

STATE OF HAWAII
DEPARTMENT OF LAND AND NATURAL RESOURCES
Division of Boating and Ocean Recreation
Honolulu, Hawaii 96819

January 13, 2017

Board of Land and Natural Resources
State of Hawaii
Honolulu, Hawai'i

Statewide

Request Approval of the Division of Boating and Ocean Recreation Sublease Rent Participation Policy

PURPOSE:

Adoption of a Division of Boating and Ocean Recreation ("DOBOR") sublease rent participation policy allows DOBOR to provided clear and consistent guidance to lessors regarding subleases and provides for conformity in determination of sublease rent participation within the Department of Land and Natural Resources by being consistent with the sublease rent participation policy currently in use by the Land Division and approved by the Board of Land and Natural Resources ("Board").

LEGAL REFERENCE:

Hawaii Revised Statutes Chapter 171-36(a)(6):

The lessee shall not sublet the whole or any part of the demised premises except with the approval of the board; provided that prior to the approval, the board shall have the right to review and approve the rent to be charged to the sublessee; provided further that in the case where the lessee is required to pay rent based on a percentage of its gross receipts, the receipts of the sublessee shall be included as part of the lessee's gross receipts; provided further that the board shall have the right to review and, if necessary, revise the rent of the demised premises based upon the rental rate charged to the sublessee including the percentage rent, if applicable, and provided that the rent may not be revised downward

REMARKS:

- I. Adoption of a DOBOR Sublease Rent Policy is consistent with the Department of Land and Natural Resources (DLNR's) Principle of providing uniform policy across the respective DLNR divisions.

On August 24, 2012, under item D-14, as amended, the Board approved the sublease rent participation policy that is currently in use for leases under the direct

management of the Land Division and is attached hereto as “**Exhibit A**”.¹ The rationale behind the establishment of a formal sublease rent participation policy was that the State should not allow excessive profiteering from commercialized use of State owned property while recognizing the lessee’s right to receive a fair return on investment.

In anticipation of current and future development opportunities that will involve subleases, DOBOR wishes to formally establish a sublease participation policy that is clear and consistent. DOBOR’s intent is to utilize the policy for every lease which will provide guidance for both lessees and staff on the determination of sublease participation rents. Current leases which allow for a rent adjustment in the event of subleasing will be informed by the policy with respect to calculating sublease rent participation and future leases will include the sublease participation policy and calculations as part of the lease.

The Board has already approved a sublease rent participation policy currently in use for leases under the direct management of the Land Division. DOBOR finds Land Division’s policy instructive and to conform state practice regarding land dispositions, intends to follow the same policy.

II. Policy:

This policy shall apply to leases under the direct management of the Department of Land and Natural Resources, Division of Boating and Ocean Recreation.

I. For lessees paying fair market rent:

- a. If the lessee subleases unimproved lands, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State. The following calculation shall be used:

Annual Sublease Base Rent:	\$
LESS: General Excise Tax:	\$()
Net annual Sublease Base Rent:	\$
LESS Annual Lease Ground Rent:	\$()
Additional Annual Sublease Rent:	\$
MULTIPLIED by 50%:	x .50
Additional Annual Rent due DLNR:	\$

- b. If the lessee subleases improvements owned by the State, the Board shall revise the rent to include as additional rent, 50% of that portion of the

¹ On July 9, 1982, under agenda item F-9, the Board approved Land Division staff’s recommendation to adopt a sublease evaluation policy which was first developed and utilized in 1968. Since then, the Board has approved the evolution of the policy in consideration of changes in the prevailing economic climate for the period. On May 26, 2000, under agenda item D-24, as amended, on January 26, 2001, under agenda item D-8, as amended, and on August 24, 2012, under item D-14, as amended, the Board approved staff recommendations for amending the sublease rent participation policy for Land Division until it reached its most recent iteration.

sublease rent in excess of the original ground rent paid to the State. The following calculation shall be used:

Annual Sublease Base Rent:		\$
LESS: General Excise Tax:		\$()
Net annual Sublease Base Rent:		<u>\$</u>
LESS total Allowances:		<u>\$()</u>
<i>Allowances:</i>		
<i>Management & Vacancy Loss</i>		
<i>(eff. inc. x%):</i>	\$	
<i>Repair and Maintenance:</i>	\$	
<i>Real Property Tax:</i>	\$	
<i>Insurance:</i>	<u>\$</u>	
<i>Total allowances:</i>	\$	
LESS Annual Lease Ground Rent		<u>\$()</u>
Additional Annual Sublease Rent:		\$
MULTIPLIED by 50%:		<u> x .50</u>
Additional Annual Rent due DLNR:		<u>\$</u>

- c. If the lessee subleases improvements not owned by the State, the Board shall not receive any portion of sublease rents from subleasing improved space unless:
- i. that right and method of calculation are specifically stated in the lease;
OR
 - ii. participation in sublease rents is warranted considering the age of the improvements (including but not limited to the extent to which the improvements have been depreciated or amortized), lessee's expenditures to maintain the same in relation to sublease revenues, and the extent to which the lessee actually occupies and uses the lease premises for its own business. The following calculation shall be used:

Annual Sublease Base Rent:		\$
LESS: General Excise Tax:		\$()
Net annual Sublease Base Rent:		<u>\$</u>
LESS total Allowances:		<u>\$()</u>
<i>Allowances:</i>		
<i>Investment Return:</i>	\$	
<i>Management & Vacancy Loss</i>		
<i>(eff. inc. x%):</i>	\$	
<i>Repair and Maintenance:</i>	\$	
<i>Real Property Tax:</i>	\$	
<i>Insurance:</i>	<u>\$</u>	
<i>Total allowances:</i>	\$	

LESS Annual Lease Ground Rent	\$(_____)
Additional Annual Sublease Rent:	\$ _____
MULTIPLIED by 50%:	x .50
Additional Annual Rent due DLNR:	\$ _____

2. For lessees paying any amount less than fair market rent:

- a. If the lessee subleases unimproved lands, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State. The calculation delineated in 1.a. above shall be used.
- b. If the lessee subleases improvements owned by the State, the Board shall revise the rent to include as additional rent, 100% of that portion of the sublease rent in excess of the original ground rent paid to the State. The following calculation shall be used:

Annual Sublease Base Rent:	\$ _____
LESS: General Excise Tax:	\$(_____)
Net annual Sublease Base Rent:	\$ _____
LESS total Allowances:	\$(_____)
<i>Allowances:</i>	
<i>Management & Vacancy Loss</i>	
<i>(eff. inc. x%):</i>	\$ _____
<i>Repair and Maintenance:</i>	\$ _____
<i>Real Property Tax:</i>	\$ _____
<i>Insurance:</i>	\$ _____
<i>Total allowances:</i>	\$ _____
LESS Annual Lease Ground Rent	\$(_____)
Additional Annual Sublease Rent:	\$ _____
MULTIPLIED by 100%:	x 1
Additional Annual Rent due DLNR:	\$ _____

- c. If the lessee subleases improvements not owned by the State, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State. The calculation delineated in 1.b. above shall be used.

3. Furthermore, the foregoing calculations generally reflect the intent of the Board of Land and Natural Resources (“Board”) regarding the calculation of sublease sandwich profit and shall serve as guidelines in such calculation. The Board authorizes staff to use their discretion in representing the State’s interest in applying these formulae to address the varying sublease arrangements that may not fit neatly into the formulae.

4. The following definitions shall be binding in the interpretation of terms used in the

calculations of sublease sandwich profits provided in part I of this policy:

ANNUAL SUBLEASE BASE RENT: The total gross yearly sublease ground rent amount collected by a general lessee without any deductions.

GENERAL EXCISE TAX: State of Hawaii G.E. Tax. This expense will be deducted only if not paid by a sublessee.

NET ANNUAL SUBLEASE BASE RENT: Annual sublease ground rent less G.E. Tax

ANNUAL LEASE GROUND RENT: The total gross yearly ground rent paid by general lessee for the proposed sublease area.

ADDITIONAL ANNUAL SUBLEASE RENT: Additional annual rent realized by general lessee from subleasing the proposed sublease area. Amount not less than zero.

ALLOWANCES: Allowances for costs incurred by a general lessee for management and maintenance of improvements.

INVESTMENT RETURN: Return of general lessee's cost of improvements over the term of the lease. If the actual cost is not determined, an estimated amount is obtained from appropriate real property assessed valuations established within eighteen (18) months from completion of improvements. A reasonable return on investment that a prudent general lessee expects, return rate fluctuates with market and economic conditions. The rate may be adjusted to reflect the change in market and economic conditions

MANAGEMENT AND VACANCY LOSS: Applicable to rent collections, accounting, legal and miscellaneous property management expenses, and allowance for non-collection of sublease rent. This allowance is not to exceed a rate of ten percent (10%) of Net Annual Sublease Base Rent.

REPAIR AND MAINTENANCE: Expenses applicable to maintenance and repairs on building(s) and premises such as painting, refuse disposal, re-paving, utilities, landscaping, security, etc. Staff may use their discretion in granting this allowance based on evaluation of necessity or repairs and maintenance. If detailed expenses are not provided by the general lessee, such expenses will be estimated at two percent (2%) of Net Annual Sublease Base Rent (Line 3) is used. This expense will be deducted only if not paid by a sublessee.

REAL PROPERTY TAX: Per current real property tax bill or notice sent by appropriate Real Property Tax Office. This expense will be deducted only if not paid by a sublessee.

INSURANCE: Premiums paid for fire and liability insurance policies. This expense will be deducted only if not paid by a sublessee.

RECOMMENDATION:

That the Board Approve the adoption of the DOBOR sublease rent participation policy as stated herein.

Respectfully Submitted,



Edward R. Underwood
Administrator

APPROVED FOR SUBMITTAL:



Suzanne D. Case
Chairperson

STATE OF HAWAII
DEPARTMENT OF LAND AND NATURAL RESOURCES
Land Division
Honolulu, Hawaii 96813

August 24, 2012

Board of Land and Natural Resources
State of Hawaii
Honolulu, Hawaii

Statewide

Modification of Staff Recommendation in Board Action of January 26, 2001, Item D-8, as Amended, Regarding Sublease Rent Participation Policy. The Purpose of the Modification is to Make the Staff Recommendation Consistent with the Board's Directives and Practice in Determining the State's Participation in Sublease Rents.

BACKGROUND:

On May 26, 2000, under agenda item D-24, as amended on January 26, 2001, under agenda item D-8, as amended, the Board of Land and Natural Resources was presented with staff recommendation for a sublease rent participation policy, which can be summarized as follows for lessees paying fair market rent:¹

- a. If the lessee subleases unimproved lands, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State.
- b. If the lessee subleases improvements owned by the State, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State.
- c. If the lessee subleases improvements not owned by the State, the Board shall not receive any portion of sublease rents from subleasing improved space unless that right and method of calculation are specifically stated in the lease.

The Board ultimately adopted a sublease rent participation policy, but specifically

¹ The policy includes detailed formulas for calculating the amount of sublease rent participation as shown in Exhibit I attached hereto. The policy also covers rent participation in subleases where the lessee is paying less than fair market rent.

Exhibit A

APPROVED BY THE BOARD OF
LAND AND NATURAL RESOURCES
AT ITS MEETING HELD ON
August 24, 2012

D-14

amended the staff recommendation by clearly articulating that it was approving general principles or guidelines for a rent participation policy and it desired and authorized staff to continue to use good land management practices in evaluating the varying factual scenarios that can arise in sublease arrangements and ultimately making a recommendation to the Board on whether the State should participate in the sublease rents, or not. Therefore, the Board amended the staff recommendation by adding the following statement into the record and minutes of the meeting (Board's amending language in bold):

This policy shall apply to leases under the direct management of the Land Division. Furthermore, the following formulae generally reflect the intent of the Board regarding the calculation of sublease sandwich profit and shall serve as guidelines in such calculation. The board authorizes staff to use their discretion in representing the State's interest in applying these formulae to address the varying sublease arrangements that may not fit neatly into the formulae.

Staff has followed, and intends to continue to follow the Board's directive by continuing to use good land management practices in evaluating a sublease arrangement and recommending departure from the general formulas noted above when adherence to them seems contrary to the State's best interests. Recent Land Board actions involved consenting to a particular lessee's sublease arrangement and participation in the sublease rents. Although the staff submittals discussed the Board's sublease rent participation policy and explained how the recommendation to participate in the sublease rents was, in staff's view, consistent with the Board's sublease rent participation policy, as amended, the staff submittals did not formally seek to refine or elaborate upon the Board policy adopted, as amended, in 2001. This submittal formally and expressly seeks to do so.

REMARKS:

The situations where the formulas summarized above would normally not allow the State to participate in sublease rent when staff's assessment is that the State should receive some benefit from the sublease often arise where the improvements have been substantially depreciated or amortized, and in cell tower or telecommunication leases, or a combination thereof. Telecommunications companies often hold leases that were entered into by direct negotiation pursuant to statute. The lessee typically obtains the lease and constructs the required improvements, usually consisting of one or two equipment/office buildings and the cell tower or antenna itself. With the Board's consent, the lessee can sublease space on the antenna to other telecommunications companies and generate revenues that more than cover the expense of the lessee's ground rent to the State.

For example, at its meeting of October 28, 2011, Item D-27, the Board approved staff's

recommendation for the State to receive 50% of the sandwich profits generated in a sublease/license situation under General Lease No. S-4223, which was issued in 1969 for microwave station and other radio communication facilities purposes. In that case, the ground rent under General Lease No. S-4223 was \$31,400 per year, and the sublease rent collected by the lessee was \$33,153.57 per year. The staff submittal noted that the improvements constructed by the lessee had largely been depreciated over the course of approximately 40 years since the issuance of the lease. The Board approved the State's participation in sublease rents at the rate of 50% even though the right to participation and method of calculation were not specifically stated in the lease.²

Similarly, at its meeting of November 10, 2011, Item D-5, the Board approved the State's participation in sublease rents under another cell tower lease at the rate of 25% in General Lease No. S-5511. In that case, the lease was issued in 1997 and less time had passed for the depreciation of the cost of improvements. Additionally, the lessee submitted evidence of its ongoing maintenance costs for the tower. General Lease No. S-5511 allowed the Board to adjust the rent in the event of a sublease, but the right to participation and method of calculation were not specifically stated in the lease.

Another situation that sometimes arises is where a State lessee acts strictly as a sub-landlord in subleasing improved lands to various sublessees.³ In such case, the State lessee may not actually occupy or operate a business (such as for industrial, commercial or agricultural use) at the premises but, instead, generates sublease income from multiple sublessees that exceeds the amount of rent the lessee pays to the State. Under the general formulas set forth above, the State would not ordinarily share in the sublease rents when the improvements constructed or owned by the lessee, unless the right to participate and method of calculation are specifically stated in the lease, regardless of whether the improvements have been substantially or fully amortized or depreciated (e.g., a 65-year lease in its 40th year noted above).

The cell tower and sub-landlord situations discussed above are two cases in which staff believe the State's participation in sublease rents is warranted depending on the age of the improvements (including the extent to which the improvements have been depreciated or amortized), lessee's expenditures to maintain the same in relation to sublease revenues, and the extent to which the lessee actually occupies and uses the premises for its own business. Staff is including a recommendation below that the Board refine and elaborate upon its existing policy to cover circumstances that may warrant the State's participation in sublease rents even where the improvements are owned by the lessee and right to participate and method of calculation are not specifically stated in the lease.

² By statute, the Board can adjust the rent under a lease as a condition to a consent to assignment or sublease, even if the lease is silent on rent adjustment in such cases. See HRS Section 171-36(a)(6).

³ In other words, the lessee is acting as a pure landlord and is in a sandwich lease position

RECOMMENDATION: That the Board:

1. Refine its prior approval (as amended) of January 26, 2001, Item D-8, by modifying the staff's prior recommendation A.1.c on page 3 to read as follows

If the lessee subleases improvements not owned by the State, the Board shall not receive any portion of sublease rents from subleasing improved space unless: (i) that right and method of calculation are specifically stated in the lease, or (ii) participation in sublease rents is warranted considering the age of the improvements (including but not limited to the extent to which the improvements have been depreciated or amortized), lessee's expenditures to maintain the same in relation to sublease revenues, and the extent to which the lessee actually occupies and uses the lease premises for its own business.

2. Except as amended hereby, the Board's prior action of January 26, 2001 shall remain the same.

Respectfully Submitted,



Kevin E. Moore
Assistant Administrator

APPROVED FOR SUBMITTAL:


William J. Aila, Jr., Chairperson

STATE OF HAWAII
DEPARTMENT OF LAND AND NATURAL RESOURCES
Land Division
Honolulu, Hawaii 96813

January 26, 2001

Board of Land and Natural Resources
State of Hawaii
Honolulu, Hawaii

Statewide

RESUBMITTAL: Amendment to the Sublease Rent Participation Policy

BACKGROUND:

On May 26, 2000, under agenda item D-24, the Board of Land and Natural Resources ("Board") approved the "Revision to Sublease Rent Participation Policy" (refer to Exhibit A). The policy was stated as follows:

"The following policy shall apply to leases under the direct management of the Land Division.

- 1) For unimproved lands, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State.
- 2) For improved lands, the Board shall not receive any portion of sublease rents obtained from subleasing improved space unless that right and method of calculation are specifically stated in the lease."

Recently, staff has come across a situation which this sublease policy does not address. The non-profit Waimanalo Teen Project was issued general lease S-5468 under section 171-43.1, HRS, and received nominal rent (25% of fair market) at \$317 per year (see Exhibit B for calculation). Sometime in mid-1999, the Waimanalo Teen Project requested that they be able to sublet part of their building to Castle Medical Center.

On July 9, 1999, under agenda item D-16, the Board approved and amended staff's recommendation to amend General Lease S-5468 by allowing for subleasing under the lease. The Board amended staff's recommendation by deleting the consent to sublease with Castle Medical Center due to concerns regarding the calculation of the sublease sandwich amount and the issue of whether Castle Medical Center was a for-profit operation circumventing the public auction process.

Based on staff's addressing of these concerns, the Board

As Amended
APPROVED BY THE BOARD OF
LAND AND NATURAL RESOURCES
AT ITS MEETING HELD ON

January 26, 2001. [Signature]

ITEM D-8

EXHIBIT 1

consented to the sublease between Waimanalo Teen Project and Castle Medical Center on November 19, 1999 under agenda item D-27. Item 4 of the recommendation was amended as follows:

"Increase of the annual rental by the amount of the annual sandwich rental profit as calculated by the staff appraiser, subject to adjustment upon renegotiation of the sublease or reopening of General Lease S-5468, or change in the policy."

Regarding the added language, Board meeting minutes reveal that there had been concern about a discrepancy in the sandwich rental calculations. The Administrator suggested deferring this item until a Board briefing to discuss a revision to the sublease policy could be conducted. The Waimanalo Teen Project accepted the rent as calculated and indicated a need to get Castle Medical Center onto the property. In response, the Board approved the consent to sublease and added that the consent would be subject to any future change in the sublease policy.

Based on this situation, staff is recommending changes to the Sublease Rent Participation Policy in this submittal. (This submittal was deferred by the Board on December 15, 2000 to allow the new Chairperson and Board Member McCrory the opportunity to comment on this matter.)

REMARKS:

When the Revision to Sublease Rent Participation Policy was drafted, staff did not account for the situation where a non-profit pays less than fair market rent. As such, staff did not address the public policy question of whether a non-profit, which is being subsidized by the State through nominal rent, should be subject to the same sublease policy provisions as lessees who are paying fair market rent.

Upon discussion among staff, including the staff appraiser, we believe that the sublease policy, as approved, should not apply to any lessee who is paying less than fair market rent. In this case, the lessee is receiving a State subsidy and should not be allowed to solely benefit from subleasing the State property without participation by the State, even where the improvements constructed by the lessee are being subleased rather than raw land.

Further, staff noticed that the approved sublease policy stated "for improved lands, the Board shall not receive any portion of sublease rents obtained from subleasing improved space unless that right and method of calculation are specifically stated in the lease." This provision was based on the premise that the lessee constructed the improvements and assumed the risk and therefore should solely benefit from any subleasing arrangements. Staff would like to clarify where the State owns the improvements (i.e., the lessee assumed no risk), then the lease rent would be revised to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent.

RECOMMENDATION:

That the Board amend the Revision to Sublease Rent Participation Policy approved by the Board on May 26, 2000, under agenda item D-24, by:

- A. Amending paragraph 2) of the Recommendation section by replacing the entire "Policy" statement to read as follows:

"Policy

This policy shall apply to leases under the direct management of the Land Division.

1. For lessees paying fair market rent:

- a. If the lessee subleases unimproved lands, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State. The following calculation shall be used:

Annual Sublease Ground Rent	\$
LESS: General Excise Tax	\$ ()
Net Annual Sublease Ground Rent	\$
LESS: Annual Ground Rent	\$ ()
Additional Annual Rent	\$
MULTIPLIED by 50%	x .50
Additional Annual Rent Due DLNR	\$

- b. If the lessee subleases improvements owned by the State, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State. The following calculation shall be used:

Annual Sublease Income	\$
LESS: General Excise Tax	\$ ()
Net Annual Sublease Income	\$
LESS: Allowances	\$ ()
Management and vacancy loss (eff. inc. x %)	
Repair and maintenance	
Real property tax	
Insurance	
Ground lease rent	
Additional Annual Income	\$
MULTIPLIED by 50%	x .50
Additional Annual Rent Due DLNR	\$

- c. If the lessee subleases improvements not owned by the State, the Board shall not receive any portion of sublease rents from subleasing improved space unless that right and method of calculation are specifically state in the lease.

2. For lessees paying any amount less than fair market rent:

- a. If the lessee subleases unimproved lands, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State. The calculation delineated in 1.a. above shall be used.
- b. If the lessee subleases improvements owned by the State, the Board shall revise the rent to include as additional rent, ~~50%~~ of that portion of the sublease rent in excess of the original ground rent paid to the State. The calculation delineated in 1.b. above shall be used.
changed to 100%
- c. If the lessee subleases improvements not owned by the State, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State. The following calculation shall be used:

Annual Sublease Income	\$
LESS: General Excise Tax	\$ ()
Net Annual Sublease Income	\$
LESS: Allowances	\$ ()
Management and vacancy loss (eff. inc. x %)	
Investment return (total invest. X %)	
Repair and maintenance	
Real property tax	
Insurance	
Ground lease rent	
Additional Annual Income	\$
MULTIPLIED by 50%	x .50
Additional Annual Rent Due DLNR	\$

- B. Deleting paragraph 4) of the Recommendation section in its entirety.
- C. The remaining approved recommendations of agenda item D-24 shall remain in effect.

Respectfully Submitted,

Dierdre S. Namiya

DIERDRE S. NAMIYA, Asst Administrator

APPROVED FOR SUBMITTAL:

Gilbert S. Coloma-Agaran
GILBERT S. COLOMA-AGARAN, Chairperson

8. **Approved as Amended.**—The staff recommendation was amended to read as follows:

This policy shall apply to leases under the direct management of the Land Division. Furthermore, the following formulae generally reflect the intent of the Board regarding the calculation of sublease sandwich profit and shall serve as guidelines in such calculation. The Board authorizes staff to use their discretion in representing the State's interest in applying these formulae to address the varying subleasing arrangements that may not fit neatly into the formulae.

Condition 2.h. was also amended by changing "... [50%] to 100% of that portion of the sublease rent ..."

D-24

STATE OF HAWAII
Department of Land and Natural Resources
Land Division
Honolulu, Hawaii 96813

May 26, 2000

Board of Land & Natural Resources
State of Hawaii
Honolulu, Hawaii

STATEWIDE

Subject: RESUBMITTAL - REVISION TO SUBLEASE RENT PARTICIPATION POLICY

Background

Chapter 171-36(a) (6), 1998 Hawaii Revised Statutes states:

"The lessee shall not sublet the whole or any part of the demised premises except with the approval of the board; provided that prior to the approval, the board shall have the right to review and approve the rent to be charged to the sublessee; provided further that in the case where the lessee is required to pay rent based on a percentage of its gross receipts, the receipts of the sublessee shall be included as part of the lessee's gross receipts; provided further that the board shall have the right to review and, if necessary, revise the rent of the demised premises based upon the rental rate charged to the sublessee including the percentage rent, if applicable, and provided that the rent may not be revised downward;"

On July 9, 1982, under agenda item F-9, the Land Board approved staff's recommendation to adopt a sublease evaluation policy. As stated in this submittal, staff recommended the Board formally adopt the format and procedure used to determine the amount of sandwich profit which was first developed and utilized in 1968. The rationale behind the policy was that the State should not allow anyone to make sandwich profits from the use of State owned property. As stated, the purpose of this policy was "to prevent speculation and to prevent the sublessor from becoming the predominant landlord." The policy also recognized the lessee's right to receive a fair return on his investment. Presently, sandwich profits are estimated using the computation sheet identified as Exhibit A. On the computation sheet, the ground rent and that portion of the rent attributable to the lessee's investment are subtracted from the sublease income to determine what rent, if any, is due DLNR.

APPROVED BY THE BOARD OF
LAND AND NATURAL RESOURCES
AT ITS MEETING HELD ON
May 26, 2000 *AV*

EXHIBIT A

ITEM D-24

Problem Definition

In light of the changed economic environment in which we operate -- in particular, the dramatic decline in property values since the Japanese bubble burst in or about 1990 -- staff revisited the Sublease Evaluation Policy. In evaluating the appropriateness of current policies, staff examined appraisal-related policies, including the sublease rent participation policy. Staff identified the following concerns regarding this policy and accompanying worksheet:

Fairness to Lessees: The current sublease evaluation policy may be unfair to the lessee because it assigns 100% of the sandwich profit to DLNR even though it is the lessee who assumes the risk.

Reduced Marketability: DLNR ground leases may not be as marketable because of the sublease evaluation policy. This may be particularly true in today's depressed economy or when a business savvy lessee is involved.

Lack of Clarity: The current worksheet is open to considerable interpretation and difficult to support.

Cost/Benefit of Implementation: The additional income received may not justify the time spent calculating and applying sandwich profits. For example, one industrial lease may have several subleases with terms of one year or less. Each time these subleases are extended and/or the rents changed, staff must re-evaluate the rents for sandwich profits. Because the law requires that we revise the lessee's rent based on the sublease rent, staff ends up continually changing the lessee's rent based on the sandwich profits determined.

Analysis

Staff's concern is the current worksheet may be too harsh on lessees who essentially act as entrepreneurs and assume much of the risk. This concern was addressed in a January 8, 1987 study done by Ming Chew Associates for the Department of Hawaiian Home Lands (DHHL). The study noted that "many lessees felt that having entered into the original lease in good faith at a set rental, it was unfair to change the rental terms of the lease during "mid-stream" with rental adjustments that were neither discussed nor agreed to during the initial signing of the lease."

The DHHL study also indicated the attempt to prevent speculation is based on the wrong circumstance (the sublease). If the intent is to have lease rents keep up with increases in land value, then the lease should be modified to consider step up rents, percentage rents, rent adjustments based on the CPI, and/or shorter reopening periods. The report stated that in the private sector, most lessors do not participate in sublease rents.

On December 9, 1999, staff conducted a briefing to provide background on the relevant issues of the sublease policy and to explore the Board's views and opinions on different alternatives for the policy.

At this Board briefing, the following issues were discussed:

- 1) The Board questioned whether other large land owners participated in sublease rents and requested that staff expand its survey of other large land owners.
- 2) The Board agreed that a 50% split was more reasonable but questioned the policy's cost/benefit.

Following this Board briefing, staff surveyed large Hawaii landowners and found the following:

Campbell Estate: The estate may take 50% of a sandwich when vacant land is concerned. Once the site is improved, Campbell does not directly participate in sandwich rents.

Bishop Estate: Bishop may also take 50% of a sandwich when vacant land is subleased; however, when a vacant parcel is leased Bishop typically knows what is planned and accounts for this via percentage rent, step-ups, etc. Finding that one of their lessees has created an unexpected sandwich position is rare. Bishop stated that either the lease prohibits such a sandwich or the lessee is being forced to sublease due to difficult economic conditions, hence a sandwich position is unlikely. Bishop would not rule out participating in sandwich rents should one ever exist.

Kaneohe Ranch: Kaneohe Ranch does not directly participate in sandwich rents. Like Bishop, Kaneohe Ranch typically knows what is planned at the start of a lease and does not expect to find unauthorized sandwich positions on its property.

Department of Hawaiian Home Lands: DHHL collects sandwich rents on both vacant and improved sites. The department revises the rent based on 50% of the amount by which the sublease rent exceeds the original rent for that portion of the property. DHHL estimates it receives less than \$5,000 per year in sandwich rents.

Damon Estate: The Damon Estate does not participate in sandwich rents and does not condemn a lessee when one is created. They have no unimproved lands.

Robinson Estate: The Robinson Estate also does not participate in sandwich rents nor does it discourage a lessee from creating a sandwich position. They stated that in fact, much of their lands got developed because sandwich positions on vacant land were permitted. The estate deals only with ground leases.

Based on these findings, staff recommends revisions to the Sublease Evaluation Policy presented at the December 9, 1999 Board briefing to ensure fairness in our dealings with lessees and increase the marketability of our leases.

Staff now believes that when a lessee improves a vacant site and subsequently subleases improved space, the State should not participate in sandwich profits obtained from subleasing that space. Staff recognizes that it is the lessee who has the vision and assumes the risk, and it is the lessee who should benefit.

Staff also believes sublease rent participation should apply when vacant land is leased and subsequently subleased. Staff suggests that when vacant land is subleased the rent paid to the State should be revised to include as additional rent, 50% of that portion of the sublease rent in excess of the rent paid to the State. This leaves the lessee with some economic incentive and allows the State to participate in sandwich profits. This should also help discourage lessees from overtly speculating with State land. The Sublease Participation Worksheet, examples of rent due and rent loss are attached as Exhibits C and D. Note the only expense is G.E. tax (4%) on the sublease rent received, which the sublessor is required to pay.

Staff notes that we are requesting the Board delegate its authority to the Chairperson when sandwich profits do not exist due to: 1) application of the new, recommended policy or, 2) the absence of a sandwich provision in the lease. This request is made to streamline the consent to sublease process.

Policy:

The following policy shall apply to leases under the direct management of the Land Division.

- 1) For unimproved lands, the Board shall revise the rent to include as additional rent, 50% of that portion of the sublease rent in excess of the original ground rent paid to the State.
- 2) For improved lands, the Board shall not receive any portion of sublease rents obtained from subleasing improved space unless that right and method of calculation are specifically stated in the lease.

The Revision to Sublease Rent Participation Policy dated April 28, 2000 was deferred due to concerns the Board had regarding the Sublease Participation Worksheet. The Board questioned the worksheet's clarity and was particularly concerned about deductions for property taxes and miscellaneous allowances. Upon review, staff determined these and all other deductions, with the exception of G.E. tax, should not be included. The revised Sublease Participation Worksheet identified as Exhibits B eliminated these deductions and simplified the line item descriptions.

April 14, 2000

Recommendation: That the Board:

- 1) Rescind its prior Board action of July 9, 1982, under agenda item F-9, including the computation worksheet identified as Exhibit A.
- 2) Approve the above stated policy.
- 3) Authorize the Chairperson to consent to a sublease when no sandwich profit exists because: 1) the lease has no provision which allows for sandwich profits or 2) the sublease involves improved property and according to the above stated policy, the State is not entitled to a sandwich profit; subject to the review and approval of the Department of the Attorney General.
- 4) Approve the revised Sublease Participation Worksheet identified as Exhibit B.

Respectfully submitted,


Benjamin L. Marx III, Staff Appraiser

Approved for Submittal:

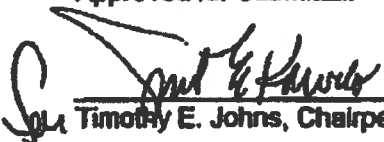

Timothy E. Johns, Chairperson

EXHIBIT A

Format

COMPUTATION SHEET

General Lease No. S-____, _____, Sublessor, sublease to
_____, Sublessee

Gross Annual Sublease Income \$
Less 4% tax _____

Effective Income \$

Less Allowances:

Management, and vacancy loss
(Eff. Inc. x %) \$

Investment return
(Total Inv. x %)

Other operating expenses paid
by sublessor such as real
property tax, insurance premium,
painting, repair and maintenance,
etc.

Reserves for Replacements

General Lease No. S-____ rental _____

Total Allowances: _____

SANDWICH PROFIT: \$

Exhibit B

SUBLEASE PARTICIPATION WORKSHEET
LAND ONLY

General Lease No.	XXXX	
Lessee:	XXXX	
Location:	XXXX	
Tax Map Key:	XXXX	
Land Area (sf):		0
Annual Ground Rent:		\$0

CALCULATIONS:

Annual Sublease Ground Rent	\$0
LESS: G.E. tax	0
Net Annual Sublease Ground Rent:	\$0
LESS: Annual Ground Rent	0
Additional Annual Rent	\$0
Additional Annual Rent Due DLNR (50%)	\$0

Exhibit C

SUBLEASE PARTICIPATION WORKSHEET
LAND ONLY

General Lease No.	S-xxxx
Lessee:	John Doe
Location:	Honolulu, Hawaii
Tax Map Key:	(1) x-x-xx:xx
Land Area (sf):	20,000
Annual Ground Rent:	\$5,000

CALCULATIONS:

Annual Sublease Ground Rent	\$10,000
LESS: G.E. tax	400
Net Annual Sublease Ground Rent:	\$9,600
LESS: Annual Ground Rent	5,000
Additional Annual Rent	\$4,600
Additional Annual Rent Due DLNR (50%)	\$2,300

Exhibit D

SUBLEASE PARTICIPATION WORKSHEET
LAND ONLY

General Lease No.	S-xxxx
Lessee:	John Doe
Location:	Honolulu, Hawaii
Tax Map Key:	(1) x-x-xxxx
Land Area (sf):	20,000
Annual Ground Rent:	\$10,000

CALCULATIONS:

Annual Sublease Ground Rent	\$10,000
LESS: G.E. tax	400
Net Annual Sublease Ground Rent:	\$9,600
LESS: Annual Ground Rent	10,000
Additional Annual Rent	(\$400)
Additional Annual Rent Due DLNR (50%)	\$0

VALUE ESTIMATE

REVOCABLE PERMIT NO. S-5870 (LOT B of TMK: 4-1-09-01)

TOTAL LAND AREA:	=	10.8930 Acres.
Adjustment: Less: Open Stream Ditch	=	<u>0.0953 Acre</u>
Net Area	=	10.7977 Acres

1. Total value of banana crop products for Oahu in 1990 = \$1,489,000 (10/12/90 Value Date)
2. Total acreage devoted to banana crop products for Oahu in 1990 = 485 acres

THUS: \$1,489,000 ÷ 485	=	\$3,070.10 per acre per year
\$3,070.10 x 3.5%	=	\$ 107.45 per acre per annum lease rental
ROUNDED	=	\$ 107.00 per acre per annum

VALUATION:

Total Net Land Acreage 10.7977 acs. @ \$107.00 p/acre	=	\$1,155.35
(FAIR MARKET ANNUAL RENTAL)		

Adjustment:

Permitted use of land for multi-community facility use	+10%	=	<u>115.53</u>
TOTAL FAIR MARKET LEASE RENTAL PER ANNUM		=	\$1,270.88
SPECIAL DISCOUNT (See Attached Board Approval) Minimum annual rent which is 20% of the market annual rental and 5% management fee which is 5% of the annual market rental)		=	<u>.25</u>
ADJUSTED FAIR MARKET LEASE RENTAL PER ANNUM		=	\$ 317.72
ROUNDED		=	\$ 317.00

FINAL ESTIMATE

\$317.00

ANNUAL LEASE RENTAL

DATE OF VALUE: October 12, 1990

EXHIBIT B