FINANCE
NEW • YORK
THE CITY OF NEW YORK
DEPARTMENT OF FINANCE

February 4, 2003

RE: Ruling Request
Anonymous
Commercial Rent or Occupancy Tax
FLR: 024796-007

Dear :

This letter responds to your request, dated September 23, 2002, for a ruling regarding the application of the New York City Commercial Rent or Occupancy Tax (the "CRT) to the hypothetical facts described below. In accordance with Finance Memorandum 00-2 (January 24, 2000) you have represented that, to the best of your knowledge and belief, no notice of determination or disallowance has been issued to any taxpayer covering the issues or facts presented in the request. This office received additional information concerning this request on November 26, 2002 and January 7 and 13, 2003.

FACTS

The hypothetical facts presented are as follows:

Parent is the parent holding company of a multinational group of companies. LLC would be a limited liability company wholly owned by Parent and its existence would be disregarded for federal, New York State, and New York City income tax purposes. Parent would form LLC solely for the purposes of engaging in the transaction described below. Under a lease between LLC, as lessee, and a trust (the "Trust") as lessor (the

"Lease"), LLC would build, maintain, and operate a new building and related improvements (the "Improvements") on a site in New York City.

A wholly owned subsidiary of the Parent (the "Subsidiary") has leased the site of the Improvements from an unrelated party (the "Ground Lessor") for a 99-year term (The "Ground Lease"). The Subsidiary would assign its rights and obligations under the Ground Lease to the Trust for no consideration. Pursuant to a construction agency agreement, the Trust would appoint LLC to act as its agent in connection with the project. LLC, acting as agent for the Trust, would demolish the existing building on the land and began construction of the Improvements. LLC will also pay the rent due under the Ground Lease directly to the Ground Lessor. You have represented that CRT is paid on the payments under the Ground Lease and no ruling is requested with respect to the payments under the Ground Lease.

The Trust would finance the costs of demolishing the existing building, and constructing the new building and of making required payments under the Ground Lease (collectively the "Project Costs") with the proceeds from the issuance of notes (the "Notes") and Certificates (the "Certificates"). The proceeds from the Notes would account for 97 percent of the Project Costs and the proceeds from the Certificates would account for the remaining three percent.

Two tranches of Notes would be issued: the A1 Notes, the principal amount of which would equal 85 percent of the Projects Costs, and the B1 Notes, the principal amount of which would equal 12 percent of those costs. The Trust would make payments on the Notes twice a year. The payments would be interest only; the Notes would not provide for any amortization of principal prior to maturity. Yields on the Notes would be based on interest rates in the commercial paper market. They would mature at the end of the Lease. The yield on the Certificates would be equal to the six month LIBOR rate, plus 1.75 percent.

The Lease would have an initial nine-year term. However, before the end of that term, LLC would be able to request an extension. The holders of the Notes and Certificates and their agent must agree to the extension. The rent during the extension term must provide for amortization of the Notes and Certificates in an amount and manner acceptable to the holders of the Notes and Certificates.

Absent an event of default and certain other events, the Lease would permit LLC to make alternations and renovations to the Improvements at its own expense. However, It could not make renovations or alterations that substantially reduced the Improvements value, square footage, volume, or utility. LLC could sublease up to 20 percent of the gross rentable space of the Improvements.

The Lease would be a triple net lease. LLC's obligations to make payments of rent would be unconditional and not limited or affected by any damage to, condemnation of, or eviction from, the Improvements. Under the Lease, LLC would be required to make all payments in connection with the Improvements, including all costs of maintenance and repair, all real estate taxes and all required insurance premiums. LLC would be solely responsible for any damage to the Improvements during the Lease's term. LLC also would indemnify the Trust for any losses resulting from non-compliance with the operative documents and the use, operation, and maintenance of the Improvements.

The Lease would provide for fixed rental payments equal to the amount the Trust must pay on the Notes and Certificates. The Trust generally would have to forward those payments directly to the holders of the Notes and Certificates. In addition to fixed rent, LLC would have to pay additional rent to cover any additional costs incurred by the Trust and the holders of the Notes and Certificates in connection with the Improvements including (i) breakage costs, (ii) reserve costs, (iii) costs arising from any future government action, (iv) all operating expenses, (v) Trustee fees, and (vi) late fixed rent.

LLC would have an option during the entire term of the Lease to purchase the Improvements from the Trust. The option exercise price would be the sum of (i) the then outstanding principal amount of, plus any accrued unpaid interest on, the Notes, (ii) the face amount, plus any unpaid yield on, the Certificates, and (iii) related costs (collectively the "Purchase Price"). LLC generally would be required to exercise the purchase option upon expiration of the Lease. However so long as no event of default has occurred, LLC by giving written notice to the Trust at least twelve months before the Lease's expiration, could abandon the Improvements upon expiration of the Lease, provided LLC satisfies certain conditions. If LLC abandons the Improvements, it would be required to pay to the Trust an amount sufficient to satisfy in full the Trust's obligations under the A1 Notes. In addition, LLC, or the Trust, if LLC fails to do so, would sell the Improvements, and the proceeds would be applied first to repay the B1 Notes and second to pay the face amount and accrued and unpaid yield on the Certificates. Any remaining proceeds would revert to LLC.

LLC would be primarily responsible for defending any action relating to the condemnation of the Improvements and to seek recovery for any damages occurring to the Improvements during the Lease term. If the Improvements were damaged or condemned, LLC would have to rebuild, replace, or restore the Improvements to substantially the same condition and value as existed before. LLC also would be entitled to receive any insurance recoveries, damages recovered from third parties, or condemnation proceeds in excess of amounts used to rebuild, replace, or restore the Improvements. If, after being damaged or condemned, the Improvements cannot be expected to be restored to its prior condition before the end of the Lease term, either party would be entitled to terminate the Lease. Upon such termination, LLC would have to buy the Improvements from the Trust for the Purchase Price, less any condemnation proceeds or damages recovered.

After an event of default under the Lease, the Trust would be able to require LLC to buy the Improvements for the Purchase Price. In addition, upon the occurrence of certain non-performance events, the Trust would be able to require LLC (i) to pay an amount sufficient to satisfy the A1 Notes, or, if such event were to have occurred prior to timely completion of the project, 89.9 percent of amounts needed to retire the Notes and

Certificates plus related costs, and (ii) to either relinquish the Improvements to the Trust or pay an amount needed to retire the remaining Notes and Certificates and obtain the Improvements.

If construction of the Improvements were not timely completed, the Lease would provide that LLC may purchase the Improvements from the Trust for the Purchase Price, sell the Improvements, or relinquish the Improvements to the Trust. In the latter two events, LLC would guarantee payment to the Trust of an amount equal to 89.9 percent of the outstanding Notes and Certificates.

Parent would guarantee all of LLC's obligations under the Lease and other operative documents. In addition, pursuant to an instrument guaranty, LLC would guarantee repayment in full of the A1 Notes.

LLC would be required to provide the Trust with periodic financial information regarding the Improvements and to notify the Trust regarding certain material events. The Trust would be entitled to record the Lease.

For federal, State and City income tax purposes, none of the parties, including Parent, LLC, the Trust and holders of the Notes and Certificates, would treat the Trust as the owner of the Improvements or as the issuer of the Notes and Certificates. Rather, LLC would be treated as the owner, but because it would be disregarded for income tax purposes, Parent would be treated as the owner of the Improvements for tax purposes. Parent also would be treated as the obligor under the Notes and Certificates. As a result, Parent would take depreciation deductions for the Improvements and deduct all payments attributable to interest on the Notes and the yield on the Certificates. For financial reporting purposes, however, Parent would treat the Lease as a lease with an option to buy the Improvements, consistent with the form of the transaction.

LLC would obtain the funds to make its required payments under the Lease, and to pay the operating expenses of the Improvements, through capital contributions from Parent to LLC.[1] The Improvements would be used principally by several subsidiaries of Parent. The Parent would use less than one percent of the Improvements' floor space. None of the users of the Improvements would make any payments of rent or payments in lieu of rent to LLC or to Parent. Rather, LLC would grant a gratuitous license to Parent and it subsidiaries to use the Improvements on a rent-free basis. Parent's subsidiaries from time to time distribute dividends to Parent. Parent, however, generally would not use the resulting cash flow to make its capital contributions to LLC, and the amount and timing of such distributions would have no correlation to Parent's capital contributions to LLC. There would also be no correlation between the amount and timing of a subsidiary's distributions to the Parent and the amount of floor space the subsidiary occupies. There will be no changes in the timing and amount of subsidiary distributions following the creation of the Lease.

[1] LLC would not own any material assets other than the Lease and assets related to its right and obligations thereunder, and would not engage in any activities other than those relating to the Lease and related transactions and maintenance of the Improvements.

ISSUES

You have requested rulings that the CRT would not apply either to the payments made by LLC to or for the benefit of the Trust under the Lease, including payment of real estate taxes by LLC on the Improvements, other than payments made under the Ground Lease directly to the Ground Lessor, or to capital contributions by Parent to LLC to fund LLC's obligations to the Trust under the Lease and to fund the operating expenses of the Improvements.

CONCLUSIONS

Based on the hypothetical facts presented and representations submitted, we have determined that the CRT would not apply either to the payments made by LLC to or for the benefit of the Trust under the Lease, including payment of real estate taxes by LLC on the Improvements, other than payments made under the Ground Lease directly to the Ground Lessor, or to capital contributions by Parent to LLC to fund LLC's obligations to the Trust under the Lease and to pay the operating expenses of the Improvements.

DISCUSSION

The CRT is imposed on rent paid by a tenant who occupies, uses, or intends to occupy or use premises in New York City for "carrying on or exercising any trade, business, profession, vocation or commercial activity." Sections 11-701(5), 11-701(7) and 11-702(a) of the Administrative Code of the City of New York (the "Code"). Code section 11-701.6 defines "rent" as:

> the consideration paid or required to be paid by a tenant for the use or occupancy of the premises, valued in money, whether received in money or otherwise, including all credits and property or services of any kind and including any payment required to be made by a tenant on behalf of his or her landlord for real estate taxes, water rents or charges, sewer rents or any other expenses (including insurance) normally payable by a landlord who owns the realty other than expenses for the improvement, repair or maintenance of the tenant's premises.

A "tenant" is defined as a "person paying or required to pay rent for premises as a lessee, sublessee, licensee, or concessionaire." Code § 11-701.3. The owner of a building who occupies space in the building is not considered a "tenant" for purposes of the CRT. *See*, Title 19 of the Rules of the City of New York ("RCNY") § 7.01.

Payments by LLC under the Lease

Under the terms of the Lease, LLC would be granted the right to use and occupy the Improvements as a lessee. The parties seek to disavow the Lease's form on the basis that LLC's rights and obligations with respect to the Improvements under the Lease would not be those of a tenant under a true lease, but rather those of a borrower under a financing arrangement.

In general, under federal and New York State tax law, a taxpayer may not disavow the form of a transaction. *See,* Commissioner v. National Alfalfa Dehydrating and Milling Co., 417 U.S. 134, 148-149 (1974); Sverdlow v. Bates, 283 AD 487, 491 (3rd Dept. 1954). However, a taxpayer may assert a transaction’s economic substance if (1) its tax reporting and actions are consistent with the substance of the transaction, Comdisco, Inc. v. United States, 756 F.2d 569, 578 (7th Cir. 1985); and (2) the taxpayer offers strong proof that the transaction is a financing arrangement, Illinois Power v. Commissioner, 87 T.C. 1417, 1434 (1986); Coleman v. Commissioner, 87 T.C. 178, 201-202 (1986), *aff’d per curiam,* 833 F.2d 303 (3rd Cir. 1987).

Substance of the transaction: For federal income tax and New York State tax purposes, a leasing transaction, including a "synthetic lease," will be treated as a financing arrangement if the lessee has the benefits and burdens of ownership despite not having title to the property. *See,* Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Helvering v. F & R Lazarus & Co., 308 U.S. 252 (1939); Rev. Rul. 68-590, 1968-2 C. B. 66; FSA Memo 199920003 (May 21, 1999) (synthetic lease situation); Matter of Sherwood Diversified Services, Inc., 382 F. Supp. 1359 (interpreting New York State sales tax law); General Electric Co., Inc, TSB-A-96(5)R (June 25, 1996) (synthetic lease situation); Eastman Kodak Co., TSB-A-90(8)S (March 12, 1990). *See also*, Matter of Erie County Industrial Development Agency v. Roberts, 63 N.Y.2d 810 (1984) *aff’g for reasons stated at* 94 A.D.2d 532 (4th Dept. 1983) (applying "benefits and burdens" analysis to lease transaction to determine if project financed by Industrial Development Agency is a "public works" project for purposes of the Labor Law). This analysis has been applied to determine the ownership of leasehold improvements, such as the Improvements. *See*, Herman B. Meislman, TC Memo 1961-90 (March 30, 1961). In our opinion, it is appropriate to apply the above "benefits and burdens of ownership" analysis for purposes of the CRT.

The factors relevant to determining whether a lease transaction is a financing arrangement include: (1) which party exercises control over the property during the lease term, including the right to make improvements; (2) who bears the risk of loss from a casualty or condemnation, and the liability for repayment of a loan; and (3) which party has the potential to obtain profit or incur loss from the holding of the property. *See*, Sun Oil Co. v. Commissioner, 562 F.2d 258, 268-269 (3rd Cir. 1977); Illinois Power, *supra*, 1437-1440; Pacific Gamble Robinson and Affiliated Companies v. Commissioner, T.C. Memo 1987-533; Eastman Kodak, TSB-A-90(8)S; FLR-93-110. *See also,* Levy v. Commissioner, 91 T.C. 838, 860 (1988); Larsen v. Commissioner, 89 T.C. 1229, 1267 (1987), *aff’d in part and reversed in part sub nom* Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Torres v. Commissioner, 88 T.C. 702, 720-722 (1987); Coleman, 87 T.C. 178, 205; Grodt & McKay Realty Inc. v. Commissioner, 77 T.C. 1221 (1981).

Addressing the first factor, the facts showing that LLC would exercise control over the property include: (i) LLC would have complete control over the design and construction of the Improvements; (ii) LLC would have the right to possess and use the Improvements; (iii) LLC would have the right to make additional renovations and alterations, provided they do not impair the Improvements' value or its square footage, volume, or utility; and (iv) LLC could sublease up to 20 percent of the Improvements. You have represented that borrowers typically impose this limitation on owners of this type of Improvements.

Addressing the second factor, the facts showing that LLC bears the risk of loss from a casualty or condemnation, and the liability for repaying the loan, include: (i) LLC would be required to insure the Improvements against any loss or liability: (ii) in the event of a casualty or condemnation, LLC would have to restore the Improvements to substantially the same condition or value as existed before the casualty or condemnation, and its obligation to pay rent under the Lease would be unchanged; (iii) if LLC were not in default under the Lease, it would receive any insurance proceeds or condemnation awards in excess of amounts applied to restore the Improvements; (iv) if LLC were in default, insurance proceeds or condemnation awards would be applied to the repayment of the Notes and Certificates, and any excess would be paid to LLC; (v) if, following a casualty, the Improvements could not be restored during the Lease term, either LLC or the Trust could terminate the Lease, and then LLC would be obligated to pay the Purchase Price and would become the owner of the Improvements; and (vi) in the event of LLC's default under the Lease, it would be required to pay the Purchase Price and acquire the Improvements.

Addressing the third factor, the facts show that LLC would have the potential to benefit from appreciation and to lose from depreciation in the value of the Improvements. If LLC exercised its purchase option or were in default under the Lease, it would pay the Purchase Price and acquire the Improvements. The Purchase Price would be a fixed amount based on the amount of the outstanding Notes and Certificates. As a result, LLC would stand to gain or lose depending on whether the Improvements appreciated or depreciated in value.

If, by the end of the Lease, LLC did not exercised its purchase option, LLC would have to pay the Trust the amount of the A1 Notes, equal to 85 percent of the total of the Notes and Certificates, and sell the Improvements. The sales proceeds would be applied first to pay the B1 Notes and Certificates, with the remainder going to LLC. As a result, LLC would stand to gain if the Improvements appreciated. Only in the unlikely event that the Improvements lost 85 percent of their value would the Trust receive less than the full amount of the outstanding Notes and Certificates as a result of the sale and, hence, suffer a loss. This potential depreciation risk would be no different than the depreciation risk borne by any nonrecourse lender. It would not spring from a genuine equity interest in the Improvements. Moreover, the Trust's depreciation risk would be quite small relative to the risk borne by LLC. The Improvements would have to lose 85 percent of its value for the Trust to suffer any loss. By contrast, LLC would be required to pay, at a minimum, 85 percent of the outstanding liabilities, regardless of the future value of the Improvements, and lose all of its interest therein. Clearly, LLC would bear the greatest risk of loss due to depreciation.

In addition to the three factors described above, the relationship of the Lease to the Notes and Certificates shows that the substance of the transaction is a financing arrangement. The "rent" during the initial term and any extensions, is not based on fair market value for a lease of the Improvements, but on the amounts needed to pay interest on the Notes and Certificates. Similarly, the Purchase Price is not based on the Improvements' fair market value at the time of the purchase, but on the amount necessary to retire the Notes and Certificates.

As a result, we conclude that you have offered strong proof that the substance of the transaction would be a financing arrangement and not a lease.

<u>Tax reporting and other actions:</u> To assert that a transaction's substance should be respected rather than its form, a taxpayer also must establish that its tax reporting and actions are consistent with the substance of the transaction. In that regard, you have represented that for federal, state and local income tax purposes, none of the parties, including Parent, LLC, the Trust and holders of the Notes and Certificates, would treat Trust as the owner of the Improvements or as the issuer of the Notes and Certificates. Rather, LLC would be treated as the owner, but because it would be a disregarded entity for income tax purposes, Parent would be treated as the Improvements' owner. Parent also would be treated as the obligor under the Notes and Certificates. As a result, Parent would take depreciation deductions in connection the Improvements and deduct all payments attributable to interest on the Notes and the yield on the Certificates. Based on those representations, we conclude that the tax reporting and other actions of the parties would be consistent with the substance of the transaction.

<u>Summary</u>: Because you have offered strong proof that the substance of the transaction would be a financing arrangement and not a true lease, and have represented that the taxpayer's tax reporting and other actions would be consistent with the substance of the transaction, we conclude that for CRT purposes, the Lease would not be treated as a true lease of, but as a financing arrangement for, the Improvements. As a result, LLC would not be a "tenant" of the Improvements under Code section 11-701.3 and the payments it would make to the Trust with respect to those Improvements would not be "rent" under Code section 11-701.6. The CRT therefore would not apply to those payments.

<u>Parent's Capital Contributions to LLC</u>

LLC would obtain the funds to make its required payments under the Lease, and to pay the operating expenses of the Improvements, through capital contributions from Parent to LLC. The Improvements would be used principally by several subsidiaries of Parent. The Parent would use less than one percent of the Improvements' floor space. None of the users of the Improvements would make any payments of rent or payments in lieu of rent to LLC or to Parent. Rather, LLC would grant a gratuitous license to Parent and its subsidiaries to use the Improvements on a rent-free basis. Parent's subsidiaries from time to time distribute dividends to Parent. Parent, however, generally would not use the resulting cash flow to make its capital contributions to LLC, and the amount and timing of such distributions would have no correlation to Parent's capital contributions to LLC. There would also be no correlation between the amount and timing of a subsidiary's distributions to the Parent and the amount of floor space the subsidiary occupies. There will be no changes in the timing and amount of subsidiary distributions following the creation of the Lease.

We have determined that the Lease is not a true lease but a financing arrangement. Because LLC would be a special purpose entity, the Parent would be making capital contributions to LLC so that it would make its payments under the Lease and pay operating expenses of the Improvements. The Parent's payments and the payments by LLC would be consistent with LLC's and Parent's status as the owners of the Improvements. Also consistent with that status is the fact that, because the Parent is using less than one percent of the floor space, it is paying far more than a tenant would pay for the space. Similarly, that the other users of the building, Parent's subsidiaries, do not make payments that have any connection to their use of the Improvements, is also consistent with that status.

An owner of property that occupies the property is not a tenant for CRT purposes. *See*, 19 RCNY § 7.01. Therefore, we have determined that the CRT would not apply to the Parent's capital contributions to LLC.

Sincerely,

Ellen E. Hoffman
Assistant Commissioner
Tax Law and Conciliations