



September 29, 2010

RE: Ruling Request  
Real Property Transfer Tax  
FLR: 10-4906-021

Dear:

This letter responds to your request, dated March 24, 2010, on behalf of the (the "Taxpayer"), for a ruling applying the New York City Real Property Transfer Tax (the "RPTT") to certain proposed transfers of property into and out of a charitable organization as described below. This office received additional information concerning this request on June 28, 2010.

### **FACTS**

The facts presented are as follows:

The Taxpayer. Upon the death of (the "Decedent") on, the Taxpayer succeeded to certain interests pursuant to a will (the "Will"), which had been executed by the Decedent on. During his lifetime, the Decedent had created separate limited liability companies (the "LLCs") for the purpose of owning, managing, developing, mortgaging, selling, or otherwise disposing of commercial property, including commercial real estate properties located in Manhattan at ("Property 1") and ("Property 2") (collectively, the "Properties").

The Properties. Property 1 was conveyed to ("LLC 1") in two separate conveyances: the Decedent conveyed lots of that property to LLC 1 by deed dated, and conveyed lot to LLC 1 by deed dated. In, LLC 1, through a wholly-owned subsidiary, obtained a construction loan in the principal amount of (the "Property 1 Loan") from the (the "Property 1 Lender"). The Property 1 Loan was secured by a first lien on Property 1, and the Decedent personally guaranteed the payment of the Property 1 Loan, subject to a cap of and certain other conditions. The maturity date for payment under the Property 1 Loan is

As of the date of the Decedent's death, LLC 1 was in default under various covenants in the Property 1 Loan documents for, among other things, failing to complete the construction of the building by the specified completion date. The Property 1 Lender notified LLC 1 of its right to accelerate the entire outstanding balance due under the Property 1 Loan. The Property 1 Lender also caused the LLC to notify the Executors of its claims against the Taxpayer for any and all sums due under the Decedent's personal guaranty.

In, the Decedent formed a second limited liability company, ("LLC 2"). By deed dated, LLC 2 acquired Property 2. To finance the acquisition, LLC 2, through a wholly owned subsidiary, obtained an acquisition loan in the principal amount of (the "Property 2 Loan" and, together with the Property 1 Loan, the "Loans") from and LLC (collectively, the "Property 2 Lenders").<sup>1</sup> The Property 2 Loan was secured by a first lien on

<sup>1</sup> You have represented that the Taxpayer is not related to the Property 2 Lenders except as a borrower.

the Property 2 as well as a pledge of the equity interests in LLC 2 and LLC 1. The Property 2 Loan matured in August 2009. However, because LLC 2 had no liquid assets to pay off the Property 2 Loan at the maturity date, the company was and continues to be in default under the terms of the Property 2 Loan documents.

Currently, the Taxpayer has a 100 percent ownership of LLC 1 and a 75 percent interest in LLC 2 (the remaining 25 percent of LLC 2 is owned by an unrelated individual).

The Will. Under the Will, Decedent's interests in the LLCs that own the Properties are considered part of the Decedent's residuary estate. Article 3 of the Will requires that the residuary estate be transferred to the (the "Foundation"), a New York non-profit and 501(c)(3) organization, "for the sole purpose of maintaining and preserving the" As a result, the Taxpayer must transfer those interests to the Foundation, even though the interests are encumbered by loans that are in default.

The Transactions. If the Taxpayer were to transfer its interests to the LLCs to the Foundation currently, the value of those interests would be significantly reduced because the Property 1 and Loans are in default. To preserve the value of the Taxpayer's assets, the Taxpayer would cause the LLCs to enter into a Loan Modification and Forbearance Agreement (the "Agreement") with the Property 2 Lenders. Under the Agreement, at the time the Taxpayer transfers its interests in the LLCs to the Foundation, as required by the Will (the "First Transfer"), a forbearance period of six months would go in effect (the "Forbearance Period"). During the Forbearance Period, the Property 2 Lenders would agree to (i) forbear from taking any action with respect to the Loans, (ii) make protective advances to fund all Property operating and maintenance expenses, taxes, and insurance, and (iii) assume responsibility for performance under the Property 1 Loan (including the personal guaranty). The Property 1 Loan would be extended and modified to permit the balance of construction to be completed and permit the Property 2 Lenders to exercise their remedies if the Loans are not repaid prior to the expiration of the Forbearance Period. In addition, pursuant to the Agreement, the Property 2 Lenders and the LLCs would appoint an asset manager with full authority to operate, manage, and lease the Properties and enter into agreements on behalf of the LLCs. In addition, during the Forbearance Period, the LLCs would agree that all the net cash flows arising from the Properties would be applied toward the indebtedness obligations to the Property 2 Lenders. Following the First Transfer, the Taxpayer would have no further economic interest or liability with respect to the Properties, except to the extent of any claims arising under the personal guaranty that the Decedent made upon securing the Property 1 Loan.

The Agreement would provide the Foundation with a number of alternatives to repay the Loans. The Foundation could repay the Loans from other sources of funds. It could also sell its interests in the LLCs, or sell the Properties directly, following a liquidation of the LLCs, to a third party, for any amount that is sufficient to cause the Loans to be repaid in full. In addition, if the Foundation has not been able to repay the outstanding balances of the Loans in full by the end of the Forbearance Period, it would be required either to transfer the interests in the LLCs to the Property 2 Lenders or transfer the Properties to the Property 2 Lenders by deed in lieu of foreclosure, following a liquidation of the LLCs. (The transfer by the Foundation of its interests in the LLCs or in the Properties is referred to herein as the "Second Transfer.")

To summarize, there may not be a Second Transfer, but should it occur, there are four alternatives: during the Forbearance Period, the Foundation could (i) sell its interest in the LLCs or (ii) liquidate the LLCs and then sell the Properties directly, and, following that period, it could (iii) transfer its interests in the LLCs to the Property 2 Lenders or (iv) liquidate the LLCs and transfer the Properties to the Property 2 Lenders by deed in lieu of foreclosure.

## ISSUES

You have requested the following rulings:

1. The RPTT would not apply to the First Transfer;
2. The RPTT would not apply to any of the four alternatives for the Second Transfer;<sup>2</sup> and
3. The step transaction doctrine would not be applied to treat the First Transfer followed by a conveyance of a controlling interest or a direct transfer of the Properties by the Foundation to a subsequent purchaser or the Property 2 Lenders as a single transaction to which the RPTT would apply.

### **CONCLUSIONS**

Based upon the facts presented and the representations submitted, we conclude that

1. The RPTT would not apply to the First Transfer because it would be a transfer pursuant to a Will;
2. The RPTT would not apply to any of the four alternatives for the Second Transfer because each transfer would involve a transfer by the Foundation, an organization exempt from the RPTT; and
3. The step transaction doctrine would not be applied to treat the First Transfer followed by a conveyance of a controlling interest or a direct transfer of the Properties by the Foundation to a subsequent purchaser or the Property 2 Lenders as a single transaction to which the RPTT would apply.

### **DISCUSSION**

The RPTT applies to each deed conveying an interest in New York City real property and to each instrument or transaction whereby any economic interest in real property is transferred when the consideration for the real property or economic interest exceeds \$25,000. Section 11-2102(a) and (b) of the New York City Administrative Code (the “Code”). Code section 11-2101(3) as “[a]ny document or writing (other than a deed or a will), regardless of where made, executed or delivered, whereby any economic interest in real property is transferred.” An economic interest in real property includes an interest in an LLC that owns real property. Code §§ 11-2101(6) and 11-126.

Code section 11-2106(b) exempts from tax any deed, instrument or transaction conveying or transferring real property or an economic interest therein by or to any entity:

organized or operated exclusively for religious, charitable, or educational purposes, or for the prevention of cruelty to children or animals, and no part of the net earnings of which inures to the benefit of any private shareholder or individual...; provided, however, that nothing in this paragraph shall include an organization operated for the primary purpose of carrying on a trade or business for profit, whether or not all of its profits are payable to one or more organizations described in this

<sup>2</sup> As discussed above, it is possible that the Second Transfer may involve two steps: first, a liquidation of the LLCs, resulting in the Foundation owning the Properties directly, and, second, a transfer of the Properties by the Foundation. You have not requested that we rule upon a transfer of the Properties from the LLCs to the Foundation as a result of the liquidation of the LLCs, but only on the ultimate transfer by the Foundation. You have noted that such a liquidation would not result in a change the beneficial ownership of the Properties and thus may be exempt under section 11-2106 (b)(8) of the New York City Administrative Code. Accordingly, this ruling does not address a transfer pursuant to the liquidation of the LLCs.

paragraph;....

On February 29, 2008, the Department of Finance (the “Department”) issued Statement of Audit Procedure RPTT 2008-1, entitled “Real Property Transfer Tax Transfers into and out of Charitable Organizations,” providing guidance to auditors and taxpayers concerning how the Department would apply the well-established “step transaction” doctrine of tax law in the context of the RPTT consequences of transactions that involve transfers into and out of charitable organizations. The step transaction doctrine treats the steps in a series of separate but related transactions involving the transfer of property as a single transaction, if certain conditions apply.

This ruling request concerns proposed transfers of controlling economic interests in LLC 1 and LLC 2 or of the Properties. Both LLC 1 and LLC 2 own real property in the City, and in the proposed transaction, interests that would exceed 50 percent of the LLCs’ ownership would be transferred. As a result, a transfer of those interests would constitute a transfer of a controlling economic interest in real property. You have asked us for a ruling concerning the RPTT consequences of the First Transfer and the Second Transfer and whether the step transaction doctrine would apply to treat those two transactions as a single transaction to which the RPTT would apply.

The First Transfer. Under the First Transfer, the Taxpayer would transfer its interests in the LLCs to the Foundation, subject to existing third party lender claims on the Properties, in accordance with the terms of the Will. Under Code section 11-2101(3), the RPTT applies to “[a]ny document or writing (other than a deed or a will), regardless of where made, executed or delivered, whereby any economic interest in real property is transferred.” Because the First Transfer is pursuant to a will, it is not subject to the RPTT.

The Second Transfer. Following the First Transfer, the Foundation would own LLC 1 and LLC 2, subject to the terms of the Agreement. As explained above, the Properties are in default under the Loans and, as a result, the LLCs and the Property 2 Lenders would enter into the Agreement to provide a six-month Forbearance Period during which the Property 2 would (i) forbear from taking any action with respect to the Loans, (ii) make advances to fund Property expenses, and (iii) assume responsibility for performance under the Property 1 Loan.

The Agreement provides a number of alternatives by which the Loans may be satisfied during the Forbearance Period. The Foundation could repay the Loans from sources of funds apart from the LLCs, in which case there would be no Second Transfer. If there is a Second Transfer, it could occur in any one of the following ways: during the Forbearance Period, the Foundation could (i) sell its interest in the LLCs or (ii) liquidate the LLCs and then sell the Properties directly, and, following that period, it could (iii) transfer its interests in the LLCs to the Property 2 Lenders or (iv) liquidate the LLCs and transfer the Properties to the Property 2 Lenders by deed in lieu of foreclosure.

The RPTT does not apply to a deed, instrument or transaction conveying or transferring real property or an economic interest in real property by or to an entity “organized or operated exclusively for religious, charitable, or educational purposes” (an “exempt organization”). Code § 11-2106(b)(2). Code section 11-2106(b)(2) closely resembles IRC section 501(c)(3), which exempts certain religious, charitable, and educational organizations from federal income tax. Code section 11-2106(b)(2) does not expressly require an organization to have received a federal exemption under IRC section 501(c)(3) to be exempt from the RPTT. However, because of the substantial similarity between the IRC and Code provisions, this Department takes the position that an organization exempt from tax under IRC section 501(c)(3) will typically be considered an exempt organization under Code section 11-2106(b)(2).

Here, because the Foundation is exempt from federal income tax under IRC section 501(c)(3), it would be

considered an exempt organization under Code section 11-2106(b)(2). As a result, any transfer to or from it that otherwise would be subject to the RPTT would be exempt. Each of the four alternatives for the Second Transfer involves the Foundation's transfer of interests in the LLCs or the Properties directly, following a liquidation of the LLCs. As each of those transfers would be a transfer from an exempt organization, they would be exempt from the RPTT under Code section 11-2106(b)(2).

The Step Transaction Doctrine. Having ruled that both the First Transfer and Second Transfer would not be subject to the RPTT when viewed separately, the remaining issue is whether those transfers, when viewed together, would be subject to tax. A transfer of the LLCs or the Properties directly from the Taxpayer to the Property 2 Lenders would not be exempt as a transfer under a will nor as a transfer to or from a tax-exempt entity. Whether the two transfers should be considered separately or as mere steps in one transfer depends on an application of the step transaction doctrine.

Well-established as a principle in income and other tax fields to deter potential abusive situations, the step transaction doctrine presents an aspect of the general principle that the substance, rather than form, of a transaction determines its tax consequences. When the step transaction doctrine applies, a series of formally separate "steps" will be treated as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result. *See, e.g., Greene v United States*, 13 F.3d 577 (2d Cir. 1994); *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987); *In re Waterman Investment Company*, NYS Tax Appeals Tribunal, DTA No. 813224 (1997).

While this Department has long had the authority to employ the "step transaction" doctrine in administering the RPTT, in SAP 2008-1, the Department issued guidance to auditors and taxpayers concerning circumstances in which the Department would apply the step transaction doctrine to a series of steps involving transfers into and out of a charitable organization. Following the principles developed in federal income tax decisions, the SAP states that steps may be collapsed if any one of the following three tests is met in the context of such a transaction:

- End result test: If the two transactions (owner to charity and then charity to new owner) were merely a means for the old owner to convey the property to a new owner, the "end result" test would be met. The SAP provides that the Department will look at whether the parties intended to convey the property to a new owner, not whether the parties meant to avoid tax.
- Interdependence test: This test would be met if it were unlikely that either of the two transfers would have taken place except in contemplation of the other.
- Binding commitment test: This test would be met if the two transactions took place pursuant to contracts entered into prior to the first transaction.

As a threshold matter, the facts presented here involve a transfer of a controlling economic interest to a charity and a possible transfer of that interest or real property out of the charity; as a consequence, the SAP, as well as the step transaction doctrine in general, might apply. Before turning to the separate tests, however, there are several facts presented in this ruling that distinguish it from situations where the use of the step transaction may be appropriate. First, the Decedent executed the Will on May 21, 2004, having decided that, upon his death, his assets in his estate would go to the benefit of the Foundation's charitable efforts. At that point, the Decedent had acquired Property 1. It was not, however, until years later, in 2008, that LLC 2 was formed and that the Property 2 Lenders, who would be the transferees if the step transaction doctrine applied, became involved with the LLC 2 by financing the acquisition of Property 2.

Second, the Agreement is the unintended consequence of business decisions of the LLCs and the Lenders and of market forces. When it acquired Property 2 and took out the Property 2 Loan in 2008, LLC 2 intended to own the Property and pay the loan, not to transfer the Properties or interests in the LLCs to the Property 2 Lenders. The defaults under the Loans, and the proposed Agreement were not intended.

Third, the Agreement provides a number of alternatives by which the Loans might be satisfied following the First Transfer that do not involve a transfer of the LLCs or the Properties to the Property 2 Lenders: the Foundation could repay the Loans from sources of funds apart from the LLCs, could sell its interest in the LLCs, or could liquidate the LLCs to sell the Properties. Only if the Loans are not satisfied during the Forbearance Period would the interests in the LLCs or the Properties be transferred to the Property 2 Lenders. In the absence of an event of foreclosure, the Foundation will either benefit from the sale of the Properties (or the interests in the LLCs) or remain the indirect legal owner of the Properties (through the LLCs).

Applying the three tests set out in SAP 2008-1 to those facts, it becomes apparent that the First Transfer and the Second Transfer should not be collapsed. Under the “end result” test, the two steps would be collapsed if they “merely a means for the old owner to convey the property to a new owner.” For the “end result” test to apply to the facts presented, the First and Second Transfers would be merely a means for the Taxpayer to convey the Properties to the Property 2 Lenders. The facts, however, do not support that conclusion: the First Transfer was the result of a Will executed long before the second owner was involved; the possibility of a Second Transfer was the result of an unintended defaults on loans; and the Second Transfer, depending on future events, may never occur. As a result, we conclude that the end result test does not apply to the facts presented.

Similarly, under the “interdependence” test, the step transaction doctrine would apply if it were unlikely that either of the two transfers would have taken place except in contemplation of the other. Here, the First Transfer and Second Transfer could not have been made in contemplation of each other because the First Transfer was the result of a Will executed long before Property 2 was acquired or the Property 2 Loan was in default. Finally, the “binding commitment” test could not apply because, among other reasons, the Agreement does not require that the interests in the LLCs or the Properties be transferred to the Property 2 Lenders.

As a result, based on your representations, we conclude that the step transaction doctrine would not apply to require that the First Transfer and Second Transfer be collapsed, and the RPTT consequences should be determined based upon a review of those transactions as separate events.

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The Department of Finance reserves the right to verify the information submitted.

Very truly yours,

Beth Goldman  
General Counsel

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