STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
VON FORD ASSOCIATES	:	DECISION DTA No. 810849
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 Von Ford Associates, 4 New King Street, MPO Box 217, Purchase, New York 10577-0217, filed an exception to the determination of the Administrative Law Judge issued on September 16, 1993. Petitioner appeared by Levine & Montana, Esqs. (Lewis Montana, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

Petitioner filed a brief on exception. The Division of Taxation filed a brief in opposition. Petitioner filed a reply brief which was received on December 13, 1993, which date began the six-month period for the issuance of this decision.

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

ISSUES

I. Whether the Division of Taxation properly calculated, for purposes of real property transfer gains tax, petitioner's consideration for the transfer of an option to purchase real property by totalling the present value of the net rental payments under a 21-year lease plus the consideration paid for the option which is exercisable in the 18th year of the lease.

II. Whether the original purchase price should be calculated under Tax Law § 1440.5(a) or (d).

FINDINGS OF FACT[1]

We find the facts as determined by the Administrative Law Judge except for finding of fact "6" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

On or about December 5, 1989, petitioner entered into a ground lease with Kaiser Foundation Health Plan of New York (the "transferee"). The ground lease has been amended seven times as follows:

Amendmen to Ground Lease, dated July 16, 1990
Second Amendment to Ground Lease, dated August 29, 1990
Third Amendment to Ground Lease, dated November 9, 1990
Fourth Amendment to Ground Lease, dated January 2, 1991
Fifth Amendment to Ground Lease, dated January 16, 1991
Sixth Amendment to Ground Lease, dated January 24, 1991
Seventh Amendment to Ground Lease, dated March 13, 1992

(Hereinafter collectively referred together with the ground lease as the "Ground Lease".)

The maximum term of the Ground Lease is 21 years; the term of the lease commenced on January 29, 1991.

The Ground Lease contains an option to purchase fee title[2] which may be exercised by the transferee any time after the 18th anniversary of the lease commencement date of January 29, 1991 up to the remaining 21-year term of the lease.

On or about November 21, 1990, petitioner submitted the TP-580 and TP-581, Real Property Transfer Gains Tax Questionnaire, and related materials. The Division received such materials on or about November 23, 1990.

We modify finding of fact "6" of the Administrative Law Judge's determination to read as follows:

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[1]On December 7, 1992 and December 10, 1992, respectively, the Division of Taxation and petitioner signed a Stipulation of Facts which the Administrative Law Judge incorporated into her findings of fact.

[2]The Ground Lease does not provide for a separate payment for the option to purchase in year 18.

> On December 7, 1990, Form TP-582, Gains Tax Tentative Assessment and Return No. A26897-2, was issued, which indicated a gross consideration of $3,649,059.36, from which a brokerage fee ($550,000.00) and original purchase price ($700,000.00) were deducted to arrive at a gain of $2,399,059.36, and a tax due of $239,905.94. The Division determined that the consideration for the subject transfer was the present value of the net rental payments under the lease plus the consideration paid for the option to purchase the real property. In calculating the present value of rental payments, the Division included all rental payments required to be made during the term of the lease.[3]

Thereafter, petitioner submitted a Supplemental Return whereby payment of the gains tax on an installment basis was elected; the annual installment as computed by petitioner was $15,993.73.

Petitioner paid the first installment of $15,993.75 on or about January 29, 1991.

Petitioner paid the second installment of $15,993.75, plus interest of $23,986.26, amounting in all to $39,979.99, on or about January 21, 1992.

On February 6, 1991, petitioner submitted Form TP-165.8, Claim for Refund of Real Property Transfer Gains Tax, concerning the first installment payment of $15,993.75. Petitioner noted that the Division calculated the consideration based on the entire 21 years of rent payments. Petitioner claimed that no tax is owing because the transferee may default under the Ground Lease or may not exercise its option to purchase the property. In the alternative, petitioner contended that if the gains tax is applicable, then consideration should not be based on the entire 21 years of rent payments but only on payments commencing in the 18th year because the option cannot be exercised prior to that time. Petitioner also argued that the original purchase price should be increased based on the provisions of Tax Law § 1440.5(d) which provides that the original purchase price, with respect to the creation of a lease or option, be calculated by a formula taking into account the fair market value of the real property.

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[3] We modified finding of fact "6" of the Administrative Law Judge's determination by adding the last two sentences to reflect the precise language of the stipulation.

Petitioner's counsel received a letter, dated February 21, 1991, from the Division indicating that petitioner's election to pay the gains tax due in installments was accepted as filed.

Petitioner's counsel received a letter, dated March 1, 1991, from the Division denying the refund claim. The Division reasoned that under the gains tax law consideration for such a lease is the present value of the rental payments beginning on the commencement of the lease and continuing until the option is no longer exercisable, plus the consideration paid for the option to purchase the real property; and that Tax Law § 1441 provides that tax on gains derived from real property transfers is imposed on the date of transfer notwithstanding the fact that a lessee subsequently may default on the lease. With respect to the original purchase price, the Division noted that Tax Law § 1440.5(a) applied and that the original purchase price cannot exceed the amount actually paid for the property. The Division permitted $700,000.00 to be applied as an original purchase price deduction. This figure was set forth on a closing statement, dated May 10, 1973, with respect to petitioner's acquisition of the premises.

Petitioner requested a conciliation conference. After a conference was held on October 22, 1991, a Conciliation Order, dated February 28, 1992, was issued sustaining the refund denial.

Petitioner filed a petition, dated May 13, 1992, contesting the $239,905.94 gains tax due. The Division filed an answer, dated August 17, 1992.

OPINION

Tax Law § 1441 imposes a 10 percent tax on "gains" derived from the "transfer of real property" within the State.

The term "gain" means "the difference between the consideration for the transfer of real property and the original purchase price of such property, where the consideration exceeds the original purchase price" (Tax Law § 1440[3]).

The Administrative Law Judge rejected petitioner's alternative assertions: 1) that since the lease would not have been subject to tax without the option because it was for a period of

less than 49 years and because the option to purchase cannot be exercised prior to the 18th year of the lease agreement, the option should be deemed nonexistent and, therefore, the "transfer" is not subject to the gains tax, or 2) at the very least the value of the first 18 years of rental payments should be deemed nonexistent, or 3) that only the value of the rental payments remaining after the option is exercisable should be included as consideration.

The Administrative Law Judge pointed out that the gains tax statute unequivocally defines a transfer of real property subject to gains tax to include an option to purchase real property,[4] and that the consideration for the option is the present value of the rental payments under the lease plus any consideration paid for the option.[5] "There is no statutory or regulatory provision that exempts rental payments made prior to the time an option is exercisable . . . . The only exemption for rental payments is provided in 20 NYCRR 590.27 for those rental payments that are made after an option is no longer exercisable" (Determination, conclusion of law "A").

The Administrative Law Judge, relying on Matter of Cheltoncort Co. v. Tax Appeals Tribunal (185 AD2d 49, 592 NYS2d 121), found "little merit" in petitioner's assertion that since the option could become nonexistent due to the transferee's default in rental payments or failure to exercise the option, there was no consideration which could be calculated.

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[4]Tax Law § 1440(7) defines "transfer of real property" to include the transfer of any interest in real property:

> "by any method, including but not limited to sale, exchange . . . option, . . . [and] the creation of a leasehold or sublease only where (i) the sum of the term of the lease or sublease and any options for renewal exceeds forty-nine years." (Emphasis added; see also, Tax Law § 1440[4].)

[5]In determining the "consideration" paid for the granting of an option with use and occupancy of real property or the creation of a leasehold interest (as defined in Tax Law § 1440[7]), the statute provides that consideration shall include:

> "the value of the rental and other payments attributable to the use and occupancy of the real property or interest therein and the value of any option to purchase or renew included in such transfer." (Tax Law § 1440[1][b].)

Finally, the Administrative Law Judge found that petitioner's application of Tax Law § 1440(5)(d) to increase the original purchase price of the property had no rational basis and contradicts the entire statutory scheme in calculating the original purchase price under Tax Law § 1440(5) and 20 NYCRR 590.28. Specifically, she determined that petitioner's reliance on a memorandum from the Executive Department concerning changes made to the definition of original purchase price by the Legislature in 1984 was misplaced:

> "[t]he problem with petitioner's reference to the above memorandum is that this memorandum refers to subdivisions (a) through (g) of section 1440.5 and not simply to subdivision (d). The reference in the memorandum to the "increase to a lessor's original purchase price" must be viewed in the context of the entire section 1440.5 which deals with original purchase price. Prior to the 1984 amendments, section 1400.5 did not contain subdivisions (a) through (g). Subdivisions (d) and (e) addressed for the first time in 1984 the original purchase price within the context of the creation of a lease or option to purchase with use and occupancy of the real property.
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> "Subdivision (e) of section 1440.5 permits the lessor to increase the original purchase price upon a subsequent sale to the transferee if the lessor paid gains tax on the transfer of the lease and option. In such a scenario, the original purchase price is increased by the amount calculated as consideration for gains tax purposes (present value of the rental payments plus consideration received for the option) in the prior transfer (see, 20 NYCRR 590.28[b], [c], [d]).
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> "Contrary to petitioner's claim, it is to this subdivision that the legislative memorandum refers when it stated that the proposals were necessary to provide the lessor with "an equitable original purchase price so that the entire consideration for each such transfer is not taxable gain." Clearly, the memorandum concerns the situation where, after the transfer of the leasehold or option, the lessor transfers the entire interest in the property upon the transferee's exercise of an option to purchase or if the option is not exercised, a transfer to a third party. In either situation, the original purchase price is increased to ensure that the lessor is not taxed twice on the same value" (Determination, conclusion of law "B").

The Administrative Law Judge found it unnecessary to address the Division's claim that the appraisal of the fair market value of the real property is flawed.

On exception, petitioner reiterates the assertions made at hearing.

In its brief on exception, the Division asserts that the determination of the Administrative Law Judge is correct. Specifically, the Division asserts that there is no statutory or regulatory basis for petitioner's assertion to exclude the rental payments for years prior to the year in which

the option is exercisable; Cheltoncort is dispositive with regard to the time when consideration is calculated; and that section 1440(5)(d) may not be used by petitioner to increase its acquisition cost beyond the actual acquisition cost of the real property. The Division reiterates its assertion that the appraisal used by petitioner to establish the fair market value of the property is

> "seriously flawed because it fails to follow the Uniform Standards of Professional Appraisal Practice (19 NYCRR §1106). There is no explanation contained within the submitted appraisal to explain and support the exclusion of any of usual valuation approaches (19 NYCRR §1106.2[b][3][x]). Similarly, it is not explained why the lease affecting the subject land is ignored by the appraiser when such an item is required to be considered (19 NYCRR §1106.2[3][iii]). In sum, the Division contends that it is not established that the petitioner's appraiser correctly employed those recognized methods and techniques that are necessary to create a credible appraisal" (Division's brief, pp. 9-10).

In its reply brief, petitioner responds to this point asserting that the appraisal is in accord with "professional standards" and that it "sets forth a certified valuation of the fair and reasonable market value, as of a date prior to the lease commencement date, at a time when the Ground Lease was not affecting the realty" (Petitioner's reply brief, p. 4).

We deal first with petitioner's assertion concerning the taxability of the option and the methodology for the calculation of consideration.

We affirm the determination of the Administrative Law Judge.

These two issues are resolved by the explicit provisions of the Tax Law. First, the term "transfer of real property" subject to gains tax includes an option to purchase real property (Tax Law § 1440[7]).[6] Second, the statute prescribes that the consideration for the option is the present value of the rental payments under the lease plus any consideration paid for the option (Tax Law § 1440[1][b]; 20 NYCRR 590.27). Petitioner's assertions are clearly contrary to the statute and the Division's regulations.

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[6]Tax Law § 1443(7) exempts from application of the gains tax "the granting of an option to purchase property without the use of occupancy of such property." Thus, only an option with use and occupancy is a taxable transfer of real property within the purview of the tax.

Nor is there any support for petitioner's position in the Division's regulations which provide that consideration is to be calculated by excluding rental payments made after the date on which the option is exercisable (20 NYCRR 590.27).[7] The apparent rationale of this regulatory exclusion is that the lease is subject to the tax only because of the option to purchase. Thus, payments after the option exercise date are excluded from consideration since they would not otherwise be taxable. We find this regulation consistent with the statute and a proper exercise of the Division's rule-making authority (cf., Boreali v. Axelrod, 71 NY2d 1, 523 NYS2d 464). In no way can it be interpreted to lend any support to petitioner's assertions.

We deal next with petitioner's assertion concerning the calculation of original purchase price. We are concerned only with calculation of petitioner's original purchase price in connection with the creation of the lease with the option to purchase. Thus, we turn our attention to subdivision (d) which, no doubt, is applicable to petitioner. The core of the problem is in the numbers used in the fraction, i.e., the present value of the the rental payments calculated by the Division under 20 NYCRR 590.26, which comprises the numerator of the fraction in subdivision (d), exceeds the denominator, the fair market value as represented by petitioner. The result is a fraction greater than one (1) which has the effect of increasing petitioner's original purchase price of the property, a result which the Administrative Law Judge correctly concluded "would be nonsensical." We note that the Division's regulation 20 NYCRR 590.26 contemplates precisely this problem and presents a resolution for it. Specifically, the

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[7]20 NYCRR 590.27 provides:

"Lease for less than 49 years containing option to purchase. [Tax Law, § 1440(1),(4)]

"Question: Is the creation of a lease for a term less than 49 years which contains an option to purchase the real property subject to the gains tax?

"Answer: Yes. Section 1440(4) of the Tax Law defines an interest in real property to include an option. The consideration for such a transfer is the present value of the net rental payments under the lease plus the consideration paid for the option to purchase (Tax Law, section 1440[1][b]). Rental payments for periods that occur after an option is no longer exercisable are not included in the calculation of the present value of the rental payments. If the sum of the present value of the net rental payments and the price paid for the option is $1 million or more, the transfer is subject to the tax (Tax Law, section 1440[1]). The present value of the net rental payments should be determined as set forth in section 590.26 of this Part."

regulations provide that a discount rate of "110 percent of the federal long-term rate compounded semiannually . . . be used in determining the present value of such payments" (20 NYCRR 590.26). Importantly, the regulations go on to provide that:

> "[i]f the taxpayer establishes . . . that a discount rate which is greater than 110% of the federal long-term rate is appropriate . . . and . . . that using a discount rate equal to 110 percent of the federal long-term rate results in the computation of consideration which exceeds the fair market value of the real property subject to the lease or sublease, the [Division] will allow the use of a discount rate that results in the computation of consideration equal to the fair market value of such real property" (20 NYCRR 590.26, emphasis added).

Petitioner did not challenge the discount rate but instead pointed to the fact that the stipulated facts indicate that "[i]n calculating the present value of rental payments the Division included all rental payments required to be made during the term of the lease" (Stipulation of Facts "13"). However, the use of the 110 percent rate by the Division results in a computation of consideration which apparently exceeds the fair market value of the property. The Division approached the problem by asserting that the appraisal offered by petitioner to establish fair market value was seriously flawed, an issue the Administrative Law Judge did not address. The confluence of these circumstances prevents us from determining the correctness of the fraction in subdivision (d).

Thus, we remand the matter to the Administrative Law Judge for a hearing or, if the parties choose, submission of evidence without a hearing, to determine the fair market value of the property and the correctness of the Division's calculation of the present value of the rents, a calculation which will affect both the consideration for the transfer of the option and the calculation of the orginal purchase price.

We will retain jurisdiction over this case based on the exception already timely filed by petitioner. After the Administrative Law Judge issues her supplemental determination, petitioner will be allowed to file an additional exception (or request an extension of time to do so) within 30 days of the issuance of the supplemental determination. If the Division wishes to except to any portion of the Administrative Law Judge's supplemental determination, the

Division will be required to submit a timely exception to the supplemental determination. Briefs (in support, opposition and/or reply) will be allowed on either or both exceptions.

Accordingly, the matter is remanded to the Administrative Law Judge for proceedings consistent with this decision.

DATED: Troy, New York
May 26, 1994

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

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