

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
PREFERRED RENTALS, STOCKTON BUILDING, INC. : DECISION
for Revision of a Determination or for Refund : DTA No. 812073
of Tax on Gains Derived from Certain Real :
Property Transfers under Article 31-B of the :
Tax Law. :
:

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on May 18, 1995 with respect to the petition of Preferred Rentals, Stockton Building, Inc., R.R. #2, Cornwall Hill Road, Patterson, New York 12563. Petitioner appeared by Margolin, Winer & Evens (James L. Tenzer, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Donna M. Gardiner, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioner filed a brief in opposition. The Division of Taxation informed the Tax Appeals Tribunal that it would not be submitting a brief in reply. Such letter was received on September 26, 1995, which date began the six-month period for the issuance of this decision. The Division of Taxation's request for oral argument was denied.

The Tax Appeals Tribunal renders the following decision per curiam.

ISSUES

I. Whether a settlement payment for the removal of a lis pendens is properly included in the computation of original purchase price for purposes of applying the real property transfer gains tax.

II. Whether legal fees associated with settling a lis pendens are properly included in the computation of original purchase price for purposes of applying the real property transfer gains tax.

III. Whether petitioner has established reasonable cause for abatement of the penalties.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "2," "4" and "5" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

On or about May 10, 1915, petitioner, Preferred Rentals, Stockton Building, Inc., acquired the land and building located at 6-10 East 32nd Street and 5-11 East 31st Street, New York, New York. Petitioner operated the property as rental property from the time of its acquisition until its leasehold transfer, which is the subject of the transfer gains tax in this proceeding.

We modify finding of fact "2" of the Administrative Law Judge's determination to read as follows:

After exploring various uses for the property, petitioner decided to lease the property to a tenant who would effectively take over the operations of the property for the term of the lease. Petitioner negotiated a leasehold interest with various parties and in 1989 entered into negotiations with 6 East 32nd Street Associates ("6-32 Assoc."), a New York general partnership.¹

Petitioner and 6-32 Assoc. entered into a December 19, 1989 agreement to enter into a lease. On September 7, 1990, petitioner entered into a "Lease and Purchase Option Agreement" with 6-32 Assoc. granting the tenant a 21-year lease with an option to purchase the property that ended after the 164th month of the lease term.

We modify finding of fact "4" of the Administrative Law Judge's determination to read as follows:

Prior to this lease, petitioner was served with a summons and complaint, dated November 8, 1988, by William J. Condren and 6 East 32nd St. Associates, L.P., a limited partnership organized under the

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We modified finding of fact "2" by adding the phrase "a New York general partnership" to more accurately detail the record.

laws of Delaware, seeking specific performance of a lease agreement and monetary damages of approximately \$30,000.00 or, alternatively, for monetary damages in the amount of not less than \$3,700,000.00 plus interest, costs, legal fees and disbursements. The complainants alleged, inter alia, that petitioner entered into an agreement with complainants to lease the property for a 49-year term and that petitioner breached that agreement when it received a better offer. Complainants also filed in court a Notice of Pendency with respect to the property.²

We modify finding of fact "5" of the Administrative Law Judge's determination to read as follows:

Petitioner commenced proceedings to remove the lis pendens filed on the property. After negotiations, petitioner and complainants entered into a July 13, 1990 "Stipulation of Settlement" whereby petitioner agreed to pay the complainants \$560,000.00 (\$200,000.00 in cash plus 40 quarterly installments of \$9,000.00 each) in exchange for their release of the claim of a leasehold interest in the property and removal of the lis pendens. The stipulation of settlement provided that petitioner had the right to terminate the settlement agreement if the closing contemplated by the agreement between petitioner and 6-32 Assoc. did not occur within 60 days of executing the stipulation of settlement. In January of 1991, William J. Condren accepted petitioner's payment of \$222,573.00 in full satisfaction of the quarterly installment payments under the Stipulation of Settlement.³

On or about August 16, 1990, petitioner filed a transferor questionnaire (Form TP-580[8/84]) reporting the anticipated gain with respect to its leasehold and option agreement with 6-32 Assoc.

The Division of Taxation ("Division") issued a "Tentative Assessment and Return", dated September 5, 1990, adjusting the consideration reported in the transferor questionnaire to include the amount of the state transfer tax (\$20,288.03) that the transferee had agreed to pay on behalf of the transferor. Petitioner elected to pay the gains tax in 14 installment payments of \$18,946.00 each, the first payment of which was due on the date of transfer. Subsequently, in

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We modified finding of fact "4" by adding the phrase "a limited partnership organized under the laws of Delaware" to accurately detail the record.

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We modified finding of fact "5" by adding the third sentence in order to reflect the record in more detail.

September of each year from 1991 through 1994, petitioner paid the installment payment of \$18,946.00, plus interest.

Petitioner filed a claim for refund, dated November 14, 1991, requesting redetermination of the transfer gains tax. Petitioner claimed that it should be allowed to adjust the gain from the sale by subtracting the settlement cost of \$422,573.00 with Condren as part of the original purchase price. Petitioner reasoned that the settlement amount was paid to remove the lis pendens so that the interest in the property could be transferred free and clear of all prior claims. Petitioner's adjustment resulted in reduced installment payments of \$15,928.00, which in turn resulted in an overpayment of the two installment payments already paid in the amount of \$6,036.00. Petitioner therefore requested a refund of \$6,036.00, plus interest.

In its deliberations with respect to the refund claim, the Division requested further documentation. In compliance with these requests, petitioner's attorney sent a letter, dated March 30, 1992, in which he explained that he could not provide a copy of the lease referred to in the complaint in the legal action of Condren and 6 East 32nd St. Associates, L.P. v. Preferred Rentals Stockton Building, Inc. because the alleged lease did not exist. Petitioner's attorney noted that:

"Plaintiff never actually, legally, or otherwise owned an interest of an owner's estate (i.e., an alleged leasehold interest) in the Property. The Plaintiff only claimed they owned an interest of an owner's estate in the Property It was this claim by the Plaintiff [that they owned an interest in an owner's estate in the Property] that the Transferor settled for \$422,573."

The Division denied the refund request stating that the cost of settlement did not fall under the statutory definition of "original purchase price" pursuant to Tax Law § 1440.5(a) because it was not paid to either acquire an interest in the real property or for any capital improvement made to the property. The Division also stated that petitioner did not respond to its request for a detailed breakdown of the legal fees claimed in the original filing which totalled \$209,260.00. The Division concluded that because it could not determine how much of the total legal fees was incurred as a result of the settlement of the lis pendens, all legal fees were

disallowed for nonsubstantiation. Thus, determined the Division, petitioner owed an additional \$20,926.00 in gains tax. Accordingly, the Division issued to petitioner a Notice of Determination, dated April 16, 1992, for gains tax due in the amount of \$20,926.00, plus \$3,588.67 in interest and \$7,324.10 in penalty, for the total amount of \$31,838.77.

Petitioner requested a conciliation conference arguing that the \$422,573.00 settlement was paid in order to quiet title to the property so that it could be transferred. Petitioner also alleged that it had incurred and paid \$209,260.00 in legal fees in connection with the negotiation and closing of the transfer of the property in question and, therefore, these legal fees constitute an "allowable selling expense" in the original purchase price.

After a conciliation conference was held on January 7, 1993, the conferee affirmed the denial of the refund claim and adjusted the amount of tax due by allowing legal fees in the amount of \$194,072.00. Accordingly, by Conciliation Order, dated April 9, 1993, the conferee reduced the amount of tax stated in the Notice of Determination to \$1,518.80. The Division also offered to petitioner an abatement of the penalty on the amount due if it paid the remaining tax and interest on the adjusted bill.

Petitioner filed a petition, dated July 6, 1993, arguing that the \$422,573.00 settlement should be included in the original purchase price for gains tax purposes; that it incurred legal fees in the amount of \$273,922.00 in connection with the removal of the lis pendens and the successful negotiation of the lease; and that the penalty and interest penalty should be abated.

The Division filed an answer, dated November 5, 1993, stating that only \$194,072.00 was substantiated and allowed as necessary legal fees incurred to sell the property pursuant to 20 NYCRR 590.17; that the \$422,573.00 settlement was properly disallowed; and that petitioner failed to establish reasonable cause for abatement of the penalty.

In support of its petition, petitioner submitted invoices from the law firm of Spengler Carlson Gubar Brodsky & Frischling describing the legal services performed for petitioner for a specified period of time and the legal fees for those services. These invoices consisted of 38

monthly or bimonthly bills from March 1, 1988 through April 30, 1992. On several of the invoices, the previously billed but unpaid legal fees were added to the amount of legal fees billed for the period specified in that bill. The last bill, dated May 24, 1992, for professional legal services rendered from March 1, 1992 through April 30, 1992 indicated that legal fees were due for that period only. In an exhibit attached to the petition (see, Div. Exh. "N"), petitioner broke down each invoice indicating the total amount of legal fees due for the period specified in the 38 individual invoices, and a breakdown of legal fees for each invoice with the total amounts as follows:

Total amount billed:	\$293,486.00
Removal of lis pendens:	168,790.00
Lease to 6-32 Assoc.:	105,132.00
Other:	19,564.00

OPINION

The Administrative Law Judge held that the settlement payment was a cost to remove a claim or encumbrance on the real property and absent removal the subject property would not be freely transferable. The Administrative Law Judge, looking to Federal case law dealing with settlement payments involving real property, determined that the settlement payment "constituted a cost to the taxpayer to preserve and protect its title to the property so that it could in turn transfer the property free of all encumbrances" (Determination, conclusion of law "A"). Having found that the settlement payment was a cost to remove a claim or encumbrance on the real property, the Administrative Law Judge held that it should be considered as a cost to acquire an interest in real property which is properly included in original purchase price. The Administrative Law Judge then reasoned that if the settlement payment is treated as a cost to acquire an interest in real property, any legal fees attendant with the settlement payment are likewise includible in original purchase price. Based on her disposition of this issue, the Administrative Law Judge did not address the issue of whether petitioner had established reasonable cause for abatement of penalties.

On exception, the Division asserts the Administrative Law Judge erred in concluding the settlement payment was a cost to remove a claim or encumbrance because a lis pendens is not an encumbrance, but rather a potential encumbrance. The Division also asserts that since petitioner already owned the real property, the settlement payment cannot be considered an acquisition cost. The Division, relying on our decision in Matter of V & V Properties (Tax Appeals Tribunal, July 16, 1992), also alleges the Administrative Law Judge erred by relying on Federal tax law in reaching her conclusion because the statutory scheme of the gains tax is different from that of the Federal income tax. Consequently, legal fees connected with the settlement of the lis pendens are not includible in original purchase price. Finally, the Division asserts that petitioner has not established reasonable cause for abatement of the penalties.

In response, petitioner asserts that a lis pendens is an encumbrance because it represents a claim to property and, as such, the payment in settlement of the lis pendens is considered a cost to acquire an interest in real property. Further, petitioner argues that the Administrative Law Judge's reliance on Federal case law was proper. Petitioner also argues that the legal fees attendant with the removal of the lis pendens are includible as an allowable selling expense regardless of whether the settlement payment is includible in original purchase price because the removal of the lis pendens was a condition precedent to the transfer. With regard to penalties, petitioner argues that notwithstanding the Administrative Law Judge's favorable determination, the penalty amount would only amount to \$532.00 based upon the conciliation conference.

We reverse the determination of the Administrative Law Judge on the issue of whether costs incurred to settle a claim and remove a lis pendens are includible in original purchase price.

New York imposes a tax equal to ten percent of the gain received on the transfer of real property (Tax Law § 1441[1]; Tax Law former § 1441). Gain is measured by subtracting the

original purchase price of the property from the consideration received on the transfer (Tax Law § 1440[3]).

"'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 . . ." (Tax Law former § 1440[5][a]).

Since it is not asserted, nor does it appear, that the settlement payment was for a capital improvement or for legal, engineering and/or architectural fees incurred to sell the property, the focus of our inquiry is on whether the settlement payment can be considered as a cost to acquire an interest in real property.

Tax Law § 1440(4) defines an interest in real property to include:

"title in fee, a leasehold interest, a beneficial interest, an encumbrance, a transfer of development rights or any other interest with the right to use or occupancy of real property or the right to receive rents, profits or other income derived from real property. Interest shall also include an option or contract to purchase real property" (Tax Law § 1440[4]).

The Division argues that the *lis pendens* is not an encumbrance, but rather a potential encumbrance. We agree.

The Administrative Law Judge reasoned that the settlement payment is to be considered a cost to acquire an interest in real property based upon the premise that such payment was made in exchange for a release of an encumbrance or claim on the property. This premise is flawed because a "*lis pendens* does not create an encumbrance or lien [citations omitted], it merely provides notice that an action is pending which may affect title to real property [citation omitted]" (Schoepp v. State of New York, 69 AD2d 917, 415 NYS2d 276, 277).

In response to the Division's argument, petitioner contends that the claim underlying the *lis pendens* constitutes an encumbrance and, thus, the settlement payment is properly included

in original purchase price. We find that a mere claim to real property is not sufficient to constitute an encumbrance.

"An incumbrance is said to import every right to or interest in the land, which may subsist in another, to the diminution of the value of the land, but consistent with the power to pass the fee by a conveyance. [citations omitted] Any right existing in another to use the land, or whereby the use by the owner is restricted, is an incumbrance, within the legal meaning of the term" (Forster v. Scott, 136 NY 577, 582).

Black's Law Dictionary defines encumbrance, in pertinent part, as follows:

"[a] claim, lien, charge, or liability attached to and binding real property; e.g. a mortgage; judgment lien; mechanics' lien; lease; security interest; easement or right of way; accrued and unpaid taxes" (Black's Law Dictionary 473 [5th ed 1979]).

The language employed by the Court of Appeals in Forster v. Scott (supra) and the definitional language and corresponding examples in Black's Law Dictionary lead us to conclude an encumbrance is a fixed and definite right or interest in real property. Here, the suit against petitioner for specific performance of an alleged agreement to enter into a lease or for money damages for breach of such agreement did not act to create an encumbrance on the property. Instead, the settlement payment represented a cost of protecting title to the property which is not properly included in original purchase price for purposes of the gains tax (Matter of V & V Properties, supra).

Relying on Federal income tax law for guidance on characterization of the settlement payment for gains tax purposes, the Administrative Law Judge stated that "regardless of the merits of the underlying claims in the specific performance actions, it is the origin and character of the underlying claims that controls the tax treatment of the settlement payment" (Determination, conclusion of law "A"). The Administrative Law Judge then held that because the settlement payment was a cost of defending title to the property it should be added to its cost basis. While we agree that the origin and character of the underlying claim controls the tax treatment of the settlement payment, we note that not all costs that are capitalized for Federal

income tax purposes are allowable costs for gains tax purposes (see, Matter of V & V Properties, *supra*; Matter of SKS Associates, Tax Appeals Tribunal, September 12, 1991; Matter of 1230 Park Associates, Tax Appeals Tribunal, July 27, 1989, *affd* Matter of 1230 Park Associates v. Commissioner of Taxation & Fin., 170 AD2d 842, 566 NYS2d 957, *lv denied* 78 NY2d 859, 575 NYS2d 455).

Next, we address whether legal fees associated with the settlement of claim and removal of the *lis pendens* are properly included in original purchase price.

Having found that the settlement payment represented a cost of protecting title to the property which is not properly included in original purchase price as a cost to acquire an interest in real property, we hold that the legal fees associated with the settlement payment likewise represent a cost of protecting title and are not included in original purchase price as a cost to acquire an interest in real property. Petitioner asserts that though legal fees incurred with the settlement and removal of the *lis pendens* may not be included in original purchase price as a cost to acquire an interest in real property, they may be included as legal fees incurred to sell the property because the removal of the *lis pendens* was a condition precedent to the transfer. We agree.

While we hold that a *lis pendens* is not an encumbrance within the legal meaning of the term, we recognize that the filing of one can have the effect of rendering property inalienable (5303 Realty Corp. v. O & Y Equity Corp., 64 NY2d 313, 486 NYS2d 877, 881). Therefore, we hold that legal fees incurred in removing a *lis pendens* in furtherance of effectuating a transfer are included in original purchase price as a legal fee incurred to sell the property pursuant to Tax Law § 1440(5)(a). Petitioner's right to terminate the settlement agreement if the closing on the transfer to 6-32 Assoc. did not occur is consistent with this conclusion as it indicates that the settlement was motivated by the impending transfer to 6-32 Assoc. Accordingly, petitioner is entitled to include the \$15,188.00 in disallowed legal fees in original

purchase price. This is the remainder of the legal fees initially claimed by petitioner and disallowed by the Division through the issuance of the Notice of Determination.

Accordingly, it is ORDERED, ADJUDGED, and DECREED that:

1. The exception of the Division of Taxation is granted to the extent that the settlement payment of \$422,573.00 is not included in original purchase price, but is otherwise denied;
2. The determination of the Administrative Law Judge is modified to the extent indicated in paragraph "1" above, but is otherwise affirmed;
3. The petition of Preferred Rentals, Stockton Building, Inc. is granted to the extent that the Notice of Determination dated April 16, 1992 is cancelled, but is otherwise denied; and
4. The Division is directed to cancel the Notice of Determination dated April 16, 1992 but the denial of the refund of \$6,036.00 is sustained.

DATED: Troy, New York
March 21, 1996

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

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

/s/Donald C. DeWitt
Donald C. DeWitt
Commissioner