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When Not-For-Profits Buy or Sell Real Estate

BY DAVID J. BIEHL

RAISE YOUR HAND if you have represented or been involved with a not-for-profit corporation or organization that has sold or purchased real property in New York City. For those of you with yours hands up, can you please explain to me why that transaction was exempt from the New York City Real Property Transfer Tax, but subject to the New York State Real Estate Transfer Tax? The rationale for this distinction has always eluded me.

Both transfer taxes apply to any "conveyance" of real property, yet New York City exempts conveyances "by or to any" organization that, generally speaking, meets the criteria for exemption from federal income taxes under §501(c)(3) of the Internal Revenue Code (a "charitable organization").

Could it be that New York City grants this exemption based on the fundamental concept that charitable organizations operate (or are intended to operate) to ultimately benefit the general public? If so, should the state follow suit?

In an attempt to answer this question, let's briefly review the ground rules governing charitable organizations.

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Charitable Organization Scheme

The federal and state governments long ago decided to promote charitable activities by granting organizations that meet certain criteria an exemption from federal and state income and/or franchise taxes.

The rationale is that the general public is benefited by these charitable activities, which either fulfill a community need or lessen the burdens of government. Either way, there is an extensive body of law governing the activities of these entities, all of which is basically designed to ensure one thing—that charitable organizations engage in activities that benefit the general public and do not benefit private interests or a specific individual or group of individuals.

This is the so-called doctrine of private inurement, which states that an entity must be operated and organized so that "no part of…[its] net earnings…inures to the benefit of any shareholder or individual."[1]

This, of course, does not mean that specific individuals or groups of individuals will not be benefited by the activities of these organization, quite to the contrary. It means that the purposes and activities of charitable organizations must be directed toward providing a public benefit and not operated to generate a profit or other economic benefit to a private individual.

In order to ensure that this public benefit is achieved, charitable organizations are not permitted to distribute any part of their earnings to a private individual.[2] In fact, except in very limited circumstances, charitable organizations are not permitted to have shareholders or other equity holders that have an economic or beneficial interest in the organization or its revenues or assets.

Instead of shareholders, charitable organizations have either "members" or a self-perpetuating board of directors (or board of trustees). Members of a charitable organization are similar to shareholders of a business corporation in that they typically have the right to appoint or elect the organization's board of directors. However, in both situations, no person may hold an economic, pecuniary or ownership interest in the corporation[3] and, under New York law, directors may not be compensated for services provided in such capacity. Further, under New York law, a charitable organization is required to distribute all of its assets to another charitable organization upon dissolution or liquidation.

When a Charity Sells Property

Now, turning to the question at hand. Should a charitable organization that sells real property be subject to the New York state transfer tax?

Well, if you accept the proposition that the ultimate beneficiary of a charitable organization is the public at large, then it would seem to follow that the People of the state of New York are taxing themselves on the sale of real property by imposing the transfer tax. New York state already exempts charitable organizations from the payment of real property taxes, state income/franchise taxes as well as

state sales taxes. So, why stop there? Does a charitable organization all of a sudden become less charitable when it sells real property?

Whatever the rationale may be, there are indications that this door may be opening.

A New Day?

Recently, the New York state tax department was presented with a situation where a transfer tax was paid by a charitable organization believing that the change of its member constituted a transfer of a "controlling interest" and triggered the transfer tax. This transaction involved a charitable organization (the "grantor entity") that owned real property located in New York City with a taxable value in excess of $25 million.

As part of a plan designed to reorganize the grantor entity, its board of directors decided to affiliate with another charitable organization (the "grantee entity") that was willing to support and invest in the grantor entity. The affiliation was to be accomplished by replacing the sole member of the grantor entity with the sole member of the grantee entity, thereby giving the sole member of the grantee entity the authority to elect and appoint the board of directors of the grantor entity. This is a typical method of accomplishing a change of control of a not-for-profit corporation.

With this element of control, the grantee entity was willing to invest in the grantor entity. In this case, it is important to note that all of the organizations were New York state not-for-profit corporations exempt from federal and state incomes taxes.

In initially analyzing the transaction for transfer tax purposes, it appears that the grantor entity determined that this membership change constituted a transfer of a "controlling interest" under §1401(b) of the tax law, thereby subjecting the transfer to the New York state transfer tax.

Briefly, the New York state transfer tax applies to the transfer of a "controlling interest" in an entity that owns real property and is deemed to have occurred when:

(a) in the case of a corporation, there is a transfer of either 50 percent or more of the total combined voting power of all classes of stock of such corporation, or 50 percent or more of the capital, profits or beneficial interests in such stock of such corporation, and

(b) in the case of other forms of entities, there is a transfer of 50 percent or more of the capital, profits or beneficial interest in any such entity.

It is easy to see why the grantor entity initially made this determination since there is almost no statutory guidance or case law dealing with the application of the New York state transfer tax to these types of transactions. In fact, it is generally understood that charitable organizations are subject to the tax and, in fact, there was an actual change of control over the grantor entity. Further, the tax law makes no clear distinction between conveyances by business corporations and conveyances by charitable organizations.

After the transfer tax was paid, the grantor entity applied to the tax department for a refund on the grounds that, in fact, there was no "conveyance" of real property (or, in this case, the transfer of a "controlling interest" in a corporation that owns real property) since the transfer of the membership interest went from one charitable organization to another. This analysis focused on the fact that merely replacing one charitable organization as the sole member of the grantor entity with another charitable organization did not constitute the transfer of a "controlling interest" since there for was no transfer of a "beneficial interest" in the grantor entity.

The grantor entity urged the tax department to look beyond whether actual control was transferred and to find that since the "ultimate beneficiary" of both the grantor entity and grantee entity were the same (i.e., the public at large), there was no "conveyance" under the tax law.

In order to support the proposition that the ultimate beneficiary of a charitable organization is the public at large, the grantor entity cited several statutory provisions and cases demonstrating the state's involvement in and oversight of a charitable organization's assets and activities and concluded that since this transaction does not involve the transfer of a beneficial interest, the transfer tax should not apply. In response, the tax department did, in fact, grant a refund of the previously paid tax.

For the Future

The state's acceptance of the foregoing proposition is significant for several reasons and potentially has far reaching consequences.

First, it essentially expands the scope of the "mere change of identity" exemption provided under §1405(b)(6) of the tax law to cover conveyances between charitable organizations. The "mere change" exemption provides that the New York state transfer tax shall not apply to conveyances that effectuate a mere change of identity or form of ownership or organization where there is no change in beneficial ownership.

While the grantor entity did not expressly argue or even make reference to the "mere change" exemption in its application, it seems clear that its position, and the state's acceptance of that position, supports the conclusion that the criteria for a "mere change" exemption are satisfied when one charitable organization transfers real property to another charitable organization.

Further, if you accept the proposition that the public is the ultimate beneficiary of a charitable organization, then by extension, shouldn't any conveyance by or to a charitable organization be exempt from the New York state transfer tax under §§1405(a)(1) and 1405(b)(1) of the tax law? Theses sections provide that the state of New York is exempt from the payment of the transfer tax and that the tax shall not apply to any conveyance "to the state of New York."

Following the same line of reasoning articulated above, aren't the People of the state of New York and, therefore, the state itself, the ultimate beneficiaries of a conveyance by a charitable organization? If so, then why would the state want to tax itself and, further, why does the state grant charitable organizations an exemption from state income and sales taxes, but not from the state transfer tax? Hopefully, the time has come for the state to fall in line with New York City (as well as other local governments that impose a transfer tax, such as the City of Yonkers) that already exempt charitable organizations from the transfer tax.

Actually, the timing to address this issue could not be better.

Due to the recently announced recommendations of the Commission on Health Care Facilities in the 21st Century (more commonly known as the Berger Commission), the state is mandating that several not-for-profit hospitals and nursing homes either close or be substantially restructured. Inevitably, these mandates will result in the sale of several rather large parcels of real property which, in turn, will require the payment of hundreds of thousands, if not millions, of dollars in transfer taxes by these not-for-profit sellers.

Clearly the time is ripe and, with the refund granted by the tax department described above, it appears that the state may be ready to recognize the appropriateness of these exemptions.

1. Internal Revenue Code of 1986, as amended (IRC), §501(c)(3).
2. IRC §501(c)(3) and N.Y. Not-For-Profit Corp. Law §508.
3. See *Manhattan Eye, Ear & Throat Hospital v. Spitzer*, 715 N.Y.S.2d 575, 592 (Sup Ct. New York County, Dec. 3, 1999).

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