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COLE SCHOTZ
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The New Bulk Sales Notification Requirements and Their Application to New Jersey Real Estate Transactions - Part II

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Bulk Sale Notification Requirements Apply To Deed in Lieu of Foreclosure

Based upon the findings of the Tax Court in N.J. Hotel Holdings, Inc. v. Dir., Div. of Taxation, 15 N.J.Tax 428, 437 (Tax Ct. 1996), the New Jersey Division of Taxation is enforcing recent changes in the New Jersey bulk sales notification requirements contained in N.J.S.A. 54:50-38 on the basis that such requirements apply to deeds in lieu of foreclosure ("deeds in lieu") of real estate accepted by lenders, regardless of the fact that no monetary consideration is being received by the lender. If N.J. Hotel Holdings, Inc. is upheld it will mean that a lender who fails to comply with the bulk sales notification requirements before accepting a deed in lieu will be deemed by statute to have assumed liability for payment of all of the borrower's outstanding tax obligations to the State of New Jersey.

(For a more general discussion of the new bulk sales requirements under N.J.S.A. 54:50-38, see **The New Bulk Sales Notification Requirements and Their Application to New Jersey Real Estate Transactions – Part 1**)

N.J. Hotel Holdings, Inc. v. Director, Division of Taxation

The question before the Tax Court in N.J. Hotel Holdings, Inc. was whether statutory bulk sales notification applied to assets acquired by way of deeds in lieu. The court unequivocally answered in the affirmative:

> In this case the court holds that a person who acquires assets by way of a deed in lieu of foreclosure and a bill of sale, and who fails to give notice to the [Director] under N.J.S.A. 54:32B-22(c), is liable for the sales and use tax liability of the person from whom the assets are acquired. [Note: the Tax Court's analysis is equally applicable to N.J.S.A. 54:50-38 and it is unlikely the case can be distinguished on the basis of the new legislation].

In N.J. Hotel Holdings, Inc., a bank made loans to several entities, secured by mortgages, assignments, and security agreements on three hotels. Following a modification and transfer of the properties and related obligations, the new owners defaulted on their obligations to the bank. Pursuant to a subsequent foreclosure agreement, the bank acquired all of the hotel assets by way of deeds in lieu. Bulk sale notification of this acquisition was not provided to the Director. As a consequence, the Director deemed the bank liable for all taxes relating to the subject property due by the defaulting owner prior to, and following, the transfer. The arguments presented by the bank in appealing the assessments of the Director can be categorically summarized:

> (1) a deed in lieu is not a transfer within the meaning of the statute,
>
> (2) because the State would have not received payment upon foreclosure, it should not receive payment when transfer is made via a deed in lieu, and
>
> (3) because no cash is exchanged in a deed in lieu transaction, there was no escrow mechanism to ultimately comply with the statute.

The court spent minimal time, and found little difficulty, dismissing the claim that a deed in lieu was not a transfer within the meaning of the statute: "It is clear that N.J.S.A. 54:32B-22(c) is meant to extend beyond . . . simple sale for cash . . . and beyond the restrictive definitions of the bulk sales act." In the present case, "the hotel assets were *transferred* to plaintiff in settlement of the foreclosure action." This was evidence enough to satisfy the court that the statute should apply.

The court then goes on to address the contention that had the foreclosure been completed, the State would have no remaining lien on the property and, as a result, would have received none of the sales tax due by the transferor. The court thwarts this argument by citing the business decision rule, reminding the transferee that it was their choice to avoid foreclosure through this asset transfer mechanism, and it is in the public interest of the State to allow such independent decision-making:

> The principle that a business decision will be given its tax effect according to what actually occurred promotes public interest in tax certainty and thereby conforms with general business expectations. Indeed, planning by individuals and businesses alike would be frustrated if courts failed to give predictable effect in formal legal documents . . . simply because of asserted ignorance of law. . . .
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> 'As a general proposition, the answer must be that it is for the taxpayer to make its business decisions in light of tax statutes rather than the other way around.'

Finally, the court focused its attention on whether the statute should be deemed inapplicable because no cash is transferred in a deed in lieu transaction, rendering a cash escrow impossible. The court viewed this as a practicality argument of little merit. The fact that a deed in lieu transaction involves other consideration rather than cash does not relieve the transferee of liability based solely on the structure of the transaction. According to the court, the value of the "choses in action, or

other consideration[s]" were greater than the sales tax obligations of the transferor, thus rendering the existence of a cash escrow irrelevant when determining the applicability of the notification requirements. Although the bank cites the interpretation of out-of-state statutes by the courts of other jurisdictions, the court rejects these alternative interpretations on the grounds of differing public policy objectives.

Life After N.J. Hotel Holdings, Inc.

The practical consequences of the holding in N.J. Hotel Holdings, Inc. are significant.

The Division's application of N.J. Hotel Holdings, Inc. in applying the rules to deeds in lieu, when coupled with N.J.S.A. 54:50-38 which applies the bulk sales rules to a wide array of real estate transactions, effectively gives the State of New Jersey a super priority lien for outstanding taxes if a lender, in accepting a deed in lieu, fails to comply with the notification requirements. This is due to the fact that the lender's deemed assumption of a borrower's outstanding tax liability to the State of New Jersey will force a lender, who has accepted a deed in lieu without complying, to first pay the State of New Jersey the outstanding tax liability before it allocates any amounts recovered from the property to the debt.

Lenders must notify the Director prior to accepting a deed in lieu for the real estate encumbered by the security instrument. This is so despite the fact that a lender could proceed to foreclosure without complying with bulk sales notification requirements. Failure to provide such notification under these statutory requirements will render the lender personally liable for all taxes, sales or otherwise, that may be due at the time of the transfer, as well as any taxes determined to be due later (for example, following an audit of the subject property). Once the lender has made the notification, if the Director requires an escrow for outstanding taxes then the lender will either have to secure the amount from the borrower, if the borrower in fact has any funds, or put up the escrow itself. Of course, a lender could foreclose and avoid the escrow, but foreclosure involves its own costs and expenses, therefore this is just one more part

of the analysis to be made by the lender of the defaulting loan and the lender's potential remedies.

(For a discussion of how to comply with the new bulk sales requirements under N.J.S.A. 54:50-38, see The New Bulk Sales Notification Requirements and Their Application to New Jersey Real Estate Transactions – Part 1)

Cole, Schotz, Meisel, Forman & Leonard, P.A.

Court Plaza North
25 Main Street
Hackensack, NJ 07601
Phone:
(201) 489-3000

900 Third Avenue
16th Floor
New York, NY 10022
Phone:
(212) 752-8000

500 Delaware Avenue
Suite 1410
Wilmington, DE 19801
Phone:
(302) 652-3131

300 East Lombard Street Suite 2000
Baltimore, MD 21202
Phone:
(410) 230-0660