

TAX AGGREGATION RULES: TRAPS FOR THE UNWARY

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Among the most confusing aspects of New York State's tax laws for real estate transactions are the various aggregation rules for Mortgage Recording Tax ("MRT") for transactions involving property in New York City, the State's Real Estate Transfer Tax ("RETT") and Additional Tax (known as the "Mansion Tax"), and The City of New York's Real Property Transfer Tax ("RPTT"). The consequences of the application of the aggregation rules can be severe.

MORTGAGE RECORDING TAX

MRT is assessed on mortgages in New York City at the rate of \$2.00 for each \$100 of principal debt or obligation secured by a mortgage of less than \$500,000, \$2.125 for each \$100 of principal amount secured by a mortgage of \$500,000 or more on a one-three family dwelling or an individual residential condominium unit, and \$2.75 for each \$100 secured in all other instances.

Assume that a mortgage on commercial property in Bronx County securing a \$300,000 debt of the ABC Corporation is executed by its President, John J. Jones. MRT is computed at the rate of \$2.00 per \$100, and MRT of \$6,000 is paid to the recording office. Nine months later, XYZ LLC records a mortgage also securing \$300,000 on a different commercial parcel in Bronx County, signed by its member, John J. Jones. Although the person signing is the same, the loans are unrelated and the entities have independent business purposes. It could reasonably be concluded that the 2% rate should apply to this mortgage as well.

However, as has been the case in a number of instances in Bronx County, the recorder may apply the MRT rate of \$2.75 per each \$100 to both the mortgage executed by XYZ LLC and, retroactively, to the recorded mortgage of the ABC Corporation, for an aggregate tax on \$600,000 of \$16,500.00. MRT could also be collected at the higher rate on any further mortgage executed by Mr. Jones submitted for recording within 12 months.

The authority to aggregate indebtedness secured by different mortgages in the City stems from Chapter 241 of the Laws of 1989, which amended the Tax Law and the City's Administrative

Code to provide that the amounts secured can be aggregated to determine the applicable tax rate when the mortgages "form part of the same or related transactions and have the same or related mortgagors". (FN 1) This overrules the 1984 Opinion of the State Tax Commission in Matter of the Petition of Chelsea-19th Street Associates (followed in other STC Decisions) that the City was without the authority to aggregate mortgages on the same property executed by the same mortgagor to separate mortgagees to apply the higher MRT rate. According to the Chelsea Decision, "there is no provision for aggregating mortgages merely because they apply to the same property". [FN 2]

The term "related mortgagors" includes, but is not limited to, family members, a grantor of a trust and the same trust, a shareholder and a corporation, a partner and a partnership, and a beneficiary and a trust, where more than 50% of the stock, capital or profits, or beneficial interest is owned or controlled, directly or indirectly, by the shareholder, partner, or beneficiary. The term also includes two or more entities owned or controlled, directly or indirectly, by the same person, corporation, or other entity or interests. It is presumed that mortgages offered for recording within a 12-month period, with the same or related mortgagors, are part of a related transaction and the higher MRT rate can be applied to the aggregated amount of principal indebtedness. The presumption that the mortgages are part of a related transaction, and not for independent business or financial purposes, may be "rebutted only with clear and convincing evidence to the contrary".

The City's earlier position, as stated in the "Mortgage Aggregation Policy" issued by the Office of the City Register on April 26, 1984, was that mortgages would be aggregated when they were recorded either against the same parcel of property or against parcels in the same ownership constituting two or more tax lots within the same or in adjacent tax blocks. A 1987 letter from the then City Register stated that aggregation rules did not apply when the mortgaged parcels were located in different counties. However, MRT regulations [FN 3] refer to the aggregation of mortgages on property "in such City", suggesting that mortgages being aggregated can be on property anywhere in the City.

The City Register previously accepted an affidavit stating facts in support of the position that the mortgage being recording was "solely for an independent business or financial purpose", subject to verification on audit. [FN 4] The City will no longer review affidavits or consider proofs to rebut the presumption that mortgages are of a related transaction. MRT is required to be paid at the higher rate, and the proper tax rate will be determined when the taxpayer seeks a refund from the State.

Aggregation for mortgage recording tax is being actively enforced in Bronx County. The recording office in the Bronx maintains an index of the names of mortgagors and signatories to enable names on newly tendered mortgages to be compared to names on prior recorded mortgages.

CONDOMINIUM UNITS AND MORTGAGE RECORDING TAX

The City's Department of Finance has also taken the position that MRT at the higher, commercial rate of \$2.75 for each \$100 of principal debt or obligation will be applied to a

mortgage for \$500,000 or more on two or more residential condominium units even if the units have, in fact, been used as a single, integrated unit having only one kitchen, unless the building's certificate of occupancy has been amended to reflect the combination of the condominium units into a single unit.

NYC REAL PROPERTY TRANSFER TAX

Consideration for the sale of two or more residential condominium units or two or more residential cooperative units may be aggregated to determine the applicable RPTT rate, even when the units have been physically combined into a single unit.

When transferring an individual residential condominium unit or an individual residential cooperative apartment unit, the RPTT rate is 1% of consideration when the amount of consideration is \$500,000 or less, and 1.425% when consideration exceeds \$500,000 (the "Lower Rates"). For all other property, the tax rate is 1.425% when the amount of consideration is \$500,000 or less, and 2.625% when consideration exceeds \$500,000 (the "Higher Rates").

1994 Letter Rulings of the Finance Department provided that consideration for the bulk sale of multiple cooperative units (including a proportionate amount of the underlying mortgage on the property of the cooperative corporation) would be aggregated to determine the rate of tax. According to the Rulings, "a bulk transfer of cooperative apartments is not a transfer of an individual cooperative apartment". Thus, for a sale of two residential cooperative apartments when each unit has a purchase price of \$300,000.00, the aggregated consideration would be \$600,000 (plus an allocated amount of the underlying mortgage), for which the RPTT rate would be 2.625%.

The Rulings indicated, however, that on a bulk sale of condominium units, consideration for the transfer of each unit would not be aggregated so long as a separate deed was used for each unit since the tax is imposed on "each deed" conveying an interest in real property. However, the RPTT rate applicable to each deed, notwithstanding consideration for each deed is less than \$500,000, would be 1.425%. According to the Rulings, "...a sale of multiple condominium units by a single grantor to a single grantee does not qualify for the lower rates applicable to a conveyance of an individual unit".

On June 19, 2000, the Department of Finance issued Memorandum 00-6 ("Real Property Transfer Tax on Bulk Sales of Cooperative Apartments and Residential Condominium Units"), which states its current position. [FN 5]. The Memorandum defines a bulk sale as the transfer of more than one cooperative apartment or residential condominium unit by a single grantor to a single grantee.

According to the Memorandum, the Department of Finance will not treat a transfer of *adjacent* cooperative apartments or residential condominium units that have been combined into a single residence as a bulk sale and, in such instances, it will apply the Lower Rates. In determining whether units have been combined, the Department "will examine all of the applicable facts and circumstances". "Issuance of a revised Certificate of Occupancy, a letter of completion from the Buildings Department [presumably issued under Procedure Notice #3/97 discussed below], or a

revised tax lot designation reflecting the joining of condominium units will be acceptable evidence of the combination of units". However, "that two or more units or apartments will be combined following the transfer will not be sufficient to permit the transaction to be treated as a transfer of an individual [cooperative] apartment or individual residential condominium unit taxable at the lower rates".

The Memorandum provides that on bulk sales of cooperative apartment and residential condominium units the Higher Rates will be applied. For bulk sales of cooperative apartments, the rates are to be applied to the aggregate consideration for the *entire* transfer and not to the consideration for the sale of each apartment. For bulk sales of residential condominium units the Higher Rates will apply, even when each unit is conveyed by a separate deed. The rate of 1.425% will apply to a unit deed for which the consideration is \$500,000 or less, and 2.625% rate will apply to a unit deed for which the consideration is greater than \$500,000. The Department will accept the taxpayer's apportionment of consideration to each deed, provided that the apportionment "reasonably reflects the relative value of the units transferred".

In 1997 the Department of Buildings issued Technical Policy and Procedure Notice #3/97 on "Combining Apartments to Create Larger Residential Units Without Affecting the Certificate of Occupancy". This Notice eliminated for all multiple dwelling buildings the requirement that a certificate of occupancy be amended when apartments are combined to create larger dwelling units so long as an Alteration Type II application is filed, certain requirements are met, and a Professional Engineer or a Registered Architect file a completion sign-off with the Department. On compliance, the Department will issue a Letter of Completion stating that "(t)he Department of Buildings does not require a new or amended certificate of occupancy for combining these apartments". (FN 6]

Prior to issuance of Memorandum 00-6, the Department of Finance informally advised it would apply the Lower Rates to the transfer of combined condominium units if submitted with the Transfer Tax Return was a copy of a Building Department Letter of Completion and an affidavit that (a) the transfer involves units combined into a single unit with the second kitchen eliminated, (b) the combination was approved by the Buildings Department, and (c) approval was issued by the Department of Buildings under Procedure Notice #3/97. Memorandum 00-6 presumably continues that procedure.

It may therefore be prudent to take steps prior to closing to have residential condominium units recognized as a single, combined unit for purpose of the RPTT to avoid having the transfer of the units treated as a bulk sale. The difference between application of the Lower Rates and the Higher Rates will be significant.

MANSION TAX

The State Additional Tax/Mansion Tax was enacted by Chapter 61 of the Laws of 1989 as Tax Law Section 1402-a. This grantee paid tax of 1% of consideration is imposed on a conveyance of residential real property when the consideration for the *entire* conveyance is \$1,000,000.00 or more. This tax may also involve aggregation issues.

20 NYCRR Section 575.3 indicates that if the overall consideration for a transfer of real property that has residential and commercial uses is \$1,000,000 or more, the residential portion of the total consideration will be taxable even if that amount is less than the \$1,000,000. The State will also aggregate to reach the threshold when the amount paid for personal property combined with the price paid for the related residential real property is \$1,000,000.00 or more. Only the real property consideration is taxed once the threshold is reached.

The State Tax Commission has informally advised that it will aggregate consideration for application of the Mansion Tax when contiguous or adjacent condominium or cooperative units are transferred between the same parties. The State may also take the same position where the transferees are related parties, such as when a husband and wife separately take title to different but adjoining units.

CONTROLLING INTERESTS

It is understood generally that New York State's RETT and New York City's RPTT apply to transfers of controlling interests in entities owning interests in real estate. A controlling interest is defined as 50% or more of any of the combined voting power of all classes of stock of a corporation, the fair market value of all classes of stock in a corporation, or 50% or more of the capital, profits or beneficial interests in such entity.

The regulations on controlling interest transfers extensively deal with the subject of aggregation. [FN 7] Transfers and acquisitions of economic interests within a three year period, or within a longer period of time if made by transferors or transferees "acting in concert", are aggregated to determine if a controlling economic interest was transferred or acquired.

It is possible, based on an amendment to Section 23-05 of the City's Rules Relating to the Real Property Transfer Tax published April 28, 1999, that the transfer or acquisition of interests in an entity may be subject to the RPTT as if a controlling interest was transferred, notwithstanding that less than 50% of the interests in the owning entity were transferred or acquired.

Under the 1999 amendment, the determination of whether a controlling interest has been transferred is to be made *prior* to application of the mere change of identity or form of ownership exemption (applicable to the RPTT since June 9, 1994). Non-mere change exempt interests are subject to tax even if they represent less than 50% of the capital, profits or other beneficial interests in the entity owning the interest in real property if the total of the interests being transferred, prior to application of the mere change exemption, is 50% or more.

Further, under the 1999 amendment, for transactions on and after January 1, 1999, the RPTT rate to be applied to a controlling interest transfer is determined based on the amount of consideration prior to the application of the mere change exemption. If consideration prior to application of the mere change exemption exceeds \$500,000 the 2.625% RPTT rate will be applied to consideration, even if the amount of taxable consideration is \$500,000 or less.

An example extracted from an illustration in the Section 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%, 29%, 24% and 14%. E, the general partner, has a 4% interest. X owns a parcel of unencumbered real property in the New York City with a fair market value of \$1,000,000. Limited Partnership X merges into Limited Partnership Y in which A, B and C each have a 24% interest, D has a 14% interest, and E has a 4% interest, for an aggregate interest in Partnership Y amongst these partners of 90%. The merger is exempt as a mere change of identity or form of ownership to the extent of 90%. RPTT is, however, imposed on the 10% 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% 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.

The RETT statute and regulations do not deal with this manner of determining when a controlling interest is transferred. (The question of the rate for the RETT is not an issue since the rate is a \$4.00 per \$1,000 of consideration regardless of amount). The State's Department of Taxation and Finance appears, however, to have informally taken the position that a determination of whether a transfer is a controlling interest transfer is to be made prior to application of the mere change exemption, with the non-exempt portion of the transfer being subject to the RETT even it is less than a 50% interest.

This would be consistent with the State's position in administering the now repealed Transfer Gains Tax (Tax Law, Article 31-B) and the Mansion Tax (as discussed above). For those taxes, the total amount of consideration has determined whether the tax applies even though the deduction of non-taxable amounts to arrive at taxable consideration would otherwise result in an amount below the threshold of taxability.

Aggregation rules are traps for practitioners and their clients, and the possibility and method of their application should be determined prior to closing, when structuring the transaction. Knowledgeable counsel at the title company to be used should be able to provide the needed information and guidance.

1. Tax Law, Section 253-a (2) and Code Section 11-2601(e).
2. TSB-H-84(12)M; 1984 N.Y. Tax LEXIS 457.
3. 20 NYCRR Section 642.4.
4. Memorandum, "Mortgage Recording Tax-Closing Loopholes etc", July 3, 1989.
5. http://nyc.gov/html/dof/pdf/00pdf/fm00_6.pdf
6. <http://www.nyc.gov/html/dob/html/tppn0397.html>
7. 20 NYCRR Part 575 and 19 RCNY Chapter 23.

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