

Transfer Tax - Real Estate Transfer Taxes - The Mere Change Exemption and Controlling Interest Transfers

*By Michael J. Berey
Senior Underwriting Counsel and Senior Vice-
President
First American Title Insurance Company of
New York*

At its October 27, 1999 Tax Representatives and Practitioners Program ("TAXRAPP") the New York City Department of Finance made known certain Amendments issued to the Rules Relating to the Real Property Transfer Tax ("RPTT"), codified at Section 23, Title 19 of the Rules and Regulations of the City of New York, on application of the mere change of identity exemption to the transfer of controlling economic interests. The Amendments, effective May 28, 1999, can be found on the Internet at <http://www.titlelaw-newyork.com> under "Transfer Taxes".

The transfer or acquisition of a controlling economic interest in an entity owning real property has been a RPTT taxable event since Local Law 71 of 1986 became effective retroactive to July 13, 1986. Section 1201 of the New York State Tax Law (the "Tax Law") and Title 11, Chapter 21 of the City's Administrative Code deal with the RPTT. Controlling interest transfers have, since July 1, 1989, been subject to tax under New York State's Real Estate Transfer Tax ("RETT") at Article 31 of the Tax Law.

The RETT and RPTT are primarily payable by the transferor of the taxable interest, with the transferee secondarily liable for the tax in the event of nonpayment. The RETT rate is \$2.00 for each \$500.00 of consideration. The RPTT rate for commercial property is 1.425% when the consideration paid or imputed is less than \$500,000,000 and 2.625% when the consideration is at least that amount.

For controlling interest transfers, the RETT and RPTT are generally computed based on the fair market value of the real property interest held by the owning entity apportioned based on the percentage of the economic interest in the entity being transferred or acquired.

To be taxable, within a three-year period (or longer, if the transfers are being made pursuant to a plan to avoid payment of tax) there must be either the transfer of an economic interest in the entity by a transferor or the acquisition of an economic interest by a transferee (or by transferors or transferees "acting in concert" or "in one or several related transfers") of at least 50 percent of

the total voting power or fair market value of all classes of stock in the case of an interest in a corporation, or of at least 50% of the capital, profits or beneficial interests in the case of an interest in a partnership, trust or other unincorporated association.

Controlling interest taxes have been broadly applied by the New York State and City taxing authorities. The transfer of a controlling interest in an entity which directly, or through its controlling economic interest in a different entity, has an interest in real property is subject to tax. The transfer of a controlling interest in an entity owning a leasehold is considered a taxable event irrespective of the remaining term of the lease, a factor usually applied in applying the RETT to leasehold grants. The transfer of a controlling interest in a contract vendee or in the holder of a foreclosure bid are considered taxable, as is the gift transfer of a controlling interest to the extent of outstanding mortgage indebtedness apportioned to the interest being transferred. Interests acquired at, and within three years of, the formation of the real property interest-owning entity by an original shareholder, partner, or member, will be aggregated. If the total of the interests so "acquired" constitutes at least a 50% aggregate economic interest, the interests obtained after formation will be taxed.

It is also the State's informal position that the taxation of controlling economic interest transfers applies to the "Additional Tax" under Tax Law Section 1402-a, popularly known as the "Mansion Tax", The Mansion Tax is a grantee tax of 1% of consideration applicable, in general, to the conveyance of a one-to-three family residence where the consideration is \$1,000,000 or more.

However, both the RETT and RPTT also provide for an exclusion from consideration to the extent that an otherwise taxable transfer constitutes a mere change in identity or form of ownership or organization, what is generally known as the "mere change" exemption.

Section 11-2106 of the City's Administrative Code was amended by Chapter 170 of the Laws of 1994 to provide an exemption from the RPTT for transfers made on and after June 9, 1994 that effect a mere change of identity or form of ownership or organization to the extent the beneficial or other ownership interest being transferred or conveyed remains the same. The mere change exemption has, by enactment of Chapter 61 of the Laws of 1989, been applicable to the RETT since July 1, 1989. RETT exemptions are at Tax Law Section 1405.

The Amendments made known at TAXRAPP include two significant, "new" positions on application of the mere change exemption to controlling interest transfers. The examples set forth below have been extracted from illustrations in the Amendments.

First, for transfers or transactions occurring on and after January 1, 1999, the determination of the RPTT rate to be applied to a controlling interest transfer will be determined based on the amount of consideration prior to application of the exemption. This is a change from the Department's prior position, which remains applicable to transfers occurring before January 1, 1999.

For example, X Corporation, having two shareholders, A and B, each owning 50% of the corporation's stock, owns 100% of the stock of Y Corporation, which owns unencumbered real

property in the City of New York having a fair market value of \$1,000,000. X Corporation distributes in liquidation 25% of the Y Corporation stock to A and 75% of the Y Corporation stock to B. The transfer of Y Corporation stock is exempt as a mere change of identity or form of ownership or organization except to the extent of the additional 25% stock interest distributed to B. The RPTT due is \$6,562.50 determined by multiplying \$250,000 (25% of the fair market value of the real property) by the tax rate of 2.625%. The higher tax rate applies since the "measure of tax" for the distribution of the Y Corporation stock is \$1,000,000, which is greater than the \$500,000 threshold for application of the increased rate

This issue does not apply to the RETT since its tax rate does not change with the amount of consideration.

Second, for transactions involving economic interests, a determination of whether a controlling interest has been transferred is to be made prior to application of the exemption. Interests that are not exempt will be 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, without consideration of the no change exemption, is 50% or more.

For example, Limited Partnership X has four limited partners and one general partner. A, B, C, and D, limited partners, have, respectively, 29%, 29%, 24% and 14% interests in the partnership. E, the general partner, has a 4% interest in the partnership. X owns a parcel of unencumbered real property in the City of New York 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 or organization to the extent of 90%. RPTT is 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%. The applicable rate of tax is determined by the full value of the consideration prior to application of the exemption, which in this example is \$1,000,000, greater than the \$500,000 threshold for application of the higher tax rate.

The Amendments state that this second position does not reflect a change in the policy of the Department of Finance. According to the "Basis and Purpose of Amendments" section of the Notice of Rulemaking, "(s)ince June 4, 1994, Department policy has been that for all transactions occurring on or after [June 9, 1994], the determination of whether a transaction constitutes a transfer of a controlling economic interest is made prior to the application of the mere change exemption".

The RETT statute and regulations do not specifically deal with this issue. It is, however, the State's informal position that the 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 part of the transfer being subject to tax even if less than a 50% interest.

The State's position is consistent with its prior position on the now repealed "Tax on Gains Derived From Certain Real Property Transfers" which applied to transfers of \$1,000,000 or more

and can be found at former Tax Law, Article 31-B. Section 590.51, of Subchapter L, Chapter III, Title 20 of the Official Compilation of Codes, Rules, and Regulations of the State of New York recited that "(t)he million dollar exemption is applied to consideration first and then the mere change exemption is applied. A transfer in which the consideration is greater than \$1 million will remain taxable, the mere change exemption only defers payment of tax on the portion of gain determined to be attributed to a mere change in form or ownership".

It is also consistent with the State's regulations on application of the Mansion Tax. Section 575.3 of Part 575, Subchapter K, of the above regulations indicates that if the overall consideration for a transfer of real property that has both residential and commercial portions is \$1,000,000 or more, the residential portion will be taxable even if it is, of itself, less than the threshold amount.

The Amendments indicate that the application of the mere change exemption to transfers to and from trusts will be dealt with at a later date.

*Published in "Metes and Bounds"
Association of the Bar of the City of New York
Winter 2000, Volume 6, No. 3*