



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

June 10, 2004

Re: Request for Ruling

Commercial Rent Tax
Real Property Transfer Tax
FLR No: 034814-721

Dear :

This letter is in response to your request, received on October 29, 2003 on behalf of (“Parent”) about the applicability of the New York City Real Property Transfer Tax (“RPTT”) and the New York City Commercial Rent Tax (“CRT”) to the transactions described below. Additional information was received on February 17 and April 5, 2004.

FACTS

The facts presented are as follows:

Parent is a corporation organized under the laws of New York and having its principal place of business in New York City. Parent owns certain property located at (the “Property”). Parent occupies most of the Property for use as its United States headquarters. Parent uses portions of the Property in its operations and leases other portions to various lessees (the “Tenants”).

To facilitate the transaction, Parent will organize and own all of the membership interests in a Delaware limited liability company (“LLC”). Parent will initially contribute only nominal assets to LLC. Parent will form LLC solely for the purpose of conveying the Property to it (the “Conveyance”) and for entering into the head lease transaction described below. Parent, its parent company, , LLC and their affiliates are collectively referred herein as “Parent Affiliates”.

Parent will transfer the Property to LLC by deed subject to the Tenants’ existing leases. Parent will retain beneficial ownership of the Property under the Conveyance through its 100 percent ownership of LLC. It is not contemplated that Parent and LLC will enter

into any lease agreement with respect to the Property. Rather, immediately after the Conveyance, Parent will continue to occupy and use the Property. For all Federal, New York State and New York City income tax purposes, LLC will be treated as a disregarded entity. Accordingly, for Federal, State and City purposes, Parent will continue to be treated as the owner of the Property and will continue taking depreciation deductions with respect to the Property and deducting all expenses relating to the ownership of the Property.

Shortly after the Conveyance, LLC will lease the Property to an unrelated third party (the "Counterparty") for a period not in excess of 40 years. This lease and an associated lease waiver agreement are referred to herein as the "Head Lease". To the extent that the Property has existing Tenants, the Head Lease will be subject to those existing leases. Upon entering into the Head Lease, the Counterparty will prepay the entire base rent under the Head Lease by making a single lump sum payment to LLC. This payment, net of a relatively small arranger payment made by LLC to an affiliate of the Counterparty at the Closing is referred to herein as the "Upfront Head Lease Payment". LLC is free to apply the funds it receives as the Upfront Head Lease Payment as it chooses. The Counterparty has no control over LLC's use of such funds.

The Head Lease will be conditioned upon, and will be entered into simultaneously with, a sublease and sublease waiver (the "Sublease") under which the Counterparty will sublease the Property back to Parent. The Sublease term will be one day less than the Head Lease term. Parent will be required to make quarterly rent payments under the Sublease, which payments will be sufficient to provide the Counterparty with the return of the Upfront Head Lease Payment and an agreed-upon return. Parent will be obligated to make payments under the Sublease on a "hell or high water basis." Thus, Parent's obligations will not be affected by any casualty or condemnation or other event that would affect Parent's ability to use the Property. To the extent that a casualty or condemnation causes a termination of the Head Lease, Parent will effectively continue to control the Property through its ownership of LLC. In that event, Parent anticipates that LLC will transfer the affected Property back to Parent.

Under the Sublease, Parent will have the right to occupy and use the Property and to make alterations consistent with Parent's practices. Parent also will have the right to further sublease all or any portion of the Property to any person that meets Parent's written guidelines for acceptable tenants.

Although the Counterparty will be responsible for paying the real estate taxes on the Property as well as elevator and HVAC¹ expenses ("Specified Property Expenses") under the Head Lease, pursuant to the Sublease, Parent will assume responsibility for paying the Specified Property Expenses. Under the terms of the Head Lease, LLC will be responsible for paying all other costs, fees, charges and expenses related to the use, possession and operation of the Property, including building maintenance costs, utilities, insurance, etc. ("Other Property Expenses"). The Other Property Expenses together with the Specified Property Expenses are referred to herein as "Property Expenses".

¹ HVAC refers to building systems for heating, ventilation, and air conditioning.

At the inception of the transaction, Parent will estimate the present value of the Property Expenses over the anticipated term of the Head Lease and will make a capital contribution in such amount (the "Capital Contribution") to LLC. Shortly after the transactions with the Counterparty have closed, LLC will make a loan to Parent (the "Parent Loan") in an amount equal to the sum of the Upfront Head Lease Payment and the Capital Contribution. The Counterparty will not be involved in the Parent Loan transaction. Parent will repay the Parent Loan, with interest, by making payments to the Counterparty under the Sublease and direct payments to LLC. In the event LLC requires additional funds to pay Property Expenses, it is anticipated Parent will make future capital contributions. The Parent Loan will be payable in full upon a complete termination of the Head Lease and Sublease.

The Counterparty, as lessee under the Head Lease, may cause a termination of the Head Lease if a "Counterparty Termination Event," occurs. A Counterparty Termination Event includes LLC's failure to pay Other Property Expenses, (ii) LLC's delivery of a "Non-Payment Notice," described below, and (iii) a defined casualty or condemnation event. In addition, after the second anniversary of the closing date (2nd Anniversary"), the Counterparty will also be entitled to terminate the Head Lease for any reason or for no reason whatsoever. LLC may give notice to the Counterparty that it intends to stop paying the Other Property Expenses (the "Non-Payment Notice"). Under the Sublease, if LLC issues a Non-Payment Notice, Parent will be entitled to pay Other Property Expenses directly and to reduce its quarterly payments to the Counterparty by that amount. Parent Affiliates believe that in that event, the Counterparty will cause a termination of the Head Lease.

On the occurrence of a termination event, LLC will be obligated to pay the "Refund Amount" to the Counterparty. You have represented that The "Refund Amount" is economically equivalent to the then outstanding principal and interest of a loan in the original principal amount of the Upfront Head Lease Payment and the interest and principal payments of which are the rent payments under the Sublease.

The Head Lease and Sublease are mutually dependent transactions the overall effect of which is that the Counterparty has the right to use or occupy the Property only on the last day of the Head Lease. Under the combined terms of the Head Lease and Sublease, the Counterparty will pay the Upfront Head Lease Payment to LLC and receive a return of that amount with an agreed-upon yield. The Counterparty will not be obligated to pay any operating expenses with respect to the Property or have any other economic risks with respect to the Property.

ISSUES

You have requested a ruling that:

1. The CRT does not apply to (a) payments made by the Counterparty to LLC under the Head Lease (b) payments made by Parent to the Counterparty under the Sublease, or (c) payments of Property Expenses by Parent.

2. The RPTT does not apply to a conveyance of the Property by Parent to LLC or to the creation or termination of the Head Lease and Sublease.

CONCLUSION

Based on the facts and representations, we have concluded that:

1. The CRT does not apply to (a) payments made by the Counterparty to LLC under the Head Lease, (b) payments made by Parent to the Counterparty under the Sublease, or (c) payments of Property Expenses by Parent.
2. The RPTT does not apply to the conveyance of the Property by Parent to the LLC.
3. The RPTT does not apply to the creation or termination of the Head Lease and Sublease, including any payment of the Refund Amount under the Head Lease.

DISCUSSION

1. CRT

The CRT is imposed on 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...” §§11-701(5), 11-701(7) and 11-702(a) of the Administrative Code of the City of New York (the “Code”).

If the Head Lease and Sublease were true leases, the rent paid under the Head Lease and the Sublease would be subject to the CRT. With the exception of space in the Property leased to Tenants, the Parent will occupy the Property throughout this transaction. The parties to this transaction are seeking to disavow the form of the transaction, however, and contend that the Head Lease and the Sublease are, in reality, a financing program. Parent contends that its payments under the Sublease and to LLC constitute principal and interest payment interest under the Parent 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); *Sverdlov v. Bates*, 283 App. Div. 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).

For United States Federal, New York State and New York City income tax purposes, LLC will be disregarded and treated as a branch of Parent. Accordingly, for all income tax purposes, Parent will treat all of the contemplated transactions as between it and Counterparty. You have represented that for all Federal, State and City income tax purposes, the parties will treat the Upfront Head Lease Payment as the proceeds of a

loan, and Parent will take deductions over the term of the Sublease for the portion of the payments under the Sublease that economically constitute interest, and will continue to claim depreciation deductions in respect of the Properties. Parent will make all withholding tax filings consistent with treating the transactions as a loan and inconsistent with treating such transactions as leases. Parent Affiliates will also treat the transactions as a loan for United States financial accounting purposes and United States bank regulatory accounting purposes.

For Federal and New York tax purposes, a considerable body of authority has held that a leasing transaction 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 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 reason 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). In our opinion, it is appropriate to apply the above “benefits and burdens of ownership” analysis for purposes of the CRT.

The relevant cases indicate that the factors to consider in determining whether a lease transaction should be characterized as 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, 87 T.C. at 1437-1440; Pacific Gamble Robinson and Affiliated Companies v. Commissioner, T.C. Memo 1987-533; Eastman Kodak, TSB-A-90(8)S. 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 Counterparty will have no control over the Property under the Head Lease. The Counterparty is required to immediately sublease the Property to Parent. The facts showing that Parent will exercise control over the property include: (i) Parent will have the right to possess and use the Property during all but the last day of the Head Lease; (ii) Parent will have the right to make renovations and alterations; (iii) Parent will be able to sublease all or any part of the Property; and (iv) if Parent defaults under the Sublease, the Counterparty has the right, but not the obligation, to sublease the Property but, in any event, Parent would remain obligated to pay rent under the Sublease.

Addressing the second factor, the facts showing that Parent and LLC bear the risk of loss from a casualty or condemnation, and the liability for repaying the Upfront Head Lease

Payment, include: (i) LLC is required to insure the Property against any loss or liability and waives any requirement that the Counterparty insure the Property; (ii) in the event of a casualty or condemnation, LLC is required to restore the Property unless either party chooses to terminate the Head Lease, in which case LLC would be obligated to pay the Refund Amount; (iii) if the Head Lease is not terminated, Parent will continue to be required to pay the rent under the Sublease even if it is unable to occupy the Property; and (iv) in the event of LLC's default causing a termination of the Head Lease, LLC would be required to pay the Refund Amount.

Addressing the third factor, the facts show that the Counterparty would not have the potential to benefit from appreciation or to lose from depreciation in the value of the Property. The amounts to which the Counterparty is entitled under the Head Lease and the Sublease are limited to the fixed rent payments and the Refund Amount, which together represent the return of the Upfront Head Lease Payment and the agreed-upon yield on that amount. The Counterparty has no risk resulting from any fall in market rents for the Property and no opportunity for profit from any increase in market rents for the Property. If LLC were in default under the Head Lease, the Counterparty could terminate the Head Lease but the Counterparty would only be entitled to the Refund Amount. The Refund Amount is a fixed amount not based on the value of the Property. As a result, the Counterparty would neither gain nor lose from any appreciation or depreciation, respectively, in the value of the Property. After the 2nd Anniversary, the Counterparty can terminate the Head Lease for any reason and receive the Refund Amount. In addition, LLC can effectively force a termination of the Head Lease and reacquire possession of the Property after the 2nd Anniversary by issuing a Non-Payment Notice. In that event, however, the Counterparty would be entitled to receive the Refund Amount.

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, New York State and City income tax purposes, Parent will be treated as the owner of the Property. As a result, Parent will take depreciation deductions in connection the Property and deduct all payments attributable to interest on the Upfront Head Lease Payment. Based on those representations, we conclude that the tax reporting and other actions of the parties would be consistent with the substance of the transactions.

The substance of the financial terms of the overall transaction is consistent with a loan advanced by the Counterparty secured by the Property. Although title to the Property is being held by the LLC, this is merely a device to facilitate the financing arrangement and must be viewed within that context. The transfer of the Property to LLC was made solely for the purpose of obtaining the financing. Once the financing arrangement is terminated, title to the Property is expected to revert to Parent. 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 CRT. *See*, Title 19 Rules of the City of New York §7.01. We have determined that the Head Lease and Sublease are not true leases and, together with the Parent Loan, are all components of a financing arrangement. Therefore, it is our determination that payments made by the Parent to the Counterparty

under the Sublease, including the payment of Property Expenses and payments under the Parent Loan, are not payments of rent by a tenant subject to the CRT.

2. RPTT

The RPTT is generally imposed on the transfer of real property when the consideration exceeds \$25,000. Section 11-2102(a) of the Code.² A transfer of real property includes the grant, assignment or surrender of a leasehold interest in real property. Code §§11-2101.2 and 11-2102(a)(10). However the RPTT does not apply to the transfer of real property from a principal to its “agent, dummy, straw man or conduit”. Code §§11-2106(b)(7).

LLC will be disregarded for Federal as well as New York State and New York City income tax purposes. LLC will be wholly owned by the Parent and will be formed for the limited purpose of acquiring title to the Property from Parent and entering into the Head Lease transaction on behalf of Parent as part of an overall financing arrangement. All funds received by LLC will be loaned to Parent under the Parent Loan and all payments made of the Refund Amount will of necessity be funded by Parent. Therefore, we have determined that the RPTT is not applicable to the Conveyance because LLC is acting as a mere agent, dummy, strawman or conduit of Parent.

As discussed above, we have concluded that the Head Lease and Sublease should be viewed as part of a financing transaction rather than as true leases. Thus, neither the creation nor termination of the Head Lease and Sublease will be subject to the RPTT pursuant to Code §11-2106(b)(6).

The Department reserves the right to verify the information submitted.

Very truly yours,

Ellen E. Hoffman
Assistant Commissioner for Tax Law
And Conciliations

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² With regard to leaseholds, the RPTT is imposed only to the extent the consideration for the leasehold is not considered rent for purposes of the CRT. Code §11-2101(a)(10)(iii).