

NOTE FROM THE REAL ESTATE GROUP

REAL ESTATE TRANSFER TAX LIABILITY UPON THE INFUSION OF NEW EQUITY

As a consequence of the decline in commercial real estate valuations and the limited availability of real estate debt financing, property owners increasingly are obtaining necessary capital (whether to refinance existing indebtedness, to fund operating shortfalls or capital improvements, or otherwise) from new equity investors with a corresponding transfer (or deemed transfer) of an interest in the real estate owning company.

In the State of New York, a transfer or acquisition, directly or indirectly, of an interest in an entity that owns real estate may trigger real estate transfer tax liability. Given the nuances under the applicable rules and regulations, a transfer or acquisition of such an interest could give rise unexpectedly to transfer tax liability, which liability, particularly if the property is located in New York City, can be significant.

Summary of the Applicable Laws

Article 31 of the New York State Tax Law imposes a real estate transfer tax (the “State Transfer Tax”) on each conveyance of real property or interest in real property if the consideration exceeds \$500, with the tax being computed at the rate of \$2.00 for each \$500 of consideration (or a fractional part thereof). Similarly, Title 11, Chapter 21 of the City’s Administrative Code imposes a real property transfer tax (the “City Transfer Tax”) on each conveyance of real property or interest in real property if the consideration exceeds \$25,000, with the tax rate for commercial property being 1.425% (where the consideration is \$500,000 or less) and 2.625% (where the consideration is above \$500,000).

Among the types of conveyances that are subject to State Transfer Tax and City Transfer Tax, are the transfer or acquisition of a “controlling interest” in a partnership, corporation or other entity owning an interest in real property. Under the applicable rules and regulations, “controlling interest” means (i) in the case of a corporation, either 50% or more of the total combined voting power of all classes of stock of the corporation, or 50% or more of the capital, profits or beneficial interests in the stock of the corporation, and (ii) in the case of a partnership, association, trust or other entity, 50% or more of the capital, profits or beneficial interest in the partnership, association, trust or other entity.

The applicable rules and regulations provide that a transfer or acquisition of a controlling interest will be deemed to have occurred when a person, or a group of persons acting in concert, transfer or acquire a controlling interest, in the aggregate, through one transaction or separate transactions occurring within a three-year period (or longer, if the transfers are being made pursuant to a plan to avoid payment of tax). In the event a transfer or acquisition of a controlling interest is deemed to have occurred, consideration

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for the purposes of calculating State Transfer Tax and City Transfer Tax generally means the *gross* fair market value of the real property (i.e., mortgage indebtedness may not be deducted in calculating fair market value), apportioned based on the percentage of ownership interest transferred or acquired in the real estate owning entity.

The following is a straightforward illustration of the application of these rules:

Owner LLC holds title to an office building in New York City with a current market value of \$20 million, which is encumbered by a mortgage loan with an outstanding balance of \$18 million. The mortgage loan is about to, or has, become due and the refinancing of such mortgage loan with new mortgage financing is not an available option in the market (or is not available on economically viable terms). So Owner LLC, in connection with refinancing the existing mortgage debt, obtains a \$3 million equity investment from Equity Investor in exchange for a 60% equity interest in Owner LLC and simultaneously obtains a new mortgage loan in the amount of \$15 million (with the existing mortgage loan being satisfied out of proceeds of such equity investment and new mortgage loan). A transfer (and acquisition) of a controlling interest has occurred and transfer taxes are due. For purposes of calculating transfer taxes, consideration is \$12 million (\$20 million fair market value x 60% ownership transferred), and State Transfer Taxes in the amount of \$48,000 ($\$12 \text{ million} \div 500 \times \2.00) and City Transfer Taxes in the amount of \$315,000 ($\$12 \text{ million} \times 2.625\%$) are due.

Set forth below is a general description of two recent transactions our clients proposed entering into, where, although it may not have been readily apparent, transfer tax liability would have been incurred by reason of the transfer or acquisition of a controlling interest. Accordingly, such exposure needed to be addressed in connection with the structuring and negotiation of the economic terms of these transactions.

Acquisition of 50% or More of the Capital Accounts

In connection with a stalled mixed-use development, our client proposed making an equity investment in the property owning entity in order to fund completion of construction, pursuant to which our client (“equity provider”) would receive a return of its entire equity investment (with an interest factor thereon) on a senior priority basis¹. Pursuant to the proposed deal terms, following the equity provider’s receipt of such return, and the subordinate return to the existing developing partner of its equity contributions thereafter (which contributions exceeded the amount of the equity provider’s investment), any cash flow generated out of the project would be paid 80% to such developing partner and 20% to the equity provider. Many real estate investors may conclude that the developing partner in this transaction will be retaining an 80% economic interest in the property owning entity (and only a 20% economic interest will be transferred to the equity provider), or that their economic interests will be deemed to be in proportion to their respective equity contributions, and therefore (in either case), no transfer taxes should be due. However, due to the deterioration in the real estate market, a sale of the real estate at its fair market value as of the date of the equity provider’s investment would fail to produce distributable proceeds in an amount sufficient to provide the existing developing partner with aggregate distributions in excess of the distributions that would be made to the equity provider. Accordingly, the State and City could take the

¹ i.e., all cash flow generated from the project, whether from ordinary cash flow or capital transactions, after payment of all expenses and mortgage indebtedness then due (and application to reserves), is first distributed to the equity provider in return of its equity investment together with a return thereon at the applicable interest factor.

position that the equity provider has acquired 50% or more of the capital of the property owning entity, notwithstanding that the equity provider has actually contributed less than 50% of the capital to the property owning entity, and therefore, a transfer tax event would occur upon the funding of such equity investment.

Bridge Equity Financing, Followed by Subsequent Additional Equity Financing

In order to allow for the restructuring and extension of an existing mortgage loan encumbering a multi-family and retail development, our client, the existing holder of all of the ownership interests in the property owning company, proposed obtaining equity financing. In connection with such equity financing, less than 50% of the capital, profits and beneficial interests in the property owning company was to be transferred, and accordingly, no transfer taxes would be incurred. As part of this equity financing, our client and the equity provider would agree to a business plan pursuant to which, in order to complete development of the project, it was envisioned that additional equity financing would be subsequently obtained from a third-party equity participant (with such equity participant being admitted as a member and acquiring less than 50% of the capital, profits and beneficial interests in the property owning entity). However, assuming that such subsequent equity financing will be obtained within three years of the equity financing obtained in connection with the restructuring of the existing mortgage loan (as envisioned under the business plan), the transfer of interests made (or deemed to be made, with respect to such subsequent equity financing) by our client in both equity financings could be aggregated for transfer tax purposes, and as so aggregated, constitute a transfer of 50% or more of an interest in the property owning company. Accordingly, a transfer tax liability could be incurred upon such subsequent equity financing.

There are many scenarios where the transfer or acquisition of an interest in an entity that owns real estate may be deemed a transfer or acquisition of a controlling interest, thereby triggering real estate transfer tax liability. In addition, there are potential exemptions and exclusions that may apply, as well as potential ways to structure the transaction to minimize or delay the realization of the tax liability. Accordingly, consultation with an attorney or tax professional, who is well-versed in the transfer tax rules and regulations, in the early stages of the negotiation and structuring of the transaction is strongly recommended in order to address (and potentially minimize or eliminate) the transfer tax risk.

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