New York Tax Litigation, Part 1: From the Administrative Forum

by Timothy P. Noonan and Christopher L. Doyle

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One of the toughest aspects of practicing in the tax area, particularly in the state and local field, is keeping current not only with legislative and regulatory changes but also with the constant flow of tax cases churned out by administrative and judicial bodies on a regular basis. And even if you have enough time to review the cases, it's another thing to step back and analyze the decisions in a broader context, over a defined period of time. So this month, we thought it time to take a step back and review some of the more notable New York cases that have been issued over the past year or so.

Of course, about half way through the first draft of this article we realized that we couldn't cover everything in one piece. Thus is born a two-part series. In this first article, we will focus on some of the more interesting and important cases that have come out of New York's Division of Tax Appeals over the past year. In our next piece, we'll review several of the important appellate court decisions issued recently by New York courts.

Administrative Law Judge Cases: Sales Tax

American Multi-Cinema (June 21, 2012). The administrative law judge in this case ruled that the delivery of on-screen content via the Internet or other wire-to-wireless transmission rendered royalty payments for showing the movies free from sales tax. That is in contrast to the old school delivery of films for projecting movies, the royalty payments of which were fully taxable. That part of the ruling is entirely consistent with the Department of Taxation and Finance's policies regarding online delivery of digital content. However, the ALJ went on to determine that the royalties for digital on-screen content were also tax exempt if the digital content was delivered through the use of a hard drive that was required to be returned to the distributor of the film. That is certainly a development that could have ramifications elsewhere. According to the ALJ, the temporary transfer of the hard drives housing the digital content served really more like a container, which was unnecessary to the exhibition of the content. Though this decision (like all other ALJ decisions) is not precedential, we have been told by department personnel that it has acquiesced to the ruling and will provide refunds to affected taxpayers.

Forestview Restaurant (June 28, 2012). This sales tax case is yet another in a long line of sales tax method cases involving the use of some form of external indices to determine tax. Often the department wins those cases, and clearly there are several examples of this in the ALJ determinations over the past year. But we're guessing that the majority of our readers are more entertained by taxpayer victories. In *Forestview*, the rejected method involved an observation test of a restaurant that had undergone significant operational changes between the audit period and the time of the observation test. Although the ALJ agreed that the auditors were justified in using an estimated method because the books and records produced by the taxpayer were insufficient for audit purposes (big surprise there, because in almost every single case that reaches ALJs, records are insufficient), the ALJ found that the taxpayer was able to establish that the audit method wasn't reasonably calculated to reflect the amount of tax due because it failed to account for the differences between the former restaurant and the remodeled restaurant. What's funny about this case is that the taxpayer itself had actually asked the department to use an observation audit! Was that an elaborate ploy by the taxpayer to trick the department into using an unreasonable audit method? We'd be shocked if there was such a plan. What's more likely is that although the taxpayers felt an observation test would be appropriate, they probably didn't expect to have the auditors make no accommodations for changes in the restaurant when applying the results of their test.

Empire Holdings LLC (Sept. 6, 2012). We often see taxpayers running into problems in the bulk sales area, and usually the question is regarding successor liability for a purchaser who fails to notify the department before a bulk sale. In this case, however, the question concerned the taxability of the assets transferred as part of a bulk sale involving a New York City hotel, for $78 million. The sales contract specified that all furniture and supplies were to be transferred as part of the sale, and thereafter the parties executed a closing agreement stating that the value of the personal property was de minimis. Funny story, though. Soon after the closing, the personal property that was transferred was appraised for approximately $1 million. The purchaser then donated it to charity and claimed the charitable deduction on his income tax return. So the furniture was worth nothing for sales tax purposes, but $1 million for income tax purposes? Obviously the ALJ did not like that result, and determined that additional sales tax was due. However, tax was due on a reduced amount owing to allowed depreciation.

GlobalSpec, Inc. (May 10, 2012). We've seen several information services cases and rulings over the past couple years, since the department upped its enforcement in that area.[1] This case dealt with the taxability of an electronic newsletter geared to the needs of engineers and other scientific professionals. The analysis in the case involved the basic bread-and-butter tests used in information services cases. The taxpayer tried to argue that since the newsletters were geared to a small segment of the population, they possibly could fall into the "personal or individual" exclusion under Tax Law section 1105(c)(1). But the ALJ rejected that argument because the service still entailed providing information to a group or segment of potential users. Also, the taxpayer attempted to argue that the service was something like a consulting service, but that was also rejected because the information presented in the newsletter was not issued in response to a particular problem or question raised by a subscriber. Nothing more really to see here, so let's move on.

Exxon Mobil Corp. (May 24, 2012). Here the ALJ was asked to consider whether some environmental testing and monitoring activities constituted taxable real property maintenance or taxable installation of tangible personal property. The parties agreed that the monitoring and testing was not done in connection with environmental cleanup jobs that might qualify as capital improvements under the tax law. So the question was whether the testing/monitoring qualified as taxable real property maintenance under Tax Law section 1105(c)(5). The ALJ determined that since the testing and monitoring services were purchased in conjunction with a "maintenance process intended to restore the property to a condition of fitness, efficiency, readiness or safety," that the testing and monitoring services were taxable as real property maintenance under Tax Law section 1105(c)(5). The ALJ reached that result even though there may have been no actual cleanup activity performed, depending on the results of the initial testing. From where we sit, though, we think there is possibly an argument that the regulations under section 1105(c)(5) go beyond the plain reading of the statute. The Tax Law imposes tax on the services of maintaining, servicing, or repairing real property. The regulations, however, define maintaining, servicing, or repairing real property to cover all activities *that relate to* keeping real property in a condition of fitness, efficiency, and so on. But aren't those two different concepts? It's one thing to impose a tax on maintaining real property. It's another thing to impose tax on services that *relate to* maintaining real property. As a tax-imposition statute (required to be given a narrow construction), the regulation seems like an unwarranted expansion of the law.

ALJ Cases: Personal Income Tax

Cooke (Nov. 15, 2012). Our favorite topic: residency! The battle here was between the taxpayers' Hamptons home and their New York City apartment, a question we often see in our practice. The taxpayers ultimately prevailed in the case, showing by clear and convincing evidence that their domicile was in the Hamptons and not in New York City. There were a couple notable aspects to the case. First, this is a great example of how important it is to present credible witnesses at a hearing in support of a position on a domicile issue. The ALJ observed that "perhaps the most compelling evidence of petitioners' Hamptons domicile was their candid, credible testimony to that effect, in addition to that of their daughter." That is true in all residency cases, and those who litigate cases for the department know it. The taxpayers (who are credible, of course) really have an advantage because of that. What's

[1]Timothy P. Noonan and Mark S. Klein, "Information Services: Taxation by Administrative Fiat in New York," *State Tax Notes*, Oct. 4, 2010, p. 63.

also notable is that it appears the taxpayers' Hamptons domicile was accepted even during periods of time when the taxpayers' daughters were going to school in New York City. Often, the location of the children's school is a determinative factor in domicile cases. But here the taxpayers were able to show that their ties to the Hamptons were so deep that — even in years when they had their children in NYC schools — their Hamptons domicile was maintained. We have a lot of cases now in which we are dealing with Hamptons versus New York City, Connecticut versus New York City, and so forth. This case provides some helpful guidance on how to go about winning that type of case.

Michaels (Apr. 12, 2012). This case involves the infamous accrual rule discussed previously in this column.[2] The taxpayer had sold her Connecticut home a couple of weeks after she moved to New York City. However, she claimed that because the contract of sale was entered into before her move, and because all conditions and contingences had been satisfied before her move, the provisions of the accrual rule required that the gain not be taxable to her as a New York resident. Quite frankly, that is a situation we've often faced on the other end of the spectrum, in which a taxpayer is trying to move *out* of New York before selling a significant asset. We've always advised our clients, based on our experience in many audits, that if all of the events had occurred before the move, the accrual rule will allow the tax department to accrue that gain into New York and tax it even if the closing happens after the move. In fact, since that aspect of the accrual test often arises with taxpayers trying to get out of New York, it's somewhat surprising that the department would even want to litigate this case! Of course, it doesn't consult us before deciding to litigate cases, and despite our best efforts,[3] the department pressed on with their position here and, quite shockingly, prevailed. Instead of following the regulatory guidance involving the accrual rule in similar property transactions, the ALJ relied on a different federal tax theory (the closed transaction doctrine) to hold that the accrual rule could not apply until the date of closing. Penalties were abated, however, since the position taken by the taxpayer was consistent with the interpretation of the accrual rule in the regulations. This decision raised a lot of eyebrows and received coverage in the popular press.[4] The taxpayers planning a move out of New York now seem to have a lot more flexibility.

Gleason (Oct. 25, 2012). It's been awhile since we've seen a stock options case, hasn't it? In this case, the question concerned gain from the exercise of stock options received by the taxpayer in 2006. For years before 2006, the taxation of nonresidents on stock option income was incredibly unsettled as a result of cases like *Stuckless*,[5] *Rawl*,[6] and others. Much of that confusion was theoretically settled in 2006 when, in response to the *Stuckless* litigation, the department enacted new regulations setting forth a "grant-to-vest" multiyear allocation formula for the taxation of stock option income to a nonresident.[7] As far as we can tell, there have been no cases explicitly challenging that method until this one. The ALJ here upheld the method set forth in the new regulations. But one interesting argument concerned retroactivity: The regulations weren't enacted until late 2006. The ALJ rejected the argument that the retroactive enforcement of the regulation was improper, though we wonder whether a different result could be reached if a taxpayer was able to show some sort of actual reliance on the prior rules and regulations.

ALJ Cases: Corporate Franchise Tax

IT USA, Inc. (Dec. 20, 2012). This is another in a long line of combination cases, this one involving a taxpayer that was attempting to file on a combined basis. In order to do that, the rules require the taxpayer to show, among other things, that distortion would occur if the entities filed on a combined basis. Though the ALJ seemed to chastise the taxpayer in the case for not providing any evidence regarding the distortion requirement during the audit, the judge nonetheless found that the evidence produced at hearing was sufficient to demonstrate the existence of distortion because of a centralized cash-management system that existed between the companies; the existence of unreimbursed loans, and the centralization of management and administrative functions between the companies. Overall, the taxpayer and its witnesses did a good job outlining the distortion elements, but the tax department has filed an exception in the case. Without doubt, this is a case

[2]Timothy P. Noonan and Joseph N. Endres, "Watch Out for New York's Accrual Rule," *State Tax Notes*, Aug. 4, 2008, p. 343.

[3]Our firm represented the taxpayer in this case.

[4]*See, e.g.*, Ashley Eberling, "A $1.16 Million Downsizing Mistake — New York Tax Collectors Get Really Greedy," *Forbes* (Apr. 27, 2012).

[5]*Matter of Stuckless*, Tax Appeals Tribunal, Aug. 17, 2006.

[6]Division of Tax Appeals, Dec. 10, 1998.

[7]20 NYCRR 132.24.

that should be watched closely. The department is aggressively pursuing de-combination in its audits, and if it loses this case, that might give taxpayers leverage to resolve open audits favorably.

Tax Appeals Tribunal Cases: Personal Income Tax

Siegel (Nov. 21, 2012). In the interest of full disclosure, we represented the taxpayer in this case, and an article 78 appeal is underway. Here, the department issued an assessment to a taxpayer for income resulting from the sale of shares of stock by other parties, under an assignment of income theory. After the hearing, the ALJ upheld the assessment, using an economic substance theory. And on exception, the tribunal appeared to apply a new theory based on the lack of evidentiary support underlying the transfer of shares to the initial parties — a question not raised on audit or at hearing. But we've said too much . . . the case is on appeal, so stay tuned.

Zigerelli (Sept. 20, 2012). The supervising ALJ dismissed the petition filed in this case *sua sponte* on the grounds that it was late-filed, and the taxpayer appealed. However, on exception, the tribunal found it was unclear from the records whether the statutory notice at issue, a Bureau of Conciliation and Mediation Services conciliation order, had been sent to the taxpayer's last known address, as is required by Tax Law section 691(b), because the request for conciliation conference and the order bore different addresses. Accordingly, the tribunal remanded the case to the Division of Tax Appeals. This ruling is somewhat emblematic of the tribunal's attempt to ensure that taxpayers be given the benefit of the doubt in mailing and timeliness cases so as to not be denied their day in court on the merits. The *Madoff* case below provides another example.

Linde (May 24, 2012). The tribunal here upheld the ALJ's determination that unlike most partnership flow-through income (like other personal income from a trade or business), which is apportioned based on a three-factor formula, gains from the sale of real estate (and income and deductions from rental real estate) are allocated in their entirety to the location of the real estate. Interesting tidbit: The partners claimed only an apportioned amount of depreciation while they owned the New York property, and claimed that this made the tax unconstitutional under the dormant commerce clause and the privileges and immunities clause. The tribunal permitted the partners (or maybe compelled the division) to true-up the partnership's basis in the real property to reflect the amount of depreciation deductions the partners were permitted to claim for New York purposes, and said that true-up cured any as-applied problem. Regarding facial constitutionality, the tribunal reminded the taxpayers that the statutes were presumed to be constitutional at the administrative level.

Tax Appeals Tribunal Cases: Sales Tax

Dunk & Bright Furniture Co., Inc. (June 28, 2012). There have been a ton of cases on empire zone questions, evidencing how hard the department has been working recently to deny benefits claimed under the program in recent years (and, in many cases, benefits that had been promised by economic development agencies). The question here was whether an empire zone-certified entity was a bona fide new business eligible for benefits. The tribunal found that the business was not formed for a valid business purpose and therefore was not a new business. The question turns on *why* an entity was formed. The statute (Tax Law section 14(j)(4)(B)) provides that the only way a certified business entity will *not* be a "new business" is if it was *both* (1) "*not formed* for a valid business purpose" and (2) "*was formed* solely to gain empire zone benefits."[8] Here, though, the tribunal, perhaps uncomfortable with the double-negatives, rewrote the rule to provide that a "new business" is "one that was created for a valid business purpose *and* was not created solely to acquire Empire Zone benefits."[9] That, of course, is not what the statute says — the tribunal's "and" should be an "or" when you factor in the double negative. It didn't matter in the tribunal's decision since it ultimately ruled that the taxpayer in the case before it failed both of the prongs. But the next taxpayer litigating this question should take note.

Madoff (Apr. 19, 2012). No, not *that* Madoff. This case involved his brother's appeal on a timeliness question. The tribunal reversed and remanded the ALJ's determination, which granted the department's motion for summary determination based on the taxpayer's failure to timely file his petition. The tribunal took issue with two affidavits submitted by the department with its motion. It found that one affiant was "not competent to assert what procedures take place in the Division's Mail Processing Center or what services the United States Postal Service performs for the Mail Processing Center personnel" and that the other "did not clearly represent whether he was employed with the Division on the date the Notice was alleged to have been mailed." Interestingly, however, on remand the petition was ultimately dismissed again,[10] so we can expect the tribunal to have at the timeliness issue a second time.

[8]Emphasis added.
[9]Emphasis added.
[10]Division of Tax Appeals, Jan. 31, 2013.

Tax Appeals Tribunal Cases: Corporate Franchise Tax

Bombardier Mass Transit (June 7, 2012). The tribunal agreed with the ALJ that the taxpayer was entitled to qualified empire zone enterprise (QEZE) credits for real property tax credits (RPTC). The taxpayer had claimed the credits based on a payment in lieu of tax agreement which the department argued was insufficient for RPTC purposes. In rejecting the taxpayer's argument, the tribunal reminded the department that while statutes creating exemptions are to be narrowly construed, "the interpretation may not be so 'narrow and literal as to defeat the settled purpose' of the exemption."[11] Readers interested in this important rule of statutory construction should tune into the next article in this series, because that rule is implicated in a few of the recent New York court decisions in the sales tax area.

Ward Lumber (July 10, 2012). Here, as in *Dunk & Bright*, the question distilled to why the corporate taxpayer was formed. The tribunal observed that the taxpayer had established a valid business purpose for its corporate reorganization, and that it was not done solely to obtain enterprise zone tax benefits. Using the same questionable test it applied in *Dunk & Bright*, as described above, the tribunal held that the taxpayer was eligible for the QEZE credits it had claimed in 2005 through 2007. Accordingly, the tribunal reversed the ALJ's determination and ordered the department to grant the credits sought by the taxpayer on its 2005 through 2007 returns.

Up Next

Our next installment in this two-part series will examine several of the interesting and important court cases in the New York tax area. New York judges have been busy with tax cases over the past year, so there is a great deal to talk about. ✰

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[11]*Citing Matter of Grace v. New York State Tax Commn.*, 37 N.Y.2d 193, 196 (1975).