STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
KALIKOW YAPHANK DEVELOPMENT CORP.	:	DETERMINATION DTA NO. 11100
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, Kalikow Yaphank Development Corp., c/o Eugene Barnosky, Esq., 534 Broadhollow Road, Melville, New York 11747, 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.

A hearing was held before Arthur S. Bray, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on March 4, 1994 at 9:15 A.M., with all briefs to be submitted by September 15, 1994. Petitioner filed a brief on June 6, 1994. The Division of Taxation filed a brief on August 11, 1994. Petitioner appeared by Howard M. Koff, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel).

ISSUE

Whether petitioner is allowed to include as part of its original purchase price certain expenses which were paid by petitioner for legal, architectural and engineering services to secure approval of a subdivision.

FINDINGS OF FACT

Petitioner, Kalikow Yaphank Development Corp. ("Kalikow"), was a real estate firm which purchased a parcel, consisting of approximately 241 acres, in Yaphank, Town of Brookhaven, Suffolk County, New York. Theproperty was purchased in 1986 for the purpose of developing a residential subdivision.

In a letter dated September 19, 1990, Kalikow was advised by the Department of Real Estate for Suffolk County that if a sale of the property involved herein could not be negotiated, then the Commissioner of Real Estate would seek condemnation from the County Legislature and would proceed with condemnation upon resolution by the County Legislature and the County Executive. Upon considering the threat of condemnation, petitioner agreed to sell the property to Suffolk County for $6,000,000.00.

On October 30, 1990, the Division of Taxation ("Division") received questionnaires which were filed by Kalikow, as transferor, and the County of Suffolk, as transferee. The transferor form reported an anticipated tax due of $350,152.20 which was calculated as follows:

Consideration		$6,000,000.00
Purchase price to acquire property	$2,138,875.00	
Other acquisition costs	36,123.00	
Cost of capital improvements to real property	298,480.00	
Allowable selling expenses	25,000.00	
Original purchase price		2,498,478.00
Gain subject to tax		3,501,522.00
Anticipated tax due		350,152.20

The Division issued a Tentative Assessment and Return, dated January 2, 1991, which disallowed the total amount claimed for cost of capital improvements to real property because "[t]he costs claimed do not relate to capital improvements made to real property" (emphasis in original). As a result, the Division determined that tax was due in the amount of $380,000.20.

On April 8, 1991, the Division received a Claim for Refund of Real Property Gains Tax which sought a refund of $29,848.00. The amount claimed equalled the amount of tax assessed and paid ($380,000.20) less the amount of tax reported due ($350,152.20). The refund claim asserted that the costs in issue relate to capital improvements under 20 NYCRR 590.16. The refund claim also argued that Suffolk County's internal appraisal and the appraisal obtained by petitioner, from Mr. Gerald Snover, each valued the parcel in excess of $6,000,000.00 and that the premises would not have been worth $6,000,000.00 unless subdivision approval could be obtained. Petitioner also argued that it had been advised by the Division that if the transfer had been by a builder, the costs would have been allowed. It is submitted that the situation with respect to a builder is indistinguishable from the transfer at issue herein because, at the time of

the expenditures, Kalikow intended to construct single-family homes on the premises. According to petitioner, the Division may not disallow a deduction for development costs associated with a capital improvement of real property because the County asserted its rights under eminent domain. Lastly, it is argued that the expenditures led to a permanent betterment of the premises since its value was increased because of petitioner's expenditures.

In a letter dated April 22, 1991, petitioner was advised that its claim for refund was denied because development costs are allowed only when they are incurred in connection with the actual physical improvement of the property. This proceeding ensued.

At the hearing, petitioner presented the testimony of Mr. Gerard Snover, a licensed real estate appraiser. Mr. Snover explained that in 1985 petitioner submitted a subdivision application to the planning department of the Town of Brookhaven. Petitioner sought to have a residential subdivision map filed for the purpose of building and marketing homes on the subdivided site.

The first step in the process of preparing for a subdivision is to obtain approval of a sketch plan which outlines the concept for the development. Thereafter, the number of proposed plots are commented upon and reviewed by the town planning board. At this time, the town planning board considers the requirements of the State Environmental Quality Review Act ("SEQRA"). In this case, the town planning board decided that the proposed subdivision would have a positive effect on the area and that it would require a formal environmental impact statement.

The next step in the subdivision process is for a decision to be made as to which governmental agency, of those agencies that have a concern, would act as the lead agency in the subdivision process. In this instance, the planning board of the Town of Brookhaven was appointed as the lead agency. Thereafter, those agencies that have some concern about the proposed development are asked to examine what is being planned and to determine what they want addressed in an environmental impact statement.

The developer next prepares a draft environmental impact statement ("DEIS"). This

requires the investment of considerable time and resources. The DEIS is submitted to the lead agency and the other agencies involved. Eventually, the DEIS is reviewed, commented upon and accepted. In order to obtain acceptance, there are usually some areas which prompt a request for additional documentation or information.

The next step for the developer is to prepare a final environmental impact statement. The receipt and approval of the final environmental impact statement leads, through a couple of steps, to a filed map.

The processing of the application for a subdivision by petitioner involved dealing with a number of governmental agencies including the Brookhaven Division of Environmental Protection, the Brookhaven Division of Traffic Safety, the Suffolk County Water Authority, the Suffolk County Department of Public Works, the Suffolk County Department of Health Services, the Suffolk County Pine Barons Review Commission, the Suffolk County Planning Board, the Suffolk County Sewer Agency and the Brookhaven Planning Department.

The property had 1,025 feet of frontage along a county highway. It extended to a depth of about a mile and a half and was L-shaped. Because of its proximity to a county roadway, the process had to be submitted to the Suffolk County Planning Department for comment as well as to the Town of Brookhaven as the lead agency. The significance of the foregoing is that if the county had any concerns or comments that might transcend the town's concern, the county could have voted against approval of the subdivision. If the county had voted against it, then town approval would have required a majority plus one.

The foregoing was a time-consuming process. Prior to the completion of the DEIS, petitioner made an application to the Suffolk County Sewer Agency because there were no public sewers within the area. Additionally, there were meetings and negotiations over a period of time because initially the county sewer agency was not inclined to approve the creation of the proposed sewer plant. The county sewer agency had previously announced a policy that it would be against the proliferation of a great number of relatively small plants throughout Suffolk County. Eventually, Suffolk County gave approval for the creation of a private sewer

plant.

During the period that the DEIS was being considered, petitioner requested approval for a cluster development from the town planning board. Under the cluster development concept, no greater number of lots would be created than would normally be allowed under a conventional subdivision. However, the building and zoning authority would allow the same number of units to be created on smaller lots. Eventually, petitioner received approval for a cluster subdivision which was a significant step towards the eventual subdivision and improvement of the site. The cluster design was a part of the subdivision application.

The property involved herein has as its highest and best use a residential subdivision. Under these circumstances, there is a well-defined series of steps to achieve the highest and best use of the property. In appraising the value of property which has proceeded partially through the subdivision process, Mr. Snover explained that one would look at the highest level and then discount because of the time and expense involved in reaching the next step. According to Mr. Snover, the level of processing achieved by petitioner transformed the land into something more than raw land and enhanced the value of the property from its status as raw land.

At the time Mr. Snover performed his appraisal, there were additional steps that needed to be taken before the subdivision plan would finally be approved. The additional steps included engineering work for a sketch plan and a yield map. An environmental impact study was also required. Further, public water was to be brought in from a distant site.

Mr. Snover explained that when he appraised the land in 1989, the value was augmented by the fact that there had been four and one-half years of effort expended in obtaining approval for subdivision development and that final approval would be achieved within 12 months. In the opinion of Mr. Snover, the processing of the subject parcel for a residential subdivision enhanced the value of the property in the amount of $712,500.00. This is an enhancement at a rate of approximately $2,500.00 per unit for the 285 units for which preliminary approval had been obtained.

The property was appraised by Mr. Snover at $8,555,500.00. This figure included

consideration of the subdivision application, cluster development approval, the application for the private sewer plant and the draft environmental impact statement.

Suffolk County paid $6,000,000.00 for the property. Since its acquisition, it has remained in its natural state for purposes of preservation. In determining what it would pay for the property involved herein, Suffolk County added an additional amount for the processing which occurred in order to obtain approval of the subdivision.

Except for test hole borings that were necessary for engineering work, there were no physical improvements to the property as of the time of the appraisal.

After the hearing, the parties entered into a stipulation which stated, in part, that the amount in issue is $275,501.75, that the amount was paid and incurred by petitioner and that the expenditures were for legal, architectural and engineering services to secure subdivision approval.

SUMMARY OF THE PARTIES' POSITIONS

It is petitioner's position that the amounts in issue were properly claimed as either acquisition costs or as capital improvements.

According to petitioner, the testimony establishes that the sales price of the property was increased by the expenses incurred for approval of the subdivision. Petitioner's argument continues that since the subject expenditures generated the substantially increased selling price, a denial of deductibility would produce a gross distortion and inequity. It is submitted that denying deductibility of the expense at issue herein would contravene the economic reality and net profit requirement of Article 31-B of the Tax Law.

Petitioner next argues that when one purchases undeveloped real property for $1,000,000.00 and then spends an additional $250,000.00 to secure subdivision approval, there are, in reality, two acquisitions -- the undeveloped land for $1,000,000.00 and the enhanced, approved status, which cost $250,000.00. Petitioner states that both expenditures should qualify as an acquisition cost under Tax Law § 1440(5)(a)(i).

In the alternative, petitioner contends that the expenses in issue qualify as a capital

improvement. It is noted that a capital improvement includes a betterment and that a betterment is a physical improvement put upon an estate or an enhanced value which an estate acquires by virtue of some public action. Petitioner submits that the approved expenditures should be allowed as a capital improvement because they enhanced the value of the land and generated an increased selling price.

In response, the Division maintains that the disputed expenses do not constitute an acquisition cost. They were post-acquisition costs which were expended in an attempt to develop the property. The Division also argues that no capital improvements were made by the expenditures at issue herein. The Division further submits that the appraisal of the property for $8,555,500.00 by petitioner's witness is questionable. According to the Division, the fact that Suffolk County paid $2,555,500.00 less than the value of the property ascribed by Mr. Snover could indicate that the appraisal was incorrect and that the expenses in issue did not add value to the property. The Division concludes that petitioner refuses to accept that not all expenses are allowed to reduce gain in real property transfer gains tax notices.

CONCLUSIONS OF LAW

A. Tax Law § 1441 imposes a tax on gains derived from the transfer of real property at the rate of 10% of the gain. The term "gain" is defined by Tax Law § 1440(3) as the difference between the consideration for the transfer of real property and the purchase price. The term "original purchase price" is defined 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 . . ." (Tax Law § 1440 [former (5)(a)]; emphasis added).

B. The Commissioner's regulations at 20 NYCRR 590.15(a) discuss what items are included in the amount paid to acquire an interest in property. The regulation states, in part:

> "(a) Question: What amounts are included in the price paid to acquire an interest in real property?

"Answer: The price paid to acquire an interest in real property includes the amount of money, property or any other thing of value provided or given up to acquire the interest in real property including the amount of any mortgage, lien or other encumbrance on the real property which was assumed or taken subject to" (20 NYCRR 590.15[a]).

C. In this case, the expenditures in question were not paid to acquire an interest in property as required by Tax Law § 1440 (former [5][a]) and 20 NYCRR 590.15(a). The record shows that the expenditures were made after the property was acquired in order to proceed with a proposed subdivision. Accordingly, the Division properly declined to include as part of petitioner's original purchase price certain expenses which were paid to secure approval of the subdivision.

D. Petitioner's arguments that the economic reality of the transaction should be recognized and that the tax should only be imposed on the gain from the transaction have been considered and rejected. It is clear that tax is imposed on the gain from the transaction (Tax Law § 1441). Further, it is well established that the economic reality of the transaction is controlling (see, e.g., Matter of Bredero Vast Goed, N.V. v. State Tax Commn., 138 Misc 2d 27, 523 NYS2d 754, affd 146 AD2d 155, 539 NYS2d 823, appeal dismissed 74 NY2d 791, 545 NYS2d 105). However, these principles do not permit the deduction of expenses which are not permitted by the Legislature (see, e.g., Matter of Mattone v. Dept. of Taxation & Fin., 144 AD2d 150, 534 NYS2d 478).

E. The Commissioner's regulations define the term capital improvement as follows:

"A capital improvement is, for the most part, an improvement, a modification, a betterment, or an addition made to real property which:

"(1) is intended to be permanently affixed to the real property; and

"(2) has a useful life substantially beyond the year following installation" (20 NYCRR 590.16[a]).

F. Here, the record shows that the expenditures in question were for legal, architectural and engineering services for approval of a subdivision. There is no evidence that any portion of the expenditures in issue was made for "an improvement, a modification, a betterment, or an addition made to real property which . . . is intended to be permanently affixed to the real

property" (20 NYCRR 590.16[a]; emphasis supplied). Therefore, it is determined that the Division properly declined to consider the expenditures as capital improvements which were includible in the computation of original purchase price.

G. The petition of Kalikow Yaphank Development Corp. is denied.

DATED: Troy, New York
March 9, 1995

/s/ Arthur S. Bray
ADMINISTRATIVE LAW JUDGE