

City and State Tax Rulings Open the Door for Synthetic Leases in New York

By Joshua Stein

Until recently, commercial real estate lawyers in New York were unsure of how the city and state would tax a real estate "synthetic lease" transaction. There was a general sense of dread, a sense that synthetic leases might attract so many state and city taxes that they were probably not feasible in New York.

The New York State Department of Taxation & Finance (the "State") recently eliminated much of that fear by issuing a favorable Advisory Opinion¹ relating to a proposed synthetic lease in Manhattan (the "Synthetic Lease Advisory Opinion").²

At about the same time, the New York City Department of Finance (the "City") issued a letter ruling³ (the "City Letter Ruling") that took a similarly favorable approach to synthetic leases for the City's various taxes.⁴ Together, the Synthetic Lease Advisory Opinion and the City Letter Ruling make synthetic leases feasible transactions in New York (at least as a matter of City and State taxation). These pronouncements represent a very welcome clarification of how the taxing authorities will look at these transactions.

A typical "synthetic lease" begins when an operating company, often publicly traded (the "User"), wants to acquire or build a new facility, but also wants to keep that real estate off its balance sheet while retaining all the benefits and burdens of ownership. This would include the benefit of possible appreciation, as well as depreciation deductions for tax purposes, but not for financial statement purposes.

Users very often want to achieve all those goals, and all simultaneously. They have in recent years been

able to do it by structuring the transaction as a "synthetic lease."

In a synthetic lease transaction, the User does not directly acquire the desired asset. Instead, the User arranges to have a single-purpose entity (the "SPE") acquire the asset directly from a third-party seller.⁵ The SPE then leases the asset to the User.

The lease from the SPE to the User—the "synthetic lease"—gives the User the functional and economic equivalent of ownership, in virtually all respects, for all purposes except the User's financial statements. If the lease satisfies a list of accounting criteria, the User need not burden its financial statements with ownership of the real estate, and those statements will show rent payments under the lease rather than interest (and indebtedness) and depreciation expenses. This makes the public markets and, hence, the User happier.

To finance the acquisition and synthetic lease of the real estate asset, the User enlists some or all of its regular bank lenders (the "Participants") to make a loan to the SPE so the SPE can acquire the asset and lease it to the User. The SPE grants a mortgage to the Participants (the "Participants' Mortgage").⁶ The "rent" payments under the lease will exactly equal the debt service payments under the Participants' loan plus some minor compensation for the equityholders of the SPE.⁷

At the end of the lease term, based on the terms and conditions of the lease, the User will almost certainly exercise one of its options to acquire the real estate from the SPE, at which point the magic of the syn-

thetic lease (the financial statement vanishing act) ends. The User must then show the real estate on its financial statements, or figure out some other way to carry the investment.

Synthetic leases and some other financing structures are collectively called "off-balance-sheet financing" because the User in effect (and in substance but not in form) borrows money but the User's financial statements don't show it. Similar but more aggressive techniques were widely used by Enron Corporation and its various partnerships ("Enron").⁸ Enron did not appear to be involved in any way in the Synthetic Lease Advisory Opinion. Still, Enron's collapse and the resulting accounting issues will probably lead the public markets, securities regulators, and the accounting profession to change their view of all off-balance-sheet financing, including synthetic leases. If that is so, then the Synthetic Lease Advisory Opinion and the City Letter Ruling may have been issued just in time to be prospectively irrelevant.

Beyond the accounting, taxation, and other issues that this article suggests, synthetic leases raise a number of other issues in almost every area of law and practice that real estate lawyers need to consider in any substantial transaction, including bankruptcy, conveyancing, corporate governance, enforceability, income taxation, qualification to do business, recharacterization, and title insurance.⁹

At least for the synthetic lease under consideration,¹⁰ the Synthetic Lease Advisory Opinion establishes a very practical and reasonable structure to define the transfer tax and

mortgage recording tax payable on one of these transactions. The State adopted a “substance over form” approach that will facilitate synthetic leases in New York.

Instead of imposing multiple transfer taxes on what is in substance a financing transaction, the State treats much of the transaction as just one taxable mortgage. The State deems any subsequent duplicative mortgages to be merely “supplemental” to the first, hence taxable only on the incremental indebtedness that they secure. This approach is far more practical and conducive to modern business transactions than the State’s approach in, for example, dealing with substantial commercial revolving loans.¹¹

Based on the Synthetic Lease Advisory Opinion, the State’s taxation of a synthetic lease transaction can be summarized as follows:

1. *Acquisition.* For transfer tax purposes, the State will treat the SPE’s acquisition of the real estate in the first instance as if the User were acquiring it.¹²
2. *Recorded Mortgage.* When the SPE records the Participants’ Mortgage, the State will collect a single mortgage recording tax on the amount secured.
3. *Deemed Mortgage.* The State will deem the User to have conveyed the real property to the SPE, but will treat this conveyance as a mortgage (the “Deemed Mortgage”), and not as a conveyance subject to transfer tax.¹³
4. *Mortgage Tax on Deemed Mortgage.* The State will treat the Deemed Mortgage as being “supplemental” to the Participants’ Mortgage.¹⁴ The State will therefore impose a mortgage recording tax on the Deemed Mortgage only to the extent that the principal amount of financ-

ing implied by the synthetic lease exceeds the principal (tax-paid) amount of the Participants’ Mortgage. The Deemed Mortgage will otherwise be exempt under New York Tax Law section 255.¹⁵

5. *Mortgage Recording Tax on Synthetic Lease.* The synthetic lease will be treated as part of the same mortgage financing described in “4” above. The implied debt in that financing would have been taxed when the State taxed the Participants’ Mortgage and the Deemed Mortgage, as described above.¹⁶ The State will collect that tax only once (on the Participants’ Mortgage and the Deemed Mortgage) and will not collect it a second time on the synthetic lease itself. Of course, if the implied financing under the synthetic lease were to exceed the amount of the Deemed Mortgage (very unlikely or impossible), then the State would collect a mortgage recording tax, but only on that excess.
6. *Net Effect.* As a result of the last five steps, the mortgage recording tax on all documents recorded to close a synthetic lease transaction will reflect the maximum total debt that those documents secure. It will, however, need to be paid only once.
7. *Repurchase.* Eventually, the User may (will?) exercise its option to purchase or otherwise acquire the real property. At that point, when the SPE transfers title to the real property to the User, that conveyance will not be subject to transfer tax but will instead be deemed a nontaxable “satisfaction” of the Deemed Mortgage.¹⁷ The Participants’ Mortgage would remain in place, and could be satisfied or refinanced.

The Synthetic Lease Advisory Opinion means that the State transfer and mortgage recording consequences of a synthetic lease financing match those of a traditional fee acquisition accompanied by a simultaneous fee mortgage. That is the right result. It should facilitate the use of synthetic leases in the State.

In the City Letter Ruling, the City took a similar approach and treated the synthetic lease as a financing. The City said it would not try to collect New York City Real Property Transfer Tax on the various conveyances after the SPE’s initial acquisition of the asset. And, even though the synthetic lease requires the User to pay “rent,” the City said it would treat those payments as nontaxable debt service for the City’s Commercial Rent and Occupancy Tax.

In reaching these very favorable and practical conclusions, both the City and the State scrutinized the synthetic lease transaction structure, and focused on a series of its characteristics. Although those characteristics mirrored those of many other synthetic lease transactions, they gave the taxing authorities a road map to reach the right result. Anyone who structures a synthetic lease in New York should try to create a similar road map.

The following briefly summarizes the elements of the synthetic lease that supported the favorable treatment in the Synthetic Lease Advisory Opinion and the City Letter Ruling:

- *Parties’ Intentions.* In all the synthetic lease documents, the parties consistently said they intended the synthetic lease be treated as a financing for tax and other purposes¹⁸—everything except the User’s financial statements.¹⁹
- *Control.* The synthetic lease gives the User complete control over

the real property. The User pays all costs of ownership, giving the SPE an absolutely “triple net” rental income. The User has nearly total flexibility in its use, alteration, and (sub)leasing of the real property.²⁰

- *Debt-like Obligations.* The User’s obligations under the synthetic lease are much like those of a corporate borrower under a financing agreement. The “rent” payments precisely equal the debt service on the implied loan. The transaction relies in large part on the User’s credit rather than the real estate.²¹
- *Development Controls.* A “Construction Agency Agreement” gave the User full control over the construction and development process and decisions, along with responsibility for all related liabilities.²²
- *Risk of Loss; Control of Appreciation.* Under the synthetic lease, the User bears the full risk of casualty and condemnation and receives the full benefit of future appreciation.²³
- *Future Purchase.* The User has a variety of purchase options and obligations. The User ultimately bears most or all of any shortfall in value (below the implied loan balance) if the real property is sold to a third party or if an Event of Default occurs. As a result of all these provisions considered together, the User is quite likely to acquire the real property at the end of the lease term or possibly earlier.²⁴
- *Corporate Headquarters.* In the particular transaction, the real property in question was to become the User’s world headquarters. Therefore, external facts further indicated that the User was likely to acquire the real property at the end of the synthetic lease.²⁵

Except for the last point, virtually any synthetic lease transaction would have all the same characteristics as this one, and hence would probably qualify for the same favorable treatment. The parties to any such future transaction may, however, not want to rely on the Synthetic Lease Advisory Opinion and City Letter Ruling.²⁶ They might instead want to obtain their own determinations.

The Synthetic Lease Advisory Opinion did not consider the tax implications if the User were to grant a leasehold mortgage, as additional security, either to the Participants or to the SPE. Based on the practicality displayed in the Synthetic Lease Advisory Opinion and the City Letter Ruling, however, it may be reasonable to expect the taxing authorities to treat such a leasehold mortgage as being another “supplemental” instrument, tax-exempt on the same basis as the other components of the transaction. Another advisory opinion and another letter ruling may be necessary to reach that result, though.

In the meantime, the Synthetic Lease Advisory Opinion and the City Letter Ruling certainly represent good news for synthetic lease transactions in New York. If the synthetic lease transaction survives as an accounting matter, it should now be feasible in New York. Even if the synthetic lease does not survive, though, these two pronouncements demonstrate a practical approach that, if followed in other contexts, may help facilitate other new and creative transaction structures in New York.

Endnotes

1. The Synthetic Lease Advisory Opinion was obtained by Carolyn Joy Lee of Roberts & Holland. Ms. Lee reviewed this manuscript in draft, and her helpful comments and suggestions are very much appreciated. The author also acknowledges with thanks the very

helpful comments of Kim N.A. Boras, a partner in the Los Angeles office of Latham & Watkins.

2. N.Y. Dep’t Tax & Fin. Comm’r Adv. Op., N.Y. Tax Rep. (CCH) ¶ 404-004 (2001) (hereinafter “Synthetic Lease Advisory Opinion”). The following discussion of the Synthetic Lease Advisory Opinion ignores some preliminary steps that occurred in the transaction before the SPE took title to the real property, in this case a condominium unit.
3. New York City Dep’t of Finance Letter Ruling, April 19, 2001 (FLR-004773-721). A copy of the City Letter Ruling can be found at: <<http://www.ci.nyc.ny.us/html/dof/pdf/00pdf/lr4773.pdf>>. The City Letter Ruling was also obtained by Carolyn Joy Lee of Roberts & Holland.
4. The City Letter Ruling considered the City’s Real Property Transfer Tax and Commercial Rent and Occupancy Tax. It did not address mortgage recording tax, which the State generally administers, although the City sometimes publicly disagrees with the State’s interpretations. No such disagreement was apparent regarding the issues this article describes.
5. To comply with accounting standards for synthetic leases, the User cannot already own the asset. The synthetic lease is not a substitute for the traditional “sale and leaseback.”
6. The User may also mortgage its leasehold under the synthetic lease, but the transaction described in the Synthetic Lease Advisory Opinion did not include that element. Although the Participants might want the User to guaranty the loan, any such guaranty would typically violate the accounting rules that synthetic leases must satisfy. The User’s rental stream under the synthetic lease does, however, give the Participants much the same level of credit support for the loan.
7. The synthetic lease must comply with certain accounting criteria to be honored for accounting purposes, including minimum outside equity capitalization of the SPE.
8. Those partnerships were in many cases subject to the same minimum outside equity requirements that apply to any synthetic lease SPE.
9. For more on all these issues, the reader should refer to the Web site operated by John Murray, Vice President and Special Counsel, First American Title Insurance Co. Chicago National Commercial Division (Chicago). Mr. Murray, a nationally recognized authority on synthetic leases, has posted on that site over a dozen of his articles on many issues that synthetic leases create. See <http://www.first.am>

- .com/faf/html/cust/jm-articles.html>. Mr. Murray's articles do not fully explore any accounting issues—issues that collectively exceed in magnitude and scope all the issues that Mr. Murray does cover in his articles. *See also* articles by Evelyn D. Giaccio, Kim N.A. Boras and Robert S. Bozarth in 456 Practising L. Inst.: Com. Real Est. Fin. 947–1079 (May 2000).
10. An Advisory Opinion may not be relied upon except by its addressees. *See* note 26.
 11. *See, e.g.,* Joshua Stein, *A Simple Proposal to Simplify New York's Mortgage Recording Tax*, N.Y. Real Prop. L.J., vol. 25, no. 1, at 26 (Winter, 1997); *New York Mortgage Recording Tax on Revolving Loans: The Problem and a New Solution for Multistate Transactions*, NYSBA Real Prop. L. Section Newsl., vol. 22, no. 1, at 13 (Winter 1994).
 12. The Synthetic Lease Advisory Opinion does not directly state this result because of certain unusual elements of the transaction. Anyone structuring a synthetic lease transaction should, however, expect that a transfer tax will be due on the SPE's acquisition of the real property from a third-party seller, unless that conveyance independently qualifies for some transfer tax exemption.
 13. Synthetic Lease Advisory Opinion at 21–22, 25.
 14. The word “supplemental” triggers partial or complete exemption from the mortgage recording tax under N.Y. Tax Law § 255 (McKinney 1999).
 15. Synthetic Lease Advisory Opinion at 26–28. In other words, the Participants' Mortgage and the Deemed Mortgage merely overlap and secure the same obligation. In Florida, which suffers from similar tax burdens (and has the benefit of a statute to much the same effect as the Synthetic Lease Advisory Opinion), attorneys who close synthetic lease transactions commonly ask the User to join in the Participants' Mortgage, simply to bolster the argument that it secures the same indebtedness as the Deemed Mortgage. (The preceding was reported to the author by John Murray, author of the Web site cited in note 9.) The User cannot, however, guaranty the loan that the Participants' Mortgage secures.
 16. Synthetic Lease Advisory Opinion at 22.
 17. *Id.* When the User exercises the purchase option and takes title to the real estate, can the Participants' Mortgage be assigned to a new lender to be “consolidated” and “restated” to save future mortgage recording tax? The Synthetic Lease Advisory Opinion does not answer that question. Presumably, instead of simply exercising the option, and perpetrating a deemed “satisfaction” of the deemed mortgage, the User will be able to figure out some way to preserve and re-use the tax-paid Participants' Mortgage.
 18. Synthetic Lease Advisory Opinion at 3–4.
 19. In the post-Enron financial world, such statements may be much less likely to be made.
 20. Synthetic Lease Advisory Opinion at 6.
 21. *Id.* at 7–8.
 22. *Id.* at 5–6.
 23. *Id.* at 8–9.
 24. *Id.* at 3, 9–12.
 25. It is unclear how much weight the Department placed on this last fact. Would a non-headquarters project create a distinguishable set of facts entitled to less favorable treatment? What if some future User were less image-conscious than this one?
 26. State advisory opinions and City letter rulings benefit only the taxpayer that requested them. Moreover, a future transaction may be structured differently, use words differently, and be distinguishable in other ways from the transaction described in the Synthetic Lease Advisory Opinion and the City Letter Ruling. Those two documents therefore amount to helpful guidance but not definitive law. *See In re U-Need-a-Roll Off Corp.*, TSB-H-84(16)S, N.Y. State Tax Rep. (CCH) ¶ 251-000 (Jan. 20, 1984); *see also* N.Y. Tax Law § 171, pt. “Twenty-fourth” (McKinney 2001–2002 Interim Pocket Part).

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