May 18, 2011

Re: Request for Ruling
Anonymous
Commercial Rent Tax
FLR 10-4913-007

Dear:

This responds to your request for a hypothetical ruling that certain payments pursuant to an instrument described as a "lease" would not be considered to be "rent" under the New York City Commercial Rent and Occupancy Tax (the "CRT"). This office received additional information concerning this request on December 23, 2010.

FACTS

You have presented the following hypothetical facts:

Owner LLC ("Owner"), a wholly-owned subsidiary of Parent Corporation ("Parent"), owns a fee interest in certain property located in New York City (the "Property"). The Owner is treated as a disregarded entity for all tax purposes.

Background. Until its acquisition by the Owner, the Property was owned by unrelated party (the "Former Owner"). At that time, the Property was subject to an existing mortgage loan (the "Mortgage Loan") held by a consortium of lenders unrelated to Owner or Parent (the "Lender"). As required under the Mortgage Loan, the Former Owner was a single-purpose, bankruptcy-remote, entity whose only purpose was to own and lease real property.

The Property was subject to an existing triple-net-lease (the "Lease") to the Operating Corporation ("Lessee"), another wholly-owned subsidiary of the Parent. Parent is the guarantor of Lessee's obligation under the Lease. Because the Lease is a true lease, the rent was determined based on the fair market value of that type of lease, for that type of property. As a result, the rent under the Lease exceeds the amount necessary to pay debt service (the regularly scheduled principal and interest) on the Mortgage Loan.

In 2009, the Parent sought to acquire the fee interest in the Property from the Former Owner. Because the provisions of the Lease cannot be amended without the Lender's approval, the Parent set up the Owner as a single-purpose, bankruptcy-remote, entity, and the Owner acquired the fee interest. The Mortgage Loan matures on July 1, 2035. However, there is an optional prepayment date in 2015, and Owner expects to pre-pay the Mortgage Loan at that time. The term of the Lease expires in 2023 (subject to two 10-year renewal options).

Proposed transaction. Because the Parent is the beneficial owner of the Operating Company and the Property, it is seeking to reduce the rent to an amount necessary to pay debt service on the Mortgage Loan. To do so, it plans to contribute all its membership interests in the Owner to the Lessee. Simultaneously, with the approval of the Lender, the Lease would be amended (the "Amended Lease") to provide that the rent payable in each period is equal to the amount of debt service payable by the Owner to the Lender under the Mortgage Loan.

Under the Amended Lease, the Lessee would be required to pay all costs to operate and maintain the Property, while the Owner would have no obligation to maintain, repair, or otherwise service the Property. The Lessee would be required to maintain insurance covering any loss or liability concerning the Property, and would be required to fully indemnify the Owner for any liability that arises during its occupancy. The Lessee would also have the an optional prepayment right permitting it to purchase the Property from the Owner for an amount equal to the balance owed to the Lender under the Loan at a designated time during the lease, and a right of first refusal during other times. In addition, the Amended Lease would provide that the Lessee could assign its rights under the Amended Lease or make material alterations to the Property with consent of the Lender and that, in those cases, the Lender could not withhold its consent unreasonably before the date of the optional prepayment.

In addition to other remedies available in the event of the Lessee's default, the Amended Lease would include a provision, the "springing rent provision," required by the Lender. That provision would operate in two circumstances: (i) if an event of default ("EOD") beyond applicable notice and grace occurs under the Mortgage Loan, the rent for the post-EOD periods would spring back to the amount that would have been payable had the Lease not been amended (thus, putting the Lender in the same position following an EOD under the Amended Lease as it would have been had the Lease not been amended), and (ii) if the Owner is required to fund certain "debt service reserves," the Lessee would provide Owner with the cash to fund those reserves by making a one-time rent payment equal to the revised amount (such it "ii" obligation, however, capped at the aggregate amount of rent savings achieved by the Lessee as a result of the Lease amendment). Both those provisions are designed to ensure the Lender that the Lessee would provide the funds necessary to comply with the Mortgage Loan documents.

After the Mortgage Loan has been repaid either upon maturity or refinancing, the Lease may be cancelled. Owner anticipates that it will refinance the mortgage on the optional prepayment date, and, subject to the consent of any subsequent lender, the Owner may terminate the Amended Lease at any time.

Tax reporting and actions. You have represented that the tax reporting and actions of the Parent, the Lessee, and the Owner would be consistent with the substance of the transaction. For example: the Owner would be treated as a disregarded entity for all tax purposes; the Lessee would be treated as the owner of the Property subjected to the Amended Lease and the obligor on the Mortgage Loan for tax purposes; on income tax returns, the Lessee would be entitled to claim the depreciation deductions for the Property and the interest deductions with respect to the Mortgage Loan; and the rental payments under the Amended Lease would not be reflected in any tax return.

ISSUE

You have requested a ruling that the CRT would not apply to the payments made by the Lessee to the Owner under the Amended Lease.

CONCLUSION

Based on the facts presented, we conclude that the CRT would not apply to the payments made by the Lessee to the Owner under the Amended Lease.

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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…." 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. Title 19 of the Rules of the City of New York ("RCNY") § 7.01.

Under the language of the Amended Lease, the Lessee would be granted the right to use and occupy the Property as a "lessee." In this case, you seek to disavow the form of the Amended Lease and related arrangements and assert that the Lessee's rights and obligations with respect to the Property under the Amended Lease would not be those of a tenant under a lease, but rather those of a borrower under a financing arrangement.

Under New York state and federal tax law, while a taxpayer generally may not disavow a transaction's form for tax purposes, see, e.g., Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 , 148-49 (1974) and Sverdlow v. Bates, 283 A.D. 487, 491 (3rd Dept. 1954), it may assert the transaction's economic substance when two conditions are met: first, the taxpayer must offer strong proof that the substance of the transaction is a financing arrangement or is not otherwise a true lease, Illinois Power Co. v. Commissioner, 87 T.C. 1417, 1434 (1986); Coleman v. Commissioner, 87 T.C. 178, 204 (1986), aff'd, 833 F.2d 303 (3rd Cir. 1987); and, second, the taxpayer's 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).

Substance of the transaction. For federal income tax and New York State tax purposes, a purported lease 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 Helvering v. F & R Lazarus & Co., 308 U.S. 252 (1939); Frank Lyon Co. v. United States, 435 U.S. 561 *(1978)*; Revenue Ruling 68-590, 1968-2 C.B. 66; Eastman Kodak Co., TSB-A-90(8)S (March 12, 1990). See also Matter of Sherwood Diversified Services, Inc., 382 F. Supp. 1359 (S.D.N.Y. 1974); Erie County Industrial Development Agency v. Roberts, 94 A.D.2d 532, 539-40 (4th Dept. 1983), aff'd, 63 N.Y.2d 810 (1984). In our opinion, it is appropriate to adopt this analysis for purposes of the CRT.

You have presented strong evidence that the economic substance of the Amended Lease would be a financing arrangement and not a true lease. As a threshold matter, the Lessee and the Owner share a common beneficial owner, the Parent. The Lessee is an operating company that uses the Property as part of its business, and it could have been borrower on a mortgage loan. The Lender, however, required that title to the Property be conveyed to a single purpose, bankruptcy-remote, entity, which would act as the borrower under the Mortgage Loan. To accomplish the Lender's requirement, the Parent formed the Owner to be the borrower. As a result, the Owner's participation in the arrangement has no meaning other than to arrange financing for the Parent and the Operating Company.

Similarly, with a true lease, such as the Lease, the rent is determined based on the fair market value of that type of lease, for type of property, at that time. By contrast, the "rent" payable under the Amended Lease in each period is equal to the amount of debt service (the regularly scheduled principal and interest) payable by Owner to the Lender under the Mortgage Loan for that period date. The fact that rent under the "lease" is determined based on the financing costs and not the market value of the lease of the property, as here, strongly indicates that the arrangement is a financing arrangement rather than a true lease.

Other facts presented further buttress our conclusion that the substance of the Amended Lease would be a financing arrangement and not a true lease. For example: (i) the Lessee must pay all costs to operate and maintain the Property at its own expense, while the Owner would have no obligation to maintain, repair, or otherwise service the Property; (ii) the Lessee would be required to indemnify the Owner for any liability that arises during the Lessee's occupancy of the Property; (iii) the Lessee would be required to insure the Property, and the Owner would not suffer any loss if the Property were to be damaged, destroyed, or condemned; (iv) the Lessee would have the right to purchase the Property from the Owner for an amount equal to the balance owed to the Lender under the Loan at date of the optional prepayment and a right of first refusal during other times; and (v) the Lessee would be able to assign its rights under the Amended Lease and make material alterations to the Property with consent of the Lender and that, in those cases, the Lender may not withhold its consent unreasonably before the date of optional prepayment.

In addition to other remedies in the event of the Lessee's default, the Amended Lease would include a provision, the "springing rent provision," required by the Lender. Under that provision, in the event of the Lessee's default, the rent payable under the Amended Lease would revert to the higher rent under the Lease. That provision merely presents a contingency that does not affect our conclusion concerning the Amended Lease. Like other contingent events that could happen upon a default or otherwise, should the "spring rent provision" go into effect, the conclusions set out in this ruling would no longer apply.

While the term of the Amended Lease would extend beyond the maximum term of the Mortgage Loan, the Mortgage Loan application expressly provides that the Amended Lease could be cancelled by the Lessee at any time following the repayment of the Mortgage Loan, and you have represented that the Lessee and Owner intend to terminate the Amended Lease immediately after the Mortgage Loan is repaid.

As a result, we conclude that the facts presented establish that the economic substance of the Amended Lease would be a financing arrangement and not a true lease.

Tax reporting and actions. The second condition that a taxpayer must meet to assert a transaction's substance over its form is that its taxpayer's tax reporting and actions are consistent with the substance of the transaction. In that regard, you have represented that the tax reporting and actions of the Parent, the Lessee, and the Owner would be consistent with the substance of the transaction. For example: the Owner would be treated as a disregarded entity for all tax purposes; the Lessee would be treated as the owner of the Property subjected to the Amended Lease and the obligor on the Mortgage Loan for tax purposes; the Lessee would be entitled to claim the depreciation deductions for the Property and the interest deductions with respect to the Mortgage Loan on income tax returns; and the rental payments under the Amended Lease would not be reflected in any tax return.

Based on those representations, we conclude that the tax reporting and actions of the Taxpayer and related entities would be consistent with the substance of the transaction.

Summary. We conclude that the Amended Lease would not be a true lease, but a financing arrangement. As a result, the Lessee would not a "tenant" under Code section 11-701.3, and the payments it makes to the

Owner would not be "rent" for purposes of Code section 11-701.6. The CRT would therefore not apply to those payments.

Very truly yours,

Beth E. Goldman
General Counsel

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