

STATE OF NEW YORK  
TAX APPEALS TRIBUNAL

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In the Matter of the Petition :  
of :  
**WATERMAN INVESTMENT COMPANY** : DECISION  
for Revision of a Determination or for Refund of Tax on : DTA No. 813224  
Gains Derived from Certain Real Property Transfers :  
under Article 31-B of the Tax Law for the Year 1990. :

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Petitioner Waterman Investment Company, c/o George H. Waterman, III, 155 Wooster Street, New York, New York 10012, filed an exception to the determination of the Administrative Law Judge issued on September 5, 1996. Petitioner appeared by Peter D. Oram, Esq. The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Peter T. Gumaer, Esq., of counsel).

Petitioner filed a brief on exception and a reply brief. The Division of Taxation filed a brief in opposition. Oral argument was not requested.

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

***ISSUES***

I. Whether the Division of Taxation properly excluded from original purchase price the June 1983 acquisition by Kalakar Corporation of a fractional interest in petitioner from Gwendolyn Waterman.

II. If the acquisition of Gwendolyn Waterman's interest should have been included in original purchase price, whether the record supports an increase in the original purchase price of \$115,013, or \$55,749.00 more than Gwendolyn Waterman's acquisition cost of \$59,264.00.

III. Whether the Division of Taxation properly excluded from original purchase price certain landscaping and other improvement costs alleged to have been incurred in the acquisition and improvement of the property in issue.

IV. Whether the handwritten invoices prepared and submitted at hearing by George H. Waterman, III for personal physical labor and for his services as general contractor as well as the invoice for legal services rendered were properly excluded from original purchase price by the Division of Taxation.

***FINDINGS OF FACT***

We find the facts as determined by the Administrative Law Judge except for findings of fact "7" and "18" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

Petitioner sold certain real property located on Fishers Island, New York on or about September 27, 1990. In the form TP-580, New York State Real Property Transfer Gains Affidavit, filed by petitioner prior to the sale, it stated gross consideration to be \$1,800,000.00, brokerage fees of \$180,000.00, original purchase price of \$729,000.00 and gain subject to tax of \$890,931.00. Petitioner claimed tax due on the transfer of \$89,093.00.

The Division of Taxation ("Division") issued to petitioner a tentative assessment of gains tax due prior to the transfer which made some modifications to original purchase price which resulted in gains tax due of \$123,862.30, which petitioner paid. However, after additional review of substantiating documentation, the Division issued to petitioner a Notice of Determination for additional real property gains tax due of \$19,662.00 plus interest.

Prior to a conference in the Bureau of Conciliation and Mediation Services, the Division reviewed additional documentation submitted by petitioner and redetermined the gain on the transfer in issue to be \$1,235,901.52, which resulted in the cancellation of the taxes assessed in the Notice of Determination and an overpayment of \$272.15.

Consistent with the Division's adjustment, a Conciliation Order was issued, dated July 8, 1994, which cancelled the Division's notice and allowed petitioner's refund claim to the extent of \$272.15.

Petitioner filed a petition for refund of \$34,497.05 based upon what it characterized as the Division's failure to allow certain acquisition costs, a step up in basis due to the acquisition of additional interests in the property and certain expenditures it made to improve the property.

Between the date of the conference, June 15, 1993, and the date petitioner submitted its final documentation herein, the Division has reviewed voluminous documentation with regard to all the issues raised by petitioner. Based upon its review, the Division has authorized the payment of an additional refund of \$395.73, raising the total refund to \$667.88.

We modify finding of fact "7" of the Administrative Law Judge's determination to read as follows:

Waterman Investment Company ("WIC"), a partnership, by agreement dated August 28, 1981, acquired a 79.03 percent interest in the subject property for the sum of \$185,000.00. WIC acquired its remaining 20.97 percent interest in the record title of the subject property from the prior interests acquired by the Linda Low Trust (a trust created for the benefit of Mr. Waterman's children), and Gwendolyn Waterman, Mr. Waterman's wife, as a result of other property exchanged by the Linda Low Trust and Gwendolyn Waterman for the property acquired by WIC. As a result of improvements made to the subject property, the Linda Low Trust and Gwendolyn Waterman received recognition of ownership of 7.16% and 25.24%, respectively, in parcel 2, the site of the main house. These were the same interests credited to them as their interests in WIC. Ownership of the other two parcels, 1 and 3, was credited to Kalakar Corporation ("Kalakar"), which was also reflected as a partner of WIC pursuant to the agreement dated August 28, 1981.

The WIC agreement referred to above stated in paragraph "8" thereof:

"8. The parties hereto hereby appoint George H. Waterman, III, with full power of substitution, the authorized signatory for the partnership to conduct all partnership business and bind the members of the partnership as to partnership matters. The members of the partnership are the only owners as described herein of the Waterman Investment Co. property. The parties hereto agree that Exchange Escrow Trust, GDW, the Linda H. Low Trust, GHW, III and Kalakar constitute the partners in WIC for so long as each such partner shall own an interest in the property and that the partnership is a general partnership and each general partner shall have all the rights of a general partner under the New York partnership law with each partner having the full power to bind the partnership on partnership business. The partnership shall not terminate on the death or incompetence of any

individual member, but the legal representative(s) thereof shall continue as a partner in such fiduciary capacity subject to all the terms hereof. Kalakar Corporation shall have a greater partnership interest in WIC on conveyance to it of parcel 1 from Exchange Escrow Trust in substitution for the partnership interest held by Exchange Escrow Trust."<sup>1</sup>

Pursuant to the terms of a Redemption of Interest Agreement, dated June 10, 1983, Gwendolyn Waterman withdrew from the partnership (WIC), surrendering her interest therein, and was given a 36.6 percent interest in parcel "2", valued at \$100,588.00,<sup>2</sup> which she immediately transferred to Kalakar Corporation. Kalakar Corporation was controlled by another corporation which was controlled by George Waterman III. In return she received other real property from Kalakar of equal value, in accordance with a real estate exchange agreement. Therefore, the exchange was a "net wash" to Kalakar and George Waterman III, as explained by Mr. Waterman in his testimony.

The Real Estate Exchange Agreement, dated June 8, 1983, between Gwendolyn Waterman and Kalakar Corporation, recited her interest in parcel "2" as 36.6%, with a dollar value of \$100,588.00. In furtherance of a divorce agreement between Gwendolyn Waterman and George Waterman, Gwendolyn Waterman conveyed her 36.6% interest in parcel "2" to Kalakar Corporation, controlled by George Waterman, in exchange for Kalakar property of equal value located in Vermont and New Mexico. In essence, the transaction between Kalakar and Mrs. Waterman was a like kind exchange between a corporation ultimately controlled by George Waterman III and his wife pursuant to a divorce settlement and resulted in a shifting of partnership interests from one partner to another.

As of the date of the transfer, the property in issue was 100% owned by Waterman Investment Company, which was comprised of only Kalakar Corporation and the Linda Low Trust. The pre-transfer filing indicated that all the parties to the Waterman Investment

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Finding of fact "7" was modified and expanded to more clearly reflect the changes in property interests affecting the subject property which ultimately became the property whose record title was held by WIC.

<sup>2</sup>Petitioner asserts this amount should be \$115,013.00.

Company agreement of August 28, 1981 were either Waterman family members or entities controlled or beneficially owned by the Waterman family. The expressed purpose for this was to have one entity, Waterman Investment Company, with record title despite shifting interests between family members or entities beneficially owned by them.

Kalakar's interest in the property at the time of the sale, 94.24%, was garnered from an initial interest in parcel "2" and "3" pursuant to agreement; acquisition costs paid to other parties to the WIC Agreement; the acquisition of Gwendolyn Waterman's interest in parcel "2" upon George Waterman's divorce from Gwendolyn Waterman in 1983; the 1984 acquisition from George Waterman III of an additional one quarter interest in parcel "2"; a second acquisition in 1984 of a six percent interest in parcel "2" for accepting the obligation to repay the Trust's money held by the Escrow Agent pursuant to the Agreement; and in 1989, before parcel "1" was sold, Kalakar accepted George Waterman's remaining interest in parcel "2" for a partial interest in parcel "1".

Petitioner made several submissions of documentation to the Division which it felt accurately showed the capital improvement expenditures made by it during a period of time between 1979 and 1990. After each of its submissions, petitioner received a response from the Division which examined and then determined which expenditures it could accept as capital improvements or costs directly related to capital improvements. As of the date of the conference, the Division allowed a total of \$384,098.48 in capital improvement costs. This took into account the purchase price of \$143,000.00, other acquisition costs of \$65,637.00, improvements to the main house and cottage of \$171,257.48 and legal costs of \$4,204.00.

Immediately prior to the conference, petitioner submitted a memorandum with documentation, dated June 8, 1993, addressed to Ms. Mary Ann Witkowski, totalling seventeen pages, which set forth numerous capital improvement expenses. On July 20, 1993, Ms. Nancy Boice, Division advocate at the conference, responded to each and every item listed by petitioner in its memorandum. Ms. Boice rejected certain costs for the following reasons: (1) the documentation did not give a description that verified the expenditure was for the property

in question; (2) other costs were disallowed because the documentation did not give enough description to determine if the cost was allowable; (3) some costs were listed without any documentation; (4) other costs were disallowed because they were accompanied by a schedule denoting the check number, names and amounts which were determined to be insufficient documentation to determine if the costs were allowable capital improvements; some of the costs were determined to be repairs, maintenance and personal property; other costs were attributed to the Windmill property which was not the realty transferred herein; there were duplicate costs; and items were included which were not allowable selling expenses.

On July 23, 1993, petitioner made a partial response to Ms. Boice's determination which explained why it sought to take expenses incurred prior to the acquisition in 1981, saying that the improvements were done pursuant to an oral agreement among close family members. Petitioner took issue with the Division's rejection of renovation costs incurred in 1983 for wallpapering, electrical switches and receptacles and lighting fixtures. In addition, petitioner contended that the expenditure for cypress gutters added to the house in 1985 should have been allowed as a capital improvement.

Petitioner submitted a more detailed response to Ms. Boice's initial determination of July 20, 1993 on February 4, 1994, some six months later, which included additional documentation and written explanations of the expenditures. In addition, there was a legal memorandum included which discussed the issue of a step-up in basis for the interest exchanged by Gwendolyn Waterman and Kalakar Corporation.

Following petitioner's final submission to Ms. Boice on February 5, 1994, she reviewed all that had been given to her and submitted her final figures to the conferee as set forth above. In summary, she allowed \$180,000.00 for brokerage commission, \$384,098.48 for original purchase price, resulting in a gain of \$1,235,901.52, yielding a tax of \$123,590.15 and a refund owed of \$272.15. The conciliation order reiterated the same figures as this Division submission.

In order to clarify her final determination submitted to the conferee, Ms. Boice prepared a memorandum for Mr. Gumaer, the Division's representative, dated June 29, 1995, which set forth in great detail those expenditures challenged by petitioner. Because of their importance to the issues herein, critical portions of that memorandum have been appended hereto as "Appendix A".

In an affidavit prepared by George H. Waterman, III, dated July 21, 1995, Mr. Waterman explained why he believed that another \$143,190.43 of capital improvements should have been allowed. Mr. Waterman stated in the memorandum that:

"[t]his memorandum was written prior to the assembly of the checks making up the complete claim for landscaping improvement costs in number 4 document listed below, amounting to \$55,000 after an allowance for normal lawn and leaf raking maintenance costs, reduced for the ten percent of the landscaping costs I have allocated to the windmill portion of the property sold separately and previously to the sale of the main house and adjacent cottage in 1990 and the \$9,010 in landscaping costs included in document number 3 below, second total, accounts for the difference of \$39,596 between the above total claim of \$173,583 in additional costs and the \$143,190 claim in document number 1."

A second seven page document attached to Mr. Waterman's affidavit was a compilation of checks written by Mr. Waterman for improvement and landscaping costs. In addition Mr. Waterman included a summary of landscaping costs of Potowomut Investment Co., Waterman Management Corp., Kalakar and George Waterman III for the years 1978 through 1990.

We modify finding of fact "18" of the Administrative Law Judge's determination to read as follows:

At hearing, petitioner submitted a 12-page exhibit (Ex. 1) which primarily summarized improvements to the cottage and the main house. It also submitted substantiation related to this exhibit. One submission, exhibit "2," was entirely related to expenses incurred in the years 1979 and 1980 for remodeling and landscaping. Another submission contained checks from Potowomut Investment Company, George H. Waterman, III and Kalakar Corporation in payment of invoices for expenditures concerning the main house on Fishers Island. In addition, petitioner submitted documentation which allegedly represented landscaping costs for the Fishers Island property between 1979 and 1990. It contained numerous checks and ledger sheets from the books of Potowomut Investment Company, Kalakar Corporation and Waterman Management Corporation which were stated to be for landscaping improvements to the property. This documentation was

submitted as the backup documentation for Division's exhibit "N," the affidavit of George Waterman, attached as exhibit "4."<sup>3</sup>

At hearing, petitioner submitted three unpaid invoices for legal services of Peter D. Oram, Esq., \$17,000.00; personal labor of George H. Waterman III for landscaping work, billed at \$10.00 per hour over a 12-year period for 3,300 hours, \$33,000.00; and a bill for general contracting services by George H. Waterman III for the same 12-year period, 1978-1990, in the sum of \$45,000.00. Each of these invoices was prepared immediately before the hearing and all were handwritten by George H. Waterman III.

Following the hearing, with the consent of the Administrative Law Judge, petitioner submitted an affidavit of George H. Waterman III, dated November 28, 1995, and additional documentation to substantiate further the improvement expenditures, legal fees, general contracting fees, personal labor fees, the issue of step-up in basis due to the transfer of Gwendolyn Waterman's interest to Kalakar Corporation, the disallowed expenditures listed in the Memorandum of Ms. Boice, dated June 29, 1995, architectural and engineering expenses and other landscaping and improvement costs.

The Division responded to petitioner's affidavit and documentation, addressing each of the expenditures asserted by petitioner. Essentially, the Division rejected the expenditures on the following grounds:

- a) the expenditure was for personal property;
- b) the related job was not a capital improvement;
- c) the expenditure was for maintenance not a capital improvement;
- d) the listed cost was a duplicate;
- e) no documentation was provided to substantiate the cost;
- f) no description of the expenditure was provided;
- g) the expenditure related to the Windmill property.

In addition, the architectural bills submitted were disallowed because the back up documentation did not provide an adequate description or they were related to the Windmill property.

The legal bill from the law firm of Nicholas Doman was disallowed because the amount of the bill was not substantiated and there was no proof that it was paid. Similarly, the expenditure for legal services of Howard Koff, Esq. was not documented.

The Division rejected the expense claimed for transfer taxes because the regulations do not allow same as a selling expense.

The Division rejected George Waterman III's bill for general contracting and landscaping because they had not been paid and the Division had no way of knowing if the amount was reasonable, what the services were, if they were necessary or if Mr. Waterman was qualified or in the business to provide the services.

The legal bill prepared by Mr. Waterman on behalf of Mr. Oram was also rejected by the Division because there was insufficient documentation, no proof of payment, and it appeared to be for services rendered in connection with the current legal proceedings as opposed to the sale of the property.

The Division's review resulted in an additional allowance of \$3,957.32, based upon the June 6, 1979 invoice from A.J. Gada in the sum of \$3,150.00 and \$807.32 for a built-in dishwasher from FINY Electronics. This yielded an additional refund of \$395.73. Added to the previously determined refund/overpayment of \$272.15, the total refund allowed by the Division was \$667.88.

The Division also noted discrepancies in the affidavit and exhibits submitted by petitioner after the hearing. The Division noted that the expenditures related to the main house were stated to be \$99,691.42 but were documented only to the extent of \$99,140. The stated total of expenditures with regard to the cottage was listed as \$11,423.45 while the exhibits only documented \$8,263.35.

***OPINION***

In his determination below, the Administrative Law Judge determined that neither the acquisition of Gwendolyn Waterman's interest by WIC nor Kalakar amounted to an acquisition of a controlling interest in WIC (the entity with the interest in the real property). In addition, it would not be deemed the acquisition of a controlling interest by virtue of being combined with other acquisitions, such as those addressed by the 1981 WIC Agreement, since it could not be aggregated with the acquisition of any pre-1983 interests. The result of the determination that less than a controlling interest was acquired is that no step-up in the original purchase price ("OPP") is allowed. Further, the Administrative Law Judge reasoned that the transaction cannot be characterized as the purchase of real property by WIC and added to OPP. The Administrative Law Judge stated, in pertinent part, that:

"[i]t was the mere shifting of interests in the partnership which did not amount to either the acquisition of a controlling interest or the purchase of additional property . . . .

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". . . The reality of the transaction was an exchange of Kalakar-owned property by George Waterman III and Gwendolyn Waterman effecting a transfer of her interest in WIC to Kalakar. Therefore, Kalakar, a corporation controlled by George Waterman III, traded properties of equal value, a 'net wash' in Mr. Waterman's own words, thereby shifting interests in the WIC general partnership, but not constituting the acquisition of a controlling interest which would have justified a step-up in basis" (Determination, conclusion of law "B").

Accordingly, a step-up in OPP in the amount of \$41,335.00 (\$100,588.00 less \$59,264.00) for the spread between the value per the redemption agreement and Gwendolyn Waterman's investment in the property was rejected.

Turning to petitioner's claimed capital improvement costs, the Administrative Law Judge sustained the Division's disallowance of costs in the amount of approximately \$173,343.00 (\$126,266.00 + \$47,077.00) and, thus, did not include such costs in OPP. In doing so, the Administrative Law Judge summarized the type of evidentiary submissions made by petitioner, reviewed pertinent regulations, and set forth the standards invoked by the issuance of an assessment. He then determined that petitioner had not met its very difficult burden of proving that the Division's adjustments were in error, since the evidence submitted to contradict the

propriety of the Division's audit methodology or conclusions was not adequate to do so. Accordingly, the Administrative Law Judge sustained the refund of \$667.88, as set forth in the facts above.

Separately addressing three particular invoices for legal costs (\$17,000.00), general contracting charges (\$45,000.00) and landscaping fees (\$33,000.00), all unpaid, handwritten, and submitted for the first time at hearing, the Administrative Law Judge rejected such bills as unsupported, suspect, and as invalid costs, and agreed with the Division's decision to exclude them from the computation of OPP.

On exception, petitioner contends that by treating the transaction as an acquisition of a partnership interest by WIC, the determination of the Administrative Law Judge ignores (1) the reality of the actual transactions entered into by the taxpayers, and (2) the fact that WIC was the record title holder of a family property that had different family members and family-owned companies as the real underlying owners. Petitioner maintains that the step transaction doctrine applied by the Administrative Law Judge should not be applied to create an unjust result contrary to the policy of Tax Law former § 1440(7)(b)(i)<sup>4</sup> which states, in part only, that a transfer of real property pursuant to a divorce proceeding should not be aggregated with other transfers.

Turning to petitioner's arguments pertaining to the capital improvements disallowed by the Division, petitioner challenges the determination of the Administrative Law Judge to the extent that it indicates that the audit as a whole must be questioned and found to be inadequate before any particular finding of that audit can be challenged.

Petitioner raises for the first time during this appeal that the Administrative Law Judge did not allow petitioner an opportunity to testify as to most individual improvement expenditures.

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<sup>4</sup>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).

Regarding items disallowed by the Division and upheld by the Administrative Law Judge, including the items of capital improvement to the main house and cottage, landscaping to the entire property, the general contracting and landscaping services rendered by Mr. Waterman and the legal fees, petitioner continues to maintain their allowability and urges reconsideration by the Administrative Law Judge on an item-by-item basis.

In response, the Division argues that the Administrative Law Judge reached a proper conclusion that no increase to OPP was allowable in this case, since the facts were absent the critical element of the acquisition of a controlling interest. Further, the Division agrees with each of the conclusions of the Administrative Law Judge which address the various costs for capital improvements, landscaping, general contracting and legal fees excluded from OPP.

We agree with the determination of the Administrative Law Judge for the reasons set forth below.

The first issue to be discussed is whether the Administrative Law Judge properly characterized the acquisition of Gwendolyn Waterman's interest as the transfer of a partnership interest and, in doing so, how OPP was affected. Petitioner continually maintains that the Division is in error in its characterization of the transaction between Gwendolyn Waterman and Kalakar as a transfer of a partnership interest. In support of its position that the transfer was one of real property, petitioner attempts to diminish the role of WIC, the entity which admittedly held record title to the property and was the ultimate transferor of a 100% interest. A taxpayer is bound by the form it invokes when structuring its transactions and may not later restructure them in order to avoid taxation (*Landmark Dining Sys. v. Tax Appeals Tribunal*, 224 AD2d 785, 637 NYS2d 524, 525). Petitioner concedes that Mrs. Waterman redeemed her interest in the partnership pursuant to the "Redemption of Interest in Waterman Investment Company" dated June 10, 1983. Attached to such agreement was a deed to Mrs. Waterman from WIC dated June 8, 1983 for her 36.6% interest in Parcel 2. Isolating that transfer, at that point in time, Mrs. Waterman became a tenant in common with WIC as to the Fishers Island parcel. Simultaneously, however, a deed of the same property description, also dated June 8, 1983, was

transferred from Mrs. Waterman to Kalakar, which remained one of the WIC partners. The Redemption Agreement, referred to above, stated: "[t]he consideration for the deed to Kalakar are conveyances to GDW of properties of equal value as set forth in the Real Estate Exchange Contract dated June 8, 1983, between GDW and Kalakar." Pursuant to the Real Estate Exchange Contract, Mrs. Waterman received a deed to property in Taos County, New Mexico, and a Landowners Agreement relating to property in Vermont. Thus, Mrs. Waterman relinquished her partnership interest, became a tenant in common with WIC, then transferred that tenancy to Kalakar in exchange for other parcels. Since Kalakar gave up something of value to Mrs. Waterman for the 36.6% interest in the Fishers Island real estate to acquire its status as a tenant in common with WIC, petitioner argues that it should be able to include the additional value in its OPP. If in fact the eventual sale by WIC was less than a 100% interest (the remaining interest being held by Kalakar), or WIC and Kalakar as tenants in common sold the property at the same time, we might agree. However, petitioner's own Transferor Questionnaire, dated September 11, 1990, filed with the Division to record the pertinent details of the transfer in issue, states that at the time of the sale, the property was 100% owned by WIC, which at that date consisted of Kalakar Corporation and the Linda Low Trust, as partners. Although petitioner correctly states that there is no documentary evidence in the record to independently verify a transfer from Kalakar to WIC of its 36.6% interest in the property, for WIC to hold record title of 100% to effectuate the transfer which is the subject of this case, the transfer to WIC had to have taken place. Petitioner explains on exception that the property was ultimately sold by WIC, which always held record title, since its purpose was to maintain continuing record title during shifting transactions among family members. This is contradicted, however, by deeds issued to other parties representing such shifting interests. Thus, although there were several actual transfers of real property, what Kalakar effectively did was transfer the two parcels (Taos and Vermont) to Mrs. Waterman for her 36.6% interest in the partnership. The support for this conclusion is found in the application of the step transaction doctrine. Although the Administrative Law Judge did not discuss the principles in detail, the

theory of the doctrine was applied by him correctly, to arrive at a proper conclusion. A review of the principles of the doctrine follow.

The step transaction doctrine treats the steps in a series of separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked. Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan (*Greene v. United States*, 13 F3d 577, 94-1 USTC ¶ 50,022). In *Greene*, the Circuit Court of Appeals reviewed two variations of the doctrine, one of which is the "end result" test. Under the end result test, the step transaction doctrine will be invoked if it appears that a series of separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result (*Green v. United States, supra*). The step transaction doctrine has been applied by the courts where property is distributed in kind to a partner which is subsequently transferred to a third party, who thereafter recontributes the property to the partnership in exchange for a partnership interest. In order to ascertain the tax consequences of the transactions, the initial distribution, transfer and recontribution are essentially ignored and the transfer is viewed as the transfer of the distributee's partnership interest to the ultimate transferee. In *Crenshaw v. United States* (450 F2d 472, 71-2 USTC ¶ 9698, *cert denied* 408 US 923, 33 L Ed 2d 333), there were four transactions to which the court applied the step transaction doctrine. A retiring partner-taxpayer received a partial interest in an apartment building owned by the partnership in exchange for her partnership interest. She then exchanged her interest in the building for an interest in a shopping center owned by her husband's estate. Acting as executrix of her husband's estate, she sold the estate's interest in the apartment to a corporation controlled by the taxpayer's former partners. The corporation then contributed its interest in the apartment building to the partnership. The first three transactions were accomplished on the same day and the fourth within 60 days thereafter. The taxpayer therein argued that each step should be treated independently, which would result in the initial distribution by the partnership being tax-free under Internal Revenue Code § 731, and the exchange with the estate tax-free under the Internal

Revenue Code § 1031 like-kind exchange provision. Although the United States Circuit Court of Appeals treated the estate as an independent party in these transactions, the new corporation was viewed as the alter ego of the continuing partners. Thus, the court viewed the transaction as a sale of the taxpayer's partnership interest to the corporation for cash, followed by a purchase of the shopping center from the estate for cash. The court deemed critical to the application of the step transaction doctrine, and ultimately its conclusion, the transfer of the undivided interest in the property back to the partnership in exchange for a partnership interest, for without it, the final position of the parties would not have been identical to that resulting from a sale.

The steps of the transaction herein are strikingly similar to those in *Crenshaw*. On the basis of that fact and the theory underlying the doctrine, we find the Administrative Law Judge properly ignored the individual steps to view the substance of the transaction as a whole in order to determine its tax ramifications. Next we must address the resulting effect of this treatment on OPP.

Petitioner has continued to maintain that the Division has denied it a deduction for its or Kalakar's cost by inappropriately characterizing the transaction as the acquisition of a partnership interest, and argues that references by the Division to whether there was a transfer of a controlling interest in an entity are entirely irrelevant. We disagree. The step doctrine, applied appropriately, prevents a taxpayer from escaping taxation by emphasizing substance over form (*Greene v. United States, supra*). Having determined that the doctrine applies in this matter, we must then look to the components of what remains after its application, which here is the acquisition by Kalakar of less than a controlling interest in the partnership which held title to such property. The law is clear that in the case of an acquisition of less than a controlling interest, the entity may not step-up its original purchase price in the property to reflect the consideration recognized on the transfer of the ownership interest (20 NYCRR former 590.49[b]; *Matter of Calverton Prop. Co.*, Tax Appeals Tribunal, December 15, 1994; *Matter of SKS Assocs.*, Tax Appeals Tribunal, September 12, 1991).

Petitioner argues that application of the step doctrine creates an unjust result contrary to Tax Law former § 1440(7)(b)(i) which states that a transfer of real property pursuant to a divorce proceeding should not be aggregated with other transfers. After application of the step doctrine, the transfer of Mrs. Waterman's interest to Kalakar pursuant to a divorce settlement between the Watermans does not result in the aggregation of that transfer with others. If anything, transfers are ignored by the utilization of the doctrine. Thus, the result reached here bears no relation to such provision of the Tax Law.

Since we did not hold that either Kalakar or WIC was entitled to an OPP adjustment, it is unnecessary to discuss whether the proper value attributable to Mrs. Waterman's interest in the Fishers Island property was \$100,588.00, as originally claimed, or \$115,013.00, as later modified by petitioner.

Turning to the issues surrounding the items of capital improvement, petitioner first argues that the Administrative Law Judge raised the entirety of the audit as a defense to considering the treatment of any particular item, and that it was an error for him to fail to rule on items individually. Petitioner has misconstrued the Administrative Law Judge's comments with respect to the audit methodology. The Administrative Law Judge stated:

"[t]he evidence submitted to contradict the propriety of the Division's determination was not adequate and did not demonstrate that the Division's audit methodology or conclusions were in error.

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"After carefully reviewing all the materials submitted by petitioner at and after hearing, the testimony of George Waterman III, and each of the responses of the Division to all the submissions made by petitioner since the audit began, it hereby is determined that the Division's audit results were arrived at after a careful analysis of each of petitioner's submissions and were grounded in a rational basis which petitioner has not demonstrated to be in error" (Determination, conclusion of law "C," emphasis added).

It was as clear to the Administrative Law Judge as it is to us that the Division's audit methodology included extensive leeway for petitioner's repeated submission of voluminous documentation. In addition, the Administrative Law Judge gave petitioner a final opportunity to make a submission of documentation post-hearing, of which petitioner took advantage. It

appears at every level of review, petitioner has been given ample opportunity to present evidence in support of its position and have it completely considered. As indicated in the above-mentioned citation, the Administrative Law Judge described his undertaking as a careful analysis of each of petitioner's submissions. The record presented makes it abundantly clear that there has been no impairment of petitioner's rights, and the fact that the Administrative Law Judge did not individually address each item in his determination does not warrant an alternative conclusion.

Petitioner raises for the first time before us the fact that the Administrative Law Judge did not allow petitioner to testify as to most of the individual items of capital improvement. First, it is improper for petitioner to raise for the first time on appeal a factual argument pertaining to the presentation of its case when petitioner was permitted an opportunity to do so in a post-hearing submission of evidence, as well as in its submission of briefs to the Administrative Law Judge below (*Greene v. United States, supra*). Nonetheless, a thorough review of the transcript, particularly pages 27 through 171, indicates considerable latitude to explain, clarify and otherwise produce evidence in support of the claimed capital improvements. Accordingly, petitioner's complaint is rejected.

As to the remaining disallowed capital improvement costs, landscaping costs and fees, general contracting costs and legal fees, we note that although substantially the same expenditure information and substantiation is required for a proper recording of the sale of real estate at both the Federal and State levels, a great deal of proper documentation was missing. Mr. Waterman was portrayed as an accomplished and sophisticated real estate investor and, as such, his failure to produce proper documentation, prepared contemporaneously with such expenditures, certainly cast a dark shadow on the reliability of the substance of the evidence submitted. As to the conclusions reached below regarding such disallowances, we uphold the determination of the Administrative Law Judge for the reasons stated in his determination. Petitioner has not raised any issues on exception with respect to these items that were not raised

below and adequately and correctly discussed by the Administrative Law Judge in his determination.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Waterman Investment Company is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Waterman Investment Company is denied; and
4. The refund claim is allowed to the extent of \$667.88, as adjusted

by the Division of Taxation.

DATED: Troy, New York  
August 7, 1997

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Donald C. DeWitt  
President

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Carroll R. Jenkins  
Commissioner

**APPENDIX A**

"The documentation did not give enough description to determine if the following costs were allowable:

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
11	11/16/79	A.J. Gada (Agree per 2/94 letter out)	\$ 344.80
21	12/10/80	A.J. Gada (Still no description of services)	581.80
22	12/31/81	Improvement reimbursed by trust 5/7/82 (Still no description of services)	1,977.00
102	06/08/91	H. Harlow }	1,000.00
103	06/15/81	H. Harlow } (Not in labor agreements)	1,000.00
107	06/24/81	H. Harlow }	1,300.00
110	07/07/81	G. C. Witmore Co. (Agreed out per 2/94 letter)	213.00
126	10/02/81	Poquonnock Welding (Agfeed out per 2/94 letter)	244.54
154	05/13/85	Fishers' Island Ferry (Windmill) C. Rowley (Was working on Windmill Contract, did verify work @ main house)	225.20 1,810.00
183	07/16/87	Gates & Beckwith (Agreed out per 2/94 letter)	216.87
192	07/88	Bouton Services (Repairs cut 974.95, allowed 128)	974.95
205A	1980	R.R. Long (Still no description of services)	342.25
208	03/05/81	R.R. Long (Still no description of services)	380.70
216	10/31/81	R.R. Long	354.20
221	07/13/82	J.V. Righter (5,831.50) (Still no documentation)	560.02
266	10/14/90	B. Clausen (Agreed out per 2/94 letter)	300.00

The following costs were listed but **NO** documentation was submitted:

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
	08/30/80	Finy Electronics (Still no documentation)	\$ 116.90
	10/14/80	A.J. Gada (Agreed out per 2/94 letter)	292.24
94	04/30/81	A.J. Gada (4071 Agreed out per 2/94 letter; 828 still not documented)	4,919.00
108	07/02/81	H. Brasses (No documentation)	49.00
124	07/22/81	Finy Electronics }	632.55
132	12/01/81	V.G. Nason's & Sons } (Still not documented)	19.08
133	12/01/81	P.E. Guerin Inc. } (-agreed-)	89.55
	12/31/81	Fishers' Island Ferry (Not documented)	15.50
141A	07/13/82	Parson's Weatherstripping (repairs)	364.00
145	03/10/92	W.H. Jason Co. (Not documented)	297.00
168	1985	H. Harlow (Still not documented)	553.80
170	1985	H. Harlow (Still not documented)	342.00
171	1985	Rex Lumber (Still not documented)	422.16
176	08/01/86	Gates & Beckwith	337.58
180	12/31/86	R.E. Wall (1,473.69 Agreedout)	1,307.01
182	12/18/87	R.E. Wall (1,242.91 Maint & personal property)	1,409.59
190	06/07/88	Bouton Services (Agreed out)	457.68
197	1988	Gruskin Hardware	72.89
199	1988	M. Bancroft (Still not documented)	755.97
200	1988	Barton (Bouton)?	536.62
201	02/17/89	Bouton Services (Agreed 764.46 out, 1,075 out windmill)	1,840.54

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
203A,B,	10/09/90	Bouton Services (P.P. & Maint ?)	762.76
	1990	Fishers' Island Elec. Co.	
	1990	Barton Refrigeration } (Still	263.56
220		GHW Exhibit I, J.V. Righter } no	3,512.50
246	1989	Chandler Palmer & King } documentation)	1,303.56
247	12/89	Decor Arts (Agreed out)	1,500.00
249	07/07/79	A.J. Gada (Still not documented)	1,012.00
268		Mathews & Ham	
269-271	10/90	Peter Oram/Law Firm of Nicholas Doman	1,503.18
272	10/16/90	Howard Koff (Still no documentation)	250.00

The following costs were claimed only accompanied by a schedule denoting the check numbers, names & amounts. This is not sufficient documentation to determine if the costs are allowable capital improvements. Accordingly the following are disallowed in full for lack of documentation: (As supported by TSB-D-92 (19)-R, copy enclosed.)

<u>Year</u>	<u>Category</u>	<u>Amount</u>
1978	Main House*	\$ 587.70
1979	Main House*	2,502.12
1980	Main House*	3,401.90
1981	Main House*	3,352.61
	Main House*	5,129.37
1982	Main House*	1,178.64
1978	Landscaping*	1,480.41
1979	Landscaping*	1,245.75
1980	Landscaping*	1,945.74
1981	Landscaping*	2,092.27
1982	Landscaping*	2,128.00

\* Not documented as capital improvements; repairs & maintenance.

The following have been disallowed as a review of the documentation revealed that these costs would be classified as repairs, maintenance and personal property which are not allowable as capital improvements:

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
4	06/29/79	Shipman's Fire Eg. (Personal property)	\$ 87.87
6	09/11/79	P. Liebbich (Personal property)	38.52
8	10/12/79	A.J. Gada (1,049.80) Agreed Disallowed	624.40
12	11/16/79	A.J. Gada (Maintenance)	385.00
13	12/11/79	A.J. Gada Tax (on capital improvement?)	155.00
18	03/20/80	A.J. Gada (Maintenance)	47.22
26	10/10/79	Finy Electronics (Maintenance)	870.10
27	11/15/79	Ricci-Cavallaro (maintenance)	159.87
32	02/14/80	Ascutney Forge	

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
37	04/23/90	A. Secondino & Son (Repairs	2,155.89
38	04/29/80	Finy Electronics (Maintenance)	62.06
39	05/20/80	Finy Electronics (Personal property)	1,000.00
40	06/02/80	Ascutney Forge (Tools/personal property)	80.22
41	06/16/80	A.J. Gada (261.21) (maintenance)	204.32
42	06/18/80	Finy Electronics (Personal property)	1,344.91
43	06/18/80	Finy Electronics (Agreed out)	77.04
44	07/11/80	T. Boodly (Maintenance)	345.49
45	07/18/80	T. Boodly "	346.14
46	07/26/80	T. Boodly "	240.67
47	07/29/80	Gruskin Hardware "	506.17
48	07/29/80	A.J. Gada	
49	07/31/90	T. Boodle (Maintenance)	252.25
50	08/08/80	T. Boodle "	320.00
51	08/15/80	T. Boodle "	322.87
52	08/30/80	Finy Electronics "	
53	09/12/80	T. Boodle "	235.00
54	09/12/80	T. Boodle "	345.20
55	09/12/80	Noank Shipyard Renov. "	74.93
56	09/18/80	T. Boodle "	345.94
57	09/16/80	T. Boodle "	85.07
58	09/24/80	T. Boodle "	372.29
59	10/03/80	T. Boodle "	393.22
60	10/10/80	T. Boodle "	355.20
61	10/15/80	A.J. Gada (Couldn't verify documentation)	142.35
62	10/80	A.J. Gada (Maintenance)	216.16
63	10/20/80	Shipman's Fire Equipment (Personal property)	213.00
64	10/20/80	T. Boodle (Maintenance)	125.51
66	12/08/80	T. Boodle "	237.54
69	12/12/80	T. Boodle "	100.00
	1981	T. Boodle "	320.00
	1981	T. Boodle "	240.00
74	01/26/81	E. Cohen (Personal property)	486.00
83	03/02/91	Finy Electronics (1,679.94) (Personal property)	900.94
88	03/29/81	F. Vuono (Repair & maintenance)	1,285.00
98	05/06/81	Finy Electronics (518.00) (Couldn't document)	19.00
111	07/07/81	A.J. Gada (1,319.00) (Duplicate)	1,011.38
113	07/22/81	J. Parvo (Disallow 95%, only 5% capital improvement)	2,850.00
115	07/23/81	Finy Electronics	536.15
118	07/31/81	Finy Electronics (1,685.70)	381.95
119	08/12/81	J. Parvo See 113 explanation above	2,850.00
120	08/25/81	J. Parvo See 113 explanation above	1,837.50
125	10/02/81	Bartol Refrigeration (Personal property, maint)	744.70
127	10/09/81	M. Hampton (Maintenance)	5,377.24
128	10/06/81	M. Hampton "	84.60
135	01/02/82	M. Hampton "	1,826.75
136	02/28/82	M. Hampton "	553.58
138	04/30/82	F. Senechal "	1,667.00
139	05/02/82	F. Senechal "	2,000.00
140	06/25/82	F. Senechal "	1,730.00
141	06/29/82	F. Senechal "	122.30

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
151	06/31/83	F. Senechal (No breakdown, couldn't allocate)	2,800.00
152	08/19/83	Wallpapers East Inc.	
158	06/14/84	H. Harlow	202.00
	09/03/85	R.E. Wall (Personal property)	580.50
	04/13/86	F. Senechal	1,530.00
173	04/14/86	M. Hampton (Allowed portion for bathroom)	1,815.15
174	04/20/86	F. Senechal (Allowed portion for bathroom)	2,000.00
175	07/16/86	F. Senechal (Allowed portion for bathroom)	2,500.00
177	08/14/86	M. Hampton (Allowed portion for bathroom)	1,534.72
178	12/19/86	Fortier Communication (Personal property)	742.05
179	12/31/86	M. Hampton (Maintenance)	1,200.00
184	05/22/87	F. Senechal "	2,000.00
185	08/06/87	F. Senechal "	2,202.00
186	10/06/87	F. Senechal "	2,000.00
187	12/31/87	F. Senechal "	2,000.00
188	01/25/88	F. Senechal "	652.00
189	05/13/88	Bouton Services (644.49 maintenance, 1316.76 not documented)	1,961.25
191	06/88	R.G. Ahman (Personal property)	125.72
194	10/05/88	Bouton Services (Couldn't verify)	391.52
196	1988	F. Senechal (Maintenance)	2,852.00
198A	08/04/88	F. Senechal "	1,452.00
256C	04/27/82	Comrie's Landscaping "	26.70

The following costs have been disallowed as they were identified as costs which are related to the Windmill transfer which has been determined to an exempt transfer:

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
1	10/12/79	A.J. Gada (Document didn't verify)	\$2,200.00
195	12/18/88	Bouton Services (Dup 201)	3,225.00
205A	1980	R.R. Long (387.25) (Couldn't verify)	45.00
IV	12/02/82	Susan Plimpton (Agreed out)	606.80
236	02/26/85	Chandler, Palmer & King (Agreed out)	190.00
237	11/06/85	P. Walker, M. Schwartz (Per TP allocation)}	
238	1985	P. Walker, M. Schwartz }	1,073.66
240	12/18/87	P. Walker, M. Schwartz }	
241	05/16/88	Chandler, Palmer & King}	
243	09/21/88	Chandler, Palmer & King} (141.90 per TP	141.90
245	12/89	Chandler, Palmer & King} allocation)	
242	08/05/99	Design Work (Not documented)	225.00

The following costs have been disallowed for the reasons stated:

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
14	01/14/80	A.J. Gada (Duplicate costs in contract)	\$ 557.74
267	1990	Ticor Title (Not an allowable selling expense)	7,257.00

<u>Item #</u>	<u>Date</u>	<u>Payee</u>	<u>Amount</u>
239	06/30/87	A.H. Shurtz (Not an allowable selling expense)	150.00
244	12/31/88	A.H. Shurtz (Not an allowable selling expense)	150.00
	10/28	Biser, Gibble & Quinn, Engineer (Included in 7,093.01 already allowed)	333.07
		Biser, Gibble & Quinn, Engineer (Included in 7,093.01 already allowed)"	1,770.00