

Pillsbury's Distressed Real Estate Task Force Presents:

Real Estate Transfer Tax and Distressed Real Estate:
New York and California

As part of Pillsbury's Swimming Lesson Series - Surviving and Navigating
the Choppy Waters of Distressed Real Estate

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Today's Discussion

1. New York

- Introduction to New York State and New York City Transfer Taxes
- Transfer Taxes on Distressed Transactions
 - Bankruptcy
 - Mortgage Foreclosures
 - Mezzanine Foreclosures
 - Deeds in Lieu of Mortgage Foreclosure
 - Assignments in Lieu of Mezzanine Foreclosure

2. California

- Introduction to California Transfer Taxes
 - Basics
 - Entity Transfers
 - Tax on Consideration Paid
- Transfer Taxes on Distressed Transactions
 - Foreclosure and Deeds in Lieu
 - Mezzanine Foreclosure
 - Bankruptcy

Introduction to NYS and NYC Transfer Taxes - Basics

- Levied by:
 - New York State (“NYS”)
 - Cities and counties within NYS
 - New York City (“NYC”), Most Significant
 - Other jurisdictions with transfer taxes include: City of Mount Vernon, Yonkers, Peekskill, Towns of Warwick and Red Hook, and Suffolk, Columbia, Essex, Tompkins, Erie and Broome Counties.
- Levied on:
 - Transfer of real property (including fee interests and leasehold estates) and
 - Transfers of controlling interests in entities owning real property (directly or indirectly).
- Payable by:
 - The grantor/transferor,
 - Grantees/transferees generally are secondarily liable for payment.
 - If paid by grantee/transferee, the tax may be “grossed-up” to reflect the tax payment as additional consideration.
 - Special rules may allow foreclosing lenders to avoid a “gross-up” for payment of transfer taxes.

Introduction to NYS and NYC Transfer Taxes – Logistical Considerations

- *Local Rules:* Rules governing the imposition of transfer tax and tax rates differ materially among NYS, NYC and other local jurisdictions in NYS that impose the tax.
- *Local Forms:* Each jurisdiction has its own required transfer tax forms, which generally must be prepared and, together with tax payment, filed for recordation or submitted by mail where no recordation is being made. Recordation will not be effected without submission of the requisite forms and payment of tax.
- *Local Audits:* Both NYS and NYC have audit groups tasked with enforcing compliance. Audits can target such matters as a determination by the parties of fair market valuation, whether a transfer of a controlling interest has occurred, or the amount of consideration for the transfer.
- *Penalties:* Significant interest and penalties can be levied on underpayment and failure to pay tax in full when due.

Introduction to NYS and NYC Transfer Taxes – Relevant Exemptions and Reductions

- Exemption from payment of transfer tax is granted to certain categories of transactions and certain categories of transferors or transferees. For example, transfers by or to not-for-profit entities are generally exempt from NYC transfer tax, although not from NYS transfer taxes.
- Special rules in some instances reduce transfer tax to REITs. These rules are not covered in this presentation.

Introduction to NYS and NYC Transfer Taxes – Tax Rates

- Tax is based on a percentage of gross consideration
 - “Consideration” is generally inclusive of liens and encumbrances remaining on the property at the time of conveyance
 - Could include gross up if paid by grantor (see prior slide)
- For Property in NYC:

NYS Rates within NYC:	NYC Rates:
<i>Commercial property including multi-family residential</i>	
If less than \$2MM: \$2.00 per \$500	Consideration up to \$500,000: 1.4625%
If over \$2MM: \$3.25 per \$500 (on full amount)	Consideration over \$500,000: 2.625%
<i>Residential property (1, 2 and 3 family house, individual condominium or cooperative apartment)</i>	
If less than \$3MM: \$2.00 per \$500	Consideration of up to \$500,000: 1%
If over \$3MM: \$3.25 per \$500 (on full amount)	Consideration over \$500,000: 1.425%
“Mansion tax” on personal residences, if consideration is \$1MM or more: 1% to 3.9% of consideration; payable by the grantee	Under appropriate circumstances, surviving liens may be excluded from “consideration”

- For Property outside of NYC:
 - NYS Tax: \$2.00 per \$500 of consideration plus
 - “Mansion Tax” on personal residences, if consideration is \$1MM or more: 1% of consideration; payable by the grantee

Distressed Real Estate and NY Transfer Taxes - Introduction

- NYS and NYC assess transfer tax on mortgage foreclosures, mezzanine loan (UCC) foreclosures and deeds or assignments in lieu of foreclosure, although the applicable NYS and NYC rules differ.
- While tax rates for distressed real estate are the same as for transactions generally, the definition of “consideration” differs from other transactions and between NYS and NYC.
- Since foreclosures and transfers in lieu of foreclosure are typically loss situations, the high cost of transfer taxes is especially painful, and frequently an incentive to a negotiated settlement.
- Occasionally, non-recourse carve-out guaranties require guarantors to indemnify the lender for payment of transfer taxes on foreclosure, which could influence the workout negotiations.
- An assignment for consideration of a bid in a foreclosure sale is a transfer taxable transaction.

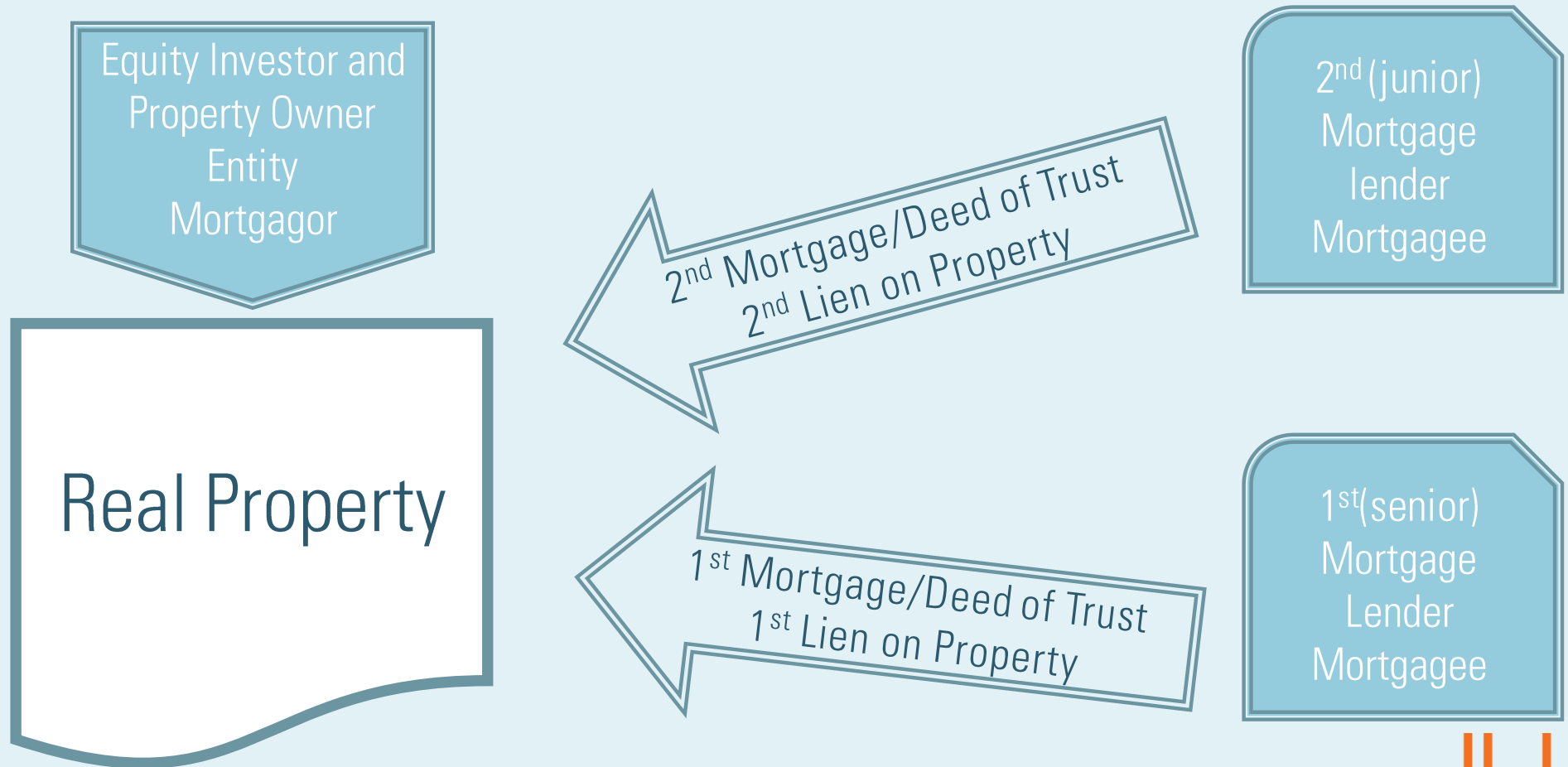
Distressed Real Estate and NY Transfer Taxes - Bankruptcy

- Bankruptcy Sales. Under Bankruptcy Code §1146(a), transfer of property under a confirmed plan of reorganization under Chapter 11 may not be taxed by any law imposing a stamp or similar tax. California, NYS and NYC transfer taxes are generally considered to qualify for this exemption.
- However, the Supreme Court in 2008 ruled that the Code §1146(a) exemption applies only after confirmation of a Bankruptcy plan (the so-called Piccadilly case [*Florida Department of Revenue v. Piccadilly Cafeterias*]). This case overruled prior practice that allowed exemptions in contemplation of a plan but entered into before plan confirmation. Prior to Piccadilly, New York City allowed parties to escrow tax for a foreclosure sale prior to plan confirmation, and a refund of the tax if a confirmed plan subsequently authorized the sale. This exemption is now unavailable.
- New York Tax Law §1405 exempts transfers under Chapter 11 of the Bankruptcy Code from NYS transfer tax. This results in an exemption from NYS (but not from NYC) transfer tax of transfers pursuant to a Bankruptcy Court order under Chapter 11, which is not conditioned on a prior confirmation of a plan of reorganization, thus avoiding the limitations of the Piccadilly case.

Distressed Real Estate and NY Transfer Taxes - Bankruptcy *(cont.)*

- The § 1146(a) exemption does not apply to Chapter 7 proceedings.
- The exemption still has some utility, particularly in prepackaged bankruptcies. Anecdotally, several prepackaged Bankruptcy plans were effected in NYC for substantial properties solely for the transfer tax savings.
- Title companies report transactions in which debtors have tried to extend the scope of this exemption by adopting reorganization plans that attempt to shield post-Bankruptcy transactions from transfer tax under §1146(a). Other plans in connection with foreclosure of a condominium project have attempted to protect subsequent sales by a sponsor from transfer tax. While some of these may have passed muster at the recording office, they are subject to audit. It is uncertain how far a plan of reorganization can exempt a subsequent transfer where the asset is identified but there is no then existing transaction.

Mortgage Structure Chart



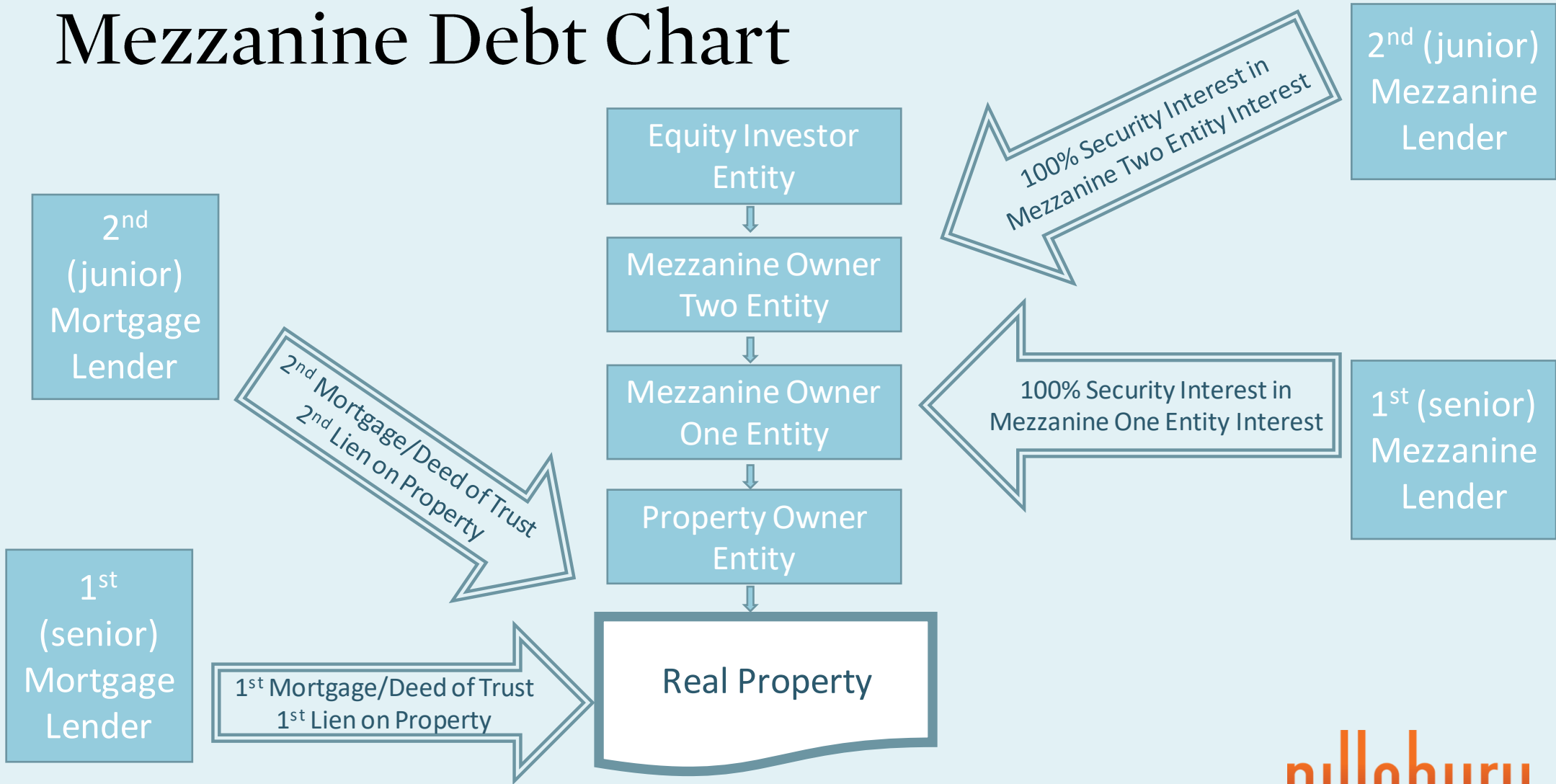
Distressed Real Estate and NY Transfer Taxes - Mortgage Foreclosures

- NYS transfer tax:
 - If the grantee is the mortgagee, its nominee or wholly-owned subsidiary, consideration is the greater of:
 - The bid price plus the amount of surviving liens or encumbrances remaining against the mortgaged property after the foreclosure, whether assumed or taken subject to; or
 - The judgment of foreclosure amount plus the amount of surviving liens or encumbrances remaining against the mortgaged property after the foreclosure, whether assumed or taken subject to.
 - For debt that is fully recourse, consideration is capped at the fair market value of the mortgaged property.
 - If a third party is the grantee, consideration is equal to the bid price plus the amount of surviving liens or encumbrances remaining against the mortgaged property after the foreclosure, whether assumed or taken subject to:

Distressed Real Estate and NY Transfer Taxes - Mortgage Foreclosures (*cont.*)

- NYC transfer tax: In all cases, consideration is equal to the amount bid in the foreclosure sale, senior liens remaining after the sale and certain selling costs paid by the grantee
- Foreclosure and bidding strategy, as a result, is affected by transfer tax consequences. There have also been situations where a lender has made a successful bid, and then subsequently flipped the property to another party. Where closing and recordation has not occurred, this may avoid two levels of transfer tax. Where closing and recordation has occurred, this is much less likely to avoid a second transfer tax payment.
- Another strategy is for the foreclosing lender to cooperate with the borrower and a third party to avoid a foreclosure sale, with the lender agreeing to accept a discounted pay-off of its loan, which avoids the risk of duplicate transfer tax payments. This can result in substantial mortgage recording tax savings by the third party purchaser.

Mezzanine Debt Chart



Distressed Real Estate and NY Transfer Taxes - Mezzanine Foreclosure - Introduction

- NYS and NYC transfer tax are payable upon an indirect transfer of real estate by transfer or acquisition of a “controlling interest”, directly or indirectly, in the property owner. Note that transfers are disregarded to the extent that there is no change in beneficial interest.
- Many, if not most, mezzanine loan foreclosures will effect the transfer of a controlling interest, and therefore generate transfer taxes both at the NYS and NYC levels.
- If less than a controlling interest is transferred, no transfer tax is due. However, in some instances transfers over a 3-year period can be amalgamated for purposes of this test. In many foreclosure circumstances, this amalgamation can be rebutted by showing that the transfers were not related or that the same interest transferred in the first event is transferred in the second event.
- If a controlling interest, but not 100% ownership, is transferred, consideration will be determined by prorating the tax so that only the percentage of the ownership interest transferred is considered. With a complex capital stack, this calculation may not be simple, and the taxpayers’ determinations of value are subject to audit.

Distressed Real Estate and NY Transfer Taxes - Mezzanine Foreclosure - NYS

- A “controlling interest” means, (i) as to a corporation, 50% or more of total combined voting power or 50% or more of capital, profits or beneficial interest, or (ii) for other entities (including partnerships and LLC’s), 50% or more of capital, profits or beneficial interest.
- Taxable “consideration” is not as easily determined as with mortgage foreclosure. This is particularly true if less than 100% of the equity interests are being foreclosed. Where less than 100% of the equity interests are being foreclosed, consideration shall be “reasonably apportioned”.
- If the grantee is the secured party, its nominee or wholly-owned subsidiary, consideration is the lesser of:
 - The then fair market value of the subject real property; or
 - The sum of (i) the unpaid balance of the secured obligations, (ii) any liens on the pledged equity or the underlying real property, or any other debts or obligations, assumed or taken subject to, and (iii) certain amounts paid by the grantee (including transfer taxes of the grantor contractually assumed by the grantee, but not if the transferee pays transfer taxes due to a default by the borrower who was contractually obligated to pay transfer taxes).
- If the grantee is a third party, the calculation is calculated as:
 - The amount bid;
 - Any surviving liens or encumbrances assumed or taken subject to on the pledged equity, or related to senior mezzanine debt or underlying mortgage debt; and
 - Other surviving debts or liabilities of the property owner assumed or taken subject to.

Distressed Real Estate and NY Transfer Taxes - Mezzanine Foreclosure - NYC

- As with NYS transfer tax, transfer of a “controlling interest”, directly or indirectly, in an entity owning real property is a transfer taxable event, to the extent of the interest transferred.
- For NYC purposes, “controlling interest” is 50% or more of the total combined voting power or of total fair market value of all classes of stock in a corporation, or, for other entities (including partnerships and LLC’s), 50% or more of the capital, profits or beneficial interest in the subject entity
- For NYC transfer tax purposes, “consideration” for a mezzanine foreclosure, subject to proration for a partial transfer is equal to:
 - The amount bid;
 - Any liens or encumbrances assumed or taken subject to on the pledged equity, or related to senior mezzanine debt or underlying mortgage debt; and
 - Foreclosure costs paid by transferee.
 - The foregoing is prorated for transfers of less than a 100% interest.

Distressed Real Estate and NY Transfer Taxes - Deeds and Assignments in Lieu

- A transfer of mortgaged property in lieu of a mortgage foreclosure is subject to NYS and NYC Transfer Tax.
- A transfer of pledged collateral in lieu of a UCC foreclosure is subject to NYS and NYC Transfer Tax if a controlling interest is transferred.
- The most significant difference between Transfer Tax on a “normal” transfer and on a transfer in lieu of foreclosure is in the calculation of “consideration” on which the tax payable is based.

Distressed Real Estate and NY Transfer Taxes - Deed-in-Lieu of Mortgage Foreclosure

- Calculation of consideration (NYS and NYC transfer tax)
- Consideration is equal to:
 - Unpaid balance of the mortgage debt;
 - Amount of any other surviving liens and encumbrances on the mortgaged property; and
 - Other amounts paid by the grantee (including transfer taxes paid by the grantee).
 - However, with a fully-recourse mortgage, consideration is limited to FMV of the mortgaged property plus other amounts paid by the grantee (including transfer taxes paid by the grantee).

Distressed Real Estate and NY Transfer Taxes - Assignment-in-Lieu of Mezzanine Foreclosure

- Calculation of consideration is consistent with that of mezzanine loan foreclosures.
- However, full amount of any mortgage or other debt on the underlying property and any senior mezzanine debt taken subject to is included in consideration.
- Transfer taxes paid by the grantee are included in consideration.

Introduction to California Transfer Taxes – Basics

- Real estate transfer taxes (“transfer taxes”) are levied by cities and counties within California.
- The California transfer tax is triggered by:
 - direct transfers of realty:
 - a Proposition 13 “entity” change in ownership event for an entity that owns California realty (*926 North Ardmere Avenue LLC v. County of Los Angeles*, 3 Cal.5th 319 (2017)).
 - an IRC section 708 termination of a partnership that owns California realty.
- Transfer tax can be assessed to either buyer or seller. Parties contractually allocate the transfer tax burden.
- Transfer Tax is typically paid with a Transfer Tax Affidavit filed at the time of recording a deeded transfer or the closing of an entity transfer. There can be substantial penalties and interest for late filing.

Introduction to California Transfer Taxes - Taxes on Entity Transfers

- Proposition 13 “entity” change in ownership causing transfer tax.
 - One owner acquiring a direct or indirect controlling interest (more than 50%) in an entity owning California realty.
 - No Prop 13 event if owners keep the same proportionate interests in new entity.
 - Conversion of an LP/LLC to a Corporation
 - Transfers among wholly owned affiliates.
 - After an exempt proportionate transfer, new entity interests are “co-ownership tainted” and subject to a new Proposition 13 change in ownership upon a cumulative transfer of more than 50% of the new entity interests.
- IRC §708 Partnership Termination
 - Pre-2018 – Cumulative transfer of 50% of partnership interests within 12 months.
 - Current – Ceasing to operate a partnership with 2 or more partners.

Introduction to California Transfer Taxes - Tax on Consideration Paid

- The transfer tax is levied on the consideration paid for the realty.
 - No transfer tax on gifts. R&TC §11930.
- The standard tax rate is 0.11% on the consideration paid.
 - The “consideration paid” for the standard rate does not include assumed debt.
- However, many California Cities have adopted substantially higher rates, and include assumed debt as “consideration paid.”
 - Sacramento 0.385%; Palo Alto, Mountain View & Vallejo 0.44%
 - Los Angeles/Culver City 0.56%; San Mateo 0.61%
 - Albany 1.26%; Alameda and Emeryville 1.31%
 - San Jose 1.94%; Berkeley & Oakland 2.61%
 - Richmond 3.1%; San Francisco 6%

California Transfer Taxes on Distressed Real Estate

- Foreclosure and Deeds in Lieu of Foreclosure. R&TC §11926
 - Lender acquiring property pays transfer tax on consideration in excess of lender's debt.
 - Lender acquiring property subject to debt of other lenders is subject to transfer tax on assumed debt of other lenders.
- Mezzanine Foreclosure
 - Lender acquires controlling ownership interests in property owner.
 - Triggering a Proposition 13 change in ownership event.
- Bankruptcy
 - No transfer tax for conveyance under a confirmed Chapter 11 plan.

Pillsbury's Distressed Real Estate Practice

- We understand that clients must act *quickly and decisively* to create or preserve value, achieve stability and seize market opportunities. Pillsbury's Real Estate team is adept at working with clients to capitalize on the effects of market disruptions – whether resulting from inefficient capital structures, asset-specific difficulties or event-driven (or macroeconomic) distress situations.

Pre-bankruptcy experience:

- debt and equity restructurings, including loan modifications and workouts, and extension and forbearance agreements
- preferred equity investments and mezzanine loans in distressed situations
- acquisition and restructuring of distressed loans or interests in loans and ownership vehicle (including from government entities),
- formation of investment structures to acquire such assets
- loan enforcement and lien priority disputes, including judicial and non-judicial foreclosures and UCC foreclosures, deeds or assignments-in-lieu-of-foreclosure, receiverships and property recovery issues, writs of attachment or possession, analysis and defense of liability claims and analysis of intercreditor or co-lender agreements in complex debt stacks
- providing advice on alternatives to bankruptcy
- negotiation of rescue and exit financing

Real Estate bankruptcy experience:

- relief from stay litigation
- cash collateral stipulations and adequate protection
- bankruptcy sales
- resolution of lien priority and intercreditor issues
- cram-down litigation
- prosecution and defense of avoidance actions (e.g., fraudulent transfers and preferences)
- representation of indenture trustees
- all facets of unexpired leases, executory contracts and intellectual property licenses
- bankruptcy discharge and non-dischargeability actions
- negotiating and confirming plans of reorganization

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