REPORT # 617

TAX SECTION

New York State Bar Association

Table of Contents

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New York State Bar Association

June 21, 1989

BY HAND

The Honorable Edward I. Koch
Mayor, City of New York
City Hall
New York, NY 10007

Re: 1990 Executive Budget
Revenue Proposals

Dear Mayor Koch:

On behalf of the Tax Section of the New York State Bar Association, I am writing to express some of our members' general comments on certain revenue proposals included in the New York City 1990 Executive Budget.

1. The entire area of corporate mergers and acquisitions and the growth of corporate debt currently is the subject of considerable discussion and debate. The United States Congress is deeply involved in an analysis of this issue, and has been considering numerous legislative alternatives. This debate presents broad social policy questions involving matters of domestic fiscal policy, corporate management and employment, potential effects on the stock market and on foreign investment in the U.S., and uncertain budgetary consequences. Many of these questions go beyond our expertise as tax practioners.

We are, however, concerned about the technical deficiencies in the proposed legislation. As we stated in our April 14 letter to The Honorable Edward I. Koch -2- June 21, 1989

Governor Cuomo and described in detail in the en-closed Report, the State's legislation was enacted in haste and is replete with major technical problems. The city's bill is not significantly different from the State legislation, and suffers from the same problems.

Given the importance and complexity of this subject, and its particular significance to New York City's economy, we strongly believe that it would be unwise for New York City to rush into legislation that compounds the mistakes made by the State. Instead, we recommend that the City wait for this difficult area to be addressed at a nationwide level.

2. The Executive Budget states that the increase in transfer tax rates was more fair than a property tax increase "because [the transfer tax] is paid . . . when a taxpayer sells real property and has income available from the sale." Currently, however, the transfer tax applies not only to income-producing sales, but also to simple restructuring transactions where property owners change the form of their ownership without changing their beneficial interest in the property. For example, if tenants-in-common contribute their property pro rata to a new partnership, the City imposes transfer tax, even though the property owners have not parted with their beneficial interests in the property and have not earned any real income or "consideration" from the transfer.

It is unreasonable for the City to take 2% of the gross fair market value of real property every time property owners change their ownership structure. The proposed 0.625 percentage point increase in the transfer tax rate will make this unfair and overly intrusive tax even worse.

We know that in the past the taxation of restructuring transactions may have served as a "rough justice" method of preventing Pan Am-type abuses. With the enactment of the anti-Pan Am legislation in 1986, however, the City extended the transfer tax to sales of controlling interests in corporations, partnerships and other entities, and closed this loophole. Accordingly, there is no longer any need or justification for taxing change-in-form transactions. The Honorable Edward I. Koch -2- June 21, 1989.

The Tax Section has repeatedly urged the City to adopt regulations exempting change-in-form transactions. We believe that members of the City administration have sympathy for our position, but have felt constrained by the language of the statute; unlike the more recent State 10% gains tax and State real estate transfer tax, the City transfer tax law and enabling legislation contain no specific exemption for change-in-form transactions. It therefore appeared that legislation was necessary to provide such an exemption. The City's current proposal to increase the transfer tax rate now provides the opportunity to enact this legislation, and balance the substantial rate increases with a more equitable transfer tax law.

We believe that no change in the transfer tax rate should be enacted unless the legislation also includes an exemption for transactions that constitute a change in form with no change in beneficial interest. Appended to this letter is a legislative proposal for a city transfer tax ex-emption modeled on the State gains tax and transfer tax.

3. Some of the proposed amendments to the mortgage recording tax appear reasonable -- specifically the taxation of assignments of rents,[1] and the taxation of mortgages that are

[1] The bill should clarify, however, that if an assignment of rents is given in connection with a recorded mortgage, no second mortgage recording tax is imposed on the assignment.

spread into New York City from other jurisdictions. However, the proposed treatment of consolidated and wraparound mortgages is unwarranted.

For example, consider a property owner who borrows $100, paying the mortgage recording tax on the $100 debt. A few years later the property owner borrows an additional $20. If he simply gives his lender a second mortgage he will pay tax on the $20 new debt, but no additional tax will be imposed on the old $100 debt. However, if the second lender buys the $100 loan from the first lender and consolidates the two mortgages, the bill provides that the borrower will have to pay a second tax on the $100 debt. The borrower has borrowed only $120, but the tax would be imposed on $220 merely because the two mortgages are consolidated. The Honorable Edward I. Koch -2- June 21, 1989.

Similarly, the treatment of wraparound mortgages is overly formalistic. A wraparound mortgage is essentially a conduit arrangement. In the refinancing context, for example, the property owner would borrow an additional $20, but instead of signing a $20 note to his second lender, he would agree to pay the second lender $120, and the second lender in turn would agree to pay off the underlying $100 debt. Again, the aggregate amount of the property owner's borrowing is only $12 0; the wraparound note simply alters the manner in which the $100 debt is repaid.

The proposed legislation places a premium on the form of refinancing transactions. The proposal appears to be neither a revenue raiser nor a loophole closer; it simply presents traps for borrowers who are either uninformed as to the technicalities of the law, or not in a position to bargain with their lenders for the better form. We therefore recommend that the proposed legislation regarding consolidated and wraparound mortgages be withdrawn.

4. The effective date of the legislation imposing transfer and mortgage recording tax on co-ops is not clear from the bill. Presumably these changes are intended to take effect July 1, 1989, but that should be clarified.

5. As drafted, the definition of "real property" proposed to be added to the mortgage recording tax is overly broad. One could read this provision to include all stock and partnership interests, particularly since the meaning of "cooperative ownership" is so vague, and the disjunctive phrase "or either of them" permits the reading that shares of stock, standing alone, are real property.

We understand that the purpose of this bill was to extend the mortgage recording tax to co-op apartments, and therefore we do not believe this broad interpretation is intended. We therefore recommend that the definition be clarified to refer instead to "shares of stock in a cooperative housing corporation and the proprietary leasehold interest appurtenant thereto, and other interests in partnerships, associations, trusts or other entities to which similar proprietary leasehold interests are appurtenant." The Honorable Edward I. Koch -2- June 21, 1989.

Thank you for the opportunity to comment on these proposals.

Very truly yours,

Carolyn Ichel
Co-Chair, Committee on
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CI/md
Enclosures

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1. Amendment to Tax Law §1201 [the enabling legislation regarding the City RPT].

Paragraph (vii) of subdivision (b) of section 1201 of the tax law, as amended by . . ., is amended to read as follows:

> (vii) Any local law enacted pursuant to this subdivision may provide for such credits as are required to avoid multiple taxation. Any local law enacted pursuant to this subdivision shall provide that a total or partial exemption shall be allowed for any deed, instrument or transaction by which any real property or any economic interest therein is conveyed or transferred, where the conveyance or transfer, however effected, consists of a mere change of identity or form of ownership or organization where there is no change in beneficial ownership.

2. Amendment to New York City Administrative Code §11-2106.

Subdivision (b) of section 2106 of title 11 of the administrative code of the city of New York, as amended by . . ., is amended by adding a new paragraph eight to read as follows:

> 8. A deed, instrument or transaction conveying or transferring real property or an economic interest therein, where such conveyance or transfer, however effected, consists of a mere change of identity or form of ownership or organization where there is no change in beneficial interest.