WHAT TO KNOW WHEN CONSIDERING IMPLEMENTING A FLIP TAX

AN ARGO REAL ESTATE WHITE PAPER

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Background

A flip tax is a revenue measure in many of New York City's cooperative and condominium buildings. It is not a tax, but rather a transfer fee, which the seller of a unit pays to the building when selling his or her apartment (although there are instances where the buyer pays the "flip tax"). The building can use this money for either (1) enhancing the building's reserve fund; or (2) annual maintenance costs and daily operations.

The tax originated in the 1970's when many rental apartment buildings in New York City converted to cooperatives. Because the buildings were in poor condition and many tenants of the formerly rent-controlled apartments could not afford to pay higher prices for a renovated building, the buildings were converted in "as-is" condition and the buyers needed to address deferred maintenance issues after conversion. The flip tax was created as a solution.

According to attorney Richard Klein, the flip tax was also created to discourage investor purchasers from buying into the building and then flipping the unit, hence the name "flip" tax.

Today, nearly 60% of cooperative apartment buildings in New York City have a flip tax in order to generate extra money without raising maintenance fees or implementing special assessments.[1]

Impact

In the past, concern was voiced that flip taxes may detrimentally affect an apartment's marketability, but Bruce A. Cholst, a Manhattan cooperative lawyer argues that this is not true anymore. People would rather pay a flip tax than higher maintenance fees or assessments.[2] Dennis H. Greenstein, another Manhattan cooperative lawyer even argues that people prefer to purchase apartments in buildings which have a healthy reserve fund due to a flip tax. In that case, maintenance charges are assumed to be more stable and therefore there will be less building assessments.[3]

CPA Abe Kleinman's experience supports this assumption. He notes that "a number of our coop clients have earmarked the flip tax for capital expenditures and, as a result, have not had to assess or borrow when they required funds for capital improvements."

CPA Robert Melina concurs, saying that a flip tax is "an excellent way to raise funds for capital improvements and replenish reserve funds. Within our portfolio of cooperatives and condominiums the buildings that have [a flip tax] are able to fund capital projects without constantly assessing and without constantly borrowing. This will result in lower maintenance and fewer capital assessments."

Calculating Flip Taxes

In order to study how flip taxes were calculated and used by buildings in New York, we surveyed 74 buildings managed by Argo Real Estate. The information about each building's flip tax was provided by Argo's Closing Department, which receives the information from each Argo managed building. Below is a list of ways flip tax can be calculated, followed by the percentage of Argo's buildings studied that use that particular method of calculation.

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[1] King, W.B., 'Flip Taxes or Transfer Fees: What You Need to Know' The Cooperator. October, 2015.
[2] Loria, Keith. 'Voting Yes to Flip Taxes: Generating Income Without Assessments' The Cooperator. July, 2005.
[3] Romano, Jay. 'Your Home; Imposing Flip Taxes in a Cooperative ' The New York Times. April 13, 2003.

Overall, 58.1% of Argo buildings have a flip tax.

1) A percentage of the sales price (53.5%)
   a. Customarily between 1 and 3 percent of the sales price.
   b. The majority of Argo buildings have the percentage at 2% of the sales price.

2) A percentage of the profit – either Gross Profit or Net Profit **(18.6%)**
   a. **Gross Profit %:** the difference between the unit's original purchase price and the sale price.
   b. **Net Profit %:** the difference between the unit's original purchase price and the sale price and further reduced by brokers' fees, legal fees, renovation costs, etc.

   This approach presents the complication of defining "net profit," as well as the practical exercise of analyzing/auditing the seller's renovation costs, which creates an administrative chore. (For this reason, most buildings prefer the clear-cut formulas like gross profit or $ per share.)

   In any case, attorney Richard Klein notes that "while a flip tax based upon a straight percentage of the sales price or on a per share basis might be the easiest to calculate, some coops opt to base it upon some measure of profit so that shareholders are protected during a 'down' market."

3) $ per Share (20.9%)
   a. A fixed number of dollars per share

4) A Flat Fee (4.7%)
   a. For example: $ 20,000. People with larger apartments in a building prefer this type of flip tax. However, this is most common in buildings in which the apartments are all similar in size.

5) X Months of Common Charges (2.3%)

Declining Scale based on Length of Ownership: Some buildings incorporate a provision whereby the longer someone lives in the building, the less of a flip tax they pay when they sell their apartment. This is believed to discourage people from buying purely for investment purposes.
   a. **Example:** 3% of sales price if owned 1-2 years, 2% of sales price if owned 2-4 years and 1% of sales price if owned 4 or more years.
   b. **Example:** $21 per share if owned less than 1 year, $18 per share if owned 1-2 years, $15 per share if owned 3-4 years and $12 per share if owned 4 years or longer.

In total, 16.6% of Argo buildings with a flip tax incorporate this methodology. 85.7% of those have a declining scale based on percentages of the sales price while the remaining 14.3% have a declining scale based on price per share.

Implementation

To implement a flip tax, there is often a requirement of consent by two-thirds (66.67%), or three-quarters (75%) of the shareholders or unit owners. In the case of a cooperative, the proprietary lease and bylaws must be amended. In the case of a condominium, the bylaws must be amended.

Boards are advised to explain the need for a flip tax in writing and/or by special meeting. To be successful in achieving a favorable vote, the Board often needs to campaign among shareholders or unit owners, explaining the long term advantages of the flip tax.

To appeal to shareholders or unit owners, many buildings have exemptions of the flip tax such as transfers between family members, spouses and domestic partners and between estates and heirs and beneficiaries. Another special exemption from the flip tax might be if someone sells one apartment in the building and buys another.[4]

<u>Rate of the flip tax to be implemented:</u> In most cases, the Board determines a "target" of the dollar amount that it wishes to achieve on an average sale via the flip tax, and backs into the type of flip tax it wishes to use, based on average sale price in the building, or average number of shares, etc.

<u>Sponsor Exemption:</u> Boards considering a flip tax should be aware that many conversion plans include a provision that exempts a sponsor or "holder of unsold shares" from the requirement to pay a flip-tax.

Case Law

The most influential cases considered simultaneously by the New York Court of Appeals were *Dan FeBland v. Two Trees Management Company* and *Thomas E. Kelly v. 330 West End Apartment Corporation (1986).*

In both cases, the Court determined that the cooperative board could institute a flip tax only if this power was specifically stated in the proprietary lease. Also, if that flip tax was not perfectly proportional, each shareholder would most likely be treated in a different manner. The court ruled that by not treating all shareholders equally, the flip tax in question violated a basic concept of New York Business Corporate Law.

Legislative Action

After the Court's ruling in the above referenced cases, the NYS legislature passed BCL 501(c)(3). This specific legislation was enacted in response to the holdings in those two cases. The law states that unequal flip taxes are acceptable, as long as enacted as an amendment to the proprietary lease.

Conclusion

The most common type of flip tax in Argo-managed buildings is calculated by taking a percentage of the sales price. From a management perspective, the simpler the flip tax formula, the better, as it will be easier to administer and monitor.

Argo Real Estate recommends that the cooperative board consider the flip tax as an enhancement to assessments for building the cooperative's capital improvement reserve fund, and that the Board utilize a flip tax to retain the reserve fund level rather than to build a reserve fund to a specific amount.

[4] Romano, Jay. 'Your Home; Imposing Flip Taxes in a Cooperative ' The New York Times. April 13, 2003.