March 30, 2000

Three Cases Show Burden Is on Taxpayer for Presale Tax Planning

By: Glenn Newman

Three cases with broad implications were decided recently by the Tax Appeals Tribunals. Two involved the New York City's Unincorporated Business Tax ("UBT") and major hometown industries (real estate owners and law firms) and the other involved the State's Corporate Franchise Tax and how New York taxes the sale of an entire business segment.

The New York City Tax Appeals Tribunal reversed an Administrative Law Judge determination that had many in the real estate industry concerned about the application of the UBT to those who converted rental properties to cooperative ownership. In *Matter of 85th Estates Company,*[1] the Tribunal held that the partnership that had converted the properties was not a dealer and, therefore, was exempt from the UBT as it was trading for its own account. In another City UBT case, *Matter of Ladas & Parry,*[2] an ALJ determined that 'special partners' in a law firm that had no equity interest in the partnership, had only limited liability for the firm's debts but had been listed as partners in Martindale-Hubbell and on the firm's letterhead were not partners under the UBT and therefore, their compensation was an allowable deduction. The State Tax Appeals Tribunal decided a case involving the sale of an entire division in *Matter of Fairchild Industries, Inc.,*[3] and the amount of New York State corporate franchise tax due on that sale.

Who is a Dealer?

85th Estates Company (the "Company") was formed through the merger, in 1979, of several partnerships that each owned one building. Ownership interests in each of the partnerships were divided between two families. In connection with the merger it was agreed that the net cash receipts from operations with respect to five buildings would be allocated only to one set of partners and that the net cash receipts from operations with respect to the other two buildings would be allocated only to the other partners. There were no plans at the time of the merger to convert the buildings to condominium or cooperative ownership. All of the buildings were operated after the merger as rental properties, through managing agents that were supervised by one or the other set of partners.

In 1981, the partners encountered difficulties in rolling over the mortgage loan on one building and in establishing the renewal rent under a ground lease (with a fair market rent reset provision) for another building. It appeared that the buildings' cash flow would not be sufficient to pay the related obligations and that conversions to cooperative or condominium ownership might be the best course of action.

Because of these circumstances, and for various other business, legal, and personal reasons, the partner overseeing one group of properties decided that those buildings should be converted to cooperative ownership; and the other partner apparently decided to convert one of the two buildings it controlled. In the same period, the partnership agreement was amended to provide each family with the power to deal with its group of buildings for all purposes, including sale or conversion, without obtaining the consent of the other family, and to apportion any gain or loss on the disposition of any building among the partners of the appropriate family only.

The Company proceeded with the conversions in the usual manner, by retaining sales agents and lawyers who in turn prepared the offering memoranda required by state law, negotiated with tenants, and marketed vacant apartments to prospective "outside" purchasers. The Company also renovated vacant apartments for use as sales offices and refurbished common areas in the one set of buildings; and offered, to prospective purchasers of vacant apartments, a package of improvements for $10,000 - $15,000 per apartment. There was also some advertising to sell vacant apartments, which was limited to building signs and newspaper ads placed by the sales agent. The advertising was typically completed for each building over a six to eight-week period.

The conversion of four of the buildings to cooperative ownership, and of one of the other partners' buildings to condominium ownership, was ultimately effectuated in 1986, apparently in large part because of adverse changes in federal tax law that took effect in the following year. A fifth building was converted to cooperative ownership two years later.

In four instances, a building was transferred to a newly formed co-op corporation in exchange for (i) cash paid to the co-op by purchasers of shares, (ii) the unsold shares, and (iii) either a wrap-around mortgage to the Company or relief from existing indebtedness secured by the building. Another building was converted to a two-unit condominium (a "cond-op") consisting of a residential unit and a commercial unit, with the residential unit being transferred to a co-op corporation as described above.

In most cases, the closing of sales of cooperative shares and condominium units occurred on the date of completion of the conversion, and unsold shares and cash proceeds were then distributed to the partners. Shares for thirteen apartments that could not be readily divided among the partners were retained by the Company together with the commercial unit of the cond-op. Unsold units from the other partner's condominium conversion were transferred to that family's partners and affiliates for notes soon after that conversion was completed in December, 1986.

Sales Total

The total amount realized from sales with respect to the co-op conversions was approximately $42 million, and the amount realized from the condominium conversion of the cond-op building was approximately $28 million.

Profits on the transfers of the six buildings were reported on the partnership's income tax returns as capital gains. In 1989, however, the City Department of Finance issued a notice of determination alleging a UBT deficiency of $1.5 million (plus interest and penalties) for 1986, with an explanation alleging that the partnership was a dealer for UBT purposes.

During the tax year at issue, the UBT provided that "[a]n individual or other unincorporated entity, *except a dealer holding property primarily for sale to customers in the ordinary course of his trade or business,* shall not be deemed engaged in an unincorporated business solely by reason of the purchase and sale of property . . .for his own account" (former Admin. Code section S46-2.0(d)).

The ALJ stated that there were no precedents under the UBT regarding whether a person converting property to cooperative or condominium ownership would be a dealer, and then reviewed federal case law applying similar language in section 1221(1) of the Internal Revenue Code, relating to the definition of capital assets. The ALJ concluded that the Company was a dealer with respect to the buildings under the criteria relied upon in federal tax cases, and therefore was a dealer for UBT purposes as well.

Decision's Effects

The decision emphasized, in support of this result, the multi-year period and extent of the activities to convert the buildings and to sell apartments in connection with the conversions, which included incurring brokerage commissions not less than $1.5 million and professional fees not less than $750,000. The decision also cited the fact that the partnership sold 130 distinct units of property, counting the condominium unit sales as well as the buildings transferred to the co-op corporations; the advertising and renovation costs incurred (approximately $70,000 and $407,000 respectively); the establishment of a sales office at each building for the use of sales agents; and the involvement of one partner from each family in setting sales prices, negotiating with tenant committees, and supervising other aspects of the conversion process.

The ALJ concluded that the so-called "liquidation of investment" exception to dealer status developed by federal cases, typically involving multiple sales pursuant to a plan of liquidation, was not applicable, because the Company did not effect a complete liquidation of its investment in the properties, retaining unsold shares relating to thirteen apartments, the commercial unit in the cond-op, and one of the other buildings. The ALJ found that, by 1986, the Company was in the business of converting buildings to cooperative and condominium ownership.

The ALJ stated that this case has unique facts, including a 189-unit condominium conversion by the same entity that transferred five other properties to co-op corporations, that may have distinguished it from a typical co-op conversion involving a partnership owning only one property. The ALJ noted that she was not required to confront the question of whether the same result would apply in other situations, such as where only one parcel of property is transferred.

While the Tribunal agreed with the ALJ's application of federal precedents to determine a taxpayer's status as a dealer, it looked at the "totality" of the circumstances and concluded that the Company "was compelled by unforeseen developments to liquidate investments in the manner most economical at the time." The Tribunal disagreed with the ALJ's emphasis on the time, effort and money spent on the conversion rather than the Company's motivation for the conversion. The Tribunal also said "the ALJ had erred in contrasting the sums spent and the effort expended with *only* those sums realized on the sale of vacant apartments." (Emphasis in the original). In addition, the Tribunal overruled the ALJ's finding that the process of cooperative conversion was the sale of apartments to multiple purchasers saying, rather, "it was a single sale to a single purchaser (the Cooperative Housing Corporation)." Accordingly, the single sale made in furtherance of the liquidation of the Company resulted in the Company's maintaining its exemption from UBT for trading for its own account. In a pithy concurring opinion, Commissioner Christopher R. Lynn stated he would "go further and hold that the City's UBT can never apply to a cooperative conversion or to a subsequent apartment sale by a person who has purchased from the CHC."

Who is a Partner?

Previous articles have discussed decisions of the City Tax Appeals Tribunal regarding the status of someone as a partner and how it affects the UBT. Under the UBT, payments made to a partner for services or use of capital are not deductible (in excess of $5,000 per year per active partner).[4] The cases are clear that *any* partnership interest, no matter how small, will render all payments made to the partner for services or the use of capital nondeductible (beyond the $5,000 limitation). But what about the practice at some law and accounting firms of having non-equity partners who may be called partners for some purposes but have *no* ownership interest in the partnership at all?

In *Matter of Ladas & Parry,*[5] a law firm had two "Special Partners" who were not parties to the firm's partnership agreement, had made no capital contribution to the partnership and were affected in only a limited way by partnership profits and losses. In addition, the Special Partners had only limited rights to attend partners' meetings or to be involved in decision-making at the firm and waived any rights to see the partnership's books and records. The City argued that the Special Partners were listed in Martindale-Hubbell and on the partnership's letterhead as partners and that such 'holding out' to the public as partners was sufficient to disallow the deduction of payments made to them under the UBT.

The ALJ analyzed the rights of the so-called Special Partners, found that they had "so few indicia of a true partnership, that were this a case of first impression" she would find the Special Partners to be employees of the firm. However, the ALJ had to discuss several cases relied upon by the City to urge that the Special Partners were partners for UBT purposes. First, *Matter of Miller Tabak Hirsch & Co.* involved persons who were conceded to have a partnership interest, albeit a small one.

The ALJ spent considerable time discussing *Matter of Johnson & Higgins,*[6] which held that the add-back of compensation (under the City's income plus compensation alternative for general corporation tax) paid to corporate officers included all those with an elective or appointed officer title. The ALJ pointed out that the New York Business Corporation Law Search7RH715 contains a definition of "officer" while the New York Partnership Law contains no definition of "partner." The ALJ also noted that other cases involved merely affirmance of an administrative determinations by the Appellate Division which explicitly stated that the evidence would have supported a finding that the taxpayer was not a partner but still found substantial evidence to support the tax department's contrary conclusion. These precedents left the ALJ free to make a determination on the merits of the facts as she saw them. The ALJ was persuaded by the totality of the facts and circumstances that the relationship was such that the Special Partners did not have a real partnership interest in the firm.

I have been told that the City will file an exception with the appellate level of the City Tax Appeals Tribunal so there is more to come. Since ALJ determinations are not precedential,[7] this determination cannot be relied upon by other law, accounting or other partnerships doing business in the City.

Corporate Tax on the Sale of a Division

The State Tax Appeals Tribunal held that New York could tax the gain on the sale of a division of a corporation even though that division had no payroll, property or receipts in New York. In *Matter of Fairchild Industries, Inc.*, the taxpayer had stipulated that there was a unitary business among the taxpayer's three business segments; the Space & Defense Electronics segment; the Industrial Products segment; and the Aeronautics segment. The company did not use the structure of corporate subsidiaries but, rather, had its three divisions operate as separate units creating their own budgets and strategic plans but with centralized accounting, legal and other services.

It was only the Aeronautics segment that had a significant presence in New York, a presence it had for many years until 1987 when the company decided to close its facility on Long Island. Over the next few years, the operations were scaled down, factories closed and property sold. In the tax year ended June, 1990, a gain of more than $176 million was reported on the federal corporate tax return attributed to the sale of the Space & Defense segment but excluded from the New York State corporate franchise tax return with a disclosure that the sale was of a non-unitary asset.

Taxpayer's Argument

The taxpayer's argument was that the statutory apportionment formula applied to the gain to arrive at the New York tax resulted in a gross distortion of tax and permitted New York to tax activities and income generated outside the State. The taxpayer argued that, notwithstanding the unitary business, the business segments were not vertically integrated; the New York operations did not contribute to the value of the Space & Defense segment; and, in fact, the New York operations 'dragged down' the value of the Space & Defense segment. It was undisputed that the New York operations lost significant amounts of money for the years leading up to the sale.

The taxpayer urged that *Matter of British Land (Maryland) v. Tax Appeals Tribunal,*[8] required the tax department to exercise its discretion to vary from the statutory apportionment formula to determine the appropriate tax on the gain on the sale of the non-New York business segment.

The Tribunal held that *British Land* was not controlling. In that case, the Court of Appeals held that New York's attempt to tax 64% of the gain on the sale of property located in Maryland (which had been held for many years) based upon that taxpayer's apportionment percentage including New York property (which was owned for only a short period of time), was grossly distortive. The Tribunal held that New York's taxation based upon Fairchild's approximately 4% business allocation percentage was not a gross distortion requiring variance from the statutory formula. The Tribunal said that the taxpayer "failed to meet its burden to show, by clear and cogent evidence, that application of the statutory formula to it attributes New York income to petitioner out of all appropriate proportion to the business transacted by petitioner within this State."

It is clear that there is a substantial burden upon the taxpayer who seeks to vary from the statutory apportionment formula. It is not sufficient to merely point to some amount of additional tax to be paid or unfairness in the New York apportionment factors. It appears that here, as in many cases in which state and local tax counsel are brought in after the transaction to handle the litigation, some pre-sale tax planning could have changed the result significantly. Of course, this is an easy comment for a tax practitioner with twenty-twenty hind sight to make.

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[1] City Tax Appeals Tribunal (decided December 22, 1999).
[2] City Tax Appeals Tribunal, Administrative Law Judge Division (decided February 24, 2000).
[3] New York State Tax Appeals Tribunal (decided March 9, 2000).

[4] Admin. Code Search7RH11-509(a). See, Matter of Miller Tabak Hirsch & Co., (City Tax Appeals Tribunal decided March 30, 1999).
[5] NYC Administrative Law Judge Determination dated February 24, 2000.
[6] City Tax Appeals Tribunal (decided October 12, 1994).
[7] New York City Charter Search7RH168(d).
[8] 85 NY2d 139 (1995).