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Ground Leases Offer Potential Benefits for both Tenants and Landowners

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Ground leases have recently become more common in the commercial real estate sector. A ground lease is an agreement between a landowner and a tenant that allows the tenant to develop, use and derive all benefits from any improvements made to the property for the duration of the lease. After the lease period, which commonly ranges from about 50 to 99 years, the entire property, including all developments and improvements, revert back to the landowner. With potential benefits for both landowners and tenants, this type of arrangement is gaining traction as an attractive option for some businesses and investors.

Modern Ground Lease Market

The ground lease concept involves separating the land from the building/business operations, and it can apply to all types of commercial real estate, from office and industrial to multifamily and retail. Safehold, a major player in the space with a ground lease portfolio of more than 100 properties worth \$4.8 billion, projected earlier this year that the ground lease market could potentially become a \$100 billion market.

Safehold, which closed more than 30 ground lease deals in 2021 totaling \$1.5 billion, has focused primarily on office, multifamily and hotel properties throughout the U.S. Ground leases are popular among some retailers, including Macy's, McDonald's, Whole Foods and Starbucks. In some cases, a corporate parent will purchase the land and sign a ground lease with a franchisee. American Tower uses ground lease arrangements to build many of its cell phone towers around the country. Some companies opt to sell their property to free up equity and continue to operate on the space through a ground lease arrangement with the new owner.

Ground Lease History

Ground leases have been around for centuries and were historically common in certain markets, including New York and Washington, D.C., where developers purchased the rights to develop parcels of land with 99-year ground leases. However, the ground leases of yesterday lacked the standardized structures of modern ground leases. They allowed for substantial rent increases that were tied to increases in the value of the property, and due to the unpredictability of rent costs, they fell out of favor with many investors. Modern ground leases have more standardized structures, with rent increases stipulated in the terms of the agreement.

How Ground Leases Work

With a ground lease, the tenant has a leasehold interest in the property, which allows the tenant to build or make changes or improvements to existing structures on the property, whether to operate the tenant's own business or to build income-producing structures that the tenant can lease to others. Typically, the tenant is responsible for all costs associated with the property, including taxes, insurance, maintenance and construction, but the tenant gets all the depreciation benefits that the IRS allows for the property.

The landlord and tenant negotiate the terms and conditions of the ground lease, including the duration. With tenants often making significant investments on the property, long-term leases are common and often range from 50 to 99 years. After the lease expires, the landowner inherits everything that was built on the land.

Depending on the terms negotiated in the ground lease, landowners may put certain restrictions on tenant uses for the property.

Benefits for Tenants

Ground leases give tenants access to desirable locations that they could not afford to buy or that might not be available for sale. The tenant does not have to come up with a down payment for the land purchase, which frees up capital for business operations. The tenant also receives certain tax benefits, including depreciation and tax deductions for rents paid on the ground lease.

However, the terms and conditions of the agreement are crucial. If the landlord can restrict or must give approvals for any changes, tenants will have less flexibility than they would have if they owned the property themselves. The tenant will also need to negotiate a favorable rent escalation clause to prevent costs from rising significantly over time.

Benefits for Landlords

Ground leases provide a steady income stream without any management costs or headaches for landowners. While there will be taxes associated with rent income, landlords avoid the capital gains taxes that would have ensued if they had sold the property. After the lease expires, the landlord will benefit from any improvements that have been made to the property. Further, depending on the conditions of the lease, the landlord may be able to maintain some control over how the property is developed.

Negotiating a Ground Lease

Whether you're a tenant or a landowner, the terms and conditions of the ground lease will have a major impact on whether this is a favorable arrangement for your business and your bottom line. It's important to work with a business lawyer with expertise in ground leases to ensure your interests are protected while drafting the agreement. Before signing on the dotted line, consider running the lease agreement by a commercial litigator, who can examine the document with a critical eye toward limiting your risks in case of future litigation.

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