New York Litigation, Part 2: Recent Headlines From the New York Courts

by Timothy P. Noonan

This is the second installment in a series reviewing recent decisions in New York tax cases of note for practitioners. The first installment focused on decisions of interest coming out of New York's Division of Tax Appeals over the past year or so.[1] In this article, I will look at tax cases coming out of what I call "real court" — that is, not through an administrative agency. As is often the case in tax litigation, given the difficulties faced by the taxpayers, it is usually more interesting when taxpayers are able to beat the government. And that is especially true for cases litigated in the New York courts, where the likelihood of success is low, particularly in cases in which decisions of administrative agencies are reviewed. But far from New York courts being just a rubber stamp, cases over the past year illustrate that judges will look critically at tax cases and will not be afraid to strike down decisions of the agency even when the standards to do so are high. I'll review several of those cases in this installment.[2]

Sales Tax

Matter of United Parcel Serv., Inc. v. Tax Appeals Trib. of the State of N.Y.[3]

This case concerned the taxability of the taxpayer's purchases of shipping supplies and other materials that were provided to its customers free of charge. The taxpayer was seeking entitlement to New York's exemption for promotional materials under Tax Law section 1115(n)(4). Consider the taxpayer's odds here: Not only was it asking to overturn a decision of New York's Tax Appeals Tribunal, whose decisions are allowed to stand unless found to be irrational or arbitrary and capricious, but the taxpayer also was trying to claim entitlement to a tax exemption. And as any state tax practitioner worth his salt knows (pun intended), that's really hard to do, since all ambiguities fall in favor of the government and the taxpayer has to prove its interpretation is the only reasonable one. In this case, the tribunal had rejected the taxpayer's arguments that those items were exempt from sales tax. Yet on appeal, in a split decision, the Appellate Division, Third Department, found that the materials at issue satisfied the ordinary meaning of "promotional materials" because they were designed and distributed for the purpose of promoting UPS's business.[4] In doing so, the court criticized the tribunal's overly narrow reading of the statute (which the department likely argued was exactly how tax exemptions should be construed!), finding that "if the Legislature intended to place the limitations on such exemption imposed by the

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[1]Timothy P. Noonan and Christopher L. Doyle, "New York Tax Litigation, Part 1: From the Administrative Forum," *State Tax Notes*, Apr. 15, 2013, p. 193.

[2]This author's firm represented the taxpayer in one of the cases discussed. The author also represented the taxpayer in another important litigation matter (*Matter of Easylink v. Tribunal*, 101 A.D.2d (2012)), but that matter is still under appeal, so it will not be addressed here.

[3]98 A.D.3d 796 (3d Dept. 2012), *lv denied,* 20 N.Y.3d 860 (2013).

[4]98 A.D.3d at 800.

tribunal here, it could have done so."[5] The lesson here isn't just about the intricacies of the promotional materials' exemption. Instead, the decision should provide hope in the difficult area surrounding tax exemptions — sometimes taxpayer can win.

Matter of EchoStar Satellite Corp. v. Tax Appeals Trib. of the State of N.Y.[6]

The taxpayer in this case faced even longer odds. It lost all the way through the administrative process *and* at the appellate division level. In New York that's usually the end of the line, unless the court of appeals takes the unusual step of granting the appellant leave to appeal. But in this case the court granted leave. How did that happen? The question here involved New York's resale exclusion and whether the taxpayer (a satellite TV provider) had to pay tax on its purchases of equipment (satellite dishes and the like) provided to its customers as part of its TV service. But that's not what caught the court's eye. Instead, the court seemed more interested in the unfairness of the department's position. Namely, the taxpayer had already collected sales taxes on its sales, treating itself as the lessor of the equipment. If the department's arguments were accepted, however, that would mean that the taxpayer should have never collected any tax from its customers in the first place. So forcing the taxpayer to pay tax on those purchases without providing corresponding refunds for the collected taxes "would amount to an unwarranted windfall to the State." Set aside, of course, that the law doesn't permit vendors like the taxpayer in this case to claim a refund of collected taxes unless and until it refunds the tax amounts to its customers. That did not trouble the court. What troubled the court — and what led it to reverse a decision that had been upheld every step of the way — was the obvious inequity of double taxation. Kudos to the court of appeals for making the right call.

American Rock Salt Company LLC v. Commissioner of Taxation and Finance[7] and *Elmer W. Davis, Inc. v. Commissioner of Taxation and Finance*[8]

As localities try to woo companies to their jurisdictions, often economic incentives and tax benefits are promised by industrial development agencies (IDAs) or economic development entities. A troubling development over the past few years has been the Department of Taxation and Finance's second-guessing of those promised benefits. In this case, the taxpayers had been induced to purchase rail cars and trucks by their local IDA, with the promise of sales tax savings on the acquisition. On audit, though, the department took a different approach, and it denied the exemption on the grounds that the cars and trucks weren't part of a "project," and weren't going to be used exclusively in the IDA's jurisdiction. That action was upheld by the tribunal, but the third department again reversed in these two cases, finding that there was no basis for such a distinction so long as the IDA "project" under which the cars and trucks were purchased involved some type of construction or expansion of real property within the IDA's jurisdiction. The court said that this was consistent with the underlying purpose of those IDAs, which is to foster economic development. It's kind of hard to do that when the tax department is trying to reverse on promises made by economic development agencies.

Matter of 677 New Loudon Corp. v. State of N.Y. Tax Appeals Trib.[9]

I couldn't *not* discuss this one. Here, the court of appeals affirmed the third department's ruling that the admission charges and private dance performance fees collected by the taxpayer — an adult "juice bar" — were subject to sales tax. In doing so, the court rejected the taxpayer's argument that the transactions at issue were eligible for the sales tax exemption in Tax Law section 1105(f)(1) for, among other things, admission charges for "dramatic or musical arts performances." Yes, that's right. The taxpayer was arguing that lap dances and the like were nontaxable dramatic or musical arts performances. It's uncertain whether this decision creates any wide-ranging legal ramifications. What is certain is that it gives us tax guys a funny story at cocktail parties.

Personal Income Tax

Matter of John Gaied[10]

The taxpayer in this case was domiciled in New Jersey but owned an apartment in New York where his elderly parents lived. In a 3-2 split decision, the third department confirmed the tribunal's decision that on account of the New York apartment, the taxpayer maintained a "permanent place of abode" in New York — even though he maintained it exclusively for his parents' benefit. The dissenting opinion noted that the taxation of this taxpayer as a resident appeared to be inconsistent with the purposes underlying New York's residency rules. Apparently, the tax department feels the same way, because its own revised audit guidelines apply a less

[5] 98 A.D.3d at 801.
[6] 20 N.Y.3d 286 (2012).
[7] 104 A.D.3d 12 (3d Dept. 2012).
[8] 104 A.D.3d 50 (3d Dept. 2012).
[9] 19 N.Y.3d 1058 (2012), *rearg. denied,* 20 N.Y.3d 1024 (2013).
[10] 101 A.D.3d 1492 (3d Dept. 2012). The author's represents the taxpayer in this case.

stringent test than that applied in *Gaied*, and department personnel have publicly acknowledged that the decision goes farther than even they would go in making residency determinations in audits. But stay tuned. The case is on appeal to the court of appeals.

Caprio v. New York State Dept. of Taxation & Fin.[11]

The focus of the taxpayer's arguments centered on New York's retroactive treatment of the taxpayer's section 453(h) election. The taxpayers in this case were nonresidents who sold their S corporation stock in a deemed asset sale with an IRC section 338(h)(10) election, and also received IRC section 453(h) installment obligations as part of the sale. When the S corporation made a liquidating distribution of the installment obligation to the taxpayers, the taxpayers treated the distribution of the installment obligations as payment for the sale of their S corporation stock and recognized no New York gain on the sale under the well-settled principle that nonresidents generally do not recognize gain on the sale of intangible assets such as stock. On audit, the department retroactively applied a 2010 law change and imposed tax on the New York-source portion of the taxpayers' gain recognized on the installment payments. The taxpayers took the case straight to court, skipping the administrative process along the way. The court, in granting the department's motion for summary judgment, determined that the retroactive application of the 2010 amendments to Tax Law section 632(a)(2) did not violate the taxpayers' due process rights. The court considered several factors in making its determination, including the taxpayers' lack of detrimental reliance on the old law and the court's determination that the amendments did not create an unconstitutional "wholly new tax" that the department was retroactively enforcing. The case is now on appeal to the appellate division and should be watched closely. We also know of several other cases (many involving our firm's clients) in which similar retroactivity questions are percolating. So stay tuned on this one.

Corporate Income Tax

Matter of Meredith Corp. v. Tax Appeals Trib. of the Dept. of Taxation & Fin. of the State of N.Y.[12]

The taxpayer here, an Iowa corporation engaged in publishing and television broadcasting, sought a refund of corporate franchise tax on the grounds that its property factor should include, as the rental of tangible personal property, its payments for television programming airing on the stations it operated out of state. Under that theory, the payments would be included in the denominator — but not in the numerator — of the property factor. The administrative law judge and the tribunal disagreed with the taxpayer and found that the programming was excluded as intangible property because it was delivered via satellite rather than on videotape. But here comes another reversal. On appeal, the third department held that television programming delivered via satellite should have been included in the property factor because that property was no different than programming delivered via videotape and that there was no "rational explanation of the video/satellite distinction that was germane to taxation."[13] The department tried to point to a 2008 policy change in which it announced that video programming was excluded from the property factor, but the court rejected the department's attempt to retroactively buttress its position with this new policy on videotapes, holding that to do so would amount to an impermissible retroactive application of a new interpretation of the statute.

Conclusion

In the past year or so we've seen New York cases on all types of questions, from the taxation of new technologies (satellite-delivered content) to some, well, older ones (exotic dancing). But what should be most interesting to readers can be found in the overall results of those cases: Taxpayers are winning, a lot. What that illustrates, I believe, is that the New York tax appeals system is working. That's easy to say when you've won many cases for your clients (as I have) but not as easy when your clients are on the losing end of the stick (yes, I've been there too). The cases outlined over these two installments show, however, that taxpayers in New York have a full and fair opportunity to receive their day in court and walk away with a successful result. ✰

Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner in the Buffalo and New York offices of Hodgson Russ LLP.

[11] 37 Misc.3d 964 (Sup. Ct., N.Y. County 2012).
[12] 102 A.D.3d 156 (3d Dept. 2012).
[13] 102 A.D.3d at 160.