

RPTT-2017-01
09/26/17

STATEMENT OF AUDIT PROCEDURE

**Identifying Bona Fide Gifts in Connection
with Transfers to or from Business Entities
under the Real Property Transfer Tax**

I. Scope

The Real Property Transfer Tax (“RPTT”) presumes that every transfer or conveyance of New York City (“City”) real property or economic interests therein (collectively, “Transfer”) is taxable. Taxpayers may rebut that presumption and show that a Transfer is non-taxable or exempt, in whole or part. A bona fide gift may qualify as a Transfer for no consideration, and, therefore, non-taxable, but taxpayers bear the burden of proving that no consideration exists. This Statement of Audit Procedure explains how auditors should determine whether a Transfer to a business entity involves a gift from one individual to another. Four examples illustrate the analysis.

II. Background

Transfers for consideration are generally subject to the RPTT if the consideration exceeds \$25,000.¹ A Transfer for no consideration is not taxable.² Because the RPTT presumes that all Transfers are taxable, taxpayers bear the burden of proving that Transfers occur for no consideration.³

Consideration is the price paid or required to be paid for the real property or economic interests therein (collectively, a “Real Property Interest”) and generally includes the amount of any debt secured by the property, regardless of whether the transferee specifically assumes it.⁴

¹ Administrative Code of the City of New York §§ 11-2102(a)(9) and (10), (b)(1)(B).

² Rules of the City of New York § 23-03(j).

³ Ad. Code § 11-2103, RCNY § 23-07.

⁴ Ad. Code § 11-2101(9).

Consideration includes property other than money, and the RPTT presumes that the value of the non-monetary consideration is equal to the value of the Real Property Interest.⁵

Bona fide gifts may constitute Transfers for no consideration, but not to the extent of any debt that encumbers the Real Property Interest.⁶ Because the RPTT presumes all Transfers are taxable, a taxpayer must prove that a Transfer is a bona fide gift. The City Register may reject an RPTT return that reports no consideration if it does not include a statement of the basis for claiming that the Transfer occurred for no consideration.⁷

A. Transfers to Business Entities

Transfers to business entities in exchange for ownership interests are generally taxable. In the case of a Transfer to a partnership or limited liability company (“LLC”), the consideration is the partnership or membership interest issued in exchange for the Real Property Interest, and its value, for tax purposes, is the greater of (i) the fair market value of the Real Property Interest or (ii) the total amount of all encumbrances on it.⁸ Transfers to corporations generally incur the same RPTT consequences.⁹

Under the exemption for mere changes of identity or form (the “Mere Change Exemption”), Transfers to business entities are non-taxable to the extent beneficial ownership of the Real Property Interests remains the same.¹⁰ The Mere Change Exemption may function as a full or partial exemption, and the consideration is taxable in proportion to the change of beneficial ownership. A facts and circumstances analysis applies to determine the extent to which a beneficial ownership interest remains the same after a Transfer.¹¹

Transfers for no consideration may occur in conjunction with Transfers that are eligible for the Mere Change Exemption.

B. Gifts to or From Natural Persons

The RPTT does not distinguish Transfers among family members from other Transfers. Inter-family transfers are presumptively taxable, and they are not in and of themselves bona fide gifts. To determine whether a Transfer is a bona fide gift, and potentially a Transfer for no consideration, DOF will look at all facts and circumstances surrounding that Transfer, and will also take into consideration federal gift tax concepts.

⁵ Ad. Code §11-2103.

⁶ RCNY § 23-03(j)(1).

⁷ RCNY § 23-09(c).

⁸ RCNY § 23-03(e)(3)(i), (v).

⁹ RCNY § 23-03(e)(1)(i).

¹⁰ Ad. Code §11-2106(b)(8). See also RCNY §23-05(b)(8).

¹¹ RCNY § 23-05(b)(8)(iv).

Accordingly, Transfers will qualify as bona fide gifts if the taxpayers establish that “detached and disinterested generosity”¹² served as the donors’ primary motive for the Transfers. Proof of a familial relationship between the grantor and grantee is relevant to DOF’s analysis because detached and disinterested generosity is more likely to exist between family members than it is between strangers or otherwise unrelated parties. In evaluating whether a Transfer is a gift, DOF will consider gift letters, federal gift tax returns (IRS Form 709), and related documents (collectively, “Federal Gift Documents”), but these documents are not dispositive.

Under the unique circumstances described below, Transfers to or from business entities can be shown to be bona fide gifts. In those instances, the individuals transferring beneficial ownership of Real Property Interests must demonstrate they completed the Transfers with the necessary detached and disinterested generosity.

III. Procedure

A. Examine the RPTT Return and explanation of the Transfer

When an RPTT return reports that a Transfer to or from a business entity occurred without consideration, the auditor reviewing it should first determine whether or not it includes an explanation of the Transfer and the basis for characterizing it as a Transfer for no consideration. The explanation should describe each step of the transaction and the end result. If the return does not include an explanation, the auditor should request an explanation from the grantor and grantee, and, if they do not provide an explanation, the auditor may issue an assessment consistent with the existing framework for taxing transfers to or from business entities.

B. Examine all recorded documents and other documents executed by the parties in connection with the transfer

After reviewing the mandatory explanation of the Transfer, the auditor should examine all the documents recorded in the Automated City Register Information System (“ACRIS”) in relation to the Transfer and each step of the transaction, to determine whether they evidence a bona fide gift. The auditor should also request copies of all other documents that bind the parties to the Transfer and each step of the transaction, or explain their meaning and intent, including, but not limited to, partnership agreements, LLC operating agreements, contribution agreements, loan agreements, trust agreements, wills, estate planning documents, and gift letters. Note that this documentation may have recitals and terms that indicate whether the Transfer arose from detached and disinterested generosity.

¹² The Supreme Court first articulated this standard, for federal income tax purposes, in *Commissioner v. Duberstein*, 363 US 278 (1960).

C. Determine whether a familial relationship exists and Examine Federal Gift Documents

In connection with reviewing the transaction documents, the auditor should also request and review documents that establish a familial relationship between the transferor and transferee or donee, as applicable, and all Federal Gift Documents.

D. Consider the facts and circumstances of the transaction that the contemporaneous documentation and Federal Gift Documents establish

An auditor may conclude that a Transfer to a business entity is a bona fide gift if the facts and circumstances show an individual obtains beneficial ownership of a Real Property Interest out of the detached and disinterested generosity of another individual. The donee may be the direct transferee of a Real Property Interest or his or her beneficial ownership may be the end result of a series of interdependent steps.

Unless the relevant individuals are spouses, the auditor may only conclude the Transfer occurred for no consideration if the parties provide contemporaneous documentation and Federal Gift Documents that demonstrate they structured the transaction to convey beneficial ownership of a Real Property Interest for no consideration.

Transfers between spouses, and Transfers that shift beneficial ownership of Real Property Interests between spouses, may not necessarily require Federal Gift Documents or other documents to explain the motives of the parties. The auditor may nonetheless conclude that a transaction involving spouses occurred from a detached and disinterested generosity, absent evidence to the contrary, and except for Transfers arising from, or in anticipation of, divorce or separation by agreement.¹³

IV. Examples

In the examples below, an LLC acquires title to a Real Property Interest and the beneficial ownership of the Real Property Interest changes because the transferor does not retain all the membership interests issued in exchange for the Transfer. These examples are representative transactions that auditors may encounter in practice, and auditors should refer to them when reviewing an RPTT return that reports a Transfer to or from a business entity for no consideration.

Example 1:

Spouses A and B are US Citizens and own a four-family residential property located in the City as equal tenants in common ("TIC"). The property is unencumbered. They convey the property to a newly formed LLC on July 23, 2017. B receives 100% of the LLC's membership interests upon formation, and the transaction documents demonstrate the LLC issues the interests in exchange for ownership of the property.

¹³ RCNY § 23-03(d)(3)

B and the LLC file an RPTT return that reports B's conveyance of a 50% TIC interest and a 0% change in beneficial ownership. A and the LLC file an RPTT return that reports A's conveyance of a 50% TIC interest and a 100% change in beneficial ownership, but they check box (j) in the Condition of Transfer section to indicate a gift transfer not subject to indebtedness. The return does not include an explanation of the Transfer.

Audit requests and A provides an explanation, proof of the spousal relationship and a gift letter executed at the time of the transfer that demonstrate A's desire to gift A's TIC interest to B. A states no IRS Form 709 exists.¹⁴

Analysis:

Two Transfers to a business entity occur because A and B each contribute a TIC interest to the LLC. B conveys B's TIC interest to the LLC in exchange for membership interests, which are consideration equal to the fair market value of the TIC interest. However, B retains 100% of the beneficial ownership of the property, and the Mere Change Exemption therefore applies to the extent of her original TIC interest in the property.

A conveys A's TIC interest to the LLC in exchange for membership interests issued to B, which, absent proof of a bona fide gift, would be taxable with consideration equal to the fair market value of the TIC interest. The Mere Change Exemption does not apply to the Transfer because A has no beneficial ownership in the property when the transaction is complete. However, the gift letter, proof of spousal relationship and explanation demonstrate that A transfers beneficial ownership of A's TIC interest to B as a bona fide gift, which rebuts the presumption the Transfer is taxable.

Example 2:

Dad is the sole owner of a three family residential property located in the City. The property is unencumbered. On July 23, 2017, he and his Daughter form an LLC in which they are equal members in all respects, including the size of their membership interests and their rights to profits, losses and capital. On July 25, 2017 Dad conveys the property to the LLC.

Dad and the LLC file an RPTT return that reports Dad's conveyance and a 50% change of beneficial ownership, and they check box (j) in the Condition of Transfer section to indicate a gift transfer not subject to indebtedness. The return includes an explanation of the Transfer.

¹⁴ Under Federal Rules, a gift to a citizen spouse is not reported on IRS Form 709.

Audit requests and Dad provides the LLC operating agreement, all transaction documents, documents showing a familial relationship, a gift letter, and Federal Gift Documents. The LLC operating agreement provides no additional information, but the contribution agreement describes the contribution as a gift.

Analysis:

Dad's conveyance is a Transfer to a business entity. Dad conveys the property in exchange for the membership interests issued to Dad and Daughter, which are consideration equal to the fair market value of the property. Because Dad retains a 50% share of profits, losses, and capital of the LLC, the Mere Change Exemption applies to the extent of that interest. Further, Dad can establish a familial relationship to Daughter, and his explanation, the contribution agreement and the Federal Gift Documents demonstrate that Dad transfers a beneficial ownership interest in 50% of the property to Daughter as a bona fide gift, which rebuts the presumption that the Transfer is taxable to the extent of Daughter's interest.

Example 3

Member 1 is the sole owner of commercial Property A and Member 2 is the sole owner of a three-family residential Property B. Both properties are located in the City. Member 1 and Member 2 form LLC-Commercial and LLC-Residential in which they are equal members in all respects, including their shares of profits, losses and capital. Member 1 conveys Property A to LLC-Commercial and Member 2 conveys Property B to LLC-Residential.

Member 1 and LLC-Commercial file an RPTT return that reports Member 1's conveyance of Property A and a 50% change in beneficial ownership, and they check box (j) in the Condition of Transfer section to indicate a gift transfer not subject to indebtedness. Member 2 and LLC-Residential file an RPTT return that reports Member 2's conveyance of Property B and a 50% change in beneficial ownership, and they check box (j) in the Condition of Transfer section to indicate a gift transfer not subject to indebtedness. Neither return includes an explanation of the Transfer.

Audit requests and the members provide explanations of the Transfers, and all transaction documents. Member 1 and Member 2 also provide proof of a familial relationship that shows they are siblings. Additional information shows they are in the business of developing real estate. They do not provide Federal Gift Documents, and the transaction documents do not refer to gifts between them.

Analysis:

Each conveyance is a Transfer to a business entity.

Member 1 conveys Property A to LLC-Commercial in exchange for the membership interests issued to Member 1 and Member 2, which are consideration equal to the value of Property A, absent proof of a bona fide gift. However, Member 1 retains a 50% interest in the profits, losses and capital of LLC-Commercial, and the Mere Change Exemption applies to the extent of that interest. The facts and circumstances do not demonstrate that Member 1 transferred a beneficial ownership interest in Property A to Member 2 from a detached and disinterested generosity, and no portion of the Transfer may be characterized as a bona fide gift. After application of the Mere Change Exemption, 50% of the membership interests issued by LLC-Commercial are taxable consideration equal to 50% of the fair market value of Property A.

Member 2 conveys Property B to LLC-Residential in exchange for the membership interests issued to Member 1 and Member 2, which are consideration equal to the value of Property B, absent proof of a bona fide gift. However, Member 2 retains a 50% interest in the profits, losses and capital of LLC-Residential, and the Mere Change Exemption applies to the extent of that interest. The facts and circumstances do not demonstrate that Member 2 transferred a beneficial ownership interest in Property B to Member 1 from a detached and disinterested generosity, and no portion of the Transfer may be characterized as a bona fide gift. After application of the Mere Change Exemption, 50% of the membership interests issued by LLC-Residential are taxable consideration equal to 50% of the fair market value of Property A.

Example 4

ABC LLC is the sole owner of commercial property located in the City. Mom and Dad share the profits, losses and capital of ABC LLC equally. Mom and Son form XYZ LLC, in which Son owns a 30% membership interest and Mom owns a 70% membership interest and their shares of profits, losses and capital are all proportionate to the membership interest percentages. ABC LLC conveys the commercial property to XYZ LLC, but does not receive a membership interest in XYZ LLC. A mortgage for a \$2,000,000 loan encumbers the property, and the fair market value of the property exceeds the loan balance.

ABC LLC and XYZ LLC file an RPTT return that reports the Transfer, a 50% change in beneficial ownership, and taxable consideration equal to \$1,000,000. They check box (k) in the Condition of Transfer section to indicate a gift transfer subject to indebtedness, but the return does not include an explanation of the Transfer.

Audit requests and the LLCs provide an explanation of the Transfer, all transaction documents, a gift letter, and Federal Gift Documents. The recitals of the contribution agreement and the recitals and terms for determining member shares of profits, losses and capital in the operating agreement of XYZ LLC

indicate that Dad desired to gift a 30% beneficial ownership interest in the property to Son and a 20% beneficial ownership interest to Mom.

Analysis:

ABC LLC's conveyance is a Transfer to a business entity. ABC LLC conveys the property in exchange for the membership interests issued to Mom and Son, which are consideration equal to the value of the commercial property, absent proof of a bona fide gift. Because Mom retains a 70% interest in the profits, losses and capital of XYZ LLC, and the Mere Change Exemption applies to the extent of her original 50% beneficial ownership of the property. Further, the explanation, transaction documents, gift letter and Federal Gift Documents demonstrate that Dad transfers his beneficial ownership in the property to Mom and Son as bona fide gifts, which rebuts the presumption that the Transfer is taxable at fair market value to the extent of Dad's former interest, and the consideration is therefore limited to the loan secured by the property. After applying the Mere Change Exemption, 50% of the membership interests are taxable consideration equal to \$1,000,000, which is 50% of the loan.