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Luxury Deregulation

Tenant Who Filed 'Amended' Return Loses in Court

In the recent case of *Classic Realty LLC v. New York State Division of Housing and Community Renewal*,[1] the New York State Court of Appeals directed the DHCR to luxury deregulate the apartment of the tenant who may have tried to evade deregulation by filing an "amended" tax return. The decision, which reversed a split decision of the Appellate Division, First Department, yields a somewhat problematic result.

As we explained in our Sept. 3, 2003 column, luxury deregulation has always been a battle between accuracy and privacy. When luxury deregulation was first proposed in 1993, landlords wanted the Housing Division and the New York State Department of Taxation and Finance (DTF) to thoroughly investigate tenant incomes. If a tenant made more than the statutory income threshold (now $175,000 per year for two consecutive years), landlords wanted the tools to prove it.

Tenants, conversely, were afraid that landlords would use the luxury deregulation process to harass, expose or embarrass them; few New Yorkers would want their incomes publically discussed. They demanded privacy safeguards that would sharply circumscribe the income verification process. Landlords argued that these safeguards could be used by unscrupulous tenants to evade luxury deregulation.

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When high income deregulation became law, protections were put in place to make the income verification process as nonintrusive as possible. Essentially, the Department of Taxation and Finance was only authorized to tell the Division of Housing and Community Renewal whether the tenant's income was or was not above the statutory threshold for the two years in question. There would be no audits, hearings, discovery or testimony.

Let the Games Begin

Although the vast majority of tenants accurately report their incomes each year, it became obvious to practitioners and landlords alike that certain tenants were seeking to evade luxury deregulation. It also became obvious that given the privacy safeguards in the Rent Stabilization Law, these evasions would succeed.

One tenant practice was to underreport income and hope that the U.S. Internal Revenue Service (IRS) would never notice. Another involved shifting income from year to year so that a tenant never made more than $175,000 in two consecutive years. This was particularly attractive to self-employed tenants.

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Another evasion involved amending tax returns. Tenants on the verge of luxury deregulation would simply amend their returns such that their income, for one or both years, would magically dip below $175,000. It was an amended return that lead to the dispute in *Classic Realty*.

Judith Lachman, her husband and her 13-year-old-son lived in a rent stabilized cooperative apartment located at 1000 Park Avenue in Manhattan. As of 1998, the tenant was paying just $3,726 per month for a magnificent 10-room, three-bedroom apartment. The fair market value of the premises was approximately $11,500 per month, and the sale value was in excess of $7 million.

In 1998, the landlord filed a petition with the Housing Division to luxury deregulate the apartment. Thus, the primary question was whether the tenant's household income for 1996 and 1997 was above $175,000 for both years. The tenant responded to the landlord's deregulation petition by stating that she had yet to file a return for 1997. By the time that Department of Taxation and Finance verified the tenant's income, however, the return had apparently been filed. The department reported that the tenant's income indeed exceeded the statutory threshold for both years.

The Housing Division gave the tenant an opportunity to respond to the Taxation Department's determination. The tenant stated that she had filed an amended return which would prove that she did not qualify for luxury deregulation. The tax department, at the Housing Division's direction, undertook a second income verification, and, lo and behold, the tenant no longer qualified for deregulation.

Investigation Demand

The landlord then demanded that the Housing Division investigate the possibility (or, according to the landlord, the probability) that the tenant had shifted income to avoid deregulation. The division declined to do so. The landlord then brought an Article 78 proceeding. Supreme Court held that the landlord's speculation did not warrant annulment of the Housing Division's order. The matter then moved to the Appellate Division First Department.[2]

The majority (Justices Tom, Mazzarelli and Gonzalez) affirmed Supreme Court, and, in turn, affirmed the Housing Division's refusal to deregulate the apartment. The majority's approach was simple: There was nothing to indicate that the tenant had done anything wrong, and even if she had, the privacy safeguards in the luxury deregulation statute insured that the landlord, the Housing Division, the Department of Taxation and Finance and the courts could do nothing about it. In response to the landlord's demand for a hearing, Justice Peter Tom wrote:

> Moreover, even if a hearing would be held, DHCR's power to examine tax issues would have been limited. DHCR necessarily would rely on information provided by DTF, but DTF is only authorized to disclose to DHCR whether the tenant's household income exceeded $175,000 and, as noted above, '[n]o other information regarding the annual income of such persons shall be provided.' Nor are the tenants required to provide 'any information regarding their income except that which is requested on the [income verification] form,' so that, procedurally, petitioner's goal is not achievable in this manner. We have noted elsewhere the degree to which legislation has thus circumscribed DHCR (as well as judicial) review of the tax information to be included. Actual income is not subject to disclosure. To require the submission of additional information, aside from just the verification of annual income, would transgress the policy goal of ascertaining whether the monetary threshold is exceeded with a minimum of intrusion on taxpayers' privacy. (internal citations omitted).[3]

The majority went on to hold that it was unlikely that the amended return was inaccurate, as such conduct "would subject the tenant to severe sanctions and penalties for under-reporting income, filing false returns, or filing other false documentation ... "[4] While the prospect of an IRS audit and penalties may be frightening to some tenants, the prospect of paying fair market value for a 10-room apartment may be even more terrifying. As of 1998, the stabilized rent for the apartment in question was $3,726 per month, whereas the fair market monthly rental value was $11,500. Thus, a finding of luxury deregulation would have raised the tenant's annual rent by almost $100,000 in the first year alone.

The dissent, in an opinion by Justice Joseph Sullivan and joined in by Justice Milton Williams, argued that the Division of Housing and Community Renewal should hold a hearing as to the circumstances surrounding the amended tax return:

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An Attempt to Evade Luxury Deregulation

> DHCR's blind acceptance in the circumstances herein of the newly minted report of annual income as reflected in the amended tax returns is irrational. Such a procedure should not be tolerated given the potential for abuse by tenants seeking to avoid decontrol and the absence of any mechanism to curb income shifting calculated to defeat luxury deregulation.
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> Thus, I would reverse the judgment and remand the matter to DHCR for further processing of petitioner's application including a hearing as to all aspects of the tenant's filing of amended tax returns for the years in question. The purpose of this hearing is not, as the majority suggests, to have "yet another verification of income," but rather, as noted, to explore the circumstances regarding the filing of the amended returns. While, as the majority notes, at this juncture there is no evidence of fraud or illegality, that is precisely why, under the circumstances of this case, further inquiry is essential.[5]

The dissent's approach, while more likely than the majority's approach to catch evasive practices, is problematic in two respects. First, as the majority pointed out, there is nothing in the governing statute to authorize a hearing or investigation, and there is much in the statute that would seem to prevent it. Second, the scope of the hearing or investigation might involve complex matters of taxation that the housing division may not be equipped to resolve. The housing division's expertise is rent regulation, not tax policy.

The Court of Appeals reversed the Appellate Division and directed Housing Division to deregulate the apartment, holding that the luxury deregulation statute contemplated only a single verification of income. Because the first verification established that the tenant qualified for deregulation, the Court ruled that the inquiry should have ended there. As Judge Ciparick wrote for a unanimous court:

> We conclude that it was arbitrary and capricious for DHCR to deny deregulation under the circumstances presented, and furthermore, the determination was affected by an error of law. Here, tenant filed an amended return after DTF verified that the tenant's income exceed $175,000. The tenant never challenged the accuracy or validity of the original verification that had been submitted, which reflected that income was over $175,000 for the subject years. Rather, tenant utilized the statutory comment period to bring the amended return to DHCR's attention. Tenant simply noted that an amended tax return would support her assertion that the apartment was not eligible for deregulation. She did not provide an explanation as to why an amended return had been filed or how the amended return differed from the return on file at the time of DTF's original verification. Tenant's Answer essentially amounted to a request for a 'do-over' rather than a comment on DHCR's proposed order.
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> DHCR's ruling cannot stand as it invites abuse of the luxury decontrol procedures which contemplate a single verification, the result of which is binding on all parties unless it can be shown that DTF made an error.

The Court of Appeals' approach has the same pitfalls as the approach suggested by the Appellate Division dissent. It is not clear how the Housing Division would gauge the quality of the tenant's "explanation" as to why an amended return had been filed. Moreover, we can safely presume that the "difference" between the original and the amended return is that the original showed an income above the statutory level, while the amended did not.

Verification Problematic

Also problematic is the Court's holding that the luxury deregulation statute permits only a single income verification. The statute does not say so explicitly. Moreover, the "one-look" policy could work to the advantage of tenants. A tenant could underreport his or her income, obtain a favorable ruling as to luxury deregulation, and then amend his or her return to reflect the proper, higher income. At that point, the landlord could be demanding a second verification.

The solution lies with the Legislature, not the courts. The statute, as written, allows dishonest tenants to prosper. If tenant income claims are to be pierced, the Division of Housing and Community Renewal or the Department of Taxation and Finance or both must be given the appropriate tools to arrive at an informed decision.

1. N.Y.L.J., Mar. 31, 2004, at 19, col. 5.
2. 309 A.D.2d 205, 763 N.Y.S.2d 271 (1st Dep't 2003).
3. 309 A.D.2d at 209.
4. Id. at 208.
5. Id. at 214, 215.