

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-93 (14) R
Real Property Transfer
Gains Tax
Real Estate Transfer Tax
Mortgage Recording Taxes
July 26, 1993

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. M930525A

On May 25, 1993, a Petition for Advisory Opinion was received from Smith Barney, Harris Upham & Co., 1345 Avenue of the Americas, New York, New York 10105.

The issues raised by Petitioner, Smith Barney, Harris Upham & Co., are:

1. Whether the up to \$500 million required to finance the acquisition and improvement of two buildings situated at 388 and 390 Greenwich Street, New York, New York (hereinafter the "Buildings") in the form of A-Notes in the principal amount of up to \$425 million, B-Notes in the principal amount of up to \$60 million, and Certificates in the principal amount of up to \$15 million either collectively or individually will be subject to New York State and New York City Mortgage Recording Taxes (hereinafter the "mortgage recording taxes").
2. Whether the granting by a trust entity (the "Trust") of a lease to Petitioner with an option to purchase the Buildings or the subsequent transfer of the Buildings to Petitioner upon the exercise of the option will be subject to New York State Real Estate Transfer Tax (hereinafter the "transfer tax").
3. Whether the granting by the Trust of a lease to Petitioner with an option to purchase the Buildings or the subsequent transfer of the Buildings to Petitioner upon the exercise of the option will be subject to New York State Real Property Transfer Gains Tax (the "gains tax").

Petitioner has agreed to acquire the Buildings pursuant to an asset purchase agreement dated as of March 12, 1993, to which Petitioner, as buyer, and Shearson Lehman Brothers, Inc. (hereinafter "Shearson"), as seller, along with certain of their affiliates are parties (the "Asset Purchase Agreement"). The acquisition and improvement of the Buildings will be financed through a Trust which will provide all of the financing.

Prior to consummation of the Asset Purchase Agreement, Petitioner will assign, for no consideration, its right to purchase the Buildings to the Trust. The instrument which effectuates the assignment will not be recorded. Upon consummation, Shearson at the direction of Petitioner will transfer title to the Buildings to the Trust. The total purchase price for the Buildings will be \$400 million (or such other amount as an appraisal determines is properly attributable to the Buildings), which will be paid in cash to Shearson at the time of closing. The Buildings will be occupied by Petitioner and certain of its affiliates as tenants-in-common, although a portion of one Building will continue to be occupied by Shearson for approximately one year after the closing.

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The deed between Shearson and the Trust will state that "[T]his deed is solely for the purpose of transferring title to the property and is not intended as a mortgage or a security instrument."

The Trust will obtain financing to purchase the Buildings through third parties. The total amount of the financing will be up to \$500 million, of which up to \$400 million will be used to purchase the Buildings, and up to \$100 million will be used for improvements. These improvements will be planned and constructed by Petitioner or its designees, under the control and supervision of Petitioner, and Petitioner will be liable if the cost of the improvements exceeds the \$100 million of financing allocated for improvements.

Of the up to \$500 million required to finance the acquisition and improvements of the Buildings, \$485 million will consist of loans from third party lenders to the Trust. The remaining \$15 million will be in the form of an investment in the Trust. The parties making the investment (the "Certificate Holders") will receive a yield equal to the excess of the proceeds from any payments made to the Trust by Petitioner under the lease over the amount paid to the third party lenders. The Declaration of Trust provides that in the event of a default, the Buildings will be sold, and any amounts owing under the Certificates will be repaid from the proceeds. In addition, the Certificate Holders will receive a junior mortgage in the Buildings, and under certain circumstances, an assignment of rents. Neither the mortgage, the assignment of rents nor the Declaration of Trust will be recorded. The Certificate Holders will be entitled to record their mortgage and assignment of rents upon a deterioration in the credit rating of Smith Barney Holdings, Inc. (the "Guarantor"), the parent corporation of Petitioner, or Petitioner.

The \$485 million in loans will be divided into two classes. The first class, consisting of up to \$60 million, will be secured by a mortgage (the "B-Notes"). The holders of the B-Notes will receive a first mortgage on the property and, under certain circumstances, an assignment of rents. The B-Note holders will not record either the mortgage or the assignment of rents, although they will be entitled to do so upon a deterioration in the credit rating of the Guarantor or Petitioner. The amount by which the Guarantor's credit rating can fall before the holders of the B-Notes are entitled to record their mortgage and assignment of rents is less than the amount by which such credit rating can fall before the Certificate Holders can record their mortgage and assignment of rents.

In the event of a default, the holders of the B-Notes will receive a payment made by Petitioner to the Trust. This payment (the "SBS Guaranty") will be an irrevocable, subordinated obligation of Petitioner to pay the Trust the outstanding balance of the B-Notes plus any accrued and unpaid interest and costs (the "Outstanding Balance"). Furthermore, the Buildings will be sold and the proceeds of the sale will be distributed, in turn, to the holders of the B-Notes (if there is any Outstanding Balance) and the Certificates to the extent of their investment plus any accrued yield and costs; any proceeds remaining after payment of the B-Notes and the Certificates will be paid to

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Petitioner where such proceeds will be commingled with Petitioner's general funds and available to all creditors of Petitioner.

The second class of notes (the "A-Notes") will have a principal amount of up to \$425 million. The holders of the A-Notes will have neither a mortgage nor any other security interest in the Buildings. Consequently, in the event of default, the A-Note holders will have no right to foreclose upon the Buildings and no right to share in any proceeds of a foreclosure sale. Rather, upon default, the A-Note holders will have only the right to collect under the Instrument Guaranty, which will be an unconditional promise by the Guarantor to pay the outstanding principal amount of the A-Notes plus any accrued and unpaid interest and costs. Both the A-Notes and the B-Notes will mature in five years.

Upon the transfer of title of the Buildings from Shearson to the Trust, the Trust will lease the Buildings to Petitioner for a period of five years. The "rent" paid by Petitioner will be an amount sufficient to pay the interest on the A-Notes and B-Notes and to pay a current yield to the Certificate Holders.

In addition to the payment of rent, Petitioner will be required to pay all real and personal property taxes, as well as any assessments, levies or fees associated with the ownership, use or financing of the Buildings. The "lease" gives Petitioner the right to, at its own expense, contest the amount of the taxes assessed on the property. Petitioner also will be responsible for managing and maintaining insurance on the property. Petitioner must indemnify the Trust and the A-Note, B-Note and Certificate Holders from any liabilities associated with the Buildings. Also, the consent of Petitioner is necessary for the Trust to encumber the Buildings.

In the event of condemnation of, or casualty that renders the Buildings unsuitable for use, any award, compensation or insurance payment to which Petitioner becomes entitled will be assigned to the Trust for the benefit of Petitioner. In addition, if Petitioner does not exercise its option to purchase the Buildings, the Guarantor will be required to pay the Trust the Guarantor Termination Value, which will equal the outstanding balance on the A-Notes plus any accrued and unpaid interest and costs. Additionally, Petitioner will be required to pay the SBS Termination Value, which will equal the outstanding balance of the B-Notes, plus interest and costs, to the Trust. Also, the Trust will be required to sell the property. Petitioner will be entitled to any excess sale proceeds (after payment of any outstanding notes and Certificates and other costs of the Trust) from the sale. In the event of a casualty that does not render the Buildings unsuitable for use, Petitioner will be required to rebuild, replace or repair any damage to restore the property to the value and operating condition immediately prior to the casualty or condemnation. In this case, Petitioner will be responsible for all costs and expenses; however, the Trust will be required to dispense funds to Petitioner from the award, compensation or insurance payment. Petitioner will be solely liable if the costs and expenses it incurs exceed the amounts received from the Trust, and will be entitled to any excess proceeds.

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If there is an event of default under the lease, the A-Note holders will be paid pursuant to the Instrument Guaranty, and the holders of the B-Notes will be paid pursuant to the SBS Guaranty. The Trust then will sell the Buildings with the net proceeds from the sale to be distributed first to the Certificate Holders (to the extent of their outstanding investment plus any yield which has accrued but has not been paid and costs) and the remainder to be returned to Petitioner.

In conjunction with the lease, Petitioner will acquire an option to purchase the Buildings. Petitioner will have the right to exercise the option at any time during the term of the lease. The option price will equal the outstanding balance of the A-Notes, B-Notes, Certificates and any accrued interest or costs thereon (the "Option Purchase Price"). Petitioner also will have the right to exercise the option at the end of the lease term.

The terms of the lease between Petitioner and the Trust require that Petitioner assume the responsibilities of an owner by burdening Petitioner with the duty to pay the tax, maintenance, repair, insurance expense and other costs associated with ownership of the Buildings. Furthermore, Petitioner is the only party that can benefit from any appreciation in the value of the Buildings. This is true because even if the option is not exercised, Petitioner will receive all of the proceeds from a sale of the Buildings over the amount necessary to repay the loans. Conversely, if the value of the Buildings depreciates, Petitioner nevertheless will be required to service the debt through the "rent" and repay the principal amount through exercising its option or through a payment by the Guarantor on Petitioner's behalf under the Instrument Guaranty.

By using the structure described herein to finance the Buildings, the Buildings and the debt associated with the Buildings will not appear on Petitioner's balance sheet. If the Buildings and such debt were on Petitioner's books, under regulatory provisions governing Petitioner's status as a broker-dealer, Petitioner's capital would be considered to be reduced by the amount of the Buildings which are non-monetary assets, which in turn would impair Petitioner's ability to conduct its business. Thus, for financial purposes, Petitioner will be treated as a lessee, not as the owner, of the Buildings. However, for income tax purposes, Petitioner will be treated as the owner of the Buildings and will take all depreciation and deductions associated with the ownership of the Buildings. Also, Petitioner will deduct the interest costs associated with the financing arrangement and will take no deduction for payments made as "rent".

Petitioner has represented that the aforesaid facts are reflected in the documents executed by the parties and furnished as part of the Petition for Advisory Opinion.

Subdivisions 1, 1-a and 2 of Section 253 of the Tax Law impose taxes on the recording of a mortgage of real property in the State measured by the principal debt or obligation, which is, or under any contingency, may be secured at the date of the execution thereof or at any time thereafter.

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The tax imposed pursuant to the authority of Section 253-a of the Tax Law in New York City is not different for purposes of this opinion.

Section 250.2 of the Tax Law defines the term "mortgage" as follows:

2. The term "mortgage" as used in this article includes every mortgage or deed of trust which imposes a lien on or affects the title to real property, notwithstanding that such property may form a part of the security for the debt or debts secured thereby. An assignment of rents to accrue from tenancies, subtenancies, leases or subleases of real property, within any city in the state having a population of one million or more, given as security for an indebtedness, shall be deemed a mortgage of real property for purposes of this article. Executory contracts for the sale of real property under which the vendee has or is entitled to possession shall be deemed to be mortgages for purposes of this article and shall be taxable at the amount unpaid on such contracts. A contract or agreement by which the indebtedness secured by any mortgage is increased or added to, shall be deemed a mortgage of real property for purposes of this article, and shall be taxable as such upon the amount of such increase or addition...

In accordance with Section 1402 of the Tax Law, a transfer tax is imposed on each conveyance of real property or interest therein when the consideration for the conveyance exceeds five hundred dollars.

Section 1401 of the Tax Law provides, in part, as follows:

* * *

(e) "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 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...

(f) "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 1405(b) of the Tax Law provides, in pertinent part, as follows:

(b) The tax shall not apply to the following conveyances:

* * *

6. Conveyances to effectuate a mere change of identity or form of ownership or organization where there is no change in beneficial ownership, other than conveyances to a cooperative housing corporation of the real property comprising the corporative dwellings or dwellings...

Pursuant to Sections 1441 and 1443.1 of the Tax Law and Section 590.1 of the Gains Tax Regulations the gains tax is a ten percent tax on the gain derived from the transfer of real property, which includes the acquisition or transfer of a controlling interest in any entity with an interest in real property, where the property is located in New York State and where the consideration for the transfer is one million dollars or more.

Section 1440 of the Tax Law provides, in pertinent part, as follows:

* * *

4. "Interest" when used in connection with real property includes, but is not limited to, title in fee, a leasehold interest, a beneficial interest, an encumbrance, a transfer of development 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. Interest shall also include an option or contract to purchase real property.

* * *

7. "Transfer of real property" means the transfer or transfers of any interest in real property by any method, including but not limited to sales, exchange, assignment, surrender, mortgage foreclosure, transfer in lieu of foreclosure, option, trust indenture, taking by eminent domain, conveyance upon liquidation or by a

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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 1443 of the Tax Law provides, in pertinent part, as follows:

Sec. 1443. Exemptions.-- A total or partial exemption shall be allowed in the following cases:

* * *

5. If a transfer of real property, however effected, consists of a mere change of identity or form of ownership or organization, where there is no change in beneficial interest.

With respect to issue "1", pursuant to Sections 253 and 253-a of the Tax Law, respectively, mortgage recording taxes are imposed on the recording of any mortgage of real property situated within New York State and New York City. Petitioner states that the mortgages, assignment of contract by Petitioner to the Trust, assignment of rents granted to the Certificate Holders and the B-Note Holders and the Declaration of Trust will not be recorded at the time the transaction is consummated, although the mortgages and assignment of rents are to be recorded upon a deterioration in the credit rating of the Guarantor. Accordingly, since the mortgages, assignment of contract by Petitioner to the Trust, assignment of rents, and Declaration of Trust will not be recorded the mortgages, assignment of rents, and Declaration of Trust will not be subject to the mortgage recording taxes at this time. It is noted, however, that if the mortgages given to the Certificate Holders or the B-Note Holders, the assignment of contract by Petitioner to the Trust, the assignment of rents or the Declaration of Trust are recorded at a subsequent time, such mortgages, assignment of contract by Petitioner to the Trust, assignment of rents or Declaration of Trust, as the case may be, will then be subject to the mortgage recording taxes at the time of recording.

Moreover, pursuant to Section 250.2 of the Tax Law, the term "mortgage" is defined to be a mortgage or deed of trust which imposes a lien on or affects the title to real property, notwithstanding that such property may form a part of the security for the debt or debts secured thereby. The deed to be recorded between Shearson and the Trust is stated to be solely for the purpose of transferring title to the property and is not intended as a mortgage or a security interest.

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Therefore, since the recording of the deed is not intended to secure the payment of money or the performance of an obligation, such deed does not rise to the level of a mortgage and its recording is not subject to the mortgage recording taxes.

Concerning issues "2" and "3", pursuant to Sections 1401 and 1402 of the Tax Law pertaining to the transfer tax and Sections 1440, 1441 and 1443.1 of the Tax Law and Section 590.1 of the Gains Tax Regulations the granting of an option to purchase real property with the right to use or occupancy of real property is a conveyance and transfer of real property subject to the transfer tax and the gains tax. In addition, the subsequent conveyance or transfer of real property in connection with the exercise of the option to purchase real property is a conveyance and transfer of real property subject to the transfer tax and the gains tax. However, Sections 1405(b)(6) and 1443.5 of the Tax Law, respectively, provide exemption from the transfer tax and the gains tax where the transfer of real property consists of a mere change of identity or form of ownership or organization where there is no change in beneficial interest.

In the instant case, for purposes of satisfying certain regulatory provisions governing Petitioner, Shearson at the direction of Petitioner will transfer the Buildings to the Trust. Simultaneously with such transfer, the Trust will grant a lease to Petitioner with an option to purchase the Buildings. For financial purposes Petitioner will be treated as a lessee, and not the owner of the Buildings. However, for income tax purposes Petitioner will be treated as the owner of the Buildings and will take all depreciation and deductions associated with the ownership of the Buildings. Also, Petitioner will deduct the interest costs associated with the financing arrangement and will take no deduction for payments made as "rent". In addition, Petitioner assumes all burdens of ownership with the duty to pay the tax, maintenance, repair, insurance expense and other costs associated with ownership of the Buildings. Furthermore, in the event of condemnation of, or casualty that renders the Buildings unsuitable for use, any award, compensation or insurance payment to which Petitioner becomes entitled will be assigned to the Trust for the benefit of Petitioner. Also, Petitioner is the only party that can benefit from any appreciation in the value of the Buildings, and will bear the economic burden should the Buildings depreciate. Moreover, the consent of Petitioner is necessary for the Trust to encumber the Buildings.

Accordingly, it is recognized that for tax purposes at all times from the conveyance of title from Shearson to the Trust that Petitioner is the beneficial owner of the Buildings. The transaction as described is being done solely to satisfy certain restrictive regulatory provisions governing Petitioner. Thus, the granting of the lease by the Trust to Petitioner coupled with the granting of

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an option to purchase and the subsequent transfer of the Buildings by the Trust to Petitioner upon exercise of the option will not be subject to the transfer tax and the gains tax since the transfers consist of a mere change of identity or form of ownership or organization and will not result in a change in beneficial interest in the real property.

DATED: July 26, 1993

/s/
PAUL B. COBURN
Deputy Director
Taxpayer Services Division

NOTE: The opinions expressed in Advisory Opinions
are limited to the facts set forth therein.