STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
32ND STREET DEVELOPMENT ASSOCIATES	:	DECISION DTA No. 812483
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 32nd Street Development Associates, c/o Robert Gladstone, RG 32nd Street Development Corporation, 875 Third Avenue, 3rd Floor, New York, New York 10022, filed an exception to the determination of the Administrative Law Judge issued on August 10, 1995. Petitioner appeared by Roberts & Holland (David E. Kahen, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Kenneth J. Schultz, Esq., of counsel).

Petitioner filed a brief on exception. The Division of Taxation filed a brief in opposition to petitioner's exception. Petitioner filed a reply brief. Oral argument was not requested.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUES

I. Whether there was a "construction period" under 20 NYCRR former 590.16(e) which would allow certain interest expenses, real estate taxes and insurance costs incurred by petitioner to be included in its original purchase price as consideration paid for capital improvements.

II. Whether interest expenses incurred by petitioner on a loan used to acquire property and buy out leaseholds was includible in its original purchase price as consideration paid for a capital improvement.

III. Whether penalties imposed may be abated or cancelled on the ground that any failure to pay the full amount of gains tax was due to reasonable cause and not due to willful neglect.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "1," "3" and "8" which have been modified. We have also made an additional finding of fact. The Administrative Law Judge's findings of fact, the modified findings of fact and the additional finding of fact are set forth below.

We modify finding of fact "1" of the Administrative Law Judge's determination to read as follows:

> Petitioner, 32nd Street Development Associates, was a firm which was formed to assemble properties, demolish structures on the properties, obtain financing and build a residential high-rise condominium or rental apartment building. The design concept of the project was a building with 240 apartments and a significant amount of space for retail use. Petitioner also anticipated that the building would have a club with a swimming pool. As the president of one of petitioner's corporate partners, it was Mr. Robert Gladstone's role to spearhead the development, design the project and be in charge of construction, marketing and finance.[1]

On February 28, 1989, petitioner sold the property which it acquired. Prior to the sale, petitioner filed a Transferor Questionnaire which reported anticipated tax due of $320,054.00, calculated as follows:

Gross consideration		$19,150,000.00
Purchase price	$8,970,000.00	
Other acquisition costs	2,952,050.00	
Cost of capital improvements	4,027,413.00	
Original purchase price		15,949,463.00
Gain subject to tax		3,200,537.00
Anticipated tax due		320,054.00

We modify finding of fact "3" of the Administrative Law Judge's determination to read as follows:

> In its gains tax questionnaire, petitioner claimed interest costs of $720,493.00, insurance costs of $56,964.00 and real estate taxes of $525,388.00 as capital improvement costs incurred during a construction period and includible in original purchase price. The interest amount included in original purchase price was computed by multiplying the total interest expense incurred as then

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[1]We have modified this finding of fact to reflect the fact that, since petitioner was a partnership, Mr. Gladstone was not its president. Rather, he was the president of one of petitioner's partners. The finding of fact was also modified to reflect the fact that Mr. Gladstone does not have a middle initial in his name.

> computed, $3,318,000.00, by the ratio which the costs of capital improvements, other than interest, as then computed, $3,306,920.00, bore to the total of acquisition costs and capital improvement costs ($15,171,900.00).[2]

Upon pre-transfer audit, the Division of Taxation ("Division") made adjustments in is tentative assessment by reducing the original purchase price by 35.71 percent of the interest, insurance and real estate tax costs claimed. To the extent pertinent, the Division stated:

> "IT HAS BEEN DETERMINED THE CONSTRUCTION PERIOD ON THIS PROJECT EXISTED FROM 10/86 TO PRESENT, AND NOT FROM 7/85 AS PREVIOUSLY CLAIMED. ACCORDINGLY, 15/42 OF [sic] 35.71% OF CONSTRUCTION PERIOD INTEREST, TAXES AND INSURANCE, MUST BE DISALLOWED.
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> | | | | |
> |---|---|---|---|
> | REAL ESTATE TAXES | 525,338 | X 35.71% | 187,598.20 |
> | INTEREST | 720,493 | X 35.71% | 257,288.05 |
> | INSURANCE | 56964 | X 35.71% | 20,341.84" |

The Division also noted that it disallowed acquisition costs of $169,993.00 for lack of substantiation.

In accordance with the foregoing, the Division issued a Tentative Assessment and Return, dated January 27, 1989, which increased the amount of gain by $635,221.09. The foregoing resulted in a gain subject to tax of $3,835,758.09 and a tentative assessment of tax due of $383,575.81.

Petitioner filed a Supplemental Return, dated February 27, 1989, which reported an increase in the gain subject to tax of $43,100.00 resulting in a gain of $3,878,858.09 and a tax due of $387,885.81. Petitioner paid the tax shown due on the return.

The Division conducted a field audit of the sale which occurred on February 28, 1989 and, as a result, determined that additional tax was due. Accordingly, the Division issued a Notice of Determination, dated August 31, 1992, which asserted that tax was due in the amount of $237,037.00, plus interest of $100,234.01 and penalty of $82,962.00, for a balance due of $420,233.01. The Statement of Proposed Audit Adjustment, which was dated April 22, 1992, calculated the amount of tax due as follows:

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[2]We modified the first sentence of finding of fact "3" to reflect the fact that petitioner claimed real estate taxes on its questionnaire, not real estate costs per se.

Tax due per audit	$624,923.00
Less: previous payment	387,886.00
Tax Due	$237,037.00

We modify finding of fact "8" to read as follows:

> As reflected in the audit workpapers that accompanied the Statement of Proposed Audit Adjustment, the assertion of additional tax due is based almost entirely on the disallowance of all or part of certain expenditures included in the acquisition and capital improvement costs that were claimed by petitioner as includible in its original purchase price for the property. The expenditures partially or completely disallowed by the auditor included the following:[3]
>
> (a) A payment to Mr. Sant Chatwal in the amount of $1,000,000.00 claimed as an acquisition cost, of which $750,000.00 was disallowed as "excessive";
>
> (b) Real estate taxes of $525,338.00 and construction period insurance costs of $56,964.00 claimed as capital improvement costs incurred during a construction period, all of which were disallowed with the explanation that "[n]o construction occurred therefore no construction period costs allowed"; and
>
> (c) Interest of $720,493.00 claimed as a capital improvement cost incurred during a construction period was disallowed, with the explanation of "[l]oan dated 4/3/87 -- to refinance and satisfy 'obligation of owners'."

The aggregate amount of acquisition costs allowed by the Division was $10,505,182.00.

In addition to the foregoing adjustments, the Division determined on audit that there was additional consideration of $45,000.00. It also found that the following acquisition costs or capital improvement costs should be disallowed: special additional mortgage recording tax of $30,635.00; legal fees to Paskus, Gordon & Mandel in the amount of $42,000.00; expenses attributed to Vasa Realty of $325,000.00; expenses attributable to Rassena of $45,000.00; legal expenses attributable to the firm of Bell Kalnick of $5,000.00; a transfer tax paid to the New York City Commissioner of Finance in the amount of $3,000.00; a brokerage commission in the amount of $2,587.00 as unsubstantiated; legal fees paid to White & Case in the amount of

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[3]We modified the first paragraph of finding of fact "8" to change the word "Changes" to "Adjustment" to accurately state the name on the form.

$43,653.00 which pertained to other transactions; miscellaneous expenses in the amount of $169,993.00; tenant buyout costs of $129,150.00 which were unsubstantiated; mortgage recording tax of $41,625.00 as unsubstantiated; title insurance of $6,298.00; and a disallowance of $131,150.00 on the grounds that one-half of the total claimed fee of $262,300.00 was in the nature of an accounting fee.

The aggregate amount of capital improvement costs allowed by the Division was $2,483,693.00 as follows:

Description (Per Workpapers)	Amount Allowed
Tenant Buyouts	$2,098,245.00
Construction & Demolition	52,000.00
Vijay Kale - Architect	10,000.00
Madison Co.	131,150.00
Crescent Equities	125,000.00
Construction/Demo submitted on audit	67,298.00
	$2,483,693.00

The Division issued a Notice of Claim for Greater Deficiency, dated August 17, 1994, pursuant to Tax Law § 1444(3)(a)(2). The notice sought additional tax due of $25,000.00, plus statutory interest from March 1, 1989 and penalty of $8,750.00. The following explanation was set forth on the document:

> "PLEASE TAKE FURTHER NOTICE that on audit the Division of Taxation allowed as a component of Petitioner's original purchase price $250,000. [sic] of the $1,000,000 claimed as having been paid to Sant Chatwal. The basis for the assertion of this greater deficiency is the disallowance of the entire $1,000,000. [sic] payment to Sant Chatwal."

The first step in the project was the purchase of the land. This was accomplished one parcel at a time. The negotiations to acquire the parcels were difficult and protracted.

The order in which the parcels were purchased and the manner in which they were purchased was very important. If the owners of the parcels knew that a real estate developer was buying properties, the purchase price would have been greater and the development would have been delayed for years.

In order to obtain the parcels, petitioner employed the services of Mr. Sant Chatwal, who, at that time, was a restaurateur and hotel operator. Mr. Chatwal was able to convince the owners of the property that he did not plan on demolishing the buildings. Mr. Chatwal told the property owners that he wanted to alter the buildings to create a "pensionne/hotel". In the retail areas, Mr. Chatwal stated that he would build restaurants and put in establishments that would sell Indian-manufactured goods.

In fact, contrary to Mr. Chatwal's representations, it had been the consistent plan of the partnership to demolish the buildings. If the plan had been revealed, the price would have been greater.

The properties obtained by petitioner consisted of retail establishments and apartments which were used as residences. In order to pursue the plan of development, petitioner needed to acquire all of the parcels that would be necessary to construct the building. It was also necessary that all possessory rights of tenants in place at the time of acquisition of each parcel be terminated.

It was petitioner's understanding that the tenants had legal protection. Therefore, steps were taken to relocate the people.

The tenant buyouts began in or about October 1986 and continued until the middle of 1988.

The negotiations in connection with the tenant buyouts and acquisition of possession were very difficult. An examination of the police blotter showed that there were significant social problems, including drug abuse, in three of the buildings. With the exception of one building, Mr. Chatwal took the principal role in negotiating the tenant buyouts.

Petitioner paid Mr. Chatwal a fee of $1,000,000.00 in consideration of his services relating principally to the assemblage of the parcels comprising the property and negotiations to terminate the tenancies. Mr. Chatwal also supervised demolition work relating to the property owned by petitioner.

At the time of the $1,000,000.00 payment to Mr. Chatwal, he had an interest in petitioner. The check for the $1,000,000.00 payment bears the signature "Chatwal" as drawer.

There was no written agreement for the $1,000,000.00 fee.

In addition to the $1,000,000.00 fee, Mr. Chatwal received another $1,200,000.00 payment. At the hearing, Mr. Gladstone was unable to explain the additional payment. However, he felt that the payment was probably made to repay advances made by Mr. Chatwal as a partner in the partnership.

The aggregate amounts paid by petitioner, and allowed on audit, as consideration for the property and the tenant possessory rights were as follows:

Purchase price for parcels of land	$ 8,970,000.00
Air rights	360,000.00
Tenant buyout costs	2,098,245.00
Total	$11,428,245.00

By completing the assemblage and the buyout of tenant rights, Mr. Chatwal added substantial value to the assemblage. The property was ultimately sold in February 1989 for consideration of $19,238,000.00.

After the tenants surrendered the apartments, the buildings were rendered uninhabitable. Among other things, petitioner removed the staircase, the floor material, all plumbing fixtures and all electrical items. Petitioner also boarded up the windows. In some cases, the building was entirely stripped, leaving the crossbeams, the roof and some floor material holding the building together.

Demolition began at the time of the first tenant buyouts, which occurred in October 1986.

Petitioner commenced demolition immediately after it acquired space from a tenant in order to avoid the use or occupancy of the building by drug users or other squatters. It also permitted the rapid completion of demolition of the building at the time deemed appropriate.

Demolition of the buildings was completed prior to the sale of the property in February 1989.

The planning of this project began in late 1985 and early 1986 as Mr. Chatwal was acquiring the land on behalf of petitioner. Mr. Gladstone did business with Mr. Chatwal on a handshake. Mr. Gladstone knew that petitioner would eventually become the developer and builder.

Initially, the funds which were used to acquire the parcels and to finance the tenant buyout costs were obtained by Mr. Chatwal from the Bank of India and the First American Savings Bank.

The original loans were subsequently satisfied through a loan from Chase Manhattan Bank ("Chase"). Petitioner then entered into an agreement with Mr. Chatwal, a group known as Crescent Equities and Chase to finance the project.

The Summary of Loan Transaction set out in the Closing Memorandum for the April 3, 1987 mortgage transaction with Chase provided as follows:

> "SUMMARY OF THE LOAN TRANSACTION
>
> "Prior to the Closing, the Mortgaged Premises was encumbered by mortgage indebtedness of (i) $2,500,000 payable to the Bank of India (the 'Bank of India Loan'), (ii) $4,800,000 payable to First American (the 'First American Loan'), and (iii) $1,070,000 payable to Kosseff's, Inc. (the 'Kosseff's Loan').
>
> "At the Closing, the Bank of India and First American mortgages were purchased by and assigned to Lender and modified and Lender made a new loan to Borrower (the 'New Loan'), in the principal amount of $4,305,000.
>
> "Lender also agreed to advance the sum of $1,070,000 to Borrower at the time of maturity of the Kosseff's Loan, which funds are to be used to satisfy the obligations of Borrower under the Kosseff's Loan, and Kosseff's agreed to assign its mortgage to Lender upon such satisfaction."

The Summary of the Loan Transaction set out in the Closing Memorandum for the July 15, 1988 mortgage transaction with Chase provided as follows:

> "SUMMARY OF THE LOAN TRANSACTION
>
> "Prior to the original loan closing on April 3, 1987 (the 'Original Closing'), the Mortgaged Premises was encumbered by mortgage indebtedness of (i) $2,500,000 payable to the Bank of India (the 'Bank of India Loan'), (ii) $4,800,000 payable to First

> American Bank (the 'First American Loan'), and (iii) $1,070,000 payable to Kosseff's, Inc. (the 'Kosseff's Loan').
>
> "At the Original Closing, the Bank of India and First American mortgages were purchased by and assigned to Lender and modified and Lender made a new loan to Borrower (the 'New Loan'), in the principal amount of $4,305,000.
>
> "Lender also agreed to advance the sum of $1,070,000 to Borrower at the time of maturity of the Kosseff's Loan, which funds were to be used to satisfy the obligations of Borrower under the Kosseff's Loan, and Kosseff's agreed to assign its mortgage to Lender upon such satisfaction.
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> "At the closing on July 1, 1987 (the 'July 1987 Closing'), Borrower advanced funds in purchase of the Kosseff's Loan and the note and Mortgage held by Gary Kosseff, as successor to Kosseff's, Inc., were assigned to Lender and modified.
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> "At the Closing described herein, Lender agreed to increase the amount of the prior loans by $1,850,000 for the purpose of making payments to tenants of the Mortgaged Premises as an inducement for them to vacate their apartments. Such loan is secured by a new mortgage of the Mortgaged Premises, a financing statement, a limited guaranty of payment in the amount of $600,000 (the 'Guaranty') and an irrevocable letter of credit in Lender's favor for the account of Borrower in the amount of $1,250,000 (the 'Letter of Credit')."

At the hearing, Mr. Gladstone testified that the "land draw" of the construction loan from Chase was disbursed and that it was his intention to draw upon the construction loan at a later date.

Petitioner decided to proceed with inclusionary zoning because it was a method which allowed for the construction of a larger building. Mr. Gladstone also explained that petitioner wanted to obtain a "421A tax abatement". In 1987 and 1988, Mr. Gladstone negotiated the purchase of the inclusionary zoning certificates and 421A tax abatement certificates with an entity known as General Atlantic Realty.

Petitioner obtained architects' plans for the site, known as schematic stage development, to obtain financing and to make major decisions such as where certain items would go, how many apartments there would be, how much retail space there would be and a cost estimate. Later, petitioner obtained design development drawings where details were highlighted. The latter item led to working drawings.

At one juncture, Mr. Gladstone became concerned because there was a dispute within the family of one of his partners. Mr. Gladstone knew that this dispute was causing unhappiness at another location and did not want the same thing to happen at this development. Therefore, in order to find financing, he met with a series of Japanese companies.

Ultimately, petitioner did not proceed with the construction of the new building for two related reasons. Notwithstanding extensive efforts to interest major construction companies in participating in the construction of the proposed building, negotiations with these construction companies proved unsuccessful. Subsequently, some of Mr. Gladstone's partners concluded that they did not want to proceed with the development and brought in a potential buyer. When Mr. Gladstone notified Chase that petitioner was not going forward with the project, Chase located a buyer and a contract for the sale of the property was agreed upon quickly.

During the course of petitioner's ownership of the property, interest, insurance and real estate costs were incurred by petitioner in the following amounts, which include certain charges not taken into account in the pre-transfer filing:

Interest	$3,383,692.94
Insurance	83,706.47
Real estate taxes	493,857.72

Mr. Gladstone enlisted the professional advice of a law firm in order to comply with the requirements of the gains tax law. It is Mr. Gladstone's belief that he and his staff undertook all efforts of which he was able in order to comply with the tax law and that the gains tax returns were correct as filed.

Petitioner made real estate tax payments aggregating $472,194.32 and insurance payments aggregating $78,911.18 during the period beginning in October 1986 and ending with the sale of the property.

We make the following additional finding of fact:

> During the period from October 1986 to the date of sale, petitioner incurred $119,298.00 in demolition costs out of $14,094,589.00 in total costs incurred on the project. Interest expense incurred on loan amounts advanced was $3,103,484.00.

Mr. Chatwal did not appear and testify at the hearing.

In accordance with section 307(1) of the Administrative Procedure Act, petitioner's proposed findings of fact were generally accepted and incorporated into the determination. It is noted that proposed findings of fact "2", "3", "5", "8", "9", "13", "15", "17" and "18" were modified to reflect the record.

The Division's proposed findings of fact have been generally accepted and included herein. Proposed findings of fact "1", "4" and "6" were modified to reflect the record.

OPINION

In the determination below, the Administrative Law Judge reviewed Article 31-B[4] of the Tax Law which provided for the imposition of tax at the rate of 10 percent upon the gain derived from the transfer of real property where the consideration received for such transfer is $1,000,000.00 or more along with a review of the definition of "gain" under Tax Law § 1440(3) and original purchase price under Tax Law § 1440(5)(former [a]), which included the consideration paid to acquire the interest in real property.

The Administrative Law Judge held that "[u]nder 20 NYCRR former 590.15 certain preacquisition and acquisition costs may be included in the computation of original purchase price such as legal, architectural and other professional fees" (Determination, conclusion of law "D") and in the matter at hand,

> "it is clear that Mr. Chatwal had a central role in acquiring the property involved herein and that the amount paid to him was 'to acquire an interest in real property' within the meaning of Tax Law § 1440(5)(a)(i). Therefore, petitioner properly included the amount paid to him in original purchase price" (Determination, conclusion of law "E").

The Administrative Law Judge also cancelled the Notice of Claim for Greater Deficiency, dated August 17, 1994, holding there was no basis for said notice since the fee paid to Mr. Chatwal was includible in original purchase price.

The Administrative Law Judge, with respect to amounts claimed for real estate taxes and insurance expenses, held that said amounts are includible in original purchase price if they are

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[4]The real property transfer gains tax imposed by Tax Law Article 31-B was repealed on July 13, 1996. The repeal applies to transfers of real property that occur on or after June 15, 1996 (L 1996, ch 309, §§ 171-180).

associated with a capital improvement and incurred during a construction period. However, after a review of 20 NYCRR former 590.16(e) which defined when a construction period begins and ends, the Administrative Law Judge held that: 1) "[p]etitioner's argument that there was a construction period relies upon its demolition activities. Under the circumstances presented herein, this reliance is misplaced"; 2) "petitioner has not established that the demolition was undertaken as part of 'a continuing plan of construction of the real property'"; 3) "[t]he testimony of petitioner's witness is clear that the demolition was undertaken primarily to secure the site from unwanted individuals rather than as part of a continuing plan of construction"; and 4) "[s]ince the demolition in this instance was not done to prepare the site for construction, petitioner has not shown that the construction began" (Determination, conclusion of law "J").

The Administrative Law Judge, while agreeing with petitioner that 20 NYCRR former 590.16(e) did not state that the sole purpose of the demolition must be for construction, held that the record "lends credence to the Division's assertion that the plan of construction was never 'essentially implemented' (20 NYCRR former 590.16[e]). For this reason, the fact that the plan of construction never came to fruition is relevant" (Determination, conclusion of law "K").

The Administrative Law Judge also: 1) rejected petitioner's argument that interest costs are includible in original purchase price since there was no construction period during which interest was paid; and 2) held that since the audit herein resulted in significant adjustments to numerous items and not just the matters at issue in this determination, petitioner failed in meeting its burden in proving that penalty was improperly assessed.

On exception, petitioner argues that the evidence in the record establishes the existence of a "continuing plan of construction" under 20 NYCRR former 590.16(e); that the demolition was a form of construction; that the primary purpose of the demolition was to clear the property for construction of the proposed building and that removal of squatters and intruders was not the primary purpose of the demolition. Petitioner maintains that under 20 NYCRR former 590.16 demolition may be included in the definition of "construction" so long as it is accomplished as part of a plan of construction. Since there was such a plan in place at the time of the demolition

in this case, petitioner contends, then the construction period commenced with the beginning of demolition, and as a result, all construction-related costs during this period should be included in original purchase price.

With respect to the interest expense in issue, petitioner maintains that such expense was a construction-related expense and, thus, properly includible in original purchase price. Petitioner argues that exclusion of acquisition loan interest from original purchase price is inconsistent with the treatment given to other construction period costs related to land, such as property taxes and insurance, which are includible in original purchase price during a construction period. Petitioner also contends that such treatment is inconsistent with that of other disciplines such as accounting and Federal income taxation. Petitioner maintains that the 1993 amendment to the law is irrelevant because it is not appropriate to interpret the law in effect at the time of petitioner's sales by referring to amendments made on a subsequent date. Finally, petitioner contends that, even if the interest incurred with respect to the land acquisition is not includible in original purchase price, the interest incurred with respect to the acquisition of the leasehold buyouts should be includible.

Petitioner also argues that "[t]he legislative purpose of Article 31-B was to impose a tax on 'gain', and any attempt to disallow a legitimate project cost violates that purpose" (Petitioner's brief, p. 12).

Petitioner further argues that "[t]he interest, real property tax and insurance costs incurred by petitioner during the construction period on amounts expended to acquire land and to acquire possession from tenants were 'customary, reasonable and necessary'," and "disallowance of these costs has the direct result of overstating petitioner's gain and unjustifiably inflating the rate of tax applied to petitioner's real gain." These "were real out-of-pocket costs incurred by petitioner pursuant to its plan of development," and "[a]ny business person would recognize these costs as reducing a taxpayer's gain. The tax law should do so as well" (Petitioner's brief, p. 13).

The Division in reply argues that the Administrative Law Judge was correct in concluding that petitioner did not have a construction period, further arguing that "the fact that demolition

occurs on real property does not mean that there was per se a construction period" (Division's brief, p. 5).

The Division argues that even though petitioner's demolition costs were allowed as a capital improvement under 20 NYCRR former 590.16(c) and $119,298.00 of such costs were permitted to be included in its original purchase price, this does not mean that there was a construction period which would have enabled petitioner to also add millions of dollars in interest expenses to its original purchase price.

The Division argues that "for there to be a 'construction period' there must be more than mere demolition." The Division further argues that:

> "[t]he word continuing in the regulation envisions a situation where demolition has been undertaken as a part of an ongoing construction project involving actual construction. If demolition only were sufficient to constitute a 'construction period', there would have been no need for the drafters of the regulation to put the word 'continuing' in the regulation" (Division's brief, pp. 6-7).

The Division argues that petitioner's claimed interest and real estate costs are not includible in original purchase price as "construction period interest attributed to acquisition costs" and submits that this argument is merely a new spin on an old argument.

The Division further argues that "[t]he 1993 amendment to section 1440.5(a) of the Tax Law is proof that the costs petitioner seeks to include in original purchase price are not allowed by the former version of that section" (Division's brief, p. 9). The Division submits that even though petitioner on exception has modified its argument on this matter by stating that those amendments are irrelevant, "the 1993 amendment to §1440.5(a) changed the law by providing for the inclusion of several new expense items in original purchase price," and "[t]he amendment was not a mere clarification of the previous version of §1440.5(a)" (Division's brief, p. 10).

The Division, regarding the matter of penalties, argues that there was a disallowance of numerous claimed items (not just those items which are the subject of this proceeding), and a different interpretation of the law does not constitute reasonable cause. Thus, petitioner has failed to demonstrate that its failure to pay the proper amount of gains tax due on the date of transfer was attributable to reasonable cause and not willful neglect.

Petitioner, in reply, disagrees with the Division's interpretation of the sentence in the regulation defining "construction period" (20 NYCRR former 590.16[e]) arguing that the Division's contention appears to be that a construction period does not arise unless a property owner combines demolition with the commencement of construction of a new building and "[t]his reading is inconsistent with the plain meaning of this sentence in the Regulation, takes the sentence out of context, and leads to irrational results regarding the computation of original purchase price, or 'OPP'" (Petitioner's reply brief, p. 1).

Petitioner further argues that the word "continuing" in the regulation modifies the phrase "plan of construction" with a reading of the entire phrase "continuing plan of construction" being a requirement for the owner to have a plan that contemplates a continuation of construction activity after demolition, as opposed to simply demolition. The evidence in the record establishes that petitioner had such a plan at the time demolition began, contemplating not only demolition but also new construction (Petitioner's reply brief, pp. 1-2).

Petitioner also argues in reply that: 1) a reading of 20 NYCRR former 590.16(e) requires a focus on the intention of the owner at the time demolition begins as it is "clear that the undertaking of demolition will commence the construction period if the purpose of the demolition is to prepare the site for construction" (Petitioner's reply brief, p. 2); and 2) no justification is cited by the Division for its interpretation that "the includibility in OPP of certain construction-related expenses, such as interest incurred during the period of demolition, cannot be determined until after a later event--that is, the undertaking or failure to undertake new construction" (Petitioner's reply brief, p. 3).

We will first address the question of whether a construction period actually commenced and, if so, whether there was a continuing plan of construction of the real property.

We reverse the Administrative Law Judge on this issue. During the period in issue, 20 NYCRR former 590.16(e) provided as follows:

"Question: When does a construction period begin and end?

"Answer: A construction period usually begins on the date on which construction, development, erection or complete renovation

> of all or part of the 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 construction period is not considered to have begun solely because a plan of construction has been prepared or a building permit has been obtained. Rather, the construction period generally will be considered to have commenced when the plan of construction is essentially implemented.
>
> "For example, in the case of the demolition of existing structures, the construction period is considered to commence when the demolition begins if the demolition is undertaken to prepare the site for construction. The construction period will not be considered to have begun solely because of the demolition of existing structures if the demolition is not undertaken as part of a continuing plan of construction of the real property."

As the regulation points out, the construction period is considered to commence when the demolition begins if the demolition is undertaken to prepare the site for construction and, further, there can be no beginning of the construction period if the demolition is not undertaken as part of a continuing plan of construction of the real property.

The record before us contains ample evidence in support of petitioner's argument that demolition was undertaken, not primarily to secure the site from unwanted individuals, but to prepare the site for construction as part of a continuing plan of construction of the real property.

The Administrative Law Judge found that petitioner was a firm which was formed to assemble properties, demolish structures on the properties, obtain financing and build a residential high-rise condominium or rental apartment building and that the negotiations in connection with tenant buyouts and acquiring the parcels needed for the project were difficult and protracted.

The Administrative Law Judge also found that petitioner obtained architects' plans for the site and design development drawings which eventually led to working drawings.

The Administrative Law Judge did not find the testimony of petitioner's witness, Mr. Gladstone (the only witness to testify), to be incredible and a review of his testimony is replete with support for petitioner's argument that there was a continuing plan of construction of the real property.

We also reject the Division's argument that the word continuing in the regulation envisions a situation where the demolition has been undertaken as a part of an ongoing construction project involving actual construction.

While we agree with the Division that the drafters of the regulation could have left the word "continuing" out if demolition was to be the only requirement needed to constitute a "construction period," we point out that we agree with petitioner that the word "continuing" in the regulation is really a modifier for the phrase "plan of construction" with a correct interpretation being a requirement of having a continuing plan that contemplates a continuation of construction activity after demolition, as opposed to simply demolition.

Therefore, petitioner's construction period began with the start of its demolition activities as the factual record more than supports petitioner's argument that there existed a continuing plan of construction of the real property.

We next deal with the question relating to costs incurred while development activities were ongoing, said costs being interest, real estate taxes, and insurance premiums. Since we have concluded that there was a construction period as defined by 20 NYCRR former 590.16(e), then real property taxes and insurance will be included in original purchase price pursuant to 20 NYCRR former 590.16(d). Accordingly, $472,194.32 in real estate tax payments and $78,911.18 in insurance payments made during the construction period are to be added to original purchase price.

The Administrative Law Judge, in concluding that petitioner did not have a construction period, rejected petitioner's argument that its interest costs are includible in original purchase price holding that, since petitioner did not pay interest during a construction period, 20 NYCRR former 590.16(d) is not applicable. The Administrative Law Judge also concluded that, because the interest paid was not derived from a construction loan, it would not be includible in original purchase price in any case.

Article 31-B of the Tax Law provides for the imposition of a tax at the rate of 10 percent upon gains derived from the transfer of real property within the State of New York (Tax Law § 1441). Tax Law § 1440(3) defined "gain" as:

> "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(5)(former [a]), in effect at the time of the transfers in issue, provided, in pertinent part, as follows:

> "'Original purchase price' means the consideration paid or required to be paid by the transferor; (i) to acquire the interest in real property, and (ii) for any capital improvements made or required to be made to such real property, including solely those costs which are customary, reasonable, and necessary, as determined under rules and regulations prescribed by the tax commission, incurred for the construction of such improvements."

Tax Law § 1440 was amended by the Laws of 1993 and, as pertinent to this issue, provided as follows:

> "Original purchase price shall also include any interest paid or required to be paid by the transferor on a loan which was used to acquire the real property; provided that such amount of interest shall be limited to the interest which accrues during a construction period, as defined under rules and regulations prescribed by the commissioner, and which is attributable to that portion of the real property which is the subject of the construction of a capital improvement during such construction period" (Tax Law § 1440[5][former(a)], added by L 1993, ch 57, § 61).

In explaining consideration paid to acquire an interest in real property, 20 NYCRR 590.15(former[c]) provided the following with respect to the specific costs not allowable as a cost to acquire property as part of the original purchase price:

> "The following costs are not allowable as a cost to acquire real property for purposes of determining original purchase price:
>
> -- Interest paid on a loan where the proceeds of such loan were used to acquire the real property or interest therein . . . ."

20 NYCRR former 590.16(d) set forth additional costs associated with construction of a capital improvement allowed to be included in original purchase price as follows:

> "Other costs that are clearly associated with construction of a real estate project can also be included as a cost of constructing a

> capital improvement. 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."

In 1994, 20 NYCRR 590.15(c) was amended in keeping with the amendment to Tax Law § 1440(5) to add the following exception to the rule that interest paid on a loan to acquire real property was not includible in original purchase price:

> "However, effective for transfers occurring on or after April 15, 1993, and to the extent that such loan . . . was attributable to the acquisition of the real property, such interest paid or required to be paid which accrues during a construction period and which is attributable to that portion of the real property which was the subject of the capital improvement, is includible as a cost of a capital improvement."

20 NYCRR 590.16(d) was renumbered 20 NYCRR 590.17(d) and added similar language under the section on allowable costs for a capital improvement during a construction period.

The Division argues that the relevant regulation to be used in this case is 20 NYCRR former 590.15(c) which set forth what is and is not includible in original purchase price as a cost to acquire real property. Petitioner, on the other hand, maintains that the governing regulation is 20 NYCRR former 590.16(d), which dealt with what costs are allowed as costs of construction of a capital improvement. In fact, both sections of the regulations must be read together. They were both promulgated pursuant to one section of the Tax Law. Tax Law § 1440(former[5]) was intended to fulfill one purpose, that is to define what is and is not included in the category of "original purchase price." The specific details of what items were to be included were left to the Commissioner of Taxation and Finance. Thus, 20 NYCRR former 590.15 and former 590.16, along with several other sections, were promulgated to accomplish this purpose.

For purposes of this matter, Tax Law § 1440(former[5][a]) delineated two categories of items which were to be included in original purchase price -- consideration paid to acquire the property and consideration paid for capital improvements made to the property. The regulations followed this pattern with a separate section for each category; however, the fundamental purpose of the regulations was the same, i.e., to determine what items were or were not to be

included in original purchase price. As the Court in Matter of Mattone v. State Dept. of Taxation & Fin. (144 AD2d 150, 534 NYS2d 478, 479) held:

> "Under these rules, interest charges and real estate taxes incurred in connection with the construction of capital improvements are included in the transferor's original purchase price while interest charges on funds used to acquire real property and real estate taxes incurred while simply carrying property are not."

With respect to interest paid on a loan used to acquire an interest in real property, during the years in issue, both the regulation and the Court in Mattone made clear that such costs were not allowable as part of original purchase price. Therefore, we must use as the starting point in the analysis the general rule set forth in 20 NYCRR former 590.15(c) that interest paid on a loan used to acquire real property is not includible in original purchase price. Then, to achieve the result sought by petitioner there must be an exception to this rule. Since there is no exception to the rule provided in 20 NYCRR former 590.15(c), then we look to 20 NYCRR former 590.16. Petitioner argues that acquisition interest incurred during a construction period should be considered a capital improvement cost. It maintains that such interest costs are the same as real property taxes or insurance expenses which are allowed as capital improvement costs during a construction period.

The problem of the approach advocated by petitioner is that it ignores the clear rule of the prior regulation that acquisition interest costs may not be included in original purchase price. The law and the regulations during the period in issue made a clear distinction between acquisition costs and capital improvement costs. One type of cost cannot be transformed into another type merely because it is incurred during a construction period, especially where another related regulation has specifically disallowed the inclusion of that cost in original purchase price. There is simply no support offered for the proposition that the "similar items" language of 20 NYCRR former 590.16(d) was intended, or could be interpreted, to provide an exception to the clear language of 20 NYCRR former 590.15(c).

A question arises over whether there is an inconsistency between the treatment given in the regulations to acquisition loan interest, which is not includible in original purchase price, and

other costs, such as real property taxes and insurance, which are includible when incurred during a construction period. The answer to this question is that there is a distinction between these two types of costs. Acquisition costs are one-time expenses incurred to acquire the land, and, once paid off, such as with a mortgage, they are not incurred again. These costs serve one and only one purpose and that is to acquire the land. Once the acquisition is accomplished, these costs have no further relevance. Property taxes and insurance are not acquisition costs, they are ongoing expenses of owning and using property. They are generally never paid off so long as the property is owned and being used. Thus, it is rational to include these costs as part of capital improvement costs incurred during a construction period because it is necessary to insure the property during construction and it is necessary to pay taxes on the property during construction. Thus, these costs are related to other more direct construction costs because they are costs for the use of the property during the construction period. Interest paid on an acquisition loan is not a cost for the use of the property, it is a cost of paying a debt incurred to acquire the property. Thus, it is an acquisition cost and not related to the capital improvement in the way that taxes and insurance are.

In cases somewhat similar to the instant matter, attempts to transform acquisition interest costs into other types of costs which are includible in original purchase price were rejected. As previously mentioned, the Court in Mattone specifically held that interest charges on funds used to acquire real property are not included in the transferor's original purchase price and that the Commissioner's regulations were a rational interpretation of the statute.

In Matter of 61 East 86th St. Equities Group (Tax Appeals Tribunal, January 21, 1993), the petitioner argued that acquisition interest expense should be considered an expense incurred to create an ownership in cooperative form and thus includible in original purchase price. We held as follows:

> "We reject the validity of petitioner's argument because the debt obligation, and its attendant interest expense, was incurred to acquire the real property, not to allow its conversion to cooperative ownership. Interest charges on funds used to acquire real property are not allowable as part of the transferor's original purchase price (Matter of Mattone v. State Dept. of Taxation & Fin., supra).

> "Petitioner claims that another basis for allowing the interest carry as an acquisition cost is that interest carry is analogous to interest incurred during a construction period (20 NYCRR 590.16[d]), since both are directly related to improvement of the property -- construction in a physical manner, and interest carry in an intangible manner, i.e., cooperative shares. We reject this argument for a number of reasons. First, the expense in question is still acquisition interest no matter how petitioner seeks to characterize it. Second, this argument was already rejected in Matter of Mattone v. State Dept. of Taxation & Fin. (supra)" (Matter of 61 East 86th St. Equities Group, supra, emphasis added.)

Thus, acquisition interest remains an acquisition cost regardless of how one attempts to classify it, whether as a cooperative conversion cost or, as here, as a capital improvement cost.

Petitioner also argues that the treatment given to the costs in issue here is inconsistent with the treatment given them in other disciplines, such as Federal taxation. As we have held in the past, treatment of costs in other disciplines is not dispositive of the treatment for gains tax purposes (e.g., Matter of V & V Properties, Tax Appeals Tribunal, July 16, 1992). Since our analysis shows that it is unnecessary to go beyond the gains tax statutes and regulations to resolve this case, there is no reason to depart from our long-standing policy in this case.

The Division contends that reference to the amended statute demonstrates that there was a change in the law which supports its interpretation of the original statute and the regulation. As can be seen from the analysis set forth above, there is no necessity to refer to the amended statute to derive the meaning and intent of the former statute and regulations.

For all of these reasons, we sustain the Administrative Law Judge's determination on the issue of whether interest paid on a loan used to acquire real property was includible in original purchase price during the period in issue and hold that such interest was not includible in original purchase price.

In the alternative, petitioner argues that, even if the specific portion of the interest on the loan allocated to the purchase of the land was not found to be includible in original purchase price, then the portion allocated to the leasehold buyouts would be includible because it is more closely related to the construction of the capital improvement. Petitioner maintains that it was necessary to acquire the leaseholds in order to commence construction of the new building.

However, the same could be said with respect to acquisition of the land itself. It was necessary to acquire the land in order to start a new building on it. Such a necessity does not convert the cost of acquiring the land into a cost of construction of a capital improvement and it does not automatically convert any other acquisition costs into capital improvement costs. The question, thus, becomes whether the leasehold buyouts were acquisitions of real property or an interest therein so that the interest paid on a loan used to acquire the leaseholds was not allowable in determining original purchase price.

Tax Law § 1440(4) defined an interest in real property as follows:

> "'Interest' when used in connection with real property includes, but is not limited to, title in fee, a leasehold interest, a beneficial interest, an encumbrance, a transfer of development rights or any other interest with the right to use or occupancy of real property . . . " (emphasis added).

Thus, acquisition of the leaseholds was a cost to acquire real property or an interest therein and as a result the interest paid on the loan used to acquire these interests was not includible in original purchase price. This interpretation is in line with the New York case law. The Court of Appeals has held the "fundamental purpose [of a lease] remains to serve as a vehicle for the conveyance of an interest in real property" (219 Broadway Corp. v. Alexander's, Inc., 46 NY2d 506, 414 NYS2d 889, 891). We find, accordingly, that the leasehold buyouts were acquisitions of interests in real property, and for the same reasons as we held the interest for the portion of the loan used to acquire the property itself to not be included in original purchase price, we also find the interest paid on the portion of the loan used for the leasehold buyouts not to be included in original purchase price.

Petitioner also argued alternatively that the bulk of the interest expense at issue was incurred pursuant to a construction loan and that this interest expense "at a minimum" should be includible in original purchase price. As we have discussed above, no part of the interest on a loan used to acquire property or an interest therein may be included in original purchase price. Only interest from a loan used in the construction of a capital improvement is includible. The loans from Chase Manhattan in this case were used both to acquire property and, to a lesser

extent, to start construction. The only expense which petitioner has demonstrated to be directly related to construction of a capital improvement was the $119,298.00 in demolition costs. The ratio of this amount to total costs incurred of $14,094,589.00 was 0.85%. Applying this ratio to total interest expense on the Chase loans of $3,103,484.00, results in interest expense on a construction loan of $26,379.61, which is to be included in original purchase price.

With respect to the issue of abatement of penalties, we agree with the Administrative Law Judge that "[i]n view of the size, number and nature of the adjustments, petitioner has not established . . . reasonable cause . . ." to cancel the penalties (Determination, conclusion of law "Q"). We note that, even taking into account the adjustments made first by the Administrative Law Judge and then by this Tribunal herein, petitioner has an outstanding assessment remaining of over $104,000.00. Since the Administrative Law Judge sufficiently addressed this issue in his determination, we sustain his determination on this issue for the reasons set forth therein.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of 32nd Street Development Associates is granted to the extent that $472,194.32 in real estate taxes, $78,911.18 in insurance costs and $26,379.61 in construction loan interest incurred during a construction period are to be included in original purchase price;

2. The determination of the Administrative Law Judge is reversed as to conclusions of law "J," "K" and "M" but is otherwise sustained;

3. The petition of 32nd Street Development Associates is granted to the extent indicated in conclusions of law "E" and "G" of the Administrative Law Judge's determination and paragraph "1" above; and

4. The Notice of Determination dated August 31, 1992 is to be modified according to paragraph "3" above, but is otherwise sustained, and the Notice of Claim for Greater Deficiency dated August 17, 1994 is cancelled.

DATED: Troy, New York
February 27, 1997

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner