

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
JOSEPH JEFFRIES-EL : DETERMINATION
for Redetermination of a Deficiency or for Refund of : DTA NO. 826103
Personal Income Tax under Article 22 of the Tax Law :
and the Administrative Code of the City of New York :
for the Years 2007 and 2008. :
:

Petitioner, Joseph Jeffries-El, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law and the Administrative Code of the City of New York for the years 2007 and 2008.

A hearing was held before Herbert M. Friedman, Jr., Administrative Law Judge, in New York, New York, on March 16, 2015 at 10:30 A.M., with all briefs to be submitted by July 6, 2015, which date began the six-month period for the issuance of this determination. Petitioner appeared pro se. The Division of Taxation appeared by Amanda Hiller, Esq. (Kent J. Gebert, Esq., of counsel).

ISSUES

I. Whether petitioner's payment in settlement of litigation was allowable as either a deductible business expense or capital expenditure to be included in petitioner's basis when calculating the gain on a sale of real property.

II. Whether petitioner's payment of mortgage interest was allowable as either a deductible business expense or capital expenditure.

FINDINGS OF FACT

1. During 2007 and 2008, petitioner, Joseph Jeffries-El, was a resident of both the state and city of New York, and filed New York State personal income tax returns for those years.

2. Starting in June 1998, petitioner was the sole shareholder of Tiffany Associates, Inc. (Tiffany), a subchapter S corporation.

3. Tiffany was the owner of two contiguous parcels of real property located at 783 Eldert Lane, Brooklyn, New York (the property). An abandoned health care facility was located on the property. The property was the primary asset owned by Tiffany.

4. Petitioner and Darshan Shah, M.D. (Dr. Shah) executed an agreement, dated October 6, 2003 (Stock Purchase Agreement), calling for petitioner to sell all of his shares in Tiffany to Dr. Shah for \$100,000.00 and the assumption of certain debt. Pursuant to the terms of the Stock Purchase Agreement, petitioner was to deliver all stock certificates of Tiffany to Dr. Shah. As a result of the Stock Purchase Agreement, Dr. Shah believed that he was the sole owner of Tiffany and, therefore, the property.

5. Petitioner never delivered the shares of Tiffany's stock to Dr. Shah.

6. In May 2007, Dr. Shah discovered that petitioner was seeking to obtain a mortgage loan in excess of \$1,000,000.00 from Staten Island Realty Group, LLC (SI Realty), to be secured by the property. In response, Dr. Shah's attorney questioned petitioner's attorney about the pending transaction and was informed that petitioner claimed ownership of Tiffany and the property. Consequently, petitioner claimed he had the right to encumber the property.

7. On May 22, 2007, Dr. Shah commenced a civil action against petitioner and Tiffany in Nassau County Supreme Court (Index No. 07/008868) (First Shah Lawsuit) to prevent petitioner from encumbering or transferring any and all assets of Tiffany, including the property, as well as

entering into any loan agreement on behalf of Tiffany. Moreover, the First Shah Lawsuit sought a determination that Dr. Shah was the sole shareholder of Tiffany and directing petitioner to deliver all outstanding stock shares of Tiffany.

8. On June 8, 2007, Dr. Shah commenced a civil action against petitioner and Tiffany in Kings County Supreme Court (Index No. 20635/2007) (Second Shah Lawsuit). The Second Shah Lawsuit sought a judgment declaring Dr. Shah owner of the property and for specific performance of the Stock Purchase Agreement. In addition, the Second Shah Lawsuit included a notice of pendency relating to the property, which Dr. Shah filed with the Clerk of Kings County.

9. Dr. Shah commenced another civil action against petitioner in Nassau County Supreme Court (Index No. 07/010083) (Third Shah Lawsuit) on June 7, 2007, seeking a money judgment for \$452,153.43, plus additional interest, for enforcement of a promissory note dated October 6, 2003 in the principal amount of \$300,000.00 between Dr. Shah, as lender, and petitioner, as maker.

10. On June 11, 2007, Dr. Shah commenced another civil action against petitioner in Nassau County Supreme Court (Index No. 07/010082) (Fourth Shah Lawsuit). The Fourth Shah Lawsuit sought summary judgment by means of a motion in lieu of a complaint. Dr. Shah's motion was granted, without opposition, on September 4, 2007, and awarded Dr. Shah a judgment in the amount of \$152,695.89. The record is devoid of evidence of the substance of the Fourth Shah Lawsuit.

11. Previously, in October 2005, Tiffany filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court, Eastern District of New York. Its plan was subsequently confirmed on March 20, 2007. In response to the Shah Lawsuits,¹ in July 2007, Tiffany filed an

¹ Collectively, Dr. Shah's lawsuits against Tiffany and petitioner will be referred to as the Shah Lawsuits.

application with the bankruptcy court for an order 1) enforcing the discharge injunction against Dr. Shah's litigation; 2) vacating the notice of pendency; and 3) finding Dr. Shah in contempt (Bankruptcy Motion). The Bankruptcy Motion was supported by petitioner's affidavit, in which he identified himself as president of Tiffany.

12. On July 23, 2007, Dr. Shah and Tiffany entered into a stipulation in the course of the bankruptcy (Bankruptcy Settlement) settling a claim by Dr. Shah in the amount of approximately \$500,000.00 emanating from the October 6, 2003 promissory note in the principal amount of \$300,000.00 (*see* Finding of Fact 9). The Bankruptcy Settlement called for a settlement amount of \$0, which, according to Dr. Shah, allowed Tiffany to emerge from bankruptcy. Petitioner, a co-maker of the note, was not a party to the Bankruptcy Settlement.

13. In August 2007, shortly after filing of the Bankruptcy Motion and ensuing Bankruptcy Settlement, petitioner, Dr. Shah, and Tiffany entered into a settlement agreement (Settlement Agreement) to globally resolve their disputes.² The Settlement Agreement called for payment of \$1,100,000.00 by petitioner and Tiffany to Dr. Shah. In return, Dr. Shah agreed to waive all claims to any ownership interest he may have in Tiffany or the property. Additionally, Dr. Shah agreed to discontinue the Shah Lawsuits,³ and execute a stipulation canceling the notice of pendency associated with the Second Shah Lawsuit. Moreover, the parties acknowledged that Dr. Shah held an existing mortgage in the amount of \$400,000.00 on the property, and extended the repayment period on the associated note for petitioner and Tiffany until July 31, 2008.

² The exact date in August 2007 on which the Settlement Agreement was signed is blank on the copies in the record.

³ In addition to the four Shah Lawsuits, the Settlement Agreement references the discontinuance of an action between Dr. Shah and petitioner pending in Nassau County Supreme Court, with index number 010191/07. According to a search of the database of the New York State Unified Court System placed in the record, however, that index number was held by five unrelated cases in other counties. Petitioner maintained at hearing that Dr. Shah purchased that index number, but never actually filed suit.

Finally, the Settlement Agreement stated that petitioner and Tiffany intended to further encumber the property and that Dr. Shah's \$400,000.00 mortgage was subordinate to the anticipated subsequent encumbrance.

14. During the course of and after emerging from bankruptcy, it was the purpose and intention of Tiffany to create two facilities on the property. The first was a nursing home to be operated by Skyview Realty Associates, Ltd (Skyview). The second was an affordable housing facility. Petitioner estimated that the two projects would provide Tiffany with a profit of approximately \$6,000,000.00.

15. After completion of the Settlement Agreement, and in order to proceed with the two projects, on September 25, 2007, Tiffany closed on a mortgage loan in the amount of \$1,850,000.00 from SI Realty that was secured by the property.⁴ As part of the closing from the disbursed funds, Dr. Shah received a check in the amount of \$1,167,560.00, which represented 1) the Settlement Agreement payment of \$1,100,000.00; 2) repayment of two advances to Tiffany totaling \$10,000.00; 3) repayment of an advance for New York City property taxes in the amount of \$23,444.11; and 4) interest on the \$400,000.00 mortgage loan.⁵

16. Additionally, a check in the amount of \$341,000.00 from the loan proceeds, which represented prepaid mortgage interest, was provided to Sovereign Bank as escrow agent for SI Realty. Petitioner placed into the record a Form 1098, Mortgage Interest Statement, in the amount of \$244,773.93, evidencing payment of interest from Tiffany to SI Realty during 2008.

⁴ The actual name of the borrower was Tiffany Associates 1, Inc. f/k/a Tiffany Associates, Inc.

⁵ The payment breakdown was described in a letter from Dr. Shah's attorney to petitioner's attorney dated September 14, 2007. The difference between the payoff figure cited in the letter (\$1,157,494.11) and the eventual payment to Dr. Shah reflects the additional accrued interest on the \$400,000.00 mortgage loan between the date of the letter and the closing.

17. Also on September 25, 2007, Tiffany transferred one of the two parcels of the property to SI Realty for forgiveness of an existing \$5,000,000.00 debt. On September 25, 2008, Tiffany sold the remaining parcel of the property to Hudson Eldert LLC for \$2,600,000.00. Dr. Shah received two checks from the proceeds of the September 25, 2008 sale; one for \$443,350.59, which represented payment in full of the \$400,000.00 loan referenced in Finding of Fact 13, and one for \$50,000.00.

18. In 2011, the Division of Taxation (Division) began an audit of Tiffany's franchise tax returns for the years 2006 through 2008. During the audit, it was discovered that Tiffany failed to report the sales of the two parcels of the property and any gain. It was also discovered that petitioner, likewise, had failed to report the sales or gain on his returns. Consequently, at the Division's request, petitioner provided documentation with regard to the sale of the property.

19. At the conclusion of the audit, Tiffany and petitioner agreed with the Division that the total consideration they received for the property was \$7,600,000.00. Tiffany and petitioner, however, maintained that the basis in the property was \$7,635,881.00, resulting in a net loss and no tax liability. Meanwhile, the Division disallowed \$1,822,766.00 of the claimed basis, resulting in a revised basis of \$5,813,115.00, and an unreported capital gain of \$1,175,582.00 for 2007 and \$611,303.00 for 2008.⁶

20. Based on the audit, the Division issued Notice of Deficiency L-039042975-8, dated February 1, 2013, to petitioner as sole shareholder of the S corporation, Tiffany. The statutory notice asserted additional tax due of \$187,951.00, penalty of \$64,684.52, and interest, for a total liability of \$325,583.17 for the years 2007 and 2008.

⁶ The Division apportioned the gain and the basis in proportion to the amount of the 2007 sale to SI Realty (\$5,000,000.00) and the 2008 sale to Hudson Eldert LLC (\$2,600,000.00).

21. After a conciliation conference, the Bureau of Conciliation and Mediation Services (BCMS) issued a conciliation order dated November 22, 2013 recomputing the statutory notice. The conciliation order reduced the tax to \$174,604.00, and sustained penalties and interest to be computed at the applicable rate on the revised tax figure.

22. After the BCMS adjustments, two issues remained. The first was the Division's disallowance of petitioner's inclusion of the \$1,167,560.00 payment to Dr. Shah in the basis of the property. The second involved treatment of Tiffany's \$341,000.00 escrow payment of mortgage loan interest to Sovereign Bank on behalf of SI Realty. The Division calculated that only a portion of the \$1,850,000.00 loan to Tiffany from SI Realty had a business purpose and, thus, conceded that \$62,936.00 of the \$341,000.00 was deductible. However, the remaining \$278,064.00 in prepaid interest payment was disallowed by the Division as having no business purpose.

SUMMARY OF THE PARTIES' POSITIONS

23. Petitioner maintains that the \$1,167,560.00 payment to Dr. Shah was a payment made in settlement of a lawsuit for specific performance and directly related to title of the property and, as such, was a capital expenditure. Therefore, petitioner asserts that it was properly included in the basis of the property. He adds that the \$341,000.00 interest payment held in escrow by Sovereign Bank was also a capital expense. Alternatively, petitioner asserts that each of these payments was deductible as ordinary or necessary business expenses.

24. The Division argues that the payment to Dr. Shah was in settlement of monetary claims and not for any claim on Tiffany's assets, including the property. Furthermore, the Division asserts that petitioner failed to substantiate the nature of the payment to Dr. Shah and

the escrow payment, causing both to be disallowed as neither capital expenditures nor deductible business expenses.

CONCLUSIONS OF LAW

A. The first issue in this matter is whether Tiffany's settlement payment of \$1,167,560.00 to Dr. Shah was a nondeductible capital expenditure as described in Internal Revenue Code (IRC) § 263 and, therefore, properly included in the basis of the property by petitioner.⁷ The starting point for determining New York personal income tax liability is a taxpayer's federal adjusted gross income (Tax Law § 612[a]; 20 NYCRR 112.1). Since the New York State personal income tax law is patterned after the federal income tax laws, the IRC provides guidelines with respect to the treatment of income and the deductibility of various expenses (*see Matter of Brenhouse*, Tax Appeals Tribunal, September 4, 2008). Moreover, in the absence of New York case law, it is proper to look to federal interpretations of similar IRC provisions (*see Matter of Yellin v. New York State Tax Commn.*, 81 AD2d 196 [1981] ["New York income tax law evinces a strong intent to conform to Federal authority wherever possible . . . "]).

B. In support of his petition, petitioner correctly cites *Anchor Coupling Co. v. United States* (427 F2d 429 [1970], *cert denied* 401 US 908 [1971]). In *Anchor Coupling*, the court found that a settlement payment made in an action for specific performance of a contract to purchase assets constituted a nondeductible capital expenditure and not a deductible ordinary and necessary business expense. The court enunciated that "the origin and character of the claim with respect to which a settlement is made . . . is the controlling test of whether a settlement payment constitutes a deductible expense or a nondeductible capital outlay" (*id.* at 433).

⁷ Petitioner was the sole shareholder of Tiffany, a subchapter S corporation. As a result, it is uncontroverted that Tiffany's tax attributes flowed through to petitioner, who filed personal income tax returns as a New York State resident under Article 22 of the Tax Law during the years at issue (*see* Tax Law § 660).

C. Applying that rule to the instant case, the record plainly shows that the settlement payment to Dr. Shah of \$1,100,000.00 was to remove his claim or an encumbrance on the property. The Settlement Agreement specifically and unambiguously provided that for the consideration of \$1,100,000.00, Dr. Shah waived all claims he may have had against Tiffany or the property. Moreover, he agreed to discontinue all of the Shah Lawsuits, most of which involved a claim for specific performance of the Stock Purchase Agreement, and one that involved creation of a notice of pendency on the property. The enforcement of the Stock Purchase Agreement, and continued pursuit of the Shah Lawsuits, would have undermined petitioner's ability to mortgage the property to SI Realty. The settlement payment, therefore, constituted a cost to Tiffany (and ultimately petitioner) to preserve and protect its title to the property so that it could in turn transfer the property free of all encumbrances. Consequently, the origin and character of the claim that was settled, i.e., Dr. Shah's claim to the property, dictates that the settlement payment of \$1,100,000.00 was a capital expenditure.

D. The Division's argument that the payment to Dr. Shah was solely for settlement of monetary claims is not supported by the record. It is true, as the Division emphasizes, that several of the Shah Lawsuits sought monetary damages and the total amount claimed to be owed by Dr. Shah exceeded the settlement payment. The Division's position, however, ignores the unambiguous language of the Settlement Agreement, which states that Dr. Shah relinquished any claims to ownership interest in Tiffany or the property in consideration of payment of \$1,100,000.00. It also disregards the origin and character of the Shah Lawsuits. In sum, petitioner has met his burden on this point.⁸

⁸ It must be noted that the Tax Appeals Tribunal has discussed the treatment of settlement payments from a lawsuit and their effect on capital gains in the context of former Article 31-B (the Real Property Gains Tax) (*see Matter of 93rd Street Associates*, Tax Appeals Tribunal, March 5, 1998; *Matter of Preferred Rentals, Stockton*

E. The remainder of the \$1,167,560.00 payment to Dr. Shah did not constitute capital expenditures, however. As expressly described by Dr. Shah's attorney in his letter of September 14, 2007, Dr. Shah received \$1,100,000.00 pursuant to the Settlement Agreement, and the remaining \$67,560.00 represented repayment of two advances to Tiffany and a New York City property tax advance of \$23,444.11, and payment of mortgage interest on the \$400,000.00 loan (*see* Finding of Fact 13). The payment of the additional \$67,560.00 was not part of the consideration in the Settlement Agreement, but rather was made to facilitate the closing on Tiffany's \$1,850,000.00 loan from SI Realty. As a result, the Division properly disallowed petitioner's claim of the additional \$67,560.00 as part of the basis of the property.

F. Nevertheless, petitioner alternatively argues that the additional \$67,560.00 payment to Dr. Shah is allowable as a deductible business expense. A taxpayer is allowed to deduct all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business (*see* IRC § 162[a][1]). "To qualify as an allowable deduction under § 162(a) . . . , an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense" (*PNC Bancorp, Inc. v. Commr*, 212 F3d 822 [3d Cir 2000], quoting *Commr v. Lincoln Sav. & Loan Ass'n*, 403 US 345, 352 [1971]). An ordinary expense is one that is common and acceptable in the particular business. A necessary expense is an expense that is

Bldg., Tax Appeals Tribunal, March 21, 1996). In both *Matter of 93rd Street Associates* and *Matter of Preferred Rentals*, settlement payments representing a cost of protecting title to property were not properly included in original purchase price and, thus, not used to calculate gain, for purposes of Tax Law former §1440(5). Nevertheless, the Tribunal made clear in both of those cases that the origin and character of the claim controls the tax treatment of the settlement payment and that federal income tax treatment is wholly independent from the (former) gains tax treatment (*id.*; see also *Matter of V & V Properties*, Tax Appeals Tribunal, July 16, 1992). Therefore, the aforementioned Tribunal gains tax cases are inapplicable to the case at bar.

appropriate and helpful in carrying on a trade or business (*see Palo Alto Town & Country Village, Inc. v. Commr*, 565 F2d 1388 [3d Cir 1977]).

The standard regarding proof of deductions is well settled. Petitioner has the double burden of (1) demonstrating entitlement to the deduction and (2) substantiating the amount of the deduction (*see* Tax Law §§ 658[a]; 689[e]; 20 NYCRR 158.1; *Matter of Macaluso*, Tax Appeals Tribunal, September 22, 1997, *confirmed* 259 AD2d 795, 686 NYS2d 193 [1999]). There must be sufficient evidence in the record to allow for the conclusion that the taxpayer paid or incurred a deductible expense in at least the amount allowed (*see Williams v. United States*, 245 F2d 559 [5th Cir 1957]). Here, petitioner has provided sufficient proof that Tiffany was engaged in the business of property development. He also demonstrated that the remaining \$67,560.00 in the payment to Dr. Shah was actually paid during one of the years at issue and the expenditures were ordinary and necessary to permit progress on Tiffany's projects on the property. Thus, the additional payment to Dr. Shah is a deductible business expense.

G. Likewise, as petitioner also asserts, the remaining \$278,064.00 of the \$341,000.00 mortgage interest payment to SI Realty is allowable as a deductible business expense. Unquestionably, petitioner presented sufficient proof, such as the check and form 1098 for SI Realty, as to the nature of the expenditure. Petitioner also demonstrated again that the payment was in furtherance of Tiffany's business. Meanwhile, the Division curiously allowed a portion of the \$341,000.00 interest payment as having a business purpose, but arbitrarily disallowed the rest, maintaining that it was not for a similar purpose without pointing to any evidence in the record to support the basis for its determination. As a result, petitioner's position that the remainder of the \$341,000.00 payment was deductible as an ordinary or necessary business expense is correct.

H. The petition of Joseph Jeffries-El is granted and the Notice of Deficiency issued February 1, 2013, as modified by the Conciliation Order dated November 22, 2013, is canceled.

DATED: Albany, New York
December 10, 2015

/s/ Herbert M. Friedman, Jr.
ADMINISTRATIVE LAW JUDGE