NY Tax Minutes: August

By **Timothy Noonan and K. Craig Reilly** (August 31, 2018, 5:46 PM EDT)

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Well, thankfully, Law360 didn't cancel our column after month one, so we're back with the second installment of "NY Tax Minutes." If we can make it here, we'll make it anywhere!

Once again, we're delivering all the month's New York state tax news in a way that's made for New Yorkers. Fast. This month, we cover New York Gov. Andrew Cuomo's brash response to the Internal Revenue Service's proposed end to one of New York's SALT deduction cap workarounds and highlight the New York Tax Appeals Tribunal's recent decision explaining the procedures for claiming sales and use tax refunds after a failure to properly protest an original assessment. We also cover two recent New York state notices addressing the state's treatment of Internal Revenue Code Section 965 repatriation amounts, along with a recent advisory opinion on the proper — or improper — use of sales tax exemption certificates.

The Headlines

New York Urges Taxpayers to Take Advantage of SALT Workarounds Before It's Too Late

On Aug. 23, 2018, the IRS 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.

Since President Donald Trump signed the Tax Cuts and Jobs Act into law in December 2017, states have plotted ways to circumvent the law's SALT deduction cap, including allowing 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 for federal income tax purposes, thereby circumventing the $10,000 cap on SALT deductions. Win-win-win, right? Taxpayers save money, state-sponsored charities receive additional funds and Democratic governors score political points by standing up to Trump's IRS. Well, not so fast.

The IRS' proposed regulations put an end to the states' plans by declaring that if a taxpayer makes a payment or transfers property to or for the use of an entity listed in Section 170(c) of the Internal Revenue Code — which includes contributions to states for exclusively public purposes — and the taxpayer subsequently receives or expects to receive a state or local tax credit in return for that payment, the tax credit constitutes a return benefit, or quid pro quo, to the taxpayer, thereby reducing the taxpayer's available charitable contribution deduction. This negates any federal benefit for taxpayers. The IRS' proposed regulations are set to prevent these types of workarounds for any "contributions after Aug. 27, 2018."

As we said in our intro, life in New York moves fast. And apparently it moves faster than life in D.C., as it appears the IRS forgot about Aug. 24, 25 and 26 — the dates between the initial release of its proposed regulations and the regulations' proposed effective date. What's the big deal? Well, on Aug. 24, Cuomo issued a public alert, not so subtly titled,

“Governor Cuomo Alerts New Yorkers to Deadline to Make Charitable Donations Before Politically Motivated IRS Regulations Take Effect.”[2] No, really Governor, tell us how you really feel!

According to the governor’s alert, the IRS’ proposed regulations are a “politically motivated” attack that seeks “to block reforms that deliver relief to New York taxpayers.” Cuomo goes 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 New York didn’t stop there. Shortly after the governor’s announcement, another temporary alert popped up on the homepage of the New York State Department of Taxation and Finance’s website, informing taxpayers that “[t]he IRS has proposed regulations that would limit the deductibility of contributions to state and local governments.” “These regulations,” the alert continued, “specify that they would apply to contributions made after Aug. 27, 2018. Charitable contributions made by mail are deemed to have been paid on the postmark date.”

The tax department therefore loudly and directly urged taxpayers to mail contributions to one of two accounts — (1) the Health Charitable Account or (2) the Elementary and Secondary Education Account — on or before Aug. 27, 2018, to ensure their full federal deductions.

The timing of the state’s notices are noteworthy for a couple of reasons. First, New York is awfully confident its interpretation of federal law will prevail if the IRS reviews taxpayers’ deductions related to pre-Aug. 27 payments. We’re used to New Yorkers speaking their mind, however, so we’re somewhat OK with New York beating its chest. But is New York right? We spent most of the day on Aug. 27 talking with clients and our accountant friends on the issue, and doing some research of our own. Needless to say, a lot of folks tapped into their inner charitable spirit on Aug. 27. We’ll have to wait to see how the IRS deals with this “effective date” issue.

The other interesting timing issue is this: How is that the governor and tax department can both issue a response to the IRS’ “politically motivated” regulations within a matter of days, but, as we noted in last month’s column, we’re still waiting for any official guidance from the state on how to interpret the U.S. Supreme Court’s decision in South Dakota v. Wayfair Inc. — perhaps the biggest SALT case of the past generation?

The Cases

Each month, we highlight noteworthy cases from New York State’s Division of Tax Appeals and Tax Appeals Tribunal (New York’s appellate-level administrative body). This month, we review the Tax Appeals Tribunal’s ruling on the proper procedures for claiming a refund of sales taxes owed under an assessment that a taxpayer fails to timely protest.

Tax Appeals Tribunal Rules on Sales and Use Tax Refund Claims

In Matter of Pugliese,[3] New York’s three-judge Tax Appeals Tribunal ruled that N.Y. Tax Law Section 1139(c) permits refunds following the issuance of a sales and use tax assessment from which a taxpayer fails to pursue administrative review but that, in order to make use of the available refund procedures, the taxpayer must pay the assessment in full. In other words, full payment of the assessment is required before a refund can be reviewed or granted. Past practice had been a bit different. We often had cases where a taxpayer

made a part payment on an assessment and was able to use that to file for a refund and revive their appeal rights on the issue. No more, says the tribunal.

In the underlying case, the petitioner originally failed to timely protest a sales and use tax notice of determination — the assessment type issued in sales and use tax cases — which covered 18 sales tax quarters. The petitioner then paid the amounts due for one of the 18 quarters and tried to challenge the resulting denial of his refund for that quarter.

The audit division of the New York State Department of Taxation and Finance made two arguments defending its decision to deny the petitioner's refund request. First, the division claimed that because the petitioner failed to timely request a conciliation conference or file a petition with the Division of Tax Appeals challenging his original assessment, the assessment became fixed and final, and the petitioner had no right to any type of refund claim. Spoiler alter, the division was wrong here. Second, the division claimed that, in order to file a valid refund claim, the petitioner was required to pay the full amount assessed, not just a portion of the assessment. OK, maybe the division has a point here.

The tribunal held that while the Legislature amended the tax law in 1996 to remove the prohibition on sales tax refunds following the issuance of a notice of determination and a taxpayer's subsequent failure to timely protest that notice — was the division really arguing for the application of a law that was changed over 20 years ago? — the current version of Tax Law Section 1139(c) did require "a finding that the notice of determination was erroneous, illegal or unconstitutional before a refund of tax, penalty or interest can be made." "Such language," the tribunal noted, "indicates that the entire determination must be reviewed for error and thus recognizes that a refund claim made following the issuance of a notice of determination is, necessarily, a protest of that assessment." Under these circumstances, the tribunal held that taxpayers are entitled to file these types of refund claims but that the entire amount of the assessment must be paid before a refund of any part of the assessment may be granted.

The tribunal then went on to quote from various pieces of legislative history to support its holding, which, in our opinion, was necessary inasmuch as the language of the statute is not as clear as the division would have one think. That being said, the underlying theme of the tribunal's decision remains, "file a timely prepayment petition in the first instance and you won't need to worry." Words of wisdom from your authors.

Other Guidance

New York Publishes New Guidance on Its Treatment of IRC Section 965 Repatriation Amounts

The federal TCJA requires certain U.S. taxpayers to recognize mandatory deemed repatriation income as Subpart F income under IRC 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 IRC Section 957, or a foreign corporation other than a passive foreign investment company, as defined under IRC Section 1297, that is not also a CFC and that has a U.S. shareholder that is a domestic corporation.

In August — which, we note, falls several months after the original New York state filing deadlines for C corporations and pass-through entities — the tax department issued two notices containing instructions for reporting these IRC Section 965 repatriation amounts on

taxpayer's 2017 New York corporation tax returns[4] and 2017 New York S corporation, partnership and fiduciary tax returns.[5] These instructions do not apply to reporting other amounts of Subpart F income, which the state has instructed must instead be reported according to the 2017 forms and instructions previously published.

The notices include line-by-line instructions for each form, along with the general warning that if a taxpayer with IRC Section 965 amounts in its 2017 tax year and has already filed its 2017 New York state tax return, "it must file an amended return using these instructions." Thanks for the heads-up, New York.

Some of the key takeaways from the department's notices, include:

- Taxpayers must use their federal or pro-forma IRC Section 965 transition tax statement when following the instructions in New York's notices.

- When computing their total federal net tax liability under IRC Section 965, corporate taxpayers are required to compute their net income tax — tax less credits — for the tax year using a federal taxable income, or FTI, amount with all IRC Section 965 amounts included. This computation is referred to by the IRS as the "with calculation." The inclusion of IRC Section 965 amounts in FTI changes federal limitations on income, deductions and credits. Corporate taxpayers must use their federal amounts used to compute the "with calculation" when preparing their 2017 New York state tax return.

- Under current New York law, entire net income, minus net investment income and net other exempt income, subject to certain modifications, equals a taxpayer's business income. "Other exempt income" means the sum of exempt controlled foreign corporation, or CFC, income and exempt unitary corporation dividends. According to the notices, New York's definition of "exempt CFC income" includes the IRC Section 965(a) inclusion amount, but taxpayers must add back to FTI interest deductions directly or indirectly attributable to the IRC Section 965(a) inclusion amount or make the 40 percent safe harbor election using the procedures in TSB-M-15(8)C, (7)I, Direct and Indirect Attribution of Interest Deductions for Article 9-A Taxpayers.

- Corporate taxpayers must add back any IRC Section 965(c) deduction used to reduce federal taxable income reported to New York.

- Exempt CFC income is not included in the numerator or denominator of the business apportionment factor.

- Corporate taxpayers must compute a pro-forma IRC Section 965 transition tax statement to show IRC Section 965 amounts computed on a separate basis if the taxpayer is part of a federal consolidated group but files separately in New York.

- The designated agent — Article 9-A — or the parent — Article 33 — of a New York combined group must compute a pro-forma IRC Section 965 transition tax statement to show IRC Section 965 amounts computed as if the New York combined group had filed a consolidated federal return if the New York combined group differs from the designated agent's or parent's federal consolidated group.

- Corporate partners and beneficiaries must include their distributive shares from partnerships and estates and trusts when computing their applicable IRC Section 965 transition tax statement and any related New York state addition or subtraction modifications under Article 9-A or Article 33.

- Flow-through entities must include their distributive shares and pro rata shares of any IRC Section 965 amounts from other flow-through entities when computing their federal IRC Section 965 transition tax statement.

- IRC Section 965 amounts are only considered to be derived from or connected with New York state sources to the extent the stock of a corporation generating the IRC Section 965 amounts was used in a trade or business in New York.

- A copy of the federal IRC Section 965 transition tax statement, along with accompanying worksheets used to compute the IRC Section 965 amounts, must be attached to the 2017 New York state tax return.

The notices go on to provide specific instructions for New York's various entity-level tax returns.

New York Tax Department Issues Advisory Opinion on Improper Use of Exemption Certificates

Like many states, the New York State Department of Taxation and Finance periodically issues advisory opinions, providing guidance to specific taxpayers on specific sets of facts. Although the opinions are binding on the department only with respect to the person or entity to whom the opinion is issued, the advisory opinions can offer other taxpayers helpful advice on what to do in certain situations, or, in the case of the department's recently issued opinion in TSB-A-18(2)S, what not to do as a vendor collecting exemption certificates from customers.

In TSB-A-18(2)S, the issue presented was whether a Form ST-120.1, Contractor Exempt Purchase Certificate, was "accepted in good faith" by a vendor who rented a truck to a contractor. Under New York tax law, certain purchases of tangible personal property, or TPP, by contractors for use in erecting, repairing, adding to or altering structures or buildings owned by tax-exempt organizations are not subject to sales tax when such TPP becomes "an integral component part" of the structures or buildings.[7]

In the facts presented in the advisory opinion, the contractor who rented the truck at issue provided the vendor with an exemption certificate, indicating that the TPP was for use as part of a project for a tax-exempt organization and that such TPP "will become an integral component part of [a] building, structure or real property" of the exempt organization. Generally, vendors who accept exemption certificates — including Forms ST-120.1 — are relieved of liability for the failure to collect sales tax when the exemption certificate is accepted within 90 days of the delivery of the goods sold and when such certificate is accepted in good faith.[8] A certificate is "accepted in good faith" when, upon the exercise of reasonable ordinary due care, a vendor has no knowledge that it is false or fraudulently presented.[9]

In our experience, the "good faith" standard provides broad protections for vendors. But as TSB-A-18(2)S shows us, there's a limit to everything. In the state's advisory opinion, the

vendor had noted in its request for the opinion that the truck was used by its customer to "haul dirt onsite from one of their locations and to haul dirt offsite to one of their dumpsites." Despite this fact, which clearly shows the truck didn't become an integral component of the structure or buildings, and not to mention, we're discussing a rental — which presumably is returned to the vendor at the end of the rental term — the vendor attempted to accept an exemption certificate that indicated the truck was exempt from tax because it become an integral part of the exempt organization's property. The certificate, according to the department, was therefore not accepted in good faith.

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[1] REG-112176-18.

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

[3] Matter of Pugliese, DTA No. 827843, https://www.dta.ny.gov/pdf/decisions/827843.dec.pdf.

[4] Notice N-18-7, https://www.tax.ny.gov/pdf/notices/n18-7.pdf.

[5] Notice N-18-8, https://www.tax.ny.gov/pdf/notices/n18-8.pdf.

[6] https://www.tax.ny.gov/pdf/advisory_opinions/sales/a18-2s.pdf.

[7] See Tax Law §§ 1115(a)(15), (16); 20 NYCRR 541.3(d)(2)(i).

[8] See 20 NYCRR 532.4(b)(2).

[9] See 20 NYCRR 532.4(b)(2)(i).