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Ground leases 101: Creativity is required – by Daniel Shirazi

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Daniel Shirazi

In today's real estate market, creativity is required for a deal to make sense for all parties involved. One example of this creativity is to ground lease a property instead of the conventional sale. Although ground leases are not a new concept, many people are not familiar with it and therefore do not take advantage of the opportunities it presents. In the simplest form, a ground lease is a long-term net lease (usually 49 years or 99 years) of land including any improvements on the said land. Assets that can be subject to a ground lease include but are not limited to, vacant land, office buildings, and large residential buildings.

Advantages for Owners/Ground Lessor:

1.The owner retains ownership to the property and therefore:

- is not responsible for any capital gains or transfer tax payments they would incur if they were to sell (although there are instances where transfer taxes might be incurred);
- keep the property in the family and thus will generate hassle-free income stream for generations;
- they can mortgage the leased property; and can sell the property.

2.The ground lessee (the tenant) under the ground lease would be responsible for all the management, costs, and expenses of the leased property.

3.The ground lessee will maximize the potential and improve the property by:

- making capital improvements to the existing structure; or in the case of a development site, they will be constructing a new building.
- Many ground leases contain a clause (reversionary clause) which transfers any improvements made by the tenant to the landlord at the end of the lease.

Advantages for Tenants/Ground Lessee:

1. The tenant's basis would be significantly reduced because the tenant would not need to provide the upfront capital that is needed to purchase the property.

2. If an owner is unwilling to sell his property, this gives the tenant/investor a way to utilize this asset in a way that can benefit both parties.

3. The tenant can mortgage the lease, however, any financing obtained will not be against the leased asset.

A few notable ground lease transactions in New York City to date include:

- 885 Third Avenue "The Lipstick Building" which was sold by SL Green to Ceruzzi Holdings.
- Gary Barnett of Extell Development signed a 99 year lease from Goldman owned properties (Solil Management) across the street from Stuyvesant Town: 516 East 14th Street, 530 East 14th Street and 222 Avenue A.
- Kaufman Organization ground leased a package of 4 office buildings from Extell Development: 119-125 West 24th Street, 13-15 West 27th Street, 19-21 West 24th Street and 45-47 West 27th Street.

Ground leases can be complex and intimidating at first. However, they provide the creativity needed to maximize an investment without the expenses associated with transferring ownership of the property.

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Question of the Month

Concerning ground leases: How should landlords handle picking the ground tenant for their property?

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Ground leases are an effective tool that property owners can use to maximize the upside potential of their asset without the expenses associated with transferring ownership of the property through a conventional sale. In general, a ground lease (master lease) is a long-term net lease (usually 99 years) of land including any improvements (if any) on the said land. Once a landlord decides to ground lease their property they must pick the right ground tenant to partner with. Unfortunately, often times owners choose a ground tenant based solely on receiving the highest offer for their property. However, this should not be the only factor to take into consideration. Landlords must properly vet any prospective ground tenant and should take into consideration asking the ground tenant my "Top 5" questions as outlined below.

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What is the ground tenant's transaction history? Have they done a ground lease in the past?

Ground leases are known to be very complex transactions and are in many ways like a partnership. It is crucial to choose a sophisticated and experienced ground tenant to successfully negotiate the terms of the lease. Working with a ground tenant that has past experiences with ground leases can provide the owner with comfort and guidance through the sometimes grueling lease negotiations. Furthermore, experienced ground tenants can provide tax efficient structures to help save the landlord money. An example of this is compounding/deferring the taxes associated with an upfront payment made by the tenant.

What type of work is the ground tenant guaranteeing?

Unlike a standard office or retail lease, obtaining a personal guaranty and/or security deposit from a ground tenant are not common practice on ground leases. However, a personal guaranty from the ground tenant guaranteeing to complete certain capital improvements on the property within a specific timeframe provides the landlord with security. All such work should be outlined in an itemized "Scope of Work" that should be attached as an exhibit to the lease. Furthermore, the more money a tenant spends the more "skin in the game" they have. It is important to note, however, that the amount of money that the ground tenant should spend depends on the condition of the property and the type of property.

Has the ground tenant ever defaulted on a ground lease?

A prior default on a ground lease does not necessarily mean that you should not pick that ground tenant. It is more important to find out the reasons for defaulting and how many times they have defaulted. Multiple defaults or defaulting due to overleveraging or inexperience should be considered red flags.

How many years has the ground tenant been in business?

Due to the cyclical nature of the real estate market, it is important to pick a ground tenant who has been through it all, and survived! However, this should not rule out new companies whose principals have ground leasing experience in their repertoire.

Has the ground tenant completed similar projects that you can tour/visit?

Ground leases can be made on all different property types including but not limited to: vacant land, industrial properties, office buildings, residential buildings, and hotels. Therefore, it is important to pick a ground lessee who specializes in the same asset class as your property. It is also helpful to visit and tour the prospective ground lessee's projects in an effort to get a better idea of their craftsmanship and expertise in their execution.

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Question of the Month: Are ground lease rent resets deal killers? How to structure rent resets - by Daniel Shirazi

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One of the biggest "deal killers" during ground lease negotiations circles around the issue of whether or not to include a rent reset in the ground lease. In general, rent resets are used to protect the landlord (lessor) from inflation which in turn can increase future ground rent paid by the ground tenant (lessee). As a consequence, the lessee is reluctant to accept a rent reset whereby "killing the deal." However, crafting language to protect both the landlord and tenant can help keep the deal "alive." Most of the time, unfortunately, the discussion surrounding rent resets is not properly handled because the parties do not have a proper understanding of the specifics and reasons for these resets. In order for a ground lease to make sense, the rent reset clause must take into consideration the needs of both the lessor and lessee.

Today, ground leases are being utilized more and more to creatively maximize value for both the lessors and the lessees. A ground lease, in essence, is a long-term net lease of land between the lessor and lessee. Depending on the terms in the lease, a ground lease can provide the lessor with substantial benefits while simultaneously allowing the lessee to maximize the assets upside potential.

For example, ground-leased properties have a host of tax advantages for lessors. Lessors will not be responsible for paying the capital gains taxes they may incur if they were to sell the property (although there are instances where capital gain taxes might be incurred). Leasing rather than selling their property via a ground lease allows owners to establish generational streams of income from the property without the responsibility of managing the property.

For lessees, they are not burdened by the upfront cost to purchase the property, therefore having more cash on hand to work on other projects. Depreciation from capital improvements they have made on the property and depending on the lease structure, the rent paid to the lessor can be deducted from their pre-tax income as expenses, whereby decreasing the overall cost-basis for the lessee.

Still, despite the benefits, one of the biggest issues in ground leases that is often in contention are the clauses regarding the lease's rent reset and how the reset will be calculated at pre-determined dates throughout the lease (generally every 25th, 33rd, or 49th year of a 100-year ground lease). The most common types of rent resets, include but are not limited to:

Fair Market Value (FMV) Reset

Appraisals are done to ensure that the rents being paid by the lessee are representative of the property's current fair market value. The danger for the lessees is that in many cases the rent that is being paid is substantially less than the current FMV resulting in a dramatic rent increase. However, dramatic rent increases can be avoided if a rent floor and ceiling has been established during lease negotiations. Generally, the rent floor would be that the rent cannot be lower than the current rent and the ceiling would be that the rent cannot exceed a certain amount.

The Lotte New York Palace hotel is set to have a rent-reset based on a fair market value reset in 2023.
SL Green Realty Corp. is also set to have a rent-reset at 625 Madison Ave. based on the property's fair market value in 2022.

Consumer Price Index (CPI) Reset

In many cases rent resets and structure are determined using the Consumer Price Index also known as a CPI. An increase in the CPI over a given period (usually in the 25th, 33rd, or 49th year of the lease term) and the loss in the property value is compensated by a proportionate percentage increase in rent that is calculated based on the change to the CPI, thereby protecting the lessor from inflationary pressures. Using the same rent floor and ceiling discussed above can alleviate the lessee's risk.

Set Escalation

Set escalation clauses are very simple and easy to underwrite. Set escalation clauses usually calculate rent increases by (i) taking an agreed upon percentage and then multiplying it by the then current rent or (ii) agreeing that the rent will increase to a set number (e.x. from $1 million to $2 million). This method allows both parties to know the exact rent amount at any given point during the course of the lease.

RFR Realty struggled to refinance their mortgage on 390 Park Ave. due to a set escalation clause in which the ground lease rent was set to increase to $20 million in 2023 relative to the current $6 milllion.

Another example, the Abu Dhabi Investment Council and Tishman Speyer were forced to put up the Chrysler Tower for sale this past January due to their rent-bill ballooning as a result of a rent reset. After paying $7.75 million in 2017, the rent in 2018 after the rent reset was $32.5million, an increase of more than 400%.

Highest and Best Use Reset

One method of calculating rent increase that has been causing issues for many iconic ground-leased properties is the method of increasing rent based on the property's "highest and best use." This is particularly true for areas where former business/office districts such as Park Ave. South and the Financial District have seen a huge rise in luxury residential development. Under this method of calculating rent resets, the rents are determined based on what is appraised to be the most profitable asset type for that parcel of land regardless of what currently exists on the plot of land. Tenants may find themselves stuck with an office building whose highest and best use is residential, but the tenant has neither the financial means nor the ability to convert the property type. If a lessor is stern on using this method, the lessee must request rent concessions in the form of free rent or reduced rent while they are repositioning the property.

Rent reset clauses should be collaboratively determined and meticulously reviewed before either party agrees to sign a lease. This is crucial to ensure that the terms are fair and also helps to avoid any potential problems that may arise. There is no reason why the rent reset should continue to be a “deal killer.” Ground leases are used to benefit both parties in a transaction; the rent reset clause should be no different.

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