

November 15, 2001

Re: Ruling Request

Commercial Rent or Occupancy Tax  
FLR-014776-007

Dear Mr. \_\_\_\_\_ :

This letter responds to your request, dated April 30, 2001, for rulings on behalf of \_\_\_\_\_ (the "First-Tier LLC") regarding the application of the New York City Commercial Rent or Occupancy Tax (the "CRT") to the transaction described below. This office received additional information concerning this request on July 13, 2001.

FACTS

The facts presented are as follows:

The First-Tier LLC is part of a group of related entities as follows:

- \_\_\_\_\_ (the "Parent") is a Delaware corporation. Its stock is publicly traded on NASDAQ. The Parent's address is \_\_\_\_\_ and its federal employer identification number ("EIN") is \_\_\_\_\_.
- (i) \_\_\_\_\_, a Delaware corporation, is a wholly owned subsidiary of the Parent ("the Subsidiary"). The Subsidiary's address is \_\_\_\_\_ and its EIN is \_\_\_\_\_.
- The First-Tier LLC, a Delaware limited liability company, is wholly owned by the Subsidiary. The First-Tier LLC's address is \_\_\_\_\_ and its EIN is \_\_\_\_\_.
- \_\_\_\_\_ LLC (the "Second-Tier LLC") a Delaware limited liability company, is wholly owned by the First-Tier LLC. The Second-Tier LLC's address is \_\_\_\_\_ and its EIN is \_\_\_\_\_.

The Parent is engaged in the \_\_\_\_\_ business. As part of that business, the First-Tier LLC designs, builds, and manages an \_\_\_\_\_ for business customers. The First-Tier LLC arranged to buy an office building located at \_\_\_\_\_, New York, New York (the "Property"). In

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connection therewith, in \_\_\_\_\_, 2000, the First-Tier LLC and \_\_\_\_\_, (the "Lender") agreed to the terms of a mortgage loan (the "Loan Application") in the amount of \$ \_\_\_\_\_ million. The First-Tier LLC and the Lender then signed a commitment letter, dated \_\_\_\_\_, 2000, (the "Loan Commitment") under which the Lender committed itself to make the mortgage loan.

Under the Loan Application and the Loan Commitment, the Mortgage Loan was to be a nonrecourse mortgage loan, secured solely by the Property and the revenues derived therefrom. With certain minor exceptions, the Mortgage Loan was to be nonrecourse to, and was not to be guaranteed by, the Parent, the Subsidiary, or the First-Tier LLC. The Mortgage Loan was to mature on \_\_\_\_\_, 2004, subject to options of the borrower to extend the maturity date for two one-year periods. Interest was at a floating rate, set at 3.5 percent above LIBOR.

The First-Tier LLC had intended to be the borrower on the 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. The Lender also required an opinion of counsel that, if the First-Tier LLC became a debtor in a bankruptcy proceeding, the Property and other assets of the borrower would not be subject to the claims of the creditors of the First-Tier LLC. The Lender also required that the borrower have sufficient revenue to make the payments required on the Mortgage Loan.

To satisfy the requirements of the Lender, on \_\_\_\_\_, 2000, the First-Tier LLC set up the Second-Tier LLC as a single purpose, bankruptcy-remote, entity for the sole purpose of holding title to the Property and acting as the borrower under the Mortgage Loan.

Before the transfer of title, the First-Tier LLC used space in the building to house equipment for providing interconnections to First-Tier LLC's \_\_\_\_\_ communications system. In addition, part of property was leased to a restaurant and part to the New York City \_\_\_\_\_.

On \_\_\_\_\_ (the "Funding Date"), the First-Tier LLC conveyed title to the Property to the Second-Tier LLC, and the Lender funded the Mortgage Loan. At that time, the First-Tier LLC and the Second-Tier LLC entered into an agreement titled "Lease Agreement" (the "Financing Lease").

The Financing Lease. Under the Financing Lease, the Second-Tier LLC is the "Landlord" and the First-Tier LLC is the "Tenant," and the First-Tier LLC pays "rent" to the Second-Tier LLC. The gross amount of that rent is \$ \_\_\_\_\_ million (the "Base Payment"). That amount is equal to the sum of (1) the anticipated annual debt service on the Mortgage Loan (determined without regard to the balloon payment that is due on Maturity), and (2) the amount that is necessary to provide a debt service coverage ratio of approximately 1.80x.<sup>1</sup>

The First-Tier LLC makes the Base Payment directly to the \_\_\_\_\_ Bank (the "Servicer") in equal monthly installments of \$ \_\_\_\_\_ (the "Gross Payment.") The Servicer then pays the Lender the monthly installment of principal and interest on the Mortgage Loan. Then, pursuant to instructions from the

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<sup>1</sup> That debt service coverage ratio was required by the Lender's internal loan underwriting criteria and by Standard & Poor's, which rated the trust certificates evidencing interests in the Mortgage Loan, which the Lender sold to investors. None of the Parent, the Subsidiary, the First-Tier LLC, the Second-Tier LLC, nor any party related to any of them, has acquired any of those trust certificates.

Second-Tier LLC, the Servicer returns all remaining funds to the First-Tier LLC. (The Gross Payment less the amount of returned funds is referred to as the "Net Payment.") The Gross Payment stays the same, while the Net Payment varies as a result of fluctuations in LIBOR; for example, for the March 1 payment it was \$ , and that for April 1 it was \$ .

Under the Financing Lease, the First-Tier LLC must pay all costs to operate and maintain the Property at its own expense. The Second-Tier LLC will have no obligation to maintain, repair, or otherwise service the Property.

The First-Tier LLC will also direct the improvement of, and installation of equipment at, the Property. If the cost of such improvements and installations exceeds the amount of the Mortgage Loan, the First-Tier LLC will bear all such excess costs.

No party to the transaction is obligated to indemnify the First-Tier LLC for liabilities arising under the Financing Lease. The First-Tier LLC must indemnify the Second-Tier LLC for any liabilities arising out of (i) the leasing, use, occupancy, operation, management, condition, design, construction, maintenance, repair or restoration of the Property, (ii) any casualty to the extent not covered by insurance, (iii) any violation by the First-Tier LLC of any provision of the Financing Lease, and (iv) any alleged, threaten or actual Environmental Violation (as defined in the Financing Lease).

The First-Tier LLC must insure the Property. If the Property is damaged, destroyed, or condemned, the First-Tier LLC must offer to buy the Property from the Second-Tier LLC for an amount equal to the outstanding principal balance on the Mortgage Loan. If the Second-Tier LLC declines to accept the offer, the First-Tier-LLC remains liable for the rental payments under the Financing Lease.

In the event of a default by the First-Tier LLC under the Financing Lease, the Second-Tier LLC may elect to terminate the Financing Lease or to repossess the Property without terminating the Financing Lease. If it elects to terminate the Financing Lease, then the First-Tier LLC must pay (i) all rent accrued under the Financing Lease as of the termination date; and (ii) a damage payment equal to the total rent due less the reasonable net rental value of the Property for the remaining term. If the Second-Tier LLC elects instead to repossess the Property without terminating the Financing Lease, then the First-Tier LLC is required to pay (i) all rent accrued under the Financing Lease prior to the date of the repossession, plus (ii) all rent required to be paid for the remaining stated term of the Financing Lease, minus (iii) any net sums thereafter received by the Second-Tier LLC through reletting the Property during the period (after deducting certain expenses incurred by the Second-Tier LLC).

The Financing Lease terminates on , 2020, while the Mortgage Loan matures on , 2006. As a result, the Second-Tier LLC will continue to own legal title to the Property after the Mortgage Loan has been repaid. The Mortgage Loan Application expressly provides that the Financing Lease could be cancelled by the First-Tier LLC at any time following the repayment of the Mortgage Loan. Because the only purpose of the Financing Lease was to satisfy the conditions imposed by the Lender with respect to the Mortgage Loan, the First-Tier LLC and Second-Tier LLC intend to terminate the Financing Lease immediately after the Mortgage Loan is repaid.

Financial and tax reporting. You have represented that, that for federal, state, and local income tax purposes, the separate existence of the First-Tier LLC and Second-Tier LLC is ignored and they are both treated as branches of the Subsidiary. The Subsidiary is thus treated as the owner of the Property

and the obligor on the Mortgage Loan for those purposes and is entitled to claim depreciation deductions with respect to the Property and interest deductions with respect to payments on the Mortgage Loan. In addition, because the First-Tier LLC and Second-Tier LLC are both ignored for tax purposes, the Financing Lease is also ignored for tax purposes, with the result that the payments made by the First-Tier LLC to the Second-Tier LLC under the Financing Lease will not be reflected on the federal, state, and local income tax returns of the Subsidiary or any other party to the transaction.

You have also represented that financial reporting for the Parent, the Subsidiary, the First-Tier LLC, and other affiliates of the Parent will be performed on a consolidated basis. As a result, that reporting does not indicate which member of the Parent's affiliated group is the owner of the Property or the obligor on the Mortgage Loan.

## ISSUES

You have requested a ruling that the CRT will not apply to the payments made by the First-Tier LLC to the Second-Tier LLC under the Financing Lease.

## CONCLUSIONS

Based on the facts presented and representations submitted, we have determined that the CRT will not apply to the payments made by the First-Tier LLC to the Second-Tier LLC under the Financing Lease.

## DISCUSSION

The CRT is imposed on "rent" paid 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 New York City Administrative Code (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 a "person paying or required to pay rent for premises as a lessee, sublessee, licensee or concessionaire." Code § 11-701.3. Thus, the payments made by First-Tier LLC to the Second-Tier LLC under the Financing Lease will be rent, and subject to the CRT, if the First-Tier LLC is making the payments as a tenant for use and occupancy of the Property.

Under the language of the Financing Lease, the First-Tier LLC will be granted the right to use and occupy the Property as a "lessee." The First-Tier LLC seeks to disavow the form of the Financing

Lease and related arrangements and asserts that its rights and obligations with respect to the Property under the Financing Lease are not those of a tenant under a true 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), *affd*, 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), affd, 63 N.Y.2d 810 (1984). In our opinion, it is appropriate to adopt this analysis for purposes of the CRT.

The facts presented establish that the rights and obligations of the First-Tier LLC are those of a borrower under a financing arrangement and not those of a lessee under a true lease. As a threshold matter, the facts presented show that the Financing Lease exists only as a result of the First-Tier LLC's efforts to obtain financing for its acquisition of the Property. The First-Tier LLC had intended to be the borrower on the 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. The "rent" payable under the Financing Lease was then determined based on the funds that would be necessary for the Second-Tier LLC to make the payments on the Mortgage Loan, rather than on the market rent for the Property.

Other facts presented indicating that the substance of the Financing Lease is a financing arrangement and not a true lease include: (i) the First-Tier LLC must pay all costs to operate and maintain the Property at its own expense, while the Second-Tier LLC will have no obligation to maintain, repair, or otherwise service the Property; (ii) the First-Tier LLC will direct the improving and equipping of the Property and must pay any costs exceeding the amount of the Mortgage Loan (iii) the First-Tier LLC must indemnify the Second-Tier LLC for any liabilities arising out of the leasing, use, occupancy, operation, management, condition, design, construction, maintenance, repair or restoration of the Property; (iv) the First-Tier LLC must insure the Property, and the Second-Tier LLC does not suffer any loss if those units are damaged, destroyed, or condemned; and (v) in the event of a default under the Financing Lease, the Second-Tier LLC can require immediate payment of all amounts of rent payable over the unexpired lease term.

The term of the Financing Lease extends beyond the maximum term of the Mortgage Loan, with the result that the Second-Tier LLC will continue to own legal title to the Property after the Mortgage Loan has been repaid. The Mortgage Loan Application, however, expressly provides that the Financing Lease could be cancelled by the First-Tier LLC at any time following the repayment of the Mortgage Loan and you have represented that the First-Tier LLC and Second-Tier LLC intend to terminate the Financing Lease immediately after the Mortgage Loan is repaid.

Tax and financial reporting. 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:

- For federal, state, and local income tax purposes, the separate existence of the First-Tier LLC and Second-Tier LLC is ignored and they are both treated as branches of the Subsidiary. The Subsidiary is thus treated as the owner of the Property and the obligor on the Mortgage Loan for those purposes and is entitled to claim depreciation deductions with respect to the Property and interest deductions with respect to payments on the Mortgage Loan.

- For financial reporting purposes, the Parent, the Subsidiary, the First-Tier LLC, and other affiliates of the Parent will be treated on a consolidated basis. As a result, that reporting does not indicate which member of the Parent's affiliated group is the owner of the Property or the obligor on the Mortgage Loan.

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

We conclude that the Financing Lease is not a true lease, but a financing arrangement. As a result, the First-Tier LLC is not a "tenant" under Code section 11-701.3, and the payments it makes to the Second-Tier LLC will not be "rent" for purposes of Code section 11-701.6. The CRT will therefore not apply to those payments.

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The Department of Finance reserves the right to verify the information submitted.

Very truly yours,

Devora B. Cohn  
Associate Commissioner  
for Legal Affairs

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