REPORT #664

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED AMENDMENTS TO THE NEW YORK STATE
REAL PROPERTY TRANSFER AND GAINS TAX REGULATIONS

August 1, 1990

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TAX SECTION

New York State Bar Association

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August 2, 1990

The Honorable James W. Wetzler
Commissioner of Taxation and Finance
New York State Department of
Taxation and Finance
State Campus, Building 9
Albany, New York 12227-0215

Dear Mr. Wetzler:

I enclose our report concerning the recently proposed changes to the regulations under the State Gains and Transfer Taxes. The report was prepared for the Committee on New York State Tax Matters by Carolyn Ichel.

The report notes that certain basic aspects of the proposed regulations make major modifications in interpretations contained in the existing regulations. We have serious doubts as to whether these proposed changes would be upheld by the courts, given the longstanding history of the present regulations, their contemporaneity with the enactment of the statute, and the absence of any indication that the current regulations are incorrect or fail to reflect legislative intent.

The report first comments on the proposals affecting leases. We note that the proposed new definition of "substantially all" of a premises would conflict with other regulatory interpretations of that term, as well as with the common understanding of the term. We also question the new definition of "premises" proposed for the transfer tax.

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We agree with the wisdom of shifting from a fixed discount rate to a floating rate in valuing taxable rents, but we note a number of inequities in the proposal. Most importantly, the proposed rate is much too low to be fair, and a taxpayer should continue to have the opportunity to establish that the benchmark rate set forth in the regulations is inappropriate to its situation. Unlike the Federal law, where the APR generally operates as a minimum rate, the proposed regulations would establish the only rate to be used in calculating tax liability. Given tenants with very different credit ratings and the various different kinds of leasing transactions subject to tax, it is unfair to mandate a discount rate that cannot be proven to be too low.

We also believe that the proposal to include renewal term rents in valuing consideration received from a taxable lease is exceedingly inequitable. Lessors do not have a present right to receive such rents, and do not control whether the lessee will elect to renew and continue to pay rent. We therefore believe it is more appropriate to establish a system for taxing the value of renewal term rents when renewals are exercised, as suggested in the report.

With respect to the proposed change in the - manner of calculating the original purchase price for a minority entity interest, we recognize that the current system allows certain gains to escape tax permanently. The proposed change is obviously designed to close that gap. As a practical matter, however, the proposed regulation would place an enormous burden on holders of minority entity interests, a burden which in many cases will make accurate compliance impractical. We do not believe that such a broad intrusion of New York's gains tax laws into sales of minority interests is necessary to solve the current problem. Instead, we propose a two-pronged approach that would address the most obvious problem situations.

Alternatively, it may prove fruitful to revisit the 1984 proposed legislation that would have shifted the "controlling interest" aspect of the tax to an entity-level tax. A copy of the Governor's 1984 Program Bill proposing these changes, and a copy of our 1984 Reports (Nos. 429 and 434) relating to that proposal are enclosed. Subsequent income tax and gains tax developments suggest that certain details of that proposal should be reconsidered, but the essential concept still has merit.

We are also seriously concerned by the unfairness of applying the new regulation to persons who have purchased minority interests in reliance on the existing regulations.

The Report also raises a number of technical questions with respect to this proposal.

The concepts inherent in the proposals regarding transfers between an Industrial Development Authority and its beneficiaries, and between third parties and IDA'S, generally correspond to the income tax treatment of such transactions, and are in conformity with the gains tax regulations. We note, however, that the case law relating to a similar issue arising under the sales tax (which upheld the availability of the exemption for third-party sales) may be difficult to distinguish.

We thank you for the opportunity to comment on these regulations. Please do not hesitate to contact me if you or your staff have any questions.

Very truly yours,

Arthur A. Feder
Chair

Enclosures

cc: William F. Collins, Esq.

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Tax Report # 664

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON NEW YORK STATE TAX MATTERS

REPORT ON PROPOSED AMENDMENTS TO THE NEW YORK STATE REAL PROPERTY TRANSFER AND GAINS TAX REGULATIONS

August 1, 1990

Report on Proposed Amendments to the State
Real Property Transfer Tax and Gains Tax Regulations[1]

This report comments on the recently proposed amendments to the regulations under the New York State real estate transfer tax (the "transfer tax" or "RET") and the State 10% real property gains tax (the "gains tax"). The Department of Taxation and Finance has proposed amendments (1) to modify the application of the gains and transfer taxes to leasing transactions; (2) to eliminate the "outside" step-up in original purchase price that the gains tax regulations currently permit for minority interests in corporations, partnerships and other entities; and (3) to set forth the transfer tax treatment of transactions involving an industrial development agency.

As an initial matter we note that the proposed definition of "substantially all" represents a significant change from the current regulations, and the proposed change in the determination of "outside" original purchase price is an outright reversal of the current regulations. In each case the existing regulations reflect longstanding administrative positions: the definition of "substantially all" was first set forth by the Department of Taxation and Finance in 1983, and the rules regarding the original purchase price for entity interests were set forth in 1984. Furthermore, the current regulations reflect administrative interpretations that were developed contemporaneously with the enactment of the gains tax statute. The "substantially all" test was first set forth in an information bulletin published five months after enactment of the gains tax; and the rules regarding step-ups in outside OPP were

[1] This Report was prepared by Carolyn Ichel. Thoughtful comments were received from Peter C. Canellos, Peter L. Faber, Arthur A. Feder, Robert Jacobsen, David E. Kahen, Robert J. Levinsohn, Ronald A. Morris, Arthur R. Rosen, Michael Schler, Kenneth R. Silbergleit and others.

promulgated in 1984, shortly after the legislature considered and rejected an administrative proposal to replace the 1983 legislation with a comprehensive system x for imposing tax at the entity level. Moreover, the legislature has made several amendments to the gains tax since these regulations were promulgated, yet none of these betrayed any legislative dissatisfaction with the existing interpretations.

New York's courts have held that years of unchallenged administrative interpretation create a presumption that the interpretation is correct, and that presumption can only be rebutted by "a clear manifestation of legislative intent to the contrary." In the Matter of Consolidated Edison Company of New York, Inc., v. State Tax Commission, 24 N.Y.2d 114 (1969) (reversal of administrative interpretation after 53 years); New York State Cable Television Association v. State Tax Commission 59 App. Div. 2d. 81 (1977), aff'g 88 Misc. 2d. 601 (reversal of (reversal administrative interpretation after 11 years).[2]

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[2] Subsequent decisions have held that the Department may reverse prior rulings — which essentially represent the opinion of the Department. In the Matter of National Elevator Industry, Inc. v. State Tax Commission, 49 N.Y.2d 538 (1980) (prior ruling policy reversed by new regulations regarding the application of the sales tax to elevator services); Metromedia. Inc., et al. v. State Tax Commission 75 App. Div. 2d 341 (1980) (prior ruling policy reversed by new regulations regarding the sales tax treatment of ice shows; regulations held invalid on substantive grounds). Further, the Department clearly can change prior interpretations where such change "is not a reversal of a long-standing interpretation espoused by the agency, but rather a correction, upon reappraisal, of an erroneous interpretation of the law or an oversight in its prior administration." In the Matter of American Telephone and Telegraph Company v. State Tax Commission, 93 App. Div. 2d 66, 73 (1983) modified 61 NY 2d 393 (1984). These decisions may appear to signal a retreat from the broad statement of Consolidated Edison and Cable Television. However, none of these later cases involved the reversal of a duly-promulgated regulation. In this regard, see especially AT&T. 61 NY 2d 393, at 404. Furthermore, even after the 1980 decisions the Third Department invalidated an administrative pronouncement that "summarily and arbitrarily changes [the] standard without advancing any legal, factual or policy justification there-

There is therefore reason to question whether the proposed reversals of prior administrative interpretations will be upheld.

1. Changes in the treatment of leasing transactions.

A. Revised definition of "substantially all".

Under both the gains tax and the RET the grant of a leasehold interest is taxable if (i) the term of the lease (including renewal options) exceeds 49 years, (ii) substantial capital improvements are or may be made by or for the benefit of the lessee; and (iii) the lease is for substantially all of the premises constituting the real property. Tax Law §§1440.7, 1401(e). Since 1983 the Department of Taxation and Finance has defined "substantially all" to mean "90% of the total rentable space, exclusive of common areas." Reg §§590.5(a)(3), 575.7(a)(3). See also Question and Answer Bulletin No. 1 (1983), Q&A 5.

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foot note continue…
for." In the Matter of Building Contractors Association. Inc., et al. v. James H. Tulley. Jr., 87 App. Div. 2d. 909, 911 (1982).

The Department now proposes to change 90% to 67%. In addition, the Department proposes to add to the RET regulations (but apparently not to the gains tax regulations) the following definition of "premises": "each unit of real property which, at the time that the lease or sublease is created, *is* capable of being sold separately." Proposed Reg. §575.7(a)(3).

Apart from the question expressed above as to whether the Department is authorized to change its interpretation of "substantially all" and substitute 67% for 90%, the proposed 67% definition conflicts with other regulatory interpretations of the term "substantially all." In the context of the sales tax, the State's regulations define "substantially all" to mean 90%. See Tax Law §1116(a)(5), Reg. §529.8(d)(2). The sales tax formed the basis for a considerable portion of the gains tax, and there does not appear to be any compelling justification for assigning a different meaning to the term under the gains tax regulations than the meaning given to the identical term in the sales tax regulations.[3]

[3] The regulations regarding combined franchise tax reporting interpret the "substantially all" requirement of Tax Law §211.4 to mean "80 percent or more". Reg. §6-2.2(a)(2). Given that the federal consolidated return rules also utilize an 80% ownership standard (see I.R.C. §1504), the use of an 80% definition in the combined reporting context may well be explained as reflecting a policy decision to conform New York's combined reporting rules as closely as possible to the stock ownership tests used for federal consolidation.

The proposed change in the gains tax and RET regulations also departs from the common understanding of the term "substantially all." Two-thirds of something simply is not "substantially all," and it does not comport with common sense to treat a lessor as having leased "substantially all" of a property when the lease covers only two-thirds of it.

The proposed definition of "premises" in Reg. §575.7 is both confusing and potentially inconsistent with other interpretations under the gains tax. Taken literally, the proposed definition would eviscerate the "substantially all" test, for in virtually every leasing transaction it could be said that the portion of the property subject to the lease is "capable of being sold separately." Thus, in the case of a lease of vacant land, it could always be argued that the leased portion of the property could be separately sold. Similarly, with leases of floors in a building, one could submit the property to a condominium regime and sell each leased floor separately. Rather than confuse the RET (and distinguish it from the gains tax) by introducing this definition, it would be preferable either to omit the definition altogether, or to incorporate a definition that is more along the lines of the Department's letter dated February 2, 1988, signed by Ralph J. Fatato. That letter articulated a definition of "premises" that essentially followed the parameters of the $1 million threshold, and included in the "premises" all contiguous and adjacent interests in real property.

B. Change in the discount rate used to value rents.

Under the gains and transfer taxes the amount of consideration received for a taxable lease is determined by discounting the net rental payments. The regulations currently provide that a 10% discount rate is presumed for purposes of determining the present value of the net rentals, but the regulations also permit the taxpayer to establish that another rate is more appropriate. The proposed regulations would, however, mandate the use of a discount rate equal to the federal long-term rate (APR), compounded semiannually.

We recognize that as a financial matter it is more appropriate to provide a floating rate than simply to use a 10% rate without regard to the current economic climate. It is, however, inappropriate to select a discount rate that does not fairly reflect, the present value of the lessee's obligations to the lessor, and in that regard the proposed regulations are deficient in several important respects.

First, utilizing the AFR (as set forth under Code §1274(d)) for purposes of calculating gains and transfer tax liabilities assumes that lessees are as creditworthy as the federal government, and that a lessor is willing to lease property at a return no greater than that derived from investing in government securities. Obviously this is rarely the case. Even the strongest tenant can fall into bankruptcy, and every lessor must therefore view the leasing transaction as having more risk than an investment in government bonds.

The AFR is therefore simply too low to represent a reasonable discount rate. By way of comparison, in computing the interest component of deferred rents for income tax purposes, Code section 467(e)(4) uses 110% of the AFR. That rate would be a more appropriate starting point for the gains and transfer taxes.

Furthermore, even 110% of AFR may prove to be unreasonably low in some situations. It is important to recognize that the function of the AFR-based rates in the Internal Revenue Code is to prescribe a minimum interest rate. In that context the use of a fairly low benchmark rate is justified by the fact that the parties can agree to a rate at the higher end of the market, consistent with their evaluations of the borrower's creditworthiness, and that higher rate will be respected. By contrast, the proposed gains and transfer tax regulations purport to prescribe the only rate that can be used in measuring taxable consideration. If that rate is unrealistically low the taxpayer would have no opportunity to demonstrate that a higher discount rate is more appropriate, and no relief from artificially overstated tax.

We are concerned about the uncertainty and administrative burden that may result if taxpayers are permitted to argue for the use of a different discount rate. On balance, however, we believe that unless the mandatory rate is sufficiently high to eliminate substantially all of the risk of overstating taxable consideration, the regulations should

continue to permit a taxpayer to demonstrate that the regulations' rate does not adequately reflect the discount factor in his particular circumstances. It may be appropriate to impose a fairly high standard of proof, but some mechanism must be afforded for establishing that the benchmark rate *is* not appropriate. This is simply a matter of fairness. If a taxpayer is able to provide convincing evidence that the assumed rate is inappropriate, there is no reasonable basis for insisting on using the wrong rate.

The use of the long-term AFR as a benchmark for all leases also can produce anomalies. As computed under Code section 1274(d), such rate pertains to debt instruments with a term over nine years. The term of taxable leases can vary, however. Since all leases with purchase options are subject to tax, one might have a rather short-term taxable lease, for which the nine-year rate would be inappropriate. It would therefore be more reasonable to determine the discount rate by reference to the AFR for debt instruments with a maturity equal to the term of the lease, i.e., short-, mid- or long-term. See Code §467(e) (4).[4]

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[4] With respect to the very long-term leases that are subject to tax, it might be more reasonable to formulate a discount rate that is based on 30-year treasury bonds, rather than using the federal long-term rate. However, if the regulations continue to permit taxpayers to demonstrate that the benchmark rate is inappropriate, so that cases of significant disparities can be reasonably resolved, the development of a "very long-term" benchmark rate should not be necessary.

The regulations also are anomalous in that they delay the application of the current AFR by as much as six months. The proposed regulation states that, in determining the AFR for a lease executed in June, one would look to the AFR for the previous January. Such a long lag time is unnecessary and inappropriate. Interest rates can, and often do, vary widely over a six-month period. Accordingly, a more current method should be used. The relevant AFR could be determined monthly, by reference to the published rates for the preceding month. Alternatively, if monthly changes are too cumbersome, one could look to the last month of the preceding calendar quarter.[5]

One might follow the federal system and allow taxpayers to select the rate applicable in any of the three preceding months. We recognize, however, that, unlike the federal context, a taxpayer's rate selection here is not counterbalanced by another party's tax concerns. As a result, the effect of this option would generally be that the highest of the three months' rates would be used.

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[5] Under the gains and transfer taxes the discount rate is used to calculate the present value of a stream of rental income — sometimes reaching over several decades — and impose current tax. It is important to use a benchmark rate that approximates market conditions as closely as possible in order to avoid unfair aberrations in the calculation of tax liabilities. For this reason, while the three-month time lag might be a useful simplification in the more general and common context of interest on underpaid taxes (see Tax Law §1096), in the gains and transfer tax calculations every effort should be made to utilize the most current rate.

The regulations also should clarify the time at which the AFR is determined. It is quite common for leases, or agreements to lease, to be executed some time before the tenant takes occupancy. There may be various conditions precedent to the lessee's obligations, which can defer the imposition of gains and transfer taxes. See Department letters dated August 26, 1986 (signed by Kenneth R. Weklar) and November 7, 1987 (signed by Ralph J. Fatato). Nevertheless, for purposes of identifying the appropriate discount rate the State should look to the first calendar month in which there is a binding written agreement setting forth the lessee's rental obligations. See Code §1274(d)(2)(B). It is the economic conditions prevailing at the time the bargain is struck that are most relevant in determining the appropriate discount rate.

C. Treatment of renewal term rents.

The proposed regulations would add to gains tax Reg. §590.26 a statement that renewal term rents are included in computing the amount of a lessor's taxable gain. A similar provision is already included in RET Reg. §575.7(b). For the reasons set forth below, we believe that the proposed amendment to the gains tax is not reasonable, and that the existing RET regulation should be changed.

The inclusion of renewal term rents in measuring current tax liabilities is unfair. Lessors have no control over whether their lessees will exercise renewal options. Renewal rights are simply lessee's options; until a renewal option is

exercised the lessor has no right to any of the renewal term rents. It is unconscionable to impose current tax as if the lessor were entitled to receive the renewal term rents. The desire to accelerate tax revenue simply goes too far when it imputes to taxpayers income they neither have nor have any right to receive.

Moreover, in many leases renewal term rents are based on future market rental rates or future appraisals of the value of the leased premises, and lease renewal provisions also may make changes in escalation and pass-through provisions. These variables not only make it less reasonable to assume that the lease will be renewed, but also make it difficult or impossible to determine the value of the renewal term rents.

A much fairer approach, and one considerably more likely to produce a reliable calculation of the amount of taxable consideration, is to tax renewal term rents when the renewal options are exercised. As renewal options are exercised, gains and transfer taxes on the value of the renewal term rents (less allocable original purchase price) would be triggered.

We recognize that there may be an issue as to whether the exercise of the renewal option will represent a transfer sufficient to invoke the application of the gains and transfer taxes. For example, if a building is leased for 40 years with one 40-year renewal option, on the initial grant of the lease it would be clear that the sum of the lease term including renewals exceeds 49 years; but there may be grounds for

questioning whether tax could be imposed on the exercise of the renewal option 40 years hence, for at that time the lease term would be just 40 years. One approach is to view the renewal as a "partial or successive transfer" and thus subject to tax. An alternative would be to require the taxpayers (lessor and lessee) to agree that the statute of limitations would be held open as to the taxation of the renewal term rents. This would be similar to the approach taken with sales for contingent consideration, and would permit the state to tax the renewal term rents when the "recognition event" — the exercise of the renewal option occurs.[6]

D. General concerns.

Leasing transactions range across a broad spectrum, from transactions that are bona fide, arm's length, market rate leases, to transactions that are in fact disguised sales. The federal income tax law has developed a sophisticated analysis of the benefits and burdens of ownership, which guides taxpayers and the government in analyzing whether a transaction denominated a lease should in fact be treated as a sale. By contrast, the indiscriminate imposition of gains and transfer taxes on all "long-term leases" and all leases with purchase options, without

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[6] Under either analysis one could discount the renewal term rents back to the date of the original grant of lease and then impose interest on the unpaid taxes. This analysis seems rather complex, however, and unlikely to yield a significant difference in collections. Accordingly, it probably makes more sense simply to value the renewal term rents and impose tax at the commencement of the renewal term.

inquiring into the economic realities of the parties' arrangements, changes the gains tax and transfer taxes from taxes on sales to taxes that incorporate a tax on rents.

The Tax Section has repeatedly commented that, assuming that the gains tax and the RET are intended to function as taxes on sales of real property, it is fundamentally unsound to assume that all long-term leases and all leases with purchase options are equivalent to sales. The proposed regulations address perceived abuses in leasing transactions by arbitrarily » expanding the scope of the taxes. It would be more consistent with the perceived purpose of these taxes if the Department instead addressed the abuses directly. Leasing transactions that fall outside the technical tests of taxability should be more actively audited, with a view to analyzing whether the overall transactions have shifted the benefits and burdens of ownership such that in substance, if not in form, the transaction is a true sale. We believe the Department can and should develop a policy for analyzing leasing transactions along the lines of the federal substance-versus-form analyses. We believe such an approach would prove a useful tool in curtailing abusive transactions, and would better reflect a policy of imposing gains and transfer taxes on transactions that are sales.

2. Changes in the treatment of minority entity interests.

The gains tax statute provides that "original purchase price" ("OPP") means "the consideration paid or required to be paid by the taxpayer: (i) to acquire the interest in real

property, and (ii) for any capital improvements made or required I to be made to such real property. ..." Tax Law §1440.5(a). It is further provided that "[i]n the case of a transfer of a controlling interest in an entity with an interest in real property, there shall be an apportionment of the original purchase price of the interest in real property to the controlling interest for the purpose of ascertaining the original purchase price of such controlling interest." Tax Law §1440.5(g).

The general rule of §1440.5(a) thus states that original purchase price is the consideration paid by the transferor for the interest, a clear statement that the starting point for measuring taxable gain is the transferor's cost. Section 1440.5(g) provides a special rule for entities by apportioning entity-level costs. This latter rule is clearly relevant in determining, for example, how to treat acquisitions and dispositions of property and capital improvements that are made subsequent to the minority owner's acquisition of the entity interest.

With respect to the OPP of interests in corporations, partnerships, trusts and other entities ("entity interests"), the current regulations, and the 1984 Questions and Answers upon which such regulations were premised, interpret the statutory provisions as follows:

a. Where there is a taxable acquisition or disposition of a controlling economic interest in an entity the original purchase price of the underlying real property

in the hands of the entity is stepped up to reflect the consideration paid for the controlling interest;

b. Where there is a transfer of a minority entity interest that is not part of a taxable acquisition or disposition there is no change in the entity's original purchase price for the underlying real property; and

c. "No matter what percentage interest was purchased, when such interest is resold the original purchase price is the apportioned amount of the entity's original purchase price (determined without regard to a step-up in original purchase price due to an acquisition of a controlling interest), or the apportioned amount of the fair market value of the real property at the time such interest was acquired, whichever is higher." Reg. §590.49(c).

The interpretation articulated in paragraph c. reaches the result of taxing each minority interest seller on the gain he or she actually derives when that interest is resold.

The proposed regulations would significantly change the determination of the OPP of minority entity interests, by proscribing any increase in "outside" OPP for transfers of minority entity interests. The difference between the application of the existing regulations and the effects of the proposed amendment is best illustrated by a simple example.

X Corp. owns Whiteacre. X Corp. purchased Whiteacre in year 1 for $100.

In year 2, Whiteacre has appreciated to $150; A buys 10% of the X Corp. shares for $15.

In year 3, Whiteacre is worth $200; A sells the 10% X Corp. interest to B for $20.

In year 4, Whiteacre is worth $250. B sells the 10% interest to C for $25. C also acquires 40% of the X Corp. stock from D for $100. B's sale of the 10% interest is therefore subject to the gains tax.[7]

The consideration derived by B is equal to the "apportioned amount" of the value of Whiteacre at the time of B's sale, or $25. Tax Law §1440.1. The existing regulations provide that B's original purchase price for the 10% interest is the greater of (x) the apportioned amount of X Corp.'s original purchase price (10% of $100 = $10) or (y) the apportioned amount of the fair market value of Whiteacre at the time B's interest was acquired (10% x $200 = $20). Under the existing regulations, therefore, B's original purchase price is $20; and B's taxable gain is $5 ($25 consideration minus $20 OPP). B's gains tax liability is therefore 50 cents.

If on the other hand X Corp. sold Whiteacre, the calculation of taxable gain under the existing regulations would not reflect any step-ups for A's or B's acquisition, for neither transaction involved *a* taxable acquisition or disposition of a

[7] After these taxable sales, C will have an OPP of $125 for its 50% stock interest. X Corp.'s OPP for Whiteacre will be "stepped up" from $100 to 1/2 of $100 + 1/2 of $250, or $175.

controlling interest. Accordingly, a sale of Whiteacre in year 4 would give rise to taxable gain of $150 ($250 fair market value minus $100 original purchase price). X Corp.'s gains tax liability would be $15 and (absent some special agreement among the shareholders) B would bear 10% of that tax, or $1.50.

The proposed regulations would deny any "outside" step-up in the original purchase price for an entity interest unless the acquisition of such interest resulted in a taxable acquisition or disposition of a controlling interest. Thus, in the above example, B's original purchase price for the 10% interest would be "the amount determined by multiplying the entity's original purchase price [$100] ... by the percentage interest in the entity that is being sold [10%]." Proposed Reg. §590.49(c). B's sale of the 10% interest to C would therefore give rise to taxable gain of $15 ($25 minus $10), and a tax liability of $1.50.

The effect of the proposed regulation is to tax minority interest holders who dispose of their interests in taxable transactions on all of the built-in gain attributable to their predecessors1 ownership. As a result, unless the minority holders had negotiated purchase price adjustments to reflect the tax on such built-in gain, a seller of a minority interest could pay gains tax that is vastly disproportionate to its actual economic gain, or pay gains tax when there is no gain at all. In the above scenario, for example, B realizes an economic gain of $5, but pays gains tax of $1.50.

The proposed regulation *is* appealing as a matter of tax theory, for it eliminates the disparate results that obtain under the current regulations. As shown above, if X Corp. sells Whiteacre, the current regulations tax all of the built-in gain attributable to B's 10% interest; but if B instead sells his 10% entity interest the tax only applies to the appreciation accruing during B's ownership, and the gain realized by B's predecessors is never taxed. This obviously creates a bias in favor of effecting property acquisitions by means of entity interest transfers, and clearly represents a "hole" in the gains tax net. The effect of this tax gap may have been perceived as particularly unsavory in takeover situations, where the considerable volume of trading activity in anticipation of the offeror's taxable acquisition often eliminates a sizeable amount of the gains tax through outside step-ups in OPP.

Furthermore, since the current system provides no entity-level step-up for minority interest transactions, it is clear that a sale of the real estate itself would produce the full tax, requiring the minority interest purchasers to bear the cost of the tax on their predecessors' built-in gain. It can therefore be argued that the proposed regulation imposes no greater record-keeping or tax burdens than those already faced by minority interest owners.

As a practical matter, however, there is an important difference between entity-level taxes on built-in gains and this new proposal. It is burdensome to impose on the sellers of

minority interests a tax that must be calculated by reference to events they were not involved in, facts they do not know, and information they cannot easily obtain. The proposed regulation would inject substantial uncertainty and inevitable cost into every minority interest transaction — every time a minority interest is transferred it will be necessary to involve a third party, the entity, in order to quantify the "inside" OPP and establish the amount of the buyer's gains tax exposure. Moreover, as noted below, if there have been previous step-ups in the entity-level OPP, or intervening capital improvements, the analysis becomes inordinately complex.

Apart from the added complexity, as noted above this proposal represents a significant departure from longstanding and contemporaneous regulatory interpretations. There is a reasonable, even strong, inference that the existing regulations appropriately reflect the legislature's intent, and that the proposed change in the regulations is not supported by the law.

We believe that the wholesale denial of outside step-ups for minority interests is an unnecessarily broad solution to the gap in the gains tax. The intrusion of New York's tax system into every transfer of interests in an entity with New York real estate is not reasonable. Instead, we suggest that the regulations adopt a different, two-pronged approach.

First, the existing practice of taxing only the people who make the end-sales to the offeror is unnecessarily narrow. In cases involving trading in takeover targets, the state should

aggregate all transfers that are made in anticipation of the takeover. All of the sellers who participate in the higher prices engendered by the takeover should be charged with tax on their share of the gains from real property. The pendency of a tender offer could be defined either by reference to the dates of official SEC filings, or by a facts-and-circumstances analysis that considers news reports, publicly available industry analyses and similar materials to establish when an entity is "in play" and aggregation of minority interest sales becomes appropriate.

Admittedly, this approach is empirical and therefore may appear more difficult to apply. We believe, however, that this kind of aggregation approach is in fact considerably more fair, and much easier for taxpayers to understand. In most cases sellers recognize whether their sale is motivated by a pending offer, and can identify a general time period during which trading in the target reflected a pending offer. Furthermore, a tax that is based on the seller's actual gain is much more reasonable than tax that is based on gain enjoyed by previous owners.

The second prong of the approach would address transactions in which transfers of entity interests are substituted for a transfer of the property itself in order to take advantage of outside step-ups and avoid gains tax. For example, where (i) 100% of the entity interests are transferred (or arrangements such as options, puts or redemption rights are used to provide for the eventual transfer of all of the entity

interests); (ii) the entity's assets (exclusive of cash, marketable securities, etc.) consist predominantly of New York real estate; and (iii) there is a substantial difference between the inside OPP and the aggregate outside OPP, there may be substantial grounds for the Department to treat the transaction as a sale of the underlying real estate. The marketplace already demonstrates a reluctance to acquire entity interests (with all the potential for liabilities) rather than the desired real estate. By adding to the buyer's natural reluctance to purchase entity interests a threat, or possibility, or probability that the seller's desired tax advantages will not be achieved, we believe that a large portion of the existing tax gap would be eliminated.

These two approaches address areas that are legitimate candidates for reform, yet avoid the enormous complexity and fundamental unfairness that is engendered by the proposed regulation.

Alternatively, it might be appropriate to revisit the possibility of completely overhauling the application of the gains tax to entity interests. As noted above, in 1984 a comprehensive system was proposed for imposing the gains tax at the entity level when transfers of interests in the entity reached a prescribed threshold. This system avoided the considerable complexities involved in imposing tax on the shareholder/partner level, yet did not produce the kind of tax gap that raises problems under the existing regulations. The Tax

Section supported that proposal in 1984, and continues to believe it may be the most viable solution to the current problems. See Tax Section Reports Nos. 429 and 434, attached hereto.

There also are a number of technical flaws in the proposed regulation. First, the regulations would apply the outside step-up only where an acquisition "resulted in either a transfer or an acquisition of a controlling interest. ..." Proposed Reg. §590.49. It is not reasonable to distinguish transactions based upon whether they "resulted in" a transfer or acquisition of a controlling interest, for that formulation technically identifies only the transfer that caused the buyer(s) or seller(s) to reach the 50% mark. Instead, if this new rule is adopted it should be rewritten to refer to previous and subsequent transfers that are required to be aggregated and that, in the aggregate, represent an acquisition or transfer of a controlling interest.

It is confusing to refer to "the percentage interest in the entity" that is being sold. If a corporation has different classes of stock, or a partnership interest represents different percentage interests in profits and in capital, there may be no readily determinable "percentage interest in the entity." The statutory language — apportioning OPP to the controlling interest — reflects a more flexible approach in that it permits other, more complicated apportionment formulae to be derived in cases where the "percentage interest in the entity" might not be a straightforward computation.

It is distortive to omit step-ups in the entity's original purchase price relating to prior transfers and acquisitions of controlling interests. Consider, for example, a taxpayer (Q) who acquires a 75% partnership interest in partnership P. P's original purchase price for its real estate Is 20. Q pays $75 for the 75% interest, producing an entity-level step-up in the amount of $60 ($75 minus 3/4 of $20). Stated differently, P's original purchase price for its realty now is the sum of $75 plus 25% of $20, or $80. P then makes a capital improvement to the realty, the cost of which is $20.

Q then sells the 75% interest. The correct original purchase price for Q's interest should be $90 ($75 plus 3/4 of the $20 capital improvement cost). However, neither the current regulation nor the proposed amendment reaches that result. The apportioned amount of the entity's original purchase price, determined without step-ups, is only $30 (3/4 of the $20 original cost plus the $20 capital improvement). The apportioned fair market value of the property at the time of Q's acquisition was only $75. The only way to reach the correct result is by including the step-ups <u>attributable to Q's interest</u> in the first calculation. Thus, original purchase price should be stated as the greater of (1) the apportioned amount of the entity's original purchase price, taking into account any step-ups attributable to the interest being sold by the transferor and (2) the apportioned amount of the fair market value of the real property at the time of Q's acquisition.

Under the first calculation Q's OPP is now computed as 3/4 of $40, plus $60, or $90.[8]

The proposed effective date for this amendment to the regulations also is troubling. Assuming the Department is upheld in reversing its prior interpretation, a change in the regulations' interpretation of the gains tax statute should not retroactively take away from taxpayers the original purchase price they had under the prior regulations. Any change must therefore "grandfather" all taxpayers who acquired entity interests before the regulation was changed, and preserve for them the same OPP formulae as currently obtain.

In order effectively to grandfather such persons, however, it is not sufficient simply to provide that the change in regulations does not apply to "conveyances and transfers of real property occurring on or after the effective date of the regulation which are made pursuant to binding written contracts . . . ." First, since the acquisition of a minority interest is not a conveyance or a transfer under the statutory definitions of those items, read literally this effective date language would not grandfather any existing owner of a minority interest. Instead the new rules for computing OPP might be held

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[8] The same problem would obtain if Q had sold a 25% interest to R before the improvement was made, and R later sold that 25% interest in a taxable transaction. Thus, R's original purchase price under the first calculation should be the sum of 1/4 *of* the $20 original cost, plus 1/3 of the $60 step-up, plus 1/4 of the $20 capital improvement cost.

to apply when that interest is later sold in a taxable transaction.

Furthermore, it is not sufficient simply to grandfather existing owners' outside OPP. If their buyers lose the existing owners' outside step-up, then as an economic matter the parties' negotiations should charge all of the gains tax on the predecessor's gain to the current owners. For example, in 1988 J sells a 5% interest to K for $5; in 1989 K sells that interest to L for $10; and L now wants to sell the 5% interest to M for $15. The entity's "inside" OPP is $0. If M loses the ability to claim an outside step-up altogether, M's purchase of the 5% interest from L would mean that M inherits $15 of built-in gain, and a $1.50 gains tax. $5 of that gain is attributable to L, but $10 of it is attributable to L's predecessors, J and K.

To avoid making a retroactive change in L's economic situation that would leave L in a position worse than if L had sold in a taxable transfer, it is necessary to give M, and all of M's successors, an outside step-up equal to L's outside OPP — or $10. Admittedly this is complicated (particularly when intervening capital improvements, or acquisitions or dispositions of real property are made by the entity), but it is the only way to avoid a retroactive adverse change in the treatment of L. Stated another way, if the regulations are amended as proposed the new rule should apply only to increases in "outside" costs over the present owner's OPP for the entity interest.

3. Clarified treatment of IDA transactions.

The proposed regulations contain several revisions to §575.11 of the RET regulations that address transactions involving industrial development agencies ("IDAs"). IDA transactions generally involve a "beneficiary," who essentially borrows funds from the IDA. As a legal matter, title to the subject property is vested in the IDA. The beneficiary then leases the property from the IDA for an annual rent (representing debt service), and has an option to purchase the property at the end of the lease term for a nominal sum. The RET provides an exemption for conveyances by or to agencies of New York State. Tax Law §1405(a)(l), (b)(l).

IDAs are state agencies, and taxpayers have therefore taken the position that conveyances by a third-party seller to an IDA, and conveyances by an IDA to a third-party buyer, are not subject to the RET. The proposed amendments to the regulations would provide that conveyances between an IDA and the beneficiary of the IDA financing are not taxed. However, if, at the direction of the beneficiary, property is conveyed to the IDA by a third party, the regulations would treat the beneficiary, not the IDA, as the transferee; with the result that the exemption for conveyances to state agencies would not apply. Similarly, a conveyance of real property by the IDA to a third party, at the direction of the beneficiary, would be treated as a conveyance by the beneficiary and thus would be taxable. Proposed Reg. §§575.11(a)(13),(14).

As an income tax matter, the "beneficiary" of the IDA transactions, not the IDA, is treated as the owner of the property. Thus, the transfer of title between the beneficiary and the IDA does not give rise to gain or loss, and the tax incidents of ownership (depreciation, tax credits, etc.) are accounted for by the beneficiary. Similarly, gains tax Reg. §590.67 provides that the beneficiary, not the IDA, is considered the owner of the property. Accordingly, the gains tax exemption for transfers by New York State agencies (Tax Law §1443.3(a)) is not applied to transfers made by the IDA.

Under New York's sales tax law, however, there is authority stating that the purchase of personal property for incorporation into an IDA-sponsored project is not subject to the sales tax. Wegmans Food Markets. Inc. v. Department of Taxation and Finance. 126 Misc. 2d. 144 (1984), aff'd. 115 App. Div. 2d 532 (1985). See also In re Fagliarone. Grimoldi & Associates. New York State Tax Appeals Tribunal, May 4, 1989.

We believe that the proposed amendments are consistent with economic reality and with the income tax treatment of such transactions. Furthermore, it is useful to adopt consistent interpretations of the gains tax and the RET. As a theoretical matter, however, the Wegmans decision is difficult to square with the interpretation espoused by the proposed regulation, and for that reason we are concerned about the validity of the regulation.