STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions of **BRENDON JAMES EDWARD CARROLL, EDWARD P. CARROLL AND NANCY J. CARROLL** for Revision of Determinations or for Refund of Tax on Gains Derived from Certain Real Property Transfers under Article 31-B of the Tax Law.	:	DETERMINATION DTA NOS. 813952, 813953 AND 813954

Petitioners, Brendon James Edward Carroll and Edward P. Carroll, P.O. Box 760, Pocono Pines, Pennsylvania 18350-0760, and Nancy J. Carroll, 1814 Chew Street, Allentown, Pennsylvania 18104, filed petitions for revision of determinations or for refunds of tax on gains derived from certain real property transfers under Article 31-B of the Tax Law.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on May 29, 1996 at 9:15 A.M., with all briefs to be submitted by October 25, 1996, which date began the six-month period for the issuance of this determination. Petitioners appeared by Urbach, Kahn & Werlin, P.C. (David L. Evans, CPA). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Peter T. Gumaer, Esq., of counsel).

ISSUES

I. Whether petitioners have established that certain expenses incurred in the rehabilitation of property known as The Preserve at Green Bay were capital expenses properly includable in original purchase price.

II. Whether interest expense incurred by petitioners during the period of their ownership of The Preserve at Green Bay may be included as part of their original purchase price for the property.

III. Whether petitioners have established that a portion of the consideration received upon their sale of the Preserve at Green Bay should be allocated to personal property included as part of the transfer.

IV. Whether the Division's assessment of gains tax against petitioners lacked a rational basis and should therefore be cancelled.

V. Whether penalty assessed against petitioners pursuant to Tax Law § 1446(2)(a) should be abated.

FINDINGS OF FACT

1. Petitioner Edward P. Carroll has, for several years, been in the business of purchasing, developing or rehabilitating, and selling recreational real estate. On or about August 5, 1988, Edward P. Carroll and petitioners Nancy J. Carroll (his former wife) and Brendon James Edward Carroll (their son), together took title to certain real property known as The Preserve at Green Bay or as Green Bay Camp (hereinafter "the property" or "Green Bay").

2. The property is located in Santa Clara, New York and is considered one of the Great Camps of the Adirondacks. It encompasses acreage on both sides of New York State Route 30, with one of its boundaries running some 600 feet along the shore line of the Upper Saranac Lake. Improvements to the property, built in 1917, include a main house with a 30 by 50 foot "great room", a guest cottage, a separate children's wing, numerous out buildings, and a separate two-story boat house with three boat slips, two bedrooms, fireplaces and a nearby gazebo. In total, the estate includes over 15 bedrooms, 8½ baths and 6 fireplaces. As acquired by petitioners, the property covered approximately 135 acres.

3. Prior to petitioners' acquisition, the property had been owned by one Anna Bedford, who acquired the property with her husband in the late 1930s. Anna Bedford continued to own and use the property for some 30 years after her husband's death, until the time of petitioners' purchase.[1]

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[1]Documents in the record indicate that the seller of record was the Watch Tower Bible and Tract Society of Pennsylvania. The relationship between Mrs. Bedford and the Watch Tower Bible and Tract Society of Pennsylvania is not specified in the record.

4. Petitioners purchased the property with the aim of rehabilitating and thereafter selling the estate. On this score, petitioner Edward P. Carroll provided some testimony regarding the physical state of the property and his intent upon purchase, as follows:

> "The condition [of the property] was one of a great old camp that had been used by a 90-year-old woman [Mrs. Bedford] for a couple months in the summertime, and had been painted every once in a while, and she put geraniums in flower pots every once in a while. But, particularly, the main building, couldn't be occupied on a year-round basis. The heating system wouldn't heat the house. There wasn't a winter water supply, only a summer water supply. The septic systems worked for a 90-year-old woman, but not for 20 people that would be there. It needed a lot of infrastructure work. I bought it, very frankly, because some developers from Tupper Lake were looking at it and wanted to tear it down and put a high-rise condo on Upper Saranac Lake, and it was the wrong thing to do. I bought it to protect the lake, and we put it back exactly the way it was in 1929." (Tr., p. 102.)

In response to the question of whether Mrs. Bedford had performed any maintenance other than painting, Mr. Carroll replied that: "[Mr. Bedford] had died when [Mrs. Bedford] was about 60, so she lived there almost as a reclusive. It was like walking into someone's attic."

5. Petitioners paid $2,250,000.00 for the property, including both the real estate and personal property. On acquisition, petitioners specifically allocated $1,750,000.00 of the purchase price to the real property and $500,000.00 to the personal property. Financing for the purchase included a loan from the First Eastern Bank of Wilkes Barre, Pennsylvania. The bank's June 24, 1988 loan commitment letter to petitioners indicates approval of a loan of up to 2.2 million dollars "for the acquisition" of the property. This commitment letter also sets forth, inter alia, the bank's understanding that petitioners planned to conditionally sell some of the assets at the property prior to closing, and that the actual dollar amount (of financing) needed could be considerably less than the 2.2 million dollars available. Further, the commitment letter specified that the loan would mature in two years, and that during such two-year period the principal of the loan "will be repaid through the sales of personalty and real estate."

6. On August 1, 1988, petitioners Edward P. Carroll and Nancy J. Carroll entered into a loan agreement with First Eastern Bank under which they borrowed 1.8 million dollars "for the purpose of acquiring personalty and real estate known as the Green Bay Camp at Upper Saranac Lake, Franklin County, New York."

7. Apparently in keeping with the above-noted plan to sell some of the assets for purposes of repayment of the loan, petitioners did subdivide and sell certain unimproved portions of the real estate in both 1989 and 1990.[2] In addition, in a November 16, 1993 letter, petitioners' accountant advised the Division of Taxation ("Division"), in connection with the audit at issue herein, that the furnishings and personal property at Green Bay had been sold in an auction sale in 1988 and yielded $450,000.00.

8. During the two and one-half year period following their acquisition of the property, petitioners engaged in a restoration project of renovating, rehabilitating and repairing the property. Petitioners maintained records including job cost summaries and supporting invoices which tracked the costs incurred in this project. Petitioners total these costs as at least $431,528.00 in materials and labor with respect to the property and $2,325.00 for land improvements. In addition, petitioners incurred interest expense of at least $195,650.00 on their loan from First Eastern Bank. Petitioners claim that these expenses are includable as part of original purchase price for the property, the result of which would be that petitioners incurred a loss upon sale of the property thus leaving no gains tax due. Specifically, petitioners seek to have all of the materials, labor and land improvement expenses treated as capital improvement costs, with the interest expense assertedly allowable as incurred during a construction period.

9. Petitioners completed their restoration project in 1990 and, thereafter, offered the property for sale. In turn, petitioners entered into a contract of sale for the property, dated December 24, 1990, pursuant to which they transferred the property to Sanford and Joan Weill for $1,750,000.00 at a closing held on January 31, 1991. Pursuant to paragraph 33 of the contract of sale, petitioners and the Weills specifically agreed that no part of the purchase price for the property was allocable to personal property. The preceeding contract paragraph (¶ 32) provides for delivery of a bill of sale conveying title to any items of personal property being

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[2]These sales and the costs associated therewith are not directly at issue in these proceedings. Therefore, unless otherwise noted, references to "the property" mean the balance of the property and improvements thereon remaining after the subdivision and sales.

transferred. No such bill of sale or other document listing or conveying any items of personal property is included in the record.

10. In connection with their sale of the property to the Weills, petitioners filed a Combined Real Property Gains Tax Affidavit, Real Estate Transfer Tax Return and Credit Line Mortgage Certificate (Form TP-584), on which they checked box "5" claiming exemption from gains tax because the transferred property consisted of premises wholly occupied and used exclusively by petitioners as a personal residence. In response, the Division issued a letter to petitioners seeking additional information about the transfer, including copies of the contract of sale and closing statement, a description of the property, and information as to whether the property was ever rented or depreciated by petitioners.

11. Petitioners responded to the Division's letter by supplying the information requested, including a letter from Edward P. Carroll stating that the property was never rented or depreciated, plus certain partnership tax returns for Mr. and Mrs. Carroll as partners with respect to the property. In addition, petitioners submitted a copy of Form 1040 Schedule C ("Profit or Loss from Business") for 1991, on which the sale of the property (carried as business property) was reported. This Schedule C contrasts a selling price of $1,750,000.00 against cost of goods sold of $2,108,982.45, thus resulting in a reported loss on sale for income tax purposes in the amount of $358,982.55.

12. By a letter dated August 24, 1993, the Division requested documentation to verify the $2,108,982.45 cost figure reported on the above-noted Schedule C, as well as information regarding depreciation amounts shown on certain of petitioner Edward P. Carroll's New York nonresident tax returns.[3] By a responding letter from petitioners' accountants, dated September 7, 1993, the $2,108,982.45 cost figure was specified as consisting of the following components:

ITEM	AMOUNT

[3]It appears the Division ultimately accepted that the depreciation amounts were in fact unrelated to the Green Bay property. Hence, although references thereto appear in certain additional correspondence, it is no longer necessary to refer to the same with respect to the matter at issue herein.

Cost of real estate purchased	$1,453,591.78
Capitalized improvements	433,852.62
Closing costs on sale	5,036.08
Capitalized interest	216,501.97
Total	$ 2,108,982.45

13. By a letter dated September 22, 1993, the Division advised petitioners that their claim for residential exemption on the property was denied because the transfer had been treated by petitioners as the sale of business property on Schedule C, and because petitioners filed New York income tax returns for the years 1989 through 1991 as nonresidents who did not maintain living quarters within New York State. The Division's letter also requested further specifics with regard to the claimed costs of the property, including the following:

-a copy of the closing statement to verify the amount petitioners paid to acquire the property;

-a schedule showing the method used in allocating the claimed $1,453,591.78 acquisition cost of the property (i.e., to show how petitioners arrived at such cost for the property after the previously-noted subdivision and sale of a portion of the property);

-a schedule breaking down the $433,852.62 of claimed capitalized improvements, showing the various types of capital improvements made and the dollar value assigned to each;

-information as to any loans used to acquire and/or improve the property;

-a schedule showing the amount of any interest incurred during a construction period.

14. Additional correspondence was exchanged between the parties, including a November 5, 1993 letter in which petitioners' counsel asserts entitlement to a residential exemption for the property as a seasonal or summer residence under 20 NYCRR 590.24, and a November 9, 1993 Division letter again requesting the documents and information sought in the Division's September 22, 1993 letter.

15. By a letter dated November 16, 1993, petitioners' accountants provided their explanation and calculations with regard to the selling price and acquisition and improvement expenses associated with the property. Petitioners claimed a selling price (consideration) of $1,750,000.00 received from the Weills, with their calculations showing no allocation of any portion thereof to personalty. The Division, for its part, agrees that $1,750,000.00 is the proper

measure of consideration received, and asserts that there should be no allocation of any portion thereof to personalty. Turning to the area of acquisition and improvement expenses, petitioners claimed an initial purchase cost of $2,275,695.15 for the entire property (i.e., before any subdivision thereof), including furnishings, which amount was allocated as follows:

ITEM	ALLOCATED AMOUNT
-main residence plus 16.68 acres	$1,202,869.50
-section 2--four lots @ approx. 5 acres each	492,829.69
-section 3--caretaker's house plus 1.25 acres	23,728.84
-section 4--approx 60.87 acres unimproved	105,867.12
-furnishings and personal property	450,400.00
TOTAL	$2,275,695.15

16. As noted earlier, petitioners subdivided and sold certain portions of the property prior to 1991. In view of these prior sales, petitioners' accountants' November 16, 1993 letter reflects a computation of acquisition costs and improvement expenses attributable to the remaining (unsold) property. In sum, this computation reduces the $2,275,695.15 cost amount set forth above by: a) $372,579.25 (representing the cost of the portion of section 2 previously sold) and b) $450,400.00 (representing the furnishings and personal property reportedly sold at auction in 1988), thus resulting in the remaining acquisition cost of $1,452,715.90. Petitioners then increase such amount by: a) $433,852.62 (representing claimed costs of improvements to the remaining property) and b) $195,650.69 (representing interest costs incurred during the period of rehabilitation). The final portion of the August 16, 1993 letter sets forth petitioners' view of the transaction for gains tax purposes as follows:

ITEM		AMOUNT
-Selling price (consideration)		$1,750,000.00
--less: Allocable costs:		
-Closing costs..............	$ 5,036.80	
-Main residence...........	1,202,869.50	
-Section 2 (remaining)..	120,250.44	
-Section 3 (caretaker)...	23,728.84	
-Section 4....................	105,867.12	
-Improvements............	433,852.62	
-Total claimed original purchase price............		$(1,891,605.32)
-Loss on sale..		$ (141,605.32)
-Gains tax due at 10%....................................		-0-

17. The foregoing calculation excludes the claimed interest expense, with regard to which the letter stated as follows:

> "[m]ost of the capitalized interest of $195,650.69 relates to interest costs on the original purchase price capitalized while renovations were in process. I cannot separate the portion capitalized related to improvements and, thus, suggest you disallow all of the capitalized interest <u>for now</u>." (Emphasis as in original.)

18. The Division responded to the foregoing submission by a letter dated November 22, 1993. First, the Division noted its position that the starting point for calculating original purchase price for the entire property as acquired (i.e., before any subdivision) was the $1,750,000.00 amount allocated to the real estate, with no increase thereto available for the $500,000.00 amount specified as paid by petitioners to acquire personalty or for any loss incurred by petitioners on their subsequent auction sale of the personalty. Thereafter, the Division advised that "other acquisition costs" of $25,387.00 should be apportioned in accordance with petitioners' apportionment between realty and personalty upon acquisition (i.e., $1,750,000.00 ÷ $2,250,000.00 x $25,387.00 = $19,745.44). Thus, the Division allocated $19,745.44 of "other acquisition costs" to realty, with the $5,641.56 balance allocated to personalty. Accordingly, the Division calculated petitioners' original purchase price (OPP) for the entire property as $1,769,745.44 (i.e., $1,750,000.00 + $19,745.44 = $1,769,745.44). The Division then proposed reducing the portion of such OPP allocable to the main residence to $1,147,319.35. This reduction from petitioners' claimed main residence allocation ($1,202,869.50) is based on eliminating the loss on the sale of personalty and eliminating the portion of the "other acquisition costs" attributable to acquiring personalty. Reference to Exhibits "G" and "J" reveal that such reduction (or reallocation) was achieved (mathematically) as follows:

<u>ITEM</u>		<u>AMOUNT</u>
-Original purchase price for all property		$1,769,745.00
--<u>Less</u>: total purchase cost amounts allocated by petitioners to property other than main residence:		
-Section 2....................	$492,829.69	
-Section 3....................	23,728.84	

-Section 4....................	105,867.12	
-Total cost other than for main residence....................		($ 622,425.65)
-Remaining cost reallocated to main residence............		$1,147,319.35

The balance of the Division's November 22, 1993 letter requests further information concerning the transfer of section 3, as well as information concerning claimed expenses for capitalized labor costs and benefits, other payments to various named individuals or entities, and a schedule and supporting documents with regard to any loans in addition to the loan from First Eastern Bank.

19. By a letter dated December 9, 1993, petitioners' accountant responded by agreeing to the Division's proposal that the correct acquisition price for the entire property was $1,769,745.44. Petitioners' accountant further agreed that the correct portion of such cost allocable to the main residence should be $1,147,319.35 as calculated above by the Division, and not $1,202,869.50 as calculated by petitioners. In addition, petitioners' accountant agreed that the cost should be further reduced by $23,728.84, because the property constituting section 3 above was not part of the sale to the Weills but had been conveyed from petitioners to the caretaker at Green Bay without consideration. The balance of the letter speaks to the various items of cost mentioned in the Division's immediately preceding (November 22, 1993) letter.

20. The Division responded by a December 20, 1993 letter seeking additional information concerning the costs capitalized by petitioners, including a breakdown or allocation of such costs between the main residence and the guest cottage, a description of the work or services for which petitioners claimed capitalized labor expenses, a similar breakdown for miscellaneous expenses, truck rental, built-in appliances and, finally, information as to any allocation of such expenses between the property sold in 1991 versus the previously subdivided and sold parcels.

21. Petitioners' accountant answered by a January 14, 1994 letter providing some general responses to the Division's requests, including a statement that a truck was rented periodically to pick up and deliver supplies, furnishings, wallpaper and other necessary construction items; that appliances purchased included several dishwashers, a huge refrigerator,

and a Garland stove; and that none of the claimed excavation, paving, landscaping or engineering costs related to the previously subdivided and sold parcels. This letter stated that petitioners had contemporaneously created and maintained records, including payroll records for laborers involved, specifically identifying their undertakings with respect to the property on a payroll by payroll basis. In this regard, petitioners' accountants' position was that the Division's requests for specific substantiation was unreasonably burdensome, inconsistent with its previous requests for samplings of the types of expenditures and supporting documentation, and would be accommodated best by the Division's dispatch of a field auditor to petitioner Edward P. Carroll's Pennsylvania offices where the relevant records were maintained.

22. The Division, in turn, issued a letter dated February 2, 1994 advising petitioners' accountants that assessments were in the process of being generated for issuance. This letter noted petitioners' right to protest such assessments, but continued the Division's request for information sought in its prior (December 20, 1993) letter. The Division's February 2, 1994 letter clarifies that the information sought was "either an explanation or a disclosure of the types of duties or costs incurred . . . rather than the more burdensome task of providing copies of all invoices, job tickets, or other pertinent documentation verifying the expenditures."

23. In total, some $441,056.55 of expenses on the Green Bay property were claimed by petitioners as capitalizable. Of such expenses, $7,203.93 were allocated by petitioners to the previously subdivided and sold parcels, leaving $433,852.62 claimed as capital expenses allocable to the property at issue herein and includable in OPP for gains tax purposes.[4] The Division allowed a total of $127,811.00 of such expenses as includable in OPP, thus leaving

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[4]Petitioners claim $2,325.00 out of the $433,852.62 total as land improvement costs, with the $431,528.00 balance claimed as materials and labor costs for improvements made to the buildings located on the main property.

some $306,042.62 as disallowed. Reference to Division's Exhibit "J" reveals those expenses disallowed and remaining in issue, as the following:

ITEM	AMOUNT
a) Aubuchon Hardware	$ 2,383.00
b) excavation contractor 1988 & 1989 *	11,099.00
c) paving contractors *	8,000.00
d) capitalized labor costs for: *	
1) 1988	55,407.00
2) 1989	20,504.00
3) 1990	22,315.00
e) Misc. expense for: *	
1) 1988	21,826.00
2) 1989	3,779.00
3) 1990	17,302.00
f) used pickup	7,000.00
g) real estate marketing	9,281.00
h) appliances *	4,335.00
i) NC Interior Design Services for:	
1) 1989	78,784.00
2) 1990	6,461.00
j) furniture refinishing	7,758.00
k) truck rentals *	2,075.00
l) insurance broker for: *	
1) 1989	12,418.00
2) 1990	3,345.00
m) gas, oil, kerosene,etc. *	4,415.00
n) engineering less amount allocated to parcels sold in 1989 & 1990	854.00
o) sales promotor & advertising	2,940.00
p) freight & delivery	3,761.00
TOTAL	$306,042.00

24. Notes accompanying the foregoing list of disallowed items shed further light on the reasons for disallowance. More specifically, those items (Items "b" through "e", "h", and "k" through "m" above) followed by an asterisk were listed as "require further documentation and/or breakdown to determine how much, if any, of said costs can be allowed as part of the original purchase price." With respect to Item "i" (NC Interior Design), it was noted that with the exception of $5,539.00 claimed in 1990 for wallpaper, the balance claimed ($78,784.00 for 1989 and $6,461.00 for 1990) was disallowed as costs incurred for furniture, bedding, lamps, window treatments, etc., representing personalty and not capital improvements. Items "g" and "o" above were listed as disallowed because the only allowable selling expenses at the time of

conveyance (1/31/91) per 20 NYCRR 590.17 were legal, engineering and architectural fees. Finally, the notes state that petitioners' claim for residential exemption was denied for lack of proof that they used the premises as a personal residence.

25. The Division issued to each of the petitioners a notice of determination assessing gains tax due under Article 31-B of the Tax Law. Each notice is dated January 1, 1994, and each assesses gains tax in the amount of $8,123.86, plus penalty and interest. The amount assessed against each petitioner individually represents one-third of the $24,371.60 total tax calculated by the Division as due from the transfer of the property, as follows:

ITEM		AMOUNT
Consideration		$1,750,000.00
Brokerage fees		0.00
Original purchase price claimed:	$1,891,605.00	
Less amounts disallowed:		
Overstated acquisition costs	79,279.00[5]	
Disallowed claimed capital items	306,042.00	
Original purchase price adjusted		$1,506,284.00
Gain		$ 243,716.00
Tax @ 10%		$ 24,371.60

26. At hearing, petitioners presented the testimony of one Camil Maroun, who was engaged by petitioners upon their acquisition of Green Bay to procure insurance coverage for the property and furnishings. Mr. Maroun personally inspected the property, including the buildings and their contents, in 1988, and noted that their were many large, unique and valuable furnishings, including antiques, at the property. Although acknowledging that he has no formal education or training in evaluating antique furnishings, Mr. Maroun pointed out that he and his insurance agency have been involved for a number of years in obtaining insurance for many of the Great Camps of the Adirondacks, and that he is "considered pretty good on the value of Great Camps." Petitioners introduced in evidence a declarations sheet for the renewal of an insurance policy on the property. This sheet, covering the period 8/5/89 to 8/5/90, includes

[5]The amount disallowed ($79,279.00) consists of: a) the loss on the sale of personal property ($49,908.59), b) "other acquisition costs" allocated to personalty acquired ($5,641.56) and, c) the amount of acquisition cost allocated to the caretaker's cottage ($23,728.84). The result of these disallowances serves to reduce the $1,202,869.50 amount of acquisition cost allocated by petitioners to the main residence to the $1,147,319.35 amount of such cost agreed to as proper. The basis for such disallowances, and the agreement to $1,147,319.35 as the proper amount of acquisition cost allocable to the main residence, are set forth in detail in Findings of Fact "18" and "19".

insurance coverage for personal property in the amount of $434,000.00. Mr. Maroun admitted that his only on-premises inspection of the property and its contents was made in 1988.

27. Petitioners also presented computerized job cost summary sheets for the amounts expended on the property, together with invoices substantiating the expenditures summarized on the cost sheets. According to petitioners, this submission was not meant to be an exhaustive submission of all invoices for all costs, but rather was meant to be illustrative of the types of expenditures petitioners incurred at the property. Petitioners presented the testimony of Edward P. Carroll to establish the fact that the costs were incurred, and to describe the system of recordkeeping in place (i.e., job cost summary with backup invoices). Mr. Carroll candidly admitted, when asked about which of the expenses incurred were capitalized, that "I don't have a clue which was capitalized--the accountants do that. I don't know anything about that. I record expenses of the job." Mr. Carroll's testimony as to the nature of the work performed at the property was quoted above in Finding of Fact "4". With respect to the particular invoices, his testimony was essentially a confirmation that the items listed were materials or supplies purchased for the property. The record contains no other testimony with regard to specifics of the types of rehabilitation activities undertaken or how the items purchased or labor expenses incurred related to such activities.

28. Review of the invoices submitted reveals purchases from a number of lumber and building material concerns, supply houses, and the like. The items purchased included materials such as lumber, plywood, insulation, nails, staples, etc., various types of equipment and parts such as roof jacks, hammers, wrenches, router bits, knee pads, drills, stone saws and blades, ropes, tarps, paint brushes and rollers, safety signs, nozzles, hoses, clamps, toilet repair parts, brooms, rakes, blades, snap fasteners, a wheel barrow, etc., and supply items including gloves, paper towels, windex, moth balls, mouse traps, light bulbs, paint, sand paper, iceaway, etc., and other items including lamps, several birch baskets, snowshoes, umbrellas, blankets, etc. There are also invoices for plumbing service calls including parts and supplies, for door

closers and hinges, outboard motor oil, tennis court paint, and an invoice for the purchase of a 1979 BMW automobile.

29. Petitioners provided no evidence concerning the nature of the expenditures for excavation contractor, paving contractors, appliances (such as their manner of installation), N C Interior Design Services (it appears the "N C" refers to petitioner Nancy J. Carroll), furniture refinishing, insurance, engineering, or freight and delivery. Similarly, no evidence was offered in explanation of the expenditures (or selling expenses) claimed for real estate marketing or for sales promoter and advertising.

30. In addition to the items listed above, petitioners seek to increase OPP (and thus decrease gain) by interest claimed in the amount of $195,650.00 incurred on their First Eastern Bank loan while renovations were ongoing at the property. Petitioners maintain that the loan proceeds were used for the purposes of acquiring and rehabilitating or improving the property, and that the related interest expense should be capitalized. The record includes no evidence of any loans incurred other than the loan from the First Eastern Bank.

SUMMARY OF PETITIONERS' POSITION

31. Petitioners argue that many of the expenditures made in rehabilitating the property were incurred in the construction of capital improvements (that is, were capital expenditures in nature), and therefore were properly includable in OPP. Petitioners admit that not all of the claimed expenses are capital expenses, but assert that the amount of those which are capital expenses exceeds the amount of gain determined by the Division, thus leaving no tax due. In short, petitioners maintain that they suffered a loss on their sale of the property. In the same vein, petitioners also claim that interest expense on the First Eastern Bank loan should be included in OPP, apparently as interest incurred on borrowings used to acquire the property and for the construction of capital improvements during a construction period.

Petitioners further argue that the premises as sold included many valuable items of personal property, and that notwithstanding the provisions of the contract of sale, there should be an apportionment of consideration between the real property and the personalty transferred by petitioners. While petitioners do not specify any apportionment ratio or dollar amount in particular, they argue that the Division's failure to make such an apportionment "leaves the record devoid of credible evidence and lacks a rational basis for the imposition of Real Property Gains Tax."

Petitioners also argue that the record lacks credible evidence supporting the notices, and that the notices are therefore without a rational basis and should be annulled. Specifically, petitioners complain that the record consists only of the audit papers, with no auditor or other witness presented by the Division. Thus, petitioners argue that they were denied the right to ask questions regarding the audit and, as a result, have been denied due process and equal protection under the law.

Finally, petitioners maintain that penalties should be abated. On this score, petitioners argue in their brief that they entered into the purchase, rehabilitation and sale of the property "with the professional guidance of a multitude of advisors." Petitioners assert that they received advice from counsel in both Pennsylvania and in New York to the effect that gains tax was not due because they sold the property at a loss. Petitioners also note that they maintained complete business records detailing expenditures relating to the purchase, rehabilitation and sale of the property.

CONCLUSIONS OF LAW

A. Article 31-B of the Tax Law provided, at the time of the transfer in question here, for the imposition of a tax at the rate of 10 percent upon gains derived from the transfer of real property within the State of New York (Tax Law § 1441).[6] Tax Law § 1440(3) defined "gain" as:

> "the difference between the consideration for the transfer of real property and the original purchase price of such property, where the consideration exceeds the original purchase price."

B. Tax Law § 1440(5)(former [a]), in effect at the time of the transfer in issue, provided, in pertinent part, as follows:

[6]The real property transfer gains tax imposed by Tax Law Article 31-B was repealed on July 13, 1996. The repeal applies to transfers of real property that occur on or after June 15, 1996 (L 1996, ch 309, §§ 171-180).

> "'Original purchase price' means 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."

C. The basic issue presented in this case is the dollar amount of petitioners' OPP. That is, petitioners claim to have incurred expenses properly includable in OPP which result in OPP exceeding the consideration received upon sale of the property, thus resulting in a loss leaving no gain subject to gains tax. The items sought to be included in OPP are the various costs set forth above at Finding of Fact "23", plus interest expense which was incurred on petitioners' loan from the First Eastern Bank. In addition to these OPP items, petitioners also assert that the Division's notices should be annulled for lack of a rational basis for their issuance, and that the consideration received by petitioners for the property should be apportioned between the real property sold and items of personalty allegedly included therein. Finally, petitioners seek abatement of penalty.

D. In response, the Division accepted that certain of the costs claimed by petitioners in fact qualified as capital improvements and allowed the same as includable in OPP. However, the Division maintains that the balance of the items sought appear to be supplies, equipment and maintenance items not allowable as OPP. The Division also challenges petitioners' claim to interest expense, arguing that the same represents interest incurred on acquisition financing which was, during the period in issue, not an allowable component of OPP. The Division further disputes petitioners' claim that the consideration received should be apportioned between real property and personal property, pointing out that the contract of sale specifically allocates all consideration to the real property, and that there is no evidence of personal property at the premises at the time of sale. Finally, the Division argues that the audit conducted herein more than provides a rational basis in support of the notices, and that penalty was properly imposed and should be sustained.

E. Petitioners, in their petitions, raised issues with respect to whether the notices were issued in a timely manner, and whether petitioners were entitled to an exemption under Tax Law § 1443(2) because the property was used by petitioners as a personal residence. The Division denied both of these claims. In turn, no evidence was offered by petitioners nor was any argument advanced at hearing in support of either of these claims. Further, these claims were not addressed in any manner in the briefs filed. Since these claims have not been pursued in any fashion, they are deemed to have been abandoned and will not be addressed as issues herein.[7]

F. Treated first is the issue of whether petitioners have established entitlement to include any of the claimed but disallowed expenses in OPP. Mr. Carroll's testimony regarding the ownership and maintenance of the property prior to his acquisition, coupled with the dollar amount of the expenses incurred by petitioners after their acquisition of the property, leave it beyond dispute that the property was in a state of disrepair when acquired by petitioners. Furthermore, petitioners' purpose in acquiring the property was to rehabilitate and sell, a purpose consistent with the recreational property development construction business in which Mr. Carroll was engaged. Thus, not only was rehabilitation anticipated before sale, but it is reasonable to accept that extensive repair would be needed due to the passage of time without sufficient maintenance being performed on the property. In this regard, Mr. Carroll alluded in testimony to needed upgrades to the heating, water supply and septic systems. Given this background, it is reasonable to conclude that some of the rehabilitation work would be of a capital nature, the cost of which would properly be includable in OPP (see, 20 NYCRR former 590.17). In fact, the Division obviously recognized and accepted this premise, and allowed nearly one-third of the expenses claimed by petitioners as capital improvement costs includable in OPP. Unfortunately, while there appears little or no question that petitioners in fact incurred

[7] It is worth observing that on the question of timeliness, the property transfer occurred on January 31, 1991 and the notices are dated January 24, 1994. Thus, the time span between the transfer and the notices falls within the three-year period of limitations on assessment found at Tax Law § 1444(3). As to the claim for residence exemption, petitioners held the property as business property and filed Schedule C with respect thereto, and offered no evidence to support a conclusion that the property was at any time (including summers or vacations) occupied as a personal residence by any of the petitioners.

the balance of the costs set forth above as disallowed, the record does not establish that such costs constitute capital costs properly includable in OPP.

First, a review of the invoices reveals a mix of items. Many of the claimed items represent supplies, equipment, personalty and services (e.g., furniture refinishing) which are clearly and simply not capital items (see, Finding of Fact "28"). Other items, such as lumber, plywood, etc., might have qualified as used in the construction of a capital improvement and been allowable, if more detail on the extent of the project and the particular uses of such materials therein had been provided. The problem, however, is the lack of evidence detailing how the purchased items were used at the property. From the record, it is not possible to determine if certain materials were used for maintenance or in making repairs, as opposed to capital reinstallations or newly constructed items. In sum, one is left to guess at the extent of the renovations and the particular purposes for which the disallowed items at issue herein were used.

Petitioners have alleged that instead of a gain on the sale of the property they actually incurred a loss. Correspondence revealed that petitioners' accounting system was an income tax based system which tracked the expenditures on the property or job. In fact, it would appear that the expenses claimed would, for income tax purposes, be deductible and would result in a loss on the sale of the property. However, not all expenses incurred and deductible for income tax purposes qualify for inclusion in OPP (Matter of V & V Properties, Tax Appeals Tribunal, July 16, 1992). Petitioner candidly admitted that not all of the costs submitted for inclusion constitute capital items. In this case, the record simply does not establish, as explained above, that any of the disallowed costs at issue were in fact capital costs properly includable in OPP.

G. Petitioners' argument that interest expense on the First Eastern Bank loan should be included in OPP is rejected. In this regard, the evidence supports the conclusion that the loan was made for the acquisition of the property. Specifically, both the loan commitment letter and the loan agreement speak of a loan for acquiring the property (see, Findings of Fact "5" and "6"). Furthermore, the property was purchased for 2.25 million dollars while the First Eastern loan was for 1.8 million dollars, leaving the loan proceeds alone less than the acquisition price with no excess proceeds available for construction costs. In fact, there is no evidence that the loan was used for construction costs, and petitioners apparently assert that the interest should be allowed, even if the loan was solely an acquisition loan, because the interest accrued during the period when the property was being rehabilitated. In Matter of Zeckendorf Columbus Co. (Tax Appeals Tribunal, February 27, 1997), the Tribunal confirmed that during the period at issue herein, interest paid on a loan used to acquire an interest in real property was not allowable as part of OPP (citing Matter of Mattone v. State of New York Dept. of Taxation & Finance, 144 AD2d 150, 534 NYS2d 478). The Tribunal rejected an accompanying argument that, prior to a 1993 amendment to Tax Law § 1440, acquisition financing interest, if incurred during a construction period, should be considered a capital improvement cost.[8] Accordingly, since the evidence supports the conclusion that the loan at issue here was to acquire the property, and since the acquisition (and sale) of the property both occurred well before the 1993 amendment, the Division properly rejected petitioners' claim to include interest expense as part of OPP for the property.

H. Treated next is petitioners' claim that the notices lack a rational basis and should be annulled because of the Division's failure to allocate any portion of the consideration received to personal property. This claim is rejected. First, the contract of sale between petitioners and the Weills specifically allocates all of the purchase price to the real estate with no consideration allocated to personalty. Further, although the contract calls for the creation of a bill of sale from petitioners to the Weills with respect to any personal property transferred, no such bill of sale was offered in evidence. Moreover, there is no claim or evidence that sales tax was remitted in

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[8]Tax Law § was amended in 1993 to read, as relevant here:

> "[o]riginal purchase price shall also include any interest paid or required to be paid be the transferor on a loan which was used to acquire the real property; provided that such amount of interest shall be limited to the interest which accrues during a construction period, as defined under rules and regualtions prescribed by the commissioner, and which is attributable to that portion of the real property which is the subject of the construction of a capital improvement during such construction period" (Tax Law § 1440[5][former(a)], added by L 1993, ch 57, § 61).

connection with the transfer of any tangible personal property as part of the transfer of the premises. In addition, the evidence shows that the furnishings acquired by petitioners when they acquired the property were in turn sold at auction. Not only is this auction sale specifically noted in correspondence from petitioners' accountant, but the same is consistent with statements in the loan commitment letter which refer to the bank's understanding that petitioners anticipated paying loan accruals during the two-year loan period from the proceeds of sales of portions of the property, including personalty. Petitioners' witness on the issue of personalty testified to the contents of the property at the time of acquisition in 1988, but did not visit the premises thereafter and therefore could shed no light on what items, if any, were in the property at the time of sale in 1991. Given the foregoing, it may well be that most or all of the original furnishings were sold at auction, and that petitioners seek apportionment of consideration based on replacement furnishings. However, even if it were appropriate to recast the specific terms of the contract of sale with regard to allocation of consideration, petitioners have provided no inventory or other evidence revealing either the specific furnishings involved or the value to be assigned thereto. Accordingly, petitioners' request to ignore the terms of the contract of sale and apportion the consideration between real property and personal property is denied (see, Matter of Shareholders of Beekman Country Club, Tax Appeals Tribunal, April 16, 1992; confirmed, Matter of Beekman Country Club v. Wetzler, 199 AD2d 640, 604 NYS2d 989).

I. With respect to petitioners' "rational basis" argument, the record as a whole contains ample evidence in support of the Division's issuance of the notices at issue. The Division presented documentary evidence detailing the auditor's ongoing requests for information and clarification, and detailing the manner in which the assessments at issue were determined. Petitioners have made no credible showing that they were unable to understand the nature of or basis for the assessments calculated by the Division. Thus, in the first instance, it cannot be said that petitioners were prejudiced by the Division's choice not to present the auditor as a witness to explain the assessments. In fact, the absence of the auditor is not a bar to the introduction of documentary evidence in support of an assessment (see, Matter of Mira Oil Co.

v. Chu, 114 AD2d 619, 494 NYS2d 458, lv denied 68 NY2d 602, 505 NYS2d 1026). Moreover, petitioners could easily have secured the presence of the auditor if they deemed it essential, either by request or, if necessary, by subpoena. Finally, petitioners were afforded full opportunity to submit evidence in support of their claims, including most specifically in support of their claimed entitlement to additional costs as OPP. Accordingly, petitioners' request for annulment of the notices for lack of a rational basis in support thereof is denied.

J. The imposition of penalty in this case is sustained. Although asserting in their briefs that they relied upon the advice of professionals, including counsel in both New York and Pennsylvania, petitioners have offered no evidence detailing the nature of the advice or the basis therefor, from which one could ascertain whether such advice was reasonable and was reasonably relied on (Matter of Shechter, Tax Appeals Tribunal, October 13, 1994). Perhaps the most probable explanation for petitioners' failure to properly file and pay tax due is that petitioners reported a loss on their sale of the property for income tax purposes, and thus believed there could (correspondingly) be no gain subject to gains tax. However, gains tax and income tax principles are not the same, and the results are not therefore always corresponding (see, Matter of V & V Properties, supra.). Further, given the clearly noncapital nature of many of the costs claimed herein, it is difficult to conclude that petitioners were reasonably advised that there was no gain and no tax due. In short, petitioners have not established that their manner of filing and reporting the transfer was reasonable under the circumstances and that penalties should be abated.

K. The petitions of Brendon James Edward Carroll, Edward P. Carroll and Nancy J. Carroll are hereby denied and the notices of determination dated January 24, 1994 are sustained.

DATED: Troy, New York
April 24, 1997

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE