

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

TSB-M-94(4)-R  
Real Property Transfer Gains Tax  
Real Estate Transfer Tax  
December 2, 1994

1994 Amendments to the Real Property  
Transfer Gains Tax and the  
Real Estate Transfer Tax

**INTRODUCTION**

On June 9, 1994, Chapter 170 of the Laws of 1994 was enacted. Chapter 170 amended several provisions of Article 31-B of the Tax Law, Tax on Gains Derived From Certain Real Property Transfers (the gains tax) and Article 31 of the Tax Law, Real Estate Transfer Tax (the transfer tax). Included in the amendments to the gains tax and transfer tax are provisions that afford special tax treatment to certain transfers or conveyances occurring in connection with the initial formation of a Real Estate Investment Trust (REIT). The purpose of this memorandum is to address the REIT provisions of Chapter 170. The Department has issued TSB-M-94(3)-R, which summarizes the Chapter 170 amendments affecting the gains tax and transfer tax, and plans to issue additional memoranda in the near future to more specifically address the other provisions of Chapter 170 that affect the gains tax and transfer tax.

The special provisions for transfers to a REIT or to an entity controlled by a REIT ("REIT transfer(s)") include a reduced tax rate for both the gains tax and transfer tax. For purposes of the gains tax, the reduced rate of tax on the gain derived from such transfers is 2.5 percent of the gain, rather than the otherwise applicable rate of 10 percent. For the transfer tax, the reduced tax rate for such conveyances is \$1 for each \$500 of consideration or fractional part thereof, rather than the otherwise applicable rate of \$2 per \$500 of consideration or fractional part thereof. These special provisions also set forth a specific method for the calculation of consideration for such transfers. Chapter 170 also reduced the tax rate for REIT transfers under the New York City Real Property Transfer Tax, which is administered by the New York City Department of Finance. Accordingly, this memorandum does not address the provisions of Chapter 170 affecting the New York City Real Property Transfer Tax.

To qualify as a REIT transfer, a transfer must occur on or after June 9, 1994, and before July 1, 1996. However, a transfer eligible for the reduced tax rates may occur after June 30, 1996, if the transfer is made pursuant to a binding written contract entered into before July 1, 1996, with a REIT or an entity controlled by a REIT, provided the transfer is disclosed in the prospectus for the initial offering of REIT shares and the date of execution of the contract is confirmed by independent evidence.

Section 301 of Chapter 170 of the Laws of 1994 added a new subdivision 2 to section 1441 of the gains tax that reads as follows. (Amendments identical in substance were made to the transfer tax by adding a new subdivision (b) to section 1402 of Article 31. However, only the gains tax amendments are reproduced here.)

### **TEXT OF GAINS TAX AMENDMENTS**

#### **REIT Transfer**

Section 1441.2(b)(ii): "For purposes of this subdivision, the phrase 'real estate investment trust transfer' shall mean any transfer of real property to a REIT, or to a partnership or corporation in which a REIT owns a controlling interest immediately following the transfer, which transfer occurs in connection with the initial formation of the REIT, provided that the conditions set forth in clauses (A) and (B) of this subparagraph are satisfied."

#### **Ownership Requirement**

Section 1441.2(b)(ii)(A): "The value of the ownership interests in the REIT, or in a partnership or corporation in which a REIT owns a controlling interest, received by the transferor as consideration for such transfer must be equal to an amount not less than forty percent of the value of the equity interest in the real property or interest therein transferred by the transferor to the transferee and such ownership interests must be retained by the transferor or owners of the transferor for a period of not less than two years following the date of transfer; provided, however, that in the case of the death of the transferor or an owner of the transferor within such two year period, this two year retention requirement shall be deemed to be satisfied notwithstanding any transfer of such ownership interests held by such individual as a result of death. The value of the equity interest in such real property or interest therein shall be computed by subtracting from the consideration for the transfer (determined in accordance with paragraph (c) of this subdivision) the unpaid balance of any loans secured by mortgages or other encumbrances which are liens on the real property or interest therein immediately before the transfer. For purposes of this computation, in the case of a transfer of real property other than a transfer or an acquisition of a controlling interest, the amount of the unpaid balance of any loans secured by mortgages or other encumbrances to be subtracted from consideration is determined by multiplying the total unpaid balance of any loans secured by mortgages or other encumbrances on the real property or interest therein by the percentage of the ownership interest in the real property or interest therein being

transferred to the transferee. In the case of a transfer which is a transfer or an acquisition of a controlling interest, such amount to be subtracted is equal to the sum of the following amounts: (I) a reasonable apportionment to the interest in real property owned by the entity of the amount of any loans secured by encumbrances on the ownership interests in the entity which are being transferred or acquired and (II) the amount of any loans secured by mortgages or other encumbrances on the real property of the entity multiplied by the percentage interest in the entity which is being transferred or acquired. Provided, however that, for purposes of this computation, any mortgages or other encumbrances on the real property or interest therein which are created in contemplation of the initial formation of the REIT shall not be considered."

### **Use of Proceeds Requirement**

Section 1441.2(b)(ii)(B): "Seventy-five percent or more of the cash proceeds received by such REIT from the sale of ownership interests in such REIT upon its initial formation must be used: (I) to make payments on loans secured by any interest in real property (including an ownership interest in an entity owning real property) which is owned directly or indirectly by such REIT; (II) to pay for capital improvements to real property or any interest therein owned directly or indirectly by such REIT; (III) to pay costs, fees, and expenses (including brokerage fees and commissions, professional fees and payments to or on behalf of a tenant as an inducement to enter into a lease or sublease) incurred in connection with the creation of a leasehold or sublease pertaining to real property or any interest therein owned directly or indirectly by such REIT; (IV) to acquire any interest in real property (including an ownership interest in an entity owning real property), apart from any acquisition to which a reduced rate of tax is applicable pursuant to this subdivision (without regard to this clause); or (V) for reserves established for any of the purposes described in subclause (I), (II) or (III) of this clause. For purposes of this clause, the term real property shall include real property wherever located."

### **Calculation of Consideration**

Section 1441.2(c): "For purposes of measuring consideration under this subdivision, the fair market value of the real property or interest therein being transferred shall be calculated by dividing (i) the net cash flow from operations with respect to such real property for the twelve-month period ending on the last day of the second month preceding the date of the transfer by (ii) the sum of (A) the federal long-term rate compounded semi-annually that is determined by the United States secretary of the treasury under section 1274(d) of the

internal revenue code in effect thirty days prior to the date of the transfer and (B) two percentage points. Provided however, if the commissioner of taxation and finance determines that either the amount in clause (i) of this paragraph or clause (ii) of this paragraph does not result in an accurate representation of the fair market value of such real property or interest therein as such value is to be determined under this paragraph, the commissioner may adjust either of such amounts. In lieu of utilizing the method prescribed in this paragraph for determining fair market value, the taxpayer may utilize any other method for determining fair market value that the commissioner of taxation and finance has prescribed in rules or regulations or otherwise."

### **EXPLANATION OF AMENDMENTS**

The remainder of this memorandum outlines: (1) the requirements for determining whether a REIT transfer qualifies as being a transfer that occurs in connection with the initial formation of the REIT; (2) the rules and methodology required to be used to determine whether a REIT transfer meets the ownership requirement of the Tax Law; (3) the use of proceeds requirement that a REIT must meet in order to qualify for the reduced tax rates; and (4) the rules and methodology required to be used to compute the "net cash flow from operations", which is employed in the calculation of consideration. These explanations are also applicable to the amendments made to the transfer tax.

#### **Initial Formation Requirement**

For purposes of determining whether a REIT transfer meets the initial formation requirement, the following transfers will qualify:

(1) any REIT transfer which is specifically disclosed in the prospectus for the initial offering of the REIT shares, regardless of when such transfer takes place; or

(2) any REIT transfer where the consideration for such transfer is paid, in part, out of the proceeds of the initial offering of the REIT shares, regardless of when such transfer takes place; or

(3) any REIT transfer made within six months after the date of the initial offering of the REIT shares, without regard to paragraphs (1) or (2) above.

Any other transfer will be presumed to not be a transfer occurring in connection with the initial formation of the REIT. However, the taxpayer may rebut this presumption by presenting

clear and convincing evidence that the transfer in question was contemplated at the time of the initial formation of the REIT, but was unable to be consummated within six months from the date of the initial offering of the REIT shares.

### **Ownership Requirement**

To benefit from the reduced tax rates provided for a REIT transfer, the transferor(s) must receive as part of the consideration for the transfer ownership interests in the REIT or an entity controlled or to be controlled by the REIT. The value of those ownership interests in the REIT or entity controlled or to be controlled by the REIT received must be equal to at least 40 percent of the value of the equity interest in the real property or interest therein transferred by the transferor(s) to the transferee. In addition, the ownership interests in the REIT or entity controlled or to be controlled by the REIT received by the transferor(s) as part of the consideration for the transfer must be retained by the transferor(s) (or an owner of the transferor) for at least two years from the date of the REIT transfer, except in the case of the subsequent transfer of these interests as a result of the death of that individual.

#### **(I) Calculation of the equity value of the property:**

The value of the equity interest (equity value) of the real property or interest therein transferred by the transferor(s) to the REIT or entity controlled or to be controlled by the REIT is computed by subtracting from the consideration (determined according to section 1441.2(c) of Article 31-B and section 1402(b)(3) of Article 31) the unpaid balance of any loans secured by mortgages or other encumbrances that are liens on the real property or interest therein immediately prior to the transfer. In the case of a transfer of real property which is a transfer or an acquisition of a controlling interest, the amount required to be subtracted from consideration is equal to the sum of: (1) a reasonable apportionment to the ownership interests in the entity being transferred of the unpaid balance of any loans secured by encumbrances on the ownership interests in the entity being transferred, and (2) a reasonable apportionment to the ownership interests in the entity being transferred of the unpaid balance of any loans secured by mortgages or other encumbrances on the real property of the entity itself.

For purposes of computing the equity value of the real property or interest therein being transferred, any mortgages or other encumbrances on the real property or interest therein which are created primarily in contemplation of the initial formation of the REIT in order to avoid or evade the gains tax or transfer tax, rather than for an adequate business purpose, are prohibited from being deducted from the consideration. In addition, unsecured liabilities are not to be considered for the purposes of computing the equity value of the real property or interest therein being transferred.

**(II) Calculation of the value of the ownership interests received:**

The value of the ownership interests in the REIT or an entity controlled or to be controlled by the REIT which are received by the transferor(s) is required to be computed by one of the following methods:

(1) In the case where the real property or interest therein is transferred directly to the REIT and the consideration for the transfer includes shares in the REIT, the value of the ownership interests in the REIT received by the transferor(s) is presumed to be equal to the arithmetic mean of the opening and closing prices of the shares of the REIT (as traded on an established securities market) on the date of transfer multiplied by the number of shares in the REIT received by the transferor(s). If the REIT offering is not a public offering but rather a private placement, the value of the ownership interests in the REIT received by the transferor(s) is presumed to be equal to the arm's-length price of the shares of the REIT, without regard to any discounts in the price of the shares, on the date of transfer multiplied by the number of shares in the REIT received by the transferor(s).

(2) In the case where the real property or interest therein is transferred to an entity controlled or to be controlled by the REIT and the consideration for the transfer includes an ownership interest in such controlled entity, there shall be a presumption that the value of the ownership interests in the entity controlled or to be controlled by the REIT is equal to the net cash proceeds (gross proceeds less underwriting discounts) of the initial offering of the REIT used by the REIT to acquire its interest in the controlled entity divided by the percentage interest in the controlled entity acquired by the REIT. To compute the value of the ownership interests received by the transferor(s) as a result of the transfer, the value of the ownership interests in the entity controlled or to be controlled by the REIT, as determined above, is multiplied by the percentage interest in the controlled entity received by the transferor(s).

However, if the taxpayer demonstrates that the amount computed by using the applicable method outlined above does not result in an accurate representation of the value of the ownership interests received, the taxpayer may use another reasonable method to compute such value.

If the value of the ownership interests received by the transferor(s) is equal to or greater than 40 percent of the equity value computed for the real property, the transfer has met the ownership requirement of the Tax Law.

For purposes of the following examples assume all of the contributed properties are located wholly within New York State.

**Example 1:** Operating Partnership 1 (**OP1**) contributes Property 1 (**P1**) to REIT 1 (**R1**) in exchange for 1,200,000 shares in **R1** plus a cash payment. The shares received by **OP1** will be held for at least two years. In addition, at least 75 percent of the proceeds of the REIT offering will be used to pay down debt on the property and to make capital improvements to the property. The consideration for **P1** is calculated based on its net cash flow from operations to be \$73 million. **P1** is encumbered by a mortgage with an unpaid balance of \$20 million. The equity value of **P1** is computed to be \$53 million (\$73 million minus \$20 million). Forty percent of the equity value is \$21.2 million (\$53 million multiplied by 40 percent). The value of **OP1**'s 1,200,000 shares in **R1** must be at least \$21.2 million to meet the ownership requirement.

On the date of transfer, the mean trading price of the shares of **R1** is \$24.00 per share. The value of **OP1**'s interest in **R1** is presumed to be \$28.8 million (1,200,000 shares multiplied by \$24.00 per share). Because the value of **OP1**'s interest in **R1** (\$28.8 million) is greater than 40 percent of the equity value of **P1** (\$21.2 million), the transfer by **OP1** to **R1** has met the ownership requirement of the Tax Law.

**Example 2:** Operating Partnership 2 (**OP2**) contributes Property 2 (**P2**) to REIT 2 (**R2**) in exchange for 500,000 shares in **R2** plus a cash payment. The shares received by **OP2** will be held for at least two years. In addition, at least 75 percent of the proceeds of the REIT offering will be used to pay down debt on the property and to make capital improvements to the property. The consideration for **P2** is calculated based on its net cash flow from operations to be \$65 million. **P2** is encumbered by a mortgage with an unpaid balance of \$27 million. The equity value of **P2** is computed to be \$38 million (\$65 million minus \$27 million). Forty percent of the equity value is \$15.2 million (\$38 million multiplied by 40 percent). The value of **OP2**'s 500,000 shares in **R2** must be at least \$15.2 million to meet the ownership requirement.

On the date of transfer, the mean trading price of the shares of **R2** is \$22.00 per share. The value of **OP2**'s interest in **R2** is presumed to be \$11 million (500,000 shares multiplied by \$22.00 per share). Because the value of **OP2**'s interest in **R2** (\$11 million) is less than 40 percent of the equity value of **P2** (\$15.2 million), the transfer by **OP2** to **R2** has **not** met the ownership requirement of the Tax Law.

**Example 3:** REIT 3 (**R3**) raises \$171.5 million in its initial offering. **R3** contributes this \$171.5 million to Umbrella Partnership 1 (**UP1**) in return for a 67 percent general partnership interest in **UP1**. Simultaneously with the formation of **UP1** and entry by **R3**, Operating Partnership 3 (**OP3**)

contributes Property A (**P-A**) and Property B (**P-B**) to **UPI** in return for a 33 percent limited partnership interest in **UPI** plus a cash payment. The limited partnership interest received by **OP3** will be held for at least two years. In addition, at least 75 percent of the proceeds of the REIT offering will be used to pay down debt on the property and to make capital improvements to the property.

The consideration for **P-A** is calculated based on its net cash flow from operations to be \$94 million. **P-A** is encumbered by a mortgage with an unpaid balance of \$40 million. The equity value of **P-A** is computed to be \$54 million (\$94 million minus \$40 million).

The consideration for **P-B** is calculated based on its net cash flow from operations to be \$113 million. **P-B** is encumbered by a mortgage with an unpaid balance of \$41 million. The equity value of **P-B** is computed to be \$72 million (\$113 million minus \$41 million).

**OP3's** 33% limited partnership interest in **UPI** is not allocated between **P-A** and **P-B**. Forty percent of the combined equity value of **P-A** and **P-B** is \$50.4 million (\$126 [\$54 plus \$72] million multiplied by 40 percent). Therefore, the value of **OP3's** limited partnership interest in **UPI** must be at least \$50.4 million to meet the ownership requirement.

The value of the ownership interests as held by the owners of **UPI** is presumed to be \$255,970,149 (\$171.5 million divided by the 67 percent general partnership interest of **R3**). The value of **OP3's** 33 percent limited partnership interest in **UPI** is presumed to be \$84,470,149 (\$255,970,149 multiplied by 33 percent). Because the value of **OP3's** limited partnership interest in **UPI** (\$84,470,149) is greater than 40 percent of the combined equity value of **P-A** and **P-B** (\$50.4 million), the transfers by **OP3** to **UPI** have met the ownership requirement of the Tax Law.

*Example 4:* REIT 4 (**R4**) raises \$115 million in its initial offering. **R4** contributes \$105 million of the \$115 million to Umbrella Partnership 2 (**UP2**) in return for a 59 percent general partnership interest in **UP2**. Simultaneously with the formation of **UP2** and entry by **R4**, the general partner (**GP**) and limited partner (**LP**) of Operating Partnership 4 (**OP4**) each contribute their interest in **OP4** to **UP2**. **OP4** is a real estate partnership. **GP** owns a 60 percent interest in **OP4** and will receive a 36 percent limited partnership interest in **UP2**. **LP** owns a 40 percent interest in **OP4** and will receive a 5 percent limited partnership interest in **UP2** plus a cash payment. The limited partnership interests received by **GP** and **LP** will be held for at least two years. In addition, at least 75 percent of the proceeds of the REIT offering will be used to pay down debt on the property and to make capital improvements to the property.

The consideration for the property held by **OP4** is calculated based on its net cash flow from operations to be \$110 million. The property held by **OP4** is encumbered by a mortgage with an unpaid balance of \$23 million. **GP** and **LP** have each pledged their interests in **OP4** as collateral for a \$6 million loan. **OP4** has unsecured liabilities in the amount of \$7.6 million. The equity value of the property held by **OP4** is computed to be \$81 million (\$110 million minus \$29 [\$23 plus \$6] million). The equity value of the property held by **OP4** is not affected by **OP4**'s unsecured liabilities. Forty percent of the equity value is \$32.4 million (\$81 million multiplied by 40 percent). The value of **GP**'s 36 percent limited partnership interest in **UP2** must be at least \$19.44 million (\$32.4 million multiplied by **GP**'s 60 percent interest) to meet the ownership requirement. The value of **LP**'s 5 percent limited partnership interest in **UP2** must be at least \$12.96 million (\$32.4 million multiplied by **LP**'s 40 percent interest) to meet the ownership requirement.

The value of the ownership interests as held by the owners of **UP2** is presumed to be \$177,966,102 (\$105 million used by **R4** to acquire its interest divided by the 59 percent general partnership interest of **R4**). The value of **GP**'s 36 percent limited partnership interest in **UP2** is presumed to be \$64,067,797 (\$177,966,102 multiplied by 36 percent). The value of **LP**'s 5 percent limited partnership interest in **UP2** is presumed to be \$8,898,305 (\$177,966,102 multiplied by 5 percent). Because the value of **GP**'s limited partnership interest in **UP2** (\$64,067,797) is greater than **GP**'s interest in 40 percent of the equity value of the property held by **OP4** (\$19.44 million), the transfer by **GP** to **UP2** has met the ownership requirement of the Tax Law. However, because the value of **LP**'s limited partnership interest in **UP2** (\$8,898,305) is less than **LP**'s interest in 40 percent of the equity value of the property held by **OP4** (\$12.96 million), the transfer by **LP** to **UP2** has not met the ownership requirement of the Tax Law.

*Example 5:* REIT 5 (**R5**) raises \$148 million in its initial offering. **R5** contributes this \$148 million to Umbrella Partnership 3 (**UP3**) in return for a 72 percent general partnership interest in **UP3**. Simultaneously with the formation of **UP3** and entry by **R5**, Operating Partnership 5 (**OP5**) contributes Property 5 (**P5**) to **UP3**. In return, **OP5** receives a 28 percent limited partnership interest in **UP3** plus a cash payment, and 750,000 shares in **R5**. **R5** has a total of 5 million shares outstanding (including **OP5**'s 750,000 shares). The limited partnership interest in **UP3** and the shares in **R5** received by **OP5** will both be held for at least two years. In addition, at least 75 percent of the proceeds of the REIT offering will be used to pay down debt on the property and to make capital improvements to the property.

**OP5** owns a 15 percent interest in **R5** (750,000 shares divided by 5 million shares

outstanding). Through its 15 percent interest in **R5**, **OP5** indirectly owns 10.8 percent of **UP3** (**RS**'s 72 percent interest in **UP3** multiplied by 15 percent). Therefore, **OP5** owns, directly and indirectly, a 38.8 percent interest in **UP3** (a 28 percent direct interest plus a 10.8 percent indirect interest).

The consideration for **P5** is calculated based on its net cash flow from operations to be \$122 million. **P5** is encumbered by a mortgage with an unpaid balance of \$31 million. The equity value of **P5** is computed to be \$91 million (\$122 million minus \$31 million). Forty percent of the equity value is \$36.4 million (\$91 million multiplied by 40 percent). The value of **OP5**'s 38.8 percent interest in **UP3** must be at least \$36.4 million to meet the ownership requirement.

The value of the ownership interests as held by the owners of **UP3** is presumed to be \$241,830,065 (\$148 million divided by the 61.2 percent [72 percent minus the 10.8 percent of **OP5**] general partnership interest of **R5**). The value of **OP5**'s 38.8 percent total interest in **UP3** is presumed to be \$93,830,065 (\$241,830,065 multiplied by 38.8 percent). Because the value of **OP5**'s total interest in **UP3** (\$93,830,065) is greater than 40 percent of the equity value of **P5** (\$36.4 million), the transfer by **OP5** to **UP3** has met the ownership requirement of the Tax Law.

**(III) Retention of ownership interests received:**

In the case where the transferor (or the owners of the transferor) receives as consideration for a REIT transfer ownership interests having a value (as determined on the date of transfer according to the applicable method outlined in this memorandum) **greater than 40 percent** of the equity value of the property (or interest therein) transferred, the transferor (or the owners of the transferor) may subsequently transfer (within two years of the date of the REIT transfer) any portion of the ownership interests related to the value of the ownership interests received in excess of 40 percent of the equity value of the property (or interest therein) transferred and still satisfy the ownership requirement of the Tax Law. The ownership requirement of the Tax Law will continue to be satisfied as long as the transferor (or the owners of the transferor) continues to maintain (for a period of two years following the date of the REIT transfer) ownership interests in the REIT or an entity controlled by the REIT having a value (as determined on the date of transfer according to the applicable method outlined in this memorandum) of **at least 40 percent** of the equity value of the property (or interest therein) transferred. However, in the case where the initial REIT transfer was the transfer or acquisition of a controlling interest, if the subsequent transfer (by the transferor, an owner of the transferor or a group of the owners of the transferor acting in concert) of such ownership interests related to the value of the ownership interests in excess of 40 percent of the equity value of the property (where such transfer

does not otherwise qualify as a REIT transfer as defined in this memorandum) results in a further transfer or acquisition of a controlling interest, such further transfer(s) will **not** be eligible for the reduced tax rates provided for REIT transfers.

*Example 1:* Assume the same facts as in example 4 above. The value presumed for each 1 percent of **GP**'s 36 percent interest is \$1,779,661 (\$64,067,797 divided by 36). Within two years of the transfer to **UP2**, **GP** may transfer up to 25.07 percent of its interest in **UP2** and still meet the ownership requirement of the Tax Law (10.93 [36 minus 25.07] multiplied by \$1,779,661 equals \$19,451,695).

*Example 2:* **X** is the owner of an 80 percent interest in real estate partnership **ABC**. **X** transfers this 80 percent interest to an umbrella partnership as part of the initial formation of a REIT. In return, **X** receives a cash payment and a 20 percent interest in the umbrella partnership. Therefore, **X** has transferred a 64 percent interest (80 percent minus a 16 percent [80 percent multiplied by 20 percent] mere-change of identity percentage) in **ABC** as a result of the transfer.

Forty percent of **X**'s portion of the equity value of the property transferred equals a 14 percent interest in the umbrella partnership as of the date of transfer. Therefore, **X** has received a 6 percent excess interest in the umbrella partnership.

Sixteen months after the date of the REIT transfer, **X** transfers its 6 percent excess interest in the umbrella partnership to the REIT or to an entity controlled by the REIT. **X**'s 6 percent excess interest in the umbrella partnership represents a 4.8 percent interest (80 percent multiplied by 6 percent) in **ABC**. This transfer does not otherwise qualify as a REIT transfer. Because this transfer occurs within 3 years of **X**'s previous controlling interest transfer, it is the further transfer of a controlling interest in **ABC** (**X** has transferred a 68.8 percent interest in **ABC** within 3 years). However, the transfer of **X**'s 6 percent excess interest is **not** eligible for the reduced tax rates provided for REIT transfers.

In the case where an entity transfers an interest in real property to a REIT or to an entity controlled by a REIT, and the value of the ownership interests received by the entity as consideration for the transfer is at least 40 percent of the equity value of the property transferred (i.e., the entity meets the ownership requirement of the Tax Law), the ownership requirement of the Tax Law will continue to be satisfied as long as the **entity** continues to retain, for a period of two years following the date of the REIT transfer, ownership interests having a value of at least 40 percent of the equity value of the property transferred, without regard to any changes in the beneficial ownership of the entity itself.

In the case where an entity transfers an interest in real property to a REIT or to an entity controlled by a REIT, and the value of the ownership interests received by the entity as consideration for the transfer is at least 40 percent of the equity value of the property transferred (i.e., the entity meets the ownership requirement of the Tax Law), the ownership requirement of the Tax Law will continue to be satisfied for each owner of the entity (determined as of the date of the REIT transfer) if the entity liquidates within two years of the date of the REIT transfer (resulting in the ownership interests being transferred to the owners of the entity) as long as such an owner of the entity continues to retain, for a period of two years from the date of the REIT transfer, ownership interests having a value of at least 40 percent of that owner's portion of the equity value of the property transferred (determined as of the date of the REIT transfer). If, as a result of such a liquidation, an owner of the entity as of the date of the REIT transfer no longer retains ownership interests having a value of at least 40 percent of that owner's portion of the equity value of the property transferred (determined as of the date of the REIT transfer), such owner no longer meets the ownership requirement of the Tax Law.

**Example 3:** Partners **X** and **Y** each own a 50 percent interest in Corporation **ABC**. **ABC** transfers a parcel of real property it holds to an Umbrella Partnership (**UP**), which is controlled by a REIT, in return for a 33 percent interest in **UP** plus a cash payment. The value of **ABC**'s 33 percent interest in **UP** is determined to be \$50 million. The equity value of the property transferred by **ABC** is determined to be \$75 million on the date of the REIT transfer. Forty percent of the equity value is \$30 million. The transfer by **ABC** meets the ownership requirement of the Tax Law. The \$30 million figure equates to a minimum 19.8 percent interest in **UP** that must be retained for a period of two years by **ABC**. Within two years of the transfer by **ABC** to **UP**, a new partner, **Z**, buys all of **Y**'s interest in **ABC**, and one-half of **X**'s interest in **ABC**. As long as **ABC** continues to hold, for a period of two years from the date of the REIT transfer, an ownership interest in **UP** of at least 19.8 percent, the ownership requirement will be satisfied, regardless of any changes in the ownership of **ABC**.

**Example 4:** Assume the same facts as in example 3 of this section, except that **Z** does not buy either **X**'s or **Y**'s interest in **ABC**. **ABC** liquidates within 2 years of its transfer to **UP** and its ownership interest in **UP** is transferred to **X** and **Y** in their respective ownership percentages. **X** and **Y** now individually hold an ownership interest in **UP** having a value of \$25 million (\$50 million multiplied by 50 percent). Forty percent of both **X**'s and **Y**'s respective portion of the equity value of the property transferred (determined as of the date of the REIT transfer) equals \$15 million (\$30 million multiplied by 50 percent). Because **X** and **Y** each continue to retain an ownership interest in **UP** having a value of at least 40 percent of their respective portion of the equity value of the

property transferred, both **X** and **Y** continue to meet the ownership requirement of the Tax Law. Both **X** and **Y** will each continue to meet the ownership requirement of the Tax Law as long as each holds for the remainder of the two year period following the date of the REIT transfer an ownership interest in **UP** having a value of at least \$15 million.

*Example 5:* Partners **G** and **H** each own a 50 percent interest in Partnership **DEF**. **DEF** transfers a parcel of real property to an Umbrella Partnership (**UP**), which is controlled by a REIT, in return for a 42 percent interest in **UP** plus a cash payment. The value of **DEF**'s 42 percent interest in **UP** is determined to be \$57 million. The equity value of the property transferred by **DEF** is determined to be \$115 million on the date of the REIT transfer. Forty percent of the equity value is \$46 million. The transfer by **DEF** meets the ownership requirement of the Tax Law.

Within two years of the date of the REIT transfer the partnership is dissolved. **G** receives 75 percent of **DEF**'s ownership interest in **UP**, and **H** receives 25 percent of **DEF**'s ownership interest in **UP** plus a cash disbursement. **G** retains an ownership interest in **UP** having a value of \$42.75 million (\$57 million multiplied by 75 percent). Forty percent of **G**'s portion of the equity value of the property transferred (determined as of the date of the REIT transfer) is \$23 million (\$46 million multiplied by 50 percent). **H** retains an ownership interest in **UP** having a value of \$14.25 million (\$57 million multiplied by 25 percent). Forty percent of **H**'s portion of the equity value of the property transferred (determined as of the date of the REIT transfer) is \$23 million (\$46 million multiplied by 50 percent). Because **G** continues to retain an ownership interest in **UP** having a value of at least 40 percent of its portion of the equity value of the property transferred (\$42.75 million is greater than \$23 million), **G** still meets the ownership requirement of the Tax Law. **G** will continue to meet the ownership requirement of the Tax Law as long as it holds for the remainder of the two year period following the date of the REIT transfer an ownership interest in **UP** having a value of at least \$23 million. However, because **H** no longer retains an ownership interest in **UP** having a value of at least 40 percent of its portion of the equity value of the property transferred (\$14.25 million is less than \$23 million), **H** no longer meets the ownership requirement of the Tax Law.

*Example 6:* Corporation **KLM** owns a 60 percent interest in Partnership **NOP**, which owns real property. **KLM** transfers this 60 percent interest to an Umbrella Partnership (**UP**), which is controlled by a REIT, in return for a 28 percent interest in **UP** plus a cash payment. The value of **KLM**'s 28 percent interest in **UP** is determined to be \$62 million. The equity value of the property owned by **NOP** is determined to be \$150 million on the date of the REIT transfer. Forty percent of the equity value is \$60 million.

**KLM**'s portion of the equity value is \$36 million (\$60 million multiplied by 60 percent). The transfer by **KLM** meets the ownership requirement of the Tax Law.

**KLM** is owned equally by four shareholders. **KLM** is liquidated within two Years of the date of the transfer to **UP** and its ownership interest in **UP** is transferred to its shareholders in their respective ownership percentages. All four shareholders now individually hold an ownership interest in **UP** having a value of \$15.5 million (\$62 million divided by four). Forty percent of each shareholder's respective portion of **KLM**'s portion of the equity value of the property owned by **NOP** (determined as of the date of the REIT transfer) equals \$9 million (\$36 million divided by four). Because each shareholder continues to retain an ownership interest in **UP** having a value of at least 40 percent of their respective portion of **KLM**'s portion the equity value of the property owned by **NOP** (\$15.5 million is greater than \$9 million), each shareholder continues to meet the ownership requirement of the Tax Law. The shareholders of **KLM** will each continue to meet the ownership requirement of the Tax Law as long as each holds for the remainder of the two year period following the date of the REIT transfer an ownership interest in **UP** having a value of at least \$9 million.

### **Use of Proceeds Requirement**

In order for a transfer to qualify as a REIT transfer, the requirement regarding the use of the net cash proceeds from the initial offering of the REIT must be satisfied. Under this requirement, at least 75 percent of the net cash proceeds (after deducting underwriting discounts) received by the REIT from its initial offering must be used for the following purposes:

(1) to make payments on loans secured by any interest in the real property owned directly or indirectly by the REIT;

(2) to pay for capital improvements to the real property owned directly or indirectly by the REIT;

(3) to pay costs, fees and expenses (including brokerage fees, commissions and professional fees) incurred in connection with the creation of a leasehold or sublease pertaining to the real property owned directly or indirectly by the REIT;

(4) to make payments to or on behalf of a tenant as an inducement to enter into a lease or sublease, including the following:

(a) a cash bonus paid to a tenant for signing a lease;

- (b) a payment for the unexpired term of a tenant's previous lease;
- (c) payment of a tenant's moving costs;
- (d) payment for a tenant's improvements that do not constitute capital improvements (such as temporary partitions or non-permanent electrical wiring for computer equipment); and
- (e) payment of a tenant's attorneys' fees.

The costs included in items (3) and (4) above will be interpreted on a basis consistent with the costs allowed in the calculation of original purchase price under section 1440.5(a)(vii) of the Tax Law.

(5) to acquire any interest in real property (including an ownership interest in any entity owning real property) **except** an acquisition that would qualify for the reduced rates of tax provided for a REIT transfer (without regard to this requirement); or

(6) for reserves established for any of the purposes described in items (1), (2), (3) or (4) above.

For purposes of this requirement, the term "real property" includes real property owned directly or indirectly by the REIT, whether located inside or outside New York State. Also, the calculation of the net cash proceeds from the initial offering of the REIT is made without regard to any proceeds resulting from the exercise of any underwriter's over-allotment option in connection with the initial offering of the REIT shares.

For purposes of the gains tax pre-transfer audit procedure only, the prospectus for the REIT offering will be reviewed to determine the intentions of the REIT with respect to the use of the proceeds of its initial offering.

### **Net Cash Flow from Operations**

The consideration for real property, or any interest therein, transferred to a REIT or to an entity controlled by a REIT is required to be calculated by dividing the net cash flow from operations for the real property for the twelve-month period ending on the last day of the second month prior to the date of the transfer (the "subject period") by the federal long-term rate compounded semi-annually (determined by the United States secretary of the treasury under section 1274(d) of the Internal Revenue Code) in effect thirty

days prior to the date of the transfer plus two percentage points. The net cash flow from operations is required to be determined according to the rules and methodology outlined below.

**(I) Calculation of net cash flow from operations:**

All revenue and expense items included in the calculation of net cash flow from operations must be included under the cash basis of accounting. All items that constitute revenue are to be recognized in the period in which they are actually or constructively received, and expenses are to be recognized in the period in which they are paid. An item of revenue is includible regardless of whether it is in the form of cash, property or services. Revenue, although not actually received, is constructively received in the period in which it is credited to the landlord's account, set apart for the landlord's use or otherwise made available so that the landlord may draw UP on it at any time.

Accordingly, the inflow and outflow of cash resulting from the operations of the real property must be computed for the subject period under the method outlined above. Adjustments must be made for items of revenue or expense not actually or constructively received or paid during the subject period when such adjustments are necessary to achieve a reasonable calculation of net cash flow from operations for the subject period that would not otherwise result. Extraordinary items of revenue and expense must be reasonably allocated to the subject period. If the Commissioner of Taxation and Finance determines that any calculation of net cash flow from operations does not result in an accurate representation of the actual earnings from operations for the real property for the subject period, the Commissioner may adjust such calculation of net cash flow from operations to reasonably reflect the actual earnings from operations for the real property, and the fair market value of the real property as such value is required to be computed under section 1441.2(c) of the Tax Law.

**(II) Additional deductions:**

Additional deductions for amortized portions of certain capital expense items, as outlined below, are allowed in the calculation of net cash flow from operations. Unless otherwise provided, for purposes of determining the term of a lease to be used in the amortization of these capital expenses, the term of the lease shall include the current unexpired term of the lease and all periods pursuant to any options to renew the lease remaining at the time the amortizable expense item was incurred or the amortizable improvement was completed and placed into service. However, if the taxpayer can clearly demonstrate that these capital expense items were related only to the initial lease term and were not related to any renewal periods, the cost of such capital expense items may be amortized over the initial lease term, without regard to any renewal periods.

(1) Leasing commissions: This category includes amounts incurred as commissions in the course of leasing the available space of the property. The amounts that accrue during the subject period may be deducted in calculating net cash flow from operations.

However, if such payments are made to partners, officers or other related entities of the landlord, they may not be deducted in computing net cash flow from operations if intended as a share of the profits, rather than guaranteed compensation for leasing commissions. The determination as to whether or not such payments qualify as deductible in computing net cash flow from operations will be made based on all the facts and circumstances surrounding the payments. If payments for leasing commissions are made to partners, officers or other related entities of the landlord, in no event will the amount allowed as a deduction in computing net cash flow from operations be greater than that which would have been paid to an unrelated third party as a result of arm's-length negotiations.

In the event that a lease is cancelled during the subject period, any leasing commissions that remain unamortized at that point may be deducted in calculating the net cash flow from operations for the period.

(2) Special tenant improvements (alterations): This category is intended to recognize specialized, tenant specific improvements made by the landlord to a tenant's space that are not reimbursed by the tenant. The amounts that accrue during the subject period may be deducted in calculating net cash flow from operations.

In the event that a lease is cancelled during the subject period, any special tenant improvements that remain unamortized at that point may be deducted in calculating the net cash flow from operations for the period. However, if the space is leased within the subject period to a new tenant that makes use of the improvements, the remaining unamortized costs are required to be amortized over the term of the **new lease**.

**(III) Non-deductible expenses:**

Debt service expenses (principal and interest), taxes (other than operating taxes such as real estate taxes and special assessments, payroll taxes, and sales and utility taxes) and depreciation amounts are **not deductible** in computing the net cash flow from operations for the property for the subject period.

TSB-M-94(4)-R  
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**(IV) Future Changes:**

This memorandum represents the Tax Department's current interpretation of the Chapter 170 amendments affecting the gains tax and the transfer tax with regard to certain transfers or conveyances occurring in connection with the initial formation of a REIT. The Tax Department reserves the right to make changes to this interpretation. Any such changes will be applied on a prospective basis.