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Sea Change in Transfer Tax

New law creates tax on certain nondeed transfers, expands Mansion Tax

By Russell Bershad and Jason R. Tuvel

This summer, the New Jersey Legislature passed legislation imposing, for the first time, transfer tax on certain nondeed transfers. The legislation, signed into law by Governor Corzine on July 8, also extends the recently enacted, so-called “Mansion Tax” to certain commercial properties. (Codified at N.J.S.A. 46:15C-1 and N.J.S.A. 46:15-7.2, respectively, effective Aug. 1, 2006).

The law creates the Non-Deed Transfer Tax only for Class 4A “commercial properties” (for the time being). Class 4A commercial properties are added to a list of properties already subject to the Buyer’s Transfer Tax.

Class 4A “commercial properties” are defined in the New Jersey Administrative Code as “any other type of income-producing property other than property in Classes 1, 2, 3A, 3B and those properties included in classes

4B and 4C.” N.J.A.C. 18:12-2.2. Class 1 is vacant land; Class 2 is residential property; Class 3B is farm property (qualified); Class 4B is industrial property, and Class 4C is apartments.

In the case of nondeed transfers, N.J.S.A. 54:15C-1, the Legislature has now imposed a tax on the sale or transfer for consideration in excess of \$1 million of a controlling interest in an entity which possesses, directly or indirectly, a controlling interest in Class 4A commercial property, which tax shall be equal to 1 percent of the consideration paid on the sale or transfer.

However, if the entity possesses, directly or indirectly, an interest in classified (i.e., Class 4A commercial property) real property, “and an interest in other property, real or personal,” there shall be a tax paid upon the sale only if the equalized assessed value of the classified real property exceeds \$1 million dollars and the tax is 1 percent of that percentage of the equalized assessed value of the classified real property that is equal to the percentage of ownership interest transferred. For example, if a 50 percent ownership interest is transferred, the entity holds classified real property and other property, real or personal, and the equalized value of the

classified real property is \$1 million, the tax is 1 percent of \$500,000.

Consideration is defined as “the actual amount of money and the monetary value of any other thing of value constituting the entire compensation paid or to be paid for the transfer including the remaining amount of any prior mortgage to which the transfer is subject or which is to be assumed and agreed to be paid by the purchaser.” Note that the tax is calculated based on the total consideration paid, not that part in excess of \$1 million.

Equalized assessed value is calculated by dividing the assessed value of a property by the municipality’s current equalization ratio, as promulgated by the state. For example, a property assessed at \$1 million in a municipality having a current equalization ratio of 50 percent has an equalized assessed value of \$2 million.

A “controlling interest” is defined under N.J.S.A. 54:15C-1 as “in the case of an entity that is a corporation, more than fifty per cent of the total combined voting power of all classes of stock of that corporation, and in the case of an entity that is a partnership, association, trust or other organization, more than fifty per cent of the beneficial ownership of classified real property of that partnership, association, trust or other organization.”

The statute contains five exemp-

Bershad is a director and chairman of the real property and environmental department and Tuvel is an associate in the real property and environmental department at Gibbons, Del Deo, Dolan, Griffinger & Vecchione of Newark.

tions on the following transfers or sales (1) by or to the United States of America, this State, or any instrumentality, agency, or subdivision thereof; (2) to a purchaser that is an organization determined by the federal Internal Revenue Service to be exempt from federal income taxation under Internal Revenue Code section 501(c)(3); (3) having the underlying characteristics of the transactions enumerated in N.J.S.A. 46:15-10 (listing transfers exempt from traditional transfer tax, including transfers for less than \$100, transfers between husband and wife, transfers in specific performance of a final judgment, etc.); (4) that are subject to the tax pursuant to N.J.S.A. 46:15-7.2 (the Buyer's Transfer Tax), or (5) that are incidental to a corporate merger or acquisition if the equalized assessed value of the real property transferred is less than 20 percent of the total value of all assets exchanged in the merger or acquisition.

The sale of a controlling interest can occur in one or a series of transactions. Transactions within six months of each other are presumed to be a series constituting a single transfer. Sale of a controlling interest can be accomplished by one purchaser or by a group of purchasers acting in concert. Purchasers who are related parties are presumed to be acting in concert.

The statute provides for the transfer tax in a nondeed transaction to be paid on or before the last day of the month in which the sale of a controlling interest is completed. The purchaser is required to file a return with the Director of the Division of Taxation accompanied by payment of the tax. The Director has very recently promulgated Form CITT-1 for this purpose.

The Legislature may well have enacted the law seeking to capture transactions structured as entity transfers to evade the Buyer's Transfer Tax. However, as written, the statute will apply in other cases, including major corporate mergers if exception (5) above (the 20 percent exception) does not apply. If the merger involves real estate companies, the 20 percent exception is

unlikely to apply.

The statute will require property valuation determinations in applying the 20 percent exception, based on the "total value of all assets exchanged in the merger or acquisition." "[R]eal or personal" property arguably is narrower than "all assets," the former, by way of example, not including intangible assets such as good will. In any event, there is no guidance in the statute for valuing the other "real or personal property," or "other assets."

Note that the 20 percent exception is not limited to entities holding only property located in New Jersey. Note, additionally, that the statute does not expressly limit real property subject to taxation to property located in New Jersey; however, property would have to be located in New Jersey to be classified as Class 4A property under New Jersey law and to be valued by applying the state-promulgated equalization ratio.

Entity reorganizations of companies owning a direct or indirect ownership interest in Class 4A property may be particularly problematic. For example, assume two persons hold all the general partnership interests in a partnership owning only Class 4A commercial property with a gross value of \$2 million, and decide to convert the form of ownership to a limited liability company in which they own all the membership interests for no stated consideration. They accomplish the conversion by merging the partnership into the LLC. Before and after the merger, the same parties own all the interests and arguably no consideration was received. Query whether the Division of Taxation would treat this as a taxable transaction.

If the property was encumbered by a mortgage, however, the outstanding balance may have to be included in calculating the consideration for the transfer based on the statute's definition of consideration. Let us assume the property was encumbered by a mortgage with an \$1.8 million balance. The tax may very well be payable calculated on \$1.8 million, even though arguably no consideration was paid for the transfer of the con-

trolling interest.

The expansion of the Mansion Tax — more accurately described as a Buyer's Transfer Tax — to Class 4A property is fairly straight forward. Previously, Mansion Tax applied only to property in Class 2 (residential), Class 3A (farm property including a residence), and cooperative units. Property in Class 1 (vacant land), Class 3B (farm property (qualified)), Class 4B (industrial) and Class 4C (apartments) remains exempt.

A 1 percent transfer tax shall be paid by the buyer if the consideration paid for the property exceeds \$1 million (as noted above, the tax is paid on the aggregate consideration, not the portion in excess of \$1 million). Property classification can best be ascertained by reviewing the property tax cards on file with the assessor for the municipality in which the real property is located.

There are two exemptions. The first exemption applies if the grantee of the deed is an organization determined by the federal Internal Revenue Service to be exempt from federal income taxation under Internal Revenue Code Section 501(c)(3). The second exemption applies if the deed transfer is incidental to a corporate merger or acquisition and the equalized assessed value of the real property transferred is less than 20 percent of the total value of all assets exchanged in the merger or acquisition. The text of this second exception is virtually identical to the 20 percent exception under the Non-Deed Transfer Tax. However, a grantee must claim this exemption at the time the deed is offered for recording by filing, in addition to the affidavit of consideration, such other information as the Director of the Division of Taxation may prescribe as to constitute a filing of a protest of the assessment of the fee. A memorandum from the Division to County Clerks/Recording Officers in August of this year directs that a grantee claiming the 20 percent exemption file a stamped, approved merger document at the county recording office with Form RTF-4, "Filing of Protest of Fee Assessment."

It is clear the municipal assessor's role in classifying property has now gained significance because of the implications for the Buyer's Transfer Tax and Non-Deed Transfer Tax. Although the New Jersey Administrative Code provides a definition for Class 4A commercial property and for the other property classes, the ultimate decision as to what classification real property receives lies with the tax assessor. Property owners will have to be vigilant to

make sure their properties are not improperly classified, which might occur, for instance, if property is subject to mixed uses. For example, what is the proper classification of property which has retail uses on the ground floor (Class 4A, subject to transfer tax) and residential apartments above (Class 4C)?

Transfer tax used to be fairly straight forward, both as to its application or exemption, and calculation of the tax. Imposition in 2004 of the

formerly monikered "Mansion Tax" started to complicate the issue, and the level of complication increased by a material magnitude with this summer's amendment to the "Mansion Tax" and enactment of the Non-Deed Transfer Tax. Some guidance will come as regulations are proposed and adopted, but it is a safe bet that transfer tax matters, including related planning and deal structuring, will require significant attorney attention. ■