STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition of **INDECK ENERGY SERVICES OF OSWEGO, INC. AND AT&T CREDIT CORPORATION** for Revision of Determinations or for Refunds of Real Estate Transfer Tax under Article 31 of the Tax Law and Tax on Gains Derived from Certain Real Property Transfers under Article 31-B of the Tax Law.	:	DECISION DTA No. 812722

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on November 9, 1995 with respect to the petition of Indeck Energy Services of Oswego, Inc., 1130 Lake Cook Road, Suite 300, Buffalo Grove, Illinois 60089-1976 and AT&T Credit Corporation, 44 Whippany Road, Morristown, New Jersey 07960. Petitioners appeared by Sidley & Austin (Paul R. Wysocki, Esq. and Bridget R. O'Neill, Esq., of counsel) and Richard J. Sinton, Esq. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Paul A. Lefebvre, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in opposition and the Division of Taxation filed a reply brief. Oral argument was heard on February 20, 1997 in Troy, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision. Commissioner Jenkins took no part in the consideration of this decision.

ISSUES

I. Whether a power generation system installed by a lessee for its own benefit is real property as defined in Tax Law § 1440(6).

II. Whether, if it is not in itself real property, a power generation system installed by a lessee is a capital improvement to real property.

FINDINGS OF FACT

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

On February 29, 1988, International Paper Company ("International Paper") entered into an agreement to supply Niagara Mohawk Power Corporation ("NIMO") with electricity (the "Power Sale Agreement").

On December 27, 1988, petitioner Indeck Energy Services of Oswego, Inc. ("Indeck") and National Energy Production Corporation entered into a contract for the construction of a thermal and electrical energy cogeneration facility to be located in Oswego, New York.

The major items of the cogeneration facility were: (1) a General Electric Frame 6 combustion gas turbine generator; (2) a General Electric steam turbine generator; (3) a heat recovery steam generator; (4) a surface condenser; and (5) a cooling tower. These items of the cogeneration facility shall be referred to collectively as the "System".

The cogeneration facility is located on three acres of land located in Oswego, New York. The land was leased by Indeck from International Paper for an initial term of 20 years at a rent of $1.00 per year (the "Land Lease"). The Land Lease is dated November 16, 1988 and was executed on January 25, 1989.

On January 25, 1989, International Paper assigned its Power Sale Agreement with NIMO to Indeck. Indeck assigned its interest in the Power Sale Agreement to Indeck Limited Partnership ("the Partnership") on March 14, 1989. NIMO consented to the assignment and assumption by the Partnership.

Indeck and International Paper entered into a Steam Supply Agreement on March 2, 1989, for a term of 20 years, renewable with the mutual consent of the parties for five-year periods. The Land Lease, which is also for a term of 20 years, is automatically renewable for five-year periods upon the renewal of the Steam Supply Agreement. Under the terms of the Land Lease, the lease converts to a fixed 15-year term if International Paper terminates operations or eliminates its need for the steam before the end of the 20-year lease term.

On April 3, 1989, Indeck entered into an agreement with the County of Oswego Industrial Development Agency ("IDA") for the construction of a cogeneration plant in Oswego, New York. The IDA is a county industrial development agency created in accordance with New York General Municipal Law § 850, et seq. The IDA passed a resolution, on February 28, 1989, to issue and sell its taxable industrial development bonds in an aggregate principal amount not to exceed $43,600,000.00 in order to finance the cogeneration plant. The bonds were never issued.

Indeck assigned its Land Lease with International Paper to the IDA on May 1, 1989. The IDA subleased to Indeck the premises which were the subject of the Land Lease at an annual rent of $1.00. The sublease required Indeck to use the leased premises to construct and operate a cogeneration system and for no other purpose. All of the terms and provisions contained in the Land Lease were incorporated into the sublease.

Indeck assigned all of its assets to the Partnership on March 14, 1990. Among the assets enumerated in the assignment and assumption agreement were the following: (1) "a net 50.4 MW combined-cycle natural gas-fired cogeneration facility" located on land in Oswego, New York (referred to as the "Site"); (2) any interest in the Site; and (3) "all buildings, structures or improvements erected or to be erected at the Site and all alterations thereto or replacements thereof."

On March 16, 1990, petitioner AT&T Credit Corporation ("AT&T") acquired a 47% aggregate partnership percentage in the Partnership from Indeck for $16,000,000.00. By supplemental agreement dated June 23, 1990, AT&T acquired a second 51% partnership percentage in the Partnership from Indeck for $11,300,000.00.

The First Amendment of the First Amended and Restated Agreement of Limited Partnership recited AT&T's share of the nonrecourse debt of the partnership as 98%.

On or about December 28, 1990, Indeck and AT&T filed New York State transferor and transferee questionnaires with the Division of Taxation ("Division"), reporting the transfer of a controlling interest in an entity with an interest in real property. The consideration to be paid for the transfer was reported as $1,004,353.00. The only amount included in original purchase price by Indeck was the cost of capital improvements totalling $602,694.00. Indeck calculated a gain subject to tax of $401,659.00 and enclosed a check in the amount of $44,237.31, representing gains tax in the amount of $40,165.90 and real estate transfer tax in the amount of $4,017.41. Indeck requested an abatement of interest and penalties for late filing on the basis that the failure to file was for reasonable cause and was based on a good-faith belief that the transfer was not subject to either the gains or transfer taxes.

With the filing of the questionnaires, Indeck filed a Combined Real Property Transfer Gains Tax Affidavit and Real Estate Transfer Tax Return. In an attachment to that form, Indeck explained its apportionment of the consideration paid for partnership interests to the real property. Total consideration paid for all partnership interests was $68,264,000.00, consisting of AT&T's allocated share of partnership debt of $40,964,000.00 plus consideration paid of $27,300,000.00.

The percentage of partnership property attributed to real property was based on a cost analysis performed by the Partnership's accountants. That analysis was summarized as follows:

> "The portion of the total Project cost of 43,032,053.00 attributable to property classified as Section 1250 property under the Internal Revenue Code of 1986, as amended, is $633,121.00 or 1.47128%."

The percentage calculated was applied to total consideration for all partnership interests to compute consideration attributable to real property of $1,004,353.00.

The Division conducted an audit of Indeck's gains tax filings, requesting additional information which was provided by Indeck. By letter dated March 29, 1991, Indeck's attorney provided the Division with information regarding project costs. Also, Indeck provided the Division with a letter from Marshall and Stevens, Incorporated, appraisers and valuation consultants, who determined that "on an allocated basis . . . the fair market value of the real property as a part of the Project is $1,118,000.00."

On audit, the Division took the position that the cogeneration facility, including the items referred to as the System above, constitutes real property within the meaning of Article 31-B of the Tax Law. The Division determined that the total cost of the cogeneration project was $43,032,000.00. Of this amount, $607,089.00 was apportioned to various items of tangible personal property. The remaining $42,424,911.00 was determined to be "Cost of real property items" or the original purchase price of the real property. The Division then calculated a percentage of 1.586354 representing a ratio of the fair market value of the partnership interest at the time of the transfer to the original purchase price of the real property ($68,264,000.00 ÷ $42,424,911.00). This percentage was applied to the original purchase price of the real property to calculate the amount of the total consideration attributable to the real property, $67,300,927.26. Gain subject to tax was then calculated as follows:

"Consideration	$67,300,927.26
Original Purchase Price	$42,424,911.00
Gain subject to tax	$24,876,016.26
	x .98 (percentage transferred)
	$24,378,495.93
Tax due (.10 x gain)	$ 2,437,849.59"

The Division issued a Tentative Assessment and Return, dated February 6, 1992, asserting additional gains tax due of $2,437,849.50, plus penalty and interest, for a total amount due of $3,684,341.45.

On or about March 16, 1992, the Division issued to Indeck a Notice and Demand (L-005379624-3) for gains tax due in the amount of $2,437,849.59, plus penalty and interest. On or about March 26, 1992, AT&T paid $3,764,867.80 to the State of New York in accordance with the Notice and Demand.

On May 20, 1992, AT&T filed a Claim for Refund of Real Property Transfer Gains Tax in the amount of $3,805,024.70. AT&T filed the claim because it paid the tax assessed against Indeck pursuant to the Notice and Demand. In its claim for refund, AT&T took the position that additional gains tax was not due on the transfer of partnership interests. AT&T characterized the System as "trade fixtures" rather than real property. This claim was assigned number R-2008 by the Division.

On or about November 18, 1992, the Division issued to Indeck a Statement of Proposed Audit Adjustment. The Division again recalculated the gains tax due on the transfer, increasing its original assessment by $286,060.00. This increase was based upon a disallowance of various project costs originally included in original purchase price and a reduction in items originally classified as tangible personal property. The statement of audit changes contained a paragraph denying AT&T's claim for a refund. The grounds for denial were set forth, in part, as follows:

> "It is the position of the Department of Taxation and Finance that the Indeck-Oswego Cogeneration Facility is real property within the meaning of Section 1440(6) of the Tax Law, and the improvements thereon are capital improvements to real property" (citations omitted).

On January 19, 1993, the Division issued to Indeck a Notice of Determination assessing gains tax of $286,060.00, plus penalty and interest. By letter dated April 16, 1993, the Division informed the attorney for Indeck that this Notice of Determination inadvertently "omitted the language denying Refund Claim R-2008, which was included in the Statement of Proposed Audit Adjustment." The letter continues as follows:

> "Since the intention and effect of the Notice of Determination was to deny Refund Claim R-2008 as well as assess additional tax due, it is our position that any appeal of Assessment L-006929619 [the January 19, 1993 notice] with the Bureau of Conciliation and Mediation Services or the Division of Tax Appeals, prior to April 19, 1993, will also serve as an appeal of the denial of Refund Claim R-2008 within the time required by Section 1445(2) of the Tax Law."[1]

On April 14, 1993, Indeck filed a Request for a Conciliation Conference in protest of the January 19, 1993 Notice of Determination of additional gains tax due. In accordance with the Division's letter, this request was deemed a timely appeal of the Division's denial of AT&T's refund claim.

On or about February 18, 1992, the Division issued to Indeck a Notice of Determination assessing additional real estate transfer tax of $265,186.59, plus penalty and interest. Indeck filed a Request for a Conciliation Conference to protest this notice on May 18, 1992. On April 8, 1993, the Division issued a Notice of Determination to Indeck for additional real estate transfer tax of $1,590.00, plus penalty and interest. On April 14, 1993, Indeck filed a Request for a Conciliation Conference to protest this notice.

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[1] The parties stipulated that the Notice of Determination issued on January 19, 1993 denied AT&T's claim for refund. The contents of the Division's letter is included here to clarify the record.

The Division issued a series of notices and demands which correspond to the notices of determination under review here. The parties stipulated that the following notices and demands were issued:

Notice Number	Date	Taxpayer	Tax Article	Tax Amount
L-006929619	4/30/93	Indeck	31-B	$286,060.00
L-006929619	6/29/93	AT&T	31-B	$286,060.00
L-005316722	9/14/93	AT&T	31	$265,186.59
L-007148398	9/14/93	AT&T	31	$ 1,590.00

On July 8, 1993, AT&T filed a Statement of Disagreement and a Request for a Conciliation Conference in connection with the Division's Notice and Demand asserting additional gains tax due of $286,060.00 (L-006929619).

On September 9, 1993, the requested conciliation conferences were held before Thomas E. Drake, Conciliation Conferee. As a result of that conference, the Division issued three conciliation orders sustaining the notices of determination issued to Indeck and denying AT&T's request for a refund of gains tax paid. The conciliation orders were dated December 31, 1993.

On March 10, 1994, AT&T paid the following amounts:

L-006929619-3	$442,764.18
L-005316722-9	$458,992.70
L-007148398-5	$ 2,754.74

AT&T and Indeck filed a joint petition with the Division of Tax Appeals on March 29, 1994.

The Division filed an answer to the petition dated May 23, 1994. In paragraph 13 of its answer, the Division asserted that its notices of determination failed to include in consideration gains tax paid by AT&T on behalf of Indeck. The Division requested that the Division of Tax Appeals exercise its statutory authority to determine a greater amount of tax due than that asserted in the notices of determination based on petitioners' concession that AT&T actually paid all assessments issued.

Petitioners' first witness was Darla A. Pishko, an employee of AT&T working in the Capital Markets Division ("AT&T Capital"). Among Ms. Pishko's responsibilities are:

ascertaining the technical and physical characteristics of potential investments; analyzing the long-term profitability of the projects based on those characteristics; and monitoring the operation of a project including both physical and financial performance over the lifetime of the investment.

Ms. Pishko described a combined cycle cogeneration facility as a power generation system that combines the gas turbine and steam turbine cycles to formulate a more efficient manner of utilizing fuel for the generation of power. According to Ms. Pishko, the profitability of the Oswego facility depends on its ability to qualify as a cogeneration facility under the Public Utility Regulatory Policies Act of 1978 ("PURPA") (Pub L 95-617). Ms. Pishko testified that any facility which used oil or natural gas to generate power was required to sell steam as part of the production and to supply the steam host a steady stream of steam. According to Ms. Pishko, Indeck's Steam Supply Agreement with International Paper was a condition of maintaining its status as a qualified facility under PURPA.

Ms. Pishko testified that the profitability of the Indeck-Oswego facility is "driven largely from the benefits resulting from the power purchase agreement with NIMO" (tr., p. 30). She testified that if petitioners were to lose their steam host and thus their qualification under PURPA, the Power Sale Agreement would become "null and void", leaving Indeck with no customer for its power.

Ms. Pishko testified that there is a market for used power generation equipment like that installed in the Indeck-Oswego facility. She also stated that if Indeck lost its customers, Indeck would consider disassembling and removing the equipment.

The Power Sale Agreement executed by International Paper, as seller, and assigned to Indeck reflects the conditions described in Ms. Pishko's testimony. Under the terms of that agreement, the seller represents that prior to the commencement of operation of the power plant it will become a qualifying facility under PURPA and a cogeneration facility as defined in Public Service Law § 2.2-a. Prior to the commencement of operation of the power plant, the seller was required to provide NIMO with evidence that the power plant was a qualifying facility. Moreover, the seller was required to provide NIMO with an executed fuel supply contract coterminous with the Power Sale Agreement. Failure of the seller to comply with this term of the contract provision provided grounds for NIMO to deem the contract null and void without any liability to NIMO.

The rates to be paid by NIMO under the Power Sale Agreement are those:

> "duly approved by the [New York State Public Service] COMMISSION applicable for payments to qualifying on-site generation suppliers, as defined in the Public Service Law, whose sales of capacity and energy to NIAGARA are made under the terms of such tariff" (Power Sale Agreement, ¶ NINTH).

If Indeck fails to maintain its status as a qualifying facility during the term of the agreement "then NIAGARA shall pay SELLER pursuant to the rates contained in NIAGARA's Service Classification No. 6 exclusive of any New York State minimum payment" (Power Sale Agreement, ¶ FIRST).[2]

Under the terms of the Steam Supply Agreement, Indeck (referred to in the agreement as the "Service Company") agreed to supply steam to International Paper (referred to in the agreement as the "Customer") from the cogeneration facility located in Oswego, New York (referred to as the "System") and described in Exhibit A of the Steam Supply Agreement. Exhibit A is entitled "DESCRIPTION OF EQUIPMENT". As pertinent here, it describes the System as follows:

> "The Facility will be a combined cycle in which the gas turbine generator sequentially produces both electrical power and waste heat. The waste heat produces steam in a waste heat recovery boiler which generates process steam and steam for a condensing steam turbine to generator produce additional electrical power.
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> * * *
>
> "The Facility will consist of the following major components:
>
> "One Gas Turbine Generator
> "One Steam Turbine Generator
> "One Waste Heat Boiler, double pressure type
> "One 13.8 kV to 115 kV 50 MW Electric Power Substation
> "One Central Distributed Digital Control System
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> * * *

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[2] There is no evidence in the record concerning the rate applicable under the two different circumstances, i.e., with or without the steam host.

> "All the major components will be housed in a building which will be a steel frame structure with metal siding.
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> "The #2 fuel oil tank will be diked and located away from the building.
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> "The three-celled cooling tower shall be erected on a concrete basin containing the circulating water pumps.
>
> "A water treatment system will be provided to process potable water from the city supply into boiler feedwater . . . .
>
> "Other auxiliary systems to be provided to support the power production . . . ."

Section 5 of the Steam Supply Agreement, entitled "Ownership of Property", provides as follows:

> "Service Company shall own the System, whether located on or off the Project Site, throughout the term of this Agreement. <u>The System shall remain personal property and no item thereof shall become a fixture of the Project Site, notwithstanding its installation on or attachment to real property or any improvement located thereon</u>. Plates or markings may be affixed to or placed on the System by Service Company to indicate its ownership thereof. <u>Upon the expiration of this Agreement, Service Company, at the option and expense of Service Company, can enter the Project Site and disconnect and/or remove the System unless Customer purchases pursuant to Section 14b</u>. Service Company shall act reasonably so as not to unduly interfere with Customer's operations at the Project Site in the course of such removal" (emphasis added).

Section 14 of the Steam Supply Agreement provides that at the expiration of the initial term of the agreement or at the end of the renewal period, the Customer and Service Company will have several options. The customer will have the option of renewing the agreement (Section 14[a]) or purchasing "the entire System at fair market value" to be determined by appraisal under a procedure provided for (Section 14[b]). In the event the Customer elects not to renew or purchase, section 14(c) provides the Service Company with the option to continue operating the System using any of Customer's equipment that had previously been used in connection with the operation of the System or "to remove all or part of the System from the Project Site as stated in Section 5.0."

Section 15 of the Steam Supply Agreement provides that the Service Company shall have the right to terminate the agreement before the System is placed in service under certain circumstances. One of those circumstances is described as follows:

> "There is any change in law, regulation or policy that, in the opinion of Service Company, materially affects the economic viability of Service Company's undertakings pursuant to this Agreement."

Section 9 of the Steam Supply Agreement sets forth the agreed-upon terms and conditions for purchase and sale of steam. Section 9.2 provides:

> "Minimum Purchase" In order to maintain qualified facility (QF) status for the System under the Public Utilities Regulatory Policies Act of 1978 ('PURPA'), the Customer shall take and purchase a minimum of 260 million pounds of steam during each calendar year. In the event that maintenance of QF status requires the purchase of more than 260 million pounds of steam per year or requires such minimum purchases to be made at a periodic rate over such year, or both, Service Company shall have the option to require Customer to comply with such requirements up to Customer's then total yearly requirements for steam."

Section 9.4 of the Steam Supply Agreement sets forth the procedures to be followed if International Paper permanently terminates manufacturing or otherwise terminates its operations so that it no longer requires steam. The parties agree to use their best efforts to mitigate the impacts of early termination by taking several steps. International Paper agrees to use its best efforts to sell or lease its manufacturing plant provided that the purchaser must assume the minimum steam requirements under the agreement. Both International Paper and Indeck agree to seek a substitute outlet for the steam "to meet the Qualified Facility requirement" (Steam Supply Agreement, § 9.4[a]). If early termination cannot be avoided and neither of the two options is available, Indeck:

> "may, at its sole option, seek to secure a timely waiver of the Steam usage requirement for Qualified Facilities from the appropriate state and federal authorities to allow the plant to continue in operation as a Qualified Facility or a nonregulated electric power producer in a manner which will not affect the existing Power Sale Agreement" (id., § 9.4[c]).

The Land Lease contains a purchase option which allows Indeck the option to purchase the land leased from International Paper under certain terms and conditions. The right became exercisable under three conditions: (1) expiration of the lease, (2) expiration of the Steam Supply Agreement, and (3) termination of the Steam Supply Agreement occasioned by default of International Paper. The purchase price of the land was to be the fair market value, determined by appraisal under a procedure agreed to in the Land Lease.

The Land Lease contains these provisions describing the leased premises:

> "The Lessor and the Lessee have entered this date an energy services agreement ('Steam Supply Agreement') pursuant to which Lessee will design, construct, own and maintain a cogeneration system that will supply Lessor with thermal energy and supply third party with electrical energy pursuant to a power purchase contract (the 'System'). The land to be leased hereunder is the land on which the System will be built.
>
> * * *
>
> "1.1 Lease. Upon the terms and conditions set forth, the Lessor leases to the Lessee and the Lessee leases from the Lessor, the land located in Oswego, New York more particularly described on the attached Exhibit A . . . ."

Article II of the Land Lease provides that if the Steam Supply Agreement terminates during a renewal period or if the agreement is not renewed then the lease will renew automatically for successive five-year terms at a rent to be agreed on by the parties. This provision goes on to state:

> "If the parties shall not agree within period of thirty days,
> the rent shall be the fair market rental value of the Premises . . . . For purposes of the preceding sentence, the fair market value of the Premises shall be the fair market rental value of the Premises only, <u>without consideration of the existence of the System on the Premises or the proximity of the Premises and the System to Lessor's manufacturing facility</u>" (emphasis added).

Article X of the Land Lease contains this provision:

> "10.3 Surrender of Premises. At the expiration of the term of this Lease (including renewal terms, if any) or upon earlier termination, Lessee shall surrender the Premises, including the System if Lessor elects to purchase the System under the terms of the Steam Supply Agreement or, excluding the System, if Lessor elects not to purchase the System under the Steam Supply Contract. At the expiration of this lease or if Lessor demands that Lessee surrender the Premises pursuant to Section 9.2(b), if Lessor does not purchase the system, <u>Lessee shall have a reasonable time to enter on the Premises and dismantle and remove the System from the Premises at Lessee's cost</u> without liability to Lessor in any suit, action or other proceeding except as provided in any other agreement pursuant to Lessee's occupation of premises" (emphasis added).

Petitioners submitted the affidavit of Edward W. Andrews, Jr., president of AT&T Capital. As relevant here, he averred as follows:

> "8. Section 5 of the Steam Supply Agreement provides that the Partnership owns the System and that the System shall remain personal property. Under this provision of the Steam Supply Agreement, the Partnership has the right to remove the System from the premises. This is important to the Partnership in the event IPC [International Paper], the steam host, ceases to operate or no longer requires the steam. The Partnership could not economically operate the System without a steam host.

"9. The economic value to the Partnership derives from the efficient operation of the System and the resultant sale of the electricity and the steam to NIMO and IPC respectively.

"10. The land lease contains no stated price for either the option to purchase or for any rent renewals. The land lease provides that the option price for any rent renewals are to be determined, in the absence of the mutual consent of the parties, at the fair market value of the premises only, without consideration given to the System. The option to purchase and lease renewals have little value to the Partnership."

In connection with this proceeding, Indeck commissioned the services of HDR Engineering, Inc. ("HDR") to prepare an estimate of the cost of dismantling and moving the power plant equipment located in Oswego, New York. HDR was also asked to render an expert opinion on whether dismantling and moving the equipment would be economically and physically feasible. HDR completed a written report which concluded that most of the plant equipment is not permanently affixed to the real property and could be removed from the Site and installed and operated elsewhere. HDR was involved in the Oswego project as independent engineer from May of 1989, shortly after construction began. HDR had been retained by the bank financing the construction project as its independent engineer. HDR's purpose was to monitor construction to determine whether it was proceeding on schedule and to verify contractor invoices.

The HDR report was authored by David Logeais, who was employed by HDR as a project manager during the time that HDR was involved in the Indeck-Oswego project. As project manager, he was involved in many aspects of engineering consulting work relating to power and energy. He has experience in both the installation and dismantling of power generation plants.

Mr. Logeais described the installation of a gas turbine generator similar to the one installed at the Indeck-Oswego facility as follows:

"The [gas turbine] at Indeck Energy Services of Oswego facility arrives at the job -- well, it's manufactured in a manufacturing plant, and is basically mounted on skids, which is like a structural industrial framework or a base. A unit of this size generally arrives in two or three different modules, so those would be shipped either by rail or by truck to the job site. They are off-loaded from the carrier and installed or set on concrete foundations which have been specially prepared for the equipment. The equipment is bolted down to the foundations, various interconnections are made between the modules. There is wiring, electric wiring to be connected. There is piping which carries fuel, compressed water and steam that needs to be connected between the modules, and there are some physical

> interconnections between the modules as well. For instance, this is a gas turbine generator. A generator arrives separately from the gas turbine, so basically the shaft of the gas turbine has to be connected to the shaft of the generator.
>
> * * *
>
> "[T]he concrete foundation, the equipment is bolted down to the foundation; it's physically bolted to the foundation. There are large anchor bolts which are generally embedded in the concrete that the foundation is built of, so you have anchor bolts that are protruding from the foundation. The equipment has corresponding holes in its skids, and the installation consists of lowering it over these bolts and bolting it down. There is an alignment and level process, of course, that is required, but fundamentally it's bolted down to the foundation" (tr., pp. 43-44).

According to Mr. Logeais, the removal of the power generating plant would be the opposite of the installation process. The dismantling would require the unbolting of equipment, the disconnection of electrical wires and the cutting of welded pipes. The large modular equipment would be lifted out of the building that housed it with large cranes. Since the building itself is a modular construction, roof panels could be unbolted and removed to allow equipment to be lifted through the top of the building, and the roof panels could then be reinstalled. Some equipment would be lifted with hydraulic jacks and then rolled off the foundation.

Mr. Logeais stated that before start-up of the plant, but after the building was completed, the HRSG (heat recovery system generator) was modified by lowering a new module system through the roof of the building and placing it in the HRSG.

Mr. Logeais testified that he was personally involved in the dismantling and removal of a gas turbine generator 2½ times the size of the one owned by the Partnership. The turbine was owned by Gulf States Utilities and located on the Gulf Coast. The utility company decided, for economic reasons, to move the turbine to Baton Rouge, Louisiana. The company purchased a HRSG from Mr. Logeais's employer at the time and installed it at the same site as the relocated gas turbine creating a cogeneration cycle. Mr. Logeais was unaware of any instance of removal of a cooling tower. He stated that he knew of boilers that have been moved and that a HRSG is a specialized type of boiler. He was not aware of an instance where a HRSG was moved.

The useful life of cogeneration equipment was estimated by Mr. Logeais to be longer than 15 to 20 years. He also testified that there is an active market for used generation equipment, several trade publications where such equipment is advertised and trade brokers who specialize in used power generating equipment.

In his report Mr. Logeais estimated the cost of dismantling and moving power plant equipment which met the following criteria:

> "1. It is not permanently affixed to the real estate.
>
> "2. Is physically and practically capable of being moved.
>
> "3. Would have practical and economic usefulness at another site" (HDR Report, p. 1).

Mr. Logeais estimated that the following equipment could be dismantled and moved at a total cost of $2,120,646.00: gas turbine, steam turbine, HRSG, condenser, dearator, BLR blowdown tank, cooling tower, HVAC system, 121kV switchgear, 480V switchgear, transformers, MCC's, air compressors, circulating water pumps, raw water pumps, DA makeup pumps, LP feed pumps, DCS, HP feed pumps, demineralizer, acid skid/tank, caustic skid/tank, HRSG platforms, bridge crane. Total costs included estimates for construction management, engineering and a 20% contingency.

Mr. Logeais's estimate assumed that dismantling costs would be 75% of the original installation costs for the gas turbine, steam turbine, HRSG and condenser; 90% for the cooling towers; and 50% for the remaining equipment. He assumed the new plant site to be located within 300 miles of the current site and the "relocated plant is essentially a duplicate of the current one" (HDR Report, p. 2). Finally, he assumed the raw water characteristics of the new site to be similar enough to those of the current site to allow use of the demineralizer system with no modification. The percentages determined by Mr. Logeais were based on his professional opinion of what the costs would be to dismantle the equipment.

In Mr. Logeais's opinion, the cogeneration equipment could be removed without physical damage to the equipment or to the concrete foundations to which it is bolted. The only damage would be the obvious damage caused by cutting welds in pipes.

Almost all of the equipment included in Mr. Logeais's estimate was manufactured in discrete modules, i.e., complete stand-alone assemblies that were shipped to the Site for installation. The cooling tower was the exception to this. It was assembled on site and not modularized. Dismantling it would involve disassembling it into its component pieces. The cost of dismantling the tower was estimated to be $71,000.00. The process of dismantling it is described in the HDR Report as follows:

> "Because the cooling tower is too large to be shipped in a single piece it was originally assembled on the job site. It is assembled on top of concrete foundations containing an integral basin to contain circulating water which is being cooled in the tower. Assembly consists of bolting together a prefabricated and precut structural steel framework. Into this framework are installed large volumes of PVC fill. A corrugated metal siding is installed around the outside. Large electrical fans with plastic fan ducts are installed on top of the cooling tower. Prefabricated walkways and ladders are bolted into place and finally water and electrical supplies are connected. In order to relocate the cooling tower it would be disassembled into component parts, which would then be crated, banded or otherwise packaged for shipment" (HDR Report, p. 12.).

Photographs of the cooling tower during construction show a steel framed structure with corrugated metal siding. To a layperson's eye, it looks like a rectangular building.

Petitioners and the Division entered into a stipulation of facts containing 37 separately numbered paragraphs. The stipulated facts have been substantially incorporated into this determination.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge concluded that the Partnership's interest in the System may be considered an interest in real property only if the System is determined to be a capital improvement. The Administrative Law Judge rejected the Division's argument that any improvement to the land is considered an interest in real property. In relying on Tax Law former § 1440(7),[3] she noted that a creation of a lease constituted a taxable transfer of real property when the following three conditions were met: (1) the lease is for longer than 49 years; (2) substantial capital improvements are or will be made; and (3) the lease is for substantially all of the property constituting the real property.

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[3]The real property transfer gains tax imposed by Tax Law Article 31-B was repealed on July 13, 1996. The repeal applies to transfers of real property that occur on or after June 15, 1996 (L 1996, ch 309, §§ 171-180).

The Administrative Law Judge also concluded that the definition of real property contained in the Real Property Tax Law (hereinafter the "RPTL") is not controlling in this case since nowhere in Article 31 or former Article 31-B does the statute refer to any provisions contained in the RPTL. Accordingly, the Administrative Law Judge determined that the System was not real property within the meaning and intent of Tax Law former § 1440(6).

In order to determine the Partnership's original purchase price, it is necessary to ascertain the price paid by Indeck to acquire the leasehold interest and the option to purchase the underlying property and the costs of any capital improvements. Thus, the Administrative Law Judge addressed whether the System qualified as a capital improvement.

Although rejecting the definition of capital improvement as set forth in Article 28 of the Tax Law, the Administrative Law Judge looked toward the gains tax regulations for guidance. In focusing on 20 NYCRR former 590.16(a), the Administrative Law Judge concluded that there was no question that the System had a useful life substantially beyond a year. Thus, her inquiry focused on whether the System was intended to be permanent. After analyzing the documents in the record, the Administrative Law Judge found that the System was not intended to be permanent and, thus, was not a capital improvement to the real property. Therefore, the costs of purchasing and installing the System are not includible in Indeck's original purchase price or in the consideration for the transfer of a controlling interest in the Partnership pursuant to Tax Law § 1440(1)(c).

With respect to the issue of transfer tax, the Administrative Law Judge noted that the definitions in Article 31 mirror those in former Article 31-B. Therefore, since the System is not deemed an interest in real property, the value of the System is not included in valuing the Partnership's interest in the real property.

The next issue addressed by the Administrative Law Judge was whether, pursuant to Tax Law § 1444(3)(a)(2), a greater amount of tax due should be determined by her since AT&T paid the gains tax in this case on behalf of Indeck. The Administrative Law Judge determined that since no evidence was presented to demonstrate that an agreement was reached between the parties whereby AT&T agreed to pay the gains tax liability of Indeck, she refused to assert a greater amount of tax due based upon this payment being deemed additional consideration for the transfer.

Lastly, the Administrative Law Judge determined that even though she found that the System was not real property, that did not excuse petitioners from timely filing their gains tax questionnaires. Therefore, the Administrative Law Judge concluded that a penalty was properly imposed on the amount of gains tax that Indeck reported to be due with its late filings. However, the Administrative Law Judge determined that petitioners' contention that the System was not a capital improvement was based upon substantial legal authority.

Arguments on Exception

On exception, the Division states that the Administrative Law Judge erroneously interpreted the gains tax by imposing a narrow reading of the statute which is in direct conflict with the legislative history of the gains tax. The Division further argues that the case law requires an expansive definition of the term "real property" in an effort to maximize the State's revenues. Therefore, it requests that Tax Law former § 1440(6) be interpreted as broadly as possible such that the term "improvement" includes valuable additions made to the property such as the System at issue herein. Although not specifically relying on the definition of "real property" contained in the RPTL, the Division asserts that we should look to that definition for guidance in our decision regarding whether the System is real property.

The Division also argues that it is clear that the installation of the System was intended to be permanent. Moreover, the Division argues that despite the parties' reference to the cogeneration facility as "personal property," such label cannot be a controlling factor in determining the parties' intent with respect to the installation of the property being deemed permanent. The Division states that petitioners did not have an absolute right to remove the System, but rather, they could remove the plant only where its lessor decided not to purchase the plant. The Division emphasizes that, in ***Matter of Emery Air Freight Corp. v. New York State Tax Appeals Tribunal*** (188 AD2d 772, 591 NYS2d 264) and ***Matter of Merit Oil of New York v. New York State Tax Commn.*** (124 AD2d 326, 508 NYS2d 107), the petitioners therein had an absolute right to remove the property which is not our case here.

Lastly, the Division argues that since petitioners failed to follow the pre-transfer filing procedures required by Tax Law former § 1447 for the transfer of a controlling interest in an entity which held real property, penalties were properly imposed and petitioners offered no evidence to establish reasonable cause.

Opinion

In her determination, the Administrative Law Judge concluded that only if the System is determined to be a capital improvement would the Partnership's interest in the System be considered an interest in real property. We agree.

Tax Law former § 1440(6) defined real property, in pertinent part, as follows:

> " . . . every estate or right, legal or equitable, present or future, vested or contingent, in lands, tenements or hereditaments, including buildings, structures and other improvements thereon and leaseholds . . . ."

The Division argues that the phrase "other improvements thereon" is applicable in this case since the System is clearly an improvement to the leasehold and, as such, the System is real property. The Administrative Law Judge concluded that the phrase "other improvements thereon" is not a separate category of real property, but rather, that the appropriate interpretation is land with the improvements on it "and leaseholds."

The Division argues that based upon the legislative goal of maximizing revenues, we must give the definition of real property the broadest possible interpretation. Although that principle is accurate, we cannot add things to the definition which are not intended. The Division's reading of the phrase "including buildings, structures and other improvements thereon and leaseholds" as a further expansion of lands, tenements or hereditaments is without merit. The Division's interpretation essentially would render the first usage of the word "and" in that phrase meaningless. It is a well-founded principle in statutory construction that every word of a statute must be given meaning (McKinney's Cons Laws of NY, Book 1, Statutes § 98). Accordingly, we agree with the interpretation of real property by the Administrative Law Judge that the System is not real property within the definition simply because it is an improvement. Moreover, as stated by the Administrative Law Judge, since the RPTL is not specifically referred to in either Article 31 or former Article 31-B, we do not find it necessary to apply the definition of real property contained in that statute for purposes of this case.

The Administrative Law Judge continues her analysis by focusing on the creation of a leasehold for gains tax purposes. She stated that:

> "Tax Law § 1440(former [7]) provides that the creation of lease or sublease is a taxable transfer of real property only where: (1) the lease is for longer than 49 years; (2) substantial capital improvements are or will be made; and (3) the lease is for substantially all of the property constituting the real property. The Division's position is that any improvement to the leasehold premises (in this case, the land since the lease is strictly a land lease) is 'real property' whether the improvement was intended to be permanent or not. In accordance with this interpretation of the statute, the creation of a lease or sublease would be subject to gains tax only if the statutory criteria are met, but the transfer of a leasehold interest pursuant to an entity transfer would always be subject to gains tax, regardless of the term of the lease or whether substantial capital improvements were made to the leasehold. The Legislature cannot have intended such a disparate result based only on the manner of transfer" (Determination, conclusion of law "E").

We disagree with the Administrative Law Judge on this conclusion. As set forth above, a leasehold is an interest in real property. In determining whether the creation of a leasehold is a taxable transaction, the Administrative Law Judge properly noted the three criteria as set forth in Tax Law former § 1440(7). However, this case does not involve the creation of a lease or sublease. Rather, as stated by the Administrative Law Judge at the outset of her determination, this case involves the acquisition of a controlling interest in the Partnership by AT&T Credit which Partnership has an interest in real property. The two specific interests at issue here are the Land Lease and the option to purchase.

Tax Law former § 1440(7) defined a "transfer of real property," in pertinent part, as follows:

> ". . . the transfer or transfers of any interest in real property by any method, including but not limited to sale, exchange, assignment, surrender, mortgage foreclosure, transfer in lieu of foreclosure, option, trust indenture, taking by eminent domain, conveyance upon liquidation or by a receiver, or transfer or acquisition of a controlling interest in any entity with an interest in real property."

We agree with the Division that the transfer of a leasehold interest pursuant to any entity transfer is subject to gains tax, regardless of the term of the lease or whether substantial capital improvements were made to the leasehold.

In the ***Matter of 52 Fulton St. Distribs., Ltd. v. New York State Tax Commn.*** (Sup Ct, Albany County, Sept. 14, 1987, Williams, J.), at issue was a lease termination. The petitioner therein entered into a 20-year lease for certain premises located at 52 Fulton Street in New York City. In order for the lessor to be able to sell the premises to a third party, lessee agreed to terminate the lease which had a remaining term of 15 years. The Court noted, in pertinent part, that:

> "there cannot be any dispute that the present termination of the lease constitutes a 'surrender' sufficient to constitute a 'transfer of real property' within the meaning of subdivision 7 of section 1440 of the Tax Law when taken in conjunction with subdivision 4 which defines 'a leasehold interest' within the definition of an interest in real property" (***Matter of 52 Fulton St. Distribs., Ltd. v. New York State Tax Commn., supra***).

Thus, the language of this case supports the position of the Division that the transfer of any leasehold is a transfer of an interest in real property for purposes of former Article 31-B.

Next, it is necessary to determine whether petitioners' transfer resulted in a gain pursuant to former Article 31-B. Tax Law former § 1440(3) defined gain as the difference between the consideration for the transfer of the real property and the original purchase price of such property. The original purchase price is "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" (Tax Law former § 1440[5][a]).

20 NYCRR former 590.16(a) provided that:

> "<u>Question</u>: How is the term <u>capital improvement</u> defined?
>
> "<u>Answer</u>: A <u>capital improvement</u> is, for the most part, an improvement, a modification, a betterment, or an addition made to real property which:
>
> "(1) is intended to be permanently affixed to the real property; and
>
> "(2) has a useful life substantially beyond the year following installation."

As noted by the Administrative Law Judge and the parties, there is no dispute that the System "has a useful life substantially beyond the year following installation" (20 NYCRR former 590.16[a]). Therefore, our inquiry focuses on whether the System was intended to be permanently affixed to the property.

In its brief, the Division argues that the record reflects that the machinery which comprises the System, i.e., a General Electric Frame 6 combustion gas turbine generator, a General Electric steam turbine generator, a heat recovery steam generator, a surface condenser and cooling tower, were intended to be permanently affixed. The Division states that none of the agreements in evidence indicates that there was a requirement of removal which militates in favor of permanence. Furthermore, the Division argues that the Administrative Law Judge erred in concluding that the testimony of petitioners' witness supported petitioners' argument that the System was not intended to be a permanent installation.

We agree with the Administrative Law Judge that analyzing the provisions of the lease agreements is appropriate in order to determine the intent of petitioners.

The Land Lease provides, in pertinent part, that:

> "[t]he Lessor and the Lessee have entered this date an energy services agreement ('Steam Supply Agreement') pursuant to which Lessee will design, construct, own and maintain a cogeneration system that will supply Lessor with thermal energy and supply third party with electrical energy pursuant to a power purchase contract ('the System'). The land to be leased hereunder is the land on which the System will be built" (Land Lease, p. 1).

As indicated by the Administrative Law Judge, in analyzing both the Land Lease and the Steam Supply Agreement, there are several provisions which indicate that the System was not intended to be permanent such as: sections 5 and 14(c) of the Steam Supply Agreement and section 10.3 of the Land Lease.

The Division argues that the fact that the System could be removed does not mean that at the time of installation, petitioners intended to remove it. The Division distinguishes the cases in the ***Matter of Emery Air Freight Corp. v. New York State Tax Appeals Tribunal*** (***supra***) and ***Matter of Merit Oil of New York v. New York State Tax Commn.*** (***supra***) by stressing that in those cases, the leases at issue required that the lessees remove the equipment, as opposed to this case, where the lessee had a right to remove it.

In ***Emery***, the Court stated, in pertinent part, that:

> "[i]t is clear that in situations where the petitioner reserves the right to remove installed property from leased premises, a finding of permanency is unlikely (***see, e.g., Matter of Glenville Cablesystems Corp. v. State Tax Commn.***, 142 AD2d 851, 852, 531 NYS2d 137). Here, the lease unambiguously demonstrates that not only did petitioner reserve the right to remove the subject systems at the conclusion of the lease term, it was required to do so pursuant to section 18.01 thereof" (***Matter of Emery Air Freight Corp. v. New York State Tax Appeals Tribunal, supra***, 591 NYS2d, at 265).

Thus, the general principle espoused by the Court is that where petitioner reserves a right of removal, permanency is unlikely. The fact that in ***Emery*** there was an absolute right of removal solidified the Division's argument therein that the petitioners' intention was not for permanent installation of the equipment. Therefore, we agree with the Administrative Law Judge that the law in ***Emery*** is applicable herein (***see also, Matter of Merit Oil of New York v. New York State Tax Commn., supra***). Accordingly, we affirm the determination of the Administrative Law Judge that the System was not intended to be a permanent affixation to the land and, thus, was not a capital improvement to the property.

Since petitioners did not take an exception to the issue of penalty nor to the Administrative Law Judge's conclusion that the consideration attributed to the real property and the gain subject to tax as reported on their gains tax filing questionnaires was correct as reported, the penalties are sustained as determined by the Administrative Law Judge and the original gains tax reported pursuant to petitioners' gains tax filing documents and the transfer tax are sustained.

Accordingly, it is ORDERED, ADJUDGED and DECREED that

1. The exception of the Division of Taxation is denied;

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

3. The petition of Indeck Energy Services of Oswego, Inc. and AT&T Credit Corporation is granted to the extent that the portion of the refund claim (R-2008) relating to amounts paid by AT&T Credit Corporation (L-005379624-3) is granted and amounts paid pursuant to notices of

determination L-006929619-3, L-005316722-9 and L-007148398-5 shall be refunded, but is otherwise denied; and

4. The amounts paid by Indeck Energy Services of Oswego, Inc. and AT&T Credit Corporation with their New York State transferor and transferee questionnaires of $40,165.90 for gains tax and $4,017.41 for transfer tax along with interest and penalties for late filing are sustained.

DATED: Troy, New York
August 14, 1997

Donald C. DeWitt
President

Joseph W. Pinto, Jr.
Commissioner