STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
93RD STREET ASSOCIATES	:	DECISION DTA No. 814086
for Revision of a Determination or for Refund of Tax on Gains Derived from Certain Real Property Transfers under Article 31-B of the Tax Law.	:	

Petitioner, 93rd Street Associates, c/o Tishman Realty Construction, 666 Fifth Avenue, New York, New York 10103, and the Division of Taxation each filed an exception to the determination of the Administrative Law Judge issued on December 19, 1996. Petitioner appeared by Hutton & Solomon, LLP (Roy F. Hutton, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Herbert M. Friedman, Jr., Esq., of counsel).

Petitioner filed a brief in support of its exception and in opposition to the Division of Taxation's exception. The Division of Taxation filed a brief in support of its exception. Petitioner filed a reply brief and the Division of Taxation filed a brief in opposition to petitioner's exception and a reply brief in support of its exception. Oral argument, at petitioner's request, was heard on September 11, 1997 in New York, New York.

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

ISSUES

I. Whether petitioner's post-transfer payment to settle a lawsuit alleging construction defects in condominium units which it sold reduces the consideration for such transfers of real property.

II. Whether legal fees incurred by petitioner in defending and settling the above-referenced lawsuit alleging construction defects constituted ordinary, necessary and reasonable selling expenses properly included in the original purchase price of the property.

FINDINGS OF FACT

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

The facts in this case are not in dispute and have been stipulated. Petitioner, 93rd Street Associates, was the sponsor of Astor Terrace Condominium, a residential condominium development located at 245 East 93rd Street in New York, New York ("the Project").

All of the units in the Project were sold between February 1985 and January 1990. Petitioner paid the gains tax on each unit sold as required by the Division of Taxation ("the Division").[1]

In July 1988, the Board of Managers of Astor Terrace ("the Board") brought an action against petitioner ("the Lawsuit") on behalf of the owners of the units purchased from petitioner seeking damages for breach of the contracts for the sales of the units.

In July 1993, the Board and petitioner settled the Lawsuit. The terms of the settlement included a payment of $1,500,000.00 from petitioner to the Board.

Petitioner incurred and paid legal fees and expenses of $481,330.30 in defending itself against the claims made in the Lawsuit. Petitioner has not been reimbursed in any way for any part of the amount paid in settlement of the claim of the Board or for the legal fees and expenses incurred in connection therewith, and petitioner is not seeking reimbursement thereof for any part of such amounts or the contribution thereto from any other party.

Petitioner filed a timely claim for refund of a portion of the gains tax it paid. Petitioner's claim is based on: a) reducing the consideration it received (and thus its taxable gain) by the amount paid to the Board in settlement of the litigation and, b) increasing its original purchase price (and thus reducing its taxable gain) by the amount of legal fees and expenses incurred in defending against the Board's Lawsuit. More specifically, petitioner is claiming a gains tax refund in the amount of $198,133.00, based on a $1,500,000.00 reduction in consideration for

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[1]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 settlement payment made to the Board and a $481,330.30 increase in original purchase price for the legal fees and expenses incurred in defending itself in the Lawsuit.

Petitioner's refund claim was denied by the Division, and such denial was thereafter sustained, after a conciliation conference, by the Division's Bureau of Conciliation and Mediation Services ("BCMS").

In support of its claim, petitioner submitted an affidavit made by one David Wynn and executed by him on November 15, 1994. Mr. Wynn is one of the attorneys who was involved in representing petitioner in the Lawsuit and in the settlement thereof. According to Mr. Wynn's affidavit, and as borne out by a copy of the complaint filed in the Lawsuit, the breach of contract was ascribed by the plaintiff/purchasers to a failure to construct the building in accordance with plans and specifications described in the offering plans, written purchase agreements and, in some respects, with the building code of the City of New York. Mr. Wynn states that it was apparent to petitioner, upon review of the complaint, that the plaintiff/purchasers' allegations of breach of contract were meritorious, and that petitioner faced exposure to liability for damages attributable thereto. Finally, Mr. Wynn notes that as part of the settlement, the Board of Managers agreed to apply petitioner's $1,500,000.00 payment amount, net of expenses, to the correction of the defects in the building and in the purchasers' individual units.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

In his determination, the Administrative Law Judge concluded that there were "acknowledged defects" in petitioner's building which existed on the dates of transfer of the condominium units and the real property transfer gains tax must be measured by the value of the property on the dates of transfer in light of these defects. Although the valuation of these defects by the settlement of the Lawsuit for breach of contract occurred subsequent to the dates of transfer, this was not a "subsequent event" which precluded the relief sought by petitioner. Due to the agreement of the condominium Board of Managers to use the settlement payment to correct the defects in the building and in the individual condominium units, the Administrative

Law Judge held that petitioner was entitled to reduce the amount of its consideration by the amount of the settlement payment.

However, the Administrative Law Judge concluded that the legal fees and expenses incurred by petitioner in defending against and resolving the Lawsuit were not incurred to allow the condominium sales to occur. Thus, they did not constitute ordinary, necessary and reasonable fees incurred to sell the property which would be allowable as part of original purchase price for the property per Tax Law former § 1440(5)(a).

ARGUMENTS ON EXCEPTION

Petitioner argues that it sold condominium units in a building that was defectively constructed. The purchasers brought an action for breach of contract which petitioner settled in 1993 to compensate these purchasers for the defects. Since the right to damages for a breach of contract action accrues on the date of the breach, petitioner's liability for breach of contract arose contemporaneously with its transfers of the units. Thus, petitioner's liability for transfer gains tax and breach of contract arose from the very same transactions and at the very same time. Petitioner argues that damages must be measured at the time that the breach occurred, damages being the amount necessary to make the purchasers whole. Since, argues petitioner, there was never any dispute that petitioner sold the property in a defective condition, the only issue was the valuation of the defects as of the date of the transfer. This valuation is not a subsequent event and as such would have no effect on consideration under the decision of this Tribunal in ***Matter of Cheltoncort Co***. (Tax Appeals Tribunal, December 5, 1991, ***confirmed Matter of Cheltoncort Co. v. Tax Appeals Tribunal***, 185 AD2d 49, 592 NYS2d 121). Petitioner argues that the settlement agreement was simply a rebate of the purchase price for the defects in construction existing at the time of transfer. It was not a voluntary payment made as a result of a subsequent renegotiation of the purchase price for which there was no provision as of the date of the transfers.

Petitioner also argues that it incurred legal expenses and fees as part of the cost of its settlement. Under the "origin of the claim" theory, petitioner argues that these fees and

expenses are deemed to have the same character as the matter for which they were incurred, as recognized by this Tribunal in ***Matter of Preferred Rentals, Stockton Bldg.*** (Tax Appeals Tribunal, March 21, 1996). Thus, they should be considered as a selling expense included in original purchase price pursuant to Tax Law former § 1440(5)(a) or as a reduction in consideration received as part of the cost of the settlement.

The Division argues that the Administrative Law Judge incorrectly determined that petitioner may reduce its consideration for the unit transfers by the amount of the Lawsuit settlement payment. Whether or not the alleged defects existed on the date of the transfers, the Division argues that petitioner failed to meet its burden of proof to show that the settlement funds were earmarked to repair any of these defects. Rather, the settlement payment represents a renegotiation of the purchase price subsequent to transfer. The Division argues that the Administrative Law Judge's determination is contrary to precedent established by ***Matter of Cheltoncort Co.*** (***supra***) especially in light of the fact that petitioner never conceded liability in the Lawsuit or the settlement for any of the alleged defects in construction. Further, the record contains no evidence of the amount expended to actually correct any of the alleged defects.

As to the legal expenses and fees, the Division argues that the Administrative Law Judge correctly rejected petitioner's argument that these items were included in petitioner's original purchase price. The Division asserts that these fees were not a selling expense nor were any of the transfers contingent on a satisfactory conclusion of the Lawsuit.

OPINION

Initially, we note that the Division has provided no basis on which to conclude that a modification of the findings of fact by the Administrative Law Judge is necessary. As a result, we affirm the findings of fact as determined by the Administrative Law Judge.

Next, we disagree with the Administrative Law Judge's conclusion that petitioner is entitled to a reduction in the amount of consideration received on the unit transfers for the payment made to settle the Lawsuit.

Tax Law former § 1441 imposed a 10% tax upon the gain derived from the transfer of real property located within New York State. Gain is measured by the excess of the consideration for the transfer over the original purchase price of the property (Tax Law former § 1440[3]). Consideration, in turn, means the price paid or required to be paid for real property or any interest therein, less customary brokerage fees if paid by the transferor (Tax Law former § 1440[1][a]).

The Administrative Law Judge concluded that the settlement payment was made to "compensate unit purchasers for the defects existing in their properties at the times of transfer" (Determination, conclusion of law "C"). In accord with this, petitioner argues in its brief in support of its exception that "petitioner paid damages to the unit owners to compensate them for the value of the defects in reduction of the amounts paid for the purchase of the units" (Petitioner's brief, p. 9). We disagree. The only evidence in the record as to the nature of the settlement payment made by petitioner is contained in the affidavit of David Wynn. Pursuant to that affidavit, payment was made to the Board of Managers of Astor Terrace and not to the individual unit owners. In fact, none of the individual unit owners were a party to the Lawsuit.

According to the Wynn affidavit, the Board of Managers agreed to apply petitioner's $1,500,000.00 settlement payment amount, net of expenses, to the correction of defects in the building and in the purchasers' individual units. There was no concession of liability by petitioner for any of the items of damage alleged in any of the causes of action in the Lawsuit. There is no indication in the record of the amount, if any, that was actually expended by the Board to correct the alleged defects or which alleged defects were actually corrected, if any. In effect, the purpose of the settlement payment was to place the premises in a condition which would make them worth the amount of money paid for them by the purchasers as of the dates of sale. However, none of the causes of action alleged in the complaint in the Lawsuit sought to reform the original contracts of purchase by lowering the price paid for such units. As a result, the consideration paid by each of the unit owners to purchase their units would not have been affected in any event by the outcome of the Lawsuit.

The statutory definition of "consideration" relates not to the net amount received by petitioner on the transfer but to the amount given by the transferees. In ***Matter of Ziegelman*** (Tax Appeals Tribunal, October 12, 1995) we stated, in analyzing the amount of consideration on the transfer of real property for purposes of the gains tax, that:

> we must not look at the "consideration" from the perspective of petitioner [transferor]; i.e., how much was actually received as a result of the transfers. Rather, we must calculate consideration by determining how much was paid or required to be paid by the purchasers for the interests in real property that were transferred.

There is no indication in the record that the amount of the settlement payment in any way affected the amount of consideration (i.e., the price paid or required to be paid for the real property) paid by the transferees for the condominium units sold by petitioner. As a result, there is no basis on which to conclude that the settlement payment reduced the amount of consideration paid on the transfers.

Petitioner argues that its settlement payment in July 1993 related back to the value of the units on their dates of transfer. A similar argument was recently presented to this Tribunal in ***Matter of McCallion*** (Tax Appeals Tribunal, September 4, 1997) and was rejected. In ***McCallion***, the transferee gave the taxpayer an unsecured promissory note for $350,000.00 as part of the consideration for a transfer of property. The face amount of that note had been included in the consideration received by the taxpayer and gains tax calculated thereon. Subsequent thereto, the transferee failed to pay the amount due on the note. The taxpayer argued that the transferee's unsecured promise to pay was worthless when given. As a result, this condition existed at the time of the transfer and the note should not have been included in consideration. The taxpayer presented no evidence, however, that at the time of the transfer, the taxpayer deemed the purchaser's unsecured promise to pay $350,000.00 a worthless promise. We held that the failure to pay the unsecured note was an event occurring subsequent to the transfer and, as a result, it had no effect on the calculation of consideration at the time of the transfer. Similarly, in the present matter, petitioner presented no evidence that at the time of any of the transfers, either the purchasers or petitioner considered any of the units to be

defective, to be worth less than the amounts that were paid for them or that the amount of consideration given for any of the units was contingent on the outcome of the Lawsuit.

In ***Matter of South Suffolk Recreation Ventures*** (Tax Appeals Tribunal, November 3, 1994, ***confirmed Matter of South Suffolk Recreation Ventures v. Tax Appeals Tribunal*** (224 AD2d 874, 638 NYS2d 515, ***lv denied*** 88 NY2d 803, 645 NYS2d 446), the transferor and transferee adjusted the purchase price of real property subsequent to its sale and related it back to the date of closing. We considered this post-transfer price reduction to be a subsequent event having no effect on the amount of gains tax due. In the instant case, petitioner attempts to achieve the same result as the taxpayer in South Suffolk by arguing that the settlement payment of an unproven claim for damages relates back to and reduces the amount of consideration given for the real property at the time of the sale. In each case, the amount received or to be received by the transferor at the time of transfer is not affected by an event taking place subsequent to the transfer which was not contemplated by either party at the time of the transfer (***Matter of Wanat v. Tax Appeals Tribunal***, 224 AD2d 873, 638 NYS2d 251, ***lv denied*** 88 NY2d 803, 645 NYS2d 446; ***Matter of Cheltoncort Co. v. Tax Appeals Tribunal***, ***supra***).

This matter is distinguishable from ***Matter of Forty Second St. Co.*** (Tax Appeals Tribunal, April 6, 1995, ***confirmed Matter of Forty Second St. Co. v. Tax Appeals Tribunal***, 219 AD2d 98, 641 NYS2d 151, ***lv denied*** 88 NY2d 807, 647 NYS2d 164). In that case, property was taken by eminent domain proceedings but the amount of consideration was not established until an award of compensation was made subsequent to the taking. The award, however, was based on the fair market value of the property on the date the property was appropriated. In its decision, the Appellate Division stated that while the fair market value of the property may not have been known as of the transfer date, that value was in no way contingent on indeterminate future events. Petitioner herein argues that "there was never any dispute as to the fact that the petitioner sold property in a defective condition. The only issue was the valuation of such defects on the facts existing on the dates of the transfers" (Petitioner's brief, p. 8). We disagree. Petitioner never admitted the validity of any of the specific claims

asserted against it in the Lawsuit. In fact, the record in this matter does not disclose any agreement as to the existence of any specific defective condition in the building or in any of the units sold. The Lawsuit was commenced in July 1988, a date subsequent to some, but not all, of the transfers of the condominium units at issue. The settlement of the Lawsuit in 1993 occurred subsequent to each of the transfers at issue. However, as stated above, there is no evidence in the record that the amount of consideration for the transfer of any unit was contingent upon the outcome of the Lawsuit. As a result, petitioner is not entitled to a reduction in consideration for the amount of the settlement payment.

Nor would petitioner be entitled to a reduction in taxable gain as a result of payment of the Lawsuit settlement by considering it to be an adjustment to petitioner's original purchase price due to the cost of the construction of capital improvements. Tax Law former § 1440(5)(a) defined "original purchase price" as:

> the consideration paid or required to be paid by the transferor; (i) to acquire the interest in real property, and (ii) for any capital improvements made or required to be made to such real property, including solely those costs which are customary, reasonable, and necessary, as determined under rules and regulations prescribed by the tax commission, incurred for the construction of such improvements. Original purchase price shall also include the amounts paid by the transferor for any customary, reasonable and necessary legal, engineering and architectural fees incurred to sell the property . . .

In ***Matter of Rhinebeck Farms Dev. Corp.*** (Tax Appeals Tribunal, August 18, 1994), we considered a situation similar to the instant case in which a condominium sponsor was made a defendant in a lawsuit brought by unit owners. The lawsuit arose from the construction and installation of certain systems in the units sold. The petitioner filed a protective claim with the Division for refund of gains tax which was based, in part, on an estimate of the construction costs to be incurred if the unit owners were successful in their pending litigation. We held that:

> here the original purchase price with respect to the capital improvements was fixed at the time of the transfer and cannot be increased simply because petitioner might incur, or did in fact incur, costs to settle litigation with respect to the construction of the condominium units. To obtain a refund, petitioner would have to show that the settlement payments represented amounts of consideration petitioner paid or was required to pay for any capital improvements made or required to be made to the real property <u>at the</u>

> time of transfer. In other words, petitioner would have to show: 1) that it was required to make capital improvements in a manner other than made, and 2) what the costs of the required capital improvements would have been at the time of the transfer [emphasis added].

As set forth above, there is no evidence in the record that consideration for the transfer of any unit was contingent upon the outcome of the Lawsuit or that at the time of the transfers, capital improvements were contemplated by either the transferor or the transferees. Thus, we conclude that petitioner has not demonstrated any basis on which it is entitled to reduce its gains tax liability by the amount of the payment made to settle the Lawsuit.

Similarly, the legal fees and expenses associated with this Lawsuit may not be offset against the amount of consideration given. In ***Matter of Preferred Rentals, Stockton Bldg***. (***supra***), the taxpayer settled a lawsuit by paying an amount to release a claimed leasehold interest and remove a lis pendens. The taxpayer then added the cost of settlement to its original purchase price on the subsequent transfer of the property, arguing that the settlement was necessary in order that the property could be transferred free and clear of encumbrances. We held that the settlement payment represented a cost of protecting title to the property which was not properly included in original purchase price pursuant to Tax Law former

§ 1440(5). While the legal fees and expenses in the instant case might have significance for the income tax liability of petitioner, it is well established that "not every cost incurred by a transferor is allowable for gains tax purposes to reduce the taxable gain" (***Matter of V & V Properties***, Tax Appeals Tribunal, July 16, 1992). There is no evidence that these expenses and fees were incurred in connection with the sale of any units. Rather, they were incurred to defend and effectuate the settlement of a lawsuit irrespective of the sales. Therefore, the legal fees and expenses at issue were not reasonable and necessary legal fees incurred to sell the property and we affirm the Administrative Law Judge's disallowance of them as part of the original purchase price for the property.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of 93rd Street Associates is denied;

2. The exception of the Division of Taxation is granted;

3. The determination of the Administrative Law Judge is reversed with respect to conclusion of law "C," but is otherwise sustained;

4. The petition of 93rd Street Associates is denied; and

5. The claim for refund in the amount of $198,133.00, as set forth in the stipulation, is denied.

DATED: Troy, New York
March 5, 1998

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Donald C. DeWitt
President

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Carroll R. Jenkins
Commissioner

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Joseph W. Pinto, Jr.
Commissioner