NY Tax Minutes: October

By **Timothy Noonan and K. Craig Reilly** October 31, 2018, 3:03 PM EDT

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We're back with the fourth installment of "NY Tax Minutes." And once again, we're delivering all the month's New York City and state tax news in a way that's made for New Yorkers. Fast.

This month, we continue to chronicle New York's response to the federal Tax Cuts and Jobs Act's $10,000 cap on state and local tax deductions; we highlight important takeaways from the attorney general's recent $30 million settlement announcement with a hedge fund manager in a tax whistleblower action; and we cover the tax department's draft amendments to the state business corporation franchise tax regulations dealing with declaring and paying estimated taxes. We also highlight this month's new and noteworthy decisions from the Tax Appeals Tribunal.

The Headlines

The Fellowship of the Reg — NY Coalition to Fight Federal SALT Cap Regulations

A new coalition of New York municipalities, school districts, and state and county groups has geared up to challenge the Internal Revenue Service if the agency enacts REG-112176-18, the IRS regulation that recommends putting an end to one of New York's — and other high-tax states' — proposed workarounds to the newly enacted $10,000 federal SALT deduction cap. Specifically, the regulation proposes an end to states' attempts to allow taxpayers to make payments in lieu of taxes to a variety of government-operated public purpose foundations, in the hope that their resident taxpayers could then treat the payments as fully deductible charitable contributions, thereby circumventing the newly enacted $10,000 cap on SALT deductions.

Led by New York State Assembly member Amy Paulin,[1] the coalition — or as one of your Tolkien-inclined authors has dubbed the group, the "Fellowship of the Reg" — has indicated that they find the IRS' proposed rules to be unfair and arbitrary. Following the lead of Gov.

Andrew Cuomo, who previously **published alerts to state taxpayers** urging them to expeditiously take advantage of the charitable deduction before the regulation's Aug. 27 effective date and **drafted a letter to the U.S. tax inspector general** requesting an investigation as to whether partisan politics have influenced the IRS' proposed regulations, the newly formed coalition of counties, cities, towns, villages and school districts, along with state and countywide professional and advocacy organizations, is calling for the withdrawal of the SALT deduction cap regulations and preservation of full deductibility for voluntary contributions made by individuals to charitable funds established by local and state governments.

In an Oct. 11, 2018 letter,[2] penned by the group's attorneys from Baker & McKenzie LLP, the coalition alleges that the regulations lack statutory authority, conflict with the current legal treatment of state and local tax benefits and "arbitrarily and capriciously treat state and local tax credits as having value solely for purposes of Section 170 charitable contribution deductions, treating otherwise identically situated taxpayers differently without a Congressional mandate or any other rationale for doing so."

For those looking to reverse the SALT deduction cap, the good fight continues and to paraphrase Elrond, Lord of Rivendell, "New York state coalition. So be it. You shall be the Fellowship of the Reg."

NY Attorney General Announce $30 Million Settlement with Investment Manager in Tax Whistleblower Case

The New York attorney general has announced[3] a $30 million settlement for tax abuses with a hedge fund manager, adding to a previous $40 million settlement with a related investment management company, Harbert Management Corp., or HMC.

In the recently announced settlement with Harbinger Capital Partners Offshore Manager LLC, the hedge fund manager accepted a $30 million settlement for under-apportioning its New York state and New York City incentive fee income. The crux of the case was Offshore Manager's failure to apportion any of its incentive fees from successful trading to New York, despite conducting its trading activities from an office in New York City.

New York City and New York state's apportionment rules for hedge fund partnerships are complex.[4] The rules involve sometimes difficult questions regarding the type of income at

issue (e.g., intangible income versus ordinary business income) and how to apportion any income that is subject to allocation and apportionment (New York state generally uses either a direct accounting, books and records method or a three-factor formula of property, payroll and receipts to apportion partnership income). So what's a taxpayer to do when faced with these tough questions about how New York's rules are employed? And what happens if they mess it up? The taxpayers in the attorney general's settlement found out the hard way.

As explained in the attorney general's press release, Offshore Manager was paid annual performance fees by one of the hedge fund's offshore feeder funds based on the fund's net profits for the year. Offshore Manager then apportioned 100 percent of the income to Alabama, where HMC's corporate headquarters and executive management was located.

A False Claims Act suit was brought against Offshore Manager in 2015, which claimed that the company had failed to pay New York state income taxes and New York City unincorporated business taxes during the years Offshore Manager's business activities were located in New York. As we've previously reported, New York state's broad False Claims Act authorizes private citizen whistleblowers (also known as realtors) to bring treble damage false claims lawsuits, subject to certain oversights by the attorney general, against taxpayers that have engaged in tax fraud or knowingly filed false tax returns. To encourage whistleblowers to come forward, the law offers potentially huge rewards for successful whistleblowers and includes strong protective measures to insulate whistleblowers from retaliation.

The attorney general's press release alleges some troubling facts, including the allegation that Offshore Manager knowingly ignored professional advice that it should pay New York state and New York City tax on its incentive fee income (including an internal note claiming the position was "unsupportable"), along with alleged false statements made under audit. But without hearing a full explanation from both sides, it's difficult to know what to make of these allegations. What is clear though is that the attorney general's settlement highlights how broadly the state interprets "knowingly" in False Claims Act cases. As we mentioned above, New York state and New York City's hedge fund partnership apportionment rules are an especially complex area of the tax law, where minimal official guidance has been issued. This raises the question of how a person can "knowingly" violate a tax law that is not clear in the first place.

The other important point for tax practitioners is to recognize the extreme differences between how partnerships and limited liability companies apportion income in New York, compared with other flow-through entities. For instance, a nonresident who operates a service company through an S corporation in New York will pay tax to New York only to the extent the S corporation has customers or clients in the state. On the other hand, the same nonresident service provider operating as a partnership or LLC would pay tax to New York based largely on the amount of services provided within the state. In other words, choice of entity matters.

Finally, the attorney general's settlement underscores that taxpayers need to understand that communications with their accountants or other professionals are not necessarily privileged in the same way as attorney-client communications. Offshore Manager's case may not sound as troubling without what the attorney general believed to be smoking gun correspondence between Offshore Manager and its accountants, suggesting the hedge fund manager knew its position was "unsupportable." This is a helpful reminder that, when necessary, it's important for taxpayers to keep confidential discussions about how to approach difficult tax issues to themselves and their lawyers.

New York Tax Department Unveils Draft Business Franchise Tax Regulations

The New York State Department of Taxation and Finance has released draft amendments to the state business corporation franchise tax regulations[5] intended to incorporate changes made during the state's 2014 corporate tax reform related to declaring and paying estimated taxes. Comments are due by Jan. 4, 2019, on the draft amendments.

Both New York S and C corporations would be required to pay a first installment equal to a percentage of the preceding year's taxes. For S corporations, the payment is based off the corporation's tax from the immediately preceding tax year. If such tax was between $1,000 and $100,000, the installment would be equal to 25 percent of the preceding year's tax, or 40 percent of the preceding year's tax if the tax exceeded $100,000. For C corporations the payment is based off the corporation's tax from the second preceding year.

The regulations cover fairly basic rules related to the payment of estimated taxes, but they also fail to correct some of the onerous rules around estimated payments. Specifically, these estimated payments can be incredibly burdensome for taxpayers whose income varies from year to year, or for taxpayers that have large liquidity events in one year,

followed by minimal income in subsequent years. We've long hoped to see the creation of a safe harbor, or some form of penalty relief, in these types of special circumstances. But, for now, the wait continues.

The Cases

Each month, we highlight noteworthy cases from New York State's Division of Tax Appeals and Tax Appeals Tribunal, along with any other cases involving New York taxes. This month, we focus on the tribunal's interpretation of the term "common carrier" — a phrase with important consequences in many sales and use tax matters — and discuss the tribunal's decision to grant a sales tax refund to a securities rating agency for taxes the tribunal ruled the agency paid out of its own funds (as opposed to collected for its customers). There was therefore no need for the agency to return any money to its customers before filing its claim for refund.

Tax Appeals Tribunal Reviews Definition of "Common Carrier" for Sales and Use Tax Purposes

In Matter of SuperMedia,[6] New York's three-judge Tax Appeals Tribunal upheld an administrative law judge's determination that a taxpayer's delivery of telephone directories using two private carries did not entitle the taxpayer to the state's exemption for promotional materials mailed or shipped "by means of a common carrier, United States postal service or like delivery service."[7]

The taxpayer, SuperMedia, arranged delivery of yellow book phone directories into New York and contracted with the United States Postal Service, and two private carriers, Product Development Corporation, or PDC, and Directory Distributing Associates Inc., or DDA, to deliver the directories. The state's sales tax auditors asserted PDC and DDA were not "common carriers" under the tax law, so they assessed over $3 million in additional tax on SuperMedia for its purchase and use (i.e., delivery) of the directories.

There are several issues involving New York state sales and use tax that turn on whether a delivery is made using a "common carrier." One example, relevant to SuperMedia's appeal, is the use tax exemption under Section 1115(n)(4) for promotional materials mailed or shipped "by means of a common carrier, United States postal service or like delivery service." Specifically, the distribution in New York of promotional materials purchased out-

of-state is a taxable use of those materials, unless the materials are shipped without charge by the purchaser to its customers and potential customers by means of a common carrier or like delivery service.

New York's tax law does not define the terms "common carrier" or "like delivery service," but several earlier cases have addressed the terms. The federal U.S. Court of Appeals for the Second Circuit, for example, in M. Fortunoff of Westbury Corp. v Peerless Insurance Co.,[8] described a common carrier as providing services without a negotiated contract and typically involving individual transactions rather than an ongoing course of business. And in Matter of Yellow Book of New York Inc. v Commissioner of Taxation & Finance,[9] the New York State Appellate Division described a common carrier as an entity that holds itself out as providing shipping services to the general public for a specified compensation. This contrasts with a contract carrier, which usually provides shipping services pursuant to bilateral contracts that are individually negotiated with more sophisticated shippers at arm's length.

Looking at SuperMedia's detailed contracts with PDC and DDA, the tribunal noted that PDC's and DDA's business models were specialized delivery services for advertising materials and directories. PDC and DDA also had long-standing business relationships with SuperMedia and both carriers followed SuperMedia's specific requirements regarding delivery of the directories (i.e., time and method of delivery). Those facts, according to the tribunal, showed that PDC and DDA acted as contract carriers and that SuperMedia was therefore not entitled to the exemption for promotional materials sent by common carrier.

As mentioned above, the term "common carrier" impacts many areas of New York state's sales and use tax laws, including nexus (delivery of tangible personal property in the state using a common carrier does not, itself, give rise to sales tax nexus but other systematic deliveries may create the necessary contacts) and place of delivery for determining whether a transaction qualifies as a New York sale (a transaction constitutes a New York sale when a customer arranges pickup from a New York seller using a contract carrier but the sale is not treated as a New York sale if the customer arranges pick up using a common carrier). This means that it's not just yellow book providers who need to pay attention to the tribunal's most recent common carrier decision. Which is especially good, since we were shocked to learn anyone still uses the yellow book.

Rating Agency Receives Refund for Uncollected Sales Taxes Paid to New York State

In Matter of Kroll Bond Rating Agency Inc.,[10] the Tax Appeals Tribunal held that Kroll Bond Rating Agency, a securities ratings agency, was entitled to a refund of sales tax paid on its securities rating services. At issue was whether Kroll had collected the tax from its customers, or simply paid the tax out of its own funds. Under Section 1139(a) of the tax law, any sales and use taxes collected from customers must first be repaid before a refund can be issued.

The taxability of securities ratings services in New York has followed a long and winding road. In Kroll's case, the company requested an advisory opinion in 2012 as to whether its services qualified as taxable information services. While it waited for a response (and waited and waited and waited ... for the record, there are long delays of late for requests for advisory opinions in New York state), Kroll decided to conservatively remit sales tax on its transactions. Kroll also included on its invoices the statement "includes any applicable sales taxes." Kroll then backed into the tax paid by grossing down the customer invoices so that the gross sales reported on its tax returns were equal to the total of receipts from its customers less the sales tax Kroll paid to the state.

In September 2013, the Audit Division issued Kroll's requested advisory opinion, concluding Kroll's credit rating service was exempt from New York state sales tax but its service was subject to New York City sales tax as a taxable credit rating service. In its advisory opinion, the division acknowledged this was a change in the state's position (historically, the division's position was that bond rating services were not subject to state or city sales taxes), and as a result, gave vendors until Sept. 1, 2015, to put systems in place to begin collecting tax.

The Tax Department initially denied Kroll's refund claim on the ground that Kroll had not first paid back the sales tax to its customers. An administrative law judge initially sustained the refund denial but the tribunal reversed the ALJ's determination and granted the refund.

The tribunal considering a number of factors in its decision, including:

- Kroll's decision to set its prices on the basis of its competitors' prices;

- The fact that Kroll's competitor's fees did not include sales tax;

- The fact that Kroll's invoices did not include a separately stated amount for sales tax (the tribunal noted that the Tax Department's own regulations provide that the words "tax included" do not constitute a separate statement of tax);

- None of Kroll's engagement agreements with its clients mentioned sales tax; and

- When Kroll did attempt to separately charge and collect tax on one of its transactions, Kroll's customer, Merrill Lynch, emailed Kroll within two hours of receiving the invoice to question the inclusion of sales tax, which Kroll then immediately removed.

Based on these facts, the tribunal determined Kroll did not include the cost of the sales tax in its ratings fees. As a result, the tribunal reversed the determination of the ALJ and held that Kroll met its burden to show it did not collect tax from its customers and was therefore entitled to the refunds it originally claimed.

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[1] http://amypaulin.com/charitable-funds/

[2] http://amypaulin.com/wp-content/uploads/2018/10/3CD-Comment-Letter_REG-112176-18.pdf

[3] https://ag.ny.gov/press-release/ag-underwood-nyc-corporation-counsel-carter-announce-30-million-settlement-investment

[4] https://www.hodgsonruss.com/media/publication/1577_Noonan%206.26.17.pdf

[5] https://www.tax.ny.gov/pdf/2018/corp/part-7-updates-post-10-5-18.pdf

[6] Matter of SuperMedia, DTA No. 826264 (September 20, 2018). https://www.dta.ny.gov/pdf/decisions/826264.dec.pdf

[7] N.Y. Tax Law Sec. 1115(n)(4).

[8] M. Fortunoff of Westbury Corp. v Peerless Insurance Co., 432 F.3d 127 (2d Cir. 2005).

[9] Matter of Yellow Book of New York Inc. v Commissioner of Taxation & Finance, 75 A.D.3d 931 (3d Dept. 2010), lv denied 16 N.Y.3d 704 (2011).

[10] Matter of Kroll Bond Rating Agency Inc., DTA Nos. 826900, 827411 (Oct. 1, 2018). https://www.dta.ny.gov/pdf/decisions/826900.dec.pdf