to tenants attributable to the period preceding closing?

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