STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
STARBURST DEVELOPMENT CO., INC.	:	DETERMINATION DTA NO. 810853
for Revision of a Determination or for Refund of Tax on Gains Derived from Certain Real Property Transfers under Article 31-B of the Tax Law.	:	

Petitioner, Starburst Development Co., Inc., 51 Glenwood Avenue, Queensbury, New York 12804, 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.[1]

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on October 13, 1992 at 9:15 A.M. In a letter dated January 4, 1993, the parties agreed that the last date for filing briefs would be February 2, 1993 which began the six-month period to issue this determination. Petitioner filed briefs dated December 8, 1992 and February 1, 1993. The Division of Taxation filed a brief dated January 19, 1993. Petitioner appeared by Lavelle & Finn (John H. Lavelle,

Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kenneth J. Schultz, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation erred by not considering petitioner's sales as the sale

[1]A hearing was also held on the petition of Northern Homes, Inc. However, after the hearing, the parties informed the Division of Tax Appeals that Northern Homes, Inc. filed a petition in bankruptcy. Therefore, no determination is rendered with respect to the petition of Northern Homes, Inc.

of subdivided parcels improved with residences within the meaning of Tax Law § 1440.7.

II. Whether petitioner is entitled to the exemption from real property gains tax pursuant to Tax Law § 1443.7.

III. Whether petitioner's sales of certain lots should be aggregated with the sales of a related corporation.

IV. Whether penalties and interest penalty should be abated.

FINDINGS OF FACT

Since 1945, Northern Homes, Inc. ("Northern Homes") has been in the business of manufacturing prefabricated houses. Generally, Northern Homes manufactures in accordance with a set of plans that it offers. In recent years, it also exported prefabricated homes.

It is Northern Homes' practice to manufacture parts of a home, including panels, interior walls, roof parts and floors. The prefabricated parts assist builders in the construction of the house.

In general, Northern Homes sells its homes through either a network of builders and dealers or through advertising campaigns. Depending on the state of the economy, from 10% to 50% of petitioner's customers are "do-it-yourselfers". Petitioner's competition comes from one of three sources. First, competition arises from other companies, such as itself, which sell packaged homes. A second source of competition is from manufacturers which sell components of a home but not packages as petitioner does. The third and largest source of competition is from the traditional homebuilder.

Bedford Close was a housing development which was started by Northern Homes in order to have model homes to display to its customers. Northern Homes planned on getting customers to buy models at a reduced price and then use the houses as models for its catalogue. Northern Homes also planned to show the houses during and after construction.

Generally, potential customers went to Northern Homes' office. Thereafter, Northern Homes' sales staff took potential customers to the existing homes. The sales staff and the customers would then review the catalogue.

When Northern Homes began building in Bedford Close, it did not have any intention of competing with builders that were selling lots from their own subdivisions. However, this is what happened. Later, Northern Homes decided to let the builder construct the house and Northern Homes would just make the contract deal.

Northern Homes never advertised that the lots were for sale and would have advertised differently if it had wished to sell just land.

Northern Homes could prevent the use of the lots for other than a Northern Homes house by withholding architectural approval for a structure. Northern Homes also filed covenants in order to induce a consumer to have Northern Homes build a house at Bedford Close.

Many covenants were put in deeds in order to create the setting whereby Northern Homes could take attractive photographs of its houses. Northern Homes helped its customers landscape their homes for the same reason. The package of restrictions placed on the subdivision was far more restrictive than on the typical subdivision.

When a customer first went to the office of Northern Homes, the parties reviewed the covenants and the architectural restrictions.

On one occasion, Northern Homes sold a lot to a person who subsequently tried to buy a house from a competitor. Northern Homes sued that individual and went through a lengthy process to try, without success, to prevent him from building a house. In the 20 or 30 years that Northern Homes owned Bedford Close, this was the only person who did not build a Northern Homes house. After this one incident, Northern Homes had its customers sign a contract of sale to make it clear that purchasers of lots were expected to build a Northern Homes residence.

It was Northern Homes' intention in working with its attorneys to restrict the lots to such a degree that the only use for a lot was a Northern Homes single-family house.

Northern Homes has maintained a continuing relationship with the residents of Bedford Close. For instance, the street signs in Bedford Close were designed and installed by Northern Homes. When a street sign falls down, Northern Homes performs the repair. It also maintains

the flowers around the entrance of Bedford Close. Northern Homes leaves brochures for people who drive through Bedford Close and has put on a fireworks display on the Fourth of July for the residents of the housing development.

Northern Homes engaged in a number of activities which were not typical of the traditional home builder. For example, Northern Homes designed the subdivision without sidewalks or curbs because it was felt that this design showcased the houses better. Northern Homes also designed streets that were curved and set aside land as a green area because it was thought it would improve photographs of the houses.

There were occasions when people attempted to conduct business from their homes or engage in other activities which did not conform to the covenants. When this occurred, Northern Homes took steps to bring a stop to these activities.

Northern Homes has been represented by real estate attorneys and large experienced certified public accounting firms which were familiar with the gains tax throughout the development of Bedford Close. The accounting firm prepared Northern Homes' taxes and audited Northern Homes' books for the bank. Northern Homes' attorneys were experienced in real estate matters and had been with Northern Homes for a long period of time. Northern Homes' attorneys and accountants never discussed the gains tax with Northern Homes until they found out that the Division of Taxation ("Division") expected Northern Homes to pay taxes.

Northern Homes operated under the premise that it was exempt from real property gains tax. If it knew that its transactions were subject to tax, it would have structured the transactions differently in an attempt to avoid tax.

Generally, a regular builder builds a house on land that he owns or has the right to purchase and then sells the entire package to the consumer.

Northern Homes did not sell homes in the same way as a regular builder. When Bedford Close first began, Northern Homes either built the house on Northern Homes' land and then deeded the item to the consumer at the time of closing or Northern Homes deeded the land to the customer immediately and then build the house on the customer's land. The time came

when banks started asking for much larger downpayments from the purchasers of homes. However, the banks permitted the customer's ownership of the land to serve as part of the equity. In order to accomplish this, the banks wanted Northern Homes to deed the land to the customer who was going to receive the mortgage. The customer then gave the first lien to the bank.

There were also occasions when Northern Homes sold the lot to builders. This arose when the builder needed construction financing to complete a home. As in the prior case, Northern Homes deeded the land to the builder and, in lieu of a payment, took back a second mortgage. Northern Homes would then look to receive its money at the final closing.

In either of the foregoing cases, Northern Homes was paid for putting a home on a lot which the owner occupied. However, there were times when Northern Homes was paid in full for the lot first.

There were separate contracts for the sale of the lot and the house. The contract for the sale of the lot might precede the sale of the home.

Everyone connected with the transaction, including the consumer, the builder and Northern Homes, was under the impression that Northern Homes was selling a single-family home to the ultimate consumer. Further, when the builders took title, they were merely an accommodation party to help the transaction all the way through to the buyer. The consumer looked to Northern Homes rather than the builder for material warranties.

In or about 1981, high interest rates caused dislocation in the housing industry. The difference in the market interest rates and the maximum interest rates which banks were permitted to charge prompted banks to decline to offer new mortgages. The number of new housing starts dropped so precipitously, Northern Homes was forced to liquidate its manufacturing operations in Chambersburgh, Pennsylvania and enter into voluntary bankruptcy. Under these circumstances, Northern Homes was unable to raise capital and continue with the development.

In order to attract the capital needed to continue with the development, a group of

individuals who were either associated with Northern Homes or related to someone who was associated with Northern Homes agreed to invest capital in a corporation known as Starburst Development Co., Inc. ("Starburst") in order to develop land which was owned by Northern Homes. The banks also agreed to invest capital provided Northern Homes contributed the land as collateral. In exchange, Northern Homes would receive 50% of the selling price of the lot.

The foregoing financing deal was structured two years prior to the enactment of the gains tax.

The homes developed by Starburst were marketed as Northern Homes and the development was done in the same fashion as Northern Homes. Further, the mechanics of the sale of the lots, such as the consumer or builder purchasing the lot prior to the sale of the home or the restrictive covenants, remained the same.

Starburst did not have its own employees. Each of the lots which Starburst sold were lots which were transferred to Starburst by Northern Homes.

No one on the staff of Northern Homes had any expertise regarding gains tax. The question of whether Starburst's transactions were subject to gains tax was never raised in conversation with Starburst's attorneys or in conversations with Starburst's certified public accounting firms which were experienced in real estate and tax. Prior to its audit, Starburst was never informed that its activities were subject to gains tax. It is Starburst's practice to rely on outside professionals on matters such as gains tax.

After a field audit, the Division determined that real property gains tax was due from Starburst in those instances where the lot was sold without being developed. The Division issued a Notice of Determination to Starburst, dated September 23, 1991, which assessed tax of $18,264.00, plus interest of $17,165.89 and penalty of $6,392.40, for a balance due of $41,822.29. The asserted deficiency of tax was premised, in part, on the finding that Northern Homes' transactions were subject to tax in those instances when the lot was sold before being developed and that the sales of Northern Homes should be aggregated with the sales of Starburst.

In accordance with New York State Administrative Procedure Act § 307(1), petitioner's proposed findings of fact "8" and "11" have been accepted and included in the record. The remaining proposed findings of fact are conclusory and not fully supported by the record.

CONCLUSIONS OF LAW

A. It is Starburst's position that its transfers and the transfers of Northern Homes[2] are not subject to real property gains tax by reason of Tax Law § 1440.7. Starburst posits that it and Northern Homes did essentially the same thing as a traditional homebuilder in their development of Bedford Close and that the purpose of developing Bedford Close was to have a neighborhood filled exclusively with Northern Homes' designs and houses. Therefore, the lots were for sale only as lots for Northern Homes' designs.

Petitioner submits that its non-traditional building method required it to operate differently for lenders and consumers. That is, Northern Homes followed a two-step process whereby the consumer first acquired title to the lot for a subordinated note to Northern Homes to facilitate financing of the Northern Homes construction materials, followed by the closing of the completed home to the homeowner and the payment to Northern Homes for its house and lot. Petitioner contends that its two-step process is virtually identical, in effect, to the process undertaken by a builder who must secure construction financing to complete a house on its own lot.

According to petitioner, the only area of controversy arises from the fact that at the time of the house site sale, the home was not assembled and not in place. Therefore, petitioner surmises that the issue is whether any substance should be given to the preliminary transfer of title to the lot in exchange for a subordinated note which enabled the transaction to be adequately collateralized.

With the foregoing as a background, Starburst submits that a "substance-over-form"

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[2]Since Northern Homes' sales were aggregated with Starburst's sales, the taxability of Northern Homes' sales has a bearing on Starburst's liability.

approach be taken to avoid artificial distinctions that have no practical weight. According to petitioner, the Legislature did not intend to tax factory-built homebuilders as opposed to all other homebuilders. Citing Matter of Cove Hollow Farms v. State of New York Tax Commn. (146 AD2d 49, 539 NYS2d 127), petitioner avers that the target of the gains tax was the taxpayer who profited from real estate appreciation, not the taxpayer who added real value to the land and had a gain as a consequence. It is submitted that but for external factors, such as banking and financing requirements, Northern Homes' transactions are indistinguishable from a homebuilder.

In response to the foregoing, the Division argues that Northern Homes' transfers do not meet the criteria set forth in Tax Law § 1440.7 in order to be considered exempt from tax. The Division also maintains that fairness has no place in the analysis of Northern Homes' transactions.

B. Tax Law § 1441 imposes a tax at the rate of 10% upon gains derived from the transfer of real property within New York State. Certain exemptions from the tax are provided for in Tax Law § 1443. However, said exemptions are strictly and narrowly construed against a taxpayer since an exemption is not a matter of right, but is allowed only as a matter of legislative grace (Matter of Grace v. New York State Tax Commn., 37 NY2d 193, 196, 371 NYS2d 715, 718). Further, petitioner bears the burden of showing clear entitlement to the exemption at issue (Matter of Lever v. State Tax Commn., 144 AD2d 751, 535 NYS2d 158, 160).

C. The term "[t]ransfer of real property" is defined by Tax Law § 1440.7. This section provides, in pertinent part:

> "that the subdividing of real property and the sale of such subdivided parcels improved with residences to transferees for use as their residences, other than transfers pursuant to a cooperative or condominium plan, shall not be deemed a single transfer of real property" (Tax Law § 1440.7).

D. Clearly, on its face, this section contemplates that the real property be improved with a residence, prior to its transfer. Therefore, the fact that the transfers in issue took place prior to any improvement precludes petitioner from having the benefit of the exemption set forth in Tax

Law § 1440.7.

It is noted that petitioner's arguments do not warrant a different result. If the Legislature had intended that the exemption include firms which build residences after the transfer of the land, it could have easily done so. Similarly, Northern Homes' reliance upon Cove Hollow (supra) is misplaced. That case presented a situation where the petitioner was selling lots from an unimproved parcel of land. There is no indication that the Court in Cove Hollow was considering a situation where a firm made a practice of building homes on lots which it previously conveyed. Therefore, the case is inapposite.

E. Starburst next argues that it is entitled to an exemption from tax under Tax Law § 1443.7. This section provides:

> "A total or partial exemption shall be allowed in the following cases:
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> * * *
>
> "7. Where a transfer of real property consists of the execution of a contract to sell real property without the use or occupancy of such property or the granting of an option to purchase real property without the use or occupancy of such property."

F. According to Starburst, if the transfer of the lots is examined, taking substance over form, there is an incomplete transaction. Petitioner submits that the consumer has secured the legal title or right to a parcel upon which no meaningful activity can occur prior to its being improved with a residence. Starburst contends that the consumer cannot use or occupy the lot in any fashion except to improve it with a single-family structure. Further, it is argued that this right constitutes nothing more than an executory contract or option to do something further, that is, to build.

Petitioner's argument continues that a proper characterization of its multi-step sales process is that Northern Homes conveyed no more than a right to complete the transaction by completing the lot with a single-family home. The conveyance of such a right is indistinguishable from an option. Petitioner concludes that these contracts and options which convey "no use or occupancy" are specifically exempted from the application of the gains tax.

In response to the foregoing, the Division responds that the exemption set forth in Tax

Law § 1443.7 has no application to the facts of this case.

G. The express language of the exemption requires accepting the Division's position. The record shows that, in this case, the Division did not attempt to tax the execution of a contract or an option to purchase real property. Therefore, the exemption which is provided for in Tax Law § 1443.7 has no bearing on this matter. It is noted that petitioner's attempt to apply the exemption to this situation by applying a form-over-substance argument is contrary to the rule that a taxpayer must clearly demonstrate that it is entitled to an exemption (see, Matter of Lever v. New York State Tax Commn., supra).

H. Petitioner next argues that it is improper to aggregate its sales with the sales of Northern Homes. Petitioner submits that since it was formed and acquired the land from Northern Homes prior to the enactment of the gains tax, it is obvious that neither Northern Homes nor Starburst could have had any agreement or plan to qualify successive transfers to avoid the gains tax. Further, it is contended that it should be obvious that Starburst was created for non-tax reasons. Petitioner submits that the mere fact of overlapping ownership should not compel the activities of the two entities to be consolidated since the investors in Starburst took a separate and independent economic risk when Starburst was formed. Petitioner further argues that none of the questions in the regulations fit the fact pattern presented herein. It is also maintained that once the land was purchased by Starburst, prior to the enactment of the gains tax, the selling of residential housing units in Starburst's tract had no connection or related purpose with any of Northern Homes' activities on other tracts.

I. The Division submits that the facts of this case clearly warrant the aggregation of the Northern Homes sales with the sales of Starburst. The Division posits that Northern homes and Starburst were engaged in a joint venture for the business of conducting the business of Northern Homes.

J. In Matter of Benacquista, Polsinelli & Serafini Mgt. Corp. v. Commr. of Taxation & Fin. (___ AD2d ___, June 10, 1993), the Division aggregated the sales of lots from subdivision plans which were filed in 1978 and 1982, respectively. One issue raised was whether it was

proper to aggregate the sales of lots which were not contiguous or adjacent. In response, the court stated:

> "Where, as here, property is subdivided pursuant to an overall subdivision plan that envisions the sale of the entire property in the form of many smaller parcels, such sales are subject to aggregation for the purposes of the real property transfer gains tax. This is so whether the subdivision plan was filed before or after the effective date of the tax (see, Matter of Cove Hollow Farm v. State Tax Commn., 146 AD2d 49, 51-52) and whether the land, with one exception, is intended for residential or commercial use (see, Executive Land Corp. v. Chu, 150 AD2d 7, 11-12, appeal dismissed 75 NY2d 946). Sales made pursuant to such a plan are aggregable, notwithstanding that the parcels were not contiguous at the time of sale, and despite the fact that they are sold to different transferees (see, id.; Matter of Cove Hollow Farm v. State Tax Commn., supra, at 52). The sole exception to this general rule is sales of subdivided parcels improved with residences for the use of the transferees (Tax Law § 1440[7]; see also, 20 NYCRR 590.43[g]; Matter of Cove Hollow Farm v. State Tax Commn., supra, at 52). Because the transfers at issue clearly do not fit into this category, they were properly aggregated." (Matter of Benacquista, Polsinelli & Serafini Mgt. Corp. v. Commr. of Taxation & Fin., supra.)

K. On the basis of the foregoing, it is clear that, in general, lots which are sold pursuant to a subdivision plan are properly aggregated. The question which remains is whether it was proper to aggregate the sales of Northern Homes with the sales of Starburst.

L. It has been recognized that the focus of the gains tax is to look through entities to determine the beneficial ownership of real property (see, e.g., Matter of 307 McKibbon Street Realty Corp., Tax Appeals Tribunal, October 14, 1988; Matter of Howes, Tax Appeals Tribunal, September 22, 1988, confirmed 159 AD2d 813, 552 NYS2d 972). The economic realities of the transactions herein warrant aggregation of the sales of Northern Homes and Starburst.

As the Division has pointed out, Starburst was formed to carry on with the business of Northern Homes. All of the land transferred by Starburst was acquired by Starburst from Northern Homes. The lots sold by Starburst were marketed under the Northern Homes name and Starburst followed the same procedure to sell homes as that used by Northern Homes. Most of the individuals who invested in Starburst were directly or indirectly connected to Northern Homes. Lastly, it is noted that the fact that Northern Homes and Starburst did not contemplate avoiding gains tax at the time of Starburst's creation does not have any bearing on this matter

since the transfers are part of a subdivision plan (see, Matter of General Builders Corp., Tax Appeals Tribunal, December 24, 1992).

M. The last issue presented is whether penalties should be cancelled. Petitioner maintains that penalties should be abated because it did everything in its power to comply with the law. Starburst submits that it hired the area's leading accounting firm and engaged an experienced law firm to handle its real estate transactions. It is argued that in the course of several hundred real estate closings, petitioner filed the appropriate forms and not once did the possibility of gains tax exposure come up. Starburst posits that it was not until the audit that it had any reason to know that it was in possible violation of the tax laws.

In response to the foregoing, the Division argues that there is no proof that petitioner ever requested guidance from the Division or its representatives as to whether its transfers of unimproved lots were subject to gains tax. The Division also argues that Starburst has not established reasonable cause or an absence of willful neglect or that its reliance upon professional advisors was sufficient to establish reasonable cause.

N. It has been held that reliance upon legal advice will warrant setting aside penalties only when the advice is reasonable under the circumstances (Matter of Benacquista, Polsinelli & Serafini Mgt. Corp. v. Commr. of Taxation & Fin., supra). Petitioner, however, has not set forth any reason why its counsel or accountants did not advise it to pay gains tax. In view of the fact that the Division has clearly and consistently explained that sales made pursuant to a subdivision plan are to be aggregated except where they have been improved with residences and used for residential purposes, it cannot be said that Starburst's failure to pay tax was due to reasonable cause (Publication 588, "Questions and Answers - Gains Tax on Real Property Transfers" [August 1983], Question and Answer number 21[G]; Publication 588, "Questions and Answers - Gains Tax on Real Property Transfers" [Rev.] [November 1984], Question and Answer number 43[G]; 20 NYCRR 590.43[g]).

O. The petition of Starburst Development Co., Inc. is denied and the Notice of Determination is sustained, together with such interest as may be lawfully due.

DATED: Troy, New York
July 30, 1993

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE