STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
VANDERVEER ASSOCIATES - NO. 1	:	DECISION DTA No. 810151
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.	:	
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Petitioner, Vanderveer Associates - No. 1, c/o Edward I. Penson, Esq., 149 Wooster Street, New York, New York 10012, filed an exception to the determination of the Administrative Law Judge issued on December 6, 1993. Petitioner appeared by Warshaw, Burstein, Cohen, Schlesinger & Kuh, Esqs. (Michael A. Scheffler, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Donald C. DeWitt, Esq., of counsel).

Petitioner did not file a brief in support of its exception. The Division of Taxation filed a brief in opposition. Petitioner was given until February 22, 1994 to file a reply brief, which date began the six-month period for the issuance of this decision. Petitioner's request for oral argument was denied.

Commissioner Dugan delivered the decision of the Tax Appeals Tribunal. Commissioner Koenig concurs.

ISSUE

Whether the Division of Taxation properly disallowed, in the computation of original purchase price, certain costs which petitioner contends were acquisition costs and/or costs of capital improvements.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "9" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

Petitioner submitted eight proposed findings of fact ("A" through "H"). Proposed findings of fact "A" and "C" through "H" contain legal argument, are conclusory in nature and are, therefore, not incorporated intothe Findings of Fact hereinafter set forth. Proposed finding of fact "B" is irrelevant to the present matter and is also, therefore, rejected.[1]

On March 18, 1987, Vanderveer Associates - No. 1 ("petitioner"), a New York limited partnership, sold property known as 1402, 1404, 1406, 1408, 1410, 1412, 1414 and 1416 New York Avenue, 3101 and 3103 Foster Avenue and 3102 and 3104 Newkirk Avenue in Brooklyn, New York ("the property") to Foster Apartments Group (a New York limited partnership which was the assignee of the purchaser's rights in a contract of sale dated May 29, 1986 between Vanderveer Associates - No. 1, as seller, and Vanderveer Realty Company - No. 1, as purchaser).

Petitioner filed a Transferor Questionnaire (Form TP-580), sworn to on December 3, 1986, on which it reported anticipated tax due of $44,032.57. On December 15, 1986, the Division of Taxation ("Division") issued a Tentative Assessment and Return (Form TP-582), assessing tax in the amount of $44,032.57.

By a Supplemental Return (form TP-583), sworn to on March 13, 1987, petitioner indicated that, pursuant to a contract modification which reduced the purchase price of the property by $404,000.00 and by virtue of additional capital improvements having been made to the property, there was no longer any gain subject to tax. Attached to the Supplemental Return

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[1]It should be noted that, along with the proposed findings of fact, petitioner also submitted six proposed conclusions of law. Since rulings on proposed conclusions of law are not required (State Administrative Procedure Act § 307[1]), they shall not be addressed herein.

were an affidavit of Edward I. Penson, a general partner of petitioner; a contract modification dated March 17, 1987 and a listing of capital improvements totalling $72,968.17 (payments for at least 7 of the 8 improvements were made during January or February 1987).

Pursuant to an audit which commenced in April 1988, the Division, on October 30, 1989, issued a notice of determination to petitioner assessing total tax due of $179,658.00, plus penalty and interest.[2]

A Conciliation Order (CMS No. 102019) dated August 9, 1991 reduced tax due to $120,156.00 plus interest (penalty imposed pursuant to the notice of determination was cancelled).

Pursuant to the audit performed, anticipated gain of $1,796,580.00 was determined. Cash consideration of $9,701,687.00 was determined by subtracting the contract modifications ($404,000.00) from the consideration set forth on the transferor questionnaire ($ 10,105,687.00). Allowed brokerage fees of $60,000.00 reduced consideration to $9,641,687.00.

Original purchase price ("OPP") was determined to be $7,845,107.00 (this amount includes the original cost per contract, acquisition expenses, capital improvement costs and cooping expenses).

Original cost per contract was $2,924,914.30 (see, Schedule B, line 4 of Transferor Questionnaire).

Petitioner claimed acquisition expenses of $790,690.00, of which costs totalling $305,450.00 were disallowed by the auditor. Broker's fees of $250,000.00 were disallowed in their entirety on the basis that such fees were actually management fees. Legal fees of $18,500.00 were disallowed (legal fees of $14,500.00 were allowed) on the basis that such fees were paid for legal services furnished in connection with the public offering of limited partnership interests in petitioner, not for acquisition of an interest in real property. Claimed

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[2]The notice of determination reflects a payment or credit of $44,032.00. However, the Division's brief, on page 3 thereof, indicates that the tax due pursuant to the Tentative Assessment was never paid. Since petitioner did not claim such payment in its petition or in any of its documentation submitted subsequent thereto, it shall be presumed that this payment or credit was erroneously reflected on the notice of determination.

accounting services of $6,950.00 were disallowed in their entirety for the same reason, i.e., that petitioner did not establish that the fees were paid as part of the acquisition of an interest in real property. The audit report (Schedule 1) also reflected an additional disallowance of $30,000.00 in broker's fees although there is no apparent explanation therefor.

Capital improvements cost in the amount of $5,835,700.00 were claimed by petitioner. The auditor disallowed capital improvement costs of $1,430,747.00. Interest on a construction loan ($697,969.00) and construction period real estate taxes ($181,876.00) were disallowed in their entirety. "Profit & Risk" payments to Faymor Housing Corporation in the amount of $536,488.00 were disallowed in their entirety on the basis that these payments were not made for construction and were not a customary and reasonable project cost. Certain additional costs ($2,806.00 for office furniture and $11,608.00 for refrigerators and stoves) were also disallowed. By virtue of these disallowances, capital improvement costs, as determined by the auditor, were found to be $4,404,953.00.

By adding original cost per contract ($2,924,914.00), allowed acquisition expenses ($485,240.00), allowed costs of capital improvements ($4,404,953.00) and cooping expenses ($30,000.00 legal expenses), the auditor determined total OPP to be $7,845,107.00. When subtracted from consideration ($9,641,687.00), anticipated gains on taxable sale of $1,796,580.00 was calculated with tax thereon, at 10%, in the amount of $179,658.00, the amount originally assessed per the notice of determination.

Pursuant to the Conciliation Order (see also, letter of February 1, 1991 from auditor to Michael A. Scheffler, Esq., petitioner's representative, which is attached to affidavit of petitioner's general partner, Edward I. Penson, Esq.), tax due was recomputed from $179,658.00 to $120,156.00 which was determined as follows:

Anticipated Gain per audit	$1,796,580.00
Less: Excess Gain per TP 583	(36,642.00)
Balance	$1,759,938.00
Less Substantiated Adjustments	(558,375.00)
Corrected Gains	$1,201,563.00
Tax Due on the gain at 10%	$ 120,156.00
Tax previously paid	- 0 -

Tax Due $ 120,156.00

The allowance of the $36,642.00 was based upon petitioner having filed a supplemental return and the adjustment of $558,375.00 was apparently an allowance, for some portion of the construction period, of construction loan interest.

Remaining at issue, therefore, are the following amounts which petitioner asserts were acquisition costs and/or capital improvement costs:

(a) $250,000.00 paid to Owners & Builders Realty Services, Inc. for brokerage and/or management fees;

(b) $18,500.00 in legal fees paid to Faust, Rabbach & Sweet;

(c) $6,950.00 in accounting fees paid to Marks Shron & Company;

(d) $181,876.00 in construction period real estate taxes;

(e) $536,488.00 in "profit and risk" paid to Faymor Housing Corp.;

(f) $72,968.17 in capital improvements as set forth on the Supplemental Return; and

(g) $24,057.00 in understated capital improvements.

Each of these costs shall hereinafter be separately addressed. It should be noted that the Division submitted, as part of its documentary evidence, a three-page affidavit of Edward I. Penson, a general partner of petitioner. This affidavit, dated December 3, 1986, was submitted to the Division in conjunction with gains tax questionnaires and had attached thereto several exhibits. Subsequently, as part of the documents submitted to the Division of Tax Appeals, petitioner provided an 18-page affidavit of Mr. Penson (along with certain attachments). Unless otherwise noted, all references to the "Penson Affidavit" shall refer to the latter affidavit which was sworn to on April 28, 1993.

Pursuant to paragraph 3 of the Penson Affidavit, petitioner acquired title to the property from Faymor Development Co., Inc. ("Faymor"), a New York corporation, on December 31, 1981. At the time of transfer, Faymor owned a 99% interest in petitioner as its sole limitedpartner and owned 100% of the stock of Vanderveer Estates Section 1 (Newkirk), Inc. ("Vanderveer Estates"), the sole general partner of petitioner.

On March 17, 1982, Faymor sold all of its 99% limited partnership interest in petitioner to VV Associates - No. 1, a New York limited partnership controlled by Mr. Penson, and Vanderveer Estates sold nine-tenths of its 1% general partner interest in petitioner to Mr. Penson and a corporation controlled by Mr. Penson (collectively, the "Penson General Partners") with Vanderveer Estates retaining a one-tenth of 1% interest as general partner.

Pursuant to pages 3 and 4 of the Purchase Agreement, dated February 18, 1982 (Exhibit "B-1" attached to December 3, 1986 affidavit of Edward I. Penson) petitioner was contemplating and apparently did obtain a building loan from Citibank, N.A., the advances under which would be insured by the U.S. Department of Housing and Urban Development ("HUD"), the building loan to be converted to permanent mortgage financing provided by the Government National Mortgage Association ("GNMA"). The proceeds of this financing were used by petitioner to do rehabilitation work pursuant to a building loan agreement between the bank and petitioner and a construction contract between Faymor Housing Corp. and petitioner.

We modify finding of fact "9" of the Administrative Law Judge's determination to read as follows:

> Pursuant to the Purchase Agreement dated February 18, 1982, Owners & Builders Realty Services, Inc. ("O & B") and S. J. Seip & Co. were hired by petitioner as agents under the Construction and Management Agreement dated March 17, 1982 (attached as Exhibit "D-1" to December 3, 1986 affidavit of Edward I. Penson) and the Agreement Regarding Additional Management Services (referred to in the Purchase Agreement).
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> Under the Construction and Management Agreement, petitioner employed O & B and Seip to manage, operate, and perform the leasing work for Section 1 (¶ 2.1). Other paragraphs of the Agreement spell out in detail the management responsibilities of O & B, including generally, the responsibility to manage and operate the project (¶ 2.2); the management, operation and leasing of Section 1 (¶ 2.3); to cause to be prepared for petitioner, timely payroll tax and other tax returns (except income tax returns) of Federal, State and local governments and pay, at petitioner's expenses, such taxes to the appropriate agencies (¶ 2.4); to maintain direct liaison with Housing in order to coordinate management concerns with the rehabilitation work by Housing on Section 1 (¶ 2.5); to maintain full and complete books and records of all transactions occurring in connection with the management and operation of the property (¶ 2.6); and to collect rents due or to become due and to terminate tenancies and to sign and service in the name of petitioner such

notices as are appropriate, to institute and prosecute actions, to evict tenants and to recover possession of premises (¶ 2.12).

By this Purchase Agreement, VV Associates - No. 1 and the Penson General Partners acquired a 99.9% interest in petitioner from Faymor Development Co., Inc.

The Penson Affidavit states that in petitioner's original submission, these fees paid to O & B were incorrectly characterized as brokerage fees. On Exhibit "C" attached to the December 3, 1986 affidavit, these fees are referred to as brokerage fees.

Attached to the Penson Affidavit is a December 10, 1990 affidavit of Arnold A. Gruber, a partner in the accounting firm of Marks Shron & Company. Paragraph 2 of Mr. Gruber's affidavit states as follows:

> "In connection with our clients' acquisition of the partnership interest (the 'Partnership Interests') in the Partnerships, fees of $250,000 and $290,000 were paid to Owners and Builders Realty, Inc. (whose name was changed to The Penson Corporation) ('O & B') for its services in connection with the acquisition of the Partnership Interests. O & B's function was to perform a due diligence review of the property owned by the Partnerships (the 'Property') and the Partnerships' books and records so that our clients could be sure that the representations made by the sellers of the Partnership Interests were correct and that it was prudent on their part to pay the purchase price requested. The fees paid to O & B had nothing to do with the on-going management of the Property or for work subsequent to the acquisition of the Partnership Interests.
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> "The fees were called 'special management fees' to differentiate them from the normal management fees for operating the property. Since these fees were in connection with the acquisition of the property, they were paid from partners' capital contributions, which were paid in over a number of years."

Pursuant to Article 4 of the February 18, 1982 Purchase Agreement, petitioner agreed that, at and after the closing, acting through VV Realty, it would retain O & B and Seip as managing agents under the Construction and Management Agreement and Agreement Regarding Additional Management Services.[3]

As to the $18,500.00 paid to Faust, Rabbach & Sweet, the Penson affidavit states that:

"These fees were paid for legal services furnished in connection with the public offering of limited partnership interests in VV Associates - No. 1 that

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[3] We modified this finding of fact by adding the second paragraph to explain the construction and management agreement in more detail.

provided the funds needed to purchase from Faymor the limited partnership interest in petitioner."

The $6,950.00 paid to Mark Shron & Company was, according to the Penson Affidavit, paid for due diligence services furnished in connection with the acquisition by the Penson Entities of the partnership interests in petitioner and should, therefore, have been allowed by the auditor.

Petitioner states (see, paragraph 3 of the Penson Affidavit) that the property underwent a complete rehabilitation during the period September 1982 to December 1983 under a GNMA project insured by the HUD.

Paragraph 11(d)(i) of the Penson Affidavit states that the aforementioned rehabilitation project involved a major renovation to the building comprising the property, their equipment and facilities and all apartments located therein, thereby requiring the relocation of tenants for certain periods. The rehabilitation included an overhaul of the plumbing and electrical lines, installation of new boilers and associated equipment, installation of new roofs, replacement of windows and main building doors, complete refurbishment of apartments, building lobbies and hallways, installation of security systems and smoke detectors and major landscaping improvements.

In response, the Division points out that the Penson Affidavit, at page 10 thereof, admits that tenants were occupying the apartments at the time the buildings were undergoing renovation. This is the basis of the auditor's disallowance of the real estate taxes, i.e., that there was no substantiation (actually there was an admission to the contrary) that, during the construction period, the property was not in use and occupied by tenants.

In the Penson Affidavit, no mention is made of the $72,968.00 in capital improvements as set forth on the Supplemental Return or of the $24,057.00 in understated capital improvements. The Division's brief states that an adjustment was made, as a result of the BCMS conference, to reflect the additional capital improvements reported on the Supplemental Return. A review of the Supplemental Return and the adjustment made (see, above) reveals that the Division is

correct, that the proper adjustments were made and the additional capital improvements were allowed per the reduction in gains tax asserted to be due.

It must be pointed out that the Transferor Questionnaire, in line 6 of Schedule B, indicates $5,859,757.00 in capital improvements, not $5,835,700.00 as petitioner states ($5,835,700.00 + $24,057.00 [the alleged understatement] = $5,859,757.00). In the audit report, claimed capital improvements of $5,835,700.00 are listed thereon (the auditor disallowed $1,430,747.00 of such expenses). This record contains no evidence of what alleged capital improvement expenditures this amount ($24,057.00) represents.

The remaining amount at issue is the $536,488.00 which has been referred to by the parties as "profit and risk" because there would be a profit to the contractor only if the building project was completed within budget. If not completed within budget, the profit was at risk because the contractor was responsible for cost overruns.

Attached to the Penson Affidavit is the cover page and pages 10 and 11 of the Confidential Offering Memorandum of VV Associates - No. 1 which is the entity that purchased the limited partnership interest in petitioner from Faymor Development Co., Inc. (see, above). On Page 10 thereof, under the heading of "Cost of Construction", it states, in part, as follows:

> "All costs of construction of the Development pursuant to the terms and conditions of the Construction Contract in excess of $3,526,773, as adjusted in the manner set forth above, which are not otherwise approved by HUD, are to be paid by the General Contractor pursuant to the provisions of the Construction Contract."

The offering memorandum (also on page 10, under the heading "Cost of Construction") provides in addition that:

> "Faymor Housing Corp., an affiliate of VES, one of the general partners of the Operating Partnership but not an affiliate of the General Partners of the Partnership, will perform the construction work, as General Contractor, ..."

Also attached to Penson Affidavit is the cover page and pages 10 and 11 of the Audit Guide for Auditing Development Costs of HUD Insured Multifamily Projects for Use by

Independent Accountants (issued by the HUD). Paragraph 13 (pages 10 and 11) provides as follows:

> "Profit and Risk Allowance. Certain sections of the National Housing Act provide for a 'Builder's/Sponsor's Profit and Risk Allowance' (BSPRA) in cases where the mortgagor and contractor have an identity of interest. In cases where BSPRA would be applicable, if there were an identity of interest, but in fact there is no identity of interest, the law provides for a 'Sponsor's Profit and Risk Allowance' (SPRA). The eligible allowances are computed as follows:
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> "(a) BSPRA. The eligible amount is 10% (unless the Secretary has prescribed a lesser percentage on FHA Forms 3306 or 3306A) of all items on the mortgagor's certificate of actual cost excluding any costs for the acquisition of a leasehold, or any supplemental management funds claimed as a cost. NOTE: if more than 50% of the actual cost of construction is subcontracted with any one contractor or subcontractor, or more than 75% with 3 or less contractors, BSPRA will not be applicable and SPRA should be claimed.
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> "(b) SPRA. The applicable percentage, generally 10% will be computed on the sum of (1) architectural fees, (2) interest and financing expenses, (3) legal and organization expenses, and (4) off-site cost, if any."

Petitioner also submitted (attached to the Penson Affidavit), FHA Form No. 2331A, Cost Certification Review Worksheet for the project entitled "Vanderveer Estates Sec. I". As item 14 thereon, Profit and Risk is stated to be $536,488.00, which amount is 10 percent of the amount of the subtotal of $5,364,879.00 listed on the line immediately above (representing the subtotal of lines 1[d] through 13).

Also, in support of its position, petitioner submitted an affidavit from Arnold Gruber, a Certified Public Accountant and a member of the accounting firm of Marks Shron & Company, which sets forth an explanation of "profit and risk", also known in GNMA projects as the "Builder's/Sponsor's Profit and Risk Allowance" or "BSPRA". Mr. Gruber states that, in all of the GNMA projects for which he provided accounting services, the BSPRA amount has been 10%. Mr. Gruber further states:

> "Inasmuch as HUD, which insures the repayment by the mortgagor of the GNMA loan, has an interest in limiting the amount of said loan, it seems abundantly clear that the amount that HUD itself prescribes for the 'profit and risk' fee, or BSPRA, is a reasonable sum. The fact that the 10% figure has been used in all of the GNMA projects where I have provided accounting services is the best evidence that it is also customary."

In the audit summary of the audit report, the auditor stated:

"The profit and risk is a cost built-in the contract which [sic] will be distributed to the sponsor at the end of the renovation. Since no contractual agreement was submitted for the above cost the amount seems excessive and customary [sic] with the industry. Under the cost certification submitted to H.U.D. the general contractor fee was allowed."

OPINION

At issue on this exception are the following amounts which petitioner asserted were acquisition costs and/or capital improvement costs:

1 - $250,000.00 paid to O & B for brokerage and management fees;

2 - $18,500.00 in legal fees paid to Faust, Rabbach & Sweet;

3 - $6,950.00 in accounting fees paid to Marks Shron & Company;

4 - $181,876.00 in construction period real estate taxes; and

5 - $536,488.00 in "profit and risk" paid to Faymor Housing Corp.

We note at the outset that, except for the legal and accounting fees at issue here, this case involves the same issues as Vanderveer No. 5, issued herewith.

We deal first with the payments to O & B.

The Administrative Law Judge determined that the Division properly disallowed, as a pre-acquisition cost, the $250,000.00 paid by petitioner to O & B. The Administrative Law Judge noted that the money was referred to as both a brokerage fee and management fee in the Penson Affidavit, and that while O & B was referred to as an agent in the purchase agreement, the Gruber Affidavit stated that the fees were paid "to review the property owned by the partnerships along with the partnerships' books and records to determine if it was prudent to purchase these partnership interests." The Administrative Law Judge concluded that "[i]nasmuch as it cannot, from the evidence presented, be determined, with any degree of certainty, exactly why this $250,000.00 was paid to O & B, petitioner cannot be found to have sustained its burden of proof . . . to show that this fee was an allowable preacquisition cost" (Determination, conclusion of law "D").

On exception, petitioner argues that it was an error for the Administrative Law Judge to disallow the fees paid to O & B since the evidence is abundantly clear, as evidenced by the Penson Affidavit, that the fees paid to O & B "were paid to them as compensation for the due diligence they conducted on our behalf in connection with our acquisition of the property." Petitioner states that in its original gains tax submission to the Division it incorrectly characterized the fees as brokerage fees. "However, regardless of what they are called, the fact remains that they are a permissible preacquisition cost." Petitioner asks that we find that:

> "the Division improperly disallowed this fee as a pre-acquisition cost. In Petitioner's original gains tax submission, this fee was mis-characterized as brokerage fees but the Petitioner corrected this mistaken characterization in its submissions made during the audit process. In addition, since O&B did act as managing agent for the Petitioner after the Penson Entities acquired the partnership interests in Petitioner, the short-hand reference to 'special management fees' on the checks issued to O&B for its due diligence services was made to distinguish these fees from the fees paid to O&B as managing agent. Whether these fees are allowable pre-acquisition costs should not be determined by the short-hand reference on the checks. This would be exalting form over substance. Moreover, it is unlikely that any potential purchaser of property would ever refer to costs expended by using the exact terminology in the gains tax statute or regulations. As demonstrated in the Penson Affidavit and in the Gruber Affidavit dated December 10, 1990, the due diligence services furnished by O&B were services provided by a professional consultant to assist the Penson Entities in assessing the advisability of purchasing the partnership interests in the Petitioner and the market value of such interests, and, as such, were 'directly related' to the real property interest" (Petitioner's Exception, Rider [5], #1, p. 1).

On exception, the Division asserts that there is no evidence to show exactly what services O & B performed in connection with the acquisition of the partnership interest. Further, there is no allowance for the cost of "due diligence" in the Division's regulations, 20 NYCRR 590.15, and finally, that it is unclear of exactly what "due diligence" consists. The Division points out that evidence submitted to the auditor discloses that O & B is one of the agents under the Construction and Management Agreement and the Agreement Regarding Additional Management Services. The February 18, 1982 Purchase Agreement states that petitioner agreed to retain O & B as managing agents under these two agreements. From these agreements, the Division surmises that O & B was to serve as a managing agent for one or more of the

properties; that since the properties contained existing structures it is reasonable that management services were an ongoing necessity and that the payments to O & B was characterized by Mr. Gruber as special management fees. There is no evidence, asserts the Division, that the fees to O & B had any relation to the acquisition of the property by petitioner in 1982.

We affirm the determination of the Administrative Law Judge that petitioner did not sustain its burden of proof to show that the fee paid to O & B was an allowable pre-acquisition cost. The evidence submitted by petitioner on this point is less than clear. As the Administrative Law Judge noted, the Penson Affidavit, while characterizing the fee paid to O & B as a brokerage fee, also indicates that the checks issued to pay these fees referred to the fees as management fees. This latter treatment is consistent with the Construction and Management Agreement.[4]

We also note that the description of O & B's functions and duties in Article 2 of the Construction and Management Agreement duties are in conflict with the statement in paragraph 2 of the Gruber Affidavit, i.e.:

> "[t]he fees paid to O & B had nothing to do with the on-going management of the Property or for work subsequent to the acquisition of the Partnership Interest.
>
> "The fees were called 'special management fees' to differentiate them from the normal management fees for operating the property" (Gruber Affidavit).

We deal next with the legal fees and accounting fees. Petitioner asserts that the $18,500.00 paid to Faust, Rabbach & Sweet were paid for legal services furnished in connection

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[4]Under the Agreement, petitioner employed O & B and Seip to manage, operate and perform the leasing work for Section 1 (¶ 2.1). Other paragraphs of the Agreement spell out in detail the management responsibilities of O & B, including generally, the responsibility to manage and operate the project (¶ 2.2); the management, operation and leasing of Section 1 (¶ 2.3); to cause to be prepared for petitioner, timely payroll tax and other tax returns (except income tax returns) of Federal, State and local governments and pay, at petitioner's expenses, such taxes to the appropriate agencies (¶ 2.4); to maintain direct liaison with Housing in order to coordinate management concerns with the rehabilitation work by Housing on Section 1 (¶ 2.5); to maintain full and complete books and records of all transactions occurring in connection with the management and operation of the property (¶ 2.6); and to collect rents due or to become due and to terminate tenancies and to sign and service in the name of petitioner such notices as are appropriate, to institute and prosecute actions, to evict tenants and to recover possession of premises (¶ 2.12).

with the public offering of limited partnership interests in VV Associates - No. 1, which offering provided the funds necessary to purchase, from Faymor Development Company, the limited partnership interest in petitioner.

The Administrative Law Judge, relying on Matter of Albe Realty Co. (Tax Appeals Tribunal, March 26, 1992, affd 194 AD2d 838, 598 NYS2d 602, lv denied 82 NY2d 657, 604 NYS2d 556), determined that, pursuant to 20 NYCRR 590.15(b):

> "in order to be includible in the computation of OPP as a preacquisition cost, such cost must be 'directly related to the New York real property.' While it can be argued that the preparation for the public offering of limited partnership interest in VV Associates - No. 1 was done with the acquisition of the real property in mind, it was not directly related thereto" (Determination, conclusion of law "D").

The Administrative Law Judge also sustained the Division's disallowance of the $6,950.00 accounting fees paid Marks Shron & Company stating that:

> "[p]etitioner has presented no evidence as to the actual services performed and how, if at all, such services were directly related to the acquisition of the real property. Since petitioner failed to sustain its burden of proof with regard to showing how such accounting services were directly related to the acquisition of the real property, disallowance thereof by the Division was proper" (Determination, conclusion of law "D").

The Administrative Law Judge rejected petitioner's consistency argument, i.e., that since the legal and accounting fees were allowed in the audit of Vanderveer Associates - No. 5, they should be allowed here since the transactions in both cases were nearly identical. "Since allowance of such fees was not at issue in that matter, it cannot be determined whether the fees were charged for the same services as are at issue herein. Mere allegations that such was the case are insufficient to warrant allowance in the present matter" (Determination, conclusion of law "D").

On exception, petitioner reiterates its assertion at hearing that the legal fees paid to Faust & Rabbach were for services in connection with the public offering of limited partnership interests in VV Associates-No.1 and should be allowed because they:

> "were a necessary expense incurred to create an ownership interest in the partnership interest since the offering plan could not have been prepared or issued without the assistance of counsel and . . . the partnership interest . . . could not have been acquired by VV Associates-No.1 without the proceeds of the public offering" (Petitioner's Exception, Rider [4], #1, p. 2).

Petitioner, citing to the Penson Affidavit, again draws our attention to Vanderveer Associates-No. 5 and asserts that there the Division allowed legal fees to Dreyer & Traub for the exact same services as are at issue here. Petitioner argues that:

> "[w]hile the Administrative Law Judge states that 'mere allegations that such was the case (i.e., that the services provided by both law firms were the same) are insufficient to warrant allowance in the present matter,' what the judge refers to as 'mere allegations' are the sworn statements by Edward Penson (an attorney admitted to the bar of the State of New York) in his affidavit. The Division has offered absolutely no evidence or assertions that refute Mr. Penson's sworn statements" (Petitioner's Exception, Rider [4], #1, p. 3).

On exception, petitioner asserts that the accounting fees paid to Marks Shron & Company should also be allowed on the basis of the Penson Affidavit which states, in relevant portion, that the "fees paid to Marks Shron & Company were 'paid for due diligence services furnished in connection with the acquisition by the Penson Entities of the partnership interests in Petitioner" (Penson Affidavit). Petitioner asserts that these same fees to the same company for the same services were allowed by the Division in Vanderveer Associates No. - 5. Petitioner asserts there is absolutely no rational basis for the differentiation made between these petitioners.

On exception, the Division asserts that the legal fees were properly disallowed since they were for legal services in connection with the public offering of limited partnership interests in VV Associates - No. 1 and, thus, were not for the acquisition of an interest in real property.

> "Similarly, as to the payment to Marks and Shron, the petitioner has not supplied evidence to meet its burden of proof to establish that such fee was paid as part of the acquisition of an interest in real property. As to both of these items, the ALJ concluded that the Division properly disallowed them as part of the original price of the property" (Division's brief, pp. 8-9).

The Administrative Law Judge dealt fully and completely with this issue and we affirm his determination for the reasons stated therein.

We deal next with the $181,876.00 construction period real estate taxes.

The Administrative Law Judge determined that the Division properly disallowed as construction period costs $181,876.00 in real estate taxes on the basis of a lack of evidence in the record to properly allocate the taxes to the construction period. The Administrative Law Judge noted that construction period interest, if paid by a transferor for the construction of capital improvements made to real property, during a construction period, may be included in the original purchase price of the property only if the real property is not in use or ready for its intended use or for real property not undergoing the activities necessary to prepare it for use (20 NYCRR 590.16[d]). Applying the regulations in this case, the Administrative Law Judge determined that "[p]etitioner's argument . . . would have been more tenable had evidence been produced to show what tenants, if any, were displaced; which portions, if any, of the buildings were inhabitable and for what periods; and any other evidence which would properly allocate the real estate taxes to actual construction periods. No such evidence was presented" (Determination, conclusion of law "E").

The Administrative Law Judge also rejected petitioner's assertion that petitioner relied on verbal assurances from Division personnel concerning the allowability of this cost, thus, the Division should be estopped from disallowing this cost. The Administrative Law Judge stated that:

> "[e]rrors or misinterpretations by certain employees of the Division are not binding on the Division (Matter of Miller, State Tax Commission, December 31, 1984, determination confirmed sub nom Jack W. Miller, Excavating Contractor v. State Tax Commn., 131 AD2d 902, 516 NYS2d 352). In addition, petitioner has not established that it reasonably relied on the alleged statements of the Division employees, thereby warranting imposition of estoppel against the Division (see, Matter of Maximilian Fur Co., Tax Appeals Tribunal, August 9, 1990; Matter of Harry's Exxon Serv. Sta., Tax Appeals Tribunal, December 6, 1988)" (Determination, conclusion of law "E").

On exception, petitioner asks us to find that petitioner's cost was clearly allowable under the Division's regulations. Petitioner asserts that:

> "'If the capital improvement requires a construction period, a period of time in which necessary activities are conducted to bring the improvement on the real property to that state or condition necessary for its intended use, the interest cost paid during that period on a construction loan, real property taxes, insurance or similar items are includible as a cost of construction' (emphasis supplied).* There is no basis in the gains tax statute or regulations for allowing construction loan interest and insurance premiums paid during a 'construction period' while disallowing real property taxes. Therefore, the real property taxes paid by the Petitioner during the 'construction period,' in the amount of $181,876, are 'includible as a cost of construction' in the calculation of the Petitioner's allowable 'capital improvement' expenses. The Division provided no rational basis for distinguishing between real estate taxes and construction loan interest or insurance premiums. The Division improperly disallowed the real estate taxes.
>
> (* In fact, a recent amendment to the Gains Tax Law now provides that land loan interest, in addition to construction loan interest, is 'includible as a cost of construction')" (Petitioner's Exception, Rider [5], #2, pp. 2-3).

Petitioner goes on to assert that:

> "[s]ection 590.16(e) of the gains tax statute provides, in part: 'A construction period usually begins on the date on which construction, development, erection or complete renovation of all or part of the real property begins, and ends on the date that the real property or other improvement is ready to be placed in service or is ready for sale.' The rehabilitation project undertaken by the Petitioner was a 'complete renovation' of the property.
>
> "Section 590.16(d) of the Gains Tax regulations . . . defines a 'construction period' as 'a period of time in which necessary activities are conducted to bring the improvement on the real property to that state or condition necessary for its intended use . . . .' Although the property was used as an apartment building before and after the rehabilitation project, the extensive rehabilitation of the buildings changed them from deteriorating structures to a completely different, higher grade class of apartment buildings. This new improved class of apartment residence was the 'intended use' of the property after the rehabilitation project. Therefore, a 'construction period' did exist during the rehabilitation project" (Petitioner's Exception, Rider [5], #2, p. 3).

Petitioner also asserts that the Administrative Law Judge erred in not applying the doctrine of estoppel to the Division stating that:

> "[t]he Administrative Law Judge also disregards the interpretation of the statutes and regulations offered by employees of the Division, who advised counsel for the Petitioner that real estate taxes, insurance premiums and construction loan interest would be allowable construction period expenses, claiming that this interpretation resulted from 'errors or misinterpretations' that are not binding on the Division. It seems rather unlikely that two different employees of the Division, the gains tax auditor and the conciliation conferee would all be guilty of the same 'misinterpretation.' Finally, contrary to the

> Administrative Law Judge's contention that the Petitioner has not established that it 'reasonably relied' on the statements of the Division employees, the fact that the statute is open to interpretation and there were no cases or opinions that covered this point, was reason enough for the Petitioner to rely upon the employees' statements"
> (Petitioner's Exception, Rider [4], #2, p. 4).

On exception, the Division's position is that the regulations provide that real estate taxes may not be included in the original purchase price if the real property is in use or ready for its intended use.

> "As set forth in the audit report, 'This case involved the acquisition and capital improvements from H.U.D. of already constructed and fully occupied buildings.' In his August 1, 1989 statement (part of audit report) the auditor cited this as the basis for his disallowance of the claimed interest and taxes. There has been no substantiation provided by the petitioner that during the 'construction period' the property was not occupied by tenants" (Division's brief, p. 9)

Finally, the Division asserts that the Administrative Law Judge was correct in denying the application of the estoppel doctrine.

The Administrative Law Judge dealt fully and correctly with these issues and we affirm his determination for the reasons stated therein.

We deal next with the $536,488.00 in "profit and risk" paid to Faymor Housing Corp.

The Administrative Law Judge found that in light of the evidence, most notably the HUD Audit Guidelines and the affidavit of Arnold Gruber, it appeared that profit and risk is a customary, reasonable and necessary expense associated with construction or renovation of projects of the type at issue. Thus, since profit and risk payment was made to the contractor for the capital improvement (see, 20 NYCRR 590.16[b]), it should be an allowable cost for purposes of computing original purchase price. However, the Administrative Law Judge found that petitioner did not show the requisite identity of interest between the mortgagor (petitioner) and contractor (Faymor) which is a HUD requirement for the "Builder's/Sponsor's Profit and Risk Allowance" (BSPRA). The Administrative Law Judge went on to find that where the only factor absent is identify of interest, HUD allows a "Sponsors Profit and Risk Allowance" (SPRA). The Administrative Law Judge concluded that "[a]bsent evidence that petitioner was

entitled to BSPRA, it is hereby found and determined that, in lieu thereof, an SPRA allowance of $147,828.10 is reasonable and proper" (Determination, conclusion of law "G").

On exception, petitioner asserts that the affidavits and the Cost Certification Worksheet submitted to HUD:

> "all substantiate without any doubt that the amount of profit and risk authorized by HUD to be paid to the contractor was 10% of the total construction costs, with the Cost Certification Worksheet showing the exact amount of the allowed profit and risk, $536,488.00. Completely ignoring this evidence, the Administrative Law Judge arbitrarily decides that the amount of profit and risk allowed here was based on some other provision in the HUD guidelines which are not referred to in either the Petitioner's papers or the Division's papers, and are not relevant to this project. After creating his own 'facts,' the Administrative Law Judge then compounds his distortion of the record by claiming that there is no 'identity of interest' between Petitioner and the contractor, which is necessary to establish that profit and risk should be 10% of the construction costs" (Petitioner's Exception, Rider [4], #3, p. 5).

Petitioner asserts that the facts as found by the Administrative Law Judge show there was the requisite identity of interest.

On exception, the Division asserts that while it did not except to the Administrative Law Judge's finding that the SPRA is applicable, nevertheless, there is no provision in the Division's regulations on costs of capital improvements to include profit and risk allowance. The Division does object to petitioner's assertion that it was entitled to the BSPRA. Specifically, the Division asserts as follows:

> "[w]hat the Division does contest is the petitioner's claim that it is entitled to the higher BSPRA allowance. It was the petitioner's burden to submit sufficient evidence to meet its burden of proof that it was entitled to the amount claimed. Part of that proof required that it establish that there was an identity of interest between itself and the contractor (Faymor Housing Corp.). While the term 'identity of interest' is not defined in any of the material submitted by the petitioner, the provisions of the Construction and Management Agreement (Exhibit D annexed to the Penson affidavit of December 3, 1986) is instructive on the relationship between Faymor Housing Corp. and the petitioner. At paragraph 1.1, page 4 of that document, it is provided that: 'The parties hereto recognize that Housing [Faymor Housing Corp.] is neither affiliated with nor related to Owner [Vanderveer
> Associates - No. 1 - petitioner].' Further, at item 11(b)(ii) of the April 28, 1993 Penson affidavit (page 11), the affiant states: 'Faymor Housing Corp. was a corporation owned and controlled exclusively by Morris Kavy and his two sons, Bert and Gil Kavy. Neither I nor any of the Vanderveer

> Associates partnerships had any interest in or control over Faymor Housing Corp.' As a result, there is evidence that no identity of interest exists between the contractor and the petitioner and that the disallowance of the BSPRA was appropriate.
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> * * *
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> "Based on the foregoing, the ALJ correctly concluded that the petitioner has not met its burden of proof to show that the Division's determination to disallow costs was erroneous" (Division's brief, pp. 14-17).

We reverse the determination of the Administrative Law Judge.

We agree with the Administrative Law Judge that since profit and risk payment was made to the contractor for the capital improvements (see, 20 NYCRR 590.16[b]), it should be an allowable cost for purposes of computing original purchase price.[5]

We disagree with the Administrative Law Judge's rejection of the cost on the basis of lack of identity of interest between the mortgagor and contractor. While identity of interest is relevant for HUD purposes, we fail to see its relevance for purposes of the gains tax. What is relevant is that the money was paid by petitioner to the contractor for capital improvements. Accordingly, we reverse the determination of the Administrative Law Judge and allow the payment for profit and risk as part of petitioner's original purchase price.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Vanderveer Associates - No. 1 is granted to the extent that the $536,488.00 in "profit and risk" paid to Faymor Housing Corp. in computing the original purchase price is allowed, but in all other respects the exception is denied;

2. The determination of the Administrative Law Judge is affirmed, except as provided in paragraph "1" above;

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[5]We note that there is no evidence introduced by the Division to controvert the HUD materials attached to the Penson Affidavit that the eligible amount of BSPRA is 10% of all items on the mortgagor's certificate of actual costs and FHA Form 2331A, Cost Certification Review Worksheet for the project entitled Vanderveer Estates sec. I introduced as part of the Penson Affidavit. As item 14 on the worksheet, Profit and Risk is stated to be $536,488.00, which is 10% of the amount of the construction.

3. The petition of Vanderveer Associate - No. 1 is granted to the extent indicated in conclusion of law "I" of the Administrative Law Judge's determination and paragraph "1" above, but is otherwise denied; and

4. The Division of Taxation is directed to modify the Notice of Determination dated October 30, 1989 in accordance with paragraphs "1" and "3" above, but such Notice is otherwise sustained.

DATED: Troy, New York
August 18, 1994

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner