NY Tax Minutes: September

By **Timothy Noonan and K. Craig Reilly** October 1, 2018, 2:08 PM EDT

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

Timothy Noonan

This month, we revisit New York's ongoing battle with the federal government over the recently enacted $10,000 cap on state and local tax deductions; we take a look at the importance of taxpayer testimony in domicile cases; we address the ever-growing list of non-audit related legal challenges facing taxpayers in New York state, including whistleblower lawsuits and class actions; and, lastly, we review New York City's recent (better late than never) guidance on repatriated income for business taxpayers.

Craig Reilly

The Headlines

New York Continues its Attack on the SALT Deduction Cap

As reported last month, the IRS recently released a set of proposed regulations,[1] which recommend 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.

The IRS' proposal included an effective date of Aug. 27, 2018, and, as we reported last month, on Aug. 24, New York state Gov. Andrew Cuomo issued a public alert, not-so-subtly entitled "Gov. Cuomo Alerts New Yorkers to Deadline to Make Charitable Donations Before Politically Motivated IRS Regulations Take Effect."[2] According to the governor's alert, the IRS' proposed regulations are a "politically motivated" attack that seek to "block reforms that

deliver relief to New York taxpayers." Gov. Cuomo went on to assure taxpayers the state is "confident that our recently enacted opportunities for charitable contributions to New York State and local governments are consistent with federal law and follow well-established precedent."

And the governor didn't stop there. On Sept. 9, 2018, the governor drafted a letter to the U.S. tax inspector general, requesting an investigation as to whether partisan politics have influenced the IRS' proposed rules on the $10,000 SALT deduction cap.[3] In his letter, Gov. Cuomo explains that "[n]ew regulations recently proposed by the IRS would change the long-standing treatment of tax credits that incentivize charitable giving" and the governor notes he is "deeply troubled by indications that the president, the Treasury secretary and perhaps others are injecting partisan concerns into the administration of the Internal Revenue Service in a manner that is jeopardizing the integrity of the service's important work."

Gov. Cuomo goes on to request "an investigation to determine whether the IRS' proposed regulations and subsequent clarification regarding business deductions are a result of improper political influence by the president, the Treasury secretary or other political officials in the administration," imploring the inspector general "to ensure the IRS' work in this area is not further politicized by internal policies that tarnish the review of future deductions claims … The livelihood of thousands of New York taxpayers and others," the governor concludes, "are threatened by these politically driven actions that are tailored to harm them."

At least some Republican lawmakers — or at least some Republican lawmakers up for re-election in heavily Democratic states — may be listening to the governor's cries. In a Sept. 7, 2018, letter to House GOP leaders, a handful of House Republicans from New York and New Jersey told chamber leaders they would oppose any future bill that makes permanent the SALT deduction cap. On Sept. 28, 2018, the House passed a bill making the cap on SALT deductions permanent. The authors of the Sept. 7 letter were four of only 10 Republicans to vote against the bill.

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 get a heavy dose of personal income tax residency and look into non-audit related legal challenges facing taxpayers in New York state.

Tax Appeals Tribunal Notes Importance of Taxpayer Testimony in Domicile Cases

In Matter of Weisen,[4] New York's three-judge Tax Appeals Tribunal upheld an administrative law judge's determination that a taxpayer failed to meet his burden of proof to show that he changed his domicile from New York City to West Palm Beach, Florida, for purposes of New York's personal income taxes.

Together, your authors have handled hundreds of domicile cases and not surprisingly, these cases are extremely fact specific. New York state's regulations define domicile (one of New York's two primary tests for determining tax residency) as "the place which an individual intends to be such individual's permanent home — the place which such individual intends to return whenever such individual may be absent." It's no accident the word "intend" appears twice in the state's definition. Domicile case are, at their core, all about proving one's subjective intent regarding one's fixed and permanent home. That's not to say objective actions aren't important. They're very important. And on audit, objective actions are generally the focus of most cases. In fact, New York auditors are instructed to focus on five primary domicile factors in every residency audit: home; active business involvement; time in and away from New York; the location of near and dear personal items; and family. But when push comes to shove and a domicile case goes beyond the audit stage, taxpayers must be able to clearly and convincingly explain their intent to leave New York and create a new domicile elsewhere.

The Weisen case is a perfect example of this necessity. The taxpayer before the tribunal, Jeremy Wiesen, had some good facts and some bad facts. His Florida home was much larger than his former New York City apartment. Good. He moved his important personal items from New York to Florida. Good. He integrated himself into the social and cultural life of Palm Beach. Also good. On the other hand, he continued to rent and own two homes in New York City and East Hampton. Not good. His son continued to live in New York. Not good. And he continued to spend more time in New York than Florida during the years under audit. Really not good.

The most noteworthy takeaway from the tribunal's decision, however, is the tribunal's focus on the taxpayer's lack of testimony. "While actions generally speak louder than words in

matters of domicile," the tribunal noted, "words also matter." And the tribunal specifically found that "testimony concerning a taxpayer's intent may be a 'critical factor' in determining whether such a taxpayer has met his or her burden of proof to show a change in domicile." In this case, the tribunal held that "[t]he absence of any such testimony, that is, the absence of petitioner's own words, is thus a significant factor in our conclusion that he has not met his burden of proof."

We're here each month to bring you the news. But we're also here to help taxpayers. So this month's free public service announcement is that when you've claimed a move out of New York state but you've decided to keep certain historic ties to New York (homes, work, family, etc.), be prepared to honestly and convincingly explain why New York is no longer your true home. And even better, consult a couple of advisers who've handled hundreds of personal income tax audits about how and what to do to properly prove your change of domicile.

Second Circuit Reminds Taxpayers Federal Court is Rarely the Forum to Litigate a Domicile Case

Continuing this month's personal income tax theme, in Campaniello v. New York State Department of Taxation and Finance,[5] the U.S. Court of Appeals for the Second Circuit, reminded taxpayers that the federal Tax Injunction Act generally deprives district courts of subject matter jurisdiction over state tax cases, including claims that New York's personal income tax laws violate the Fourteenth Amendment to the U.S. Constitution.

In Campaniello, the taxpayers, who were married, but lived separately for approximately half the year (the husband claimed to live in Florida; the wife lived in New York), argued that the Department of Taxation and Finance's decision to treat the husband as a New York state tax resident violated their Fourteenth Amendment "right to live their marriage in the manner in which they desire." While New York state's personal income tax regulations expressly note that "under some circumstances" husbands and wives may acquire separate domiciles, in practice, the general presumption is that spouses share a domicile.

The taxpayers had previously appealed the Tax Department's determination before an administrative law judge and the Tax Appeals Tribunal. And prior to filing their complaint in federal court, the taxpayers also appealed the Tax Appeals Tribunal's decision to the New York State Supreme Court, Appellate Division, arguing the decision was arbitrary and

capricious and not supported by substantial evidence (the taxpayers' Article 78 action remains pending).

But the U.S. District Court for the Southern District of New York dismissed the taxpayers' federal complaint for lack of subject matter jurisdiction and the Second Circuit affirmed the district court's ruling. According to the Second Circuit, the Tax Injunction Act,[6] "prevents federal courts from giving injunctive relieve or declaratory relief, as long as there is a plain, speedy and efficient remedy in state court." And because the U.S. Supreme Court previously ruled that New York's procedures for challenging tax assessments satisfied this standard, the Second Circuit ruled it was "without jurisdiction under the [act] to grant [the taxpayers] any injunctive relief." In other words, back to state court you go.

New York State Appellate Court Upholds False Claims Act Complaint Against Moody's Treatment of Captive Insurance Companies

In Anonymous v. Moody's Corp., et. al.,[7] the New York State Supreme Court Appellate Division reversed a lower court's ruling and held that the plaintiff-realtor had sufficiently alleged in its False Claims Act complaint that Moody's along with Marsh & McLennan Companies Inc., knowingly submitted false information concerning the appropriate amount of tax to be paid by one of Moody's related captive insurance companies.

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 high-end taxpayers (along with their advisers) 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. With the adoption of its new whistleblower laws in 2010, New York took a step rejected by the federal government and most states that have a false claims act, which prohibit cases based on a violation of tax laws.

In the Moody's case, a whistleblower filed a qui tam on behalf of the state, alleging that Moody's knowingly filed "materially false and fraudulent" tax returns treating one of its subsidiaries as a legitimate captive insurance company, despite knowing the subsidiary "did not qualify for the protections of the laws governing captive insurance companies."

In 1997, the New York State Legislature enacted Article 70 of the Insurance Law, which enabled companies like Moody's to form captive insurance subsidiaries as a form of self-insurance and granted favorable state tax status to captives licensed by the Department of Financial Services. Specifically, certain captives are able to file tax returns separate from their parent companies and pay a special franchise tax on premium income only. For a captive to qualify for favorable tax status, however, the majority of the captive's revenue must consist of "bona fide" insurance premiums. A captive that does not satisfy that requirement is deemed an "overcapitalized captive insurance company" and is required to file a combined return with its parent, paying taxes on all of its income at the higher corporate rate.

In response to the whistleblower's qui tam action, Moody's moved to dismiss the false claims complaint, asserting, in part, that: its tax treatment of the captive in question was proper; the complaint failed to allege that Moody's knowingly submitted false tax claims; and a prior closing agreement with state and city tax authorities barred the whistleblower's claims.

On appeal, the appellate division held that: the complaint "sufficiently alleges that Moody's 'tax treatment of [its captives] was aggressive, risky, and/or abusive due to its sham nature;" Moody's knowingly submitted false claims; and the qui tam action was not barred by virtue of certain agreements between Moody's and the state and city tax authorities regarding its tax liabilities for the years in question.

The court's ruling regarding the impact of the settlement agreements on the whistleblower claim definitely perked our interest. As explained by the court, Moody's, along with certain "combined affiliates" had previously entered into a closing agreement regarding their taxes owed. Notably, however, the captive insurance company at issue in the whistleblower action was only listed as one of the "combined affiliates" in the closing agreement for one year. Accordingly, the court ruled that the "closing agreements do not purport to finally dispose of the liability" for the captive insurance company in question. The closing agreements (like most closing agreements we see in New York state and city tax matters) were also "final, conclusive and irrevocable for the liabilities of the taxpayer for the subject taxes, penalties, interest and audit period, except upon a showing of fraud, malfeasance or misrepresentation of a material fact." The court noted that these "carve-outs" for misrepresentations of material fact removed the qui tam action from the scope of the release in the closing agreements.

With more and more tax whistleblower cases appearing in New York courts, the Moody's ruling, although not a final judgment on the merits of the whistleblower's claims, is another reminder that taxpayers, even those entering into audit closing agreements, may continue face new complaints regarding questionable and/or aggressive tax planning.

Federal District Court Dismisses Sales Tax Class Action Against Costco

In addition to the increase in whistleblower actions facing taxpayers, the other recent litigation trend we've noticed are class actions against retailers for allegedly over collecting sales tax. That's right, taxpayers are also being sued for collecting too much tax! The next time an auditor or Tax Department official tells you "when in doubt, tax it out," you may want to remind them of this little wrinkle in the analysis.

In Guterman v. Costco Wholesale Corp.,[8] a New York federal district court granted Costco's motion to dismiss one such class action claim. In the Costco case, the plaintiffs alleged that Costco illegally charged its New York customers sales tax on the full price, rather than the reduced price, of their coupon-related warehouse purchases. New York state has different tax rules for different types of coupons: specifically store-issued and manufacturers' coupons.

Store-issued coupons generally entitle a customer to a discount on the price of an item. These coupons are offered as incentives to customers to shop at the seller's establishment and the amount of the discount is not reimbursed by a third party. Since the seller is not reimbursed for the amount of the coupon, the actual amount received is reduced and tax is calculated on the reduced price.

Manufacturers' coupons, on the other hand, involve a reimbursement to the retailer, so sales tax is due on the full price of the item, not on the discounted price. If the coupon discloses the fact that it's a manufacturers' coupon, the seller may collect tax on the full price from the customer. When a coupon does not show a manufacturers' discount on its face but the seller is still reimbursed by the manufacturer, the seller collects tax from the customer on the reduced price only and the seller itself is liable for the tax on the difference between the reduced price and the full price.

As noted by the district court in Guterman, the court had some questions about whether

Costco may have overcharged its customers on the tax due on its undisclosed manufacturers' coupons but the court held that the plaintiffs' remedy lied exclusively within the refund procedures laid out in New York state's sales tax laws, not in federal court. Specifically, the court noted that the explicit language of Section 1140 of the tax law provides that the administrative refund procedures set out in the tax law are the "exclusive remedies" for a person challenging the imposition of a sales tax. Those remedies are to file a claim for refund within three years from when the tax was paid. While the court noted the plaintiffs have "alleged troubling conduct by Costco," the court held that it "cannot rewrite New York law, which dictates that plaintiff's remedy lies with the Tax Commission and not the court."

Other Guidance

New York City Publishes New Guidance on its Treatment of Section 965 Repatriation Amounts

Following the state guidance we reported last month, New York City has now followed suit and issued new guidance on repatriated income for business taxpayers. As we noted in our coverage of the state's guidance, New York state's publications were issued several months after the original filing deadlines for C corporations and pass-through entities. Well, congratulations, New York state. At least you beat the city in terms of timely issued taxpayer guidance.

As our readers are now aware, the federal Tax Cuts and Jobs Act requires certain U.S. taxpayers to recognize mandatory deemed repatriation income as Subpart F income under Internal Revenue Code Section 965. In general, this is accomplished by U.S. shareholders recognizing post-1986 accumulated earnings and profits and deficits of specified foreign corporations as if those earnings had been repatriated to the United States. Very generally, a specified foreign corporation means either a controlled foreign corporation, or CFC, as defined under Section 957, or a foreign corporation other than a passive foreign investment company, as defined under Section 1297, that is not also a CFC and that has a U.S. shareholder that is a domestic corporation.

On Sept. 25, 2018, the New York City Department of Finance issued new guidance, instructing taxpayers to file amended returns in accordance with the city's new instructions and to use their recomputed federal taxable income with all Section 965 amounts on their

city tax returns. The Finance Department issued two memoranda, containing detailed instructions for reporting these Section 965 repatriation amounts on taxpayer's 2017 New York City business corporation tax returns[9] and 2017 New York City general corporation tax, unincorporated business tax and banking corporation tax returns.[10] These instructions do not apply to reporting other amounts of Subpart F income, which the city has instructed must instead be reported according to the previously published 2017 forms and instructions.

The memoranda include line-by-line instructions for each tax type, along with the general warning that if a taxpayer with Section 965 amounts in its 2017 tax year has already filed its 2017 New York City tax return, "it must file an amended return using these instructions." As we mentioned last month, thanks for the heads up, New York.

Timothy P. Noonan is a partner at Hodgson Russ LLP. K. Craig Reilly is an associate at the firm. Noonan and Reilly are regular contributors to Tax Authority Law360.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc. or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] REG-112176-18.

[2] https://www.governor.ny.gov/news/governor-cuomo-alerts-new-yorkers-deadline-make-charitable-donations-politically-motivated-irs

[3] https://www.governor.ny.gov/sites/governor.ny.gov/files/atoms/files/GAMC_Letter_to_TIGTA_re_SALT_regs_9.9.2018.pdf

[4] In Matter of Weisen, DTA No. 826284 (Sept. 13, 2018).

[5] Campaniello v. New York State Department of Taxation and Finance, 2018 WL 4520056

(Second Cir., Sept. 20, 2018).

[6] 28 U.S.C.S. § 1341 .

[7] Anonymous v. Moody’s Corporation, et. al., 2018 WL 4139963 (N.Y. App., Aug. 30, 2018).

[8] Guterman v. Costco Wholesale Corporation, 2018 WL 4572257 (S.D.N.Y., Sept. 24, 2018).

[9] Finance Memorandum 18-7, https://www1.nyc.gov/assets/finance/downloads/pdf/fm/2018/fm-18-7.pdf.

[10] Finance Memorandum 18-8, https://www1.nyc.gov/assets/finance/downloads/pdf/fm/2018/fm-18-8.pdf.