ASK THE EXPERT

Tax considerations for ground leases

For investors looking for new opportunities, ground leases are catching on in New York City and beyond. A ground lease occurs when the property owner sells the land to an investor, then leases it back from the investor.

The transaction is documented in a ground lease, a document that usually lasts from 35 to 99 years. Often, during the time that the tenant is leasing the property, he or she may decide to build another structure on it; sometimes that entails razing an existing structure. Once the lease hits its expiration date, the tenant transfers the ownership of the improvements to the property owner.

Many types of property are ground-leased, including vacant land, industrial property, office buildings, multifamily residential properties and hotel properties. In New York City some co-ops are built on property that was ground-leased, allowing the owners to price the co-ops at very competitive prices. The co-op developers save some money by leasing the land, instead of buying it, and are able to pass this along to the residents. They also pass along the cost of paying for the ground lease, however, which contributes to monthly maintenance fees that may exceed those of other types of apartments.

Many property owners like the ground lease because it allows them to derive value from land they may not be using or are underusing.

For instance, some universities that own vacant land or own unused student housing have turned to ground leasing, creating a new revenue stream to fund campus programs and initiatives. Family businesses may opt for ground leases to keep a property in the family, even if they don't have the funds or the desire to develop it. For some owners, ground leases can generate higher returns on a property than they would get from its appreciation over time.

Although ground leases can offer many advantages to investors, there are also tax considerations. The tenant must pay the property taxes when the property is subject to a ground lease.

It important to get expert advice from knowledgeable commercial real estate professionals on how to take stock of a property for which the owner is considering ground leasing, what type of deal best meets the needs of the owner, and the level of control the owner will have over any construction on the property, among other issues. The owner will need legal protections in case the tenant does not take care of the property in the agreed-upon manner. Beyond this, the owner will need to develop a marketing strategy for the property that's to be made available for ground leasing.

For insight, **Crain's Content Studio** spoke with Jonathan Stein, a director at Goulston & Storrs. Stein provides tax advice for commercial and real estate transactions. Among his clients are real estate investment trusts, developers, institutional and family office investors, closely held enterprises, family businesses, fund sponsors, portfolio companies and lenders.

Stein focuses on complex tax matters involving joint ventures, cross-border and tax-exempt structuring, tax-free exchanges, transfer taxes, leasing and finance matters. He also represents investment fund sponsors and portfolio companies in both taxable and tax-free merger-and-acquisition transactions.

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CRAIN'S: How do ground leases work and why are they becoming popular?

STEIN: A new wave of ground lease investors is seeking to restructure the real estate capital stack by separating the ownership of the land under a commercial building from the building itself. In practice, the way this works is that an investor buys the land from the real estate owner or developer and then leases it back to the seller under a long-term ground lease. Because these ground leases can unlock additional liquidity and lower the cost of capital, they are very attractive for owners and developers.

CRAIN'S: What tax issues arise with a ground lease?

STEIN: As with all things real estate, there are some important tax considerations at stake. Foremost, the parties must decide whether to treat the sale and leaseback of the land as a "true lease" for tax purposes. If the lease is respected as such, then the seller may have what is known as a "gain on sale." This gain could be deferred by entering into a like-kind exchange. This is when property used for business or as an investment is exchanged for another similar property that is used for the same purposes.

If the tax cost of a sale is high and a like-kind exchange is not feasible, then it may be possible to treat a long-term lease as financing or a loan instead of a "true lease." In this scenario, the form of the transaction as a ground lease is ignored for income tax purposes. Instead, the owner of the real estate is treated as if the "purchase price" it received for the land was a loan, and the payments of "rent" are payments of principal and interest on this loan. Whether a given lease can be treated as financing depends on the terms of the lease, and in particular how the option to buy back the land is structured.

CRAIN'S: What about depreciation?

STEIN: Occasionally sale-leasebacks will include a purchase of the buildings and improvements, as well as the ground. In this circumstance the purchaser-landlord will be able to depreciate the building instead of the seller-tenant. This tax result is subject to negotiation, and seller-tenants are often able to keep the benefits of depreciation on the improvements. Because land is not depreciable, this issue does not arise for a true ground lease.

CRAIN'S: Are there transfer taxes?

STEIN: This varies based on the jurisdiction. In New York the grant of a ground lease is usually subject to New York state transfer tax, either because the transaction contains a purchase option or because the lease term is longer than 49 years or both. New York City transfer taxes typically do not apply to a new ground lease because "rents" under the city's Commercial Rent Occupancy tax are excluded from transfer tax. However, assignments of ground leases may be taxable in both New York state and New York City. With proper planning, it may be possible to avoid paying transfer tax twice, once on the sale and once on the leaseback.

CRAIN'S: Are there any other structuring considerations?

STEIN: Leases should be analyzed to determine whether there is prepaid or deferred rent. If so, special tax accounting rules may apply so that the prepaid or deferred amounts are accrued ratably over the lease term. ■

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