

Using Leasehold Condominiums to Reduce Rent for Educational Institutions, Medical Centers

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In this article, the author discusses using leasehold condominiums to enable landlords to produce revenue while providing additional space to educational and medical institutions so they can achieve their missions at a more affordable (i.e., below market) rent.

Recent changes in law and policy have resulted in educational institutions - including colleges, universities, charter and religious schools, and medical centers - finding ways to operate more efficiently, reduce their operating costs and control the rent paid to commercial landlords. For example, landlords may be able to avoid paying real estate taxes on space rented to nonprofit entities by having the nonprofit institutions agree to pay the real property tax for which it pays a reduced rent for the space and then receive a tax exemption. That can be accomplished in New York by converting leases into leasehold condominiums, enabling the landlords to reduce their real estate tax obligations and having the rent paid by the nonprofit institutions. This structure enables the nonprofit educational and medical institutions to rent space that they would not otherwise be able to afford and allows landlords the ability to lease space for the same net rent as they would have received if they had to pay the real property taxes.

This article discusses the potential to use this structure in other cities to enable landlords to produce revenue while providing additional space to educational and medical institutions so they can achieve their missions at a more affordable (i.e., below market) rent.

It is important to note that this structure, which has never created a problem for a lender with a mortgage on the property because the use of a leasehold condominium structure does not create a lien against the fee interest in the real estate, could be available to use in any jurisdiction that recognizes leasehold condominiums and provides a tax exemption for property owned by a nonprofit and used for nonprofit purposes. Although this article explains the structure and how it has been utilized to satisfy the needs of property located in New York, the concept could be available in many other jurisdictions.

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LEASEHOLD CONDOMINIUM STRUCTURE

The leasehold condominium structure has become a popular way for landlords and non-profit entities to establish or modify their relationship to permit space that the nonprofit would formerly lease to qualify for a real property tax exemption. The tax exemption is based on an interpretation of the law, which provides that a not-for-profit organization acquiring property in the form of a leasehold condominium unit would qualify for a real estate tax exemption under the New York State Real Property Tax Law (RPTL) if the following requirements are satisfied:

1. The leasehold condominium must be devoted exclusively to nonresidential purposes.
2. The underlying leasehold interest in the land must have a remaining term of at least 30 years after the non profits acquisition of the leasehold condominium unit.
3. The unit owner must be required under the lease to pay both land and building taxes assessed on the leasehold condominium unit.
4. The not-for-profit organization must satisfy the ownership and use criteria for exemption as set forth in the law.

The first and second requirements are due to quirks in the New York Condominium Act that are not required by the Uniform Condominium Act or Uniform Common Interest Ownership Act and probably will not be necessary in other jurisdictions.

The RPTL provides a tax exemption from real property taxes for nonprofit organizations

- which are organized for religious, charitable, hospital or educational purposes or for the mental and moral support of men, women and children - that “own” property in New York. Generally, the tax exemption available under the RPTL is not available to nonprofits that lease (rather than own) the properties they utilize, since “ownership” is the precondition even if the nonprofit pays the real property taxes and the exemption is available only if the property is used for nonprofit purposes.

However, a ruling in New York in 2009 recognized that the ownership of a unit in a leasehold condominium is the ownership of property, even though the leasehold condominium and leasehold condominium unit would cease to exist on the termination of the ground or other lease upon which it was based.

Moreover, the ruling also provided that a nonprofit’s eligibility for the tax exemption is not lost when a for-profit subsidiary of the fee owner also owns a separate leasehold condominium unit in the same condominium.

Accordingly, the for-profit use of a different part of the building does not affect the tax exemption of the for-profit’s unit owner in the same condominium, even if the affiliate is owned and controlled by the fee owner. In that situation, the nonprofit would obtain a tax exemption for only the part of the building it is using. For example, if the nonprofit takes 40 percent of a building and uses it for nonprofit purposes, the 40 percent portion of the building used by the nonprofit would be exempt from the taxes.

FEE CONDOMINIUM VERSUS LEASEHOLD CONDOMINIUM

The difference between a fee condominium

and leasehold condominium is that the common elements in a fee condominium include the land, while the common elements in a leasehold condominium include only the leasehold interest in the land. Therefore, by using a leasehold condominium rather than a fee condominium, the landlord is not converting the fee interest in the property or actually selling the property and does not have to pay income taxes on a sale.

Moreover, if the nonprofit defaults, the landlord has to terminate only the underlying lease, and the leasehold condominium ceases to exist. The leasehold condominium structure works regardless of whether the nonprofit takes the entire building, a portion of a building, or one or more floors in an existing condominium - although the transactional documents differ, as does the complexity of the transaction.

Furthermore, either the fee owner or the nonprofit can create the condominium, but (under New York law) only the nonprofit can apply for the tax exemption, and only if the nonprofit is responsible for the payment of the real estate taxes on its units. This structure treats nonprofits the same as they would be treated in states that permit nonprofits to receive an exemption from paying real property taxes on leased facilities.

It is also important to note that this structure is not just applicable to new leases for newly leased space. Accordingly, an existing lease can be extended to have a remaining term of more than 30 years (a New York requirement), where the tenant is responsible for the real estate taxes and, after the lease is converted to a leasehold condominium, the nonprofit can apply for an exemption.

TRANSACTION STRUCTURE

The basic structure of the transaction includes the following elements:

1. The fee owner and nonprofit or an affiliate of the fee owner enter into a ground lease of the existing building or a building to be built or renovated, including the land on which it is built (the ground lease, but the structure works with other leases that include the land).

2. The ground lease must be for more than 30 years from the condominium's formation (a New York-specific requirement) and acquisition of the unit by the nonprofit and requires the tenant to pay the real property tax and not just the excess tax over a base year.

3. The owner or lessee of the lease and the nonprofit execute a purchase and sale agreement to sell one or more of the leasehold condominium unit(s) to the nonprofit for either:

- A nominal price;
- A price based on the rent to be paid during the term of the lease; or
- For a purchase price based on the rent that would have been paid under the operating lease (if one has been executed) or, if the existing operating lease is replaced by the leasehold condominium structure or the transfer can be nominal, considering the payment included in the nonprofit's common charges

4. The nonprofit, as the leasehold condominium unit owner, would be obligated to perform the tenant's obligations under the ground lease or the portion of the building included in the lease.

5. The owner or lessor (or the nonprofit, if the nonprofit is forming the condominium) submits an application for a No Action Letter permitting the formation of the condominium (a New York-specific requirement).

6. After the condominium is formed, all or some of the leasehold condominium unit(s) are conveyed to the nonprofit, and the nonprofit applies for the tax exemption.

Only the nonprofit can apply for the tax exemption, and it cannot be sought or obtained until after the nonprofit owns the leasehold condominium unit (a New York-specific requirement).

ADDITIONAL CONSIDERATIONS

In the event that the nonprofit is taking only part of a building - regardless of how large (e.g., 99 percent of the building) or how small (e.g., 1 percent of the building) - the ground lease must still be for the entire building and must be for at least 30 years from the condominium's formation, which are New York-specific requirements. In some situations, a fee condominium must first be formed to separate the for-profit and nonprofit portions of the building, and then a leasehold condominium of the nonprofit portion of the building is formed to avoid encumbering the fee with anything other than a lease.

If the property is encumbered by a mortgage and the mortgagee has to approve the structure and the transaction, there should not be any difficulties obtaining the waiver because the entire leasehold condominium is based only on a lease - the tenant's interest in which becomes a condominium.

In a situation where the property is already

a condominium, a more complicated structure is required in order to satisfy the requirement that the nonprofit actually own property. Although several approaches have been utilized in the past, a "condo-within-a-condo" (CWC) structure that entails creating a separate condominium (and not just a unit) within the existing condominium unit can be used. In this approach, the leasehold condominium would exist solely of an existing unit of a preexisting condominium. However, in New York, the leasehold interest in the unit (which includes a leasehold interest in the land) must have a remaining term of more than 30 years upon the nonprofit's acquisition of the nonprofit unit. The nonprofit must be required under the lease to pay both land and building taxes assessed on the nonprofit unit. The nonprofit would also have to satisfy the ownership and use criteria for the exemption as described in RPTL.

Essentially, the CWC structure requires that the owner of a unit within a condominium (the Original Unit) leases the Original Unit to an affiliate or a nonprofit (the Original Unit Tenant) for a period of more than 30 years. The Original Unit Tenant then executes a Condominium Declaration and has tax maps prepared, which creates a separate condominium (the CWC Condominium) within the Original Unit. The declarant of the CWC Condominium then deeds the newly created unit (the CWC Unit) to a nonprofit. When the procedure is completed, the Original Unit still exists and is owned by the Original Unit Tenant, and the nonprofit owns the CWC Unit and can apply for a tax exemption for it.

This structure can be utilized in developing a new building or in an existing building and for the entire building or just a small portion of

the building. However, as indicated above, only the portion of the building that is “owned” by the nonprofit and used in furtherance of its nonprofit purposes can obtain a tax exemption. It is the landlord not being responsible for paying the real estate taxes that enables the landlord to charge the nonprofit the lower rent for the space. Because real estate taxes are frequently among the landlord’s largest expenses, the landlord’s net profit on the space is not reduced. This is why lenders find the structure so acceptable: It is the equivalent of the space being leased to a large commercial tenant, which protects the landlord’s cash flow and the lender’s debt service.

For nonprofits that want to simplify the transaction, an “Affiliate Structure,” where the fee owner forms an affiliate, leases the property to the affiliate to form the leasehold condominium and conveys the leasehold condominium units to the nonprofit, can be used. The affiliate approach also satisfies the requirement of nonprofits that do not want to execute the structuring documents or are limited based on organizational documents, state law, funding requirements or audit considerations.

The concept of the leasehold condominium may seem complicated, but it is flexible and can be utilized in any situation regardless of the sophistication of the parties.

IN SUMMARY

- Recent changes in law and policy have resulted in educational and medical institutions finding ways to operate more efficiently, reduce their operating costs and control the rent paid to commercial landlords.
- New York landlords have been able to avoid paying real estate taxes on space rented to nonprofit entities by having the nonprofit institutions agree to pay the rent, obtain a reduced rent for the space and then receive a tax exemption.
- This structure may be useable in other cities to enable landlords to produce revenue while providing additional space to educational and medical institutions so they can achieve their missions at a more affordable (i.e., below market) rent.