REPORT #741

TAX SECTION

New York State Bar Association

Report on Proposed Amendments to Rules Relating to the
New York City Commercial Rent or Occupancy Tax

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New York State Bar Association

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December 4, 1992

Simon G. Salas, Esq.
Deputy Commissioner for Legal Affairs
345 Adams Street
Brooklyn, NY 11201

Dear Mr. Salas:

In accordance with the notice of opportunity to comment on proposed amendments to Rules relating to the New York City Commercial Rent or Occupancy Tax, we enclose our written comments on the proposed Rules.

Yours very truly,

Robert J. Levinsohn
Co-Chair, Committee On
New York City Tax Matters

RJL:bld
enclosure

cc: Ellen E. Hoffman, Esq.

BY HAND

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Tax Report #741

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON NEW YORK CITY TAX MATTERS

Report on Proposed Amendments to Rules Relating to the New York City Commercial Rent or Occupancy Tax[1]

The Commissioner of Finance has published proposed amendments to the Rules relating to the New York City Commercial Rent or Occupancy Tax ("Rent Tax"), primarily in relation to the definition of taxable premises where premises are used by a nonprofit organization.

Chapter 7 of Title 11 of the Administrative Code for the City of New York, relating to the Rent Tax, contains two provisions relevant to the application of the tax to nonprofit organizations. Subdivision a.4 of Adm. Code §11-704 provides that the following shall be exempt from the payment of the Rent Tax:

> "Any corporation, or association, or trust, or community chest, fund or foundation, organized and operated exclusively for religious, charitable, or educational purposes, or for the prevention of cruelty to children or animals, and no part of the net earnings of which inures to the benefit of any private shareholder or individual and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation; provided, however, that nothing in this paragraph shall include an organization on a trade or business for profit, whether or not all of its profits are payable to one or more organizations described in this paragraph".

[1] This report was prepared by Robert J. Levinsohn, with assistance from Abraham Gutwein and Theodore Schnoll. Helpful comments were received from Franklin L. Green.

In addition, under Adm. Code §11-701, subd. 7, the "base rent" on which the tax is levied is only rent paid for "taxable premises". "Taxable premises" are defined in part in Adm. Code §11-702, subd. 5, as

> "Any premises in the city occupied, used or intended to be occupied or used for the purpose of carrying on or exercising any trade, business, profession, vocation or commercial activity, including any premises so used even though it is used solely for the purpose of renting, or granting the right to occupy or use, the same premises in whole or in part to tenants...."

The existing Rules of the Department of Finance contain an exemption for charitable, etc., organizations in Rule §7-04(d) which tracks the language of Adm. Code §11-704, subd. a.4; a definition of "taxable premises" in Rule §7-01 which includes in its last paragraph a statement that premises not devoted to or intended for use in the conduct of a trade or business are not taxable premises and an example of the application of the rule to a bar association; and provisions in Rule §7-05 for applications for exemption, which apparently are not required in every case where exemption is claimed.

The proposed amendments make no change in Rule §7-04(d). They replace the last paragraph of the definition of "taxable premises" in Rule §7-01 with entirely new language, and they make significant changes in Rule §7-05. A copy of the proposed amendments is attached. They will be summarized to the extent relevant in the course of our comments as set forth below.

In general, the proposed amendments represent a commendable effort to clarify the scope of the existing Rules.

However, there are several aspects of the amendments which we believe require further clarification.

1. The first paragraph of the proposed amendments to Rule §7-01 states that premises used by an organization exempt from Federal income taxation pursuant to §501(a) of the Internal Revenue Code ("Code"), other than an organization described in §501(c)(2) or (25), will be presumed not to be taxable premises, absent substantial evidence to the contrary, provided the premises are not used substantially in connection with an unrelated trade or business, as described in §513 of the Code. Literally, this provision states merely that premises used substantially in connection with an unrelated trade or business are not eligible for the favorable presumption, leaving the implication that on a proper showing it might still be possible to establish that the premises are nontaxable. However, the example in the sixth paragraph of the proposed amendments to Rule §7-01 states flatly that once the facts show that the premises are used substantially in connection with an unrelated business, the premises are wholly taxable without more. If this is the intent, which seems correct under the statute, the first paragraph should be rewritten to eliminate any ambiguity and state this clearly as part of the substantive provision, rather than leaving it to be made explicit only in the example.

2. The fifth paragraph of the proposed amendments to Rule §7-01 states that in determining whether premises are used substantially in connection with an unrelated trade or business, all the facts and circumstances will be considered, including, but not limited to, the portions of the square footage and gross receipts and the number of personnel connected with the unrelated business. However, the example in the sixth paragraph relies exclusively on the percentage of employees involved in the

unrelated business and ignores the other factors specifically listed in the preceding paragraph. To the extent that the example suggests that any one "bad" factor is sufficient to render the whole of the premises taxable, it is too harsh and not consistent with the substantive rule itself. Accordingly, we suggest that the example be modified to incorporate the basic rule that all facts and circumstances must be considered.

3. The language in the fifth and sixth paragraphs, discussed above, although ambiguous, is susceptible of the interpretation that if a substantial portion of the square footage of a premises is used in connection with an unrelated trade or business, the entire premises is taxable. We believe that if only a discrete and segregable portion of the premises is used for the unrelated business, it would be consistent with the statute to provide that only that portion is taxable, and we recommend that such a provision be incorporated in the Rules.

4. The last paragraph of the proposed amendments to Rule §7-01 states that nothing in the definition of taxable premises shall subject to the Rent Tax organizations exempt from tax under Adm. Code §11-704, subd. a(4). These are charitable, etc. organizations of a type covered by §501(c)(3) of the Code, provided they are not operated for the primary purpose of carrying on a trade or business for profit. The implication is that so long as a §501(c)(3)-type organization is not as an overall matter primarily operated to carry on a profit-making business, a particular premises of the organization is exempt even if it is exclusively devoted to an unrelated trade or business. If this is the Finance Department's understanding of the statute, it should be made explicit in the Rules.

5. As noted above, the proposed amendments make no change in Rule §7-04(d), which merely tracks the language of the statute as to the exemption for charitable organizations. It is worth noting that the exemption in Adm. Code §11-704, subd. a.4, is not as broad as that in §501(c)(3) of the Code. The latter includes as exempt organizations organized and operated exclusively for scientific, testing for public safety or literary purposes, or to foster amateur sports competition, none of which purposes are listed in the Administrative Code exemption. It might serve to avoid confusion if Rule §7-04(d) were amended to spell out the extent to which the City exemption is narrower than that in the Code.

6. The third paragraph of the amendments to Rule §7-01 states that premises used by an organization that has been denied an exemption from Federal income tax pursuant to §501(a) of the Code will be presumed to be taxable premises, absent substantial evidence to the contrary. Adm. Code §11-703, subd. a, and existing Rule §7-06 provide that it shall be presumed that all premises are taxable premises until the contrary is established. If the third paragraph is merely intended to restate where the burden of proof lies if an organization is not Federally exempt, query if it is not superfluous in light of the pre-existing Rule §7-06 and the corresponding statutory provision. If the new provision is intended to place a greater than normal burden of establishing non-taxability where Federal exemption has been denied, it does not seem appropriate. Federal exemption may be denied to an organization as a whole for reasons that are entirely unrelated to whether a particular premises is utilized for business activities. The taxable status of the latter for City Rent Tax purposes should be determined under normal burden of proof rules without being required to run the gauntlet of the "absent substantial evidence" standard.

7. The fourth paragraph of the amendments to Rule §7-01 provides that premises used or occupied or intended to be used or occupied by a Federally exempt organization that are subleased in whole or in part by such organization will not be considered taxable premises to such organization by reason of such sublease, provided that the rent received qualifies for exclusion from unrelated business taxable income under §512(b)(3) of the Code. The interrelation of this provision with the succeeding paragraph, discussed in item 2 above, is not clear. If a nonprofit organization subleases 75 percent of its premises for rent which is eligible for the §512(b)(3) exemption, and utilizes the remaining 25 percent in an unrelated trade or business, is the sublease "good" premises for purposes of determining whether the overall premises is "substantially" used in connection with an unrelated trade or business, so that the premises might be wholly nontaxable under the standard suggested by the example in the fifth paragraph? Or is the subleased space ignored, so that the remaining space is taxable premises because it is 100% used in an unrelated business? This should be clarified.

We assume that the fourth paragraph is intended to apply to any space occupied under lease by a tax-exempt organization even though it has been subleased from the inception of the lease, and that the introductory language is not intended to establish as a condition to the exception for subleased space that there must be a showing of some specific intent on the part of the organization to use or occupy the space itself at some time in the future. Any contrary interpretation would be unwarranted, and it might be desirable to revise the proposed language to eliminate any ambiguity.

8. Rent that would otherwise be excludable from unrelated business taxable income under §512(b)(3) of the Code may become includible in whole or in part by reason of §512(b)(4) (relating to debt-financed property) or (13) (relating to controlled subsidiaries). Since the fourth paragraph of the amendments to Rule §7-01 refers to rent that qualifies for exclusion from unrelated business taxable income under subsection (b) of section 512, presumably it incorporates all of the exceptions in the various paragraphs of subsection (b), and therefore would not apply to rent that paragraph (4) or (13) treats as includible in gross income. Since disqualification under Code §512(b)(4) from the exclusion of real property rents from unrelated business income under §512(b)(3) results solely from the presence of acquisition indebtedness, as defined in Code §514(c), with respect to the property, it could be argued that this is irrelevant to the determination of whether the premises is occupied or used for trade, etc. purposes, and that rent which otherwise qualifies for exclusion from unrelated business taxable income should be treated as so excluded for rent tax purposes even if it is included in unrelated business income for Federal purposes solely because of §512(b)(4).

However this question is resolved, to whatever extent the proposed amendments leave in place the inclusions in unrelated business income under either §512(b)(4) or (13), the proposed amendments leave unclear how the test of the fourth paragraph is to be applied where rent is only partially includible under either §512(b)(4) or (13). Since the basic principle established by the first paragraph of the amendments is that premises of an exempt organization will be presumed nontaxable unless they are used substantially in connection with an unrelated trade or business, we suggest that it would be appropriate to incorporate the same concept into the fourth

paragraph, so that taxability of subleased premises will result only if the portion of the rent which §512(b)(4) or (13) treats as includible in unrelated business income is substantial in relation to the operation of the premises as a whole. Any addition to the Rules along these lines should be consistent with the treatment of the issues discussed in item 3 and the first paragraph of item 7 of this report.

9. The proposed amendments to Rule §7-05 appear intended to make it mandatory for an application for exemption to be made in every case where either exemption is claimed under Adm. Code §11-704, subd. a.4, or it is claimed that premises used by a nonprofit organization are not taxable premises. Apparently this is a change from existing practice. If so, transition rules and effective dates are needed in order to provide a mechanism by which existing organizations are either "grandfathered" or are allowed a period of time within which to file applications for exemption. In addition, if filing for existing organizations is necessary, the tax periods and premises to which such an exemption would relate must be clarified, as well as whether the criteria of the "new" proposed or "old" rules (in cases where they may differ) govern. This suggests that an effective date should also be set forth for the amendments to Rule §7-01.

10. In view of the significance placed by the amended Rules on the use of premises in connection with an unrelated trade or business, it might be appropriate to add to the Rules a requirement that an otherwise Federally tax-exempt organization occupying premises as a tenant in New York City, which has not theretofore been filing returns for taxable premises, notify the Department of Finance when it files a Form 990-T with the Internal Revenue Service, or is otherwise determined by the Service to have unrelated business taxable income. Authority for

such a requirement may be found in Adm. Code §11-705, subd. b, permitting the Commissioner of Finance by regulation to require the filing of information returns by tenants of taxable premises, whether or not they are required to pay any Rent Tax.

THE CITY OF HEW YORK

DEPARTMENT OF FINANCE

NOTICE OF OPPORTUNITY TO COMMENT ON
PROPOSED AMENDMENTS TO RULES RELATING TO THE
NEW YORK CITY COMCERCIAL RENT OR OCCUPANCY TAX

NOTICE IS HEREBY GIVEN POKSUANT TO THE AUTHORITY VESTED IN THE Commissioner of Finance by sections 389(b) and 1043 of the New York City Charter and section 11-713.1 of the Administrative Code of the City of New York, and in accordance with the requirements of section 1043 of the New York City Charter, that the New York City Department of Finance intends to adopt the following proposed Amendments to Rules Relating the Kew York City Commercial Rent or Occupancy Tax which are necessary to carry out the powers and duties delegated to the Commissioner of Finance by chapter 7 of title 11 of the Administrative Code of the City of New York.

Written comments regarding these proposed rules must be submitted to the office of Simon G. Salas, Deputy Commissioner for Legal Affairs, 345 Adams Street, Brooklyn, New York, 11201 on or before December 7, 1992.

A hearing for public comment shall be held on December 7, 1992 at 345 Adams Street, 3rd Floor, Brooklyn, New York at 9:30 A.M. Persons seeking to testify are requested to notify Natalie Horns at (718) 403-3747 at least three business days prior to the date scheduled for the hearing, although such notice is not required by law.

Written comments and an audio tape recording of oral comments received at the hearing will be available for public review within a reasonable time after receipt, by appointment between the hours of 9:00 A.M. and 5:00 P.M. on weekdays at the office of Gerald Koszer, Records Access Officer, 345 Adams Street, Brooklyn, New York.

Note: New matter <u>underscored</u>; old matter in brackets [] to be deleted.

Section 1. The third unnumbered paragraph of the definition of "Taxable premises" contained in Section 7-01 of Title 19 of the Compilation of the Rules of the City of New York (Rules Relating to the Commercial Rent Tax), promulgated June 1, 1963 and amended on October 22, 1984 and February 26, 1986, is amended to read as follows:

[Premises not devoted to or intended for use in the conduct of a trade or business are not taxable premises. Thus, premises used by a bar association or other professional organization not primarily concerned with furthering the interests of its members are not deemed to be taxable premises to the extent that such premises are utilized by the organization for the fulfillment of its purposes and not sublet to others]

<u>Absent substantial evidence to the contrary, premises used or occupied by or intended to be used or occupied by an organization that the Internal Revenue Service has determined to be exempt from federal income taxation pursuant to subsection (a) of section 501 of the Internal Revenue Code, other than an organization described in paragraph (2) or (25) of subsection (c) of section 501, will be presumed not to be taxable premises provided the premises are not used substantially in connection</u>

with an unrelated trade or business, as described in section 513 of the Internal Revenue Code.

Premises used or occupied by or intended to be used or occupied by an organization described in section 501(c)(2) or (25) of the internal Revenue Code are taxable premises.

Absent substantial evidence to the contrary, premises used or occupied by or intended to be used or occupied by an organization that has been denied an exemption from federal income tax pursuant to subsection (a) of section 501 of the Internal Revenue Code will be presumed to be taxable premises.

Premises that would not be taxable premises under this definition because they are used or occupied or intended to be used or occupied by an organization exempt from federal Income taxation under subsection (a) of section 501 of the Internal Revenue Code that are subleased in whole or in part by such organization will not be considered taxable premises to such organization by reason of such sublease, provided that rent received by such organization from such sublease qualifies for exclusion from unrelated business taxable income under subsection (b) of section 512 of the Internal Revenue Code.

In determining whether premises used or occupied or intended to be used or occupied by a nonprofit organization will be considered to be used substantially in connection with an unrelated trade or business, consideration will be given to all of the facts and circumstances of each case including, but not limited to, the following factors; the portion of the square footage used in connection with the unrelated trade or business, the portion of gross receipts derived from activities the premises from unrelated business activities, and the number

personnel at the premises engaged in unrelated business activities.

The following example illustrates the foregoing;

Example: X Corp. is a nonprofit organization exempt from federal income tax under Internal Revenue Code section 501(c)(4). As part of its nonprofit activities, X Corp. publishes a magazine on topics related to its exempt purpose that carries advertisements of a general nature. The income from selling advertising space in the magazine is subject to tax as income from an unrelated business. Fifty percent (50%) of the staff located at premises rented by X Corp. in New York City are exclusively engaged in selling advertising space in the magazine. On the basis of the facts of this case, the premises will be considered to be used substantially in connection with an unrelated business and all of the rent paid by X Corp. for those premises will be subject to the tax.

Nothing in this definition of taxable premises shall be construed to subject to the commercial rent or occupancy tax imposed by chapter 7 of title 11 of the Administrative Code persons or organizations exempt from the tax under section 11-704.a(4) of the Administrative Code. See section 7-04 of these Rules.

§2. Section 7-05 of these Rules is amended to read as follows:

A person claiming exemption from the commercial rent or occupancy tax under section 11-704.a(4) of the Administrative Code [may] shall be required to make application for such exemption to the Commissioner [of Finance] and to submit to the

Commissioner [of Finance] such information as will enable the Commissioner to rule upon the applicant's status. A person claiming that certain premises used by a nonprofit organization are not taxable premises must make an application to the Commissioner for a determination of whether such premises are taxable. The Commissioner, if satisfied that the applicant is entitled to the exemption or that the premises in question are not taxable, will issue a letter [of exemption] to that effect to the applicant.

A corporation or unincorporated entity organized and operated for nonprofit purposes, claiming exemption under [§7-04(d)] section 11-704 a(4) of the Administrative Code or claiming premises not to be taxable premises under §7-01 of these [regulations] Rules, [or otherwise] is required to submit an affidavit which shall set forth the following:

(a) The type of organization using the premises;
(b) The purposes for which it is organized;
(c) Its actual activities;
(d) The source and disposition of its income;
(e) Whether [or not] any of Its income is credited to surplus or ay inure to any private stockholder or individual; and
(f) Such other facts which may affect its right to exemption including, in the case of a claim that certain premises are not taxable premises, a description of the activities carried on at the premises bv the organization and a description of any sublease or other arrangement whereby any other person or entity uses or occupies the premises.

The [Commissioner nay require that the] affidavit must be supplemented by a copy of the articles and certificate of incorporation, or articles of association, as the case may be, a copy of the by-laws of the organization, a financial statement showing its assets and liabilities, a statement of its receipts and disbursements for the most recent year, a copy of its federal, state and city income tax returns for the most recent three years and a photostatic copy of the letter, if any, from the United States Treasury Department granting the organization exemption from federal income taxation.

BASIS AND PURPOSE OF PROPOSED AMENDMENTS

These amendments affect the portion of the Rules Relating to the New York City Commercial Rent or Occupancy Tax governing the definition of taxable premises where premises are used by a nonprofit organization. The definition has been clarified to provide that premises used or occupied or intended to be used or occupied by certain organizations that have been determined to be exempt from federal income tax under section 501(a) of the Internal Revenue Code will be presumed not be taxable premises provided the premises are not used substantially in connection with an unrelated trade or business.

Carol O'Cleireacain
Commissioner of Finance