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The New York State Gains Tax--A Constitutional Analysis

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ARTICLES

THE NEW YORK STATE GAINS TAX- A CONSTITUTIONAL ANALYSIS

The Supreme Court allows states broad powers of taxation as an inherent attribute of state sovereignty.[1] Viewed by the Supreme Court as the primary repository of the taxing power,[2] state legislatures possess great freedom to set classifications[3] deciding which individuals or groups will be affected by a tax.[4] However, the Equal Protection Clause of the United States Constitution[5] is

[1] Hoge v. Richmond & Danville R.R. Co., 99 U.S. 348, 355 (1878). "The power of taxation is an attribute of sovereignty, and is essential to every independent government. Stripped of this power, it must perish." *Id.*; *see* Allied Stores v. Bowers, 358 U.S. 522, 526 (1959); International Harvester Co. v. Wisconsin Dep't of Taxation, 322 U.S. 435, 444-45 (1944); Curry v. McCanless, 307 U.S. 357, 366 (1939); McCulloch v. Maryland, 17 U.S. 316, 429 (1819); People v. Adirondack Ry. Co., 160 N.Y. 225, 236 (1899), *aff'd*, 176 U.S. 335 (1900).

[2] In Green v. Frazier, 253 U.S. 233, 239 (1919), the Court stated:

> The taxing power of the States is primarily vested in their legislatures, deriving their authority from the people. When a state legislature acts within the scope of its authority it is responsible to the people, and the right to change the agents to whom they have entrusted the power is ordinarily deemed a sufficient check upon its abuse.

Id.; *see* Allied Stores v. Bowers, 358 U.S. 522, 526 (1959); Aero Mayflower Transit Co. v. Georgia Pub. Serv. Comm'n, 295 U.S. 285, 292 (1935); Magoun v. Illinois Trust and Sav. Bank, 170 U.S. 283, 295 (1898); Bell's Gap R.R. v. Pennsylvania, 134 U.S. 232, 237 (1889); J. NOWAK, R. ROTUNDA & J. YOUNG, HANDBOOK ON CONSTITUTIONAL LAW 395 (2d ed. 1983).

[3] *See* Southern Package Corp. v. State Tax Comm'n, 164 So. 45, 47 (Miss. 1935). "Classification . . . is the grouping of things in speculation or practice because they agree with one another in certain particulars and differ from other things in the same particulars." *Id.*

[4] Bell's Gap R.R. v. Pennsylvania, 134 U.S. 232, 237 (1889). The states are allowed flexibility in designing reasonable taxation schemes and exemptions; they can vary taxes upon different trades, professions, products and property. *Id.* Hostile discriminations against particular persons and classes are to be avoided. *Id.*; *see* Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 359 (1973); Allied Stores v. Bowers, 358 U.S. 522, 526-27 (1959); Tax Comm'r v. Jackson, 283 U.S. 527, 537 (1931); Ohio Oil Co. v. Conway, 281 U.S. 146, 159 (1930); Southwestern Oil Co. v. Texas, 217 U.S. 114, 121 (1910); Magoun v. Illinois Trust and Sav. Bank, 170 U.S. 283, 293 (1898).

[5] U.S. CONST. amend. XIV, § 1. The Equal Protection Clause of the fourteenth amend-

offended by classifications that are arbitrary and capricious, rest on no rational basis and bear no reasonable relation to the purpose of a statute.[6]

On March 29, 1983, the New York State Legislature enacted Article 31-B of the New York Tax Law (the gains tax).[7] With a few exceptions,[8] all real property transfers in New York State, when the gross consideration exceeds one million dollars, are subject to the tax.[9] Recently, the constitutionality of the gains tax has been questioned under the Equal Protection Clause of the United States and New York State Constitutions.[10]

The New York gains tax was enacted as part of a revenue bill to provide funds for the 1983-1984 state budget.[11] The tax has engendered problems of interpretation and administration including questions concerning mortgages,[12] mortgage foreclosures,[13] capi-

ment provides in pertinent part: "No State shall make or enforce any law which shall . . . deny to any person within its jurisdiction the equal protection of the laws." *Id.* The New York Constitution contains a similar equal protection clause: "No person shall be denied the equal protection of the laws of this state or any subdivision thereof." N.Y. CONST. art. I, § 11.

[6] *See* Royster Guano Co. v. Virginia, 253 U.S. 412, 415 (1920). "[C]lassification must be reasonable, not arbitrary, and must rest upon some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike." *Id.*; *see* Louisville Gas & Elec. Co. v. Coleman, 277 U.S. 32, 37 (1928).

[7] Ch. 15, § 181, [1983] N.Y. Laws 134 (codified as amended in N.Y. TAX LAW § 1440-1449 (McKinney Supp. 1986)). The gains tax resembles an earlier tax imposed on 10% of gains derived from the transfer of industrial and commercial real property in New York City. *Compare* Ch. 487, § 1422, [1981] N.Y. Laws 1745, *repealed by* Ch. 57, § 1, [1982] N.Y. Laws 1359 *with* N.Y. TAX LAW § 1441 (McKinney Supp. 1986). The present gains tax levies a 10% tax on gains derived from the transfer of real property within New York State. N.Y. TAX LAW § 1441 (McKinney Supp. 1986).

[8] *See* N.Y. TAX LAW § 1443 (McKinney Supp. 1986); *see also infra* note 30.

[9] *See* N.Y. TAX LAW §§ 1441, 1443 (McKinney Supp. 1986).

[10] *See* Trump v. Chu, 65 N.Y.2d 20, 24, 478 N.E.2d 971, 974, 489 N.Y.S.2d 455, 458, *appeal dismissed*, 106 S. Ct. 285 (1985).

[11] *See* New York State Assembly Debates, Act of March 28, 1983, ch. 15 at 30. At the time of its passage, the gains tax was expected to raise revenues of approximately ninety million dollars per year. *Id.* That annual figure was exceeded in the month of December, 1985, alone. *See* Morris & Golkin, *Impact of Transfer Gains Tax on Cooperatives, Condominiums*, N.Y.L.J., Jan. 30, 1986, at 1, col. 3. Revenues from the tax now yield over five hundred million dollars annually, 80% of which is derived from real property transactions in New York City. *Id.* Currently, an effort to increase the tax from 10% to 12.5% for New York City transactions is receiving favorable consideration from Mayor Koch and Governor Cuomo. *Id.*

[12] *See* Ch. 15, § 181, [1983] N.Y. Laws 134, 136 (codified as amended in N.Y. TAX LAW § 1440.7 (McKinney Supp. 1986)). Section 1440.7 now excludes from tax liability the creation, modification, extension, spreading, severance, consolidation, assignment, transfer, release or satisfaction of a mortgage. *Id.*; *see also* Underberg, McCarroll & Rubenstein, *Real Property Taxation*, 35 SYRACUSE L. REV. 609, 612-13 (1984).

[13] *See* N.Y. TAX LAW § 1440.7 (McKinney Supp. 1986). Under section 1440.7, a mort-

tal improvements and "soft costs,"[14] the pre-transfer audit procedure[15] and partnership transfers.[16] This article will begin by examining key provisions of the gains tax. After analyzing the constitutional implications of the tax, possible legislative solutions will be offered.

gage foreclosure is deemed to be a transfer of real property. *Id.*; *see also* Rifkin, *New York's Real Property Gains Tax and Mortgage Foreclosure*, N.Y.L.J., Nov. 14, 1984, at 48, col. 1. The original statute provided little guidance as to the responsibilities of the parties involved in mortgage foreclosures. *See* Ch. 15, § 181, [1983] N.Y. Laws 134, 139-40 (codified as amended in N.Y. TAX LAW § 1447.3(b) (McKinney Supp. 1986)); *see also* New York State Dep't of Taxation and Finance, Publication 588, *Questions and Answers - Gains Tax on Real Property Transfers* (Nov. 1984) [hereinafter Publication 588].

Publication 588 is a pamphlet published by the New York State Department of Taxation and Finance interpreting various aspects of the gains tax. The New York State Department of Taxation and Finance has interpreted N.Y. TAX LAW § 1447.3(b) as exempting transferees (successful bidders at a foreclosure sale) from any personal liability for gains taxes due from transferors (defaulting mortgagors). Publication 588, *supra*, at 22 (Q.59(b)). The defaulting mortgagor must furnish a statement of no tax due or tentative assessment to a referee prior to the foreclosure sale. *Id.* at 21 (Q.59(a)). Defaulting mortgagors who fail to supply this assessment will have their gains computed for purposes of the gains tax with zero as the original purchase price. *Id.* The referee will then pay the gains tax to the extent funds remain after payments to lienholders. *Id.* Any excess proceeds are then paid to the court for disposition. *Id.* If there are not sufficient proceeds to pay the gains tax, the defaulting mortgagor remains liable for payment. *Id.* at 22 (Q.59(c)).

[14] *See* Underberg, McCarroll & Rubenstein, *supra* note 12, at 613. Article 31-B provides no definition for a capital improvement leading to speculation as to whether "soft costs," such as professional fees, were to be included in the term. *Id.* The New York State Department of Taxation and Finance has narrowly defined a capital improvement as "an improvement, a betterment, or an addition made to real property which: 1) is intended to be permanently affixed to the real property, and 2) has a useful life substantially beyond the year following installation." Publication 588, *supra* note 13, at 5 (Q.16).

[15] *See* Frankel, *New York State Gains Tax On Real Property Purchases*, N.Y.L.J., June 15, 1983, at 1, col. 2. All real estate transfers with consideration of $500,000 or more and which are not owner-occupied residences must be processed through the New York State Department of Taxation and Finance before they can be completed. *Id.* at 24, col. 3. The Department will then furnish a tentative assessment of the amount of tax due within twenty days. *Id.* A reasonably correct computation of the amount of gain in a complex real estate transaction is difficult to estimate within such a short period of time. *Id.*

[16] *See* Cohen, *A Guide to the Real Property Gains Tax*, N.Y.L.J., Mar. 13, 1985, at 23, col. 1 (discussing difficulty of calculating partner's profit share in partnership when partnership interests are sold). Though partnership interests may change over the course of the partnership, there is no concise answer as to how changes in partnership profit share should be calculated for the gains tax. *Id.* at 30, cols. 3-4. A partner who acquires a controlling interest in a partnership which owns real property in New York State is subject to the gains tax. N.Y. TAX LAW §§ 1440.2, 1440.7 (McKinney Supp. 1986).

I. KEY PROVISIONS OF THE GAINS TAX

A gains tax is imposed when real property[17] or an interest in real property[18] located within New York State is transferred.[19] A ten percent levy is imposed on the gain[20] which is the excess of consideration over the original purchase price of the property.[21]

[17] N.Y. TAX LAW § 1440.6 (McKinney Supp. 1986). Real property means "every estate or right . . . in lands . . . including buildings, structures and other improvements in leaseholds which are located in whole or part within [New York State]." *Id.*; *see also* Publication 588, *supra* note 13, at 1 (Q.2).

[18] N.Y. TAX LAW § 1440.4 (McKinney Supp. 1986). An "interest in real property" includes "title in fee, a leasehold, a beneficial interest, an encumbrance, a transfer of development rights or any other interest with the right to use or occupancy of real property or the right to receive . . . income derived from real property . . . [and] an option or contract to purchase real property." *Id.*; *see* Publication 588, *supra* note 13, at 1 (Q.3).

[19] N.Y. TAX LAW § 1440.7 (McKinney Supp. 1986).

> "Transfer of real property" means the transfer . . . of any interest in real property by any method including . . . sale, exchange, assignment, surrender, mortgage foreclosure, transfer in lieu of foreclosure, option, trust indenture, taking by eminent domain, conveyance upon liquidation or by a receiver or acquisition of a controlling interest in any entity with an interest in real property.

Id.; *see* Publication 588, *supra* note 13, at 1 (Q.4).

Section 1440.2 provides a definition of a "controlling interest":

> "Controlling interest" means (i) in the case of a corporation, either fifty percent or more of the total combined voting power of all classes of stock of such corporation, or fifty percent or more of the capital, profits or beneficial interest in such voting stock of such corporation, and (ii) in the case of a partnership, association, trust or other entity, fifty percent or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity.

Id.; *see also* Publication 588, *supra* note 13, at 17 (Q.'s 44-45(b)) (New York State Department of Taxation and Finance will examine transaction to determine if group of individuals is acting in concert in acquiring controlling interest). If various purchasers are deemed to interact so that one purchaser influences or controls the action of another they will be deemed to be acting in concert; if they acquire fifty percent or more of an entity the transaction will be taxable. *Id.* For example, if a parent and a wholly-owned subsidiary each purchase a 30% interest in an entity, the Department of Taxation and Finance will deem the parent to have purchased a 60% interest and the gains tax is triggered. *Id.* (Q.45(b)).

[20] N.Y. TAX LAW § 1441 (McKinney Supp. 1986).

[21] N.Y. TAX LAW § 1440.3 (McKinney Supp. 1986); *see* Publication 588, *supra* note 13, at 2-3 (Q.8). " 'Gain' is the difference between the consideration for the transfer of real property and the original purchase price of such property, where the consideration exceeds the original purchase price." N.Y. TAX LAW § 1440.3 (McKinney Supp. 1986).

"Consideration" is the price paid for the real property including interest and also including payment for an option or contract to use real property. N.Y. TAX LAW § 1440.1(a) (McKinney Supp. 1986). It includes money, property or anything of value paid by the transferor including the amount of any mortgage loan or other encumbrance. *Id.*; *see* Publication 588, *supra* note 13, at 4 (Q.15(a)).

"Original purchase price" is the consideration paid or required to be paid to acquire the real property plus the consideration paid or required to be paid for capital improvements to the property and fees paid to dispose of the property. N.Y. TAX LAW § 1440.5(a) (McKinney Supp. 1986); *see* Publication 588, *supra* note 13, at 4 (Q.14). Certain pre-acquisition

Costs allowable as part of a property's original purchase price are divided by the New York State Department of Taxation and Finance into the following categories: (a) the price paid to acquire an interest in real property;[22] (b) amounts paid for particular "capital improvements" to property;[23] and (c) costs clearly associated with the construction of a real estate project.[24] "Soft costs" related to the marketing and maintenance of real property are not included in a property's original purchase price.[25] Transfers pursuant to mortgage foreclosures, condemnation proceedings, development rights, air rights and bankruptcy liquidations are taxable exchanges.[26] Also taxable in some instances are corporate mergers,[27] and dividends in the form of real property.[28] Certain ex-

costs directly related to the New York real property may be included in original purchase price. *Id.* at 4-5 (Q.15(b)). Examples of such costs are legal, architectural and other professional fees, studies, payments to obtain an option to acquire real property, certain closing costs and real estate taxes. *Id.* at 5 (Q.15(b)). Excluded costs that cannot be included in real purchase price include interest paid on a loan whose proceeds were used to acquire the real property, interest paid on a note or bond secured by a true purchase money mortgage, tax abatement fee and title closing gratuities. *See id.* (Q.15(c)).

[22] *See* Publication 588, *supra* note 13, at 4 (Q.15(a)). The "price paid to acquire an interest in real property" includes the amount of money or property used to acquire the property interest including a mortgage or lien. *Id.*

[23] *See id.* at 5 (Q.16(a)). A "capital improvement" is "an improvement, a modification, a betterment, or an addition made to real property which: 1) is intended to be permanently affixed to the real property, and 2) has a useful life substantially beyond the year following installation." *Id.* Examples of costs associated with the cost of capital improvements include surveying fees, construction equipment rental and excavation costs. *See id.*

[24] *See id.* at 6 (Q.16(c)). Construction period costs include accounting fees, construction lender appraisals, construction period real property taxes, mortgage recording tax, construction period insurance and construction period security. *Id.* Expenses incurred to maintain property are not included in construction period costs. *Id.* at 7 (Q.16(e)). However, some maintenance expenses are considered capital improvements, e.g., installation of entire flooring, complete roof replacement and initial painting for a new structure. *Id.*

[25] *See* N.Y. TAX LAW § 1440.5(a) (McKinney Supp. 1986). Original purchase price includes amounts paid by the transferor for legal, engineering and architectural fees incurred in selling real property. N.Y. TAX LAW § 1440.5(a) (McKinney Supp. 1986); *see also* Publication 588, *supra* note 13, at 7 (Q.17); Underberg, McCarroll & Rubenstein, *supra* note 12, at 613 (marketing costs such as advertising and property maintenance costs such as trash and snow removal are not listed as part of "original purchase price").

[26] *See* N.Y. TAX LAW § 1440.7 (McKinney Supp. 1986). Mortgage foreclosures and condemnation proceedings (taking by eminent domain) are specifically included in section 1440.7 as "transfers of real property." *See* N.Y. TAX LAW §§ 1440.4, 1440.7. Development rights are specifically included in the definition of "interest" and are therefore an interest in real property subject to the gains tax. *Id.* § 1440.4; *see* Publication 588, *supra* note 13, at 22 (Q.63). Finally, the U.S. Bankruptcy Court has held that the debtor in a bankruptcy proceeding is not exempt from liability for the gains tax. *In re* Jacoby Bender Inc., 758 F.2d 840 (2d Cir. 1985); *see* 11 U.S.C. § 1146(c) (Supp. 1986).

[27] *See* Publication 588, *supra* note 13, at 20 (Q.54). If a corporate merger results in a controlling interest in an entity which owns real property in New York State the transfer may be taxable under the gains tax. *Id.*

[28] *See id.* (Q.53). In a non-liquidating dividend distribution in the form of unencumbered

changes which are tax-free under section 1031 of the Internal Revenue Code are taxable under the gains tax.[29] Certain transactions, however, are totally or partially exempt from the gains tax.[30] Transfers consisting of changes in the form of ownership when there is no change in beneficial interest are examples of transactions exempt from the gains tax.[31]

Consideration received by a transferor for the transfer of contiguous or adjacent parcels of property is, in most cases, aggregated for purposes of the tax.[32] Transfers pursuant to a coopera-

real property, the gains tax will not be due initially but will be due on any subsequent transfer of the real property received as a dividend. *Id.* The gains tax, as measured by the fair market value of the real property, will apply to liquidating dividend distributions where the shareholders will hold individual title to separate parcels of real property of equal value. *Id.*

[29] *See id.* at 22 (Q.60). In a section 1031 exchange of property:

> each party is the transferor of the property he is giving up, as well as the transferee of the property received in the exchange. The consideration received is equal to the fair market value on the date of exchange of the property received in the exchange, plus any amount of cash and the value of any other property received in the exchange. The gain is the difference between the consideration received and the original purchase price of the property exchanged.

Id.; *see* Board of Governors of the Real Estate Board of New York, Inc., *Proposals For Amendment of the New York State Real Property Gains Tax* 13 (Jan. 1984).

[30] *See* N.Y. TAX LAW § 1443 (McKinney Supp. 1986). The gains tax is not applicable to sales of real property when the consideration is less than one million dollars or when the real property is occupied by the tranferor as his residence. *Id.* §§ 1443.1, 1443.2 (the latter exemption applies only to the premises actually occupied and used for residential purposes by the transferor); *see* Publication 588, *supra* note 13, at 1-2 (Q.7). A transfer is exempted from the gains tax to the extent it "consists of a mere change of identity or form of ownership or organization, where there is no change in beneficial interest." *Id.* The gains tax is thus inapplicable to particular partnership and corporate transactions which are mere changes of identity. *Id.* at 19 (Q.50). For a listing of other exemptions, see *id.* at 1-2 (Q.7).

[31] N.Y. TAX LAW § 1443.5 (McKinney Supp. 1986); *see* Publication 588, *supra* note 13, at 19 (Q.50). Examples of such exempt transfers include: (1) the transfer of real property by an individual to a partnership in exchange for an interest in the partnership; (2) the transfer by tenants-in-common of their interest in real property to a partnership, to be owned in the same pro rata share as by the tenants-in-common; (3) the transfer of real property by a corporation to its shareholders, who will hold the real property as tenants-in-common in the same pro rata share as they own the corporation; (4) the transfer by a corporation to its wholly owned subsidiary, from a wholly owned subsidiary to its parent, or from one wholly owned subsidiary to another and; (5) the transfer by tenants-in-common of real property to a corporation which the tenants own in the same pro rata share. *Id.* (Q.50(a)).

[32] *See* Publication 588, *supra* note 13, at 15 (Q.42). Although separate deeds are used to transfer adjacent property, they are treated as a single transfer of property. *Id.* The burden is on the transferor to show that even though the properties are adjacent, they were not used for a common purpose. *Id.*

tive or condominium plan are also aggregated while transfers of subdivided real property improved with residences are not.[33] In the case of partial or successive transfers not pursuant to a cooperative or condominium plan, the gains tax is imposed when the aggregate consideration paid exceeds one million dollars.[34]

With a few exceptions, before a deed may be recorded in New York State, tranferors and tranferees must either file a tentative tax assessment or an affidavit claiming an exemption.[35] A statement of tentative assessment of the amount of tax due must be supplied by the Department of Taxation and Finance within twenty days after the filing of affidavits.[36]

II. Constitutional Implications of the Gains Tax

The Supreme Court upholds the constitutionality of legislative enactments whenever possible.[37] Only laws that interfere with fundamental constitutional rights or contain suspect classifications are not presumed to be constitutional.[38] Classifications created by tax-

[33] N.Y. Tax Law § 1440.7 (McKinney Supp. 1986).

[34] *Id.* § 1442; *see also* Publication 588, *supra* note 13, at 24 (Q.68).

[35] N.Y. Tax Law §§ 1447.1(f)(1)(ii), 1447.1(f)(2) (McKinney Supp. 1986). A conveyance of real property can be recorded if a sworn affidavit is filed that the transfer is for less than $500,000. *See id.* § 1447.1(f)(2).

A transferee must withhold consideration from the transferor in an amount sufficient to pay the taxes determined from the tentative assessment. *See id.* § 1447.3(a). If a tentative assessment of gains tax due has been issued by the New York State Department of Taxation and Finance, transferees who fail to withhold the required amount for the tax are held personally liable if the tax is not paid by the transferor. *Id.* § 1447.3(a). *See* Publication 588, *supra* note 13, at 25-26 (Qs. 70(b), (c)).

[36] N.Y. Tax Law § 1447.2 (McKinney Supp. 1986).

[37] *See, e.g.*, Clements v. Fashing, 457 U.S. 957, 963 (1982) (assumed legislatures act constitutionally in equal protection questions); Panama R. Co. v. Johnson, 264 U.S. 375, 390 (1924) (statute must be construed to avoid any doubt of its constitutionality); Butler v. Commonwealth, 51 U.S. (10 How.) 402, 415 (1850) ("[A] law of one of the sovereign states should never be . . . denominated [unconstitutional], if it can upon any other principle be correctly explained.").

[38] *See* San Antonio Indep. School Dist. v. Rodriguez, 411 U.S. 1, 17 (1973); Sugarman v. Dougall, 413 U.S. 634, 638-43 (1973). In *Sugarman*, the Court held that a New York Civil Service Law allowing only United States citizens to hold permanent positions with the state civil service was violative of the fourteenth amendment. 413 U.S. at 646. Classifications based on alienage are suspect and subject to close judicial scrutiny. *Id.* at 642. Similarly, in Dunn v. Blumstein, 405 U.S. 330, 335-60 (1972), the Court held that to require a one year residency requirement as a prerequisite to voting was a violation of the Equal Protection Clause. 405 U.S. at 352. Such requirements discriminated between old and new residents of the state and created a suspect classification that penalized citizens who moved interstate. *Id.* at 334-35. In Shapiro v. Thompson, 394 U.S. 618 (1969), a statute denying wel-

ing enactments may be challenged under the Equal Protection Clause of the fourteenth amendment[39] but, as examples of economic or commercial legislation, they are upheld if the legislature could have reasonably concluded that the statutory distinction would promote a legitimate state purpose.[40] Thus, the states may make reasonable classifications among groups for purposes of taxation.[41] Since state legislatures possess such great freedom in determining classifications,[42] the burden rests on the challenger of a tax statute to discredit any conceivable basis supporting the statute.[43] As a result, the challenger of the constitutionality of a taxing statute is at a distinct disadvantage.[44]

The presumption of constitutionality, however, is a rebuttable one.[45] The legislature's power in selecting classifications is not absolute in that the equal protection demanded by the fourteenth amendment forbids arbitrary classifications.[46] Classifications based on differences unrelated to the purpose of legislation violate the

fare benefits to those not residents of a state for one year was held unconstitutional as a denial of equal protection. 394 U.S. at 627. The Court stated that the Constitution guarantees citizens freedom of movement between states. *Id.* at 619. The argument that a one year waiting requirement promotes state administrative efficiency by providing a ready means of determining residency did not amount to a compelling state interest justifying the statute. *Id.* at 636.

[39] Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 359 (1973) (quoting Allied Stores v. Bowers, 358 U.S. 522, 526-27 (1959)); Tax Comm'r v. Jackson, 283 U.S. 527, 537-38 (1931) (duty of court is to question the classifications adopted by legislature); Magoun v. Illinois Trust and Sav. Bank, 170 U.S. 283, 293 (1898) (court must test reasonableness of state's classification).

[40] *See* Exxon Corp. v. Eagerton, 462 U.S. 176, 196, *appeal dismissed,* 464 U.S. 801 (1983); New Orleans v. Dukes, 427 U.S. 297, 303 (1976).

[41] *See supra* note 4 and accompanying text.

[42] *See supra* note 2 and accompanying text.

[43] *See* McGowan v. Maryland, 366 U.S. 420, 535 (1961) (Frankfurter, J.); Borden's Farm Prods. Co. v. Baldwin, 293 U.S. 194, 203 (1934); Lindsley v. Natural Carbonic Gas Co., 220 U.S. 61, 78-79 (1911).

[44] *See supra* notes 1-4, 37 & 40 and accompanying text.

[45] *See* Borden's Farm Prods. Co. v. Baldwin, 293 U.S. 194, 209 (1934). The constitutionality which attaches to legislation is of a factual nature. *Id.* If rebutted, the legislation will be subjected to constitutional attack. *See* Merit Oil v. State Tax Comm'n, 111 Misc. 2d 118, 120, 443 N.Y.S. 2d 604, 606 (Sup. Ct. Albany County 1981); Lindsley v. Natural Carbonic Gas, 220 U.S. 61, 78-80 (1910); Society of Plastics Indus., Inc. v. City of New York, 68 Misc. 2d 366, 375, 326 N.Y.S.2d 788, 798 (Sup. Ct. N.Y. County 1971).

[46] Louisville Gas & Elec. Co. v. Coleman, 277 U.S. 32, 37 (1928) (classifications based on "mere difference" do not satisfy Equal Protection Clause); Gulf, Colo. & Santa Fe Ry. v. Ellis, 165 U.S. 150, 159 (1896).

Equal Protection Clause.[47]

Recently, in *Trump v. Chu*[48] the constitutionality of the New York gains tax was challenged. In *Trump*, real estate developers maintained that the tax violated the Equal Protection Clauses of the United States and New York State Constitutions by imposing discriminatory classifications on those who transfer real property for consideration over one million dollars and also upon condominium and cooperative transferors.[49] In *Trump*, the New York Court of Appeals rejected plaintiffs' assertions that the court should be guided by *Stewart Dry Goods v. Lewis*[50] and *Merit Oil v.*

[47] *See* F.S. Royster Guano Co. v. Virginia, 253 U.S. 412, 415 (1920). Classifications "must rest on some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike." *Id.* Similarly, in an earlier case the Court stated:

> Classification for legislative purposes must have some reasonable basis upon which to stand. It must be evident that differences which would serve for a classification for some purposes furnish no reason whatever for a classification for legislative purposes. The differences which will support class legislation must be such as in the nature of things furnish a reasonable basis for separate laws and regulations. Thus the Legislature may fix the age at which persons shall be deemed competent to contract for themselves, but no one will claim that competency to contract can be made to depend upon stature or color of the hair. Such a classification for such a purpose would be arbitrary.

Gulf, Colo. & Sante Fe Ry. v. Ellis, 165 U.S. 150, 155-56 (1897) (quoting State v. Loomis, 115 Mo. 307, 314, 22 S.W. 350, 351 (1893)).

In New Orleans v. Dukes, 427 U.S. 297 (1976), the Supreme Court stated that it would defer to a state's enactment of specific economic legislation unless the legislation violated a fundamental right or was directed at a suspect class. *Id.* at 303. This is because the "judiciary may not sit as a superlegislature to judge the wisdom or desirability of legislative policy determinations in areas that neither affect fundamental rights nor proceed along suspect lines." *Id.* Economic classification need only be rationally related to a legitimate state interest to avoid strict judicial scrutiny. *Id.*

The Court has held statutes invalid as a violation of the Equal Protection Clause even under the rational basis analysis. In Zobel v. Williams, 457 U.S. 55 (1982), the Supreme Court employed a rational basis analysis (not requiring strict scrutiny) to find that an Alaska dividend distribution plan of state funds violated the Equal Protection Clause of the fourteenth amendment. *Id.* at 60-61, 65. The Court analyzed the state legislature's purpose in distributing dividends increasing with the number of years of a citizen's residence in the state and concluded such a classification was not rationally related to a legitimate state purpose. *Id.* at 65.

Also, in Hooper v. Bernalillo County Assessor, 105 S. Ct. 2862 (1985), the Supreme Court, applying a rational basis analysis, held that a New Mexico property tax exemption for Vietnam veterans based on a durational residence requirement was invalid as violative of the Equal Protection Clause. *Id.* at 2865-67.

[48] 65 N.Y.2d 20, 478 N.E.2d 971, 489 N.Y.S.2d 455, *appeal dismissed*, 106 S. Ct. 285 (1985).

[49] *Id.* at 24, 478 N.E.2d at 974, 489 N.Y.S.2d at 458.

[50] Stewart Dry Goods v. Lewis, 294 U.S. 550 (1935).

State Tax Commission.[51]

In *Stewart*, the Supreme Court overturned a revenue statute where the amount of tax due was based on a merchant's gross sales.[52] The Court held that such a classification was arbitrary and violated the Equal Protection Clause.[53] In *Merit*, a New York State Supreme Court overturned a gross receipts tax as violative of the Equal Protection Clause of both the New York and United States Constitutions.[54] The tax was imposed on retailers who sold more than sixty million gallons of petroleum in New York State, but granted an exemption to those who sold less.[55] The Court of Appeals distinguished the gross receipts taxes in *Stewart* and *Merit* by noting that both revenue taxes were imposed on gross sales, regardless of profit, while the gains tax before the court was imposed only on the amount of gain, although initial tax liability was determined by reference to gross consideration.[56] Under this reasoning, arbitrary classifications will survive so long as the statute taxes profits and not gross receipts.[57] However, the *Merit* court found the law unconstitutional because the statute treated members within the same class unequally.[58]

[51] Merit Oil v. State Tax Comm'n, 111 Misc. 2d 118, 443 N.Y.S.2d 604 (Sup. Ct. Albany County 1981).

[52] Stewart Dry Goods v. Lewis, 294 U.S. 550, 566 (1935). The challenged statute in *Stewart* levied a tax on the sales of retail merchants measured by the amount of gross sales. *Id.* at 555. The rationale behind the tax was that those with greater sales were generally earning a greater profit and this justified the classification. *Id.* at 557-58. The *Stewart* Court noted that although profits increase with the amount of sales, there were so many exceptions to the general rule depending on the type of sales activity, that a classification could not be justified on these grounds. *Id.* at 559. A tax based upon gross receipts was unfair because it taxed transactions by their size and without regard to their profitability. *See id.* at 558-59.

[53] *Id.* at 554, 557.

[54] Merit Oil v. State Tax Comm'n, 111 Misc. 2d 118, 443 N.Y.S.2d 604 (Sup. Ct. Albany County 1981).

[55] *Id.* The *Merit* court objected to the way the statute treated members within the same class of "retailers" by granting a total tax exemption to those retailers whose petroleum sales were not above a certain volume. The *Merit* court noted that "legislation providing for classifications based upon [sales] is constitutional except where . . . all persons so engaged are not treated alike." *Id.* at 120, 443 N.Y.S.2d at 606.

[56] *Trump*, 65 N.Y.2d at 26, 478 N.E.2d at 976, 489 N.Y.S.2d at 460. The *Trump* court viewed the holdings in *Stewart* and *Merit* as standing for the proposition that gross receipts taxes that treat similarly situated taxpayers differently based on sales volume violate equal protection simply because the taxes are imposed without regard to profits. *Id.*

[57] *See supra* note 56.

[58] Merit Oil v. State Tax Comm'n, 111 Misc. 2d 118, 120, 443 N.Y.S.2d 604, 606 (1981). The *Merit* court examined the gross profits tax and could "glean no rational basis

It is submitted that, in spite of the New York court's decision in *Trump v. Chu*, the *Stewart* Court's rationale is directly applicable to the constitutionality of the gains tax. The *Stewart* Court rejected the contention that a classification based on sales volume was justified because a merchant's ability to pay a tax increased with his volume of sales.[59] According to the *Stewart* Court, such a statutory distinction discriminated in an unequal and arbitrary way between persons similarly circumstanced.[60] However, the *Trump* court asserted the one million dollar classification based on gross consideration, mandated by the gains tax, was rational because the state legislature could have concluded that "generally speaking" profits increase as the amount of gross consideration increases.[61] Such reasoning contradicts the Supreme Court's recognition in *Stewart* that a merchant's profits do not necessarily increase with gross sales.[62] The New York gains tax allows those with identical gains

for the creation of a total exemption for those retailers selling less than 60,000,000 gallons of petroleum, while fully taxing from 'dollar one' all profits . . . of those companies selling more than said amount." *Id.*

[59] Stewart Dry Goods Co. v. Lewis, 294 U.S. 550, 559 (1935). After thorough analysis, the *Stewart* Court refused to accept such an argument that gross sales could reasonably serve as the basis of a tax classification. *Id.* at 557. Instead, the Court found that:

> gross sales of a merchant do not bear a constant relation to his net profits; that net profits vary from year to year in the same enterprise; that diverse kinds of merchandise yield differing ratios of profit; and that gross and net profits vary with the character of the business as well as its volume.

Id. at 558-59.

[60] *Id.* at 565-66. The Court noted that the Supreme Court had upheld classifications that taxed chain stores at higher rates than single stores because the different form of organization had inherent advantages. *Id.* at 565. However, the Court could find no basis for sustaining a classification founded solely on volume of business. *Id.* at 566. The *Stewart* Court noted that the gross receipts tax "exacts from two persons different amounts for the privilege of doing exactly similar acts because the one has performed the act oftener than the other." *Id.*

[61] *See* Trump v. Chu, 65 N.Y.2d 20, 27, 478 N.E.2d 971, 976, 489 N.Y.S.2d 455, 460 (1985). The *Trump* court inaccurately quoted the *Stewart* opinion by stating that "generally speaking" profits increase in proportion to an increase in gross consideration. *Id.* The *Stewart* Court accepted this finding, which was made by the district court, but further stated that "[t]he ratio of increase, however, differs in different lines of activity and even as between concerns carrying on the same business, and so many exceptions and reservations must be made that averages are misleading." Stewart Dry Goods Co. v. Lewis, 294 U.S. 550, 559 (1935). The *Trump* court reasoned that so long as the statute taxed only net gains, it would be rational for the legislature to conclude that profits will increase with gross consideration. *Trump*, 65 N.Y.2d at 27, 478 N.E.2d at 976, 489 N.Y.S.2d at 460.

[62] *See* Stewart Dry Goods Co. v. Lewis, 294 U.S. 550, 558-59 (1935). The *Stewart* Court criticized the trial court for not finding a relationship between gross sales and net profits before upholding the gross receipts tax. *Id.* Similarly, the *Trump* decision was not based on

to be taxed differently based on the consideration for the sale of real property.[63]

Reasonable classifications are allowed in systems of taxation.[64] The Supreme Court has noted that "some injustice is bound to result from any general rule of classification and equal protection demands only reasonable uniformity in dealing with parties similarly circumstanced."[65] It is submitted that the classifications engendered by the New York gains tax lack such reasonable uniformity.[66]

The *Trump* court upheld the one million dollar exemption on the basis of administrative convenience.[67] Such a rationale can be used by legislatures to establish classifications only if the classification bears some reasonable relationship to the amount of the tax.[68] The *Stewart* Court, however, specifically rejected administrative convenience as a rationale for upholding arbitrary taxation.[69]

actual findings of a correlation between a greater amount of gross consideration and increased profits in a real property transfer. *See* Trump v. Chu, 65 N.Y.2d 20, 27, 478 N.E.2d 971, 976, 489 N.Y.S.2d 455, 460 (1985).

[63] *See Trump*, 65 N.Y.2d at 24, 478 N.E.2d at 974, 489 N.Y.S.2d at 458. The plaintiffs in *Trump* pointed out that "[a] taxpayer who sells his property for $999,999 and has a gain of $500,000 owes no tax whereas a taxpayer who sells his property for $1,000,001 and has a similar $500,000 gain must pay a tax of $50,000." *Id.*

[64] *See supra* note 6 and accompanying text.

[65] Stewart Dry Goods Co. v. Lewis, 294 U.S. 550, 564 (1935).

[66] *See* Brief Amicus Curiae of Citizens Tax Council, Inc. for Appellants at 8, Trump v. Chu, 65 N.Y.2d 20, 478 N.E.2d 971, 489 N.Y.S.2d 455 (1985). The classifications in the New York gains tax are arbitrary because the purpose of the tax was to raise revenue. However, the gains tax is triggered on transactions involving minimal profits while transactions involving large gains are left untouched. A hypothetical seller could transfer a parcel of real property in which he has a basis of $1,000,000 for $1,000,001. Under the New York gains tax his one dollar of gain is subject to a ten percent levy. Another transferor sells a parcel of real property with a basis of $100,000 for $999,999. His $899,999 gain is tax exempt. *Id.* at 8.

[67] *See* Trump v. Chu, 65 N.Y.2d 20, 27, 478 N.E.2d 971, 976, 489 N.Y.S.2d 455, 460 (1985).

[68] *See* Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 511 (1937).

[69] *See Stewart*, 294 U.S. at 560. "If the commonwealth desires to tax incomes it must take the trouble equitably to distribute the burden of the impost. Gross inequalities may not be ignored for the sake of ease of collection." *Id. Cf.* Schlesinger v. Wisconsin, 270 U.S. 230, 240 (1926) (arbitrary classification in taxation cannot be sustained because the legislature found such classification a necessary aid in collecting inheritance taxes). *But see* Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 511 (1937). The *Carmichael* Court appeared to hold a contrary view when that Court stated "[a]dministrative convenience and expense in the collection or measurement of the tax are alone a sufficient justification for the difference between the treatment of small incomes or small taxpayers and that meted out to

The plaintiffs in *Trump* also contended that different tax classifications for cooperative and condominium developers and developers of subdivided parcels with improved residences were unconstitutional.[70] The court in *Trump* employed the following rationalizations to support the legislature's different tax classifications for cooperative and condominium developers and developers of subdivided realty: (1) condominium and cooperative developments involve greater administrative costs to the state because of special laws;[71] (2) condominium and cooperative developments are more likely to occur in urban areas, creating increased demands on public services;[72] (3) treating condominium and cooperative sales as separate tax transactions involves greater administrative expense than sales of subdivided realty;[73] and (4) the classification would encourage the development of individually owned residences and discourage the conversion of rental apartments to condominiums and cooperatives.[74] A New York Supreme Court has recognized that "fanciful conjecture" cannot save a statute from constitutional attack if facts are proven which show that a classification is arbitrary.[75] It is submitted that since these judicial rationalizations are rebuttable, the Court of Appeals erred in upholding the New York gains tax.

The New York Attorney General already collects statutorily imposed fees for the filing of cooperative or condominium offering statements which are designed to offset the state's administrative costs.[76] Also, cooperative and condominium developments are not

others." *Id.* (citations omitted). It is submitted that the *Stewart* and *Carmichael* cases are reconcilable. In *Stewart,* there was no reasonable relation between gross receipts and net gain. *Stewart,* 294 U.S. at 560. In *Carmichael,* the exclusion of employers of less than eight employees was in fact reasonably related to the amount of tax collectible. *Carmichael,* 301 U.S. at 511. This provided the legislature with a reasonable basis to conclude that monies spent collecting the tax from the excluded class would not be recovered through its collection. *Id.*

[70] *See* Trump v. Chu, 65 N.Y.2d at 28, 478 N.E.2d at 976-77, 489 N.Y.S.2d at 460-61.

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *See* Society of Plastics Indus. v. City of New York, 68 Misc. 2d 366, 375, 326 N.Y.S.2d 788, 798 (Sup. Ct. N.Y. County 1971).

[76] See N.Y. GEN. BUS. LAW § 352(e)(7)(a) (McKinney Supp. 1986) which empowers the New York Attorney General to collect fees on a sliding scale for cooperative or condominium plan offering statements. The legislative history behind Section 352(e)(7)(a) of the New

only endemic to urban areas and there is no evidence these developments increase demands on public services.[77] Furthermore, the administrative costs for collecting the gains tax on condominium and cooperative developments are the same as those for subdivided real property[78] and, realistically viewed, there is no evidence that the challenged classification will slow down the conversion of rental apartments to cooperatives and condominiums.[79]

III. Proposals For Legislative Revision of the Gains Tax

It is submitted that in its present form, the gains tax treats similarly circumstanced individuals in a discriminatory and unfair manner.[80] Any proposal for legislative revision of the gains tax should therefore focus on amending the current one million dollar gross consideration exemption.[81] Individuals with comparable gains on real property transactions should be taxed at similar rates.[82] By making the imposition of the gains tax dependent on the transferor's gain without regard to the amount of gross consideration of a transfer, this disparity would be eliminated and the financial well-being of the state would be enhanced.[83]

York General Business Law indicates these fees were intended to offset the State's regulatory costs in reviewing the plans. Memorandum of the Executive Chamber, N.Y. Governor's Bill Jacket, L. 1962, ch. 57, 7-8.

[77] *See, e.g.*, N.Y. Times, May 20, 1984, § 8, at 1, col. 1 (development of condominium community in Southhampton, N.Y.); N.Y. Times, Apr. 22, 1984, § 8, at 10, col. 1 (cooperative projects in Montauk, New York); N.Y. Times, Mar. 2, 1984, at B7, col. 1 (new condominiums being built in western Nassau County).

[78] *See* N.Y. Tax Law § 1447.1(e) (McKinney Supp. 1986). Unless the transaction is exempt from the gains tax, the recording officer cannot accept a deed for filing in New York State for either a condominium or a private home unaccompanied by a statement of tenative assessment of gains tax due. N.Y. Tax Law § 1447.1(f)(1)(i), (ii) (McKinney Supp. 1986). No difference exists in the collection procedure for condominiums as opposed to subdivided improved property. *See id.*

[79] *See* Brief for Appellants at 14-15, Trump v. Chu, 106 S. Ct. 285 (1985). The extra costs incurred by transferors due to the gains tax will be passed on to buyers without slowing condominium or cooperative construction or conversion. Brief for Appellants at 17.

[80] *See supra* notes 61-63, 66 and accompanying text.

[81] *See supra* note 9 and accompanying text.

[82] *See supra* note 66 and accompanying text.

[83] *See* Board of Governors of the Real Estate Board of New York, Inc., *Proposals for Amendment of the New York State Real Property Gains Tax* 56 (Jan., 1984). The gains tax affects the New York State economy adversely by discouraging continued real estate investment and development in the state. *Id.* Large financial institutions such as insurance companies who administer pension funds and act in a quasi-fiduciary manner are the major sources of financing for investment properties. *Id.* Since the gains tax may lower the profits

Conclusion

The New York State gains tax is a complicated piece of legislation that unfairly discriminates between similarly circumstanced individuals. The gains tax is triggered not by an individual's profit on a transaction but by an arbitrarily set gross consideration amount. Such an arbitrary classification scheme violates the Equal Protection Clauses of the New York State and United States Constitutions. Because the judiciary is unwilling to correct the disparities created by arbitrary classifications in the tax, the legislature should amend the Act to make the amount of gain and not the amount of gross consideration the trigger for imposition of the tax. Further changes should be made to the gains tax to insure that both residential and commercial construction activity and the health of New York's economy are not inhibited.

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of a property sale, these institutions would have difficulty justifying a New York project site if one were available in another state which did not impose a levy on real property transfers. *Id.* In addition, new construction projects are an investment risk. *Id.* at 4. These projects become even more of a risk in New York because of the combined rates of New York State and City corporate and individual income taxes. *See id.* (New York imposes 18.1% capital gains and 7.4% personal tax; Texas imposes none).

A high level of state construction activity produces sales tax revenue and benefits the real estate tax assessment base. *Id.* Because of the present tax disparity imposed on cooperative and condominium projects as opposed to subdivided real property, the gains tax inhibits the construction of new rental housing and cooperative and condominium developments. *See supra* note 33. Therefore, it is submitted that the present tax disparity imposed on cooperative and condominium projects as opposed to subdivided real property should be eliminated because it serves no rational purpose. *See supra* notes 65, 74-77 and accompanying text; Trump v. Chu, 65 N.Y.2d at 28-32, 478 N.E.2d at 977-79, 489 N.Y.S.2d at 461-63 (Kane, J., dissenting). Critics of the gains tax therefore believe that it should be amended to exclude all newly constructed residential properties from taxation. *See* Board of Governor's Report, *supra* note 82, at 9; *see also* Memoranda of State Executive Department of New York, *reprinted in* [1984] N.Y. Laws 3456 (McKinney).