

HOW LONG A GROUND LEASE?

By Joshua Stein, Principal, Joshua Stein PLLC

Property owners and developers who negotiate ground leases sometimes disagree on how long the lease should run. Though 99 years is the norm, sometimes the parties try to do something else. But it's not a difficult issue. If you're negotiating a ground lease, usually no good reason exists to make the term less than the typical 99 years.

This discussion often begins when someone points out that if you keep the ground lease to 49 years, then you avoid transfer taxes. Sometimes that comment is followed by the brilliant idea of still avoiding transfer taxes by having a 49-year term, but giving the tenant options to bring the lease up to 99 years or some other very long duration.

Yes, a ground lease of 49 years or less generally does not incur transfer taxes. But transfer taxes shouldn't guide the decision. There's a lot more to the discussion.



To start with, if the term starts at 49 years but the tenant has renewal options, then the tax collectors will measure the term assuming the tenant will exercise all its renewal options. That's a pretty good assumption. So the tax collectors are way ahead of the great mind that suggested a 49-year term with renewal options. Usually the main function of those options is just to give the landlord a future windfall if the tenant forgets to exercise or screws it up. So a tenant should try to just have a very long term (99 years?) rather than agree to option terms and wait for the excitement and litigation they can bring.

What if we just forget about renewal options and limit the term to 49 years? Shouldn't we try to mitigate transfer tax? Transfer taxes in New York City are rather high, aren't they?

Not necessarily. Quite anomalously, transfer taxes on New York ground leases are no higher than typical transfer taxes on real estate transactions in most of America (0.4%). City and State transfer taxes on a ground lease are less than a seventh of what they would be for an equivalently valued outright sale. That's because the City transfer tax considers only any payments the tenant makes to obtain the lease, key money or other up-front consideration. The City transfer tax ignores the tenant's rent. The State isn't so kind in its view of how to tax ground leases—it does tax the ground rent—but the State transfer tax (at 0.4% of consideration) is much lower than the City's (2.625% of consideration).

Net result: instead of consuming 3.025% of the value of a trans-

action, transfer taxes on creation of a ground lease consume only 0.40% of that value. It's a huge difference, especially when compared against a typical developer's equity investment in a deal.

And the State doesn't just count up all the ground rent and tax it. Instead, the State present-values the ground rent. It allows the taxpayer (the landlord) to use a discount rate that seeks to assure

the present value of the rent approximates the value of the ground-leased property as if it were sold. Considered as a whole, it's hard to get too agitated about transfer taxes on a ground lease. They should hardly drive fundamental decisions like whether to make the lease last 49 years or 99 years or 299 years.

So what should drive those decisions? Really, the tenant should just try to get as long of a term as possible. The problem with ground leases is they end. And before they end, buyers of the leasehold—and lenders who might finance those purchases—and appraisers who help those people decide how much to invest—know ground leases will end. Starting

perhaps 25 years before the end of the term, buyers and lenders will worry that the "short" remaining term makes the ground lease not such an attractive investment. And in fact the ground lease is a "wasting" asset, losing value as its remaining term drops. General appreciation of all real estate may counterbalance some of this, at least in periods when real estate is appreciating, but it doesn't always appreciate.

In any case, the last 25 years of a ground lease is not all that appealing to a tenant or a lender, both for trying to achieve a favorable exit and for making major capital expenditures that might have a useful life longer than the lease. At a certain point, once the remaining term dwindles below 10 years, the tenant may find it becomes difficult to sign space leases, because they can't extend beyond the ground lease term, absent special arrangements with the property owner.

If a tenant agrees to a 49-year term, then the tenant only assures itself of 24 "really good" years of lease term. A 99-year term triples the number of "really good" years. A tenant should always try to get that or more. And transfer taxes shouldn't stand in the way.

Joshua Stein
 Joshua Stein PLLC
 501 Madison Avenue, Suite 402
 New York, NY 10022
 212-688-3300
joshua@joshuastein.com