



August 25, 1999

NYC Real Property Tax: The City's Tax Appeals Tribunal Finds a "Conduit"

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Lawyers dealing with the New York City Real Property Transfer Tax have long struggled to define the scope of the so-called "conduit" exception, which provides that the transfer tax does not apply to a "deed, instrument or transaction conveying or transferring real property or an economic interest therein from a mere agent, dummy, straw man or conduit to his principal" or vice versa (N.Y.C. Admin. Code Search7RH11-2106.b.7.).

The City's Department of Finance has tended to read this exception narrowly, and the examples in the New York City Rules of the application of this exception address only situations where (i) a corporation receives property as a dummy or straw man to facilitate a mortgage financing or the performance of a mortgage spreader agreement, or (ii) a conveyance is made between two parties who have a clearly established agency relationship between them. A recent decision of the New York City Tax Appeals Tribunal (*In the Matter of 46 West 55th Street Corp.*, Decision no. 92-0408, June 3, 1999) offers welcome support for a broader interpretation of this exception.

Facts of the Case

The 46 West 55th Street Corporation (the "petitioner"), which owned real property located on West 55th Street in Manhattan, entered into a "Real Estate Exchange Agreement" to sell the property to a buyer ("B") for \$2,400,000. The agreement permitted the petitioner to receive payment in cash or, in the alternative, to receive other real property selected by the petitioner. The petitioner had the right under the agreement to enter into a contract with the owner of a target property (referred to below as the "replacement property") for an exchange (between petitioner and the seller ("S") of the replacement property) of the 55th Street property for the replacement property. The petitioner then had the duty under the agreement to cause S to transfer the 55th Street property to B.

The petitioner ultimately chose to exchange the 55th Street property for replacement property in an exchange intended to qualify as a like-kind exchange for federal income tax purposes under Internal Revenue Code section 1031. A Contract of Sale was entered into between S as seller, and petitioner, as purchaser, providing that petitioner would purchase the replacement property from S. The contract further provided that petitioner could pay for the replacement property in whole or in part by conveying to S the 55th Street property. In addition, the contract provided that:

[Petitioner] may pay by means of exchange property only if, simultaneously with the closing hereunder [S] shall, pursuant to arrangements made by [petitioner], sell the exchange

property to [petitioner's] designee for the price designated by [petitioner]...it being the intention of the parties that [S] shall, upon consummation of the closing hereunder and the conveyance of the exchange property, receive at the closing in cash the same amount as it would have received had there been no exchange.

To effectuate the exchange, on December 29, 1986: (i) S transferred the replacement property to petitioner, (ii) in exchange therefor the petitioner transferred to S the 55th Street property and cash (in an amount reflecting the difference between the selling prices of the two properties) and (iii) S then transferred the 55th Street property to B for cash. S had agreed, in effect, to act as an intermediary with respect to the 55th Street property, in addition to selling its own property.

Transfer tax returns were filed and tax was paid with respect to the transfer of the replacement property by S to the petitioner and the transfer of the 55th Street property by S to B. A transfer tax return was also filed with respect to the transfer of the 55th Street property by the petitioner to S, but the return asserted that this transfer was "without Consideration to or from Agent, Dummy or Conduit," and apparently no tax was paid with that return.

In June, 1987, the New York City Department of Finance issued a notice of determination to the petitioner asserting that tax, interest, and penalty were due with respect to the transfer by the petitioner.

At the hearing that followed, the petitioner contended that the transfer was by a principal to its agent, dummy, straw man or conduit, and therefore that no tax was due. The Department of Finance contended that S was acting on its own behalf and not as an agent or conduit and, therefore, the tax was applicable to the transfer of the 55th Street property from petitioner to S.

The Commissioner of Finance concluded, according to the decision of the tribunal, that S was "an active participant and not a passive intermediary functioning on behalf of" the Petitioner or as an agent or conduit for the petitioner. A notice of final determination asserting a tax deficiency was accordingly issued on January 10, 1992. The petitioner then filed a petition, under the rules regarding administrative review then in effect (significantly different from current procedures), seeking to overturn that notice.

On appeal, the petitioner asserted that S never acquired beneficial ownership of the 55th Street property; that S was required, under its contract with the petitioner, to act on behalf of and subject to the control of the petitioner with respect to the 55th Street property; and that the relationship between the petitioner and S, as to the transfer of the 55th Street property, was therefore a "classic agency."

The commissioner argued that (1) there was no written agency agreement or other evidence that a principal-agent relationship existed between petitioner and S; (2) the existence of such an agency relationship would fatally undermine petitioner's effort to qualify for nonrecognition of gain under I.R.C. section 1031 (since S's receipt of cash would be imputed to petitioner) and it is impermissible for petitioner to claim for transfer tax purposes a position inconsistent with that which it took under oath for federal tax purposes; (3) S was not acting as petitioner's agent, dummy or conduit in acquiring the 55th Street property, because S had its own real economic interest in the transaction and received a deed conveying true ownership of the 55th Street property; and (4) petitioner is bound by the form of its transaction, which included two deeds of the 55th Street property.

Responding to the commissioner's arguments, the petitioner asserted that characterization of S as the petitioner's agent would not have invalidated its transfer as a like-kind exchange for federal income tax purposes, since the essential requirements of section 1031 were met by the simple comparison of petitioner's holdings before and after the transaction. The petitioner also argued that it did not have to establish that there was an agency relationship with S in order to prevail in this transfer tax case, because the exemption from tax would also apply if S were acting as a "conduit", "straw man" or "dummy."

The Tribunal's Opinion

The tribunal held for the petitioner, saying it is hard to conceive of a better candidate for the label "conduit" insofar as the 55th Street property is concerned. S had no interest whatsoever in exercising ownership rights to the 55th Street Property. By contract, S was required to re-transfer that property to B immediately upon acquiring it. Even before S had the chance to exercise any rights as owner, it had bound itself to the immediate divestiture of ownership. S's presence in the chain of ownership existed solely to accommodate the tax planning of petitioner and offered S no rights or obligations of real ownership, possession or enjoyment. The tribunal added that even if B were not a formal "agent", it could still qualify for the exemption as a mere "conduit", a term whose very inclusion in the language of the exemption demonstrates conclusively that formal agency cannot be the sole standard for qualifying.

Without concluding that S was the petitioner's agent, the tribunal asserted that the commissioner's characterization of S as the petitioner's agent would not, even if correct, preclude the application of Internal Revenue Code section 1031. Moreover, even if the petitioner's assertions in these proceedings were inconsistent with its federal income tax position, the tribunal stated that its duty is to apply the transfer tax based on the record before it and to determine the "true nature of the transaction" as derived from the record, rather than to attempt to protect "the interests of all of the many taxing authorities" by insisting that a characterization adopted for one tax be determinative for all taxes.

Observations

The tribunal's decision as to the applicability of the "conduit" exception is clearly correct, even if the same cannot be said of its analysis of Internal Revenue Code section 1031. S held legal title to the 55th Street property for only a moment, and because of its contractual obligations had no beneficial interest in the property. Since transfer tax had been paid on the conveyance of the replacement property and on one conveyance of the 55th Street property, it is hard to understand, as a policy matter, why the City should be entitled to (or even litigating for) a third tax on the transaction.

The difficult issues under I.R.C. section 1031 as to whether one party to a purported like-kind exchange was acting as the agent of another, and, if so, the consequences of the agency relationship, have largely been mooted by the adoption (subsequent to the transaction at issue) of the "qualified intermediary" rules in the regulations under section 1031. It is an oddity of our legal system that a New York City Tax Appeals Tribunal must try to find a path through a maze of complex and sometimes inconsistent federal tax authorities that the Internal Revenue Service ultimately side-stepped by adopting the current regulatory system.

Finally, on a procedural point, the law governing decisions of the tribunal currently bars any appeal by the City. However, under the former provisions of the New York City Charter, which are applicable to these proceedings (because of the age of the case), the commissioner may appeal this decision. If appealed, the decision, one hopes, will be affirmed. Whether affirmed on appeal or left standing without an appeal, the

decision should have enduring value as support for the independent significance of the term “conduit” in the categories of transfers not subject to the real property transfer tax.

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