STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
F. W. WOOLWORTH CO.	:	DETERMINATION DTA NO. 809563
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, F. W. Woolworth Co., 233 Broadway, 22nd Floor, New York, New York 10279, 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 held at the offices of the Division of Tax Appeals, 500 Federal Street, on February 8, 1994 at 9:15 A.M., with all briefs to be submitted by May 4, 1994. Petitioner, appearing by its director of tax planning and senior tax counsel, Jeremy Nowak, submitted a brief on March 15, 1994. The Division of Taxation, appearing by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel), submitted its post-hearing memorandum of law on April 14, 1994. The Division of Tax Appeals was in receipt of petitioner's reply brief on May 4, 1994. Thereafter, each of the parties submitted correspondence in lieu of a brief regarding an issue in dispute. Such documents were received from the Division of Taxation and petitioner on May 11, 1994 and June 9, 1994, respectively, and concluded the submission of documents in this record. After due consideration of the record, Catherine M. Bennett, Administrative Law Judge, renders the following determination.

ISSUES

I. Whether the three-year statute of limitations bars recovery of the gains tax sought by the Division of Taxation in this matter.

II. Whether petitioner's obligations under a lease dated May 24, 1984 constituted a "surrender" of its leasehold interest which amounted to a transfer of real property for gains tax

purposes.

III. Whether the monthly payments made to petitioner during the "closed store period" shall be deemed "consideration" for petitioner's surrender of its lease.

IV. Whether the Division of Taxation properly disallowed leasehold improvements made by petitioner under leases prior to 1960 in the computation of petitioner's original purchase price in the leased premises.

V. Whether petitioner has established reasonable cause for failure to pay gains tax as due sufficient to result in abatement of penalties.

VI. Whether payment of the gains tax assessed in this matter by petitioner's transferee constitutes additional consideration to petitioner (the transferor) resulting in additional gains tax due.

VII. Whether the Division of Taxation should be allowed to amend its pleadings to conform to the proof in this matter.

FINDINGS OF FACT

The parties to this matter stipulated to the following facts which have been incorporated into this determination.

Background Facts and Description of Transaction

Petitioner, F. W. Woolworth Co. ("Woolworth"), either directly or through its predecessors, has been engaged in the business of general merchandise retailing for more than a century, operating variety stores throughout the United States.

Since at least 1917, Woolworth has operated a variety store in premises located at 201 East 86th Street, a/k/a 1527-1533 Third Avenue, in New York City. This store continues to operate to this day.

The premises occupied by the store have been leased from a succession of landlords. The first lease, which was to have run from 1917 until 1930 (including extensions), was renegotiated, modified and extended in 1923 to permit Woolworth's continued occupancy of the premises through 1963 (including extensions).

The parties stipulate that on July 11, 1960 a lease was executed between Naomi Engelsman, et al, as landlords, and F. W. Woolworth Co., as tenant. Such lease, a 16-page document, was introduced into evidence as an exhibit attached to the stipulation of facts. The term of the lease commenced on July 11, 1960 and ended January 31, 1981, bearing additionally one option to extend the term of the lease for ten years.

In 1979, the 1960 lease was renegotiated, modified and extended to cover occupancy through 2003. A copy of this 1979 lease modification was submitted into evidence. The 1960 lease, as modified by the 1979 lease modification agreement, will be referred to as the "1960 lease".

In 1984, the fee interest in the premises was purchased by KSB Eighty-Six Associates ("KSB"), a New York limited partnership. In conjunction with the purchase, a new instrument, a copy of which was submitted into evidence, was executed by Woolworth and KSB. This instrument, which is dated May 24, 1984, was brought into effect on or about August 10, 1984. It gave Woolworth the right to occupy space until January 31, 2007 in a new building to be constructed on the site. Eight successive five-year renewal options could extend the term to the year 2047. Article 46 of this instrument states that the 1960 lease was terminated simultaneously with the date of commencement of the May 24, 1984 lease.

By instrument dated December 14, 1984, a copy of which was introduced as evidence, the May 1984 document was modified in several minor respects. The May 1984 document, as modified by the December 1984 agreement, will be referred to as the "1984 lease".

The 1984 lease has been in effect continuously from its effective date to the present.

The premises leased by Woolworth from 1917 to 1984 consisted of a three-story building, the third story and basement of which were built by Woolworth in 1937. A total of 51,690 square feet of space was occupied by Woolworth. The base rent for this space under the 1960 lease was $100,000.00 per year, or $1.93 per foot.

Under the 1984 lease, Woolworth would occupy the portions of the ground floor, second floor and basement as retail space, in addition to a sub-basement stockroom, for a total of

32,946 square feet of space. The base rent for this space under the 1984 lease was $275,000.00 per year, or $8.35 per foot.

By notice dated November 1, 1984, KSB exercised its option and required Woolworth to vacate the premises effective February 1, 1985. The store was closed on or about February 15, 1985. Construction of the new building began shortly thereafter.

The new building was completed in mid-1987 and Woolworth occupied the premises specified in the 1984 lease beginning in September 1987.

During the period the store was closed, KSB made payments to Woolworth totalling $2,129,100.00 pursuant to Article 41 of the 1984 lease. Woolworth also received payments of $155,960.00 under Article 43 of the 1984 lease and payments totalling $40,000.00 under Article 40 of the 1984 lease.

If Richard C. Luy, petitioner's executive vice president and chief financial officer, were to testify in this matter, he would testify to the facts and in the manner stated in his affidavit sworn to February 7, 1984, set forth below:

> "1. I am the Executive Vice President, Finance, and Chief Financial Officer of the petitioner in this matter, F.W. Woolworth Co ('Woolworth'). I make this affidavit in conjunction with the Stipulation of Facts being entered into by the parties to this matter.
>
> "2. I have been continuously employed by Woolworth for more than 37 years. From 1983 through 1989, I was the Vice President, Finance, and Chief Financial Officer of the U.S. General Merchandise Group ('USGMG') of Woolworth.
>
> "3. For most of the last 77 years, Woolworth has operated a general merchandise variety store on the northeast corner of Third Avenue and 86th Street in Manhattan. This store has been consistently profitable for many years. For the fiscal years ending January 31, 1982, 1983, and 1984, the last three years before the store was temporarily closed, this store generated operating profits of $582,551, $669,534, and $696,340.
>
> "4. Throughout my tenure as CFO of the USGMG, I was a member of the USGMG's Management Committee, the management group charged with responsibility for reviewing, among other items, all significant capital spending requests for the USGMG.
>
> "5. The Committee reviewed all significant capital spending requests to ascertain whether a proposed capital expenditure would provide Woolworth with at least the minimum targeted return on its investment. Many of the capital spending requests reviewed by the Committee involved either substantial remodeling of

existing stores or the opening of new stores.

"6. Among the projects the Committee reviewed in May 1984 was a request to temporarily close this store to allow a developer to tear down the existing three story building that we leased, then build a new mixed-use high-rise, the bottom two floors and basement of which would be leased to us on a long-term, moderate-rent basis. A copy of the approval request, Form R.O. 29, for this project is attached as Exhibit 1. The supporting memoranda that the Committee reviewed in connection with this request and memoranda confirming the approval of the request are attached as Exhibit 2.[1]

"7. For lease surrenders or buyouts of profitable store locations, our internal guidelines required that we calculate an adjusted operating profit for the last full year (in this case, $833,529), projected increases (or decreases) in this profit figure based on prior history (in this case, 4% to 6%), then present value the projected profit for the remaining 19 years of the lease term. Had we performed this type of analysis for a buyout of this lease, it would have indicated a minimum buyout price of $10-12 million.

"8. As a check on this type of pricing analysis, we would also have determined the profit we could have realized from subletting the space. As indicated on the Form R.O. 29, Exhibit 1, we believed that the fair rental value of the leased premises was approximately $37.50/foot or a total of $1,250,000 per year. This amount far exceeded the minimum lease payments that we had been making, roughly $2.00/foot or $275,000 per year. On these facts, we would not have considered a lease surrender proposal or a purchase of the lease unless we were to receive a payment approximately equal to the present value of the bargain element in the lease. Since the lease had 19 years to go and had a bargain element of $975,000 per year, we would have been looking for a minimum buyout price of $9 - $10 million.

"9. Instead of a buyout, we agreed to accept a payment equal to our lost profits for the period during which the store was closed. This money merely made us whole during the reconstruction period. What made the deal attractive to us, however, was the opportunity to continue our profitable operations for an additional 43 year period at a choice, established location and at a relatively modest rent."

Statute of Limitations

After the 1984 lease went into effect, counsel for KSB, David M. Goldberg, wrote to the Transfer Tax Unit of the Division of Taxation

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[1] In a separate affidavit of Mr. Luy submitted by petitioner at hearing he added the following statement:

"From our [senior management's] perspective, the economic substance of this transaction was a lease modification and extension, rather than a lease buyout or surrender."

("Division"). A copy of this letter dated February 15, 1985, describing documents submitted to the Division is reproduced below:

> "Enclosed please find copies of:
>
> "1. Lease, dated July 11, 1960, between Naomi Engelsman, Alan Barth and Lloyd Merrill, as Landlord, with F.W. Woolworth Co., as Tenant, demising premises at 1527-33 Third Avenue, Manhattan, New York;
>
> "2. Agreement, dated January 15, 1979, made by Alan Barth, Roger J. Merrill, Jack K. Merrill, Roger and Jack Merrill as trustees, and Ralph G. Engelsman, Jr. and Roy Plant as executors with F.W. Woolworth Co. amending the above lease.
>
> "3. Lease, dated May 24, 1984, made by KSB Eighty-Six Associates, as Landlord, with F.W. Woolworth, as Tenant;
>
> "4. Lease Modification Agreement, dated December 14, 1984, made by KSB Eighty-Six Associates with F.W. Woolworth Co.
>
> "You will note that the July 11, 1960 Woolworth lease was, by means of the May 24, 1984 Woolworth lease, extensively recast to add eight five year options.
>
> "Although we do not believe that the transaction is subject to the New York State transfer gains tax, we submit these documents for purposes of disclosure. Please advise if you require any gains tax questionnaires."

A letter dated March 8, 1985 from KSB's counsel to Ms. Jodi Martin of the Transfer Tax Unit referencing a telephone conversation with her (see, Finding of Fact "28") was submitted along with a copy of the Transferor Questionnaire filed by KSB. In the questionnaire section labelled "Type of Interest to be Transferred," the block labelled "Leasehold Grant" is marked.

By letter dated March 29, 1985, KSB transmitted on behalf of Woolworth a Transferee Questionnaire for this transaction. Enclosed with this letter is a copy of the Transferee Questionnaire filed by Woolworth. In the questionnaire section labelled "Type of Interest to be Acquired," the block labelled "Leasehold Grant" is marked.

The Division issued a "Statement of No Tax Due" dated April 17, 1985, in response to these questionnaires, in which the block labelled "Leasehold Grant" was marked in the section labelled "Type of Interest to be Acquired".

Included as another exhibit is a letter dated May 10, 1990 sent by David M. Goldberg (KSB's counsel) to Mr. Fred Havenbrook of the Division. Attached to such correspondence is a

statement of "review of the lease payment situation" prepared by Mr. Goldberg who was advocating KSB's position in a separate matter, and reproduced below:

"Re: New York State Department of Taxation and Finance
Statement of Proposed Audit Changes
L-001644370-C001-2
KSB Eighty Six Associates
c/o Louis Feil, Broadway Mgmt
370 Seventh Avenue, New York, New York 10001
Date: 4/30/90
Assessment ID: L-001644370-4
Total Amount Due: $215,092.38
Payment Due Date: 5/10/90
Taxpayer ID: B-13-3212534-9
Tax Type: Real Property Gain
Tax Article: 31B
Audit ID: GA2551601
Function Code: CRL

"Article 41 of the Lease, dated May 24, 1984, by KSB Eighty-Six Associates ('Landlord') with F.W. Woolworth Co. ('Tenant') provides for monthly payments during a 'Closed Store Period.' The Article commences: 'As an inducement for Tenant to enter into this lease, Landlord agrees to pay to the Tenant in equal monthly payment (sic) on the first day of each and every month during the Closed Stored [sic] Period sums as follows:...' The 'Closed Store Period' is defined as 'that period of time commencing on the date Tenant closes its present store for business as herein provided and ending on the date Tenant commences to pay rent to Landlord pursuant to Art. 5 hereof.' The monthly amounts are to be prorated to reflect the actual closing of business and commencement of rent dates.

"The Lease refers, in Article 46, to a prior lease, dated July 11, 1960, with Naomi Engleman [sic] et al. That Prior Lease terminated and was replaced by the May 24, 1984 lease.

"The May 24, 1984 lease provides for an annual rent of $275,000 commencing with the opening by the Tenant of 'its complete store.' The Landlord is required, by Article 29 to construct a new high-rise building and to construct within that new building a store for the Tenant. There are various lease clauses dealing with notice to vacate and reentry.

"The Landlord, KSB Eighty-Six Associates, paid Woolworth $2,129,000, as payments under Lease Article 41.

"The Landlord acquired the site of the Woolworth store, July 27, 1984. The Landlord is a partnership formed to erect a high-rise residential building on the site, 201 East 86th Street, New York, New York.

"Accordingly, Landlord, as a developer, needed the right to construct a new building on the site. The developer had to buy-out leasehold rights of the tenant. The July 11, 1960 Woolworth lease was an encumbrance; inasmuch as it did not permit development, the site was subject to what appraisers call 'contractual obsolescence,' and, accordingly, the price for the site was less than it would have been if the site had been unencumbered. To obtain the vacating by Woolworth of

its store to permit development, the Landlord entered a lease agreement with Woolworth pursuant to which Woolworth vacated, the prior lease was replaced, the Landlord undertook to build a building in which Woolworth would have a new store to be occupied by Woolworth as tenant and Woolworth reoccupied. Therefore, the $2,129,000 of payments were to buy-out Woolworth's leasehold rights in order to enable the Landlord to build a new building.

"The $2,129,000 was not paid for a lease yielding a base rent of $275,000 per annum. It is further general knowledge that Woolworth, whatever its merits as a general retailer may be, does not provide any 'status' to a high-rise apartment building on Manhattan's Upper Eastside. Hence, a lease buy-out.

"In February of 1985, there was a filing with the Department of Taxation and Finance for the May 24, 1984 lease. A statement of no tax due was issued with respect to the May 24, 1984 lease." (Emphasis added.)

Original Purchase Price

In the Notice of Determination, the Division determined that Woolworth was liable for transfer gains tax in the amount of $212,900.00, interest of $202,006.18, and penalty of $74,515.00. In making this determination, no amount was allowed as "original purchase price". However, upon subsequent submission by KSB of materials assembled by petitioner, the Division allowed an original purchase price of $944,682.78.

From 1917 to 1984, Woolworth made capital improvements, additions and alterations to the leasehold premises. If William A. Esmond, petitioner's tax manager, were called to testify in this matter, he would testify to the facts and in the manner stated in his affidavit sworn to December 20, 1990. Pertinent facts from Mr. Esmond's affidavit follow:

"2. I am fully familiar with the recordkeeping methods and practices utilized by Woolworth to record the capital expenditures made in connection with the construction and renovation of its general merchandise variety stores in the United States. These records are created and maintained in the course of Woolworth's regularly conducted business activities.

"3. I have reviewed the capital expenditure records for the F.W. Woolworth store #242 at 201 East 86th Street, New York, NY (a/k/a 1527-1533 Third Avenue, New York, NY). From November 1917, when the store first opened at its present location, through February 1985, when the store was temporarily closed to allow the landlord, KSB Eighty-Six Associates, to construct a new building on the site, capital expenditures totalling $1,544,611.58 were made to this leasehold. Ninety percent ($1,382,354.04) of these expenditures were incurred in four major renovations of the store completed in March 1928, August 1937, July 1962 and October 1979."

By letter dated April 3, 1991, a copy of which is attached as Exhibit "B" to the petition

in this matter, the amounts sought by the Division were reduced in response to the Esmond affidavit to the following amounts: tax, $118,431.72; interest (to May 2, 1991), $118,076.50; and penalty, $41,451.10. The following explanation was provided, in pertinent part:

"KSB Eighty-Six Associates, Landlord
F.W. Woolworth Co., Tenant

Consideration: $2,129,000.00

Of the total $2,333,060.00 paid to Woolworth's, payments made under Article 43 (reimbursement of improvements) and under Article 40 (reimbursement of expenses) were not included in the Department's consideration figure.

Orginal [sic] Purchase Price (O.P.P.) Amount Claimed $1,544,611.58

Section 1440.5(a) of the Tax Law provides, in part, that 'Original Purchase Price' means the consideration paid or required to be paid by the transferor (i) to acquire the interest in the real property, and (ii) for any capital improvements made . . . .

Since the interest in real property was created on July 11, 1960, in the form of a leasehold, costs for capital improvements that were incurred prior to that date can not be allowed.

Adjustment $390,879.79

Expenses which were incurred to repair and maintain the property in a condition of fitness, readiness and/or safety, or to preserve such condition are not allowable. Thus, as discussed in my letter of February 1, 1991 to David M. Goldberg, the following are disallowed:

(a) maintenance/repairs, part of item #29	$33,182.00
(b) maintenance/repairs, item #30	19,907.01

Finally, the payments made to Woolworth's under Article 43 of the Lease were reimbursements to the tenant for improvements made to the real property, but unamortized. Consequently, any improvements made by a tenant, whereby a landlord has ultimately made payment, would have to be disallowed.

Adjustment $155,960.00
Total Adjustments 559,928.80
O.P.P. Allowed $944,682.78

Computation of tax due:

Consideration	$2,129,000.00
Less: O.P.P.	944,682.78
Gain	$1,184,317.22
Tax @ 10% of Gain	$118,431.72
Penalty @ 35% of Tax	41,451.10

Interest is due from June 8, 1984 (15 days from the May 24, 1984 transfer date).
Interest from June 8, 1984 to May 2, 1991 on $118,431,72 [sic] is $118,076.50 making the total tax, penalty and interest due (as of May 2, 1991) $277,959.32."

Procedural Matters

On or about June 23, 1992, KSB paid the reduced amount of tax ($118,431.72) to the Division. This amount shall be credited against the gains tax liability, if any, of Woolworth determined in this action.

Prior to submitting this matter to the Division of Tax Appeals for decision, the parties have executed a Waiver of Hearing requesting that this matter be decided pursuant to papers, the facts stipulated above, the attached exhibits and affidavits, and supplemental materials offered by each party.

Requested Findings of Fact

Petitioner requested the Administrative Law Judge to find certain facts in this case and set forth 28 facts for her consideration. Facts "1" through "3", "5", "6", "8" through "19", "21" through "24", "26" and "28" are set forth (in some form) as part of the stipulated facts, including facts established from affidavits introduced into evidence. Requested findings of fact "4", "7", "20", "25" and "27" will be discussed below.

Requested finding of fact "4" was not supported by the record and thus rejected; however, some discussion regarding this fact is necessary as it relates to several issues. Petitioner's request for a finding of fact "4" would include a finding of the following:

> "This 1923 lease was, in turn, renegotiated, modified, and extended in 1960 to permit Woolworth's continued occupancy of the premises through 1981 (including extensions)."

Petitioner alleges the same in its petition and the answer of the Division admits the allegations contained in such paragraph. In fact, the initial execution of the stipulation of facts in this

matter included the same statement. However, at the hearing the Division clearly raised its own error in this regard. The Division noted that such stipulated fact referred to the Division's calculation of original purchase price and commented that it was not clear from documents in the record that the 1960 lease was, in fact, a modification and renegotiation of the 1923 lease. The Division noted that the 1923 lease was not made a part of the stipulation or any other part of the record. Petitioner offered to send the Division and submit for the record the 1923 lease which purportedly would clarify the fact that the 1960 lease was a modification, extension and renewal of the prior lease. The Administrative Law Judge gave petitioner the opportunity to submit the lease document post-hearing. Petitioner's representative, Mr. Nowak, in attempting to provide an explanation of the provisions of the 1960 lease, stated the following:

> "It's a replacement lease. I think there is a new landlord who bought the premises in 1960 and they want to lock us in for a new term. We wanted, as we did in 1984, more term in that space. So we agreed to cancel -- to enter into this new lease now which replaced the 1923 lease which went into 1962 with the last options. The 1923 lease was a twenty-five year lease with -- I think it was two five-year options. Should be four.
>
> "Anyway, we had one more five-year option which took us through 1962 and that this new lease, you could call it, cancelled the last two years of the old lease and extended or granted us a new lease extending it until 1982, I believe it was. It was twenty years fixed." (Tr., pp. 30-31.)

After a further brief discussion on this matter, the parties agreed to go off the record to hold a brief discussion and come to a conclusion as to whether or not they would delete the paragraph from the stipulation as noted above. The parties concluded the paragraph would be deleted from the stipulation. With that, they replaced the fact with the stipulated fact which is now "4". The brief submitted by the Division's representative reiterated its position that the record did not support a finding that the 1960 lease was a modification and extension of the leasehold interest that commenced in 1923. Petitioner's reply brief attempted to counter the same by stating that the landlord remained the same, the tenant remained the same and the demised premises remained the same, and that substantive changes such as rent and term are often made and can be styled as either a new lease or a lease modification and that the label on a document does not change the economic substance of the parties' agreement. Petitioner additionally asserted that

the Division was foreclosed from raising the issue since the answer formerly admitted such fact and that no motion to amend the answer had been made. In post-brief correspondence dated May 10, 1994, the Division addressed this issue referencing the discussion which took place at the time of the hearing. The Division stated that although it believed that its position was clear at the hearing, that this particular fact could not be agreed to, since an objection by petitioner had been raised, the Division requested that its pleadings be conformed to the evidence in the hearing record. By correspondence received by the Division of Tax Appeals on June 9, 1994 petitioner opposed the Division's informal motion to conform its answer to the evidence on the grounds that (1) the motion was made untimely and (2) that the granting of the motion would be unjust and prejudicial to petitioner. Petitioner's representative stated the following with respect to petitioner's agreement to eliminate the stipulated fact:

> "When counsel belatedly had second thoughts about ¶ 4, Woolworth graciously agreed to amend this paragraph to eliminate the discussion of the relationship between the 1960 Lease and the 1923 Lease. However, we did so with the knowledge that this portion of the Stipulation was unnecessary because it was already addressed in the Petition and Answer."

Petitioner further argued that, had the Division moved to conform its pleadings on a timely basis, petitioner would have objected and if the Administrative Law Judge had indicated that the motion would be granted, petitioner claims that it would have requested a continuance in order to seek additional stipulations, testimony or affidavits. Petitioner claims prejudice on the fact that one of the parties with first-hand knowledge of such negotiations has retired and moved to another state and the other has recently entered a nursing home and thus it would be fundamentally unfair to allow an amended pleading at this time. The details on the background information regarding the requested finding of fact were provided to show the relationship between such fact and various issues presented in this matter (Issues "IV and "VII").

Rather than submitting the 1923 lease to complete the submission of documents, as petitioner stated was its desire, on February 17, 1994 petitioner supplemented the record with an affidavit and certain other exhibits concerning the circumstances surrounding the execution of the 1960 lease. The affidavit was that of J. F. O'Hara, the real estate vice president of

Woolworth. He stated that among his responsibilities for petitioner is the maintenance of permanent lease files which were maintained in the course of the company's regularly conducted business activities. Having reviewed the lease file for this location, he included and referred to internal memoranda pertaining to the modification, extension and renewal in 1960 of the lease for this particular store. No mention was made of the 1923 lease and it was not included. The internal memoranda spoke of the negotiations which took place during 1960 addressing various management figures. One document referred to "a renewal lease". Another referred to a "new 20-year lease". Another document referenced the fact that a majority of the articles in the lease (Woolworth's standard form of lease) had been modified or amended to some extent.

Requested finding of fact "7" summarized provisions of the May 24, 1984 lease, as modified in December of that year. The summarization set forth by petitioner is accepted as reflected by the lease document introduced into evidence and is thus reproduced below:

> "7. The [May 24, 1984] Lease contained a series of detailed provisions memorializing the parties' agreements on a complex transaction. The substance of the key provisions may be summarized as follows:
>
> "(a) At the outset, Woolworth was permitted to continue to operate its store and Woolworth agreed to pay rent to KSB at a rate of $633.33 per day. (Stip., Ex. C, Article 46)
>
> "(b) At limited times, upon written notice, and subject to fulfillment of substantial conditions (including payment by KSB to Woolworth of $155,960 in cash and the delivery to Woolworth of a letter of credit for $750,000 to secure performance of KSB's obligations), KSB had the right to require Woolworth to close its store and temporarily vacate the premises. (Stip. ¶ 6, Ex. C, Article 45)
>
> "(c) After the store was closed, KSB agreed to tear down the old building and promptly construct a new building on the site. (Stip., Ex. C, Article 29)
>
> "(d) Most of the ground floor, second floor, basement, and sub-basement of the new building would be built out to Woolworth's specifications and Woolworth would then resume occupancy. (Stip., Ex. C, Article 29). If KSB failed to complete the new premises before February 1, 1988, Woolworth would no longer be obligated to resume occupancy and could sue KSB for damages. Id.
>
> "(e) For each month the store was closed, KSB agreed to pay Woolworth a fixed amount. This amount was intended to compensate Woolworth for lost profits during the period the store was closed. (Luy Aff., Pet. Ex. 1; Stip. ¶ 14, Ex. E) If the store closed in 1985 (as it did, Stip. ¶ 11), the amount to be paid was fixed at $60,000 per month for the first twelve months the store was closed, $66,000 per month for the next twelve months, $72,600 for the third twelve month period, and $79,860 for the fourth twelve month period. (Stip., Ex. C, Article 41). A total of

$2,129,100 was paid to Woolworth under this provision. (Stip. ¶ 13)

"(f) The term commenced on August 10, 1984, the date of complete execution by the parties, with a fixed term running through January 31, 2007. (Stip., Ex. C, Article 3; Stip. ¶ 6). The Lease provided for a minimum rent of $275,000 per annum, plus percentage rents. No rent was due for the period during which the store was closed. (Stip., Ex. C, Article 5 and 5A).

"(g) The Lease also granted Woolworth eight successive five year renewal options. During these renewal terms, the minimum rent would be increased to include any percentage rent paid during the preceding three years. (Stip., Ex. C, Article 28)

"(h) Since this agreement modified or superseded the material provisions of the 1960 lease that Woolworth had been operating under (Stip. ¶ 5, Ex. B), both the standard form language of the Lease (Stip., Ex. C, Article 26) and a typed rider provision (Stip., Ex. C, Article 46) provided that all prior leases were cancelled.

"(i) The Lease also contains a standard provision providing that captions are for convenience only and do not limit or amplify the terms of the Lease. (Stip., Ex. C, Article 27)"

Requested finding of fact "20" is supported by the record to the extent that David Goldberg, counsel to KSB, issued a sworn affidavit stating the same. Such fact is also reproduced below:

"20. In response to the submission of documents to the Division, KSB's counsel was advised orally by an employee of the Department of Taxation and Finance, Ms. Jodi Martin, that transferee and transferor questionnaires should be filed with regard to the Lease showing KSB as landlord and petitioner as tenant. (Pet. Ex. 2, ¶ 5)"

Requested finding of fact "25" is accepted and set forth the following:

"The Department of Taxation and Finance did not treat any of these pre-1960 expenditures as part of Woolworth's original purchase price. (Pet. Ex. B) A substantial portion of the improvements created by these expenditures, including the third floor of the old building, the basement and an addition on the north side of the store, were still in use at the time the Lease became effective. (Stip ¶ 9; Stip ¶ 20, Ex. J)".

Requested finding of fact "27" is accepted and supported by documents in the record. It states as follows:

"Interest has been calculated [on the notice in issue] from May 24, 1984 even though the Lease did not become effective until August 10, 1984, and Woolworth did not vacate the premises until February 15, 1995 [sic]"[2] (see, Finding of Fact

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[2] The correct date is 1985.

"22").

ADDITIONAL FINDINGS OF FACT

In a separate but closely related action, a petition was brought before the Division of Tax Appeals seeking a determination by KSB (the landlord under the May 24, 1984 lease with Woolworth) that there was no New York State transfer gains tax due from KSB with respect to or arising out of

the transactions between KSB and Woolworth. In December 1990, KSB moved for summary determination in that matter and Leonard Boxer, a general partner of KSB, who was actively involved in the business affairs of KSB and fully familiar with the circumstances surrounding the transactions in issue, submitted an affidavit in support of KSB's motion for summary determination, which was submitted into evidence in this case. In his affidavit, he continually refers to the May 24, 1984 lease as the "replacement lease". In addition, his affidavit sets forth additional pertinent facts as follows:[3]

> "6. F.W. Woolworth Co. (hereinafter called 'Woolworth' or 'Tenant') leased store premises at 201 East 86th Street, Manhattan, New York, pursuant to lease, dated July 11, 1960, between Naomi Engelsman, Alan Barth and Lloyd Merrill, as Landlord, with F.W. Woolworth Co., as Tenant, as amended by Agreement dated January 15, 1979 . . . .
>
> "7. KSB desired to purchase the premises ('Premises') known as 201 East 86th Street, Manhattan, to demolish the then existing building and to construct a high-rise apartment building. KSB and Tenant entered into a replacement lease, dated May 24, 1984, made by KSB with F.W. Woolworth Co., as amended by lease modification agreement, dated December 14, 1984. The prior lease was for a term ending January 31, 2003. The replacement lease is for a term ending January 1, 2007, with the Tenant having eight five-year renewal options . . . .
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> * * *
>
> "9. The Tenant was granted a 'right of possession following the date of termination of the Prior Lease to continue occupancy of its present store

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[3]Only portions of Mr. Boxer's affidavit are reproduced herein since many of the facts which establish a chronological sequence of events have previously been set forth in this determination. Where certain facts are duplicated, it is done so to assist the reader.

premises . . . for the period from said termination date of the Prior Lease to the date Tenant vacates and surrenders possession of the present store premises pursuant to Art. 45 hereof . . .' . . . .

"10. Other provisions of the replacement lease provided that the Tenant would 'surrender possession of the present F.W. Woolworth store,' the Landlord would then build a new building and the Tenant would reoccupy. Replacement lease Art. 41 provided for the payment of monthly payments during the 'Closed Store Period,' which was the period during which the Tenant's old store would be closed in order to enable the Landlord to demolish and rebuild. Payments aggregating $2,129,000 were made pursuant to lease Article 41. It was patent that KSB did not pay $2,129,000 to obtain a lease paying base rent of $275,000 per annum; the payments were for vacancy [emphasis supplied].

"11. The May 24, 1984 lease is acknowledged by KSB, May 24, 1984, and by Woolworth, August 9, 1984. That lease was agreed to in advance of KSB's purchase of the Premises and upon information and belief, that lease was delivered in August, 1984.

"12. KSB acquired the premises July 27, 1984.

"13. In substance, KSB wanted to develop the site, Woolworth wanted to remain in possession as a retail store tenant. In order to provide KSB with the ability and right to enter upon the leased premises to demolish and construct, Woolworth vacated temporarily. KSB compensated Woolworth, for the period that Woolworth vacated the Premises and at the end of that period Woolworth resumed occupancy as a tenant. The monthly payments were made over a period commencing February 26, 1985 and ending on or about January 6, 1988, which was the period of vacancy and construction.

* * *

"17. In 1990, KSB sold the Premises. In connection with that sale, KSB filed a transferor questionnaire, showing as 'Payments to commercial tenant to permit construction,' the payments made under new lease Article 41 to the Tenant. Upon information and belief, the transferor questionnaire was extensively reviewed by the Department, the particular point of the payments under the Lease was considered and the payments were recognized as part of the Original Purchase Price. A tentative assessment in accordance with that determination, was issued February 17, 1990. The closing of title occurred March 28, 1990.

"18. By Statement of Proposed Audit Changes, dated April 30, 1990, Case No. A-25516, the Department reversed its prior finding under the February 17, 1990 Tentative Assessment and determined that the payments made for the Closed Store Period were not correctly included in the Original Purchase Price. The Department quoted the introductory phrase for Lease Article 41 of the new lease ('As an inducement for Tenant to enter into this lease') as the basis to assert that the payments were made to induce Woolworth to enter into a new lease, rather than as an inducement to grant entry rights to the Landlord.

"19. By letter dated May 25, 1990, the Department withdrew 'at this time' the additional assessment.

"20. By Notice of Determination dated June 4, 1990, the Department assessed KSB with transferee liability, plus penalties and interest from May 24, 1984 for a lease surrender.

"21. The Department cited transfer gains tax law Section 1447 to the effect that transferees are required to set forth the consideration paid to transferors and Section 1447.3(a) to the effect that 'in a case where no tentative assessment has been issued because the transferee did not file the requested questionnaire . . . the transferee shall be personally liable for the taxes stated to be due in a Notice of Determination, . . .' . . . ."

In support of a finding that KSB had no further tax liability, Mr. Boxer concluded:

"By reason of the foregoing [affidavit]:

"At no time, was there a New York State Transfer Gains Tax assessable against either Petitioner [KSB] or Woolworth;

"Even if there were such a tax assessable, the reporting requirements have been complied with and the assessment of any such tax is invalid by reason of the passage of time since the filing by Petitioner and Woolworth of transfer gains tax questionnaires;

"Even if there were a transfer gains tax assessable, Petitioner has no transferee liability;

"Even if there was a transferee gains tax assessable against Petitioner, Petitioner has no liability for penalties and interest . . . ."

The Notice of Determination against Woolworth seeking the tax due for the transactions in issue was dated February 2, 1991. In June 1992, as previously stated, KSB paid the reduced amount of tax in the amount of $118,431.72 to the Division prior to review by the Tax Appeals Tribunal of the previous KSB matter (see, Finding of Fact "23").

SUMMARY OF THE PARTIES' POSITIONS

With respect to the statute of limitations and whether the same bars recovery of gains tax sought by the Division, petitioner takes the position that since a complete set of supporting documents and gains tax questionnaires were prepared in good faith and filed with the Division on or before April 2, 1985, the Notice of Determination dated February 2, 1991 was untimely and must be annulled.

The Division takes the position that neither the filed questionnaires nor the correspondence of KSB's counsel indicated that a leasehold surrender had also taken place pursuant to the 1984 lease agreement. Since the documents required by the Division with

regard to the lease surrender were not filed, the statute of limitations is not a bar to the assessment in issue.

Turning next to whether Woolworth's obligations under the May 24, 1984 lease constituted a surrender of its leasehold interest, petitioner maintains that since Woolworth's rights under the lease were not surrendered, the fact that Woolworth temporarily vacated the space does not elevate this transaction to one intended to be covered by the gains tax statute. Petitioner alternatively characterizes what took place as a modification and extension of the 1960 lease. Such characterization, petitioner argues, as a single, nontaxable lease modification and extension, is consistent with Woolworth's intent and the financial arrangement between the parties.

The Division concludes that since a transfer of real property includes "surrender" of an interest, and "interest" in real property includes "a leasehold interest", pursuant to Tax Law § 1440(4) and (7) it follows that the surrender of a leasehold interest is a transfer subject to gains tax.

Petitioner argues that the payments made under Article 41 of the May 24, 1984 lease do not constitute consideration for a lease cancellation since these payments were made to reimburse Woolworth for lost profits for each month the store was closed during the reconstruction period. The Division specifically contends that the 1984 lease cancelled the 1960 lease and the payments made pursuant to Article 41 of the 1984 lease constituted consideration for the leasehold surrender by Woolworth.

Regarding allowable leasehold improvements to comprise original purchase price, petitioner alleges as error the fact that the Division failed to include within Woolworth's original purchase price $390,879.79 expended for capital improvements made prior to 1960 under the theory that such expenses were incurred by the beneficial owner of such property. Petitioner believes it should be given credit for substantial capital improvements made to the premises under a prior lease when petitioner continued to occupy the same premises under a subsequent lease.

The Division, relying on regulatory provisions, states that a lessee's original purchase price for its leasehold interest shall include capital improvements made with respect to such leasehold interest and not, as petitioner suggests, capital improvements made under a prior interest.

Turning to KSB's payment of the gains tax, the Division asserts that such payment results in additional consideration to petitioner. Petitioner takes the position that since such payment was not made pursuant to a negotiated agreement between the parties, it does not fall within the purview of the regulatory provision and is not additional consideration.

Petitioner submits it made a good-faith filing with the Division disclosing all the operative documents and characterizing the transaction in a manner that it believed to be accurate and, as such, has established the absence of willful neglect. Given the facts presented, petitioner asserts it has established reasonable cause for abatement of penalties.

The Division maintains petitioner fails to offer any clear or convincing evidence for the waiver of penalties assessed by the Division.

The Division requested that its pleadings be conformed to the evidence in the hearing record with respect to the fact that the 1960 lease was a modification of an earlier lease (a fact attempted to be established by petitioner). Petitioner opposes the Division's informal motion on the ground that it was made untimely and that the granting of such motion would be unjust and prejudicial to petitioner.

CONCLUSIONS OF LAW

A. Tax Law § 1444.3 provides that no assessment of gains tax may be made after the expiration of three years from the date of transfer unless the questionnaire required by Tax Law § 1447 is filed after the date of transfer, in which case the three years commences on the date the questionnaire was filed. Petitioner argues that it fully complied with the questionnaire filing on or before April 2, 1985 because the questionnaires advised by the Division and the supporting documents filed with the Division sufficiently put the Division on notice of the transaction covered by the lease documents. Petitioner maintains that the facts in this case are

plainly insufficient to prevent the period of limitations from commencing where (1) a form (though arguably the wrong one) required by the statute was filed and (2) the forms and attachments that were filed disclosed all the information needed to determine the tax liability. Petitioner cites to certain case law where the courts ruled that the filing of a return under one type of taxation or a return filed under a particular theory rather than the one ultimately determined to be correct in those cases started the running of the period of limitations so long as the returns actually filed disclosed sufficient information to determine the correct tax (see, Airborne Freight v. Michael, 94 AD2d 669, 462 NYS2d 663; Transocean Gateway Corp., New York City Tax Appeals Tribunal, September 30, 1993; In Re Radio Relay Corp., New York City Tax Appeals Tribunal, September 23, 1992; In Re Polaroid Corporation, New York City Tax Appeals Tribunal, September 23, 1992). Petitioner notes that the document that was sufficient to disclose the facts necessary to determine the nontaxability of the leasehold grant is the same document that contained the provisions allegedly giving rise to the lease surrender and, in fact, the Division made its determination of tax liability without examining any additional documents or requesting any further information from petitioner.

The Division claims petitioner failed altogether to comply with the pre-transfer audit procedures applicable to transfers subject to gains tax. The Division reminds petitioner that although the operative lease was dated May 24, 1984, the first notification that the parties were engaging in a transaction was received by the Division in February 1985 when KSB's attorney forwarded the documents to the Division. Noting the language in Mr. Goldberg's letter (see, Finding of Fact "15"), there is no specific reference to either one transaction or another, but rather he only references "the transaction" and indicates that the documents were submitted for purposes of disclosure and he further requests advice as to whether any gains tax questionnaires should be filed. The Division maintains that "the transaction" referred to by Mr. Goldberg impliedly refers to the main leasehold grant transaction and that neither the filed questionnaires nor the correspondence of Mr. Goldberg indicate that a leasehold surrender had also occurred by execution of the 1984 lease. The Division does not dispute that Mr. Goldberg was advised to

file those questionnaires at the direction of the Division's personnel, but notes that Mr. Goldberg's affidavit offers no information as to the extent that the Division employee was informed about the 1984 lease with respect to surrender. The Division concludes by stating that Tax Law § 1447(1)(a) requires reporting on specific forms transfers of real property subject to gains tax. The Division asserts that petitioner was not relieved of this filing requirement by virtue of the disclosure it made of documents relating to the KSB-Woolworth lease transaction.

B. It must be noted from the onset that the real property transfer gains tax had been enacted nearly two years by the time Mr. Goldberg notified the Division by disclosing the documents pertaining to the transactions in issue. At that point, the gains tax provisions were merely of relative newness to practitioners. Only months after their enactment, the Division issued Publication 589 which explained that each transferor and transferee were required to complete a questionnaire covering a transaction. Although a questionnaire from a transferee and a transferor were submitted in this case, it is important to note that, as to the leasehold grant, KSB was the transferor and Woolworth was the transferee. As to the purported leasehold surrender, the parties swap hats -- Woolworth is the transferor and KSB bore the responsibility as transferee. Petitioner makes a very compelling argument with respect to its comparison to cases where, although a wrong return was filed, the taxpayer was essentially given "credit" for the fact that it had attempted to pay taxes on the transactions in issue with an erroneous filing and was not held responsible for the correct tax for the period then barred by the statute of limitations (see, Airborne Freight Corp. v. Michael, supra; In re Transocean Gateway Corp., supra). This matter, however, may be distinguished by an important point. The lease documents in question allegedly give rise to two potentially taxable transactions, at the very least two reportable transactions, if the Division is correct in its assessment that Woolworth's absence from the store amounted to a leasehold surrender. In light of the fact that two transactions were potentially taxable, then separate amounts of tax would be calculated in each case. In this matter, the only questionnaires (returns) filed covered the one transaction and not the other, unlike the cases cited by petitioner where a return had been filed covering all of the

transactions in question, though admittedly the wrong return, and in one case, a return filed understating income. Since in this case petitioner filed no questionnaire for the leasehold surrender, it is impossible for the statute of limitations to have commenced running. Given the fact that petitioner's position, that Woolworth's departure from the premises did not amount to a leasehold surrender subject to gains tax, is a plausible one (the details of which the Division had been given) which would have required no filing, the result is somewhat harsh. Nonetheless, petitioner did not comply with the Tax Law requirements and the statute of limitations is no bar to the assessment in issue.

C. Tax Law § 1441 imposes a tax on gains derived from the transfer of real property at the rate of ten percent of the gain. Section 1440.7 defines a "transfer of real property" to mean a "transfer of any interest in real property by any method, including but not limited to sale, exchange, assignment, surrender, mortgage foreclosure, transfer in lieu of foreclosure, option transferred with use and occupancy of real property . . ." (emphasis added). Section 1440.4 defines "interest" as a leasehold interest and section 1440.6 defines "real property" as:

> "every estate or right, legal or equitable, present or future, vested or contingent, in lands, tenements or hereditaments, including buildings, structures and other improvements thereon and leaseholds . . ." (emphasis added).

"In assessing whether a transaction is subject to taxation, the statute which levies a tax is construed in favor of the taxpayer" (Matter of Bredero Vast Goed v. Tax Commn. of the State of New York, 146 AD2d 155, 539 NYS2d 823, 825, appeal dismissed 74 NY2d 791, 545 NYS2d 105). However, in their interpretation of what constitutes a "transfer of real property", the courts have recognized that the "statute employs an expansive definition designed to maximize revenues" (id., 539 NYS2d at 825 [and cases cited therein]). In this case, Article 45 of the May 24, 1984 lease required Woolworth to surrender possession of its leasehold interest upon notice by KSB and characterized the payments made by KSB to Woolworth during this "Closed Store Period" as "an inducement for tenant to enter into this lease." Petitioner argues that the payments made by KSB were not consideration for a lease surrender because Woolworth remained entitled to its leasehold interest and vacated for purposes of construction

of the new building in which it had already secured a tenancy. The Division claims that the unambiguous provisions of the statute must be applied to the terms as stated in the 1984 lease and that, as such, they describe a taxable transaction.

The Division additionally relies on the characterization of the transaction as a "buy-out of leasehold rights" by David Goldberg's May 10, 1990 correspondence to the Division in its representation of KSB in the position opposite Woolworth (see, Finding of Fact "19"). Petitioner explains that the reason for such characterization was to enable KSB to include the payments it made to Woolworth as part of its OPP for the new building. According to petitioner, the Division adopted KSB's reasoning, then proceeded to make a transferee assessment against KSB in connection with the 1984 lease, which gave rise to the situation under which KSB paid the tax in this matter. The affidavit of Leonard Boxer, a general partner of KSB takes a different position, however, when he classifies the payments as having been made to compensate for the vacancy, rather than as a buy-out of the leasehold. Given the fact that Mr. Goldberg was representing KSB's interest, and proceeded in a light most favorable to his client, his characterization is not given a great deal of weight.

The facts reveal that KSB desired to maintain Woolworth as a tenant as it proceeded to negotiate the purchase and potential reconstruction of the property in issue. In fact, KSB committed itself to a lease agreement prior to the actual acquisition of the property. Woolworth remained on the premises until the construction commenced, having been given notice in accordance with their agreement. Woolworth did not conduct operations in an alternative location to replace the profits lost during its absence from 201 East 86th Street, but rather accepted monetary compensation for such lost profits. Subsequent to the construction of the new building, Woolworth took its place as a tenant in January 1988 in accordance with the May 1984 lease agreement. The lease agreement drawn between KSB and Woolworth prior to the "surrender" remained in effect throughout the reconstruction and further defined the terms of the tenancy post-construction. New York law has established that:

> "a surrender of demised premises occurs only through the consent or agreement of the parties, evidenced either by an express agreement or by some act of the parties

> to the lease that is so inconsistent with the relation of landlord and tenant as to indicate that both had agreed to consider the surrender as made . . . . [I]t is essential to a surrender, whether express or implied, that there be a mutual agreement between the landlord and the tenant that the lease terminate . . ." (74 NY Jur 2d, Landlord and Tenant, § 793).

Woolworth's leasehold rights were never interrupted and the lease did not terminate. The compensation paid to Woolworth did not even closely approximate a calculation of the present value of the future bargain element for the remaining term of the lease, nor the present value of the projected profit for the same term. It clearly represented a replacement of forgone profits during the reconstruction period. Petitioner, at best, surrendered the physical premises and nothing more. Accordingly, it is concluded that petitioner's actions to vacate during the closed-store period were not a surrender of its leasehold interest which amounted to a transfer for gains tax purposes (Tax Law §§ 1441, 1440[7]).

D. If it is alternately determined that petitioner surrendered its leasehold interest during the closed-store period, the Division asserts that the payments received by petitioner shall be deemed consideration for such transfer. Tax Law § 1440.1(a) defines "consideration", in pertinent part, as follows:

> "Consideration means the price paid or required to be paid for real property or any interest therein . . . . Consideration includes any price paid or required to be paid, whether expressed in a deed and whether paid or required to be paid by money, property, or any other thing of value and including the amount of any mortgage, purchase money mortgage, lien or other encumbrance, whether the underlying indebtedness is assumed or taken subject to . . . ."

The Division specifically contends that the 1984 lease (Article 46) cancelled the 1960 lease and the cancellation or the surrender of the leasehold interest under such lease, which was acquired by the 1960 lease, was a transfer of real property subject to gains tax. Thus, the Division argues, that payments made to Woolworth during the construction period constituted consideration for the leasehold surrender by Woolworth.

First, petitioner maintains that the lease is not cancelled. Secondly, petitioner argues that the payments were not consideration for cancellation of the lease, even if it is determined that cancellation did occur, but rather the payments were to compensate Woolworth for lost profits during the closed-store period. Petitioner takes the position that not only are the payments not

connected to the cancellation language within the lease document, but they are also wholly inadequate to compensate petitioner for surrender of the 19-year term remaining under the 1960 lease. Petitioner argues, in the alternative, that if the consequences of the grant by Woolworth to KSB of a right to use the space for a period of time during which reconstruction took place, the transfer of such space should be characterized as the grant of a nontaxable sublease. As such, the payments made under Article 41 would be characterized as consideration for a nontaxable sublease rather than a taxable leasehold surrender.

E. If it were to be determined that the 1984 lease agreement resulted in a surrender of leasehold rights for which petitioner was compensated, the amounts received must be deemed consideration, since it was the compensation petitioner received for vacating the premises. Although the computational basis of the compensation was lost profits, the characterization as consideration if the transaction were determined to be taxable does not change. The fact that the consideration did not take into account the present value of the projected profit for the remaining lease term (19 years), or the bargain element of the lease that petitioner would forgo for the same time period, does not change this result, but adds credence to the determination above that surrender was neither intended nor accomplished.

Petitioner makes an interesting argument by raising the issue of a sublease arrangement. Although the language of the 1984 lease (pertaining to surrender) did not provide for a sublease arrangement between the parties, and it would be reaching to construe such language as resulting in the same, it must be noted here that New York law supports the definition that "a sublease is a grant by a tenant of an interest in the demised premises less than his own, retaining to himself a reversion" (74 NY Jur 2d, Landlord and Tenant, § 705). Effectively this is what petitioner agreed to in the 1984 lease. This additionally lends credence to the conclusion drawn above that a surrender of the leasehold rights did not occur, since Woolworth retained its "reversionary" interest.

F. If the leasehold interest was surrendered by petitioner resulting in a taxable transfer, the calculation of OPP becomes significant in this case. Tax Law former § 1440.5(a) insofar as

relevant to this matter, provides 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 . . . ."

20 NYCRR 590.28(c) provides some guidance as to the OPP of a lessee for his leasehold interest, as follows:

> "The original purchase price of a lessee for his leasehold interest includes costs incurred by the lessee to acquire the leasehold interest (e.g. attorneys' fees and brokers' fees), consideration paid for an option to renew the lease or purchase the underlying property, and the costs of any capital improvements made by the lessee . . . ."

This case presents a rather unique set of facts surrounding the OPP issue. The dispute in this case concerns the timing of capital improvements made by Woolworth to the property it leased at the East 86th Street location since 1917. In the calculation of taxable gain on the leasehold surrender, the Division did not include in petitioner's OPP $390,879.79 expended for capital improvements made on the property it leased prior to 1960, the commencement date of the lease that the Division claims was surrendered. The Division reasoned that a lessee's OPP for his leasehold interest includes capital improvements made with respect to such leasehold interest, and not with respect to a different leasehold interest, i.e., that which preceded the interest created by the 1960 agreement. Petitioner contends this position is not supported by the regulations as suggested by the Division. Petitioner relies on the argument that Woolworth was the beneficial owner of the pre-1960 improvements since it used them exclusively and was free to alter or dispose of the same.

The relevant starting point with this issue is with the regulatory language which includes "costs incurred by the lessee to acquire the leasehold interest . . ." as part of original purchase price (20 NYCRR 590.28[c]). Assuming there was a leasehold surrender in 1984, the creation of the interest then held by petitioner was accomplished by the 1960 agreement. In support of looking back to previous leasehold interests petitioner also asserted that the 1960 agreement was merely an extension and modification of the prior 1923 agreement. If petitioner was able to

show that the particular leasehold interest surrendered had actually been created prior to 1960 by a lease that was merely modified at that time, then serious consideration would have to be given to including capital improvements covered by such interest. However, in this case, petitioner was unable to carry this burden. During the hearing, a lengthy discussion regarding these two leases took place (giving rise to a later motion to amend the pleadings which is addressed infra), and the parties agreed that a previously stipulated fact would be removed. As petitioner continued to maintain its position that the 1960 lease was merely an extension of the 1923 lease, the Administrative Law Judge allowed petitioner an additional opportunity to submit the 1923 lease and/or related documents to allow the Administrative Law Judge to find such fact independently. Post-hearing, petitioner submitted the affidavit of J. F. O'Hara accompanied by internal memos from the corporate lease file pertaining to the "renewal" of the 1960 lease. The 1923 agreement was not included, and no explanation was provided for its absence. Although certain memos speak to the 1960 lease as the "renewal lease", there is also a document which describes "a new 20-year lease at this location." Given the fact that the 1923 lease provisions were not provided for review herein, and the fact that the documents submitted are conflicting on this point, petitioner has not established that the "interest" in the leasehold was created prior to 1960. Accordingly, only expenditures for capital improvements made after petitioner acquired the 1960 leasehold would be includable in OPP if a calculation of OPP were required. Whether petitioner is the beneficial owner of such improvements does not change the interest pursuant to which such improvements were made. Likewise, the fact that the parties stipulated to the fact that petitioner occupied such premises since 1917 does not establish the provisions of the 1923 lease in order to consider whether the leasehold interest was in fact created at an earlier time and merely modified and extended in 1960.

G. With respect to the imposition of penalties, Tax Law § 1446.2(a) permits abatement or waiver of penalty if it can be determined that petitioner's failure to timely pay the gains tax due to reasonable cause and not due to willful neglect. The reasonableness of a taxpayer's failure to pay the tax must be evaluated in light of the Division's articulated policy (see, Matter

of Benacquista, Polsinelli & Serafini Mgt. Corp. v. Commr of Taxation & Fin. of the State of New York, 191 AD2d 80, 598 NYS2d 829, 832) and "the extent of the taxpayer's efforts to ascertain its tax liability" (Matter of KAL Associates, Tax Appeals Tribunal, October 17, 1991). In determining reasonable cause all of the actions of a taxpayer are considered relevant (Matter of LT&B Realty Corp. v. New York State Tax Commn., 141 AD2d 185, 535 NYS2d 121).

Petitioner asserts in support of its claim of reasonable cause that the position it has taken with respect to the leasehold surrender was a reasonable one, not contrary to statutory or other authoritative source published by the Division. In addition, petitioner points to the filing by KSB's counsel of all the operative documents of the transaction, which placed the Division on notice of the transactions arising from the lease agreement. The Division maintains that petitioner fails to offer a clear and convincing argument for waiver or abatement of penalties. The Division acknowledges the contact made by KSB. However, although it was contacted by KSB, the Division notes the failure by Woolworth to similarly do so.

H. The Division accurately notes that it was KSB who informed it of the occurrence of the lease transaction. However, after the Division instructed which questionnaires were to be filed by both KSB and petitioner, it was clear that the Division had already been provided with the documents necessary to arrive at such conclusion. Why would Woolworth then duplicate the efforts of KSB in that regard? Petitioner made it clear that it believed no taxable transaction occurred with respect to the surrender portion of the transaction. The position it took was a reasonable one as is established herein. If there was a (second) taxable transfer, (which is an unusual situation), the transaction was disclosed to the Division by documents submitted which requested advice on the taxability. Although the correspondence from KSB's attorney did not specify a particular transaction for the Division to consider, the primary document (the 1984 lease) was 18 pages in length and its provisions were clearly delineated by separate headings.

In Matter of Rose (Tax Appeals Tribunal, June 30, 1994), petitioner included with his gains tax filings pertaining to a sale, an affidavit describing the basis upon which the OPP was calculated. The affidavit described a prior assignment, the relationship between certain parties

and the purchase price paid for the property involved. The Administrative Law Judge in that matter concluded that petitioner specifically disclosed his position regarding OPP to the Division by a very detailed affidavit submitted with his gains tax filings. Recognizing the complexity of the transaction in Rose and noting petitioner's full disclosure thereof, penalties were abated. In its review of the case, the Tax Appeals Tribunal noted that although it is unusual for an affidavit to be submitted in explanation of a certain aspect of the transfer, by submitting the affidavit, "petitioner was calling attention to, and inviting the Division's scrutiny of, this element of the transfer. In our view, this attention getting activity was equivalent to asking the Division's opinion on whether petitioner was entitled to the increase in original purchase price" (id.). In sustaining the abatement of penalties, the Tribunal found relevant the disclosure of pertinent facts, and held that petitioner's reliance on his affidavit constituted reasonable cause to abate penalties.

The Division has not suggested that it did not have all the facts necessary to make a determination that the same set of documents potentially gave rise to two taxable transactions, or that its advice was not sought as to taxation arising from such documents. Neither KSB nor Woolworth specifically called the Division's attention to the surrender transaction as did the petitioner in the Rose case. However, even the Tribunal pointed out that any detailed explanation of an aspect of a transaction was the exception to the rule, and its abatement of penalties in that case centers around the disclosure of significant facts to the Division. Rose also differed since it was not a matter where two taxable transactions arose from the same set of documents. Given the facts that all relevant documents needed to assess the transactions in issue were provided to the Division by one of the parties to the transaction, petitioner filed what was requested of it, and the position it took with respect to the surrender was reasonable and not contrary to any stated policy of the Division, petitioner has established that its failure to timely pay the gains tax was due to reasonable cause and not willful neglect.

I. With its post-hearing memorandum of law the Division raised an issue that had not been previously addressed by the parties pertaining to the payment of tax in this matter by KSB.

The Division maintains that pursuant to regulations, additional consideration is considered received by a transferor where a transferee agrees to pay gains tax. When mathematically applied to this situation, a recomputation of the taxable gain, as advanced by the Division, results in a tax deficiency of $13,159.08. The Division cites to 20 NYCRR 590.9 which provides:

> "Question: If an agreement is negotiated between a transferor and transferee whereby the transferee agrees to pay the gains tax for the transferor, does such payment constitute additional consideration to the transferor?
>
> "Answer: Yes. The consideration for the transfer is the price paid or required to be paid for the real property or any interest therein, and includes the cancellation or discharge of an indebtedness or obligation. Since the transferor is personally liable for payment of the gains tax, payment of the tax by the transferee constitutes additional consideration to the transferor . . . ."

Petitioner points out that although gains tax was, in fact, paid by the the transferee, it was not done so pursuant to a negotiated agreement as called for by the regulatory provision. There is no designation as to who would be responsible for the payment of real property gains tax in the 1984 lease agreement. Thus, petitioner maintains that the Division's argument must fail.

Clearly the regulation, which embellishes the general statutory concepts addressing consideration, predicates including such payment by the transferee as additional consideration to the transferor upon an agreement negotiated between the parties. The basis for such a rule is that the transferee, by paying, has cancelled or discharged an obligation of the transferor. In this case, such payment by KSB neither cancelled nor discharged Woolworth's obligation for the gains tax, or the Division would not now seek to hold petitioner responsible. The Division's argument that a deficiency remains is rejected and if petitioner were held liable for gains tax on the leasehold surrender, it would only be to the extent of the tax computed on the gain.

J. This final section addresses the Division's motion to amend its pleadings to conform to the record.

There were numerous times where, throughout the hearing and within the documents, the Division made abundantly clear its position rejecting the 1960 lease's being characterized as an extension and modification of the 1923 lease. When the Division raised its own error with

regard to a stipulated fact dealing with such issue, its position that the 1960 lease would not be automatically viewed as an extension, modification or renewal of the 1923 lease for the same premises was clarified. As the Division actually sought to negate this portion of the stipulation, to which petitioner agreed, it effectively was amending its answer in a like manner, though not by formal motion. In petitioner's reply brief, it objected to the Division maintaining its previously stated position on this matter, and the Division responded with a post-hearing request to conform its pleadings to the evidence in the hearing record. Petitioner objected on the basis that the motion is untimely and if granted, would be unjust and prejudicial to Woolworth.

K. The Tax Appeals Tribunal Rules of Practice and Procedure provide that:

> "[t]he administrative law judge . . . may permit pleadings to be amended before the hearing is concluded to conform them to the evidence, upon such terms as may be just . . ." (20 NYCRR 3000.4[c]).

The CPLR, from which guidance may be sought, includes a commentary discussion on Rule 3025 with respect to amended and supplemental pleadings. In its discussion of allowing amendments to conform pleadings to the evidence, the commentaries pose the following:

> "When one considers that the purpose of the CPLR is to diminish the importance of pleadings and to direct effort instead to the substantive rights involved, it appears sound policy indeed to enable a court, even where the variance between pleading and proof approaches the substantial, to put the trial off for a few days rather than dismiss the case or preclude a party altogether from putting in important evidence because of a pleading oversight. If the party should be penalized at all for the pleading omission, the punishment would more appropriately be an imposition of costs than a dismissal or refusal to permit a conforming amendment . . .
>
> "When no prejudice is shown, the amendment may be allowed 'during or even after the trial', Dittmar Explosives, Inc. v. A. E. Ottaviano, Inc., 20 NY2d 498, 285 NYS2d 55 . . . .
>
> "Prejudice -- irremediable prejudice -- is the main barrier . . ." (Siegel, Practice Commentaries, McKinney's Cons Laws of NY, Book 7B, CPLR C3025:15, at 364).

As guided by the CPLR on this issue, the amendment may be allowed after the hearing, when no prejudice is shown. Petitioner states that if the motion had been timely, it would have sought a continuance of the hearing to seek additional stipulations, testimony or affidavits. However, since the closing of the hearing record, petitioner complains that key figures with

knowledge of the facts in issue have retired, moved to remote locations, or entered a nursing home. The Administrative Law Judge allowed petitioner ample opportunity to submit for the record the 1923 lease and any support it may have had in its possession to establish that the 1960 lease was merely an extension of the 1923 lease. The post-hearing submission by petitioner dated February 17, 1994 did not include the 1923 lease, restate any of its provisions, or support petitioner's contention with any certainty. Accordingly, even if the Division is not found to have constructively (at hearing) amended its pleadings to conform to the evidence in the record, petitioner has not shown it would be prejudiced sufficiently to require the denial of the Division's motion. Thus, the Division's motion to amend its pleadings to conform to the evidence is granted.

L. The petition of F. W. Woolworth Co. is granted and the Notice of Determination dated February 7, 1991, as revised (see, Finding of Fact "22"), is hereby cancelled.

DATED: Troy, New York
December 8, 1994

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE