STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition of 61 EAST 86TH STREET EQUITIES GROUP[1] 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.	:	DETERMINATION

Petitioner, 61 East 86th Street Equities Group, c/o Lowenthal, Landau, Fischer & Ziegler, P.C., 250 Park Avenue, New York, New York 10177, filed a petition 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 (File No. 803837).

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on May 23, 1988 at 1:15 P.M., with all briefs to be submitted by September 1, 1989. Petitioner appeared by Lowenthal, Landau, Fischer & Ziegler, P.C. (Stephen S. Ziegler, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Paul A. Lefebvre, Esq., of counsel).

ISSUES

I. Whether the original purchase price for certain shares of a cooperative housing corporation ("CHC") acquired by petitioner should be based on an allocation of petitioner's original cost for the property (prior to petitioner's transfer thereof to the CHC) as opposed to an allocation based on the CHC's cost for such property.

II. Whether the CHC's mortgage indebtedness on the property should be allocated to and included in consideration received by petitioner upon its sales of CHC shares.

III. Whether petitioner should be allowed to reduce the amount of gain subject to tax by allowance of certain estimated costs, calculated as the excess of maintenance and management costs over gross rents (denominated "negative carry") and the excess of interest expense over net operating income (denominated "interest carrying cost").

IV. Whether petitioner has established that penalties asserted for failure to timely file certain returns and failure to timely remit tax due should be abated.

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[1] This matter serves as the "test case" on the issues addressed herein pursuant to a "test case agreement" executed by the parties. A list of other matters potentially affected by the outcome of this test case is included herein as Appendix "A".

FINDINGS OF FACT

On September 18, 1987, authorized representatives for petitioner (Stephen S. Ziegler, Esq.) and for the Division of Taxation (Paul A. Lefebvre, Esq.) executed a Stipulation of Facts pertaining to the matter at issue. This Stipulation, modified herein only insofar as to delete references to various documents included with the Stipulation as exhibits (the existence and authenticity of which documents are not disputed), provides as follows:

STIPULATED FACTS

On July 12, 1982, Francis Greenburger ("FG"), as nominee for 61 East 86th Street Equities Corp. (the "Transferor"), entered into a contract (the "Purchase Contract"), with an unrelated party ("Seller"), to purchase for a price of $2,218,000 the property located at 61-69 East 86th Street, New York, New York (the "Property").

The Transferor was formed under a Limited Partnership Agreement by and among FG, Morton L. Olshan ("MLO") and Philip Rudd ("PR").

FG and MLO are the general partners and PR is a limited partner of the Transferor, and their percentages of the profits and losses of the Transferor are as follows:

General Partners	Profit and Loss Percentage
FG	40%
MLO	50%
Limited Partner	
PR	10%
TOTAL	~~100%~~

MLO has no family relationship to FG and is not an employee of or contractor for Greenburger or any affiliates of Greenburger.

Apart from their participation as co-partners of the Transferor and except as set forth in the next sentence, there have been no business relationships between MLO (and his affiliates) and FG (and his affiliates). In the period from June 1982 to February 1986, FG and/or affiliates purchased five properties from MLO at fixed prices totaling $10,040,000.

Olshan is an experienced and successful real estate entrepreneur, e.g.

(a) He owns directly through affiliates over 5,000 housing units in the New York City metropolitan area.

(b) His company has built over 10 million square feet of regional shopping malls.

(c) He is currently building at a cost believed to be over $100 million and is marketing condominium units in a luxury apartment house named the Savoy on 61st Street and Third Avenue.

(d) He is one of the founding members of CHIP, one of the most active real estate industry organizations in New York City and actively participates in the organization.

On October 21, 1982, the Transferor purchased the Property pursuant to the Purchase Contract.

On December 8, 1983, there was filed with the New York Attorney General an Offering Plan (the "Plan") to convert the Property to cooperative ownership. The Plan was a non-eviction plan. After subsequent amendments, the Plan was declared effective March 4, 1985.

On October 19, 1982, the Transferor entered into a Contract of Exchange (the "Exchange Contract") to transfer the Property to the Corporation in exchange for:

(a) the Corporation issuing to the Transferor all the Shares of the Corporation which had either not been subscribed for prior to the Closing Date or as to which the cash payment for subscriptions had not been received on the Closing Date or within a few weeks thereafter (the "Unsold Shares"),

(b) the Corporation agreeing to issue to the Transferor a purchase money mortgage of $2,000,000, and

(c) the Corporation paying to the Transferor an amount equal to the net proceeds realized from the sales of the Shares issued by the Corporation to persons other than the Transferor (the "Subscribers") after deducting therefrom:

(i) the expenses incurred on behalf of or by the Corporation in connection with the promulgation and consummation of the Plan and the acquisition of the Property pursuant thereto, and

(ii) the working capital and reserve funds to be retained by the Corporation at the closing.

In April 1985, the Exchange Contract was amended to provide that, instead of issuing a purchase money mortgage to the Transferor, the Corporation would acquire the Property subject to a mortgage payable to Independence Savings Bank of $1,300,000 (the "Independence Mortgage") and a mortgage payable to Chemical Bank of $300,000 (the "Chemical Mortgage") and that the Corporation would immediately retire the Chemical Mortgage.

On May 1, 1985 (the "Closing Date"), the Transferor transferred the Property to the Corporation for total consideration as follows:

Cash	$1,490,541
Corporation acquiring the Property subject to the Independence Mortgage	1,300,000
Corporation retiring Chemical Mortgage	300,000
Corporation's issuance to the Transferor of the 4,481 Unsold Shares of the Corporation's stock, valued at	

an estimated fair market value of $424.80 per Share[2]	1,903,529
Total Consideration	~~$4,994,070~~

As of the Closing Date, the Corporation issued 10,688 Shares of its common stock as follows:

(a) pursuant to Subscription Agreements entered into before the Closing Date, at, or shortly after the Closing Date, the Corporation issued 6,207 Shares (the "Sold Shares") to subscribers other than the Transferor (the "Subscribers") for gross proceeds of $2,685,675, and

(b) as part of the consideration for the Transferor's transfer of the Property to the Corporation, the Corporation issued its remaining 4,481 Shares to the Transferor (the "Unsold Shares").

The cash payment made by the Corporation to the Transferor as part of the consideration for the transfer of the Property represented the following:

Gross proceeds of issuance of Shares to Subscribers pursuant to Subscription Agreements in effect on Closing Date	$2,685,675
Less: Proceeds used to retire Chemical Mortgage	(300,000)
Less: Working Capital and Reserve Funds	(300,000)[3]
Less: Costs to Corporation of acquiring Property and issuing shares	(595,134)
Cash Payment	~~$1,490,541~~

The costs to the Corporation that were subtracted in imputing the cash payment were:

Tenant Buy-out payments	$ 70,000

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This represents 40% of the outsider price for the Shares sold, which was deemed to represent the fair market value of the Unsold Shares on an occupied basis.

3

Of this amount $75,000 was paid by the Sponsor to the Cooperative Housing Corporation ("CHC") after the closing.

Title & recording	120,683
Conversion fee total (15%)	402,851
Miscellaneous	1,600
	~~$595,134~~

The 6,207 Sold Shares issued to the Subscribers were all subscribed to after March 28, 1983.

Subsequent to filing the Plan, during the period from September 4, 1984 through the Closing Date (the "Pre-Closing Period")[4], the Transferor incurred an interest cost in carrying the Property (the "Interest Carrying Cost") as follows:

Interest Expense	$148,706
Less: Net Operating Income before depreciation[5]	(22,529)
	~~$126,177~~

At the time it filed its Amended Gains Tax Return, the Transferor estimated that it was incurring a net operating loss (the "Negative Carry") in holding the Unsold Shares at a monthly rate per share computed as follows:

Expenditures		
Maintenance charges to Corporation		$13,265
Management fee (3% of gross rents)		283
Repairs, insurance and other expenses (an estimated $55 per apartment per month)		800
Total Expenditures		$14,428
Less: Gross rental income		(9,435)
Negative Carry per month		$ 4,993
Divided by Number of Unsold Shares	Divided by 4481	
Negative Carry per Share per Month		~~$ 1.11~~

[4]September 4, 1984 was the date of an amendment to the Gains Tax statute permitting a deduction for the costs of converting a property to cooperative ownership.

[5] In computing net operating income, non-cash charges such as depreciation were not subtracted.

Based on said current Negative Carry per Share per month and the assumptions in regard to the holding period of the Unsold Shares used in calculating the estimated gain per Share under Option B (which assumptions are described in Finding of Fact "18"), Transferor projected in its Amended Return that it would incur a total Negative Carry of $405,887 in carrying the Unsold Shares in the period from the Closing Date through the disposition of all the Unsold Shares (the "Post-Closing Period").

The assumptions as to the holding period of the Unsold Shares were that 30% of the Shares would be sold as apartments become vacant after an average holding period of 48 months and 70% of the Shares would be sold for occupied apartments after an average holding period of 96 months. These assumptions were accepted by the Department upon audit in regard to the calculation of the estimated sales price on future sales of Shares and in regard to the calculation of the deduction for post-Closing mortgage amortization.

By an agreement dated December 24, 1982 (the "Sales Agent and Services Agreement"), the Transferor retained Time Equities, Inc. ("TEI") to furnish sales agent and administrative services in regard to the conversion of the Property to cooperative ownership.

Under the Sales Agent and Services Agreement, TEI was required to provide and pay for all other direct expenses associated with all services in regard to the sales of the Shares of the Corporation and the preparation, processing and implementation of the Plan.

The fee for all services provided by TEI was a conversion fee (the "Conversion Fee") as follows:

(a) A nonrefundable retainer of $75,000 was paid on December 24, 1982, to be credited against fees earned under paragraph (b) below.

(b) TEI was to be paid a fee equal to 15% of the actual selling price of all Shares.

On sales made by the Corporation, the Transferor would cause the Corporation to pay the Conversion Fee. On sales of Unsold Shares issued to the Transferor, the Transferor would pay the Conversion Fee.

On April 1, 1985, the Transferor filed a Gains Tax return (the "Original Return") under Option B for 5,196 of the Shares which were sold by the Corporation to Subscribers as of the Closing Date. In regard to this return, the Department issued a Notice of Tentative Assessment and Return, dated May 3, 1985. Under protest, the Transferor paid the Gains Tax liability of $126,525 reported on the Gains Tax return.

On August 15, 1985, the Transferor filed an amended Gains Tax return (the "Amended Return"):

(a) covering the sales of an additional 1,011 Shares for the total of 6,207 Shares sold as of the Closing Date, and

(b) adopting certain positions required by the Department under audit of Gains Tax returns of other properties in which TEI participated in the conversion to cooperative ownership.

Under protest, the Transferor paid an additional $55,801 of Gains Tax with the Amended Return for a total tax payment of $182,326.

In preparing the Amended Return under Option B, the Transferor followed certain positions set forth by the Department in meetings with the Transferor in regard to this and other properties, that is, the Transferor:

(a) followed Revised Publication 588 by:

(i) calculating the purchase price for the Sold Shares with reference to the Transferor's original cost for the Property, rather than with respect to the Corporation's cost for the Property; and

(ii) including in the allocable portion of the sales price for the Sold Shares the allocable portion of the Mortgage on the Property held by the Corporation, instead of excluding said Mortgage from the sales price of the Sold Shares;

(b) followed the position taken by the Department on audit of other properties in which TEI participated in the conversion to cooperative ownership, by not including in the costs of converting the Property to cooperative ownership, the Interest Carrying Cost sustained by the Transferor in carrying the Property in the Pre-Closing Period;

(c) followed the position taken by the Department on audit of other properties in which TEI participated in the conversion to cooperative ownership, by not including in the costs of converting the Property to cooperative ownership, the estimated Negative Carry to be incurred by the Transferor in carrying the Unsold Shares in the Post-Closing Period; and

(d) followed the position taken by the Department upon audit of other properties in which TEI participated in the conversion to cooperative ownership, by deducting from the sales price of the Sold Shares only a 10% Conversion Fee paid to TEI, instead of deducting the full 15% Conversion Fee actually paid to TEI.

Pursuant to the Amended Return (as modified by Agreement upon audit), the Transferor calculated its estimated gain per Share as follows:

Consideration	Present	Estimated	Total
1. Actual Non-Grandfathered Sales	$2,685,675		$2,685,675
2. Estimated Future Sales		$2,854,845	2,854,845
3. Mortgage taken over by Corporation on Closing Date	1,300,000		1,300,000

4. Less: 10% Brokerage Fee	(268,568)	(285,485)	(554,052)[6]
~~TOTAL CONSIDERATION~~	~~$3,717,108~~	~~$2,569,360~~	~~$6,286,468~~
Less: Costs			
5. Purchase Price	$2,218,000		$2,218,000
6. Other Acquisition Costs	199,436	120,683	320,119
7. Capital Improvements	35,609	142,765	178,374
8. Expenses to Convert to Cooperative Ownership[7]	370,000		370,000

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[6]This calculation is not precise due to rounding differences.

[7]

9. Mortgage Amortization	__________	60,447	60,447
10. TOTAL COSTS	~~$2,823,045~~	~~$ 323,895~~	$3,146,940
11. Less: Costs Attributable to Grandfathered Shares			-0-
12. Costs Attributable to Taxable Shares			$3,146,940
13. Gain (Difference between Total Consideration and Total Costs Attributable to Taxable Shares)			$3,139,528
14. Total Number of Shares (Sold and Unsold)		Divided by	10,688
15. Gain Per Share (Gain Divided by Total Number of Shares)			~~$ 293.74~~

Based on the foregoing calculation of gain per Share, the calculation of Gains Tax in the Amended Return for the 6,207 Sold Shares was as follows:

Gain per Share	$ 293.74
x Shares sold	x 6,207
Total Gain	$1,823,244
x 10% Gains Tax	x 10%
Gains Tax Liability	~~$ 182,324~~

Subsequent to the filing of the Amended Return and this claim for refund with the Department the Transferor sold an additional 1,226 Shares and paid Gains Tax totaling $36,013 in regard thereto.

Hence, the Transferor has paid total Gains Tax of $218,339 ($126,525 with the original return, $55,801 with the Amended Return and $36,013 after the Amended Return) with respect to a total of 7,433 Shares.

In its Petition[8], the Transferor calculated its estimated gain per share as follows:

Consideration	Present	Estimated	Total

Working capital and reserve fund of $300,000 plus tenant buyout fees of $70,000.

[8]The following schedule reflects adjustments of figures set forth in the petition. The adjustments were determined by TEI in internal audits and represent the Transferor's most current cost figures.

1. Actual Non-Grandfathered Sales	$2,685,675		$2,685,675
2. Estimated Future Sales		$2,854,845	2,854,845
3. [Mortgage taken over by Corporation omitted]			
4. Less: 15% Brokerage Fee	(402,851)	(428,227)	(831,078)
TOTAL CONSIDERATION	~~$2,282,824~~	~~$2,426,618~~	~~$4,709,442~~
Less: Costs			
5. Purchase Price	$4,994,070		$4,994,070
6. Other Acquisition Costs to Transferor[9]	70,044	120,683	190,727
7. Capital Improvements[10]	[omitted]	147,653	147,653
8. Expenses to Convert to Cooperative Ownership			
(a) Accepted by Department	370,000		370,000
(b) Interest Carrying Cost	126,177		126,177
(c) Negative Carry		405,887	405,887
9. [Amortization of Mortgage on line 3 omitted]			
10. Total Costs	~~$5,560,291~~	~~$ 674,223~~	$6,234,514
11. Less: Costs Attributable to Grandfathered Shares			-0-
12. Cost Attributable to			

[9]Since this claim for refund is calculated on the basis of the Corporation's cost for the Property, these expenditures exclude the acquisition costs of the Transferor totaling $123,392. (See Amended Return Schedule E).

[10]Since this claim for refund is calculated on the basis of the Corporation's cost for the Property, these expenditures exclude the $35,609 of capital improvements made by the Transferor prior to the Closing Date. (See Amended Return Schedule F).

Taxable Shares		~~$6,234,514~~
13. Gain (Difference between Total Consideration and Total Costs Attributable to Taxable Shares)		(1,525,072)
14. Total Number of Shares (Sold and Unsold)	Divided by	10,688
15. Gain (loss) Per Share (Gain Divided by Total Number of Shares)		~~$ (142.69)~~

On this basis, the Transferor has applied for a refund of the full Gains Tax paid of $218,339, together with the interest that has accrued thereon.

By letter dated May 22, 1986, the Department denied the claim for refund.

The Transferor and the Department agree that the issues are as follows:

Issue I is as follows:

(a) should the Corporation's mortgage be included in the sales price for the Sold Shares (as determined by the Department); and

(b) should the Transferor's purchase price for the Sold Shares be determined by making an allocation of the Corporation's cost for the Property (as claimed by the Transferor), rather than as an allocation of the Transferor's cost for the Property prior to transfer of the Property to the Corporation (as determined by the Department).

Issue II.

Should the Transferor be permitted to include, in its costs for converting the Property to cooperative ownership under Section 1440-5 the Interest Carrying Cost incurred by the Transferor after September 4, 1984 in carrying the Property in the Pre-Closing Period, i.e., the excess of the interest expense in this period over the net operating income produced by the Property.

Issue III.

Should the Transferor be permitted to include in its costs for converting the Property to cooperative ownership under Section 1440-5 the estimated Negative Carry incurred and to be incurred by the Transferor after September 4, 1984 in carrying the Unsold Shares in the Post-Closing Period, i.e., the excess of the maintenance charges to the Corporation and management fees over the rents derived from tenants occupying those apartments.

Issue IV.

Should the Transferor be entitled to a deduction for the full Conversion Fee of 15% of the sales price paid to TEI (as claimed by the Transferor) rather than a 10% Conversion Fee (as determined by the Department).

The parties agree that issues I, II and III will proceed to decision based upon the briefs. A hearing will be held only on Issue IV. Following said hearing, Issue IV will be submitted for decision based upon this stipulation, the briefs and the hearing.[11]

Subject to audit, the Department concedes the Transferor's figures on amounts of:

(a) the cost of the Property to the Corporation (applicable if the Transferor wins Issue I);

(b) the Interest Carrying Cost (applicable if the Transferor wins Issue II), and

(c) the estimated Negative Carry (subject to adjustments based on the updated Gains Tax returns prepared in accordance under Option B) applicable if the Transferor wins Issue III.

The Transferor concedes the figures in the Amended Return on the cost of the Property to the Transferor (applicable if the Transferor loses Issue I).

Additional Facts

In addition to the above-stipulated facts, the following facts are found:

On May 23, 1988, a hearing was held on the issue of penalty abatement, at which time petitioner presented the testimony of TEI's general counsel, one Philip Brody, who described TEI's staffing and operation, particularly with reference to gains tax compliance.

In regard to a cooperative conversion, TEI, as the managing general partner, provides a full range of services for a sponsor including, but not limited to, preparing the co-op plan, negotiating thereon with the Attorney General and with tenants, providing sales agent services (including completing sales) and also providing legal, accounting and engineering services described, in total, as an overall coordination function. The general legal structure of TEI conversions is as follows:

(a) TEI is the service entity which renders conversion services to various partnerships which sponsor conversions.

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[11] Subsequent to execution of the parties' stipulation, a modification to the manner of proceeding was agreed to between the parties and approved by the Division of Tax Appeals. More specifically, Issue IV as described in Stipulated Fact "34" (the 15% versus 10% conversion fee issue) has been severed from consideration in this determination. Said severance is for the purpose of allowing the parties to pursue settlement negotiations on such issue without impeding or delaying progress to determination on the remaining issues presented herein. Should resolution of the conversion fee issue not be achieved, a separate hearing will be held and determination rendered thereon. Finally, the parties have presented for determination in this proceeding the issue of whether penalties imposed against petitioner should be abated, with evidence and argument thereon presented at hearing on May 23, 1988 and by briefs filed thereafter. Accordingly, Stipulated Facts "34" and "35" are hereby deemed modified to reflect the manner of proceeding described by this footnote.

(b) The partnership holds the property and/or the contract to acquire a property and transfers it to a CHC.

(c) TEI renders sales agent and other services to the CHC up to and including the co-op closing date and thereafter to the sponsor.

(d) TEI is responsible for filing Gains Tax returns.

During the 1983-1985 period, there were 34 conversions made by the TEI Sponsors, including the conversion sponsored by petitioner herein. In those properties, a total of approximately 1,100 cooperative apartment units were sold during such three-year period.

Prior to 1985, TEI had assigned the following staff to carry out its Gains Tax reporting duties:

(a) one full-time junior accountant;

(b) about 40% of the time of its general counsel (Mr. Brody);

(c) as a later replacement for the full-time junior accountant, a full-time employee who was an accountant and an attorney; and

(d) a substantial amount of time of outside tax counsel.

Prior to the spring of 1985, the TEI Sponsors encountered difficulty in filing returns on a timely basis related to:

(a) the burdensome nature of Option A for cooperative filings, and

(b) the apparent risks involved for any taxpayer utilizing Option B prior to the issuance of "safe-harbor" guidelines by the Division of Taxation under Option B.

Option A and Option B filing methods for cooperatives and condominiums were described by the Division of Taxation via TSB-M-83(2)-R (August 22, 1983).[12]

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[12]In further explanation, prior to approximately August of 1986, the Division had allowed two acceptable methods of calculating gains tax liability upon transfers of cooperative apartment units. These two methods, known as Option A and Option B, may summarily be described as follows:

> Option A: Gain is computed based upon the actual consideration received on each unit transfer less the amount of total original purchase price apportioned to each such unit (including actual brokerage fees, advertising expenses, vacancy preparation costs and other selling expenses incurred). An update of the figures was required on four specific occasions (being respectively when 25%, 50%, 75% and 100% of the units had been transferred), or more frequently if requested by the Division of Taxation.

> Option B: Gain is computed based upon the total anticipated (i.e. actual plus estimated future) consideration as apportioned to each unit less the total (i.e. actual plus estimated future) original purchase price apportioned to each unit. This method essentially allowed

Prior to an April 1985 audit meeting with the Division of Taxation (see, Finding of Fact "50", infra), TEI made gains tax filings under Option A (that is, preparing a separate return with a different (actual) sales price and different (actual) vacancy preparation costs and selling expenses for every unit sold). While TEI filed returns for hundreds of sales in this period, many were admittedly filed late, and TEI was struggling to catch up in filings for other sales. As of the start of 1985, TEI was concededly behind in the submission of gains tax returns.

TEI attributes its lateness in filing returns to a number of factors including:

(a) the volume of cooperative conversions it was handling;

(b) the difficulty, in light of such volume of conversions, to utilize Option A which required actual calculations of amounts, as opposed to estimates (anticipated amounts) for each unit sold;

(c) a hesitance to utilize Option B (and apply estimates) based on the concern that penalties would be imposed if estimates made proved to be incorrect;

(d) the lack of written guidelines from the Division of Taxation as to how to deal with certain issues ("computational uncertainties") in the preparation of gains tax returns. Such computational uncertainties included:

(i) computation of basis to a sponsor who had acquired the real property from an affiliate prior to March 28, 1983 ("affiliate purchase issue");

(ii) deductibility of interest costs and other financing fees;

(iii) treatment of vacancy preparation costs;

(iv) treatment of contingent consideration (e.g. final sale price dependent upon certain future events/amounts).

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an apportionment of anticipated gain to each unit. Updates were required at the same sellout plateaus (or more frequently upon Division of Taxation request) as for Option A.

Commencing in or about August of 1986, the Division of Taxation eliminated Option A as an acceptable method of calculation. In addition, new filing procedures were established whereunder standards were set for estimating anticipated consideration under a cooperative conversion plan. These standards for estimation, when applied, would result in a so-called "safe harbor" estimate of anticipated consideration and treatment as though the transferor's estimate of consideration exactly equalled the actual consideration ultimately received. In ultimate effect, compliance with the "safe harbor" method would avoid imposition of penalty and interest on any underpayment of gains tax on unit transfers (to the extent such underpayment represented the excess of actual consideration over the safe harbor estimate of consideration). This August 1986 change resulted, in essence, in the only acceptable method of computation being a modified Option B computation including guidelines for computing the safe harbor amounts. Updating was optional at the 25% plateau, and was required at the 50%, 75% and 100% plateaus (see generally TSB-M-83-[2]-R, TSB-M-86-[2]-R and TSB-M-86-[3]-R).

TEI's general counsel testified that TEI attempted to contact the Division of Taxation for guidance, but in most instances was unable to do so, allegedly due to the fact that at that time the Division's Gains Tax Unit only had one open telephone line for public inquiries, which was "constantly busy". Mr. Brody further testified that when TEI did reach Department officials, the issues were sufficiently complex that no clear answers were obtained.

TEI noted that, prior to the audit, TEI received no inquiries or challenges from the Division regarding its manner of reporting on many returns (i.e., specifically challenging petitioner's position on the substantive issues as raised herein).

TEI's general counsel prepared (with assistance from TEI's outside tax counsel) an "in-house" memorandum setting forth, in detail, the application of the Gains Tax to many of the issues involved in TEI's conversions, with successive revisions to this memorandum made as further knowledge was obtained. Each new staff person hired by TEI was individually instructed as to the application of the statute, based on this "in-house" memorandum.

TEI was aware that its filings were behind as of early 1985 and, in an effort to close the gap, retained an outside accounting firm, Brucia & Zwilling, on special assignment. Working with TEI's staff, the outside accounting firm completed, and submitted for audit at the April 1985 meeting with the Division's representatives (see, Finding of Fact "50", infra), Option A returns for all sales in all buildings, as to which returns had not then been filed.

In early 1985, the Division called to advise TEI that it planned to start an audit. In or about April 1985, a delegation of Division personnel visited TEI (the "audit commencement meeting"). At this meeting, the Division advised TEI that henceforth, the Division planned to mandate the use of filing Option B, because the Division could not administratively cope with the separate returns with different figures for each sale as required under Option A. Division officials advised TEI that they realized there were possibilities for substantial tax deferral in Option B which were not present in Option A (e.g., by means of the projection of low future sales prices for unsold shares). The Division advised that this change from Option A to Option B was for the Division's administrative convenience.

At the April 1985 meeting, TEI's representatives strenuously objected to being required to use Option B in the absence of some assurance that penalties would not be imposed if TEI's estimates of sales prices, etc., were reasonable when made but proved to be different from the actual results. TEI urged the Department to adopt safe harbor guidelines regarding the projection of future sales.

At the meeting, the Division and TEI agreed to guidelines for estimating sales prices by TEI Sponsors that would be accepted by the Department as reasonable (pending the issuance of safe harbor guidelines for the entire industry), with the understanding that if TEI used these guidelines, penalties would not be imposed if the estimates proved to be incorrect. The guidelines agreed to at the meeting were that TEI would assume that 30% of the unsold shares would be sold at the outsider price, and 70% would be sold at a price representing 40% of the outsider price. This would result in a weighted average assigned sales price for the unsold shares of 58% of the outsider price -- which was 8% higher than the safe harbor guideline of 50% of the outsider price (or insider price, whichever is less) later adopted by the Department.

In summary, TEI received the following critical assistance from the April 1985 meeting with Division officials:

(a) authorization to use Option B, with guidelines which protected against penalties if certain estimated sales prices were used, and

(b) a statement of the Division's position on the Affiliate Purchase and Contingent Price issues.

TEI pledged an all out effort to prepare amended Option B Gains Tax filings for all of its conversions in a short period of time and it did so. In addition to its Gains Tax personnel mentioned above, TEI committed to this effort the services of the outside accounting firm as well as two full-time employees from its accounting department. As a result of this effort, by July 1985 (i.e., within less than two months), TEI had redone under Option B and submitted to the Division's agents for audit Gains Tax returns on all of its outstanding conversions.

TEI developed its own forms specifically for reporting under Option B since, as of that time, the Division had published no such specific Option B forms. As contrasted with the one page Transferor Form (TP 580) which the Division had theretofore issued for all transfers of real property, which had no separate calculation forms or instructions for cooperative conversions, TEI's Option B form was over ten pages long. The DTF forms issued by the Division for cooperative conversions over a year later (in June 1986), are similar to the forms developed by TEI on its own.

The Division then audited these returns. As requested by the Division representative supervising the audit, all returns were redone to reflect changes required by the Division's agents and then the returns were accepted as corrected and payment made. This took place over the period from June 1985 through October 1985.

As testified to by TEI's general counsel, through the completion of the audit in October 1985 TEI's work hours and expenditures relative to gains tax included the following:

a. TEI's legal staff spent over 4,698 man hours in these efforts for which the TEI Sponsors were billed $462,339.

b. TEI replaced the staff accountant initially working on Gains Tax returns (under the supervision of its general counsel), with a C.P.A. who was also an attorney, and who had previously worked at a large accounting firm. In addition, TEI employed an auditor with full-time Gains Tax responsibility and as his assistant, an accountant with computer experience, who computerized TEI's Gains Tax reporting.

c. As set forth above, TEI retained the accounting firm of Brucia & Zwilling on special assignment. This firm submitted bills totaling $42,718 during 1985 representing over 717 man hours.

d. In the period from January 1984 to July 31, 1986, TEI's tax counsel submitted bills on Gains Tax compliance for more than $67,327 representing approximately 392 man hours.

Petitioner maintains that penalties imposed for late filing and payment should be abated, upon any one or all of three basic premises, as follows:

(a) petitioner prevails on the basis/mortgage issues leaving no tax due; and/or

(b) petitioner's legal position on the substantive issues, although different from the Division's, was taken after consultation with outside counsel and was supportable and logical (and thus reasonable) under the terms of the statute; and/or

(c) petitioner's failures to timely file and pay resulted despite reasonable efforts to comply, as based upon the argument and facts outlined above. More specifically, petitioner points to the computational uncertainties, as well as the large volume of cooperative conversions handled by TEI, coupled with the difficulty of using Option A and the described hesitation in using Option B (before safe harbor rules) for fear of incurring penalties for incorrect estimates.

CONCLUSIONS OF LAW

A. Petitioner raises a number of issues herein, including substantive/computational issues (the "basis" and "mortgage" issues and the "negative carry" and "interest carry" issues), as well as the issue of whether penalty imposed should be abated. As to the "basis" and "mortgage" issues, the essence of petitioner's argument is that the transfer of the real property by the realty transferor to the cooperative housing corporation is the first of two separate taxable events for gains tax purposes. The second taxable event is the transfer of shares by the realty transferor to cooperative apartment unit purchasers. Adoption of petitioner's position would result in calculations whereunder the amount of the mortgage would be included as consideration only on the transfer from the petitioner to the cooperative housing corporation (herein escaping gains tax altogether because said transfer occurred pursuant to a pre-March 28, 1983 contract). In addition, petitioner's position would cause the original purchase price for the property to be determined based on the cooperative corporation's acquisition of the realty, rather than on petitioner's acquisition of the realty. Petitioner does not argue that share sales made after March 28, 1983 escape taxation because a "grandfathered" realty transfer is involved (Tax Law § 1443.6); rather, petitioner's position is that such sales receive the benefit of a stepped-up basis and mortgage non-inclusion due to the prior realty transfer (an allegedly independent step) to the cooperative housing corporation.

As to the "negative carry" issue, petitioner argues that negative carry[13] is a cost that meets the statutory requirements of Tax Law § 1440.5(a). Petitioner maintains negative carry arises as a "customary, reasonable and necessary expense incurred to create ownership interests in property in cooperative form", because it inevitably exists in cooperative conversions as a result of the interaction of the rent control, rent stabilization and non-eviction laws in New York City (i.e., the statutory limits on rent amounts nearly always leaves gross rents inadequate to cover maintenance, management, and other costs). The crucial issue is whether negative carry can be characterized as an expense incurred to create ownership in the cooperative form.

B. Petitioner admits, by brief, that the identical above-three issues were argued before and decided by the Tax Appeals Tribunal in Matter of 1230 Park Associates and Crystal Management, Inc. (Tax Appeals Tribunal, July 27, 1989). In 1230 Park Associates the Tribunal rejected petitioners' "basis" and "mortgage" arguments, upon the conclusion that cooperative conversions should not be viewed as a two-stage transaction for gains tax purposes (citing Mayblum v. Chu, Sup Ct, Queens County, May 11, 1984, Graci, J., affd 109 AD2d 782, mod 67 NY2d 1008; Matter of Normandy Associates, Tax Appeals Tribunal, March 23, 1989). Although petitioner argues herein to the contrary, petitioner establishes no distinguishing basis sufficient to warrant departure from the Tribunal's reasoning and result on such issues as set forth in 1230 Park Associates.

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[13]The difference (loss) between rental income (earned by a sponsor through leasing unsold cooperative units to non-purchasing tenants) versus the costs to the sponsor (including maintenance charges, management expenses, interior repairs and painting, etc.) of owning such units. Negative carry was estimated to be $405,887.00 spanning the period from closing (5/1/85) through projected sellout.

Similarly, the "negative carry" issue was also presented for decision in 1230 Park Associates. The Tribunal determined that negative carry, as sought to be added to original purchase price by petitioners, was a cost of carrying cooperative units and not of creating ownership in cooperative form and hence was not allowable. In this regard, negative carry is described by petitioner herein (by brief) as "the out-of-pocket loss sustained by a sponsor in carrying unsold cooperative units" (emphasis added). Such description of what is essentially a loss incurred while holding cooperative units supports a conclusion that the costs sought were not incurred in creating ownership of the units in cooperative form. In sum, there is no reason to depart herein on the negative carry issue from the Tribunal's result in 1230 Park Associates.

C. As to the "interest carry" issue presented herein, petitioner seeks, per Tax Law § 1440.5, to add to original purchase price its interest expense on indebtedness for the period spanning September 4, 1984 through May 1, 1985 (the pre-closing period).[14] By brief, petitioner noted the interest expense was incurred on loans the proceeds of which were used both to acquire the property and to pay various "conversion expenses" (including [deductible] legal fees for plan preparation, engineering report, etc.). This interest carry issue was not presented for decision in 1230 Park Associates.

Petitioner does not dispute the general rule that interest on realty acquisition financing is not allowable as a part of original purchase price (20 NYCRR 590.15[c]; see Matter of Mattone v. Dept of Taxation and Finance, 144 AD2d 150). However, petitioner argues that its pre-closing interest expense, which includes such acquisition financing interest expense as well as "conversion cost" interest expense, should nonetheless be allowed, at least insofar as it exceeds pre-closing net operating income. Petitioner likens such expense to interest expense incurred on debt used to construct or develop new property (i.e. capital improvement construction period interest per 20 NYCRR 590.15[d]). Petitioner argues that where the property is acquired solely for the purpose of co-op conversion and is promptly converted, and the interest expense is incurred on borrowings used to so acquire and so convert, a resulting excess of interest expense over net operating income is a customary, reasonable and necessary expense of the conversion to and creation of ownership in cooperative form. Petitioner maintains that the excess of interest expense over net operating income prior to conversion (attributed to leaving apartments vacant thus resulting in a greatly reduced rental revenue stream) is analogous to the interest expense (loss) incurred during a construction period (during which the interest expense is incurred but no revenue is realized). In sum, petitioner argues that the period for construction of capital improvements is essentially the same as the period for conversion to cooperative ownership, likening the creation (construction) of physical property (the capital improvement), a precursor to receipt of revenue, to the creation of ownership interests in the form of cooperative shares, a precursor to the receipt of revenue from sales of shares.

D. Petitioner's argument, though interesting, is rejected. First petitioner admits there is no provision allowing interest expense on acquisition indebtedness in the capital improvement scenario, and advances no persuasive distinguishing argument whereby such acquisition interest expense should be allowed because incurred in acquiring property to be co-oped. Further, changing the form of ownership (i.e., ownership of a building with apartment units to ownership of shares of a corporation which owns a building with apartment units) is not, as argued, the same as constructing a capital improvement. In addition, even if interest expense was allowable on costs other than acquisition cost (i.e., conversion costs), there is no breakdown provided here between acquisition interest versus conversion cost interest. Finally, on these facts, petitioner's analogy of "construction period" interest, when expenses are incurred

[14] The $126,177.00 difference (loss) between interest expense versus net operating income produced by the property during the pre-closing period.

but no revenue is realized, to "conversion period" interest, when interest expense exceeds net revenue, seems strained. The former involves creation of new physical property to be placed "in service", whereas the latter involves changing the form of ownership of property already "in service". Accordingly, petitioner is not entitled to increase its original purchase price by its interest carrying cost.

E. Finally addressed is the issue of whether the penalties against petitioner should be abated. Tax Law § 1446.2(a) provides, inter alia, as follows:

> "Any transferor failing to file a return or to pay any tax within the time required by this article shall be subject to a penalty.... If the tax commission determines that such failure or delay was due to reasonable cause and not due to willful neglect, it shall remit, abate or waive all of such penalty and such interest penalty."

In arguing that its failures to timely file returns and remit taxes when due were not unreasonable, petitioner asserts that its substantive arguments, which were taken after consultations with counsel, were logical and supportable. More specifically, petitioner maintains that its substantive positions were reasonably taken in light of the then newly-enacted statute which contained less than clear language regarding its application to cooperative conversions. Petitioner also argues that it made extensive efforts to comply with the tax, as set forth by the facts found herein.

F. Initially, it is clear that reliance on the advice of counsel does not, of itself, establish reasonable cause (Matter of L T & B Realty v. State Tax Commn., 141 AD2d 185). Rather, it has been consistently held that the reasonableness of a taxpayer's positions must be evaluated by a comparison to the Division of Taxation's articulated policy. In August 1983, the Division issued Publication 588, "Questions and Answers - Gains Tax on Real Property Transfers." At question and answer number 20, the Division describes in some detail the application of the gains tax to cooperative conversions. This explanation is directly contrary to the two-stage theory advanced by petitioner. In addition, on August 22, 1983, the Division issued TSB-M-83(2)R, which describes two options for calculating the tax due on each transfer of a cooperative or condominium unit. These options are consistent with Publication 588 in that a cooperative conversion is taxed as a single transaction. Petitioner, although headed by persons admittedly very experienced in the New York City real estate business, including cooperative conversions (see, Finding of Fact "5", supra), rejected this method of calculating. Further, the trial court's opinion in Mayblum (supra) was issued on May 11, 1984. When petitioner started filing (with the closing) some one year later, petitioner calculated the tax by excluding the mortgage and by using the cooperative corporation's, rather than petitioner's, acquisition cost of the realty as the original purchase price. This manner of calculating tax arises from petitioner's two-stage theory of the gains tax and thus is in clear conflict with the Division's articulated policy and with the trial court's opinion in Mayblum. Accordingly, petitioner's reliance on its position in the face of the position's direct conflict both with the Division's interpretation and the Supreme Court's decision in Mayblum does not establish reasonable cause for the failure to file and pay gains tax.

In addition to the foregoing, petitioner argues that timely compliance was made difficult due to:

(a) the volume of conversions being handled by TEI;

(b) certain computational uncertainties not finally settled until the April 1985 audit commencement meeting; and

(c) the noted workload involved with using Option A (considered in light of the volume of conversions being handled by TEI) and the reluctance to use Option B (prior to the existence of safe-harbor rules) for fear of incurring penalties due to erroneous consideration estimates.

Further, petitioner notes that it made yeoman efforts and became current as of the April 1985 audit initiation meeting, continued to make such effort in switching to Option B and becoming current thereunder apace with the audit and, finally, that since the audit petitioner (TEI) has remained current with its ongoing filings.

These arguments, considered both alone as well as in light of the full course of action followed by petitioner, do not suffice to result in a waiver of penalties. The fact that petitioner was able to complete all returns and become current (under Option A) in time for the audit, via hiring additional help in the form of an outside accounting firm, indicates that staffing (or lack thereof in light of the volume of conversions), and not simply the burdensome calculational workload required under Option A, was the main reason for the lateness. Further, regarding the computational uncertainties and, to an even greater degree, the hesitance in using Option B (pre safe-harbor), petitioner's arguments are largely unpersuasive. Petitioner's hesitance and concern over the possibility of incurring penalties, based on the possibility of miscalculation or "bad estimates of consideration" and resulting underpayment (i.e., penalties if estimates of consideration proved incorrect), would have to be evaluated in light of the reasonableness of such estimates and not simply upon whether such estimates were, in fact, ultimately correct or incorrect. Assuming, arguendo, such estimates had been reasonably made, penalties should not follow and, presumably, the returns would (or should) have been timely. Finally, while hiring extra help and becoming current is laudable, it was admittedly done in the face of an impending audit and, in light of all the facts and circumstances, does not negate petitioner's lateness or suffice to cause waiver of penalties based on reasonable cause.

G. The petition of 61 East 86th Street Equity Group is hereby denied.

DATED: Troy, New York
March 1, 1990

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE

APPENDIX A

Name of Sponsor	Address	Gains Tax #
4-10 West 101 St. EG	4-10 West 101st St.	G-03299
Windsor Associates	5 Tudor City Place	G-20205
Time Equities Associates	8-10 Bethune St.	C-743
Cooperative Eq. Grp. IV	25 Bethune St.	C-3062
Cooperative Eq. Grp. III	25 Chittenden	C-847
25 Tudor Associates	25 Tudor City Place	G-20296
Lincoln Park Eq. Group	29 West 64th St.	C-1015
Cooperative Eq. Grp. II	31 Gram Pk. S.	C-3153
Time Equities Associates	34-36 Bethune St.	C-1062
35 W. 90th St. Eq. Group	35 West 90th St.	C-3082
Cooperative Eq. Grp. III	40 Remsen St.	G-203
Time Equities Associates	41 Perry St.	G-3922
Cooperative Eq. Grp. III	42 Remsen St.	G-202
Cooperative EG III	44 Remsen St.	
Time Equities Associates	45 Perry St.	C-987
Prospect Associates	45 Tudor City Place	G-20406
49 West 72nd St. Eq. Group	49 West 72nd St.	G-5395
Time Equities Associates	51 Jane St.	C-742
61 E. 86th St. Eq. Group	61 East 86th St.	G-3415
Cooperative Eq. Grp. II	66 Montague St.	C-973
Time Equities Associates	66 West 84th St.	C-3318
Burns Equities Group	88 Burns St.	G-3991
70 Park Terrace East EG	70 Park Terrace East	
TMS Equities Group	80-82 Charles St.	G-5068
Charles St. Equities Group	84-88 Charles St.	G-341
100 Bennett Avenue EG	100 Bennett Avenue	G-20078
Bedford St. Equities Group	104 Bedford St.	G-3220
Cooperative Eq. Grp. IV	126 East 12th St.	G-5135
127 W. 82nd St. EG	127 W. 82nd St. (Condo)	G-20367
Cooperative Eq. Grp. II	136 West 13th St.	C-1095
143-50 Hoover EG	143-50 Hoover AVenue	G-20551-0061
Cooperative Eq. Grp. I	160 West 77th St.	C-1329
Remsen St. Equities Group	161 Remsen St.	To be filed
Time Equities Associates	176 West 87th St.	C-231
Cooperative Eq. Grp. IV	194 Riverside Dr.	C-3614
Cooperative Eq. Grp. IV	201 West 16th St.	C-3457
202-214 W. 85th EG	202-14 W. 85th St.	G-20366
220 E. 87th St. Eq. Group	220 East 87th St.	C-3278
221 W. 82nd St. EG	221-223 West 82nd St.	C-40302-B-Coop/ C-40302-A-
Condo		
West Waverly Eq. Group	227 West 11th St.	G-3584
250 Cabrini TEI Eq. Group	250 Cabrini Blvd.	G-3332
Cooperative Eq. Grp. IV	251 Seman Ave.	C-3170
Cooperative Eq. Grp. IV	255 West End Ave.	C-1303
270 Seaman Avenue EG	270 Seaman Avenue	G-03397
Bedford St. Equities Group	309 West 93rd St.	G-3557
Time Equities Associates	309-344 West 11th St. 713-715 Washington St.	G-3709
Cooperative Eq. Grp. IV	310 West 99th St.	C-1326

Time Equities Associates	320 West 90th St.	C-1034
Woodstock Associates	320 E. 42nd St.	G-20369
Cloister Associates	321 E. 43rd St.	G-20486
Time Equities Associates	323 West 11th St.	C-933
Essex Associates	325 E. 41st St.	G-20396
325 W. 45 Equities Group	325 W. 45th St.	G-30239
Bedford St. Equities Group	325 West 83rd St.	G-3471
Manor Associates	333 East 43rd St.	G-5552
Park Equities Group	333 Central Park West	G-5187
Time Equities Associates	343 West 12th St.	C-947
Time Equities Associates	344 West 12th St.	C-3051
Time Equities Associates	345 W. 4th/306 W. 13th St.	C-744
Time Equities Associates	350/4 West 12th St.	C-275
359 Ft. Washington EG	359 Fort Washington Ave.	G-30043
Cooperative Eq. Grp. V	360 Cabrini Blvd.	G-5005
415 Central Park West EG	415 Central Park West	G-03759
447 Ft. Washington EG	447 Ft. Washington Ave.	G-03544
Time Equities Associates	741 West End Ave.	C-3259
1045 Park Ave. Eq. Group	1045 Park Ave.	G-914
Cooperative Eq. Grp. IV	1855 East 12th St.	G-3801
2400 East 3rd St. EG	2400 E. 3rd St.	G-03526
3626 Kings Hwy. EG	3626 Kings Hwy.	G-20457
Susan Equities Group	4410 Cayuga Ave.	G-3523
Time Equities Associates	6035 Broadway	C-957
Clinton Hill Eq. Group	Clinton Hill	C-1104
Time Equities Associates	Washington & W. 11th St.	G-3709
371 Fort Washington Ave. Equities Group	371 Ft. Washington Ave.	G-30045
2875 Sedgewick Ave. Assoc.	2875 Sedgewick Ave.	G-30679