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Income Subject to UBT —City's Tax Applied to Condominium and Co-Op Conversions

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The New York City Unincorporated Business Tax ("UBT") imposes a tax at the rate of 4% on the income of a business wholly or partly carried on within the City by an individual or by a partnership or other unincorporated entity (hereinafter collectively referred to as a "partnership").

In general, the UBT does not apply to a business consisting of the purchase, holding, and sale of property for a partnership's own account, or to the leasing or management of real property by an owner or lessee. The tax does apply, however, to gain from the sale by a partnership of City real property if the property was held primarily for sale to customers in the ordinary course of business, as would be the case, for example, if the partnership's business consists of buying unimproved land, subdividing the land, building improvements, and then selling the improved lots.

"85th Estates"

Many tax practitioners have been concerned regarding the potential applicability of the UBT in non-development contexts, such as in connection with conversions of rental property to cooperative or condominium ownership. A recent decision of an ALJ of the New York City Tax Tribunal concludes that the tax applied to gains realized in 1986 from sales of condominium units upon a conversion to condominium ownership, and, perhaps more surprisingly, to gains realized upon transfers by the same partnership of several buildings to co-op corporations, notwithstanding that the buildings converted were held for many years by the partnership and predecessor entities as rental properties. *In re 85th Estates Company* (TAT(H) 93-4058(UB), Feb. 11, 1998).

Facts. 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 equally or almost equally between two families referred to below as "GF" and "PF."

In connection with the merger it was agreed that the net cash receipts from operations with respect to five buildings would be allocated only among GF partners and that the net cash receipts from operations with respect to the other two buildings would be allocated only among PF 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 a GF partner, in the case of the GF buildings, and by a PF partner in the case of the PF buildings.

Conversions Planned

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 GF partner overseeing the GF buildings decided that those buildings should be converted to cooperative ownership; and the counterpart PF partner apparently decided to convert one of the two PF buildings. 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, beginning in 1982 or 1983, 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 GF 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 6 to 8 week period.

The conversion of four of the GF buildings to cooperative ownership, and of one PF building 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. The fifth GF building was converted to cooperative ownership two years later.

Proceeds Distributed

In four instances, a GF 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 GF 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 GF partners were retained by the Company together with the commercial unit of the cond-op. Unsold units from the PF condominium conversion were transferred to the PF partners and affiliates for notes, apparently soon after that conversion was completed in December, 1986.

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 PF 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.

Analysis

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 begins by stating that there are no precedents under the UBT regarding whether a person converting property to cooperative or condominium ownership would be a dealer, and then reviews federal case law applying similar language in section 1221(1) of the Internal Revenue Code, relating to the definition of capital assets. The ALJ concludes 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.

The decision emphasizes, 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 cites 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 also concludes 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 13 apartments, the commercial unit in the cond-op, and one of the PF buildings. The ALJ found that, by 1986, the Company was in the business of converting buildings to cooperative and condominium ownership.

The determination states 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 distinguish 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.

Observations

A possibly critical question is whether a partnership that holds at least one property primarily for sale to customers in the ordinary course of business is for that reason a dealer for UBT purposes with respect to all of its properties and activities. In the federal context, an individual or entity may hold some property primarily for sale to customers in the ordinary course of business while holding other property for investment purposes.

The same approach should apply in the UBT context as well, and seems implicit in the UBT regulations.[1]

The conclusion with respect to the condominium units is not particularly surprising, since the federal authority regarding whether a property owner that converts a building into condominium units for sale holds those units as capital assets provides some support for the argument that the condominium units in the PF building were held primarily for sale. The federal cases also, however, provide some support for a contrary view.

It could be argued that the liquidation-of-investment argument made by the taxpayer should have prevailed, and that the taxpayer's continued ownership of one building for rental purposes is not inconsistent with a conclusion that the sale of the other building as condominium units was pursuant to a liquidation of that activity. The fact that almost all of the sales occurred at the same time further supports the liquidation analysis.

With respect to the transfers of the GF buildings to co-op corporations, the conclusion that each of these buildings was held primarily for sale to customers in the ordinary course of business seems more surprising. The gains at issue arose from the transfers of the buildings in exchange for unsold shares and other consideration, rather than from transfers of shares to individual purchasers.

Had each building that was converted to cooperative ownership been sold to an unrelated purchaser rather than transferred to a co-op corporation, a strong argument could be made that the Company would not have been a dealer with respect to those properties. A transfer to a co-op corporation arguably should not be viewed any differently for this purpose.

The references to substantial brokerage and legal fees, extensive negotiations, and renovation costs in support of the conclusion that the properties were held primarily for sale to customers in the ordinary course is consistent with the type of analysis in many of the cases dealing with the analogous federal tax issue, but appears to be rather slight support for the conclusion in this determination.

Substantial brokerage and legal fees are typically paid in connection with the sale of larger commercial and multi-family residential properties, and the renovations were apparently minor (the cost was less than 1% of the overall receipts from the conversion of the buildings). Similarly, the modest advertising efforts were typical in relation to sales of real property generally and should not carry great weight in such an analysis.

Finally, it is appropriate to consider the question presented here by reference to a general concept of the types of income intended to be subject to the UBT. The UBT is intended to reach, in general, gains that are attributable primarily to the skill and efforts of a developer in pulling together the myriad elements necessary for a successful project, and applies to the activities of a speculator whose business consists of arbitrage between owners who are prepared to sell at lower prices and buyers who are prepared to pay more.

Under the exceptions referred to above, however, the UBT does not generally apply to gains attributable principally to the appreciation of real property by reason of market forces over time. By this standard, it seems fairly clear that the UBT should not have applied here.

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[1] Apart from the point that whether property is held primarily for sale to customers in the ordinary course must be decided on a property-by-property basis, the economic, management, and control arrangements between the two families suggest that a strong argument could be made that, for tax purposes, there were two partnerships. In that event, the activities with respect to one group of properties should perhaps not be considered at all in evaluating the dealer question with respect to the other group. This argument, however, was not made by the parties or referred to in the determination.