

STATE OF NEW YORK  
TAX APPEALS TRIBUNAL

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In the Matter of the Petition	:	
of	:	
<b>CLASSIC RESIDENCES, INC.</b>	:	DECISION
	:	DTA No. 810986
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 Classic Residences, Inc., formerly known as Raynes Conversions, Inc., 551 Madison Avenue, New York, New York 10022, filed an exception to the determination of the Administrative Law Judge issued on January 27, 1994. Petitioner appeared by Margolin, Winer & Evens (James L. Tenzer, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition. Petitioner filed a reply brief which was received on June 24, 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 certain interest charges denominated by petitioner as "conversion period interest," could properly be included in the calculation of petitioner's original purchase price where there was no evidence that the underlying loans and interest, were customary, reasonable and necessary expenses incurred to create ownership interests in cooperative form.

II. Whether petitioner has established that it incurred expenses for market surveys and miscellaneous conversion costs in the amount of \$2,036.00, which it is entitled to include as part of its original purchase price.

III. Whether petitioner has established that penalties asserted for failure to correctly report and remit the gains tax due should be abated.

### ***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., is the sponsor of the plan to convert 225 East 73 Street, New York, New York ("the property"), consisting of 88 apartment units, to cooperative ownership.

In August 1987, prior to the initial closing of the sale of apartment units, petitioner, as transferor, filed a Real Property Transfer Gains Tax Questionnaire for Cooperative and Condominiums (Form DTF-701) (hereinafter "Transferor's Questionnaire") with the Division of Taxation ("Division"). This form reported the anticipated transfer of apartment units at the property under "safe harbor" guidelines discussed, infra. Petitioner reported the actual anticipated "gross consideration" for the 54 units having pending contracts of sale, representing 14,778 shares of stock in the cooperative, and the "safe harbor" "gross consideration" (50 percent of the actual sales price of units sold vacant to "outsiders") for the 34 unsold units, representing 8,218 shares of stock in the cooperative.

Petitioner uses the term "conversion period interest" in its brief. Petitioner states that it had conversion period interest of \$345,724.00. This figure, petitioner states, represents its total interest expense incurred in connection with all amounts borrowed to convert the property to cooperative ownership (Petitioner's brief, p. 7).

The Real Property Transfer Gains Tax Schedule of Original Purchase Price for Cooperatives and Condominiums (DTF-700) (hereinafter "Gains Tax Schedule") filed by petitioner sets forth the costs it included in computing its original purchase price for the property. Toward the bottom of the attached supplemental worksheet (DTF-703), under the heading "Additional Conversion Costs", petitioner reported conversion period interest of \$345,724.00. This figure was transferred to, and reported on, the gains tax schedule (DTF-700) at page 2, Part IV, line 10 as part of the \$848,535.00 (Actual) and \$293,201.00 (Anticipated) in "Other conversion Costs". The \$345,724.00 in conversion period interest is also reported on page 1, line 7 of petitioner's real property gains tax questionnaire (DTF-701) as a part of the conversion costs reported on that line.

The gains tax schedule (DTF-700) (at page two, line 26) referred to in Finding of Fact "7", reflects that petitioner also reported as part of original purchase price, \$282,865.00 in "Interest paid during the construction period on loans where the proceeds of such loans were used to make capital improvements" (emphasis added). This figure is in addition to the interest charges of \$345,724.00 described above.

In the course of converting the property to cooperative use, a total of \$628,589.00 in interest charges was incurred, all of which was included by petitioner in computing its original purchase price reported to the Division. Of this amount, \$282,865.00 related directly to loans used to make capital improvements to the property and \$345,724.00 related to loans used for other unspecified purposes.

Total mortgage recording tax reported by petitioner as part of its original purchase price was \$63,000.00, of which \$7,000.00 was attributable to special additional mortgage recording tax (hereinafter "SAMRT").

The gains tax questionnaire petitioner prepared and filed with the Division reported a negative "Gain Subject to Tax" of (\$46,152.00) computed as follows:

Anticipated Gross consideration under "safe harbor"	\$13,424,670.00
Less: Brokerage Fees	<u>(535,921.00)</u>
Anticipated Consideration	\$12,888,749.00
Less: Original Purchase Price	<u>(12,934,901.00)</u>
Gain Subject to Tax:	(\$ 46,152.00)

Petitioner's gains tax questionnaire was the subject of a field examination conducted by the Division. On April 24, 1990, upon completion of the field examination, the Division issued a Statement of Proposed Audit Adjustment asserting additional gains tax due in the amount of \$19,346.49, computed as follows:

Anticipated Gross Consideration:	\$13,401,420.00	
Less: Brokerage Fees	<u>(535,921.00)</u>	
Anticipated Consideration:	\$12,865,499.00	
Original Purchase Price:	\$12,934,901.00	
Disallowed:		
1) Conversion period Interest	(345,724.00)	
2) Special Additional Mgt. Recording Tax (\$2,930,000 X .25%)	(7,000.00)	
3) Interior Designer Fees	<u>(7,750.00)</u>	(12,574,427.00)
Anticipated Gain		\$ 291,072.00
Anticipated Tax at 10%		\$ 29,107.00
"Tax due per audit" on 56 units sold as of the date of the Statement of Audit Changes (29,107 X 15,284 shs/22996 shs)		\$ 19,346.49
Interest		\$ 5,675.10
Penalty		<u>\$ 6,771.27</u>
"Pay this Amount"		\$ 31,792.86

On August 3, 1990, the Division issued a Notice of Determination to petitioner asserting additional real property gains tax ("gains tax") due in the amount of \$19,346.49 plus penalty and interest. At petitioner's request, a conciliation conference was held by the Bureau of Conciliation and Mediation Services. At this conference petitioner produced documentation in support of its claimed architectural fees of \$7,750.00. These fees were allowed by the conferee,

and the resulting Conciliation Order dated April 10, 1992 reduced the tax asserted to \$18,829.89 plus penalty and interest. This is the amount remaining in dispute.

### ***OPINION***

The Administrative Law Judge rejected petitioner's argument that since it had been involved in converting the property to cooperative ownership from inception, the entire amount of its interest expense on funds borrowed to convert the property should be allowed as part of the cost of conversion. The Administrative Law Judge stated "[t]his argument ignores that Tax Law § 1440(5) limits the costs that can be included in original purchase price to those which are 'customary, reasonable and necessary' as determined 'under rules . . . prescribed by the tax [commissioner]'" (Determination, conclusion of law "E") and that 20 NYCRR 590.39 does not provide for the inclusion in original purchase price of the entire amount of interest expense on funds borrowed to convert property. The Administrative Law Judge also found tenuous petitioner's analogy of construction period interest expense to conversion period interest expense. The Administrative Law Judge stated that construction period interest expense "creates new property which is then placed in service" while conversion period interest expense "simply changes the form of ownership of property" (Determination, conclusion of law "E"). The Administrative Law Judge noted that arguments similar to petitioner's were recently rejected by this Tribunal in Matter of 61 East 86th St. Equities Group (Tax Appeals Tribunal, January 21, 1993) and by the Appellate Division in Matter of Mattone v. State of New York Dept. of Taxation & Fin. (144 AD2d 150, 534 NYS2d 478).

The Administrative Law Judge, citing 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), also determined that petitioner had to show that "the loan proceeds giving rise to the conversion period interest were customary, reasonable and necessary expenses used to create ownership interest in cooperative form" (Determination, conclusion of law "F"). The Administrative Law Judge found that petitioner presented no evidence to show how the loans were used. The

Administrative Law Judge would not allow the canceled checks petitioner submitted with its reply brief into evidence as these checks were submitted after the record was closed.

The Administrative Law Judge allowed petitioner to include the \$7,000.00 in SAMRT in computing its original purchase price because the Division's regulation at 20 NYCRR 590.39 expressly allows the mortgage recording tax as an element of original purchase price.

With respect to the expenses petitioner incurred for market surveys and miscellaneous expenses, the Administrative Law Judge found that the record does not show that petitioner proved that these expenses were incurred or that the Division disallowed them.

Finally, the Administrative Law Judge found that petitioner ignored the Tax Law, regulations and Technical Services Bureau memoranda governing what could be included in original purchase price, which were available at the time it filed its gains tax schedules and questionnaires. The Administrative Law Judge also found that petitioner offered no explanation for its failure to follow the Division's established guidelines and, thus, sustained penalty and interest penalty.

On exception, petitioner argues that the conversion period interest incurred by it from inception in connection with converting the property to cooperative ownership should be included in original purchase price and is a customary, reasonable and necessary expense incurred to create ownership interests. Specifically, petitioner argues that 20 NYCRR 590.39 lists certain types of expenses which are includible in original purchase price but that the list only illustrates the costs that are includible in original purchase price and "is not intended to be all inclusive" (Petitioner's brief, p. 7). Petitioner further argues that several forms issued by the Division in 1985 provide space for reporting other conversion costs or additional conversion costs and that these forms "support the intention that the list contained in the Regulations is merely illustrative" (Petitioner's brief, p. 8). Petitioner also argues that by disallowing conversion period interest the Division is "broadening the application of the Gains Tax from a 10% tax on economic gain to a 10% on capital" and that this result is not required by statute and is not legislatively or administratively correct (Petitioner's brief, p. 8).

Petitioner disagrees with the Administrative Law Judge's conclusion that it did not establish how the loans giving rise to the interest were used. Petitioner asserts that the amounts incurred were completely documented during the field examination process. Petitioner argues that it borrowed all the funds required to improve and convert the property in a single line of credit and that periodically it "made a single interest payment on the loan, a portion of which was properly allocated to the 'construction costs' and a portion of which was properly allocated to the 'conversion costs'" (Petitioner's brief, p. 9). Petitioner then argues that in order for the Division to find that \$282,865.00 was paid by the transferor and properly classified as construction period interest, it would also have had to find that \$345,724.00 was paid by the transferor and properly classified as conversion period interest.

Petitioner also argues that the Administrative Law Judge's reliance on Matter of Mattone v. State of New York Dept. of Taxation & Fin. (supra), Matter of 61 East 86th St. Equities Group (supra) and Matter of 1230 Park Associates (supra) is misplaced. Petitioner argues that the issue in Mattone was whether acquisition interest is includible in original purchase price, the issue in 61 East 86th Street was whether interest carry is includible in original purchase price and the issue in 1230 Park Assocs. was whether negative carry was an expense incurred to create ownership in the cooperative form. The issue in this matter, argues petitioner, is whether interest incurred on amounts borrowed to fund the costs incurred to create ownership interests in cooperative form should be included in original purchase price and, therefore, Mattone, 1230 Park Assocs. and 61 East 86th Street are not relevant here.

Finally, petitioner argues that any penalties assessed should be abated. In support of its position, petitioner argues that at every stage in the filing process it was in full and complete compliance with the requirements of Article 31-B. Petitioner also argues that TSB-M-86(3)-R states that penalty may accrue and that, therefore, penalty should not be automatically assessed. In addition, petitioner asserts that it did not ignore the Tax Law or regulation as they "do not contain any statement prohibiting the inclusion of 'conversion period interest' in OPP, but, in fact, expressly provide that 'customary, reasonable and necessary' expenses incurred in creating

ownership interests in cooperative form are includible in OPP" (Petitioner's brief, pp. 14-15). Petitioner further argues that "any failure to pay any amount of Gains Tax ultimately determined to be due was due to 'reasonable cause and not willful neglect'" (Petitioner's brief, p. 16).

In response, the Division argues that the burden of proof in this matter was on petitioner to show how the loan proceeds that generated the conversion period interest were used (20 NYCRR 3000.10[d][4]). The Division argues that petitioner has not met this burden. The Division asserts that, in view of 20 NYCRR 590.16 which allows for inclusion in original purchase price of construction period interest and 20 NYCRR 590.15 which disallows inclusion in original purchase price of interest expense on loans where the proceeds are used to acquire real property, it should have been clear to petitioner that it was necessary to provide some details on the use of the loans that generated the conversion period interest (Division's brief, p. 4-5). The Division asserts that while it did accept petitioner's construction period interest as being includible in original purchase price, the disallowance of \$345,724.00 in conversion period interest by the Division's audit adjustment does not "document such expense or constitute an agreement as to the petitioner's characterization of how the funds generating the interest expense were utilized" (Division's brief, p. 5).

In addition, the Division asserts that it cannot respond to petitioner's argument that the cases cited by the Administrative Law Judge involving "negative carry" or "interest carry" are distinguishable from this matter. The Division states that in view of petitioner's failure to provide any explanation of the debt obligation giving rise to the conversion period interest claimed, it is impossible to determine if the interest was related to the acquisition of real property and thereby excluded from original purchase price pursuant to 20 NYCRR 590.15.

With respect to penalties, the Division argues that petitioner has not shown reasonable cause for the abatement of penalties. The Division argues that based on Publication 588 published in November 1984 and regulations promulgated thereafter, petitioner could have properly calculated its original purchase price.



In its reply brief, petitioner renews its argument that documentation for the interest incurred has been submitted to the Division more than once and has been reviewed by the Division.

Petitioner also argues that it has established reasonable cause for the waiver of penalties assessed. Petitioner argues that it had complete filing compliance, its arguments are reasonable and that it properly included conversion period interest in its original purchase price.

We affirm the determination of the Administrative Law Judge that conversion period interest is not includible as an allowable element of original purchase price for the reasons stated in said determination. In addition, we note that since the Administrative Law Judge's determination was issued, this Tribunal has expressly rejected conversion period interest as an allowable element of original purchase price (see, Matter of 44 West 62nd St. Assocs., Tax Appeals Tribunal, August 11, 1994).

While we find that petitioner did not ignore explicit statements regarding conversion period interest in the Tax Law, regulations and Technical Services Bureau memoranda as there is no mention of conversion period interest in those authorities, we sustain the imposition of penalty and penalty interest based on the fact that petitioner has not shown the position it took was based on reasonable cause.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Classic Residences, Inc. is denied;
2. The determination of the Administrative Law Judge is sustained;

3. The petition of Classic Residences, Inc. is granted to the extent indicated in conclusion of law "G" of the Administrative Law Judge's determination, but is otherwise denied; and

4. The Division of Taxation is directed to reduce the Notice of Determination issued on August 3, 1990 in accordance with paragraph "3" above, but such Notice as modified by the Conciliation Order is otherwise sustained.

DATED: Troy, New York  
December 1, 1994

/s/John P. Dugan

John P. Dugan  
President

/s/Francis R. Koenig

Francis R. Koenig  
Commissioner