STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
MACBET REALTY CORP.	:	DECISION
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, Macbet Realty Corp., c/o Max Migdol, 647 Hudson Street, New York, New York 10014, filed an exception to the order of the Administrative Law Judge issued on March 10, 1988 which dismissed petitioner's motion for a default determination and to the determination of the Administrative Law Judge issued on May 11, 1989 with respect to petitioner's 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. 804684). Petitioner appeared by Goldberg, Weprin and Ustin, Esqs. (Andrew W. Albstein, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Paul A. Lefebvre, Esq., of counsel).

Both parties submitted briefs. Oral argument was heard at the request of petitioner on January 31, 1990.

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

ISSUE

I. Whether the Division of Taxation's failure to answer the petition within the time prescribed in the rules of the Tribunal should result in the granting of the petition on default pursuant to Tax Appeals Tribunal Rule § 3000.4(a)(4).

II. Whether the Administrative Law Judge properly held that the value of the rental payments required to be made under a net lease at the time of its assignment was more than $1.00.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge and such facts are stated below and we find the additional facts indicated below.

Petitioner, Macbet Realty Corp. ("Macbet"), was formed by Max Migdol in 1972. Macbet's stock was owned by Mr. Migdol and his wife, and Mr. Migdol was president of and also actively managed petitioner. Mr. Migdol has been an active investor, owner and manager of residential properties in New York City for the past 33 years and has, during such time, owned approximately 40 to 60 such properties.

In or about 1971, Mr. Migdol purchased certain premises located at 222/226 East 21st Street, Borough of Manhattan, New York, New York. These premises consisted of a total of 50 apartments, of which 41 were then vacant and 9 were occupied. Mr. Migdol obtained a building loan from Knickerbocker Savings Bank to finance renovation of the premises. During the years 1971 and 1972, Mr. Migdol renovated the premises such that after the renovation the 50 apartments were divided into 42 rent-stablized apartments and 8 rent-controlled apartments.

On or about April 1, 1974, Mr. Migdol transferred ownership of the premises to one Harvey Levine. At the same time, Mr. Levine leased the premises back to Mr. Migdol under what is known as a "net" lease. The subject net lease required Mr. Migdol, as lessee, to pay all expenses of operation of the premises including, inter alia, all taxes, fuel, maintenance, superintendent, repairs, water and sewer expenses. In addition to all of such operating expenses, Mr. Migdol was to pay annual rent to Mr. Levine in an amount equal to the cost of amortizing the mortgage on the property (which mortgage had been assumed by Mr. Levine) plus a percentage of the additional amount ($150,000.00) for which Mr. Migdol sold the premises to Mr. Levine.[1]

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[1]In summary, the annual "rent" amount paid to Mr. Levine was equal to all annual mortgage expenses, plus 10% of the $150,000.00 amount for each of the first five years of the lease with such percentage to increase by 1% per five-year period throughout the remaining term of the lease.

This net lease commenced on April 1, 1974 and was, by its terms, to run for a period of 33 years through March 31, 2007. In addition, under the terms of the lease, the lessee (Mr. Migdol) was entitled to exercise options for renewal of the lease for two additional 33-year periods. Under the terms of the net lease, Mr. Migdol was entitled to sublease the apartments in the premises to various tenants.

Pursuant to the terms of the net lease, assignment thereof by the lessee was permitted without the prior written consent of the landlord so long as the lessee was not in default of any of the terms and conditions of the lease. If such an assignment were to occur, the assignee was required to assume all of the obligations of the lessee/assignor, and the lessee/assignor was to promptly advise the landlord in writing of the assignment (via a duplicate original counterpart of the assignment document). The net lease provides that upon such assignment (and delivery to the landlord of such duplicate original of the instrument of assignment) the lessee/assignor was to be released from the performance of all the terms, covenants and conditions of the lease thereafter to be performed by the assignee. There is no evidence that petitioner was in default in any manner under the net lease at any time.

On November 1, 1976, Max Migdol assigned the subject net lease to petitioner, Macbet Realty Corp, and petitioner operated the premises thereafter.

On July 2, 1986 two contracts relative to the subject premises were entered into. Petitioner, as the net lessee, entered into a contract with 222-21st Street Associates, for the assignment of the net lease held by petitioner. At the same time, Harvey Levine, as the owner of the fee, entered into a contract of sale with the same 222-21st Street Associates for the transfer of the fee interest in the premises. The selling price under the contract for the assignment of the lease was $999,999.00, while the selling price for the fee interest was $1,400,000.00. Each of these contracts was dependent upon the successful completion of the other contract (that is, the sale of the fee was conditioned upon the completion of the assignment of the net lease and, reciprocally, the contract for the assignment of the net lease was conditioned upon closing of title

on the fee). It is the transfer of the leasehold interest, by assignment, and specifically the amount of consideration therefor, which is at issue herein.

On November 6, 1986, petitioner submitted requisite transferor and transferee questionnaires (Forms TP-580 and 581) in connection with the transfer of the leasehold interest, requesting therewith the issuance of a Statement of No Tax Due on such transfer. However, the Division of Taxation issued a Tentative Assessment against petitioner seeking tax due under Tax Law Article 31-B ("gains tax") in the amount of $99,999.00. Petitioner paid such amount and, subsequently, submitted a claim for refund of the amount paid.

By letter dated May 1, 1987, the Division of Taxation denied petitioner's claim for refund.

Petitioner's president, Mr. Migdol, appeared and gave testimony at the hearing. Mr. Migdol explained that he never had any problem filling vacancies at the premises, noting that the particular area in which the premises are situated is a "prime" area where residential rental apartments for lower and middle income persons are always in high demand. Mr. Migdol also offered an explanation as to how he arrived at the selling price ($999,999.00) for the assignment of the lease, as follows:

> (a) The amount of rental income generated by the premises during the year 1986 was totaled. Such total, $245,751.68, consisted of $239,426.16 from the 42 rent-stabilized apartments and $6,325.52 from the 8 rent-controlled apartments.
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> (b) The amount of actual expenses incurred in operating the premises in 1986 was calculated. This total, $69,800.00, consisted of the following items: gas ($18,000.00), superintendent ($3,600.00), electricity ($2,100.00), insurance ($7,400.00), repairs ($10,100.00), water and sewer ($5,200.00), and real estate taxes ($23,400.00).
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> (c) Mr. Migdol then calculated (by projection) the total rental income to be received over the life of the lease. This calculation reflects petitioner's so-called "worst case scenario". In essence, petitioner utilized a 3% per year increase over the amount of 1986 rental income to be received from the 42 rent-stabilized apartments and a 2% per year increase in income over the 1986 amount of rental income to be received from the 8 rent-controlled apartments. Projecting these increases in rental income over the life of the lease results in a calculation of $7,484,085.01 in total rental income.

> (d) Mr. Migdol also similarly calculated a projection of the total expenses to be paid over the life of the lease. This calculation was made by using the $69,800.00 total of 1986 operating expenses and increasing such amount by 5% each year. These yearly operating expense amounts were then added to the yearly amounts of rent to be paid under the terms of the lease (see___, Finding of Fact "3", supra), with such annual amounts of operating expenses plus rental expenses totalled to arrive at $3,968,623.62 in total expense over the life of the lease.
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> (e) The total lease expenses, as projected ($3,968,623.62), were then subtracted from the total lease income, as projected ($7,484,085.01), to arrive at a net profit over the life of the lease of $3,515,461.39. This net profit figure would also represent the total return if the $999,999.00 received for the assignment were to be invested at 6.2% over the remaining term of the lease.

Petitioner introduced in evidence other calculations of rental income over the life of the lease based on percentages differing from the above-described "worst case scenario". These calculations reflected 6% and 9% rent increases for the rent-stabilized apartments and 0%, 4% and 6% rent increases on the rent-controlled apartments. Mr. Migdol noted that rental increases in the rent-stabilized apartments were (historically) never less than 3%, and that on rent-controlled apartments such increases customarily run in the neighborhood of 7%. No explanation was offered as to why the transfer price was set on the basis of the worst case scenario, other than the statement that if the lease were assigned for $1,000,000.00 or more, petitioner would have incurred an immediate gains tax liability. Petitioner's president stated that had he continued to lease the building he would expect to have earned a much greater return than 6.2%. He also noted that by assigning the lease and investing the $999,999.00, he could earn a much greater return than 6.2% and, at the same time, have none of the responsibilities of managing the building. Finally, Mr. Migdol stated that the assignment's effect of relieving petitioner from making any further rental payments under the terms of the lease was "not really a factor because [petitioner] was making money (a net profit) on the lease in any event".

We find the following facts in addition to those found by the Administrative Law Judge.

Petitioner filed its petition on July 14, 1987, which petition was deemed perfected by letter of the Secretary to the former State Tax Commission dated July 24, 1987. On November 27, 1987, petitioner filed a motion for determination on default. The Division of Taxation subsequently filed an answer in response to the perfected petition, together with an affirmation in opposition to the motion for default. These documents (answer and affirmation in opposition) bear an indate stamp indicating that they were received in the offices of the Division of Tax Appeals on December 18, 1987, said date being some 88 days beyond the due date for the filing of an answer in response to petitioner's perfected petition.

OPINION

The Administrative Law Judge denied petitioner's motion for a default determination based on the Division's 88 day delay in filing its answer to petitioner's petition. The Administrative Law Judge concluded that petitioner had not established that it was substantially prejudiced by the Division's delay and that such a showing was necessary to obtain a default determination.

The Administrative Law Judge also determined that the present value of the remaining lease payments due under the net lease at the time of its assignment was more than $1.00. Since the cash portion of the consideration for the assignment equalled $999,999.00, the Administrative Law Judge concluded that the total consideration for the assignment was more than $1 million.

On exception, petitioner argues that the Administrative Law Judge erred in failing to default the Division, arguing that the answer is required by the Tribunal's Rules of Practice and that the Division presented no explanation for its delay in answering the petition. Petitioner also contends that the Administrative Law Judge erred in finding that the remaining net lease payments had any positive value. Petitioner asserts that the fact that it was relieved of the obligation to make rental payments by the assignment cannot be considered alone, but must be considered with the fact that it was also giving up the right to receive rental payments from the sublessees. Under petitioner's analysis, since the net lease was profitable, i.e., the future rental income from the sublessees exceeded the future payments due under the net lease, the future net

lease payments have no present value as consideration. Alternatively, petitioner argues that the value of the remaining rent should not be included as consideration because the leasehold interest was extinguished by this transaction, as it resulted in the ownership of the fee and leasehold interests in the same person. Thus, petitioner reasons there were no rental payments to be made and nothing to be valued.

The Division argues that the Administrative Law Judge was correct, that a motion for default cannot be granted unless the petitioner proves that the late answer caused substantial prejudice to its position. The Administrative Law Judge was also correct, asserts the Division, in finding that the present value of the remaining rental payments must be added to the other consideration to apply the $1 million exemption and that the present value of the remaining payments here must be more than $1.00. The Division also argues that it is irrelevant to our inquiry that the lease merges in the fee after the lease assignment.

We affirm the Administrative Law Judge.

We first address our conclusion that the petition should not be granted on default because of the Law Bureau's failure to serve an answer within the required time period.

The Rules of Practice and Procedure of the Tax Appeals Tribunal provide that:

> "The Law Bureau shall serve an answer on the petitioner or the petitioner's representative, if any, within 60 days from the date the supervising administrative law judge acknowledged receipt of a petition in proper form." (20 NYCRR 3000.4[a][1].)

We agree with the Administrative Law Judge that the time period imposed upon an administrative agency for a responsive pleading is directory rather than mandatory (Matter of Geary v. Commissioner of Motor Vehicles, 92 AD2d 38, 459 NYS2d 494, affd 59 NY2d 950, 466 NYS2d 304). This principle was applied explicitly to the rule of the former State Tax Commission which was substantially similar to § 3000.4(a)(1) (Matter of Hamelburg v. Tully, Sup. Ct., Albany County, April 16, 1979, Prior, J.; Matter of Santoro v. State Tax Commn., Sup. Ct., Albany County, January 4, 1979, Conway, J.). The Administrative Law Judge correctly held that an agency's failure to act within a specified period will not result in dismissal of the agency's action in the absence of a showing of substantial prejudice as a result of the delay (Matter of

Cortlandt Nursing Home v. Axelrod, 66 NY2d 169, 495 NYS2d 927, cert denied 476 US 1115 [1986]; Matter of Geary v. Commissioner of Motor Vehicles, supra; Matter of G. H. Walker & Co. et al v. State Tax Commn., 62 AD2d 77, 403 NYS2d 811; Matter of Hamelburg v. Tully, supra; Matter of Santoro v. State Tax Commn., supra; Matter of Dworkin Construction Co., Inc., Tax Appeals Tribunal, August 4, 1988).

The only prejudice alleged by petitioner here is loss of the use of its refund money during the period of the delay. Since interest would be paid pursuant to section 1446.1 of the Tax Law on any refund made, we do not see any basis for finding prejudice to petitioner nor any to justify a default determination.

Although we affirm the Administrative Law Judge's denial of the default motion, we note, as we have before (Matter of Maggin, Tax Appeals Tribunal, March 8, 1990), that a systematic disregard of the time limitation for filing answers may be sufficiently prejudicial as to require a default determination or such other relief as is warranted (20 NYCRR 3000.4[a][4]) even if the taxpayer has not established that it has suffered a specific harm. A systematic disregard for our Rules of Practice would interfere with our responsibility to provide "the public with a just system of resolving controversies with [the] department of taxation and finance" (Tax Law § 2000).

With respect to the merits of this case we begin with section 1441 of the Tax Law which imposes a tax, at the rate of 10%, on the gain derived from the transfer of real property with New York State. The gain on a transfer is the difference between the consideration and the original purchase price of the property (Tax Law § 1440.3). Consideration is defined for purposes of calculating the taxable gain at section 1440.1 of the Tax Law. At section 1443.1(a)(b) and (c) there are three special provisions which require increases to the consideration defined by section 1440.1, but the increases are required only for the purpose of applying the $1 million exemption of section 1443.1. At issue here is the provision at section 1443.1(c), which provides that for purposes of applying the exemption, "[i]n the case of an assignment of a lease by the lessee," consideration shall be deemed to also include "the value of the remaining rental payments required to be made pursuant to the terms of such lease." The value of the rental payments is

taken into account only to determine if the transfer exceeds the $1 million threshold; it is not taken into account for purposes of calculating the gain on the transfer (Matter of Festival Leasehold, Tax Appeals Tribunal, January 20, 1989; 20 NYCRR 590.30).

We conclude that section 1443.1(c) quite plainly requires the conclusion reached by the Administrative Law Judge and does not allow for the calculation urged by petitioner. On its face, the statute requires the value of the rental payments still due under the net lease, the lease being assigned, to be included as part of the consideration to determine if the assignment is exempt because it is for less than $1 million. There is absolutely nothing in the statute to support the subtraction urged by petitioner of the value of the rent stream from the subleases petitioner, as sublessor, is giving up. While this offsetting of the assets (the sublease rents) against the liability (the rent due under the net lease) would be relevant when determining the economic profitability of the net lease, it has no place where only the consideration, not the gain, is being determined for purposes of the $1 million exemption of section 1443.1.

We also find petitioner's argument with respect to the merger of the leasehold into the fee interest without merit. We agree with the Division that section 1443.1(c) is concerned only with consideration to the transferor/assignor for the assignment, not with the ultimate disposition of the leasehold interest. Moreover, petitioner's argument is completely undermined by the Supreme Court decision in 52 Fulton St. Distributors, Ltd. (Special Term, Albany County, July 10, 1987, Williams, J.) which upheld the calculation of consideration at issue here where the leasehold interest was being surrendered to the owner of the fee. Since the surrender would also result in the extinguishment of the leasehold interest, this theory is disposed of by 52 Fulton Street.

For the above reasons, we conclude that the rental payments required to be made pursuant to the net lease had a value of more than $1.00 and that the total consideration for the lease assignment for purposes of the section 1443.1 exemption was more than $1 million.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Macbet Realty Corp. is denied;

2. The order and determination of the Administrative Law Judge are affirmed;

3. The petition of Macbet Realty is denied; and

4. The Division of Taxation's denial of petitioner's refund claim is sustained; provided, however, that the matter is remanded to the parties for a determination of original purchase price as required by conclusion of law "L" of the Administrative Law Judge.

DATED: Troy, New York
May 17, 1990

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

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

/s/Maria T. Jones
Maria T. Jones
Commissioner