

TRANSACTIONAL REAL ESTATE

Expert Analysis

Tax Exemption Eligibility Extended to Foreign Govt's

New York City boasts the largest cluster of diplomatic and consular offices in the world, with the headquarters of the United Nations General Assembly and Security Council and (according to a 2016 guide issued by the New York City Mayor's Office for International Affairs) 193 permanent missions, 114 consulates and 75 trade missions. From Afghanistan to Zimbabwe, countries around the world need facilities in New York to support their foreign affairs and to provide services (related to passports, notarization, immigration matters and other needs) to the millions of foreign nationals living, working and traveling in and around the five boroughs and the surrounding metropolitan area.

New York City's status as a hub for foreign government offices provides a permanent source of demand for real estate, with a long-term need for space and one that is less susceptible than private investment to market cycles or the vicissitudes of the economy.

Real Estate Tax Exemption for Owned Property

Section 418 of the New York Real Property Tax Law provides an exemption from

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real estate taxes for properties owned by foreign governments or related organizations and used in their official capacities, stating in pertinent part as follows:

Real property of a foreign government which is a member of the United Nations or any world-wide international organization as defined in section four hundred sixteen of this chapter, the legal title to which stands in the name of such foreign government or the principal resident representative or resident representative with the rank of ambassador or minister plenipotentiary of such foreign government to the United Nations or other such world-wide international organization, used exclusively for the purposes of maintaining offices or quarters, for such representatives, or offices for the staff of such representatives, shall be exempt from taxation ...

While this exemption is of use to foreign governments that choose to own their properties in New York, it has not historically been used by those that lease the

properties they occupy—a highly common situation, particularly in the high-rise Manhattan buildings where offices are likely to be located. Because the phrase “legal title” has long been interpreted to refer to fee ownership, foreign governments that lease space have been advised that, where (as is normally the case) their landlords are for-profit entities subject to taxation, they have no alternative but to pay real

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estate taxes indirectly, in the form of rent or escalations of rent payable through their landlords.

A method to address this disparate treatment of owned and leased facilities has been found in a different, but parallel, context.

Leasehold Condominiums for Not-for-Profit Corporations

Like foreign governments, not-for-profit corporations that own real property and

use it for qualifying purposes are granted an exemption from real estate taxation under New York State law. Under Section 420-a of the New York Real Property Tax Law:

Real property owned by a corporation or association organized or conducted exclusively for religious, charitable, hospital, educational, or moral or mental improvement of men, women or children purposes, or for two or more such purposes, and used exclusively for carrying out thereupon one or more of such purposes either by the owning corporation or association or by another such corporation or association as hereinafter provided shall be exempt from taxation ...

As with Section 418 (applicable to foreign governments), it was long believed that Section 420-a offered no possibility of a real estate tax exemption to not-for-profits occupying space that they lease but do not own.

In a 2009 letter ruling, the New York City Department of Finance (DOF) approved a way to help non-profits work around this owning/leasing distinction by taking advantage of a different provision of New York State statutory law.

Section 339-d of the New York Real Property Law (the Condominium Act) allows, under certain circumstances, the creation of “leasehold condominiums”—condominiums in non-residential properties based not on fee ownership of the underlying property, but rather on leasing for a term of at least 30 years.

A related section of the Condominium Act, Section 339-g, states that each unit within the leasehold condominium, together with its common interest, constitutes real property for all purposes. In effect, the statute considers (in the condominium context) a long-term leasehold as tantamount to ownership and, accordingly, permits a condominium to be formed on that possessory interest. Put another way, the Condominium Act establishes a means by which a leasehold interest can be “owned.”

In the 2009 letter ruling (FLR-08-4886), DOF noted the intersection of Section 420 of the New York Real Property Tax Law (which provides a tax exemption on property owned by non-profits) and the Condominium Act (which recognizes leasehold condominiums as a form of ownership), and determined that not-for-profit corporations that follow the formalities of both leasehold condominiums and tax exemptions—including filing the necessary paperwork with DOF’s Exemptions Unit—are entitled to exemption from real estate taxes. Among the prerequisites is that, under the applicable documents, the lessee (not the lessor) be responsible to pay real estate taxes.

A number of non-profits have made use of the 2009 letter ruling—and subsequent rulings that clarify it and expand its application in related circumstances—to obtain tax exemptions for properties leased for terms exceeding 30 years via the use of leasehold condominium structures.

As described in more detail below, the process of fulfilling all of the various requirements in both the condominium and exemption settings is complex and lengthy, and requires cooperation by the landlord and other parties, but by making their way through the thicket of necessary documentation and other steps these non-profits have achieved significant cost savings that would otherwise have been unavailable. And while the 2009 letter ruling was issued by DOF in its capacity as a New York City agency, other jurisdictions in New York State have followed its logic and granted exemptions to not-for-profit organizations on the same basis.

Leasehold Condominiums for Foreign Governments

As the real estate tax exemption for not-for-profits using leasehold condominiums has become increasingly well-recognized, the question arose: Does the logic of the 2009 ruling apply equally to foreign governments? In other words, does ownership of a leasehold condominium unit satisfy Section 418 of the New York Real Property

Tax Law in the same way that it satisfies Section 420-a?

Last year, DOF issued a letter ruling (FLR-20-5004) confirming that this is in fact the case. Using the same reasoning as in the 2019 letter ruling, DOF concluded that a foreign government could use a leasehold condominium structure to obtain a real estate tax exemption under Section 418.

As stated in the ruling, when analyzing the statutes in connection with a foreign government’s interest in a leasehold condominium unit, “it follows that the unit as well as the underlying leasehold of the land constitutes real property for purpose of RPTL §418” and accordingly the foreign government is eligible for exemption from real estate taxation.

As a result, a foreign government holding a non-residential lease with a term of over 30 years can form a leasehold condominium and—assuming that all of the procedural obstacles are overcome—achieve the cost savings that would follow from an exemption from taxation over a 30-year term.

Structure and Procedure

The process for forming a leasehold condominium, and then obtaining a tax exemption, has many steps and can take many months to finalize.

DOF rulings currently permit two different types of leasehold condominium eligible for exemption (each with different advantages, based on the applicable situation).

Under the first method, the property owner (i.e., a third-party landlord) leases the entirety of the land and building to a separate entity (generally affiliated with the landlord) for a term of 30 or more years. The separate entity declares a leasehold condominium of the entire property, and then deeds one or more units in the leasehold condominium to the exempt entity for consideration that reflects the value of the occupancy interest (i.e., for the term of 30 or more years under the underlying lease). In practice, the parties generally structure the

transfer as an installment sale with the installment payment in each month being equal to what the rent would have been for such month under a normal leasing arrangement.

The second method, often called “con-do-within-a-condo,” involves the property owner’s subjecting the land and building to a fee condominium (if that type of ownership structure is not already in place) and leasing one or more fee condominium units comprised of the applicable space to the tax-exempt entity. The exempt entity, as the lessee of that fee condominium unit, then declares a leasehold condominium of that space.

In either event, because the leasehold condominium is (by definition) created on an underlying leasehold, the nature of the estate automatically terminates at the expiration of the underlying lease (i.e., at least 30 years after the lease is signed), and the condominium is automatically collapsed at the expiration of the underlying lease.

The administrative process for creating the leasehold condominium includes the following (some, but not all, of which can be done at the same time as others):

- negotiating and finalizing the applicable lease and ancillary documents;
- engaging an architect to prepare condominium floor plans showing the applicable units;
- obtaining Department of Buildings approval of the floor plans;
- applying for a so-called “no-action letter” from the Real Estate Finance Bureau of the New York State Attorney General’s Office (i.e., confirmation that the condominium is being formed privately, without units being sold to the public, and therefore further documentation such as an offering plan is not necessary);
- drafting and executing a leasehold condominium declaration and by-laws;
- receiving assignments of tax lot numbers and approval of condominium tax lot subdivisions from DOF;

- recording the floor plans, declaration and by-laws with the Office of the City Register; and
- executing and recording a deed for the leasehold condominium units.

After all of these conditions have been fulfilled, the exempt entity—as owner of the leasehold condominium unit(s)—can apply to the Exemptions Unit of DOF for a real estate tax exemption. The exemption is usually retroactive to the date of the deed.

Note that foreign governments wishing to make use of a real estate tax exemption face additional procedural hurdles involving the U.S. State Department. Under the Foreign Missions Act (22 U.S.C. Sections 4301-4316), the U.S. Secretary of State has the right to establish policies relating to diplomatic and consular properties of foreign governments located in the United States. This authority has been delegated

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to the Under Secretary of State for Management and (in some respects) to the U.S. Mission to the United Nations.

Under currently applicable rules promulgated under the Foreign Missions Act, foreign missions are required to notify and obtain approval from the U.S. Department of State’s Office of Foreign Missions (OFM) before finalizing a proposed lease, purchase, sale or any other acquisition or disposition of real property in the United States. In the absence of prior approval, no exemption from real estate taxation can be granted.

Furthermore, state and local tax authorities are not permitted to grant real estate tax exemptions except with written authorization from the Director of OFM’s Office of Diplomatic Property, Tax, Services and Benefits.

In light of how recently the DOF letter ruling regarding leasehold condominiums for foreign governments was issued, no public reports of a foreign government pursuing this route for an exemption have yet appeared. However, there is no reason to believe that the State Department would reject the leasehold condominium structure as a means to obtain a real estate tax exemption, since it is available as a matter of state statutory law as applied by a local taxing authority.

Conclusion

The 2020 DOF letter ruling recognizing leasehold condominium ownership as a means for a foreign government to obtain a real estate tax exemption under Section 418 of the Real Property Tax Law provides opportunities for diplomatic and consular offices in New York City to reduce operating costs—and for landlords to attract those users for their properties. The process to form a leasehold condominium is multi-faceted and time-consuming, but the reward (particularly over the minimum 30-year time period required by statute) can justify the effort.