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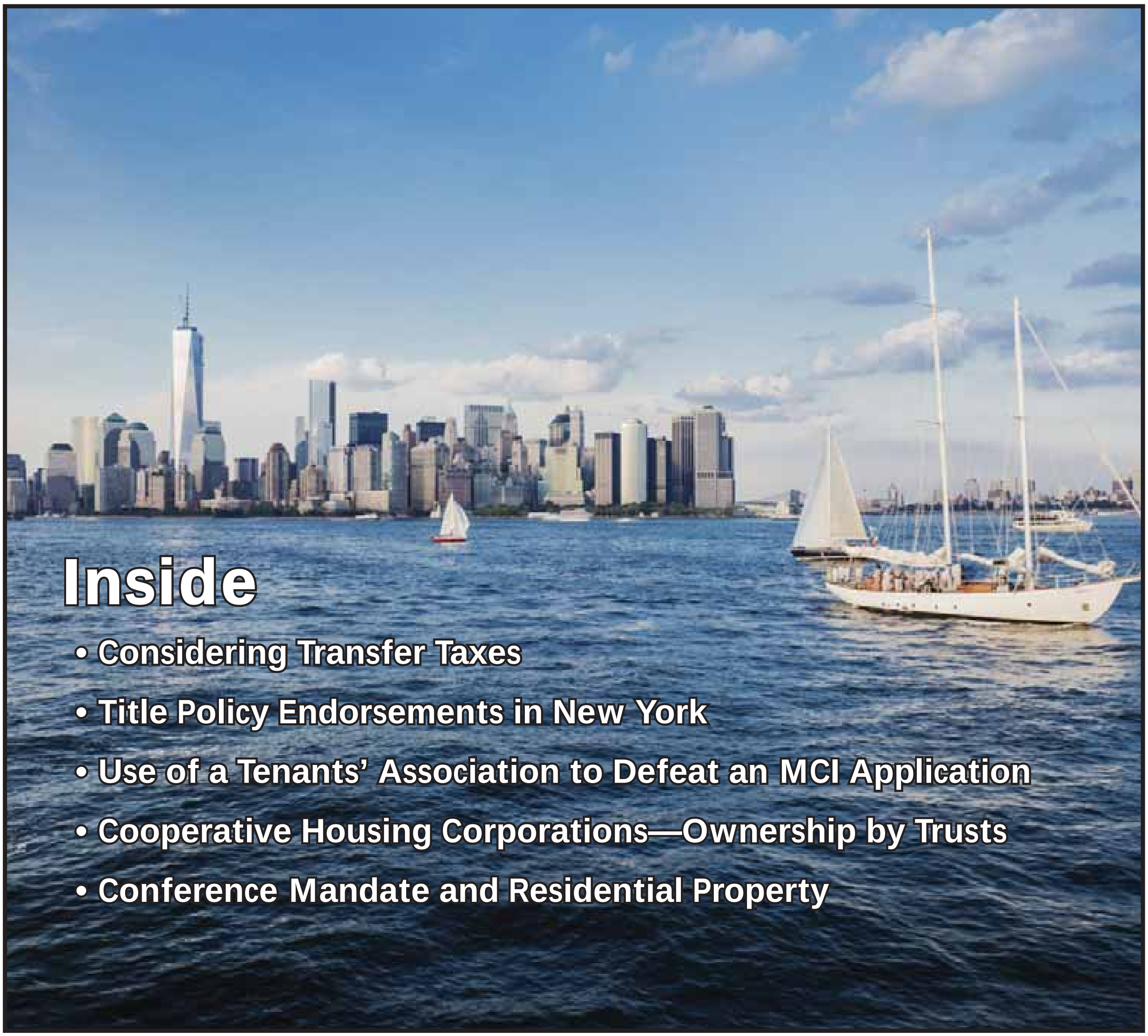

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Message from the Outgoing Section Chair

How quickly a year has passed. It is hard for me to believe that the end of my term of office is drawing near. Despite its brevity, the year was filled with many exciting challenges and achievements.

The members of our Executive Committee have worked hard to chair their respective committees and as a result, the Real Property Law Section has been a leader in many endeavors. We have provided numerous CLE opportunities, co-sponsored events with other Sections, and initiated new programs that will undoubtedly serve the Bar well in the coming years. Notably, our efforts on the legislative front have been very successful.

I would like to thank each committee chair, member at large and district representative for his or her devoted service to our Section. I am confident that they will remain encouraged to continue to serve for the good of the public and our profession. On behalf of the entire State Bar, I want to commend them for the job they have done, and I look forward to seeing what will be done in the future.

Our incoming Chair, David Berkey, has extraordinary leadership skills and a great passion for the Section. I am certain that he will be an especially effective leader. He will be supported by the Section's strong team of officers; Leon Sawyko, Mindy Stern, Patricia Watkins and Spencer Compton, each of whom I admire greatly. I eagerly await the great things that they will accomplish during their tenure.

Benjamin Weinstock

Message from the Incoming Section Chair

I look forward to working with all members of our Real Property Law Section, and especially those who serve on its Executive Committee, who chair and co-chair our many substantive committees, and who create and promote our CLE programs and publications. Our 4,000 Section members keep our Section strong by attending and participating in our functions, undertaking tasks as committee members, acting as hosts for our Student Interns and by mentoring new "dirt lawyers" who will be our Section's strength in years to come.

We have an excellent group of officers, who keep our membership energized, record our meetings, control our costs and keep us apprised of legislation and substantive legal issues that affect our membership. Leon Sawyko will be taking us to the Queens Landing Hotel at Niagara on the Lake, Ontario, Canada, for a beautiful 2014 Summer Meeting, and I hope to see many of you there. Mindy Stern is already planning our 2015 Summer Meeting. Spencer Compton has helped us increase our Section's budget surplus at a time when membership in all Sections has fallen, allowing us to support young lawyers and seasoned lawyers by increasing our grants and scholarship awards to deserving lawyers and law students.

I will have a difficult job following the great leadership exhibited by Benjamin Weinstock, my immediate predecessor, and by the many Section Chairs who have preceded him. Ben's work on the title insurance agent licensing bill was superb and his energy and commitment to our Section sets an example for all to follow.

There are many paths that bring lawyers to our Section. My former partner, Stanley Dreyer, enlisted me to be secretary of the Section's Condominiums and Cooperatives Committee when he was its co-chair. Eventually, I became that Committee's co-chair, spoke at many CLE programs involving cooperative and condominium issues, became co-chair of our Section's Membership Committee, started our Student Intern initiative and was asked to join the officer "ladder," leadingto my present position. I truly enjoyed arranging our 2013 Summer Meeting program at Mohonk Mountain House and our 2014 Annual Meeting. Our attendance at those events was stellar and I hope many of you have fond memories of them.

My focus as Section Chair will still be on rejuvenating and expanding our membership, by helping our Membership Committee and Law School Internship Committee reach out to law students and newly admitted real estate lawyers that are the future of our Section. We will also try to hold joint events with other Sections, so that our great strengths—our CLE programs, our publications, our collegiality and our willingness to help others—will lead to continued growth of our Section. My first task will be to contact all Committee chairs to learn what programs are being planned for the June 2014-15 year, to see if we can help expand the Committees' reach and membership, and to help them work with law schools by creating student committee internship positions that will allow talented law students to help the Committees achieve their goals.

We will continue our Section's great traditions into the future.

David L. Berkey

Considering Transfer Taxes

By Elias M. Zuckerman

When negotiating the distribution of marital property, tax consequences must always be taken into account. There are federal, state and local taxes to consider. Leaving any of these out of the equation, particularly when the divorcing couple is wealthy, can mean that assets the parties might have benefited from are lost to the tax man.

A Hypothetical

Let's look at one hypothetical couple's situation. The married parties, Henry and Willa, own a townhouse in Manhattan (the Townhouse). They also each own a 50% membership interest in H & W, LLC (the Company), which owns a residence in Amagansett, N.Y. Neither property is subject to any mortgage.

In May 2013, Henry and Willa engaged a neutral arbitrator / mediator to bring about their mutual agreement on the terms of their separation and divorce. Henry and Willa then proposed that Henry transfer his interest in the Townhouse to Willa prior to their execution of a separation agreement. In turn, she would transfer her membership interest in the Company to him prior to execution of such agreement. Thus, following these two transfers, Willa would own the Townhouse and Henry would own all the interest in the Company, and thus, would own the Amagansett house.

The questions posed by this scenario are: 1) Whether these transfers would be subject to New York State, New York City and Peconic Bay Region transfer taxes, and 2) Whether the tax treatment of the transfer of the beneficial ownership in the Amagansett residence is affected by the fact that the property is owned by the Company rather than Henry and Willa directly.

When Is an Exchange Taxable?

New York State imposes a real estate transfer tax (the RETT) on each conveyance of real property, or interest therein, when the consideration exceeds $500.[1] The RETT is generally imposed at the rate of two dollars for each $500 of consideration (that is, four-tenths of one percent (.4%) of the consideration).[2]

New York State also imposes an additional 1% tax (the so-called "Mansion Tax") on each conveyance of residential real property, or any interest therein, when the consideration for the entire conveyance is $1 million or more.[3] Residential real property includes any premises that are or may be used in whole or in part as a personal residence, including, but not limited to, a one-family house.[4]

Similarly, Article 31-D of the New York Tax Law grants the Town of East Hampton (as well as other towns in the Peconic Bay Region) authority to impose a real estate transfer tax on each conveyance of real property, or interest therein, located in its town.[5] The rate of this tax is 2% of the consideration after subtraction of a $250,000 exemption for improved property ($100,000 for unimproved property (that is, vacant land)).[6] As Amagansett is within the Town of East Hampton, this tax applies to conveyances of real property or interests therein located in Amagansett.

Section 1401(d) of the New York Tax Law defines "consideration" for purposes of the RETT and Mansion Tax in relevant part as:

> …the price actually paid or required to be paid for the real property or interest therein, including payment for an option or contract to purchase real property, whether or not expressed in the deed and whether paid or required to be paid by money, property, or any other thing of value. It shall include the cancellation or discharge of an indebtedness or obligation. It shall also include the amount of any mortgage, purchase money mortgage, lien or other encumbrance, whether or not the underlying indebtedness is assumed or taken subject to.[7]

A similar definition applies for purposes of the transfer tax imposed by the Town of East Hampton.

Section 575.9(c)(4) of the regulations issued by the New York State Department of Taxation and Finance and applicable to the RETT and Mansion Tax provide that "…conveyances without consideration and otherwise than in connection with a sale, including conveyances by bona fide gift" are exempt from such transfer taxes.[8] On the other hand, Section 575.11(a)(1) of such regulations provides that:

> A conveyance in exchange for other property is taxable. If the other property is real property or an interest therein, the tax will apply to both conveyances.[9]

Again, the Town of East Hampton has adopted similar regulations applicable to its transfer tax.

The New York State transfer tax regulations do not define the term "bona fide gift." However, Section 575.9(c)(4), as quoted above, cites a "bona fide gift" as an example of a conveyance without "consideration."[10] In turn, "consideration" is broadly defined in Section 1401(d) of the Tax Law to include "money, property or any other thing of value."[11] Thus, for purposes of determining whether a conveyance is a gift for transfer tax purposes, the test would appear to be whether the transferor receives any *quid pro quo.*

In this regard, the transfer tax cases and rulings often adopt principles from the federal income tax law, under which a payment is considered a gift if it proceeds from a "detached and disinterested generosity" "out of affection, respect, admiration, charity or like impulses."[12]

Applying the Law

In our hypothetical, Willa's transfer of her interest in the Company to Henry does not appear to proceed from "detached and disinterested generosity." Rather, Henry's transfer of his interest in the Townhouse to her is the *quid pro quo* for her transfer of her interest in the Company to him. Consequently, if all the facts are considered, it is not possible to characterize her transfer to him as a "bona fide gift" that is exempt from transfer tax. Instead, her transfer of her interest in the Company to him constitutes an exchange. The consideration she receives from him for her transfer is his interest in the Townhouse. The RETT payable with respect to her transfer, as well as the Mansion Tax and Peconic Bay transfer tax, will be based on the value of the interest she receives from him. (For purposes of this article, I leave aside the question of whether the tax should be measured by the fair market value of her 50% interest in the Company, rather than his 50% interest in the Townhouse, in a case in which the values of the two interests were not equal.)

Of course, under this analysis, Henry's transfer of his interest in the Townhouse to Willa will also be subject to the RETT and the Mansion Tax. In addition, his transfer will be subject to the New York City Real Property Transfer Tax (the RPT). (The New York City RPT is generally imposed on a deed at the time of delivery by a grantor to a grantee when the "consideration" for the real property exceeds $25,000.[13] For this purpose, "consideration" is defined in a manner virtually identical to the manner in which the term is defined in Section 1401(d) of the New York State Tax Law for purposes of the RETT.[14])

Similarly, in a rule virtually identical to Section 575.9(c)(4) of the New York State tax regulations, the Department of Finance has adopted a regulation excluding from the RPT as a transfer without consideration, a transfer that constitutes a "bona fide gift."[15]

Transfer Pursuant to a Separation Agreement

A second provision of the New York State transfer tax regulations supports the conclusions that Willa's transfer of her interest in the Company to Henry and his transfer of his interest in the Townhouse to her are subject to transfer tax. Section 575.11(a)(10) of the regulations issued by the New York State Department of Taxation and Finance provides that:

> A conveyance from one spouse to the other pursuant to the terms of a divorce or separation agreement is subject to tax. (There is a rebuttable presumption in such case, that the consideration for the conveyance, which includes the relinquishment of marital rights, is equal to the fair market value of the interest in the real property conveyed.)[16]

Again, the Town of East Hampton and New York City have adopted similar regulations. (Note that the instructions included on Schedule E of the New York City Real Property Transfer Tax Return provide that a transfer or property pursuant to a "marital settlement agreement" is also subject to transfer tax.)

The Step Transaction Doctrine

Because Willa and Henry had not executed a "separation agreement" (as such term is used in Section 170 of the New York Domestic Relations Law) and they had not obtained a decree of divorce, if Willa now transferred her interest in the Company to Henry and he transferred his interest in the Townhouse to her, couldn't they take the position that, literally, the transfers were not "pursuant to the terms of a divorce or separation agreement" within the meaning of Section 575.11(a)(10) of the regulations?

Inasmuch as the transfers would be "in contemplation of" the execution of a separation agreement and would be integral to the subsequent closing of such an agreement, under the "step transaction" doctrine, as described below, the transfers should be treated as made "pursuant to" the terms of a separation agreement within the meaning of the regulation and thus subject to tax.[17]

The Internal Revenue Service and the federal courts have frequently invoked the step transaction doctrine to ensure proper income tax treatment of a series of transactions.[18] In *True v. U.S.*, the Tenth Circuit observed that:

> Deciding "whether to accord the separate steps of a complex transaction independent significance, or treat them as related steps in a unified transaction, is a recurring problem in the field of tax law." In search of an answer to this problem, courts utilize a variety of approaches, including a particular incarnation of the basic substance over form principle known as the step transaction doctrine. Simply stated, the step transaction doctrine provides that "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction."[19]

The New York State and New York City tax authorities have similarly applied the "step transaction" doctrine in transfer tax cases.[20]

For example, in *In re Fleetwood Realty Company*, the taxpayer partnership held a leasehold interest in rental real property located at East 65th Street in Manhattan.[21] The fee interest in the property was owned by Peter S. Kalikow (Kalikow), who beneficially owned all the interests in the taxpayer. The leasehold and fee were both subject to a $38 million mortgage debt held by Travelers Insurance Company (Travelers).

Kalikow wanted to convert the property to cooperative or condominium ownership. Under the terms of the mortgage, Travelers' consent was required for such a conversion. Furthermore, New York law prohibited a so-called leasehold condominium. So the taxpayer and Kalikow requested that Travelers release the mortgage lien on the taxpayer's leasehold estate and permit a merger of the leasehold and fee.

On Oct. 4, 1989, Travelers and Kalikow executed a release agreement pursuant to which Travelers released its mortgage lien on the taxpayer's leasehold estate and confirmed that the taxpayer's liability to pay the debt was terminated. The following day, the taxpayer assigned its leasehold estate to Kalikow, thereby merging the leasehold into the fee.

For purposes of computing the New York State and New York City transfer taxes on the transfer of rental or other commercial property, consideration ordinarily includes the amount of mortgage debt assumed in connection with such transfer and the amount of mortgage debt to which the property is subject.[22] In *Fleetwood Realty*, the taxpayer took the position that, since its leasehold was released from the Travelers' debt before the leasehold was assigned to Kalikow, it received no consideration in the form of any relief from indebtedness.[23] However, the New York City Department of Finance disagreed and the New York City Tax Appeals Tribunal upheld the department's position.[24]

In the view of the administrative law judge, inasmuch as the taxpayer's indebtedness to Travelers was discharged on the day prior to the day of the taxpayer's assignment of the leasehold, the taxpayer was seeking to elevate form over substance. The judge rejected this approach, concluding that since the assignment was clearly contemplated by all the parties at the time the taxpayer's debt to Travelers was released, the two steps should be analyzed as an "integrated transaction."[25] Accordingly, the judge held that the taxpayer received taxable consideration for its assignment of its leasehold in the form of a release from its indebtedness.[26]

The tax authorities have applied the step transaction doctrine to combine a series of transactions separated by much more than one day. For example, in *Seven West 34th Street Development Corp.*, an issuance of the taxpayer's stock was determined to be an element of a single transaction with the subsequent transfer of real property to the taxpayer nearly one year later.[27]

In any event, as the transfers by our hypothetical couple, Willa and Henry, were contemplated as a condition of their execution of any separation agreement, such transfers should be treated as made pursuant to such agreement. Thus, they are subject to transfer tax.

Transfer of an Interest in a Company

The RETT is imposed on "…each conveyance of real property or interest therein when the consideration exceeds five hundred dollars…."[28] The term "conveyance" is defined, in relevant part, as "the transfer or transfers of any interest in real property… including [a] transfer or acquisition of a controlling interest in any entity with an interest in real property."[29] In turn, a "controlling interest" means, in the case of a partnership, association, trust or other entity (other than a corporation) "…fifty percent or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity."[30] In other words, the RETT is payable in the case of a transfer of 50% or more of the capital or profits in a partnership or limited liability company that owns real estate located in New York.

In Willa and Henry's case, the Operating Agreement of the Company provides that each owns a 50% membership interest in the Company. Under this agreement, they are each entitled to 50% of the profits and losses of the Company, as well as 50% of the distributions made by the Company. Accordingly, for purposes of the RETT, each owns a controlling interest in the Company. Therefore, Willa's transfer of her interest in the Company to Henry will be treated, for purposes of the RETT, in a manner similar to her transfer of an interest in real property to him.

Similarly, the Mansion Tax applies to "each conveyance of residential real property or interest therein when the consideration for the entire conveyance is one million dollars or more."[31] Since the term "conveyance" includes the transfer of a controlling interest in an entity owning real property, the Mansion Tax is also imposed on the transfer of a controlling interest in an entity owning residential real property.[32] Accordingly, Willa's transfer of her interest in the Company to Henry will be subject to the Mansion Tax if the transfer is subject to the RETT.

Finally, the transfer tax statute enacted by the Town of East Hampton follows the RETT. Therefore, Willa's transfer of her interest in the Company to Henry will also be subject to the town's transfer tax if the transfer is subject to the RETT.

Conclusion

Willa and Henry's agreements represent transfers for value rather than bona fide gifts. That is, Henry's transfer of his interest in the Townhouse to Willa is the *quid pro quo* for her transfer of her interest in the Company to him (and vice versa). Accordingly, as each party is receiving consideration for the property he or she is transferring, each party will be subject to New York State transfer tax (including the Mansion tax) as well as the applicable local transfer tax.

Furthermore, there is an alternative ground for imposing transfer tax in this case. New York State, New York City, and the Town of East Hampton (within which the Amagansett house is located) each impose a transfer tax on a transfer made pursuant to a separation agreement. Here, while the parties proposed to make the transfers prior to their execution of a separation agreement, the transfers are in fact a step in an overall plan to divide their property under their separation agreement. Accordingly, under the so-called "step transaction" doctrine, the transfers will be treated as made pursuant to their separation agreement, and thus subject to transfer tax.

And, finally, the fact that Willa will transfer to Henry a 50% membership interest in the Company, rather than a tenancy-in-common interest in the Amagansett residence, will not result in an avoidance of the New York State or Peconic Bay Region transfer taxes. All such taxes (including the Mansion Tax) are imposed on transfers of a controlling interest in an entity that owns real property located in the applicable jurisdiction.

Endnotes

1. N.Y. Tax Law § 1402(a).
2. *Id.*
3. N.Y. Tax Law § 1402-a.
4. *Id.*
5. N.Y. Tax Law § 1449-bb.
6. N.Y. Tax Law § 1449-ee 3(a).
7. N.Y. Tax Law § 1401(d).
8. N.Y. Comp. Codes R. & Regs. tit.20, § 575.9(c)(4).
9. N.Y. Comp. Codes R. & Regs. tit.20, § 575.11(a)(1).
10. N.Y. Comp. Codes R. & Regs. tit.20, § 575.9(c)(4).
11. N.Y. Tax Law § 1402(d).
12. Commissioner v. Duberstein, 363 U.S. 278 (1960).
13. New York City Administrative Code § 11-2102.a.
14. *See* New York City Administrative Code § 11-2101(9).
15. 19 RCNY § 23-03(j)(1). *See, e.g.*, *In re* Jungil Song, TAT (H) 06-12 (RP) (New York City Tax Appeals Tribunal, September 29, 2008) (wife's recent execution of a guarantee of a mortgage on property suggested that the subsequent transfer by husband of an interest in such property to wife was not a gift).
16. N.Y. Comp. Codes R. & Regs. tit.20, § 575.11(a)(10).
17. *Id.*
18. *See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).
19. True v. U.S., 190 F.3d 1165, 1174 (10th Cir. 1999) (quoting King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969); quoting Commissioner v. Clark, 489 U.S. 726, 738 (1989)).
20. *See In re* Kevin Kelly, DTA No. 819863 (State of New York—Division of Tax Appeals, Dec. 8, 2005); *see also In re* Exchange Plaza Partners v. City of New York, 159 A.D.2d 333 (1st Dep't 1990), *appeal denied*, 76 N.Y.2d 702 (1990); *In re* Fleetwood Realty Company, TAT (H) 93-294 RP), TAT (H) 95-12 (RP) (New York City Tax Appeals Tribunal—Administrative Law Judge Division) (Feb. 28, 1995); *In re* Seven West 34th Street Development Corporation, FHD-92-436 (RPT) (New York City Department of Finance, March 31, 1992); New York City Department of Finance, Statement of Audit Procedure RPTT 2008-1 (2./29/08).
21. *In re* Fleetwood Realty Company, TAT (H) 93-294 CRP), TAT (H) 95-12 (RP) (New York City Tax Appeals Tribunal—Administrative Law Judge Division) (Feb. 28, 1995).
22. N.Y. Comp. Codes R. & Regs. tit.20, § 575(d)(1).
23. *In re* Fleetwood Realty Company, TAT (H) 93-294 CRP), TAT (H) 95-12 (RP) (New York City Tax Appeals Tribunal—Administrative Law Judge Division) (Feb. 28, 1995).
24. *In re* Fleetwood Realty Company, TAT (H) 93-294 CRP), TAT (H) 95-12 (RP) (New York City Tax Appeals Tribunal—Administrative Law Judge Division) (Feb. 28, 1995).
25. *Id.* at 10.
26. *In re* Fleetwood Realty Co., TAT(H) 93-294 (RP), TAT(H) 95-12 (RP), at 13-14 (NYC Tax Appeals Tribunal) (Feb. 28, 1995), http, http://www.archive.citylaw.org/tat/1995/93294det0295.pdf.
27. *See In re* Seven West 34th Street Development Corporation, FHD-92-436 (RPT) (New York City Department of Finance, March 31, 1992); *See also* Statement of Audit Procedure RPTT 2008-1 (N.Y.C. Dept. of Fin. 2/29/08), http://www.nyc.gov/html/dof/downloads/pdf/08pdf/charitysap2008.pdf.
28. N.Y. Tax Law § 1402(a).
29. N.Y. Tax Law § 1401(e).
30. N.Y. Tax Law § 1401(b).
31. N.Y. Tax Law § 1402-a(a).
32. *See* N.Y.S. Dept. of Taxation & Fin. Publication 577, FAQS Regarding the Additional Tax on Transfers of Residential Real Property for $1 Million or More, *available at* http://www.tax.ny.gov/pdf/publications/real_estate/pub577.pdf.

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Title Policy Endorsements That Are Available in New York

By Marvin N. Bagwell

Currently, there are only six promulgated title policy forms which are approved by the State Department of Financial Services and offered by title companies for use in New York State: the Owner's or Fee policy, the Loan or Mortgage policy, the TIRSA Owner's Extended Protection Policy (also known as the TOEPP policy), the Short Form Resident Loan Policy, the Residential Limited Coverage Junior Loan Policy and the United States of America policy. However, there are almost fifty endorsements available to real estate practitioners that provide extended or additional coverage above those offered by the policy forms. In this article, the author will provide a list of the endorsements and a brief description of each endorsement. By necessity, the full terms and conditions of each endorsement are not set forth in this outline. The reader is directed online to TIRSA.org for the full text of each endorsement.

Unless indicated otherwise, the premium for each endorsement is $25.00.

Access Endorsement

- This endorsement insures the lender against loss in the event that there is no access to the insured premises over a physically open and specifically named public street.

Endorsement for Additional Interest

- This endorsement insures the lender against loss in the event that a court holds that "additional interest," as defined in the loan documents, is (1) invalid or unenforceable or (2) does not have the same lien priority as the principal of the loan secured by the mortgage. However, the endorsement does not insure the amount of the additional interest although it does permit the title company, by filling in a blank, to cap the amount of the loss or damage which the insured can suffer. Note that the endorsement also does not insure against the results of a bankruptcy filing or against "unconscionability or unreasonableness."
- This endorsement requires underwriter approval prior to issuance.
- The premium is the full applicable loan rate per thousand for the amount of insurance above the face amount of the policy.

Cluster Endorsement (a.k.a. Aggregation Endorsement)

- The Cluster endorsement enables a lender to aggregate coverages on multi-site transactions. The endorsement provides an amount of total coverage but also breaks down the coverage on a per parcel basis. The fact that the endorsement totals the coverage allows the lender to also shift some title losses from one parcel to another. However, in New York the endorsement does not cover losses attributable to the failure to pay the mortgage recording tax.
- This endorsement requires underwriter approval prior to issuance.

Condominium Endorsement

- This endorsement insures against loss or damage if: the unit and its common elements are not part of the condominium regime; the failure of the condominium documents to create a condominium under New York law; violations of covenants that restrict the use of the condominium unit (except environmental); the priority of any condominium liens prior to the policy date; failure of the unit to be assessed for real property taxes; against encroachment of one unit upon another; and the loss of title through the condominium's board exercise of its right of first refusal.

Co-Insurance Endorsement

- In co-insurance, any number of underwriters will agree to assume the liability for a certain percentage of the total amount of the purchase price or mortgage upon the subject property. In this endorsement the names of the co-insuring underwriters, their addresses, policy number, amount of insurance and the proportion of their liability is set forth. The endorsement provides that each underwriter is only liable for its percentage of the whole amount. The endorsement further provides that notice of the claim must be given to each underwriter at its address, and any future endorsement must be signed by all of the co-insurers, and the endorsement takes effect on the closing day and may be executed in counterparts.

Contiguity Endorsement

- This endorsement insures against loss or damage if it turns out that the parcels are not contiguous with each other along their common boundary.

Commercial Contract Vendee Endorsement

- This endorsement insures that the Contract Vendee has a valid and enforceable interest under the Contract of Sale. The policy insures against loss or damage due to the unenforceability of the right to receive a deed, the refusal of a trustee in bankruptcy to give a deed and the inability of the insured to take title free of intervening adverse interests, except those which were excepted. There are many exclusions from coverage such as real estate taxes, mechanic's liens, federal tax liens, state tax liens, defects which would have been shown by an accurate survey, changes in laws, mortgage recording taxes, attorney fees and expenses and problems resulting from the failure to record the Contract of Sale. The amount of the title underwriter's liability is limited to the policy amount or to the sum of difference between the fair market value of the land at the time the insured was to purchase it under the Contract and the cost under the Contract, plus the unreimbursed consideration paid the insured, plus the actual cost of the building and improvements actually made by the insured and the actual direct costs related to the acquisition of the land.

- This endorsement requires underwriter approval prior to issuance.
- The premium is one hundred twenty percent (120%) of the owner's rate for the amount of the insurance purchased.

Residential Contract Vendee Endorsement (Fee or Leasehold)

- This endorsement does not cover nor exclude as much as the Commercial endorsement. The Residential endorsement covers the right to receive a deed under the contract, unless the insured does not fulfill the contract's terms, and that a trustee in bankruptcy will not decline to issue a deed. The endorsement does not cover matters arising after the policy date, pre-policy mechanic's liens, attorney fees to enforce the contract except those incurred in a defense of the validity of the contract, and the imposition of mortgage recording taxes.
- The premium is one hundred twenty percent (120%) of the owner's rate for the amount of the insurance purchased.

Cooperative Endorsement (Owner's and Loan)

- This endorsement excludes from coverage liens and encumbrances that were of record prior to the date of the deed to the Cooperative Corporation. However, the policy provides that all mortgages affecting the Cooperative Corporation are set forth in Schedule B. The endorsement covers title to the building and land; the validity of the cooperative regime; the proper location of the cooperative building; there being no forfeiture or reversion provision; that real estate taxes on the land and building have been paid up to the closing date; maintenance charges on the unit have been paid up to the closing date; and that the co-op board's right of first refusal has not been exercised. In addition, the owner's endorsement covers the cost of moving the owner's personal property in the event of an eviction as the result of a matter insured against.

Environmental Protection Lien Endorsement: New York

- This endorsement only protects against environmental liens that are recorded at the date of policy. It excludes liens provided for the Section 1307 of the Public Health Law, which provides for nuisance and sanitation liens.

Environmental Protection Lien Endorsement: New York City

- This endorsement provides the same coverage as the State endorsement but excludes overage for liens arising under Section 17-151 of the Public Health provisions of the City's Administrative Code. This provision authorizes the Department of Public Health to impose liens against properties in which health violations exist. The endorsement can only be issued for properties located in New York City.

Environmental Protection Lien Endorsement (for Mortgages Made to the State of New York or a Public Benefit Corporation Thereof and Federal Government Agencies)

- This endorsement provides the same coverage against recorded liens as the prior two endorsements but does not contain exclusions for statutory liens.

Fannie Mae Balloon Mortgage Endorsement: New York

- In the event that a mortgage will be insured by or sold to Fannie Mae, this endorsement insures that the mortgage will not be rendered invalid nor will its lien priority be lost because of the exercise of the balloon provision in the mortgage including the extension of the loan terms and a change in the interest rate provided that no other liens or defects have arisen since the policy date.

First Loss Endorsement

- If the lender experiences a loss or series of losses which aggregate to ten percent (10%) of the policy's face amount, then the title company cannot require the foreclosure of the mortgage or deed of trust before having liability for a compensable loss under the title policy. The title company also agrees to subordinate its subrogation rights to the rights that the insured may have against the property.
- This endorsement requires underwriter approval prior to issuance.

- The premium is ten percent (10%) of the full applicable loan rate.

Industrial Development Agency of Similar Public Benefit Corporation Transfer to Beneficial Owner Endorsement

- Under the terms of this endorsement, the title underwriter extends the coverage provided under the policy to the Beneficial Owner of the property. The Beneficial Owner is defined as the legal entity that is or will be the grantor to the IDA, is or will be the grantee from the IDA, or is or will be the IDA's nominee. "Beneficial Owner" also includes that assignee of a leasehold from the IDA. The endorsement also passes on the title coverage to certain identified successors-in-interest to the Beneficial Owner.

Joint and Several Liability Endorsement

- Under this endorsement, the underwriters agree to be responsible for the loss of the other underwriters up to a certain amount. Once that amount is reached, then the underwriter's liability is in proportion to its pro rata share of the transaction.
- The premium is charged by each underwriter at the rate of $1 per $1,000 of the total amount of insurance for which the joint and several liability applies.

Junior Loan Policy Endorsement 1 and 2

- The Junior Loan Policy endorsement 1 protects the second mortgage lender from the loss of priority resulting from the recording of a deed to or a mortgage on the subject property after the policy date or the date of the endorsement. If the property is one to four family residential, then Junior Loan Policy endorsement 2 insures the second lender that its mortgage will retain the mortgage's original loan priority even if the lender makes future advances to the borrower or the loan's interest rate is changed. Real estate taxes, assessments, water and sewer charges, Federal tax liens and liens and encumbrances known to the lender are excluded from coverage.

Land Same as Survey Endorsement

- This endorsement insures that the land as described in the title policy is the same as the land shown on the survey.

Leasehold Endorsement (Loan Policy) & Leasehold Endorsement (Owner's Policy)

- These two endorsements cover the leasehold owner or lender from certain defined losses and damages if the lessee is evicted from the property as a result of the loss of a covered matter under the underlying policy. The covered loss or damage includes the value of the remaining leasehold estate as well as the cost of removing personal property up to 100 miles, the rent that the insured may be obligated to continue to pay and damages which the lessees may be required to pay to its sublessees, among others.

Manufactured Housing Unit Endorsement

- This endorsement amends the term "land" in the title policy to include a manufactured housing unit located on the land on the policy date. However, this is just the beginning of the story. New York does not have a law, as do other states that permit a manufactured home to be legally attached to the land. Mobile homes that were manufactured after 1994 in New York are registered in the Division of Motor Vehicles, as are automobiles. Therefore, manufactured homes built after 1994 cannot be legally attached to land. The result is that some title underwriters will not insure manufactured homes while others go through all sorts of gyrations involving tax assessment information, affidavits and UCC requirements or exceptions to insure titles. Some underwriters will insure modular homes while others will not. The best advice is to contact your underwriter.

Market Value Policy Rider

- Section 6409(c) of the Insurance Law requires title underwriters to offer at the time of closing or before a market value rider to natural person owners of a one-to-four family residential property including cooperative units. Under the endorsement, the title underwriter insures the owner against loss or damage not exceeding the market value of the property at the time of the loss. The market value is determined by a panel of three arbitrators; one selected by the insured, one by the title underwriter and the third by the two arbitrators. There is a similar endorsement for the TIRSA Extended Owner's Protection Policy (TOEPP) as well.
- The premium is ten percent (10%) of the full owner's rate.

Mezzanine Financing Endorsement

- Mezzanine financing works as follows: your client is probably a member of an LLC or a partner in a partnership. Let us stick with the LLC for clarity's sake. The LLC owns a parcel of real property. The parcel is probably encumbered by a mortgage, the priority of which is insured by a title underwriter. In addition, the LLC is the insured under a fee or owner's title insurance policy. Your client, the member of the LLC, is about to borrow additional funds from a lender. To secure the loan, the lender is going to require that your client, the LLC member, pledge his or her membership interest to the lender. If a title claim were to arise, the membership interest in the LLC might lose a great deal of is value. Therefore, the lender wants "divs" on any payment that the title underwriter may make to the member in resolution of the title claim. The payment to the lender would be made pursuant to the terms and conditions of the Mezzanine Financing endorsement. The lender is the Mezzanine Lender and the loan secured by a pledge of the member's interest in the Mezzanine Loan.

- Under the Mezzanine endorsement, the borrower assigns his or her right to a claim payment under the title policy to the Mezzanine Lender. If there is a loss under the title policy before the Mezzanine Lender gains control of the member's interest, the claims payment goes to the Mezzanine Lender. In order to make this assignment of a claims payment possible, the borrower is required to execute the endorsement.
- The loss under the policy is the member's proportionate share amount of the Actual Loss as that term is defined in the policy.
- For its part, the Mezzanine Lender agrees that it has no rights in the title to the land, that it has no right to negotiate with the title underwriter as to amount of the loss, that the title underwriter has not waived any defenses that it might have against the borrower, that the title company still has its subrogation rights if it makes a payment, and that the title company still has the rights to insure additional mortgages secured by the land without obtaining the lender's consent. The title underwriter agrees that if a loss occurs after the Mezzanine Lender acquires title to the member's interest, it will not deny having liability because of the transfer.
- This endorsement requires underwriter approval prior to issuance.
- The premium is twenty percent (20%) of the owner's rate.

Mortgage Tax Endorsement

- Under New York statutory law, even if one could record a mortgage without paying the recording tax, the lender cannot assign nor foreclose the mortgage until the tax is paid. Pursuant to the Mortgage Tax endorsement, the title underwriter insures the owner of the mortgage against loss or damage if the correct mortgage tax is not paid.

New York City "Development Rights" Endorsement

- A development right is the right of the owner to build a structure to the height permitted by the City's zoning code. Simplified, if the code permits a building to be constructed up to six floors, but the existing building only has four floors, then the owner of the building has two floors of excess development rights. Provided that certain requirements are met, a neighboring owner may purchase the excess two floors of development rights from the owner of the building. The agreement setting forth the terms of the transfer of the development rights from one building to another is the Zoning Lot Development Agreement ("ZLDA"). The Declaration of Zoning Lot Restrictions evidences the agreement of the adjoining property owners and other "parties in interest" to the terms and conditions of the new zoning lot. The Development Rights endorsement insures that all of the parties in interest as defined by the Zoning Resolution of the City of New York have joined in the execution of the ZLDA and the Declaration of Zoning Lot Restrictions. The endorsement may insure an Easement for Light and Air if one is created. The endorsement does not insure the amount of the floor area development rights. Therefore, contrary to popular thought, the endorsement does not insure the development rights themselves.

Non-Imputation Endorsement

- If the incoming partner purchases a non-imputation endorsement, the title company will waive its right to deny a claim based upon the act of the insured policy exclusion but only to the extent of the lease of the percentage interest purchased by the incoming partner, the difference in value of the insured estate without the defect and its value with the defect, or the policy amount.
- The premium is twenty percent (20%) of the full owner's rate.

Option Endorsement

- The Option endorsement insures the holder of the option that it has a valid and enforceable interest as Optionee under the Option to purchase the land. Since the terms and conditions of this endorsement mirrors the Contract Vendee endorsement discussed above, please see that discussion for a fuller explanation.
- This endorsement requires underwriter approval prior to issuance.
- The premium charge depends upon so many variables that it will not be stated here. Inquiring minds are directed to Section 33 of the TIRSA Rate Manual.

Partial Release of Mortgage Premises Endorsement

- This endorsement provides that the mortgage remains as a valid and enforceable lien on the land not released and that the mortgage's lien priority is not affected by the release.

- The premium for this endorsement is $150.

Planned Unit Development Endorsement

- This endorsement insures against the lender or unit owner from suffering a loss due to violations of restrictive covenants unless a notice of the violation has been recorded, unpaid prior unit owner assessments, enforced removal of any structure which encroaches upon adjoining land and the enforcement of a first right of refusal to purchase the land.

Residential Revolving Credit Endorsement (Owner-Occupied One-to-Six Family)

RCE-1

- This endorsement insures the lender against loss that the lender may incur because of a loss of the lien priority of the insured mortgage as a result of advances made by the lender to the owner. Losses resulting from Federal tax liens, bankruptcies, real estate taxes, assessments and water and sewer charges are not covered.
- The premium for this endorsement is ten percent (10%) of the full applicable loan rate.

Commercial Revolving Credit Endorsement for Commercial Credit Line Mortgages Which Secure a Maximum Principal Indebtedness of Less Than $3,000,000

RCE-2

- In New York, there are three Commercial Revolving Credit endorsements. All three insure the lender against loss or damage which the lender might sustain arising from a loss of priority due to advances made under the loan documents, provided of course that the lender has no actual notice of the sale or transfer of the property. The first endorsement covers commercial transactions for less than $3 million. This endorsement excepts from coverage federal tax liens, bankruptcy filings, real estate taxes and assessments, mechanic's liens and other statutory liens, which have priority over the mortgage.
- The premium for this endorsement is ten percent (10%) of the full applicable loan rate.

Commercial Revolving Credit Endorsement (Limited Term Special Coverage) for Commercial Line Mortgages Which Secure Maximum Principal Indebtedness of Less Than $3,000,000

RCE-3

- This endorsement is only effective if the insured mortgage has a term of three years or less and is not a building loan. This endorsement provides coverage against losses caused by mechanic's liens.
- This endorsement requires underwriter approval prior to issuance.
- The premium for this endorsement is twenty percent (20%) of the full applicable loan rate.

Commercial Revolving Credit Endorsement for Commercial Credit Line Mortgages Which Secure a Maximum Principal Indebtedness of $3,000,000 or More

RCE-4

- In addition to the exclusions set forth in the less than $3 million endorsement described above, this endorsement excludes mechanic's liens from coverage. It also adds an exclusion for New York's mortgage tax.
- Under statute (Tax Law, 253-b), only commercial line mortgages under $3 million enjoy an exemption from the imposition of mortgage taxes.
- This endorsement requires underwriter approval prior to issuance.
- The premium for this endorsement is ten percent (10%) of the full applicable loan rate.

Residential Mortgage Endorsement

- This endorsement insures the lender against loss that results from an easement that is not fixed or ascertainable or which interferes with the use of the building and improvements located on the land. The endorsement also insures that there are no violations of any covenants and restrictions reference in Schedule B or the policy on the land and that a future violation will not cause a forfeiture of reversion of title.

TIRSA or ALTA 9 (Restrictions, Encroachments, Minerals) a/k/a "All-Inclusive" or "Comprehensive" Endorsement

- The TIRSA or ALTA 9 (American Land Title Association) endorsement insures against loss or damage caused by:

  1. Covenants and Restrictions ("C & R's") which adversely affect the insured mortgage's lien priority;
  2. C & R's, violations thereof, encroachments, recorded environmental protection notices, unless excepted in Schedule B of the policy;
  3. Future violations of C & R's which would result in a forfeiture or reversion of title;
  4. Damage caused to shrubbery or trees which are located in the easement areas; and
  5. Final court orders requiring the removal of encroach-

ments, or denying the right to maintain any improvements on the land.

- This endorsement is available only to lenders.
- The premium for this endorsement is ten percent (10%) of the full applicable loan rate.

Reverse Mortgage Endorsements for Mortgages Made Pursuant to Sections 280 and 280-a of the Real Property Law

- This endorsement insures the lender against a loss of lien priority due to advances made to a borrower under a reverse mortgage including shared appreciation, accrued but unpaid interest or compound interest. However, the endorsement does not insure against usury, violations of consumer protection laws or of RPL Sections 280 or 280-a. Losses resulting from Federal tax liens, bankruptcies, real estate taxes, assessments, water and sewer charges, and liens encumbrances or other matters known to the lender are not covered. Finally, the title company does not cover legal fees, costs and expenses incurred by the lender to establish the amount of the loan.

Successor-in-Ownership of Indebtedness Endorsement (Loan Policy)

- Based upon the representations of the assignee or purchaser of the indebtedness, the title underwriter will extend the coverage provided by the title policy to the new owner of the indebtedness. However, the endorsement does not change the policy's effective date, the amount of coverage, and it continues the exclusions and exceptions contained in the original policy. Further, it does not insure the legal sufficiency or validity of the assignment.

Standard New York Endorsement (Loan and Owner's)

- Certain provisions of the ALTA loan and owner's policy are replaced by the Standard endorsements. The Loan policy version provides coverage for mechanic's liens that arise prior to the loan's closing date, excludes from coverage real estate taxes, assessments and water and sewer charges which are incurred between the closing date and the recording date. The endorsement also excludes High Cost Home and Subprime Home Loans, as statutorily defined, from coverage. The Owner's endorsement also provides coverage for losses attributable to pre-closing date mechanic's liens, but as in the Loan policy, it too excludes coverage for real estate taxes, assessments and water and sewer rents.
- There is no premium for this endorsement.

SWAP Agreement Endorsement

- An interest rate swap occurs when one party agrees to pay a set interest rate and the other agrees to accept a floating rate. When the floating interest rate is higher than the set rate, additional interest will be generated. The concern is that this additional interest does not adversely affect the mortgage's lien priority. This endorsement provides the requested coverage. However, the endorsement does not cover usury nor does it insure the amount of additional interest that a court may determine is proper.
- The premium is the loan rate per thousand for the amount of insurance above the face amount of the policy.

Tax Parcel Endorsement—Single Tax Lot and Tax Parcel Endorsement—More Than One Lot

- The endorsements are self-descriptive. Both insure that the lands as described in Schedule A of the policy are not assessed as separate tax lots, which include no land other than that which is described in Schedule A. Hence, the title company is insuring that a foreclosure of lands not included in Schedule A but which are shown as a part of the tax lot will not result in a loss of title to the insured property.

Variable Rate Mortgage Endorsement, Variable Rate Mortgage Endorsement—Fixed Rate Conversion—and Variable Rate Mortgage Endorsement—Negative Amortization

- The three endorsements referenced above provide coverage that a future interest rate change or conversions will not render the underlying mortgage unenforceable nor destroy the mortgage's lien priority. The title company will require that the lender set forth the conversions clearly in the recorded loan documents

Waiver of Arbitration Endorsement

- This endorsement deletes Conditions and Stipulations Section 13 of the ALTA Owner's Policy and Section 14 of the ALTA Loan Policy, thereby eliminating the arbitration requirement from both policies.

This may not have been the most exciting of articles to ever appear in this *Journal*, but the author hopes that it is helpful.

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How to Use a Tenants' Association to Defeat an MCI Application

By Adam Leitman Bailey and Dov Treiman

I. General Overview

Major Capital Improvement Increases (MCIs) are a concept that parties can contract for if they are not subject to rent regulation.[1] However, generally speaking, unregulated residential tenants rarely do contract for them. They are therefore, in a practical sense, uniquely belonging to the world of rent regulation and are a means whereby landlords can profit from the installation of new or replacement systems in the building complex.

In regulated housing, a landlord may only obtain an MCI upon application to the New York State Division of Housing and Community Renewal (DHCR).[2]

While the Rent Stabilization Code (RSC) lists the most common of the systems eligible for MCI treatment, any building system can qualify, provided that it:

(a) is deemed depreciable under the Internal Revenue Code, other than for ordinary repairs; and

(b) is for the operation, preservation and maintenance of the structure; and

(c) is an improvement to the building or to the building complex which inures directly or indirectly to the benefit of all tenants, and which includes the same work performed in all similar components of the building or building complex, unless the owner can satisfactorily demonstrate to the DHCR that certain of such similar components did not require improvement.[3]

If the system is not on the RSC list,[4] there is a procedure the landlord can employ for qualifying it as well. However, it is very rare that off-list systems are installed and therefore it is unnecessary to discuss them here.

MCIs are written into the rent stabilization system as a means of incentivizing the landlord to upgrade the building as a whole as well as its individual apartments.[5] The incentive is that most basic to capitalism—profit. Therefore, while some tenant advocate organizations in New York City seek to eliminate MCIs as another means of landlord profit, it is so strongly part of the entire system that one can assume that so long as there is rent stabilization, there will be MCIs.

The profit, crudely on its face, appears from the fact that an improvement appears to become 100% reimbursed to the landlord seven years after it is made.[6] Actually, that is an over-simplification. The granting or denial of the application can take years before the DHCR and usually does. It therefore leaves inflation unaccounted for. On the other hand, once the rent increase is put through, it becomes part of the base rent and a means towards the landlord's goal of achieving high rent deregulation when the legal rent exceeds $2,500 per month.[7] Since it is part of the base rent, it is also subject to the annual or biennial rent increases as well as vacancy increases. Therefore, the recovery can be much faster than the seven years after approval of the application.[8]

Buildings converted to cooperatives and condominiums present special issues. While the no longer rent-stabilized units are part of the arithmetic for computing the increase, they do not themselves generate increased revenue to the landlord from an MCI.[9]

Therefore, the system is really designed for an MCI increase in a cooperative- or condominium-converted building to be just one more tool for the landlord to drive the rent-regulated tenants out of the building prior to selling the apartments.

However, that does not mean tenants are without their weapons in such matters. The bulk of this article will explore that arsenal.

II. MCIs: A Highly Technical Application

Only a very foolish landlord would undertake an MCI application in a large building with a vigorous tenant organization without having all its ducks lined up. However, accidents and mistakes do happen and sometimes facts uncomfortable for the landlord are simply papered over. All of these create vulnerabilities for the tenant advocates to use to their advantage. It is the tenant advocate's job to find these flaws.

III. The Requirements of MCI

a. The work must affect *all* residential units in the building.[10]

In order to qualify for an MCI, the improvement must affect all residential units in the building.[11] It need not have any effect on the commercial units at all.

However, "all" does not really mean "all." If a building has, for example, 1,000 windows, the replacement of 900 windows would not qualify for MCI treatment. However, the replacement of 997 windows would. These numbers are only given as examples. They are not fixed percentages, but merely an indication that the DHCR has the discretion to construe "almost all" to be "all" for the building.[12] Also, windows are only given as one example of the many kinds of building systems that could be replaced. However, they are a very special system because:

i. They are easy to count; and

ii. They normally affect all units in the building.

Other examples of building systems that come down to a question of whether *all* of the apartments are affected would be the rewiring of the building. While there would not normally be a valid reason to skip a particular apartment for rewiring, there could be a valid reason for skipping replacement of a particular window where, for example, a window identical to the new ones going into the building had to be replaced a year before the MCI window replacement program started.[13]

Therefore, the Tenants' Association must count the building systems that were actually replaced. The count must be precise. If too few systems were replaced, the application for MCI treatment must be denied.

b. The things being replaced must be too old to be within their "useful life" as defined by the RSC.[14]

The RSC sets forth a list of what is a "useful life" for any particular building system and in some cases distinguishes amongst various kinds of particular systems.[15] The tenants' lawyers can guide the Tenants' Association to the particular RSC provisions to ascertain which useful life (or lives) apply to the particular building systems for which the landlord is laying claim.

Therefore, the Tenants' Association must ascertain both the specific type and the age of the systems that were replaced. If the application for MCI overstates the age of the building system or misrepresents the type that was replaced, the application could be defeated.

c. The increase must be 1/84th of the actual cost.[16]

It will be necessary for the tenants' lawyers, sometimes with the assistance of certified public accountants, to scrutinize the actual MCI application to see if the costs set forth are reasonable, appropriate, and accurate, both as to the law, and as to standard accounting practices.[17]

d. The leases must authorize the charge.[18]

MCIs are only authorized with respect to a particular apartment if that apartment is held by the tenant pursuant to a lease that actually includes a lease clause authorizing MCI increases.[19] It is possible that the leases do not contain such clauses. It is also possible that neither the landlord nor the tenant is actually in possession of any lease.

It will therefore be necessary for the Tenants' Association to gather copies of all the leases of all of the apartments fighting the increase.

It will also be necessary for staff at the tenants' lawyers to study these leases to ascertain whether they have MCI clauses.

e. The application must have been filed within two years after the completion of the installation of the windows.[20]

It will therefore be necessary for the Tenants' Association to check the precise timing from the completed installation to the first application for MCI increase.

f. The improvements cannot have been funded out of a cooperative's or condominium's cash reserves.[21]

While it is unlikely that such funding is used, the tenants' lawyers will have to trace the funds.

g. The MCI application may not be granted if the landlord is failing to furnish essential services or if there are immediately hazardous conditions in the building.[22] There are brand new amendments to the Rent Stabilization Code that expand the restrictions "C" violations place on the granting of MCIs.[23] Under the new amendments, the presence of a "C" violation, discovered by DHCR itself, or reported by essentially anybody, will now require the dismissal of the MCI application, with leave to renew within sixty days, if the violation is cured.[24] That can prove extremely difficult, and can wind up bringing the application outside the required two years.

It will therefore be necessary for the Tenants' Association to inspect the entire complex to search for such breaches of services or violations. It is often prudent to hire engineers to do so. If any such violations are found, the Tenants' Association will want to be on the telephone immediately, reporting them to the City. Ideally, these violations should be phoned in before the completion of the MCI work so that the violations are already in place at the time of the MCI application.

h. The MCI application will not be granted if there is shoddy workmanship.[25]

It will therefore be necessary for the Tenants' Association to survey whether all of the claimed building systems are functioning properly and to identify those that are not.

The MCI application must contain detailed financial proofs of the expenditures the landlord claims. These proofs "should include at least one of the following:

1) Cancelled check(s) contemporaneous with the completion of the work;
2) Invoice receipt marked paid in full contemporaneous with the completion of the work;
3) Signed contract agreement;
4) Contractor's affidavit indicating that the installation was completed and paid in full.[26]

Whenever it is found that a claimed cost warrants further inquiry, the processor may request that the owner provide additional documentation."[27]

It will therefore be necessary for the tenants' lawyers to examine these proofs and determine if there are flaws in them that can be exploited to knock out the application.

IV. Special Equities

a. The RSC allows the DHCR to consider special or unique circumstances with regard to the entire building and with regard to individual apartments to ascertain if there is anything that makes imposition of an MCI with respect to a particular apartment inappropriate.[28]

It will therefore be necessary to the Tenants' Association to gather volunteers to interview individual tenants with respect to their peculiar situations that may make for unique circumstances excusing the imposition of the MCI increase.

It will therefore be necessary for the tenants' lawyers to train these volunteers. Where it appears from a volunteer's report that there is something special about a particular apartment, the tenants' lawyers will have to re-interview the affected tenants. Training the volunteers entails:

i. Having the volunteers keep detailed records of who was interviewed, when, and where.

ii. Having the volunteers asking questions about health, income, economic hardships, special expenses, senior citizen status, disabilities, special reasons that the claimed improvement would be of no use to a particular apartment, any other unique circumstances the interviewed person can think of.

iii. Having the volunteers make and keep copies of all notes of all interviews and turning over one copy of the notes to the Tenants' Association Interview Captain.

b. Certain senior citizens may be exempt from the MCI, particularly those who qualify for Senior Citizen Rent Increase Exemption (SCRIE) treatment.[29]

It will therefore be necessary for the Tenants' Association to ascertain if any of the affected apartments are subject to SCRIE. Generally speaking such seniors or those who manage their affairs will be able to identify the affected seniors to the Tenants' Association.

V. Calculating the MCI

a. The RSC has MCIs apportioned over the building by using a ratio based on the building's total room count compared to the number of rooms in a particular apartment. The formula works approximately as follows:

$$\text{ROOMS}_{\text{Particular Apartment}} \times \frac{\text{TOTAL COST OF IMPROVEMENT}}{84 \times \text{ROOMS}_{\text{Entire Building}}}$$

Equals

Increase to Monthly Base Rent[30]

For example:

If a landlord has a construction project that costs $42,000, which is in all other respects qualified for MCI treatment, and the tenant in question has a five-room apartment and there are 1000 rooms in the entire building, and the tenant's rent was, before the MCI, $500 per month, the formula would look like this.

$\text{ROOMS}_{\text{Particular Apartment}} = 5$
TOTAL COST OF IMPROVEMENT = $42,000
$\text{ROOMS}_{\text{Entire Building}} = 1000$
Initial Base Rent = $500

$$\frac{5 \times \$42{,}000}{84 \times 1000} + \$500 =$$

$$\frac{\$210{,}000}{84{,}000} + \$500 =$$

$2.50 +$500 = $502.50

Thus, under this example, the new base rent upon which all future increases would be calculated becomes $502.50.

We have purposely selected artificially low and round numbers to illustrate the formula. These numbers have nothing to do with any particular building complex. They have everything to do with how the calculations work. Note the number "84" is fixed directly in the RSC. Everything else is fictitious.

It should also be noted that the formula for calculation of MCIs is meant to apply to *any* kind of improvement the landlord may make.[31] So, although logic would seem to demand, standing in a vacuum, that the MCI rent increase with regard to windows, for example, would be based on how many windows are actually in a particular apartment, that is *not* part of the calculation. Since MCIs are allowed for items like trash compactors that aren't actually in particular apartments, the "room count" formula is used for *all* MCIs, even if logic would seem to be out of whack with particular MCIs that clearly benefit some apartments more than others.[32]

b. What is a "room"?

The definition of "room" for purposes of the RSC and for purposes of an MCI is highly technical and beyond the scope of this article.

On the subject, the DHCR states:

The definition of a room for MCI purposes only is as follows:

1) A windowless kitchen containing at least 59 square feet or a kitchen of any size with window. In either case, a kitchen must be enclosed by at least three sides, excluding the side(s) that contain(s) the entranceway; or

2) An enclosed area with window containing at least 60 square feet; or

3) An enclosed area without window containing at least 80 square feet;

4) Bathrooms, walk-in closets, porches, terraces and hallways are not rooms.[33]

There are more details to the qualifications. However, there are certain principles of which you should be aware:

"Rooms" include all *residential* rooms in the entire building, regardless of how many are rent regulated, unregulated, occupied, or unoccupied.[34] They do not include commercial space.[35] They are also unaffected by alterations made to the building.[36]

If, for a example, the original "G" line to a particular building was architecturally designed to have seven "rooms" as the word "room" is understood in this context, the fact that two bedrooms removed a partition so as to make one larger bedroom does *not* make a particular apartment into a six-room apartment when it is a G line apartment. It still counts as seven. This is particularly important in building complexes where the sponsor of a cooperative or condominium conversion is, in fact, combining various apartments throughout the complex and changing the room counts of the original architecture.

It is therefore necessary that the Tenants' Association undertake a study of the entire complex as originally designed to see how the total room count as designed compares to the room count set forth on the MCI application REGARDLESS OF STATUS OF PARTICULAR APARTMENTS.

It is also necessary that the Tenants' Association provides to the tenants' lawyers an analysis of the number of rooms for each line in the complex. This will enable the tenants' lawyers to ascertain whether the individual apartments' room counts as set forth in the MCI application is correct.

c. Maximum increases

i. All tenants

MCI increases cannot amount to a higher increase in any one year of more than 6% above the then current base rent. Extra increases are carried forward.[37] The amount of an increase with any particular apartment therefore becomes calculated not only based on the room count as above described, but also on this 6% ceiling. We will illustrate.

An apartment has a base rent of $500 per month. The room count MCI increase calculation entitles the landlord to an increase of $45. However, 6% of $500 is only $30. The landlord is therefore entitled to a $30 increase per month in the first year of the MCI increase and a $15 increase in the second year of the MCI increase. Please note, these spread forward increases are calculated *annually* and have nothing to do with when the lease is set to expire. The spread forward rent increases take place on the anniversaries of the first increase, which is unlikely to coincide with the lease's expiration date.

ii. Senior citizens

Those senior citizens who are eligible for SCRIE cannot have their rents increased above 1/3 of their annual household income.[38] The rest of the MCI increase simply passes to the landlord as a real estate tax credit instead.[39]

iii. Disabled persons

Under the January 8, 2014 amendments to the Rent Stabilization Code, the exemptions enjoyed by senior citizens with respect to MCIs do not have general applicability to disabled persons.[40] However, the new regulations do set forth such an exemption with respect to electrical submetering, but not directly in connection with MCIs.[41] The Tenants' Association interviewing team should carefully note all disabilities.

VI. Concluding Observations

a. There is nothing automatic about the granting of an MCI application. A strong showing on behalf of the tenants that the application should be denied has historically resulted in the denial of many of these applications.

b. While tenants acting individually can, on occasion, defeat an MCI application, they stand a vastly inferior chance of doing so, compared to the organized work of a good solid Tenants' Association.

c. It takes a great deal of homework by and on behalf of the tenants to effect the denial of an MCI application.

d. MCI applications are rarely defeated by law firms who do landlord-tenant work only as a sideline, although firms doing exclusively tenant work or exclusively landlord work enjoy no advantage over those who represent either side, depending on who retains them first.

e. In order to maximize the chances of defeating an MCI application at minimum expense to the tenants, the Tenants' Association and the tenants' lawyers will have to develop a strong working relationship. To that end, all of the principles that make a good Tenants' Association are most particularly true. The Association must be run fairly, transparently, and in a manner that earns the full faith and confidence of the tenants so that when Association leaders confer with the tenants' lawyers, the lawyers can rely on what is being said and act accordingly. Such a system inevitably strengthens the collective position of the tenants in MCI applications so as to get the proper presentations prepared to make the MCI either denied or long delayed.

Endnotes

1. In a major capital improvement, a landlord takes a percentage of its expenditure on some serious upgrade to building systems to incorporate that into the base rent charged for a rental unit during the pendency of an existing lease. Thus, when lease renewal time comes, any increase is indexed against the new, higher base rent. The methodology for this in the rent stabilized setting appears in § 2522.4(a) of the New York Rent Stabilization Code. Other rent regulatory systems have it as well. However, there is nothing to stop individuals coming up with similar systems and commercial leases routinely have analogous provisions.
2. *See* 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(2) (2003).
3. *Id.* at § 2522.4(a)(2)(i)(a-c).
4. *Id.* at § 2522.4(a)(2)(i)(d)(e).
5. *See generally id.* at § 2522.4(a).
6. *See id.* at § 2522.4(a)(4).
7. *See* N.Y. Unconsol. Law § 8625(13) (McKinney 2011).
8. 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(8) (The formula is even more complicated than that as the DHCR award is for rent increases retroactive to the date of the filing of the application, but the rent accumulated from the retroactivity can only be collected at a capped figure of 6% of the then current rent at any given moment.).
9. *But see id.* at § 2522.4(a)(9).
10. 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(2)(i)(c) ("an improvement to the building or to the building complex which inures directly or indirectly to the benefit of all tenants and which includes the same work performed in all similar components of the building or building complex…").
11. *Id.*
12. *Id.* at § 2522.4(a)(3).
13. *Id.* at § 2522.4(a)(2)(i)(c) ("is an improvement to the building or to the building complex which inures directly or indirectly to the benefit of all tenants and which includes the same work performed in all similar components of the building or building complex *unless the owner can satisfactorily demonstrate to the DHCR that certain of such similar components did not require improvement*" (emphasis supplied)).
14. *Id.* at § 2522.4 ("the owner must submit with the application evidence that the useful life of the item or equipment being replaced has expired").
15. *Id.* at § 2522.4(a)(2)(i)(d).
16. 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(4).
17. *Id.* at § 2522.4(a)(6) ("The determination of the appropriate adjustment of a legal regulated rent shall take into consideration all factors bearing on the equities involved subject to the general limitation that the adjustment can be put into effect without dislocation and hardship inconsistent with the purposes of the RSL and *including as a factor a return of the actual cost to the owner* exclusive of interest or other carrying charges and the increase in the rental value of the housing accommodations." (emphasis supplied)).
18. *Id.* at § 2522.4(a)(5).
19. *Id.*
20. *Id.* at § 2522.4(a)(8).
21. *Id.* at § 2522.4(a)(9).
22. 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(13).
23. *Id.* at § 2522.4(a)(13) (Jan. 8, 2014) (amending to provide that when an MCI rent increase application is received, DHCR will initiate its own search to determine if there is an "immediately hazardous" violation in a building and, if there is such a violation, the application will be rejected with leave to renew once the violation is remedied).
24. *Id.*
25. *Id.* at. § 2522.4(a)(15).
26. Jemrock Realty Co., LLC v. Krugman, 853 N.Y.S.2d 450, 454 (App. Term 2007) (referencing DHCR Policy Statement 90-10).
27. *Id.*
28. 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(6).
29. 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(8) ("A senior citizen with a valid Senior Citizen Rent Increase Exemption (SCRIE) is exempt from paying any portion of the MCI increase that would raise his or her total rent to over 1/3 of the tenant's total disposable income. However if the owner requests it any increase in the security deposit resulting from the MCI rent increase must be paid by the SCRIE tenants.").
30. *Id.* at § 2522.4(a)(4), (12).
31. *Id.* at § 2522.4(a)(3).
32. *Id.*
33. Plaza Mgmt. Co. v. City Rent Agency, 48 A.D.2d 129, 130 (1975).
34. 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(16).
35. Elliot G. Sander, Office of Rent Adm., N.Y.S. Div. of Hous. & Cmty. Renewal, Policy Statement 90-3 (1990).
36. *Id.*
37. 9 N.Y. Comp. Rules & Regs. § 2522.4(a)(8).
38. *Id.*
39. *Id.* at § 2522.4(b)(3)(iii).
40. *Id.* at § 2522.4(a)(8).
41. *Id.* at § 2522.4(d)(3)(ii).

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Cooperative Housing Corporations—Ownership by Trusts: A Retrospective and a Forecast

By Anita Rosenbloom and Eva Talel

Every decade or so, we write an article discussing trends in trust ownership of cooperative apartments.[1] Trends are largely driven by changes (or feared ones) in the Federal estate, gift and generation-skipping tax laws. This article therefore addresses recent changes in the Federal estate, gift and generation-skipping taxes and their impact on requests to transfer ownership of cooperative apartments to a variety of estate planning trust vehicles, as well as how cooperative housing boards evaluate such requests. We hope that our insights will be helpful to both counsel to cooperative housing corporations and individual shareholders, and will facilitate such requests to symbiotically achieve the apartment owner's personal estate planning objectives while protecting the integrity of the cooperative housing corporation and its fiduciary obligations to all shareholders.

Overview of Changes in the Federal Estate, Gift and Generation-Skipping Taxes

Our last article was written shortly after passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"),[2] when we noted an increase in the number of such transfer requests and forecast that the trend would continue. While we were correct in our forecast that there would be a steady increase in such requests under EGTRRA, what we did not fully predict was the magnitude of requests that would occur in 2011 and 2012 due to the fiscal cliff drama in Washington and dramatic shifts in the Federal estate, gift and generation-skipping tax laws.

Under EGTRRA, substantial increases in the Federal estate and generation-skipping ("GST") exemptions were phased in from 2002 until 2009, when they reached the $3,500,000 level. On January 1, 2002, the gift tax exemption increased to $1 million but remained frozen at that level. In 2010, the unthinkable happened when Congress failed to act and the sunset provisions of EGTRRA actually kicked in and the Federal estate and GST taxes were temporarily repealed in 2010. But the gift tax remained hale and hearty with a $1 million exemption and a 35% Federal tax rate.

On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Relief Act")[3] uniformly increasing the exemption amounts for Federal gift, estate and GST taxes to $5 million as of January 1, 2011 and decreasing all transfer tax rates to 35%. A surprising feature of the Act was the unification of the Federal estate and gift tax systems, with the gift tax exemption jumping from $1 million to $5 million. Essentially, the 2010 Act opened the floodgates on January 1, 2011 for wealthy couples to gift up to $10 million free of transfer taxes.

The exemptions for all three taxes—estate, gift and GST tax—were subject to further adjustments for inflation so that on January 1, 2012, the exemptions rose to $5,120,000 and the combined exemptions for a married couple became $10,240,000.

Unfortunately, to add further to the fiscal cliff drama, the 2010 Tax Relief Act had its own sunset provisions and on January 1, 2013, the Federal estate and gift tax exemptions were scheduled to drop to $1 million ($1,430,000 for the GST exemption) and the transfer rates were to skyrocket to 55%. It was this threat of a dramatic drop in the estate, gift and GST tax exemptions and spike in the transfer tax rates that fueled the flood of requests received by cooperative housing corporations for permission to transfer apartments to a variety of trusts before December 31, 2012, when the gates might close and eclipse the opportunity to make such transfers without the payment of transfer taxes. While there was a notable increase in such requests throughout 2011 and 2012, there was an avalanche of requests in November and December of 2012, when Congress came dangerously close to failing to act once again. Managing agents received requests down to the last few weeks in December, imploring cooperative housing corporations to consummate such transfers before January 1, 2013.

With 20/20 hindsight, we now know that on January 2, 2013 President Obama signed the American Taxpayer Relief Act of 2012 (ATRA),[4] which continued to unify the Federal estate, gift and GST exemptions at the historically high level of $5 million, currently at $5,340,000 for an individual and $10,680,000 per couple as a result of further inflation indexing, and increased all transfer tax rates to 40%. Most individuals who secured the use of their exemptions by consummating gift transfers of their apartments on or before December 31, 2012 are pleased that they took such measures.

However, we heard of a few instances of "giftor's remorse," where individuals have regretted relinquishing control over their residence by transferring ownership to a trust. Some of these regrets related to the uncertainty regarding the availability of the NYC real property tax abatement to trusts discussed below—an uncertainty that many practitioners believe has since been put to rest by virtue of an amendment to the tax abatement law which makes certain trusts eligible for the abatement, coupled with clarification from the NYC Department of Finance ("DOF") that only one apartment owner need be eligible in order for the full tax abatement to be available to an otherwise qualifying apartment.[5]

Less than four months after President Obama signed ATRA, he released his 2014 budget proposal in which he proposes reinstating the estate, gift and GST tax parameters as they existed in 2009. The President's proposal would drop the current estate and

GST exemptions from $5,340,000 to $3,500,000 and decrease the gift tax exemption from $5,340,000 to $1,000,000. The exemptions would no longer be indexed for inflation. Curiously, the President's proposal to reinstate the 2009 estate, gift and GST exemptions and tax rates would not be effective until 2018. The President's proposal would increase the rate for all transfer taxes from 40% to 45%. Portability of unused estate and gift exemptions between spouses would remain permanent.

Although it is difficult to assess the likelihood that the President's proposal will be enacted, the current estate and gift tax laws are only "permanent" if Congress enacts no new legislation. Numerous bills have been introduced, primarily by Republicans, to repeal the estate tax. Some proposed bills would continue the gift tax while others would repeal it as well. There currently is widespread speculation as to whether any "tax reform" can be enacted in the current political and economic environment. The uncertainty in Washington regarding the fate of the Federal estate, gift, and GST exemptions and transfer tax rates, coupled with an apparent rebound in the real estate markets, makes it likely that individuals who have not fully exhausted the use of their $5,340,000 ($10,680,000 per couple) exemption are likely to consider transferring ownership of their residences to a variety of trust vehicles. Cooperative housing corporations therefore can expect requests for permission to transfer residences to trusts to continue, but perhaps, barring unforeseeable developments in Washington, not at such-pent up levels as those experienced in 2011 and 2012.

There are countervailing factors that an individual will consider in deciding whether to transfer ownership of a residence to a trust in a gift transaction. For married couples, the permanent portability of the Federal estate / gift exemptions (but not the GST exemption) will take some pressure off of the need to use the exemption during an individual's lifetime. As of January 1, 2011, the Federal tax law introduced a new concept, "portability," allowing a surviving spouse to use a deceased spouse's unused estate (but not GST) exemption for lifetime gifts or upon death. Portability was made permanent under ATRA. Portability is not a panacea, however, as the GST exemption is not portable.

In addition, a major factor that an individual should carefully weigh in deciding whether to transfer a residence to a family trust, which is not includible in that individual's estate for estate tax purposes, is the loss of the step-up in income tax basis upon death. Of course, where an individual has a relatively high basis in the residence, this will not be a factor. But for those individuals with a low basis, the loss of the step-up should be carefully considered. Under current law, subject to certain limited exceptions, assets inherited from a decedent generally receive a "stepped-up" basis equal to the fair market value of the asset on the date of the decedent's death (or six-month anniversary of death if an alternate valuation date is elected). This step-up in basis would wipe out the taxable gain on any appreciation in the value of the residence that occurred prior to the decedent's death. In contrast, when an individual gifts a residence to a trust, the beneficiaries receive a carryover basis equal to the lesser of the donor's basis or the fair market value of the residence on the date of the gift (increased by any gift tax paid on any unrealized appreciation).[6] As a result, the built-in gain is passed along to the beneficiaries.[7] This factor is extremely important given the current convergence of the transfer and income tax rates as a result of ATRA.

While the estate tax rate is likely to be higher than the capital gains rate in the typical case, the spread between the Federal estate tax rate and higher federal capital gains tax rate has narrowed. Under ATRA, the top Federal income tax rate on capital gains was increased by 33.3% (from 15% to 20%). As a result, there may be less of an incentive for making gifts of appreciated residences likely to be sold soon after death. In addition, there may be state and city capital gains taxes to contend with. Of course, the potential capital gain may not be of great concern if it is anticipated that the remainder beneficiaries of the trust will continue to own the residence for a lengthy period of time so that recognition of the gain is delayed, or that the beneficiary will convert the residence to his or her principal residence (with the consent of the cooperative housing corporation) and hold it for the requisite period to qualify for the $250,000 exclusion of gain ($500,000 in the case of a married couple) in his or her own right. Simply put, for certain individuals it may no longer make sense to gift a low basis residence to a trust. A comparison of the potential estate tax savings versus income tax costs is essential before proceeding.

Another factor to be taken into account for residents of states such as New York, where there is no gift tax but an estate tax with an exemption well below the Federal exemption (i.e., currently $2,062,500), is that by gifting the residence, future New York estate tax on the fair market value of the residence (as of date-of-death or alternate valuation date) is eliminated. The New York estate tax exemption is scheduled to increase over the next several years so that beginning January 1, 2019, the exemption will match the then Federal exemption. However, the increase in the New York estate tax exemption is largely illusory for wealthier New Yorkers, as the exemption is phased out for New Yorkers whose estates are between 100% and 105% of the exemption amount, and the exemption is completely wiped out for New Yorkers whose estates exceed 105% of the exemption amount. As noted above, there is no New York gift tax, with the caveat that gifts made within three years of death (which are not otherwise includible in the Federal gross estate) are added back to a decedent's estate if the gifts are made after April 1, 2014 but before January 1, 2019.[8]

Yet another consideration that is likely to influence an individual's decision to defer gifting one's residence to a family trust is simply the fact that there currently are no hard-wired sunset provisions in the Federal estate, gift and GST exemptions or tax rate. Therefore, time may not be of the essence in making this determination.

Some individuals may adopt the philosophy that it is better to be safe than sorry and will secure the use of their gift and GST exemptions which are currently at a historically high level of $5,340,000 ($10,680,000 per couple), particularly if the subject of the gift is a high basis residence. In some cases, individuals may try to leverage the use of their $5,340,000 exemptions by transferring a partial interest in a residence to one or more trusts and claiming a fractional interest discount, because such discounts may be eliminated by future legislation. However, as discussed below, some cooperative housing corporations will not favor consent to transfers of partial interests in cooperative apartments.

Cooperative housing corporations are structured so that the shares and proprietary lease for an apartment designate ownership and occupancy by a single family unit—either a single individual or spouses, and their immediate families. Divided or fractional ownership is inconsistent with this model and can result in disputes between those in occupancy and a fractional trust owner. The corporation may become embroiled in such disputes, thereby unnecessarily incurring legal fees and creating uncertainty as to occupancy rights and the like that may be created by the fractional ownership. An inherently risk-averse entity such as a cooperative housing corporation may not wish to subject itself and its shareholders to such cost and uncertainty.

Overview of More Common Types of Trusts and Trends in Transfer Requests

Historically, there were two types of trusts into which transfers were sought to be made: the grantor trust (also commonly referred to as a "revocable trust" or a "living trust") and the qualified personal residence trusts ("QPRT"). More recently, for reasons discussed below, QPRTs have become less popular and we have seen an increase in requests for apartments transfers to dynasty trusts (i.e., trusts which are intended to be exempt from the generation-skipping tax and which span multiple generations), as well as spousal lifetime access trusts known by the relatively new acronym "SLATs." We also have seen an increase in requests to purchase apartments by existing trusts of all different types. This is likely a result of the fact that it has become much more commonplace for residences to be owned by trusts and that cooperative housing corporations generally have become more accepting of trust ownership of apartments.

For grantor trusts, ATRA should have absolutely no impact on their popularity because these trusts are not designed to achieve any estate or gift tax savings. Typically, they are includible in the grantor's gross estate for estate tax purposes.[9] In contrast, as discussed below, the QPRT is a statutory creature of the Internal Revenue Code and generally the sole reason for establishing it is to attain gift and estate tax savings. Whether it makes sense for an individual to transfer a cooperative apartment to a QPRT in light of ATRA will depend upon an analysis of traditional factors such as the individual's age, state of health, available gift tax exemption, anticipated estate tax exemption, projected taxable estate, cost basis in the apartment, the value of the apartment and, most importantly, the individual's comfort level with parting with ownership. It also may depend upon her or his estate planning counsel's confidence in predicting whether there ultimately will be a reduction of the Federal estate, gift and GST exemptions as the President has proposed, or a permanent repeal of the Federal estate tax as Republican representatives have tried to achieve.

There are several reasons why QPRTs have become less popular. First, in low interest rate environments, the actuarial value of the remainder interest (which is the gift reported) is enhanced. As interest rates rise, the value of the remainder interest (i.e., the taxable gift) will decline so the impact of this factor may need to be revisited. However, the main reason why a QPRT may be unattractive is the loss of the step-up in income tax basis. As the Federal gift and estate tax transfer tax rate and income tax capital gains rate converge, it may no longer make sense to gift a low-basis residence to a QPRT. Once the transfer to a QPRT is made, it is not reversible. The QPRT Trust Agreement must contain a provision precluding the sale or transfer of the residence held in trust, directly or indirectly, to the grantor, the grantor's spouse or an entity controlled by the grantor or the grantor's spouse during the trust term, or at any time after the trust term that the trust is a grantor trust.[10] From a generation-skipping tax perspective, there is also another disadvantage. It is not permissible to allocate the generation-skipping tax exemption upon the creation of the QPRT. Under the Internal Revenue Code,[11] the Grantor cannot allocate his or her GST exemption to property transferred during the period for which the property would be includible in the grantor's estate, if he or she were to die immediately after the transfer. Because the trust assets are includible in the grantor's estate, if the grantor were to die during a retained term,[12] the grantor cannot make an effective allocation of the GST exemption until the retained interest by the grantor terminates at the then fair market value of the residence and other trust assets. For this reason, QPRTs are seldom used as a planning vehicle to maximize the use of an individual's GST exemption or to pass property to grandchildren.

From time to time, cooperative housing corporations receive requests for transfers of apartments to a testamentary trust under the Will of a deceased shareholder (typically to fund a credit shelter trust) or a request for a transfer to (or a purchase by) an existing trust established by a third party other than the intended resident. It is likely that these types of transfer requests will continue. Indeed, it is possible that there will be an increase in the number of requests to transfer cooperative apartments to credit shelter trusts under a deceased shareholder's Will, as the Federal estate tax exemption has now expanded to $5,340,000 and a larger portion of an estate will pass into these trusts, unless the individual decides to avail herself or himself of portability and forgo fully funding the credit shelter trust.

Because it is likely that cooperative housing corporations will continue to receive a steady stream of requests for apartment transfers to trusts, we will now discuss the ramifications of these transfers from the perspective of the corporation and with a view towards facilitating shareholder transfer requests where feasible.[13]

Role of Counsel

For those cooperative housing corporations which have not already been faced with the issue of trust ownership of an apartment, ideally they should seek the advice of counsel in advance of a trust transfer or purchase request in order to formulate a policy to deal with such requests and be prepared to address them when they are received. With or without a pre-existing general policy, when a board receives a request for an apartment transfer to or purchased by a trust, it should seek the advice of counsel in reviewing the particulars of the request. Counsel for the corporation should understand that the decision as to whether to permit a transfer to or purchase by a trust is within the discretion of the board. If a board is inclined to accommodate a request for a transfer to or purchase by a trust, the corporation's counsel should endeavor to ensure that the corporation is at no greater financial or other risk with a trust as a shareholder than it is with a natural person.

The first step in the process is review of the trust instrument itself.[14] It cannot be emphasized enough that each trust instrument—and this means the entire instrument, not just excerpts—must be reviewed by an attorney well-versed in trust issues. After review of the actual and complete trust instrument, the corporation's counsel should advise the board of the basic terms of the trust and any problematic provisions and should recommend documentation which may alleviate board concerns. Counsel should also consider and advise whether there is any legal impediment to a transfer to the trust. Ultimately, in the absence of a legal impediment, the final decision is within the discretion of the board.

Importantly, it should be made clear to the shareholder seeking the transfer or the trust entity purchaser that the fees of the cooperative housing corporation's counsel for review of the trust documents and advice to the board, as well as other fees in connection with the transfer, will be borne by the shareholder seeking the transfer, or the trust purchaser, regardless of whether the transfer or purchase is approved. Legal fees will vary dramatically depending on the complexity of the trust instrument and the extent of document modification and / or creation required to allay board concerns. Shareholders seeking to make trust transfers and / or trust purchasers should be made aware of this and their agreement to be responsible obtained before fees are incurred.

Grantor Trusts

A grantor trust is a revocable, amendable trust created primarily for the benefit of the shareholder / grantor during his or her lifetime. Often, assets other than a cooperative apartment will be transferred to a grantor trust. Typically, the income and principal of the trust may be freely used by the trustee for the grantor's benefit during the grantor's lifetime. The grantor trust is often used as a Will substitute, providing for the disposition of the trust assets upon the death of the grantor, but does not result in estate or gift tax benefits. There is a perception that the grantor trust permits the avoidance of probate proceedings, saves expenses and facilitates property transfers. However, these benefits may not actually materialize.[15] At a minimum, the grantor trust may be used to administer assets where the grantor becomes disabled or incapacitated. Because revocable grantor trusts are often used as a Will substitutes, they are generally governed by the law of the grantor's domicile. As a result, there can be significant differences between revocable grantor trusts governed by New York law and those governed by the laws of other jurisdictions, such as California and other community property states, where the common practice is to have joint revocable trusts by spouses. This can greatly increase the complexity of the trust agreement. Often the dispositive provisions, and which spouse has authority to act with respect to revoking and amending the trust and withdrawing assets, may turn upon the classification of whether the apartment is community property. These issues must be dealt with when the apartment is sought to be transferred to or purchased by a trust, so that the cooperative corporation knows who has authority to act at any given time. The best way to handle such matters is to obtain a legal opinion letter addressing these issues from counsel to the Trustees admitted to practice in the state whose law governs the trust agreement.

In the case of the grantor trust, very little is likely to change in the occupancy of the cooperative apartment during the grantor's life. The grantor will continue to be the primary occupant and will not be obliged to pay rent to the trust, which often is necessary in the case of other types of trust vehicles where the grantor is attempting to achieve gift and estate tax savings. As a result, the concerns raised for a cooperative housing corporation by the grantor trust and the QPRT are somewhat different. For example, in the case of a QPRT, the grantor is likely to be alive at the termination of the trust, giving rise to issues of occupancy and control of the cooperative apartment. Further, virtually the only asset in a QPRT will be the cooperative apartment, while a grantor trust is usually funded with other assets. Despite these differences, the documentation recommended to allay the corporation's concerns raised by the grantor trust, the QPRT and most other common types of trusts are similar. In a transfer to a grantor trust, as with any transfer of a cooperative apartment to a non-individual, occupancy of the apartment should be controlled by an occupancy agreement. The occupancy agreement should also have the grantor of the trust, the Trustees and current beneficiaries confirm that no further transfer of the apartment from the trust, either during the grantor's lifetime or after his or her death will be permitted without board approval, even if the trust provides for the transfer to a named beneficiary of the trust. A personal guaranty by the grantor is advisable as a secondary source of funds for payment of maintenance and other charges, should the trustees fail to pay the same. Finally, the attorney opinion letter discussed below should be obtained.

QPRTs

The QPRT is a potentially effective estate planning device for an individual who owns a valuable residence. Final Treasury Regulations[16] setting out the requirements for this form of trust were issued in 1992. A QPRT is a form of trust which can be used to remove a residence from an individual's gross estate while making a taxable gift valued below that of the present market value of the residence. The residence may be a fee interest in a house, a condominium or a cooperative apartment, but it must be a personal residence of the grantor as defined in the applicable Treasury Regulations.

The QPRT plan generally works as follows: An individual transfers a personal residence into an irrevocable QPRT, retaining the right to use the residence for a fixed term, for example five years. The QPRT provides that upon the expiration of the term, the residence is to pass to designated beneficiaries or to a follow-on trust for such beneficiaries or others. The creation of the QPRT is a completed gift to the beneficiaries, but only in the amount of the current actuarial value of the remainder interest (as reduced by the grantor's contingent reversionary interest should he or she die during the trust term), which passes to the designated beneficiaries upon the expiration of the term for which the grantor has reserved the use of the residence. For example, if an individual 60 years of age transfers a residence worth $1,000,000 to a QPRT in June of 2014, retaining the use of the property for 10 years, the amount of the taxable gift would be approximately $686,880.[17] If the term of the QPRT is extended, the amount of the taxable gift is reduced. On the other hand, if the term is shortened, the amount of the taxable gift would be increased.[18] Note that for the QPRT to achieve estate tax savings, the grantor must survive the fixed term for which he or she retains the right to use the residence. If the grantor dies within the term of the QPRT, the entire QPRT (including the residence) would be includible in his or her taxable estate.

A QPRT is established under a trust agreement which is irrevocable (to accomplish its gift and estate tax objectives), although some QPRTs may grant the trustees a limited power to amend the QPRT to comply with requirements of the tax laws, as they may be amended. The QPRT is a form of grantor retained income trust, commonly referred to in estate planning circles by the acronym "GRIT." Thus, some of the transmittal documents provided to the cooperative housing corporation by the shareholder making the request to transfer a cooperative apartment may refer to the trust as a "GRIT." In almost all cases, however, the trust agreement is likely to make a reference to a "QPRT." Although most of the requests that cooperative housing corporations are likely to receive will involve a QPRT, not all GRITs are QPRTs. In certain limited circumstances, it is possible that the request will be to transfer an apartment to a GRIT which is not in the QPRT format. It should also be noted that while a QPRT may be a "grantor trust" for *income tax purposes* for a certain period of time, depending upon how the trust instrument is drafted, its provisions will be substantially different from the revocable form of grantor trusts discussed above.

In order to achieve its estate planning objectives, each QPRT must be drafted to comply with the requirements imposed by Treasury Regulations. These require certain language to be incorporated in the trust agreement. Some issues to be considered by a cooperative housing corporation board in reviewing trust transfer requests are set forth below.

1. The grantor (i.e., the shareholder) will reserve the right to use the apartment for a fixed term of years. Although the QPRT trust agreement may restrict occupancy to the grantor during the term for which he or she has reserved the use of the apartment, boards nevertheless should have an occupancy agreement executed by the grantor individually and the Trustees of the trust, confirming that the grantor and the grantor's immediate family will be the sole occupants of the apartment throughout the term of the trust.
2. The trust agreement should preclude the Trustees from holding assets other than the subject cooperative apartment and sufficient cash to meet six months of expenses for the apartment. While the trust agreement may permit the infusion of cash from time to time to cover six months of expenses, generally there will be no requirement that such moneys be added to the trust. Although not mandatory under the Treasury Regulations, many QPRTs may impose upon the grantor the obligation to meet all expenses relating to the apartment, such as maintenance and assessment charges due pursuant to the proprietary lease, and insurance premium costs. The fact that the residence is subject to a mortgage does not jeopardize the trust's status as a QPRT under the Treasury Regulations, but may impact the size of the initial taxable gift and have further gift tax implications when mortgage payments are made, depending upon whether the debt is recourse or nonrecourse.[19] Thus, in dealing with all QPRTs, it is incumbent on a cooperative housing corporation board to obtain a personal guaranty of the proprietary lease's obligations from the grantor, as there may be nominal funding of the trust other than with the residence itself.
3. As previously noted, the QPRT Trust Agreement must contain a provision precluding the sale or transfer of the residence to the grantor, the grantor's spouse

or an entity controlled by the grantor or grantor's spouse during the trust term or at any time thereafter that the trust term is a grantor trust for income tax reporting purposes. This effectively precludes the grantor from swapping out a low basis residence before death in order to achieve a step-up in basis. This limitation does not apply to other forms of planning vehicles, such as dynasty trusts and SLATs, which may therefore be preferable vehicles in the case of low-basis residences.

4. Upon the expiration of the fixed term for which the grantor has reserved the use of the apartment, the trust principal (including the apartment) will pass to designated beneficiaries such as children, other family members or even non-family members. In some cases, the trust agreement will provide that the apartment passes outright to the children or other beneficiaries; in other cases it will provide that it passes into a "follow-on trust" for the particular beneficiaries. For example, it may pass into a combined discretionary trust for the grantor's issue and name a non-family trustee (who is not one of the grantor's issue) as the trustee. Some grantors feel that this gives them greater assurance that their children (or other beneficiaries) will not sell the apartment while they remain in residence and that the trustee will enter into a lease which will permit the grantor to continue to occupy the apartment after the expiration of the fixed term. If the grantor wishes to continue to occupy the apartment following the expiration of the fixed term, he or she will have to lease the apartment from the new owners at a fair market rent to avoid potentially adverse gift and estate tax consequences. This is another reason why it may be preferable for the residence to continue to be held in trust. If the follow-on trust is treated as owned entirely by the grantor for income tax purposes, the grantor should be able to rent the residence from the Trustees without generating taxable income. Regrettably, this important benefit of follow-on trusts which are intentionally income tax defective is frequently missed by less experienced estate planning counsel. As a practical matter, many cooperative housing corporations will insist that during the grantor's lifetime, the residence continue to be held in a follow-on trust for the remainder beneficiaries in order to avoid splintered ownership.

   If a board is willing to consent to the transfer of an apartment into a QPRT, it also must decide whether it is willing at the time of the initial application to consent to the subsequent transfer of the apartment to the grantor's children (or other beneficiaries) at the expiration of the fixed term. If a board is reluctant to pre-approve the transfer to the children (or other beneficiaries) as owners, it could limit its approval to the initial transfer of the apartment into the QPRT. While this may not fully accommodate the grantor's wishes, because the grantor may wish to continue to occupy the apartment at the expiration of the fixed term by entering into a lease or similar arrangement with his or her children (or other beneficiaries) who will then become the new owners, such board preapproval is rarely, if ever, given, although this is entirely a policy decision to be made by the board. A compromise might be to allow occupancy by the grantor but permit other occupancies without a change in ownership, such as permitting occupancy by the immediate family of the grantor who, by virtue of the relevant proprietary lease provisions, may be entitled to occupy an apartment.

   Note that a board's refusal to pre-approve the transfer to the grantor's children (or other beneficiaries) may only delay the issue because, if the grantor survives the term of the QPRT and the apartment is not sold during the term, the board will most likely receive a request at the expiration of the term for approval of the transfer of the apartment to the beneficiaries. The likely board response will be that the apartment should be transferred to a follow-on trust.

   If a board is unwilling to pre-approve the transfer to the grantor's children (or other beneficiaries), it is important that the board obtain a written confirmation from the grantor and the Trustees that the board is only approving the initial transfer of the apartment into the trust and that all further transfers by the Trustees, including those to the beneficiaries upon the expiration of the fixed term or the grantor's prior death, must be approved by the board at such time. It is also recommended that the occupancy agreement contain a general confirmation from the grantor and the Trustees that, in the event of a conflict between the terms of the trust agreement and the corporation's proprietary lease, by-laws, certificate of incorporation or the occupancy agreement, the provisions of the proprietary lease, by-laws, certificate of incorporation and occupancy agreement shall prevail.

5. As noted above, if the grantor does not survive the fixed term, the trust fails as an estate planning device and the trust agreement typically will provide that all of the trust assets (including the apartment) are to be distributed upon the grantor's death as the grantor may appoint pursuant to a testamentary power of appointment, to the executors of the grantor's estate or perhaps to designated beneficiaries. This should not present a problem for the cooperative housing corporation because it is no different than if the grantor owned the apartment individually at the time of death and disposed of it under

the terms of a will. In both cases, all transfers following the death of the shareholder would require board approval pursuant to the proprietary lease.

6. There will be extensive provisions in the trust agreement which deal with the possibility that the trust could cease to be a QPRT, within the meaning of the Treasury Regulations. In general terms, this could happen if the apartment ceases to be used or held for use by the grantor as a personal residence, if the apartment is sold and a new residence is not purchased within a two-year period or the apartment is destroyed and the proceeds of insurance are received and not used to purchase or construct a new apartment within two years after the date of receipt of such proceeds. In such events, the trust agreement must provide that, within 30 days after the date on which the trust has ceased to be a QPRT, either (a) the trust be terminated and the assets (i.e., the apartment) be distributed to the grantor, (b) the trust be converted to a qualified annuity trust pursuant to which the grantor is entitled to receive a qualified annuity interest (as defined by the applicable Treasury Regulations) or (c) the trustees be given the option of complying with either (a) or (b). These provisions will appear in all QPRTs, as they are required by Treasury Regulations. However, these provisions should not to be of concern to a board because the events which trigger them, such as the sale of the apartment or the rental of the apartment so that it ceases to be a personal residence of the grantor, would require board approval in the ordinary course.

7. As in the case of all proposed transfers of a cooperative apartment to a trust, it is advisable to obtain an opinion from the grantor's counsel, admitted to practice in the state the laws of which govern the trust, addressed to the co-op, to the effect that: (a) the copy of the trust agreement furnished to the co-op is a true and correct copy; (b) there have been no amendments to the trust agreement; (c) the trust is a valid and existing trust under the law of the particular state cited in the trust agreement; (d) the trustees named in the trust agreement are the current trustees of the trust; (e) these individuals, in their capacities as trustees, have full authority to execute the proprietary lease and assume all of the obligations thereunder, and to execute the occupancy agreement and letter agreement described above; and (f) the obligations under the proprietary lease which are being assumed by the trustees will be binding upon any successor trustees.

Spousal Lifetime Access Trusts

With the dramatic increase in the gift tax exemption to $5 million on January 1, 2011 (currently $5,340,000 with inflation indexing) and the threat that the gift tax exemption could dramatically recalibrate to $1 million on January 1, 2013, came the emergence of the spousal lifetime access trust. For those individuals who were not comfortable with limiting their access to gifted property, such as a residence, they could have access through the "back door" by making their spouse a beneficiary of the trust. This type of trust has now become fairly commonplace and is known as a spousal lifetime access trust or "SLAT." In many cases, the spouse will be a discretionary beneficiary as to both income and principal and there may be other current beneficiaries, such as children and more remote descendants.

In addition to the donor-spouse having indirect access to the use of the residence, there are other features which may make the SLAT a much more efficient planning vehicle than a QPRT. If the beneficiary-spouse is permitted to occupy the residence either because she has a mandatory income interest or because the Trustee simply exercises his or her discretion to permit such occupancy, it is fairly well settled that the donor-spouse can continue to occupy the residence with the beneficiary-spouse without triggering inclusion of the residence in the donor-spouse's gross estate, which would ordinarily occur under Section 2036 of the Internal Revenue Code, because of the retention of beneficial enjoyment. Instead, the co-occupancy of the residence by the donor-spouse is considered to be a natural aspect of the marital relationship.[20] For those individuals who do not relish the idea of having to pay a fair market rent to continue to occupy their apartment after completing a gift transfer, the SLAT may be the perfect solution. On the other hand, individuals who are more focused on maximizing the tax benefits of their plan will perceive the payment of rent as a way of making an additional tax free gift to the trust. Of course, the affordability of paying a fair market rent, which can be quite substantial in New York City, will be a factor to consider. If the Trustee rents the apartment to the donor-spouse for fair market rent, the rent will not be a taxable transaction because of the grantor trust status of the trust, and will enhance the benefits to the intended beneficiaries of the trust who may be children or more remote descendants. Another reason why a SLAT may be superior to a QPRT is that there is nothing to preclude the grantor from purchasing a low-basis residence from the trust during his or her lifetime in order to achieve a step-up in basis at death. QPRTs also have the mortality risk of the grantor dying during the initial term resulting in the inclusion of the residence in the grantor's gross estate, which does not exist with a SLAT. As previously mentioned, QPRTs are not as desirable in extremely low interest rate environments but this may change if interest rates rise. Finally, there is no bar to the grantor allocating GST exemption upon the creation of a SLAT as there is with a QPRT. It should be noted that one disadvantage of a SLAT, compared to other types of trusts to which gifts of a residence may be made such as a dynasty trust, is that it is generally not eligible for gift splitting.

A word of caution. While it is possible for spouses to create residential (or financial) SLATs for each other, care must be taken not to run afoul of the reciprocal trust doctrine. While a full discussion of this issue is beyond the scope of this article, it suffices to say that if the trusts which the spouses create for each other are so similar that the trusts leave each spouse in the same economic position, each spouse may be treated as having created the trust for his or her own benefit resulting in estate tax inclusion. There are ways to stay clear of this hazard, such as by creating the trusts at different times, designating different Trustees, giving the spouses different beneficial interests and most importantly, in the case of residential SLATs, by perhaps gifting interests in different residences. Unfortunately, in the race to consummate planning before December 31, 2012, less care may have been taken by some practitioners than ordinarily would be to avoid the application of the reciprocal trust doctrine and / the step transaction doctrine. Taking an apartment which is owned by a couple as tenancy by the entirety and dividing it into tenancy in common moments before creating reciprocal looking SLATs for each other may prove hazardous. In some egregious cases, one spouse hurriedly transferred ownership to his or her spouse who then created a trust for the original owner spouse. It remains to be seen how all of this will turn out. As discussed above, for some cooperative housing corporations, transfers creating divided ownership would not be permitted in any event.

Dynasty Trusts

These are trusts which are designed to be exempt from the generation-skipping tax for the maximum period permitted under the rule against perpetuities of the governing law jurisdiction or indefinitely (for now)[21] if the jurisdiction has abolished the rule against perpetuities. Dynasty trusts are generally created for children and more remote descendants and are intended to span several generations. There are many different varieties. Some will include a spouse as a discretionary beneficiary to have access indirectly to the residence gifted by the donor-spouse as described in our discussion about SLATs. Many of these trusts will be intentionally defective for income tax purposes. This is an important consideration. In addition to the perceived benefit of the grantor sparing the trust and its beneficiaries from income taxes during the grantor's life, this may be essential if the grantor is required to pay a fair market rent in order to prevent the inclusion of the residence in his or her estate for estate tax purposes. By having the grantor treated as the owner of both the income and principal of the trust, there will be no tax consequence to the grantor paying rent. Typically, the plan will be for the grantor to allocate GST exemption up front upon the creation of the trust on a timely filed gift tax return to insulate the residence and other trust assets, and their appreciation from the GST tax, throughout the term of the trust.

Many individuals who feel uncomfortable gifting financial assets in the range of $5 million to children and more remote descendants may find it far more acceptable to gift a residence or fractional interest in a residence to a dynasty trust, particularly if the spouse is a beneficiary.

For more sophisticated plans, the grantor may wish to gift a fractional interest in the residence in order to claim valuation discounts. The cooperative corporation's tolerance for divided ownership will vary from board to board. Most boards will permit such ownership as long as there is a commitment that all future transfers of these interests are transferred as a unity and are subject to board approval at such time. However, as discussed above, some boards simply will not permit divided ownership. The obvious benefit of gifting a fractional interest is to claim a tenancy-in-common discount and to leverage the use of the donor's gift and GST exemptions. From time to time, individuals also will request permission to transfer a partial interest in an apartment to a QPRT or other trust vehicle to achieve similar discounts.

For even more sophisticated plans, from time to time a cooperative corporation will receive a request for permission to *sell* an apartment to an existing family trust—almost certainly a trust which is intentionally income tax defective. Under those scenarios, it will be necessary to review the cooperative corporation's operative documents to determine whether a flip tax or other charges will be imposed. It also would be prudent for counsel for the Trustees to determine whether there are any real estate transfer taxes which will be imposed in the case of a sale but that would not apply in a gift transaction. A sale is likely to be considered where the donor has previously exhausted the use of his or her gift and / or GST exemptions and wishes to leverage the exemptions by selling an interest (perhaps a fractional interest) in the residence to an existing trust. Another word of caution in structuring such sales—the general rule of thumb is that for the transaction to be respected as a sale by the taxing authorities there must be at least a 10% debt / equivalent ratio.

Testamentary Trusts and Trusts Created by Third Parties

In addition to what have become routine requests for transfers to grantor trusts, QPRTs, SLATs and Dynasty Trusts, from time to time a cooperative housing corporation may receive a request for a transfer to a trust created under the Will of a deceased shareholder, or a request for a transfer to, or a purchase by, an existing trust established by a party other than the intended resident. Generally, if the board's policy permits non-individual shareholders such as trusts to own an apartment, the proposed transferee should be reviewed by the board as it would review an individual transferee, including a review of financial stability. The trust instrument should be reviewed for troublesome issues, such as spendthrift provisions discussed below. Documentation similar to that recommended for other trusts previously discussed should be obtained.

Spendthrift Provisions

While each trust instrument must be examined for problematic provisions, one particular trust provision that boards should be aware of is a "spendthrift" provision which purports to protect the assets of the trust from the creditors of the beneficiary and / or grantor. If a spendthrift provision is valid in the jurisdiction governing the trust, it might preclude a cooperative housing corporation from seeking satisfaction of claims that it may have against the grantor of the trust (or any other beneficiary of the trust) out of the trust assets, such as claims arising out of a personal guaranty of the proprietary lease obligations. Spendthrift provisions are most common and most troublesome in the case of grantor trusts, because it is likely that the grantor will have transferred substantially all, or at least a significant portion, of his or her assets into the trust. However, in many jurisdictions, including New York, a spendthrift provision in a grantor trust would not be binding against the grantor's creditors.[22]

Regardless of whether, as a matter of law, a spendthrift provision is binding against the grantor's creditors, a board should be wary of permitting the transfer of an apartment to a trust which provides on its face that the shares and proprietary lease (as well as all other assets of the shareholder placed in the trust) would be beyond its reach should it seek to execute a judgment against the grantor or other beneficiaries, as the corporation would be on notice of the existence of these provisions. To alleviate the concerns raised by the presence of a spendthrift provision, it is recommended that either (1) the trust agreement be amended in such a manner as to confirm that the spendthrift provisions shall be of no force or effect against the corporation, and that any claim that it may have against the grantor, individually, or in his or her capacity as trustee, or against any other trustee, including but not limited to claims arising out of a default under the proprietary lease, may be asserted against and satisfied out of the trust assets; or (2) the attorney's opinion letter referred to above include a confirmation of the same. An amendment to the trust agreement would appear to be preferable as it would afford the corporation the greatest protection and should be obtainable in the case of an amendable grantor trust. While amending a QPRT may be problematic, the spendthrift issue arises less frequently in QPRTs because the transfer of a cooperative apartment will be the sole reason for the QPRT and board approval will invariably be sought before the QPRT is created. Thus, any spendthrift provision can be deleted or revised at the drafting stage.

Conclusion

There appears to be no legally well-founded reason for a cooperative housing corporation's board to reject proposed transfers to most trusts which are created for routine estate planning purposes such as grantor trusts, QPRTs, dynasty trusts, SLATs, testamentary trusts or third-party trusts, provided that the particular trust instrument does not contain problematic provisions, appropriate collateral documentation (an occupancy agreement and financial guarantees) is obtained and the particular circumstances surrounding the proposed transfer do not otherwise raise independent concerns. The corporation can be adequately protected and most shareholder requests are motivated by a reasonable desire to facilitate estate planning.

Such transfers provide a substantial benefit to such shareholders. For example, what could be a more compelling set of circumstances than to permit the transfer of an apartment to a credit shelter trust under a Will for the benefit of a surviving spouse and / or other family members, when there are otherwise inadequate assets to fund such trust? Another appealing circumstance is where a request is made for the purchase of an apartment by a trust for the primary benefit of the intended resident which was created by a third party, such as a parent or grandparent. The trust (which is the proposed purchaser) may enjoy a tax-favored status, such as being exempt from the generation-skipping tax and insulated from estate tax on the death of the beneficiary, which benefits the shareholder's family.

Occasionally, a trust transfer request may be made for permission to transfer a cooperative apartment to an asset protection trust where one of the objectives is to place the trust assets (including the cooperative apartment) beyond the reach of the grantor's creditors. Such requests pose entirely different issues, ones which are beyond the scope of this article and should be reviewed with great caution by counsel to the board.

Sometimes, a board's refusal to consent to an estate-planning based trust transfer request may be due to its lack of familiarity with the various forms of trusts and how readily the corporation can be insulated from any financial or other risk that may arguably be posed by trust ownership. As the desirability of trust ownership of residences becomes more commonplace in estate plans, both for tax and non-tax reasons, and cooperative apartments increasingly represent a significant asset of shareholders' estates, we urge boards to consider transfer requests with an open mind. Although few in number, there are some buildings which still have an absolute policy against permitting trust ownership of apartments.[23] We encourage such boards to review their policy for the benefit of their shareholders.

In the end, the decision to permit a trust (or other non-natural person) to own cooperative apartments is a policy decision for boards. Some boards have determined that non-individual ownership of apartments is inconsistent with the basic cooperative housing principle of owner-occupancy.[24] Most proprietary leases are drafted presuming that a natural person is the lessee. Thus, they include provisions which do not make sense for non-individual ownership. For example, most proprietary leases restrict occupancy to the named lessee and his or her family; obviously, a trust lessee can have no family. Further, the corporation is arguably at greater risk of disputes when actual ownership and beneficial ownership are divided as between a trust, its trustees, its grantor and its beneficiaries. These concerns can be alleviated by the documentation we have discussed above. While the question may arise as to whether this documentation, which arguably modifies certain terms of a proprietary lease relating to occupancy and transfers, constitutes an amendment of the proprietary lease which is invalid without shareholder approval, no case law offers guidance on this issue. However, the board's absolute right to withhold consent from a proposed transfer—to a trust or otherwise—for any reason or for no reason likely implies the right to also impose conditions—such as an occupancy agreement and the like—to a trust transfer.

Boards of cooperative housing corporations, with the advice of counsel, should carefully consider all aspects of trust ownership and formulate a policy which is acceptable and appropriate for the building, balancing the accommodation of shareholders and the duty to serve the entity as a whole. In our experience, which has spanned over 30 years with approximately 200 buildings which have addressed this based on our advice, most buildings have permitted trust transfers. Importantly, those cooperatives that have allowed trust transfers to date have not, to our knowledge, encountered any problems resulting from trust ownership.

To ensure compliance with requirements imposed by the United States Treasury Department in Circular 230, we inform you that any tax advice contained in this article is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Endnotes

1. Richard Siegler & Anita Rosenbloom, *Cooperatives, Condominiums: Ownership by Trust*, NYSBA Trusts and Estates Law Section Newsletter, Spring 1994; Richard Siegler & Anita Rosenbloom, *Housing Cooperatives: Ownership by Trusts*, NYSBA N.Y. Real Property Law Journal, Spring 2002, Vol. 30, No. 2.
2. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA), P.L. 107-16 (2001).
3. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act of 2010), P.L. 111-312.
4. The American Taxpayer Relief Act of 2012, Pub. L. No 112-240 (2012).
5. New York Real Property Tax Law § 467-a; Laws of New York 2013, Chapter 4. Available at: http://public.leginfo.state.ny.us under the hyperlink for Chapters. (last visited 10/15/2013); NYC Dept. of Finance Cooperative and Condominium Tax Abatement page available at: http://www.nyc.gov/html/dof/html/property/coop_condo_abatement.shtml; NYC Finance Cooperative/Condominium Tax Abatement Fact Sheet available at: http://www.nyc.gov/html/dof/downloads/pdf/faq/coop_condo_tax_abatement_faq.pdf (last visited 10/15/2013).
6. I.R.C. § 1015(d).
7. For trusts created prior to May 16, 1996, it was possible through a clever maneuver to shield the remainderman from the gain by having the grantor reacquire the residence from the QPRT just prior to expiration of the grantor's retained term. Under this "bait and switch" technique, the remainderman would receive cash or other assets. Further, if the grantor retained the residence until death, its basis would be stepped-up. The Internal Revenue Service responded by issuing Treasury Regulations, effective for trusts created after May 16, 1996, requiring that, in order to qualify as a QPRT, the trust instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse or an entity controlled by the grantor or the grantor's spouse. Treas. Reg. § 25.2702-5(c)(9).
8. L. 2014, ch 59, part x. The New York estate tax exemption amounts are as follows:

Date of Death	Exemption Amount
April 1, 2014 to March 31, 2015	$2,062,500
April 1, 2015 to March 31, 2016	$3,125,000
April 1, 2016 to March 31, 2017	$4,187,500
April 1, 2017 to December 31, 2018	$5,250,000

Starting January 1, 2019, the New York estate tax exemption will be indexed for inflation from 2010, which will bring it up to the Federal amount in effect in 2019.

9. I.R.C. §§ 2036, 2038.
10. Treas. Reg. § 25-2702-5(b)(1) and § 25.2702-5(c)(9).
11. I.R.C. § 2642(f).
12. I.R.C. § 2036(a)(1).
13. The Tax Reform Act of 1986 amended I.R.C. § 216 to include in the definition of "tenant-stockholder," non-natural persons, including trusts, owning co-op shares," so that trust ownership of a cooperative apartment does not impair the corporation's tax status and its ability to pass-through to its shareholders their pro rata share of the mortgage interest and real estate taxes paid by the corporation. Richard Siegler, *Impact of Tax Reform on Co-op Housing*, N.Y.L.J., March 4, 1987, p. 1, col. 1.
14. Note that for various reasons, trusts are established under the laws of different states; just because the cooperative apartment is located in New York does not mean that the trust will be governed by New York law.
15. *See Should I Create a Revocable Inter Vivos Trust*?, 63 N.Y. St. B.J. 48 (Dec. 1991); *Revocable Trusts—A Contrarian's Viewpoint*, 68 N.Y. St. B.J. 34 (Feb. 1996).
16. Treas. Reg. § 25.2702-5(c).
17. If the transfer is made after June 2014, the figures may vary. This is because the interest rate upon which the Internal Revenue Service's valuation tables are based fluctuate from month to month. The interest rate is equal to 120 percent of the average yield on Treasury obligations with maturities between three and nine years. This example further assumes that the grantor has reserved a contingent reversionary interest in the QPRT instrument providing that, if the grantor fails to survive the trust term, the residence will pass to his estate or as he may appoint by a general testamentary power of appointment. The value of the grantor's contingent reversionary interest reduces the value of the gift.
18. The amount of the taxable gift turns on five factors: (1) the interest rate used by the Internal Revenue Service in its valuation tables, (2) the value of the residence on the date of the gift, (3) the grantor's age, (4) the length of the trust term and (5) whether the grantor has reserved a contingent reversionary interest.
19. Treas. Reg. § 25.2702-5(c)(2)(ii). Note that shareholders with loans must generally obtain their lender's consent to a transfer to a trust.
20. *Gutchess v. Comm'r*, 46 TC 554 (1966), Acq, 1967-2 C.B. 1; *Union Planters National Bank, Executor v. U.S.*, 361 F.2d 662 (6th Cir. 1966). *See also*, Revenue Ruling 70-155; PLR 9735035; PLR 9827037; PLR 200240020.
21. Since the release of the 2011 Greenbook, the Obama administration has proposed limiting the term that a trust could be exempt from the generation-skipping tax to 90 years.
22. EPTL 7-3.1.
23. In the event that the cooperative housing corporation refuses to consent to the proposed transfer to a QPRT, the IRS has confirmed that it nevertheless may recognize the transfer for transfer tax purposes. PLR 9447036 (Aug. 29,

1994); PLR 9433016 (May 18,1994); PLR 9249014 (Sept. 4, 1992). In those cases, after the board disapproved the request for transfer to the QPRTs, the donor assigned beneficial title to the cooperative apartment's shares and the proprietary lease to the QPRT and undertook as nominee to hold legal title for the QPRT. We would not recommend this course of action as it would be a default under the proprietary lease.

24. Many proprietary leases provide that board consent is not required for a transfer of an apartment to the spouse of the shareholder and / or that board consent to a transfer to a financially responsible member of the shareholder's family may not unreasonably be withheld. This raises the issue of whether a transfer to or by a trust for the benefit of a grantor's spouse or other family member should be subject to the same relaxed consent provisions. In addition, most proprietary lease provisions imposing a flip tax are triggered by a sale and payment of consideration and do not expressly cover a gift transfer to a trust. Therefore, each flip tax provision should be reviewed. If a board wishes to amend the proprietary lease to impose a fee upon trust transfers, this generally requires shareholder approval by a super-majority (66%) of the outstanding shares.

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Bergman on Mortgage Foreclosures: Does the Conference Mandate Apply to *All* Residential Property?

By Bruce J. Bergman

The short answer to the question raised by the title of this piece is "no." A recent case confirms this concept, but merits further comment here. [*Independence Bank v. Valentine*, 113 A.D.3d 62, 976 N.Y.S.2d 504 (2d Dept. 2013)].

The focus of the issue is differentiating between a commercial case and what is denominated a home loan foreclosure. That should not be so obscure but tends nonetheless to be a contentious point.

In particular, the facts here involved a not uncommon commercial loan transaction. This is a typical scenario: the borrower is a corporation or an LLC, obtaining a loan for some business purpose. Owning no real estate to pledge (or owning real estate of insufficient value) the lender requires a guaranty (usually from the principal of the borrower entity) with that guaranty then secured by the pledge of the principal's home. (It could be other property, of course, but most often with smaller corporations the officer's only real property asset is the home.)

So when there is a default and a foreclosure is begun, does the usual requirement to conduct a settlement conference (a very time consuming process) apply? The decision here confirmed the rule in the negative, something well understood by mortgage servicers' attorneys, but often ignored or disputed by borrowers' counsel.

The answer comes from the statutory requirement for the conference which in turn refers to the foreclosure statute for the definition of a home loan. The conference imperative originates in CPLR §3408. This requires a settlement conference to be conducted in "any residential foreclosure action involving a home loan as defined by RPAPL 1304 and where the defendant resides at the property." Especially because the foreclosure statute—RPAPL Article 13—refers also to "residential property," being precise about the definition of a home loan is widely important. Per RPAPL 1304(b), this is a home loan, inclusive of an open-end credit plan, but not encompassing a reverse mortgage where:

- The principal amount at inception did not exceed the conforming loan size established by Fannie Mae for a comparable dwelling; and
- The borrower is a natural person; and
- The debt is incurred—by the borrower—and primarily for personal, family or household purposes; and
- The loan is secured by a mortgage whereupon is presently located, or in the future will be located, a structure intended principally to be used as a one-to-four family residence and which is or will be occupied by the borrower as his principal dwelling.

Here, the actual borrower was a corporation which obviously was not a natural person. (The owner of the home was a guarantor, not a borrower.) Moreover, the purpose of the loan was for business (purchase of equipment to set up a store) and therefore this other branch of the definition of home loan was not met either. Perhaps not surprisingly, counsel for the owner fought for the conference, the definition of a home loan notwithstanding. The court, however, confronted the issue directly and lucidly ruled accordingly.

In sum, while the conference obligation applies to many residential foreclosures, it does not apply to *every* residential foreclosure. It therefore never applies to a commercial case, nor does it apply to this type of commercial case even though the property mortgaged is ultimately a home.

All of this is good to know for lenders and servicers involved with commercial loans. But it also underscores the continued tribulation that lenders and servicers suffer in New York. Their merits aside, the host of borrower oriented statutes passed in recent years have, in many instances, created traps for the foreclosing plaintiff which either slow up the process or defeat it. Here, both the trial court judge and the appellate division were correct and the lender was victorious. But as is commonplace in foreclosures, the action was delayed and the lender had to suffer the time and expense of the appeal process to be vindicated on an issue which should not be recondite but rather should be well understood and accepted. This has been and may continue to be an ongoing problem.

Mr. Bergman, author of the four-volume treatise, *Bergman on New York Mortgage Foreclosures*, LexisNexis Matthew Bender, is a member of Berkman, Henoch, Peterson, Peddy & Fenchel, P.C. in Garden City. He is a fellow of the American College of Mortgage Attorneys and a member of the American College of Real Estate Lawyers and the USFN. His biography appears in *Who's Who in American Law* and he is listed in *Best Lawyers in America* and *New York Super Lawyers*.

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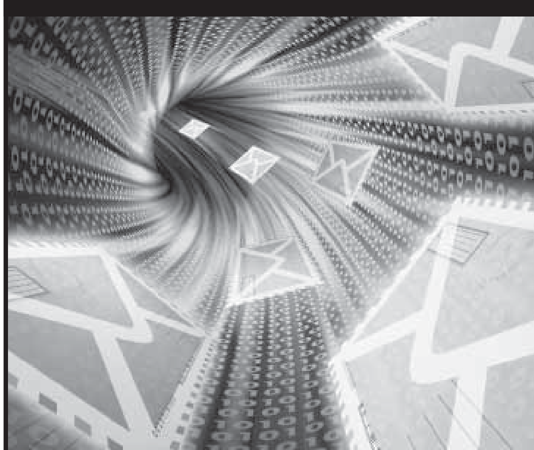

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