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Avoiding Transfer Tax Pitfalls

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Transfer taxes are an important part of real estate planning that is often overlooked by practitioners, even though the combined New York City and New York State transfer taxes can exceed 3 percent of the gross value of the property. A real estate owner who buys and sells leveraged properties may often find that its transfer tax bill exceeds its income tax bill or even its net sales proceeds. *In the Matter of GKK 2 Herald LLC*, NYC Tax Appeals Tribunal, Administrative Law Judge Division (ALJ), TAT(H) 13-25(RP), decided April 1, 2015, illustrates a failed attempt to structure around transfer taxes that resulted in millions of dollars of transfer tax liability.

Transfer Tax Basics

The New York City transfer tax rate is 2.625 percent of the transferred consideration, which is, generally, the gross value of the property transferred. For example, if one sells a New York City property with a gross value of $100 million, subject to $70 million of mortgage debt, the transferred consideration is $100 million and the NYC transfer tax is $2.625 million, even though the net equity is only $30 million. Similar rules apply for the New York State transfer tax, which is imposed at the rate of 0.4 percent on the transferred consideration for all real properties in New York State, for a combined transfer tax rate of 3.025 percent. The transfer taxes are generally paid by the grantor/seller of the taxed property.

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Relevant Code Provisions

Two specific provisions in the New York City Administrative Code were relevant in the GKK case. First, a transfer of an interest in an entity (such as a limited liability company, or LLC) that owns New York City real property is subject to NYC transfer tax only if a "controlling interest" in the entity is being transferred. In the case of a corporation, a controlling interest is 50 percent or more of the total voting power of all the corporation's stock classes, or 50 percent or more of the fair market value of the corporation. In the case of a partnership, LLC, or other entity, a controlling interest is defined as 50 percent or more of the "capital, profits, or beneficial interest" in such entity.

As a result, a transfer of a 49 percent non-controlling interest in an LLC that owns NYC real property is not subject to the NYC transfer tax. In order to prevent real property owners from avoiding transfer tax altogether by making multiple transfers of less than 50 percent interests, special presumptions apply to aggregate any transfers of non-controlling interests made within a three year period.

It is important to note that the 'exception' for transfer of a non-controlling interest applies only to interests in entities. If a taxpayer owns real property directly and transfers a 40 percent undivided tenancy-in-common (TIC) interest in the property to a third party, the 40 percent transfer is a transfer of real property subject to transfer tax. Similarly, a taxpayer who owns an existing 40 percent TIC interest and sells the TIC interest to a third party is subject to transfer tax.

A separate rule provides that the NYC transfer tax does not apply to any transfer of real property (or economic interest in real property) that effects a mere change of identity or form of ownership or organization, to the extent that the beneficial ownership of such real property (or economic interest) remains the same. For example, if a taxpayer sells 100 percent of an LLC (owning $100 million of NYC real property) to a partnership that is owned 60 percent by the taxpayer and 40 percent by the taxpayer's child, the NYC transfer tax is equal to 2.625 percent of 40 percent of the $100 million of consideration, or only $1.05 million of tax, because 60 percent of the beneficial ownership in the property is remaining with the taxpayer. The example is a transfer of a controlling interest, even though the child acquires only 40 percent of the beneficial interests in the property, because 50 percent or more of the interests in the LLC is transferred to the partnership.

'GKK 2 Herald'

The *GKK* case illustrates how the mere change in form rule interacts with the controlling interest rule. The petitioner, a subsidiary of Gramercy Capital Corp, owned a 45 percent TIC interest in the property at 2 Herald Square, New York NY since 2007. SLG 2 Herald LLC ("SL Green") owned the other 55 percent TIC interest.

On December 22, 2010, the petitioner and SL Green contributed their respective 45 percent TIC and 55 percent TIC interests to a newly formed entity, 2 Herald Owner LLC, with the petitioner acquiring a 45 percent membership interest in 2 Herald Owner LLC. The parties recorded the deeds and paid no New York City transfer taxes, on the basis that the transfers were exempt under the mere change in form rule, given that the petitioner owned 45 percent of the beneficial interests in the property before and after the contribution. Similarly, SL Green owned 55 percent of the beneficial interests in the property before and after the contribution to 2 Herald Owner LLC.

Later on the same day, the petitioner sold its 45 percent 2 Herald Owner LLC membership interest to SL Green for $25 million of cash, and SL Green became the 100 percent sole member of the LLC. The parties filed a second set of New York City transfer tax returns that reflected no tax due, because the transfer of the 45 percent LLC interest was not a transfer of a controlling interest.

Step Transaction Doctrine

Following an audit, the New York City Department of Finance claimed that the two transactions should be stepped together for NYC transfer tax purposes. Under this theory, the transaction was in substance a taxable transfer of 45 percent of the property to SL Green. The taxable consideration was $111 million, equal to the sum of the $25 million of cash consideration and the petitioner's 45 percent share of the $191 million underlying mortgage. The total New York City transfer tax assessed in the notice of determination was approximately $3 million.

The petitioner argued that the two steps should not be stepped together, relying on an example in the New York City transfer tax regulations, where a general partnership was converted to an LLC, followed by the sale of a non-controlling interest in the LLC by one member to the other member without any transfer tax liability. The ALJ, however, noted that the conversion from a general partnership to an LLC in the example was not a transfer in the first place, since the two entities were considered the same entity under state law, and accordingly there was only one transfer of a non-controlling LLC interest. In contrast, the transfer of TIC interests to an LLC was a separate transfer, albeit one subject to a 100 percent mere change in form exemption.

The ALJ applied the step transaction doctrine to treat the two transfers as part of an integrated plan. Federal income tax authorities have established two tests under the step transaction doctrine: an 'interdependence test' that inquires as to whether on a reasonable interpretation of objective facts, the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series, and an 'end result' test, under which purportedly separate transactions will be amalgamated into a single transaction where it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.[1]

The TIC contribution and the LLC interest sale occurred on the same day, and the initial TIC contribution step generated a number of document provisions that contemplated the second step. For example, title insurance covered only the petitioner's 45 percent interest and not SL Green's pre-existing 55 percent interest. The petitioner alone assumed responsibility for any transfer taxes incurred with the transactions. Therefore, the ALJ found that "[u]nder these circumstances, it is unlikely that either the conversion of Petitioner's TIC Interest to its Membership Interest or the sale of its Membership Interest would have occurred without the other. The interdependence test is satisfied under the facts of this matter. … It is apparent that the events occurring in December, 2010, were components of one transaction, the end result of which was intended to achieve the sale by Petitioner of its TIC interest to SLG while avoiding the payment of RPTT on such transaction and, the end result test is satisfied." Once the two steps were recharacterized as a single transaction, the result was a taxable transfer of a 45 percent interest in the property to SL Green, with no mere change in form exemption.

The ALJ also took a confusing digression and appeared to conclude that the mere change in form exemption did not apply at all to the step of the petitioner contributing its TIC interest to the LLC. The ALJ concluded that the petitioner did not own the same 45 percent beneficial interest in the property before and after the contribution. The ALJ noted that:

> Although Petitioner obtained a 45% membership interest in Herald, the Operating Agreement did not provide Petitioner with any express interest in Herald's available cash flow. Instead, §3.4.1 of the Operating Agreement directed that the distribution of available cash flow be made as the "[m]embers shall jointly determine in their sole discretion." Since Petitioner held only a minority interest in Herald, it is unclear whether Petitioner could have compelled any distribution. Petitioner has not established that its Membership Interest is the same beneficial interest with the same bundle of rights that Petitioner had when it owned its TIC interest.

Given that the petitioner's transitory ownership of its LLC interest was entirely disregarded by applying the step transaction doctrine, there was no real need for the ALJ to separately disallow the mere change in form exemption for the TIC contribution step on this basis. Since many LLCs provide that cash flow distributions are made with the sole discretion of the managing member, taxpayers and practitioners might be surprised that transfers to such LLCs by a non-managing member would not qualify for the mere change in form exemption. Such a rule would undermine the entire mere change in form exemption, as different forms of ownership always involve somewhat different legal rights.

In conclusion, the ALJ's application of the step transaction doctrine overrode the taxpayer's too clever attempt to take advantage of both the mere change in form rule and the controlling interest rule to pay zero transfer taxes. The case serves as a warning with respect to the risks involved in many routine transactions, though it contained several extreme facts supporting application of the step transaction doctrine that should be avoided, such as the fact that the two transactions were pre-planned to occur on the same day.

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1 See, e.g., *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).