STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition

of

ROBERT A. HOWES

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.

DECISION
DTA #803778

Petitioner, Robert A. Howes, 30 Rockefeller Plaza, Room 2405, New York, New York 10112, filed an exception to the determination of the Administrative Law Judge issued on November 13, 1987 with respect to his 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 (File No. 803778). Petitioner appeared by Chadbourne and Parke, Esqs. (William G. Cavanagh and Ewing W. Madole, Esqs., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Paul A. Lefebvre, Esq., of counsel).

The petitioner filed a brief on exception; the Division of Taxation filed a letter in opposition to the exception. The petitioner requested oral argument but later withdrew this request.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether petitioner is entitled to an allocation of the consideration received on the transfer of certain mixed use (residential and business use) real property, whereby said transfer would be exempt from the imposition of gains tax (Tax Law Article 31-B) as falling below the million dollar gains tax threshold.

FINDINGS OF FACT

On April 30, 1987 the representatives of the parties executed a stipulation of facts pertaining to the instant matter. Such stipulated facts, numbered "1" through "17", follow:

1. On April 29, 1977, Counsel Properties, Inc. ("CPI"), a New York corporation, purchased a four-story building (along with the underlying land and assorted personalty) located at 47 West 9th Street, New York, New York (hereinafter "subject property") which consisted of five apartments.

2. After such purchase, the apartments in the basement and on the second through fourth floors (hereinafter "business use property") were leased to third parties by the owner; the ground floor apartment (hereinafter "personal residence") was used exclusively by petitioner, Mr. Howes, as his personal residence.

3. Immediately after acquiring the subject property, CPI was liquidated and the subject property was distributed to the sole shareholder, Mr. Howes.

4. The reason Mr. Howes purchased the subject property through CPI was to facilitate bank financing.

5. Immediately after CPI was liquidated the business use property was contributed to Counsel Properties Company ("CPC"), a New York general partnership of which Mr. Howes is a general partner.

6. Thereafter, the business use property was owned by CPC and the personal residence was owned by Mr. Howes individually.

7. For convenience, the partnership agreement authorizes Mr. Howes to hold title to the business use property in his own name notwithstanding the partnership's ownership of such property.

8. On March 19, 1985, Mr. Howes executed a contract of sale for the subject property, for a total consideration of $1,400,000, of which $1,396,000 was allocable to the real property and $4,000 was allocable to the personal property.

9. The sale was consummated on July 3, 1985 by transfer of a single deed for the entire subject property. Since title to both the business use property and the personal residence was held in the name of Mr. Howes, as permitted by the partnership agreement, Mr. Howes executed the deed.

10. On April 29, 1985, Mr. Howes filed a New York State Real Property Transfer Gains Tax ("Gains Tax") Questionnaire-Transferor (Form TP-580) in connection with the above sale in which he allocated the total consideration allocable to the real property of $1,396,000 as follows: 35% ($488,600) to the personal residence and 65% ($907,400) to the business use property.

11. During an audit in 1978 through 1979 the Internal Revenue Service had prescribed such an allocation for Mr. Howes' 1977 Federal income tax return.

12. The anticipated tax due of $65,151.50, as shown on Schedule B of Form TP-580, was computed only with respect to the business use property.

13. The allocation of purchase price between the business use property and the personal residence was consistent with the allocation used by CPC on its respective Federal and State income tax returns for purposes of depreciating the business use property, reporting annual income or loss on the business use property, and reporting the gain from the instant transfer.

14. On June 20, 1985, the New York State Department of Taxation and Finance issued a Tentative Assessment and Return (Form TP-582) with respect to this sale showing a total tax due of $65,151.50.

15. The entire amount of tax of $65,151.50 was paid on July 3, 1985.

16. On August 29, 1985, Mr. Howes filed a Claim for Refund of Real Property Transfer Gains Tax (Form TP-165.8) requesting that the entire tax paid be refunded.

17. On March 31, 1986, the Division issued a letter denying the Claim for Refund in total.

The Administrative Law Judge found facts in addition to the stipulation as follows:

The contract of sale for the subject property included a rider which provided, at paragraph 42(f), as follows:

> "42. Seller [Robert A. Howes], to induce Purchaser to enter into this Agreement and to purchase the premises, represents and warrants to Purchaser as follows:
>
> * * *
>
> Seller [Robert A. Howes] is the sole owner of the property and has all legal right to convey the same to Purchaser."

CPC consisted of Mr. Howes and one Suzette Hennion, as partners. The initial capital contributions to the partnership were $220,000 by Mr. Howes and $5,000 by Ms. Hennion, with any partnership profits to be split equally and any net partnership losses allocated 99 percent to Mr. Howes and 1 percent to Ms. Hennion.

We find the facts as stipulated to by the parties and as found by the Administrative Law Judge and such facts are incorporated herein by this reference.

We find as additional facts that the partnership agreement contained the following provisions:

> "The title to all partnership assets shall be in the individual partners in proportion to the amount of capital each has contributed, regardless of the names in which the title shall be recorded in any public office."
>
> * * *
>
> "Except as otherwise provided herein, any distribution of assets of the partnership shall be made equally to the partners without consideration being given to the respective amounts of each partner's capital account."

OPINION

The issue in this case involves the interaction of two separate exemptions from the gains tax. The first is the exemption for transfers for less than $1 million (Tax Law, {1443.1) and the second is the exemption for premises, or the portion thereof, that are the transferor's residence (Tax Law, {1443.2). The Division of Taxation's regulations provide that the $1 million exemption is applied first to the total consideration for the transfer (20 NYCRR 590.25). If the total consideration for the transfer is more than $1 million, then only the portion attributable to the residential part of the premises is exempt, the consideration attributable to the business portion of the property is taxable.

Petitioner seeks to avoid the application of this regulation by arguing that this case does not involve the transfer by a single transferor of mixed use property, but instead the transfer by two transferors, the petitioner and the partnership, of two interests in the real property each of which should be viewed separately for purposes of applying the exemption. Thus, under petitioner's view, the consideration for the business portion of the property, $907,400, would not be aggregated with the consideration for the residential portion, $488,600, and the business use property would be exempt from the tax.

The Administrative Law Judge determined that two transfers had not occurred and that only a single transfer occurred. The denial of petitioner's claim for a refund was sustained.

On exception, petitioner challenges the Administrative Law Judge's conclusion that only a single transfer occurred. Further, the petitioner argues that even if only one transfer occurred, the consideration for the residential and business use property should not be aggregated because the two interests were not used for a common or related purpose. Petitioner relies on the Division's regulations dealing with the transfer by one transferor of contiguous or related properties (20 NYCRR 590.42) for this proposition.

Whether the subject transaction involved two transfers or just a single transfer is not dispositive of the issue in this case. The issue to be resolved is who owned the beneficial interests in the real property transferred.

The parties stipulated that, "the business use property was owned by CPC." The application of the gains tax is not determined, however, simply by a finding that a partnership or any other entity owns real property. A further inquiry is necessary, one that involves looking through the entity to identify the owners of the entity which owns the real property. The purpose of this inquiry is to determine the beneficial ownership of the real property.

The focus of the gains tax through entities to determine the beneficial ownership of real property is evidenced both by the imposition provisions of the statute and by its exemptions.

The tax is imposed on transfers of real property which are defined to include an "acquisition of a controlling interest in any entity with an interest in real property." (Tax Law {1440.) The tax is imposed based on the percentage interest, if 50% or more, acquired in a corporation, partnership or other entity (Tax Law {1440.1[c]). This imposition on acquisitions of controlling interests in entities that own real property expresses the theory of the tax to look down through entities and to equate ownership of real property through an entity, beneficial ownership, with direct ownership of real property. The focus of the tax through two tiers of entities was upheld in the decision of Bredero Vast Goed, N.V., et al., Sup Ct, Albany County, Jan. 7, 1988, Travers J. (See, also, 595 Investors Limited Partnership v. Biderman, Sup Ct, NY County, July 6, 1988, Lehner, J. applying the New York City Real Property Transfer Tax through two tiers of entities.)

Further, "'Interest' when used in connection with real property includes, but is not limited to, title in fee, a leasehold interest, a beneficial interest . . ." (Tax Law {1440.4, emphasis added).

This focus of the gains tax through entities is also expressed in the exemption contained in Tax Law section 1443.5 which exempts a transfer to the extent it "consists of a mere change of identity or form of ownership or organization where there is no change in beneficial interest." (Tax Law {1443.5, emphasis supplied.)

The Division's regulations illustrate this mere change in form exemption with a series of examples indicating that a transfer to an entity is exempt from tax to the extent that the transferor owns an interest in the transferee and, thus, retains a beneficial interest in the real property (20 NYCRR 590.50). For example, a transfer of real property by an individual to a partnership in exchange for a partnership interest is said to be exempt to the extent of the individual's interest in the partnership (20 NYCRR 590.50[a][1]).

This exemption which looks through entities to exempt transfers based on beneficial ownership must necessarily be coupled with a similar look through the entity to determine beneficial ownership where, as here, an entity is selling real property. If not, the tax would be rendered a nullity through transactions structured in two steps, with the first step designed to benefit from the section 1443.5 exemption and the second from the less than $1 million exemption. For example, an individual or entity intending to sell a parcel of real property for more than $1 million to a third party could make intermediate transfers to entities it wholly owns. Such transfers would be entirely exempt from gains tax pursuant to the section 1443.5 exemption. If the commonly owned entities subsequently transferred to the intended transferee each for less than $l million, the entire transaction would escape gains tax. Surely this was not a result intended by the Legislature. Accordingly, in the transaction at issue, the beneficial ownership of the interests in real property being transferred must be determined.

To determine petitioner's ownership interest in the partnership, and thus his beneficial interest in the real property, the definition of controlling interest in the case of a partnership directs us to the ownership of "capital, profits, or beneficial interest in such partnership" (Tax Law, {1440.2). Since this definition would control how the tax and mere change in form exemption would apply on the transfer of the real property to the partnership in exchange for a partnership interest,[1] it also applies in determining the taxability of a subsequent transfer by the partnership.

The partnership agreement provided that the petitioner was entitled to 50% of the net profits and 99% of the net losses. Further, the agreement indicated that petitioner had contributed $220,000 of the $225,000 capital of the partnership, or 97.78%, and as a result held title to 97.78% of the partnership assets. The interaction of this ownership provision with the provision of the agreement that, except as otherwise provided, assets of the partnership would be distributed evenly, is not clear. However, pursuant to the ownership provision, the petitioner had a 97.78% interest in the capital of the partnership and thus a 97.78% beneficial interest in the partnership.

With respect to his 97.78% beneficial interest in the business property and 100% interest in the residential property, petitioner must be treated in the same way as a person who individually holds title directly to mixed use property. The $1 million exemption must be applied to the consideration for the entire transaction. To hold otherwise would encourage individuals to transfer ownership to the business portion of mixed use property to an entity they own, a transaction exempt

[1] Since the transfer to the partnership occurred in 1977, it was not subject to the gains tax which applied to transfers occurring on or after March 28, 1983.

from gains tax, prior to transferring the entire property to the intended transferee. Therefore, the consideration attributed to petitioner's 97.78% beneficial interest in the business use property (97.78% x $907,400 = $887,255.72) must be added to the consideration attributable to the residential portion ($488,600) to apply the $1 million exemption of section 1443.1 of the Tax Law. Since this total, $1,375,855.70, was more than $1 million, petitioner's 97.78% beneficial interest in the real property was subject to tax. The remaining 2.22% beneficial interest was not subject to tax, nor was the residential portion of the premises.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Robert A. Howes is granted to the extent that 2.22% of the business use property was not subject to gains tax, but except as so granted, is in all other respects denied;

2. The determination of the Administrative Law Judge is modified as stated in paragraph "1" above, but except as so modified, is in all other respects affirmed; and

3. The petition of Robert A. Howes is granted to the extent indicated in paragraph "1" above and the Division of Taxation is directed to compute and grant a refund with respect to 2.22% of the business use property, but except as so granted, is in all other respects denied.

Dated: Albany, New York
September 22, 1988

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner