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Law and Practice

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Contents

Phillips Lytle LLP is a premier regional firm with a highly recognized real estate practice consisting of over 40 attorneys who have a broad range of expertise. With six offices across New York State, as well as offices in Washington, DC, Cleveland, Ohio and Ontario, Canada, Phillips Lytle has historically handled the highest-profile real estate development projects throughout New York State and beyond, and has nationally recognized experience across numerous areas, including those involving institutional lenders, corporations, REITs, private developers, public utilities, municipalities, individuals and others in connection with large and small commercial, industrial, office, professional, retail and residential projects. The practice includes national high-volume, high-technology representation in the telecommunications, lending and foreclosure areas, as well as nationwide multi-location retail leasing and portfolio sales. Areas of expertise in the real estate sector include acquisitions and dispositions, commercial leasing, construction litigation, entity formation, land use and zoning, real estate development, real estate finance, real estate litigation and work outs, tax and title insurance.

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1. General

1.1 Main Substantive Skills

Real estate law encompasses a broad range of skills and practice areas. To adequately represent a client, a real estate attorney must understand the client's needs, the nature of the client's business and the client's willingness to take risks. For any particular project, issues typically arise within the following areas of law: tax, finance, corporate, securities, environmental and land use, bankruptcy, government relations, insurance and construction, among others. A real estate practice must understand the potential issues that may arise for a particular project and have the capability to handle those issues. To that end, practitioners must be resourceful and have the ability to communicate and negotiate effectively. Current trends typically do not impact the skills required to practise real estate law; however, one must remain aware of the current trends in order to effectively assist clients in closing their deals.

1.2 Most Significant Trends

Upstate New York continues to experience slow and steady growth and development. Generally low interest rates on loans and mortgages combined with tax incentives (ie, historic tax credits and brownfield credits) have continued to encourage investors to undertake development of residential and commercial real estate. Cities across the Upstate New York region have witnessed commercial office and industrial vacancy rates decline as development continues to increase. Mixed-use development projects continue to be an active component of Upstate New York's growth.

Recently, the real estate community – including investors, developers and municipalities – is increasingly becoming aware of and interested in the opportunities associated with the Qualified Opportunity Zones ("QOZ") program, as discussed in **1.3 Impact of New US Tax Law Changes**.

1.3 Impact of New US Tax Law Changes

The Tax Cuts and Jobs Act (the "Act"), enacted on 22 December 2017, made significant changes to federal tax law and included a number of benefits to the real estate industry. It is still too early to know the full impact of these changes on real estate development and investment in New York relative to other factors such as interest rates, state and local incentive packages, and general economic conditions. That said, the real estate industry generally came out ahead under the Act.

Because most real estate is held through limited liability companies treated as partnerships for US federal income tax purposes, the owners of those companies should be able to benefit from the 20% pass-through deduction on qualified business income generated by the companies.

Real estate owners can still dispose of real property in a tax-efficient manner through the use of like-kind exchanges under Section 1031 of the Internal Revenue Code.

While the federal historic rehabilitation tax credit underwent some changes, it remains in place as an incentive for real estate developers to rehabilitate historic structures.

The Act limited the deductibility of interest expenses for many businesses; however, real estate businesses can elect out of the interest deduction limitations.

The Act created the QOZ program, which is designed to spur investment in low-income communities. Under this program, taxpayers that sell or exchange capital assets can obtain certain tax benefits if the gain from those transactions is contributed into a Qualified Opportunity Fund ("QOF"), which is an entity organized for the purpose of investment in certain types of property located in QOZs. QOZs are low-income communities (identified by census tracts) that have been designated by each state (and certified by the Treasury Department) for the purpose of receiving investment pursuant to the QOZ program. Taxpayers who contribute gains from the sale or exchange of a capital asset in a QOF may be able to receive some or all of the following tax benefits:

- deferral of recognition of capital gain until 31 December 2026;
- a step-up in the basis of the QOF interest equal to 10% of the gain deferred if the QOF interest is held by the taxpayer for five years;
- an additional step-up in the basis of the QOF interest of 5% of the gain deferred if the QOF interest is held by the taxpayer for seven years; and
- an increase of the basis of the QOF interest to its fair market value on the date of the sale or exchange of the interest if it is held for at least ten years.

The expectation is that this program will provide a new source of capital to develop real estate projects located in QOZs. A client's QOZ real estate project typically will require a multidisciplinary approach from the legal team, ranging from formation of QOFs (corporate law, securities law and tax law) to structuring the purchase of real property located in a QOZ in a manner that is compliant with the applicable sections of the Internal Revenue Code and Treasury Regulations.

In 2019, the governor of New York proposed making permanent a 2% cap on local property taxes. The cap has been in effect for six years and is up for renewal this year.

2. Sale and Purchase

2.1 Ownership Structures

Owners can choose from several ownership structures to hold real estate. The most prevalent forms of ownership in this jurisdiction are individual ownership and joint ownership through legal entities such as limited liability companies, limited partnerships, corporations or trusts. Typically, investors in commercial real estate take title through an entity or series of entities owned and controlled by the individual investors. Residential real estate owned by more than one person may take title as tenants-in-common, joint tenancy with the right of survivorship or tenancy by the entirety for married couples.

2.2 Important Jurisdictional Requirements

In the vast majority of transactions, parties are able to buy and sell real estate without complying with any jurisdictional requirements. Only certain specific types of parties or real property are subjected to state or local regulation. For instance, certain charitable corporations must obtain the permission of the Supreme Court of the State of New York or the New York Attorney General before transferring real property.

Similarly, a party seeking to purchase a residential home that is in default on a mortgage loan must comply with the New York Home Equity Theft Prevention Act. In addition, properties that are suffering from environmental contamination may require the selling party to notify the New York State Department of Environmental Conservation or subsequent parties in title of the existence of the contamination or any restrictions placed upon the real property.

2.3 Effecting Lawful and Proper Transfer of Title

Transfer of title is effectuated by the delivery and acceptance of a deed, in recordable form, to the subject real property. To be in recordable form, a deed must be signed, acknowledged and contain an adequate description of the property. While delivery and acceptance of a deed is sufficient to transfer title to real property, one must record the deed in the county clerk's office and pay the applicable taxes and fees to perfect the transfer. This final step is important because New York is a 'race notice' jurisdiction. This means a party can simultaneously issue two deeds to two separate parties for the same real property. The person who wins the 'race' to the applicable county clerk's office and has their deed recorded first will be the owner of the real property, provided that the party had no knowledge of the other deed.

2.4 Real Estate Due Diligence

Depending on the complexity of the acquisition, purchasers of real estate typically engage third parties such as attorneys, institutional lenders, real estate brokers and appraisers, engineers, surveyors, architects, general contractors, title insurance/search companies, accountants, insurance agents, environmental consultants, zoning research companies, representatives from local municipalities and certain other third parties. Sophisticated purchasers often communicate directly with the above-referenced third parties. Contracts for the purchase and sale of real property typically provide the purchaser a specific time period in which to conduct all real estate due diligence, the length of which is usually negotiated and extended depending on the complexity of the deal.

Purchasers engage attorneys to coordinate with the above-referenced third parties and review their work product to ensure that it is accurate and satisfactory to the purchaser. Attorneys are also responsible for examining abstracts of title, instrument surveys and other title documents to ensure the purchaser is receiving good and marketable title to the property.

2.5 Typical Representations and Warranties for Purchase and Sale Agreements

The representations and warranties in a purchase and sale contract can vary greatly between transactions. However, in commercial transactions, the following representations and warranties are common:

- authority and capacity to execute the agreement and to perform the obligations under the agreement;
- no pending or threatened lawsuits against the parties or the subject real property;
- no pending or threatened eminent domain or condemnation proceedings against the real property;
- no pending or threatened changes in the assessed valuation or tax rate applicable to the real property;
- no pending or threatened changes in the zoning classification of the real property;
- no known environmental defects with the real property or any actions being taken by any agency with respect to the environmental condition of the real property; and
- the existence and good standing of all permits and certificates necessary for legal use or occupancy of the real property.

In commercial transactions, there are generally no representations or warranties provided for under state or local law. This is not true of residential transactions. For instance, with respect to newly built homes, each sale is subject to certain warranties regarding the quality of construction under the Housing Merchant Implied Warranty. For pre-built homes, sellers are required to make certain disclosures with respect to the condition of the real property by providing to the purchaser a property condition disclosure form. These forms require the owner to represent certain facts, including general historical, environmental, mechanical and structural information with respect to the property.

In commercial transactions, the remedies against a seller who breaches a representation are customarily defined in the contract. The remedies can include anything from monetary damages to the ability to cancel the contract. However, sellers typically limit their liability for representations and warranties by negotiating into the contract a "sunset provision" on the survival of the representations and warranties.

The statutory protections that exist in residential transactions also include remedy provisions. These remedies generally include payment for actual damages if covered by warranty or if the misrepresentations prevented the buyer from learning the truth before purchasing the real property.

2.6 Important Areas of Law for Foreign Investors

The most important areas of law for a foreign investor may be roughly divided into three areas: (i) tax considerations, (ii) collateral regulatory burdens and (iii) Committee on Foreign Investment in the United States ("CFIUS" or "Committee") review.

Tax

At the federal level, the US does not tax or impose a fee on the mere acquisition or ownership of US real property itself. Income derived from business conducted on or through the property will generally be subject to the ordinary income tax rates. Passive income, such as rents, paid to a foreign individual or partnership is generally subject to a 30% withholding tax; however, in many cases, this is modified or eliminated by one of a number of tax treaties that may be in force between the US and the country of the investor, or an election that allows rents to be taxed at ordinary income tax rates. In the event of a sale or disposition of the property, foreign investors who are not engaged in a trade or business in the US will be subject to a 15% withholding tax on the purchase price under the Foreign Investment in Real Property Tax Act. Nonresident individuals, trusts and estates are generally required to pay the estimated New York State income tax on the sale of real property located in the state.

Collateral Regulatory Burden

Depending on what kind of other businesses an investor may own or manage, and where those enterprises operate, the acquisition of a US property may render an investor – and its other businesses – a "US person" subject to compliance with a panoply of US business regulations, such as the Foreign Corrupt Practices Act, various sanctions regimes and other regulatory regimes, which could dramatically affect how its other businesses can operate and increase their "regulatory risk." The SEC and Department of Justice ("DOJ") have regularly found seemingly slight and tenuous connections with the US sufficient to establish jurisdiction over large and diverse enterprises. Of course, even a passive investor will be subject to any local or federal environmental regulations attached to the property or its use.

CFIUS

CFIUS's jurisdiction comes into play when a foreign investor seeks to acquire a controlling interest in an existing US business. For the real estate investor, that has recently been found to include a hotel or office complex. The committee will review a proposed transaction to determine whether it involves the potential transfer of an asset (usually technology, but it can be property) that is economically strategic or related to the national security of the US. The recent record suggests that transactions involving potential investors with any links to China will be subjected to particular scrutiny.

2.7 Soil Pollution and Environmental Contamination

As the owner or operator of the real estate asset, the buyer could be held strictly, jointly and severally liable for preexisting soil pollution or environmental contamination pursuant to state and federal laws. Therefore, depending on the nature of the transaction, typical allocations of environmental risk in Purchase and Sale Agreements are tailored to the intent of the parties, the site conditions and the presence of contaminants of concern.

Under the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"), current owners and operators of a property are strictly liable for all response and remediation costs regarding hazardous wastes and substances that were released on a property, unless a statutory defense is established. Statutory defenses include acts of God or war and acts of third parties, as well as landowner liability protections, such as the Innocent Landowner defense, Bona Fide Prospective Purchaser defense and Contiguous Property Owner defense.

In addition to the landowner liability defenses, if the buyer expends money to clean up the contamination caused by others, there are contribution claims available for recovery of those monies under state and federal laws.

2.8 Permitted Uses of Real Estate Under Zoning and Planning Law

A buyer can ascertain the permitted uses of a parcel of real estate by undertaking an analysis of the applicable zoning map and code to identify the zoning district of the parcel in question, the uses permitted by right in that district, as well as the uses permitted upon issuance of a Special Use Permit. In addition, a buyer should review the applicable zoning code to determine the associated bulk requirements within that zoning classification. Further background is often available in a municipality's land use/comprehensive plan as well. For information on development agreements with relevant public authorities, see **4.5 Agreements with Local or Governmental Authorities**.

2.9 Condemnation, Expropriation or Compulsory Purchase

Governmental taking through eminent domain or condemnation is a possible risk in this jurisdiction. While there is only a slight risk that a governmental taking will occur, it appears more prevalent along rights of way to accommodate roadway widening projects or the installation of public utilities.

The process for a governmental taking in New York is codified in the New York Eminent Domain Procedure Law. The statute allows for condemnation by the (i) filing of an appropriate map with the applicable county clerk (at which time the property set forth in the map vests in the governmental agency), or (ii) filing of petition to condemn, which seeks an order allowing the filing of an acquisition map. It is upon the filing of the acquisition map that title vests in the condemnor. In either case, the condemning party is required to pay just compensation (defined as the fair market value of the property) to the former owner for the property that was acquired through condemnation.

2.10 Taxes Applicable to a Transaction

For the transfer of real estate, a transfer tax is due to the New York State Department of Taxation and Finance, and is paid to the applicable county clerk upon recordation of a deed. In fact, in order to record a deed, a transfer tax return (known as a form TP-584) must also be presented to the county clerk. The state transfer tax is USD4 for every USD1,000 of consideration paid or the fair market value of the real property. Local municipalities may also impose a separate transfer tax, which varies by county. Transfer tax and the cost of filing a form TP-584 are customarily seller expenses. There is also an additional tax – known as the "Mansion Tax" – imposed on the conveyance of residential real property where the consideration is USD1 million or more. The tax rate for Mansion Tax is 1% of the consideration paid. Mansion Tax is customarily paid by the buyer.

A transaction of shares in a property-owning company also triggers a transfer tax obligation if the grantee acquires a controlling interest from one or more grantors within a three-year period. The transfer tax will be calculated in the same fashion as a straight transfer of title – by utilizing the consideration paid for the shares or the grantor's pro rata share of the fair market value of the real property owned by the property-owning company.

There are standard exemptions to the imposition of transfer tax, including conveyances:

- to the federal or state government or their agencies or political subdivisions;
- to secure a debt or other obligation;
- to confirm, correct, modify or supplement a prior conveyance;
- made as gifts;
- that are only intended as a change of identity;
- given in connection with a tax sale;
- by deed of partition;
- made pursuant to the federal Bankruptcy Act;
- that only consist of certain contracts to sell or options to purchase real property; or
- not deemed a conveyance within the meaning of New York tax law.

2.11 Rules and Regulations Applicable to Foreign Investors

See **2.6 Important Areas of Law for Foreign Investors**.

3. Real Estate Finance

3.1 Financing Acquisitions of Commercial Real Estate

Acquisitions of commercial real estate are typically financed through commercial real estate loans made by institutional lenders. Commercial real estate loans are customarily secured by a mortgage, which is recorded in the office of the county clerk where the property is located. In addition, commercial mortgage loans are usually further supported by guarantees of payment from the individual principals of the borrower. The amount of the mortgage loan typically depends on a number of factors, including the amount of equity the borrower has in the property, the approved loan-to-value ratio set by the lender and a third-party appraisal. For new construction, borrowers can apply for a construction loan mortgage.

In addition to mortgage loans, purchasers of commercial real estate may obtain mezzanine financing to finance amounts beyond what is approved by the institutional mortgage lender. Mezzanine loans are secured by a pledge of the borrower's equity interest in the entity which owns the property. Developers also raise funds to purchase real estate by selling equity in exchange for cash contributions.

3.2 Typical Security Created by Commercial Investors

Unless otherwise agreed to by the parties, typically the security interest created in connection with a mortgage loan is a first-in-priority mortgage lien on the real property. If permitted by the lender, one could borrow additional money from the same or a different lender secured by a mortgage, which would be subordinate to the first mortgage. The security interest is created when the original mortgage is recorded. The mortgage lender may also choose to file a UCC Financing Statement to create a security interest in any fixtures located at the property or to perfect a security interest in all of the assets of the borrower.

With respect to mezzanine financing, the mezzanine lender may perfect its security interest by filing a UCC Financing Statement in the state of formation of the borrower entity. In addition, the mezzanine lender may require the borrower to opt in to Article 8 of the UCC, which merely changes the characterization of the pledged equity interest as a "security" under Article 8 as opposed to a "general intangible" under Article 9. In order to perfect its security interest in this manner, the mezzanine lender would require the borrower to deliver original certificates of equity interest.

3.3 Regulations or Requirements Affecting Foreign Lenders

See **2.6 Important Areas of Law for Foreign Investors**. In addition, the Bank Secrecy Act governs the obligation of financial institutions, including lenders, to engage in strict compliance and reporting measures with regard to the prevention of possible money laundering, terrorism finance or sanctions violations in international funds transfers or guarantees. Institutions must conduct extensive diligence of the parties to such transfers, routinely report all details and file immediate reports of any suspicious activity.

3.4 Taxes or Fees Relating to the Granting of Enforcement of Security

Mortgage recording taxes vary widely based on the county where the property is located, but generally range between 0.75% and 1.25% of the loan amount. The county clerk will also charge a fee to record the mortgage and accompanying loan documents, the cost of which also vary widely based on the type of mortgage or other document being recorded, as well as the length of the document.

3.5 Legal Requirements Before an Entity Can Give Valid Security

Typically, there are no rules or requirements that must be complied with before an entity can give a valid security interest over its real estate assets. However, an entity and its principals must comply with its charter documents and take all steps necessary in both those charter documents and applicable law to authorize the granting of the security interest for the grant to be valid and binding on the entity. In addition, certain charitable entities may also be required to obtain the permission of the Supreme Court of the State of New York or the New York Attorney General before granting a security interest in its real estate assets.

3.6 Formalities When a Borrower is in Default

The debtor protections that must be overcome vary greatly depending on whether the foreclosure involves residential or commercial property. For commercial properties, the only debtor protections that need to be overcome involve protections drafted into the note, mortgage and ancillary loan documents. For residential transactions, the environment is quite different. New York law requires that, at least 90 days before commencing a foreclosure action, a lender or servicer must provide the homeowner statutory notice that includes information as to how an owner can cure the default and a list of government-approved housing counselling agencies.

When the foreclosure action is commenced, the attorney commencing the action must file a certificate of merit whereby he or she confirms, among other things, that the case has merit. When serving the summons and complaint, a notice must also be delivered advising the owner that he or she may lose their home if he or she fails to resolve the default. Only after all of the above conditions precedent are met can a lender proceed with the foreclosure action.

Even at this point, there are certain requirements that a foreclosing party must follow. The most onerous is the requirement of the parties to go through a mandatory settlement conference before the foreclosing party can seek judgment on liability. As a result of these statutory requirements, a standard mortgage foreclosure action in New York can take years to complete.

While there are many steps needed to enforce a mortgage in New York, no additional steps are necessary to ensure priority. As New York is a 'race notice' state, once the mortgage is recorded, its priority is established. Any lien or interest that is recorded later will not have priority over the mortgage (except for certain super liens, such as real property taxes and assessments). That being said, the foreclosing party will need to obtain a title search to determine what parties have an interest subordinate to the foreclosing party. These parties will need to be named in the foreclosure action so their interests can be extinguished. In addition, it is imperative that a foreclosing party file a notice of pendency. This notice places all parties on record notice of the foreclosure action and binds any subsequent creditors and interest holders to the outcome of the foreclosure action despite the fact that they were not named as parties therein.

3.7 Subordinating Existing Debt to Newly Created Debt

Subordination agreements are common in commercial transactions. In these agreements, an existing lender agrees to be subordinate in priority to an incoming lender and upon what terms. These agreements are usually recorded in the county clerk's office to place all parties on notice of each party's rights and priorities.

In New York, there is also the concept of equitable subrogation that allows one party to replace another party when it comes to a legal right. For example, assume a property is encumbered by a first mortgage and second mortgage. The owner refinances only the first mortgage with a new lender (who intends to have a first-priority lien). Based solely on New York's 'race notice' statute, the second mortgage would have priority over the new lender (whose mortgage was recorded later). However, using the concept of equitable subrogation, to the extent the new lender paid off the first mortgage and intended to retain priority (ie, was unaware of the second mortgage), the new lender would preserve that priority as to the amount paid to discharge the first mortgage.

While equitable subrogation may be a useful legal concept, it is best practice to negotiate and record a subordination agreement between the mortgage lenders.

3.8 Lender's Liability Under Environmental Laws

Lenders are generally exempt from liability under federal and state environmental laws as long as the lender does not take title to a contaminated property or "participate in the management" of the property. Activities such as requiring a borrower to take response action to address contamination, or renegotiating the terms of the secured interest, do not generally rise to the level of "participating in the management" and will not subject a lender to environmental liability. However, if a lender exercises decision-making control over day-to-day activities or the environmental compliance of the site, such as directing hazardous waste management or disposal, or takes title to the property, they may be held liable for contamination.

3.9 Effects of Borrower Becoming Insolvent

In the event that a security interest is created and a foreclosure action is commenced prior to the filing of a bankruptcy by the borrower, the mortgage lien is generally secure and will typically survive the bankruptcy unless discharged by payment during bankruptcy (assuming there is no defect in the mortgage or in its recordation). However, any attempts to enforce the mortgage or further pursue the foreclosure action are generally stayed unless and until the automatic bankruptcy stay is lifted.

Once a foreclosure sale occurs, the debtor's rights of redemption will have expired. Therefore, if a borrower files bankruptcy after a foreclosure sale, the real property is generally considered to be outside the borrower's bankruptcy estate and the title may be transferred to a winning bidder notwithstanding the pendency of the bankruptcy and corresponding automatic stay.

4. Planning and Zoning

4.1 Legislative and Governmental Controls Applicable to Design, Appearance and Method of Construction

A municipality's zoning code will set forth certain development criteria and regulations with respect to appearance and construction of a project. In addition, there may be supplemental/overlay design guidelines dependent on the parcel's location within a specific neighborhood or historic district. Compliance with design, appearance and method of construction is normally handled through the site plan review process with the municipal planning board.

4.2 Regulatory Authorities

The local municipal government (city, town or village) is typically responsible for regulating development of individual parcels within the municipality, along with input from municipal planning boards. The municipal zoning code is designed to provide a framework for decision-making in connection with the physical development of property, which is based upon the community's expectations and preferences regarding development. In addition, the municipality's land use plan serves as a bridge between the municipality's comprehensive plan and zoning code by recommending the appropriate type, intensity and character of development in the municipality.

4.3 Obtaining Entitlements to Develop a New Project

New projects or major refurbishments typically require local municipal approvals (site plan, special-use permit and/or variances) from local municipal boards after a formal filing is made and a public hearing is held. Compliance with the State Environmental Quality Review Act is often a part of this review process. Third parties or members of the public may appear at the public hearing regarding the proposal and the municipality may consider the opinions of the public in connection with its determination on the development proposal. Generalized community objections are not a valid basis to support denials. Requests for variances require application to the municipal zoning board of appeals. Rezonings generally require an application to a municipal board for the zoning amendment, which is often referred to the municipal planning board for its review and recommendation.

4.4 Right of Appeal Against an Authority's Decision

Typically, a municipality will have a specific section in its municipal code for appealing a relevant authority's decision in connection with an application for a development proposal or an issue related to the interpretation of the code. Usually, an appeal will begin with an adverse determination by a code enforcement officer. Appeals are normally heard by the zoning board of appeals and once all municipal avenues have been exhausted, an aggrieved party is normally provided the right to appeal further in the State Supreme Court.

4.5 Agreements with Local or Governmental Authorities

Agreements with local governments, authorities or utility suppliers are not generally necessary to obtain permits or approvals for development projects; however, they can be required by local jurisdictions in some instances. Two common examples of these agreements are incentive zoning agreements and reimbursement agreements. Incentive zoning offers rights to a developer in exchange for public benefits to the community. Rezoning of property is negotiated between the developer and municipality. Some municipal zoning codes contain provisions for Planned Unit Development. In addition, reimbursement agreements allow a municipality to hire certain professionals – ie, any consultant or expert necessary to assist in reviewing a land use application – and require the applicant to cover all fees associated with the same. However, such fees may only be lawfully imposed in New York State if they are reasonable and necessary, and not simply for the convenience of the local town/planning/zoning board.

4.6 Enforcement of Restrictions on Development and Designated Use

Restrictions on development and designated uses are typically enforced through certain bulk provisions in the zoning code regulating height, density, lot coverage, minimum/maximum parking requirements, setbacks and other similar considerations. Restrictions may also be enforced through conditions to zoning approvals. Proposed development is evaluated by the municipality's planning/zoning department and existing development is monitored through the municipality's code enforcement officer/building department. Violations can be generated through citizen complaints or permitting and routine inspections, and fines can be assessed.

5. Investment Vehicles

5.1 Types of Entities Available to Investors to Hold Real Estate Assets

There are several types of entities available to investors to acquire and hold real estate, including, but not limited to, limited liability companies, corporations and partnerships. Limited liability companies are the most commonly used entity type to acquire real estate because they are typically characterized by flexible organizational governance and offer limited liability protection to all members. In addition, members of a limited liability company can define their contractual obligation in the company's operating agreement and tailor it to reflect their business agreement and financial arrangements.

5.2 Main Features of the Constitution of Each Type of Entity

Corporation

A corporation is an association of shareholders formed under the New York Business Corporation Law that is a legal entity separate and distinct from its shareholders with the capacity for perpetual existence, (i) to acquire, hold and dispose of property, (ii) to sue or be sued, and (iii) to have such other powers as may be conferred upon it by law. Owners of a corporation are shareholders who do not manage the day-to-day affairs of the corporation. Instead, the shareholders elect directors and approve extraordinary transactions and activities of the corporation.

The primary benefit of corporations is that the shareholders are generally not personally liable for the debts and obligations of the corporation, and liability is limited to the assets of the corporation. Directors and officers are generally not liable to shareholders or the corporation for their actions or inactions with respect to the corporation provided that they act consistent with their fiduciary duties of care and loyalty. Corporations may also limit or eliminate personal liability of directors for their acts and omissions. However, while the governing documents of a corporation may deviate from certain statutory rules with respect to governance, corporations do not afford the same level of flexibility as do partnerships and limited liability companies.

Limited Liability Company

A limited liability company ("LLC") is an unincorporated organization of one or more persons having limited liability for the contractual obligations and other liabilities of the business. An LLC is a hybrid business organization that combines the flexibility of governance and economic arrangements of a partnership and a corporation. The primary benefit of an LLC as a real estate investment vehicle is that it offers its members the limited liability protection akin to shareholders of a corporation, is taxed like a partnership (except for a single-member LLC) and is governed by contract, whereby the operating agreement is the primary document defining the rights of members, the duties of managers and the financial arrangements among the LLC's members. Members and managers are generally not liable for any debts, obligations or liabilities of the LLC, whether arising in tort, contract or otherwise, solely by reason of being a member or manager.

Partnership

A partnership is a voluntary agreement between at least two persons who bring together their money, property, labor or skills to conduct a business and share profits and losses. In this jurisdiction, commercial real estate is more often held in limited partnerships than general partnerships. General partners are jointly liable for the debts and obligations of the partnership, while limited partners are not liable for the contractual obligations of a partnership unless they are also general partners or they participate in the control of the business.

The benefit of real estate acquisition through a limited partnership is material for the limited partner whose liability is restricted to the amount that the partner has contributed to the partnership, plus the partner's share of any undistributed income. Whether a general partnership or limited partnership, the partners do not have a separate interest in the property and are therefore obliged to treat the partnership property as joint property. This is often a deterrent to some commercial real estate owners or investors who value the freedom to deal with their undivided interest in the property as would be permitted under a co-ownership arrangement.

As between the two types of partnerships, general partnerships are typically avoided by commercial real estate owners, investors and developers due to the joint and separate liability structure.

5.3 Tax Benefits and Costs

Generally, corporations are subject to federal and state income tax at the corporate level. In addition, shareholders are subject to income tax on distributed dividends. Certain domestic corporations may be eligible to make elections that have the effect of eliminating federal and (in most cases) state income taxes at the corporate level.

S corporations are domestic corporations that make an election with the Internal Revenue Service and New York State Department of Taxation and Finance to not be subject to income tax. Instead, the corporation passes income and loss to its shareholders, who are subject to tax on their pro rata shares of the corporation's income. In order for a domestic corporation to be eligible to make an S corporation election, it (i) may not have more than 100 shareholders who are US citizens or residents, certain types of trusts, estates and 501(c)(3) organizations, and (ii) must have one class of stock. Voting and non-voting classes are permissible, but all classes of stock must have the same economic rights.

An LLC with one member is treated as an entity disregarded as separate from its owner for income tax purposes, but as a separate entity for purposes of employment tax and certain excise taxes. An LLC with at least two members is classified as a partnership for federal income tax purposes. An LLC can also elect to be classified as an association taxable as a corporation or as an S corporation, which is less common among real estate investors in this jurisdiction.

Partnerships are generally not subject to federal and New York State income tax. Instead, the income or loss passes through to the partners, who pay income tax on any income at their respective tax rates. Unlike S corporations, there are no special requirements to be a partner or limits on the number of partners. Moreover, partnerships may have multiple classes of equity, pay preferred returns and allocate income or loss in ways other than pro rata.

5.4 Applicable Governance Requirements

The day-to-day management of a corporation's activities is the responsibility of the directors of the corporation, who in turn generally delegate such management to officers. Corporate governance is dictated by the provisions of the certificate of incorporation and the bylaws as well as statutory law. While the governing documents of a corporation may deviate from certain statutory rules with respect to governance, corporations do not afford the same level of governance flexibility as do partnerships and limited liability companies.

An LLC is presumed to be managed by its members unless the articles of organization expressly provide that the management is carried on by managers. Except as provided in the operating agreement, each member of an LLC is entitled to vote in proportion to the member's share of current profits. The articles of organization of an LLC may provide for classes or groups of members having such relative rights, powers, preferences and limitations as the operating agreement of such LLC may provide. Members in a member-managed LLC and managers in a manager-managed LLC who exercise management powers or responsibilities have the duty of care and loyalty.

Partnerships are managed by at least one of their general partners. Partnership governance is dictated by the terms of the partnership agreement with the partnership law setting forth statutory defaults. In order to insulate the limited partners from unlimited liability, the general partner must be solely responsible for the management and operation of the partnership business. The limited partners cannot participate in the management or operation of the business. A limited partner who does take part in the control, management or operation of the business of the limited partnership, including signing any documents on behalf of the partnership in its own capacity as a limited partner, risks being exposed to unlimited liability.

6. Commercial Leases

6.1 Types of Arrangements Allowing the Use of Real Estate for a Limited Period of Time

A lease and a license are two common legal arrangements that allow a person, company or other organization to occupy or use real estate that it does not own.

A lease is a contract between a landlord and a tenant whereby the tenant is given the exclusive right to occupy the landlord's property for an agreed-upon time period. A leasehold is an interest in the property that can typically be transferred to another, subject to certain restrictions.

A license is an agreement granting a limited use of a property. A license is not an interest in real property. A license is typically terminable by the licensor, not transferrable, not exclusive and may be subject to a right of relocation.

6.2 Types of Commercial Leases

There are several types of commercial leases, as follows.

- *Net leases* – the tenant pays rent as well as all or a portion of the operating expenses for the property, such as taxes, insurance, maintenance and utilities. Parties sometimes refer to net leases as single net leases, double net leases or triple net leases. The distinctions are not absolute, but in a triple net lease the tenant pays all costs and expenses with respect to the real property.

- *Gross leases* – the landlord provides services and pays the operating expenses for the property, but these expenses are typically factored into the tenant's rent. In addition, the tenant typically pays escalation charges with regard to real property taxes and operating expenses. In Class A office buildings, the tenant typically pays its proportionate share of operating expenses over the negotiated base year. In retail leases, the tenants typically pay their proportionate share of such expenses from the first dollar.
- *Ground leases* – the landlord leases the land to the tenant. The tenant pays ground rent, covers all costs and expenses, and is responsible for all improvements to the premises. Upon the expiration of the lease, possession of the land and ownership of any improvements revert to the landlord.

6.3 Regulation of Rents or Lease Terms

There is no commercial rent regulation in New York. The terms of commercial leases are generally a matter of negotiation between the parties, subject to case law and statutes pertaining to specific issues.

6.4 Typical Terms of a Lease

A typical commercial lease term is five to ten years. However, a typical ground lease term is 50 to 100 years.

The tenant is typically responsible for maintaining and repairing the space it occupies, whereas a landlord is typically responsible for repairing and maintaining the common areas, the structure and the exterior of the property.

Rent payments are typically made on a monthly basis, although in a ground lease it is not unusual for rent to be paid annually or quarterly.

6.5 Rent Variation

Rent typically increases by a predetermined amount, either annually or once every three or five years, depending on the terms of the lease.

6.6 Determination of Changes in Rent

Increases in rent are typically determined by negotiation prior to entering into a lease. Increases can be expressed in terms of a fixed dollar amount, a per-square-foot amount or a formula based on, for example, the Consumer Price Index ("CPI").

6.7 Payment of VAT

Value-added tax or other taxes or governmental levy are typically not payable on rent. An exception is the New York City Commercial Rent Tax ("CRT") that is imposed on the rent paid by tenants of commercial property located south of 96th Street in Manhattan. Generally, the CRT applies to tenants whose gross annual rent is at least USD250,000. The tax rate is 6% of the base rent. However, all taxpayers are given a 35% base rent reduction, effectively reducing the number of taxpayers that are subject to the CRT as well as reducing the tax rate to 3.9%. In addition, a tax credit is given to those tenants whose annual base rent is between USD250,000 and USD300,000 before the 35% reduction.

6.8 Costs Payable by Tenant at the Start of a Lease

The costs payable by a tenant at the start of a lease depend in part on whether there is a net lease or a gross lease. In a net lease, the tenant is responsible for constructing or remodeling any existing improvements and for the payment of all expenses in connection therewith. In a gross lease, landlords often deliver the space with mechanical services stubbed to the premises, or in "white box" condition, and give the tenant a dollar allowance for the construction of the tenant's improvements.

Alternatively, the landlord may be responsible for building out the space to meet the tenant's needs. This is known as a "turn-key" lease. Such leases may include a cap on the landlord's construction costs, with the tenant responsible for expenses that exceed this cap.

6.9 Payment for Maintenance and Repair

The landlord is typically responsible for paying for the maintenance and repair of common areas used by several tenants, such as lobbies, elevators, parking lots and gardens. However, tenants are often responsible for reimbursing the landlord for their pro rata share of operating expenses.

6.10 Payment for Services, Utilities and Telecommunications

Telecommunications and utilities are typically paid for by the tenants. Each tenant's space is metered or submetered for electricity, or the tenant pays pursuant to a formula.

The charges for heating, ventilation and air conditioning ("HVAC") depend on how the property is engineered. Each tenant may have its own cooling system, or the tenants may be served by a building-wide cooling system during business hours and subject to significant charges for after-hours HVAC. In addition, tenants often have their own supplemental cooling system for data and telecom rooms, or to provide after-hours cooling for some or all of their space.

6.11 Insuring Real Estate that is the Subject of a Lease

The landlord and tenant each have to insure their respective interests in the real estate, subject to the terms negotiated and included in the lease.

6.12 Restrictions on the Use of Real Estate

The landlord can impose restrictions on the tenant's use of the real estate via the permitted use provision, which typically lists specific permissible uses of the space and allows a landlord to declare a default and exercise available remedies if the tenant engages in an unpermitted use. The tenant's use can also be restricted by local zoning laws as well as building and health regulations. In addition, leases sometimes grant specific exclusive use rights to individual tenants, particularly in the retail context.

6.13 Tenant's Ability to Alter or Improve Real Estate

Tenants are typically permitted to alter or improve the real estate during the lease with the landlord's approval, and landlords generally allow cosmetic alterations without prior approval. A lease usually contains a limit on the cost and type of alterations a tenant can make without the landlord's approval.

6.14 Specific Regulations

Commercial leases are generally governed by the agreement between the parties. However, there are laws and licensing requirements that are specific to particular uses, such as the operation of hotels, restaurants, etc.

There are several regulations and laws that apply to residential leases.

- *Warranty of Habitability* – residential tenants are entitled by law to a sanitary and safe apartment.
- *Duty to Mitigate* – if a residential tenant vacates the premises before the lease expires, the landlord has a legal duty to find a new tenant before he or she can seek to collect rent from the vacating tenant; there is no such duty for commercial landlords.
- *Rent Regulation* – some residential buildings are subject to rent stabilization regulations which establish caps on the amount of rent landlords can charge and the amount of increases they can impose. In addition, some residential tenancies are protected by older rent control laws. There are no commercial rent stabilization or rent control laws in New York.

6.15 Effect of Tenant's Insolvency

The effect of the tenant's insolvency upon its lease obligations is governed by the applicable bankruptcy, insolvency and creditors' rights statutes.

When the tenant files for bankruptcy, an "automatic stay" is imposed which initially restricts the enforcement of remedies or the termination of the lease by the landlord. Thereafter, there are specific requirements under bankruptcy law with respect to whether a lease, which is a contractual agreement, is to be assumed or rejected.

6.16 Forms of Security to Protect Against Tenant's Failure to Meet Obligations

Upon the signing of the lease, the landlord typically requires a "security deposit" from the tenant to protect against a default by the tenant.

The amount of the security deposit is a matter of negotiation and may depend on the amount of rent, the landlord's upfront costs and the tenant's financial condition. The security deposit may be in the form of cash or a letter of credit, which is a document through which the issuing bank promises to pay the security deposit to the landlord.

A letter of credit is generally considered more desirable to a landlord than a cash security deposit because it puts the landlord in a better position in the event of the bankruptcy of the tenant.

6.17 Right to Occupy After Termination or Expiration of Lease

A tenant typically does not have an automatic right to occupy the relevant real estate after the expiry or termination of a commercial lease. However, tenants often negotiate renewal options in the lease with an agreed-upon rent increase for the renewal term, which may be a fixed dollar amount or based on CPI increases or "fair market rental value" which may be the subject of arbitration or other dispute resolution.

Commercial leases typically have a "holdover" provision that states that if a tenant continues to occupy the premises after the expiry or termination of the lease then the tenant must pay a multiplier of the rent for the last month of the lease (typically 150-200%) and become a month-to-month tenant or a tenant at sufferance. A landlord can only evict a month-to-month tenant upon notice, whereas a tenant at sufferance may be evicted at any time after the expiry of the lease or pursuant to termination of the lease, subject to applicable laws. In addition, leases may give the landlord the right to impose consequential damages upon the tenant for failure to vacate.

6.18 Right to Terminate Lease

There are several events that typically give the landlord or the tenant the right to terminate the lease. For example, the lease typically states that if the landlord fails to complete the build-out of the space, the tenant has the right to terminate after a certain date.

The parties typically have a right to terminate in the event of a casualty if the space is not restored within a certain time. In addition, a landlord can terminate the lease if the tenant defaults and fails to cure the default; for example, by failing to pay rent, failing to maintain proper insurance or failing to adhere to the covenants of the lease, such as a violation of the permitted use provision.

A tenant may negotiate the right to an early termination of the lease, but such early termination rights are often very expensive. A landlord may negotiate the right to relocate the tenant to other space or even terminate the lease if the landlord wants to redevelop the subject property and tenants resist such provisions.

6.19 Forced Eviction
A tenant can be forced to vacate (eg, be evicted) in the event of default prior to the lease expiration date. For example, a tenant can be evicted for failure to pay rent or for otherwise violating the lease. Such actions are governed by the Real Property Actions and Proceedings Law of the State of New York.

6.20 Termination by Third Party
A lease may be terminated by the government through eminent domain (condemnation), which is the government's right to take private property for a public purpose. For example, the government may need space for a road.

New York condemnation law requires a public hearing, advance notice of the hearing to the property owner and publication of a summary of the government's determination, a copy of which is served on the affected owner. Any owner who wants to challenge the determination may appeal. Federal and state constitutions require that the government compensate any affected owner by paying the fair market value of the property, determined as of the date on which the government acquires the property.

7. Construction

7.1 Common Structures Used to Price Construction Projects
Fixed price is still the most often used structure for pricing construction projects. Occasionally, guaranteed maximum price is used as the pricing structure.

7.2 Assigning Responsibility for the Design and Construction of a Project
The responsibility for design in New York is by law assigned to a professional, architect or engineer. Most often the architect leads the design team, employing additional professionals as subcontractors. For construction, most often the management of the project is assigned to a construction manager who either is "at risk," holding all the contracts for subcontractors, or "not at risk," meaning that the owner holds all the contracts for the work. The "not at risk" model is used on public projects due to New York State law.

7.3 Management of Construction Risk
Construction risk is managed by indemnification, warranties, limitations of liability, waivers of damages and provisions relating to insurance. Indemnification is limited by New York General Obligations Law § 5-322.1 which makes contract indemnification provisions in favor of the owner or contractor void and unenforceable. Warranties are almost always limited in duration by express contract provision.

In addition, limitations of liability and waivers of damages are limited to the extent that the liability or damages were in contemplation of the parties at the time of entering into the contract. Provisions relating to insurance are used to address the risks occasioned by the limitation on indemnity. This results in the owner or contractor being named as an additional insured on the Certificates of Insurance provided by contractors and subcontractors.

7.4 Management of Schedule-related Risk
Contract provisions require contractors and subcontractors to adhere to schedules prepared by the construction manager or architect on behalf of the owner. A time extension must be promptly sought by the contractor or subcontractor. Owners can receive compensation for delays if provided for in the contract. Most often, compensation is in the form of liquidated damages. In the absence of a liquidated damage clause, owners can recover actual damages to the extent damages can be proven.

7.5 Additional Forms of Security to Guarantee a Contractor's Performance
The most common form of additional security to guarantee a contractor's performance is a performance bond. Performance bonds are required for most public projects.

7.6 Liens or Encumbrances in the Event of Non-payment
Contractors and designers may file liens to encumber property in the event of non-payment pursuant to New York Lien Law. The filing of a lien subjects the construction lender to liability for any advances made after the filing of a lien. The owner can remove a lien by posting a bond equal to 110% of the lien or by payment of money into court.

7.7 Requirements Before Use or Inhabitation
A Certificate of Occupancy must be obtained before a building may be occupied.

8. Tax

8.1 Sale or Purchase of Corporate Real Estate
The sale or purchase of corporate real estate may be subject to federal, state and local taxation. Federal income tax applies to the gain recognized on the sale of the property. That gain will generally be the difference between the sale price and the seller's adjusted basis in the property (generally the price the seller originally paid for the property, plus the amount of capital improvements made to the property, less depreciation deductions). The rate at which gains are taxed

will depend on whether the seller is an individual or corporation, how long the seller held the property, and whether the seller held the property as inventory or a capital asset.

A seller may be able to minimize or defer the tax when selling real estate. Internal Revenue Code Section 1031 provides that gain is not recognized on the sale of real property held for either productive use in a trade or business, or for investment if the property is exchanged solely for real property of like kind, which is also to be held for either productive use in a trade or business, or investment. Section 1031 exchanges may be structured as simultaneous swaps of one qualifying property for another. However, most Section 1031 exchanges are not simultaneous. Instead, the seller usually disposes of its property, deposits the proceeds with a third party who meets certain requirements and uses the proceeds of that sale to acquire replacement property at a later date.

A seller could also defer tax by contributing real estate to a partnership (or a limited liability company treated as a partnership for US federal income tax purposes) in exchange for partnership (or LLC) units under Internal Revenue Code Section 721.

New York State generally follows the federal rules with respect to the income taxation of sales of real property located in the state, although New York does not have preferential capital gains tax rates. New York imposes a transfer tax on the sale of real estate, including the sale or transfer of at least 50% of the ownership or beneficial interest in an entity owning real estate. The state's tax applies at a rate of USD2 for each USD500 of consideration. A mortgage tax is also imposed when a mortgage is recorded on commercial real estate. In and around New York City, the combined state and municipality mortgage tax typically varies between 1.25% and 2.17% of the mortgage debt or obligation secured. In Upstate New York, the combined state and municipality mortgage tax typically varies between 0.75% and 1.25% of the mortgage debt or obligation secured. Typically, the seller will pay the transfer tax, while the buyer pays the mortgage tax, but this is negotiable.

8.2 Mitigation of Tax Liability

Parties occasionally use a Consolidation Extension and Modification Agreement to reduce mortgage recording tax. Provided both the existing lender and the new lender agree, the existing lender assigns its mortgage to the new lender, which will then amend the terms of the mortgage for refinance or purchase of the property. A buyer will then pay mortgage tax on the difference between the outstanding balance of the seller's existing mortgage and the buyer's new mortgage, rather than paying tax on the entire amount of the new mortgage.

8.3 Municipal Taxes

In Upstate New York, municipal taxes are typically not paid on the occupation of business premises or on the payment of rent.

8.4 Income Tax Withholding for Foreign Investors

Foreign investors are generally subject to a 30% withholding tax on certain US source income, including real property rental income. In certain cases, an income tax treaty may reduce the withholding tax rate.

The Foreign Investment in Real Property Tax Act requires the purchaser of real property owned by a foreign investor to withhold a 15% tax on the total amount realized on the purchase.

The Act added a new 10% withholding tax on the sale of partnership interests owned by foreign investors. Because real estate in the US is frequently owned through entities treated as partnerships for US federal income tax purposes, foreign investors will have exposure to this tax if they dispose of the equity in a partnership owning real estate.

8.5 Tax Benefits

Taxpayers that own real estate used in a trade or business may be entitled to a number of beneficial tax deductions. For instance, taxpayers may take depreciation deductions with respect to improvements made to real property.

In addition, to the extent that the owner of the real estate used in a trade or business financed the acquisition of, or improvements to, the property with debt, the interest is deductible. For many businesses, the amount of interest that can be deducted is generally limited to 30% of the taxpayer's adjusted taxable income, but real estate businesses that meet certain requirements can elect to fully deduct their entire interest expense.

Individuals who own real estate directly or through a pass-through entity pay tax on any long-term capital gain recognized at significantly lower rates than other types of income. The current capital gain tax rate for individuals in the top income tax bracket is 20%.

Real property owners who hold their property for investment or for use in a trade or business may dispose of that property in tax-efficient ways not available to other types of

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property. As discussed above, Section 1031 of the Internal Revenue Code allows a taxpayer to defer gain on the disposition of real property if other real property is received in the exchange. This deferral provision does not apply to other types of property.

8.6 Key Changes in Federal Tax Reform

See **1.3 Impact of New US Tax Law Changes**.