STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
470 NEWPORT ASSOCIATES	:	DETERMINATION DTA NO. 804485
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 470 Newport Associates, 66 Commack Road, Suite 300, Commack, New York 11725 filed a petition 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.

A hearing was commenced before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on February 6, 1990 at 1:15 P.M., continued at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on March 13, 1990 at 10:00 A.M. and continued to conclusion on May 30, 1991 at 11:00 A.M., with all briefs to be submitted by November 13, 1991. Petitioner submitted a brief on September 6, 1991. The Division of Taxation submitted its brief on October 15, 1991 and petitioner's reply brief was received by the Division of Tax Appeals on November 13, 1991. Petitioner appeared by Hutton & Solomon (Kenneth I. Moore and Stephen Solomon, Esqs., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kenneth J. Schultz, Esq., of counsel).

ISSUES

I. Whether, for purposes of gains tax, the "original purchase price" of the stock acquired by petitioner in exchange for the real property at 470-480 Halstead Avenue prior to March 28, 1983 is (i) the fair market value of the property at the date of its transfer to the cooperative corporation on November 10, 1982, or (ii) the purchase price of such property when acquired by petitioner on September 15, 1976, as adjusted.

II. Whether the Division of Taxation properly allocated pro rata the value of a mortgage assumed by the cooperative corporation in exchange for the property, among all tenant-shareholders upon the subsequent sale of stock.

III. Whether the sale of apartment 480-6J on May 10, 1983, which occurred pursuant to an agreement executed on March 26, 1983, was properly considered a sale after the effective date of the gains tax statute and thereby taxed.

IV. Whether penalties for failure to pay gains tax should be abated.

FINDINGS OF FACT

On January 20, 1987, following an audit of the cooperative conversion of property located at 470-480 Halstead Avenue, Harrison, New York, the Division of Taxation ("Division") issued to petitioner, 470 Newport Associates ("the sponsor"), a Notice of Determination of Tax Due under Gains Tax Law assessing total tax due in the amount of $445,581.00, penalty of $72,634.00 and interest of $40,174.00, for a total amount due of $558,389.00. The notice also reflected amounts paid of $479,417.00 leaving a balance due of $78,972.00.

Petitioner, a New York limited partnership, purchased the property located at 470-480 Halstead Avenue (the "Property") on September 15, 1976 for $5,750,000.00.

On May 10, 1981, petitioner entered into an agreement as a realty transferor to sell the Property to 470 Owners Corp., a cooperative housing corporation ("CHC"), which had been incorporated under the laws of the State of New York on April 14, 1981. A cooperative conversion plan was submitted to the Attorney General's Office for approval. The sale of the Property from petitioner to the CHC pursuant to the agreement of May 10, 1981 was closed on November 10, 1982.

In exchange for a fee interest in the property, petitioner received various consideration valued at $15,773,302.20, which was comprised of the following:

Cash	$ 2,171,100.00
Unsold shares of the CHC	6,935,162.57
Mortgages to which the	

Property was subject	6,667,039.63
	~~$15,773,302.20~~

The audit summary and other pertinent documentation submitted into evidence established that the plan to convert the Property to cooperative ownership involved an offering of 140,030 shares, after various amendments, of which 55,295 shares were sold prior to March 29, 1983 and therefore considered "grandfathered". Thus, the total number of shares subject to tax was 84,735. The notice of determination represents real property gains tax assessed upon the sale of 45,695 shares of the cooperative corporation sold by petitioner between March 29, 1983 and the time of the audit. The 45,695 shares upon which the additional tax is assessed represents 32.63% (45,695 divided by 140,030) of the total offering plan. The mortgage indebtedness component of consideration received by petitioner from the CHC and the original purchase price ("OPP") are allocated to the shares being taxed in accordance with such percentage. The tax assessed was computed as follows:

Estimated consideration (per audit)		$4,832,602
Mortgage indebtedness 6,700,000 x 32.63%		2,186,405
Gross consideration		7,019,007
Less: brokerage fees		481,797
		6,537,210
Less: OPP:		
Acquisition Cost	$5,750,000	
Acquisition Expenses	35,617	
Capital Improvements	379,418	
Co-oping Expenses	153,365	
Total OPP	$6,318,400	
	x 32.63%	2,061,883
Gain on shares - taxed per audit		~~$4,455,827~~
Tax due @ 10%		445,583
Penalty		72,634
Interest		40,174
Total due		558,391
Amount paid		479,417
Balance Due		~~$ 78,974~~

The total mortgage indebtedness assumed by the CHC was divided by the total number of shares per the cooperative offering plan, as amended, to arrive at the mortgage indebtedness per share. Using this calculation, the auditor allocated $47.85 of assumed mortgage debt to

each share.

Petitioner's position utilizes as unallocated OPP the consideration received upon transfer of the property to the CHC. Petitioner requests a refund of $479,417.00 (the entire amount of tax it has paid), premised upon a computation of "gain" as follows:

Estimated consideration (per audit)	$4,832,602
Less: brokerage	481,797
	4,350,805
Less: OPP ($15,773,302 x 32.63%)	5,146,828
Gain on shares	-0-

Tax due @ 10%	-0-
Penalty	-0-
Interest	-0-
Total due	-0-
Amount paid	479,417
Overpayment	$ 479,417

One of the issues in this case involves the sale of a cooperative unit referred to as 480-6J. Introduced into evidence was a document entitled "Application for Non-Binding Apartment Reservation", dated March 26, 1983. It indicates that petitioner was in receipt of a deposit which reserved for the prospective purchaser an apartment for 30 days, after which a binding purchase agreement would be signed and a down payment made toward the purchase if the purchaser chose to complete the transaction. The application also contained the following declaration:

> "Reservation Deposit to be held in GWFAT 470 SPECIAL ACCOUNT in trust until returned or applied as set forth in Offering Plan for the cooperative. The Apartment Reservation Deposit shall be refunded in full, without interest, on demand, at any time before Purchaser executes a binding Purchase Agreement and upon return of the Offering Plan. Sponsor reserves the right to return said deposit at the expiration of the Reservation Period. In any event, the Apartment Reservation Deposit shall be returned no later than 30 days after the date hereof should Purchaser not execute a binding Purchase Agreement. Pursuant to the requirements of governmental authorities having jurisdiction, a Purchase Agreement for the sale and purchase of shares of a cooperative apartment may not be executed and exchanged between a Selling Agent and Prospective Purchaser until after the Prospective Purchaser has had not less than 72 hours to review the Cooperative Offering Plan." (Emphasis supplied.)

The sale of apartment 480-6J took place on May 10, 1983. The Division asserts that the sale effectively took place after March 26, 1983 and should therefore be subject to gains tax. The calculation of the tax by the Division was as follows:

Consideration		$52,800
Mortgage Indebtedness (550 shares x $47.85)		26,318
Gross Consideration		$78,118[1]
Less: Sales Commission	$ 3,168	
Conversion Fee	2,466	

[1] This amount should be $79,118.00.

Capital Improvement (550 shares x $45.12)	24,816	30,450
Taxable Profit		$47,668
Tax @ 10%		$ 4,767
Interest		1,573
Total		$ 6,340

SUMMARY OF PETITIONER'S POSITION

Petitioner's first argument is that OPP for the purpose of determining gain on the transaction at issue should be stepped up to the fair market value of the property at the time it was transferred to the CHC rather than the actual price paid by petitioner in 1976, with adjustments. Petitioner argues that other transactions involving the transfer of cash and stock and the assumption of mortgages between a partnership and a corporation receive such a step-up in value, and therefore any different treatment where a corporation "sell[s] its stock to tenant-shareholders" is improper. Petitioner argues that making a distinction between a corporation and a CHC is arbitrary and capricious.

Petitioner then argues that the pro rata apportionment of the mortgage indebtedness among all of the shares sold (both before and after March 28, 1983) is improper. Petitioner equates the mortgage indebtedness to a bargain lease (a lease providing for rent below fair market value) which is valued upon its creation at the present value of the difference between the rent payable under such lease versus the fair market rent for the leased premises over the term of the lease. The Division acknowledged its practice that consideration attributable to a bargain lease received prior to March 29, 1983 is grandfathered and not included in determining gain on the shares of stock sold after March 28, 1983. Petitioner in turn argues that since the mortgage indebtedness here was entered into prior to March 29, 1983, it (similarly) should not be included as consideration subject to gains tax on shares sold after March 28, 1983. Petitioner maintains there is no basis in the law for discrimination between consideration attributable to different types of liabilities encumbering the property, and that any disparity in treatment "is irrational, illogical and contrary to law."

Petitioner claims that both of its

previously discussed arguments show the Division's failure to afford equal treatment to all taxpayers. According to petitioner, the Division's refusal to step up the purchase price upon transfer of property to a CHC denies the sponsor equal protection under the law and is an arbitrary and capricious act.

Regarding unit 480-6J, petitioner claims an agreement for the sale of such unit was entered into prior to the enactment of Article 31-B thus leaving such unit exempt from taxation under Tax Law § 1443.6.

With respect to penalties, petitioner asserts first that no gains tax is due, and thus no penalties are owing. Petitioner argues alternatively that if it is found that gains tax is due and owing, penalties should nonetheless be abated because petitioner "timely filed their returns in accordance with their understanding of the law, and that they fully cooperated with the representative of the N.Y. State Tax Commission."

SUMMARY OF THE DIVISION'S POSITION

The Division asserts that petitioner's arguments are without merit and have been addressed in a series of cases decided by the Tax Appeals Tribunal, the Appellate Division and the New York State Court of Appeals. It argues that the transfer to the cooperative corporation is not a taxable event for gains tax purposes and that such corporation acts as a conduit for the sale of real property by the cooperative sponsor to the tenant-shareholders, the ultimate purchasers. As a result, the Division argues there should be no step-up of the original purchase price. The Division asserts specifically that the gains tax statute is designed to treat cooperative corporations differently from other corporations. It claims that:

> "[t]he Gains Tax statutory scheme was designed with the recognition that the cooperative corporation functions essentially as a conduit in transferring cooperative apartment units to third parties."

With regard to the issue of the pro rata apportionment of the mortgage indebtedness among all shareholders, the Division cites to Matter of Birchwood Associates (Tax Appeals Tribunal, July 27, 1989), for the proposition that since a cooperative conversion is taxed as a single transfer, the value of a mortgage is properly added to the consideration received for each unit. With regard to petitioner's allegations of the inconsistent treatment of bargain leases and mortgages, the Division asserts that even if petitioner's contentions of inconsistency are true, the outcome petitioner seeks is not warranted. More specifically, assuming that the Division does treat mortgages differently from bargain leases, the Tribunal has already ratified the Division's treatment of mortgages in Birchwood, and therefore, the only possible result is a modification of the Division's treatment of bargain leases to conform with its treatment of mortgages (thus benefitting the Division and not the taxpayer). The Division also asserts that there is a distinction between a bargain lease and a mortgage, in that a lease encumbers only one unit owned by the cooperative corporation whereas the mortgage encumbers all of the units. The Division claims that this distinction itself justifies disparate treatment.

With respect to unit 480-6J, the Division argues that since the agreement entered into prior to March 28, 1983 was not a binding contract of sale, unit 480-6J is properly subject to gains tax.

Finally, the Division claims that petitioner has not met its burden to show both the lack of willful neglect and the existence of reasonable cause in order to support its claim that penalties should be abated.

CONCLUSIONS OF LAW

A. Tax Law § 1441, which became effective March 28, 1983, imposes a tax at the rate of 10% on gains derived from the transfer of real property within New York State. In this proceeding, petitioner argues that the transfer at issue should result in no gains tax because the appropriate measure of the original purchase price of the property should be (in simple terms) the CHC's costs (i.e. representing in essence a "stepped-up" OPP) and not the sponsor's costs.

Petitioner also argues that since the mortgage on the subject premises was entered into before the gains tax became effective, such mortgage should not be included as part of consideration for any units sold after the statute became effective.

B. Petitioner's arguments are based on the position that a cooperative conversion involves two separate transfers. The first transfer, according to petitioner, would be from petitioner, the sponsor, to the CHC; the second would be from the cooperative corporation to the tenant-shareholders. On the facts of this case, the first transfer would escape taxation because it occurred prior to the effective date of Article 31-B. In turn, tax due on the second transfer would be ten percent of the difference between the value of the consideration received by the cooperative corporation from the tenant shareholders and the OPP to the cooperative corporation.

C. Petitioner's argument ignores the fact that the transfers involved in a cooperative conversion are considered one transfer for the purpose of calculating gains tax (Mayblum v. Chu, 67 NY2d 1008, 503 NYS2d 316; Matter of Normandy Assoc., Tax Appeals Tribunal, March 23, 1989). The Tax Appeals Tribunal addressed the step-up and mortgage

inclusion/allocation issues in Matter of Birchwood Assoc. (supra), wherein the petitioner requested a finding that the gains tax recognizes as separate taxable events the realty transfer from the realty transferor to the CHC and the subsequent sale by the realty transferor of the shares it received on the prior transfer. The Tribunal's analysis included the following:

> "Petitioner advances its theory of the application of the gains tax to cooperative conversions to achieve two calculation goals. First, petitioner seeks to include the amount of the Mortgage as consideration only on the transfer from the petitioner to the cooperative housing corporation. Second, petitioner wants the original purchase price for the sale of shares to be determined based on the cooperative corporation's acquisition of the realty, rather than by the petitioner's acquisition of the realty.
>
> Petitioner would apply its two stage taxation theory and the calculations to the instant facts as follows. According to petitioner, since the realty transfer to the cooperative housing corporation took place prior to March 28, 1983 these transfers would presumably be exempt from tax. Further, since petitioner would treat the Mortgage as consideration for this exempt transfer, the Mortgage would not generate any gain subject to tax. With respect to the second stage of the conversion, while petitioner would treat the sale of shares as taxable, the gain on these sales would be significantly reduced by 'stepping up' their original purchase price to reflect the value of the realty at the time it was acquired by the cooperative housing corporation, rather than its value at the time it was acquired by petitioner."

In Birchwood, the Tribunal additionally reflected upon its decision in Matter of Normandy Assoc. (supra), where the Tribunal was also presented with issues concerning a two-stage transaction analysis. In both cases, the petitioners asserted, as here, that Mayblum (supra) did not control the resolution of the issues. The Tribunal disagreed and described the taxing scheme as follows:

> "In contrast to the two stage theory advanced by petitioner, we conclude, as we did in Normandy, that the tax treats the transfer of shares by the realty transferor to unit purchasers as the only taxable event. However, the gain on these transfers is measured by the difference between the consideration for the shares and the realty transferor's original purchase price in the real property prior to its transfer to the cooperative housing corporation. This scheme in effect ignores the realty transferor's transfer to the cooperative housing corporation and instead treats the realty transferor as if it were directly transferring its interest in the real property to the unit purchasers. Under this scheme the gains tax is imposed on the entire cooperative conversion plan, encompassing the real property prior to its transfer to the cooperative housing corporation and the sale of shares by the realty transferor subsequent to the property's conversion to cooperative ownership. The transfer to the cooperative corporation is then treated merely as a conduit which allows the transformation of the real property into shares allocated to units.
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> * * *

> "Since we conclude that a cooperative conversion is taxed as a single transfer, it follows that we reject petitioner's calculations that would allocate the Mortgage entirely to the realty transfer to the cooperative corporation and 'step-up' the original purchase price of the shares."

D. Tax Law § 1442 requires that the tax on a cooperative apartment be calculated using "an apportionment of the original purchase price of the real property and total consideration anticipated." Consideration is defined by Tax Law § 1440.1 to include, among other things, money, property, mortgages and any other encumbrance. Since cooperative conversions are treated as single transactions, every form of consideration received by the sponsor for each of the units must be included in the total consideration for the cooperative conversion. This total consideration is then distributed among the shares of the corporation in order to determine the actual consideration for each unit of the cooperative. Any unit sold prior to the effective date of the gains tax would not be subject to tax. However, the total consideration for each unit sold after such effective date is taxed. This total consideration properly includes a portion of the mortgage assumed by the cooperative corporation.

E. Petitioner also advances the argument that the Division does not treat cooperative corporations in the same manner as it treats other corporations. This argument is equally flawed. The fact that other corporate transfers are afforded a step-up for gains tax purposes is irrelevant to the issue of cooperative corporations because the Legislature chose to treat such corporations differently. Tax Law §§ 1440.7 and 1442 make specific references to cooperative conversions or transfers of real property pursuant to a cooperative or condominium plan. Petitioner appears to be attacking the constitutionality of the disparate treatment of cooperative corporations versus other corporations. However, the "equal protection clause does not prevent State Legislatures from drawing lines that treat one class of individuals or entities differently from others unless the difference in treatment is 'palpably arbitrary' or amounts to an 'invidious discrimination' (citations omitted)" (Trump v. Chu, 65 NY2d 20, 25, 489 NYS2d 455, 459, appeal dismissed 474 US 915). With regard to the taxation of cooperative conversions, petitioner has not shown that the Division's conduct was arbitrary (especially in light of the clear distinctions drawn by the Legislature regarding gains tax and cooperative corporations)

nor has it shown any invidious discrimination.

F. Petitioner attempts to show by analogy that the Division's treatment of mortgages is arbitrary. It compares the pro rata apportionment of mortgages to the Division's policy regarding bargain leases. Petitioner's argument hinges on the assertion that there are no distinctions between a bargain lease and a mortgage. Petitioner fails to attribute significance to an obvious difference. The mortgage involved encumbers each individual unit. The property owned by each tenant-shareholder is subject to a mortgage. Dissimilarly, the property owned by each shareholder is not subject to a bargain lease. Petitioner is correct in stating that the ultimate shareholders shoulder the cost of a bargain lease as they do a mortgage. However, the actual units involved are not directly encumbered by a bargain lease as they are by a mortgage. In any event, the Tribunal has previously rejected the argument that mortgages incurred prior to the enactment of Article 31-B should not be included as consideration to the sponsor on shares sold subsequent to March 28, 1983. (Matter of Birchwood Associates, supra.) Petitioner's argument is, therefore, rejected.

G. Turning specifically to the claim of the "grandfather" exemption on Unit 480-6J, transfers made pursuant to a contract entered into on or before the effective date of Tax Law Article 31-B are exempt from tax (Tax Law § 1443.6). This is not a blanket rule, however. In Matter of Lever v. State Tax Commn. (144 AD2d 751, 535 NYS2d 158), the Appellate Division determined that in order to qualify for an exemption under section 1443.6, petitioner must show by independent evidence that a binding contract was entered into prior to March 28, 1983 (id., 535 NYS2d at 160). As in Lever, the alleged binding contract at issue in this case between petitioner and a prospective purchaser was an agreement to execute a "binding Purchase Agreement". The Application for Non-Binding Apartment Reservation contains a declaration stating that the deposit included with the application would automatically be returned within 30 days if the parties did not enter into a binding purchase agreement, indicating that the parties thereto did not intend to be bound by such agreement but that a later binding agreement was contemplated (see, Brause v. Goldman, 10 AD2d 328, 199 NYS2d 606, affd 9 NY2d 620, 210

NYS2d 225).

In order to qualify for an exemption from taxation, petitioner has to clearly demonstrate its entitlement thereto (Matter of Old Nut Co. v. New York State Tax Commn., 126 AD2d 869, 511 NYS2d 161, lv denied 69 NY2d 609, 516 NYS2d 1025). Here, in addition to showing (by independent evidence) that an agreement was entered into on or prior to March 28, 1983, the taxpayer also had to show that the agreement was binding. Petitioner has not met this latter burden. Hence, petitioner is not entitled to a "grandfather exemption" with regard to apartment Unit 480-6J.

H. Turning to the imposition of penalty, petitioner's assertions, centered essentially upon an interpretation of the law different from that taken by the Division, do not establish that penalty is inappropriate and do not support a conclusion that penalty should be abated. Initially it is noted that guidelines as to the taxability of cooperative conversions including, specifically, computational explanations, had been issued by the Division and were available to the public well before the subject audit occurred.[2] Not only were such guidelines issued and the Division's position made known before the audit herein, but there does not appear to have been any request by petitioners (or their counsel) to the Division for enunciation or clarification of its position until the time of the hearing herein drew near. Further, and specifically with respect to gains tax penalties, it has been held that:

> "the failure to pay a tax due to a different legal interpretation of a statute need not be considered 'reasonable cause'. In fact, if it were so considered, [the Commissioner] would rarely if ever be entitled to levy such penalties" (Matter of Auerbach v. State Tax Commn., Sup Ct, Albany County, July 7, 1987, Williams, J., affd 142 AD2d 390, 536 NYS2d 557).

Accordingly, the Division's imposition of penalties herein was appropriate and is sustained.

I. The petition of 470 Newport Associates is denied and the Division's denial of the claim for refund of real property transfer gains tax is hereby sustained.

DATED: Troy, New York
October 8, 1992

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[2]For example, Department of Taxation and Finance Publication 588, "Questions and Answers - Gains Tax on Real Property Transfers", was issued in August 1983.

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE