

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
PREFERRED RENTALS, STOCKTON BUILDING, INC.	:	DETERMINATION
for Revision of a Determination or for Refund	:	DTA NO. 812073
of Tax on Gains Derived from Certain Real	:	
Property Transfers under Article 31-B of the	:	
Tax Law.	:	

Petitioner, Preferred Rentals, Stockton Building, Inc., R.R. #2, Cornwall Hill Road, Patterson, New York 12563, 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.

On May 31, 1994 and June 13, 1994, respectively, petitioner, represented by Margolin, Winer & Evens (James L. Tenzer, and Wayne M. Olson, Esqs., of counsel) and the Division of Taxation, represented by William F. Collins, Esq. (Donna M. Gardiner, Esq., of counsel), signed an agreement consenting to have the controversy determined on submission without a hearing, with all briefs and documents due by January 9, 1995. The Division of Taxation filed documents on July 25, 1994. Petitioner filed its brief and documents on October 14, 1994. The Division of Taxation filed its brief on December 16, 1994 and petitioner filed a reply brief on January 9, 1995. Upon review of the entire record, Marilyn Mann Faulkner, Administrative Law Judge renders the following determination.

ISSUES

I. Whether the settlement payment for the removal of a lis pendens notice on property and an underlying property claim can be included in the original purchase price under the real property transfer gains tax law.

II. Whether the legal fees for settling the lis pendens claim can be included in the original purchase price.

III. Whether there is reasonable cause to abate the penalty and interest penalty.

FINDINGS OF FACT

On or about May 10, 1915, petitioner, Preferred Rentals, Stockton Building, Inc., acquired the land and building located at 6-10 East 32nd Street and 5-11 East 31st Street, New York, New York. Petitioner operated the property as rental property from the time of its acquisition until its leasehold transfer, which is the subject of the transfer gains tax in this proceeding.

After exploring various uses for the property, petitioner decided to lease the property to a tenant who would effectively take over the operations of the property for the term of the lease. Petitioner negotiated a leasehold interest with various parties and in 1989 entered into negotiations with 6 East 32nd Street Associates ("6-32 Assoc.").

Petitioner and 6-32 Assoc. entered into a December 19, 1989 agreement to enter into a lease. On September 7, 1990, petitioner entered into a "Lease and Purchase Option Agreement" with 6-32 Assoc. granting the tenant a 21-year lease with an option to purchase the property that ended after the 164th month of the lease term.

Prior to this lease, petitioner was served with a summons and complaint, dated November 8, 1988, by William J. Condren and 6 East 32nd St. Associates, L.P. seeking specific performance of a lease agreement and monetary damages of approximately \$30,000.00 or, alternatively, for monetary damages in the amount of not less than \$3,700,000.00 plus interest, costs, legal fees and disbursements. The complainants alleged, inter alia, that petitioner entered into an agreement with complainants to lease the property for a 49-year term and that petitioner breached that agreement when it received a better offer. Complainants also filed in court a Notice of Pendency with respect to the property.

Petitioner commenced proceedings to remove the lis pendens filed on the property. After negotiations, petitioner and complainants entered into a July 13, 1990 "Stipulation of Settlement" whereby petitioner agreed to pay the complainants \$560,000.00 (\$200,000.00 in cash plus 40 quarterly installments of \$9,000.00 each) in exchange for their release of the claim of a leasehold interest in the property and removal of the lis pendens. In January of 1991,

William J. Condren accepted petitioner's payment of \$222,573.00 in full satisfaction of the quarterly installment payments under the Stipulation of Settlement.

On or about August 16, 1990, petitioner filed a transferor questionnaire (Form TP-580[8/84]) reporting the anticipated gain with respect to its leasehold and option agreement with 6-32 Assoc.

The Division of Taxation ("Division") issued a "Tentative Assessment and Return", dated September 5, 1990, adjusting the consideration reported in the transferor questionnaire to include the amount of the state transfer tax (\$20,288.03) that the transferee had agreed to pay on behalf of the transferor. Petitioner elected to pay the gains tax in 14 installment payments of \$18,946.00 each, the first payment of which was due on the date of transfer. Subsequently, in September of each year from 1991 through 1994, petitioner paid the installment payment of \$18,946.00, plus interest.

Petitioner filed a claim for refund, dated November 14, 1991, requesting redetermination of the transfer gains tax. Petitioner claimed that it should be allowed to adjust the gain from the sale by subtracting the settlement cost of \$422,573.00 with Condren as part of the original purchase price. Petitioner reasoned that the settlement amount was paid to remove the lis pendens so that the interest in the property could be transferred free and clear of all prior claims. Petitioner's adjustment resulted in reduced installment payments of \$15,928.00, which in turn resulted in an overpayment of the two installment payments already paid in the amount of \$6,036.00. Petitioner therefore requested a refund of \$6,036.00, plus interest.

In its deliberations with respect to the refund claim, the Division requested further documentation. In compliance with these requests, petitioner's attorney sent a letter, dated March 30, 1992, in which he explained that he could not provide a copy of the lease referred to in the complaint in the legal action of Condren and 6 East 32nd St. Associates, L.P. v. Preferred Rentals Stockton Building, Inc. because the alleged lease did not exist. Petitioner's attorney noted that:

"Plaintiff never actually, legally, or otherwise owned an interest of an owner's estate (i.e., an alleged leasehold interest) in the Property. The Plaintiff only

claimed they owned an interest of an owner's estate in the Property It was this claim by the Plaintiff [that they owned an interest in an owner's estate in the Property] that the Transferor settled for \$422,573."

The Division denied the refund request stating that the cost of settlement did not fall under the statutory definition of "original purchase price" pursuant to Tax Law § 1440.5(a) because it was not paid to either acquire an interest in the real property or for any capital improvement made to the property. The Division also stated that petitioner did not respond to its request for a detailed breakdown of the legal fees claimed in the original filing which totalled \$209,260.00. The Division concluded that because it could not determine how much of the total legal fees was incurred as a result of the settlement of the lis pendens, all legal fees were disallowed for nonsubstantiation. Thus, determined the Division, petitioner owed an additional \$20,926.00 in gains tax. Accordingly, the Division issued to petitioner a Notice of Determination, dated April 16, 1992, for gains tax due in the amount of \$20,926.00, plus \$3,588.67 in interest and \$7,324.10 in penalty, for the total amount of \$31,838.77.

Petitioner requested a conciliation conference arguing that the \$422,573.00 settlement was paid in order to quiet title to the property so that it could be transferred. Petitioner also alleged that it had incurred and paid \$209,260.00 in legal fees in connection with the negotiation and closing of the transfer of the property in question and, therefore, these legal fees constitute an "allowable selling expense" in the original purchase price.

After a conciliation conference was held on January 7, 1993, the conferee affirmed the denial of the refund claim and adjusted the amount of tax due by allowing legal fees in the amount of \$194,072.00. Accordingly, by Conciliation Order, dated April 9, 1993, the conferee reduced the amount of tax stated in the Notice of Determination to \$1,518.80. The Division also offered to petitioner an abatement of the penalty on the amount due if it paid the remaining tax and interest on the adjusted bill.

Petitioner filed a petition, dated July 6, 1993, arguing that the \$422,573.00 settlement should be included in the original purchase price for gains tax purposes; that it incurred legal fees in the amount of \$273,922.00 in connection with the removal of the lis pendens and the

successful negotiation of the lease; and that the penalty and interest penalty should be abated.

The Division filed an answer, dated November 5, 1993, stating that only \$194,072.00 was substantiated and allowed as necessary legal fees incurred to sell the property pursuant to 20 NYCRR 590.17; that the \$422,573.00 settlement was properly disallowed; and that petitioner failed to establish reasonable cause for abatement of the penalty.

In support of its petition, petitioner submitted invoices from the law firm of Spengler Carlson Gubar Brodsky & Frischling describing the legal services performed for petitioner for a specified period of time and the legal fees for those services. These invoices consisted of 38 monthly or bimonthly bills from March 1, 1988 through April 30, 1992. On several of the invoices, the previously billed but unpaid legal fees were added to the amount of legal fees billed for the period specified in that bill. The last bill, dated May 24, 1992, for professional legal services rendered from March 1, 1992 through April 30, 1992 indicated that legal fees were due for that period only. In an exhibit attached to the petition (see, Div. Exh. "N"), petitioner broke down each invoice indicating the total amount of legal fees due for the period specified in the 38 individual invoices, and a breakdown of legal fees for each invoice with the total amounts as follows:

Total amount billed:	\$293,486.00
Removal of lis pendens:	168,790.00
Lease to 6-32 Assoc.:	105,132.00
Other:	19,564.00

SUMMARY OF THE PARTIES' POSITIONS

Petitioner contends that it inadvertently omitted the \$422,573.00 settlement from the original purchase price in calculating the amount of gains tax due on its original transferor questionnaire. Petitioner argues that the settlement amount was paid in order to remove the lis pendens so that the interest in the property could be transferred free and clear of all prior claims as required under the negotiated lease. Petitioner notes that the purpose of a notice of lis pendens is to warn all persons that title to property is in litigation and that any interest acquired by a prospective purchaser in that property is subject to a court decision in the underlying litigation. Thus, asserts petitioner, the settlement payment allowed petitioner to convey clear

title to the property. Petitioner cites Federal case law for the principle that costs incurred to quiet title to property, in court actions for specific performance, are properly capitalized into the cost or basis of the property. Petitioner concludes that the settlement of the claim is the equivalent of petitioner's acquisition of an interest in the property.

In brief, petitioner claims that it paid \$293,486.00 in legal fees for services rendered with respect to (1) removal of the lis pendens and (2) the negotiation and closing of the transfer of the property in question. Petitioner also claims that penalty and interest penalty should be abated inasmuch as petitioner voluntarily and timely filed the gains tax questionnaire reporting the transfer of the property, in good faith reported the amount owed based on a reasonable interpretation of the Tax Law, and timely paid installment payments.

The Division argues that the settlement payment should not be included in the original purchase price because the payment was made to the complainants to settle litigation concerning a claim against the property and not for an interest in real property. The Division argues that because none of the documents concerning the underlying litigation indicate a conveyance by the complainants of any interest in real property to petitioner, the settlement payment does not constitute an acquisition cost.

With respect to the legal fees issue, the Division argues that the invoices submitted in support of its petition do not establish that these invoices were paid. The Division also notes that the dates on the invoices, which were submitted as petitioner's Exhibit "22", do not correlate with the dates listed on the summary of the first page of that exhibit. The Division asserts that the conferee disallowed \$15,188.00 of the originally claimed \$209,260.00 in legal fees because petitioner did not substantiate whether the \$15,188.00 was related to the litigation or the lease transfer. The Division points out that petitioner is now claiming an additional \$84,226.00 above the original claim of legal fees (\$209,260.00) and that, without proof of payment or that such legal fees were incurred in relation to the transfer, petitioner has not established entitlement to additional legal fees.

Finally, the Division argues that petitioner has failed to establish reasonable cause to

abate the penalty and interest penalty and has not articulated which provision it relied on to claim litigation expenses as part of its selling expenses.

In its reply brief, petitioner argues that the complainant's claim of a leasehold interest and the lis pendens constituted an encumbrance on the real property in question. With respect to the Division's claim that the invoices do not establish that they were paid, petitioner notes that the invoices indicate any unpaid balance from a previous invoice and that because subsequent invoices do not contain unpaid balances, the only reasonable conclusion is that each invoice was ultimately paid in full. Petitioner claims that at the conciliation conference it presented evidence of the legal fees incurred in the amount of \$293,487.00 and that of that amount the conferee allowed only \$194,072.00. Petitioner asserts that the \$99,415.00 difference between legal fees incurred and those allowed by the conferee have been documented by invoices to be fees that can be deducted from the gain it derived from the leasehold transfer.

CONCLUSIONS OF LAW

A. Under Tax Law Article 31-B, section 1441 imposes a 10% tax on gains derived by a transferor from the transfer of real property. Tax Law § 1440.3 defines "gain" as the difference between the consideration for the transfer of real property and the original purchase price.

Under Tax Law § 1440(5)(a)(i), the original purchase price means:

"the consideration paid or required to be paid by the transferor (A) to acquire the interest in real property, and (B) for any capital improvements made or required to be made to such real property, including solely those costs which are customary, reasonable, and necessary, as determined under rules and regulations prescribed by the commissioner, incurred for the construction of such improvements.

(ii) Original purchase price shall also include the amounts paid by the transferor for any customary, reasonable and necessary legal, engineering and architectural fees and any customary, reasonable and necessary advertising and marketing costs not included in customary brokerage fees paid by the transferor incurred to sell the property . . ." (emphasis added).

Section 1440.4 defines an "interest" when used "in connection with real property" to include, but not be limited to:

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

(emphasis added).

The Division argues that the settlement payment was to settle litigation concerning a claim against the property but not to settle a property interest. The Division asserts that the documents in the underlying litigation did not indicate that petitioner received an interest in the property as a result of the settlement payment and, therefore, the settlement payment cannot be considered an acquisition cost.

In contrast to the Division's view, the settlement payment represents a cost to remove a claim or encumbrance on the property. Absent the removal of this encumbrance, the property was not freely transferable to the transferee in this case. Although the statutory framework of the New York transfer gains tax is distinct, the Federal case law cited by petitioner is instructive. In Anchor Coupling Co. v. United States (427 F2d 429 [7th Cir 1970], cert denied 401 US 908, 27 L Ed 2d 806), the court held that a settlement payment made in an action for specific performance (an action to enforce a proposed sale of assets) constituted a nondeductible capital expenditure that could not be deducted as an ordinary and necessary business expense. The court noted that the proper test in determining the character of the payment was to examine the origin and character of the underlying claim and that the settlement payment in that case was the cost of defending the taxpayer's title to the property. The court also agreed with another argument by the government in support of this result. It concluded that the settlement and release received in return for the settlement payment created enforceable rights which constituted the acquisition of a capital asset. It reasoned that the settlement payment accomplished the same purpose as if the taxpayer had completed the claimed sale and then repurchased the assets for a price in excess of the original sale, that excess constituting an amount equal to the settlement payment. The court noted that there would be no doubt that the difference in price between the original purchase and repurchase would be included in the new book value of the assets and that because the settlement payment accomplished the identical purpose as a repurchase, it should be given identical tax treatment.

The courts reached similar results in Wise v. Commr. (311 F2d 743 [2d Cir 1963]) and

United States v. Wheeler (311 F.2d 60 [5th Cir 1962], cert denied 375 US 818, 11 L Ed 2d 53).

Both cases involved settlement payments in actions for specific performance: Wise involved an action to compel the taxpayer, or lessor of real property, to allow the lessee to exercise an alleged option to purchase the real property and Wheeler involved a claim that the taxpayer breached a contract to sell a controlling stock interest. The courts in both cases held that the settlement payments were made to preserve and protect title to the property and therefore constituted nondeductible capital expenditures which were to be added to the cost basis of the property and could not be deducted as ordinary and necessary business expenses.

These Federal cases stand for the proposition that, regardless of the merits of the underlying claims in the specific performance actions, it is the origin and character of the underlying claims that controls the tax treatment of the settlement payment. The settlement payment represents the cost of defending title to the property and therefore should be added to the cost basis of the property. The application of these principles to the definition of "original purchase price" is rational in the present context. In this case, the nature and origin of the claim underlying the specific performance action involved an allegation that the taxpayer breached a contractual obligation to lease the property in question. The enforcement of this alleged contractual obligation would have undermined petitioner's ability to transfer the property to the transferee in this case. The settlement payment, therefore, constituted a cost to the taxpayer to preserve and protect its title to the property so that it could in turn transfer the property free of all encumbrances. Similar to the situation in Anchor Coupling Co. v. United States (supra), the settlement payment accomplished the same purpose as if the taxpayer transferred the property to the claimants and then reacquired the property for the original transfer price plus an amount equal to the settlement payment. Inasmuch as the settlement payment was made in exchange for a release of an encumbrance or claim on the property, it should be considered a cost to acquire an interest in the property and thus be included as part of the original purchase price.

B. Legal fees incurred to acquire an interest in real property may be included as part of the original purchase price (Tax Law § 1440.5[a][ii]; 20 NYCRR 590.15[b]). Therefore,

inasmuch as the settlement payment may be considered a cost to acquire an interest in the property transferred, legal fees incurred to settle the property claim should also be included as part of the original purchase price.

Contrary to the Division's assertion, the invoices are sufficient evidence that petitioner had incurred and paid more than \$15,188.00 in legal expenses¹ to reach a settlement of the specific performance action and removal of the lis pendens. The invoices indicate both the amount and the nature of the legal fees. Because these invoices also indicate amounts not paid on a previous invoice, it is reasonable to infer that petitioner paid any past amounts due if those amounts were not carried forward on the subsequent invoices for petitioner's ongoing legal expenses.

C. The petition of Preferred Rentals, Stockton Building, Inc. is granted and the Notice of Determination, dated April 16, 1992, is cancelled, the Division is directed to refund the sum of \$6,036.00, plus interest, to petitioner, and petitioner's annual installment payments are to be reduced to \$15,928.00.

DATED: Troy, New York
May 18, 1995

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE

¹The only jurisdictional documents being petitioned are the refund denial, Notice of Determination, dated April 16, 1992, and Conciliation Order, which reduced to \$1,518.00 the amount of tax due with respect to unsubstantiated legal fees. Therefore, although the rationale for including the legal fees could apply to the total amount now claimed by petitioner in its briefs, this determination covers only the \$15,188.00 in legal fees that were asserted in the Notice of Determination.