REPORT #604

TAX SECTION

New York State Bar Association

Memorandum

March 30, 1989

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TAX SECTION
New York State Bar Association

March 30, 1989

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New York State Department of Taxation and Finance
State Campus - Building #9
Albany, NY 12227

Re: 1989 Budget Bills

Dear Deputy Commissioner Collins:

Thank you for forwarding to us copies of the Governor's Budget Bills for our review. Enclosed is our memorandum, drafted by Carolyn Ichel, relating to S.2447/A.3647 and S.2458/A.3658; memoranda relating to the other bills will follow shortly.

Although we understand that the budget process has resulted in many changes to the original bills, we hope our comments will be useful since, we assume, many of the concepts and much of the proposed statutory language of the original bills have been incorporated in later versions.

Time constraints prevented consideration of this memorandum by the full Executive Committee of the New York State Bar Association Tax Section, and therefore this is not a formal Report; the memorandum has, however, been unanimously approved by the Administrative Committee of the Tax Section.

This memorandum addresses many issues, which may be summarized as follows:

A. Gains Tax

1. Residence Exemption

- The extension of the gains tax to sales of residences raises a number of policy questions At a mimimum, there should be a rollover similar to I.R.C. 31034.

- Allowing a step-up in original purchase price (OPP) to date-of-death value of the decedent's residence will alleviate record-keeping problems heirs otherwise will encounter in establishing: the OPP of a residence.

2. Installment Payments

- All elections and payments should be considered timely if made within a specified period of time [10 days] after the date of transfer.

- Interest on installments should follow the underpayment rate, not an entirely new formula.

- The acceleration of installments seems unnecessary in light of the imposition of interest on deferred payments, and presents unnecessary complexities.

- Effective date provisions should grandfather transfers made prior to the effective date, and should provide some grace period for late elections.

3. Deficiency Assessments.

- If the Commissioner has the ability to raise new issues when a taxpayer appeals to the Tribunal, the law should require the Stat to bear the burden of proof on such new issues.

- Extension agreements should bind only those persons who are parties thereto.

4. Persons Liable for Tax

- The extension of personal liability for unpaid tax and penalties to officers, partners and employees of the transferor and transferee is unreasonable.

5. $1 Million Exemption

- The proposed changes in the treatment of entities with leases, contracts and options are technically deficient.

6. Tax on Gain

- The exclusion of certain selling expenses and other costs from the computation of original purchase price results in the imposition of gains tax on amounts greater than the transferor's true gain.

The statute should permit the inclusion of all selling expenses, carrying costs during construction and development, and other similar expenditures that are made in the expectation that the cost will be recovered out of sales proceeds.

B. State Transfer Tax

1. Conveyance by devise, bequest or inheritance.

- The proposed amendments appear to repeal the State transfer tax exemption for transfers on death.

2. Taxation of Co-ops.

- In requiring that consideration include a proportionate share of the co-op's underlying indebtedness, the proposed amendments impose a greater tax burden on sales of individual co-ops than is imposed on sales of condos and individual homes.

3. Credits for previously taxed leases.

- As drafted, the credit diminishes as rents are received, resulting in a transfer tax that is essentially a tax on rental income. This is particularly burdensome to transactions that are not disguised sales but are in fact bona-fide leases.

- The credit is not available for option or contract payments received, resulting in a double tax on such amounts,

- The imposition of transfer tax on renewal term rents is unfair as it imposes a current tax on amounts a lessor has no right to receive and may never receive.

5. Payment of Tax

- The due dates for the gains tax and State and City transfer taxes should be coordinated, and again the statute should provide that payments made within a reasonable time after the transfer are timely.

- In the case of State transfer taxes on a grant of lease, transferors should be allowed to pay the tax over time as rents are collected.

C. City Transfer Tax

1. Change-in-Form Exemption

- To eliminate the duplicative imposition of the City transfer tax, an exemption should be provided for transactions that constitute changes-in-form. Since the City has the power to tax controlling interests, it no longer is necessary to tax change-in-form transactions. Under both the gains tax and the proposed state transfer tax, exemptions are provided for changes-in-form, and with respect to a Pan-Am type of transaction the City transfer tax already contains a credit provision to avoid the imposition of a double tax. The existing City credit does not address all of the instances of duplicative transfer taxes, however, and should therefore be re-placed with a change-in-form exemption.

Sincerely,

Arthur R. Rosen

ARR:jcm
Enclosure

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March 30, 1989

Memorandum

This memorandum sets forth the comments of members of the New York State Bar Association Tax Section on the 1989 Budget Bills relating to the New York State real property gains and transfer taxes, the mortgage recording taxes, and the enabling legislation regarding local real estate transfer taxes (S2447/A3647, and S2458/A3658).[*] There are many aspects of the Bills that we support and on which we have no comment; in the interests of brevity this memorandum discusses only those aspects of the bills which we believe require further consideration or technical improvement.

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[*] This memorandum was prepared by Carolyn Ichel. Helpful comments were received from William L. Burke, John A. Corry, Arthur A. Feder, David E. Kahen, Howard M. Koff, Ronald A. Morris, James M. Peaslee, Arthur R. Rosen, and Marlene F. Schwartz. Time constraints prevented consideration of this memorandum by the full Executive Committee of the New York State Bar Association Tax Section, and therefore this is not a formal Report; the memorandum has, however, been unanimously approved by the Administrative Committee of the Tax Section.

In reviewing the proposed amendments there is one fundamental comment that cannot be overemphasized: There is a critical need for conformity among the gains tax, the State transfer tax and local transfer taxes. We cannot and do not comment on the tax policy of imposing substantial State and local real property transfer taxes. However, as tax law specialists with day-to-day involvement in advising clients of their tax responsibilities, we must report that the current intracacies, nuances and variations among the three tax laws have generated confusion, complexity, and compliance problems that are out of proportion to the taxes involved. Proper application of the tax law currently requires a detailed analysis of three different transfer taxes, and all too often this analysis produces three different results. We do not believe that tax policy is advanced, nor is the perception of New York enhanced, by this state of affairs. We therefore urge that, in making these and any subsequent amendments to the gains tax, the State transfer tax and the local transfer taxes, the utmost attention be paid to rationalizing, coordinating and conforming the application of the taxes. Noted below are several specific instances in which greater coordination of the three taxes is needed.

A. Comments on proposed amendments to the New York State Gains Tax (S2447/A3647 hereinafter the “First Bill”)

1. Residence Exemption. Section 28 of the First Bill repeals the gains tax exemption for sales of New York residences. [Page 43, line 27.]

a. We have no expertise in social policy. However, we strongly believe that the imposition of a 10% tax on sales of residences would have a severely negative effect on the attractiveness of New York State as a place to live. Individuals who are considering the purchase of a home in a range that could reasonably appreciate to $1 million or more would have a strong incentive to buy outside New York State, where the appreciation in their home will not be taxable. We do not believe it is in New York's best interest to encourage people to live in New Jersey or Connecticut. New York would be gaining some future gains tax revenue while foregoing current income tax revenue.

Moreover, the application of the gains tax to sales of homes would be a striking departure from long-established governmental policies encouraging home ownership.

While the objective of the proposal may be to avoid having to postpone the general rate reductions, we believe that over the long run the loss of the residence exemption will prove to be more intrusive, more disruptive of personal planning, and more injurious to the business community's perception of New York than the postponement of the rate reductions.

b. In contrast to the income tax law, the gains tax proposal contains no exemption for transferors who “rollover” their sales proceeds into the purchase of another residence. Homeowners therefore will experience a direct reduction in the amount of funds available to purchase a new home, because 10% of the appreciation in their old home must be paid to New York State. The cost of the gains tax in this situation is exacerbated by the fact that as a practical matter the gains tax is nondeductible, so the 10% gains tax on the residence's appreciation must be paid out of after-tax dollars.* The tax thus becomes a 10% tax on New Yorkers who move.

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* Code 5164 allows a deduction for State income taxes but the gains tax is generally considered not to constitute an income tax. See Internal Revenue Service Rev. Rul. 80-121, 1980-1 C.B. 43 (concerning a similar Vermont gains tax), New York State Department of Taxation and Finance Publication 588, page 27 (November, 1984). Section 164 also provides that [non-income] taxes incurred on the disposition of property are treated as reducing the amount realized, and thus reducing the tranferor's gain or increasing his loss. In the case of a nonrecognition transaction, however, such as the sale of a personal residence qualifying for the 51034 rollover, the reduction in the amount of a seller's gain has little practical consequences, and is of no real benefit unless and until a taxpayer sells a residence without reinvesting and qualifying for the rollover.

We recommend that, if the residence exemption is repealed, the tax should be imposed on the sale of a residence only to the extent the gain on such sale does not qualify for nonrecognition of gain under Internal Revenue Code section 1034 (under that section, gain is not recognized if there is reinvestment in another principal residence). Alternatively, rather than completely applying the section 1034, rollover, the exemption could be limited to taxpayers who sell their principal residence and reinvest in another principal residence located in New York. This approach would avoid penalizing New Yorkers on changes in their personal residences, yet permit the collection of gains tax (i) on all sales of second homes and vacation residences, and (ii) on sales of primary residences where the seller does not invest at least as much as the sales price in a new primary residence (or a primary residence located in New York). The coordination of the gains tax exemption with existing income tax exemptions also would simplify the application of the gains tax to many individuals, and eliminate existing differences between the gains tax and the income tax.

c. Unlike the income tax, the gains tax provides no step-up in original purchase price on death. This imposes upon heirs the burden of determining the amounts paid by a decedent for his interests in real property.

In the case of business properties this burden may have been manageable, inasmuch as income tax returns and financial accounting records often provide historical data from; which original purchase price can be reconstructed. In the case of inherited residences, however, it may prove particularly difficult to establish the amount a deceased individual paid for the residence. To alleviate this burden, consideration should be given to providing that, in the case of a residence acquired by devise, bequest or inheritance, the original purchase price of the residence to the “heir” is deemed to be the value of the residence at the date of the decedent's death. This value often can be obtained from estate tax records.

d. The April 15, 1989 effective date proposed for repeal of the residence exemption, and the even earlier contract date, will present real hardships to individuals who, unlike the business community, are not in touch with the rapid developments in the tax law and may have committed themselves to a course of action without being aware of the new 10% gains tax. For example, an individual may have purchased a new residence without yet selling or having a contract to sell his old residence, or an individual may have contracted to sell his home in March, before learning of this proposal. We believe that special considerations should be applied to these cases, and that the increasingly common use of the bill introduction date as the cut-off for grandfathered contracts is inappropriate when applied to individuals selling their personal residences. Accordingly, although it would entail some revenue loss, we believe it would be more fair to provide a delay in the effective date of this provision, perhaps similar to the July 1, 1989, effective date utilized in other parts of the bill.

2. Installment payment provisions. The First Bill makes a number of changes in the provisions governing the deferred payment of the gains tax.

a. Section 1 (page 3, line 1) amends Tax Law 51442 to require that, in order to pay the gains tax in installments, an election must be made on or before the date of transfer. The requirement that the installment method be affirmatively elected by a taxpayer differs from the federal income tax, where an election is presumed made unless the taxpayer elects out. The current federal procedures requiring elections oat is the result of 50 years of federal experience with requiring affirmative elections. New York should benefit from this experience and follow the current federal procedure.

Moreover, the requirement that the election be made on or before the date of transfer conflicts, we believe, with present practice in many real estate closings. The initial installment of tax generally will not be paid, nor will any return be filed, prior to the date of closing, due may not be determinable until the closing, and (iii) the Supplemental Return and initial payment of tax must be presented to the recording officer in order to record the transaction. Even on the date of transfer it may be difficult to file the election. Many real estate transactions are not recorded until a few days after the closing, either because the title insurance company or the closing attorneys simply cannot get the relevant documents to the recording officer until after the closing date, and in the case of a nonrecorded transaction, delays in the mail generally prevent taxpayers from delivering payments to Albany on the date of transfer.

Because the proposed changes appear to preclude an installment election unless it is filed on the date of closing, they are at odds with current real estate practices and present traps that can unjustifiably result in the denial of the installment payment method.* Indeed, even though

* The Governor's memorandum in support of this change justifies the requirement that transferors elect by the closing date on the basis that it will protect unwitting buyers who do not expect their seller to pay tax in installments. It is submitted, however, that purchasers of $1 million interests in real property can adequately bargain for appropriate gains tax protections; the adoption of an impractical tax reporting requirement is an unduly intrusive solution.

payment of the gains tax itself currently is due on the date of transfer, we understand that the Department recognizes the procedural difficulties in getting payment to the recorder's office or to Albany, and does not generally impose late payment penalties or interest provided the payment is received within a few days after transfer.

We therefore recommend that, if an affirmative election requirement is imposed with respect to 51442 (c) and (d) installment payments, 51442(f) should provide that the election must be made on a form filed within a specified period after the date of transfer; we believe it would be reasonable to require that transferors make such election by the earlier of the date of recording or within 10 days after the transfer.

b. With respect to the deferred payment of gains tax on leasing transactions, the proposed legislation creates some confusion. The reference in proposed 51442(d) to "... equal installments, as provided in subdivision (c)" [page 5, line 3] suggests that the three-year installment period prescribed in subdivision (c) might apply to leases. Obviously this is not intended. To avoid confusion it would be preferable to delete from (d) the reference to subdivision (c), and instead have both subdivisions (c) and (d) refer to subdivision (f). Subdivision (f) should contain all of the rules that are common to both (c) and (d).

c. The proposed legislation would impose interest on deferred payments of gains tax. While we do not object to this in principle, we believe that the interest rate suggested in the bill is unnecessarily high and gives rise to inordinate complexity. As proposed, a semi-annual determination of the then current prime rate is necessary to calculate the interest due on installment payments. Apart from initiating a new interest calculation requirement, this will invariably produce interest rates for installment payments that differ from the underpayment rates, which, in turn, could leave the person who properly elects the installment method paying interest at a higher rate than the person who underpaid gains tax.

We submit that it is more appropriate, and considerably less complicated, to apply the underpayment rate of interest to deferred payments of gains tax (as such rate may change from time to time). A similar approach to installment payments is now employed under Code 5453A. See 5453A(c)(2)(B).

d. The proposed amendments will accelerate the due date of installment payments whenever the transferor receives “all or substantially all” of the balance of the installments prior to the anniversary date. Given the imposition of interest charges on deferred gains tax, this acceleration provision seems unnecessary — whatever gains tax is not yet paid will bear interest so the loss to the State is eliminated. Moreover, the provision would give rise to administrative burdens for both the taxpayer and the State, since neither can be certain of the payment schedule over the next 15 years.

e. Some of the effective date provisions appear to suggest that the acceleration of gains tax may apply to transfers that closed prior to the enactment of the new legislation. In addition, each of the new installment provisions seems to have a different effective date. We recommend that First Bill section 32(1)(a) [page 45] and, if the “substantially all” acceleration provisions is not deleted, section 32(1) (b) [page 46], be revised to provide that the changes in the installment payment rules apply only to transfers made on or after the effective date of the new legislation, with grandfathering available for transfers made under binding, written contracts entered into on or before February 16, 1989. The effective date of the legislation, whether on date of enactment, thirty days thereafter, or July 1, 1989, should be the same for these similar provisions.

In addition, the provisions regarding the imposition of interest and installment payments are somewhat confusing. See Bill 532 (1)(c) [page 46, line 3] and proposed 51446.3(a) [page 7, line 21]. Again, we recommend that the new law apply to transfers made on or after the effective date of the new legislation, unless pursuant to a binding written contract entered into on or before February 16, 1989.

f. The effective date of the installment election provision also may unfairly surprise some taxpayers who are unaware of the new requirement affirmatively to elect the installment method. We therefore recommend that there be some delay before that requirement is imposed or that there be some grace period within which a late election can be made. We also would urge the Department of Taxation and Finance to begin notifying taxpayers with pending pre-transfer audits of the new, statutorily prescribed election requirements. Since the burden of a late election is the complete loss of the installment payment method, and since the First Bill would imposed interest on installment payments in any event, every effort should be made to facilitate taxpayers' timely elections.

g. We question whether the new collection provision [51444-a, Bill 525, page 40, line 17] might inadvertently override the installment method payment provisions, inasmuch as it assesses gains tax on the date of transfer. This section could be clarified in this respect by including a reference to the installment payment rules and providing that, where such rules are complied with, no tax is due or payable until the date therein prescribed.

3. Deficiency Assessments.

a. Section 24(a) of the First Bill [page 39, line 21] provides that, if after receiving a notice of determination of gains tax due, the taxpayer exercises his right to appeal to the division of tax appeals, the Commissioner of Finance will have the ability to reopen his prior determination and claim additional gains tax.

The Governor's supporting memorandum states that “similar” provisions are found in other tax laws. Significantly, such other provisions generally require that the burden of proof with respect to any such new matters be shifted to the State. See Tax Law 5689(c), S1089(c). If this kind of provision is enacted, there is no basis for making it more onerous than existing provisions. We therefore recommend that the State be required to bear the burden of proof with respect to any matters raised subsequent to the commissioner's issuance of the notice of determination.

b. We also note that currently there is a mismatch between the taxpayer's statutory period for claiming refunds (2 years) and the State's statutory period for assessing deficiencies (3 years). We believe this is unfair. Further, this conflicts with the procedures applicable under other taxes (e.g., the Personal Income Tax), and is therefore antithetical to the general effort to establish uniformity among the various taxes. We thus recommend that the same period apply to both parties.

c. The proposed provision permitting an extension of the statute of limitations by agreement [524(c), page 40, line 8] should provide that, after the expiration of the statutory period of limitations, tax may be assessed only against such person or persons who have entered into the extension agreement. As discussed below, the new definition of “person liable for the tax” can include a number of individuals and entities. An extension agreement should apply only to its signatories, not to everyone within the defined term.

4. Persons Liable for Tax. Section 22 of the Bill [page 38, line 1] proposes two new definitions in the gains tax that, in turn, reflect a desire to extend the scope of responsibility for payment of gains tax. “Person” would include individuals, corporations, and other entities, and officers and employees of a corporation and members and employees of a partnership under a duty to perform an act required by the gains

tax law. “Person liable for the tax” would be defined as a “person who is personally liable for the tax whether as a transferor or as a transferee” pursuant to Tax Law section 1447.3(a).

The Bill then would amend other provisions of the gains tax law by replacing the term “transferor” with one or the other of the above-defined terms. See “51442(a) [page 3, line 4] (tax shall be paid by the “person liable for the tax”); 51446.1 [page 6, line 5} (the “person liable for the tax” will pay interest on any underpayment); and 51446. 2(a) [page 6, line 2] (any “person” failing to file a tentative assessment and return or to pay any tax will be liable for any resulting penalties).

a. It appears that these changes are designed to extend liability for gains tax to corporate officers, partners, and employees who are considered to be “under a duty to perform an act required by the gains tax law.” We strongly believe that it is inappropriate to attempt to collect gains tax from the personal assets of the officers, partners and employees of a transferor and transferee. In sharp contrast to the sales tax, where sellers collect sales tax from buyers as fiduciaries on behalf of the State and their officers are therefore personally responsible for any failure to remit the collected tax to the State, the gains tax presents numerous scenarios where tax will be imposed even where no cash payments are received and where, far from absconding with revenues collected on behalf of the State, the officers or employees of the transferor and transferee have no practical means to pay the tax. For example, on a foreclosure sale the transferor is liable for gains tax, but there may be no funds available for payment of the tax. Similar problems can arise on transfers for non-cash consideration, such as like-kind exchanges, or transfers into or out of entities. Absent active fraud or collusion in stripping the transferor and transferee of assets, it is unreasonable to attempt to extract the transferor's gains tax from individuals who are not otherwise liable for the transferor's debts on some vague duty to act theory. Instead, the proper remedy for the State is to proceed against the assets of the parties to the transfer using existing procedures. This is how income taxes are collected, and there is no justification for dealing differently with the gains tax.

b. The extension of <u>penalties</u> to persons liable for tax also is a significant change in the responsibility of transferors, transferees, and their officers, employees and partners. As drafted, it appears that a fiscal officer of a transferee entity could be individually responsible for penalties caused by the underpayment or late payment of the transferor's tax, including penalties due to the transferor's fraud. Such an extension of responsibility is inappropriate and unnecessary to the enforcement of the tax law.

c. The definition of persons responsible for the tax can include several different persons. It should be clarified that, even if there are several people who qualify as “persons responsible for tax,” in no event will duplicate tax, penalty or interest liabilities be imposed.

d. Under current law it is fairly clear, based on Tax Law section 1442(a), that the transferor is primarily liable for the tax. Under the First Bill it could be argued that the transferor's liability is no greater or more direct than the transferee's (setting aside certain limitations on transferee liability that may arise through the tentative assessment procedure). This change could therefore raise questions as to the income tax and gains tax consequences of the payment of gains tax by a transferee. Under present law such payments are regarded as additional consideration to the transferor. See Gains Tax Reg. 5590.9. Under the language of the Bill this result would no longer be clear.

e. Apart from the substantive issues described above, there are references in the bill to “taxpayer” that may cause confusion. See page 5, line 8; page 6, line 2.

5. $1 Million Exemption. The changes to 51440.7 may fail to accomplish their intended effect. Specifically, on a taxable “acquisition of a controlling interest” there is no actual transfer of the option, contract or lease owned by the entity. The last clause of each of subdivisions (a),(b) and (c) therefore fails to mesh with with newly added language. We recommend that the words “being transferred” be deleted in each case, and that the word “such” be inserted in lieu of “the” immediately before “option agreement,” “contract,” and “lease.”

6. Tax on Gain. Although the gains tax attempts to tax transferors and transferees only on their economic gain from an interest in real property, there are several respects in which the definition of gain fails to take into account all of a transferor's costs. As a result, the gains tax often is imposed on an amount greater than the transferor's true gain, and sometimes is imposed where the transferor actually has a loss.

a. A limited category of selling expenses is allowed under existing law, but the definition excludes several items that represent significant costs to transferors, for example, advertising costs, transfer taxes and flip taxes paid to a co-op. We recommend that the statute be amended to permit the deduction of all selling expenses. This will produce a more accurate measure of a transferor's true gain.

b. The Department of Taxation and Finance generally has disallowed “carrying costs” associated with the ownership of real property while it is being prepared for construction or development, has disallowed interest costs attributable to carrying the underlying land while property is under construction, and has disallowed costs and losses incurred by the transferor while his property is being held for sale. In each of these situations property owners incur expenses that they expect to recoup, not out of operating income from the property, but out of the proceeds of sale. Inasmuch as sales from which they recover these costs are subject to the gains tax, it is inappropriate to disallow these costs in computing the transferor's gain. To arrive at a truer reflection of the transferor's “gain,” all of these costs should be permitted to be taken into account as part of original purchase price.

B. Comments on proposed amendments to the New York State Real Estate Transfer Tax (S2447/A3647)

1. Conveyance by devise, bequest or inheritance. Under existing law no state transfer tax is imposed on a conveyance pursuant to a will. Similarly, there is no gains tax and no city transfer tax on conveyances by devise, bequest or inheritance. It appears, however, that the proposed changes to the state transfer tax, in substituting “conveyance” for “deed” [page 31, line 15] no longer exempt transfers at death. As a result, any transfer of encumbered property by devise, bequest or inheritance would become subject to state transfer tax. It is not clear this result was intended; certainly it is a significant change in law, and would result in a serious loss of conformity with the other taxes. We recommend that the proposed definition of “conveyance” be revised to exclude transfers by devise, bequest or inheritance.

2. Taxation of Co-ops. The First Bill generally extends the application of the New York State real estate transfer tax to sales of co-operative apartments, and in so doing brings the tax treatment of co-op sales into closer conformity with the treatment of sales of individual homes and condominiums. However, as described below, in one respect the First Bill makes taxation of co-ops more burdensome than the taxation of condos

and individual homes. We see no reason for creating more nonconformity in this area, and urge that the tax treatment of co-ops be in all respects the same as that of condos and individual homes.

The First Rill provides that, on any sale of a co-op apartment, a proportionate share of the co-op's underlying mortgage indebtedness is to be included in the selling shareholder’s consideration. (Proposed 51401(d)(v), page 31, line 1.) By contrast, the statute specifically provides that, on a sale of a one- two- or three-family home or an individual condominium unit, the seller's taxable consideration excludes the “value of any lien or encumbrance. remaining thereon at the time of conveyance.” (Proposed 51402, page 33, line 7.) Given the expressed interest in “levelling the playing field,” no justification is apparent for imposing a greater tax burden on sellers of co-ops than is imposed on sellers of condos.

3. Credits for previously taxed leases. The credit provided under proposed 51405-A [page 35, line 6], appears not to achieve the correct result in several instances. Consider the following example. On January 1, Lessor enters into a 15-year lease with Lessee, and an option agreement entitling Lessee to purchase the property for $200,000 at any time during the lease term. The present value of Lessee's rentals is, say, $150,000. In

addition, Lessee pays $10,000 for the option. Lessee thereafter exercises the option and purchases the property for $200,000. Assume that the annual rentals are fair market rentals, and the $200,000 option price reflects a fair purchase price for the property; in other words, the leasing transaction is not a disguised sale but a bona fide lease that includes a market value option.

To the extent Lessor has received rent from Lessee at the time of the sale, the proposed legislation gives lessor no credit for the transfer tax paid on such rents. Accordingly, if the Lessee purchases the property at the end of the lease term, the Lessor must pay tax on the $200,000 purchase price, over and above the transfer tax he paid on the $150,000 rents. Similarly, if Lessor sells to a third party at the end of the lease term, again he must pay tax on the full $200,000. The transfer tax thus has become a tax on rents. Moreover, it has its most burdensome impact on leases that are true economic leases, not disguised sales, for it is in those cases that the rents on which lessors are required to pay tax do not represent disguised payments of purchase price.

By contrast, the gains tax affords a full step-up in original purchase price whenever tax is imposed on a grant of lease. This reflects the fact that, while grants of leases may be subjected to gains tax to close up an otherwise obvious method of tax avoidance, when the lessor does eventually sell the property he should be given credit for what was essentially a pre-payment of gains tax. In other words, the gains tax is applied to leases to prevent leasing transactions from being used to effectively transfer ownership without paying tax, but the gains tax also recognizes that a transferor should not be taxed on the same consideration twice, and that if a leasing transaction turns out not to have been a disguised sale, the transferor should be given credit against the tax incurred on an actual sale for the tax he previously paid on his rental income.

We recommend that, to avoid the effect of imposing a state occupancy tax on leasing transactions, lessors should be afforded a full credit for the amount of transfer tax paid on a grant of lease, except to the extent it is shown that the taxable rents exceeded fair market rents and thus constituted part payment for the real property.

In addition, as proposed the credit would not be available for the tax paid under 51401(d)(i) on the amount received for an option (or contract), even though on the sale of the property such amounts apparently again would be included in consideration pursuant to proposed 51401(d). (Page 29, lines 24-25.) The Lessor in the above example would therefore be taxed twice on the $10,000 payment received for the option. This result seems unintended; but in any event would not obtain if the credit were revised as described above.

4. Taxation of renewal term rents. As proposed, 51401(d)(i) would include in taxable consideration on the grant of a lease “the value of rental or other payments attributable to the exercise of any option to renew.”

In virtually all cases the renewal of a lease is at the option of the lessee -- the lessor cannot compel renewal nor does he have any right to receive the renewal term rents until the lessee exercises the renewal option. It is unfair, therefore, to impose a transfer tax as if the lessor had received the renewal term rents in consideration for the grant of the lease. We therefore recommend that renewal rents not be included in consideration at the time the lease is granted, unless the lessor has the right to compel the lessee to exercise the renewal rights. Instead the law should provide that upon any exercise of a renewal right by a lessee the lessor will be deemed to receive additional consideration; such additional consideration will be taxable at the time of renewal if, taking into account the terms of the lease with respect to which such renewal right arose, the underlying transaction is within the definition of a taxable grant of lease. For example, if a 20-year lease with two 20-year renewal terms is taxable by virtue of the 49-year test, each exercise of a renewal right would, at the time of renewal, give rise to additional consideration taxable to the lessor.

5 Payment of Tax.

a. The First Bill provides that, except in the case of transfers for which no gains tax pre-transfer tax audit is required, the state transfer tax is to be paid on the date of transfer. (Proposed 51410, page 14, line 8.) The Bill also provides for coordination of the state transfer tax returns with New York City transfer tax filings. However, the City transfer tax is not due, and no returns are required to be filed, until 30 days after the transfer.

We favor the coordination of State and City transfer tax filings, but obviously that coordination must extend to the due dates of the returns and tax payments. As discussed in Paragraph A(2)(a), above, as a practical matter it is difficult to deliver returns and payments on the date of transfer. Closings often extend beyond the office hours of the register or county recording office; title companies experience delays in processing conveyancing documents, which delays can run into several weeks; and even with unrecorded transfers there may be delays in mailing or delivering the required forms and payments to Albany.

We therefore recommend that each of the gains tax, the state transfer tax and the City transfer tax provide the same deadline for the payment of tax and filing of returns, and that in each case there be some grace period after the date of transfer within which payment and filings will still be timely. As noted above, it would be reasonable to require that the tax be paid by the earlier of the date of recording or 10 days after the transfer.

b. The extension of the State transfer tax to grants of leases presents a special payment problem, in that lessors may be required to pay transfer taxes significantly in advance of their collecting the: rents. We therefore recommend that installment payment provisions similar to those of the gains tax be available for any lease subject to State transfer tax.

C. Comments on Proposed Amendments relating to the New York City Real Property Transfer Tax (S2458/A3658)

1. Mere Change Exemption.

The “Anti-Pan Am” enabling legislation was enacted in 1981 as a direct response to a form of transaction that was used to escape transfer tax. The Anti-Pan Am amendments permitted the imposition of City transfer tax on sales of controlling interests, and thus brought both direct and indirect transfers within the scope of tax.

The problem with the Anti-Pan Am amendments as adopted and implemented by Mew York City is that they go too far, and have the result of imposing duplicative transfer taxes, with no credit or offsets. New York City's is the only transfer tax that applies both to sales of controlling interests and to transfers that constitute a change in form with no change in beneficial interest. The gains tax applies to controlling interests, but provides an exemption for change-in-form transactions. Similarly, in amending the state's transfer tax to include controlling interests, the First Bill also includes a change-in-form exemption. Thus, both the gains tax and the state transfer tax recognize that, once it is possible to tax both direct and indirect sales of real property, it no longer is necessary to tax transfers into and out of entities where there is no change in beneficial interest.

The lack of a change-in-form exemption in the City transfer tax has resulted in excessively burdensome, duplicative transfer taxes. For example, if a property owner contributes real estate to his wholly-owned corporation and then sells the stock of that corporation, he must pay two City transfer taxes -- 4% of the gross fair market value of his property. Similar problems occur where an entity is liquidated and its owner then sells the property, or where interests in an entity are acquired and then property is distributed in a transaction that does not qualify for the single narrow credit prescribed in existing law.

Clearly this duplication of transfer taxes was not the motivation of the Anti-Pan Am amendments, for in the specific circumstances of the Pan Am transaction the new legislation provided a credit that prevented a double transfer tax. However, the credit simply does not cover all of the aspects of the double-taxation problem. We therefore recommend that the existing credit be replaced with a change-in-form exemption comparable to that of the state gains and transfer taxes. Not only would this achieve greater conformity among the taxes, but it also would alleviate the unreasonable burden of multiple taxation.

It should be noted that the Tax Section has twice issued reports urging the City Department of Taxation and Finance to adopt such a change-in-form exemption by regulation. However, the City administration has not followed this suggestion. We understand that the administration’s unwillingness to adopt a change-in-form regulation was attributable in part to a reluctance to create an exemption in the absence of specific statutory guidance, and in part to the fact that the City traditionally has collected tax revenues from change-in-form transfers of real estate. While we recognize that the City has in the past provided by regulation for the taxation of, for example, contributions to newly-form entities, we believe that the expansion of the tax base to controlling interests obviated the need to tax such change-in-form transactions. Moreover, we do not believe it is reasonable to use the anti-Pan Am legislation to double-up on taxes. We therefore believe that, as is currently proposed with respect to the State transfer tax, the City transfer tax enabling legislation also should be amended to provide for a change-in-form exemption.

2. Tax on Grants of Leases. Currently the City transfer tax applies to consideration received on any grant of a lease, except to the extent the lessor receives rents subject to the City's commercial occupancy tax. Consideration should be given to conforming the City taxation of grants of leases to that of the State gains tax and the proposed State transfer tax, so that the grant of lease would trigger City transfer tax only in the event it met the 49-year test or was coupled with a option or contract. Of course, since rents are still subject to City commercial occupany tax, City transfer tax should continue to exclude from taxable consideration any amounts constituting rent for purposes of the commercial occupany tax; otherwise these transactions would be subject to double taxation.