



September 29, 2010

**Re:** Request for Ruling  
Commercial Rent Tax  
FLR-104905-007

Dear :

This letter is in response to your request for a ruling, received on March 17, 2010, regarding the application of the New York City Commercial Rent or Occupancy Tax ("CRT") to the transaction described below, involving (the "Lessee") and (the "Lessor"). Additional information was received on May 27, June 16, and June 17, 2010.

#### FACTS

The facts presented are as follows:

The Lessor is a wholly owned subsidiary of the Lessee. On December 1, 2009, the Lessor purchased from an unrelated third party an improved parcel of real property located at Eleventh Avenue, New York, New York (the "Premises"). Lessor paid \$84.35 million for the Premises. Pursuant to the lease agreement (the "Lease") executed shortly before the Lessor's purchase of the Premises, the Lessor leased the Premises to the Lessee as of the date of the purchase, December 1, 2009. The Lease provides for an initial term of seven years. The Lease also provides for automatic extensions for five subsequent consecutive renewal terms of five years each, unless either the Lessor or Lessee sooner terminates the Lease.

The Lease requires Lessee to pay monthly rent consisting of Basic Rent and Additional Rent. During the first two years of Lease's initial term, which the Lease describes as the "Construction Term," the Lessee's monthly Basic Rent is determined under the following formula:

1/12 of 60% of (\$84.35 million plus any amounts Lessor has advanced to Lessee ("Improvement Allowance") plus any adjustment for Capitalized Interest (described below) (collectively these amounts are the "Principal Amount") multiplied by the London Inter-Bank Offer Rate ("LIBOR") (to be adjusted monthly) plus 235 basis points.<sup>1</sup>

Following the Construction Term, the Lessee's monthly Basic Rent is determined under the following formula:

1/12 of the product of the Principal Amount multiplied by the applicable percentage (as set forth below) multiplied by the 7-year Swap Rate on the second anniversary of the Lease plus 364 basis

<sup>1</sup> A basis point is an interest rate term that means 1/100 of a one percent rate of interest. Hence, 235 basis points will be equal to an interest rate of 2.35 percent.

points. The applicable percentage is determined according to the schedule below:

Lease Year	Applicable percentage
3	70%
4	80%
5	95%
6 & 7	100%

To the extent any monthly Basic Rent is an amount that is based on less than 100 percent of the Full Interest Rate (i.e. the LIBOR interest rate or the Swap interest rate plus the set number of basis points), the resulting difference between an amount of monthly Basic Rent that would be based on the Full Interest Rate (i.e. the full Interest Rate multiplied by an applicable percentage of 100 percent) and the Basic Rent is Capitalized Interest that is to be added as an adjustment to the Principal Amount.

The Lessee's monthly Basic Rent for each renewal term will be based on the following:

The Lessor's cost of borrowing at the beginning of that renewal term for a loan for the duration of that renewal term plus a market profit multiplied by the Principal Amount.

The Lessee must also pay monthly Additional Rent consisting of other amounts and obligations that it is required to pay under the Lease as well as any late charges for the late payment of Basic Rent. These obligations include the payment of all taxes, levies, assessments; water and sewer rents and utility charges; license, permit or inspection fees for, on or relating to the Premises.

Under the terms of the Lease, Lessee is required to maintain the Premises and make all necessary repairs and replacements. Lessee has also agreed to indemnify Lessor and hold it harmless from all damages, losses, liabilities and claims arising from the Premises and the ownership, use, nonuse, occupancy and maintenance thereof, except to the extent that any loss, claim or liability is the result of the gross negligence or intentional wrongful act of the Lessor. Lessee must also maintain insurance with respect to the Premises, including: (1) insurance against loss or damage to the Premises; (2) comprehensive general liability insurance concerning personal injury death or property damage in, on or about the Premises; and (3) other insurance including worker's compensation insurance, terrorism risk insurance, insurance concerning the explosion of steam or pressure boilers, and insurance for risks related to any alterations of or to the Premises.

Lessee's obligations under the Lease, including its obligation to pay the monthly Basic Rent and Additional Rent will not be reduced or otherwise affected as a result of any interference with Lessee's use of the Premises for any reason, which include, but are not limited to, any of the following: (i) any damage or destruction of the premises; (ii) any Condemnation; (iii) the prohibition, limitation, or restriction of the use of the Premises; (iv) any eviction due to superior title or otherwise; (v) Lessor's acquisition of ownership of the any part of the Premises, except as provided in the Lease; (vi) any default on the part of the Lessor; (vii) any defect in or loss of the Premises; (viii) the breach concerning guarantees by any seller or manufacturer of the equipment on the Premises.

Lessee may make alterations to the Premises without Lessor's prior consent, provided the alterations do not impair the structural integrity or fair value of the premises. Also, Lessee may assign its rights under the Lease or sublet all or part of the Premises without Lessor's consent, provided the Lessee is not in default. However, no such assignment or sublease will relieve the Lessee of its obligations under the Lease.

Upon Lessor's default, Lessor may terminate the Lease or reenter the Premises and relet the Premises to

another party. The rent from such reletting of the Premises shall be used first to offset Lessor's costs of collection and reletting the Premises, and then against Lessee's monthly rent obligations under the Lease. If the amount received from such reletting is not sufficient to offset these amounts, Lessor shall be liable for the amount of any such deficiency. In the event Lessor terminates the Lease or reenters the Premises, Lessor shall also have the right to obtain final liquidated damages from Lessee which shall be equal to the present value of the amounts by which the Lessee's monthly rent under the Lease's unexpired term exceeds the reasonable monthly rental value of the Premises, plus the Lessor's costs resulting from the default, including legal fees, less any monthly deficiencies previously recovered from Lessee.

During the entire term of the Lease, Lessee has the option to purchase Premises for a purchase price equal to the outstanding Principal Amount (\$84.35 million plus the amount of Improvement Allowance plus the adjustment for Capitalized Interest), provided Lessor is not in default. Further, upon expiration the Lease term, Lessee may purchase the premises for the outstanding Principal Amount, and Lessor may require Lessee to make such purchase. Finally, the Lease states that the Lessor and Lessee intend the transaction to be an operating lease for financial accounting purposes and a financing arrangement for tax purposes.

#### ISSUE

Whether Lessee's payments to Lessor under the Lease are subject to the CRT.

#### CONCLUSION

The Lessee's payments to Lessor under the lease are not subject to the CRT.

#### 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 City<sup>2</sup> 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, sub lessee, 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, Rules of the City of New York (RCNY), § 7.01.

Given the form of the Lease transaction, in which Lessee must make payments to Lessor under the Lease, such payments would be subject to the CRT. However, Lessee 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 (3<sup>rd</sup> 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 (3<sup>rd</sup> 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 (7<sup>th</sup> Cir. 1985).

<sup>2</sup> 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)

Proof Transaction is a Financing Arrangement

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 property owner borrowing funds 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 (4<sup>th</sup> Dept. 1983). In our opinion, it is appropriate to apply this 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 (3<sup>rd</sup> Cir. 1977); Illinois Power, 87 T.C. 1417, 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 (9<sup>th</sup> 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).

Here, the facts establish that Lessee’s rights and obligations under the Lease are those of a property owner borrowing funds under a financing transaction and not those of a lessee under a true lease. First, the calculation of rent clearly resembles the repayment calculation under a financing transaction and not under a true lease. During the Lease’s initial term, the Lessor’s monthly Basic Rent is based on generally referenced interest rates plus an added additional percentage (basis points) multiplied by an applicable percentage and then by the Principal Amount. During the Lease’s Construction Term, Basic Rent is an applicable percentage of a Full Interest Rate determined using the LIBOR interest rate plus 235 basis points (2.35%). During the remainder of the Lease’s initial term, Basic Rent is as an applicable percentage of a Full Interest Rate determined using the 7-year Swap interest rate plus 364 basis points (3.64%). While, during the first five years of the Lease, Basic Rent is an amount that is determined by multiplying the Full Interest Rate by an applicable percentage of less than 100 percent and then by the Principal Amount, the difference between what would be the Basic Rent amount using 100 percent of the Full Interest Rate and the Basic Rent is added to the Principal Amount as Capitalized Interest. Hence, this Capitalized Interest is merely deferred, and must be repaid at a later date. During any renewal term, Basic Rent is to be based on the Lessor’s cost of borrowing at the beginning of that renewal plus a market profit.

With regard to control, risk of loss and potential for profit, the facts further indicate the Lease is, in reality, a financing transaction. At any time during the term of the Lease, or upon its termination, Lessee has the option to purchase the Premises for the outstanding Principal Amount. The only restriction on the Lessee’s exercise of this option is that it cannot be in default. In addition, Lessor may require Lessee to purchase the premises at the end of the Lease. Also, Lessee is required to pay all costs to operate and maintain the Premises, while Lessor has no obligation to maintain, repair or otherwise service the Premises. Further, Lessee is required to maintain insurance covering any loss or liability concerning the Premises, as well as certain other insurance, and must fully indemnify Lessor for any liability that arises during its occupancy. Moreover, Lessee may assign its rights under the Lease or sublet all or part of the Premises. Lessee may also make alterations to the premises, without Lessor’s consent, provided such alterations do not impair the

structural integrity or fair market value of the premises.

Hence, it appears that Lessee exercises very significant control over the Premises, and bears the risk of its loss or destruction. Further, Lessee's purchase option during or at the expiration of the Lease term for a price equal to the outstanding Principal Amount suggests that it is the party with the potential for profit or loss from the holding of the Premises. The only restriction on the Lessee's exercise of the purchase option is that it cannot be in default of the Lease. However, even the Lease's default provisions are consistent with Lessee rather than Lessor being the owner of the Premises.

Should Lessee default under the Lease, it will remain liable for its obligations under the Lease, including its obligation to pay monthly rent. Further, while Lessor may terminate the Lease and/or reenter and relet the premises on Lessee's default, Lessee will be liable for any deficiency between the amount it owes under the lease and the amount Lessor receives from reletting the Premises. Also, Lessor may obtain liquidated damages based on the amount the monthly rent due under the Lease exceeds the reasonable rental value of the Premises. These default provisions are consistent with the rights and obligations a borrower and lender would have upon default on a mortgage or similar secured financing that lead to foreclosure. Thus, Lessee's rights and obligations under the lease are consistent with that of the owner of the Premises, while Lessor's rights and obligations are consistent with those of a secured lender.

#### The Taxpayer's Reporting Actions

The tax reporting actions of the Lessee and Lessor will be consistent with the substance of the transaction. The Lease itself provides that the Lease will be treated as a financing arrangement for federal, state and local tax purposes.

Accordingly, we conclude that the Lease between the Lessee and Lessor is a financing arrangement, and that Lessee owns the Premises for CRT purposes. Hence, Lessee is not a tenant under Code section 11-701(3), and the CRT is inapplicable to the payments that the Lessee must make pursuant to the Lease. Our conclusion here is fully consistent with the position we have taken in prior rulings in various contexts.

The Department reserves the right to verify the information submitted.

Sincerely,

Beth Goldman  
General Counsel