# DON'T TRANSFER THAT INTEREST! HOW THE "MERE CHANGE EXEMPTION" PROVIDES LITTLE RELIEF TO TAXPAYERS

*Eric J. Greenberg**

## I. INTRODUCTION

During the past several years, after experiencing the effects of a recession and a severe industry downturn, real estate owners are finally starting to see some relief in real estate values.[1] That being said, the economic outlook for real estate owners is not all positive, highlighted by the fact that realty transfer taxes continue to grow in scope and complexity.[2] Considering the increase in real estate values, the economic cost of realty transfer taxes can be significant, further evidenced by the fact that they are generally imposed on total consideration and/or fair market value ("FMV") rather than gain, and are therefore imposed whether or not the seller even realizes a gain.[3]

Another interesting development is the taxation of conveyances of controlling economic interests in real property. Several states now impose realty transfer taxes on the sale or transfer of controlling interests in corporations, partnerships, or trusts that own real property.[4] These laws were adopted to prevent tax evasion by eliminating the possibility of structuring a transfer of realty as a sale of corporate stock, a partnership interest or a trust interest.[5] While the law is successful in reducing opportunities for taxpayers to otherwise avoid the tax through such transactions,[6] these laws have

---

* Eric J. Greenberg, J.D., Brooklyn Law School, 2015; B.S. in Accounting and minor in Economics, cum laude, Quinnipiac University, 2009; is a Manager at Ernst & Young, LLP in the Transaction Advisory Services – Transaction Tax Group. I would like to thank Professor Bradley T. Borden of Brooklyn Law School for his tireless commitment, support and insight.

[1] *See The US Real Estate Market is Edging Closer to Full Recovery*, NUWIRE INV'R (Dec. 15, 2014), http://www.nuwireinvestor.com/the-us-real-estate-market-is-edging-closer-to-full/.

[2] *See* Cris K. O'Neall, T*ransfer Taxes are Now a Costly Consideration in Real Estate Transactions*, NAT'L REAL ESTATE INV'R (Dec. 8, 2015), http://www.nreionline.com/viewpoints/transfer-taxes-are-now-costly-consideration-real-estate-transactions.

[3] *See, e.g.*, N.Y. TAX LAW § 1402(b)(3) (McKinney 2018).

[4] *See, e.g.*, TAX § 1402(b)(2)(B).

[5] *See* 101 N.Y. JUR. 2D *Taxation and Assessment* § 2252.

[6] *See* DEP'T OF TAXATION AND FIN., PUBLICATION 576, TRANSFER OR ACQUISITION OF A

created an additional layer of rules, regulations and filings for which buyers and sellers of realty must be aware. As a result, many buyers and sellers who are uninformed or not properly represented in such transactions may very well subject themselves to significant unforeseen tax burdens.

This article will look to explore the current standing of the real estate transfer tax ("RETT") in New York and its potential negative effects on unsuspecting taxpayers. Part II of this article will provide the context of the current law in New York. Part III will present a hypothetical transaction and analyze how the holding in *In re Petitions of Chase Manhattan Corporation*[7] affects the outcome. Part III will also consider whether *Chase* was the proper application of the Step Transaction Doctrine as well as whether this holding creates a "Lock-In Effect" on future realty transfers. Finally, Part IV will offer a recommendation to try and minimize the potentially unforeseen tax burdens to taxpayers.

## II. BACKGROUND OF THE REAL ESTATE TRANSFER TAX IN NEW YORK

Initially, the New York RETT, effective August 1, 1968,[8] was substantially similar to the prior federal documentary stamp tax on realty transfers.[9] In 1989, it was extended to transfers of economic interests in real estate by L. 1989, c. 61.[10] Subsections A & B of this section discuss the current standing of the law and how it is applied to real estate transfers.

### *A. New York State Real Estate Transfer Tax ("RETT")*

#### 1. Determination of New York State Real Estate Transfer Tax

Under New York Tax Law §1402(a), a state real estate transfer tax is imposed "on each conveyance of real property or interest therein."[11] The New York State RETT is imposed at a 0.4 percent rate[12] on direct

CONTROLLING INTEREST IN AN ENTITY WITH AN INTEREST IN REAL PROPERTY 5 (2008).

[7] *In re* Petitions of Chase Manhattan Corporation, 2005 N.Y. Tax LEXIS 28 (N.Y. Div. Tax App. Feb. 4, 2005).

[8] *See* JOSEPH F. ZIMMERMAN, THE GOVERNMENT AND POLITICS OF NEW YORK STATE 259 (2d ed. 2008).

[9] *See id.*

[10] Budget—Fees, Taxes, Interest Rates, Investment of Statute Funds, 1989 N.Y. Sess. Law Serv. 61, § 179 (McKinney).

[11] N.Y. TAX LAW § 1402(a) (McKinney 2018).

[12] *See id.*; *New York State Governor Proposes Significant Changes to the New York State Real*

transfers of real estate, indirect transfers/acquisitions of either 50 percent or more of the total combined voting power of all classes of stock of a corporation which has an interest in New York real property,[13] or 50 percent or more of the capital, profits, or beneficial interests in such voting stock of such corporation.[14] In the case of a partnership, association, trust or other entity, New York imposes the same tax on transfers of 50 percent or more of the capital, profits or beneficial interests in such entities.[15] New York State may aggregate multiple transfers if the parties are acting in concert or if they occur within a three year period.[16]

2. Beneficial Ownership Defined

N.Y. Tax Law §1402(a) states that a real estate transfer tax is imposed "on each conveyance of real property or interest therein when the consideration exceeds five hundred dollars."[17] However, Tax Law §1405(b)(6) provides an exemption from the real property transfer tax when the conveyance "effectuate[s] a mere change of identity or form of ownership or organization where there is no change in beneficial ownership."[18] The statutory language is more akin to exclusion than exemption, but the "mere change in beneficial ownership" provision has been contradictorily interpreted by courts and the New York Department of Taxation and Finance as alternatively providing an exclusion and an exemption.[19] The bigger issue, and one that continues to plague taxpayers, is the fact that the term "beneficial ownership" is not defined in the N.Y. Tax Law.[20] This has left a feeling of uncertainty among taxpayers and a gaping

---

*Estate Transfer Tax Rules*, TAX NEWS UPDATE (Feb. 9, 2017), https://taxnews.ey.com/news/2017-0287-new-york-state-governor-proposes-significant-changes-to-the-new-york-state-real-estate-transfer-tax-rules?uAlertID=bm8wSaE%2FOYQRGfQiiIvsUg%3D%3D.

[13] *See* TAX § 1401(b).

[14] *See id.* The RETT is due no later than the fifteenth day after the delivery of the instrument affecting the conveyance by the grantor to the grantee. *See* TAX § 1410(a). The date of the instrument affecting the conveyance is presumed to be the date of delivery of such instrument. *Id.* The grantor is responsible for paying the RETT. TAX § 1404(a).

[15] *See* TAX § 1401(b).

[16] *See* N.Y. COMP. CODES R. & REGS. tit. 20 §575.6(d) (2018).

[17] TAX § 1402(a).

[18] TAX § 1405(b)(6).

[19] *See, e.g.*, *In re* Yonkers and Hempstead Realty, LLC, DTA No. 819336, 2004 WL 1091022, at *2 (N.Y. Div. Tax App. May 6, 2004); *In re* Viacom, Inc., DTA No. 819591, 2005 WL 1304457, at *4 (N.Y. Div. Tax App. May 26, 2005); N.Y. Dep't Tax & Fin. Adv. Op. TSB-A-97(9)R, (2)M (Dec. 19, 1997).

[20] *See* CBS Corp. v. Tax Appeals Tribunal of New York, 867 N.Y.S.2d 270, 273 (App. Div. 2008) (citations omitted).

hole for the courts to fill.

In *CBS Corp. v. Tax Appeals Tribunal of New York*, the New York Tax Appeals Tribunal ("Tribunal") held that the RETT exemption did not apply to the May 2000 merger of CBS Corporation ("CBS") and Viacom, Inc. ("Viacom").[21] At the time of the merger, CBS owned real estate valued at over $200 million.[22] The returns filed in conjunction with the merger claimed an exemption under Tax Law §1405(b)(6) aggregating 70.44 percent, consisting of a 15.56 percent exemption based upon the fact that CBS shareholders had also held Viacom stock before the merger, and a 54.88 percent exemption based on the fact that the holders of CBS voting common stock received nonvoting common stock in Viacom as a result of the merger.[23] During an Article 78 appeal of the Tribunal's holding, the court did not agree with the petitioner's interpretation of the "change-in-form" exemption "asserting that the exemption applies when a transferor retains an ongoing economic interest in the transferred real property, without regard to voting power, dominion and control."[24] The court instead agreed with the Tribunal's definition of "beneficial ownership," holding that in the context of §1405(b)(6), beneficial ownership could only be fully discerned by considering the phrase "in conjunction with the definitions of 'conveyance' and 'controlling interest,'" since the exemption provides that the tax shall not apply to conveyances to effectuate a mere change in beneficial ownership.[25] The court, noting that the definition of "controlling interest" refers only to voting stock, held that the surrender of 100 percent of the voting stock of CBS in return for 54.88 percent of nonvoting stock in Viacom resulted in a transfer of "controlling interest."[26] Accordingly, the court held that there had been a change in beneficial ownership rendering Viacom ineligible for a real estate tax exemption under §1405(b)6).[27] As a result, the real estate transfer tax was imposed on the FMV of the real estate that had a change in beneficial ownership, equal to 84.44 percent (with 15.56% being exempt §1405(b)(6)).[28]

---

[21] *See id.* at 272.

[22] *See id.*

[23] *See id.*

[24] *Id.*

[25] *See id.* (citations omitted).

[26] *See id.* at 273.

[27] *See id.*

[28] *See id.* at 272. The concept of prorating the tax based upon the percentage ownership change is not always the rule in many states. *See, e.g.*, CAL. REV. & TAX. CODE § 11925(a) (West 2000). In California, if you trip the 50 percent change in control of realty (even at fifty-one percent), transfer tax is assessed on 100 percent of the FMV of the underlying real estate. *See*

3. Acting in Concert

A transfer or acquisition of a controlling interest in a corporation that has an interest in real property occurs when "a person, or group of persons acting in concert, transfers or acquires a total of 50 percent or more of the voting stock in such corporation."[29] "Acting in concert" describes persons who "have a relationship such that one person influences or controls the actions of another."[30] As an example of this, "if a parent corporation and a wholly-owned subsidiary each sell or purchase a 25 percent interest in an entity, the two corporations [are treated as having] acted in concert to transfer or acquire a controlling interest (i.e., 50 percent) in the entity" because the parent is deemed to be able to influence or control the actions of the subsidiary.[31]

### *B. New York City Real Property Transfer Tax ("RPTT")*

1. Determination of New York City Real Property Transfer Tax

New York City RPTT is imposed at a 2.625 percent rate[32] on direct transfers of real property, indirect transfers/acquisitions of "[50 percent] or more of the total combined voting power of all classes of stock of [a] corporation" that has an interest in New York City real property, "or [50 percent] or more of the total [FMV] of all classes of stock of such corporation."[33] It should be emphasized that unlike New York State, New York City imposes transfer tax upon the transfer of either 50 percent or more of the vote or 50 percent or more of the value of a corporation that owns New York City real property.[34] "[I]n the case of a . . . partnership, association, trust or other entity,"

CAL. REV. & TAX. CODE § 64(c)(1) (West 2000).

[29] N.Y. COMP. CODES R. & REGS. tit. 20, § 575.6(a) (2018). Where there is no common control or ownership, acting in concert can be found based on four factors: 1) "[t]he transfers or acquisitions are closely related in time"; 2) "[t]here are few grantors or grantees"; 3) "[t]he contracts of sale contain mutual terms"; and 4) "[t]he grantors or grantees have entered into an agreement in addition to the sales contract binding themselves to a course of action with respect to the transfer or acquisition." *Id.* § 575.6(b)(2)(i–iv).

[30] *Id.* § 575.6(b)(1).

[31] *Id.*

[32] N.Y.C. ADMIN. CODE § 11-2102(b)(1)(B)(ii) (2018).

[33] ADMIN. CODE § 11-2101(8). Consideration "[i]n the case of the transfer of a controlling economic interest in real property includes . . . the amount paid for the stock in a corporation or the interest(s) in a . . . partnership [plus] a proportionate share of the amount of any mortgage on the real property." N.Y.C.R. tit. 19, § 23-02 (2018).

[34] SEAN KANOUSIS AND WAYNE BERKOWITZ, NAT'L LAW INST., TRANSFERS TAXES: WHO OWES WHAT AND HOW MUCH 7 (2011), http://nationallawinstitute.com/wp-content/uploads/2016/12/Transfer-Taxes-Who-Owes-What-And-How-Much-NLI.pdf.

the threshold is "50% or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity."[35] New York City may combine multiple transfers if they are related (i.e., if they are "made pursuant to a plan" or if they are made within a three year period).[36] Similar to New York State, New York City provides for a mere change of identity or form exception.[37]

2. Aggregation

"A transfer of a controlling economic interest made by one or several persons, or in one or several related transfers, is subject to the [RPTT]."[38] "Related transfers, includ[ing] transfers made pursuant to a plan to . . . acquire a controlling economic interest in real property," "are aggregated in determining whether a controlling economic interest has been transferred."[39] Generally, all "[t]ransfers made within a three year period are presumed to be related and are aggregated unless the grantor(s) or grantee(s) can rebut this presumption by proving that the transfers are unrelated."[40]

## III. THE "PROPOSED TRANSACTION" AND THE PROBLEM AT ISSUE

This article considers how a hypothetical transaction would be treated under the current standing of the law. The Proposed Transaction is detailed in Subsection A of Part III. Subsection B then considers how *Chase* applies to the proposed transaction. Subsection C considers whether the court's application of the law in *Chase* was an appropriate application of the Step Transaction Doctrine and the potential "Lock-In Effect" that the law creates.

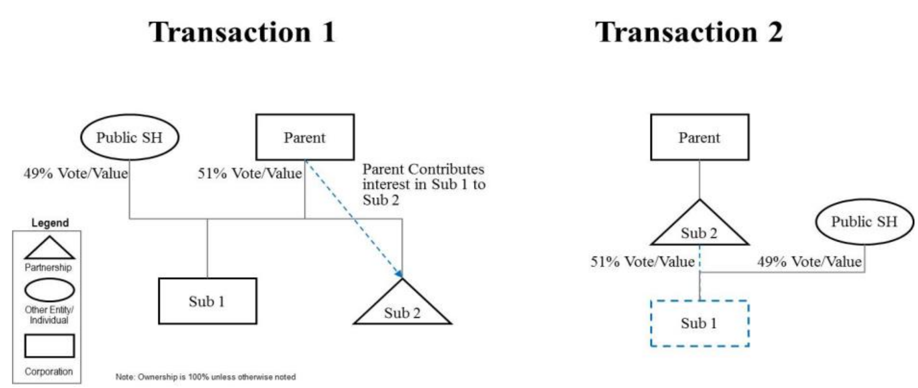
[35] ADMIN. CODE § 11-2102(b)(1)(C)(3); N.Y.C.R. § 23-02.
[36] *See* N.Y.C.R. § 23-02.
[37] *See* N.Y.C.R. § 23-05(b)(8).
[38] N.Y.C.R. § 23-02.
[39] *Id.* In the case of a tiered structure, where one entity owns an economic interest in another entity that owns an economic interest, the percentage of both interests must be considered to determine whether a controlling economic interest in real property has been transferred. KANOUSIS & BERKOWITZ, *supra* note 34, at 89–90.
[40] N.Y.C.R. § 23-02. Transfers made more than three years apart may nevertheless be aggregated if parties are acting in concert. *Id.* For example, if A and B each own one-third of a corporation's stock, and, acting in concert, time their transfers to occur four years apart, the transfers will be treated as related and will be aggregated. *Id.*

### *A. The "Proposed Transaction"*[41]

In the Proposed Transaction, Parent Corporation ("Parent") (a domestic corporation for U.S. federal income tax purposes) restructured its ownership in Subsidiary 1 ("Sub 1"), an entity which owns real property in New York City and New York State, so that such entity was held under a new subsidiary ("Sub 2") (a domestic partnership for U.S. federal income tax purposes in which all items of income, deduction, gain and loss flow through to its owners).

Prior to the Proposed Transaction, Parent directly owned 51% of the voting power and 51% of the value of Sub 1, and as a result of the Proposed Transaction, Parent continued to indirectly own Sub 1 in the same amounts, through Sub 2. Even though there was a transfer, there was ultimately no change in the beneficial ownership of the Sub 1 shares: both before and after the aforementioned transactions, Parent owned 51% of Sub 1 by vote, and 51% of Sub 1 by value, with Public Shareholders owning the remaining 49%.

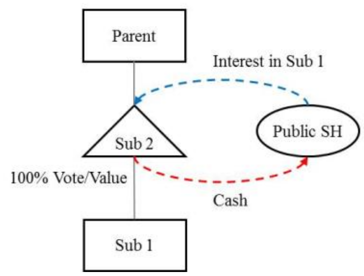
Shortly after the completion of transaction 2, Parent decided to take Sub 1 private by purchasing all outstanding shares from public shareholders due to a change in economic conditions surrounding Sub 1's share price. Sub 2, which is wholly-owned by Parent, then purchased all outstanding stock in Sub 1 held by public, unrelated shareholders.




[41] The Proposed Transaction includes three separate and distinct transactions. They are in no way meant to be interrelated or part of a plan and should be viewed as individual transactions.

In effect, Sub 2, and indirectly Parent, came to increase its ownership position of voting power and value from 51% of Sub 1 to 100% of Sub 1.

**Transaction 3**



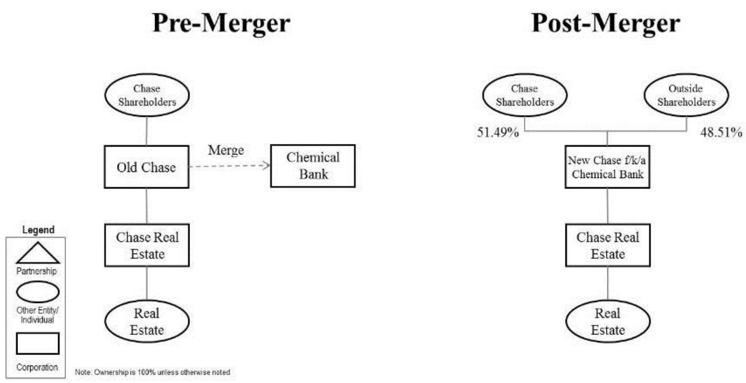

At the completion of the Proposed Transaction, we are left with two underlying questions. First, we must consider whether aggregation of transaction one through three is appropriate. Second, if aggregation is appropriate, is there any real estate transfer tax or real property transfer tax due? In order to answer these questions, we must first understand the holding in *Chase* and the effects it has on the Proposed Transaction.

1. The *Chase* Case

In *In re the Petitions of the Chase Manhattan Corporation*, Chase Manhattan Corporation ("Old Chase") merged into Chemical Bank Corporation ("Chemical") via a stock for stock statutory merger.[42] Both entities were Delaware corporations and had stock traded on the New York Stock Exchange.[43] "Old Chase's shareholders exchanged their . . . shares in Old Chase for [shares in Chemical]."[44]

[42] *In re* Petitions of Chase Manhattan Corporation, 2005 N.Y. Tax LEXIS 28, at *3 (N.Y. Div. Tax App. Feb. 4, 2005).
[43] *Id.*
[44] *Id.* at *5.

At the time of the merger, Old Chase operated as a holding company and wholly-owned subsidiaries, known collectively as Old Chase Real Estate, which held all of the interests in real property.[45] Following the merger, Chemical Bank adopted a new name: The Chase Manhattan Corporation ("New Chase").[46] As a result of the merger, Old Chase shareholders ended up owning 51.49 percent of New Chase in both voting power and value.[47]




The issue for the court to consider was whether the mere change exemption[48] is applied before or after the determination of whether there has been the transfer of a controlling economic interest.[49] As part of this issue, the court also considered, as a sub-issue, whether or not the mere change exemption applied to any portion of this transaction, and if so, which portion.[50] As a result of the merger, New Chase was owned, in part by Old Chase shareholders (making up 51.49 percent ownership).[51]

The court determined that in order for a mere change exemption to exist, the court first must determine whether there has been the transfer of a controlling interest.[52] Therefore, it only makes sense

[45] *Id.* at *5–6.
[46] *Id.* at *4.
[47] *See id.* at *38.
[48] N.Y.C. ADMIN. CODE § 11-2106(b)(8) (2018) ("The tax imposed by this chapter shall not apply to any of the following deeds, instruments or transactions: . . . . A deed, instrument or transaction conveying or transferring real property or an economic interest therein that effects a mere change of identity or form of ownership or organization to the extent the beneficial ownership of such real property or economic interest therein remains the same, other than a conveyance to a cooperative housing corporation of the land and building or buildings comprising the cooperative dwelling or dwellings.").
[49] *See Chase Manhattan Corp.*, 2005 N.Y. Tax LEXIS 28, at *38.
[50] *See id.* at *40–41.
[51] *See id.* at *40.
[52] *See id.* at *42.

that the mere change exemption is applied after the determination of whether there has been the transfer of a controlling economic interest.

N.Y.C. Admin. Code §11-2101(6) defines an "'[e]conomic interest in real property'" to include "[t]he ownership of shares of stock in a corporation which owns real property."[53] Code §11-2101(7) provides that the terms "'[t]ransfer' or 'transferred' . . . in relation to an economic interest in real property . . . shall include [one transfer or multiple related transfers] constitut[ing] a controlling interest in [the] corporation."[54] Code §11-2101(8) defines a "'[c]ontrolling interest'" to include "fifty percent or more of the total combined voting power" or value of a corporation.[55]

The court held that while 100% of Old Chase was transferred to Chemical and thereby constituted a controlling economic interest transfer, 51.49 percent of the transfer was covered under the mere change exemption.[56] Beneficial ownership of 51.49 percent of Old Chase did not change.[57] As such, only 48.51 percent of the transfer was counted taxable under RPTT and RETT.[58]

2. Applying the Chase Case to the Proposed Transaction

Under New York State law, all transactions that occur within a three year period will automatically be aggregated together and considered as one transaction.[59] Transactions more than three years apart will not be aggregated unless the transfers or acquisitions are considered to be "part of a plan to avoid the real estate transfer tax."[60] In New York City, transfers or acquisitions that occur in a three-year period are also aggregated.[61] That being said, New York City affords the taxpayer the opportunity to rebut the presumption that these transactions were related.[62] New York State provides no such relief.[63]

---

53 N.Y.C. ADMIN. CODE § 11-2101(6).
54 *Id.* § 11-2101(7).
55 *Id.* § 11-2101(8).
56 *See Chase Manhattan Corp.*, 2005 N.Y. Tax LEXIS 28, at *43.
57 *Id.* at *40.
58 *Id.* at *42.
59 N.Y. COMP. CODES R. & REGS. tit. 20, § 575.6(d) (2018).
60 *Id.*
61 N.Y.C.R. tit. 19, § 23-02 (2018).
62 *Id.*
63 COMP. CODES R. & REGS. § 575.6(d).

In *Chase*, there was only one transaction that occurred.[64] Therefore, the aggregation rules play no role in determining whether the New York City RPTT and the New York State RETT apply to the transaction. That being said, the decision should affect the analysis of the Proposed Transaction. In the Proposed Transaction, the aggregation rules have a profound effect on the overall taxability of the various transactions. First, in considering whether or not to aggregate transactions 1 through 3, a different result could occur for New York City and New York State. In New York State, the transactions are automatically aggregated if they occur within a three-year period.[65] In New York City, the transactions *may* not be aggregated as the City provides the taxpayer an opportunity to rebut the presumption that the transactions are related.[66] Consider for a moment that the City agrees that the transactions are not related. At that moment, New York City and New York State, faced with the same facts and circumstances, using rules that were written in contemplation of each other, would reach different results. New York State would impose a tax on 49% of the transfer because it would automatically aggregate the Proposed Transaction.[67] New York City would impose no tax because it would not aggregate the Proposed Transaction and would view the transactions as separate and distinct.[68] Considering further, we must question whether this automatic aggregation is truly in line with the judicially created Step Transaction Doctrine.[69]

Next, we must apply the holding in *Chase* to the Proposed Transaction. The court determined that in order for a mere change exemption to exist, a court first must determine whether there has been the transfer of a controlling interest.[70] Through the application of the aggregation rules, the Proposed Transaction would constitute a transfer of a controlling interest under both the New York State[71]

[64] *See In re* Chase Manhattan Corp., 2005 N.Y. Tax LEXIS 28, at *3 (N.Y. Div. Tax App. Feb. 4, 2005).

[65] COMP. CODES R. & REGS. § 575.6(d).

[66] N.Y.C.R. § 23-02.

[67] *See* COMP. CODES R. & REGS. § 575.6(a), (d).

[68] *See* N.Y.C.R. § 23-02.

[69] For further analysis, *see infra* Part III.C.2.

[70] *See In re* Chase Manhattan Corp., 2005 N.Y. Tax LEXIS 28, *39–42 (N.Y. Div. Tax App., Feb. 4, 2005) (citations omitted).

[71] *See* COMP. CODES R. & REGS. § 575.6(a) ("Controlling Interest. In the case of a corporation which has an interest in real property, the transfer or acquisition of a controlling interest in the corporation, as defined in section 575.1(b) of this Part, occurs when a person, or group of persons acting in concert, transfers or acquires a total of 50 percent or more of the voting stock

and New York City[72] rules.[73] As a result, the courts, when contemplating the Proposed Transaction, will first consider and ultimately determine that a 100% controlling interest transfer occurred (51 percent transfer in transactions 1 and 2, 49 percent transfer in transaction 3). Next the court will apply the mere change exemptions for both New York State[74] and New York City[75] to the Proposed Transaction. Because transactions 1 and 2 should qualify for a mere change exemption, the court would likely find that 51 percent of the transfer (transactions 1 and 2) is exempt from the RETT and the RPTT whereas 49 percent (transaction 3) will be subject to both of the aforementioned taxes. If there was no controlling interest transfer in the Proposed Transaction, then there would be no tax assessed on transaction 3.

### *B. Is This Result Consistent with the Law and What Effect Will It Have on Future Transactions?*

This subsection of the Article will explore the potential negative effects that the current application of the law, coupled with complying with the court's holding in *Chase*, will have on future controlling interest transfers. Subsection 1 will discuss what this article terms as the "99 and 1" effect. Subsection 2 will explore the judicially created "Step Transaction Doctrine" and how the current law deviates from the sound and established legal principles of the Step Transaction Doctrine. Subsection 3 will discuss what has become known as the "Lock-In Effect," focusing on how transfer taxes

in such corporation. In the case of a partnership, association, trust or other entity having an interest in real property, the transfer or acquisition occurs when a person, or group of persons acting in concert, transfers or acquires a total of 50 percent or more of the capital, profits or beneficial interest in such entity.").

[72] *See* N.Y.C. ADMIN. CODE § 11-2101(8) (2018) ("'Controlling interest.' 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 total fair market value of all classes of stock of such corporation; and, 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.").

[73] Absent the taxpayer successfully rebutting the presumption of relatedness under N.Y.C.R. § 23-02.

[74] N.Y. TAX LAW § 1405(b)(6) (McKinney 2018) ("The tax shall not apply to the following conveyances: . . . Conveyances to effectuate a mere change of identity or form of ownership or organization where there is no change in beneficial ownership, other than conveyances to a cooperative housing corporation of the real property comprising the cooperative dwelling or dwellings.").

[75] *See* ADMIN. CODE § 11-2106(b)(8).

lead to this effect and the issues it causes when considering future transactions.

1. The "99 and 1" Argument

"Equity is an important aspect of tax policy and the analysis of tax law,"[76] and it plays a significant role in the "99 and 1" argument made in this subsection. "Tax policy divides equity into two subcategories: horizontal equity and vertical equity."[77] Horizontal equity suggests that equals should be treated equally.[78] Vertical equity "call[s] for an appropriate differentiation among unequals."[79] This Article discusses both horizontal equity and vertical equity. For purposes of the "99 and 1" argument, horizontal equity is one of the main focuses. A discussion of vertical equity appears in Part IV Subsection A of this Article.

If the holding in *Chase* was taken to its logical conclusion, it would result in very inequitable outcomes. Consider, for a moment, what this paper defines as the "99 and 1" effect. As the statutes and case law currently stand, the internal transfer of 99 percent of the interests in an entity would be exempt as a mere change, but the acquisition of the remaining 1 percent of such entity from an unrelated seller would be taxable.[80] One might ask, is this truly the intent of the statute, to tax 1 percent of a transfer? It seems that while the result of *Viacom* is logical, the same cannot be said for *Chase*. In *Viacom*, the court applied the real property transfer tax and real estate transfer tax to the transaction in question because the transaction resulted in a significant change in voting power.[81] By exchanging their CBS Corp. voting stock for non-voting Viacom stock, those former CBS shareholders lost voting power, and in effect effectuated a change in identity.[82] Unlike in *Viacom*, the Old Chase

[76] Bradley T. Borden, *The Like-Kind Exchange Equity Conundrum*, 60 FLA. L. REV. 643, 659 (2008); *see* HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 30 (1938) ("[W]e may say that tax burdens should bear similarly upon persons whom we regard as in substantially similar circumstances, and differently where circumstances differ.").

[77] Borden, *supra* note 76, at 659.

[78] Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113, 113 (1990) ("Horizontal equity requir[es] equal treatment of equals.").

[79] *Id.*

[80] *See* N.Y. TAX LAW § 1405(b)(6) (McKinney 2018); N.Y.C. ADMIN. CODE §11-2106(b)(8) (2018).

[81] *See* CBS Corp. v. Tax Appeals Tribunal of N.Y., 867 N.Y.S.2d 270, 273 (App. Div. 2008).

[82] *See id.* (citation omitted).

shareholders did not surrender voting power or value.[83] Yet, the court still considers this transfer a change in identity, even though the transfer is clearly under the 50 percent threshold established by the statute.[84] If the ownership of stock in *Chase* were 99 percent old shareholders and 1 percent new shareholders, one might consider that the court potentially could have come to a different, and seemingly more equitable, holding. Hence, when replacing the ownership percentages in *Chase* with 99 percent and 1 percent, the "99 and 1" effect shows that the holding is abundantly inequitable because it does not capture the inherent purpose of establishing a controlling interest transfer tax.

Viewed from another perspective, *Chase* involved Chase Manhattan Corp. ("Chase Manhattan") merging into Chemical Bank.[85] But what if Chase Manhattan had instead sold 49 percent of its stock and used the proceeds to purchase Chemical Bank? In that transaction, New York State and City would not tax Chase Manhattan on the FMV of its real estate, because it would meet the exception under §1405(b)(6) and RCNY §23-05(b)(8) that exempts from tax any transaction that is a mere change of identity.[86] The controlling interest in Chase's Real Estate would not change as the Chase Manhattan shareholders that controlled the corporation continue to do so after the transaction.[87] The question remains as to how the substance of either transaction is different. When Chase Manhattan merged into Chemical Bank, it was subject to the RPTT and RETT, but, if Chase Manhattan had sold 49 percent of its outstanding shares and used the proceeds to purchase Chemical Bank, Chase Manhattan would not be subject to the RPTT or the RETT.[88] The beneficial ownership of Chase Manhattan is the same in both the before and after pictures of each scenario, yet one is taxable and the other is not. Horizontal equity requires that "similar persons should be treated similarly."[89] Yet, the holding in *Chase* does the complete opposite. One transaction, under the theories and

[83] *See In re* Chase Manhattan Corp., 2005 N.Y. Tax LEXIS 28, at *38 (N.Y. Div. Tax App. Feb. 4, 2005).

[84] *See id.* at *42.

[85] *Id.* at *3.

[86] *Id.* at *40, *41; *see* N.Y. TAX LAW § 1405(b)(6); N.Y.C.R. tit. 19, § 23-05(b)(8) (2018).

[87] *See Chase Manhattan Corp.*, 2005 N.Y. TAX LEXIS 28, at *38.

[88] *See id.* at *39–45.

[89] A.C. PIGOU, A STUDY IN PUBLIC FINANCE 5 (3d rev. ed. 1962) (emphasis omitted); *accord* HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE 367 (8th ed. 2008) ("People in equal positions should be treated equally.").

analysis relied on in *Chase*, results in the imposition of tax, whereas the seemingly same result is treated differently, and results in no such imposition. The difference in such similar scenarios creates an excess burden on taxpayers and is highly inequitable.

### 2. The Step Transaction Doctrine

The aggregation rules in New York State and New York City were created in order to prevent tax evasion.[90] The purpose of these rules and their application closely resemble the judicial doctrine known as the Step Transaction Doctrine.[91] The Step Transaction Doctrine was established via case law, and it states that

> interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus "linking together all interdependent steps with legal or business significance, rather than taking them in isolation," federal tax liability may be based "on a realistic view of the entire transaction."[92]

There are three tests for applying the Step Transaction Doctrine: (1) a "binding commitment"; (2) a "mutual interdependence" of steps; or (3) the intent of particular result.[93] The "binding commitment" test was established in *Commissioner v. Gordon*.[94] Under the binding commitment test, the courts will combine a series of separate steps or transactions if the parties had a formal obligation to complete each step.[95] The "mutual interdependence" test will combine a series of individual events if legal relationships created by the first transaction would be meaningless without completion of the subsequent transactions.[96] Finally, the "end result" test looks to the relationship between a series of steps and the taxpayer's overall intended purpose.[97]

---

[90] *See* 101 N.Y. JUR. 2D *Taxation and Assessment* § 2252.

[91] Comm'r v. Clark, 489 U.S. 726, 738 (1989) (citations omitted).

[92] *See id.* (citation omitted).

[93] Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 403 (1988).

[94] Comm'r v. Gordon, 391 U.S. 83 (1968).

[95] *See id.* at 96.

[96] To see the how the mutual interdependence test is applied, *see, e.g.*, Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1246 (5th Cir. 1983).

[97] For an example of the application of the "end results" test, *see, e.g.*, Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 192 (D. Conn. 2004); *aff'd sub nom.* Long-Term Capital Holdings, LP v. United States, 150 F. App'x 40 (2d Cir. 2005).

When New York State and New York City adopted their rules for aggregation relating to real estate transfers,[98] they went beyond the intended application of the Step Transaction Doctrine, eliminating any need or opportunity for the courts to weigh the facts and circumstances of the transactions and the subsequent results. Instead, the legislature threw these time tested legal theories to the way side, opting to create a hard and fast rule. The way the statutes are written and interpreted results in courts looking solely at the form of transactions, thereby abandoning the true application of the Step Transaction Doctrine, which traditionally requires courts to consider the substance of said transactions.[99] When drafting the New York State RETT, the ideology supporting the application of the Step Transaction Doctrine was completely disregarded, leaving in its wake an unfair and highly inequitable result for taxpayers. The Step Transaction Doctrine was a time-tested application of legal principles, and New York State disposed of it, replacing it with a form over substance analysis. The result is astronomical. No longer will taxpayers have the opportunity to show that a series of transactions are not interrelated.[100] Instead, any and all transactions effectuated by a taxpayer considered to be "acting in concert" that occur within a three year period, no matter how unrelated they may be, will be aggregated for purposes of imposing the real estate transfer tax.[101] Consider for a moment the Proposed Transaction described in Part II Section A of this article. Under the Step Transaction Doctrine, it can be argued that, when applying the three tests of the Step Transaction Doctrine, the courts would agree that the transactions were not interrelated, and thereby not impose the RETT. Under NYCRR §575.6(d), these transactions are automatically aggregated, no matter the circumstance surrounding the transactions.[102] So, in reality, what is the end result of New York State disregarding the sound legal theory of substance over form established by the Step Transaction Doctrine? For large corporations that can afford to pay counsel substantial fees to avoid the intricacies and black holes of the

[98] *See, e.g.*, N.Y. COMP. CODES R. & REGS. tit.20, § 575.6 (2018);

[99] *See Long Term Capital Holdings*, 330 F. Supp. 2d. at 191 (quoting Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1521 (10th Cir. 1991)).

[100] *Compare* N.Y.C.R. tit. 19, § 23-02 (2018) (allowing taxpayers to rebut the presumption that controlling economic interest transfers made within a three-year period are not related) *with* COMP. CODES R. & REGS. § 575.6(d) (aggregating controlling economic interest transfers made within a three-period automatically).

[101] *See* COMP. CODES R. & REGS. § 575.6(d).

[102] *See id.*

tax code, nothing. But for the small businesses and the average homeowner, the implications are potentially dire. Unaware of these complicated and hardline rules, the average taxpayer is substantially more likely to be subject to the RETT and the RPTT, with absolutely no regard or potential recourse provided for those effectuating a number of basic transactions within a three-year period.[103] The Step Transaction Doctrine, which requires an intensive facts and circumstances inquiry,[104] at least provides for a potential recourse whereas the aggregation rules applied in New York State provide no opportunity for any recourse, leaving those unsophisticated taxpayers unaware and substantially disadvantaged.

3. The "Lock-In Effect"

Another reason to reconsider the current standing of the RETT and the RPTT is the "Lock-In Effect" created by the imposition of these taxes.[105] The "Lock-In Effect" is a legal principle first discussed in *Burnet v. Harmel*.[106] In *Burnet*, the Court considered whether the taxpayer owed tax computed at the favorable capital gains rate or at the higher ordinary income rate.[107] Holding for the taxpayer, the court explained:

> The provisions of the 1921 [R]evenue [A]ct for taxing capital gains at a lower rate, reenacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.[108]

The excessive tax burden the court was referring to is what is commonly known as the "Lock-In Effect." The "Lock-In Effect" occurs when investors are locked into profitable investments because of the possibly harsh reality that gain is taxed when a realization event occurs.[109]

---

[103] *See* FISCAL POLICY INST., NEW YORK CITY TAXES—TRENDS, IMPACT AND PRIORITIES FOR REFORM 1 (2015), http://fiscalpolicy.org/wp-content/uploads/2015/01/NYC-Tax-Report-Jan-13-2015.pdf.

[104] *A Comprehensive Guide to Section 355(e) of the Internal Revenue Code*, *in* 55 USC LAW SCHOOL INSTITUTES ON MAJOR TAX PLANNING ¶ 102.2(C) (2003).

[105] *See* Joseph Dodge, *A Deemed Realization Approach Is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 442 (2001).

[106] Burnet v. Harmel, 287 U.S. 103 (1932).

[107] *See id*. at 106.

[108] *Id*.

[109] These tax considerations can be illustrated. *See* STAFF OF JOINT ECONOMIC COMM., 88TH

Applying this theory to transfer taxes is an easy transition or extension of the principle. Transfer taxes are similar to capital gains taxes in that tax liability is generally triggered by a transaction,[110] and will arguably induce asset owners to hold on to assets that they otherwise would dispose of. The key difference between the two taxes is that transfer tax liability does not depend on the appreciation of the asset since acquisition.[111] Rather, transfer taxes are generally imposed on the total consideration received for the property and/or the property's FMV at the time of transfer.[112] In the case of controlling interest transfers, the RETT and RPTT are generally computed based on the FMV 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.[113] While legislatures and courts would find it hard to disagree that a higher tax rate applied to the sale of appreciated property will have an adverse effect on the disposition of appreciated property, applying this same logic to an assessment of tax not on a sale, but rather a transfer in interest, imposed on the total consideration received without taking into account any gain or loss realized on the property constitutes a sever adverse effect on the taxpayer.

The "Lock-In Effect" is one of the strongest arguments against taxing capital gains at the same rates as ordinary income.[114] By increasing the capital gains rate, proceeds from the realization of appreciated property will decrease.[115] This creates a conundrum for

CONG., THE FEDERAL TAX SYSTEM: FACTS AND PROBLEMS 77–78 (Comm. Print 1964) ("An investor [owns] 100 shares of corporation X bought at $50 and now selling at $80 per share. Assume that the X stock is now yielding 6 percent on the basis of its current price and the taxpayer is considering a shift to another stock yielding 7 percent on the basis of its current price. At the tax rate of 25 percent, the net proceeds after the tax from the sale of the X stock would be $7,250 ($8,000 minus 25 percent of $3,000) which, if invested in the new stock, would yield more than the yield in the securities sold ($507.50 compared with $480). The switch would therefore be justified. It would also be justified if the taxpayer expected his present holdings to remain at their present price while the new stock was expected to rise in price by 10.3 percent or more. Similarly, sale of the present holdings would be justified if the price was expected to decline by $7.50 or more per share (from $80 to $72.50 or less).").

[110] *Compare* N.Y. TAX LAW § 1402(a) (McKinney 2018) (stating that RETT applies when the conveyance is $500 or more) *and* N.Y.C. ADMIN. CODE § 11-2102(a) (2018) (stating that RPTT applies when the considered exceeds $25,000) *with* 26 U.S.C. § 1(h) (2016) (stating that the capital gains tax applies to taxpayers when there is a net capital gain).

[111] *See, e.g.*, ADMIN. CODE § 11-2102(a).

[112] *See, e.g.*, *id.*

[113] *See* TAX § 1402(b)(1); ADMIN. CODE § 11-2101(8).

[114] *See* Daniel N. Shaviro, *Uneasiness and Capital Gains*, 48 TAX L. REV. 393, 395, 396 (1993).

[115] *See* Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 5 (1992).

the taxpayer. It essentially requires that a taxpayer consider whether an alternative investment the taxpayer is contemplating has an expected return that will not only bring back an acceptable return, but also provide sufficient return to cover the cost of the disposition.[116] If the alternative investment does not provide such a return, the taxpayer, who normally would have disposed of the asset but for the tax, will be locked into their current investment.[117] The same can be said for the imposition of a RETT. It is easy to conjure up a number of situations in which a taxpayer wishes to dispose of a property but does not do so due to the transfer tax.[118] What makes a RETT even more burdensome is how it is calculated. With regard to a capital gains tax, the lock-in effect will only be considered by a taxpayer in a gain realization situation.[119] Transfer tax, on the other hand, does not consider the taxpayer's current gain or loss position in the property;[120] it is an equal opportunity burden. Thus, the "Lock-In Effect" of a transfer tax is that much more severe. As such, applying the RPTT and RETT to transactions, such as the one described in *Chase* or the Proposed Transaction, exacerbates the "Lock-In Effect" because it imposes tax on transactions that are substantively unrelated and should therefore not be subject to tax based on the current exemptions provided by the law.

## IV. THE RECOMMENDED SOLUTION

This article has focused on the current state of the real estate transfer tax in New York and the real property transfer tax in New York City. Part III Subsection C specifically focused on how the current law is not in tune with the long-established Step Transaction Doctrine and how the current application of the law creates a significant "Lock-In Effect" for current property holders. In Part IV, this article will focus on two recommended solutions which will specifically address the deviation from long standing law and will look to minimize the "Lock-In Effect."

[116] *See id.*
[117] *See id.*
[118] *See, e.g.*, Dodge, *supra* note 105, at 442.
[119] *See* Shaviro, *supra* note 115, at 5.
[120] *See* N.Y. TAX LAW § 1402(a) (McKinney 2018).

### *A. Hybrid Solution That Includes Application of the Step Transaction Doctrine*

New York Tax Law § 1400[121] and all related sections show no regard for the judicially created and widely accepted Step Transaction Doctrine. The Step Transaction Doctrine allows for the courts to consider the substance of a transaction over the mere form of the transaction.[122] The general principle that taxation should give effect to a transaction's economic substance, rather than its mere form, underlies much of tax law.[123] The presence of substance over form as a factor relevant to tax decisions dates back as far as the beginning of United States Federal income taxation in 1913.[124] By 1921, the Supreme Court expressly "recognize[d] the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder."[125] Yet, New York has decisively ignored these long standing and accepted principles, instead imposing what this article considers a rudimentary form of taxation. By throwing these long-standing principles by the wayside, New York and all other states that employ a similar transfer tax are effectively disregarding one of the oldest and most recognized principles when imposing taxation.

But, alas, these states can recognize their deviation from these thoroughly developed principles by adapting the first solution this article recommends. Instead of simply focusing solely on the simplicity of administering the current statute, New York should look to impose a tiered analysis when considering particular transactions. Instead of applying the current standard of unquestioned aggregation, New York should make all transactions or transfers involving property below a certain FMV completely exempt.[126] By

---

[121] *Id.* § 1400.

[122] *See* Estate of Weinert v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961).

[123] *See id.* ("The principle of looking through form to substance . . . is the cornerstone of sound taxation.").

[124] *See, e.g.*, S. Pac. Co. v. Lowe, 247 U.S. 330, 337 (1918) ("[I]t was the purpose and intent of Congress, while taxing 'the entire net income arising or accruing from all sources' during each year commencing with the first day of March, 1913, to refrain from taxing that which, in mere [form] only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before.").

[125] United States v. Phellis, 257 U.S. 156, 168 (1921).

[126] N.Y. TAX LAW § 1402(a) currently provides an exemption for transactions or transfers in which consideration is less than or equal to $500. N.Y.C. ADMIN. CODE §11-2102(a) provides an exemption for transactions or transfers in which consideration is less than or equal to

exempting certain lower valued transactions, New York can provide a reasonable safeguard that the unsophisticated taxpayer engaging in these transactions will most likely not be subject to transfer tax. The adoption of this suggestion would result in acknowledgement of the traditional concept of vertical equity which "call[s] for an appropriate differentiation among unequals."[127] Stated another way, "vertical equity requires that unalikes be treated unalike in proportion to their unalikeness."[128] By differentiating between sophisticated and unsophisticated taxpayers, the recommended solution achieves the tax policy goal of vertical equity.

For transactions or transfers above this FMV threshold, New York should craft aggregation rules that mirror the principles set forth in the Step Transaction Doctrine. By adopting this hybrid solution, New York will once again employ taxation that is true to form while providing a level of simplicity to unsophisticated taxpayers. This recommended hybrid solution also creates a remedy for sophisticated taxpayers in the form of a facts and circumstance inquiry into the substance of the transactions being aggregated.

### *B. Replace the Real Estate Transfer Tax with a Real Property Gains Tax*

The "Lock-in Effect" of the real estate transfer tax is exacerbated by the fact that transfer taxes are generally imposed on the total consideration received for the property at the time of transfer or the FMV of the real estate in a change in identity transfer.[129] The tax, in its current state, does not consider the taxpayer's current gain or loss position in the property.[130] As a result, the economic burden imposed on the taxpayer is considerably more severe. Instead of taxing all transfers regardless of the economic position of the taxpayer and the property, New York, and all states employing a similar transfer tax should look to enact or re-enact a real property capital gains tax instead of a transfer tax. New York previously had a Real Estate

$25,000. These exemptions are far too low. A reasonable exemption for transactions in New York State, and especially New York City, would be $500,000 based on the current average fair market value of properties in the New York Metropolitan area.

[127] Musgrave, *supra* note 78, at 113.

[128] Borden, *supra* note 76, at 659.

[129] *See* TAX § 1402(a).

[130] *See id.*

Capital Gains tax[131] which was repealed in 1996.[132] Simply stated, New York State repealed the wrong law. The fact remains that the "Lock-In Effect" can never truly be cured unless no tax existed on transfers or dispositions of capital assets, but it can be minimized by taxing transactions that only have gain. New York, not at all considering the "Lock-in Effect" or its potentially harmful results, made the decision to retain the tax that creates substantially more of a "Lock-In Effect." As a result, taxpayers are not only taxed on realization events, but rather, they are taxed any time real property changes hands, both physically and theoretically.[133]

## V. CONCLUSION

The real estate transfer taxes imposed by New York State and New York City are complex and transfers could trigger unintended consequences if not carefully analyzed and considered. Moreover, the application of transfer taxes at both the state and local level might very well be different, potentially resulting in taxation at the state level but not the city level and vice versa and almost certainly creating even more confusion. The current standing of the law creates an undue burden on unsophisticated taxpayers, forcing them to further rely on the advice of professionals for seemingly simple transactions, while at the same time provides no remedy for sophisticated taxpayers by disregarding the time tested legal principles of the Step Transaction Doctrine. Fueled by the belief that a mere change in a controlling interest should equate to no change for tax purposes, this article aimed to point out the shortcomings of the current law, and provides a recommended solution that will help to minimize the burden placed on taxpayers.

---

[131] *See* N.Y. TAX LAW § 1441 (repealed 1996).

[132] N.Y. DEP'T OF TAXATION AND FINANCE, TSB-M-96 (3.1)-R, REPEAL OF THE REAL PROPERTY TRANSFER GAINS TAX (ARTICLE 31-B OF THE TAX LAW) (1996).

[133] *See* TAX § 1402(a); N.Y.C ADMIN. CODE § 11-2102(a) (2018).