STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of UNITED STATES LIFE INSURANCE COMPANY IN THE CITY OF NEW YORK 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.	: : : : : :	DETERMINATION DTA NO. 809614

Petitioner, United States Life Insurance Company in the City of New York, 125 Maiden Lane, New York, New York 10038, 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 before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on February 4, 1992 at 4:00 P.M., with all briefs to be submitted by July 3, 1992. The Division of Tax Appeals received petitioner's post-hearing brief on April 20, 1992, the Division of Taxation's letter brief on June 15, 1992, and petitioner's reply on June 29, 1992. Petitioner appeared by Dreyer and Traub (Jay I. Gordon, Esq., and Joseph Gulant, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kenneth Schultz, Esq., of counsel).

ISSUE

Whether a portion of the mortgage indebtedness incurred in connection with the construction of a building located at 125 Maiden Lane in New York City is includable in petitioner's original purchase price for purposes ofcomputing its gains tax liability upon the sale of the building and the land upon which it is located.

FINDINGS OF FACT

United States Life Insurance Company in the City of New York ("petitioner") and the

Division of Taxation ("Division") stipulated to numerous facts which have been fully incorporated into the findings below.

Petitioner is a domestic life insurance company having its principal place of business and home office in Manhattan. On January 6, 1960, petitioner petitioned for the approval of the New York State Superintendent of Insurance to enter into a contract for the purchase of land located at 125 Maiden Lane in New York City. Such petition was the result of petitioner's projection in January 1954 of its own growth rate and the desirability of a site capable of handling petitioner's operations vis-a-vis its growth rate. After review of numerous sites, land was purchased in 1955 by Continental Casualty Company, a corporation which then owned the majority of petitioner's stock, for the purpose of erecting on such property a new home office building for petitioner. In July 1956, Continental Casualty Company sold its majority interest in petitioner and abandoned its plans to construct petitioner's office space.

Petitioner was unable to acquire the land itself and construct a building thereon because of its status as a regulated insurance company. Its petition to the Superintendent of Insurance indicated that the economics of New York City real estate coupled with the investment limitations imposed by the New York Superintendent of Insurance under the law precluded petitioner from owning a building providing the desired floor area and requisite space for its growth. Thus, petitioner sought approval of the Superintendent of Insurance to the transactions which will be described in this matter.

Although petitioner was prohibited from directly acquiring or constructing a building due to regulatory restrictions, petitioner sought the approval of the Superintendent of Insurance of the transactions described below which were designed to effect a "proprietary interest". Petitioner presented its position in its petition to the Superintendent of Insurance, describing the proposal for which it sought approval as follows:

> "[W]hereas the occupancy lease . . . makes no provision for petitioner's acquisition of a proprietary interest in the building occupied as its home office, and whereas it is desirable that there be such a proprietary identification of petitioner with the building, and whereas it would be to petitioner's advantage to invest in the subject property in consideration of the return offered, and whereas petitioner is desirous of securing control over future allocations of space . . . . "

In 1958, a developer, 125 Maiden Lane Building Company ("MLBC"), acquired the land located at 125 Maiden Lane ("Land") from Continental Casualty Company for $1,300,000.00. MLBC sold the Land to General Electric Pension Trust ("GEPT") for $1,400,000.00 under a bargain and sale deed dated March 1, 1960 pursuant to a sale/leaseback arrangement under which GEPT immediately leased the Land back to MLBC (the "Ground Lease") for 30 years and 10 days. MLBC issued a deed to the Land to GEPT in exchange for payment of $1,400,000.00, the price paid by MLBC for the Land, plus a reasonable allowance for taxes and carrying expenses from the date of acquisition to the passing of title. MLBC reserved title in the building for itself. The Ground Lease provided that MLBC would retain no interest or other rights in the building upon termination of the lease, but instead the building would by contract and operation of law become the property of the owner of the Land. The Ground Lease between GEPT and MLBC was at an annual rate of $77,000.00, which was equivalent to interest at the rate of 5½% on the $1,400,000.00 advance to purchase the Land. At the end of 30 years and 10 days GEPT would have unencumbered legal title to the property comprised of the Land and the building. Since it was petitioner who desired to own the Land and building at the end of the Ground Lease, petitioner and GEPT simultaneously entered into a purchase agreement requiring petitioner to acquire the land 30 years later in 1990 upon termination of the Ground Lease for $1,400,000.00, the same acquisition cost established in the 1960 transaction.

In order for MLBC to construct the building on the Land, it required additional financing of $6,750,000.00. GEPT (as mortgagee) agreed (pursuant to the Consolidation, Extension, Modification and Spreading Agreement dated March 1, 1960) to loan this amount to MLBC (as mortgagor) based on the credit of petitioner since it was petitioner's funds that would ultimately repay the debt through its rental obligation. Thus, GEPT loaned $6,750,000.00 to MLBC secured by a mortgage (the "Leasehold Mortgage") on MLBC's Ground Lease and required MLBC to re-lease the entire building to petitioner (the "Building Lease"). According to petitioner, the Building Lease required an annual rental equivalent to the ground rent described above plus the Leasehold Mortgage debt service and other items, including real estate taxes. In the event of refinancing of the Leasehold Mortgage, the Building Lease incorporated a rental adjustment to maintain equality with the debt service. Petitioner claims that, as a result of the fact that MLBC pledged the Building Lease to GEPT as further security for the Leasehold Mortgage, petitioner became directly and unconditionally obligated to make payments to GEPT of all expenses of the property as well as amounts due under the Leasehold Mortgage and Ground Lease.

As petitioner described the transactions proposed in its petition for approval of the New York Superintendent of Insurance, petitioner indicated that it desired an arrangement under which it could expand into areas of a site location as its growth required. However, the agreements obligated petitioner to pay rent and occupy the entire building. In order to compromise these competing factors, petitioner entered into an arrangement with MLBC which provided MLBC an opportunity to profit. Petitioner subleased the entire building back to MLBC (the "Sublease"), who in turn leased the majority of the building to petitioner and the remainder to unrelated third parties with terms identical to that of the Building Lease requiring MLBC to pay petitioner exactly that which petitioner was obligated to pay MLBC under the Building Lease. MLBC's opportunity to profit existed if it was able to attract tenants other than petitioner who would pay rent at levels higher than that which was to be paid by MLBC under the Sublease. The components of the form of the transaction and the flow of the funds was as follows:

(a) funds received by MLBC from the rental of a portion of the building to unrelated third parties and petitioner would be paid by MLBC to petitioner pursuant to the Sublease;

(b) in form such funds would be paid from petitioner to MLBC under the Building Lease; and

(c) then flow from MLBC to GEPT and others for the expenses of maintaining the property, such as for payment of the debt service and real estate taxes. In reality, GEPT sought payment from petitioner directly, bypassing MLBC.

It is noted that petitioner's cost to occupy the building was not set at a market rate of rent. In fact, petitioner rented the space for approximately $4.00 per square foot as a result of the March 1960 transactions when it would have otherwise had to pay $4.75 per square foot.

Another simultaneous agreement entered into in March 1960 was established to pay MLBC a fee for developing the property. This agreement between petitioner and MLBC provided that upon the acquisition by petitioner of legal title to the property petitioner would enter into a new ground lease (the "Second Ground Lease") with MLBC for an initial term of 20 years at an annual rent of $140,000.00 plus 50% of the annual net income from the building. Petitioner asserts that MLBC's right to 50% of the net income for a predetermined period represented compensation to MLBC.

In 1975 MLBC defaulted under the Sublease and filed for bankruptcy. Petitioner's rights under the agreement entitled it to accelerate the purchase of land under the Purchase Agreement with GEPT. Petitioner and MLBC settled the matter by entering into a Joint Venture Agreement dated May 24, 1976 which was deemed effective October 1, 1975 and was to supersede the Building Lease and the Sublease to the extent of any inconsistencies. Although the Joint Venture Agreement provided that petitioner and MLBC would be required to make equal contributions to cover expenditures of the building, if in fact MLBC failed to make its required contribution, petitioner was required to advance amounts due and thereafter to be paid therefor (with interest) from the interest of MLBC in all future distributions that would have been payable to MLBC under such agreement. Petitioner waived further rights against MLBC for its failure to make required contributions. From October 1, 1975 to the dissolution of such agreement on September 9, 1986, only petitioner made cash contributions to the Joint Venture. Petitioner claims to have incurred a primary and direct legal obligation to satisfy all obligations of the property in lieu of its obligations under the Building Lease. Petitioner asserts that it acquired a "beneficial interest" in the property and directly assumed liability for the Leasehold Mortgage (the balance of which was $4,478,288.00) and all other debts and expenses under the terms of the Joint Venture Agreement. The termination of the Joint Venture Agreement was

March 10, 1990 and upon termination MLBC was obligated to convey its interest in the property to petitioner at no cost.

In 1986 petitioner paid MLBC $3,342,400.00 in exchange for all of its rights, title and interest in the Joint Venture Agreement, the Land and the building. Petitioner obtained the ground lease position and title to the building subject to the Purchase Agreement and Leasehold Mortgage. On November 26, 1986, petitioner acquired legal title to the Land from GEPT in accordance with the Purchase Agreement for $1,300,000.00. GEPT had agreed to accelerate the closing date from the original proposed date of March 1, 1990 and discount the purchase price from $1,400,000.00 to $1,300,000.00. Petitioner subsequently sold the property to RREEF USA Fund III ("RREEF") in December 1986 for $48,333,000.00. When petitioner filed its gains tax documents with reference to the sale of 125 Maiden Lane to RREEF, petitioner calculated its total original purchase price in the amount of $9,120,628.00 for gains tax purposes as follows:

(a) $4,478,228.00 represented the outstanding balance of the Leasehold Mortgage as of October 1, 1975;

(b) $3,342,400.00 represented funds paid to MLBC in exchange for its interest in the building in 1986; and

(c) $1,300,000.00 was the amount paid by petitioner to acquire legal title to the Land from GEPT.

The basis for the parties' disagreement relates to the amount of the Leasehold Mortgage properly includable in original purchase price. The Division allowed $1,423,811.54 of the Leasehold Mortgage in petitioner's original purchase price which was equivalent to the outstanding balance of such debt as of the date petitioner acquired legal title in August 1986. The disallowed portion in the amount of $3,054,416.46 represented that portion of the mortgage balance outstanding as of October 1, 1975 which was amortized through payments by petitioner between 1975 and 1986.

MLBC carried the building as an asset on its balance sheet and depreciated the building for income tax purposes at all relevant times prior to the transfer of the building to petitioner in 1986. Petitioner took no depreciation expense deductions with respect to the building for income tax purposes until after it acquired legal title to the building in 1986.

Petitioner took no interest deductions attributable to the amortization of the mortgages encumbering the Land and building for income tax purposes until after it acquired legal title to the Land and building in December 1986.

Transferor and transferee questionnaires were properly issued by petitioner and RREEF in accordance with the sale between petitioner and RREEF dated December 5, 1986. On December 16, 1986 a Tentative Assessment and Return was computed by the Division based on the filing of such questionnaires indicating total gains tax due of $3,782,888.10. A post-audit review of the information provided with the questionnaires reporting the transfer of 125 Maiden Lane indicated the following:

> "The Joint Venture Agreement between U.S. Life and 125 Maiden Lane Bldg. Co. provides that '[e]ach joint venturer shall retain the basis that it now has in the Joint Venture property'. Based on the foregoing, the claimed mortgage assumption of $4,478,228.00 by U.S. Life, has been disallowed."

A Statement of Proposed Audit Changes dated October 30, 1989 was issued assessing additional tax of $447,822.80,[1] plus interest in the amount of $124,516.43, for a total amount assessed of $572,339.23. Subsequently, on December 26, 1989, the Division issued to petitioner a notice of determination assessing additional tax due of $305,441.65, plus interest in the amount of $92,888.72, for a total amount assessed of $398,330.37.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner's primary position is that the property was transferred to petitioner for purposes of gains tax in 1960 and that from that point in time petitioner's status was that of a contract vendee in possession. Petitioner asserts that the transaction in substance was a

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[1]This amount represented tax on the claimed mortgage assumption by petitioner of $4,478,228.00 which the Division disallowed. It was adjusted before the issuance of the notice to reflect the fact that the Division ultimately allowed $1,423,811.54 of the Leasehold Mortgage in original purchase price (balance in August 1986).

disguised installment sale of the property and that petitioner must be treated as acquiring the property in 1960 for $11,492,400.00[2] comprised of the following:

Purchase Agreement Purchase Price	$ 1,400,000.00
Assumption of Leasehold Mortgage	6,750,000.00
Cash Obligation to MLBC	3,342,400.00
	$11,492,400.00

Petitioner believes the same result is reached if Tax Law § 1440.4 is properly applied in this case and the transfer of property for gains tax purposes acknowledges the "beneficial interest" that petitioner obtained in the property at 125 Maiden Lane.

In the alternative, petitioner argues that if it is determined that petitioner was not a beneficial owner of the property in 1960, petitioner clearly acquired the beneficial interest in the property upon execution of the Joint Venture Agreement from its effective date of October 1, 1975. At that time, the outstanding balance on the Leasehold Mortgage was $4,478,228.00. Petitioner asserts that such balance must be included in original purchase price.

The Division maintains that petitioner is not entitled to include in original purchase price any amounts paid by petitioner prior to its acquisition of legal title to the property. The Division asserts that this matter does not turn on whether petitioner possessed a beneficial interest in the property. The Division notes that the assertion that petitioner became owner of the property on March 1, 1960 is inconsistent with the manner in which the property was treated by the parties for tax purposes. The Division maintains that the Joint Venture Agreement did not vest ownership of the property in petitioner and that clearly petitioner did not "acquire an interest in real property" at that time in order to enable it to claim the mortgage balance as of October 1, 1975 as a component of original purchase price.

CONCLUSIONS OF LAW

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

[2] Petitioner's brief asserts original purchase price should be $11,392,400.00; however, the components total $11,492,400.00.

which is defined as a "transfer . . . of any interest in real property by any method . . ." (Tax Law § 1440.7). "Interest" in real property includes the following:

> "title in fee, a leasehold interest, a beneficial interest, an encumbrance, a transfer of development rights or any other interest with the right to use or occupancy of real property or the right to receive rents, profits or other income derived from real property. Interest shall also include an option or contract to purchase real property." (Tax Law § 1440.4.)

This matter centers around a component of original purchase price, which the Tax Law defines, in pertinent part, as "the consideration paid or required to be paid by the transferor . . . to acquire the interest in real property . . ." (Tax Law § 1440[5]).

B. The transactions herein were structured such that, at the termination of the Ground Lease, petitioner would receive legal title to the property at a price equal to the cost 30 years earlier and GEPT would receive back the $1,400,000.00 it advanced to MLBC. Any appreciation in the value of the building inured to petitioner's benefit. Petitioner argues that GEPT was nothing more than a lender and the Ground Lease, taken with the Purchase Agreement, was a financing device to accomplish petitioner's goals. Petitioner was in possession of the building under the Building Lease where its obligation was equal to the total of principal and interest payments to GEPT under the loan to construct the building, MLBC's Ground Lease payments, plus other expenses of operating the business. In fact, petitioner paid amounts due under the Building Lease (between MLBC and petitioner) directly to GEPT with no payments passing through MLBC. Petitioner asserts after 30 years when the leases terminated and the Purchase Agreement with GEPT was met, petitioner would have been entirely responsible for the cost of operating the property, repaying the land acquisition cost (by fulfilling the Ground Lease obligations), and extinguishing the construction loan (by satisfying the Leasehold Mortgage), with the ultimate result of clear and free title. Petitioner suggests that in evaluating this arrangement the interaction of the various documents must be considered. Petitioner notes that if it were in default under the Building Lease, GEPT would not be obligated to perform under the Purchase Agreement. Petitioner asserts GEPT held legal title only as security for repayment of its advance and if certain amounts were not repaid pursuant to the Building Lease, GEPT would not have to release its security. In addition, it is noted that the documents provide that in the event of a complete condemnation of the property, GEPT would be entitled only to the first $1,400,000.00 of proceeds in spite of its legal title and any remainder would be applied toward repayment of the Leasehold Mortgage. Thereafter, petitioner would receive any proceeds. Had GEPT been the true owner of the property, it would have received all proceeds.

C. Petitioner has presented a unique situation where the substance of the transaction must be carefully reviewed in light of the form in which it was structured. The Tax Appeals Tribunal has held:

> "The focus of the gains tax through entities to determine the beneficial ownership of real property is evidenced both by the imposition provisions of the statute and by its exemptions" (Matter of 307 McKibbon Street Realty Corp., Tax Appeals Tribunal, October 14, 1988; Matter of Howes, Tax Appeals Tribunal, September 22, 1988).

Petitioner asserts as one of its arguments that it possessed a beneficial interest in the property when the intricate web of intertwined agreements dated March 1, 1960 were simultaneously executed. The Division claims that the resolution of this matter does not turn on whether and to what extent petitioner possessed a beneficial interest in the property. The Division seeks to limit the inquiry into the beneficial interest to a situation where it is necessary to "look through" entities to determine which person(s) or entity owns the real property (citing, 307 McKibbon and Howes, supra). The Division is correct in stating that this matter does not present a situation where petitioner owns an entity which owns real estate such that an analysis of the tiers is determinative. Insomuch as the statute and regulations do not further define "beneficial interest", however, I believe petitioner has properly applied this concept in its assessment of gains tax liability. These interdependent agreements effectuated petitioner's goal to acquire a proprietary interest that insurance regulations would not directly permit. In fact, in its petition for approval of the Superintendent of Insurance it sets forth its goal as "to enter into a contract for the purchase of the land at 125 Maiden Lane." Petitioner has established that its enjoyment, use and occupancy of the property would have been substantially similar had it held legal title to the building commencing March 1, 1960 and, as such, has established that it maintained a "beneficial interest" from that date forward. In addition, petitioner enjoyed a more than $30,000,000.00 profit from the sale in 1986, indicating that it was clearly understood by all parties that from 1960 forward petitioner had all the benefits and burdens of ownership. Thus, petitioner shall be treated as acquiring the property at 125 Maiden Lane in 1960 for purposes of the calculation of gains tax, with an original purchase price of $11,492,400.00 as set forth by its components in Paragraph "14", reduced by the $100,000.00 discount negotiated with GEPT.

D. A discussion regarding the characterization of the transactions as petitioner argues in the alternative is deemed unwarranted in light of Conclusion of Law "C".

E. The petition of United States Life Insurance Company in the City of New York is hereby granted and the notice of determination dated December 26, 1989 is hereby cancelled and any modifications to the gains tax assessment and refund pursuant to Conclusion of Law "C" shall be made accordingly.

DATED: Troy, New York
March 25, 1993

/s/ Catherine M. Bennett
ADMINISTRATIVE LAW JUDGE