STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:
of	:
32ND STREET DEVELOPMENT ASSOCIATES	:DETERMINATION DTA NO. 812483
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, 32nd Street Development Associates, c/o Robert G. Gladstone, 875 Third Avenue, New York, New York 10022-6225, filed a petition for revision of a determination or for refund of tax on gains derived from certain real property transfers under Article 31-B of the Tax Law.

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on August 22, 1994 at 1:15 P.M. In a letter dated February 2, 1995, petitioner was given until February 10, 1995 to serve and file its reply brief which commenced the six-month period for issuing this determination. Petitioner filed briefs on November 22, 1994 and February 8, 1995. The Division of Taxation filed its brief on January 6, 1995. Petitioner appeared by Roberts & Holland (David E. Kahen, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Kenneth J. Schultz, Esq., of counsel).

ISSUES

I. Whether petitioner's payment of $1,000,000.00 to Mr. Sant Chatwal in December 1986 was consideration paid to

acquire an interest in real property within the meaning of Tax Law § 1440(5).

II. Whether petitioner has established that certain real estate taxes, insurance and mortgage interest are includible in original purchase price and, if so, whether the expenses have been substantiated.

III. Whether petitioner is liable for the additional tax, interest and penalties set forth in the notice of claim for greater deficiency.

IV. Whether petitioner has demonstrated that its underpayment of gains tax was attributable to reasonable cause and not willful neglect.

FINDINGS OF FACT

Petitioner, 32nd Street Development Associates, was a firm which was formed to assemble properties, demolish structures on the properties, obtain financing and build a residential high-rise condominium or rental apartment building. The design concept of the project was a building with 240 apartments and a significant amount of space for retail use. Petitioner also anticipated that the building would have a club with a swimming pool. As petitioner's president, it was Mr. Robert G. Gladstone's role to spearhead the development, design the project and be in charge of construction, marketing and finance.

On February 28, 1989, petitioner sold the property which it acquired. Prior to the sale, petitioner filed a Transferor Questionnaire which reported anticipated tax due of $320,054.00, calculated as follows:

Gross consideration
$19,150,000.00
Purchase price $8,970,000.00
Other acquisition costs 2,952,050.00
Cost of capital improvements 4,027,413.00
Original purchase price
15,949,463.00
Gain subject to tax
3,200,537.00
Anticipated tax due
320,054.00

In its gains tax questionnaire, petitioner claimed interest costs of $720,493.00, insurance costs of $56,964.00 and real estate costs of $525,388.00 as capital improvement costs incurred during a construction period and includible in original purchase price. The interest amount included in original purchase price was computed by multiplying the total interest expense incurred as then computed, $3,318,000.00, by the ratio which the costs of capital improvements, other than interest, as then computed, $3,306,920.00, bore to the total of acquisition costs and capital improvement costs ($15,171,900.00).

Upon pre-transfer audit, the Division of Taxation ("Division") made adjustments in its tentative assessment by reducing the original purchase price by 35.71 percent of the interest, insurance and real estate tax costs claimed. To the extent pertinent, the Division stated:

> "IT HAS BEEN DETERMINED THE CONSTRUCTION PERIOD ON THIS PROJECT EXISTED FROM 10/86 TO PRESENT, AND NOT FROM 7/85 AS PREVIOUSLY CLAIMED. ACCORDINGLY, 15/42 OF [sic] 35.71% OF CONSTRUCTION PERIOD INTEREST, TAXES AND INSURANCE, MUST BE DISALLOWED.
>
> REAL ESTATE TAXES 525,338 X 35.71%
> 187,598.20
> INTEREST 720,493 X 35.71%
> 257,288.05
> INSURANCE 56964 X 35.71%
> 20,341.84"

The Division also noted that it disallowed acquisition costs of $169,993.00 for lack of substantiation.

In accordance with the foregoing, the Division issued a Tentative Assessment and Return, dated January 27, 1989, which increased the amount of gain by $635,221.09. The foregoing resulted in a gain subject to tax of $3,835,758.09 and a tentative assessment of tax due of $383,575.81.

Petitioner filed a Supplemental Return, dated February 27, 1989, which reported an increase in the gain subject to tax of $43,100.00 resulting in a gain of $3,878,858.09 and a tax due of $387,885.81. Petitioner paid the tax shown due on the return.

The Division conducted a field audit of the sale which occurred on February 28, 1989 and, as a result, determined that additional tax was due. Accordingly, the Division issued a Notice of Determination, dated August 31, 1992, which asserted that tax was due in the amount of $237,037.00, plus interest of $100,234.01 and penalty of $82,962.00, for a balance due of $420,233.01. The Statement of Proposed Audit Adjustment, which was dated April 22, 1992, calculated the amount of tax due as follows:

Tax due per audit
$624,923.00
Less: previous payment
387,886.00
Tax Due
$237,037.00

As reflected in the audit workpapers that accompanied the Statement of Proposed Audit Changes, the assertion of additional tax due is based almost entirely on the disallowance of all or part of certain expenditures included in the acquisition and

capital improvement costs that were claimed by petitioner as includible in its original purchase price for the property. The expenditures partially or completely disallowed by the auditor included the following:

(a) A payment to Mr. Sant Chatwal in the amount of $1,000,000.00 claimed as an acquisition cost, of which $750,000.00 was disallowed as "excessive";

(b) Real estate taxes of $525,338.00 and construction period insurance costs of $56,964.00 claimed as capital improvement costs incurred during a construction period, all of which were disallowed with the explanation that "[n]o construction occurred therefore no construction period costs allowed"; and

(c) Interest of $720,493.00 claimed as a capital improvement cost incurred during a construction period was disallowed, with the explanation of "[l]oan dated 4/3/87 -- to refinance and satisfy 'obligation of owners'."

The aggregate amount of acquisition costs allowed by the Division was $10,505,182.00.

In addition to the foregoing adjustments, the Division determined on audit that there was additional consideration of $45,000.00. It also found that the following acquisition costs or capital improvement costs should be disallowed: special additional mortgage recording tax of $30,635.00; legal fees to Paskus, Gordon & Mandel in the amount of $42,000.00; expenses attributed to Vasa Realty of $325,000.00; expenses attributable to Rassena of $45,000.00; legal expenses attributable to the

firm of Bell Kalnick of $5,000.00; a transfer tax paid to the New York City Commissioner of Finance in the amount of $3,000.00; a brokerage commission in the amount of $2,587.00 as unsubstantiated; legal fees paid to White & Case in the amount of $43,653.00 which pertained to other transactions; miscellaneous expenses in the amount of $169,993.00; tenant buyout costs of $129,150.00 which were unsubstantiated; mortgage recording tax of $41,625.00 as unsubstantiated; title insurance of $6,298.00; and a disallowance of $131,150.00 on the grounds that one-half of the total claimed fee of $262,300.00 was in the nature of an accounting fee.

The aggregate amount of capital improvement costs allowed by the Division was $2,483,693.00 as follows:

Description (Per Workpapers)	Amount Allowed
Tenant Buyouts	$2,098,245.00
Construction & Demolition	52,000.00
Vijay Kale - Architect	10,000.00
Madison Co.	131,150.00
Crescent Equities	125,000.00
Construction/Demo submitted on audit	67,298.00
	$2,483,693.00

The Division issued a Notice of Claim for Greater Deficiency, dated August 17, 1994, pursuant to Tax Law § 1444(3)(a)(2). The notice sought additional tax due of $25,000.00, plus statutory interest from March 1, 1989 and penalty of $8,750.00. The following explanation was set forth on the document:

> "PLEASE TAKE FURTHER NOTICE that on audit the Division of Taxation allowed as a component of Petitioner's original purchase price $250,000. [sic] of the $1,000,000 claimed as having been paid to Sant Chatwal. The basis for the assertion of this greater

deficiency is the disallowance of the entire $1,000,000. payment to Sant Chatwal.

The first step in the project was the purchase of the land. This was accomplished one parcel at a time. The negotiations to acquire the parcels were difficult and protracted.

The order in which the parcels were purchased and the manner in which they were purchased was very important. If the owners of the parcels knew that a real estate developer was buying properties, the purchase price would have been greater and the development would have been delayed for years.

In order to obtain the parcels, petitioner employed the services of Mr. Sant Chatwal, who, at that time, was a restaurateur and hotel operator. Mr. Chatwal was able to convince the owners of the property that he did not plan on demolishing the buildings. Mr. Chatwal told the property owners that he wanted to alter the buildings to create a "pensionne/hotel". In the retail areas, Mr. Chatwal stated that he would build restaurants and put in establishments that would sell Indian-manufactured goods.

In fact, contrary to Mr. Chatwal's representations, it had been the consistent plan of the partnership to demolish the buildings. If the plan had been revealed, the price would have been greater.

The properties obtained by petitioner consisted of retail establishments and apartments which were used as residences. In order to pursue the plan of development, petitioner needed to acquire all of the parcels that would be necessary to construct

the building. It was also necessary that all possessory rights of tenants in place at the time of acquisition of each parcel be terminated.

It was petitioner's understanding that the tenants had legal protection. Therefore, steps were taken to relocate the people.

The tenant buyouts began in or about October 1986 and continued until the middle of 1988.

The negotiations in connection with the tenant buyouts and acquisition of possession were very difficult. An examination of the police blotter showed that there were significant social problems, including drug abuse, in three of the buildings. With the exception of one building, Mr. Chatwal took the principal role in negotiating the tenant buyouts.

Petitioner paid Mr. Chatwal a fee of $1,000,000.00 in consideration of his services relating principally to the assemblage of the parcels comprising the property and negotiations to terminate the tenancies. Mr. Chatwal also supervised demolition work relating to the property owned by petitioner.

At the time of the $1,000,000.00 payment to Mr. Chatwal, he had an interest in petitioner. The check for the $1,000,000.00 payment bears the signature "Chatwal" as drawer.

There was no written agreement for the $1,000,000.00 fee.

In addition to the $1,000,000.00 fee, Mr. Chatwal received another $1,200,000.00 payment. At the hearing, Mr. Gladstone was unable to explain the additional payment. However, he felt

that the payment was probably made to repay advances made by Mr. Chatwal as a partner in the partnership.

The aggregate amounts paid by petitioner, and allowed on audit, as consideration for the property and the tenant possessory rights were as follows:

Purchase price for parcels of land	$ 8,970,000.00
Air rights	360,000.00
Tenant buyout costs	2,098,245.00
Total	$11,428,245.00

By completing the assemblage and the buyout of tenant rights, Mr. Chatwal added substantial value to the assemblage. The property was ultimately sold in February 1989 for consideration of $19,238,000.00.

After the tenants surrendered the apartments, the buildings were rendered uninhabitable. Among other things, petitioner removed the staircase, the floor material, all plumbing fixtures and all electrical items. Petitioner also boarded up the windows. In some cases, the building was entirely stripped, leaving the crossbeams, the roof and some floor material holding the building together.

Demolition began at the time of the first tenant buyouts, which occurred in October 1986.

Petitioner commenced demolition immediately after it acquired space from a tenant in order to avoid the use or occupancy of the building by drug users or other squatters. It also permitted the rapid completion of demolition of the building at the time deemed appropriate.

Demolition of the buildings was completed prior to the sale of the property in February 1989.

The planning of this project began in late 1985 and early 1986 as Mr. Chatwal was acquiring the land on behalf of petitioner. As president of petitioner, Mr. Gladstone did business with Mr. Chatwal on a handshake. Mr. Gladstone knew that petitioner would eventually become the developer and builder.

Initially, the funds which were used to acquire the parcels and to finance the tenant buyout costs were obtained by Mr. Chatwal from the Bank of India and the First American Savings Bank.

The original loans were subsequently satisfied through a loan from Chase Manhattan Bank ("Chase"). Petitioner then entered into an agreement with Mr. Chatwal, a group known as Crescent Equities and Chase to finance the project.

The Summary of Loan Transaction set out in the Closing Memorandum for the April 3, 1987 mortgage transaction with Chase provided as follows:

"SUMMARY OF THE LOAN TRANSACTION

> "Prior to the Closing, the Mortgaged Premises was encumbered by mortgage indebtedness of (i) $2,500,000 payable to the Bank of India (the 'Bank of India Loan'), (ii) $4,800,000 payable to First American (the 'First American Loan'), and (iii) $1,070,000 payable to Kosseff's, Inc. (the 'Kosseff's Loan').
>
> "At the Closing, the Bank of India and First American mortgages were purchased by and assigned to Lender and modified and Lender made a new loan to Borrower (the 'New Loan'), in the principal amount of $4,305,000.
>
> "Lender also agreed to advance the sum of

$1,070,000 to Borrower at the time of maturity of the Kosseff's Loan, which funds are to be used to satisfy the obligations of Borrower under the Kosseff's Loan, and Kosseff's agreed to assign its mortgage to Lender upon such satisfaction."

The Summary of the Loan Transaction set out in the Closing Memorandum for the July 15, 1988 mortgage transaction with Chase provided as follows:

"SUMMARY OF THE LOAN TRANSACTION

"Prior to the original loan closing on April 3, 1987 (the 'Original Closing'), the Mortgaged Premises was encumbered by mortgage indebtedness of (i) $2,500,000 payable to the Bank of India (the 'Bank of India Loan'), (ii) $4,800,000 payable to First American Bank (the 'First American Loan'), and (iii) $1,070,000 payable to Kosseff's, Inc. (the 'Kosseff's Loan').

"At the Original Closing, the Bank of India and First American mortgages were purchased by and assigned to Lender and modified and Lender made a new loan to Borrower (the 'New Loan'), in the principal amount of $4,305,000.

"Lender also agreed to advance the sum of $1,070,000 to Borrower at the time of maturity of the Kosseff's Loan, which funds were to be used to satisfy the obligations of Borrower under the Kosseff's Loan, and Kosseff's agreed to assign its mortgage to Lender upon such satisfaction.

"At the closing on July 1, 1987 (the 'July 1987 Closing'), Borrower advanced funds in purchase of the Kosseff's Loan and the note and Mortgage held by Gary Kosseff, as successor to Kosseff's, Inc., were assigned to Lender and modified.

"At the Closing described herein, Lender agreed to increase the amount of the prior loans by $1,850,000 for the purpose of making payments to tenants of the Mortgaged Premises as an inducement for them to vacate their apartments. Such loan is secured by a new mortgage of the Mortgaged Premises, a financing statement, a limited guaranty of payment in the amount of $600,000 (the 'Guaranty') and an irrevocable letter of credit in Lender's favor for the account of Borrower in the amount of $1,250,000 (the 'Letter of Credit')."

At the hearing, Mr. Gladstone testified that the "land

draw" of the construction loan from Chase was disbursed and that it was his intention to draw upon the construction loan at a later date.

Petitioner decided to proceed with inclusionary zoning because it was a method which allowed for the construction of a larger building. Mr. Gladstone also explained that petitioner wanted to obtain a "421A tax abatement". In 1987 and 1988, Mr. Gladstone negotiated the purchase of the inclusionary zoning certificates and 421A tax abatement certificates with an entity known as General Atlantic Realty.

Petitioner obtained architects' plans for the site, known as schematic stage development, to obtain financing and to make major decisions such as where certain items would go, how many apartments there would be, how much retail space there would be and a cost estimate. Later, petitioner obtained design development drawings where details were highlighted. The latter item led to working drawings.

At one juncture, Mr. Gladstone became concerned because there was a dispute within the family of one of his partners. Mr. Gladstone knew that this dispute was causing unhappiness at another location and did not want the same thing to happen at this development. Therefore, in order to find financing, he met with a series of Japanese companies.

Ultimately, petitioner did not proceed with the construction of the new building for two related reasons. Notwithstanding extensive efforts to interest major construction companies in participating in the construction of the proposed

building, negotiations with these construction companies proved unsuccessful. Subsequently, some of Mr. Gladstone's partners concluded that they did not want to proceed with the development and brought in a potential buyer. When Mr. Gladstone notified Chase that petitioner was not going forward with the project, Chase located a buyer and a contract for the sale of the property was agreed upon quickly.

During the course of petitioner's ownership of the property, interest, insurance and real estate costs were incurred by petitioner in the following amounts, which include certain charges not taken into account in the pre-transfer filing:

Interest
$3,383,692.94
Insurance
83,706.47
Real estate taxes
493,857.72

Mr. Gladstone enlisted the professional advice of a law firm in order to comply with the requirements of the gains tax law. It is Mr. Gladstone's belief that he and his staff undertook all efforts of which he was able in order to comply with the tax law and that the gains tax returns were correct as filed.

Petitioner made real estate tax payments aggregating $472,194.32 and insurance payments aggregating $78,911.18 during the period beginning in October 1986 and ending with the sale of the property.

Mr. Chatwal did not appear and testify at the hearing.

In accordance with section 307(1) of the Administrative

Procedure Act, petitioner's proposed findings of fact were generally accepted and incorporated into the determination. It is noted that proposed findings of fact "2", "3", "5", "8", "9", "13", "15", "17" and "18" were modified to reflect the record.

The Division's proposed findings of fact have been generally accepted and included herein. Proposed findings of fact "1", "4" and "6" were modified to reflect the record.

CONCLUSIONS OF LAW

A. Initially, petitioner maintains that the fees paid to Mr. Chatwal are includible in original purchase price as an acquisition cost under Tax Law § 1440(5)(a) and 20 NYCRR former 590.15(b). According to petitioner, the fee was directly related to the acquisition in the same manner as fees that are specifically enumerated in the foregoing regulation are allowable. Petitioner also contends that the efforts of Mr. Chatwal resulted in a substantial increase in the value of the properties acquired by petitioner by permitting separate parcels of land encumbered by small, obsolete buildings to be combined into a single, large parcel suitable for immediate construction. Lastly, petitioner notes that the Division presented no evidence that the fee paid was unreasonable or that the services could have been obtained elsewhere for a lower cost.

In response to the foregoing, the Division contends that the $1,000,000.00 payment was not includible in original purchase price because it was not paid or required to be paid by the transferor to acquire an interest in real property. It is

submitted that petitioner bears a heavy burden of proving that the $1,000,000.00 fee paid to Mr. Chatwal is one of the costs and expenses explicated by the Division in the regulations. The Division further posits that whether Mr. Chatwal's efforts increased the value of the property has no relevance to whether the fee is an allowable component of original purchase price. The Division concludes by stating that petitioner has not established that the only reasonable construction of Tax Law § 1440(5)(a)(1) and 20 NYCRR former 590.15 allows the inclusion of the $1,000,000.00 fee in original purchase price.

In its reply brief, petitioner first notes that the Division has not been consistent regarding the inclusion of Mr. Chatwal's fee in original purchase price. Initially, the Division included $250,000.00 of the $1,000,000.00 fee with the balance of the fee being disallowed as excessive. Petitioner also contends that the evidence shows that the fee was paid to Mr. Chatwal in consideration of his services relating principally to the assemblage of parcels of property and negotiations to terminate tenancies. Petitioner submits that the fact that Mr. Chatwal was a partner does not preclude the inclusion in original purchase price of fees paid in his capacity as a partner. After reviewing Tax Law § 1440(5)(a), it is contended that a fee or other amount paid by a transferor to acquire an interest in real property is includible in original purchase price regardless of whether the category of expenditure is specifically enumerated in the regulations promulgated under that provision.

According to petitioner, statements in the Division's brief regarding the burden on petitioner are inappropriate because 20 NYCRR former 590.15 is consistent with petitioner's position. Further, petitioner argues that the list in 20 NYCRR former 590.15 is illustrative and not exclusive. Petitioner maintains that the Division failed to offer any reason for treating the fee paid to Mr. Chatwal in a different manner from other acquisition-related costs.

According to petitioner, its proposed findings of fact are supported by the record. Further, the nature and veracity of the statements made by Mr. Chatwal are not in issue. It is also argued that there is no evidence to support the inference that the amount paid to Mr. Chatwal was a distribution with respect to his interest as a partner.

Petitioner contends that since the fee was paid in order to effect the acquisition of parcels of property, it is includible in original purchase price regardless of whether the fee was "reasonable". In addition, it is maintained that the payment was reasonable in light of the services rendered and the results achieved.

B. Article 31-B of the Tax Law provides for the imposition of tax at the rate of 10 percent upon the gain derived from the transfer of real property where the consideration received for such transfer is $1,000,000.00 or more (Tax Law §§ 1441, 1443[1]). Tax Law § 1440(3) defines "gain" as:

> "the difference between the consideration for the transfer of real property and the original purchase price of such property, where the consideration exceeds the original purchase price."

C. The definition of original purchase price is set forth in Tax Law § 1440(former [5][a]). This provision states:

> "'Original purchase price' means the consideration paid or required to be paid by the transferor; (i) to acquire the interest in real property, and (ii) 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 tax commission, incurred for the construction of such improvements. Original purchase price shall also include the amounts paid by the transferor for any customary, reasonable and necessary legal, engineering and architectural fees incurred to sell the property and those customary, reasonable and necessary expenses incurred to create ownership interests in property in cooperative or condominium form, as such fees and expenses are determined under rules and regulations prescribed by the tax commission."

D. Under 20 NYCRR former 590.15 certain preacquisition and acquisition costs may be included in the computation of original purchase price such as legal, architectural and other professional fees.

E. In this instance, it is clear that Mr. Chatwal had a central role in acquiring the property involved herein and that the amount paid to him was "to acquire an interest in real property" within the meaning of Tax Law § 1440(5)(a)(i). Therefore, petitioner properly included the amount paid to him in original purchase price.

F. In reaching this conclusion, several points may be noted. First, the fee paid to Mr. Chatwal may be regarded as a professional fee within the meaning of 20 NYCRR former 590.15(b) and therefore includible in original purchase price within the meaning of the Commissioner's regulations. Second, on its face, the list of those costs which are included in original purchase

price, set forth at 20 NYCRR former 590.15(b), is, on its face, intended to be illustrative. The regulation does not state that the list is intended to be exclusive. Third, the fee paid to Mr. Chatwal justly and fairly represented the worth of his services. The record establishes the difficulties of the negotiating process and that Mr. Chatwal's efforts resulted in a significant increase in the value of the properties acquired by petitioner.

Lastly, it is noted that in Matter of Enders Farms Associates (Tax Appeals Tribunal, December 1, 1994), the Tribunal affirmed the determination of an Administrative Law Judge which found that the cost of the services of a certain individual were includible in original purchase price. As was the case with Mr. Chatwal, these services included negotiating the purchase price of property.

G. Since the fee paid to Mr. Chatwal was includible in original purchase price, there was no basis for the Notice of Claim for Greater Deficiency. Accordingly, the Notice of Claim for Greater Deficiency, dated August 17, 1994, is cancelled.

H. The next question presented is whether the Division properly excluded from original purchase price the amounts claimed for real estate taxes and insurance expenses.

Initially, petitioner claims that, by virtue of 20 NYCRR 590.17(c), the construction period began when it commenced demolition of the buildings. It is then noted that, under 20 NYCRR 590.17(d), interest, insurance costs and real property taxes are includible in original purchase price if they are

associated with a capital improvement and incurred during a construction period. Relying upon 20 NYCRR 590.17(e), petitioner submits that a construction period begins when there is a plan of construction and the plan of construction is essentially implemented. It is petitioner's position that the record shows that there was a plan of construction and the construction plan was essentially implemented through the demolition of the existing structures.

In its brief, the Division submits that in order to prevail petitioner must show that the only reasonable construction of Tax Law § 1440(5)(a)(ii) and 20 NYCRR 590.16(e) allows the inclusion of the claimed construction period expenses. It is noted that it determined that the demolition work done by petitioner constituted a capital improvement and allowed petitioner to add $119,298.00 in demolition costs to its original purchase price. However, this does not mean there was a construction period. Relying upon 20 NYCRR 590.16(e), the Division argues that petitioner did not have a construction period because the demolition was not part of a continuing plan of construction. It is contended that the construction plan never came to fruition.

In its reply brief, petitioner submits that since the Division has not objected to its schedule of expenses, the evidence in the record establishes the amounts of interest, insurance and real estate taxes paid by petitioner and when these amounts were paid.

In response to the argument that there was not a continuing

plan of construction, petitioner argues:

> "Robert Gladstone's testimony at the hearing, and documents introduced in evidence, as reviewed on page 10 of Petitioner's brief, establish that there was a plan of construction. Pursuant to the plan, demolition commenced in October, 1986, at the time the first tenant buyouts occurred (Transcript pp. 34-35). Mr. Gladstone's testimony at the hearing also demonstrated that the plan of construction continued to be pursued at least until late in 1988 (Transcript pp. 43-45). The Division has not introduced any evidence, or argued, that the construction period (if established) ended at any time prior to the sale of the Property in February, 1989. Accordingly, there was a 'continuing plan of construction' at the time demolition began in 1986." (Petitioner's reply brief, pp. 8-9.)

Petitioner next argues that there is no basis for distinguishing between types of demolition work, such as between exterior and interior demolition. Further, 20 NYCRR 590.16(e) does not state that the sole purpose of the demolition must be for construction. Petitioner contends that the assertion in the Division's brief that "no construction took place here" is inconsistent with the evidence and the meaning of the term "construction" as used in 20 NYCRR 590.16.

Petitioner maintains that the statement in the Division's brief that "[n]o building permits were obtained" is unsupported by the record and incorrect. Lastly, petitioner states that it is irrelevant that the plan of construction never came to fruition.

I. During the period in issue, 20 NYCRR former 590.16(e) provided as follows:

> "Question: When does a construction period begin and end?
>
> "Answer: A construction period usually begins on the date on which construction, development, erection

> or complete renovation of all or part of the property begins, and ends on the date that the real property or other improvement is ready to be placed in service or is ready for sale. The construction period is not considered to have begun solely because a plan of construction has been prepared or a building permit has been obtained. Rather, the construction period generally will be considered to have commenced when the plan of construction is essentially implemented.
>
> "For example, in the case of the demolition of existing structures, the construction period is considered to commence when the demolition begins if the demolition is undertaken to prepare the site for construction. The construction period will not be considered to have begun solely because of the demolition of existing structures if the demolition is not undertaken as part of a continuing plan of construction of the real property."

J. Petitioner's argument that there was a construction period relies upon its demolition activities. Under the circumstances presented herein, this reliance is misplaced.

Demolition may be regarded as the beginning of the construction period (20 NYCRR former 590.16[e]). However, this is only the case if the demolition was undertaken to prepare the site for construction and is part of a continuing plan of construction. Here, petitioner has not established that the demolition was undertaken as part of "a continuing plan of construction of the real property" (20 NYCRR former 590.16[e]). The testimony of petitioner's witness is clear that the demolition was undertaken primarily to secure the site from unwanted individuals rather than as part of a continuing plan of construction.

It is the foregoing point which renders petitioner's argument specious. Since the demolition in this instance was not done to prepare the site for construction, petitioner has

not shown that the construction began. Further, the burden was not on the Division to show when the construction period ended.

K. Petitioner is correct that 20 NYCRR former 590.16(e) does not state that the sole purpose of the demolition must be for construction. However, the fact that demolition began in October 1986, the last tenant buyout occurred in the middle of 1988 and construction was not underway by February 1989 lends credence to the Division's assertion that the plan of construction was never "essentially implemented" (20 NYCRR former 590.16[e]). For this reason, the fact that the plan of construction never came to fruition is relevant.

L. Petitioner next argues that the schedule of interest costs included in its analysis shows that interest charges of $3,103,484.04 were paid by petitioner during the construction period. On audit, all interest costs incurred by petitioner were disallowed as allegedly not relating to a construction loan.

It is petitioner's position that all interest paid during the construction period, whether attributable to the cost of acquiring the property or other construction or development costs, should be included in original purchase price under Tax Law § 1440(5). It is submitted that the amendment to the Tax Law in 1993, under which interest paid during the construction period on loans incurred to acquire real property is explicitly included in original purchase price, should be viewed as a clarification of existing law.

If the foregoing is not accepted, petitioner submits that

construction period interest must at a minimum be included in original purchase price to the extent allocable to capital improvement costs.

Petitioner determined the total amount of capital improvement costs as follows:

Tenant possession costs
$2,098,245.00
Demolition ($52,000.00 + $67,298.00 on audit)

119,298.00
Mortgage recording tax
41,625.00
Title insurance
6,298.00
Construction period insurance
78,911.00
Construction period taxes
472,194.00
Architect
10,000.00
Management fees
131,150.00
Total
$2,957,721.00

Petitioner notes that, based on the workpapers, the aggregate amount of acquisition costs incurred and allowed on audit was the sum of $8,970,000.00 (the amount paid for the parcels of land) and other acquisition costs of $2,166,868.00 for a total of $11,136,868.00. Petitioner submits that the total amount of acquisition costs and capital improvement costs is the sum of $2,957,721.00 and $11,136,868.00, or $14,098,589.00. On the basis of the foregoing, petitioner surmises that the allocation ratio may be calculated as $2,957,721.00 divided by $14,094,589.00, or that 20.98 percent of the total interest costs, or $651,111.00, is includible in original purchase price.

In response to the foregoing, the Division submits that the loans from Chase were neither construction loans nor acquisition loans. It is also argued that the amended version of Tax Law § 1440(5)(a) does not apply to the facts of this case.

In a reply brief, petitioner reiterates the position it previously asserted. Petitioner also acknowledges that the amendment to Tax Law § 1440(5)(a) does not apply to this transfer. Rather, it is petitioner's position that the amendment was a response to the Division's prior erroneous interpretation. Petitioner also asserts that Matter of Mattone v. State of New York Dept. of Taxation & Fin. (144 AD2d 150, 534 NYS2d 478) is inapplicable because the interest costs were paid after construction allegedly commenced.

Lastly, petitioner submits that if its position on acquisition of indebtedness is not accepted, it continues to maintain that the interest paid by it is includible in original purchase price to the extent that the funds were used to pay costs incurred to develop the property.

M. Petitioner's argument that its interest costs are includible in original purchase price is rejected. For the reasons previously stated, it is concluded that petitioner did not have a construction period. It follows that petitioner did not pay interest during a construction period and that 20 NYCRR former 590.16(d) is inapplicable.

N. It is also concluded that the Division has accurately noted that the summaries of loan transaction establish that the interest which petitioner seeks to include in original purchase

price was not from construction loans allocable to capital improvements.[1] Therefore, the interest costs would not be includible in original purchase price as a customary, reasonable and necessary capital improvement cost under Tax Law § 1440(5).

O. Lastly, petitioner argues that there is no basis for the imposition of penalties in this case. It is noted that it filed a pre-transfer questionnaire on a timely basis, endeavored to comply with the gains tax law, obtained qualified professional advice as to the requirements of the gains tax law in preparation of questionnaires, and paid tax shown on the tentative assessment on a timely basis. It is also argued that petitioner's positions with respect to includible costs were consistent with the published positions of the Division and reasonable in light of the limited guidance from the statute and from the Division.

In response to the foregoing, the Division argues that the audit resulted in numerous disallowances, not just the items at issue herein, and there is no reasonable cause for the underpayment of those items.

As to the fee paid to Mr. Chatwal and the claimed construction period expenses, the Division contends that petitioner is responsible for paying the proper amount of tax on the date the payment is due. The pre-transfer audit is not intended to replace a detailed audit. Therefore, it is

[1]It is noted that Mr. Gladstone testified that the "land draw" of the Chase loan was disbursed and that it was his intention to draw upon the construction loan at a later date (tr., p. 56).

submitted that the fact that the construction period was taken into account during the pre-transfer audit procedure does not relieve petitioner of paying the proper amount of tax on the due date. The Division concludes that petitioner has not established that its failure to pay the proper amount of tax due was attributable to reasonable cause and not willful neglect.

In its reply brief, petitioner argues that the difficulties and uncertainties in determining gains tax due are highlighted by the Division's varying positions over the items at issue. During the pre-transfer audit, following extensive disclosure in petitioner's Transferor Questionnaire, the auditor determined that there was a construction period that began in October 1986.

Petitioner surmises that no penalty should be imposed because the foregoing shows that the proper treatment of the item was unclear at the time the questionnaires were filed and petitioner's positions were reasonable and adopted in good faith. It is also argued that petitioner made extensive efforts to comply with the gains tax law.

P. Tax Law former § 1446(2)(a) provides that:

> "[a]ny transferor failing to file a return or to pay any tax within the time required by this article shall be subject to a penalty . . . . If the tax commission determines that such failure or delay was due to reasonable cause and not due to willful neglect, it shall remit, abate or waive all of such penalty and such interest penalty."

Q. The burden of proving that the penalty was improperly assessed is upon the taxpayer (see, Matter of Bachman v. State Tax Commn., 89 AD2d 679, 453 NYS2d 774). Here, the audit resulted in significant adjustments to numerous items and not

just the matters at issue in this determination. In view of the size, number and nature of the adjustments, petitioner has not established that the failure to pay the tax within the time required by Article 31-B of the Tax Law was due to reasonable cause and not due to willful neglect.

R. The petition of 32nd Street Development Associates is granted to the extent of Conclusions of Law "E" and "G"; the Division is directed to modify the Notice of Determination, dated August 31, 1992, accordingly and to cancel the Notice of Claim for Greater Deficiency, dated August 17, 1994; except as so granted, the petition is, in all other respects, denied and the Notice of Determination is sustained, together with such penalty and interest as may be lawfully due.

DATED: Troy, New York
August 10, 1995

/s/ Arthur S. Bray

ADMINISTRATIVE LAW JUDGE