STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
CLINTON HILL EQUITIES GROUP	:	DETERMINATION DTA NO. 811804
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, Clinton Hill Equities Group, Attn: L. Polansky, Time Equities, 55 Fifth Avenue, New York, New York 10003-4301, 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 Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on August 15, 1994 at 10:45 A.M. Petitioner filed a brief and proposed findings of fact on November 16, 1994. The Division of Taxation filed a brief and a response to petitioner's proposed findings of fact on December 19, 1994. Petitioner filed a reply brief on January 23, 1995 and this date commenced the six-month period for the issuance of this determination pursuant to Tax Law § 2010(3). Petitioner appeared by Ziegler, Sagal & Winters, P.C. The Division of Taxation appeared by William F. Collins, Esq. (Paul A. Lefebvre, Esq., of counsel).

ISSUE

Whether a "financing fee", pursuant to which petitioner paid to a lender a percentage of proceeds from the sale of cooperative apartment units, constituted a customary, reasonable and necessary expense incurred tocreate ownership interests in property in cooperative form under 20 NYCRR former 590.39 and was therefore includible in petitioner's original purchase price pursuant to Tax Law § 1440(5)(a)(ii).

FINDINGS OF FACT

Petitioner, Clinton Hill Equities Group, a New York general partnership, is the sponsor in the cooperative conversion of property located at 165 Clinton Avenue, Brooklyn, New York (the "property").

Francis Greenburger is the sole stockholder, chairman and chief executive of Time Equities, Inc. ("TEI"). He has been engaged in the cooperative conversion business for approximately 15 years and has participated in converting to cooperative ownership in excess of 50 projects involving approximately 100 buildings.

TEI provides the various professional services necessary to accomplish a cooperative conversion, including preparing the co-op plan, acting as the sales agent, and acting as the managing agent for the converted building.

Insofar as is relevant herein, there are two categories of financing that are used to achieve a cooperative conversion. One is the permanent or underlying mortgage financing that will be on the property when the co-op takes title. The second type of financing (sometimes referred to as "end loan" financing) is the financing for the individual purchasers to purchase their apartments.[1]

Prior to the recession of the mid-1970's, cooperatives had been common in the more affluent areas of New York City (the "City"), such as Park Avenue and Central Park West, but had been less common or relatively unknown in the middle-income and lower-income areas.

During the period when the Clinton Hill conversion was proceeding, the general market for cooperative financing was very limited.

In the 1981-1984 period, TEI undertook to convert some apartment buildings that were located in Greenwich Village, and had to get financing from a private mortgage company called BRT Realty Company ("BRT"). The interest rate that BRT charged was approximately five

[1]A third type of financing that is often utilized is known as unsold share financing, which would provide the sponsor with a loan against the units that he does not sell immediately upon the conversion.

points over prime, plus a percentage of the income realized from the conversion. This kind of hybrid financing structure was relatively common.

In some cases, when TEI negotiated with sellers, it attempted to get them to provide the underlying mortgage portion of the financing or, on occasion, the unsold share financing and possibly even an end loan for the tenant-stockholders. Typically, for doing that, the lender would receive an incentive participation in the profits from the conversion (commonly known as an "equity kicker") of from 5% to 25%.

The Clinton Hill area had at one time been the location of the Brooklyn Navy yard, and the buildings making up the Clinton Hill project were originally built to house Navy personnel. When the Navy yard closed, the nature of the area changed and a new population moved in -- primarily low-income/minority families.

Many of the buildings in the area had suffered significant deferred maintenance, and many of them were vacant and had been boarded up.

In the years leading up to petitioner's acquisition, the property had suffered by virtue of the limited income it generated (because it was subject to rent control and rent stabilization). In general, there was a lot of deferred maintenance and the project was facing a crisis.

Mr. Greenburger initially entered into a contract of sale, dated January 30, 1981, with an unrelated party, Clinton Hill Associates ("CHA"), to purchase the property.

In the contract, the seller, CHA, acknowledged and indicated its understanding of Mr. Greenburger's intention:

> "to prepare a co-op plan and submit same for filing to the Attorney General's Office and seek acceptance for filing of said plan from the Attorney General during the term of this Agreement to offer said plan to the tenants in the premises and to enter into binders with prospective purchasers, in accordance with law."

The contract noted the seller's agreement to cooperate with the buyer by providing documentation and information as requested and to provide access to the premises. The contract further provided, however, that the "Seller shall have no liability and, Purchaser shall not be relieved of any of its obligations under this Agreement, if for any reason whatsoever said plan is not accepted for filing by the Attorney General's Office."

Following the execution of the January 30, 1981 contract of sale, Mr. Greenburger endeavored to present a plan of cooperative ownership to the tenants and see whether he could interest them in participating in the transition of the project from rental status to cooperative ownership.

Mr. Greenburger's first step was to approach the lender, which was The Equitable Life Insurance Company ("Equitable") -- whose mortgage on the property was to expire in two or three years -- and try to interest it in providing financing for the co-op. He even offered Equitable the possibility of some sort of equity participation. Equitable said it was not interested at all, that it was getting out of the residential lending business and that it just wanted to be paid.

Although Mr. Greenburger tried to explain that this was minority housing facing a crisis, the individuals at Equitable with whom he had been dealing were still not interested. It was only after several subsequent appeals to senior management that Mr. Greenburger eventually received a better hearing. At that point, the person with whom he was speaking indicated that although Equitable really did not want to be involved with the project, it would give Mr. Greenburger the following option. If Mr. Greenburger was successful in his efforts to find a new financing source, Equitable would discount its mortgage so that the new lender would have to provide a lower amount.

Once Mr. Greenburger accomplished that, he then began to search for a lender who would provide a permanent mortgage, as well as the end loan, because, in his judgment, there would be no co-op unless the tenants could finance the purchase of their apartments.

Mr. Greenburger approached approximately 100 financial institutions and had substantive discussions with approximately 20. The reaction of these institutions was uniformly negative for a variety of reasons, but most of all because of the nature of the project (i.e., its location and tenant population), which most financial institutions perceived as being an untraditional market for cooperatives.

One of these financial institutions, Citibank (hereinafter sometimes referred to as the "bank"), had initially considered providing financing, but after some period of time turned it down.

Shortly thereafter, however, Mr. Greenburger received a telephone call advising him that if he wanted to appeal the bank's decision, he could present his case to one of the bank's senior lending officers, Len Druger. The first question Mr. Druger asked Mr. Greenburger was whether the planned conversion had political support in the area. Since prior to undertaking this project Mr. Greenburger had met with the various elected officials, he knew that the planned conversion had political support and he so informed Mr. Druger.

After Mr. Druger confirmed Mr. Greenburger's representations of political support, he called Mr. Greenburger and told him that the bank was interested in discussing the matter further, and very lengthy, arduous negotiations ensued.

Early on in the negotiations, Mr. Druger outlined for Mr. Greenburger what would be the broad parameters of the type of financing package the bank would consider. Although Mr. Druger was not prepared to commit to these terms, he wanted to know whether they would be acceptable to petitioner if the bank went ahead. One of the items that was on the list was a financing fee -- which was substantially higher than the one that was finally agreed to.

The bank wanted to make the loan only if it could get very favorable terms because it felt that it was going out of its way to make the loan; that the end loans would be difficult because they required a lot more paperwork than usual (due to many applications for SONYMA [government assisted] financing); there were small amounts involved and a much higher risk than usual. Although the bank was under political pressure to make more loans in the boroughs, it wanted to mitigate what it perceived as a heightened financial risk by better financial terms.

Initially, the bank proposed a fee of 15% of gross sales. Mr. Greenburger was able to negotiate the deduction of certain types of costs from the fee base, and also eventually achieved a reduction in the rate to 7%.

The overall negotiations with Citibank took over a year and were extremely difficult, with the bank contesting virtually every point raised by petitioner.

The overall negotiations between Mr. Greenburger and the bank involved both the fixed commitment fee and the financing fee at issue herein. Such negotiations ultimately resulted in the issuance by the bank of two separate commitment letters, both dated August 11, 1982, regarding the underlying mortgage financing (the Citibank refinancing) and the end-loan financing, respectively. The letter detailing the bank's commitment to the underlying mortgage financing set forth the details regarding both the fixed commitment fee (ultimately $252,000.00) and the financing fee at issue. The letter detailing the bank's commitment to end-loan financing indicated that the bank would make such financing available to individual unit purchasers and set forth the terms and conditions of such financing. This letter did not make any reference to the financing fee at issue herein.

In Mr. Greenburger's opinion, there was no possibility of doing the Clinton Hill conversion without an end-loan financing package.[2]

In Mr. Greenburger's opinion, at that time there was no other financing available that was remotely close to providing what Citibank provided. Thus, in his opinion, there was no alternative to the Citibank financing that he could have utilized.

On June 1, 1982, Francis Greenburger assigned his rights to acquire the property under the January 30, 1981 contract to petitioner (a general partnership of which Mr. Greenburger was the managing general partner), and petitioner purchased the property.

The purchase price paid at the closing was $12,300,000.00, consisting of the following:

Purchase Money Mortgage	$ 4,758,855.00
Transferor taking subject to existing mortgage payable to Equitable (the "Equitable mortgage")	6,820,180.00
Cash and other consideration	720,965.00
Total Price	$12,300,000.00

The Citibank refinancing of the Equitable mortgage closed on December 23, 1982, with

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[2]Individual unit purchasers were not obligated to utilize Citibank to finance their purchase. During the early part of the conversion period, most purchasers financed through Citibank. Later, more unit purchasers financed their purchase through other banks.

a $6,000,000.00 loan from Citibank (the "Citibank loan").

On April 24, 1984, the date of the transfer of the property to the cooperative housing corporation (the "CHC"), the Citibank loan had a balance of $5,985,793.00.

The Citibank mortgage contemplated that it could and would be assumed by the CHC upon conversion of the property to a cooperative. Thus paragraph 10(a) provided:

> "Mortgagor represents and warrants to Mortgagee, as an inducement to Mortgagee to enter into the transaction secured hereby, that Mortgagor shall use its efforts to convert the Premises to cooperative ownership lawfully established in accordance with the applicable laws and regulations of the State of New York. In connection therewith, Mortgagor has prepared and submitted an initial draft of the Offering Plan with the Attorney General."

Similarly, the Citibank mortgage (¶¶ 8[b]-[d]) provided the following affirmative covenants of petitioner:

> "(b) Comply with all other affirmative covenants set forth in the Commitment and/or the End Loan Commitment.
>
> "(c) Promptly furnish to the Bank preliminary and final copies of the Offering Plan and of all amendments thereto which are filed with the Attorney General, and copies of all correspondence, communications, notices and other writings of the Attorney General with respect to the Offering Plan.
>
> "(d) Use its efforts to effectuate and consummate the Offering Plan."

The Citibank mortgage (¶ 9[c]) provided as a negative covenant of petitioner that petitioner would not "voluntarily abandon the Offering Plan."

Pursuant to the Loan Agreement, the Citibank loan was also secured by a pledge of the proceeds of any cooperative conversion of the property.

The terms of the Citibank loan in regard to interest rate and maturity were less advantageous if the property was not converted to a cooperative by November 30, 1984; that is:

(a) Interest was payable at 1% over the Citibank "base rate" until the earlier of the date of conversion of the property to cooperative ownership or November 30, 1984.

(b) In the event the conversion occurred on or before November 30, 1984, then after such conversion, interest was payable at Citibank's individual cooperative 30-month loan rate plus 1½% per annum, adjustable after five years.

(c) In the event the conversion did not occur on or before November 30, 1984, from and after December 1, 1984 interest was payable at a rate equal to Citibank's individual cooperative 30-month loan rate plus 4½% per annum, with adjustments on June 1, 1987, December 1, 1989 and June 1, 1992.

(d) In the event that the interest payable during the period ending on the earlier of December 1, 1984 or the conversion was in excess of 15%, such excess would be accrued. Thereafter, interest in excess of 18% would be accrued. Accrued interest was to be carried forward to the first period in which the interest rate was less than the rate at which accrual was required.

(e) Amortization based on 30-year term.

(f) Balance due December 1, 1994 or 10 years from the end of the month of the conversion (later determined to be May 1, 1994).

At the time that Citibank agreed to refinance the Equitable mortgage, it also agreed to offer financing to purchasers of cooperative apartments in the conversion.

As set forth above, petitioner paid a financing fee to induce Citibank to make the Citibank loan.[3]

The Loan Agreement provides, in part:

> "A. Pursuant to a certain commitment letter dated August 11, 1982, as amended by letter agreements dated November 24, 1982 and December 21, 1982 (hereinafter the commitment, as amended, the 'Commitment'), the Bank undertook to make a loan (hereinafter the 'Loan') of up to $6,000,000 to the Borrower to be secured in part by a first mortgage lien (hereinafter the 'Mortgage') on certain property (hereinafter the 'Property') consisting of land and residential apartment buildings thereon located at 169, 185, 193, 201, 205, 209, 210, 325, 345, 355, 361 and 365 Clinton Avenue, Brooklyn, New York, recently acquired by the Borrower.
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> * * *
>
> "J. To induce the Bank to make the Loan, the Borrower agrees to pay to the Bank from time to time the Financing Fee (as defined below) more particularly described in Section 4 hereof.
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> * * *

[3]Petitioner alleges that it paid $1,174,513.00 of the financing fee. This amount has not been audited. If petitioner prevails, this fee would be allowed subject to verification by the Division of Taxation. Petitioner also paid a commitment fee of $252,000.00.

> "4. <u>Financing Fee</u>
>
> "(a) After an amount equal to the Reserve Requirements has been applied and received by the Bank and/or reimbursed to the Borrower out of the Gross Proceeds in accordance with the provisions of Section 3 of this Agreement, the Borrower shall pay to the Bank a fee (the 'Financing Fee') in an amount equal to seven percent (7%) of Adjusted Sales Proceeds received thereafter from time to time by the Borrower.
>
> * * *
>
> "(d) The obligation of the Borrower to pay the Financing Fee shall survive the satisfaction or prepayment of the Mortgage and/or release or application of all collateral held hereunder and shall remain the personal obligation of the Borrower notwithstanding (i) any one or more conveyance(s) of the Property whether to the Apartment Corporation or otherwise and/or (ii) any one or more sales or transfers of Unsold Shares to affiliated persons and/or to persons or entities that are not <u>bona fide</u> third party purchasers until the earlier of (i) September 30, 2032 or (ii) the sale of all of the Shares to <u>bona</u> <u>fide</u> third party purchasers who are not affiliated persons and the payment of the Financing Fee to the Bank."

For gains tax purposes, petitioner included the financing fee in original purchase price as a cost of the conversion of the property.

The Division of Taxation ("Division") disallowed the entire financing fee. The Division stated the basis for the disallowance of the financing fee as follows:

> "Citibank Additional financing fees disallowed by Albany ($1,174,513) since not customary or normal and there is already a commitment fee."

On December 9, 1991, the Division issued to petitioner a Notice of Determination which asserted an additional gains tax liability of $43,957.00, plus interest, resulting from the disallowance of the financing fee.

Petitioner submitted proposed findings of fact numbered 1 through 40.

(a) Proposed findings of fact 1, 2, 4 through 10, 13, 14, 16 through 23, and 27 through 39 are accepted (and renumbered) herein as Findings of Fact "2", "3", "5" through "11", "15", "16", "18" through "25", and "29" through "41", respectively.

(b) Proposed finding of fact 3, renumbered as Finding of Fact "4" herein, has been modified by substituting "used" for "necessary". Proposed finding of fact 15, renumbered as Finding of Fact "17" herein, has been modified by substituting "in his judgment" for "obviously". Proposed finding of fact 25, renumbered as Finding of Fact "27" herein, has been modified by adding "In Mr. Greenburger's opinion", and by adding footnote "2". Proposed finding of fact 26, renumbered as Finding of Fact 28 herein, has been modified by adding "in Mr. Greenburger's opinion" to each of the sentences and by adding the word "other". All of the foregoing modifications have been made to better reflect the record.

(c) Proposed finding of fact 11 is rejected. Contrary to the assertion made therein, the January 30, 1981 contract was, by its terms, a contract of sale, not an option. Moreover, again contrary to the proposed finding, the language of the contract does not give the purchaser an extended period to effect the conversion.

(d) Proposed finding of fact 12 is rejected. The contract of sale contains no language providing the seller the right to accelerate the closing date if it received another offer to purchase the project.

(e) Proposed finding of fact 24 is rejected. There is insufficient evidence to conclude that, in the negotiations, the bank "never differentiated between the fixed commitment fee and the financing fee" as asserted therein. Moreover, the commitment letters (see, Finding of Fact "26") clearly distinguish between the commitment fee and the financing fee.

(f) Proposed finding of fact 40 is rejected. This proposed finding is in the nature of a conclusion of law rather than a finding of fact.

CONCLUSIONS OF LAW

A. Pursuant to Tax Law § 1441, a tax is imposed on gains derived from the transfer of real property within New York ("gains tax"). "Gain" is defined, for purposes of the tax, as the difference between the consideration paid for the transfer and the original purchase price of the property (Tax Law § 1440[3]). "Original purchase price" includes the consideration paid or required to be paid by the transferor to acquire the property and, insofar as is relevant herein, also includes:

> "those customary, reasonable and necessary expenses incurred to create ownership interests in property in cooperative or condominium form, as such fees and expenses are determined under rules and regulations prescribed by the

commissioner" (Tax Law § 1440[5][a][ii]).[4]

B. Pursuant to the foregoing grant of authority, the Commissioner promulgated 20 NYCRR former 590.39 (amended and renum 20 NYCRR 590.40, eff November 9, 1994) which provided:

"Question: What are the allowable costs of co-oping (or converting property to condominium form) if paid or required to be paid by realty transferor?

"Answer: The following list illustrates costs that are includible in original purchase price as costs to convert property to cooperative or condominium form:

-- legal, accounting and engineering fees incurred directly as a result of cooperative or condominium formation and transfer of title to the cooperative corporation
-- filing and recording fees
-- costs of printing offering plan
-- title insurance
-- New York City Real Property Transfer Tax paid as a result of conveyance of title to the cooperative corporation
-- New York State Real Estate Transfer Tax paid as a result of conveyance to the cooperative corporation
-- appraisal fees
-- mortgage recording tax on mortgages created as a result of conveyance of title to the cooperative corporation
-- mortgage commitment fees
-- points paid to lender
-- the cost of 'buying down' the interest rate on co-op loans to purchasers
-- the cost of 'buying out' nonpurchasing tenants
-- amounts paid to relocate nonpurchasing tenants"

C. Inasmuch as the statute (Tax Law § 1440[5][a][ii]) "expressly vests explicative power in the [former] state tax commission", the former Commission's determination as to which conversion costs are allowable and which are not allowable must be given deference (see, Mattone v. Dept. of Taxation & Fin., 144 AD2d 150, 534 NYS2d 478, 479).

D. The cost in question, the financing fee, was incurred pursuant to the terms of the Citibank refinancing agreement. Specifically, the commitment letter dated August 11, 1982 and loan agreement both issued in connection with the $6,000,000.00 Citibank loan set forth the

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4 The quoted provision reflects the law as amended effective June 9, 1995 (L 1994, ch 170). As relevant to this matter, the amendment did not constitute a substantive change to the law as in effect during the period in issue.

terms of the financing arrangement, including the financing fee at issue. The Citibank loan resulted from petitioner's acquisition of the property. The financing fee at issue was thus a cost to petitioner for a loan to finance its purchase of the property. Such fees are properly categorized as acquisition interest expenses and acquisition interest expenses are expressly disallowed under 20 NYCRR former 590.15(c).[5] The financing fee was not a cost to convert the property to cooperative form and was therefore properly excluded from the calculation of petitioner's original purchase price.

That the financing fee was not a cost of converting the property is further evidenced by the fact that the contract of sale by which the property was transferred to petitioner was not conditioned on conversion and by the alternative terms of the Citibank loan in the event that the conversion did not occur. These two facts underscore that the financing fee at issue was a cost to petitioner as a result of its acquisition of the property and was not a cost of conversion, for even if the conversion had been unsuccessful, the contract still required transfer of the property to petitioner and the loan agreement remained in place, albeit under different repayment terms.

E. Petitioner asserted that the acquisition financing and the end-loan financing were parts of a single overall financing package. Accordingly, the financing fee is properly characterized as a conversion cost. This contention must be rejected, for it rests upon an erroneous premise; that is, that transfer of the property and the acquisition financing (and fees

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[5]20 NYCRR former 590.15(c), which was amended effective November 9, 1994, provided, in relevant part:

> "Question: What specific costs are allowable as a cost to acquire property as part of original purchase price?
>
> "Answer: The following costs are not allowable as a cost to acquire real property for purposes of determining original purchase price:
>
> -- Interest paid on a loan where the proceeds of such loan were used to acquire the real property or interest therein . . . ."

paid in connection therewith) was conditioned on the conversion of the property. The contract of sale and loan documents clearly show that the sponsor's acquisition of the property was not so conditioned. Certainly, the acquisition and the conversion were linked in the sense that all interested parties were aware of the sponsor's intent to convert the property and in the sense that the terms of the loan provided for alternate interest schemes under both the conversion and non-conversion scenarios. This circumstance does not, however, transform the financing fee into an allowable conversion cost given the clear distinction between the acquisition and conversion of the property as indicated by the contract of sale and the loan documents.

F. Petitioner also asserted that the financing fee was "the cost of buying down the interest rate for the cooperative below the rate applicable to the property in rental form" (Petitioner's reply brief, p. 2) and that, as such, the inclusion of the financing fee is expressly provided for in 20 NYCRR former 590.39 (see, Conclusion of Law "B").

This contention is without merit. The regulation lists "the cost of 'buying down' the interest rate on co-op loans to purchasers" as among those costs includible in original purchase price. This provision clearly refers to loans to purchasers of cooperative units and not to acquisition loans to sponsors. When viewed in the context of the alternative terms of the Citibank loan where the property was not converted to a cooperative (see, Finding of Fact "37"), the financing fee at issue may be seen as a cost of buying down the interest rate on the acquisition loan to the sponsor. The financing fee is thus not a cost of buying down interest rates on loans to unit purchasers.

G. Petitioner also argued that the disallowance of the financing fee from inclusion in petitioner's original purchase price would be contrary to the New York State public policy of encouraging the investment of private capital in low- and moderate-income housing and encouraging the conversion to cooperative ownership of such housing. Petitioner's contention must be rejected. The gains tax law makes no special provision for transfers or conversions involving or related to low- and moderate-income housing. However laudable or socially beneficial the project at issue may have been, I cannot confer a tax benefit on petitioner where no such provision exists or read a provision into the law which simply is not there.

H. The petition of Clinton Hill Equities Group is denied and the Notice of Determination, dated December 9, 1991, is sustained.

DATED: Troy, New York
June 29, 1995

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE