STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : | |
| of | : | |
| **330 THIRD AVENUE OWNERS' CORP.** | : | DETERMINATION<br>DTA NO. 809615 |
| for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Year 1986. | : | |

Petitioner, 330 Third Avenue Owners' Corp., c/o Edward M. Virshup, 330 Third Avenue, New York, New York 10010, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the year 1986.

On November 22, 1995 and December 4, 1995, respectively, petitioner, appearing by Martin A. Stoll, Esq., and the Division of Taxation, appearing by Steven U. Teitelbaum Esq. (Vera R. Johnson, Esq., of counsel) consented to have the controversy determined on submission without hearing. On January 9 and 11, 1996 the Division of Taxation submitted documentary evidence. On February 13, 1996 the parties submitted a stipulation of facts. On February 16, 1996 petitioner submitted documents and a brief. On March 13, 1996 the Division of Taxation submitted a brief. On March 27, 1996 petitioner submitted a reply brief. Accordingly, the six-month period for the issuance of this determination began on March 27, 1996. After due consideration of the record, Timothy J. Alston, Administrative Law Judge, renders the following determination.

## *ISSUES*

I. Whether petitioner, a cooperative housing corporation as defined in section 216(b)(1) of the Internal Revenue Code ("IRC"), is a "membership organization" within the meaning of IRC § 277(a).

II. Whether petitioner is "operated primarily to furnish services or goods" within the meaning of IRC § 277(a).

III. Whether petitioner is subject to Subchapter T of the Internal Revenue Code.

IV. Whether, assuming petitioner is subject to IRC § 277(a), a portion of the New York depreciation deduction otherwise allowable should be disallowed as a consequence of the application of the principles of IRC § 277(a) and Revenue Ruling 90-36.

## *FINDINGS OF FACT*[1]

1.Petitioner, 330 Third Avenue Owners' Corp., was incorporated on March 31, 1982 under the Business Corporation Law of the State of New York.

2. During 1989 the Division of Taxation ("Division") commenced a franchise tax audit of petitioner's books and records for 1986.

3. Petitioner filed a 1986 New York State corporation franchise tax report (Form CT-3) on a calendar year basis.

4. Petitioner filed a 1986 Federal corporation income tax return (Form 1120) on a calendar year basis.

5. Petitioner's 1986 Form 1120 reported Federal taxable income (loss), before an allowance for a net operating loss deduction carryover, of ($384,247). Such loss of ($384,247) did not reflect the adjustments required by Section 277 of the Internal Revenue Code of 1986, as amended ("IRC § 277"), to be made by certain organizations.

6. Petitioner reported on its 1986 Form 1120 deductions of $1,423,009 which included a deduction $516,733 for accelerated cost recovery system depreciation ("ACRS Depreciation") pursuant to Section 168 of the Internal Revenue Code, and a deduction of $4,993 for New York State franchise tax (the "NYS Tax").

7. Petitioner reported on line 29 of its 1986 Form CT-3 an allowable depreciation deduction of $316,479 (the "NYS Depreciation").

8. In two statements of audit adjustment, dated August 10, 1989, the Division recomputed petitioner's 1986 franchise tax and metropolitan transportation business tax liabilities and determined deficiencies for 1986, as follows:

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[1]The facts set forth in the stipulation submitted by the parties in this matter are incorporated herein.

| | | |
|---|---|---|
| Federal taxable income before net operating loss deduction | | $(384,247) |
| Total deductions in computing Federal taxable income | $ 1,423,009 | |
| Total deductions allowed to the extent of membership income | (1,002,846) | |
| Excess membership deductions | | 420,163 |
| Federal taxable income required to be shown on report | | $ 35,916 |
| Add: New York State franchise tax deducted on Federal return | $ 4,993 | |
| ACRS depreciation | 516,733 | 521,726 |
| Total additions | | $ 557,642 |
| Subtract: Allowable New York depreciation | | (316,479) |
| Adjusted entire net income | | $ 241,163 |
| | | |
| Tax at 10% | | $ 24,116 |
| Tax per report | | (3,972) |
| Deficiency | | $ 20,144 |
| Metropolitan transportation business tax deficiency | | 3,424 |
| Total deficiencies | | $ 23,568 |

9. In one of the statements of audit adjustment the Division advised petitioner of the basis for adjusting its tax liabilities, as follows:

> "Section 208.9(a), of Article 9-A, provides in pertinent part - entire net income is presumed to be the same as taxable income which the taxpayer is required to report to the United States Treasury Department, subject to certain modifications.
>
> "Section 277 of the Internal Revenue Code limits the membership expenses (deductions) in computing federal taxable income, to the extent of membership income."

10. As a result of the audit, the Division issued to petitioner notices of deficiency numbered C890810712N and C890810713M, dated October 2, 1989, which asserted deficiencies in franchise tax and metropolitan transportation business tax totalling $23,568, plus interest, for tax year 1986.

11. The notices of deficiency are premised on the proposition that IRC § 277 applies to petitioner. They assert the same $23,568 of deficiencies as set forth in the statements of audit adjustment.

12. Petitioner filed a request for a conference with the Bureau of Conciliation and Mediation Services (the "BCMS") within 90 days of the issuance of the notices of deficiency,

and a Conciliation Order was issued on February 22, 1991 which reduced the deficiencies asserted in the statutory notices to a total of $6,059.

13. Based on a Federal taxable income of $9,978 determined pursuant to IRC § 277, BCMS revised petitioner's 1986 NYS tax liability by determining an adjusted New York State entire net income of $97,330, as follows:

| | |
|---|---|
| Federal taxable income required to be shown on report | $ 9,978 |
| Add: NYS and local taxes ($4,993 x 61.119%) | 3,122 |
| ACRS depreciation ($516,733 - $18,602 (commercial) x 61.119% + $18,602) | 323,055 |
| Less: NY depreciation ($316,479 - $11,393 (commercial) x 74.547% + $11,393) | (238,825) |
| Adjusted entire net income | $ 97,330 |

14. Based on the calculation of New York State entire net income of $97,330, BCMS determined that petitioner's tax liabilities, and deficiencies, for 1986 were as follows:

| | |
|---|---|
| Franchise tax at 10% | $ 9,733 |
| Met. trans. bus. tax | 978 |
| Total taxes | $10,711 |
| Taxes per report | (4,652) |
| Deficiencies | $ 6,059 |

15. After the Division's audit, petitioner submitted additional evidence upon which BCMS revised petitioner's tax liability. Pursuant to those revisions, petitioner's gross income of $1,038,762 that was reported on its 1986 Form 1120 consisted of income of $970,246 from its tenant-stockholders, income of $32,600 from its commercial lessees, and interest income of $35,916.

16. During 1986 petitioner owned and operated an apartment building at 330 Third Avenue in New York City which, in addition to containing dwelling units leased to tenant-stockholders, also contained a garage and a laundry room leased to two unrelated lessees for commercial purposes to provide garage and laundry services to the tenant-stockholders. During 1986 petitioner received rent from its tenant-stockholders and the two commercial lessees, and interest income.

17. During 1986 petitioner was a "cooperative housing corporation" within the meaning of Section 216(b)(1) of the Internal Revenue Code of 1986, as amended.

18. Based on the BCMS revisions, and the parties' agreement, the expense items listed below that were deducted on petitioner's 1986 Form 1120 should be classified as follows, if IRC § 277 applies to petitioner:

| Deductions | Form 1120 Total | Allowable Membership | Allowable Commercial | Disallowed |
|---|---|---|---|---|
| R/E tax | $ 280,814 | $270,705 | $10,109 | $ -0- |
| Interest | 82,830 | 79,848 | 2,982 | -0- |
| Depreciation | 516,733 | 288,045 | 45,447 | 183,241 |
| Franchise tax | 4,993 | 3,051 | -0- | 1,942 |
| Gas/elec. | 38,979 | 23,823 | -0- | 15,156 |
| Fuel | 49,685 | 30,367 | -0- | 19,318 |
| Water/sewer | 18,866 | 11,530 | -0- | 7,336 |
| Payroll | 251,550 | 153,744 | -0- | 97,806 |
| Misc. | 178,559 | 109,133 | -0- | 69,426 |
| | $1,423,009 | $970,246 | $58,538 | $394,225 |

19. If IRC § 277 applies to petitioner, (a) the Federal taxable income required to be shown on petitioner's 1986 Form 1120 would have been $9,978, which $9,978 amount was set forth in the Conciliation Order, and (b) petitioner's 1986 Form 1120 would have reflected the following income and allowable deductions in arriving at such $9,978 of Federal taxable income:

| | | |
|---|---|---|
| Income: | | |
| Tenant-stockholders | $970,246 | |
| Commercial lessees | 32,600 | |
| Interest | 35,916 | $ 1,038,762 |
| Deductions: | | |
| R/E tax | $280,814 | |
| Interest | 82,830 | |
| Depreciation | 333,492 | |
| Franchise tax | 3,051 | |
| Gas/elec. | 23,823 | |
| Fuel | 30,367 | |
| Water/sewer | 11,530 | |
| Payroll | 153,744 | |
| Misc | 109,133 | (1,028,784) |
| IRC § 277 1986 Federal taxable income | | $ 9,978 |

20. If IRC § 277 applies to petitioner, the amount of petitioner's allowable and disallowed deductions for New York State tax and ACRS Depreciation would be as follows:

NYS Tax:

| | |
|---|---|
| Reported on Form 1120 | $ 4,993 |
| Allowable under IRC § 277 | (3,051) |
| Disallowed under IRC § 277 | $ 1,942 |

ACRS Depreciation:

| | |
|---|---|
| Reported on Form 1120 | $ 516,733 |
| Allowable under IRC § 277 | (333,492) |
| Disallowed under IRC § 277 | $ 183,241 |

21. In determining the amount of petitioner's 1986 New York State entire net income, based on the BCMS revisions and the parties' agreement that the expense items should be classified as set forth in Finding of Fact "18", above, the Division subsequently made the following adjustments to petitioner's $9,978 of 1986 IRC § 277 Federal taxable income:

| | | |
|---|---|---|
| Federal taxable income required to be shown on Form 1120 | | $ 9,978 |
| Add: | | |
| NYS Tax | $ 3,051 | |
| ACRS Depreciation | 333,492 | 336,543 |
| Subtract: NYS Depreciation | | (243,010) |
| NYS entire net income | | $ 103,511 |

22. While the Division's New York State entire net income amount exceeds the entire net income figure upon which the BCMS order was based ($103,511 rather than $97,330), the Division does not assert a deficiency in the instant case greater than the deficiency set forth in the Conciliation Order.

23. Petitioner timely filed a petition with the Division of Tax Appeals within 90 days of the issuance of the Conciliation Order.

24. On October 15, 1991 petitioner made a payment to the New York State Income Tax Bureau (the "Bureau") in the amount of $9,427.12, representing the $6,059 of deficiencies set forth in the Conciliation Order, plus interest through the date of payment of $3,368.12.

25. In a letter dated September 27, 1993 the Office of Counsel confirmed that it would not object to petitioner's amending the pleadings in the instant case to show that petitioner now seeks a refund of the $9,427.12 payment previously made by it.

26. Petitioner's certificate of incorporation provides, in part, the following with respect to the purposes for which petitioner was formed:

> "The primary purpose of this Corporation is to provide homes for its shareholders by leasing to them, under leases known commonly as proprietary leases, apartments in the building or buildings on such premises and all of its shareholders shall be entitled solely by reason of their share ownership in the Corporation to proprietary leases, entitling them to occupy for dwelling purposes, apartments in the building or buildings."

27. Similarly, petitioner's by-laws provide the following with respect to the purposes for which petitioner was formed:

> "The primary purpose of the Corporation is to provide residences for shareholders who shall be entitled, solely by reason of their ownership of shares, to proprietary leases for apartments in 330 Third Avenue, New York, New York."

28. Petitioner's board of directors allocates shares to each apartment in petitioner's building. The proprietary lessee of an apartment in the building must own the number of shares allocated to the lessee's apartment.

29. Petitioner's stockholders are entitled to one vote per each share of stock owned. Petitioner's stockholders may cast such votes either in person or by proxy. There is no limit as to the number of shares an individual stockholder may acquire.

30. Petitioner's tenant-stockholders were not required to occupy their apartments. With the consent of the board of directors such persons could sublet their apartments. The consent of the board of directors was also required to sell shares of petitioner's stock or to assign a proprietary lease.

31. The operation of petitioner was vested in a board of directors. Members of petitioner's board were not required to be shareholders.

32. Petitioner's standard proprietary lease provided the following with respect to services to be provided by petitioner as lessor, under the lease:

"Services by Lessor. The Lessor shall maintain and manage the building as a first-class apartment building, and shall keep the elevators and the public halls, cellars and stairways clean and properly lighted and heated, and shall provide the number of attendants requisite, in the judgment of the Directors, for the proper care and service of the building, and shall provide the apartment with a proper and sufficient supply of hot and cold water and of heat, and if there be central air conditioning equipment supplied by the Lessor, air conditioning when deemed appropriate by the Directors. The covenants by the Lessor herein contained are subject, however, to the discretionary power of the Directors to determine from time to time what services and what attendants shall be proper and the manner of maintaining and operating the building, and also what existing services shall be increased, reduced, changed, modified or terminated."

## *CONCLUSIONS OF LAW*

Issue I

A. Among the four bases used in the computation of the corporation franchise tax imposed under Tax Law § 209(1) is the entire net income base (see, Tax Law § 210[1]). Tax Law § 208(9) provides that "entire net income . . . shall be presumably the same as the entire taxable income which the taxpayer is required to report to the United States treasury department" subject to certain additions, including amounts allowable for recovery property as the ACRS deduction pursuant to Internal Revenue Code § 168 (see, 20 NYCRR 3-2.3[a][17]). Federal taxable income is the starting point in computing entire net income (20 NYCRR 3-2.2[b]).

B. In determining Federal taxable income, Internal Revenue Code § 277(a) provides, in pertinent part, that:

"In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members, and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members. . . . If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year." (Emphasis added.)

C. The deficiency at issue herein, as modified by the Conciliation Order dated February 22, 1991, results from the Division's determination that petitioner is a "membership organization" subject to the deduction deferral provisions of Internal Revenue Code § 277(a). Pursuant to this section, the Division determined petitioner's Federal taxable income for

purposes of applying Tax Law § 208(9) by limiting petitioner's deductions to its membership income.

D. Petitioner argued that it was not subject to section 277 because it was not a "membership organization" within the meaning of that section.[2] In Matter of Beechwood Gardens Owners, Inc., Tax Appeals Tribunal, May 25, 1995) the Tribunal held that a cooperative housing corporation was a membership organization within the meaning of IRC § 277(a). With respect to this issue, the facts of Beechwood Gardens do not differ significantly from the facts herein. Consequently, since this specific issue was "presented, considered and squarely decided" by the Tribunal, Beechwood Gardens is binding precedent and compels the finding that petitioner was a "membership organization" within the meaning of IRC § 277(a) (see, People v. Bourne, 139 AD2d 210, 531 NYS2d 899, 902-903 citing Empire Square Realty Co. v. Chase Nat. Bank of the City of New York, 181 Misc. 752, 43 NYS2d 470, affd 267 App Div 817, 47 NYS2d 105, appeal denied 267 App Div 901, 48 NYS2d 325).

Issue II

E. Petitioner also contended that it was not properly subject to IRC § 277 because it was not "operated primarily to furnish services or goods" within the meaning of said section. This contention is important because in order to be subject to IRC § 277 a "membership organization" must be "operated primarily" for such a purpose. This question was not presented to the Tribunal in Beechwood Gardens. Accordingly, Beechwood Gardens is not controlling with respect to this issue. Additionally, this question was not presented to the Tax Court in Concord Consumers Housing Cooperative v. Commr., 89 T.C. 105 [1987], a case deemed "persuasive" by the Tribunal in Beechwood Gardens. In this regard, it is noted that the Tax Court in that case did comment briefly on the question in a footnote stating that, although no issue had been raised as to the applicability of section 277, "the record does not suggest that petitioner is other than an organization described in section 277" (id. at 116). However, since

[2]Petitioner also asserted that it was not a "social club" within the meaning of IRC § 277(a). Since the Division did not assert that petitioner was such a social club, this determination addresses only the membership organization question.

the issue was not argued by the parties in Concord Consumers Housing nor squarely addressed by the Tax Court, this gratuitous statement is properly given little weight herein.

F. It is well-established that "the words of statutes - including revenue acts - should be interpreted where possible in their ordinary, everyday senses." (Crane v. Commr., 331 US 1, 6, 91 L Ed 1301, 1306.) Pursuant to this principle the term "primarily" has been determined to mean "of first importance" or "principally" (Malat v. Riddell, 383 US 569, 572, 16 L Ed 2d 102, 105, cf., The Synanon Church v. Commr., 57 TCM [CCH] 602 [1989], [where section 277 was held not to apply where the provision of services and goods was only an "incidental part" of the taxpayer's operations.]). Similarly, as petitioner correctly asserts, the term "services" may be properly defined in the present context as "useful labor that does not produce a tangible commodity" (Webster's Ninth New Collegiate Dictionary, 1989, p. 1076). Additionally, the term "goods" is defined in Webster's Ninth New Collegiate Dictionary (1989) at page 527, as "personal property having intrinsic value but usu. excluding money, securities and negotiable instruments" and, in the plural, as "wares, commodities, merchandise".

G. The facts of this matter indicate clearly that petitioner is not "operated primarily to furnish services or goods" within the generally accepted meaning of those terms as discussed above. IRC § 277 therefore does not apply to petitioner.

Specifically, as stated in both its certificate of incorporation and its by-laws, petitioner's "primary purpose" was to provide "homes" or "residences" for its shareholders (see, Findings of Fact "26"and "27"). The method by which petitioner accomplished this purpose was, first, to acquire, hold, operate and manage the building at 330 Third Avenue. The legal mechanism by which petitioner provided residences to its shareholders was the issuance of shares. Ownership of such shares entitled shareholders to proprietary leases, which, in turn, entitled such shareholders to occupy, for dwelling purposes, apartments in the building. There can be little doubt that a cooperative housing corporation such as petitioner would exist but for its purpose as a vehicle to provide shareholders with ownership interests in real property. That petitioner's primary purpose is the provision of residences to its shareholders is further evidenced by the

fact that $970,246 of $1,038,762 or 93.4 per cent of petitioner's gross income during the year at issue was derived from amounts paid by shareholders as rent pursuant to proprietary leases (see, Finding of Fact "15").

Since petitioner was operated primarily to provide residences to its shareholders, the next question to be addressed is whether petitioner's provision of such residences may properly be characterized as "goods" or "services". Clearly, the answer to this question is no.

An interest in a cooperative apartment combines aspects of both personal property and real property; that is, the interest is represented by stock (personal property), but the economic reality, represented by the proprietary lease, is that what is owned is the right to occupy real property (see, Matter of Estate of Carmer, 71 NY2d 781, 784, 530 NYS2d 88, 89). Proper characterization of such an interest thus depends on which aspect of the interest predominates in a particular case (id. 71 NY2d at 785, 530 NYS2d at 89). In the context of IRC § 277, which is concerned with what is "furnish[ed]" to "members", it is appropriate to focus on the economic reality aspect of what is owned by petitioner's shareholders and to characterize such interests as real property interests (cf., Grenader v. Spitz, 537 F2d 612, 617-620, cert denied, 429 US 1009, 50 L Ed 2d 619).

Since petitioner was operated primarily to provide real property interests to its shareholders, it follows that petitioner was not operated primarily to provide services or goods to its shareholders since a real property interest is neither a service nor a good within the commonly accepted meaning of those terms. In this regard it is noted that Revenue Ruling 90-36, relied upon by the Division in making its determination on audit and on brief, states summarily that "a cooperative housing corporation furnishes housing and maintenance services to its tenant-shareholders." "A revenue ruling, without more, of course, is simply the contention of one of the parties to the litigation, and is entitled to no greater weight." (Estate of Lang v. Commr., 64 TC 404, 407 [1975].) Since the Ruling offers no explanation for this statement and since, as discussed, the plain meaning of the language of the statute provides to the contrary, this determination declines to follow Revenue Ruling 90-36.

It is further noted that, obviously, petitioner did "service", i.e., repair and maintain, its property. Such repair and maintenance obligations are referenced in the proprietary lease (see, Finding of Fact "32"). This fact, however, does not mean that petitioner provided "housing services" to its shareholder-tenants. Such services were performed as part of petitioner's duties and obligations as the owner/lessor of the property. Indeed, the fact that petitioner's obligations are set forth in the proprietary lease indicates that an interest in real property is what petitioner's tenant/shareholders received from petitioner. As noted by petitioner in its brief, services performed by petitioner are analogous to maintenance services performed by a landlord on property leased to a tenant. Such a landlord is not a provider of housing services. Rather, like petitioner, the landlord provides tenants with an interest in real property and, as part of the transaction, the landlord may agree to maintain the property in good repair.

H. The lack of a specific reference to real property or the use of real property in the language of IRC § 277 also indicates that this section is not applicable to cooperative housing corporations such as petitioner. As noted by petitioner on brief, Congress has used the term "facilities" along with the terms "services" and "goods" to explicitly show that a provision is applicable to real property (see, e.g., IRC § 512[a][3][B]). No such language is present in section 277. Moreover, as noted by petitioner, IRC § 512(a)(3) was enacted along with § 277 as part of the Tax Reform Act of 1969 (see, Pub. L. No. 91-172, § 121[b][1][3], 83 Stat 487 [1969]) and IRC § 512(a)(3)(B) contains the phrase "goods, facilities or services". These circumstances support the conclusion that Congress chose not to include the term "facilities" in IRC § 277 and thereby chose not to extend coverage of this statute to organizations, such as petitioner, operated primarily to provide housing or real property interests to members.

I. Additionally, as petitioner correctly notes, that cooperative housing corporations were not intended by Congress to fall within the purview of IRC § 277(a) may also be seen by examining IRC § 216, the regulations promulgated thereunder and the policy objectives of IRC §§ 216 and 277.

Section 216(a) of the Internal Revenue Code allows tenant-shareholders of a cooperative housing corporation to deduct their proportionate share of the corporation's real estate taxes and mortgage interest. Eligibility for such deductions depends upon the corporation's qualification as a cooperative housing corporation under the statute, which requires, inter alia, that at least 80 per cent of the corporation's gross income be derived from tenant-shareholders (see, IRC § 216[b][1][D]). Obviously, then, it was the intent of Congress to allow cooperative housing corporations to derive up to 20 per cent of their income from non-tenant-shareholders. Moreover, where a cooperative housing corporation has non-tenant-shareholder income, IRC § 216(a) and the regulations (Treas Reg § 1.216-1[a], [b] and [h] [example 2]) reduce the tenant-shareholders' deductible proportionate share of the cooperative housing corporation's real estate taxes and interest.

"The tax policy objective of section 277 . . . is to preclude 'a social club or other membership organization' from avoiding tax on its investment or other outside income by conducting its membership activities at a loss." Buckeye Countrymark, Inc. v. Commr., 103 TC 547 [1994]. As may be observed, Section 216 and the regulations thereunder operate to effectuate the same purpose as IRC § 277. This is accomplished in two ways. First, the "80-20" rule of section 216(b)(1)(D) serves to sharply limit the amount of non-tenant-shareholder income that a cooperative housing corporation may earn. Second, section 216(a) and regulations subject non-tenant-shareholder (or non-membership) income to tax (see, Treas Reg § 1.216-1[b]). The difference between the taxation of such income under section 216 and section 277 is that section 216 taxes non-tenant-shareholder income at the shareholder level by reducing deductions. In contrast, of course, section 277 taxes nonmembership income directly at the organization level. Nonetheless, the outside income of the cooperative housing corporation does not escape taxation under IRC § 216.

Since section 216 contains mechanisms to correct the problem addressed by section 277 and since the predecessor to section 216 was enacted in 1942, long before the enactment of section 277 (see, S. Rep. No. 1631, 77th Cong., 2nd Sess. [1942]), it is reasonable to conclude

that cooperative housing corporations subject to the provisions of section 216 were not intended to be subject to IRC § 277.

Issue III

J. Alternatively, assuming that petitioner is an organization subject to IRC § 277(a), petitioner asserts that it qualifies as a non-exempt cooperative subject to the provisions of subchapter T of the Internal Revenue Code.[3] "If an entity is subject to the provisions of subchapter T, then it is not subject to section 277" (Trump Village Section 3, Inc. v. Commr., 69 TCM 2985, 2994 [1995]; see also, Buckeye Countrymark, Inc. v. Commr., supra).

IRC § 1381(a) specifies the organizations that are subject to subchapter T. Insofar as is relevant herein, said section lists "any corporation operating on a cooperative basis" as subject to subchapter T (IRC § 1381[a][2]). The application of this subchapter is not elective; that is, if a corporation is found to be "operating on a cooperative basis" then the provisions of subchapter T apply "as a matter of law" (Trump Village Section 3, Inc. v. Commr., supra at 2994).

K. A determination as to whether a corporation is "operating on a cooperative basis" is properly made based upon the following principles:

> "(1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor." (Puget Sound Plywood, Inc. v. Commr., 44 TC 305, 308 [1965].)

In asserting that petitioner is not governed by subchapter T, the Division contends that petitioner does not meet the subordination of capital and democratic control requirements listed above. For the reasons which follow, this determination agrees with the Division and finds that petitioner is not subject to subchapter T. It is noted that this determination does not address the third requirement listed above since this requirement was not contested by the Division.

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[3]Although the resolution of Issue II is dispositive of this matter, the remaining issues raised by the parties are addressed herein pursuant to Tax Appeals Tribunal policy (see, Matter of United States Life Insurance Co. in the City of New York, Tax Appeals Tribunal, March 24, 1994).

L. To demonstrate subordination of capital "limitations must be imposed upon the amounts that can be distributed with respect to the cooperative's stock, and control over the management and direction of the cooperative must be vested in the members of the cooperative, as opposed to its stockholders" (Trump Village Section 3, Inc. v. Commissioner, supra at 2995). In Puget Sound Plywood, supra, the corporation was organized by its worker-members who formed, controlled and operated a plywood production plant on a cooperative basis, for their mutual benefit. Each member of the cooperative was required to be a worker or potential worker as well as a shareholder (Puget Sound Plywood v. Commr., supra at 317-318). Ten shares of the association's stock were issued to each worker-member of the cooperative. The holding of such shares entitled the member to cast one vote at any meeting of the shareholders and to work as a member of the association. (Puget Sound Plywood v. Commr., supra at 314). Similarly, in Trump Village the tenants of the Trump Village housing project, like the Puget Sound Plywood workers, controlled and operated the cooperative enterprise (i.e., the housing project) for their mutual benefit. Each tenant in the Trump Village housing project (who was referred to in the occupancy agreement executed by each tenant as a "cooperator") was required to own shares of the petitioner's capital stock. This requirement insured that each tenant was a stockholder and that control over the operations of the housing project was in the hands of the tenants "by reason of their position as tenants in [the] housing project" (Trump Village Section 3, Inc. v. Commissioner, supra at 2995). The management of the Trump Village housing project was entrusted to a board of directors consisting of sixteen members. Fifteen members were elected by the stockholders and were required to be stockholders of the building who were residing or domiciled in the apartment building; the sixteenth member was appointed by the New York City Commissioner of Housing (id. at 2988).

Management and control of the apartment building owned by petitioner is not in the hands of petitioner's residents to the same extent that the Trump Village housing project was in the hands of its tenants. As with any business corporation, control of petitioner is in the hands of the stockholders who have a right to occupy an apartment by reason of their position as

stockholders. Unlike the Puget Sound Plywood workers or the Trump Village tenants, however, petitioner's shareholders and residents are not required by statute, by-laws or contract to be one and the same. Tenants of the apartment building are not required to be shareholders. Shareholders have a right to occupy an apartment but are not required to do so and are not prohibited from subletting (although the consent of the board of directors is required to sublet an apartment). Additionally, petitioner's by-laws do not require a director of petitioner to be a shareholder. Thus, the by-laws do not require that residents of the building even be represented on the board, much less guarantee that the building will be operated and controlled by its residents.

In addition, the principle of subordination of capital is not demonstrated by petitioner's certificate of incorporation or by-laws or any statute governing petitioner's operations. As petitioner points out, there were some limitations on a shareholder's rights of ownership. Most notably, the consent of the board of directors was required to sell shares of petitioner's stock, assign a proprietary lease or sublet under the proprietary lease. Additionally, under IRC § 216(b)(1)(C) no stockholder of a cooperative housing corporation is entitled to receive any distribution not out of earnings and profits, except on a complete liquidation of the corporation. However, the limitations arising from ownership of petitioner's stock are far less than are the limitations on the benefits of ownership accruing to Trump Village's stockholders. As noted, the requirement that each tenant be a stockholder effectively precludes a Trump Village stockholder from subleasing his or her apartment. Although petitioner's lessees must obtain the consent of the board of directors in order to sublet, they are not prohibited from doing so; an individual shareholder thus may profit from his or her investment by renting one or more apartments. The Trump Village stockholder's participation in the distribution of any surplus or property at the dissolution of the corporation is restricted by the Mitchell-Lama Act. In addition, the maximum price for which a Trump Village cooperator can sell his or her shares of stock is the price paid for the stock plus any capital contributions made to Trump Village and a proportionate share of certain debt (id. at 2988, 2996). Petitioner's shareholders do not have

similar limitations on the amount stockholders may receive upon the sale of their shares of stock or upon liquidation of the corporation. There is no limit on the financial return a shareholder may earn from contributed capital and no guarantee that the gains earned from the corporate enterprise will inure to the mutual benefit of the cooperative participants. Based on the above discussion, it is concluded that the first principle of cooperative theory, subordination of capital, is not present in petitioner's corporate structure.

M. Additionally, petitioner does not function under the principle of democratic control as contemplated by the court in Puget Sound Plywood, Inc. V. Commr., supra. In that case, the court stated that this principle is implemented "by having the worker-members themselves periodically assemble in democratically conducted meetings at which each member has one vote and one vote only, and at which no proxy voting is permitted" (id. at 308). The taxpayer in Puget Sound Plywood, which was determined to be a "nonexempt cooperative association" for Federal tax purposes, had a "one member - one vote" rule. Similarly, the tenant-shareholders in Trump Village were entitled to one vote at all shareholder meetings, regardless of the number of shares of stock owned. The relevant case law thus points toward the conclusion that "one member - one vote" control is a necessary element of a cooperative association for purposes of Tax Law § 1381(a).

In contrast, petitioner's shareholders are entitled to one vote per share of stock owned. Since there is no limit on the number of shares or apartments an individual may acquire, some shareholders may be entitled to a greater voice in the operation of petitioner than others. This distribution of voting rights does not conform to the requirement of democratic control of the cooperative enterprise by its members as first enunciated by the Tax Court in Puget Sound Plywood and subsequently followed in Trump Village.

Petitioner contended that its per share voting system constituted democratic control by its tenant-shareholders and compared its system of voting with that of the United States House of Representatives and the New York State Assembly. Petitioner asserted that in each of these

legislative bodies, States and areas with larger populations have more votes than states and areas with smaller populations.

While the phrase "democratic control" generally may be said to encompass many forms of voting systems, including the traditional corporate per share system, the Tax Court in both Puget Sound Plywood and Trump Village clearly ascribed a "one member - one vote" meaning to this phrase. Furthermore, petitioner's attempt to compare its voting system to those of the House of Representatives and the State Assembly actually works against petitioner's position since each member of the House and Assembly has one vote. These bodies thus effectuate the one member - one vote principle. Members representing a particular state or area within the state do not vote as a group, as petitioner seems to suggest, but as individual representatives. In contrast, shareholders of petitioner may have varying numbers of votes depending upon the number of shares owned.

Petitioner also contended that Congress has recognized that a one member - one vote system is not a prerequisite to qualification as an organization subject to subchapter T. Petitioner based this contention on the enactment of IRC § 1042(c)(2) which defines the term "eligible worker-owned cooperative" for purposes of the nonrecognition provisions of section 1042 to mean any organization that, inter alia, is an organization to which subchapter T applies (IRC § 1042[c][2][A]) and a majority of whose board of directors is elected by members on "the basis of 1 person 1 vote" (IRC § 1042[c][2][D]). Petitioner reasoned that if one person - one vote was already a part of subchapter T, then there would have been no need for Congress to specifically enumerate the requirement set forth in IRC § 1042(c)(2)(D).

This contention is rejected. IRC § 1042 was enacted in 1984 (see, Pub. L. No. 98-369, § 541[a] 98 Stat 194, [1984]). The Tax Court's decision in Puget Sound was issued in 1965. As noted previously, that decision held that a cooperative association for purposes of the Federal tax statutes must adhere to the one member - one vote democratic control principle. Moreover, the one member - one vote principle had long been a fundamental characteristic of cooperative associations (see, e.g., New York Cooperative Corporations Law § 44). It is

concluded therefore that had the Congress wished to legislatively overrule Puget Sound in 1984, it would have done so directly and would not have sought to effectuate such an intent in the indirect manner of enacting section 1042.

Issue IV

N. As noted previously herein, Tax Law § 208(9) provides that "entire net income . . . shall be presumably the same as the entire taxable income which the taxpayer is required to report to the United States treasury department" subject to certain additions, including amounts allowable for recovery property as the ACRS deduction pursuant to Internal Revenue Code § 168 (see, 20 NYCRR 3-2.3[a][17]).

Tax Law § 208(9)(a)(11) provides, in pertinent part, as follows:

"(a) Entire net income shall not include:

* * *

(11) the amount deductible pursuant to paragraph (j) of this subdivision;"

Tax Law § 208(9)(j) provides, in pertinent part, as follows:

> "[A] taxpayer shall be allowed with respect to recovery property the depreciation deduction allowable under section one hundred sixty-seven of the internal revenue code as such section would have applied to property placed in service on December thirty-first, nineteen hundred eighty."

O. With respect to Issue IV, the dispute involves the proper New York depreciation deduction under Tax Law § 208(9)(a)(11), (j) in a case where IRC § 277 applies. Obviously, in addressing this issue, it is presumed that petitioner is subject to section 277.

The Division contended that a portion of the otherwise allowable depreciation deduction under Tax Laws § 208(9)(a)(11), and (j) must be disallowed as a consequence of the application of the principles of IRC § 277 to the amount "allowable" under IRC § 167 with respect to property placed in service on December 31, 1980. The Division's rationale appears to be that because an adjustment to petitioner's ACRS deduction of $516,733.00 was required pursuant to section 277 to properly determine its Federal taxable income, a similar adjustment to petitioner's $316,479.00 in depreciation otherwise allowable under IRC § 167 is also required. To determine the percentage of allowable deductions under IRC § 167 which, in turn, formed the

basis of the depreciation deduction under Tax Law §§ 208(9)(a)(11) and (j), the Division was guided by Revenue Rule 90-36, which provides a method by which deductions disallowed pursuant to section 277, are allocated to various corporate expenses. Specifically, BCMS calculated the ratio of petitioner's total allowable "non-pass-through" deductions (i.e. deductions other than real estate taxes and mortgage interest) to total non-pass-through deductions "as if" petitioner calculated depreciation under IRC § 167. This ratio was determined to be 74.547%. In recomputing petitioner's 1986 tax liability, BCMS computed and allowed a New York depreciation deduction of $238,825. BCMS used the 74.547% ratio in its calculations (see, Finding of Fact "13").

Petitioner contended that, in the language of the statute, the depreciation deduction "allowable" under IRC § 167 is $316,479.00, which is the deduction allowable under IRC § 167 absent the application of section 277. Petitioner noted that this amount is "allowable" only under New York Tax Law, and that this amount is not an amount "allowable" in determining petitioner's Federal taxable income, whether such income is determined with or without IRC § 277, since IRC § 167 played no role in determining petitioner's Federal taxable income. Petitioner further asserted that the relevant New York Tax Law and regulations (see, Conclusion of Law "N"), provide for a depreciation subtraction in computing entire net income. These provisions allow for a deduction for an amount that "would have applied" under IRC § 167. Petitioner noted that these provisions apply whether or not IRC § 277 applies and contended that no adjustment pursuant to IRC § 277 is authorized by these provisions.

P. For the reasons that follow, it is concluded that the Division's calculation of petitioner's depreciation deduction under Tax Law §§ 208(9)(a)(11) and (j) was reasonable. Petitioner's contentions regarding this issue are therefore rejected.

The calculation of petitioner's Federal taxable income, the starting point for determining petitioner's entire net income, included an ACRS deduction which reflects the application of IRC § 277. That is, the ACRS deduction "allowable" to petitioner under IRC § 168 was $516,733.00. Under the BCMS calculations, application of section 277 reduces the amount of

the "allowable" ACRS deduction to $323,055.00 (see, Finding of Fact "13"). Pursuant to Tax Law § 208(9)(a)(10), BCMS added-back petitioner's ACRS deduction as modified by IRC § 277 to petitioner's Federal taxable income. Since the amount of the ACRS depreciation deduction otherwise "allowable" to petitioner under IRC § 168 was adjusted pursuant to IRC § 277 and since this adjusted amount was added-back to calculate petitioner's entire net income, for purposes of Tax Law § 208(9)(j) it is reasonable to similarly adjust the amount of the depreciation deduction under IRC § 167 which would otherwise be "allowable" to petitioner but for the application of IRC § 277. To calculate the depreciation deduction without regard to section 277, as petitioner suggests, is inconsistent with the treatment of the ACRS add-back, which has been adjusted pursuant to IRC § 277. Moreover, the relevant statutory language gives no indication that these provisions should be given different treatment. To the contrary, both Tax Law § 208(9) (a)(10) (ACRS add-back) and § 208(9)(j) (New York depreciation deduction) refer, respectively, to deductions "allowable" under sections 168 and 167 of the IRC. Thus, while one could argue, as petitioner does herein, that since Tax Law 208(9)(j) refers only to IRC § 167 then no adjustment may be made pursuant to section 277, any such argument applies with equal force to the add-back under Tax Law § 208(9)(a)(10). That is, if no adjustment may be made with respect to the deduction under section 208(9)(j), then no adjustment may be made to the add-back under section 208.9(a)(10). In this case such a rule would clearly work to petitioner's disadvantage.[4]

Q. The petition of 330 Avenue Owners' Corp. is granted and the notices of deficiency dated October 2, 1989, are cancelled. Additionally,

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[4]Specifically, if no section 277 adjustments are made, then petitioner's ACRS add-back is $516,733.00 and petitioner's depreciation deduction is $316,479.00, a net increase to petitioner's entire net income of $200,254.00. Pursuant to the BCMS recomputation of petitioner's ENI, which included section 277 adjustments, petitioner's ACRS add-back is $323,055.00 and petitioner's depreciation deduction is $238,825.00, a net increase of only $84,230.00.

petitioner's claim for refund of amounts paid in respect of the notices of deficiency dated October 2, 1989 (see, Finding of Fact "25") is granted.

DATED: Troy, New York
September 26, 1996

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE