NY Tax Minutes: November

By **Timothy Noonan and K. Craig Reilly** · November 30, 2018, 2:12 PM EST

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We're back with the fifth 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 welcome Amazon HQ2 (or 1/2?) to New York City and review the Internal Revenue Service's most recent response to the ongoing lawsuit brought by New York and other states over the federal government's state and local tax deduction cap. We also highlight this month's new and noteworthy decisions from the Division of Tax Appeals and cover a recent advisory opinion addressing what constitutes a "permanent place of abode" for purposes of New York's statutory residency test.

The Headlines

New York City Welcomes a New Amazon Office

On Nov. 13, 2018, New York Gov. Andrew Cuomo and New York City Mayor Bill de Blasio jointly announced, "Amazon Selects Long Island City for New Corporate Headquarters."[1] If you're paying attention, you'll notice one small, but important, difference between the governor and mayor's announcement and our headline. The politicians gleefully welcomed a new corporate headquarters. We saw the arrival of a new corporate office.

After getting dozens of cities to offer financial incentives, zoning changes and other inducements to win Amazon's "second headquarters," Amazon, in the end, picked two winners: Northern Virginia and Long Island City, Queens. But this didn't damper the state and city's excitement for the project. According to the governor and mayor, Amazon will make over $3.6 billion in total investment, fill at least 25,000 new high-paying jobs by 2029 and up to 40,000 jobs by 2034, and create countless other peripheral benefits, such as new construction and development projects. Overall, the state and city announced that "the project is estimated to create more than 107,000 total direct and indirect jobs, over $14 billion in new tax revenue for the state and a net of $13.5 billion in city tax revenue over the next 25 years." According to the release, "[t]he project provides a 9:1 return on investment."

In exchange for these benefits, the state and city offered Amazon a package of performance-based incentives totaling approximately $1.705 billion. Included in the package were $1.2 billion in tax credits through the state's Excelsior Jobs Program, the potential for nearly $900 million in New York City Reallocation and Employment Assistance Program credits, approximately $386 million in Industrial & Commercial Abatement Program property tax abatements and a $505 million capital grant. The state and city also each pledged an additional $5 million (with another $5 million to come from Amazon) to create new workforce development programs focused on technology training and recruitment specific to New York City and targeted toward underrepresented segments of the workforce.

We think it's great that Amazon is coming to New York. Everyone loves getting an Amazon package on their doorstep and this one comes with thousands of new jobs and billions of dollars of new investment. Whether New York City, with its talented workforce, global reputation and other major industries, needed to shell out a couple billion dollars of incentives to convince Amazon to open an office in a location it likely was already considering is, however, less clear. Let's just say the case that subsidized economic development results in more net economic activity is slightly weaker in a place like New York City than it might be in, say, Buffalo (we can say that, we live in Buffalo). But New York City was able to entice Amazon to help achieve some of the city’s long-term economic development goals — specifically, redistributing commerce away from Manhattan to the outer boroughs. And that should come as welcome news to New Yorkers.

If, in the end, the project pays out at 9 to 1, that’s a good investment. Not quite as a good as 9 to 0, but good nonetheless. And, for the time being, we’re happy to see more companies and employees heading to the Empire State.

IRS Files Motion to Dismiss SALT Cap Deduction Lawsuit

The ongoing saga over New York’s (and other states’) response to the federal Tax Cuts and Jobs Act’s $10,000 SALT cap continues this month with shots fired by the federal government. On Nov. 2, 2018, the IRS filed a Motion to Dismiss the Complaint in State of New York, et. al. v. Mnuchin.[2]

Filed in the U.S. District Court for the Southern District of New York by Connecticut, Maryland, New York and New Jersey, the states’ lawsuit alleges that the SALT cap overturns more than 150 years of precedent, dating back to the first federal income tax enacted in 1861. And the states claim the law is unconstitutional, violating the 10th Amendment, the 16th Amendment and Article 1, Section 8 of the U.S. Constitution.

In asking the federal district court to dismiss the case, the IRS’ lawyers outline a few different arguments:

First, attorneys told the court that it doesn’t even need to consider whether the SALT deduction cap violates any of the constitutional challenges raised in the states’ complaint because of “threshold jurisdictional issues” barring the lawsuit. According to the feds, the states do not have standing. The states are not the ones being aggrieved by the cap. Instead, the government contends taxpayers are the ones who have standing to bring suit. Any volunteers?!

In a different twist on the issue of standing, based on the Anti-Injunction Act, before even weighing the merits of the states' constitutional claims, the federal government argues that the states cannot pursue injunctive relief to prevent the payment of taxes or use of the SALT cap. As noted above, the feds claim it is the actual individual taxpayer who should sue, not the states on behalf of the taxpayers residing in the states. As an interesting alternative for relief, the federal government urges taxpayers to challenge the SALT cap themselves. Pay your taxes first and then sue for a refund. Seriously, who's coming with us?!

The government also posits that the TCJA made other changes to the Internal Revenue Code that positively affected individual taxpayers' overall liabilities. So it's not like taxpayers are going to be all that aggrieved by a SALT cap, federal lawyers estimate. The U.S. Department of the Treasury argues that the majority of residents would be paying fewer federal taxes given the lowered tax rates and larger standard deductions.
In our view, the states could be picking a fight they can't win — at least one they probably can't win in the federal courts. But again, this lawsuit is just one part of the fight. Workarounds like the charitable deduction play or entity-level taxes continue to pop up in states like New York. And we don't expect New York's politicians to back down any time soon.

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 highlight two recent sales and use determinations, one addressing Apple's back to school promotions and one (somewhat rare) taxpayer win involving an indirect sales tax audit methodology. We also note our firm's ongoing dispute with the Tax Department over the constitutionality of New York's dual resident tax credit provisions.

New York Alleges Underpayment of Tax on Apple's Back to School

Promotions

In Matter of Apple Inc.,[3] an administrative law judge from New York's Division of Tax Appeals found that Apple failed to properly collect and remit sales tax on qualifying device sales made during its 2011 and 2012 back to school promotions.

As part of Apple's promotions, customers who purchased qualifying Apple computers or iPads received gift cards for either $100 or $50, depending on the product purchased. For in-store purchases, Apple computed the tax due based on the price of the qualifying device less the value of the gift card. In other words, if a customer purchased a $1000 computer and received a $100 gift card, tax was collected and remitted on a value of $900. According to Apple, this was done to avoid over-collecting tax, as customers would later be charged and tax would be collected at the time they redeemed their $100 gift card. In New York, sales tax is not imposed on the sale of gift cards; instead tax is imposed when a customer exchanges the gift card for an item subject to tax. Apple, in essence, viewed the transaction as two separate purchases: a discounted computer, subject to tax on the discounted price, and a full-price gift card, not subject to tax.

Based on the terms and conditions of Apple's promotion, however, and on other facts surrounding Apple's sales, the Division of Tax Appeals disagreed. According to the ALJ, the promotion actually required the purchase of a qualifying computer at full price (upon which Apple should have charged and collected full tax) in order to receive a free gift card, which remained exempt. The result, as applied to our hypothetical, being that tax was due on $1000, not $900.

The ALJ based his decision on several facts. First, although the terms and conditions of the back to school promotion did not state that the gift card was "free," supporting advertisements implied the card was being given away without charge. One ad in particular noted, "Congratulations. Your Mac will come with a $100 Back to School Gift Card. We'll add your $100 Back to School Gift Card to your order. You'll see it appear in your cart but you will not be charged for it at checkout."

It also didn't help Apple's case that for the company's online sales during the promotion periods, it collected and remitted tax on the full value of the devices. And although the Division of Tax Appeals acknowledged Apple's concern for double taxation, the court didn't see it that way. According to the ALJ, "double taxation does not occur." Using a similar hypothetical to ours, the ALJ noted that "[i]n the first transaction, the customer is taxed on the amount paid for a computer, which is the full $1,000.00. In the second transaction, where the customer uses the gift card to purchase taxable applications, sales tax is imposed upon the value of the gift card used to consummate the purchase (citing 20 NYCRR 526.5(a)). The gift card is something of value, whether paid for by cash or whether given to the customer for free. As such, it qualifies as a receipt under the Tax Law." "The incidence of taxation," the ALJ concluded, "does not relate back to how petitioner obtained the gift card."

Given our pro-taxpayer leanings, it'd be easy for us to line up in support of Apple but we'd also be lying if we didn't admit this determination was much debated on the Hodgson Russ state and local tax group floor. And no, we don't have anything better to talk about.

Audit Division Applies Flawed Methodology in Case with Inadequate Sales Tax Records

In Matter of Majestic Deli Grocery Inc.,[4] we saw a rare win for a taxpayer in a case involving indirect sales tax audit methodologies.

The background is one we've seen countless times. The taxpayer, in this case a New York City deli and grocery store, was found to have maintained inadequate records for the Audit Division to complete a detailed audit. Specifically, the taxpayer's cash register tapes were not itemized, the taxpayer failed to produce complete purchase records and did not provide a general ledger, purchase journal or cash disbursements journal. (Side note: the division always alleges inadequate records.)

Based on the finding of inadequate records, the auditor decided to determine taxable sales by looking to the Internal Revenue Service's financial ratios contained in the IRS Corporate Financial Ratios guide. Specifically, the auditor computed the taxpayer's gross sales by using the taxpayer's rent expenses multiplied by a rent factor from the Financial Ratios guide.

The Division of Tax Appeals approved of the auditor's approach but in applying the rent factor, the auditor failed to include any nontaxable sales, despite the auditor acknowledging that he was aware the taxpayer sold nontaxable items such as milk, juice, fruit, etc. The division argued that because there is a presumption that all items are subject to tax until the contrary is established and because the taxpayer failed to maintain itemized register tapes specifically detailing what was sold, the taxpayer could not rebut this presumption and its assessment was therefore proper. But the ALJ disagreed. According to the ALJ, the taxpayer did have certain "sales records and it is not obvious that these records could not have formed a basis to estimate some rate of nontaxable ... sales, even if the records were inadequate to support a detailed audit." The ALJ then looked to the Tax Appeals Tribunal's holding in an earlier decision, which noted that "applying the presumption of taxability to all sales where the auditor knew the presumption did not apply is not a method reasonably calculated to reflect the taxes due." Based on this analysis, the ALJ cancelled the assessment in full.

These cases are important since although Section 1138 of New York's tax law allows tax to "be estimated on the basis of external indices" when inadequate records are maintained, the division is still required to select a methodology reasonably calculated to reflect the tax due. And when they don't, the assessment should rightfully be cancelled.

Plaintiffs File First "Wynne" Challenge to New York's Statutory Residency Scheme

In 2016, our firm filed a lawsuit on behalf of Richard Chamberlain and Martha Crum against the New York State Tax Department,[5] alleging that New York's statutory residency scheme improperly subjected the couple to double taxation in violation of the federal commerce clause.

Our suit was primarily based on the constitutional analysis employed by the U.S. Supreme Court's 2015 Wynne v. Maryland decision,[6] where the court struck down a portion of Maryland's resident credit scheme on constitutional grounds. We alleged that, in light of the analysis used by the Supreme Court in the Wynne decision,[7] New York's scheme was unconstitutional. As part of our original submission to the court, we included an expert affidavit from Professor Ruth Mason, the author of one of the influential amicus curiae briefs in the Wynne case and one of the nation's leading authorities on the dormant commerce clause and tax discrimination.

Earlier this month, the state's Appellate Division, Third Department held[8] that New York's scheme was constitutional, despite the U.S. Supreme Court ruling and affirmed a lower court's decision to grant the Tax Department's motion for summary judgment. According to the court, the Wynne decision has not abrogated the New York Court of Appeals prior ruling in Matter of Tamagni v. Tax Appeals Tribunal,[9] in which the court rejected a claim that New York's failure to provide credits for taxes paid to other states on intangible income violates the commerce clause to the U.S. Constitution. The court relied primarily on a First Department case on the same issue, a case that we are also handling.[10]

The taxpayers plan to appeal the Third Department and First Department rulings to New York's Court of Appeals, the highest judicial court in New York, which could mark the second time in the last few years that New York's high court has been presented with an issue concerning New York's tax on “statutory residents.” In 2014, we argued Matter of Gaied,[11] a case before the Court of Appeals, in which the court unanimously reversed a lower court ruling and held that the Tax Department’s interpretation of the “permanent place of abode” requirement of the statutory residency test was irrational and inconsistent with the language and intent of the statute.[12]

Other Guidance

Speaking of the Tax Department’s interpretation of the “permanent place of abode,” or PPA, requirement, earlier this month, the department released a long-awaited advisory opinion[13] addressing whether a taxpayer’s office in Long Island could be deemed to qualify as a PPA within the meaning of Tax Law Sec. 605(b)(1)(B).

In the facts presented in the advisory opinion, the taxpayer and his wife were domiciled in Washington, D.C., but the taxpayer regularly commuted to his office with a New York-based investment management firm. And because the taxpayer was responsible for overseeing international daily trading activity for several investment funds traded on overseas markets, he generally worked during the night to consult with the firm’s traders during European and Asian trading hours. Because of this, the firm allowed the taxpayer to stay overnight in this office but only when the international markets were open. The taxpayer was not permitted to have overnight guests while at his office and per a written agreement, he was required to vacate the office at the end of the trading week.

When he did stay overnight, the taxpayer slept on a Murphy bed in the office, which was approximately 330 square feet and did not include any cooking facilities, bathing facilities or a separate bathroom. The taxpayer did have access to common restrooms and an on-site gymnasium with showering facilities, along with a kitchen area but the kitchen was intended for use by the firm’s kitchen staff and not for employees’ personal use. When the taxpayer was in New York, he therefore ordered meals from local restaurants and didn’t use the cooking facilities in the building. Finally, the taxpayer did not make any payments to the firm for the sleeping arrangement.

According to the advisory opinion, the taxpayer's arrangement did not rise to the level of "maintaining a permanent place of abode" for purposes of New York's statutory residence test. Importantly, the opinion concluded that the taxpayer was not provided unfettered access to the dwelling. Instead, the Tax Department found that the taxpayer's use of the office space was restricted to work nights when overseas markets were open and the taxpayer was prohibited from staying overnight on nights other than those specifically allowed.

In addition to the lack of unfettered access (we question whether "unfettered access" is really the right question in the wake of the Court of Appeals' requirement that taxpayers maintain a "residential interest" in order for a dwelling to qualify as a PPA — see Matter of Gaied[14] — the advisory opinion also notes that the taxpayer's arrangement demonstrated a lack of other necessary characteristics for the dwelling to be considered a PPA. Those factors included: a lack of bathing or kitchen facilities in the office as ordinarily found in a permanent dwelling; the fact that the building was not permitted by zoning laws to be used as a residence; the taxpayer's lack of any financial contribution to the dwelling; the limited personal items kept in the office; and the fact that the taxpayer did not use the office address on any registrations or receive any personal mail at the office. Based on these facts, the Tax Department concluded that the taxpayer's office did not constitute a PPA for purposes of Tax Law section 605 (b)(1)(B).

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Disclosure: Hodgson Russ represented plaintiffs Richard Chamberlain and Martha Crum in Chamberlain v. NY State Department of Taxation and Finance.

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] https://www.governor.ny.gov/news/governor-cuomo-and-mayor-de-blasio-announce-amazon-selects-long-island-city-new-corporate

[2] https://docs.justia.com/cases/federal/district-courts/new-york/nysdce/1:2018cv06427/497533/43

[3] Matter of Apple Inc., DTA No. 827287 (Nov. 1, 2018), https://www.dta.ny.gov/pdf/determinations/827287.det.pdf

[4] Matter of Majestic Deli Grocery Inc., DTA Nos. 827533 and 827534 (Nov. 15, 2018), https://www.dta.ny.gov/pdf/determinations/827533.det.pdf

[5] Chamberlain v. N.Y. State Dep't of Taxation & Fin., 2018 NY Slip Op 07383 (3rd Dept., App. Div.).

[6] Comptroller of the Treasury v. Wynne, 135 S. Ct. 1787 (2015). https://www.supremecourt.gov/opinions/14pdf/13-485_o7jp.pdf

[7] http://www.nysscpa.org/news/publications/the-tax-stringer/stringer-article-for-authors/deconstructing-maryland-v.-wynne-a-big-time-development-in-the-state-tax-area#sthash.E5yxugBT.EyALaE89.dpbs

[8] https://law.justia.com/cases/new-york/appellate-division-third-department/2018/525967.html

[9] Matter of Tamagni v. Tax Appeals Tribunal , 91 N.Y.2d 530 (1998).

[10] Edelman v. New York State Department of Taxation & Fin. , 162 A.D.3d 574 (1st Dept 2018).

[11] Matter of Gaied, 22 N.Y.3d 592 (2014).

[12] We never resist the urge to cite the Gaied case!

[13] https://www.tax.ny.gov/pdf/advisory_opinions/income/a18-3i.pdf

[14] We did it again!