



Recent Advisory Opinion Helps Clarify Transfer Tax Applicability to Long Term Lease Arrangements

Section 575.7(a) of the Real Estate Transfer tax Regulations describes those lease and sublease transactions that are subject to transfer tax. This issue unsuspectingly comes up late in lease negotiations well after the parties have factored in all the costs associated with the economics of the deal. At that point, even though it is technically a transferor's expense, landlords sometimes attempt to push some or all of the cost onto the lessee. Lawyer's for the parties then race to do some quick research and often come away with differing opinions of what the statute and the regulations require.

In response to a taxpayer request to clarify some of the ambiguity of the regulations, New York recently published Advisory Opinion TSB-A-07(2) R (copy attached for your convenience).

As provided by section 1401 (a) of the Tax Law and section 575.5 (a) of the Regulations, the creation of a ground lease for a leased parcel will constitute a taxable conveyance if all three of the following conditions are met: (1) the sum of the term of the lease including any options for renewal exceeds 49 years; (2) substantial capital improvements are or may be made by or for the benefit of the lessee; and (3) the lease is for substantially all of the premises constituting the property.

The opinion concludes that the ground lease in question met the first two tests, but questioned whether or not it met the third.

The opinion made a distinction of the fact that the lease in question, even though a ground lease, was part of a shopping center. Analyzing prior opinions, as well as federal statutes and case law, the opinion recognized the uniqueness of shopping centers in that "a landlord of a shopping center retains strong legal and economic control in the operation and use of the entire shopping center property, including each store that is leased within it. These conclusions do not apply to a lease for real property not located in a shopping center or where there is an option to purchase contained in the lease."



Since it was part of a shopping center, the opinion concluded that the ground lease did not meet the third test since it was not a lease for substantially all of the premises constituting the property. It determined that the property included the entire shopping center and not just the ground leased parcel.

The opinion cautions that since its conclusions are highly dependent on the particular facts, any determination of taxability based on different fact patterns, will be made on a case-by-case basis. It does, however, provide some guidance when analyzing long-term lease arrangements, especially for, and as part of a shopping center. Query, whether or not a long-term ground lease as part of an office park would result in the same opinion.



**New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division**

TSB-A-07(2)R
Real Estate Transfer Tax
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STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. M070131A

On January 31, 2007, the Department of Taxation and Finance received a Petition for Advisory Opinion from Marmon Enterprises, Inc., 197-23 47th Avenue, Flushing, New York 11358.

The issue raised by Petitioner, Marmon Enterprises, Inc., is whether real estate transfer tax is due upon the signing of a lease with a term in excess of 49 years that covers a portion of a retail shopping center as described below.

Petitioner submitted the following facts as the basis for this Advisory Opinion.

Petitioner is the fee owner of approximately 5.085 contiguous acres in Queens, New York, on which there is a free-standing supermarket, a free-standing bank building, a fenced-in retail garden center (including a retail building and auxiliary structures), and a common parking lot shared by all of the retail tenants. The property is operated by Petitioner as an integrated shopping center for all of the retail tenants.

On the northeast corner of the property, there is a small unimproved area that has been used, among other things, for truck ingress and egress to the garden center, temporary parking and unloading of trucks making deliveries to the garden center, and private parking as permitted by Petitioner. Petitioner would like to combine the unimproved area with a small portion of the garden center property so that a new retail building with expanded parking can be added to the shopping center. Petitioner believes that the new retail stores will draw additional customers to the shopping center, creating mutual benefits for both new and existing tenants. In order to create an area large enough for the proposed new building and parking, Petitioner entered into negotiations with the garden center tenant. Following the negotiations, the garden center tenant agreed to a reduction in the size of the garden center, arrangements were made for truck ingress and egress into the garden center through the existing parking lot, and a part of the fence surrounding the garden center was moved so a small portion of the garden center acreage became available for the new construction. As a result, approximately 0.498 acre of the shopping center is available for construction of the new building and parking area (the "Leased Parcel").

Petitioner entered into negotiations with a prospective ground lessee of the Leased Parcel and the parties are ready to enter into a ground lease for a term of more than 49 years. The ground lessee would construct the new building and additional parking, but no option to purchase would be included in the ground lease. With possible minor exceptions for specific parking spots, the parking area of the Leased Parcel will be open to customers of the entire shopping center and the currently existing shopping center parking area will be open to all

customers of tenants of the Leased Parcel. When the construction is completed on the Leased Parcel, the building, together with all of the buildings in the currently existing shopping center, will share common parking with common entrances and exits. Uniform rules and regulations will prevail with respect to all common areas. The Leased Parcel will be less than 50% of the total rentable space of the shopping center, exclusive of common areas. In order to maintain a proper mix of tenants and merchandise in the shopping center, most tenant leases in the new building will include a variety of restrictive covenants prohibiting the sale of certain items.

Applicable law and regulations

Section 1402(a) of the Tax Law imposes the real estate transfer tax on each conveyance of real property or interest therein and provides, in part:

A tax is hereby imposed on each conveyance of real property or interest therein when the consideration exceeds five hundred dollars, at the rate of two dollars for each five hundred dollars or fractional part thereof; . . .

Section 1401(c) of the Tax Law provides:

"Real property" means every estate or right, legal or equitable, present or future, vested or contingent, in lands, tenements or hereditaments, including buildings, structures and other improvements thereon, which are located in whole or in part within the state of New York. It shall not include rights to sepulture.

Section 1401(e) of the Tax Law provides, in part:

"Conveyance" means the transfer or transfers of any interest in real property by any method, including but not limited to sale, exchange, assignment, surrender, mortgage foreclosure, transfer in lieu of foreclosure, option, trust indenture, taking by eminent domain, conveyance upon liquidation or by a receiver, or transfer or acquisition of a controlling interest in any entity with an interest in real property. Transfer of an interest in real property shall include the creation of a leasehold or sublease only where (i) the sum of the term of the lease or sublease and any options for renewal exceeds forty-nine years, (ii) substantial capital improvements are or may be made by or for the benefit of the lessee or sublessee, and (iii) the lease or sublease is for substantially all of the premises constituting the real property. . . .

Section 1401(f) of the Tax Law provides:

"Interest in the real property" includes title in fee, a leasehold interest, a beneficial interest, an encumbrance, development rights, air space and air rights, or any other interest with the right to use or occupancy of real property or the right to receive rents,

profits or other income derived from real property. It shall also include an option or contract to purchase real property. It shall not include a right of first refusal to purchase real property.

Section 575.7(a) of the Real Estate Transfer Tax Regulations (the "Regulations") provides, in part:

Creation of a taxable lease or sublease not coupled with an option to purchase. The creation of a lease or sublease is a conveyance subject to tax only where:

(1) the sum of the term of the lease or sublease and any options for renewal exceeds 49 years; and

(2) substantial capital improvements are or may be made by or for the benefit of the lessee or sublessee; and

(3) the lease or sublease is for substantially all of the premises constituting the real property. *Substantially all* means ninety percent or more of the total rentable space of the premises, exclusive of common areas. For the purpose of determining whether a lease or sublease is for substantially all of the premises constituting the real property, premises shall include, but not be limited to the following:

(i) an individual building, except for space which constitutes an individual condominium or cooperative unit;

(ii) an individual condominium or cooperative unit; or

(iii) where a lease or sublease is of vacant land only, any portion of such vacant land.

Opinion

As provided by section 1401(e) of the Tax Law and section 575.7(a) of the Regulations, the creation of a ground lease for the Leased Parcel will constitute a taxable conveyance if all three of the following conditions are met: (1) the sum of the term of the lease including any options for renewal exceeds 49 years; (2) substantial capital improvements are or may be made for the benefit of the lessee; and (3) the lease is for substantially all of the premises constituting the real property. Pursuant to the facts presented by Petitioner, conditions (1) and (2) are met for the ground lease. Thus, to determine whether the ground lease is subject to tax, the issue at hand is whether the ground lease is for substantially all of the premises constituting the real property.

To make this determination, it is necessary to determine exactly what are the premises constituting the real property under the facts presented. Section 575.7(a)(3) of the Regulations provides that the term premises includes, *but is not limited to*, an individual building, an individual condominium or cooperative unit, or any portion of vacant land. Here, it is important to view the matter with an eye on the unique nature of the shopping center enterprise from a business and legal perspective and look beyond the examples given in the regulation.

In *Harter, Secrest & Emery, LLP*, Adv Op Comm T & F, September 27, 2005, TSB-A-05(1)R, it was recognized that because a shopping center is operated by the landlord and tenants as a closely integrated retail enterprise, the relevant premises must include all of the real property constituting the shopping center. In reaching this conclusion, the opinion stated that from a business perspective, shopping center leases generally contain provisions that distinguish them from standard commercial real estate leases. These include provisions such as percentage rent clauses (based on a percentage of a tenant's store sales), radius clauses (limiting a tenant's operation of another store within a certain geographic radius of the shopping center), provisions related to products to be sold (tenant mix), use and control of parking and common areas, hours of operation, merchandise displays and show windows, signage, advertising, use of trade name, and name changes. These types of lease provisions demonstrate that landlords generally have an interest not only in the real estate aspects of the shopping center, but also in the tenants' retail operations in relation to the entire shopping center.

From a legal perspective, the opinion looked to the United States Code (11 U.S.C. § 365) and to a recent decision by the United States Court of Appeals, *In re Trak Auto Corporation v West Town Center, LLC*, 367 F3d 237 (4th Cir 2004), to determine that, historically, both Congress and the courts have recognized the unique nature of shopping center lease arrangements. That is, a landlord in a shopping center retains strong legal and economic control in the operation and use of the entire shopping center property, including each store that is leased within it.

In the instant matter, the entire shopping center, including the Leased Parcel, will share all public parking, which will be controlled by Petitioner, as landlord, in accordance with its rules and regulations. Uniform rules and regulations will prevail with respect to all common areas. Some tenants will have restrictive covenants prohibiting the sale of certain items, and the entire shopping center will be operated as an integral unit for all of the retail tenants. The Leased Parcel (including both the new building and the new parking) will constitute less than 90% of the total rentable space available to all tenants in the entire shopping center, exclusive of common areas. Accordingly, the ground lease for the Leased Parcel will not be for substantially all of the premises constituting the real property and, therefore, no transfer tax will be due on execution of the ground lease. See section 575.7(a)(3) of the Regulations.

These conclusions do not apply to a lease for real property not located in a shopping center or where there is an option to purchase contained in the lease. In addition, since this

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analysis is highly dependent on these particular facts, any determination of taxability based on different fact patterns must be made on a case-by-case basis.

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/s/
Jonathan Pessen
Tax Regulations Specialist IV
Technical Services Division

NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion.