

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

TSB-A-90 (5) R  
Real Property  
Transfer Gains Tax  
May 29, 1990

STATE OF NEW YORK  
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. M900221A

On February 21, 1990, a Petition for Advisory Opinion was received from Beekman C. Cannon, individually and as agent for Anne S. Cannon, Julia Cannon Wertenbaker, Henry B. Cannon, III and Urling C. Kingery, Lessor, c/o Wien, Malkin and Bettex, 60 East 42nd Street, New York, New York 10165.

The issue raised by the Petitioner, Beekman C. Cannon, is whether an adjustment in the computation of rent resulting in a reduction of the amount payable in order to settle a disputed provision in a lease, executed prior to the March 28, 1983 effective date of the tax on gains derived from certain real property transfers (the "Gains Tax") result in a transfer of real property subject to the Gains Tax.

Petitioners are the fee owners of certain real property in New York City (hereafter referred to collectively as "Petitioner" or "Lessor") subject to a restated agreement of lease (the "Lease"), with a remaining term of approximately 60 years as of January 1, 1988, consisting of 20 years remaining under the primary term plus four renewal options of 10 years each (the term of the Lease as expressed herein includes renewal options). The lessee is a residential cooperative housing corporation (hereafter referred to as "Lessee"). The Lease contains no purchase option. The Lease was entered into on or about January 1, 1970, before enactment of the "Gains Tax".

Annual rent for each year through December 31, 1987 consisted of the sum of (i) basic rent ("Annual Net Rental") of \$50,000 plus (ii) additional rent determined by multiplying Annual Net Rental for the year by the percentage increase in the average consumer price index ("CPI") for such year over the December, 1969 CPI (the "Base Price Index"). Total rent for 1987 was approximately \$140,000 consisting of Annual Net Rental of \$50,000 and additional rent calculated under the CPI formula of approximately \$90,000.

The Lease provides (Articles Two and Twenty-six) that Annual Net Rental is to be redetermined commencing January 1, of each of 1988, 1998, 2008, 2018, 2028 and 2038, as an amount equal to the greatest of (i) \$50,000, (ii) Annual Net Rental paid for the immediately preceding term, and (iii) 5% of the fair market value of the land determined seven months prior to the January 1 effective date of each of the applicable years (six months prior to the effective date of each renewal term).

The revised Annual Net Rental as of January 1, 1988 based on the existing terms of the Lease is \$783,300 (i.e., 5% of \$15,666,666, the fair market value of land as of June 1, 1987 as determined pursuant to an arbitration/appraisal procedure under the Lease). The Lessee is current in payment of this amount.

The additional rent for 1988 (Article Three), based on the CPI adjustment formula (which, as discussed below, Lessee disputes), would be approximately \$1,600,000. The Lessee has advised the Lessor that it disputes the CPI rent formula and has indicated that the CPI rent provision is erroneous in that the parties must have intended that it be based on the CPI immediately preceding each January in which Annual Net Rental is to be adjusted and not the December, 1969 CPI. The Lessor did not initially agree with the Lessee's claim of error.

Petitioner and Lessee have been involved in negotiations to resolve this dispute for more than two years and have concluded that, to avoid the delay, expense and uncertainties involved in litigating this matter, it would be in their mutual best interests to compromise this issue. Accordingly, Petitioner and Lessee have agreed to settle the dispute regarding the CPI rent computation by restating certain provisions of the Lease to more accurately reflect their original intentions at the time of the original execution of the Lease as follows:

- (i) Annual Net Rental should continue, as presently provided in the Lease, to be based on 5% of the fair market value of the land effective as of the same dates currently provided for, i.e., January 1, of each of 1988, 1998, 2008, 2018, 2028, and 2038;
- (ii) the Lessee would make a payment to the Lessor of \$1,200,000 plus interest from July 1, 1989 in full satisfaction of the CPI additional rent payable for 1988;
- (iii) For each lease year beginning after December 31, 1988, the CPI adjustment would be determined by treating the CPI for the December immediately preceding each January in which Annual Net Rental is to be adjusted as the CPI Base Price Index for each adjustment or renewal period, rather than December, 1969; however, the maximum CPI additional rent for the calendar year 1989 would be \$35,000; and
- (iv) The Lessee would grant a sublease of four commercial retail stores and garage space at the premises (the "Commercial Space") to a new limited partnership in which the Lessee would be the general partner and Petitioner the limited partners. The limited partners would receive for each year beginning January 1, 1989 the greater of (i) an amount equal to 30% of gross annual rental income derived from the Commercial Space during each year [gross rental income is to be reduced by the cost of leasing (such as brokerage and advertising costs)] and (ii) an amount equal to 22.5% of such rental income for the year in question, as projected by the Lessee's real estate advisors and set forth on a schedule attached to Partnership agreement. Such payments would be payable only from the rental income actually received from the Commercial Space and if said rental income is less than 22.5% of the gross rental income as projected, the payment of the amount of such shortfall would be deferred and be payable from future Commercial space rents with interest at the applicable Internal Revenue Service rate. Beginning January 1, 2004, and annually thereafter, the amount payable to the Petitioner, as limited partner, shall be the greatest of (x) \$ 2 7 8 , 2 1 9 ; ( y ) a n

amount equal to 25% of the said rental income with respect to the prior year; and (z) an amount equal to 30% of such rental income for the year in question. Interest shall accrue on the amount payable to the limited partner with respect to Periods beginning January 1, 1989 at the Internal Revenue Service rate from July 1, 1989 until paid. If the minimum amount payable to the limited partner pursuant to the formula described above is not actually paid for any three consecutive years, the limited partner at its option may terminate the partnership and, upon such termination, the percentage amount of 5% in Articles Two and Twenty-six of the Lease shall be increased to 8.5%, effective retroactively as of January 1 of the first of said. three calendar years.

The term of the Lease would not be extended, no purchase option would be granted to the Lessee, and all other provisions of the Lease would remain unchanged, except for certain ministerial provisions, the inclusion of a provision which would transfer the obligation to make the payments payable to the Petitioner under the partnership agreement to the Lease in the event the partnership is terminated, and the Lessee would be given a one-time right of first refusal on any sale or transfer by any of the present owners (or a successor) of their interest in the property to a bonafide third party purchaser. The amount payable to the Lessor under the Lease and pursuant to the partnership agreement, i.e., items (ii), (iii) and (iv) above or if Annual Net Rental is determined at the rate of 8.5% of the fair market value of the land if the partnership is terminated, is currently (and for the future is projected to be at all times) significantly less than the amount which would otherwise be payable to the Lessor under the Lease but for the settlement described herein. The Modification of Lease Agreement would specifically provide that the total amount payable to the Petitioner pursuant to the restated lease and the partnership agreement during any calendar year will not exceed the amount that would have been paid to the Petitioner under the original lease during such calendar year.

Section 1443(6) of Article 31-B of the Tax Law states in pertinent part:

"A total or partial exemption shall be allowed in the following cases:

(6) Where a transfer of real property occurring after the effective date of this article is pursuant to a written contract entered into on or before the effective date of this article, provided that the date of execution of such contract is confirmed by independent evidence, such as recording of the contract, payment of a deposit or other facts and circumstances as determined by the Tax Commission. ... "

Section 590.21(a) of the Gains Tax Regulations states:

"(A) Question: If a contract entered into on or before March 28, 1983 is amended after such date, will the contract continue to be exempt by reason of section 1443(6) of the Tax Law?

Answer: Yes. As long as the amendment is of a non substantial nature. The determination of what constitutes a nonsubstantial change will be made on a case-by-case basis. However, any change in the amount of consideration for the real property automatically results in a transfer which is not pursuant to a written contract entered into on or before March 28, 1983, and thus such transfer is taxable."

The Petitioner and lessee dispute the Consumer Price Index (CPI) adjustment formula used to compute the additional rent for years starting in 1988. (There are approximately 60 years including renewals remaining on the lease as of January 1, 1988. A substantial change to the grandfathered lease in such year would lead to the creation of a lease for more than 49 years and thereby subject the lease to the gains tax). The lessor initially believed that the intent of the lease was to compute additional rent based upon increases in the CPI over the 1969 base rent. The lessee initially believed that the intent of the lease was to compute additional rent based upon the CPI immediately preceding each January in which the base rent is adjusted and should not remain at the 1969 level. The parties to the lease have decided that the lessor's interpretation of the CPI formula would create an unbearable economic burden on the lessee leading to bankruptcy, a situation which was not intended at the time of the execution of the lease. Therefore, the parties have decided to clarify the lease in order to reach an agreement which would allow the lessee to continue and operate in a reasonable manner.

The modifications that would be made to the lease would decrease the rental payments which would be required under the lessor's interpretation of the lease. This confirms the lessee's contention that cumulative increases in the CPI are automatically reflected under an annual net rental adjustment which is made at certain intervals in the lease and therefore the use of the December 1969 CPI as the base rent was not the intent of the parties.

The modifications to be made to the lease would be made with the intent to clarify a problematic provision in such lease and thereby apply settled rules to unusual conditions so as to do equity between the parties without the necessity of extended litigation. Therefore, the modifications to the lease would be made for the purpose of clarifying the computation of the rental payments so as to reflect the original intent of the parties rather than changing the amount of the consideration for the lease. This would be required because the original terms of the lease, if construed as claimed by the lessor, would lead to an outrageous, oppressive, unconscionable and unintended result ultimately, in all probability, causing the tenants to lose their homes.

It is noted that the payment of the \$1,200,000 would be in satisfaction of the CPI additional rent payable for 1988.

It is further noted that the sublease from the lessee to a limited partnership, in which the lessee would be the general partner and the Petitioner would be the limited partner, would not be a transaction subject to the gains tax in accordance with Section 1440.7 of the Tax Law since the term of the sublease would not exceed 49 years.

Such amendments would therefore be of a nonsubstantial nature as intended by Section 590.21(a) of the Regulations. Accordingly, the lease would remain grandfathered under Section 1443(6) of the Tax Law as there would be no substantial change in such lease. It is noted that the regulation provides that the determination of what constitutes a nonsubstantial change will be made on a case-by-case basis and thus this opinion applies only to this particular case and the peculiar factual pattern contained therein.

DATED: May 29, 1990

s/PAUL B. COBURN  
Deputy Director  
Taxpayer Services Division

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