

STATE OF NEW YORK  
DIVISION OF TAX APPEALS

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In the Matter of the Petition :

of :

SKS ASSOCIATES : DETERMINATION  
T/A FARDALE GARDENS

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, SKS Associates T/A Fardale Gardens, 100 Clinton Avenue, Mineola, New York 11501, 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 (File No. 804517).

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on February 7, 1990 at 2:45 P.M., with all briefs filed by July 20, 1990. Petitioner appeared by Richard S. Kestenbaum, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Paul A. Lefebvre, Esq., of counsel).

ISSUES

I. Whether the original purchase price of real property held by a partnership may be stepped up to reflect the consideration paid for the acquisition of a controlling interest in such partnership, as defined in Tax Law § 1440(5) and the regulations promulgated thereunder.

II. Whether, if it is determined that a controlling interest was not acquired, petitioner is entitled to a stepped-up value of the original purchase price pursuant to the regulation at 20 NYCRR 590.49(c).

FINDINGS OF FACT

Sometime in 1985, petitioner, SKS Associates ("SKS"), filed a gains tax return with the Division of Taxation indicating an original purchase price for certain property owned by SKS

known as Fardale Gardens which further indicated the use by petitioner of a stepped-up original purchase price. The Division disallowed the stepped-up original purchase price and SKS made a payment in full of the tax calculated by the Division.<sup>1</sup>

On November 5, 1986, SKS filed a Claim for Refund of Real Property Gains Tax in the sum of \$3,250.56. The explanation provided by petitioner on the claim for refund was as follows:

"The taxpayer requests this refund because it feels the disallowance of additional basis was incorrect. The additional basis was the result of the 2 partners of the taxpayer purchasing (for cash) part of the property from a third party (who was originally a partner of this taxpayer). This transaction was reported on the taxpayer's return (Federal) as a Section 754 adjustment. Enclosed is an article explaining the rationale for this adjustment which taxpayer feels is also appropriate for inclusion as basis for New York State gains tax purposes."

On January 30, 1987, the Department of Taxation and Finance, Central Miscellaneous Tax Section, responded to the claim for refund by SKS and denied same in full. The explanation offered by the Department was as follows:

"The basis of the claim is that in June, 1983, Fred Seidenfeld, a one-third owner in a cooperative, sold his interest to the two remaining partners. As a result, you contend that the two

remaining partners acquired a controlling interest in the property, and should, therefore, be allowed the amount paid as part of the partnership's original purchase price.

Section 590.44 of the New York State Transfer Gains Tax Regulations defines controlling interest, in part, as '...(ii) in the case of a partnership, association, trust, or other entity, fifty percent or more of the capital, profits, or beneficial interest in such partnership, association, trust, or other entity.'

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<sup>1</sup>It is noted that the original assessment and all documents filed with regard to the ultimate sale of Fardale Gardens in 1985, 1986 and 1987 were not provided to this forum. The information stated in Finding of Fact "1" is inferred from the documents which have been entered into evidence.

Section 590.45(c) states, 'For purposes of determining whether a controlling interest is acquired, only acquisitions of interest occurring after March 28, 1983 are added together'.

In addition, Section 590.49(b) states, 'If less than a controlling interest were acquired, the entity may not step-up its original purchase price in the property'.

In this case, as the two remaining partners acquired less than a controlling interest after March 28, 1983, then the stepped-up basis is not allowed."

It is not disputed that in June 1983, Fred Seidenfeld, a partner in SKS, sold his one-third interest in said New York partnership to the remaining partners, Aaron Sokol and Michael Kluger.<sup>2</sup> In consideration for his one-third interest, Mr. Seidenfeld received \$1,306,317.00 in cash and was relieved of mortgage liabilities of \$827,908.00. Mr. Seidenfeld's one-third portion of the original purchase price of the underlying realty was \$1,264,792.00. Mr. Seidenfeld's gross profit was \$869,433.00 on the transaction. This gain was determined to be taxable to Mr. Seidenfeld, the transferor in the transaction, pursuant to

Tax Law §§ 1441 and 1443(1). On November 3, 1983, the Division of Taxation issued a Statement of No Tax Due on the transaction.<sup>3</sup>

SKS Associates filed a United States Partnership Return of Income for calendar year 1983 which listed its principal business activity as real estate and its principal product as rentals. Attached to said return was an Election of Special Basis Adjustment pursuant to Internal Revenue Code § 754. The election stated, in part, as follows:

"SKS Associates hereby elects under Code Sec. 754 to apply the provisions of Code Secs. 734(b) and 743(b) beginning with the calendar year 1983 to the return for which year this statement is attached."

Internal Revenue Code § 754 states, in part, as follows:

"If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a

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<sup>2</sup>SKS Associates operated as a partnership without a written partnership agreement.

<sup>3</sup>This fact was alleged in the answer filed by the Division but the actual Statement of No Tax Due was not entered into evidence.

transfer of a partnership interest, in the manner provided in section 743."

Since the instant case deals with a transfer of partnership interest, IRC § 743 applies.

That section provides, in part, as follows:

"(a) GENERAL RULE. -- The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

(b) ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY. -- In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect, shall -- (1) increase the adjusted basis of the partnership property by the excess of the basis to the

transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property."

#### SUMMARY OF THE PARTIES' POSITIONS

Petitioner argues that it is entitled to a step-up in its basis for the purposes of computing its gain derived from the transfer of real property. It reasons that since the intent of the gains tax is to tax actual economic gain realized by a taxpayer on certain transfers of real property, it is only equitable that credit be given to the taxpayer for the full underlying purchase price paid for the property prior to its ultimate sale. Petitioner argues that if a step-up in basis is not allowed here, where property is purchased for a fair market value in excess of its original cost and then subsequently sold by the partnership, the remaining partners will be forced to recognize gain on the increase in fair market value for which they have already paid and will be paying tax on a gain from which they received no economic benefit.

Petitioner argues that relief is granted on the Federal level through Internal Revenue Code § 754 which allows the transferees of partnership interest to adjust their basis in the partnership property and avoid recognizing gain on appreciation for which the transferee partner or partners has already paid.

Petitioner also argues that since the remaining partners have acquired a controlling interest in the partnership, as that term is defined in the regulations, they should be allowed to step-up their basis in the partnership property pursuant to 20 NYCRR 590.49(b).

Finally, petitioner argues that even if it is concluded that the remaining partners did not acquire a controlling interest, they are entitled to step-up their basis pursuant to NYCRR 590.49(c) wherein it is provided that when less than a controlling interest in an entity is resold, the original purchase price is the apportioned amount of the entity's original purchase price or the apportioned amount of the fair market value of the real property at the time the interest was acquired, whichever is higher.

The Division argues that the regulations clearly set forth that, for purposes of Article 31-B only, acquisitions after March 28, 1983 are to be added together to determine if the controlling interest has been transferred. Since the remaining partners in SKS Associates did not acquire a controlling interest after March 28, 1983, there was no taxable event. Further, the Division concedes that the remaining partners would be entitled to a step-up in the original purchase price of their partnership shares but only if they sold said shares (see 20 NYCRR 590.49[c]).

#### CONCLUSIONS OF LAW

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

Petitioner does not take issue with the tax imposed on the gain derived from the transfer of real property herein, rather the computation of that gain and, more specifically, whether an adjustment to the original purchase price of the real property is permissible.

Petitioner argues that when one of the three partners in SKS Associates, Fred Seidenfeld, sold his one-third interest in the partnership to the two remaining partners, Aaron Sokol and Michael Kluger, the remaining partners essentially paid Mr. Seidenfeld's underlying basis in the real property and, since they paid fair market value at the time of the purchase, they also paid for his appreciation in the underlying real property. Petitioner contends that if the Division fails to recognize this payment by the remaining partners and upwardly adjust their basis in the underlying real property, the partners would be unfairly taxed on gain for which they had already paid.

Consistent with this position, petitioner argues that Internal Revenue Code § 754 provides for partnerships to elect an optional adjustment to the basis of partnership property by filing an election therefor. Once such an election is made, the Internal Revenue Code provides for an adjustment to the basis of undistributed partnership property or an adjustment to the basis of partnership property as the result of a transfer of an interest in the partnership. In fact, petitioner herein did file such an election pursuant to Internal Revenue Code § 754 on its partnership return for the year 1983.

Petitioner urges that the Division allow a similar adjustment for the purposes of gains tax treatment. However, the New York Tax Law does not have a provision similar to IRC §§ 754, 734 or 743. Therefore, other than on an equity basis, to allow an analogous step-up in basis for the purposes of computing gains tax from the transfer of the real property is not possible. Although petitioner argues that it should be taxed only on its "actual economic gain", i.e., taking into account the acquisition of Mr. Seidenfeld's share at fair market value, it cites no authority for doing so. Without applicable New York statutes, regulations or case law, there is no basis for adjusting the original purchase price of the real property herein.

B. "Gain" has been defined in the Tax Law 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[3]).

The original purchase price is defined in the same section as:

"The consideration paid or required to be paid by the transferor; (i) to acquire the interest in real property..." (Tax Law § 1440[5]).

The regulation promulgated pursuant to Tax Law § 1440(5) at 20 NYCRR 590.49 states, in part, as follows:

"(a) Question: What is the original purchase price used by the transferor to calculate gain?

Answer: Generally, it is the original purchase price of the real property as held by the entity, apportioned to the interest the transferor is transferring."

Thus far there has been no mention either in the law or the regulations with regard to stepping up the basis in the original purchase price. However, in subdivision (b) of the

regulation at 20 NYCRR 590.49, the issue is first addressed as follows:

"(b) Question: Is the original purchase price of the real property as held by the entity stepped-up upon the acquisition of a controlling interest?"

Answer: Yes, in the case of an acquisition of a controlling interest, where the mere change exemption was not applied, the original purchase price in the real property as held by the entity may be stepped up to reflect the consideration recognized on the transfer of the ownership interest.

If less than a controlling interest were acquired, the entity may not step-up its original purchase price in the property."

The term controlling interest, as defined in Tax Law § 1440(2)(ii), in the case of a partnership, association, trust or other entity, is 50% or more of the capital, profits or beneficial interest in such partnership, association, trust or other entity. The same provision is found in the regulations at 20 NYCRR 590.44. The regulation enhances the statute by providing that the acquisition occurs "when a person or group of persons, acting in concert, acquires a total of fifty percent or more of the capital, profits or beneficial interests in such entity." The regulations also provide that a group of persons acting in concert means when various purchasers have a relationship such that one purchaser influences or controls the actions of another (20 NYCRR 590.45).

Although the two remaining partners concededly acted in concert in fulfillment of the regulation at 20 NYCRR 590.45, they have not shown that they have acquired a controlling interest.

Specifically, the regulation at 590.45(c) provides as follows:

"(c) Question: If a shareholder owned a 20% interest in a corporation prior to March 28, 1983 and acquires an additional 35% on July 10, 1984, has there been an acquisition of a controlling interest?"

Answer: No. For purposes of determining whether a controlling interest is acquired, only acquisitions of interest occurring after March 28, 1983 are added together."

Since the acquisitions of the remaining partners' interest in the partnership occurred both prior to and after March 28, 1983, they may not be added together for the purposes of determining whether or not the remaining partners acquired a controlling interest and therefore the acquisition by the remaining partners of Mr. Seidenfeld's partnership share cannot be construed

as the acquisition of a controlling interest.

C. Petitioner argues, in the alternative, that even if the two remaining partners did not acquire a controlling interest, the partnership is still entitled to a step-up in basis pursuant to the regulation at 20 NYCRR 590.49(c) which provides, in part, as follows:

"(c) Question: What is the transferor's original purchase price when any percentage interest in an entity is resold?

Answer: No matter what percentage interest was purchased, when such interest is resold, the original purchase price is the apportioned amount of the entity's original purchase price (determined without regard to a step-up in original purchase price due to an acquisition of a controlling interest), or the apportioned amount of the fair market value of the real property at the time such interest was acquired, whichever is higher."

However, it appears that petitioner has erred in its interpretation of 20 NYCRR 590.49(c). The mere selling of a percentage interest in the partnership, without regard to whether it is a controlling interest, does not automatically entail a step-up in basis in the underlying property.

In this regard, it is imperative to study the example given in the regulation at 20 NYCRR 590.49 and from such an analysis understand that SKS's original purchase price of the underlying realty does not change, only the original purchase price of the percentage interest being resold. In the instant matter, the Division was correct in pointing out that the remaining partners would have been entitled to a step-up in their original purchase price of their partnership shares if they sold those shares. Since they have not done so, there is no provision for a step-up in basis in the realty.<sup>4</sup>

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<sup>4</sup>Example 4 listed under the regulation at 590.49(c) provides as follows:

"Example 4: T acquired a 40% interest in corporation S, at a time when the fair market value of the real property was \$2,000,000. Corporation S's original purchase price in the property was \$1,000,000. T now sells his 40% to W, who has just purchased the other 60%. T is taxable since W acquired a controlling interest. The property is now worth \$5,000,000. Corporation S's original purchase price is still \$1,000,000. T's consideration is \$2,000,000 (40% x \$5,000,000), and its original purchase price is the greater of \$400,000 (40% x \$1,000,000) or \$800,000 (40% x \$2,000,000), thus T's original purchase price is \$800,000."



D. The petition of SKS Associates is denied and the Claim for Refund of Real Property Transfer Gains Tax was properly denied by the Division.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE