IN THE MATTER OF GKK 2 HERALD LLC – EFFECTS OF THE STEP TRANSACTION DOCTRINE

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INTRODUCTION

In pre-17th century England, a transfer of land was not required to be recorded. Furthermore, a transfer was conducted by the landowner, who would take a handful of soil and then physically hand it to the purchaser. This ceremony was referred to as a "livery of seisin."

The practice of transferring one's property is very different in today's world. It is no longer required for the individuals involved to be present on the property to accomplish the transfer. The entire transaction can take place without ever setting foot on the property and is instead carried out by signing the appropriate documents at an attorney's office.

Within the last few centuries, the transfer of property has evolved into a complicated multistep transaction where various types of ownership can be transferred not only from an individual, but from various entities that may hold an interest in the property. In addition to signing various documents to record the transfer, Federal, state, and local governments also impose tax on the transfer.

The complicated nature of the various taxes imposed on a transfer of property is best illustrated by the recent case litigated in the State of New York Division of Tax Appeals Tribunal and the New York City Appeals Tribunal.

IN THE MATTER OF GKK 2 HERALD LLC

Facts

On April 9, 2007, GKK 2 Herald LLC, a Delaware limited liability company (the "Petitioner") and SLG 2 Herald LLC ("S.L.G.") acquired real property located at 2 Herald Square, New York, N.Y. (the "Property") as tenants in common ("T.I.C."). On the same date, the Petitioner and S.L.G. entered into a Tenants in Common Agreement (the "T.I.C. Agreement"), which governed their respective rights and obligations as owners of the Property. The Petitioner acquired a 45% undivided interest, while S.L.G. acquired a 55% undivided interest.

On December 14, 2010, the Petitioner and S.L.G. formed a third Delaware limited liability company, 2 Herald Owner LLC ("Herald"). On December 22, 2010, the Petitioner and S.L.G. entered into a Tenants in Common Contribution Agreement (the "T.I.C. Contribution Agreement") under which both the Petitioner and S.L.G. agreed to contribute their respective undivided interests as T.I.C. in the Property. The T.I.C. Contribution Agreement contained a number of provisions describing the Petitioner's rights and obligations in connection with the contribution of its T.I.C. interest in the Property. Among other things, the T.I.C. Contribution Agreement released the

Petitioner from all obligations under a mortgage loan secured by Herald's interest in the Property and received back its collateral, while S.L.G. received no such release.[1]

In addition, on December 22, 2010, the Petitioner and S.L.G. executed the Limited Liability Company Agreement of Herald (the "Herald L.L.C. Agreement"). The T.I.C. Contribution Agreement provided that the Petitioner and S.L.G. intended to form Herald and would enter into an L.L.C. agreement under which the Petitioner would have a 45% membership interest in Herald and S.L.G. would have a 55% membership interest in Herald. However, the Herald L.L.C. Agreement did not specify the Petitioner's or S.L.G.'s membership interests. The Herald L.L.C. Agreement merely provided that the available cashflow of Herald should be distributed from time to time as the members jointly determined in their sole discretion, and that profits and losses should be allocated jointly to the members. There were no other provisions in the Herald L.L.C. Agreement regarding the interests of the Petitioner and S.L.G. in Herald. Furthermore, on the same day, December 22, 2010, the Petitioner and S.L.G. entered into a Membership Interest Purchase Agreement (the "Purchase Agreement"), under which the Petitioner agreed to sell, and S.L.G. agreed to purchase, the Petitioner's membership interest in Herald. The Petitioner and S.L.G. timely filed state and city tax returns but asserted the "mere change in form" exception and did not pay either New York State real estate transfer tax ("R.E.T.T.") or New York City real property transfer tax ("R.P.T.T.").

On December 21, 2012, the New York City Department of Finance (the "Department") issued a Notice of Determination asserting New York City R.P.T.T. Additionally, on April 1, 2013, the New York State Division of Taxation (the "Division") issued a Notice of Determination to the Petitioner for New York State R.E.T.T.

"New York State imposes R.E.T.T. on each conveyance of real property or interest therein."

State of New York Division of Tax Appeals

New York State imposes R.E.T.T. on each conveyance of real property or interest therein.[2] This includes the transfer or transfers of any interest in real property by any method, including but not limited to "sale, exchange, assignment . . . or transfer or acquisition of a controlling interest in any entity with an interest in real property."[3] The term "controlling interest" means 50% or more of the capital, profits, or beneficial interest in such partnership, association, trust, or other entity."[4] There is an exception that can eliminate the transfer tax if the transfer is a mere change of identity or form of ownership or organization where there is no change in the beneficial ownership of the property.[5]

Interestingly, the Division conceded that, as standalone transactions, the Petitioner's contribution of its 45% T.I.C. interest and S.L.G.'s contribution of its 55% T.I.C. interest to Herald in exchange for an interest in Herald are each exempt from R.E.T.T. as mere changes in the form of ownership. Accordingly, under the Division's own regulations, the conveyance by T.I.C. of their interests in real property to a partnership or a corporation, the partnership or corporation's resulting interests being the same *pro rata* shares as the T.I.C. held prior to the conveyance, is not taxable as there is

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[1] *In the Matter of GKK 2 Herald LLC*, TAT(E) 13-25(RP).

[2] N.Y.S. Tax Law §1402(a).

[3] N.Y.S. Tax Law §1402(e).

[4] N.Y.S. Tax Law §1401(b).

[5] N.Y.S. Tax Law §1405(b)(6).

no change in beneficial ownership.[6]

The Division unsuccessfully tried to aggregate three nontaxable transactions in order to impose R.E.T.T. on the transfer of a minority interest:

- The transaction between S.L.G. and Herald (which effectuated a mere change in form of ownership)
- The transaction between the Petitioner and Herald (which effectuated a mere change in form of ownership)
- The transaction whereby the Petitioner transferred its 45% interest in Herald to S.L.G.[7]

To overcome the controlling interest limitation, the Division argued that under the New York codes, rules, and regulations (the "N.Y.C.R.R."), multiple "transfers or acquisitions" of interests in real property can be added together to determine if a transfer or acquisition of a controlling interest has occurred.[8] According to the Division, the transfer of the Petitioner's interest in Herald to S.L.G., when combined with S.L.G.'s 55% interest in Herald, resulted in S.L.G.'s "acquisition" of a "controlling interest" in Herald.[9] The N.Y.C.R.R. language provides that

> [w]here there is a transfer or acquisition of an interest in an entity that has an interest in real property, on or after July 1, 1989, and subsequently there is a transfer or acquisition of an additional interest or interests in the same entity, the transfers or acquisitions will be added together to determine if a transfer or acquisition of a controlling interest has occurred. Where there is a transfer or acquisition or a controlling interest in an entity on or after July 1, 1989, and the real estate transfer tax is paid on that transfer or acquisition and there is a subsequent transfer or acquisition of an additional interest in the same entity, it is considered that a second transfer or acquisition of a controlling interest has occurred which is subject to the real estate transfer tax. No transfer or acquisition of an interest in an entity that has an interest in real property will be added to another transfer or acquisition of an interest in the same entity if they occur more than three years apart.[10]

The New York State Division of Tax Appeals (the "N.Y.S. Tribunal") disagreed with the Department's argument and pointed out that the initial transaction, in which the Petitioner and S.L.G. transferred T.I.C. interests to Herald, was a mere change in the form of ownership and not a transfer or acquisition. The Petitioner and S.L.G. both held the same beneficial ownership in the property before and after the "mere change" transaction with Herald, as their resulting interests in Herald were the "same *pro rata* shares as the T.I.C. held prior to conveyance." Furthermore, the N.Y.S. Tribunal stated that the transaction between S.L.G. and Herald was not a transfer or acquisition of an interest in an entity with an interest in real property and

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[6] 20 N.Y.C.R.R. 575.10(a).

[7] *In the Matter of GKK Herald LLC*, Tax Appeals Tribunal, (May 26, 2016).

[8] 20 NYCRR 575.6(d).

[9] *In the Matter of GKK Herald LLC*, Tax Appeals Tribunal, (May 26, 2016).

[10] 20 NYCRR 575.6(d).

that transaction cannot, under the plain language of the statute and regulations, be aggregated with the Petitioner's subsequent transfer of a noncontrolling interest.[11]

As for the second part of the regulation, the N.Y.S. Tribunal pointed out that the plain language required three things:

- There is a transfer or acquisition of a controlling interest in an entity with an interest in real property.
- R.E.T.T. is paid on that transfer or acquisition.
- The transaction is followed by a subsequent transfer or acquisition of an additional interest in the same entity within three years.[12]

The initial transfer between S.L.G. and Herald was not a transfer or acquisition of a controlling interest, but merely a change in form of ownership, and as such, no R.E.T.T. was paid. The N.Y.S. Tribunal rejected the Division's argument that the subsequent transfer of the Petitioner's 45% interest to S.L.G. should be considered a second transfer or acquisition of a controlling interest that is subject to R.E.T.T. because this argument is inconsistent with the regulation and ignores the plain language requiring that R.E.T.T. must have been paid on the initial transaction for aggregation to apply. There is no dispute that R.E.T.T. did not apply to the initial transaction between S.L.G. and Herald, wherein S.L.G. exchanged its 55% T.I.C. interest in the Property for a *pro rata* 55% interest in Herald. As such, the regulation relied upon by the Division is inapplicable.

New York City Tax Appeals Tribunal

New York City approached the case in a different way and sought to impose R.P.T.T. by applying the step transaction doctrine to the transfers. R.P.T.T. applies on each deed at the time of delivery by a grantor to a grantee when the consideration for the real property and any improvement thereon exceeds $25,000.[13] Furthermore, R.P.T.T. is imposed on each instrument or transaction, at the time of the transfer, whereby any economic interest in real property is transferred by a grantor to a grantee where the consideration exceeds $25,000.[14]

For the purposes of R.P.T.T., an "economic interest in real property" includes

- the ownership of shares of stock in a corporation that owns real property;
- the ownership of an interest or interests in a partnership, association, or other unincorporated entity that owns real property; and
- the ownership of a beneficial interest or interests in a trust that owns real property.[15]

The definition of "controlling interest" is similar to the state definition. Here, a controlling interest includes 50% or more of the "capital, profits or beneficial interest" in

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11 *In the Matter of GKK Herald LLC*, Tax Appeals Tribunal, (May 26, 2016).

12 20 NYCRR 575.6(d).

13 N.Y.C. Admin. Code §11-2102.

14 N.Y.C. Admin. Code §11-2102.b(l).

15 N.Y.C. Admin. Code §11-2101.6.

a "partnership, association, trust or other entity."[16] Thus, R.P.T.T. applies to a transfer of an economic interest in an entity that owns real property in the city only if the economic interest represents a controlling (*i.e.*, 50% or more) interest in the entity.

The New York City Administrative Code provides exemptions from R.P.T.T. for a number of persons and transactions, including an exemption commonly referred to as the "mere change exemption."[17] The R.P.T.T. rules provide that

> [f]or purposes of determining whether and to what extent the mere change of identity or form of ownership or organization exemption applies, the determination of the beneficial interest of the real property or economic interest therein prior to a transaction and the extent to which the beneficial interest therein remains the same following the transaction will be based on the facts and circumstances.[18]

Step Doctrine

The step transaction doctrine is a widely recognized, judicially-created concept applied in tax cases whereby a court, after reviewing the facts and circumstances surrounding a series of related actions or events, can determine that they should be treated as components of a single, integrated transaction and taxed accordingly.[19] The step transaction doctrine is generally viewed as involving two tests:[20]

- *End Result Test*: If it is evident that the various steps were undertaken to achieve a specific ultimate result, they will be taxed as a single transaction.
- *Interdependence Test*: Separate steps will be consolidated where it is clear that no single step would have been undertaken except as part of the whole transaction.[21]

The Department asserted that the events that took place on December 22, 2010 were steps in a single transaction whereby the Petitioner sold its 45% T.I.C. interest in the Property to S.L.G. Further, the Department asserted that the transaction was not exempt from R.P.T.T., either as a mere change in form of ownership or as a transfer of a noncontrolling economic interest. Unlike the N.Y.S. Tribunal, in the state case both the Administrative Law Judge ("A.L.J.") and the New York City Tribunal (the "N.Y.C. Tribunal") agreed with the Department.

When the R.P.T.T. rules were published in their proposed form, they contained a provision stipulating that if a transaction purporting to qualify for the mere change exemption is preceded or followed by one or more transactions that are all part of a single plan, then all of the transactions pursuant to the plan would be taken into account in determining the extent to which the mere change exemption would apply.[22] This provision was not included in the final R.P.T.T. rules, therefore the Petitioner

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16 N.Y.C. Admin. Code §11-2101.8.

17 N.Y.S. Tax Law §1401(b), N.Y.C. Admin. Code §11-2106(8)(b).

18 19 RCNY §23-05(b)(8)(iv).

19 *Id.*

20 *King Enterprises v. the United States*, 418 F.2d 511, 516 (1969).

21 *In the Matter of GKK 2 Herald LLC*, TAT(E) 13-25(RP).

22 *Id.*

argued that the removal of the provision from the final R.P.T.T. rules evidenced an intent to not apply the step transaction doctrine. However, the N.Y.C. Tribunal found that there was no evidence of such intent.

According to the N.Y.C. Tribunal, the final R.P.T.T. rules contain a provision that is broad enough to allow the application of the step transaction doctrine in examining the facts and circumstances of a transaction in determining the extent to which the mere change exemption applies. Specifically, the R.P.T.T. rules provide that

> [f]or purposes of determining whether and to what extent the mere change of identity or form of ownership or organization exemption applies, the determination of the beneficial ownership of the real property or economic interest therein prior to a transaction and the extent to which the beneficial interest therein remains the same following the transaction will be based on the facts and circumstances.[23]

The N.Y.C. Tribunal concluded that it is appropriate to apply the step transaction doctrine, even in the absence of any rules or regulations authorizing such application.

According to the N.Y.C. Tribunal's decision, it is clear that the actions taken on December 22, 2010 were wholly-interrelated components of a single transaction, whereby the Petitioner conveyed its T.I.C. interest in the Property to Herald in exchange for cash and relief from liability under the mortgage loan. All of the essential documents were executed on that same date. At the beginning of that day, the Petitioner held a 45% T.I.C. interest in the Property, while at the end of that day, the Petitioner had no interest in the Property either directly or through an interest in Herald. Instead, the Petitioner had received $25,312,500 in cash, had been relieved of any liability for the mortgage loan, and had received the return of a letter of credit provided as collateral for the mortgage loan.

"The N.Y.C. Tribunal concluded that it is appropriate to apply the step transaction doctrine, even in the absence of any rules or regulations authorizing such application."

The N.Y.C. Tribunal agreed with the A.L.J.'s conclusion that the End Result Test was satisfied, because the intended result of the actions taken was the sale by the Petitioner of its T.I.C. interest to S.L.G. Furthermore, the N.Y.C. Tribunal also found that the Interdependence Test was in fact the easier test to apply in this case, because the recitals in the T.I.C. Contribution Agreement, the Herald L.L.C. Agreement, and the Purchase Agreement describe each of the interrelated steps.

The Supreme Court has ruled that under the step transaction doctrine, "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction."[24] Under the Interdependence Test, the court examines the steps taken to determine whether any of the steps would have been undertaken except as part of the whole.

Here, all of the steps were completed within one day. Moreover, the Herald L.L.C. Agreement did not identify the interests of the Petitioner and S.L.G. but merely stated that they would share profits, losses, and cashflow "jointly" or as they would "jointly determine." The N.Y.C. Tribunal interpreted this as lacking the intent to create a long-lasting joint venture.

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[23] 19 RCNY §23-05(b)(8)(iv).

[24] *Commr. of Internal Revenue v. Clark*, 489 US 726, 738 (1989).

The N.Y.C. Tribunal also distinguished this case from Example C in the R.P.T.T. rules.[25] In the example, the issue presented is whether a transfer results from the conversion of a partnership to an L.L.C. that could be aggregated with the subsequent sale of a 49% interest in the L.L.C. The example expressly states that "the conversion will not be considered a transfer of real property or an economic interest in real property." Therefore, there is no transfer, exempt or otherwise, prior to the sale of the 49% interest that could be aggregated with it.

Had the conversion constituted a transfer, even one qualifying under the mere change exemption, the subsequent sale of a 49% interest might have been aggregated with that initial transaction and, therefore, be taxable as a sale of a controlling economic interest in the entity.[26] However, according to the N.Y.C. Tribunal, Example C has no relevance to the transaction in this case.

CONCLUSION

In the Matter of GKK 2 Herald LLC clearly shows two different stances being taken on the same facts. In the state case, the Division did not challenge the initial transfer,[27] while in the city case, the Department clearly identified the steps taken during the transfers as part of an overall plan.

For taxpayers, the takeaway from these decisions should be to tread with caution when planning. The New York City decision places an additional burden on taxpayers with a less than 50% interest in a partnership, association, trust, or other entity. To overcome the application of the step transaction doctrine, taxpayers must plan carefully to ensure that the transfer clearly represents a mere change of form.

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25 19 RCNY §23-05(b)(8)(ii).

26 *In the Matter of GKK 2 Herald LLC*, TAT(E) 13-25(RP).

27 It should be noted that the Division has filed an exception that is pending in the New York State Tax Appeals Tribunal.

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