

TAX SECTION

New York State Bar Association

Application of the New York state 10%
Tax on Gains Derived from
Certain Real Property Transfers to
Transfers Involving Interests in Troubled Real Estate

SEPTEMBER 25, 1991

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TAX SECTION**New York State Bar Association****OFFICERS**

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1 Liberty Plaza
New York City 10006
212/225-2440

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September 25, 1991

The Honorable James W. Wetzler
Commissioner of Taxation and Finance
State of New York
Building 9, State Campus
Albany, NY 12227-1215

Re: Application of the New York State
10% Tax on Gains Derived from
Certain Real Property Transfers to
Transfers Involving Interests in
Troubled Real Estate

Dear Commissioner Wetzler:

Enclosed is a joint report of the New York State Bar Association Tax Section and the Association of the Bar of the City of New York, Committee on State and Local Taxation. This report responds to your request that the bar associations' tax committees examine and report on problem areas in the application of the gains tax to troubled real estate, focusing primarily on changes that can be implemented administratively.

The report addresses six specific areas:

A. Measurement of Taxable Gain.

A persistent problem in the gains tax has been that the Department disallows many significant project costs in computing taxable

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gain. As a result, tax is imposed on phantom gains, and sometimes is imposed even where the taxpayer has sustained a loss. In short, the "gains tax" often fails to measure true economic gain. The report recommends that the Department revisit the administrative interpretations it applies in measuring gain, and craft interpretations that capture economic gain fairly and accurately.

B. Foreclosures.

The report discusses a number of questions presented by foreclosure transactions. The report addresses the measurement of the transferor's consideration on a foreclosure sale. The report also includes certain proposals regarding the application of transferee liability and gains tax priority rules to transfers pursuant to judicial enforcement of nonmortgage liens, and to sales of collateral under the U.C.C.

C. Deeds in Lieu of Foreclosure.

The report discusses the issue of transferee liability where a lender acquires property in a transfer in lieu of foreclosure. The report focuses on the fact that transferee liability in the gains tax statute is based on an obligation to withhold tax from consideration paid, and contains specific proposals that would reduce or eliminate transferee liability in many deed-in-lieu situations.

D. Transfers in Bankruptcy.

The report does not comment on the ongoing litigation involving the application of the gains tax to transfers pursuant to Chapter 11 plans. Whatever the outcome of that litigation, however, there are a number of procedural changes that would be helpful, and these are discussed in the report.

E. Special Issues Involving Cooperative Housing Corporations.

The increase in sponsor defaults has raised a number of questions regarding the transferee liability of cooperative housing corporations that take back unsold shares from defaulting sponsors. The report discusses these issues, and contains a specific proposal for administrative action to ameliorate these problems. The report also notes the need to update the Department's co-op and condominium filing procedures, particularly the "Safe Harbor Estimates" permitted by the Department.

F. Penalties.

The bar associations are very concerned about the Department's application of the gains tax penalty provisions. Although the statute specifically permits the Department to abate penalties, the imposition of gains tax penalties appears to be almost automatic, with little or no inquiry into whether an underpayment reflects willful disregard of the law. This approach is inappropriate. The report urges the Department to adopt a more reasonable attitude in dealing with the many taxpayers who endeavor in good faith to apply this complicated and still developing law to a variety of sophisticated and novel transactions.

The Tax Section appreciates your interest in this area. We would be pleased to discuss our recommendations with you or your staff and to help in any way we can to refine and implement the proposals.

Very truly yours,

James M. Peaslee
Chair

cc: The Honorable Vincent Tese
Commissioner
New York State Department of
Economic Development
1515 Broadway
New York, New York 10036

THE ASSOCIATION OF THE BAR
OF THE CITY OF NEW YORK
42 WEST 44TH STREET
NEW YORK, NY 10036-6690
COMMITTEE ON STATE AND LOCAL TAXATION

GORDON D. HENDERSON

CHAIR

767 FIFTH AVENUE
30TH FLOOR

NEW YORK, N.Y. 10153

(212) 310-8446

FAX #(212)310-1007

CAROLYN JOY LEE ICHEL

VICE-CHAIR

30 ROCKEFELLER PLAZA

20TH FLOOR

NEW YORK, N.Y. 10112

(212) 903-8761

FAX # (212) 974-3059

September 25, 1991

STUART J. COLORING

SECRETARY

767 FIFTH AVENUE
30TH FLOOR

NEW YORK, NY 10153

(212)310-8312

FAX # (212) 310-8007

The Honorable James W. Wetzler
Commissioner of Taxation and Finance
State of New York
Building 9, State Campus
Albany, NY 12227-1215

Re: The Enclosed Joint Report on the Gains Tax

Dear Commissioner Wetzler:

I am pleased to enclose the joint report of the New York State Bar Association Tax Section and our Committee on State and Local Taxation, which addresses a number of issues under New York State's 10% gains tax. The report responds to your request that the bar associations' tax committees examine and report on problem areas in the application of the gains tax to troubled real estate, focusing primarily on changes that can be implemented administratively. The substance of the report is summarized in the enclosed cover letter from Jim Peaslee, chair of the State Bar Tax Section.

We sincerely appreciate your interest in this area, and your willingness to consider avenues for prompt administrative action. Our committees look forward to the opportunity to work with you to craft the important reforms that are necessary to the fair administration of the gains tax.

Cordially,

Carolyn Ichel
Vice-Chair

CI/md
Enclosure

CC: Vincent Tese
Commissioner
NYS Department of Economic Development

Application of the New York state 10%
Tax on Gains Derived from
Certain Real Property Transfers to
Transfers Involving Interests
in Troubled Real Estate

SEPTEMBER 25, 1991

Application of the New York State 10%
Tax on Gains Derived from
Certain Real Property Transfers to
Transfers Involving interests
in Troubled Real Estate*

I. Introduction.

The New York State 10% Tax on Gains Derived from Certain Real Property Transfers¹ (the "gains tax") was originally enacted in March of 1983.² Certain problems in the application and administration of the law quickly became apparent and, to its credit, the Department of Taxation and Finance ("Department") took heed of many of these concerns and responded with Information Bulletins and with proposals that resulted in the 1984 amendments to the statute.³

* This report was prepared by an ad hoc committee comprising members of the New York State Bar Association ("NYSBA") Tax Section and the Association of the Bar of the City of New York ("ABCNY") Committee on State and Local Taxation. The Report has been approved by the Executive Committee of the Tax Section of the NYSBA, and by the Committee on State and Local Taxation of the ABCNY. In addition to the above Committees, the report was reviewed and commented on by members of the NYSBA Tax Section Committee on Income from Real Property and the NYSBA Real Property Section and the ABCNY Committee on Real Property. The principal authors of the report are Carolyn J. L. Ichel and Susan Mancuso, with substantial commentary from Stuart J. Goldring, Stuart J. Gross, Joel i. Miller and Kenneth I. Moore. Helpful comments were received from E. Parker Brown, Richard G. Cohen, Dale S. Collinson, John A. Corry, Harvey Dale, Haskell Edelstein, Albert Feuer, Leonard Gerson, Victor Keen, K. C. McDaniel, Stephen L. Millman, Melvyn Mitzner, Ronald A. Morris, Linda L. Ng, James M. Peaslee, Elliot Pisem, Bernard M. Rifkin, Arthur R. Rosen, David Sachs, Ira S. Sheinfeld, Alan H. solarz and Lary S. Wolf.

¹ Tax Law Article 31-B, §§1440 through 1449-c.

² 1983 Laws Chs. 15, 16.

³ 1984 Laws Ch. 900.

From the outset there were issues regarding the application of the gains tax to troubled real estate situations. However, in the economic climate of the mid-1980's practical experience with these problems was rather limited. It was difficult, both for practitioners and for the Department, fully to appreciate the nature and scope of the problems that would arise in applying the gains tax during a widespread downturn in the real estate market.

Unfortunately, the cycle has now turned and the real estate market has changed in ways not foreseen or imagined when the gains tax was enacted. Throughout the State, real property owners and their lenders are struggling with the problems of defaults, foreclosures and bankruptcies.

The Department, recognizing the fundamental changes in the economic environment, asked the New York State and City Bar Associations to examine and report on problem areas in the application of the gains tax to troubled real estate. The Department requested that we focus primarily on what can be done administratively -- without the need for statutory amendments -- to address the problems, in response to that request, this report addresses six common problem areas under the gains tax. In each case the report outlines reforms that can and should be achieved by administrative action.

Given the nature of the Department's request and the scope of the gains tax issues themselves, this report does not attempt to address questions under the transfer taxes and the mortgage recording tax, nor does it address issues of substantive real property law. However, in order to fashion a comprehensive approach to the problems of troubled real estate, these important areas must also be addressed. This is particularly evident with

respect to the "dormant mortgage" provisions of Real Property Law section 275, where hurriedly enacted provisions designed to enhance tax revenues have raised unintended and potentially serious questions on very basic and substantive issues of real estate law.

II. Summary of Areas Considered and Principal Conclusions.

In considering the application of the gains tax to troubled properties it is important to examine both whether the gains tax is in fact charged on true economic gain, and whether the gains tax is borne by the persons who enjoyed that gain. Set forth below is a brief summary of the issues addressed in this report, and the principal conclusions of the report.

A. Measurement of Taxable Gain.

The analysis of the impact of the gains tax on troubled real estate must begin with the fundamental question of whether taxable gain is being properly measured. To take a common example, a construction lender's concern about liability for the gains tax steins not only from the transferee liability rules, but also from the fact that the Department disallows many significant project costs in computing the gains tax due. As a result, tax is imposed on phantom gains, and sometimes is imposed even where there is an economic loss on the project.

This has been a persistent problem in the gains tax and it produces significant inequities. The report illustrates the problem with examples of interest costs that the Department currently disallows. There are a number of other areas where this problem arises. Given the intent of the statute to tax economic gain and the Department's statutory authority to identify "customary, reasonable, and necessary costs" that are allowable in computing taxable gain, these problems are particularly suited to administrative relief.

B. Foreclosures.

The report addresses the computation of the transferor's consideration on a foreclosure sale. The interpretations currently reflected in portions of the regulations and set forth in the Department's recent TSB-A-91(4)-R appear to be correct and of general application.

The report recommends that the Department's interpretations in this area be articulated more directly. The report also considers gains tax transferee liability questions in foreclosure actions. The gains tax statute contains a provision exempting transferees in mortgage foreclosure actions from transferee liability, and the Real Property Actions and Proceedings Law prescribes rules assigning priority to the payment of the gains tax. The report concludes that these provisions should be interpreted to cover not just foreclosures of mortgages on real property, but any judicial enforcement of a lien or other security interest in real or personal property. The report also states that the Department could conclude that relief from transferee liability is appropriate in the case of sales of collateral under the U.C.C. However, the U.C.C. has no provision comparable to the gains tax priority specified under the RPAPL,

and it is therefore more difficult to conclude that the Department can promulgate administrative interpretations applying the priority rules of the RPAPL to U.C.C. sales.

C. Transfers in Lieu of Foreclosure.

The report discusses the issue of transferee liability where a lender acquires property in lieu of foreclosure -- that is where the debtor and lender agree that encumbered property will be transferred to the lender in full or partial satisfaction of a security interest in the property. The report concludes that where a lender acquires property in a transfer in lieu of foreclosure of a valid security interest arising out of a bona fide loan, the transferee should have no withholding liability because it has not "transferred over" any consideration to the transferor.

The report discusses authorities in related areas that support this conclusion, and discusses several additional aspects of the basic proposal. The report also recommends that any administrative guidance issued in this area include provisions to prevent abuse, and lists certain factual inquiries that might be considered in developing anti-abuse rules.

The report also describes procedural changes that could be implemented to address the practical problem of transferee liability relief where instruments evidencing a transfer in lieu of foreclosure must be recorded.

D. Transfers in Bankruptcy.

The report does not comment on the substantive aspects of the issues currently being litigated in the "Stanhope" case. There are, however, a number of procedural issues that exist without regard to the outcome in Stanhope, and further procedural questions that will be raised if the taxpayer prevails in Stanhope. These items are addressed in the report.

E. Special Issues Involving cooperative Housing Corporations.

The report does not generally address the Department's approach to the taxation of cooperative and condominium plans. It does, however, discuss two problems that relate specifically to the application of the gains tax to troubled co-ops. First, the report discusses the potential transferee liability of a cooperative housing corporation if the co-op has to take back shares from a sponsor who has defaulted on maintenance payments. The co-op's exposure to transferee liability in these situations derives directly from the administration's unique application of the gains tax to co-op transactions. The report concludes that the Department could reasonably determine, under the framework of its existing treatment of co-op transfers, that the transfer of co-op shares from the sponsor to the co-op does not trigger the payment of gains tax.

The report further recommends that the Department update its guidance regarding "Safe Harbor Estimates" of consideration on co-op and condominium plans to reflect current market conditions.

F. Penalties.

There are serious problems with the Department's application of penalties under the gains tax. The 1984 amendments to the gains tax provided that, where an underpayment of tax is attributable to reasonable cause and not willful neglect, penalties shall be abated. The practice of the Department, however, seems to be to assert penalties almost automatically. This is not appropriate, nor is it consistent with the statutory intent. The report urges the Department to review its policies in this area.

III. Overview of the Gains Tax.

The gains tax applies to certain transfers of real property within New York State⁴ and imposes a 10% levy on gain derived from these transfers. "Gain" is defined as the "difference between the consideration for the transfer of real property and the original purchase price."⁵ Calculation of taxable gain thus requires determining the "consideration" received by the transferor, and determining the transferor's original purchase price (or "OPP") for the transferred property.

The definition of a taxable "transfer" includes:

"sale, exchange, assignment, surrender, mortgage foreclosure, transfer in lieu of foreclosure, option, trust indenture, taking by eminent domain, conveyance upon liquidation or by a receiver, or transfer or acquisition of a controlling interest in any entity with an interest in real property."⁶

⁴ Tax Law §§1441, 1443.

⁵ Tax Law §1440(3).

⁶ Tax Law §1440(7).

The tax therefore clearly applies both to foreclosures and to transfers in lieu of foreclosure, and applies to transfers of direct interests in real property⁷ and to transfers of controlling (50%) interests in entities that own real property.⁸

The State interprets the gains tax as being payable on transfers of stock in a cooperative housing corporation pursuant to a cooperative plan, regardless of the percentage interest such stock represents in the co-op corporation. Under this approach the tax on cooperative conversions is payable not on the sponsor's conveyance of real property to the co-op corporation, but on the transfer of co-op shares to third-party purchasers.⁹ Unsold shares held by the sponsor (or related persons) therefore carry with them the tax due on gain inherent in the sponsor's earlier sale of the property to the co-op corporation. The gains tax regulations further state that re-sales of co-op apartments by investors are subject to tax where the aggregate consideration is \$1,000,000 or more, again without regard to the investor's percentage interest in the co-op corporation.¹⁰

The gains tax does not apply to:

"the creation, modification, extension, spreading, severance, consolidation, assignment, transfer, release or satisfaction of a mortgage; a mortgage subordination agreement, a mortgage severance agreement, an instrument given to perfect or correct a recorded mortgage; or a release of lien of tax . . .

." ¹¹

⁷ See Tax Law §§1440(4), 1440 (6)

⁸ See Tax Law §1440(2).

⁹ See 1230 Park Associates v. Commissioner, 566 N.Y.S.2d 957 (3rd Dept. 1991).

¹⁰ 20 NYCRR §§590.24, 590.40.

¹¹ Tax Law §1440(7).

As a procedural matter, the gains tax requires that, at least 20 days prior to transfer, the transferee and the transferor submit to the Department pre-transfer audit questionnaires.¹² These questionnaires are used by the Department to make a tentative assessment of the amount of gains tax due on the transfer; and the Department furnishes copies of its tentative assessments to the transferor and the transferee. The tentative assessment form has two practical effects. First, it sets forth the amount of gains tax that must be paid in order to record an instrument of transfer.¹³ Second, it sets forth the amount of tax for which the transferee has personal liability. Specifically, the statute provides that:

"whenever [the Department] shall inform the transferee that a tentative assessment of [gains] tax exists, any sums of money, property or other consideration, which the transferee is required to transfer over to the transferor shall be subject to a first priority right for any [gains] taxes stated to be due from the transferor to the state in such tentative assessment, and . . . the transferee is forbidden to transfer to the transferor any such sums of money, property or consideration to the extent of the amount of the state's claim stated in such tentative assessment For the transferee's failure to comply . . . the transferee . . . shall be personally liable for the payment to the state of any such taxes stated in such tentative assessment" ¹⁴

¹² Tax Law §1447.

¹³ Tax Law §1447(1)(f)(1).

¹⁴ Tax Law §1447(3)(a). A special rule applies in the case of mortgage foreclosure actions, which is discussed in Section B, below. As an alternative to personal liability, the transferee may post a bond. Tax Law §1447(3)(c).

IV. Discussion.

A. Measurement of Taxable Gain.

As noted above, taxable gain is the excess of "consideration" over "OPP." In interpreting these terms the Department has taken some positions and promulgated certain interpretations that overstate the amount of gain. Some of these interpretative problems are specific to troubled real estate; others are endemic to the gains tax. Any analysis of the peculiar problems affecting transfers of troubled real estate must however begin with the problems that exist in that element basic to the tax: The definition of gain.

Over the years, the Department has received numerous complaints and correspondence regarding a range of administrative positions that reflect questionable, often unpublished, and economically unrealistic policy decisions. Enormous progress was made in 1983 and 1984. Since that time, however, whether citing revenue considerations, or pointing to features of the gains tax that distinguish it from an income tax, or expressing an inability to find a particular cost on one of the regulations' various lists, the Department has been essentially unwilling to consider changes in its interpretations that are necessary in order accurately to measure true economic gain. As the real estate situation worsens, the impact of the Department's uneconomic determinations has been magnified, and the burden of paying tax on inflated or nonexistent gain is felt more severely. It is difficult to think of an area of the gains tax in which relief is more necessary, more appropriate, or more suited to administrative action than this problem of overstated gain.

1. Interpretation of Original Purchase Price.

a. Background.

The statute was intended to tax economic gain. Its very title makes this clear. Under the original gains tax statute the definition of OPP was quite narrowly drawn, and property owners "were paying tax on what was not true economic gain."¹⁵ The definition of OPP was therefore completely reworked in a statutory amendment enacted in 1984.

Under the revised definition, OPP is:

"the consideration paid or required to be paid by the transferor; (i) to acquire the interest in real property, and (ii) for any capital improvements made or required to be made to such real property, including solely those costs which are customary, reasonable, and necessary, as determined under rules and regulations prescribed by the tax commission, incurred for the construction of such improvements."

The statute further provides that:

"Original purchase price shall also include the amounts paid by the transferor for any customary, reasonable and necessary legal, engineering and architectural fees incurred to sell the property and those customary, reasonable and necessary expenses incurred to create ownership interests in property in cooperative or condominium form, as such fees and expenses are determined under rules and regulations prescribed by the tax commission."¹⁶

¹⁵ Interview with John P. Dugan, former Deputy Commissioner and Counsel of the Department of Taxation and Finance, reported in The New York Times, Sunday, July 24, 1983.

¹⁶ Tax Law §1440(5)(a) (emphasis added).

As stated in the Governor's 1984 memorandum in support of this statutory provision, the amendment:

"[g]rants the [Department] the authority to prescribe by regulation which costs of capital improvements, which legal, architectural, and engineering fees related to the sale of the property, and which condominium and cooperative costs, shall be permitted to reduce taxable gain. The bill also provides that a transferor may include in his original purchase price the cost of capital improvements not yet made at [the] date of transfer, but which he is required to make.... The proposal to allow customary, reasonable and necessary legal, architectural, and engineering costs, related to the sale of the property, and costs of creating cooperative and condominium ownership interests as an additional offset to taxable gain would impose the gains tax more accurately on the economic gain derived from a transfer. The proposal to allow the customary, reasonable and necessary expenses of capital improvements would codify the Department's interpretations that the soft costs of capital improvements do reduce taxable gain."¹⁷

Clearly the 1984 amendments vested in the Department the authority to identify costs of acquisition, construction, conversion and sale that are to be included in original purchase price. Just as clearly, the focus of the Department's inquiry must be to impose the tax on true economic gain. The Court of Appeals assumed as much when, in 1985, it rejected a taxpayer's argument that the gains tax might be imposed even where a net loss was sustained, stating that:

¹⁷ Governor's Memorandum in support of Senate Bill No. 10119 (the 1984 statutory amendments) ("Memorandum in Support"), page 2, para, i, and page 5, para, i (emphasis added).

"the regulations promulgated by the Department of Taxation and Finance to implement the statute make it clear that all customary, reasonable and necessary costs related to the acquisition and improvement of real property are included in the original purchase price so that the tax will be imposed only in the case of a net profit."¹⁸

The regulations to which the Court of Appeals referred do indeed include extensive lists to "illustrate [] the specific costs which may be included in the computation of original purchase price if incurred in connection with the acquisition of the real property";¹⁹ "illustrate [] the specific costs . . . that are allowable as a cost of capital improvements";²⁰ and "illustrate [] costs that are includible in original purchase price as costs to convert property to cooperative or condominium form."²¹ These lists are not all-inclusive nor do they purport to be. Yet in the years since these regulations were issued in 1985 there has been an increasing tendency on the part of the Department to exclude from OPP any amount that is not specifically listed in the regulations, even where it is clear that the costs relate to the acquisition, improvement or conversion of real property and that the denial of such costs will result in the artificial overstatement of taxable gain, and in some cases the imposition of gains tax where there are real out-of-pocket losses.

¹⁸ Trump v. Chu. 65 NY2d 20, 27.

¹⁹ 20 NYCRR §590.15.

²⁰ 20 NYCKR §590.16.

²¹ 20 NYCRR §590.39.

b. Problems with Disallowed Interest Expense.

The Department's restrictive treatment of interest expense provides a telling example of this problem that is particularly relevant to troubled real property. Hardly a real estate project exists in which financing is not an important consideration; it is especially important for new development. Considered in the context of troubled real estate, there should be very few situations in which a construction lender should have to be concerned about transferee liability, for if the project has to be taken over by the lender the unfortunate likelihood is that there is no economic gain. Invariably, however, the Department's determinations of the allowable interest expense result in significant overstatements of taxable gain, and can produce gains tax even where there is an economic loss.

(1) Interest on Land during Construction.

One of the chief causes for overstated gain on these projects is that, as a matter of audit policy, the Department does not include in OPP the interest expense incurred during the construction period on indebtedness that is attributable to the underlying land. The regulations do not require this disallowance.²² The regulations provide that interest on purchase price is not an allowable acquisition cost;²³ that position is defensible, but it has no relevance to the identification of allowable construction costs. The

²² See 20 NYCRR §590.16(d).

²³ 20 NYCRR §590.15(c).

regulations also provide that OPP includes interest on loans the proceeds of which are used to make improvements. From this listed item of allowable costs, however, the Department infers that interest expense incurred during the construction period to carry the land on which the construction takes place is not allowable.

The ostensible distinction between allowed and disallowed interest expense is that the allowed interest pertains to a capital improvement, whereas the other does not. The significance of this distinction loses its meaning, however, when one considers other costs that are permitted if incurred during the construction period, such as construction period real property taxes (which clearly include taxes on the land as well as those on improvements).²⁴ The Department's disallowance of construction period interest on land is therefore inconsistent with its own regulatory treatment of analogous costs.

It also should be noted that the Department's treatment of interest on land is directly contrary to the income tax treatment of the same item. Federal regulations promulgated under Code section 263A relating to construction period interest provide that the land on which construction takes place is part of the overall "production expenditures" for the project.²⁵ Accordingly, taxpayers are required to capitalize and include in the basis of the constructed improvement the interest costs attributable to the underlying land. It is anomalous that

²⁴ 20 NYCRR §590.16(d).

²⁵ Treas. Reg. §1.263A-1T(b)(2)(iv)(B). On August 9, 1991, the Treasury Department issued proposed regulations under Internal Revenue Code §263A(f). I.R.S. Notice of Proposed Rulemaking (1A-120-86) (to appear in the Federal Register on August 16, 1991). This report does not consider such proposed regulations.

the income tax requires this interest to be capitalized and not deducted, but the gains tax, which can account for an expense only by including it in OPP, refuses to recognize this same interest cost as a cost of the constructed asset. The consequence of the Department's administrative posture regarding interest on land is that an offset for such interest expenditures is denied altogether, even though as an economic matter the costs incurred in carrying the land while the improvements are under construction are expected to be reflected in the value of the finished project.

(2) Definition of Construction Period.

As discussed above, the gains tax definition of construction and development costs includible in OPP should be no less inclusive than the federal definition of costs that are required to be included in basis. Given the unique nature of the gains tax, however, construction and development costs can only be accounted for by including them in OPP – there is no concept of deducting costs on a current basis in measuring taxable gain. There are therefore situations in which, even though federal income tax rules permit a current deduction and do not require development-related expenditures to be included in basis, such costs must be included in OPP in order to apply the gains tax fairly.

The definition of allowable construction period costs represents such a situation. Here, the Department's narrow administrative definition of the "construction period" under the gains tax produces inequities both at the beginning and at the end of a development project.

(a) The Beginning.

The development of real estate begins long before the first swing of the wrecking ball or the groundbreaking thrust of the shovel. Among the activities integral to real property development are assembling various parcels of real property, negotiating air rights agreements, obtaining zoning approvals and building permits, and securing interim and permanent financing. The regulations provide that a construction period "usually begins on the date on which construction, development, erection or complete renovation of all or part of the real property begins. . . . The construction period is not considered to have begun solely because a plan of construction has been prepared or a building permit has been obtained. Rather, the construction period generally will be considered to have commenced when the plan of construction is essentially implemented."²⁶

Undoubtedly the commencement of physical construction work is a customary, reasonable and necessary activity signalling the commencement of development. However, the restrictive view that the construction period has not commenced unless physical construction work is underway is neither required under the statute nor economically justifiable.

²⁶ 20 NYCRR §590.16(e). This description apparently was based on the 1976 "Bluebook" discussion of the then newly-enacted federal interest capitalization rules. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 (H.R. 10612, 94th Cong., P.L. 94-455), page 27.

The Department's regulations already recognize the expansive nature of the real estate development process by permitting a wide range of costs to be included in OPP, including marketing and feasibility studies,²⁷ soil tests and environmental studies, even where they are incurred prior to acquisition of the property. A comparable interpretation in the construction context would be to recognize that the development of real property can begin when the taxpayer initiates assemblage activities, applies for zoning approvals, undertakes feasibility studies, engages architects to draw up plans, and so forth.²⁸ In measuring economic gain from a construction project it is appropriate to begin when the project begins, not when physical construction work commences. The Committee believes that in order to apply the statute properly the Department must exercise its regulatory authority and develop a more realistic definition of construction period so that the definition of OPP includes all of the costs of development.

In reaching this conclusion the Committee takes note of the Third Department's decision in Mattone v. State of New York Department of Taxation and

²⁷ 20 NYCRR §590.15(b).

²⁸ See also Internal Revenue Code §266, under which taxpayers can elect to capitalize certain costs incurred with respect to unimproved and unproductive real property, and costs incurred for the development or construction of real property.

Finance.²⁹ In that case the Third Department upheld the Department's disallowance of pre-construction interest and real property taxes claimed with respect to properties the taxpayer sought to develop. The Court stated that it was:

"constrained to defer to the Tax Commission's interpretation of a statute to the extent it involves matters within its expertise. . . particularly where, as here, the statute expressly vests explicative power in the Tax Commission. . . . Furthermore, we find nothing irrational or unreasonable . . . in the Tax Commission's interpretation . . . that carrying costs incurred prior to the commencement of construction of capital improvements are [not includible in OPP]."³⁰
(Citations omitted.)

Mattone presented some rather unusual facts. It appears that the taxpayer's properties were in fact occupied by tenants. The Court also stated that the taxpayer may have taken current income tax deductions for the expenses sought to be included in OPP (rather than capitalizing such costs). Furthermore, the taxpayer in Mattone never actually engaged in construction. There was therefore no reason to invoke any of the construction rules. In essence, the treatment in Mattone was the same as the treatment of costs incurred by a potential buyer who fails to acquire property. In such a case the regulations state that "[p]re-acquisition costs relating to real property that was not ultimately purchase[d] may not be include in the computation

²⁹ 144 AD2d 150 (3rd Dept. 1988).

³⁰ Id. at 152.

of original purchase price of any related property that was purchased."³¹ The case does not, therefore, address the more pertinent question of measuring the costs of an actual construction project.

Mattone also is important for reflecting the court's deference to the Department's interpretation of the statute. This deference supports the Committee's view that the Department has broad authority under the law as it now stands to adopt regulations and interpretative positions defining taxable gain. It also highlights the responsibility the Department has to exercise its authority in a balanced manner in order to achieve the purpose of the statute.

(b) The End.

The Department's treatment of the end of the construction period also disallows legitimate project costs and distorts the computation of taxable gain. Under the regulations "[t]he construction period ends when the real property is substantially complete and ready to be placed in service."³² The regulations further provide that construction is complete when property is "ready to be placed in service or is ready for sale," and state that, in the event a construction period is suspended due to "insufficient sales or insufficient

³¹ 20 NYCRR §590.15(b).

³² 20 NYCRR §590.16(e). This description also appears to be based on the 1976 "Bluebook."

rental demands . . . the construction period has ended, and [interest] will no longer be allowed."³³

Again, these regulations reflect an unnecessarily narrow approach to the measurement of taxable gain for gains tax purposes. During the economic boom of the mid-1980's the lag time between having a building ready for rental or sale and its actual sale or lease-up often was quite short, in that environment the administrative decision to disallow all costs incurred after the completion of physical construction may well have reflected a bright line test that, in most cases, could be assumed to approximate the correct economic result. Given the current development climate, however, it has become clear that this simplified approach no longer works fairly, and results in overstated gain. Developers now experience considerable delays between the time a project is completed and the time it achieves sell-out or lease-up. These delays are unfortunate, they are endemic to the industry, and they are expensive.

The often severe problems that result from the current administrative approach are best illustrated by an example. This example depicts, albeit in simplified form, a fairly common scenario in troubled real estate projects.

Consider Developer "D," who bought land for \$100 and began constructing condominiums. His project lender "L" financed \$80 of the purchase price for the land, and

³³ NYCRR §590.16(e).

committed to lend another \$400 for the condominium construction. The interest rate on L's loan is 10%.

Three years into construction, after L has advanced \$300, L asserts that the project is not progressing on schedule, and declares D in default. L stops advancing funds, and the project grinds to a halt. D and L then begin negotiating, taking into consideration a possible work-out, the possibility of finding a new equity investor, the extent of D's personal exposure, the possibility of foreclosure or bankruptcy, and D's potential claims against L for breach of its loan commitment. After several months of negotiations L commences a foreclosure action, and, one year after construction stopped, the property is transferred to L in a foreclosure sale.

On the day construction stopped D owed L \$380 of principal, plus the interest that had accrued thereon. Making some simplifying assumptions (to ignore compound interest and account for the fact that construction draws are spread across the three-year period), that interest can be estimated at:

\$80 x 10% x 3 years	= \$24
\$100 x 10% x 2 years	= \$20
\$100 x 10% x 1 year	= <u>\$10</u>
	\$54

On that day, although the costs incurred by D exceed the amount of the debt by \$20, the Department would treat D as having taxable gain, as follows:

Consideration received (\$380 + \$54)	\$434
OPP	
Land acquisition cost	(\$100)
Construction Costs ³⁴	(\$300)
Allowed Interest (\$20 + \$10)	(\$ 30)
	<u>\$ 4</u>

By the time of the foreclosure sale D's debt to L has accrued another year's interest, and now aggregates \$92, computed as follows:

\$80 x 10% x 4 years	= \$32
\$100 x 10% x 3 years	= \$30
\$100 x 10% x 2 years	= \$20
\$100 x 10% x 1 year	= <u>\$10</u>
	\$92

The Department may well disallow all of that year's interest accruals in computing OPP. The regulations state that if a construction period is suspended, interest will no longer be allowed.³⁵ Applied to this situation, those regulations reach an extraordinary result. D's consideration in the foreclosure sale is increased by the interest accruing on the \$380 owed to L, but that accruing interest is not allowed in computing OPP. As a result, although D's project clearly did not become more profitable in the year between default and foreclosure, D's taxable gain increased:

Consideration (\$380 + \$92)	\$472
OPP	
Land acquisition cost	(\$100)

³⁴ This assumes all of L's advances for the project were expended for items includible in OPP. In many cases, however, the Department's definitions of allowable project costs will mean that some of the expenditures paid out of the construction loan are not included in OPP.

³⁵ NYCRR §590.16(e).

Consideration Costs	(\$300)
Allowed Interest (\$20 + \$10)	<u>(\$ 30)</u>

Taxable "Gain" \$ 42

D has lost his equity investment and he lost the project. Overall the project costs exceeded the amount of L's loan by \$20. But when L forecloses on the project the Department will seek \$4.20 of gains tax. The Department's disallowance of interest costs means that the longer a project is in trouble, the greater the gains tax. The gains tax was intended to apply to economic gain, but in these situations it actually works in reverse.

This result does not make sense, and it is a common problem for properties in trouble. The Department should respond to this difficult reality and preserve the essential nature of the gains tax by developing a more accurate description of the end of a construction period.

There are a number of sources on which the Department can draw. For example, standards utilized by the accounting profession³⁶ and the rules re-characterizing a developer's income under the federal passive loss provisions³⁷ may provide helpful guidance. There also are a number of objective factual inquiries that could be relevant in determining whether a construction period has ended, such as whether the

³⁶ See the Statement of Financial Accounting Standards No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects (October 1982), at para. 22.

³⁷ See Treas. Reg. §1.469-2T(f)(5).

property is still subject to a construction loan. (The terms of construction loans are generally more onerous than other financing, and developers are therefore unlikely to continue construction loans simply to achieve a gains tax advantage.)

Certainly the Department has a legitimate concern for distinguishing between costs that are incurred by a holder of productive, operating property and costs that are incurred with respect to property under development. Any new approach would have to take this concern into account. The Department's current approach, however, fails to balance this concern against the need for proper measurement of taxable gain. Too often developers of newly constructed properties incur economic losses on their projects -- lose their equity investment in the failed project -- yet the Department determines that there is taxable gain. That is not reasonable, and it is why the Department should reexamine the positions it takes in defining OPP.

The Committee does note that the more flexible definition of construction period advocated here would not be as simple to apply as a "physical work" standard, and would require more information from taxpayers and more judgment calls by the Department. However, in the Committee's experience the State is already very active in auditing gains tax filings. Moreover, the Department has the exceptional ability to audit transfers twice, once at the pre-transfer stage, and again on a

field audit after the transfer has taken place. Finally, and perhaps most importantly, the determinations that the Department makes in measuring the start and the end of a development period are not made while the development project is ongoing and its future unknown. Instead these determinations are made when the property is disposed of by its owners, and the use and history of the property can be ascertained. We therefore believe that it is both necessary as a matter of equity and practicable as a matter of tax administration to develop a more reasonable view of the kinds of activities that signal the commencement of a development project and the events that show that development is complete.

2. Interpretation of Consideration.

There also are issues on the consideration end of the gains tax formula that merit review. As discussed below, the Committee believes that the analysis set forth in the Department's recent TSB-A-91(4)-R regarding the computation of consideration in various circumstances is correct, and commends the Department for its reasonable and practical response in this area.

In an analogous area, the Department reportedly takes the position that, on the transfer of property encumbered by a recourse indebtedness to the lender or to a third party, the transferor's consideration includes the full face amount of the indebtedness, even though the transferor may still be liable for a portion of the indebtedness. As an administrative matter this

approach may be warranted in the initial stages of pre-transfer audit, particularly if the parties are in dispute as to whether the value of the property fully satisfies the borrower's personal liability on the debt.

However, where the transferor and transferee submit questionnaires reporting the same value for the property, that value should be used as consideration in completing the pre-transfer audit, even where it is less than the face amount of the debt.³⁸ Furthermore, where the transferor/borrower otherwise establishes that the value of the property is less than the face amount of the debt (for example because the judgment in foreclosure exceeds the bid price of a successful third party bidder), the transferor's consideration for the real property should be limited to the portion of the debt that was satisfied with the property.

3. Summary.

The issues outlined above illustrate just some of the areas in which the Department takes positions that are antithetical to the intent of the gains tax and result in determinations of tax on more than the net economic gain. Individual Committee members have encountered additional problem

³⁸ The Department can of course audit the reported consideration by conducting a field audit subsequent to the transfer. However, where the transferor and transferee questionnaires report the same consideration, it is not appropriate to delay the pre-transfer audit process by requiring the parties to provide appraisals or some other external evidence of value.

areas, and no doubt the Department is aware of still others. It is not the purpose of this report to set forth a complete analysis of all of the areas in which Departmental interpretations are giving rise to overstated gains tax, or even to provide answers for all of the problems discussed herein. The Committee does, however, want to emphasize its urgent conviction that there are serious inequities in the current measurement of gain, and that providing relief for troubled real estate does not simply involve relieving lenders from the burden of their borrowers' gains taxes, but also requires achieving a fairer measure of the amount of the gains tax due.

We urge the Department to be responsive to these very serious problems, and to revisit the administrative interpretations it applies in measuring gain. The inquiry should be where, in the reasonable exercise of the administration's clear interpretative authority under this unique tax, lines should be drawn in order to capture economic gain fairly and accurately.

In the initial years of the gains tax a group of attorneys, accountants, title insurance representatives, lenders, real estate owners and other informed groups pooled their resources to advise the Department on the development of its gains tax interpretations. This process worked well. It seems appropriate to repeat that process now, identifying problem areas

in the definition of taxable gain and crafting, as promptly as possible, workable administrative solutions.

B. Foreclosures.

1. Background.

Understanding the gains tax treatment of mortgage foreclosures requires examination of three essential areas. The first element, again, is the measurement of taxable gain. This was touched on in Section A(2), above, and is discussed in greater detail in Section B(2), below.

The second element relates to transferee liability. The Tax Law, as amended in 1984, provides that:

"the transferee in an action to foreclose a mortgage is not forbidden to transfer the consideration to the officer conducting the sale, and the transferee shall be released from personal liability for taxes determined to be due from the mortgagor under this article."³⁹

Thus, even when the transferee in a mortgage foreclosure sale transfers consideration over to the officer conducting the sale, the transferee has no obligation to withhold the gains tax due out of money, property or other consideration paid over on the foreclosure sale, and has no personal liability for the defaulting mortgagor's gains tax.

The third element is reflected in the Real Property Actions and Proceedings Law ("RPAPL"), which assigns

³⁹ Tax Law §1447(3)(b).

priorities to the payment of the defaulting mortgagor various debts by providing⁴⁰ that the officer conducting the sale is required to distribute the proceeds of the foreclosure sale:

First, to pay the expenses of the sale and to pay the plaintiff's (i.e., the foreclosing mortgagee's) debt, interest and costs;

Second, to pay taxes, assessments and water rates on the property;⁴¹

Third, to pay the holder of subordinate mortgages, as directed by the judgment of sale;

Fourth, to pay the defaulting mortgagor's gains tax; and

Fifth, to pay any excess into court.

These priority rules mean that the State's gains tax is collected from the proceeds of the mortgage foreclosure sale only after the mortgages have been paid in full.⁴² In effect, therefore, the 1984 amendments to the gains tax and the RPAPL not only relieved purchasers at mortgage foreclosure sales from potential liability and withholding responsibilities as transferees, but also gave mortgage lenders priority over the State in taking the proceeds of a for enclosure sale.

⁴⁰ RPAPL §§13 54 (1)-(5).

⁴¹ In some cases these may be superior to the foreclosing mortgagee's lien and thus paid first, as expenses of sale.

⁴² See also the Memorandum in Support, supra, at page 2, para. j.

2. Definition of Taxable Gain.

In determining the amount of the transferor's consideration and the transferee's original purchase price for property transferred in a foreclosure, the RPAPL provides that, in the event the transferor fails to furnish a tentative assessment or a statement of no tax due with respect to the sale, the amount of the gains tax due from the defaulting mortgagor is 10% of "the sum of the amount of the proceeds [of the mortgage foreclosure sale] before any distributions are made under [RPAPL §1354] and the amount of any other liens which the real property is taken subject to."⁴³ The gains tax regulations provide that in such a case "the referee is required to compute gain using zero for the original purchase price."⁴⁴

The gains tax regulations further provide that the OPP of the successful bidder in a mortgage foreclosure is the bid price paid for the property, increased by any other liens that the property was taken subject to or that the bidder became liable for.⁴⁵ However:

"[i]n the event the mortgagee is the successful bidder in an action to foreclose a mortgage, his original purchase price will be the higher of the price paid (the bid price) or the amount of judgment in foreclosure as established by the referee to be due the mortgagee. Such amount would generally include the amount of mortgage debt, the expenses of the sale and the cost of the action."⁴⁶

⁴³ RPAPL §1354(4).

⁴⁴ 20 NYCRR §590.59(a).

⁴⁵ 20 NYCRR §590.59(d). Subsequent expenditures for capital improvements, allowable selling expenses, etc., also would be included in the bidder's OPP on a subsequent sale.

⁴⁶ Id

The special rule that applies in the case of transfers to the mortgagee presumably derives from the statutory definition of "consideration" as including "the cancellation or discharge of an indebtedness or obligation."⁴⁷ The regulations also express a comparable rule in describing the consideration on a [taxable] sale in bankruptcy⁴⁸ Pulling together the various regulatory and statutory provisions, the rules that emerge are as follows:

1. If the mortgagee is the successful bidder at a foreclosure sale, then the price paid for the property, for purposes of measuring the transferor/mortgagor's consideration and the transferee/mortgagee's OPP, is the aggregate amount of the mortgagor's indebtedness to the mortgagee (or, if greater, the amount paid by the mortgagee).

2. If a third party is the successful bidder at a foreclosure sale, then the transferor/mortgagor's consideration and the transferee/bidder's OPP are the amount of the proceeds paid to the referee plus the amount of debt assumed or taken subject to by the bidder.

These rules are quite clearly articulated in the Department's recent Advisory Opinion.⁴⁹

⁴⁷ Tax Law §1440(1). See also 20 NYCRR §590.65. See also the opinion letter of the Department dated February 25, 1986 regarding a transfer of property worth only slightly more than the debt to a lender in lieu of foreclosure ("the amount of indebtedness being discharged as a result of such transfer must be included in such consideration").

⁴⁸ 20 NYCRR §590.65.

⁴⁹ TSB-A-91(4)-R.

The amount derived under paragraph 1 is not necessarily the same as that derived under paragraph 2. However, any difference in result seems both contemplated by the gains tax law and entirely appropriate. If a property is sold in foreclosure for more than the amount of the aggregate indebtedness, then the transferor obviously should pay tax on the total consideration, not just the debts. Conversely, if a property is sold to a third-party bidder on a free and clear basis for less than the amount of the debt, or if a third-party bidder assumes or takes subject to less than the full debt on the property, then the most the transferor can be said to have received "for real property" is the price paid by the bidder. Any excess of the total indebtedness over the bid price may still be due to the lender, may be forgiven, or may be extinguished as a consequence of the foreclosure. However, neither the gains tax nor the RPAPL should treat the cancellation or discharge of indebtedness by a person other than the transferee as consideration for the transfer of real property.

The regulations' articulation of this principle and the recent Advisory Opinion are, we believe, consistent with the statutes. However, it is somewhat confusing to have to piece together the RPAPL, two different regulations, and an Advisory Opinion to infer the amount of the transferor's consideration on a foreclosure transfer. It would be helpful to revise Regulation section 590.59 to treat that question more directly.

Another question along these same lines is the treatment of transferor and transferee when the successful bidder in the foreclosure action is a party related to one or more mortgagees.⁵⁰ Given the general treatment accorded transfers that are change-in-form transactions,⁵¹ it seems reasonable to apply the foreclosure rules to such transactions as if the related lender were the successful bidder. Thus, where the bidder is 100% related to the lender (or owned proportionally by all the lenders), the transaction would be treated in its entirety as if the lender(s) had acquired the property. Where the successful bidder is related to only one of the lenders (as in situation 3 of the Advisory Opinion) or where the bidder is beneficially owned in part by one or more of the lenders and in part by third parties, a bifurcated approach should be used, measuring consideration and OPP by the amount of the debts to the extent the lender's beneficial interest continues after the foreclosure; and measuring consideration and OPP by the bid price (including debts assumed or taken subject to) to the extent the lender's interest is increased or decreased following the foreclosure.

⁵⁰ This may occur where a lender forms a wholly-owned subsidiary to acquire the property in foreclosure, for example to insulate the lender's core businesses from the risks of operating real property.

⁵¹ Tax Law §1443(5); 20 NYCRR §590.50.

3. Treatment of Nonmortgage Liens.

The rights and responsibilities of debtor, creditor and referee with regard to the application of the gains tax are fairly well defined in the case of a straightforward foreclosure of a mortgage encumbering an interest in real property. There is, however, a large and important area in which the law is underdeveloped and where administrative guidance would be both useful and appropriate -- that is the treatment of (a) foreclosures of liens on real property that are not technically "mortgages" and (b) foreclosures of security interests in personal property.

With the growing complexity and sophistication of the real estate and financial industries, it is increasingly common for lenders to advance funds secured by pledges of stock or partnership interests, or to have other nonmortgage security interests. Two of the more common areas in which this is encountered are the co-op area, where owners of co-op stock pledge their shares and proprietary leases as collateral for loans, and the partnership area, where partners in a partnership owning real property may pledge partnership interests to secure their debts. The treatment of lenders⁵² who enforce such security interests, and of third parties who bid to purchase the collateral in judicial sales or in public or private sales, is of great practical significance.

⁵² The term "lender" as used herein encompasses consensual lenders, lienors and other secured parties.

To date the Department's position (although not reflected in the regulations) apparently has been that the transferee liability relief provisions of Tax Law section 1447(3)(b) are only available to persons who acquire direct interests in real property pursuant to a judicial mortgage foreclosure proceeding. Thus, in the Committee's experience the Department has read the statute fairly narrowly, to apply only to foreclosures of mortgages on real property and not to the enforcement of other kinds of security interests.

This narrow interpretation of the statute is not warranted. First, while the statute uses the term "mortgage," the Department has already demonstrated that the term can include other types of security interests as well. Thus, the gains tax statute provides that the "creation, modification, extension, spreading, severance, consolidation, assignment, transfer, release or satisfaction of a mortgage; a mortgage subordination agreement, a mortgage severance agreement, [and] an instrument given to perfect or correct a recorded mortgage"⁵³ are not transfers. The gains tax regulations repeat this language and also state: "in addition, the grant, satisfaction or assignment, or the like, of other types of security interests (such as a pledge of stock, or a collateral assignment of leases or rents) does not constitute a transfer of real property within the meaning of section 1440.7 of the Tax Law." The Department has thus demonstrated that the term "mortgage" can be interpreted broadly where such interpretation is consistent with the statutory purpose.

⁵³ Tax Law §1440.7 (emphasis added).

Here, a broader interpretation of the transferee liability relief provisions would better achieve the stated purpose of that provision, which was to replace the "inequitable system" that "effectively imposes the gains tax on the transferee in a mortgage foreclosure, since the transferor, the defaulting mortgagor, cannot reasonably be relied on to pay the gains tax."⁵⁴ The reason for imposing personal liability on a transferee is to elicit the cooperation of the transferee in the collection process and motivate the transferee to see to it that questionnaires are filed and tax is paid by the transferor -- it is not to shift the burden of the tax to the transferee. The mortgage foreclosure provisions explicitly recognize that even where the transferor is financially unable to pay the tax, there is no sound reason for making the transferee responsible for the transferor's tax. To achieve the equities sought by the 1984 amendment, therefore, the Department should apply the transferee relief provision to any foreclosure situation in which the Department is satisfied that there exists the same "viable method of collecting the tax, that is from the officer conducting the foreclosure sale,"⁵⁵ as is present in foreclosures of mortgages on real property.

a. Judicial Foreclosures.

Persons who purchase at judicial sales conducted to enforce liens and other nonmortgage security interests in real and personal property should qualify for the transferee liability relief. For example, New York's Real Property Law states that:

⁵⁴ Memorandum in Support, supra, at page 5, para. j.

⁵⁵ Id.

"[the lien of a condominium board of managers for unpaid common charges] may be foreclosed by suit authorized by and brought in the name of the board of managers, acting on behalf of the unit owners, in like manner as a mortgage of real property " ⁵⁶

Similarly, New York's Lien Law states that the foreclosure rules of the RPAPL apply to actions to enforce mechanics' liens on real property. ⁵⁷

The New York statutes also provide that a security interest in personal property, such as a pledge of stock or of a partnership interest, may be enforced in the same manner as a mortgage on real property. Thus, in addition to the specialized remedies that are available to secured parties under New York's Uniform Commercial Code, ⁵⁸ the law also provides that a secured party "may reduce his claim to judgment, foreclose or otherwise enforce the security interest by any available judicial procedure." ⁵⁹ New York's Lien Law further provides that "[t]he procedure in an action to foreclose a mortgage on real property, in so far as it may be applicable, shall apply in actions to foreclose a mortgage or other lien on chattels or other personal property." ⁶⁰

⁵⁶ Real Property Law §339-aa.

⁵⁷ NY Lien Law §43.

⁵⁸ See NY U.C.C. §§9-503, 9-504 and 9-505, and the discussion below.

⁵⁹ NY U.C.C. §9-501(1).

⁶⁰ NY Lien Law §206.

New York's statutes therefore provide ample authority for the Department to apply the mortgage foreclosure provisions of RPAPL section 13 54 to a broad range of security interests. In fact, where a creditor utilizes a judicial foreclosure mechanism that specifically invokes the RPAPL the most reasonable interpretation is to apply the priority rules set forth in RPAPL section 1354 in distributing the proceeds of the foreclosure sale and to apply Tax Law section 1447(3)(b) to absolve the transferee from personal liability.

b. U.C.C. Sales.

In the case of sales that are effected pursuant to New York's Uniform Commercial Code ("U.C.C."), the analysis is somewhat more complex. The U.C.C. provides that when a debtor is in default the secured party may enforce its lien by seizing and retaining the collateral in satisfaction of the obligation,⁶¹ or by disposing of the collateral in a public or private sale.⁶² Where the secured party gives written notice that it proposes to retain the collateral in satisfaction of the debt the transfer is akin to a deed in lieu of foreclosure; such transactions are discussed in Section C, below. The following discussion addresses issues that arise when a lender sells, leases or otherwise disposes of collateral by public or private sale under U.C.C. section 9-504.

⁶¹ U.C.C. §59-503, 9-505(2).

⁶² U.C.C. §9-504.

(1) Time of Transfer.

In order to evaluate the proper approach to transferee liability in these situations it is first necessary to identify the taxable event. The U.C.C. permits a secured party to take possession of the collateral, and in some cases the secured party may enter the "chain of title" as the legal owner of the collateral. However, except where the lender has given notice that it intends to retain the collateral and the time for objection by the debtor and third parties has expired,⁶³ the lender is not the beneficial owner of the collateral. Instead, the lender holds the collateral for the benefit of the debtor, with the statutory duty to make a commercially reasonable sale and to apply the proceeds of sale on the debtor's behalf (i) to the expenses of sale; (ii) to satisfy the debt due the secured party; (iii) to satisfy subordinate creditors; and (iv) to pay any surplus to the debtor.

The secured party has a power to sell the collateral, but it does not become the beneficial owner of the property solely by reason of exercising that power and enforcing its rights to sell the collateral. For that reason, there is no basis for the Department to seek to impose gains tax until the collateral is transferred to a third party (or purchased by the secured party) pursuant to the public or private sale. It is when that sale occurs that the taxable transfer takes place, from the defaulting debtor, as transferor, to the purchaser, as transferee.⁶⁴

⁶³ See U.C.C. §9-505(2).

⁶⁴ Where a secured party has given notice that it proposes to retain the collateral the taxable transfer should take place when the rights of "notice parties" to object and require a sale have lapsed. That transfer is from the defaulting debtor, as transferor, to the lender, as transferee. See Section C, below.

(2) Transferee Liability.

With respect to the transferee liability of a purchaser at a public or private sale, U.C.C. section 9-504(4) provides that a purchaser for value takes the property free of the debtor's rights and free of security interests and liens. The Department might interpret this provision to mean that, in the context of the gains tax, a purchaser at a U.C.C. sale has no personal liability for any of the defaulting debtor's unpaid debts, including the gains tax. The transferee therefore would have no withholding responsibility.

By exempting buyers at U.C.C. sales from transferee liability, such an interpretation could be quite useful. For example, it would permit a third-party purchaser to bid on co-op stock without having to ascertain whether the defaulting debtor was a co-op sponsor and therefore could be liable for tax as a realty transferor in an amount greater than 10% of the consideration paid by the bidder. Similarly, a purchaser bidding on a minority interest in a corporation or partnership could do so without having to investigate whether prior sales (by the debtor or some other person), or potential future sales, might cause a gains tax to be due with respect to the minority interest. There are therefore good policy arguments and a reasonable statutory basis for promulgating regulations that exempt a purchaser for value from liability for the transferor's tax.

(3) Priority of Payments.

With respect to the priority of payment of the gains tax, the U.C.C. statute does not specify that the gains tax on a public or private U.C.C. sale is to be paid after secured debts have been satisfied. By contrast, the RPAPL specifically assigns a low priority to the gains tax and makes it junior to mortgages on the transferred property.⁶⁵ Another distinction between the two is that the disbursement of proceeds in judicial foreclosure sales is overseen by a disinterested officer of the court, whereas U.C.C. sales involve no disinterested court officer charged with conducting the sale. Given these distinctions the Department might conclude that it cannot promulgate administrative guidance applying the priority rules of the RPAPL to sales pursuant to New York's U.C.C.

If the gains tax is not assigned a lower priority on a U.C.C. sale, then lenders disposing of collateral by means of a U.C.C. sale would have to bear the debtor's gains tax if the proceeds of sale were insufficient to cover both the debtor's tax and the indebtedness to the lender. In essence, the State's "first priority right" would attach to the sales proceeds in the lender's hands, and would have priority over the lender's own claims. Under this interpretation the foreclosing lender would have the burden of ascertaining the debtor's gains tax

⁶⁵ RPAPL §1354, and see Trefoil Capital Corp. v. Creed Taylor, Inc., et al., 125 Misc. 2d 152(1984), rev'd 121 AD2d 874 (1st Dept. 1986).

exposure, and as described above that could involve some complications. Overall, however, it seems less burdensome to place this responsibility on the lender (who presumably has access to the debtor and in many cases can address these considerations when the loan is initiated) than on a purchaser for value. And while placing the gains tax burden on a lender seems to conflict with the objectives of the 1984 amendments, this particular problem may require legislative change.

What can be achieved by administrative action is, to summarize:

- Clarification of the computation of consideration;
- Clarification that even nonmortgage lenders have the option of avoiding transferee liability and advancing the priority of their liens by pursuing a judicial foreclosure action;
- Clarification of the events that will trigger the gains tax; and
- Clarification that purchasers at U.C.C. sales are exempt from transferee liability, and that the State will look to the proceeds of sale (even if ahead of the creditors' liens) for payment of the tax.

C. Transfers in Lieu of Foreclosure.

1. Background.

In a troubled situation borrowers and lenders may agree to eliminate the potential complexities of judicial enforcement proceedings and instead simply transfer the encumbered asset to the lender in full or partial satisfaction of the debt. The delivery of a deed in lieu of foreclosure is commonly considered when dealing with troubled real estate subject to nonrecourse financing. This option also is considered where property is encumbered by recourse mortgages, and where lenders hold recourse or nonrecourse indebtedness secured by interests in personal property (such as stock and partnership interests).⁶⁶

A transfer in lieu of foreclosure clearly is a taxable transfer under the tax law.⁶⁷ The gains tax issue presented by these "deed-in-lieu" transactions is one of transferee liability: Is a lender who lends money on a secured basis and subsequently acquires the encumbered property liable as

⁶⁶ The fact that property is transferred in foreclosure or by deed-in-lieu of foreclosure does not necessarily mean that the transferor/debtor is insolvent. For example, the owner of property subject to nonrecourse debt may conclude that it is uneconomic to continue to carry the property, even though as a financial matter the debtor could do so. Thus, in considering the potential revenue effects of relieving transferees from gains tax liability, it should not be assumed that these transfers always involve judgment-proof transferors.

⁶⁷ Tax Law §1440.7 specifically refers to a "transfer in lieu of foreclosure."

transferee for the debtor/transferor's tax on the gain inherent in the property? To date the Department's answer has been "Yes." The Committee believes, however, that the Department's broad assertion of transferee liability against lenders in these situations is not warranted.

The scope of the transferee liability provisions is apparent from the face of the statute. Transferee liability is not based on the "consideration" derived by the transferor; it is based on the consideration that the transferee transfers over to the transferor. In the section defining transferee liability that concept is reflected many times:

"any sums of money, property or other consideration, which the transferee is required to transfer over to the transferor shall be subject to a first priority right for any such taxes";

"the transferee is forbidden to transfer to the transferor any such sums of money, property or consideration";

"[the Department's failure to issue a tentative assessment within twenty days] will release the transferee from any further obligation to withhold any sums of money, property or other consideration, which the transferee is required to transfer over to the transferor";

"[the transferee's personal liability] shall be further limited to the sums of money, property, or other consideration which the transferee is required to transfer over to the transferor";

"the transferee may make payment of such claim to the state from any sums of money, property or consideration withheld . . . except that such payment shall be limited to the sums of money, property or other consideration which the transferee is required to transfer over to the transferor";

"the transferee in an action to foreclose a mortgage is not forbidden to transfer the consideration to the officer conducting the sale";

"the transferee is not forbidden to transfer the consideration to the transferor [where a bond is posted]."⁶⁸

⁶⁸ Tax Law §1447(3) (emphasis added).

These repeated references to amounts transferred over by the transferee show that transferee liability is premised not on the finding of a taxable event, nor on the finding that a transferor has derived consideration. Instead there must be a finding that the transferee has transferred over to the transferor something of value from which the transferee could have and should have paid the transferor's gains tax.

The Committee believes that, in the case of a transferee who acquires property by a transfer in lieu of foreclosure of a valid security interest arising out of a bona fide loan, the most appropriate interpretation of the statute is that the transferee is not personally liable for the transferor's gains tax because the transferee transfers nothing over to the transferor. Unlike the mortgage foreclosure situation, where a successful bidder in a foreclosure sale in fact transfers consideration over to the referee and thus requires specific statutory protection from transferee liability, in the deed-in-lieu situation the absence of transferee liability follows from the fact that the transferee transfers over no consideration out of which it can withhold and make payment to the State.

2. Comparison to Sales Tax Rules.

Several lines of reasoning support the Committee's conclusion. First, it is useful to consider the Court of Appeals' Spandau decision,⁶⁹ which has been cited by the Department as support for the proposition that transferees in "deed-in-lieu" situations are subject to transferee liability under the gains tax. Spandau was a sales tax case, and it involved the application of the bulk sale transferee liability rules. These particular rules are strikingly similar to the gains tax transferee liability provisions, and merit being set forth in part here:

"Whenever the purchaser, transferee or assignee [in a bulk sale] shall fail to give notice to the tax commission [of the sale], or whenever the tax commission shall inform the purchaser, transferee or assignee that a possible claim for [sales] tax or taxes exists, any sums of money, property or choses in action, or other consideration, which the purchaser, transferee or assignee is required to transfer over to the seller, transferrer [sic] or assignor shall be subject to a first priority right and lien for any such taxes theretofore or thereafter determined to be due from the seller, transferrer [sic] or assignor to the state, and the purchaser, transferee or assignee is forbidden to transfer to the seller, transferrer [sic] or assignor any such sums of money, property or choses in action to the extent of the amount of the state's claim."⁷⁰

What is significant about Spandau, and what distinguishes it in a very important respect from the deed-in-

⁶⁹ Spandau v. United States and State of New York Department of Taxation and Finance, 73 NY2d 832 (1988).

⁷⁰ Tax Law §1141(c) (emphasis added).

lieu inquiry, is that Spandau involved the purchaser's assumption of the seller's recourse indebtedness to third parties. In Spandau the transferees paid cash into escrow and "[t]he purchasers had additionally assumed seller Surfside Pizzeria's personal debt on a promissory note. This relief from obligation constitutes 'other consideration' under the tax collection statute."⁷¹

This same fact situation can be found in many bulk sales transferee liability cases. In each case the analysis is the same: the purchaser's agreement to assume the seller's obligations to third parties -- its agreement to pay money to other persons on the seller's behalf -- is consideration that the buyer transfers over to the seller, and will be taken into account in measuring the transferee's liability for sales taxes. See Meyers v. State Tax Commission ("petitioners [transferees] promised to incur new financial obligations in return for the transfer of the [seller's] assets");⁷² Anna Manzella ("payments by petitioner of the debts and taxes owed by the seller constituted part of the purchase price of business assets").⁷³

The situation of a lender who acquires collateral from its debtor is different from the transferee who assumes or takes subject to third party debts. Indeed, the Department itself

⁷¹ Spandau, supra note 69, at 834.

⁷² 101 AD2d 650, 651 (1984).

⁷³ TSB-H-81 (97)S Revised.

acknowledges this difference in applying the bulk sales rules. Specifically, the sales tax statute provides that a purchaser, transferee or assignee in bulk is subject to liability for the seller's unpaid sales tax.⁷⁴ The Department's regulations provide, however, that "[t]he term 'bulk sale' does not include . . . sales, transfers or assignments of business assets in settlement or realization of a valid lien, mortgage or other security interest."⁷⁵ By administrative interpretation, therefore, the acquisition of collateral by a bona fide lender has been carved out of the bulk sales rules, rules whose only relevance is the imposition of transferee liability for unpaid sales taxes. In the context of evaluating what can and should be done administratively to address transferee liability under the gains tax, this administrative interpretation of the sales tax is a significant analogy.

The Committee notes that the exclusion of transfers to lenders from the definition of "bulk sale" is reflected in the Uniform Commercial Code,⁷⁶ and therefore an argument might be made that the sales tax exclusion was mandated by U.C.C. conformity. That does not appear to be the case, however. The

⁷⁴ Tax Law §1141(c).

⁷⁵ 20 NYCRR §537.1(a)(4). This interpretation is also reflected in opinions of counsel dated March 15, 1968, 1968 NYTB-V.1, p. 68 (issued 1/69), and April 16, 1968, and in the Department's "Guidelines for Bulk Sales Transactions," TSB-M-83(6)S (April 7, 1983).

⁷⁶ U.C.C. §6-103(3); NY U.C.C §6-103(3).

portion of the Uniform Commercial Code that imposes transferee liability on a bulk sale for the debts of the seller was not adopted in New York.⁷⁷ Furthermore, transferee liability for sales tax on a bulk sale is a matter of New York's Tax Law, not its Uniform Commercial Code. It would seem, therefore, that the exclusion of deed-in-lieu type transfers from sales tax transferee liability was effected by the Department because it reflects the correct interpretation and application of the transferee liability rules. A lender taking over collateral has not and will not transfer over anything out of which it can be required to pay the transferor's sales tax, and the application of transferee liability in these situations is not justified.

3. FIRPTA Rules.

Another analogous line of authority that supports the conclusion reached by the Committee is provided by the federal FIRPTA withholding rules. Internal Revenue Code section 1445 requires a transferee of real property to "deduct and withhold" 10% of the amount realized by the transferor. The statute makes no special provision for foreclosure situations or deeds in lieu of foreclosure.

In adopting regulations under Code section 1445, however, the Treasury recognized that the usual withholding requirements were not appropriate for foreclosures and transfers in lieu of foreclosure. Accordingly, special rules were developed.

⁷⁷ Compare U.C.C. §6-106.

Under Treasury Regulation section 1.1445- 2(d)(3)(i)(B), a transferee of a U.S. real property interest pursuant to a deed in lieu of foreclosure is not subject to any withholding liability if:

(1) the transferee is the only person with a security interest in the property;

(2) no cash or other property (other than incidental fees incurred with respect to the transfer) is paid, directly or indirectly, to any person with respect to the transfer; and

(3) appropriate notice is given to the Internal Revenue Service.

Again, this rule represents administrative recognition that, where the lender/transferee in a deed-in-lieu situation is not transferring anything to the debtor, either by assuming or taking subject to other security interests or by making payments to the debtor or to third parties, the imposition of a withholding liability on the lender is inappropriate.

4. Treatment of the Original Borrowing.

It might be asserted that since the transferee/lender did in fact advance monies to the transferor (or otherwise extend credit) in the original loan transaction, transferee liability should be imposed on the lender for failing to withhold the gains tax out of the loan proceeds. There are,

however, serious flaws in that analysis. In a bona fide loan transaction the lender advances monies not as payment for real property but in exchange for the borrower's promise or obligation to repay the loan. Furthermore, the gains tax specifically provides that the creation of a mortgage or other security interest is not a "transfer." The loan transaction is therefore entirely outside the scope of the gains tax. Accordingly, there does not appear to be any basis for imposing transferee liability on a lender for failing to withhold gains tax out of the proceeds of a bona fide loan.

5. Additional Considerations.

a. Liabilities Assumed or Taken Subject To.

Where a transferee in a deed-in-lieu transaction in fact transfers over money, property or other consideration to the transferor (other than in payment of fees and costs incidental to the deed-in-lieu), the statute requires that such consideration instead be transferred to the State in payment of the transferor's debt, and to that extent a transferee would have transferee liability. To take a simple example, if a lender pays cash to the debtor, the lender would have personal liability equal to the amount of the cash paid if the tax shown in the tentative assessment were not paid.

Where a transferee assumes or takes subject to third-party debts, however, the analysis is more complex. The

holding in Spandau may lead to the conclusion that the lender's assumption of, or taking subject to, third-party obligations represents consideration "transferred over" to the transferor, and that, to the extent of such consideration, the transferee/lender can be subjected to transferee liability. It must be recognized, however, that Spandau did not involve a lender as transferee. The possibility of transferee liability by reason of a lender's acquisition of collateral subject to senior liens does not arise under the sales tax, because the sales tax regulations contain a blanket exception for all "in-lieu" kinds of transfers.

There also is a fundamental difference between purchasers like the ones in Spandau, Meyers and Manzella and lenders in deed-in-lieu situations. The buyers in the Spandau cases incur new obligations in order to acquire new assets. Before such acquisitions, the buyers have neither an economic interest in the assets, nor any exposure to the burdens of the debts.

By contrast, secured lenders already have an interest in the property -- their liens. They have already made an investment in the property, and they have an interest in protecting that investment. When senior obligations arise they impair not just the borrower's equity in the property, but also the lender's liens. Thus, the lender's decision to pay off "senior" debts, particularly in the case of troubled properties,

cannot simply be labelled a payment for the owner's equity, for it also serves to protect the lender's investment. This distinction suggests that the Department should not automatically extend Spandau to produce transferee liability in deed-in-lieu situations, but instead should explore the legal and economic differences between a Spandau type of sale transaction and a lender's takeover of a troubled property. There are fundamental differences between these scenarios, and these differences may lead to different results.

b. Recourse vs. Nonrecourse Debt.

One might question whether, in applying the gains tax transferee liability provisions, a distinction should be drawn between recourse and nonrecourse lenders. In the case of nonrecourse debt, the lender's right to enforce payment of the debt is limited to the right to proceed against the collateral. A lender who acquires property by means of a deed in lieu of foreclosure in respect of a nonrecourse debt therefore is quite passive. It does not release anyone from personal liability or otherwise forego the exercise of other valuable rights. It gives the defaulting debtor nothing; it simply accepts the ownership of the property.

In the case of recourse indebtedness, however, the lender who takes property in lieu of foreclosure generally will release the transferring debtor from part or all of the obligation under the indebtedness. There may therefore be a

question as to whether the lender's delivery of a separate release to the debtor constitutes "money, property or other consideration" that is subject to the state's "first priority right" for gains tax. Similarly, some deed-in-lieu situations will involve the lender's release of claims against guarantors, principals of the debtor, or other parties. Again, the question is whether the lenders' agreement to release these persons from liability triggers transferee liability on the deed-in-lieu.

At first blush, it might appear that these releases are "other consideration" that triggers transferee liability. Interestingly, however, New York's sales tax makes no distinction between recourse and nonrecourse debts, nor do the FIRPTA rules respecting withholding on deeds-in-lieu suggest any distinction. There is, therefore, no basis in the analogous authorities for distinguishing recourse debt from nonrecourse.

Furthermore, what a recourse creditor has in these situations -- what it is giving up -- is the right to sue for any difference between the value of the security and the amount of the lender's claims. Such a right has value only to the extent the lender's claims exceed the value of the property. It would be anomalous to treat the lender's release of the right to sue for a deficiency in property value as constituting consideration for the real property. Stated differently, as an economic matter the lender paid for the property with the moneys it advanced or the value it gave in the initial loan transaction. The portion of the debt that is recourse or is

guaranteed is not a debt separate from or in addition to the original advance, it is an element of the basic indebtedness. The lender who releases its claims therefore is not like the transferee in Spandau who took on new debts to acquire assets; instead, the lender who releases claims in a deed-in-lieu should simply be viewed as acknowledging that the full amount of its debt has been economically "repaid" by the transfer of the property. This may be a difficult distinction to appreciate at first, but it is real, and it is important.

Moreover, given the withholding aspect of transferee liability, it would seem unnecessarily formalistic to require a lender to "withhold" out of its rights to sue for deficiencies and to "transfer over" such rights to the State. In light of the foregoing, it seems appropriate that releases of recourse claims and guarantees be disregarded in evaluating transferee liability

c. Anti-Abuse Rules.

The Committee believes that the Department's concern about potentially abusive transactions concern is entirely appropriate and legitimate, and should be reflected in any administrative action taken by the Department. It is not appropriate, however, to restrict all progress in this area on the basis that liberalizing the interpretation of transferee liability will open the door for tax abuse. There are simply too

many troubled situations in which the lack of abusive intent is plain.

Both the sales tax bulk sale rules and the FIRPTA withholding rules regarding transfers-in-lieu contain provisions designed to forestall abusive manipulation of the transferee liability rules. These rules may not be entirely relevant or sufficient in the context of the gains tax, but they provide insight into the types of limitations the Department might impose to forestall abuse.

For example, the sales tax rules require that the transfer be pursuant to a "valid lien, mortgage or other security interest." It is not sufficient for the transferee simply to acquire assets from a transferor in satisfaction of a debt; the transferee's debt must have been secured by a valid security interest in such assets.⁷⁸ One reasonable requirement would therefore be that the transferee/lender be protected only to the extent it acquires assets in which it had a valid security interest.

Similarly, the FIRPTA withholding regulations contain an anti-abuse rule under which a foreclosure or deed-in-lieu transfer will be presumed to have a principal purpose to avoid the withholding requirements if:

⁷⁸ See March 15, 1968, Op. of Counsel, supra note 75; Talco Contractors, Inc., TSB-H-86(196)S ("a security interest which, in the opinion of the Commission, is not enforceable under the Uniform Commercial Code is not a valid security interest within the meaning of 20 NYCRR 537.1(a)(4)(i).")

(i) the transferee acquires property in which it has a security interest; and

(ii) the security interest did not arise in connection with the debtor/transferor's (or a related party's or predecessor in interest's) acquisition, improvement or maintenance of the property; and

(iii) the aggregate debt on the property exceeds 90% of its fair market value.⁷⁹

Not all of these factors necessarily indicate an abusive situation. Therefore, a presumption, rather than an absolute rule, is the better approach.

Other factors the State might find relevant in determining whether a transfer-in-lieu suggests an abusive transaction include:

- whether the lender/transferee is a financial institution, lending institution, or previous seller holding a purchase money obligation.⁸⁰
- whether there has been a meaningful period of time in which the parties, and relevant third parties, treated, considered, reported, etc. the transaction as a loan.

⁷⁹ The date on which this third condition is tested is not clear from the FIRPTA regulations. If this test were applied at the time of the deed-in-lieu transfer it would be met in most cases. It seems therefore to be more relevant if applied at the time of the loan.

⁸⁰ The presence of this fact ought to be very strong evidence that the deed-in-lieu is not an abusive situation.

- the length of time the transferee/lender held the indebtedness prior to the transfer-in-lieu.
- whether the lender acquired rights in connection with the transaction that one does not generally find in loan transactions. For example, a loan of a substantial portion of the property's value coupled with the lender's taking occupancy of the property merits further scrutiny.

The essential inquiry should be whether the cash paid over in connection with the original loan advance was in fact related to the creation of a bona fide indebtedness secured by an enforceable security interest. If this is the case, then the original loan is excluded from the scope of the gains tax, and on the subsequent transfer-in-lieu the transferee/lender has no withholding liability. If this is not the case, however -- if the loan and the subsequent deed-in-lieu are parts of a "partial or successive transfer . . . pursuant to an agreement or plan to effectuate by partial or successive transfers a transfer which would otherwise be included in the coverage of [the gains tax],"⁸¹ or if the transactions have been "so formulated that the

⁸¹ Tax Law §1448(1).

of such formulation is the avoidance or evasion of the tax imposed by this article, rather than for an adequate business purpose"⁸² -- then the Department can and should seek to impose transferee liability,

d. Recording Issues.

Determining that a deed-in-lieu transferee is not subject to liability for the transferor's gains tax (except to the extent the transferee actually transfers over consideration) means that the transferee can accept a deed or assignment transferring ownership of the collateral without incurring gains tax liability. In many circumstances this protection will be sufficient to enable the transferee to utilize the deed-in-lieu procedure.

However, if the transferee has to record an instrument of transfer in order to complete the deed-in-lieu transaction, it becomes necessary to consider a mechanism that will permit the transferee to do so without being required to pay the transferor's tax. In these situations, the absence of legal liability for the transferor's gains tax is of little real comfort if as a practical matter the lender cannot record its deed without paying the tax.

In devising a practical solution to this problem it is useful to consider the purposes of the State's pre-transfer audit and tentative assessment procedures, and of the statutory

⁸² Tax Law §1447(1)(f)(1).

requirement that recording officers assist in the enforcement of the tax by refusing to record conveyances without some evidence of compliance with the gains tax.

The Tax Law provides that a recording officer shall not record or accept for record any conveyance unless it is accompanied by (i) a statement of tentative assessment together with payment of the tentative assessment of the amount of tax; (ii) a statement that no tax is due? or (iii) an affidavit that the transfer is one of certain exempt conveyances under the gains tax.⁸³ The affidavit procedure is not relevant to the deeds-in-lieu considered here; accordingly, for a transferee to record a deed-in-lieu it must either produce a tentative assessment and pay the amount set forth therein, or it must produce a statement that no tax is due.

Both of these forms are generated by the State's gains tax auditors in Albany, following a pre-transfer audit. The statute prescribes this approach:

"The department of taxation and finance shall make available as soon as practicable a pre-transfer audit procedure to be applicable to all transfers subject to tax under this article. Pursuant to such procedure, the department shall determine a tentative assessment of the tax to be levied hereunder. When the transferor and the transferee shall have furnished pertinent affidavits and any other information necessary to determine such tentative assessment at least twenty days prior to the date of transfer, such department shall provide the transferor and transferee with a statement of tentative assessment of the amount of tax, or a statement that no tax is due, at or prior to the date of closing and, if such affidavits

⁸³ Tax Law §1447(1)(f)(1).

and information are furnished within such period, such department shall provide such statement as soon as practicable, but not later than twenty days from the date such affidavits and other information have been furnished to the tax commission. The tentative assessment of the amount of tax due shall not be deemed to be a determination of the actual amount of tax due."⁸⁴

The tentative assessment of gains tax generated on a pre-transfer audit does not fix the transferor's gains tax liability. It establishes the amount of a transferee's potential liability;⁸⁵ it recites the amount of tax the recording officer is to collect;⁸⁶ and it shows the amount of tax that is deemed assessed on the date of transfer.⁸⁷ However, it does not prevent the State from determining additional tax due on a post-transfer audit, nor does it affect the transferor's liability for interest or penalties⁸⁸ on unpaid tax.

The practice of the Department following the pre-transfer audit has been to deliver the same basic document to

⁸⁴ Tax Law §1447(2).

⁸⁵ Tax Law §1447(3)(a).

⁸⁶ Tax Law §§1447(1)(f)(1), 1449-b.

⁸⁷ Tax Law §1444-a(1).

⁸⁸ However, issues affecting the calculation of tax due might be disclosed in the pre-transfer audit, which should be taken into account in any later application of the penalty provisions. See Section F, below.

both transferor and transferee. Thus, if the Department determines that a transferor owes \$100 of gains tax on a proposed transfer it will generally issue a Tentative Assessment of Gains Tax Due - Transferor's Copy to the transferor showing the \$100 tax liability (and any adjustments made on pre-transfer audit to determine that tax liability); and issue to the transferee a Tentative Assessment of Gains Tax Due - Transferee's Copy showing \$100 of gains tax due. Similarly, if the Department determines that no tax is due it will issue a statement of no tax due to both transferor and transferee. In the vast majority of cases this parallelism makes sense and is consistent with the statutory purpose.

In deed-in-lieu cases, however, where there is a gains tax due from the transferor but the transferee has no liability for such tax (or is liable for less than the full amount of the tax), the matching of transferor and transferee forms can lead to anomalous results. If the transferee receives only a tentative assessment showing \$100 due, then as a practical matter it cannot record its deed without paying \$100. As a result, the Department's procedures in issuing tentative assessments could eviscerate the legal conclusion that the transferee is not liable for the transferor's tax.

The statute (quoted above) requires that the State deliver a tentative assessment form or a statement of no tax due to both transferor and transferee. It does not require that

identical forms be delivered to both. Furthermore, the statute prohibits the recording officer from recording a conveyance without a tentative assessment form or statement of no tax due, but it does not specify that the recording officer must be given the transferor's form. Accordingly, it appears that the Department could, within the terms of the existing statute, adopt a procedure for deeds-in-lieu of foreclosure that would conform the Department's practices to a legal determination that the liability of such transferees is limited as described above.

Specifically, the Department could issue to the transferor a tentative assessment and return showing the amount of the transferor's tentatively assessed gains tax liability; and could issue to the transferee a separate tentative assessment and return showing the amount of the transferee's gains tax liability, as determined under the rules governing transfers in lieu of foreclosure. The transferee could then deliver its copy of the tentative assessment form to the recorder's office, pay any amount set forth therein, and have the conveyance to it recorded.

Adopting a procedure such as this for processing pre-transfer audits of transfers in lieu of foreclosure would have a number of beneficial effects. First, it would continue to ensure that taxable transfers are reported to the Department and are subjected to its pre-transfer audit procedures. Second, it would provide a mechanism for the Department to evaluate, in advance of

the transfer and under the anti-abuse standards promulgated by the Department, the legitimacy of the transferee's claim for exemption from transferee liability. Furthermore, this procedure would ensure payment of gains tax to the extent the transferee in fact is transferring other consideration out of which it can withhold. Finally, the Department would be alerted, at a very early date, of the need to pursue its remedies against the transferor if the full amount of tax tentatively assessed against the transferor is not paid on the date of transfer.

As noted above, the purpose of transferee liability is not to shift the burden of the tax, but to elicit the transferee's cooperation and assistance in enforcing the tax. The procedures described above, or another similar approach, would protect the interests of the State without forcing the transferee to pay a debt for which it is not otherwise liable.

6. Conclusion.

Given the repeated focus of the gains tax statute on amounts the transferee transfers over to the transferor; given the Department's administrative interpretation of the essentially indistinguishable sales tax rules; and given the analogous regulatory developments in the area of transferee liability under FIRPTA, the Committee has concluded that the Department has the authority to promulgate regulations as described above, thus limiting the liability of transferees of deeds in lieu of foreclosure. The Committee believes this is the most reasonable -- possibly the only reasonable -- reading of the existing gains tax law.

Some practitioners do however question the adequacy of the Committee's deed-in-lieu proposals. First, these proposals are not as comprehensive as the statutory rules prescribed for foreclosures. As a result, even if the Department adopts these proposals there will continue to be workout situations in which the possibility of transferee liability remains a serious problem.

Second, there is concern that a proposal for a "partial" solution to the question of who pays the gains tax on deeds-in-lieu will distract the Department from the more pressing problem that the amount of taxable gain is not being properly measured.

Third, gains tax issues are not the only problems confronting troubled real estate. Workout participants also have to address the application of the New York State and City transfer taxes and mortgage recording taxes, as well as basic questions of substantive real property law. In the absence of a comprehensive review of all of these areas, focusing particularly on issues raised by the many statutory changes enacted in the 1980's, it is unclear whether administrative changes under the gains tax alone would be sufficient to resolve the deed-in-lieu imbroglio.

The Committee is sympathetic to these concerns with the deed-in-lieu proposal. However, addressing these concerns would generally require legislative change. In the context of this report we were asked to address a more limited question: what can be done under the existing gains tax statute to ameliorate the problems facing troubled real estate. In the Committee's view, even under this limited approach, there is considerable potential for sound and legitimate administrative action that will provide significant relief for many transfer-in-lieu situations.

D. Transfers in Bankruptcy.

1. Background.

Section 1146(c) of the United States Bankruptcy Code⁸⁹ ("BC §1146(c)") provides as follows:

"The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax."

Gains tax regulation section 590.65 currently provides that a debtor in bankruptcy "is not exempt from liability for the gains tax under section 1146(c) of the Federal Bankruptcy Code," citing as authority for this proposition the 1984 Bankruptcy Court decision (Eastern District) in re Jacoby

⁸⁹ 11 U.S.C. §1146(c).

Bender.⁹⁰ Subsequent to that decision the State refunded the contested gains tax and as a result, although the case was appealed to the Second Circuit (which held that the New York State real estate transfer tax and the New York City real property transfer tax are within the exemption of BC §1146(c)), the lower court's characterization of the gains tax in Jacoby Bender was not reviewed.

Last year, in the "Stanhope" case, a Bankruptcy Court judge in the Southern District of New York held that the gains tax was a "stamp tax or similar tax" within the meaning of BC § 1146(c), and thus could not be imposed on a sale of real property pursuant to a confirmed Chapter 11 plan.⁹¹ This decision was recently affirmed by the District Court,⁹² and the State has appealed that affirmance to the Second Circuit.

Inasmuch as this litigation is still active the Committee does not express any view on the merits of the Stanhope case. This report on the application of the gains tax to troubled properties would be incomplete, however, if it did not

⁹⁰ 40 BR 10 (Bankr. E.D.N.Y. 1984) ("Jacoby Bender"), aff'd mem., No. 84-1564 (E.D.N.Y. 1984), aff'd 758 F.2d 840 (2d Cir. 1985).

⁹¹ 995 Fifth Avenue Associates, L.P. v. New York State Department of Taxation and Finance (In re 995 Fifth Avenue Associates, L.P.), 116 BR 384 (Bankr. S.D.N.Y. 1990) ("Stanhope").

⁹² In re 905 Fifth Avenue Associates, L.P., 90 Civ. 5744 (S.D.N.Y. May 16, 1991).

address certain (essentially procedural) questions that this area presents.

2. Treatment of Taxable Transfers.

If as a matter of law the gains tax is not covered by the exemption of BC §1146(c), then the sale of property by the trustee in bankruptcy (or debtor in possession) will be taxed as any other sale. And, without regard to the outcome in Stanhope, any bankruptcy sale that is not pursuant to a confirmed Chapter 11 plan is fully subject to tax. Inasmuch as a trustee in bankruptcy is a different person from the bankrupt (and, in the case of a bankrupt individual, the bankruptcy estate is a separate taxpayer for income tax purposes),⁹³ there may be a need for guidance on the application of certain aspects of the gains tax to taxable sales in bankruptcy. For example, the qualification of a sale for the personal residence exemption;⁹⁴ the application of the \$1 million threshold and the related aggregation rules;⁹⁵ the application of the controlling interest provisions and the regulations' three-year aggregation period;⁹⁶ and the application of the special rules regarding co-op sponsors,⁹⁷ all present areas in which the interposition of the

⁹³ I.R.C. §1398.

⁹⁴ See Tax Law §1443 (2).

⁹⁵ See Tax Law §1443 (1); 20 NYCRR §§590.42, 590.43.

⁹⁶ See Tax Law §§1440(2), 1440(7); 20 NYCRR §590.45.

⁹⁷ See 20 NYCRR §590.35.

trustee in bankruptcy might give rise to some confusion. In these circumstances it may be appropriate to treat the trustee as equivalent to the bankrupt, and determine the gains tax treatment accordingly. In general, however, this seems an area in which a comprehensive dialogue among Department administrators, tax experts and bankruptcy professionals could be productive.

3. Certain Procedural Suggestions.

If as a matter of law the gains tax is held to be covered by the exemption of BC §1146(c), then the existing regulations obviously will have to be amended. In addition, there are certain technical points in this area where it would be helpful to have guidance. The following discussion presents certain issues that should be considered further if the application of BC § 1146(c) to the gains tax is upheld.

First, BC §1146(c) refers to "[t]he issuance, transfer or exchange of a security or the making or delivery of an instrument of transfer." It therefore would appear that the exemption is available not only for sales of interests in real property, but also for transfers of controlling interests and taxable grants of leases. The Department should consider these areas and address them in any new regulations. The regulations also should explain the effect of the Bankruptcy Code exemption on transferee liability.⁹⁸

⁹⁸ See Director of Revenue, State of Delaware v. CCA Partnership (In re CCA Partnership), 72 Bankr. 765, (D. Del. 1987), aff'd without op., 833 F.2d 303, 304 (3d Cir. 1987).

Second, the federal statute provides that the exemption of BC §114 6(c) is available only for sales pursuant to confirmed Chapter 11 plans."⁹⁹ In some cases, the actual sale of property may occur before it is determined that the transfer is covered by the exemption. In order to permit these sales to proceed it would be useful to have in place a procedural mechanism that would permit a deed to be recorded, address transferee liability, preserve the monies reserved for the gains tax so that they will be readily available to fund the plan once confirmed, and safeguard the unpaid gains tax in the event the transfer is not in fact covered by the exemption. (That could occur, for example, where a bankruptcy is converted from a Chapter 11 filing to a Chapter 7 filing subsequent to the sale.) Ultimately it will be up to the presiding bankruptcy judge in each case to determine how the estate will handle these transactions, but working out an established procedure that can be proposed in these situations would be helpful to all concerned parties.

The Committee believes that one workable approach would be the following:

- (i) The transferor and transferee would be required to comply with the pre-transfer audit procedures as if the proposed sale were fully taxable.

⁹⁹ See also the District Court decision in Jacoby Bender.

(ii) The State would then issue a tentative assessment setting forth the amount of potential gains tax due, as determined on the pre-transfer audit.

(iii) The State would also enter into an escrow agreement with the bankruptcy trustee (or the debtor in possession) and any other party designated by the Bankruptcy Court, under which the amount of gains tax stated to be due in the tentative assessment would be placed in escrow. The escrow agreement would provide that, upon the confirmation of a Chapter 11 plan, the escrowed funds would be remitted to the bankrupt estate, and the State would have no further rights to assert a claim for gains tax with respect to the sale against any party. The agreement would further provide that, if the Chapter 11 filing were terminated without a confirmed plan, the escrowed funds (plus interest from the date of transfer at the statutory rate) would be remitted to the State, together with an executed copy of the tentative assessment and return.

(iv) The recording officer would then be directed, either by order of the Bankruptcy Court or by the State's issuance of a statement that no tax is due, to record the instrument of transfer.

It would be inappropriate to assert penalties with respect to the escrowed tax. Accordingly, the State should announce that, where these or other appropriate procedures have

been followed, it will abate or waive all penalties and interest penalties with respect to the escrowed tax.

If the Chapter 11 filing is terminated without a confirmed plan, the State would be entitled to assert any additional claims for gains tax due against the bankrupt estate, and the estate would be entitled to file any claims for refund. There may be some problems with respect to the statute of limitations, however. Under the statute, gains tax refunds may be claimed within two years of (i) the date of transfer or (ii) the date of payment, whichever is later.¹⁰⁰ If the Chapter 11 filing terminates without a confirmed plan, triggering gains tax liability, the date of payment of the tax should be the date on which the funds are transferred out of escrow. Thus, the bankrupt estate would have two years from that date to seek a refund.

With respect to the State, however, the statute provides that no assessment of additional tax may be made after the expiration of three years from that date of transfer, unless "the questionnaires required by [Tax Law §1447]. . . is [sic] filed after the date of transfer, in which case the tax may be assessed at any time within three years after the date on which such questionnaires or affidavit is filed."¹⁰¹ It appears that the "questionnaires" to which this provision refers may be the

¹⁰⁰ Tax Law §144 5.

¹⁰¹ Tax Law § 1444(3)(a)(1).

pre-transfer audit Transferor and Transferee Questionnaires. Under that reading, if the bankrupt estate and its transferee have complied with the pre-transfer audit procedures as contemplated by this approach, the three-year statute of limitations period would begin on the date of transfer.

To protect against the possibility that the outcome of the bankruptcy case will not be known until well into that three-year period, or possibly after the period has expired, the State should require that the transferor enter into an agreement under Tax Law section 1444(3)(c) providing that, if the sale is not pursuant to a confirmed plan under Chapter 11 of the Bankruptcy Code, the State may assess additional gains tax at any time prior to the expiration of three years from the earlier of the date the State receives notice from the debtor to the effect that the transfer was not pursuant to a confirmed plan, or the date that, upon motion of the debtor or the State, the Bankruptcy Court declares that the exemption is not applicable to the sale.

4. Refunds.

Another important issue that must be addressed if the gains tax is held to be within the bankruptcy exemption, an issue highlighted in the Stanhope case, is the ability of a bankrupt transferor¹⁰² to obtain a refund of gains tax paid. In Stanhope, the Department takes the position that state sovereign

¹⁰² Or its transferee, in a case where the buyer pays the gains tax.

immunity and the Eleventh Amendment bar a Bankruptcy Court from requiring New York State to refund gains tax already paid, even where the imposition of the tax is held to have violated the federal bankruptcy exemption. Unlike the substantive question of the scope of the bankruptcy exemption, where the outcome will be the same in all cases, this constitutional argument is a fact-dependent one; its outcome could easily vary from case to case depending upon the State's conduct in the particular bankruptcy proceeding.

If the federal courts hold that the gains tax is covered by the bankruptcy exemption and cannot be imposed on transfers pursuant to confirmed Chapter 11 plans, it seems an unreasonable burden for taxpayers to have to re-litigate the issue in the New York courts in order to obtain a refund of gains tax heretofore paid.¹⁰³ Therefore, if it is held that New York's gains tax is covered by BC §1146(c), the Committee believes that the appropriate administrative response would be for the Department to grant timely filed applications for refund without further litigation.

¹⁰³ Since a deed generally cannot be recorded without payment of the gains tax asserted by the State, there probably are many situations in which bankrupt transferors have paid gains tax.

E. Special Issues Involving Cooperative Housing Corporations.

1. Background.

As briefly described in Section III, above, the Department has formulated a unique method of taxing gain on co-op conversion transactions. This system gives rise to a fair number of complexities, and in the context of troubled properties there are two issues in particular that should be addressed.

2. Sponsor Default.

There has been a pronounced increase in the number of New York cooperative housing corporations that are experiencing financial hardship as a result of sponsor defaults. These situations often involve a sponsor who converted a building to cooperative ownership but continued to hold a substantial number of "unsold" apartments. Often these apartments are subject to statutory tenancies protected by rent control and rent stabilization laws, and the rent derived from the statutory tenants is inadequate (or is not being applied) to offset the sponsor's carrying costs. Increasingly these situations deteriorate to the point where the cooperative housing corporation is forced to take over the sponsor's unsold apartments and attempt to sell them.

There is concern that the cooperative housing corporation may be personally liable for the sponsor's gains tax when it takes over the sponsor's unsold apartments. Thus, where

a cooperative housing corporation cancels the sponsor's proprietary lease and takes over (or causes an affiliate to take over) the unsold apartments, there is concern that the cooperative housing corporation may become immediately liable for the unpaid gains tax on the original conversion.

Legislation to remedy this problem was recently introduced in the New York legislature, but was not adopted. In the interim, it may be appropriate to consider an administrative approach that, while less comprehensive than the proposed legislation, would at least provide some relief. The Department's approach to the gains tax treatment of co-op conversions provides a basis for concluding that the transfer of apartments from the sponsor to the co-op corporation should not give rise to a current gains tax liability. As noted above, in the case of co-ops, the tax is not paid on the sponsor's transfer of the underlying real estate to the co-op corporation. Instead, as summarized in Regulation section 590.33 the Department's approach is that:

"Basically, the statute provides that the transfer of the real property to a cooperative corporation is not the event which requires payment of tax. Rather, it is the transfers of shares pursuant to the plan which are the events requiring payment of the tax."

Regulation section 590.35 illustrates this approach with a variety of examples involving transfers of co-op shares. Some of these transactions are treated as transfers pursuant to

the plan that trigger gains tax, while other do not trigger tax. Under this regulation, transfers to "persons who buy shares and are granted proprietary leases with respect to units," transfers to "investors . . . unrelated to the realty transferor who purchase the shares for investment or resale and transfers to family members of the sponsor all trigger gains tax. Reg. §590.35(1), (2) and (3).

By contrast, transfers by the co-op corporation to the sponsor are not subject to gains tax, nor is a transfer by the co-op corporation to owners of interests in the sponsor entity, or a transfer by the sponsor entity to its owners. Reg. §590.35(4), (5) and (6). These latter transfers are not considered to be transfers pursuant to the plan, and thus do not trigger payment of the gains tax. Since these transfers do not require the payment of tax, the units retain an OPP determined by reference to the sponsor's OPP for the real estate. When the units are eventually disposed of in a transaction requiring the payment of gains tax, the consideration is determined by reference to the price paid by the third-party buyer (and a pro rata share of the mortgages on the property at the time of conversion).

The informing notion of this approach is that the tax on co-op plans is payable when there is a sale to third-party buyers. As stated in Mayblum v. Chu, "[t]he transfer of shares to individual unit purchasers is the operative event and its

designation is consistent throughout the statute."¹⁰⁴ In considering the application of the gains tax to transfers by the sponsor, therefore, the key question is whether there has been a transfer of the type that triggers payment of the gains tax.

Applying this approach to sponsor default situations, the Department could reasonably determine that the transfer of units from a sponsor to the co-op corporation is not a transfer that triggers payment of gains tax.¹⁰⁵ Under such a reading the Department would instead collect the proportionate amount of tax on the gain inherent in a unit when the unit is sold to a third party, treating the co-op corporation as the transferor on those sales.

For the same reason, the Department could treat a transfer to a co-op by an affiliate of the sponsor who acquired the unsold units in a "tax-free" transfer as not being an event requiring payment of the tax.¹⁰⁶ Similarly, if the defaulting sponsor (or sponsor affiliate) transfers unsold units to an entity related to a cooperative housing corporation gains tax should not be payable. This latter type of transaction may occur with some frequency because of liability concerns, and because of

¹⁰⁴ Sup. Ct., Queens, Spec. Term, Part 1, Index No. 17922/83, May 11, 1984 (emphasis added), aff'd 109 AD2d 782 (2d Dept. 1985), aff'd 67 NY2d 1008 (1986).

¹⁰⁵ See NYCRR §590.35(4).

¹⁰⁶ See NYCRR §590.35(5) and (6).

the need to comply with federal income tax requirements under section 216 of the Internal Revenue Code.

3. Safe Harbor Estimates.

The calculation of consideration under the "safe Harbor Estimate" rules for transfers pursuant to condominium and cooperative plans is another area in which the Department should exercise its authority to alter the rules that currently are in effect. The rules concerning Safe Harbor Estimates, set forth in TSB-M-86-(3)-R, provide a method for estimating the consideration to be received from the sale of unsold units as part of a condominium or cooperative plan. Consideration must be calculated in connection with the initial closing of the plan and then pursuant to "Update Submissions" after 50%, 75%, and 100% of the units have been sold.¹⁰⁷ This consideration calculation is used by the Department to compute the anticipated gain on the entire project. Gain is then allocated, typically on the basis of units, shares, or percentage interest in common elements, to arrive at the gains tax that must be paid by the sponsor on the sale of each unit. By following the Safe Harbor Estimates, a sponsor is protected against interest and penalties if there is an underpayment of gains tax because actual consideration exceeds the consideration estimated pursuant to the Safe Harbor.

¹⁰⁷ Form DTF-701-I (10/90), Instructions for Forms DTF-701 and DTF-702, Section G. For new construction and non-eviction plans, a taxpayer may also file an update submission after 25% of the units have been sold.
Id.

The Safe Harbor Estimate rules were designed to provide a workable method that would be fair to both taxpayers and the State. Clearly, however, the Department retained the authority to change these administrative rules. In the final paragraph of TSB-M-86-(3)-R it is provided that the Department "reserves the right to change the formulation of the Safe Harbor Estimates based on its experience and on changing market conditions." Market conditions have changed dramatically since the Safe Harbor rules were first proposed by the Department, and it has now become appropriate to modify the rules.

For example, a problem has arisen in connection with the Safe Harbor Estimates for Update Submissions with respect to non-eviction conversion plans.¹⁰⁸ The Safe Harbor Estimate for the initial submission is calculated by valuing the unsold units at the lower of 100% of the offering plan prices established for insiders at the closing of the plan or 50% of the vacant market value. This standard for calculating anticipated consideration at the time of the initial submission generally has worked fairly, and these Safe Harbor rules have been widely employed by sponsors in co-op conversions.

In contrast to the rules applied to new construction and vacant conversions, however, the Safe Harbor Estimate for an Update Submission for non-eviction and eviction

¹⁰⁸ The same issue arises with respect to eviction plans. This type of plan occurs less frequently, however.

conversion plans is the same as that used in the initial submission. The estimate is therefore based on the lower of the insider offering plan prices or 50% of the vacant market value as in effect at the time of the initial closing. In the current market, where there often are price reductions after the initial closing, this calculation of anticipated consideration overstates the gains tax due, relative to the sales price being received by the sponsor.

A sponsor can elect to cease following the Safe Harbor Estimate rules and use another method to calculate anticipated consideration with respect to unsold units. Unfortunately, the hazards of this approach -- the certainty of interest and the virtual certainty a penalty will be asserted if the sponsor's estimate is incorrect -- make this alternative unattractive.

A fairer and more accurate measure, in both good and bad markets, is to calculate anticipated consideration with respect to unsold units by reference to the prices in effect at the time of the Update Submission. The Safe Harbor Estimate for the Update Submission should equal the lower of 100% of the offering plan prices then in effect for insiders¹⁰⁹ or 50% of the

¹⁰⁹ Typically, the insider price expires after a certain period of time. In this market, however, sponsors have made second exclusive offerings to insiders at prices significantly less than the insider prices in effect at the initial closing. Where that occurs sponsors should be entitled to use the new "insider" price in computing anticipated consideration.

then vacant market value (as determined under the methodology of the TSB, based on the then-current sales experience). That would bring the treatment of these plans into parity with newly constructed and vacant conversion plans, where the rule already looks to offering plan prices in effect at the time the Update Submission is filed.

Practitioners have encountered several other problems with the Safe Harbor Estimates. The Committee again recommends that the Department meet with individuals who are experienced and knowledgeable in this area to identify the problems and develop workable solutions.

F. Application of Penalties.

The gains tax law imposes substantial penalties for underpayments of tax. There is a flat penalty of 10%, plus an interest penalty of 2% per month to a maximum of 25%, for an overall total penalty of as much as 35% of the tax due. The statute also provides, however, that:

"[i]f the commissioner . . . determines that [the] failure or delay [in paying tax] was due to reasonable cause and not due to willful neglect, commissioner . . . shall remit, abate or waive all of such penalty and such interest penalty."¹¹⁰

This provision was added to the law in 1984. The impetus for enabling the commissioner to eliminate penalties

¹¹⁰ Tax Law §1446(2)(a).

where the underpayment of tax was attributable to reasonable cause was well described in the Memorandum in Support: "Given the complicated nature of the gains tax and the difficulty the Department has had in some areas of its interpretation, the proposal to allow the Tax Commission to abate penalties, in appropriate cases, is necessary to allow for the equitable treatment of taxpayers."¹¹¹

In practice, however, the Committee members have generally found that the Department applies penalties automatically. Almost invariably a notice of determination of gains tax due includes an assessment of penalty and interest penalty; and in settlement negotiations the Department often proceeds as if penalties are necessarily part of the equation. The administrative posture seems to be that the penalty is abated only in the most unusual and compelling situations. The concerns that were articulated in 1984 -- that the tax is complicated and difficult of interpretation, and for the equitable treatment of taxpayers -- now seem to be secondary within the Department.

The unique pre-transfer audit process applicable under the gains tax also should be taken into account in considering penalties. Taxpayers' positions frequently are disclosed to the State and subject to review even before the tax is due. Yet, even where taxpayers' pre-transfer filings make specific and clear disclosure of positions taken in unclear areas, auditors persist

¹¹¹ Memorandum in Support, supra. at page 4, para. g.

in asserting penalties.¹¹² They appear to have little discretion to evaluate whether a penalty is appropriate, and as a practical matter this means that taxpayers, particularly in smaller transactions where protracted arguments are not economic, are faced with a system that treats the gains tax as a 13.5% tax.

This is not appropriate. Penalties are meant to punish. The law provides that penalties are to be imposed where there is willful neglect. That language means something beyond simply underpaying tax, and the audit policies of the Department must respect that standard. The gains tax has no precedent. It must be made to apply to extraordinarily complex questions relating not only to the costs of buying, constructing, owning, and selling real estate, but also to sophisticated leasing transactions, complicated entity transfers, and, increasingly, problems involving distressed properties.

In applying the tax to a novel problem one looks first to the existing guidance, and in many cases that provides a sufficient answer. Frequently, however, the gains tax law does not yet address a question, and one must look to analogous areas in the income tax and transfer tax laws, to accounting principles, to relevant aspects of the bankruptcy law, or the

¹¹² Committee members have in some cases been advised by field auditors that determinations made at the pre-transfer audit level are irrelevant in field audits. That approach may be entirely appropriate in auditing the amount of the gains tax that is due, but it is completely inappropriate when the subject is penalties.

real estate law, or whatever else might shed light on the appropriate application of the tax, and one exercises good faith judgment in deciding what would be a reasonable application of the tax. Too often the Department dismisses these efforts as meaningless, and assumes that if the tax was, in its view, underpaid then a penalty must be due.

It is imperative that the Department acknowledge, not just at its upper echelons but in the rank and file of daily decision makers, that in the world of the gains tax all is not yet known. Penalties should be reserved for cases in which the taxpayer's willful neglect of the law deserves punishment. They should not be asserted automatically, and they should not be used so commonly as a bargaining point in settlement negotiations.

This is an area in which reform is necessary. Without question this is wholly a matter of administrative action. The statutory provision granting the Department the authority to abate penalties is clear and it is fair. The legislative purpose underlying this grant of authority was clearly and fairly stated. What has been missing, and what should be easily attainable, is a broader respect of the good faith attempts of taxpayers to comply with a law that is still new, is complicated, and must be applied in a variety of sophisticated and novel situations.