



FINANCE
NEW • YORK
THE CITY OF NEW YORK
DEPARTMENT OF FINANCE
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July 27, 2007

Re: Request for Ruling
Commercial Rent or Occupancy Tax
FLR-074864-007

Dear Mr. _____ :

This is in response to your request for a ruling, dated January 15, 2007 and received on January 30, 2007, regarding the application of the New York City Commercial Rent and Occupancy Tax (CRT) to the hypothetical transaction described below. Additional information was received on March 16 and May 3, 2007.

FACTS

The facts presented are as follows:

In the hypothetical transaction, a limited liability company (“LLC”), referred to as Parent LLC (“Parent”), is an LLC organized under the laws of Delaware and is authorized to do business in New York. Parent owns 100 percent of the membership interests in a single-member LLC referred to as Holdco LLC (“Holdco”), which in turn owns 100 percent of the membership interests in two other single-members LLCs: Opco LLC (“Opco”) and Propco LLC (“Propco”). Holdco, Opco and Propco are all organized under the laws of Delaware and authorized to do business in New York. Parent purchased the assets, which consisted of several parcels of real property and an operating business, from an unrelated entity. Opco was organized to own the operating business and Propco was organized to own all of the real property assets. Propco will rent the real property assets to Opco pursuant to a lease (the “Lease”). One of these real property assets is located in the City of New York in the Borough of Manhattan south of 96th Street.

This arrangement was created to satisfy the mortgage lender (the “Lender”), which required that the real property assets be owned by a single-purpose, bankruptcy-remote entity whose only purpose is to own and operate the leased real property. The mortgage financing was necessary to assist Parent in its acquisition of the assets from the unrelated entity. The Lender established the terms of the Lease between Propco and Opco, with the Lender having the sole discretion to modify the Lease. The amount of rent to be paid under the Lease is determined by the cash flow necessary to cover the debt service on the mortgage loan and to fund certain escrow accounts. The cash flow amounts are allocated among the properties. The Lease requires Opco to pay all costs to operate and maintain the leased real property. In addition, Opco must cover all insurance costs and fully indemnify Propco for any liability during Opco’s occupancy. Further, Propco will have no obligation to maintain, repair or otherwise service the leased real property.

Moreover, the occurrence of any of the following events due to Opco's default will not relieve Opco's obligations under the Lease, which shall survive any of these events: (i) the termination of the Lease; (ii) the repossession of the leased property; (iii) the failure of Propco to relet the leased real property; and (iv) the reletting of all or any part of the leased real property. Upon the occurrence of any of these events, Opco would be required to pay to Propco all the rent then due and payable under the Lease. In addition, Opco would be required to pay damages to Propco, at Propco's option, consisting of either of the following: (1) Without termination of Opco's right to possession of the leased real property, Opco would be required to pay an installment of rent, based on an average of annual rent due under the Lease, plus other sums due under the Lease as these monthly installments and other sums become due and payable under the Lease plus applicable interest on any overdue installment; or (2) the sum of following: (i) the present value, at the time of the termination, repossession or reletting, of the amount by which the sum of the unpaid rent for the balance of the term of the Lease exceeds the amount of lost rent that Opco proves Propco could reasonably avoid, less any rent Propco received after the time of the termination, repossession or reletting; and (ii) any other amount needed to compensate Propco for any loss or detriment resulting from Opco's default.

Although the term of the Lease is twenty 20 years, the mortgage financing is for a period of two (2) years with the possibility of three (3) one-year extensions, at the option of the borrower, Propco. Once the mortgage loan has been repaid, however, the terms of the mortgage permit cancellation of the Lease at any time. Because the Lease was created to obtain the mortgage, as soon as the mortgage loan is repaid, the parties intend to terminate the Lease.

Finally, Holdco, Opco and Propco are all disregarded entities for tax purposes. Accordingly, the Lease and any payments thereunder will be ignored for tax purposes and will not be reflected on any tax return; Parent will be the only entity among the above entities to file tax returns; and Parent will take the deductions for depreciation and interest related to the leased real property on its tax returns. Parent has represented that but for the Lender's requirements, Holdco, Opco and Propco would not exist, and Parent would own directly the operating business and the real property assets acquired from the unrelated entity.

ISSUE

Whether Opco's payments to Propco under the Lease with are subject to the CRT.

CONCLUSION

Based on the hypothetical facts presented and representations submitted, we have determined that Opco's rental payments to Propco under the Lease are not subject to the CRT, because the substance of the transaction is a financing arrangement.

DISCUSSION

The CRT is imposed on the rent paid by a tenant who occupies, uses, or intends to occupy or use premises in New York City¹ for "carrying on or exercising any trade, business, profession, vocation or commercial activity...." Administrative Code of the City of New York ("Code") §§ 11-701(5), 11-701(6), 11-701(7) and 11-702(a). 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

¹ For periods beginning on or after September 1, 1995, the rent on any premises located in boroughs other than the Borough of Manhattan or located north of the center line of Ninety-Sixth Street in the Borough of Manhattan is exempt from the CRT. Code § 11-704(h)(1)

the building is not considered a “tenant” for purposes of the CRT. See Title 19, Rules of the City of New York (RCNY), § 7.01.

Given the form of the Lease in the hypothetical transaction, which is structured as a lease of the real property between Propco and Opco, Opco’s rental payments under the Lease would be subject to the CRT. However, Opco seeks to disavow the form of the transaction and contend that the Lease is, in reality, a financing transaction in which its rights are not those of a tenant under a true lease but are those of a borrower under a loan.

In general, 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 App. Div. 487, 491 (3rd Dept. 1954). However, a taxpayer may assert a transaction’s economic substance if (1) 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), and (2) 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).

For federal income tax and New York State tax purposes, a leasing transaction will be treated as a financing arrangement if the rights and obligations with respect to the property of the party, described as the “lessee”, are, in substance, those of a borrower under a financing arrangement. See Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Helvering v. F & R Lazarous & 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). In our opinion, it is appropriate to apply this analysis for purposes of the CRT.

The hypothetical facts establish that the rights and obligations of Opco are those of a borrower under a financing transaction and not those of a lessee under a true lease. First, as a threshold matter, the hypothetical facts show that the Lease exists only as a result of Parent’s need to obtain financing in connection with its asset acquisition transaction. The Lender required the acquired real property assets to be conveyed to a single purpose, bankruptcy-remote entity, which would act as the borrower on the mortgage loan, and whose only purpose would be to own and operate the leased real property.

Other hypothetical facts also indicate that the Lease is a financing transaction and not a true lease. For example, the amount of rent due under the Lease equals the cash flow needed to cover the mortgage payments. Also, Opco is required to pay all costs to operate and maintain the leased real property, while Propco will have no obligation to maintain, repair or otherwise service the leased real property. Further, Opco is required to maintain insurance covering any loss or liability concerning the leased property, and must fully indemnify Propco for any liability that arises during its occupancy. Moreover, in the event of a default under the Lease, Propco can require Opco to, in essence, repay the mortgage loan by either mandating Opco to continue to make payments of rent and other amounts that would become due under the Lease as they become due, or requiring Opco to pay the present value of the unpaid rent less certain allowances for rent collected or losses that Opco can prove Propco could have avoided.

The term of the Lease extends well beyond the term of the mortgage, which would result in Propco’s ownership of the leased real property subsequent to the repayment of the mortgage. However, once the

mortgage loan has been repaid, the terms of the mortgage permit cancellation of the Lease at any time, and you have represented that the parties intended to terminate the Lease upon the repayment of the mortgage loan.

The tax reporting and actions of Parent, Holdco, Opco and Propco will be consistent with the substance of the transaction. You have represented that Holdco, Opco and Propco are all disregarded entities for tax purposes and are treated as branches of Parent. Accordingly, Parent is treated as the owner of the leased real property and the obligor on the mortgage loan for tax purposes, and is entitled to claim the depreciation deductions for the leased real property and the interest deductions with respect to the mortgage loan on income tax returns. In addition, the rental payments under the Lease will not be reflected on any tax return.

Based on these hypothetical facts, we conclude that the tax reporting and actions of the taxpayer are consistent with the substance of the transaction. Accordingly, we conclude that the Lease is not a true lease, but a financing arrangement. Thus, the payments Opco makes to Propco under the Lease are not subject to the CRT, because they are not rent for purposes of Code section 11-701(6) and Opco is not a tenant within the meaning of Code section 701(3).

Sincerely,

Dara Jaffee,
Assistant Commissioner
Legal Affairs