

# Step Transaction Doctrine Applied to New York City Transfer Tax

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A Determination of New York City's Tax Appeals Tribunal, Matter of the Petition of GKK 2 Herald,<sup>1</sup> dated April 1, 2015, upheld the New York City Finance Department's application of the "step transaction" doctrine to the administration of the City's Real Property Transfer Tax (RPTT). An administrative law judge found that a transaction was structured in steps to avoid payment of the RPTT, ruling that RPTT was due when title was transferred to a new entity in which there was initially no change in any beneficial interest followed by the transfer of less than a 50 percent beneficial interest in the transferee entity.

Transfers of Interest

Facts considered in the Determination include the following. Petitioner GKK2 Herald LLC owned a 45 percent tenant-in-common interest in real property located at 2 Herald Square in Manhattan. SLG 2 Herald LLC (SLG) owned the remaining 55 percent tenant-in-common interest. Petitioner and SLG conveyed their tenant-in-common interests to 2 Herald Owner LLC. Petitioner received a 45 percent member interest in Herald; SLG received a 55 percent member interest in Herald. On the same date as the date of the conveyance to Herald, petitioner transferred its 45 percent member interest to SLG.

Petitioner and SLG filed RPTT returns reporting that the deeds to Herald were exempt as constituting a mere change in identity or form of ownership. A transfer of real property or of an interest in an entity owning real property, otherwise subject to the RPTT, is generally exempt "to the extent the beneficial ownership of such real property or economic interest therein remains the same..."<sup>2</sup>

Petitioner, the holder of a 45 percent tenant-in-common interest, obtained a 45 percent member interest; SLG, the holder of a 55 percent tenant-in-common interest, obtained a 55 percent member interest. The RPTT return filed for the transfer of the 45 percent member interest to SLG claimed that no tax was due, less than a controlling economic interest having been transferred.

It should be noted that the transfer of petitioner's tenant-in-common interest directly to SLG would have been a taxable event, notwithstanding that the tenant-in-common interest being transferred represented less than 50 percent of the beneficial interests in the property. Each tenant-in-common interest is treated separately as an interest in real property.

New York City's Department of Finance concluded that the transfer from petitioner to SLG was a transfer taxable as a 45 percent change in beneficial ownership. The administrative law judge concurred. Petitioner filed a Petition for a Hearing with New York City's Tax Appeals Tribunal seeking the redetermination of a tax deficiency asserted in a Notice of Determination by the city's Finance Department.

### Tenants in Common

The Determination first dealt with the petitioner's claim that the transfer of the tenant-in-common interests to Herald was exempt from RPTT as a mere change in identity or form of ownership. Petitioner further argued that under the Rules & Regulations of the City of New York (RCNY), the transfer of title by tenants in common to an entity in which they hold beneficial interests equivalent to the interests in the property they formerly had is specifically exempt as a mere change under the RCNY.<sup>3</sup>

However, the ALJ ruled that petitioner did not establish "that its Membership Interest is the same beneficial interest with the same bundle of rights that Petitioner had when it owned its TIC interest." According to the administrative law judge, "the record is silent as to any agreement between Petitioner and SLG regarding their respective interests in the profits, losses, distributions, rights upon dissolution and voting power while they operated the property as tenants in common. 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..." The mere change exemption therefore did not apply.

### Step Transaction Doctrine

Perhaps more significant is the administrative law judge's ruling that the conversion of petitioner's tenant-in-common interest to a member interest in Herald and the sale of its member interest to SLG were components of one interdependent transaction intended to achieve the sale of petitioner's tenant-in-common interest to SLG without the payment of transfer tax. The petitioner countered that the Department of Finance lacked the authority to apply the step transaction doctrine. This requires a review of some background pertaining to the regulation on application of the RPTT to the transfer of a controlling economic interest in an entity owning real property.

A controlling interest is defined in New York State Tax Law Section 1201 ("Taxes administered by cities of one million or more") as being "(1) in the case of a corporation, fifty percent or more of the total combined voting power of all classes of stock of such corporation, or fifty percent or more of the fair market value of all classes of stock of such corporation; and (2) in the case of a partnership, association, trust or other entity, fifty percent or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity."

With the exception to the 50 percent threshold discussed below, and the possible aggregation of the transfers or acquisitions of interests over a three-year period to apply the RPTT,<sup>4</sup> a 50 percent interest in an entity owning real property needs to be transferred or acquired for there to be a taxable event.

Under 19 RCNY Section 23-05, the determination of whether a controlling interest has been transferred is to be made prior to the application of the mere change in identity or form of ownership exemption. Non-mere change interests are subject to tax, even if they represent less than a 50 percent interest in the property-owning entity, if the total of the interests being transferred, prior to application of the mere change exemption, is 50 percent or more. According to the RCNY, "[f]or transactions involving economic interests, the determination of whether a controlling economic interest has been transferred is made prior to the application of this [the mere change of identity] exemption."<sup>5</sup>

An example of the application of this rule set forth in 19 RCNY Section 23-05 is the following: Limited Partnership X has four limited partners and one general partner. Limited partners A, B, C and D, have respective interests of 29 percent, 29 percent, 24 percent and 14 percent. E, the general partner, has a 4 percent interest. X owns a parcel of unencumbered real property in New York City with a fair market value of \$1 million. Limited Partnership X merges into Limited Partnership Y in which A, B and C each has a 24 percent interest, D has a 14 percent interest, and E has a 4 percent interest, for an aggregate interest in Partnership Y amongst these partners of 90 percent.

The merger is exempt as a mere change of identity or form of ownership to the extent of 90 percent. RPTT is, however, imposed on the 10 percent interest that is not a mere change. The tax due is \$2,625, determined by multiplying \$100,000 (the fair market value of the real property apportioned to the 10 percent interest in Partnership Y not covered by the mere change exemption) by the tax rate of 2.625%, since consideration prior to application of the exemption exceeds \$500,000.

What if transfers of interests are accomplished in steps? Draft Amendments to 19 RCNY Section 23-05 ("Exemptions") were published on April 28, 1999. The draft included a section, not included in the Amendments as finally published, captioned "Application of mere change exemption to multi-step transactions," which, together with its accompanying illustration, would have clearly incorporated the step transaction doctrine:

Where pursuant to a plan, a transaction that would be exempt in whole or in part from the tax as a mere change of identify or form of ownership or organization is preceded or followed by one or more other transactions, all of the transactions pursuant to the plan will be taken into account in determining the beneficial ownership of the real property or economic interest therein prior to the transaction and the extent to which the beneficial interest therein remains the same following the transaction.

The following illustration accompanied this proposed subsection:

A owns an office building in New York City. Pursuant to a plan to finance improvements to the building through a stock offering A transfers the building to X Corporation and takes back 100% of the stock in X. Pursuant to the plan, A sells 49% of the stock of X to individuals B, C, D and E. The sale of stock to B, C, D and E will be taken into account in determining the extent to which A retains a beneficial interest in the building following the transfer of the building to X

Corporation and, therefore, the extent to which the transfer of the building to X Corporation is exempt as a mere change of identity or form of ownership or organization.

This text, applying the step transaction doctrine, was not included in the regulation as amended. Instead, 19 RCNY Section 23-05(b)(8)(iv) recites only that "[f]or purposes of determining whether and to what extent the mere change of identity or form of ownership or organization exemption applies, the determination of the beneficial interest of the real property or economic interest therein prior to a transaction and the extent to which the beneficial interest therein remains the same following the transaction will be based on the facts and circumstances."

Petitioner claimed that the failure to include the text and its accompanying illustration, setting forth the step transaction doctrine, meant that the doctrine could not be applied. The administrative law judge merely stated, in response to this argument, that the inference that the intention was not to apply the step transaction doctrine "is speculative at best."

As noted in the Determination, "[t]he purpose of the step transaction doctrine is 'to assure that tax consequences turn on the substance of a transaction rather than on its form.'" "[S]teps in a series of formally separate but related transactions [are treated] as a single transaction if all of the steps are substantially linked."<sup>6</sup>

In 2008, the department advised in a Statement of Audit Procedure<sup>7</sup> that it would apply the step transaction doctrine to the transfer of real property, or to the transfer of an economic interest in real property, to a charity that is followed by a transfer of the property by the charity to a for-profit entity. Such a set of transfers would presumably be structured to take advantage of exemption from the RPTT for a deed, instrument or transaction conveying real property, or an economic interest in real property, to or from an entity "operated exclusively for religious, charitable or educational purposes."<sup>8</sup>

According to the Statement of Audit Procedure. "[c]ourts regularly permit taxing authorities to look at the substance rather than the form of a transaction so that 'mere formalisms' do not obscure the transaction's true nature. The 'step transaction doctrine'...is an example of the use of the 'form over substance' principle. The doctrine will be applied to prevent the use of a charity as a means to avoid paying transfer tax on an otherwise taxable transfer or series of transfers."

#### Endnotes:

1. TAT(H) 13-25(RP), posted at <http://www.nyc.gov/html/tat/downloads/pdf/1325DET0415.pdf>.
2. 19 RCNY Section 23-05(b)(8). This exemption does not apply to "a conveyance to a cooperative housing corporation of the land and building or buildings comprising the cooperative dwelling or dwellings."
3. 19 RCNY Section 23-05(b)(8)(ii) Example A.
4. 19 RCNY Section 23-02 ("Controlling interest...(2) Aggregation").
5. 19 RCNY Section 23-05(b)(8)(ii). See Berey, "The Mere Change Exemption and Controlling Interest Transfers," "Metes and Bounds," Association of the Bar of the City of New York, Winter 2000, and "Tax Aggregation Rules: Traps for the Unwary," "Real Estate and Title Insurance Trends," NYLJ Sept. 30, 2002.

6. Citing *King Enterprises v. US*, 418 F2d 511, 517 (Ct Cl 1969) and *Greene v. US*, 13 F3d 577, 583 (2d Cir. 1994).
7. "Real Property Transfer Tax Transfers Into and Out of Charitable Organizations", RPTT 2008-1, 2/29/2008, posted at <http://www1.nyc.gov/assets/finance/downloads/pdf/08pdf/charitysap2008.pdf>.
8. 19 RCNY Section 23.05(b)(2).

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