

Analysis

Releasing value



A capital markets slowdown is leading owners to think creatively around leaseholds, [Samantha Rowan](#) writes

A generational real estate wealth transfer and a capital markets slowdown are leading advisers to take a closer look at leaseholds as a way to unlock value in underperforming properties with significant value and little to no tax basis.

Leasehold transactions are not for the faint of heart due to their inherent complexity, which involves bifurcating a property into the ground and the structure above. But their use has become more common as the family owners and operators of highly valued real estate think creatively about estate planning, generational wealth transfer or simple portfolio management in a time of reduced liquidity, says Ben

Tapper, director of the national investment services group at Lee & Associates.

“Many people bought properties decades ago in New York and have since depreciated their basis down to nothing while simultaneously watching the value appreciate exponentially,” Tapper adds.

Owners of properties which fit this description often consider 1031 Exchange transactions. But there are situations in which there is a near-term catalyst to transact, like a maturing mortgage or a major vacancy, where a leasehold can be a better option. “There are some situations where 1031s are not achievable,” Tapper says.

As Tapper has worked with clients on leaseholds, he has also used another

tool which works within the existing leasehold framework – a Section 467 Rental Agreement.

“Structuring a Section 467 Rental Agreement adds more complexity to a deal, but it still can fill an important spot in a strategy for generational owners of various asset types and qualities,” Tapper says.

One of the benefits of doing a Section 467 within a leasehold is that the fee owner and the leaseholder can allocate the upfront payment over the term of the lease as prepaid rent, Tapper notes.

The benefits to the owner include a larger upfront payment and the ability to reinvest that capital as well as having more ability to retire debt. For a leaseholder, while there is a larger capital

commitment at the outset, it should significantly reduce the collective payments made to the property owner over the life of the leasehold while meaningfully increasing the arbitrage, he adds.

Case study

A case in point is a New York office property on which Tapper and his team started work in 2019. Going in, Tapper thought the firm would be working on a straightforward sale transaction on a 1970s vintage office building.

The property was leased on a long-term basis to a city agency and was being sold by a generational ownership group. The expectation was the owners would sell the asset, retire existing debt and either redeploy any proceeds via a 1031 exchange or simply take profits and pay the capital gains tax.

The reality, however, was a complex transaction on which Tapper and his team worked for more than two years before ultimately structuring a leasehold with a Section 467.

“What started out as a simple sale turned into a two-year odyssey culminating with the creation of a 99-year leasehold with an upfront 467 payment for 80 percent of the building’s value and an ongoing revenue stream for the ownership group,” Tapper says.

Additionally, the deal allowed the ownership group to navigate a negative tax basis and retire existing debt that became a higher percentage of the value once the building unexpectedly went vacant.

There is a specific subset of transactions that work well within the structure of Section 467, including the scenario Tapper and his team worked through. In particular, the loss of the building’s long-term tenant and a resultant drop in valuation that caused the debt-to-equity ratio on the transaction to rise steeply was a factor that nearly entirely derailed the transaction.

“There are cases in which the value of an asset could diminish due to lease expirations or other short-term issues with the building, leading to situations

in which the debt-to-equity ratio on a building is too high,” Tapper says. “In cases like these, the debt-to-equity ratio means the financing is not replaceable and an ownership group would need to contribute significant equity, which is often not an option.

“If we had moved ahead with a sale,



“Many people bought properties decades ago in New York and have since depreciated their basis down to nothing while simultaneously watching the value appreciate exponentially”

BEN TAPPER
Lee & Associates

the debt ratio at that moment would have obligated the owners to make a significant equity contribution. There were six different owners and three generations of a family tree, so no one owner was liquid enough without selling another asset. There was no way to sell this building and retire the debt, so we pivoted to a leasehold.”

There was one final element Tapper had to consider: the property had a negative tax basis in which the debt on the property exceeded its actual tax basis. That meant Lee & Associates’ ultimate goal was to structure a transaction that did not incur a capital gains tax because of the owner’s negative tax basis, retire an existing loan with a high loan-to-value ratio, cover all transaction costs and return equity to the owner.

Looking ahead

The structure is a useful one for owners that are thinking creatively about properties in a generational way, with Tapper noting that leaseholds are an important method for those who want to retain ownership over the long-term.

A sale was not an option for the New York property Tapper worked on, mainly because it would not have made economic sense for the owners.

“Additionally, attempting to complete a 1031 exchange was also problematic given the equity and debt requirements needed to meet the regulations,” Tapper says. “That was why early on, we transitioned from a sale to trying to create a leasehold. With a leasehold, there is no capital gains liability because you are not actually transferring the title. We also knew that the only way to cure the negative tax basis was to pay down the mortgage principal with income from the property over time.”

Despite its complexities, Section 467 transactions typically work well. “There is a time and monetary component to a 467 that can augment the benefits of a leasehold for both parties,” Tapper says. ■