

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
UNITED STATES LIFE INSURANCE COMPANY	:	DECISION
IN THE CITY OF NEW YORK	:	DTA No. 809614
	:	
for Revision of a Determination or for Refund	:	
of Tax on Gains Derived from Certain Real	:	
Property Transfers under Article 31-B of the	:	
Tax Law.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on March 25, 1993 with respect to the petition of United States Life Insurance Company in the City of New York, 125 Maiden Lane, New York, New York 10038. Petitioner appeared by Dreyer and Traub (Jay I. Gordon, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kenneth Schultz, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in response and the Division of Taxation replied. Oral argument was held on October 14, 1993 and began the six-month period for the issuance of this decision.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUE

Whether a portion of the mortgage indebtedness incurred in connection with the construction of a building located at 125 Maiden Lane in New York City is includable in petitioner's original purchase price for purposes of computing its gains tax liability upon the sale of the building and the land upon which it is located.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

United States Life Insurance Company in the City of New York ("petitioner") and the Division of Taxation ("Division") stipulated to numerous facts which have been fully incorporated into the findings below.

Petitioner is a domestic life insurance company having its principal place of business and home office in Manhattan. On January 6, 1960, petitioner petitioned for the approval of the New York State Superintendent of Insurance to enter into a contract for the purchase of land located at 125 Maiden Lane in New York City. Such petition was the result of petitioner's projection in January 1954 of its own growth rate and the desirability of a site capable of handling petitioner's operations vis-a-vis its growth rate. After review of numerous sites, land was purchased in 1955 by Continental Casualty Company, a corporation which then owned the majority of petitioner's stock, for the purpose of erecting on such property a new home office building for petitioner. In July 1956, Continental Casualty Company sold its majority interest in petitioner and abandoned its plans to construct petitioner's office space.

Petitioner was unable to acquire the land itself and construct a building thereon because of its status as a regulated insurance company. Its petition to the Superintendent of Insurance indicated that the economics of New York City real estate coupled with the investment limitations imposed by the New York Superintendent of Insurance under the law precluded petitioner from owning a building providing the desired floor area and requisite space for its growth. Thus, petitioner sought approval of the Superintendent of Insurance to the transactions which will be described in this matter.

Although petitioner was prohibited from directly acquiring or constructing a building due to regulatory restrictions, petitioner sought the approval of the Superintendent of Insurance of the transactions described below which were designed to effect a "proprietary interest". Petitioner presented its position in its petition to the Superintendent of Insurance, describing the proposal for which it sought approval as follows:

"[W]hereas the occupancy lease . . . makes no provision for petitioner's acquisition of a proprietary interest in the building occupied as its home office, and whereas it is desirable that there be such a proprietary identification of petitioner with the building, and whereas it would be to petitioner's advantage to invest in the subject property in consideration of the return offered, and whereas petitioner is desirous of securing control over future allocations of space "

In 1958, a developer, 125 Maiden Lane Building Company ("MLBC"), acquired the land located at 125 Maiden Lane ("Land") from Continental Casualty Company for \$1,300,000.00. MLBC sold the Land to General Electric Pension Trust ("GEPT") for \$1,400,000.00 under a bargain and sale deed dated March 1, 1960 pursuant to a sale/leaseback arrangement under which GEPT immediately leased the Land back to MLBC (the "Ground Lease") for 30 years and 10 days. MLBC issued a deed to the Land to GEPT in exchange for payment of \$1,400,000.00, the price paid by MLBC for the Land, plus a reasonable allowance for taxes and carrying expenses from the date of acquisition to the passing of title. MLBC reserved title in the building for itself. The Ground Lease provided that MLBC would retain no interest or other rights in the building upon termination of the lease, but instead the building would by contract and operation of law become the property of the owner of the Land. The Ground Lease between GEPT and MLBC was at an annual rate of \$77,000.00, which was equivalent to interest at the rate of 5½% on the \$1,400,000.00 advance to purchase the Land. At the end of 30 years and 10 days GEPT would have unencumbered legal title to the property comprised of the Land and the building. Since it was petitioner who desired to own the Land and building at the end of the Ground Lease, petitioner and GEPT simultaneously entered into a purchase agreement requiring petitioner to acquire the land 30 years later in 1990 upon termination of the Ground Lease for \$1,400,000.00, the same acquisition cost established in the 1960 transaction.

In order for MLBC to construct the building on the Land, it required additional financing of \$6,750,000.00. GEPT (as mortgagee) agreed (pursuant to the Consolidation, Extension, Modification and Spreading Agreement dated March 1, 1960) to loan this amount to MLBC (as mortgagor) based on the credit of petitioner since it was petitioner's funds that would ultimately repay the debt through its rental obligation. Thus, GEPT loaned \$6,750,000.00 to MLBC secured by a mortgage (the "Leasehold Mortgage") on MLBC's Ground Lease and required

MLBC to re-lease the entire building to petitioner (the "Building Lease"). According to petitioner, the Building Lease required an annual rental equivalent to the ground rent described above plus the Leasehold Mortgage debt service and other items, including real estate taxes. In the event of refinancing of the Leasehold Mortgage, the Building Lease incorporated a rental adjustment to maintain equality with the debt service. Petitioner claims that, as a result of the fact that MLBC pledged the Building Lease to GEPT as further security for the Leasehold Mortgage, petitioner became directly and unconditionally obligated to make payments to GEPT of all expenses of the property as well as amounts due under the Leasehold Mortgage and Ground Lease.

As petitioner described the transactions proposed in its petition for approval of the New York Superintendent of Insurance, petitioner indicated that it desired an arrangement under which it could expand into areas of a site location as its growth required. However, the agreements obligated petitioner to pay rent and occupy the entire building. In order to compromise these competing factors, petitioner entered into an arrangement with MLBC which provided MLBC an opportunity to profit. Petitioner subleased the entire building back to MLBC (the "Sublease"), who in turn leased the majority of the building to petitioner and the remainder to unrelated third parties with terms identical to that of the Building Lease requiring MLBC to pay petitioner exactly that which petitioner was obligated to pay MLBC under the Building Lease. MLBC's opportunity to profit existed if it was able to attract tenants other than petitioner who would pay rent at levels higher than that which was to be paid by MLBC under the Sublease. The components of the form of the transaction and the flow of the funds was as follows:

- (a) funds received by MLBC from the rental of a portion of the building to unrelated third parties and petitioner would be paid by MLBC to petitioner pursuant to the Sublease;
- (b) in form such funds would be paid from petitioner to MLBC under the Building Lease; and

(c) then flow from MLBC to GEPT and others for the expenses of maintaining the property, such as for payment of the debt service and real estate taxes. In reality, GEPT sought payment from petitioner directly, bypassing MLBC.

It is noted that petitioner's cost to occupy the building was not set at a market rate of rent. In fact, petitioner rented the space for approximately \$4.00 per square foot as a result of the March 1960 transactions when it would have otherwise had to pay \$4.75 per square foot.

Another simultaneous agreement entered into in March 1960 was established to pay MLBC a fee for developing the property. This agreement between petitioner and MLBC provided that upon the acquisition by petitioner of legal title to the property petitioner would enter into a new ground lease (the "Second Ground Lease") with MLBC for an initial term of 20 years at an annual rent of \$140,000.00 plus 50% of the annual net income from the building. Petitioner asserts that MLBC's right to 50% of the net income for a predetermined period represented compensation to MLBC.

In 1975 MLBC defaulted under the Sublease and filed for bankruptcy. Petitioner's rights under the agreement entitled it to accelerate the purchase of land under the Purchase Agreement with GEPT. Petitioner and MLBC settled the matter by entering into a Joint Venture Agreement dated May 24, 1976 which was deemed effective October 1, 1975 and was to supersede the Building Lease and the Sublease to the extent of any inconsistencies. Although the Joint Venture Agreement provided that petitioner and MLBC would be required to make equal contributions to cover expenditures of the building, if in fact MLBC failed to make its required contribution, petitioner was required to advance amounts due and thereafter to be paid therefor (with interest) from the interest of MLBC in all future distributions that would have been payable to MLBC under such agreement. Petitioner waived further rights against MLBC for its failure to make required contributions. From October 1, 1975 to the dissolution of such agreement on September 9, 1986, only petitioner made cash contributions to the Joint Venture. Petitioner claims to have incurred a primary and direct legal obligation to satisfy all obligations of the property in lieu of its obligations under the Building Lease. Petitioner asserts that it

acquired a "beneficial interest" in the property and directly assumed liability for the Leasehold Mortgage (the balance of which was \$4,478,288.00) and all other debts and expenses under the terms of the Joint Venture Agreement. The termination of the Joint Venture Agreement was March 10, 1990 and upon termination MLBC was obligated to convey its interest in the property to petitioner at no cost.

In 1986 petitioner paid MLBC \$3,342,400.00 in exchange for all of its rights, title and interest in the Joint Venture Agreement, the Land and the building. Petitioner obtained the ground lease position and title to the building subject to the Purchase Agreement and Leasehold Mortgage. On November 26, 1986, petitioner acquired legal title to the Land from GEPT in accordance with the Purchase Agreement for \$1,300,000.00. GEPT had agreed to accelerate the closing date from the original proposed date of March 1, 1990 and discount the purchase price from \$1,400,000.00 to \$1,300,000.00. Petitioner subsequently sold the property to RREEF USA Fund III ("RREEF") in December 1986 for \$48,333,000.00. When petitioner filed its gains tax documents with reference to the sale of 125 Maiden Lane to RREEF, petitioner calculated its total original purchase price in the amount of \$9,120,628.00 for gains tax purposes as follows:

- (a) \$4,478,228.00 represented the outstanding balance of the Leasehold Mortgage as of October 1, 1975;
- (b) \$3,342,400.00 represented funds paid to MLBC in exchange for its interest in the building in 1986; and
- (c) \$1,300,000.00 was the amount paid by petitioner to acquire legal title to the Land from GEPT.

The basis for the parties' disagreement relates to the amount of the Leasehold Mortgage properly includable in original purchase price. The Division allowed \$1,423,811.54 of the Leasehold Mortgage in petitioner's original purchase price which was equivalent to the outstanding balance of such debt as of the date petitioner acquired legal title in August 1986. The disallowed portion in the amount of \$3,054,416.46 represented that portion of the mortgage

balance outstanding as of October 1, 1975 which was amortized through payments by petitioner between 1975 and 1986.

MLBC carried the building as an asset on its balance sheet and depreciated the building for income tax purposes at all relevant times prior to the transfer of the building to petitioner in 1986. Petitioner took no depreciation expense deductions with respect to the building for income tax purposes until after it acquired legal title to the building in 1986.

Petitioner took no interest deductions attributable to the amortization of the mortgages encumbering the Land and building for income tax purposes until after it acquired legal title to the Land and building in December 1986.

Transferor and transferee questionnaires were properly issued by petitioner and RREEF in accordance with the sale between petitioner and RREEF dated December 5, 1986. On December 16, 1986 a Tentative Assessment and Return was computed by the Division based on the filing of such questionnaires indicating total gains tax due of \$3,782,888.10. A post-audit review of the information provided with the questionnaires reporting the transfer of 125 Maiden Lane indicated the following:

"The Joint Venture Agreement between U.S. Life and 125 Maiden Lane Bldg. Co. provides that '[e]ach joint venturer shall retain the basis that it now has in the Joint Venture property'. Based on the foregoing, the claimed mortgage assumption of \$4,478,228.00 by U.S. Life, has been disallowed."

A Statement of Proposed Audit Changes dated October 30, 1989 was issued assessing additional tax of \$447,822.80,¹ plus interest in the amount of \$124,516.43, for a total amount assessed of \$572,339.23. Subsequently, on December 26, 1989, the Division issued to petitioner a notice of determination assessing additional tax due of \$305,441.65, plus interest in the amount of \$92,888.72, for a total amount assessed of \$398,330.37.

OPINION

¹This amount represented tax on the claimed mortgage assumption by petitioner of \$4,478,228.00 which the Division disallowed. It was adjusted before the issuance of the notice to reflect the fact that the Division ultimately allowed \$1,423,811.54 of the Leasehold Mortgage in original purchase price (balance in August 1986).

The Administrative Law Judge determined that petitioner had obtained a beneficial interest in the property on March 1, 1960 and that it was entitled to calculate its original purchase price as if it had acquired the property in 1960. The Administrative Law Judge stated that this original purchase price was \$11,492,400.00, less \$100,000.00 for the discount negotiated by GEPT, which included \$6,750,000.00 for the assumption of the leasehold mortgage. The original purchase price determined by the Administrative Law Judge based on the 1960 acquisition of the real property exceeded that claimed by petitioner on its transferor questionnaire, the latter having been calculated under the theory that petitioner acquired the property in 1975 through the Joint Venture Agreement. As a result, the Administrative Law Judge determined that petitioner not only did not owe the tax assessed in the Notice of Determination, but had overpaid the tax calculated on its transferor questionnaire. Based on these findings, the Administrative Law Judge cancelled the Notice of Determination and ordered a refund based on her calculation of original purchase price. The Administrative Law Judge decided not to address petitioner's argument that the 1960 transaction constituted a transfer for gains tax purposes (i.e., the execution of a contract to sell real property with the use and occupancy of the property) because of her disposition of the case under the beneficial interest theory.

On exception, the Division argues that petitioner was not entitled to any amount of the leasehold mortgage until it acquired title to the property in 1986 because petitioner could not assume, nor take subject to, any mortgage within the definition of consideration until it became the owner of the property. The Division also argues that in treating petitioner as the beneficial owner of the property, the Administrative Law Judge erroneously ignored the form of the transaction in favor of the substance of the transaction. On the other hand, the Division states that "[f]ar too much significance is given to the fact that the Petitioner was a contract vendee for the sale of the land and that its lease payments serviced the mortgage(s) on the property" (Division's brief on exception, p. 9). The Division also contends that the Administrative Law Judge was without jurisdiction to grant petitioner a refund.

In response, petitioner argues that the Administrative Law Judge correctly found that petitioner had acquired the beneficial ownership of the property in 1960. Petitioner also continues to assert, in the alternative, that the 1960 transaction was a transfer for gains tax purposes because it consisted of the execution of a contract to sell the property, coupled with the lease granting use and occupancy of the property. As a third alternative, petitioner argues that at the least it acquired the beneficial ownership of the real property in 1975 when the joint venture agreement became effective. Finally, petitioner argues that the Administrative Law Judge was authorized to grant a refund because the Division of Tax Appeals has the mandate to make a determination of tax due after the taxpayer protests an assessment.

We remand this matter to the Administrative Law Judge for an additional determination on this matter for the following reasons.

The fullest possible development of an issue occurs in our two-stage hearing/exception process when the Administrative Law Judge renders a determination on an issue stating a complete rationale for the conclusion and the litigants debate the correctness of the Administrative Law Judge's rationale and conclusion on exception. This two-stage process gives the Tribunal, and ultimately the courts, the benefit of the Administrative Law Judge's research and analysis as well as the parties' research and analysis in response to the Administrative Law Judge's determination. To the extent that an Administrative Law Judge does not address an issue explicitly raised by the parties in the proceeding or does not state a rationale for a conclusion that is reached, we are either deprived of this benefit or we must remand the case to obtain the Administrative Law Judge's opinion and the parties' responses to it (see, e.g., Matter of Plymouth Tower Assocs., Tax Appeals Tribunal, December 27, 1991, Matter of Air Flex Custom Furniture, Tax Appeals Tribunal, September 12, 1991). In either case, the hearing/exception process does not perform in its most effective and efficient manner. Therefore, we believe that the Administrative Law Judges should, as a general rule, address every issue raised by the parties in the proceeding before them, so long as the issue has not been

subsequently abandoned by the parties. Because the Administrative Law Judges' determinations are not precedential and can be appealed by either party, we can see no reason for an Administrative Law Judge to refrain from deciding issues simply because the Administrative Law Judge has disposed of the case on another ground. Any additional work imposed on the Administrative Law Judges by this rule is offset by the benefit created for the entire system from the Administrative Law Judge's work product.

In this case, the Administrative Law Judge did not address the "contract with use and occupancy theory" by petitioner and did not state any rationale for her ability to grant petitioner a refund. To remedy these omissions, we are remanding this matter for a supplemental determination by the Administrative Law Judge to be issued as expeditiously as possible by the Administrative Law Judge.

We are aware that the Administrative Law Judge did not receive much guidance from the Division on the contract with use and occupancy issue. In its brief before the Administrative Law Judge, the Division never stated whether a contract to sell, coupled with the grant of use and occupancy of the property, was a transfer for gains tax purposes, nor did it state any position on what the original purchase price of the contract vendee would be in such a situation. The Division's only comment was that 20 NYCRR 590.28(c) was not relevant to indicate that lease payments could be included in petitioner's original purchase price because the regulation dealt with the transfer of the lease, not the transfer of the fee, and petitioner had not shown that the lease payments were not for occupancy of the property (Division's hearing brief, p. 3). As a result, we recommend that before issuing her supplemental determination, the Administrative Law Judge request the Division to file a brief stating: 1) its position as to whether the creation of a contract to sell with use and occupancy is a taxable transfer for gains tax purposes;² 2) whether the instant transaction was such a transfer that would have been taxable if it occurred after March 28, 1983; and 3) if so, the Division's explanation as to the

²Our research revealed that the Division has issued at least one private letter ruling, dated November 18, 1985 and signed by a Tax Technician II, that explicitly stated that a contract to sell with use and occupancy was a transfer subject to gains tax. Several other private letter rulings clearly suggest that such a transaction would be subject to tax, e.g., a letter dated November 25, 1985 signed by a Tax Regulations Specialist.

consideration and resulting original purchase price for such a transfer. The Administrative Law Judge will give petitioner an opportunity to respond to any brief filed by the Division.

With respect to the refund granted, we request that the Administrative Law Judge explain the factual and legal source of her authority to grant the refund. The Administrative Law Judge may, if she wishes, request the parties to brief this issue at the same time as the contract with use and occupancy issue.

We will retain jurisdiction over this case based on the exception already timely filed by the Division. After the Administrative Law Judge issues her supplemental determination, the Division will be allowed to add to its existing exception and brief so long as it does so within 30 days of the issuance of the supplemental determination, or requests an extension of time to do so within the 30-day period. Petitioner will be given an opportunity to respond to any additional material submitted by the Division. If petitioner wishes to except to any portion of the Administrative Law Judge's supplemental determination, petitioner will be required to submit a timely exception to the supplemental determination.

Accordingly, it is ORDERED, ADJUDGED and DECREED that this matter is remanded to the Administrative Law Judge for the issuance of a supplemental determination in accordance with the foregoing decision.

DATED: Troy, New York
March 24, 1994

/s/John P. Dugan

John P. Dugan
President

/s/Francis R. Koenig

Francis R. Koenig
Commissioner