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In this installment of Noonan's Notes, Noonan and Doolittle examine some of the more notable state and local tax cases coming out of New York in 2021, including matters addressing residency and the sales tax primary function test.

This year was just another boring, ho-hum year in the tax world, with not much going on, right? We're guessing our readers would have a different view. And by the looks of this year-end edition of *Tax Notes State*, this past year was anything but boring for us state and local tax folks. Indeed, for New York tax practitioners, 2021 brought an increase in tax rates, a huge (and continuing) migration of taxpayers out of New York,[1] the explosion of telecommuting and tax issues therein,[2] and stepped-up enforcement by the New York tax department. Plus, since New York's tax appeals systems — perhaps unlike many other courts across the country — stayed more or less operational during most of the pandemic, 2021 brought a bevy of new tax cases for us SALT nerds. In this article, we'll look at some of the more notable ones coming from the New York administrative tribunals and the courts.

Sales Tax Cases

Matter of 1Life Healthcare Inc.

First, and hot off the presses, in this determination issued late in November,[3] an administrative law judge ruled for the taxpayer in a case involving the taxability of annual membership fees paid by users of a software service. The annual fee was paid by consumers to access a membership-based service that the taxpayer provided to patients of a medical practice through the taxpayer's proprietary technology platform. The services provided by the taxpayer were nonclinical, personal services such as booking medical appointments, assisting with billing and insurance inquiries, confirming prescription orders and refills, and wellness and behavioral coaching. Some of these services were delivered via phone, via email, or in person, but others were provided through messaging in the mobile app and web portal — and there is where the issue arose. The parties agreed that these services were otherwise not taxable, but the tax department argued that because of the technology functions provided through the mobile application and web portal, the taxpayer was selling taxable pre-written software.

The ultimate issue here revolved around the primary function test, often called the true object

[1] *See* Timothy P. Noonan and Emma M. Savino, "COVID-19: The Year of the Great Migration," *Tax Notes State*, Mar. 1, 2021, p. 897.

[2] Noonan and Savino, "New York's Convenience Rule: Under the COVID Microscope," *Tax Notes State*, May 31, 2021, p. 893.

[3] *Matter of 1Life Healthcare Inc.*, DTA No. 829434 (N.Y. Div. Tax App., Nov. 10, 2021).

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test in other jurisdictions. Under this test, courts are required to look at the overall service offering in its entirety, "as opposed to reviewing the service by components or by the means in which the service is effectuated."[4] In other words, the question is what the purchaser was actually buying — what the primary function of the service was. And in this case, the ALJ held that the primary function of the taxpayer's service was providing "care navigation services associated with the administrative part of its members' medical needs." And since these services are not among the enumerated taxable services under N.Y. Tax Law section 1105(c), the ALJ held that the membership fee was not subject to sales tax. The fact that the services were sometimes delivered via a mobile application or web portal didn't transform the service into a sale of software.

This is a good win for the taxpayer, of course, but it's a little surprising that the tax department chose to take this one on in the first place. When initially confronted with internet or software situations, the department did seem to take a "tax first, ask questions later" approach in a lot of audits, basically arguing that any service that involved software or the internet was tainted as the sale of software. But in more recent years, after issuing dozens of advisory opinions on software-related issues, the department seemed to take a more nuanced approach, recognizing the limitations created by the primary function test and making reasonable distinctions on the taxability of service offerings based on that analysis. The taxpayer here somehow slipped through the cracks; this appears to be the kind of case the tax department would not have taken on five or six years ago.

Matter of Dynamic Logic

This case[5] highlights the other side of the primary function analysis and focuses on the difficulty in differentiating between nontaxable consulting services and taxable information services. The ALJ ruled against the taxpayer and found that its services, which measured and reported the effectiveness of clients' advertising campaigns, were taxable information services subject to sales tax. Applying the primary function test, the ALJ observed that "to be an information service, the taxpayer's primary function must be the business of furnishing information, including the services of collecting, compiling or analyzing information and furnishing reports thereof" and noted that the mere fact that information is being transferred will not create a taxable event. The taxpayer argued that the primary function of its service was providing a consulting service. The ALJ, however, found that "its primary function is to collect information regarding the effectiveness of its clients' advertising by conducting surveys, analyze that information, and furnish that information and analysis to its clients via reports," which she concluded rendered it a taxable information service. In doing so, the ALJ said the taxpayer's services fell "squarely within the realm of N.Y. Tax Law section 1105(c)," explaining that the "process of collecting, compiling and analyzing information is the very essence of an information service." Further, the fact that the survey data could be shared by the taxpayer's clients and was included in the benchmarking product rendered the statutory exclusion for "the furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons" inapplicable.

The case is on appeal to the tax appeals tribunal, but it's a cautionary tale about the difficulties inherent in dealing with services like consulting services in states that have a tax on information services. Indeed, every consulting service endeavors to provide information, but that alone doesn't make all consulting services taxable as information services. And often true consulting services, such as those offered in the investment-research world, are largely that — specialized guidance and consultation from industry experts to help guide their clients' decision-making. But when those same services include some information, and especially when other clients get that same information, it becomes difficult to draw the line between taxable and nontaxable services.

[4] *See id.*, citing *Matter of SSOV '81 Ltd.*, DTA Nos. 810966 and 810967 (N.Y. Tax App. Trib., Jan. 19, 1995).

[5] *Matter of Dynamic Logic*, DTA No. 828619 (N.Y. Div. Tax App., Jan. 14, 2021).

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People v. B&H Foto & Electronics Corp.

This case[6] arose under New York's False Claims Act (FCA) and involved New York's sales tax rules around coupons and discounts. The rules in this area are straightforward: If the retailer offers a discount on the sales price, then it is required to collect sales tax only on the discounted amount. But if the retailer is reimbursed by another party — usually the manufacturer — for the discount, then it must collect sales tax on the full sales price, as if there were no discount.[7] In this case, brought by New York's attorney general under the FCA, the complaint claimed that the retailer made false claims and cheated on state sales taxes over the past 13 years by failing to pay tax on some vendor-sponsored rebates totaling at least $67 million from 2006 to 2017. But the trial court dismissed the complaint, agreeing with the taxpayer that the instant rebate program it had in place with the manufacturer was not a true manufacturer's coupon situation, with the customer presenting a coupon for a discount for which the retailer was later reimbursed. In doing so, the court observed that two advisory opinions issued by the tax department provided "persuasive guidance" for the taxpayer's filing position, i.e., that the rebates are not calculated into receipts. For some, this case is "Exhibit A" for the notion that New York's FCA should not be used to argue technical points of law that are better left to the tax department and the tax appeals system.

Income Tax Cases

Matter of Pilaro

Our favorite topic: New York residency! This case[8] serves as a reminder that the taxpayer's burden of proof in statutory residency cases requires the taxpayer to "prove the negative." Under the statutory residency test in N.Y. Tax Law section 605(b)(1)(B), an individual is taxable as a full statutory resident in any year that person (1) spends more than 183 days in the state and (2) maintains a permanent place of abode (PPA) for substantially all of the taxable year.

In this case, the taxpayer was in New York for more than 183 days, so the sole issue was whether he maintained a PPA for substantially all the 2014 tax year. The taxpayer rented a small apartment in New York City from January 1 to November 1, 2014, and conceded that he became domiciled in the city on December 3, 2014, when he purchased another apartment there. But during the audit, the taxpayer declined to respond to the auditor's request for information on where he stayed during the intervening period — from November 1 to December 3, 2014 — and the taxpayer testified vaguely at the hearing that he stayed with friends in the city. The ALJ observed that, to defeat the assessment against him, it was the taxpayer's burden to prove a negative — that is, that he did not maintain a PPA in the city for more than 11 months of the year. Noting that the two apartments were maintained by the taxpayer for an aggregate period of "11 months exactly," and in light of the taxpayer's failure to submit any evidence proving that he did *not* maintain a PPA in New York during the intervening period, the ALJ concluded that the taxpayer had not met his burden of disproving the PPA prong of the statutory residency test and therefore would be treated as a resident for the 2014 tax year.

The determination is on appeal to the tax appeals tribunal. One issue that didn't arise in the decision surrounds an issue we call the *Sobotka* rule in honor of a 2015 case we handled dealing with this rule.[9] There an ALJ ruled that in part-year domicile cases, only the portion of the year the taxpayer is not domiciled in New York should be considered when determining whether the "more than 183 days" test of statutory residency is met. The law was subsequently amended to provide that a taxpayer could be a resident of New York by being domiciled in New York *or* by maintaining a PPA and spending in excess of 183 full or part days in the state. But this anti-*Sobotka* legislation was made effective prospectively, starting with

[6] *People v. B&H Foto & Electronics Corp.*, No. 452106/2019, 2021 (N.Y. Sup. Ct., Sept. 21, 2021).

[7] *See* 20 NYCRR section 526.5.

[8] *Matter of Pilaro*, DTA No. 829204 (N.Y. Div. of Tax App., Aug. 26, 2021).

[9] *Matter of Sobotka*, DTA No. 826286 (N.Y. Div. Tax App., Aug. 20, 2015).

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the 2019 tax year, so the *Sobotka* argument could have been made here if the taxpayer were able to prove that he was in New York less than 183 days between January 1 and December 2, 2014.

Matter of Obus

In another statutory residency case[10] the state tax appeals tribunal held that the taxpayers' seldom used vacation home in Northville, New York, more than 200 miles from the taxpayer's office and similarly far from their home in New Jersey, qualified as a PPA since it was suitable for year-round habitation insofar as it had year-round climate control and could theoretically be used by someone year-round.[11] We covered this case in the *Tax Notes State*'s 2019 year-end edition, previewing it as a case to watch in 2020 (we apparently were a year early).[12] The case offered the tribunal the first opportunity to address whether a rarely used vacation property was sufficient to confer statutory-resident status on a New York City commuter since the New York Court of Appeals' 2014 decision in the *Gaied* case, in which New York's highest court helped redefine what it really meant for a taxpayer to have a PPA in the state.

Interestingly, in its decision, the tribunal did recognize that its prior decisions on this vacation home debate (including *Matter of Barker*, also handled by yours truly) were abrogated by *Gaied*. Score 1 for the good guys! Nonetheless, the tribunal held that even applying the new rule from *Gaied* — that the taxpayer must maintain a "residential interest" in the dwelling for it to constitute a PPA — the taxpayers in *Obus* still fell short, since it determined their use of the place as a vacation home, however infrequent, was still sufficient to show that they exercised a residential interest in the dwelling. The *Obus* case is on appeal to New York's Appellate Division, Third Department.

Matter of LePage

The case[13] involved New York's mandatory S election rule under N.Y. Tax Law section 660(i) — a law that was enacted to curb tax-abusive strategies.[14] Historically, shareholders of a federal S corporation could elect to treat the corporation as an S corporation for New York tax purposes. Otherwise, if no election was made, the company would be treated as an S corporation for federal tax purposes and a C corporation for state tax purposes. This hybrid structure was (and is) ideal in some instances and is common in New York, sometimes because of failing to make the election and sometimes deliberately. For example, hybrid entities that are manufacturers or qualified emerging technology companies are eligible for reduced tax rates, including a 0 percent tax rate for manufacturing companies that would not apply if the company were an S corporation and the income flowed through to shareholders. However, under N.Y. Tax Law section 660(i), enacted in 2007, the state required mandatory S elections if more than 50 percent of a taxpayer's income in the year was investment income. And as is clear from the legislative history, this law was designed to close a loophole that allowed some taxpayers (usually New York residents with high net worth) to dump their investment portfolios into these hybrid structures to defer or eliminate New York taxes on investment gains.[15]

The taxpayers in the case were not at all in this profile. They simply owned an S corporation that sold off all its assets during the tax year at issue. But the tax department's position was that, under the language of the statute, gains from the sale of assets qualified as investment income so that the mandatory S election provisions kicked in. In the decision below, the ALJ recognized that the legislative intent of section 660(i) was not to cover transactions like this but nonetheless concluded that the statute itself was not so narrowly drawn, ultimately finding that the hybrid entities in the

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[10] *Matter of Obus and Coulson*, DTA No. 827736 (N.Y. Tax App. Trib., Jan. 25, 2021).

[11] Our firm served as amicus curiae to the tribunal in this case. *See Matter of Obus*, DTA No. 827736 (N.Y. Tax App. Trib., Oct. 1, 2020).

[12] Noonan and Joshua K. Lawrence, "Looking Ahead in New York Taxes: Ending the Vacation Home Debate," *Tax Notes State*, Dec. 16, 2019, p. 927.

[13] *Matter of LePage*, DTA Nos. 828035-828038 (N.Y. Tax App. Trib., May 17, 2021).

[14] Our firm also served as amicus curiae to the tribunal in this case. *See Matter of LePage*, DTA Nos. 828035-828038 (N.Y. Tax App. Trib., Oct. 1, 2020).

[15] *See* N.Y. Tax Department's Mem. in Support, Bill Jacket, L. 2007, ch. 60.

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case were subject to the mandatory S election. The tribunal affirmed in this decision, and the case is on appeal to the appellate division.

Corporate Tax Cases

Matter of International Business Machines Corp.

In this corporate tax case,[16] the tax appeals tribunal affirmed the determination that royalties received from foreign affiliates were not excludable from the taxpayer's income under former Tax Law section 208.9(o)(3) because the exclusion from income is permitted only if "such royalty payments would not be required to be added back" to the income of the royalty payer. Normally we wouldn't include a case about former provisions of the tax law, but the implication of the case is interesting since it raises internal consistency questions that might escape the tribunal's review since it cannot consider facial constitutional challenges.[17] From an internal consistency standpoint, if every jurisdiction applied New York's law, double taxation would be inevitable whenever the royalty payer was not taxable in the same jurisdiction as the royalty recipient. We understand that this case is on appeal to the appellate division, and we hope that the issue will be raised in that venue.

Matter of Gerson Lehrman Group Inc. v. N.Y. Tax Appeals Tribunal

This is an apportionment case involving New York City taxes,[18] and it came out of New York's Appellate Division, First Department. Here the court affirmed the city tribunal's decision in a case centered on the proper method for calculating the receipts factor for the city's general corporation tax (GCT). The taxpayer sold a subscription-based service that was used to access subject matter experts and consultants in a variety of disciplines. The experts and consultants — who interacted with the taxpayer's clients verbally and through consultations, written surveys, and seminars — were non-agent independent contractors. Also, the taxpayer employed salespeople, consultant managers, and IT personnel.

For GCT purposes, NYC Admin. Code section 11-604.3(a)(2)(B) provides that receipts from "services performed within the city" are allocated to the city but is silent when services are considered performed in the city, whose services are counted in the math, and so forth. GCT rule section 11-65(b)(1) states that all amounts received by the taxpayer in payment for services performed in New York City are allocable to the city "irrespective of whether such services were performed by employees or agents of the taxpayer, by subcontractors, or by any other persons." GCT rule section 11-65(b)(3)(i) further states that when a taxpayer receives payment "for services within and without New York City, the amount attributable to services within New York City is to be determined on the basis of the relative values of, or amounts of time spent in performance of, such services within and without" the city.

To compute the receipts factor for its services, the taxpayer argued that only the services performed by the experts and consultants should be included. In this vein, the taxpayer asserted that the services performed by its other employees, such as salespeople, consultant managers, and IT personnel, should be omitted. Since the experts and consultants were mainly located outside the city, and the other employees, such as salespeople, consultant managers, and IT personnel, were mainly located within New York City, the result was a lower receipts factor for GCT purposes. The tribunal disagreed, and the appellate division affirmed, finding that the city tribunal correctly "focused its inquiry upon the nature of [the taxpayer's] business and the personnel who contributed to the performance of the service [it] provided, which included [its] salespeople, IT staff, and consulting managers," and that the compensation for those employees must be accounted for in determining the corporation's receipts factor.

This decision illustrates how difficult it is to apply the services performed rule when you have lots of different employees doing lots of different things for clients. Indeed, even within the decisions in the case, the variety of approaches

[16] *Matter of International Business Machines Corp.*, DTA Nos. 827825, 827997, and 827998 (N.Y. Tax App. Trib., Mar. 5, 2021).

[17] *See Matter of Obus*, DTA No. 827736.

[18] *Matter of Gerson Lehrman Group Inc. v. NYC Tax Appeals Tribunal*, 193 A.D.3d 452 (1st Dep't 2021), *aff'g sub nom Matter of Gerson Lehrman Group Inc.*, 2017 WL 7053949 (N.Y.C. Tax App. Trib., Dec. 28, 2017).

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that could have been taken border on being comical. The tax department auditors came up with one approach on audit, the city ALJ decided on another, and the city tribunal picked yet a different one! So this case is a cautionary tale for taxpayers when wading through apportionment issues for services providers. And, just a preview, this services performed test — still applicable for corporate taxes on S corporations and for the city's unincorporated business tax — will create even more issues for 2020-21 tax filings and audits since so few service providers actually performed services in New York City in 2020-21 because of COVID-19-related restrictions and telecommuting.

Matter of Goldman Sachs Petershill Fund Offshore Holdings

Lastly, we have a nexus case,[19] in which the city tribunal affirmed the ALJ's determination that a capital gain recognized by an upper-tier partnership's passive corporate partner was required to be apportioned to the city for GCT purposes. The taxpayer, Petershill Fund, was owned by two limited partnerships that were both offshore entities. These two upper-tier partnerships' investment strategy entailed purchasing equity interests in alternative investment management companies. They formed the Petershill Fund, which, in turn, formed the Master Fund. The Petershill Fund owned 88.91 percent of the equity in the Master Fund, which in 2008 purchased a 9.9 percent limited liability interest in Claren Road Asset Management LLC (Claren). Both Claren and the Master Fund were treated as partnerships for tax purposes. The Petershill Fund reported and paid GCT on its share of Claren's income, deductions, gains, and losses, which flowed through to it via the Master Fund. But neither the Petershill Fund nor the Master Fund engaged in any business activities in New York City, aside from the Master Fund's investment in Claren.

In 2010, when the Master Fund sold its interest in Claren to an unrelated purchaser, it reported a capital gain on its federal income tax return but excluded the gain from entire net income on its 2010 GCT return, taking the position that the gain did not constitute doing business in the city for GCT purposes and likening the structure to the ownership of stock in a corporation. The tribunal disagreed, finding that Claren was properly characterized as a partnership for federal income tax and GCT purposes and it was a mere conduit for income derived from its NYC activities that flowed to the partners. Therefore, as partner in Claren, the Petershill Fund was treated for GCT purposes as having been engaged in Claren's business activities, which took place entirely within New York City.

This is a nexus issue that has arisen in other states, with mixed results. For example, in *Swart v. Franchise Tax Board*,[20] a California court held that "passively holding" a 0.2 percent ownership interest in a California LLC was sufficient to constitute doing business in that state. And while the de minimis nature of the taxpayer's passive 0.2 percent interest in *Swart* might be distinguishable from the Master Fund's 9.9 percent interest in Claren, there are still questions about where that line should be drawn and, more generally, whether a passive investor in a limited partnership really can be deemed to be doing business in a state where it otherwise has no connections or contacts. ■

[19] *Matter of Goldman Sachs Petershill Fund Offshore Holdings (Delaware) Corp.*, TAT(E)16-9(GC) (N.Y.C. Tax App. Trib., Mar. 12, 2021).

[20] *Swart v. Franchise Tax Board*, 7 Cal. App. 5th 497 (Cal. Ct. App. 2017).

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