STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
CLASSIC RESIDENCES, INC.	:	DECISION DTA No. 810528
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.	:	

Petitioner Classic Residences, Inc., 551 Madison Avenue, New York, New York 10022, filed an exception to the determination of the Administrative Law Judge issued on April 28, 1994. Petitioner appeared by Margolin, Winer & Evens (James L. Tenzer and Wayne M. Olson, Esqs., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

Petitioner submitted a brief in support of its exception and the Division of Taxation filed a brief in opposition. Petitioner filed a reply brief which was received on September 13, 1994 and began the six-month period for the issuance of this decision. Petitioner's request for oral argument was denied.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUES

I. Whether, in a cooperative conversion, the Division of Taxation properly assessed gains tax following petitioner's 50% project update submissions on units previously transferred or whether such tax is properly payable on the sale of the remaining unsold units.

II. Whether petitioner has shown that the actual consideration received in respect of its transfer of the "commercial unit" was $14,750,000.00 and not $18,000,000.00 as reported on petitioner's gains tax filings, and if so, whether the Division of Taxation should recompute the gain determined herein accordingly.

III. Whether the Division of Taxation properly disallowed "conversion period interest" from inclusion in petitioner's original purchase price for the subject property.

IV. Whether the Division of Taxation properly disallowed "leasing commissions" from inclusion in petitioner's original purchase price for the subject property.

FINDINGS OF FACT

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

Petitioner, Classic Residences, Inc., formerly known as Raynes Conversions, Inc., together with Classic Properties Limited Partnership ("CPLP")[1] is the sponsor of the plan to convert 777 Madison Avenue, New York, New York ("the Property") to condominium ownership[2] and, in turn, to convert the residential condominium unit ("the Coop Property") to cooperative ownership.

On June 18, 1985, CPLP acquired an option to purchase all of the outstanding shares of stock of 970 Park Avenue, Inc. ("Inc.") which held title to the Property.

On July 24, 1985, 45 East 66th Owners Corp., a cooperative housing corporation ("CHC"), was formed.

On March 19, 1987, the CHC submitted to the Attorney General a plan to convert the residential condominium unit, i.e., the Coop Property, to cooperative ownership.

Pursuant to an "Exchange Agreement" entered into by CPLP and the CHC and dated June 1, 1986, CPLP agreed to exchange its interest in the Coop Property for (a) the proceeds from the sale of apartment units at the Coop Property; (b) the remaining unsold units at the

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[1]CPLP was formerly known as Raynes Associate Limited Partnership. CPLP is the sole shareholder of petitioner.

[2]The condominium conversion created four condominium units located on the Property: the residential condominium unit, which consisted of 33 residential apartments; the commercial condominium unit; and two professional condominium units.

Coop Property; and (c) a purchase money mortgage. CPLP subsequently assigned its interest in the "Exchange Agreement" to petitioner.

In June 1987, CPLP entered into a "Purchase Agreement for Stock" to purchase all of the issued and outstanding stock of Inc. Also in June 1987, CPLP assigned its interest in the "Purchase Agreement for Stock" to petitioner. Petitioner thus became the sole shareholder of Inc. On July 13, 1987, the "Exchange Agreement" was consummated and pursuant thereto petitioner caused Inc. to transfer the Coop Property to the CHC and then caused Inc. to liquidate. Petitioner thus became the owner of all the shares of stock in the CHC, representing the 33 cooperative apartment units at the Coop Property, along with the appurtenant proprietary leases.

On July 25, 1988, petitioner filed the Fifth Amendment to the offering plan, declaring the plan "effective". It is noted that the plan was a "non-eviction plan".

In September 1988, prior to the initial closing of the sale of apartment units, petitioner filed a Real Property Transfer Gains Tax Transferor Questionnaire for Cooperatives and Condominiums (Form DTF-701) with the Division of Taxation ("Division") reporting the anticipated transfer of apartment units at the Coop Property under "safe harbor" guidelines (discussed herein at Conclusion of Law "C"). Specifically, in its initial filing petitioner reported a total anticipated selling price of all units of $12,695,372.00. This amount included the actual anticipated gross consideration for the 15 residential apartment units under contracts of sale at the time of filing and the safe harbor gross consideration for the 18 unsold resident apartment units. Petitioner reported total anticipated consideration under the safe harbor estimates of $10,620,052.00 and an original purchase price of $16,343,952.00, for a "gain subject to tax" of a (loss) of ($6,309,421.00).

Following its examination of petitioner's Initial Transferor Questionnaire and related filings, the Division issued to petitioner a tentative assessment and return which indicated "no tax due" for the units under contracts of sale.

Of significance herein is the fact that in its initial gains tax filings, petitioner excluded from the computation of "total anticipated consideration" any amounts for the remaining condominium units (i.e., the professional and commercial condominium units). Petitioner made reference to this exclusion in a statement attached to its initial Form DTF-700 (designated therein as Exhibit "A").

The offering plan (at page 3 thereof) states the following with respect to the sponsor's intent regarding the sale of the remaining condominium units:

> "The Sponsor presently intends to retain fee title to the Commercial Unit and the Professional Units on the Closing Date, subject to the terms and conditions of the Condominium Declaration . . . . If Sponsor elects to sell the Commercial Unit or the Professional Units, or any unit created by the subdivision or construction of the Commercial Unit or the Professional Units, Sponsor will amend the Plan to disclose the sale."

Petitioner, as seller, and Mitsui Real Estate Sales New York Co., Ltd., as purchaser, subsequently entered into an Agreement for Sale of the commercial condominium unit on November 8, 1990. Pursuant to this agreement, the selling price for the commercial unit was $18,000,000.00.

On December 5, 1990, petitioner filed its 50% project update submission (i.e., Forms DTF-700 and DTF-701). With this filing, petitioner reported a gain subject to tax as follows:

Anticipated gross consideration	$29,557,946.00
Less: Brokerage fees	(1,013,373.00)
Anticipated consideration	$28,544,573.00
Less: Original purchase price	(22,852,018.00)
Gain Subject to Tax	$ 5,692,555.00

On its project update submission, petitioner included in the calculation of "anticipated gross consideration" and "anticipated consideration" the $18,000,000.00 contract price for the sale of the commercial condominium unit. Petitioner also included its cost of acquisition of the commercial unit in its calculation of "original purchase price".

Also on December 5, 1990, a transferee questionnaire (Form TP-581) was filed in connection with the sale of the commercial condominium unit. Said questionnaire indicated $18,000,000.00 as the consideration to be paid to the transferor by the transferee.

Petitioner's initial filing (September 1988) indicated a "method of apportionment" of "share allocation" and a "common denominator of all units" of "total shares". The December 5, 1990 project update filing indicated a "method of apportionment" of "common element percentage" and a "common denominator of all units" of "98.36% of common elements".[3]

By letter dated December 27, 1990, the Division advised petitioner of a revised anticipated gain subject to tax of $6,393,911.00. The Division's letter also advised that "as a result of this current update, additional tax is determined to be due in the amount of $332,046.54." The Division's computations, which were attached to the letter in a "Schedule of Adjustments", are set forth below:

Anticipated Gross Consideration		$29,389,536.00[4]
Less: Brokerage fees		(1,013,373.00)
Anticipated Consideration		$28,376,163.00
Less: Original Purchase Price	$22,852,018.00	
Disallowed:		
Conversion Period Interest	559,304.00	
Leasing Commissions	178,343.00	
"Other" Disallowances[5]	132,119.00	(21,982,252.00)
Gain Subject to Tax		$ 6,393,911.00
Tax Due to Date		$332,046.54
Tax Paid to Date		0.00
Tax Due on Units Sold		$332,046.54

On January 7, 1991, the Division issued to petitioner a Statement of Proposed Audit Changes which asserted gains tax due in the amount of $332,046.54.

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[3] The common elements percentages allocable to the four condominium units were as follows:

Residential Unit	89.45%
Commercial Unit	8.91%
Professional Unit	0.94%
Professional Unit	0.70%
Total	100.00%

[4] The Division's adjustments, which resulted in a decrease in "anticipated gross consideration" from $29,557,946.00 as reported by petitioner to $29,389,536.00, are not in dispute herein.

[5] Such "Other" disallowances are not at issue herein.

In response to the Division's statement, by letter dated February 1, 1991, petitioner paid the asserted deficiency "under protest" and, along with such payment, returned to the Division its "Payment Document" (Form DTF-968) indicating disagreement with the Division's "findings".

On February 19, 1991, the Division issued to petitioner a Notice of Determination which formally assessed real property gains tax against petitioner in the amount of $332,046.54. Petitioner protested said notice by timely filing a Request for Conciliation Conference. Following such conference, a Conciliation Order dated November 22, 1991 was issued sustaining the assessment. The Conciliation Order also noted that petitioner's payment of $332,046.54 had been applied to the asserted liability.

By an agreement dated May 10, 1991, petitioner, as seller, and Mitsui Real Estate Sales of New York Co., Ltd. amended their Agreement of Sale of the condominium unit to provide for an adjustment in the purchase price from $18,000,000.00 to $14,750,000.00.

Petitioner introduced into the record an affidavit of Jay D. Solinsky, senior vice-president of petitioner, dated September 14, 1993 which stated, in part:

> "6) From inception, it was [petitioner's] intention to retain the commercial and professional condominium units (the 'Units') as an investment for both i) current cash flow, to assist in achieving its cash flow requirements and ii) for future appreciation. To that end, [petitioner] did not:
>
> a) Offer the Units for sale,
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> b) List the Units for sale with a real estate agent, real estate broker or other sales agent or agency,
>
> c) Advertise the Units for sale, or
>
> d) Solicit offers, in any way, from prospective purchasers.
>
> "7) In 1990 [petitioner] received an unsolicited inquiry and offer to purchase the commercial condominium unit (the 'Unit'). Although . . . its intention was to retain the Unit, due to the difficult economic environment, the increasing cash flow drain of the unsold residential units at the Property and at the other properties owned by [petitioner], and the extreme financial difficulties experienced by the entity that was its primary source of required funding, management decided that it was prudent to consider the offer.

"8) Extensive negotiations culminated in the November 8, 1990 'Agreement of Sale' (the 'Agreement') between [petitioner], as seller, and Mitsui Real Estate Sales New York Co., Ltd., as purchaser for a purchase price of $18,000,000.

"9) On May 10, 1991, after extensive negotiations, the Agreement was amended to reduce the purchase price to $14,750,000.

"10) On June 19, 1991 title to the Unit was transferred to the purchaser."

Petitioner introduced no closing documents showing that the commercial unit was transferred for a purchase price of $14,750,000.00.

As noted previously, petitioner claimed, and the Division disallowed, as part of its original purchase price for the subject property $559,304.00 in conversion period interest.

Petitioner conceded that the $559,304.00 amount did not include amounts of interest incurred on funds borrowed to acquire the Property or to improve the Property.

Petitioner stated that such conversion period interest expense was incurred in connection with "amounts borrowed to fund the costs to convert the Coop Property." Petitioner presented no evidence as to what specific costs of conversion necessitated such borrowing.

Petitioner established by documentary evidence that it did incur interest expense of $559,248.00.

As also noted previously, petitioner claimed, and the Division disallowed, as part of its original purchase price for the subject property leasing commissions in the amount of $178,343.00. Such commissions were paid in connection with the acquisition of tenant leases for space in the commercial condominium unit.

Attached to the Agreement of Sale dated November 8, 1990 entered into the record herein was a listing of the commercial leases then in effect for the commercial unit. The list indicates that five such leases were in effect at the time the agreement was entered into. The leases bore dates ranging from August 14, 1986 to January 16, 1990 and, based on the lease expiration dates which were also listed, each of the leases had a term of approximately 10 years.

OPINION

The first issue addressed by the Administrative Law Judge was whether the Division erred in issuing an assessment for the increased tax that resulted from the sale of the commercial unit or whether this amount was properly payable on the sale of the remaining units.

The Administrative Law Judge rejected petitioner's contention that it "properly followed safe harbor guidelines as set forth in TSB-M-86-(3)-R and that, therefore, any gains tax determined by the Division following its examination of petitioner's 50% project update filing is properly payable upon the sale and transfer of the remaining unsold units" (Determination, conclusion of law "D"). Instead, the Administrative Law Judge concluded that the Division properly assessed tax following petitioner's 50% project update filing.

The Administrative Law Judge described the safe harbor guidelines as follows:

> On May 1, 1986, the Division issued certain standards, called the "Safe Harbor Estimates," to be followed by taxpayers to estimate consideration to be received pursuant to cooperative and condominium conversion plans (see, "Safe Harbor Estimates for Transfers Pursuant to Condominium and Cooperative Plans," TSB-M-86-[3]-R). Such standards represent a modification of pre-1986 Division guidelines in computing gain subject to tax for condominiums and cooperative conversions called "Option B" (see, TSB-M-83-[2]-R). Hence, the 1986 standards are also referred to as "modified Option B" and "new Option B."
>
> Under modified Option B (as under the prior Option B), total consideration anticipated and total original purchase price were apportioned to each unit sold and, based upon these apportioned amounts, an apportionment of total anticipated gain for each unit sold was calculated. The Division's "Safe Harbor Estimates" provided guidelines for determining anticipated total consideration and anticipated gain. Where a taxpayer uses the appropriate safe harbor estimates of anticipated consideration on unsold units, that transferor will be treated as if he had estimated consideration at the exact amount that is actually received on these units when sold. Accordingly, where the safe harbor estimates are lower than the actual selling price (resulting in an underpayment of tax), no penalty or interest will be imposed on such underpayments (see, TSB-M-86-[3]-R). The taxpayer is thus able to postpone the full amount of tax owed based on actual consideration. Under such circumstances, the tax per unit or per share will be increased for the remaining unsold shares when recalculated at the 50% and 75% plateaus and tax may be due at the 100% sell-out point.

> Where the safe harbor estimates are greater than the actual selling price, the tax per unit or per share will be reduced for the remaining unsold shares when recalculated at the 50% and 75% plateaus. Under such circumstances, a refund may be due at the 100% sell-out point.
>
> As noted, where safe harbor estimates are properly used, no penalty or interest shall accrue during the sell-out period. Penalty and interest may accrue during such sell-out period, however, where overstatement of original purchase price or understatement of any other component of consideration under the plan results in underpayment of tax (TSB-M-86-[3]-R)" (Determination, conclusion of law "C").

The Administrative Law Judge determined that petitioner did not comply with the safe harbor guidelines because in its initial filing petitioner did not include the commercial unit in the calculation of anticipated gross consideration. The Administrative Law Judge determined that the safe harbor guidelines, in conjunction with the Option B filing method for cooperatives and condominiums, were premised on the requirement that all of the units sold pursuant to the plan be included in the initial filing. The Administrative Law Judge also noted that petitioner would reap a windfall if safe harbor protection were allowed, because tax on the commercial unit would be paid only on the future sales and not on all of the units sold pursuant to the plan. The Administrative Law Judge also determined that petitioner's intent with respect to the commercial unit was irrelevant to the issue of whether petitioner complied with the safe harbor guidelines. The Administrative Law Judge also found that petitioner's reliance on Matter of Belvedere Garden Assocs. (Tax Appeals Tribunal, June 18, 1992) was misplaced because the petitioner in Belvedere Garden had complied with the safe harbor guidelines.

On exception, petitioner asserts that on its initial gains tax filing it disclosed that the commercial unit was excluded from the filing, that significant discussions were had on this point with representatives of the Division and that at the end of the pre-transfer review the Division issued a tentative assessment that excluded any amount attributable to the commercial condominium unit. Petitioner also points out that the Division did not, in its preparation of the "Statement of Proposed Audit Adjustment," require that estimated consideration for the

remaining nonresidential units be included in the calculation of tax. Petitioner contends that the Division is inconsistent in its treatment of the commercial units.

The fact that petitioner disclosed the existence of the commercial units in its initial gains tax filing has no bearing on the issue before us. A transferor was not required to use the safe harbor guidelines set forth in TSB-M-86-(4)-R (Matter of Mendler, Tax Appeals Tribunal, September 23, 1993). Instead, this was a method of estimating consideration that could be elected by the transferor and which petitioner chose not to follow. Because the Division could not require petitioner to follow the safe harbor guidelines, we think it is irrelevant that the Division knew that petitioner was choosing not to follow them. Finally, the fact that the Division has continued to respect petitioner's right not to follow the guideline with respect to the remaining commercial units is not inconsistent with the assessment. The principle underlying the Division's actions is that petitioner had the right not to follow the safe harbor guidelines and, as a result of this choice, petitioner lost any protection the safe harbor estimates would have provided.

Because the Administrative Law Judge accurately and adequately addressed the other points raised by petitioner on this issue, we affirm the determination of the Administrative Law Judge on these points for the reasons stated in the determination.

Next, the Administrative Law Judge concluded that petitioner did not prove that the actual consideration for the commercial unit was $14,750,000.00. The Administrative Law Judge noted that the agreement which reduced the consideration for the commercial unit was dated May 10, 1991, while the Statement of Proposed Audit Changes was dated January 7, 1991. The Administrative Law Judge found that on January 7, 1991, the documents before the Division indicated only the $18,000,000.00 consideration and that petitioner did not raise the $14,750,000.00 figure until the petition dated February 19, 1992. Under these circumstances, the Administrative Law Judge found petitioner's objection to the Division's use of the $18,000,000.00 disingenuous. Even if petitioner proved the actual consideration was $14,750,000.00, the Administrative Law Judge found that it would be improper to require the

Division to make a recomputation because petitioner had made no gains tax filings which indicated a $14,750,000.00 consideration.

We reverse the determination of the Administrative Law Judge on this issue.

The Administrative Law Judge found as a fact that the May 10, 1991 agreement adjusted the price of the commercial unit from $18,000,000.00 to $14,750,000.00. Based on this fact, and the absence of any fact indicating that the commercial unit was actually transferred for more than $14,750,000.00, we conclude that petitioner established that the unit was transferred for $14,750,000.00. Further, we do not agree that the absence of any gains tax filings by petitioner reflecting the smaller consideration precludes a recomputation. Although the Notice of Determination may have been accurate based on the information before the Division at the time the Notice was issued, the failure of petitioner to file amended or corrected forms should not preclude an adjustment to the Notice.

Turning to the next issue, the Administrative Law Judge disallowed $559,248.00 in interest expenses incurred by petitioner which petitioner claimed as includible in its original purchase price as conversion period interest. The Administrative Law Judge held that petitioner failed to describe or explain these costs with any degree of specificity and that in the absence of such an explanation petitioner had failed to establish that the costs were "customary, reasonable and necessary" as required by section 1440(5)(a) of the Tax Law.

On exception, petitioner states that the:

> "'conversion period interest' represents the total interest expense incurred by the Petitioner from inception in connection with all amounts borrowed to fund amounts paid to convert the Coop Property to cooperative ownership as documented by the accompanying information. The $559,304 amount represents the interest relating to that portion of amount borrowed to fund the costs to convert the Coop Property, and does <u>not</u> include, the additional amounts of interest

incurred on funds borrowed to acquire the Property or to improve the Property" (Petitioner's brief on exception, pp. 16-17).

Petitioner asserts that it had been in the process of converting the co-op property to cooperative ownership from inception and, therefore, that the entire amount of its interest expense on funds borrowed to convert the co-op property should be allowed.

Section 1440(5)(a) of the Tax Law defines original purchase price to include customary, reasonable and necessary expenses incurred to create ownership interests in property in cooperative or condominium form. We agree with the Administrative Law Judge that petitioner has not shown the costs to be customary, reasonable and necessary. Further, as we have previously held, conversion period interest is not a cost "incurred to create ownership interests in cooperative form. These costs are merely expenses incurred to carry the property and not incurred to create ownership interests in the property" (Matter of Mattone v. State Dept. of Taxation & Fin., 144 AD2d 150, 534 NYS2d 478). We direct petitioner's attention to our decision in Matter of 1230 Park Assocs. (Tax Appeals Tribunal, July 27, 1989, affd Matter of 1230 Park Assocs. v. Commissioner of Taxation & Fin., 170 AD2d 842, 566 NYS2d 957, lv denied 78 NY2d 859, 575 NYS2d 455) where we stated the test was whether the cost "can be characterized as an expense incurred to create ownership in the cooperative form" (Matter of 44 West 62nd St. Assocs., Tax Appeals Tribunal, August 11, 1994).

Lastly, the Administrative Law Judge held that $178,343.00 in leasing commissions was not properly includible in original purchase price as either other acquisition costs or allowable selling expenses. With respect to the former, the Administrative Law Judge held that the tenant leases for which the commissions were expended were unrelated to petitioner's acquisition of the property. On the latter point, the Administrative Law Judge held that the Division's regulations at 20 NYCRR 590.17 explicitly disallow expenses designed to make the property easier to sell or to obtain a desired price.

On exception, petitioner renews its argument that the leasing commissions were a cost to acquire the commercial unit. We affirm the determination of the Administrative Law Judge on this issue for the reasons stated in the determination.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Classic Residences, Inc. is granted to the extent that the Division of Taxation is directed to recompute the tax due based on a consideration of $14,750,000.00 for the commercial unit rather than $18,000,000.00, but is otherwise denied;

2. The determination of the Administrative Law Judge is modified to the extent indicated in paragraph "1" above but is otherwise affirmed;

3. The petition of Classic Residences, Inc. is granted to the extent indicated in paragraph "1" above, but is otherwise denied; and

4. The Division of Taxation is directed to modify the Notice of Determination dated February 19, 1991 in accordance with paragraph "1" above, but such Notice is otherwise sustained.

DATED: Troy, New York
March 2, 1995

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

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