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EDITORS

Hollis L. Hyans
hhyans@mofo.com

Irwin M. Slomka
islomka@mofo.com

STATE + LOCAL TAX GROUP

NEW YORK

Craig B. Fields cfields@mofo.com
Hollis L. Hyans hhyans@mofo.com
Mitchell A. Newmark mnewmark@mofo.com
Irwin M. Slomka islomka@mofo.com
Philip S. Olsen polsen@mofo.com
Michael A. Pearl mpearl@mofo.com
Rebecca M. Balinskas rbalinskas@mofo.com
Matthew F. Cammarata mcammarata@mofo.com
Eugene J. Gibilaro egibilaro@mofo.com
Nicole L. Johnson njohnson@mofo.com
Kara M. Kraman kkraman@mofo.com

CALIFORNIA

Bernie J. Pistillo bpistillo@mofo.com
William H. Gorrod wgorrod@mofo.com
Maureen E. Linch mlinch@mofo.com

WASHINGTON, D.C.

Philip M. Tatarowicz ptatarowicz@mofo.com

A SECOND APPELLATE COURT UPHOLDS THE CONSTITUTIONALITY OF NEW YORK'S STATUTORY RESIDENCY SCHEME

By Hollis L. Hyans

The New York Appellate Division, Third Department, has upheld the dismissal of a declaratory judgment action brought by out-of-state domiciliaries challenging the constitutionality of New York's system for taxing the income of statutory residents. *Chamberlain v. N.Y.S. Dep't of Taxation & Fin.*, No. 525967, 2018 NY Slip Op. 07383 (3d Dep't, Nov. 1, 2018). The court agreed with a decision by the First Department in *Edelman v. New York State Department of Taxation & Finance*, 162 A.D.3d 574 (1st Dep't, 2018), and found that the U.S. Supreme Court's decision in *Comptroller of the Treasury v. Wynne*, 135 S. Ct. 1787 (2015), does not affect the constitutionality of New York's statutory residency scheme.

Statutory Background. Under New York's personal income tax law, individuals who are domiciled outside New York may be taxed as "statutory residents" of New York if they maintain a permanent place of abode in New York and are present in New York for more than 183 days during a year. Tax Law § 605(b). While New York, like many states, provides a tax credit for income taxes paid by its residents to other states, the credit is only available where the taxes paid to the other state arise from income "derived" from (*i.e.*, earned within) that other state. Tax Law § 620. The credit is generally not available for intangible or investment income, which is usually not treated as having been directly derived from any specific state.

Twenty years ago, the New York Court of Appeals (the State's highest court) upheld a constitutional challenge to New York's statutory residency scheme. *Tamagni v. Tax Appeals Trib.*, 91 N.Y.2d 530 (1998). The plaintiffs in that case, who were domiciled in New Jersey and statutory residents of New York, asserted that the potential for multiple taxation inherent in New York's statutory residency scheme discriminated against interstate commerce in violation of the dormant Commerce Clause. The *Tamagni* court concluded that the dormant Commerce Clause was not applicable to the income taxation of state residents and quoted the U.S. Supreme Court decision in *Goldberg v. Sweet*, 488 U.S. 252, 266 (1989), for the proposition that, even if the dormant Commerce Clause was generally applicable, it would not apply to the plaintiffs because it does not "protect state residents from their own state taxes."

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However, in 2015, the U.S. Supreme Court in *Wynne* explicitly repudiated the statement in *Goldberg* that was relied on in *Tamagni*. In the *Wynne* decision, the U.S. Supreme Court concluded that Maryland's residency credit scheme, which allowed credits against a state-level tax for taxes paid to other states but not against a county-level tax, violated the Commerce Clause's "internal consistency" test, which requires a tax to be structured so that if every state were to impose an identical tax, no multiple taxation would result.

[T]he Appellate Division upheld the determination of the trial court, concluding that *Tamagni* remained the law in New York despite the decision in *Wynne*.

Chamberlain Case. Plaintiffs Richard Chamberlain and Martha Crum, a married couple domiciled in Connecticut, worked in New York City during 2009 through 2011. They filed joint Connecticut resident income tax returns and paid tax on their worldwide income, which included income from their sale of a business entity that did business in New York. They also filed joint New York Nonresident Income Tax Returns, based on wage income earned in New York. Their nonresident returns were audited by the Department of Taxation and Finance, which determined that they were statutory residents who should have filed New York resident income tax returns. The Department assessed tax of over $2.7 million on their intangible income, derived from interest, dividends and capital gains, which was calculated without any credits for the taxes Mr. Chamberlain and Ms. Crum had paid to the State of Connecticut. The couple paid the disputed amount and filed an action in the Supreme Court, Albany County, seeking a declaratory judgment that New York's taxation of statutory residents violates the Commerce Clause. The trial court upheld the statute, found that "*Tamagni* remains controlling law" despite the U.S. Supreme Court decision in *Wynne*, and cited *Tamagni* in concluding that the "double taxation that occurred here 'does not fall on any identifiable interstate market' and 'does not favor intrastate commerce over interstate commerce in a manner violative of the dormant Commerce Clause.'" The plaintiffs appealed directly to the Court of Appeals, which transferred the appeal to the Appellate Division, Third Department, stating that the constitutional question presented was "not substantial."

Appellate Decision. In a single paragraph, the Appellate Division upheld the determination of the trial court, concluding that *Tamagni* remained the law in New York despite the decision in *Wynne*. The court cited and relied on *Edelman*, which distinguished *Wynne* as involving taxpayers who were residents of only one state whose out-of-state business income was at issue, rather than involving intangible investment income as in *Tamagni*, *Chamberlain* and *Edelman*. The court found that "[n]otably, New York provides a credit for income taxes paid by its residents to other states if the income is '"derived therefrom" – i.e., earned in the other [s]tate'" and that therefore New York's residency tax system was not unconstitutional.

ADDITIONAL INSIGHTS

Neither the Third Department in *Chamberlain* nor the First Department in *Edelman* seems to have considered the fact that the *Tamagni* court, in reaching its conclusion, relied heavily on the determination by the U.S. Supreme Court in *Goldberg v. Sweet* that the Constitution does not protect state residents from their own state taxes, a determination expressly overruled in *Wynne*, in which the Supreme Court held that the appropriate test—even when state residents were involved—is the internal consistency test. Neither Appellate Division court applied that test, even though the dissent in *Tamagni* did and would have found New York's statutory residency scheme unconstitutional.

Although the Court of Appeals has already declined to grant a direct appeal in *Chamberlain*, finding the constitutional issue insubstantial, if presented with the issue again on appeal from the decisions of two different appellate divisions in *Edelman and Chamberlain*, perhaps it—or, eventually, the U.S. Supreme Court—will grant review to determine if New York's system passes the internal consistency test.

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APPELLATE COURT HOLDS THAT SETTLEMENT PAYMENT RESULTED IN NEW YORK SOURCE INCOME

By Irwin M. Slomka

The question of when a settlement payment will constitute New York source income to a New York State nonresident can be difficult to answer definitively. A settlement payment received by an individual who was a nonresident member of a limited liability company in New York was held by the Appellate Division to constitute New York source income to the member for New York State personal income tax purposes. *Murphy v. N.Y.S. Tax Appeals Trib.*, No. 524874, 2018 NY Slip Op. 07377 (3d Dep't, Nov. 1, 2018).

Facts. James and Jane Murphy, a married couple, were New Jersey residents. Mr. Murphy was a member of an insurance company operating as a limited liability company that did business in New York. In 1999, he assigned his 18.75% membership interest to his wife, Jane Murphy. That assignment resulted in litigation between Jane Murphy and the LLC, including an action brought by Ms. Murphy seeking, among other things, the value of her membership interest and a distribution of profits from the LLC.

In 2006, the LLC (which, for income tax purposes, had been taxable as a partnership) was dissolved. In 2007, a trial court awarded Ms. Murphy approximately $593,000 for her membership interest and $1,044,000 as a profit distribution, plus interest. The parties settled the litigation, with Ms. Murphy receiving a payment in 2007 of approximately $2.1 million, $593,000 of which the parties agreed constituted capital gain for her membership interest, with the remaining $1,475,000 being unspecified.

On their 2007 New York State Nonresident Income Tax Return, the Murphys did not report any portion of the $593,000 capital gain or the $1,475,000 settlement amount as New York source income. Following an audit, the Department of Taxation and Finance assessed additional personal income tax on a portion of the $1,475,000, which the Murphys had reported as "other income" on their federal return, by applying the LLC's allocation percentage from its New York State Partnership Return to that amount. This litigation followed.

Law. A nonresident individual is taxable on his or her "New York source income," which includes a "distributive share of partnership income, gain, loss and deduction," as well as any income "derived from or connected with . . . a business . . . carried on in this state." Tax Law §§631(a)(1)(A) and 632(b)(1)(B).

ALJ and Tribunal Decisions. The Murphys maintained that the $1,475,000 of "other income" was non-New York source income, claiming that it represented a "return on an intangible asset"—a membership interest in an LLC—and not a distribution of profits from a New York business. They argued that, as an assignee of her husband's membership interest, Ms. Murphy could not participate in the business of the LLC and that her payment was not attributable to property employed in a trade or business carried on in New York, one of the criteria for New York source income under the Tax Law. Both the Administrative Law Judge and the Tribunal held that the $1,475,000 payment, as apportioned by the Department using the LLC's apportionment percentage, constituted New York source income. The Murphys brought an Article 78 action contesting the Tribunal's decision.

The court held, that to determine the taxable status of a settlement payment, it is necessary to consider what the payment is being made in exchange for.

Appellate Division Decision. The Appellate Division confirmed the Tribunal's decision. Applying a deferential standard of review—including special deference because the case "involves specific application of broad statutory language" regarding the term "New York source income"—the court held that the fact that Ms. Murphy was not a member of the LLC "had no bearing on whether the profit distribution to her was taxable" because being an assignee of her husband's interest did entitle her to a share of the LLC's profits. The court noted that "it is undisputed that [the LLC] 'carried on' business" in New York.

The court held that, to determine the taxable status of a settlement payment, it is necessary to consider what the payment is being made in exchange for. Here, since Ms. Murphy brought an action seeking her share of the LLC's profits, it was reasonable to apply that characterization to all but the $593,000 payment that she recovered. The court also rejected the Murphys' claim that a portion of the settlement

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payment represented non-taxable interest on the judgment, noting that it was the taxpayers' burden to prove the portion representing interest, and the court stated that it was unwilling to disturb the Tribunal's finding on that issue as well.

ADDITIONAL INSIGHTS

The court's conclusion that the $1,475,000 was for Ms. Murphy's share of profits from the LLC is not unreasonable, although there is some question as to how someone with no involvement in a business can derive New York source income from that business by receiving a settlement payment. It is also problematic that no portion of the settlement payment was found to represent interest, despite the trial court having awarded interest to Ms. Murphy. It is a reminder that parties to a settlement should carefully document the components of the settlement payment. Finally, it is noteworthy that the court applied a particularly deferential standard of review—which arguably it did not have to apply here—concluding that it must defer to the Tribunal on questions of statutory interpretation if the taxpayer's interpretation is not "the 'only logical construction'" of the statute, a standard that has usually been applied to statutory *exemption* provisions, which were not in issue in this case.

FIRST DEPARTMENT AFFIRMS DISMISSAL OF ACTION SEEKING RELIEF IN THE ABSENCE OF DEPARTMENT ACTION

By Hollis L. Hyans

The Appellate Division, First Department, has affirmed the decision of the Supreme Court, New York County, and unconditionally dismissed an action brought by a taxpayer to challenge results anticipated to arise from an audit, finding that the cases were not ripe for review by the court. *SunGard Capital Corp. v. N.Y.S. Dep't of Taxation & Fin.*, Nos. 155042/15, 7558, 155041/15, 7557, 2018 NY Slip Op. 07539 (1st Dep't, Nov. 8, 2018).

Background. SunGard Capital Corp. initially brought an action in 2015 against the New York State Department of Taxation and Finance, as well as a companion action against the New York City Department of Finance ("DOF"), asking for a declaratory judgment that a gain it incurred on the sale of two subsidiaries in 2012 should be excluded from its New York State entire net income, consistent with the method it used on its returns as filed. SunGard alleged that it expected the Department and the DOF to argue, pursuant to the decision in *Matter of Bausch & Lomb, Inc.*, DTA No. 819883 (N.Y.S. Tax App. Trib., Dec. 20, 2007), and the Department's subsequent guidance in a *Technical Memorandum*, "Treatment of the Sale of Subsidiary Stock when a Subsidiary Is Included in a Combined Report," TSB-M-08(3)C (N.Y.S. Dep't of Taxation & Fin., Mar. 10, 2008), that the gain should have been included in SunGard's 2012 entire net income. SunGard contended that the gain should either be excluded under Tax Law former § 211(4)(b)(2) and Admin. Code § 11-605(4)(b)(2) as gain from the sale of a subsidiary, even if the subsidiary had been a member of a combined tax return; and second, in the alternative, that, if the gain is not excluded, it should be characterized as investment income rather than as business income.

The Appellate Court . . . found that because the Department and the DOF had not yet completed their audits of SunGard and no tax had been assessed, the actions were not ripe and should have been dismissed.

In *Bausch & Lomb*, the New York State Tax Appeals Tribunal agreed with the taxpayer and held that a loss from the sale of a subsidiary that had been included in the taxpayer's New York combined return was not attributable to subsidiary capital and therefore was includable in the computation of entire net income. The Department then issued TSB-M-08(3)C, setting out its position that the holding in *Bausch & Lomb* also applied to gains from the sale of stock of a corporation included in a combined return. No reported decisions have yet considered the issue in the context of a gain.

Prior decisions. In August 2015, the Department and the DOF moved to dismiss SunGard's complaint on the ground that the court lacked jurisdiction, since no audit had yet been completed and no tax had yet been determined, and therefore there was no "justiciable controversy" for the court to resolve. The Department also argued that, even if additional tax were to be assessed under the theories outlined in SunGard's complaint, SunGard would be required to exhaust its administrative remedies through the Division of Tax Appeals before it could bring an action in court. The Department also maintained that it needed to

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conduct an audit and that it was not yet even clear that SunGard had properly filed a combined return or that its calculation of tax was correctly based on entire net income rather than on one of the alternate bases that would apply if it resulted in a higher tax. In response, SunGard contended that the Department's position was already determined, that there were no facts in issue, and that it was facing a "direct and immediate" "threat of harm" entitling it to declaratory relief.

In May 2016, the trial court issued a short decision dismissing SunGard's action, but it did so on the condition that the Department "review the relevant tax return and issue a final determination within 120 days." The action against the DOF was similarly dismissed on the same condition.

In September 2016, the Department moved to renew its original motion to dismiss for lack of jurisdiction, and also moved to reargue, asking the court to modify its original order to delete the requirement that it complete the audit and issue its determination within the 120-day period, claiming that the audit was delayed due to a lack of cooperation by the taxpayer and that, in any case, the court had lacked authority to issue a conditional order in the first place because it had lacked jurisdiction. SunGard responded, asking for the action to move forward since the Department had not issued a notice within the 120-day deadline; denied it had delayed the audit; and contended that all necessary information had been supplied to the auditor, pointing out, in particular, that the question of the correct composition of its combined return had been finally resolved by the decision in *Matter of SunGard Capital Corp., et al.*, DTA No. 823631 et al. (N.Y.S. Tax App. Trib., May 19, 2015), in which the SunGard group had been allowed to file combined returns including most of its related entities. SunGard also claimed that it had no administrative remedies to exhaust, since no notice had been issued, and that it was raising strict questions of law as well as a constitutional challenge. The trial court dismissed the action for lack of subject matter jurisdiction and directed SunGard to exhaust administrative remedies before returning to seek any judicial review.

Appellate Division Decision. The Appellate Court sustained the dismissal of SunGard's action. It found that, because the Department and the DOF had not yet completed their audits of SunGard and no tax had been assessed, the actions were not ripe and should have been dismissed for that reason. It also found that SunGard did not "face any direct or imminent harm" from either defendant. Finally, the court also found that SunGard admitted it had not exhausted administrative remedies and that it did not fall within any exception, including an exception for constitutional challenges, because the complaint raised no issue of unconstitutionality. The court also declined to reach the merits of SunGard's action, finding that only the defendants—the Department and the DOF—had made motions for relief and that SunGard did not cross-move or otherwise seek any affirmative relief.

Additional Insights. It is very difficult to challenge a deficiency determination by the Department or the DOF that has not yet been made, even when a taxpayer has a reasonable expectation of the position that the taxing agency is likely to take, whether based on previous audits or published guidance. In general, taxpayers must proceed through an audit, receive an assessment, and then challenge the assessment in an administrative hearing before bringing an action in court, unless one of the recognized exceptions to that requirement is met, such as a claim that a statute is unconstitutional or that the statute simply does not apply to it. Here, the burden was particularly difficult, since there was no assessment to challenge. As frustrating as it may sometimes be, taxpayers seem to have little recourse to contest what is only an expected assessment.

INSIGHTS IN BRIEF

APPELLATE COURT UPHOLDS DENIAL OF QEZE CREDITS FOR FAILURE TO ESTABLISH INCREASE IN EMPLOYMENT

The Appellate Division, Third Department, has upheld the denial of Qualified Empire Zone Enterprise property tax credits because the taxpayers did not meet their burden of proving that certain employees qualified for the credit calculation. *Spiezio v. Comm'r of Taxation & Fin.*, No. 524018 (3d Dep't, Oct. 25, 2018). In order to claim the credit, the taxpayer must satisfy an employment increase factor, and, when calculating the number of employees for that factor, the taxpayer may not include individuals employed in New York by a related person within the immediately preceding 60 months. The court found that the taxpayers' proof that the employees in question were concurrently employed using a common paymaster—which, in certain circumstances, allows the employees to be counted in the factor—was inadequate to meet their burden of proof. It found that the affidavits introduced into evidence by the taxpayers were inadequate without contemporaneous supporting documentation, as were employee payroll records and an employee lease agreement for prior years.

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TAX APPEALS TRIBUNAL AFFIRMS DECISION DENYING RELIEF ON COLLATERAL ESTOPPEL GROUNDS

Concluding that the same issues had been raised and addressed in a prior proceeding, the Tax Appeals Tribunal has affirmed an ALJ's finding that the petitioner was a responsible person for a company's unpaid sales taxes. *Matter of Michael Silverstein*, DTA No. 826952 (N.Y.S. Tax App. Trib., Oct. 23, 2018). In the prior proceeding, the Tribunal had decided that the petitioner was a responsible person based on his guilty plea admitting that he was an officer and responsible person, as well as documentary evidence demonstrating he was an officer and signatory to a banking agreement on behalf of the company. In this new proceeding, the Tribunal held that the ALJ had properly granted summary judgment to the Department, that the petitioner had been provided with a full and fair opportunity to be heard, and therefore that the petitioner was barred by the doctrine of collateral estoppel from relitigating the issue of his responsibility.

ON REMAND, ALJ UPHOLDS RETROACTIVE APPLICATION OF QEZE STATUTORY CHANGE

An ALJ has upheld the retroactive application of statutory amendments that restricted the availability of QEZE tax credits after the issue was remanded by the Tax Appeals Tribunal because the ALJ had initially found that application of a statute enacted in April 2009 to the beginning of the 2009 year did not involve retroactive application. *Matter of NRG Energy, Inc.*, DTA No. 826921 (N.Y.S. Div. of Tax App., Nov. 8, 2018). NRG Energy, Inc. relied on the holding by the New York Court of Appeals that retroactive application of the 2009 QEZE amendments to the year beginning January 1, 2008, violated the Due Process Clause and was unconstitutional, *James Square Assocs. LP. v. Mullen*, 21 N.Y.3d 233 (2013), and the Tribunal agreed that applying the amendments back to January 2009 was indeed a retroactive application. However, on remand, the ALJ concluded that, despite the absence of a public purpose for the amendments, due to the extremely short period of retroactivity, the application of the 2009 amendments back to January 2009 did not violate NRG's due process rights.

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