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Recent State Tax Department Advisory Opinion Addresses Interesting Development Technique

By: Joseph Lipari

After a brief down period during the years 2008 and 2009, the real estate market in New York City has bounced back making development parcels in Manhattan, Brooklyn and Queens extremely attractive. An interesting structural problem that arises from time to time involves a property owner that uses property in his business, for example a store or restaurant, where the underlying land would permit the construction of a much larger building. While in most cases, the simplest solution would be to sell the land to a developer and move the business to a new location, often the property owner has either a sentimental or economically rational preference to maintain the current location for the business. A savvy developer will often see the advantages in accommodating the desires of such an owner.

It is easy to envision the end result the property owner and developer desire, a large building with the property owner's business located on the ground floor and residential or commercial units constructed above it. It has, however, generally been difficult to agree on a transaction structure that would achieve such objectives at a reasonable tax cost.

A recent Advisory Opinion by the New York State Department of Taxation and Finance sets forth a form of this transaction that may be employed in a variety of situations.[1] Although the Advisory Opinion addresses only the impact of the New York State Real Estate Transfer Tax ("RET")[2], and does not state or comment upon the income tax consequences, it contains a useful description of the operative arrangements.

The Advisory Opinion describes a transaction where the owners ("Owners") of a property (the "Property") entered into a tenancy-in-common ("TIC") arrangement with a third party ("Developer") (Owners and Developer collectively, the "Parties"), with a conveyance by the Owners to Developer of an undivided 87.68% TIC interest in the Property. The Owners retained the remaining undivided 12.32% TIC interest. At the closing, the Parties paid all of the transfer taxes due on the conveyance of the 87.68% interest to New York City and State.

At the time of the conveyance, the Parties also entered into a TIC and Retail Unit Construction and Exchange Agreement (the "TIC Agreement"). Under the TIC Agreement, the Developer engaged a contractor to construct a building on the Property, 12.32% of which would be ground floor commercial space (the "Commercial Space"), corresponding to the Owners' percentage of the TIC. Under the TIC Agreement, each of the Parties agreed to pay its pro-rata share of the costs to construct the building, with Owners agreeing to pay the hard and soft costs attributable to the Commercial Space, and Developer agreeing to pay the costs of constructing and designing the balance of the building (such portion comprising residential units). The Owners controlled construction of the Commercial Space.

The TIC Agreement also provided that, after construction of the building was completed and the Parties paid off all of the construction expenses, the building would be converted to a statutory condominium under Article 9-B of the Real Property Law, with the Commercial Space comprising one unit and residential units for the upper floors. At that point each of the condominium units would still be owned as tenants in common, with Owners owning an undivided 12.32% TIC interest and Developer owning an undivided 87.68% interest. The Parties would then swap interests with Owners' interest in the residential units conveyed to Developer and Developer's interest in the Commercial Space conveyed to Owners. Thus, after all of the transfers, Owner would own a condominium unit comprising the Commercial Space, and Developer would own the residential condo units.

The Owners and Developers requested three separate rulings under the RET: (1) whether transfer taxes would be due with respect to the payment by

***Joseph Lipari** is a partner I the law firm of Roberts & Holland LLP.*

Owners to Developer of $4,275,000, Owner's share of the hard and soft costs of construction of the Commercial Space; (2) whether RET would be due on the transfer by Owner to Developer of Owner's 12.32% TIC interest in the residential units; and (3) whether RET would be due on the transfer by Developer to Owner of Developer's 87.68% TIC interest in the Commercial Space.

In its legal analysis, the Advisory Opinion focused on three sections of the Tax Law. Section 1402(a) provides that the RET is imposed on each "conveyance" of real property or interest therein. Section 1401(c) defines "conveyance" as a "transfer or transfers of any interest in real property by any method. . . ." Section 1405(b)(6) provides an exemption from RET for conveyances "that effectuate a mere change of identity or form of ownership or organization where there is no change in beneficial ownership."

The Advisory Opinion concludes that, under the agreement, although each TIC owner owns its percentage interest in each unit, the economic arrangement between the Owners and the Developer is, from the beginning, that Owners own the Commercial Unit and Developer owns the residential units. The opinion explains:

> Pursuant to the TIC Agreement, Developer has a nominal undivided interest in the Commercial Space, but Developer has no right to sell, lease, license, use or further encumber the unit. After the conveyances, Owners will have a fee interest in the commercial space equal to the fee interest in the Property that they had prior to the construction of the building. Likewise, . . . all proceeds for the sale or lease of any residential condominium unit can accrue solely to Developer . . . . The parties were in exactly the same position before and after the conveyances.

On that basis, the Advisory Opinion concluded that the conveyances by the Owners to the Developer and from the Developer to the Owners of their respective interests in the other units were exempt as mere changes in form.

The Advisory Opinion relied on a few prior opinions, most notably one involving the construction of the Time Warner Center in Columbus Circle.[3] That project involved the construction of a multi-use real estate project that eventually consisted of seven condominium units: a Time Warner Unit, an Office Unit, a Hotel Unit, a Residential Unit, a Retail Unit, a Garage Unit and a Unit to be owned by a non-profit entity Jazz at Lincoln Center. During construction, Columbus Centre LLC owned the project, as one-entity ownership facilitated construction finance and administration. Each of the unit owners was responsible for the costs of construction attributable to its unit.[4] Following completion of construction, the separate condominium units were formed and distributed to the seven unit owners. In that Advisory Opinion, the Tax Department also ruled that each unit holder should be viewed as the owner of its unit prior to the distribution so that the distribution, itself was a mere change in form of ownership.

It is hoped that the rationale of these Advisory Opinions can be carried over to the income tax. Transactions similar to the Advisory Opinion issued in October have raised interesting income tax questions.[5] If such transactions are viewed as the transfer of land by the owner to the developer in exchange for the transfer of a condominium unit, such an exchange might or might not result in taxable gain for income tax purposes to both parties. In some cases taxable gain may be deferred by means of the tax-free exchange provisions of IRC section 1031, although in most cases section 1031 treatment is unavailable when the replacement property is being constructed.[6] A contribution of the property to a partnership or limited liability company followed by a distribution of the condo unit by the partnership may be considered a deemed taxable exchange under the provisions of IRC sections 707(a)(2)(B) and 737. There are other possible approaches involving leases, options and other more complicated arrangements.

It should also be kept in mind that in the recent Advisory Opinion, the Owners apparently sold the 87.68% undivided interest in the Property, in which event, the Owners recognized taxable gain. Similarly the Owners were willing to pay for the costs of developing the remaining 12.32% interest. Transactions in which the property owner wishes to obtain the value of the improvements in exchange for its share of a portion of the property on a tax-deferred basis will be more difficult to structure.

1 TSB-A-13(7)R (Oct. 17, 2013).

2 The Advisory Opinion also does not address the impact of the New York City Real Property Transfer Tax ("RPT"). NYC Administrative Code sections 11-2101 et seq. Since the operative provisions of the RPT are substantially identical to those of the RET, so long as the rationale of the Advisory Opinion is accepted by New York City, the result should be the same.

3 TSB-A-01(3)R (Apr. 18, 2001).

4 The costs attributable to Jazz at Lincoln Center were shared by the other unit holders.

5 I often say the only thing worse than interesting income tax questions are interesting medical questions.

6 Although Treas. Reg. § 1.1031(k)-1(e) permits the use of "property to be produced" as replacement property, the duration of real property construction will generally exceed the 180-day replacement period for projects of even modest scale.