STATE OF NEW YORK

TAX APPEALS TRIBUNAL

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| In the Matter of the Petition | : | |
| of | : | |
| **OCEAN TERRACE OWNERS, INC.** | : | DECISION<br>DTA NO. 809719 |
| for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 1986 through 1988. | : | |

Petitioner Ocean Terrace Owners, Inc., c/o Marvin Gold Mgt., 2940 Avenue X, Brooklyn, New York 11235, filed an exception to the determination of the Administrative Law Judge issued on September 12, 1996. Petitioner appeared by Spahr, Lacher & Sperber, LLP (Jack Mitnick, CPA and Stephen J. Schwartz, CPA). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Vera R. Johnson , Esq. and James Della Porta, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition and petitioner filed a reply. By an order dated October 14, 1997, the Tax Appeals Tribunal granted the motion brought by 330 Third Avenue Owners' Corp. (DTA No. 809615) to file an *amicus curiae* brief in this matter. The order also granted the motions brought by petitioner and 330 Third Avenue Owners' Corp. to consolidate their matters since both cases deal with the issue of whether each petitioner, a cooperative housing corporation pursuant to Internal Revenue Code § 216(b)(1), is properly subject to subchapter T of the Code or whether it is governed by section 277 of the Code.[1] An *amicus curiae* brief was filed by Martin A. Stoll, Esq.

[1]Although the matters of petitioner and 330 Third Avenue Owners' Corp. are consolidated, we are issuing separate decisions on the same date due to the different facts of each case.

on behalf of 330 Third Avenue Owners' Corp. The Division of Taxation filed a reply to the *amicus* brief.

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

## *ISSUE*

Whether the Division of Taxation correctly determined that petitioner is subject to the provisions of Internal Revenue Code (hereinafter "IRC") § 277.

## *FINDINGS OF FACT*

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

As a result of an audit, the Division of Taxation ("Division") issued to petitioner, Ocean Terrace Owners, Inc. (the "Corporation"), six notices of deficiency, each dated April 30, 1990. The notices assert deficiencies of corporation franchise tax and the metropolitan transportation business tax surcharge (MTS) pursuant to Article 9-A of the Tax Law as follows:

| Year | Tax | Amount |
|---|---|---|
| 1986 | franchise | $ 32,509.00 |
| 1986 | MTS | 5,526.00 |
| 1987 | franchise | 30,114.00 |
| 1987 | MTS | 5,120.00 |
| 1988 | franchise | 30,262.00 |
| 1988 | MTS | 5,144.00 |

Petitioner is a cooperative housing corporation incorporated in New York State on November 5, 1982 pursuant to Business Corporation Law § 402. It is the owner of residential property located at 2650 Ocean Parkway, Brooklyn, New York (the "building" or "apartment building").

Petitioner is authorized by its Certificate of Incorporation to issue 65,200 shares of common stock and to issue no other class of stock. During the assessment period, it issued 58,605 shares of common stock.

The primary purpose of the Corporation is to make apartments in the building available to its shareholders for residential purposes, under leases known as proprietary leases, and to operate and maintain the apartment building for its shareholders.

Petitioner's shareholders are entitled, by reason of their ownership of shares in the Corporation, to proprietary leases entitling them to occupy apartments in the apartment building owned by petitioner. Shares of the Corporation are issued solely in connection with the execution of proprietary leases for apartments in the building, and every proprietary lease specifies the number of shares issued to the lessee in connection with the execution of the proprietary lease.

Tenant shareholders are not entitled to receive any distribution not out of earnings and profits of the Corporation except upon a complete or partial liquidation of the Corporation.

The apartment building is operated and managed by a board of directors elected by the shareholders. The by-laws of the Corporation limit the number of directors serving on the board of directors to not less than three and not more than seven. Section 5 of the by-laws states as follows:

> "Voting. Each shareholder of record shall be entitled at each shareholders' meeting to one vote, in person or by proxy, for each share standing in his name on the stock book at the time of the meeting. When voting for the election of directors, such shareholder shall be entitled to one vote for each said share per director to be elected, but shall have no right to cumulate his or her votes in favor of any one or more directors to be elected. . . . All elections shall be determined by a plurality vote and unless otherwise specified in these by-laws or the Certificate of Incorporation, the affirmative vote of a majority represented at any meeting of shareholders shall be necessary for the transaction of any item of business (other than election of directors) and shall constitute the act of the shareholders." (Emphasis added.)

During the assessment period, the sponsor of the cooperative conversion plan (also referred to as the "holder of unsold shares") held a majority of the shares of issued common stock. Regarding the sponsor's voting rights, the Offering Plan states as follows:

> "The holder of Unsold Shares shall be entitled to vote all shares held by them for any number of directors subject to the following limitations. If the Unsold Shares constitute, in the aggregate, 50% or more of all outstanding shares: (i) The holder(s) of Unsold Shares shall not collectively vote their Unsold Shares for more than a bare majority of the directors to be elected and (ii) At all elections held after the fifth anniversary of the Closing Date, they will vote their Unsold Shares for not more than one less than a majority of the directors to be elected. At closing, each holder of Unsold Shares will sign an agreement to the foregoing effect."

During the assessment period, the issued shares were distributed between the sponsor and other shareholders as follows:

| Year | Sponsor Shares | Other Shareholders | Total |
|---|---|---|---|
| 1986 | 36,730 | 22,645 | 59,375 |
| 1987 | 32,330 | 22,045 | 59,375 |
| 1988 | 31,065 | 28,310 | 59,375 |

The ninth paragraph of petitioner's Certificate of Incorporation sets forth voting requirements for transacting certain business of the Corporation. For example, at least two-thirds of the members of the board are necessary to constitute a quorum at any meeting relating to the cancellation of a proprietary lease by reason of objectionable conduct or relating to the termination of all proprietary leases or to the amendment, alteration, repeal or addition to the by-laws. The votes of at least two-thirds of the members of the board are necessary to undertake such actions.

Section 8 of petitioner's by-laws provides that every share of stock issued by the corporation shall bear the following legend:

> "The rights of any holder of the shares evidenced by this certificate are subject to the provisions of the Certificate of Incorporation and the by-laws of the corporation and to all the terms, covenants, conditions and provisions of a certain proprietary

> lease made between the Corporation, as Lessor, and the person in whose name this certificate is issued, as Lessee, for an apartment in the apartment house which is owned by the Corporation and operated as a co-operative, which proprietary lease limits and restricts the title and rights of any transferee of this certificate.
>
> "The shares represented by this certificate are transferable only as an entirety and only to an assignee of such proprietary lease approved in writing in accordance with the provisions of the proprietary lease. . . ."

A stockholder may not sell shares of his or her stock or assign a proprietary lease or sublet an apartment without first obtaining the consent of the board of directors. However, if the board refuses consent, these actions may be taken with the written consent or vote of shareholders owning at least 65% of the Corporation's outstanding shares.

During the assessment period, petitioner filed Federal corporation income tax returns (Form 1120) on a calendar year basis and used an accrual method of accounting. More than 80% of petitioner's gross income for this period was derived from receipts from petitioner's tenant shareholders.

For the three years in issue, petitioner's expenses exceeded the income received from tenant shareholders as follows:

| Year | Excess Expenses |
|---|---|
| 1986 | $ 381,416.00 |
| 1987 | 406,652.00 |
| 1988 | 371,021.00 |

In calculating its Federal income tax liabilities, petitioner deducted what is denominated here as "excess expenses" from Federal taxable income.

Following an audit of petitioner's New York State corporation franchise tax returns, the Division issued to petitioner statements of audit adjustment for the years 1986, 1987 and 1988, recomputing petitioner's tax liability for each year. As pertinent, the Division added back the excess expenses to Federal taxable income, increasing Federal taxable income (which is the

starting point for determining New York entire net income) by that amount. The statements of audit adjustment provide the following explanation for the audit adjustment:

> "Section 208.9 of Article 9A provides in pertinent part-Entire Net Income is presumed to be the same as the taxable Income which the taxpayer is required to report to the U.S. Treasury Dept., subject to certain modifications.
>
> "Section 277 of the IRS Code limits the Membership expenses (deductions) in computing Federal Taxable Income, to the extent of Membership Income."

Petitioner filed a petition with the Division of Tax Appeals dated June 26, 1991 alleging that it is not a membership organization subject to the restrictions of Internal Revenue Code § 277.

Petitioner and the Division executed a Stipulation on December 13, 1995. The Stipulation of the parties is incorporated herein by this reference; however, only those facts necessary to resolution of the matters in controversy are recited in these findings of fact.

The Stipulation includes a recalculation of petitioner's corporation franchise tax liability for the years in question. In accordance with the Stipulation, the Division asserts the following deficiencies of corporation franchise tax liability in this proceeding:

| Year | Tax Deficiency |
|---|---|
| 1986 | $ 27,195.00 |
| 1987 | 24,939.00 |
| 1988 | 25,991.00 |

The parties agreed that the MTS notices would be revised in accordance with their stipulation.

Paragraph 47 of the Stipulation states: "The parties agree that the sole issue in controversy is whether the Division of Taxation correctly determined that petitioner is subject to the provisions of IRC § 277."

***THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE***

The Administrative Law Judge determined, based upon the stipulated facts, that petitioner was a cooperative housing corporation as defined by IRC § 216(b)(1). Therefore, the Administrative Law Judge reasoned that, pursuant to Revenue Ruling 90-36, petitioner is subject to the deduction limitations set forth in IRC § 277(a). Although petitioner argued that it was not a membership organization as that term is used in section 277, the Administrative Law Judge, relying on our decision in ***Matter of Beechwood Gardens Owners*** (Tax Appeals Tribunal, May 25, 1995), rejected petitioner's argument and concluded that a cooperative housing corporation, as defined in IRC § 216(b)(1), was a "membership organization" governed by section 277.

Lastly, the Administrative Law Judge determined that petitioner was not governed by subchapter T which provides special tax treatment for "any corporation operating on a cooperative basis," with certain enumerated exceptions not relevant to petitioner herein (IRC § 1381[a][2]). Although noting that the phrase "operating on a cooperative basis" is not defined in the Internal Revenue Code or the Treasury Regulations, the Administrative Law Judge set forth the three criteria governing the principles of economic cooperative theory as discussed in ***Puget Sound Plywood v. Commissioner*** (44 TC 305) which are: (1) subordination of capital; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor in proportion to the worker-members' active participation in the cooperative endeavor. The Administrative Law Judge agreed with the Division that petitioner lacked two of the three characteristics of economic cooperative theory: subordination of capital and democratic control of the cooperative enterprise. Accordingly, the Administrative Law Judge determined that petitioner was not subject to subchapter T and was properly determined to be subject to the provisions of IRC § 277.

## *ARGUMENTS ON EXCEPTION*

Petitioner argues that as a non-exempt section 216 cooperative housing corporation, it is subject to subchapter T and not subject to section 277. Petitioner cites to ***Thwaites Terrace House Owners Corp. v. Commissioner*** (T.C. Memo 1996-406, 72 TCM 578) in support of its position. Petitioner asserts that it meets all three criteria of economic cooperative theory as set forth in ***Puget Sound Plywood v. Commissioner*** (***supra***). Alternatively, petitioner argues that even if subchapter T does not apply, it does not operate primarily to furnish goods or services to members and, as a result, is not subject to IRC § 277.

In opposition, the Division argues that petitioner is operated primarily to furnish goods or services to its members and, as such, is subject to section 277. The Division asserts that petitioner maintains, services and operates the cooperative premises and, since most of the tenants of the premises are petitioner's stockholders, it is operated primarily to provide services to them (Division's brief, p. 8).

The Division concedes that if petitioner is subject to subchapter T then it would not be subject to section 277. However, the Division argues that petitioner is not subject to subchapter T since there is no subordination of capital present in petitioner's corporate structure and there is no democratic control. Therefore, the Division asserts that the Administrative Law Judge properly applied the law to the facts of this case and she correctly determined that petitioner was subject to IRC § 277.

## *OPINION*

The determination of the Administrative Law Judge did not analyze the decision rendered by the Tax Court in ***Thwaites Terrace House Owners Corp. v. Commissioner*** (***supra***) which case is controlling upon the outcome of the facts presented herein. In ***Thwaites***, the question

presented was whether the petitioner therein, a housing cooperative under section 216, was subject to subchapter T or whether it was a membership organization under section 277. The court concluded that conventional cooperative housing corporations should be subject to subchapter T and that the petitioner had established that it met the three-prong test of economic cooperative theory as set forth in ***Puget Sound Plywood v. Commissioner*** (***supra***). The court stated that because the petitioner was subject to subchapter T, it was not subject to section 277. The court concluded that: "[i]n ***Buckeye Countrymark, Inc. v. Commissioner*** [103 TC 547, 581], we said that 'the provisions of section 277 conflict with the provisions of subchapter T and that the application of section 277 to nonexempt cooperatives would lead to absurd or futile results'" (***Thwaites Terrace House Owners Corp. v. Commissioner***, ***supra***, 72 TCM 578, 581).

As set forth above, the Administrative Law Judge concluded that petitioner herein was a cooperative housing corporation pursuant to section 216(b)(1). The Division, however, continues to maintain that petitioner does not operate on a cooperative basis and, thus, is not governed by subchapter T. The Division asserts that petitioner lacks two characteristics of the economic cooperative theory: subordination of capital and democratic control of the cooperative enterprise.

In ***Puget Sound,*** the court identified three guiding principles of economic cooperative theory:

> (1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor [***Puget Sound Plywood v. Commissioner***, ***supra,*** at 308].

As stated by the Administrative Law Judge, to demonstrate subordination of capital, the Tax Court stated that "limitations must be imposed upon the amounts that can be distributed with respect to the cooperative's stock, and control over the management and direction of the cooperative must be vested in the members of the cooperative, as opposed to its stockholders" (***Trump Village Section 3 v. Commissioner***, T. C. Memo 1995-281, 69 TCM 2985, 2995). The Administrative Law Judge concluded that petitioner lacks both of these elements of subordination of capital. We disagree.

In ***Thwaites Terrace House Owners Corp. v. Commissioner*** (***supra***), the Tax Court set forth a more concise test of subordination of capital than that stated in ***Trump Village***. In ***Thwaites***, the court stated that the petitioner therein met the subordination of capital criteria "because its tenant-shareholders and patrons are identical and petitioner operated for the benefit of its patrons" (***Thwaites Terrace House Owners Corp. v. Commissioner, supra***, 72 TCM 578, 581).

In this case, petitioner's certificate of incorporation states that its primary purpose is, in pertinent part, as follows:

> to make apartments in the apartment building or buildings owned or leased by the Corporation available to its shareholders for residential purposes under leases, commonly known as proprietary leases. All such shareholders shall be entitled, solely by reason of their ownership of shares in the Corporation, to proprietary leases entitling them to occupy apartments in the said apartment building for residential purposes. Anything herein contained to the contrary notwithstanding, shares of the Corporation shall be issued solely in connection with the execution of proprietary leases for apartments in said building [exhibit "1," p.1].

From this language, we conclude that petitioner's tenant-shareholders and patrons are identical.

Furthermore, the provisions of the proprietary leases from petitioner (***see***, Exhibit "4") indicate that the cash requirements consider the creation of a reserve for contingencies and repairs and take into account income other than rent and cash on hand. From a review of the rent (maintenance) provision, it is clear that the rents established by petitioner are limited to cover its costs of operations. As such, we find that this meets the subordination of capital criteria set forth by the court in ***Thwaites*** of operating for the benefit of its patrons.

The next requirement to be discussed is whether petitioner functions under principles of democratic control. The Administrative Law Judge determined that petitioner also failed to meet this criteria. The Administrative Law Judge relied on ***Puget Sound*** wherein the court stated that the principle of democratic control was effected "by having the worker-members themselves periodically assemble in democratically conducted meetings at which each member has one vote and one vote only, and at which no proxy voting is permitted" (***Puget Sound Plywood v. Commissioner***, ***supra,*** at 308). The Administrative Law Judge stated that since petitioner's shareholders are entitled to one vote, in person or by proxy, per share of stock owned, then some shareholders were entitled to a greater voice in the operation of the apartment building than others. Thus, she concluded that this distribution of voting rights did not demonstrate democratic control. We disagree.

As stated by the court in ***Thwaites***:

> the fact that petitioner's shareholders have one vote for each share they own (instead of one vote per shareholder) and that they own shares based on the relative sizes of their various dwelling units is not contrary to democratic principles. The ownership percentage of shareholders of a housing cooperative is not only a measure of their investment, it is also a measure of their relative "patronage" of the housing cooperative [***Thwaites Terrace House Owners Corp. v. Commissioner, supra, 72 TCM 578, 581***].

Consequently, we hold that petitioner does adhere to principles of democratic control.

The third and final principle of economic cooperative theory was not in dispute. Therefore, we reverse the determination of the Administrative Law Judge and find that petitioner is subject to subchapter T and, as such, is not subject to section 277.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Ocean Terrace Owners, Inc. is granted;

2. The determination of the Administrative Law Judge is reversed;

3. The petition of Ocean Terrace Owners, Inc. is granted; and

4. The notices of deficiency are cancelled.

DATED: Troy, New York
March 26, 1998

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner