Originally published in the:
New York Law Journal *February 23, 2022*

Can't You Hear the Whistle Blowing: Whistleblower Case Addresses New York Transfer Tax Issues

By: Ezra Dyckman and Charles S. Nelson

Joint venture transactions involving entities owning real property in New York can sometimes raise complicated New York State and City real property transfer tax questions. A recent case, *State ex rel. Saric v. GFI Breslin, LLC*, No. 101812/2018 (Sup. Ct. Apr. 16, 2021) illustrates many of the issues that can arise.

New York State and New York City each imposes a real property transfer tax. For commercial real estate located in New York City, the highest New York State rate is 0.65% and the highest New York City rate is 2.625%, for a combined total of 3.275% of the consideration. The taxes are imposed both on transfers of direct interests in real property, such as fee interests and tenancy-in-common interests (regardless of percentage interest), as well as on transfers of controlling interests in entities that own real property. A "controlling interest" is defined as 50% or more of the stock of a corporation or 50% or more of the capital, profits, or beneficial interests in a partnership, limited liability company, trust, or other entity.

In determining whether there has been a transfer of a controlling interest in an entity, transfers that are related to one another or are pursuant to a common plan are aggregated, and any transfers that occur within three years of one another are presumed to be related. Thus, for example, if a person sells a 25% interest in an LLC owning New York real estate and, within three years, sells an additional 25% interest in the LLC, the transfers will be presumed to be related, with the result that both transfers will be subject to transfer tax, unless the taxpayer can provide evidence to rebut the presumption.

State ex rel. Saric v. GFI Breslin, LLC is an unusual case because it involved a *qui tam* action (commonly referred to as a "whistleblower" case) pursuant to the New York False Claims Act. The "whistleblower" was a 5% member of one of the defendants, GFI Breslin, LLC (GFI). GFI initially owned a 20% interest in 1186 Broadway LLC ("Broadway"), which owned a ground leasehold in the real property located at 1186 Broadway in Manhattan. The remaining 80% of the interests in Broadway were owned by Dune, an unrelated third party.

In September 2015, GFI purchased 49% of the membership interests in Broadway from Dune for $22 million, leaving Dune with a 31% interest. Simultaneously with the sale, the LLC agreement for Broadway was amended such that Dune's 31% interest was recapitalized into a $14 million preferred interest. Proceeds from capital transactions would be distributed first to Dune in payment of its preferred interest and any unpaid preferred return, and upon Dune's receipt of its entire preferred amount, its membership interest in the company would automatically be terminated.

The LLC agreement also granted Dune a put right to sell its remaining membership interest in Broadway to GFI for a price equal to its unpaid preferred amount and any unpaid preferred return.

The relator alleged that Dune transferred a controlling interest in Broadway to GFI, because Dune's remaining 31% interest in GFI was like a debt to be collected, and thus should be added to the 49% interest in determining whether a controlling interest was transferred. He therefore claimed that the defendants should have paid New York State and City transfer tax on the transfer, and alleged that the defendants made a false statement on an Unincorporated Business Tax Return that asked about controlling interests.

The court rejected the relator's arguments and granted the defendants' motion to dismiss. The court noted that the objective economic realities showed that the parties negotiated a purchase price for Dune's remaining 31% interest in Broadway, but left the timing contingent. Until Dune's interest was redeemed or Dune exercised its put option, Dune retained ownership of its 31% interest, and thus a controlling interest in Dune had not been transferred. The court rejected the relator's characterization of Dune's interest as debt.

In addition, the court held that the relator did not adequately plead a reverse false claim under the New York False Claims Act. In his complaint, the relator had alleged that the defendants may have answered "no" to a question on an Unincorporated Business Tax Return asking whether 50% of ownership had been transferred.

The court held that the complaint was inadequate because it lacked specific factual allegations that the defendants had actual knowledge of fraud, or acted with reckless disregard or deliberate ignorance when they responded to that question.

The court was clearly right in holding that Dune's preferred interest in Broadway should not be viewed as debt and should not be treated as having already been transferred to GFI; transfer tax law is largely form driven and preferred equity would not be treated as debt. Moreover, at the time the decision was entered into, Dune had apparently not exercised its put option and had not yet been redeemed.

Interestingly, as noted by the court, if Dune were to exercise its put option, its transfer of the 31% interest would be aggregated with the transfer of the 49% interest for transfer tax purposes, which would render both transactions taxable. If instead of exercising its put option, Dune were redeemed through distributions of cash flow, the result might be different.

In sum, *State ex rel. Saric v. GFI Breslin, LLC* appears to have been rightly decided, and the False Claims Act context of this case in particular seems to have warranted dismissal. Nevertheless, the case raises interesting issues that must be considered when determining the transfer tax consequences of transactions involving entities that own New York real estate and is a chilling warning of how much trouble a 5% whistleblower member can cause.

Ezra Dyckman *is a partner at Roberts & Holland.* Charles S. Nelson *is an associate at the firm.*