

NEW YORK CITY TAX APPEALS TRIBUNAL
ADMINISTRATIVE LAW JUDGE DIVISION

In the Matter of the Petition

Of

GKK 2 Herald LLC

DETERMINATION

TAT(H) 13-25 (RP)

Gallancy-Wininger, A.L.J.:

Petitioner, GKK2 Herald LLC, a Delaware limited liability company, having an address c/o Gramercy Capital Corp., 420 Lexington Avenue, 19th Floor, New York, New York 10170, filed a Petition for Hearing (Petition) with the New York City (City) Tax Appeals Tribunal (Tribunal) seeking a redetermination of a tax deficiency of Real Property Transfer Tax (RPTT) under Chapter 21 of Title 11 of the City Administrative Code (Administrative Code), asserted in a Notice of Determination dated December 21, 2012 (Notice of Determination), in the amount of \$3,392,627.12 consisting of principal of \$2,923,593.75 and interest of \$469,033.37 calculated to January 3, 2013. Petitioner requested a Conciliation Conference before Respondent's Conciliation Bureau. Petitioner disagreed with the Conciliator's Proposed Resolution and, on June 11, 2013, Respondent issued a Conciliation Determination discontinuing the matter. The Petition protests the Conciliation Determination.

Petitioner appeared by Thomas P. McGovern, Esq., Irwin M. Slomka, Esq. and Kara M. Kraman, Esq. of Morrison & Foerster LLP. The Commissioner of Finance (Respondent) was represented by Amy Bassett, Esq., Assistant Corporation Counsel.

Petitioner and Respondent executed and submitted a Consent to Proceed on a Stipulated Record dated June 11, 2014 pursuant to § 1-09 (f) of the Rules of Practice and Procedure of the Tribunal together with a Stipulation (Stipulation) as to certain facts and documents, including various Exhibits. Petitioner submitted its Opening Brief on August 1, 2014. Respondent submitted a Brief on September 22, 2014. Petitioner submitted a Reply Brief on October 21, 2014 and Respondent submitted a Reply Brief on November 21, 2014.

ISSUE

Whether Petitioner GKK2 Herald LLC's December 22, 2010 transfer of its 45% tenancy-in-common (TIC) fee interest (TIC Interest) in real property consisting of land located at 2 Herald Square, New York, New York (Land or Property) in exchange for a 45% membership interest (Membership Interest) in 2 Herald Owner LLC (Herald), and Petitioner's sale, on the same date, of the Membership Interest in Herald to SLG 2 Herald LLC (SLG), is taxable for RPTT purposes (Transactions).

Whether the step transaction doctrine may be applied to an analysis of the Transactions.

FINDINGS OF FACT

Petitioner, SLG, and 1328 Broadway Owners LLC entered into an Agreement of Sale dated April 9, 2007.

By deeds dated April 9, 2007, Petitioner acquired a 45% TIC Interest and SLG acquired a 55% TIC Interest in the Property.

Petitioner and SLG, as lessors, entered into a ground lease dated April 9, 2007, with Sitt 2 Herald LLC, as lessee (Ground Lease).¹

Petitioner and SLG entered into a Tenants In Common Agreement dated April 9, 2007 (TIC Agreement), which governed their respective rights and obligations as to the Land.² The record is silent as to the specific terms of the TIC Agreement.

In December of 2010, Petitioner and SLG entered into the following agreements and transactions:

Herald, a Delaware limited liability company, was formed on December 14, 2010.

On December 22, 2010:

(a) Petitioner and SLG executed a TIC Contribution Agreement pursuant to which Petitioner and SLG each agreed to contribute to Herald their TIC Interests together with their respective interests in the Ground Lease in exchange for, in the case of Petitioner, a 45% Membership Interest in Herald and, in the case of SLG, a 55% Membership Interest in Herald.³

¹The Ground Lease was amended as of June 30, 2007 to reflect its assignment to 1328 Broadway Owners LLC, as lessee.

²TIC Contribution Agreement, exhibit H at 1.

³Gramercy Capital Corp., Petitioner's parent, joined in the execution of the TIC Contribution Agreement solely with respect to (i) certain limited representations and warranties, and (ii) an indemnity in favor of SLG and Herald with respect to transfer taxes payable by either SLG or Herald in connection with the transactions under such agreement. (TIC Contribution Agreement, exhibit H, ¶ 12.16.)

- (1) The TIC Contribution Agreement contained a number of provisions that reflect the intended sale by Petitioner to SLG of its new Membership Interest. For example, as a condition to closing under the TIC Contribution Agreement, Petitioner was to be released from, and Herald was to assume, the obligations under mortgage loan documents relative to a mortgage in the amount of \$191,250,000 (Mortgage) from Goldman Sachs Commercial Mortgage Capital, L.P., (Mortgagee).⁴

- (2) A prerequisite to SLG's obligation to close under the TIC Contribution Agreement was the issuance of an irrevocable commitment by a title insurance company to issue a specific title insurance policy, insuring Herald's marketable fee simple title to the land as of the closing date, subject only to certain permitted title exceptions. Although Herald is the entity to which both Petitioner's TIC Interest and SLG's TIC Interest were to be conveyed, under the TIC Contribution Agreement only the conveyance by Petitioner (and not the conveyance by SLG) had to satisfy certain title requirements. SLG had the right to either terminate the TIC Contribution Agreement or "cause" Herald to accept title subject to the title exceptions. Although Herald was to be the grantee, Herald had no independent right to terminate the agreement if title was unsatisfactory.⁵

- (3) Although both Petitioner and SLG were grantors of their respective TIC Interests, under the TIC Contribution

⁴Guarantors and indemnitors were also to be released by the Mortgagee. However, Petitioner remained liable for certain retained obligations.

⁵TIC Contribution Agreement, exhibit H, ¶ 5.2.

Agreement, Petitioner alone assumed responsibility for the payment of any transfer taxes arising under the TIC Contribution Agreement. Petitioner's parent, Gramercy Capital Corp., agreed to indemnify, defend and hold SLG and Herald harmless from such transfer taxes.⁶

- (4) Only SLG (and neither Petitioner nor Herald), had a limited right to cancel the TIC Contribution Agreement in the case of condemnation proceedings.⁷ Additionally, the TIC Contribution Agreement contained several representations made by Petitioner to SLG but not to Herald, the intended grantee.⁸
- (5) The TIC Contribution Agreement also provided that both a letter of credit given by Petitioner to the Mortgagee and collateral for the letter of credit were to be returned to Petitioner. SLG was required to deliver a replacement letter of credit to the Mortgagee.
- (6) The TIC Contribution Agreement further provided that if the transactions under such agreement were not consummated as a result of Petitioner's default, SLG would have the right to cancel the agreement; if the transactions were not consummated as a result of SLG's default, Petitioner would have the right to cancel the

⁶TIC Contribution Agreement, exhibit H, ¶ 12.16.

⁷TIC Contribution Agreement, exhibit H, ¶ 7.1.

⁸These representations by Petitioner included (i) there were no outstanding purchase options in favor of another party, and (ii) Petitioner owns and has good title to its TIC Interest. SLG did not make analogous representations.

agreement. Herald, the intended grantee under the TIC Contribution Agreement, did not have a similar right.⁹

(7) SLG acknowledged that Petitioner did not make any representations that were not contained in the TIC Contribution Agreement. The TIC Contribution Agreement did not include analogous acknowledgments by either Petitioner or Herald.¹⁰

(b) Petitioner and SLG each executed deeds conveying their TIC Interests to Herald in exchange for their respective 45% and 55% Membership Interests in Herald.

(c) Petitioner and SLG executed and delivered City RPTT returns reporting that the transfer to Herald was exempt as a mere change of identity or form of ownership.

(d) Pursuant to the TIC Contribution Agreement, Herald assumed the Mortgage, the Ground Lease and a management agreement with SL Green Management Corp. as manager.

(e) Petitioner and SLG, each as members (Members) and two independent non-member managers executed the Limited Liability Company Agreement of Herald (Operating Agreement). The Operating Agreement provides, among other things, that "the [a]vailable cash flow of the LLC shall be distributed . . . as the Members shall jointly determine in their sole discretion." (Operating Agreement § 3.4.1).

⁹TIC Contribution Agreement, exhibit H, ¶ 9.2.

¹⁰TIC Contribution Agreement, exhibit H, ¶ 10.1.

(f) Petitioner and SLG executed a Membership Interest Purchase Agreement pursuant to which Petitioner agreed to sell and SLG agreed to purchase Petitioner's Membership Interest for \$25,312,500. The recitals in the Membership Interest Purchase Agreement include the following:

WHEREAS, immediately following the formation of the Company [Herald] and the execution and delivery of the Operating Agreement, the Company intends to acquire the Land (defined below); and

WHEREAS, subject to the terms hereof, Seller desires to sell the Petitioner's Membership Interest and Purchaser desires to purchase the Petitioner's Membership Interest in accordance with the terms hereof.

(g) Petitioner and SLG executed an Assignment and Assumption Agreement whereby Petitioner assigned its Membership Interest to SLG. The Assignment and Assumption Agreement provided for Petitioner's withdrawal as a member of Herald simultaneously with Petitioner's execution of such agreement.¹¹

(h) Petitioner filed an RPTT return which describes the condition of the transfer of its Membership Interest to SLG as "Other. Transfer of 45% interest in LLC" and reports that no RPTT is due.

Respondent commenced an audit in this matter. Beginning in March, 2012, the auditor requested information from Petitioner and SLG. Respondent's audit file and Respondent's tax return file include copies of: (i) correspondence from Petitioner explaining its position that the Transactions are not taxable; (ii) the April 9, 2007 deed between 2 Herald Holding LLC, as grantor and SLG and

¹¹Exhibit M, § 5.

Petitioner, as grantees of their respective TIC Interests; (iii) the TIC Contribution Agreement; (iv) a closing statement; (v) the Membership Interest Purchase Agreement; (vi) a Grantor Balance Sheet for Two Herald Square (vii) an Assumption Agreement pursuant to which Herald assumed the obligations under a promissory note in the original principal amount of \$191,250,000, which note is secured by the Mortgage; (viii) the deeds and related City and State transfer tax returns for the transfer from (a) Petitioner to Herald, conveying its 45% TIC Interest, and (b) SLG to Herald, conveying SLG's 55% TIC Interest.¹² Respondent's tax return file also contains the City and State transfer tax returns for the transfer of Petitioner's Membership Interest to SLG.

The auditor concludes in the Audit Case Summary that "ownership of 100% controlling economic interest in real property by [SLG], resulted in a 55% non-taxable mere change and a 45% taxable change in beneficial ownership." The auditor calculated the taxable consideration of \$111,375,000, based on the purchase price for the GKK Membership Interest of \$25,312,500 plus a 45% pro-rata share of the Mortgage (\$191,250,000 x 45% or 86,062,500). The NOD reflecting consideration in the amount of \$111,375,000 was issued on December 21, 2012.

STATEMENT OF POSITIONS

Petitioner asserts that the transfer of its 45% TIC Interest in exchange for its 45% Membership Interest is exempt from RPTT as a mere change in form under Administrative Code § 11-2106 (b) (8) and its sale of that interest to SLG is exempt from RPTT as a

¹²Respondent's Audit File, exhibit O.

transfer of a non-controlling interest. (See, Administrative Code § 11-2101 [7], [8].)

Petitioner also asserts that it has the legal right to structure the transaction to eliminate taxes to the extent permitted by law.

In addition, Petitioner asserts that Respondent is not authorized to apply the step transaction doctrine to the Transactions and further, any such application is contrary to Respondent's regulations. Moreover, Petitioner asserts that the Transactions do not satisfy either of the two pertinent step transaction tests, namely the "interdependence test" and the "end result test."

Petitioner further asserts that amendments to Respondent's Rules did not include (1) the Proposed Rule (19 RCNY) § 23-05 (b) (8) (iii), and (2) the illustration that follows (Proposed Rule).¹³ Petitioner argues that Respondent's failure to include the Proposed Rule in its final Rules, is a recognition that "the RPTT statute did not support [Respondent's] multi-step transaction position."

Petitioner also asserts that Respondent's attempt to tax the transfer of its Membership Interest is based on a statute imposing taxes and must be construed in favor of the taxpayer.

¹³The Proposed Rule stated: *Application of mere change exemption to multi-step transactions.* Where pursuant to a plan, a transaction that would be exempt in whole or in part from the tax as a mere change of identity or form of ownership or organization is preceded or followed by one or more other transactions, all of the transactions pursuant to the plan will be taken into consideration in determining the beneficial ownership of the real property or economic interest therein prior to the transaction and the extent to which the beneficial interest therein remains the same following the transaction.

Respondent asserts that the Transactions are subject to the step transaction doctrine. Respondent characterizes the relevant statutes as exemption statutes and asserts that Petitioner has the burden of proof to establish the applicability of the statutory exemptions to the Transactions. Respondent further asserts that a tenancy in common is not an interest in an entity; rather, it is a direct interest in real property and the mere change exemption is unavailable. Respondent also asserts that as the mere change exemption does not apply, the subsequent transfer of Petitioner's Membership Interest is not a transfer of a controlling interest. Accordingly, Respondent argues the Transactions are subject to RPTT.

CONCLUSIONS OF LAW

Administrative Code § 11-2102 (a) imposes the RPTT 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 (whether or not included in the same deed) exceeds twenty five thousand dollars."

Administrative Code § 11-2104 imposes the obligation to pay the RPTT on the grantor, although the grantee is also liable for the payment of the RPTT if the amount due is not paid by the grantor or the grantor is exempt from tax. (Administrative Code § 11-2104.)

Mere Change in Form Exemption

Administrative Code § 11-2106 (b) (8) provides an exemption from the RPTT where the deed conveying real property "effects a mere change of identity or form of ownership or organization to the extent the beneficial ownership of such real property or economic

interest remains the same . . ." (Emphasis supplied). (Mere Change Exemption)

The interest held by Petitioner before it transferred its TIC Interest to Herald was a tenancy in common. The United States Supreme Court, in *US v Craft*, (535 US 274, 279, 280 [2002]) described the common law interest of a tenancy in common as follows:

The common law characterized tenants in common as each owning a separate fractional share in undivided property. Tenants in common may each unilaterally alienate their shares through sale or gift or place encumbrances on these shares. . . . Tenants in common have many other rights in the property, including the right to use the property, to exclude third parties from it, and to receive a portion of any income produced from it. (Emphasis added. Citations omitted).

A tenancy in common has been described as a:

tenancy whereby each cotenant has an equal right to possess and enjoy all or any portion of the property as if he or she is the sole owner.

(24 NY Jur 2d, Cotenancy and Partition § 3 [accessed January 15, 2015].) Further,

[E]ach tenant [in common], as to his or her share, is deemed to be the owner of an entire estate, separate and distinct from that of his or her cotenants, with only a unity of possession between them. As between tenants in common who are united only in their right to possess real property, however, there is neither privity of title nor union and entirety of interest. (Emphasis supplied.)

24 NY Jur 2d Cotenancy and Partition § 7 [accessed January 15, 2015].)

Respondent issued several letter rulings that support the application of the Mere Change Exemption in situations involving the conveyance of TIC interests or percentage interests in real property to an entity in which, on the facts specific to the particular rulings, the beneficial ownership of the property remains the same after the conveyance as it was before the conveyance. For example, Finance Letter Ruling (*FLR*) No. 034806-21 (NY City Dept Fin 2003) states that “[T]he determination of the beneficial ownership of real property before a transaction and the extent to which the beneficial interest remains the same following the transaction, will be based on the facts and circumstances.”¹⁴ (See, *FLR* 97-4700 [NY City Dept Fin 1997]; *FLR* 95-4651 [NY City Dept Fin 1996]; *FLR* 94-4549 [NY City Dept Fin 1995]. See also, Real Property Transfer Tax (RPTT) Rules of the City of New York (19 RCNY) § 23-05 (b) (8) (ii) Example A, which explains that a transfer to a corporation by equal tenants in common is exempt from RPTT because the beneficial ownership of the real property remains 100% the same before and after the transfer.)¹⁵

The term “beneficial interest” has been defined as being more than a mere financial interest. (*Matter of Viacom, Inc.*, NYS Tax Appeals Tribunal Decision, [NY St Div of Tax Appeals DTA No. 819591, May 3, 2007], in which a change in voting rights was found

¹⁴Letter rulings are not precedential but nevertheless illustrate Respondent’s position. (See, (16 RCNY) 16-05 [a]).

¹⁵A State advisory opinion considering the State Real Estate Transfer Tax § 1402, distinguishes ownership of a tenancy in common interest, which is a direct interest in real property, from ownership of an interest in an entity. (See, *TSB-A-98(2)R*, *TSB-A-98(12)C*, *TSB-A-98(2)M*, at 6.)

to be a change in beneficial interest for State Real Estate Transfer Tax purposes). The State Tax Appeals Tribunal found that, "[b]eneficial ownership is marked by the command over property and enjoyment of its economic benefits." (*Viacom*, citing, *Yelencsics v Commissioner*, 74 TC 1513, citing, *Anderson v Commissioner*, 164 F2d 870, 48-2 USTC 9109, *affg* 5 TC 443; *Matter of Racal Corp & Decca Elecs*, NYS Tax Appeals Tribunal Decision [NY St Div of Tax Appeals DTA No.807361, May 13, 1993]; *Matter of Shechter*, NYS Tax Appeals Tribunal, [NY St Div of Tax Appeals DTA No. 808585, October 13, 1994]. See also, *Macon, Dublin & Savannah R.R. Co. v Commissioner*, 40 BTA 1226 [1939].) Other indicia of beneficial ownership include entitlement to profits, dividends and bonuses. (*Yelencsics v Commissioner*, (74 TC 1513 at 1527, 1528, [1980].) In FLR 95-4651, Respondent ruled, "[i]n the case of a limited liability company, a member's beneficial interest is the member's interest in the profits, losses, distributions, rights upon dissolution and voting power in the company." (Emphasis supplied.) (See also, *FLR 97-4700, supra.*)

The record is silent as to any agreement between Petitioner and SLG regarding their respective interests in the profits, losses, distributions, rights upon dissolution and voting power while they operated the Property as tenants in common. Although Petitioner obtained a 45% membership interest in Herald, the Operating Agreement did not provide Petitioner with any express interest in Herald's available cash flow. Instead, § 3.4.1 of the Operating Agreement directed that the distribution of available cash flow be made as the "[m]embers shall jointly determine in their sole discretion." Since Petitioner held only a minority interest in Herald, it is unclear whether Petitioner could have compelled any distribution. Petitioner has not established that its Membership Interest is the same beneficial interest with the

same bundle of rights that Petitioner had when it owned its TIC interest.

Transfer of a Controlling Economic Interest.

Administrative Code § 11-2102 (b) (1) imposes the RPTT on transfers of economic interests in real property.

An "economic interest in real property" includes "the ownership of an interest or interests in a partnership, association or other unincorporated entity which owns real property . . ." (Administrative Code § 11-2101 [6].)

Administrative Code § 11-2101 (8) defines the word "transfer" as follows:

When used in relation to an economic interest in real property, the terms "transfer" or "transferred" shall include the transfer or transfers or issuance of shares of stock in a corporation, interest or interests in a partnership, association or other unincorporated entity, or beneficial interests in a trust, whether made by one or several persons, or in one or several related transactions, which shares of stock or interests constitute a controlling interest in such corporation, partnership, association, trust or other entity.

A "controlling interest" in a partnership, association, trust or other non-corporate entity, consists of "fifty percent or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity." (Administrative Code § 11-2101 [8].)

Petitioner's reliance on 19 RCNY 23-05 (b) (8) (ii) Example C, is misplaced. Example C involves the conversion of a general partnership, comprised of two equal partners, to a limited liability company, followed by the sale of a non-controlling interest by one member of that company to the other member. Example C states that, relative to the mere change exemption, the issue is whether "under the applicable state law X Company is considered to be the same entity as before the conversion [in which case] the conversion will not be considered a transfer of real property or an economic interest in real property." Respondent asserts that Petitioner converted a TIC Interest (rather than a partnership interest) to a Membership Interest, and therefore, the entities before and after the transfer are not the same under state law. However, Respondent has issued several letter rulings that treat transfers of real property from tenancies in common to limited liability companies, as non-taxable mere changes in form where the beneficial interests of the parties to the transfer remain the same before and after the transfer. (See, FLR 97-4700 [NY City Dept Fin 1997]; FLR 95-4651 [NY City Dept Fin 1996]; FLR 034806-021, [NY City Dept Fin 2003].) Respondent may not argue that Example C is inapplicable to this matter merely because a TIC interest is not the same a partnership interest. Rather, with respect to the Mere Change Exemption, the question is whether Petitioner owns the same beneficial interest before and after the conveyance. Nominally, Petitioner retained the original 45% interest. Under the Operating Agreement, however, Petitioner had no clear right to distributions of available cash flow. Petitioner has failed to establish that the attributes of such interest were the same both before and after the conversion of its TIC Interest to its Membership Interest.

Further, the transfer of a less-than-controlling TIC interest (*i.e.*, less than 50%) is subject to RPTT. (*See, Matter of Dalia Horowitz*, City Tax Appeals Tribunal TAT (H) 96-77 (RP) [City Tax Appeals Tribunal, August 31, 2001]).¹⁶ Had Petitioner directly conveyed its TIC interest to SLG, that conveyance would have been subject to RPTT.

The Step Transaction Doctrine

The step transaction doctrine has its roots in *Gregory v Helvering* (293 US 465 [1934]) (where a taxpayer formed a corporation solely to receive assets that were distributed to the taxpayer as a liquidating dividend) and *Minnesota Tea v Helvering*, (302 US 609 [1938]), (where the court treated as taxable gain, cash in the hands of shareholders used to pay corporate debts). Under the step transaction doctrine, [']steps['] in a series of formally separate but related transactions [are treated] as a single transaction if all of the steps are substantially linked." (*Greene v US*, 13 F3d 577, 583 [2nd Cir 1994]), (regarding charitable donations of futures contracts while the donor retained the right to certain income.) The purpose of the step transaction doctrine is "to assure that tax consequences turn on the substance of a transaction rather than on its form." (*King Enterprises, Inc. v US*, 418 F2d 511, 517 [Ct 1969].)

In *Crenshaw v US* (450 F2d 472 [5th Cir 1971]), the US Court of Appeals for the Fifth Circuit, determined that the subject transaction was a sale of a partnership interest in real property rather than a distribution in liquidation. (*Crenshaw* at 476.) The

¹⁶Decisions of City Administrative Law Judges may not be cited as precedent. They are nevertheless instructive. (*See, NY City Charter* § 168 [d]).

Court noted that "the substance rather than the form of a transaction determines its tax consequences, particularly if the form is merely a convenient device for accomplishing indirectly what could not have been achieved by the selection of a more straightforward route." (*Crenshaw* at 475.) The Court stated "[t]ransparent devices totally devoid of any non-tax significance to the parties cannot pass muster even though a literal reading of the statutory language might suggest otherwise." (*Crenshaw* at 475.) Further, the Court held that:

[a] corollary proposition, equally well established, is that the tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan. [Citations omitted.] Taken individually-or a few, but not all, steps at a time - each step in the sequence may very well fit neatly into an untaxed transactional compartment. But the individual tax significance of each step is irrelevant when, considered as a whole, they all amount to no more than a single transaction which in purpose and effect is subject to the given tax consequence.

(*Crenshaw* at 475.)

In order to determine whether the step transaction doctrine applies to a particular matter, courts have established two tests: an 'interdependence test,' and an 'end result test.' (*Security Industrial Insurance Company v US*, 702 F2d 1234 [5th Cir 1983]; *King Enterprises* at 516.)¹⁷ Only one test must be satisfied in order for the step transaction doctrine to apply. (See, *Associated*

¹⁷A 'binding commitment' test was enunciated in *Commissioner v Gordon*, 391 US 83 [1968]. However, the Court in *King* noted, that test "has seldom been applied since." (*King* at 1530, n 6).

Wholesale Grocers, Inc. v US, 927 F2D 1517, 1527-28 [10th Cir 1991], which involved loss recognition in a corporate restructuring).

The US Court of Claims in *King* discussed the two tests as follows:

The 'interdependence test' requires an inquiry as to 'whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series'. . .[Citations omitted.]

and

The 'end result test'. . .establishes a standard whereby * * * purportedly separate transactions will be amalgamated into a single transaction where it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.

(*King* at 516.)

The US Court of Appeals for the Tenth Circuit, in *Associated Wholesale Grocers*, citing *Kuper v Commissioner*, (533 F2d 152, 156, [5th Cir, 1976]) stated that, "[d]isregarding the tax effects of individual steps under [the interdependence test] is, therefore, [']especially proper where. . . it is unlikely that any one step would have been undertaken except in contemplation of the other integrating acts. . . ." (*Associated Wholesale Grocers* at 1523.)

Petitioner owned a TIC interest from April, 2007 until December, 2010. Only on December 22, 2010, did Petitioner execute the TIC Contribution Agreement and convert its TIC Interest to a Membership Interest. That conversion occurred on the same day that Petitioner executed the Operating Agreement, the same day it

executed the Membership Interest Purchase Agreement, and the same day Petitioner sold its newly created Membership Interest to SLG.

The TIC Contribution Agreement included provisions that extended beyond the mere exchange of a TIC Interest for a Membership Interest, addressing matters relating to the conveyance of real property including: (a) a guaranty by Petitioner and its parent (but not SLG) of the payment of any transfer taxes arising out of the transactions (even though both Petitioner and SLG transferred TIC membership interests to Herald), (b) a release of Petitioner from its obligations under the Mortgage and the return of certain collateral, (c) the right of SLG to cause Herald to take certain actions in the case of title exceptions affecting Petitioner's TIC Interest (without providing for rights in favor of Petitioner or Herald in the case of title issues affecting SLG's TIC Interest) and, (d) certain representations made by Petitioner, without comparable representations from SLG (*i.e.*, that (i) there were no outstanding purchase options in favor of another party; and (ii) Petitioner owns and has good title to its TIC Interest).

The Operating Agreement provided that Petitioner's right to distributions of available cash was only "as the members shall determine." Petitioner's lack of express rights regarding such distributions is an indication that the Operating Agreement was intended to have only a transitory effect on Petitioner. Indeed, Petitioner withdrew as a Member of Herald simultaneously with its assignment of its Membership Interest to SLG.

Recitals in the Membership Interest Purchase Agreement describe a sequence of events consisting of the formation of Herald, the execution and delivery of the Operating Agreement, the

acquisition by Herald of the Land and Petitioner's sale of its Membership Interest to SLG.

Under these circumstances, it is unlikely that either the conversion of Petitioner's TIC Interest to its Membership Interest or the sale of its Membership Interest would have occurred without the other. The interdependence test is satisfied under the facts of this matter.

It is apparent that the events occurring in December, 2010, were components of one transaction, the end result of which was intended to achieve the sale by Petitioner of its TIC interest to SLG while avoiding the payment of RPTT on such transaction and, the end result test is satisfied.

In *Associated Wholesale Grocers*, the Court addressed the question of whether the lack of business purpose is a prerequisite to the application of the step transaction doctrine, or whether the presence of a business purpose precludes the application of the doctrine. The Court stated that "the law is unclear as to the relationship between the step transaction doctrine and the business purpose requirement." (*Associated Wholesale Grocers* at 1526). It noted that "[i]n some cases the existence of a business purpose is considered one factor in determining whether form and substance coincide. In others, the lack of business purpose is accepted as a reason to apply the step transaction doctrine." (*Associated Wholesale Grocers* at 1526, 1527.)

In Revenue Ruling 79-250, the IRS stated,

threshold steps will not be disregarded under a step transaction analysis if such preliminary activity results in a permanent alteration of a previous bona fide business relationship. Thus the substance of each of a series of steps will be recognized and the step transaction doctrine will not apply, if each step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not for the mere avoidance of taxes.

On the other hand, the Court in *Associated Wholesale Grocers* determined that it is not necessary to reach the question of whether there is an independent business purpose in order for the step transaction doctrine to apply. (*Associated Wholesale Grocers* at 1526, 1527.)

In *Greene v US*, (13 F3d 577 [2nd Cir, 1994]), the US Court of Appeals for the Second Circuit, citing *Penrod v CIR*, 88 TC 1415, stated that, to apply [the independence test], a court must determine whether the individual steps had "independent significance or whether they had meaning only as part of a larger transaction." (*Greene* at 584).

Petitioner argues that the Transactions had independent significance because it was the intention of the parties that Herald would own the Property and such intention was fulfilled by Petitioner and SLG conveying their respective TIC Interests to Herald in exchange for Membership Interests. Further, Petitioner posits that it was the intention of the parties that SLG would become the sole owner of Herald, which was accomplished by the sale of Petitioner's Membership Interest. Petitioner asserts that if

the first transaction is disregarded, Herald would not own any portion of the Property and if the second transaction is disregarded, Petitioner would continue to own a 45% interest in Herald. Clearly, in this matter, the individual steps would not have been undertaken separately and had meaning only as part of a larger transaction. The application of the step transaction doctrine in this matter does not result in a fictitious transaction. It merely treats as one integrated transaction the transfer by Petitioner of its TIC Interest in exchange for its Membership Interest and the sale of its Membership Interest to SLG on the same day.

A second issue relating to the step transaction doctrine, concerns the extent to which it is permissible for taxpayers to avail themselves of "planning possibilities." The Court in *Associated Wholesale Grocers* considered *Chisholm v Commissioner*, (79 F2d 14, 15 [3rd Cir 1935]) and *Commissioner v Day & Zimmermann*, (151 F2d 517 [3rd Cir 1945]). The US Court of Appeals for the Third Circuit in *Chisholm*, considered "whether the transaction under scrutiny is in fact what it appears to be in form." The same Court, in *Day & Zimmermann*, scrutinized the bona fides of a stock purchase by the taxpayer's treasurer, concluding that the taxpayer's stock should not be aggregated with that of its treasurer to determine whether, for loss recognition purposes, the taxpayer held less than 80% of the corporation's voting stock. (See also, *Crenshaw* at 475, 476.) Based on the facts in this matter, it does not appear that the Transactions under scrutiny are in fact what they appear to be in form.

There is nothing in the record to support Petitioner's assertion that Respondent's failure to include the Proposed Rule in its final Rules, is in recognition that "the RPTT statute does not

support [Respondent's] multi-step transaction position." Such an inference is speculative at best.

The step transaction doctrine has been invoked in matters involving the taxation of real property transactions. (See, *Matter of Waterman Investment Company*, NYS Tax Appeals Tribunal Decision, [NY St Div of Tax Appeals DTA No. 813224, August 7, 1997] regarding the transfers of two parcels in exchange for an interest in a partnership; see also, *Matter of Kevin Kelly*, NYS Tax Appeals Tribunal Decision, [NY St Div of Tax Appeals DTA No. 819863, Feb. 1, 2007] holding that the purchase of land and the construction of a home was one transaction for the purpose of State Tax Law § 1402-a, the so-called "mansion tax"; *Commissioner v Court Holding Co.* (324 US 331 [1945]), involving the sale by shareholders of a corporation of an apartment house which was the sole corporate asset, until its distribution to the corporate shareholders as a liquidating dividend). (See also, *Matter of Square Plus Operating Corp.*, City Tax Appeals Tribunal TAT No. 90-1221 at 4 [City Tax Appeals Tribunal, October 29, 1992]; *aff'd* 212 AD2d 448 [1st Dept 1995], *lv den*, 87 NY2d 804 [1995], involving commercial rent tax.)

Respondent does not lack legal authority to apply the step transaction doctrine. The Court of Appeals, in *Matter of Roman Catholic Diocese of Albany v New York State Department of Health*, (66 NY2d 948 [1985]), agreed with the dissenting opinion of Justice

Howard A. Levine at the Appellate Division (109 AD2d 140 at 146 [1985]) who stated that:

[T]he general principal of administrative law [is] that an agency is free to evolve standards, if consistent with the statutory framework, on a case-by-case basis and apply them to the individual proceeding at hand. [']And the choice made between proceeding by a general rule or by individual *ad hoc* litigation is one that lies primarily in the informed discretion of the administrative agency.['] (*Securities Comm v Chenery Corp.*, 332 US 194, 203)

In view of the body of law requiring taxes to be levied on the substantive transaction rather than on a series of formalized steps, *Grace v State Tax Commission*, 37 NY2d 193 (1975) is inapplicable to save a transaction from the application of the step transaction doctrine.

ACCORDINGLY, IT IS CONCLUDED THAT Petitioner is liable for the RPTT asserted in the Notice of Determination, as the Transactions constitute step transactions and, as such, Petitioner is not entitled to avail itself of either the Mere Change Exemption under § 11-2106 (b) (8) of the Administrative Code or the exclusion applicable to the sale of a non-controlling interest pursuant to Administrative Code §§ 11-2101 (7) and (8).

The Petition of GKK 2 Herald LLC is denied and the Notice of Determination is sustained.

DATED: April 1, 2015
New York, New York

Jean Gallancy-Wininger
Administrative Law Judge