New York State Bar Association

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July 27, 1998

Devora B. Cohn
Assistant Commissioner for Legal Affairs
Office of Legal Affairs
345 Adams Street
Brooklyn, New York 11201

Dear Commissioner Cohn:

I am pleased to enclose a report of the New York State Bar Association Tax Section concerning proposed amendments to the rules relating to the New York City Real Property Transfer Tax dealing with the exemption for transfers that effect a mere change in identity or form of ownership of real property or an economic interest therein. The report addresses a number of issues, including the following:

1. The proposed rules deal with the interaction between the mere change exemption, on the one hand, and the rules dealing with transfers of controlling economic interests and applicable tax rates, on the other. We suggest that these rules be applied prospectively from the date the rules were proposed, without any inference as to the proper interpretation of the statute prior to that date.

2. The proposed rules raise questions concerning the application of the real property transfer tax to corporate acquisition transactions, extending beyond the mere change exemption. We note several of these issues and discuss approaches for their possible resolution.

3. The proposed rules include a "step-transaction" rule for determining the application of the mere change exemption. We question the scope of this rule in light of the nature of the transfer tax and State interpretations of similar transactions under the gains tax.

Please let me know if we can be of any further help on these issues.

Sincerely,

Steven C. Todrys
Chair

Enclosure

cc: The Honorable Alfred C. Cerullo, III
Commissioner of Finance

Ellen Hoffman, Esq.
Director, Tax Law and Concilliations

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON PROPOSED AMENDMENTS TO RULES RELATING TO THE NEW YORK CITY REAL PROPERTY TRANSFER TAX[1]

July 27, 1998

This report comments on recently proposed amendments to the rules relating to the New York City Real Property Transfer Tax intended to reflect the enactment of Administrative Code section 11-2106.b(8) by Chapter 170, Laws of 1994, section 308, which provides for an exemption from the tax for transfers on or after June 9, 1994, that effect a mere change of identity or form of ownership or organization to the extent the beneficial ownership remains the same.

The text of § 11-2106.b(8) is as follows:

"Sec. 11-2106. Exemptions. - ****

b. The tax imposed by the chapter shall not apply to any of the following deeds, instruments or transactions:

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8. 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. For purposes of this paragraph, the term "cooperative housing corporation" shall not include a housing company organized and operating pursuant to the provisions of article two, four, five or eleven of the private housing finance law."

The transfer tax applies not only to deeds but also to transfers of economic interests which constitute controlling interests in a corporation, partnership, association or other unincorporated entity, or beneficial interests in a trust, which owns real property located in whole or in part within New York City (where the consideration for the deed or transfer exceeds $25,000). Adm. Code §§ 11-2101.5, 6 and 7; 11-2102.a and b. "Controlling Interest" means 50% or more of the total combined voting power or 50% or more of the total fair market value of

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[1] This report was prepared by Robert J. Levinsohn. Helpful comments were received from Glenn Newman, Carolyn Joy Lee, Michael L. Schler and Maria T. Jones.

all classes of stock of a corporation, or 50% or more of the capital, profits or beneficial interest in a partnership, association, trust or other entity. Adm. Code § 11-2101.8.

Except in the case of certain residential properties, the tax on transfers of such controlling interests is at the rate of 1.425% of the consideration where the consideration is $500,000 or less, and 2.625% of the consideration where the consideration is more than $500,000. Adm. Code § 11-2102.b.(1)(B)(ii).

Thus, the 1994 "mere change" amendment applies to both deeds conveying real property and transactions transferring controlling economic interests in real property.

The only relevant history in the bill jacket for Chapter 170 is in the following paragraph at page 46 of a 60-page letter from Commissioner of Taxation and Finance Wetzler to Governor Cuomo dated June 9, 1994, recommending approval of the bill:

> "Section 308 of the bill amends Section 11-2106(b) of the Administrative Code of the City of New York to add a new paragraph eight to provide, for purposes of the New York City real estate transfer tax, an exemption for any conveyances or transfers which effect a mere change of identity or form of ownership of the real property to the extent that the beneficial ownership in the property remains the same. This exemption, which is modeled after the exemptions under the State real estate transfer tax and the gains tax, will apply only to conveyances or transfers occurring on or after the effective date of this bill."

(The State real property gains tax was repealed by Ch. 309, Laws 1996, effective for transfers on or after June 15, 1996.)

The bulk of the proposed amendments (which are 18 pages in length) consist of revised examples or new examples illustrating the City's interpretation of the application of the "mere change" amendment. In general, the proposals represent a commendably thorough effort to explain the new provision. We have the following specific comments:

1. The most significant interpretations of the new provision are not set forth explicitly in any textual material, but may only be gleaned from reading the examples. These are (a) that the transfer of a controlling economic interest is treated as taxable to the extent the beneficial ownership changes, even though the portion of the interest thus subjected to tax is less than 50%, and (b) that the higher tax rate for total consideration over $500,000 applies even though the portion taxable after applying the "mere change" rule is less than $500,000.

Both of these interpretations are exemplified by Illustration B in Rule § 23-03(g)(2)(ii), as added by § 9 of the proposals. There, on the liquidation of X Corporation, 100% of the stock of Y Corporation (which owns real property in New York City valued at $1,000,000) is distributed to X's two 50-50 shareholders, 25% to shareholder A and 75% to shareholder B. The transfer of a 25% interest in Y stock from A to B on the distribution for allocable consideration of $250,000 is stated to be (a) taxable, even though the distribution of 75% of the Y stock is exempt from tax as a mere change of identity or form of ownership or organization, and (b) subject to the higher tax rate because the total consideration, before applying the mere change exemption, exceeded $500,000.

As to taxing a transfer of less than a 50% controlling interest after applying the mere change rule, see also Rule § 23-05(b)(8)(i) (added by § 11 of the proposals), Example D, taxing the transfer of a 10% interest on the merger of two partnerships, and Example E, taxing the transfer of an aggregate 40.4% interest on the merger of two corporations. As to applying the higher tax rate to taxable consideration of less than $500,000, see also Rule § 23-03(d)(5), Example (ii), amended by § 1 of the proposals, where taxable consideration of $187,500 is subjected to the higher tax rate.

In the two State taxes stated in Commissioner Wetzler's letter to be the models for the new City provision, the wording of the corresponding mere change provisions is similar, but not identical, to the City provision. Indeed, given that the State exemptions for mere changes are stated to be applicable "where there is no change in beneficial ownership" (transfer tax, Tax Law § 1405(b).6), and "where there is no change in beneficial interest" (former gains tax, Tax Law § 1443.5), whereas the new City provision is applicable only "to the extent" the ownership or interest remains the same, it could be argued that the City's interpretations are more strongly supported by the statutory language of the Administrative Code than they would be by the corresponding language in the State's statutes.

In any event, the former State gains tax, which had the same 50% definition of a controlling interest as does the City tax, has been interpreted as taxing the transfer of an interest that is less than 50% after application of the mere change exemption, in the same manner as the examples in the City's proposed rules, at least in cases where a single person has transferred or acquired a 50% or greater interest. Matter of William Iser, Tax Appeals Tribunal, May 8, 1997 (CCH New York State Tax Reporter ¶ 402-726) (transfer of 40% partnership interest taxed). See also Latham Motors, Inc., Advisory Opinion, May 17, 1993, TSB-A-93(6)-R (1993 N.Y. Tax Lexis 630) (transfer of 3.6% interest taxed in corporate merger).[2] As a policy matter, apart from the technicalities of the statutory language of the mere change provision, one could question whether there has been a change in control, within the loophole-closing intent of the controlling interest provisions, when a majority interest continues to be held by the same beneficial owners before and after the transaction and the portion left to be taxed after applying the mere change rule is less than 50%.

As to measuring the tax rate by the total consideration before applying the mere change exemption, the former State gains tax was not a graduated tax, but applied only where the

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[2] We also note, however, that in Matter of Whiteface Limited Partnership, Tax Appeals Tribunal, November 3, 1994, a case involving the application of the gains tax, which involved a two-step transaction shifting ownership of a partnership from approximately 25-75 to 50-50, the State Tribunal held that the individual partner's increase from 25% to 50% was not a taxable acquisition of a controlling interest even though the other 75% initially owned beneficially by two corporations was changed to a 50% interest owned by a third corporation, all these corporations being within the same affiliated group. The Tribunal did not address a possible contention that, before applying the mere change exemption to the inter-affiliated group transfer, there was a shift of an aggregate 75% controlling interest from the first two corporations to the individual and the third corporation. The Tribunal in Iser rejected a contention that Whiteface was a precedent against taxability, without detailed discussion.

consideration was at least $1,000,000. Tax Law § 1443.1. The gains tax regulations provided expressly that the million dollar exemption was applied to the consideration before the mere change exemption was applied, so that a transfer in which the consideration before that exemption was $1,000,000 or more would remain taxable. Reg. § 590.51 (c). This regulation was applied in Matter of Paul D. Jaffe, Tax Appeals Tribunal, March 18, 1996 (CCH New York State Tax Reporter ¶ 402-369) (transfer by tenants in common in exchange for interests in newly formed partnership taxed on gain calculated on consideration of $562,500, where total consideration before applying mere change of identity exemption was $1,250,000).

The New York State real estate transfer tax also has the 50% controlling interest definition, and has a million dollar exemption for an additional tax on conveyances of residential real property or interests therein. Tax Law § 1402-a. However, no authority has been found on the interrelation of these two provisions with the mere change exemption for this tax.

Given such authority as there is on the analogous provisions in the former gains tax, we believe that, where aggregation of multiple transfers by one or more transferors is otherwise supported by their "relatedness" (see paragraph 4(b) below), the City is justified in taking the substantive positions indicated in the examples regarding the interrelation of the mere change provision with both the controlling interest rule and the application of the graduated rate. We do have the following recommendations:

A. The positions on these two principles, the interrelation of the mere change rule with the definition of controlling interest, and with the application of the graduated rate, should be spelled out in the text in addition to being illustrated in the examples. Given the importance of these rules, and the less than definitive support for these conclusions in the statute or case law, it is crucial that these conclusions be affirmatively stated in the rules.

B. We recommend that the application of the positions set forth in the proposed rules on these two points should be made prospective from the date the rules were proposed, without any inference as to the proper interpretation of the statute prior to that date. We note that the primary section spelling out the mere change rule, § 23-05(b)(8), added by § 11 of the proposed rules, does not have any effective date at all, although at other points in the proposals the new provisions are made effective for transactions on or after June 9, 1994, the effective date of the statute.

In the first place, the positions taken on the two issues in question are counterintuitive and they are not readily apparent on a surface reading of the statute, although, as indicated above, they can be justified on a detailed legal analysis. In the second place, neither the Real Property Transfer Tax Return, Form NYC RPT, nor the instructions, that have been in use since the 1994 amendment, make manifestly clear how the mere change rule interacts with the controlling interest requirements, except possibly in the case of transfers of economic interests pursuant to the liquidation of the owning entity[1]. More significantly, the position taken in the

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[1] The return form contains a Schedule H for transfers of controlling economic interests and a Schedule M for mere change of form transfers, but there is nothing in either the form or the instructions that explains what figure to enter in the tax computation schedules on page 3 where (continued...)

return form as to the relationship of the mere change rule with the graduated rate is squarely contrary to the proposed rules. See Schedule M of the return, where the percentage of shift in beneficial or economic interest, after giving effect to the mere change exclusion, is applied to the tax base on line 1 of Schedule 3 or line 1 of Schedule D, before calculating the applicable tax rate.

We recognize that there may be sufficient support in the existing authorities under analogous State statutes and in the current City return form for the City's combination of simultaneous transfers made by a single transferor in a liquidation transaction, where part of the interest is transferred in an exempt, change-in-form transfer and part is not, as in Illustration B in § 9 of the proposals (discussed at page 2 above), and for such approach to apply to that type of transaction on a retroactive basis. However, it is not at all clear that existing authorities and the current return form support the retroactive combination of the change-in-form transfers by the partners in X with the 10% transfer by partner D to partners A and B in the partnership merger in example D, nor the similar combination of the shareholder-level transfers in the corporate merger in Example E, both in § 11 of the proposals (see page 2 above). Given the substantive and policy issues raised by the proposed combination of change-in-form transfers, the paucity and unclarity of the analogous State authorities, the absence of clear instructions in the return form, and the confusion that would ensue if some transfers were combined retroactively but others were combined only prospectively, we believe the combination of change-in-form transfers with actual transfers, for purposes of determining whether there has been a transfer of a controlling interest, should be applicable only prospectively in all cases.

There is precedent for prospective application in the provisions adopted in 1995 changing the definition of an economic interest in real property as applied to tiered entities. Rule § 23-02, definition of "Economic interest is real property," paragraphs (3) and (4). Although these amendments were also precipitated by the enactment of the mere change rule by Ch. 170 of the Laws of 1994, they were made effective for transfers on or after April 24, 1995, with the pre-existing rules remaining applicable to transactions pursuant to binding written contracts entered into prior to that date. See our letter to the Deputy Commissioner for Legal Affairs dated May 25, 1995, commenting on this proposed amendment to the rules and recommending the binding contract exception.

We therefore recommend that the proposed rules on the interrelation of the mere change exemption with both the controlling interest definition and the graduated rate be made effective for transactions entered into no earlier than the date of publication of the proposed rules in the City Record, with the same binding contract exception as in Rule § 23-02, paragraph (4), referred to above, without any inference as to the proper interpretation of the statute prior to that date.

2. The proposed rules contain no illustrations of the application of the mere change provision where real property is owned through tiered entities. We recommend that such

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1 (...continued)
both Schedules H and M apply. The return form does include cross-references between Schedule M and Schedule D, which relates to transfers pursuant to a partial or complete liquidation of a corporation, partnership, or other entity, and contains its own tax computation schedule.

examples be added to paragraphs (3) and (4) of the definition of "Economic interest in real property" in Rule § 23-02, discussed above.

3. The proposed amendments include no changes in Rule § 23-03(h), dealing with transfers relating to cooperatives. Given the express exclusion of certain cooperative transactions from the benefit of the new mere change statute, clarifying examples should be added to this paragraph of the Rules. These should demonstrate that, whereas transfers of real property into cooperative ownership are not eligible for treatment as mere changes in form, transfers of cooperative units may be so eligible.

4. There are several additional problems in Example E of proposed Rule § 23-05(b)(8)(i), referred to in paragraph 1 above:

(a) The example describes the transaction between Corporations X and Y as a "merger". It then says that the transfer of City real property from X to Y "pursuant to the merger would be exempt from tax. See section 23-03(e)(2) of these rules." But § 23-03(e)(2), as it exists and as proposed to be amended by § 3 of the proposals, applies only to "a statutory merger or consolidation." If the merger in Example E is intended to be a statutory merger, the text should say so. If, on the other hand, Example E is intended to imply that transactions other than statutory mergers may be exempt from tax at the corporate level (such, for example as those described in § 368(a)(1)(B), (C) and (D) of the Internal Revenue Code), this would require a change in § 23-03(e)(2) of the rules. In any event, the City's views on the application of the statute to corporate transactions other than statutory mergers (those described in § 368(a)(1)(A) of the Internal Revenue Code) should be clarified, perhaps by the inclusion of additional examples[4].

(b) Example E should be more explicitly correlated with the definition of "Controlling Interest" in Rule § 23-02. Adm. Code § 11-2101.7 defines "Transfer" or "transferred", in relation to an economic interest in real property, as a transfer of stock or interests constituting a controlling interest, "whether made by one or several persons, or in one "or several related transactions" (emphasis added). Rule § 23-02 is careful to state that transfers by several persons are aggregated only when they are "related," and, in each of the illustrations dealing with multiple transferors, whether or not the transfers are aggregated is expressly stated to depend on whether the transferors either are "acting in concert", as in Illustration (i), or the transfers are or are not "related", as in Illustrations (viii), (x), and (xi). See also the definition of "Transfer or transferred" in § 23-02.- Example E aggregates transfers made by four grantor shareholders, without addressing the factors that cause such transfers to be considered related. The text should

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[4] We note that there is also another apparent inconsistency, in Example D of proposed Rule § 23-05(b)(8)(i), which deals with the "merger" of general partnership X with limited partnership Y. The example states that "The transfer of the assets of X to Y is not a taxable transfer of real property," referring to pre-existing Rule § 23-03(c)(4). But that rule exempts from tax only transfers in a merger or consolidation of two or more limited partnerships, and only when they are pursuant to Article 8-A of the New York Partnership Law or comparable provisions of the partnership laws of other jurisdictions within the United States. Here again, it is not clear whether the example is intended to extend the scope of the pre-existing rule.

address this issue with due regard to the "Controlling Interest" and "Transfer" definitions in Rule § 23-02.

(c) The State statutes pertaining to the real estate transfer tax and the former gains tax do not contain the language applying the concept of transfers of economic interests which constitute controlling interests "whether made by one or several persons, or in one or several related transactions". Nevertheless, the applicable State regulations state that the transfer or acquisition of a controlling interest occurs "when a person, or group of persons acting in concert" transfers or acquires 50% or more of the voting stock in a corporation or of the capital, profits or beneficial interest in a partnership or other entity. Reg. § 575.6(a), relating to the real estate transfer tax; Reg. § 590.45(a), relating to the gains tax. The State regulations go on to provide detailed definitions of "acting in concert". Reg. § 575.6(b); Reg. § 590.46(b). Under these regulations, the State has ruled in an Advisory Opinion that a recapitalization of a publicly held corporation effecting a transfer of more than 50% of the voting common stock to the former nonvoting preferred shareholders will not constitute the transfer or acquisition of a controlling interest because no single stockholder will transfer or acquire 50% or more of the voting stock and each stockholder, in voting on the recapitalization, is able to vote independently of all other stockholders, and therefore the stockholders are not acting in concert to transfer or acquire a controlling interest. Crossland Savings, FSB, TSB-A-90(8)-R, October 24, 1990.[5] The existing City rules, in Rule § 23-02 defining "Controlling Interest", Illustration (i), use the term "acting in concert" but do not define it. We suggest that it would be useful for the City to achieve greater conformity by incorporating in its rules the definition of "acting in concert" now in State Reg. § 575.6(b). The rules should also spell out in greater detail the extent to which the City statutory language referring to "related transactions" goes beyond the "acting in concert" concept of the State regulations, and whether it would lead to a different result in a case like Crossland Savings. What is the City's view as to the result in Example E if Corporations X and Y were publicly held?

(d) Adm. Code § 11-2101.14 and 15 define "grantor" as including "the person or persons who transfer an economic interest in real property" and "grantee" as including "the

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[5] Note that the State statutes' use of the phrase "transfer or acquisition of a controlling interest" in the definition of "Conveyance" in the real estate transfer tax, Tax Law § 1401(e), and in the definition of "Transfer of Real Property" in the gains tax, Tax Law § 1440.7(a), does not appear in the City's definition of "Transfer" or "transferred", Adm. Code § 11-2101.7, which refers only to transfers or issuance of stock in a corporation, etc., which constitute a controlling interest. Thus, in an Advisory Opinion on the real estate transfer tax, Consolidated Edison Company, TSB-A-97(9)R, December 19, 1997 (CCH New York State Tax Reporter ¶ 402-954), involving an I.R.C. § 351-type reorganization under which, upon shareholder approval, the common stock shareholders of Consolidated Edison were deemed, by operation of law, to have exchanged their stock for common stock of a new holding company on a one-for-one basis, the State ruled that, because under the exchange the holding company acquired a controlling interest in an entity with an interest in real property, the transaction resulted in "a taxable conveyance" of real property (making unnecessary any discussion of whether the transferring stockholders were acting in concert) which, however, under the "mere change" provision will be exempt from real estate transfer tax because the former stockholders of Consolidated Edison will receive a proportionately equal amount of holding company common stock.

person or persons to whom an economic interest in real property is transferred. The definitions of "Grantor" and "Grantee" in existing Rule § 23-02 merely repeat the statutory language. Tax Law § 1401(g), relating to the real estate transfer tax, is more explicit in defining "grantor," where there is a transfer of a controlling interest, to include not only "an entity with an interest in real property" but also "a shareholder or partner transferring stock or partnership interest " in such entity. Example E treats Shareholders B, C, D, and E as the grantors and apparently treats Shareholder A and the other Corporation Y shareholders as the grantees, which seems consistent with the statutory definitions. However, it would add clarity if the definition of "grantor" in Rule § 23-02 were expanded to include language referring explicitly to shareholders or partners similar to that in Tax Law §1401(g), above.[6]

(e) In the case of a tax on the transfer of an economic interest in real property, the real property transfer tax must be paid by the grantor (or the grantee if the grantor does not pay) within thirty days after the transfer, to the Commissioner of Finance at the Department of Finance, Operations Division, Real Property Transfer Tax Group. Adm. Code § 11-2104; Rule § 23.08. "In the case of a transfer of an economic interest in real property, a joint return shall be filed by both the grantor and the grantee for each instrument or transaction by which such transfer is effected, whether or not a tax is due thereon. . . . The return shall be signed under oath by both the grantor or his agent and the grantee or agent". Adm. Code § 11-2105.a. Such return must be filed at the above office at the time the tax is paid, or if no tax is due, within 30 days after the transfer. Rule § 23-09(a). "Where a deed, or instrument or transaction has more than one grantor or more than one grantee, the return may be signed by any one of the grantors and by any one of the grantees, provided, however, that those not signing shall not be relieved of any liability for the tax imposed by this chapter". Adm. Code § 11-2105.e. Neither the existing nor proposed Rules shed any light on how these provisions will apply to transactions involving publicly traded corporations. If Example E involved a merger of two public corporations and the shareholders of X and Y are the grantors and grantees, respectively, can Corporations X and Y sign the return as agents for their shareholders? If it is the shareholders who owe tax as the grantors (or grantees), assuming that the City would require aggregation in such a case, how would this tax be collected? Any payment by one of the corporate parties on behalf of their shareholders would have to be carefully structured to avoid jeopardizing the income tax-free status of the reorganization. Since, as in Example E, not every shareholder's burden is proportionate to his stock ownership, there would be considerable administrative problems in auditing the transaction, and in collecting any additional tax if any were found due from the shareholders. We believe that these are issues which should be addressed by clarifying who the "grantee" is for all purposes in a situation like Example E, unless the problem can be avoided by the City's adopting the reasoning of the Crossland Savings opinion for both the grantor and the grantee where they are publicly traded corporations, so that there would be no tax in such a case.

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[6] The treatment of Shareholder A and the Y Shareholders as the grantees is stated indirectly in Example E by describing beneficial interests in Corporation X's real property as having been "transferred" to them, leaving some question as to whether it was the intent of the Example to infer that they will be "grantees" for all purposes, such as return filing and tax liability (see paragraph 4(c) below).

Many of the problems discussed in (e) above would be eliminated if the City either identified Y as the grantee of the X shares for purposes like return filing and tax liability (on facts like those in Example E) or deleted the existing exemption of transfers made pursuant to statutory mergers from tax at the corporate level in Rule § 23-03(e)(2). This rule predates the adoption in the statute both of the controlling interest rule in 1986 and the mere change exemption in 1994. The retention of the merger rule following the 1986 amendments was important to avoid a double transfer tax on a corporate merger. However, with the enactment of a change-in-form exemption for the City, this no longer seems necessary.

In the State real estate transfer tax, Tax Law § 1405(b).6 originally contained an exemption for deeds given pursuant to mergers, etc., which was repealed in the 1989 legislation enacting both the controlling interest and mere change rules. Currently, the State's position is that, in a corporate reorganization resulting in the acquisition of a controlling interest in Company X, an entity with an interest in real property, by Company Y, both widely held and publicly traded, Company X and its shareholders are the grantors and are equally liable for the entire transfer tax due, and if they fail to pay, then Company Y is liable as grantee. See Coopers & Lybrand, LLP, Advisory Opinion, February 21, 1997, TSB-A-97(2)R (CCH New York State Tax Reporter ¶ 402-671), relating to a reverse triangular merger. With the adoption by the City of both the controlling interest and mere change rules, we suggest that the City consider whether the statutory merger exemption in the rules could be seen as having become obsolete to the same extent that the similar exemption in the Tax Law was deemed expendable when corresponding changes were adopted at the State level. Bear in mind, however, that the Coopers opinion relies in part on definitions of "Grantor" and "Grantee" in Tax Law § 1401(g) and (h) which differ from the corresponding definitions in Adm. Code § 11-2101.14 and 15. See paragraph 4(d) above. With particular reference to the difference in the definitions of "grantor," the City must consider whether the suggested change in regulatory interpretation would be consistent with the statute.

5. We recommend addition of examples of the following:

A. A transfer to or from an LLC.

B. An actual cash sale that is nevertheless exempt to some extent as a mere change in form.

6. The proposed Rules include a step-transaction rule, Rule § 23-05(b)(8)(iii), under which the analysis of the application of the change-in-form exemption would include examinations of transactions occurring before and after the apparent mere change-in-form transfer, to determine "the extent to which the beneficial interest therein remains the same following the transaction." While we understand the theoretical justification for applying such principles in determining the extent to which a transfer effects a change in beneficial ownership, we do have some concerns with this proposal.

The transfer tax has long been applied in a formalistic manner, and has not heretofore employed broadly applicable recharacterization provisions. It is true that, since the enactment of the controlling interest provisions, the rules have included provisions for aggregating transfers of interests in entities for purposes of determining whether there has been a transfer of a controlling interest, with a rebuttable presumption that transfers within a 3-year period are aggregated. Rule § 23-02, definition of Controlling Interest, paragraph (2). These are, however,

rules for determining whether actual transfers of minority interests in entities were in fact made "pursuant to a plan to either transfer or acquire a controlling economic interest in real property" such that there was in fact a transfer of a controlling interest. (Under § 23-02, transfers aggregated with respect to whether a controlling interest has been transferred are also aggregated with respect to the $25,000 threshold for tax and the applicable tax rate.)

The proposed "step-transaction" rule addresses a different kind of question—whether transfers made in some particular form or order can be recharacterized in order to create a different taxable event. Thus, the proposed example concludes that a transfer of real property to a wholly-owned corporation, followed by a sale of a 49% interest in the corporation, results in the imposition of tax on 49% of the consideration for the transfer of the property. Exactly how the two transfers are to be recharacterized is not clear, but the proposed treatment of the first transfer as partially taxable, notwithstanding its formal qualification for a full exemption is, in our view, a qualitatively different application of the concept of "plan" than that heretofore applied to minority entity interests.

The proposed rule is in some respects analogous to the existing rule for multi-step transactions completed within 30 days, set forth in Rule § 23-03(f). We note, however, that that rule is specifically limited in scope, suggesting in turn that the ability to recharacterize a series of planned transactions and compute tax without regard to intervening, planned steps, has heretofore been quite limited. See also Department of Finance Bulletin, December, 1981 (transfer of property in a three-way exchange is taxable twice, notwithstanding parties' plan that the first transfer be immediately followed by the second).

Similarly, while the statute has long included an exemption for transfers involving "a mere agent, dummy, straw man or conduit," Adm. Code § 11-2106(b)(7), this exemption has been narrowly construed to require essentially the income-tax equivalent of a nominee relationship, and has not been available based solely on parties' ability to demonstrate a plan. See, e.g., Petition of The 35-37 West 23rd Street Partnership, New York City Tax Appeals Tribunal, ALJ Division, October 31, 1995 (CCH New York State Tax Reporter ¶600-223). The existing statutory credit provisions, which collapse certain transfers and permit the overall tax liability to be determined in a manner that could be said to reflect a step-transaction analysis, also are narrowly drawn. See Adm. Code §§ 11-2102 (b) (2) and (c) (2), both of which are limited to specific types of related transactions, and include explicit 24-month time limitations.

In addition, it is not clear from the proposed rule what standards will be applied in determining whether different transfers will be considered to be made "pursuant to a plan." For example, do the concepts underlying the aggregation rules of Rule § 23-02 also inform the application of the step transaction doctrine, or is the proposed rule a more limited inquiry into the actual beneficial ownership of property following its transfer? While the application of a step-transaction concept may be appropriate in measuring the change in beneficial interest, we do not believe it is appropriate to apply, for example, a presumption of relatedness to all transactions occurring within three years before or after a transfer. The substance-over-form principles that underlie a step-transaction theory have a long history in the income tax laws, where there is abundant, if not always clear, authority regarding the application of this concept. If this concept is now imported into the City transfer tax, we recommend that it be applied by reference to the

income tax concepts of step transactions, and not by reference to the different concepts that underlie the aggregation rules of Rule § 23-02.

It also should be made clear that, since the basis for the application of such a doctrine here is to arrive at an accurate representation of the true beneficial interest in property following its transfer, taxpayers likewise are entitled to invoke this rule, so that two transfers which, in form, would not qualify for the change-in-form exemption might nonetheless be shown to be sufficiently related to be exempt from tax.

The administration of such a rule must also be addressed. If the ministerial process of recording deeds for actual conveyances becomes a forum for inquiries into the possibility of related transfers, there will be serious transactional problems raised by the application of this rule. In the illustration in proposed § 23-05(b)(8)(iii), is the tax on the 49% said not to be exempt as a mere change of form due at the time the building is transferred to X Corporation, or at the time the sale of stock to B, C, D and E takes place?

We also believe that the application of a step-transaction rule in applying the change-in-form exemption is directly contrary to the State's interpretation of its transfer tax and, prior to that, the State's interpretation of the gains tax. Compare, e.g., Peter S. Kalikow, Advisory Opinion, January 18, 1991, TSB-A-91(1)(R) (CCH New York State Tax Reporter ¶ 253-751) (transfer of property to 100% owned corporation, followed by sale of 20% stock interest, is not subject to the gains tax). We are concerned about the development of different State and City interpretations of the same statutory exemption. Such nonconformity in the administrative interpretations of essentially identical statutory provisions increases the burdens of complying with New York's taxes, and ought generally to be avoided. We urge the City to coordinate with the State to consider whether the policy reasons for their position might also be applicable to the City tax, and to endeavor to avoid the complexities created by differing interpretations.

Finally, given the fact that this interpretation differs from the limited step-transaction analysis heretofore applied under the City transfer tax statute and rules, and from the interpretation (as we understand it) of the change-in-form exemptions by the State, we believe this rule should be applied prospectively only.

7. The following are recommended stylistic or grammatical corrections:

A. In Illustrations (ii) and (iii) of Rule § 23-03(e).2, added by § 3 of the proposals, we suggest replacing "would be meaningless" with "would not affect X's beneficial interest in Y's real property".

B. In Example B of Rule § 23-05(b)(8)(i), added by § 4 of the proposals, we recommend that "gets" in the 6th and 7th sentences be replaced with "receives".

C. In § 1, amending Examples (i) and (ii) in Rule § 23-03(d), in the first sentence of Example (ii) add "in 1990" (or some other pre-effective date), as in Example (i).

D. In §§ 2 and 4, amending Rule § 23-03(e)(1) and (3), put new subparagraphs (iv) at the beginning of their respective paragraphs as new subparagraphs (i), so that the reader

does not have to wade through three subparagraphs before being told that they are no longer applicable.

E. In § 2, above, add the following at the end of the first sentence of subparagraph (iv) as proposed: "whether or not shares of stock are issued in exchange."

F. On page 4 of the proposals, 7 lines from the bottom, "retains" should be "retain."