Ground Leases

A Guide for Developers, Public Officials, and Lenders

Preface

Historically utilized in a variety of situations, in recent years, ground leases have found frequent use in Joint Development projects on land owned by transit agencies. Ground leases appeal to transit agencies as a means to encourage transit oriented development at agency-owned sites and to generate a long-term and dependable source of income for transit. As the value of land surrounding large transit investments generally increases over time, ground leasing can allow the transit agency to "recapture" some of the value created by the transit investment. Additionally, ground leases provide private developers access to high-value land adjacent to transit stations, facilitating the creation of transit oriented development that ultimately enhances the effectiveness of transit and improves the public realm near transit.[1]

Ground leases are sometimes viewed less favorably among developers. Despite concerns over added complication, ground leases can deliver real benefits in the form of reduced up-front land acquisition costs. In addition, there are potential tax benefits associated with having land cost become an operating cost.

This guide is designed to provide developers, public officials, and lenders with a general understanding of the merits and challenges of ground leasing public land for transit oriented development.

What is a Ground Lease?

Ground leases are a long-term, land-only rental in which the tenant pays for the right to use the landowner's property to construct a building or to put the land to another use.[2] An inherent feature of a ground lease is that it separates land ownership from building ownership, with the land being owned by the landowner while the building and other improvements are owned by the tenant.

This arrangement necessitates several other features of ground leases. Because a building is tied to the land it is on, a ground lease must specify what is to become of any improvements once the lease ends. The lease may specify that all improvements have to be removed, or that the landlord automatically acquires all improvements, or there may be a purchase provision for any remaining improvements.

In addition, ground leases must be long enough for the tenant to make a reasonable return on investment in the improvements. Although some ground leases are as short as 20 years, most TOD improvements are expected to last longer. Terms of 50 years or more are common for TOD leases.

Finally, the separation of land and building ownership also results in the need to negotiate the maintenance and tax responsibilities for the property for the duration of the ground lease. While these issues are settled on a case-by-case basis, the most common arrangement is that maintenance and property taxes are the responsibility of the tenant. This arrangement is typical because it meets the need of the tenant to have independence over the day-to-day functions on the property, and allows the landowner to assume a passive role in which their main responsibility is collecting the rent.

The Pros and Cons of Ground Leasing

The Developer's Perspective

The most frequent complaint against ground leases is that they require too much time to negotiate and make it difficult to obtain financing for the improvements. Such negative perceptions are not without merit. Ground leases often require more time to negotiate than a simple sale, because ground leases require an ongoing relationship between multiple parties, each of which must have their exact responsibilities specified.[3] Likewise, it may be more difficult for a developer to obtain financing for a project when they are not the landowner because they are not able to use the fee interest in the land as security for a loan.[2] Nevertheless, ground leases are common instruments for commercial and retail development and lenders may be more willing to offer leasehold financing than developers realize.[4]

For a developer to see the value in a ground lease, they must look past the complexity and see the benefits that a ground lease can deliver. The most substantial of these benefits is the elimination of initial land acquisition costs.[5] As buying land is generally one of the largest up-front development costs, removing this expense can benefit the financial outlook of the project.[6] In addition, there may be tax advantages to a ground lease, as rent is generally deductible for federal and state income tax purposes.[6] These advantages mean that while ground leases come with added challenges, they can deliver significant benefits to developers as well.

The Transit Perspective

For a transit agency, a ground lease can have the joint benefits of creating a long-term and dependable source of revenue while simultaneously encouraging transit oriented development near station areas.

A ground lease's financial benefit to a transit agency can come from several sources. When a large-scale public investment such as a transit line is built, adjacent land values often increase.[7] If the the transit agency ground leases adjacent land, it allows the agency to capture both the initial value created by the transit investment, as well as any long-term increases in value. A third source of value created by a ground lease that facilitates TOD comes in the form of increased ridership and therefore revenue generated by the development.

Ground leases are generally preferable for meeting an agency's TOD goals as well. Because ground leases allow a landowner to retain some say over how their land is used, a transit agency can ensure any development facilitates safe and efficient transit operations and is compatible with increasing ridership.[8] It is difficult to maintain similar control when ownership of a property is sold.

When to Ground Lease and When to Sell

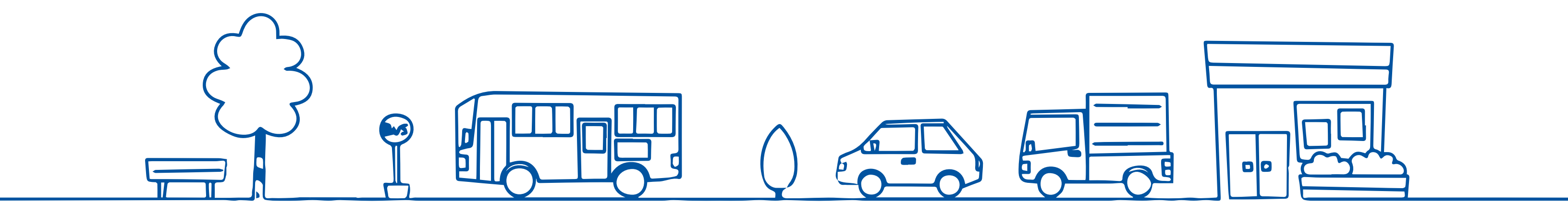
Transit agencies often find themselves in the possession of property that is underutilized or no longer needed for transit purposes. While determining what to do with such a property depends on a case-by-case consideration of the property and an agency's priorities, there are several factors that make a property more suitable to being ground leased vs sold.

Factors that Favor Ground Leasing

- **The property is needed for transit purposes (station, bus turnaround, park and ride, etc.)**
- **The market is supportive of immediate or short-term development**
- **The property has high potential for TOD**
  - » **Within walking distance of an LRT or BRT station, or high-frequency bus service**
  - » **Located in a walkable, mixed-use area**
- **The property is likely to increase in value over time**
- **The proposed ground lease has a high Net Present Value compared with the likely sales price.**

Factors that Favor Selling

- **The property is no longer needed for transit purposes**
- **The property is unlikely to be developed for some time**
- **The property has limited potential for TOD**
  - » **Property is not near LRT, BRT, or high-frequency bus**
  - » **Property is surrounded by auto-centric development**
- **A favorable offer has been made to purchase the property**



Typical Provisions of a Ground Lease

Term Length	At least 50 years is common, though the term depends on the type, size, and cost of the improvements.[5] Generally, developers will push for longer terms with options to extend in order to postpone the date when they lose control of the land and ownership of the buildings or improvements. From a landowner's perspective, all else being equal, a shorter term is better as it reduces the time in which the landowner will not have full control of their land.[8]
Initial Rent	Initial rent is determined by multiplying a market capitalization rate by the appraised value of the land. For example, if a property is valued at $1 million and the ground lease capitalization rate is set at 5%, the rent for the first year would be $50,000. The ground lease capitalization rate depends on local market conditions and a tenant's credit history.[8]
Rest Escalation	Because ground leases are long-term, setting a proper rent escalation is essential if the property is to obtain a fair return on investment for the landowner. There are two ways in which this is commonly done. One is to tie the rent to a Consumer Price Index (CPI) or another measure of inflation. Doing so ensures that the rent will not lose value over time. An alternative measure is to have appraisals of the land conducted at regular intervals. Each of these methods should not be viewed as mutually exclusive as they ensure a fair rent in different ways. A CPI index maintains that the value of money remains constant, while a regular appraisal measures changes in the specific property's value.
Land Use Restrictions	The landowner should maintain control over what is built on their property in order to ensure it is consistent with their goals. When ground leasing public land near transit, these goals include maintaining safe and efficient transit operations and increasing ridership. If a property is currently used as a transit center, bus turnaround, or park and ride, the ground lease should state that the landowner has the right to object to any development that would negatively affect transit operations.
End of Term Disposition	A ground lease usually provides that on expiration of the lease, all improvements become the property of the landowner without payment, free from all liens, and in good condition.[9] The landowner should also maintain the right to require the tenant to demolish any improvements and return the land to its original state at the landowner's option.[5]
Subordination	In a subordinated ground lease, the landowner allows their fee interest to be placed as a security on any financing attained for the property.[9] Although this practice can make it easier for a developer to obtain financing,[10] it generally should not be done on public property in which a transit interest is maintained due to the possibility of foreclosure.
Due Diligence	All due diligence that accompanies the sale of a property generally applies to a ground lease. It is the usually tenant's responsibility to conduct research on the environmental and financial conditions of the project and to obtain all necessary approvals and construction permits.
Maintenance	The maintenance of all improvements is generally the responsibility of the tenant, unless there are parts of the property for which the landowner wishes to control the maintenance.[11] If the property has active transit components, the transit agency or public landowner will need to be involved. An operations and maintenance agreement will then need to be developed to delineate roles and responsibilities.

Summary

While they may appear complicated, a ground lease on public land can result in significant benefits for a transit agency and a private developer alike. From a transit agency's perspective, ground leasing can create a consistent source of revenue, ensure the property remains compatible with transit, and allow a return on investment for transit projects. From a developer's perspective, ground leasing can eliminate large, upfront land acquisition costs and create an operating expense that reduces income taxes. While the specifics of each situation ultimately determine whether a ground lease is desirable, the practice of ground leasing is a tool that transit agencies and developers alike should be familiar with.

References

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