STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
OCEAN TERRACE OWNERS, INC.	:	DETERMINATION DTA NO. 809719
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1986 through 1988.	:	

Petitioner, Ocean Terrace Owners, Inc., 2611 West 2nd Street, Brooklyn, New York 11223, 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 years 1986 through 1988.

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on December 13, 1995 at 2:00 P.M., with all briefs to be submitted by April 22, 1996 which date began the six-month period for the issuance of this determination. Petitioner appeared by Jack Mitnick, C.P.A. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Vera R. Johnson, Esq., of counsel).

ISSUE

Whether the Division of Taxation correctly determined that petitioner is subject to the provisions of Internal Revenue Code § 277.

FINDINGS OF FACT

1. As a result of an audit, the Division of Taxation ("Division") issued to petitioner, Ocean View Terrace, Inc. (the "Corporation"), six notices of deficiency, each dated April 30, 1990. The notices assert deficiencies of corporation franchise tax and the metropolitantransportation business tax surcharge (MTS) pursuant to Article 9-A of the Tax Law as follows:

Year	Tax	Amount
1986	franchise	$ 32,509.00
1986	MTS	5,526.00
1987	franchise	30,114.00
1987	MTS	5,120.00
1988	franchise	30,262.00
1988	MTS	5,144.00

2. Petitioner, is a cooperative housing corporation incorporated in New York State on November 5, 1982 pursuant to Business Corporation Law § 402. It is the owner of residential property located at 2650 Ocean Parkway, Brooklyn, New York (the "building" or "apartment building").

3. Petitioner is authorized by its Certificate of Incorporation to issue 65,200 shares of common stock and to issue no other class of stock. During the assessment period, it issued 58,605 shares of common stock.

4. The primary purpose of the Corporation is to make apartments in the building available to its shareholders for residential purposes, under leases known as proprietary leases, and to operate and maintain the apartment building for its shareholders.

5. Petitioner's shareholders are entitled, by reason of their ownership of shares in the Corporation, to proprietary leases entitling them to occupy apartments in the apartment building owned by petitioner. Shares of the Corporation are issued solely in connection with the execution of proprietary leases for apartments in the building, and every proprietary lease specifies the number of shares issued to the lessee in connection with the execution of the proprietary lease.

6. Tenant shareholders are not entitled to receive any distribution not out of earnings and profits of the Corporation except upon a complete or partial liquidation of the Corporation.

7. The apartment building is operated and managed by a board of directors elected by the shareholders. The by-laws of the Corporation limit the number of directors serving on the board of directors to not less than three and not more than seven. Section 5 of the by-laws states as follows:

> "Voting. Each shareholder of record shall be entitled at each shareholders' meeting to one vote, in person or by proxy, for each share standing in his name on the stock book at the time of the meeting. When voting for the election of directors, such shareholder shall be entitled to one vote for each said share per director to be elected, but shall have no right to cumulate his or her votes in favor of any one or more directors to be elected. . . . All elections shall be determined by a plurality vote and unless otherwise specified in these by-laws or the Certificate of Incorporation, the affirmative vote of a majority represented at any meeting of shareholders shall be necessary for the transaction of any item of business (other than election of directors) and shall constitute the act of the shareholders." (Emphasis added.)

8. During the assessment period, the sponsor of the cooperative conversion plan (also referred to as the "holder of unsold shares") held a majority of the shares of issued common stock. Regarding the sponsor's voting rights, the Offering Plan states as follows:

> "The holder of Unsold Shares shall be entitled to vote all shares held by them for any number of directors subject to the following limitations. If the Unsold Shares constitute, in the aggregate, 50% or more of all outstanding shares: (i) The holder(s) of Unsold Shares shall not collectively vote their Unsold Shares for more than a bare majority of the directors to be elected and (ii) At all elections held after the fifth anniversary of the Closing Date, they will vote their Unsold Shares for not more than one less than a majority of the directors to be elected. At closing, each holder of Unsold Shares will sign an agreement to the foregoing effect."

9. During the assessment period, the issued shares were distributed between the sponsor and other shareholders as follows:

Year	Sponsor Shares	Other Shareholders	Total
1986	36,730	22,645	59,375
1987	32,330	22,045	59,375
1988	31,065	28,310	59,375

10. The ninth paragraph of petitioner's Certificate of Incorporation sets forth voting requirements for transacting certain business of the Corporation. For example, at least two-thirds of the members of the board are necessary to constitute a quorum at any meeting relating to the cancellation of a proprietary lease by reason of objectionable conduct or relating to the termination of all proprietary leases or to the amendment, alteration, repeal or addition to the by-laws. The votes of at least two-thirds of the members of the board are necessary to undertake such actions.

11. Section 8 of petitioner's by-laws provides that every share of stock issued by the corporation shall bear the following legend:

"The rights of any holder of the shares evidenced by this certificate are subject to the provisions of the Certificate of Incorporation and the by-laws of the corporation and to all the terms, covenants, conditions and provisions of a certain proprietary lease made between the Corporation, as Lessor, and the person in whose name this certificate is issued, as Lessee, for an apartment in the apartment house which is owned by the Corporation and operated as a co-operative, which proprietary lease limits and restricts the title and rights of any transferee of this certificate.

"The shares represented by this certificate are transferable only as an entirety and only to an assignee of such proprietary lease approved in writing in accordance with the provisions of the proprietary lease. . . ."

12. A stockholder may not sell shares of his or her stock or assign a proprietary lease or sublet an apartment without first obtaining the consent of the board of directors. However, if the board refuses consent, these actions may be taken with the written consent or vote of shareholders owning at least 65% of the Corporation's outstanding shares.

13. During the assessment period, petitioner filed Federal corporation income tax returns (Form 1120) on a calendar year basis and used an accrual method of accounting. More than 80% of petitioner's gross income for this period was derived from receipts from petitioner's tenant shareholders.

14. For the three years in issue, petitioner's expenses exceeded the income received from tenant shareholders as follows:

Year	Excess Expenses
1986	$ 381,416.00
1987	406,652.00
1988	371,021.00

15. In calculating its Federal income tax liabilities, petitioner deducted what is denominated here as "excess expenses" from Federal taxable income.

16. Following an audit of petitioner's New York State corporation franchise tax returns, the Division issued to petitioner statements of audit adjustment for the years 1986, 1987 and 1988, recomputing petitioner's tax liability for each year. As pertinent, the Division added back the excess expenses to Federal taxable income, increasing Federal taxable income (which is the starting point for determining New York entire net income) by that amount. The statements of audit adjustment provide the following explanation for the audit adjustment:

"Section 208.9 of Article 9A provides in pertinent part-Entire Net Income is presumed to be the same as the taxable Income which the taxpayer is required to report to the U.S. Treasury Dept., subject to certain modifications.

"Section 277 of the IRS Code limits the Membership expenses (deductions) in computing Federal Taxable Income, to the extent of Membership Income."

17. Petitioner filed a petition with the Division of Tax Appeals dated June 26, 1991 alleging that it is not a membership organization subject to the restrictions of Internal Revenue Code § 277.

18. Petitioner and the Division executed a Stipulation on December 13, 1995. The Stipulation of the parties is incorporated herein by this reference; however, only those facts necessary to resolution of the matters in controversy are recited in these Findings of Fact.

19. The Stipulation includes a recalculation of petitioner's corporation franchise tax liability for the years in question. In accordance with the Stipulation, the Division asserts the following deficiencies of corporation franchise tax liability in this proceeding:

Year	Tax Deficiency
1986	$ 27,195.00
1987	24,939.00
1988	25,991.00

20. The parties agreed that the MTS notices would be revised in accordance with their stipulation.

21. Paragraph 47 of the Stipulation states: "The parties agree that the sole issue in controversy is whether the Division of Taxation correctly determined that petitioner is subject to the provisions of IRC § 277."

CONCLUSIONS OF LAW

A. 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.)

The Division determined that petitioner is a membership organization as that term is used in Internal Revenue Code § 277(a), and since petitioner is not exempt from taxation, it is subject to the deduction limitations of the statute. Accordingly, the Division determined petitioner's Federal taxable income for purposes of applying Tax Law § 208(9) by limiting deductions to membership income. Petitioner claims that section 277 does not apply to it.

B. In 1990, the Internal Revenue Service issued Revenue Ruling 90-36 which provides that Internal Revenue Code § 277 applies to limit the deductions of a "cooperative housing corporation", as defined by Internal Revenue Code § 216(b)(1) (Mertens, Laws of Federal Income Taxation, 1989-1990, Rulings, citing Concord Consumers Housing Cooperative v. Commr., 89 TC 105 [1987]). A "cooperative housing corporation" is defined in the Internal Revenue Code as a corporation:

"(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant- stockholders." (IRC § 216[b][1].)

Based on the stipulated facts, petitioner is a cooperative housing corporation, as defined by Internal Revenue Code § 216(b)(1) (see, Findings of Fact "2", "3", "4" and "8"). Pursuant to Revenue Ruling 90-36, petitioner is thus subject to the deduction limitations of section 277(a). Regardless of the Revenue Ruling, petitioner contends that it is not a membership organization as that term is used in section 277. It premises its argument on three allegations (1) that it is not operated primarily to provide goods and services to its members; (2) that it has shareholders, not members; and (3) that it does not charge or receive membership fees.

The argument made by petitioner here was also made by the petitioner in Matter of Beechwood Gardens Owners (Tax Appeals Tribunal, May 25, 1995). That argument was rejected by the Tax Appeals Tribunal which explicitly followed the guidance provided by Revenue Ruling 90-36 and held that a cooperative housing corporation is a membership organization subject to the deduction limitations of Internal Revenue Code § 277(a). Petitioner asserts that the precedent of Beechwood Gardens need not be followed in this case because the reasoning on which it rests was overruled by the decision of the Tax Court in Trump Village Section 3, Inc. v. Commissioner (69 TCM [CCH] 2985). This assertion will be addressed at the outset because, if petitioner is wrong, the Tribunal's decision in Beechwood Gardens is a binding precedent which will dispose of petitioner's contention that section 277(a) does not apply to it.

The petitioner in Trump Village was a not-for-profit cooperative housing corporation organized under New York's Mitchell-Lama Law. Upon audit of the petitioner's income tax returns, the Internal Revenue Service determined that the petitioner was subject to Internal Revenue Code § 277, recalculated its income and deductions accordingly and issued notices of deficiency to the petitioner. In support of its position that the notices were issued in error, the petitioner made two arguments which are pertinent here: (1) the petitioner argued, as petitioner does here, that it qualified as a section 216(b)(1) cooperative housing corporation but was not a membership organization under section 277; and (2) it contended that it was operated on a "cooperative basis" within the meaning of section 1381(a)(2) of the Internal Revenue Code with the result that it was governed by the taxing provisions of subchapter T of the Code rather than those of section 277. The court resolved the case without considering the petitioner's first argument. Rather, it decided the case in favor of the petitioner based entirely on its agreement with the petitioner's second argument. Since the Trump Village opinion did not consider whether a conventional cooperative housing corporation organized under the New York Business Corporation Law is subject to the deduction limitations of section 277, it did not overrule the Tribunal's decision in Matter of Beechwood Gardens Owners (supra) or undermine

the reasoning of Revenue Ruling 90-36. In accordance with the Beechwood decision, it must be concluded that petitioner, a cooperative housing corporation as defined in IRC § 216(b)(1), was a "membership organization" governed by section 277.

C. Alternatively, petitioner adopts the second argument of the Trump Village petitioner and argues that as a cooperative housing corporation it is governed by subchapter T of the Internal Revenue Code, rather than section 277. Subchapter T provides special tax treatment for "any corporation operating on a cooperative basis", with certain enumerated exceptions not relevant here (IRC § 1381[a][2]). If a corporation is operating on a cooperative basis, it is governed by the provisions of subchapter T as a matter of law (Trump Village Section 3, Inc. v. Commissioner, supra at 2994; Concord Consumers Housing v. Commissioner, 89 TC at 126); moreover, "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. Commissioner, supra at 2994, citing Buckeye Countrymark v. Commr., 103 TC 547).

The phrase "operating on a cooperative basis" is not defined in the Internal Revenue Code or the Treasury Regulations. The Tax Court, in Puget Sound Plywood v. Commr. (44 TC 305), identified three guiding principles of economic cooperative theory:

> "(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." (Id. at 308).

It is the Division's position that petitioner does not operate on a cooperative basis and thus is not governed by subchapter T. The Division argues that the Corporation lacks two characteristics of economic cooperative theory -- subordination of capital and democratic control of the cooperative enterprise. I agree and find that petitioner is not governed by subchapter T of the Internal Revenue Code.

To demonstrate subordination of capital "limitations must be imposed upon the amounts that can be distributed with respect to the corporation's stock, and control over management and

direction of the cooperative must be vested in the members of the cooperative as opposed to the stockholders" (Trump Village Section 3, Inc. v. Commissioner, supra at 2995). Petitioner lacks both of these elements of subordination of capital.

In Puget Sound Plywood, 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). The Tax Court in Trump Village found that the tenants of Trump Village, like the Puget Sound Plywood workers, controlled and operated the cooperative enterprise for the mutual benefit of the tenants. Each tenant in the Trump Village housing project was required to own shares of the petitioner's capital stock. This requirement insured that each tenant was a stockholder and that "[c]ontrol over the housing project was in the hands of the shareholders by reason of their position as tenants (Trump Village Section 3, Inc. v. Commissioner, supra at 2995; emphasis added). The management of the housing project was entrusted to a board of directors consisting of 16 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).

Control over management and direction of petitioner's cooperative enterprise is not in the hands of the building'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 the Corporation is in the hands of the stockholders who have a right to occupy an apartment by reason of their position as stockholders. Unlike the Trump Village tenants, petitioner's shareholders and residents are not required by statute, by-laws or contract to be one and the same. Residents 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. They are not prohibited from subletting (although the consent of the board of directors is required to sublet an apartment).

During the period in issue, over 50% of the corporate stock was owned by the sponsor of the cooperative conversion plan which rented the apartments under its control. During this period then, a large number of residents of the apartment building were not shareholders and were not entitled to participate in the management of the apartment building, much less control it. Petitioner's by-laws provide "that at least one less than a majority of directors to be elected shall be residents of the Building" (Offering Plan of Premises known as Ocean Terrace, p. 87). Thus, the by-laws require that residents of the building be represented on the board, but they do not guarantee that the building will be operated and controlled by its residents.

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. 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 shareholders must obtain the consent of the board of directors in order to sublet, they are not absolutely prohibited from doing so, hence an individual shareholder 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 to 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, I conclude that the first principle of cooperative theory, subordination of capital, is not present in petitioner's corporate structure.

The second principle of cooperative theory is not met either because petitioner does not function under principles of democratic control. This principle was described in Puget Sound Plywood as being effected "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" (Puget Sound Plywood v. Commr., supra, 44 TC at 308). The tenants of Trump Village were also entitled to one vote at all shareholder meetings regardless of the number of shares of stock owned. Petitioner's shareholders are each entitled to one vote, in person or by proxy, per share of stock owned. Since shares of stock were not equally distributed to each apartment, some shareholders would be entitled to a greater voice in the operation of the apartment building than others. During the assessment period, the sponsor held a majority of the shares of issued common stock, and it had control of the corporation by virtue of its stock ownership. This distribution of voting rights does not demonstrate democratic control of the cooperative enterprise by its members.

Petitioner claims that there were restrictions on the power of the sponsor to control the corporation which guaranteed democratic control of the corporation. During the assessment period, the sponsor was entitled to vote for no more than a bare majority of the directors to be elected. At all elections held after the fifth anniversary of the closing date, the sponsor was entitled to vote for no more than one less than a majority of the directors. The existence of these provisions does not demonstrate democratic control of the cooperative enterprise. Quite the opposite. By virtue of its stock ownership and its control of the board of directors, the sponsor was in control of the Corporation throughout the assessment period. Moreover, the

restrictions placed on the sponsor merely insured that other shareholders would have a voice in operating the Corporation. They did not provide for one vote for each shareholder.

D. The petition of Ocean Terrace Owners, Inc. is granted to the extent stipulated by the parties (see Finding of Fact "19"), but in all other respects the petition is denied.

DATED: Troy, New York
September 12, 1996

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE