Volume 2, Issue 4

April 2011

MoFo New York Tax Insights

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Tribunal Holds That Television Broadcaster Cannot Include Film in its Property Factor

By Hollis L. Hyans

Upholding a policy first announced by the Department of Taxation and Finance in 2008, the New York State Tax Appeals Tribunal has affirmed the decision of an Administrative Law Judge that film cannot be included in the property factor, reversing years of contrary treatment in New York. *Matter of Meredith Corporation*, DTA No. 822396 (N.Y.S. Tax App. Trib., Mar. 10, 2011).

The dispute concerned the petitioner's television broadcasting business, operated out of its headquarters in Des Moines, Iowa, during the tax years ended June 30, 1998, June 30, 1999, and June 30, 2000. During the course of an audit, the petitioner sought to include in its property factor payments it made to secure television programming from various third parties. The petitioner was initially advised by auditors from the Department that programming delivered on videocassette was properly included in the property factor calculation, but not programming delivered by satellite transmission. The petitioner then filed refund claims for each year, premised on including in its property factor all payments for programming. Virtually all of petitioner's programming was delivered by satellite transmission, although the agreements also provided for the delivery of a hard

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copy, which was generally employed as a backup arrangement. Because all of petitioner's television stations were located outside of New York, the payments were included in the denominator but not in the numerator of the property factor, thereby decreasing the allocation of income to New York.

At the hearing, petitioner introduced the testimony of two witnesses who testified that satellite signals are tangible and "'very real'" and that satellite transmission was "'something physical.'" The petitioner argued that the combination of satellite transmission and backup tapes constitutes personal property under Tax Law § 208(11).

The petitioner also relied on a letter issued by the Department's Office of Counsel on July 2, 1991, confirming another taxpayer's position that the payments made for film were included in the property factor by multiplying the amount paid by the New York State viewing audience divided by the total viewing audience. The advice given in the 1991 letter was in accordance with TSB-M-83(20)C (N.Y.S. Dep't of Taxation & Fin.), "Valuation of Films Produced by Broadcasters for Television Exhibition in Computing the Property Factor of the Business Allocation Percentage," a policy statement that held that, for corporations engaged in the business of broadcasting television programs, the value of a film attributable to New York State was determined by multiplying the average fair market value of the film by the New York State viewing audience ratio. In 2008, the Division issued TSB-M-08(6)C, "Computation of the MTA Surcharge for Corporations Engaged in the Business of Broadcasting" (N.Y.S. Dep't of Taxation & Fin. June 4, 2008), which, for purposes of the MCTD allocation percentage, announced that the value of a program received in hard copy "may not be included in the property factor…since it is not considered to be tangible personal property. This new position applies to taxable years beginning on or after January 1, 2008." The 2008 TSB-M also noted that programs obtained in electronic form "have always been considered an intangible right or license" and cannot be included in the MCTD property factor.

THE TRIBUNAL HELD THAT WHAT THE PETITIONER WAS ACQUIRING WAS THE RIGHT TO BROADCAST A PROGRAM, WHICH IS EQUIVALENT TO A COPYRIGHT AND CONSTITUTES AN INTANGIBLE ASSET, WHICH CANNOT BE INCLUDED IN THE PROPERTY FACTOR.

The Tribunal held that what the petitioner was acquiring was the right to broadcast a program, which is equivalent to a copyright and constitutes an intangible asset, which cannot be included in the property factor. The Tribunal, as had the ALJ, relied heavily on the decision in *Matter of Disney Enterprises*, DTA No. 818378 (N.Y.S. Tax App. Trib., Oct. 13, 2005), *confirmed*, 40 A.D.3d 49 (3d Dep't 2007), *aff'd on other grounds*, 10 N.Y.3d 392 (2008), concluding that the rights acquired by the petitioner were similar to those at issue in *Disney*, which concerned how Disney was permitted to value the films it acquired in order to reproduce them for sale in the consumer market. The Tribunal in *Meredith* found that the copyrights derived from the ownership of film negatives in *Disney* are "analogous to broadcast rights from licensing agreements," and that it was "of no moment" that in *Disney* the challenge was to a fair market valuation. The Tribunal in *Meredith* also rejected the arguments raised by The Motion Picture Association of America in an amicus curiae brief, stating that it rejected the "arguments based upon the definition of film because this matter does not concern film, but rather the licensing of broadcast rights."

Additional Insights. This decision in effect reverses New York's long-standing practice of generally treating film as tangible personal property and including it in the property factor. *See, e.g., Matter of MCA, Inc.*, TSB-H-78(7)C (May 3, 1978), in which the State Tax Commission treated film as tangible personal property for purposes of the New York investment tax credit; TSB-M-81(19)C (N.Y.S. Dept of Taxation & Fin. Nov. 20, 1981), which stated that "motion picture films" are property for purposes of computing the property factor of the New York business allocation percentage. The decision is also contrary to the position taken by California, another state with a large number of taxpayers in the television and film business, which provides by regulation that "[a] 'film' is deemed to be tangible personal property" and is included in the property factor, with various special provisions regarding valuation, timing, etc. Cal. Code Regs. tit. 18, § 25137-8(a)(4). However, due to New York's shift to a single sales factor, fully effective as of 2007, the long-term effect of this change should not be significant.

The Tribunal's reliance on *Disney* is curious. In both the ALJ and Tribunal decisions in *Disney*, the issue appears not to be whether the film is included in the factor at all, but rather whether it would be valued on a cost basis or on a fair market value basis. The Tribunal in *Disney*, in affirming the ALJ, described the ALJ's decision as rejecting the argument that "the film masters should be included in the property factor at their fair market value instead of at a value equal to their original cost," but neither the ALJ decision nor the affirmance by the Tribunal appears to require that the film be entirely excluded from the factor. The Tribunal in

Meredith also states that it rejected the *amicus* arguments made by The Motion Picture Association of America because the matter does not concern film, but rather the licensing of broadcast rights, but the *Disney* decision, on which the Tribunal relies so heavily, also concerned film negatives, which the Tribunal found "analogous" to broadcast rights.

Department Limits Application of Article 9-A Separate Accounting Election

By Irwin M. Slomka

In an Advisory Opinion with important implications, the Department of Taxation and Finance has ruled that the foreign corporate limited partner election under Article 9-A is not available to a corporation holding a general partnership interest in a partnership that was not itself conducting business in New York State, but which received income from another partnership that did. *Advisory Opinion*, TSB-A-11(5)(C) (N.Y.S. Dept. of Taxation & Fin., Feb. 24, 2011).

The taxpayer is a corporation ("Taxpayer") that holds an 85% general partner interest in a limited partnership ("LTD"), which in turn holds a 6% membership interest in a limited liability company ("Channel LLC"). Channel LLC operates a cable television channel in New York City. It is classified as a partnership for both federal and New York tax purposes. LTD licenses a trademark from a related entity and sublicenses it to Channel LLC in exchange for trademark revenues. All of LTD's activities are conducted in Utah.

Taxpayer's only activity is to hold a general partner interest in LTD. Taxpayer files Article 9-A returns in which it reports its distributive share of the pass-through of income, gains, losses, and deductions generated by Channel LLC, and passed through by LTD, in which Taxpayer is an 85% general partner.

At issue was the treatment of Taxpayer's distributive share of a gain generated by LTD's sale in 2005 of a portion of its membership interest in Channel LLC. In its Article 9-A return, Taxpayer claimed the foreign corporate limited partner election, currently 20 NYCRR 3-13.5, and excluded its distributive share of LTD's gain (although it did include its distributive share of the flow-through of Channel LLC's income, gain, loss, and deductions). Under this election, in effect since 1990, 20 NYCRR 3-13.5(a)(1) where a non-New York corporation is subject to Article 9-A solely because it holds a limited partnership interest in a partnership that conducts business in New York State, it may "elect to compute its tax bases by taking into account only its distributive share of each partnership item of receipts, income, gain, loss and deduction" of that partnership. This irrevocable "separate accounting" election must be made on the original tax return for the tax year. The election is available unless the limited partnership and the corporate group in which the corporate partner is a member are engaged in a unitary business and there are substantial intercompany transactions with the limited partnership.

THE DEPARTMENT... RULED THAT THE FOREIGN CORPORATE LIMITED PARTNER ELECTION UNDER ARTICLE 9-A IS NOT AVAILABLE TO A CORPORATION HOLDING A GENERAL PARTNERSHIP INTEREST IN A PARTNERSHIP THAT WAS NOT ITSELF CONDUCTING BUSINESS IN NEW YORK STATE.

The regulation providing the election was adopted the same year the Department issued its "corporate limited partner" nexus regulations (20 NYCRR 1-3.2), which resulted in most non-New York corporate limited partners in New York partnerships being subject to Article 9-A. The election was an attempt to soften the impact of the nexus regulation upon non-New York corporate limited partners by limiting taxability to the corporate partner's distributive share of income from the limited partnership doing business in New York. Since the results of the normal apportionment rules are often unpredictable, and were viewed by many as discouraging corporations from investing in New York partnership businesses, the election was the Department's attempt to address that concern by permitting separate accounting in limited circumstances.

The Taxpayer in the Advisory Opinion appears to have argued that it was entitled to make the election because of the "aggregate theory" of taxation of corporate partners under 20 NYCRR 1-3.2(a)(6), adopted in 2007, which attributes the income and activities of a partnership to its corporate partners. Under such argument, since LTD's income and activities are attributed to the Taxpayer under the aggregate theory, the foreign corporate limited partner election should also be available to the Taxpayer under that same theory. Assuming that LTD's membership interest in Channel LLC was itself a limited partnership interest, since LTD's activities were aggregated with the Taxpayer's, the election that would be available to LTD if it were subject to Article 9-A should be available to the Taxpayer.

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Department Limits Separate Accounting Election

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The Department ruled, however, that the foreign corporate limited partner election was not available to the Taxpayer, because the corporation was not taxable "solely" by reason of its ownership of a limited partnership interest under the regulations. According to the Department, since its *general* partnership interest in LTD is what subjected the Taxpayer to Article 9-A, the election was inapplicable. As for the Taxpayer's position under the aggregate theory — which was not part of the regulations in 2005 — the Department concluded the opposite, that "the aggregate theory demonstrates that Petitioner does not qualify" for the election, because under that theory LTD was considered to be doing business in New York as a result of Channel LLC's New York activities. Channel LLC's activities were thus considered the activities of the Taxpayer as a general partner in LTD.

Additional Insights. The Advisory Opinion addresses the application of the foreign corporate limited partner election in a tiered partnership ownership structure, an issue not directly addressed by the regulations. While the Advisory Opinion is correct that a corporate general partner in a New York partnership does not qualify under the regulations for the election, it is questionable why a corporate general partner would not qualify if the partnership itself is considered to be doing business here only because it holds a limited partnership interest in another partnership that does. Unfortunately, the Advisory Opinion does not indicate whether LTD's membership interest in Channel LLC was considered a limited partnership interest. If it was, then notwithstanding the Taxpayer's general partnership interest in LTD, the Taxpayer's connection with New York State was because of LTD's limited partnership interest in a New York cable television business, not because of the Taxpayer's general partnership interest. Indeed, since LTD itself did business only in Utah, the Taxpayer would not have been subject to Article 9-A if not for LTD's limited partnership interest in Channel LLC.

Although the Advisory Opinion does not fully explain the Taxpayer's position regarding the aggregate theory, it appears to have been based on the seemingly reasonable argument that since the aggregate theory caused LTD's activities to be considered the activities of the Taxpayer, then the nature of LTD's interest in Channel LLC should determine the availability of the foreign corporate limited partner election to the taxpayer. If the interest is a limited partnership interest, the Taxpayer had a reasonable basis for claiming the election.

Tribunal Grants State's Motion to Reargue Residency Case

By Irwin M. Slomka

Although decisions of the Tax Appeals Tribunal cannot be appealed by the Department, the Tribunal's rules of practice do permit either party, within four months of a Tribunal decision, to file a motion to reargue. Motions to reargue a Tribunal decision are rare, and the Tribunal's granting of such motions even rarer. Therefore, it is noteworthy that the Tribunal has recently granted the Department's motion for reargument in *Matter of John Gaied* (Order and Opinion) DTA No. 821727 (N.Y.S. Tax App. Trib., Feb. 24, 2011), a decision involving the "permanent place of abode" definition for statutory residency.

On July 8, 2010, the Tribunal issued a decision in *Gaied,* reversing an Administrative Law Judge determination, which held that a New Jersey domiciliary who owned a second home in Staten Island, New York did not maintain a permanent place of abode there for purposes of the statutory residency test. The Staten Island home was divided into two apartments. The taxpayer leased out one apartment; the other was occupied by his parents. The taxpayer worked near the Staten Island home, would occasionally stay overnight at the apartment where his parents lived, and filed his tax returns as the head of the household listing his parents as his dependents. The Department took the position that the home was the taxpayer's permanent place of abode, and that he was a statutory resident of New York City. The ALJ agreed.

On appeal, the Tribunal reversed the ALJ's decision, and held that the Staten Island home was not the taxpayer's permanent place of abode because it was occupied by his parents, he did not maintain living quarters at the apartment, including a bedroom or a bed, and did not have any personal effects there. *Matter of John Gaied*, DTA No. 821727 (N.Y.S. Tax App. Trib., July 8, 2010). In reaching its decision, the Tribunal concluded that "the physical attributes of an abode, as well as its use by a taxpayer, are determining factors in defining whether [an abode] is permanent."

Within the four-month period permitted under the Division of Tax Appeals rules, the Department filed a motion to reargue the case, principally on the basis that the Tribunal misapplied legal principles. In particular, the Department cited to the Tribunal's decision in *Matter of Robert and Judith Roth*, DTA No. 802212, (N.Y.S. Tax App. Trib., Mar. 2, 1989), which held that in order for an abode to be considered a

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Tribunal Grants State's Motion to Reargue Residency Case

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permanent place of abode, "[t]here is no requirement that the petitioner actually dwell in the abode, but simply that he maintain it." The Department argued that the Tribunal's decision in *Gaied* could not be reconciled with its decision in *Roth*, and with other decisions of the Tribunal, and it urged that if the Tribunal was now departing from *Roth*, it should clarify the change and its reasons for doing so. The Department also argued that the Tribunal misapprehended certain facts.

The Tribunal granted the Department's motion to reargue. The Tribunal first discussed the standard for motions to reargue, permitted under the Tribunal's rule 20 NYCRR 3000.16(c), which gives discretion to the Tribunal to allow a party to demonstrate that the Tribunal "'overlooked or misapprehended the relevant facts, or misapplied any controlling principle of law.'" (Citation omitted). The Tribunal concluded here that the Department had met this standard, noting "the unique issues of fact within this case, as well as the need for clarity in the terms defining statutory residency." The case will presumably now be set for reargument.

Additional Insights. As noted above, it is highly unusual for the Tribunal to grant motions to reargue, particularly where, as here, the same Commissioners who decided the case are the ones who have now granted the Department's motion. It is even more surprising here inasmuch as the Tribunal had reversed the ALJ decision, and clarified or recast several of the unusual facts in the case. Given the Tribunal's willingness to hear the Department's reargument, it would not be surprising to see significant changes to the outcome of the case, or at least to the Tribunal's analysis. As a possible point of reference, in *Matter of E. Randall Stuckless*, DTA No. 819319 (N.Y.S. Tax App. Trib., Aug. 17, 2006), after granting the Department's motion to reargue, the Tribunal concluded that the Tribunal's earlier decision was in error and withdrew it, replacing it with a new decision.

THE DEPARTMENT ARGUED THAT THE TRIBUNAL'S *DECISION* IN *GAIED* COULD NOT BE RECONCILED WITH ITS DECISION IN *ROTH*

The new decision, applying a different legal analysis, still held for the taxpayer. If the Tribunal concludes here that the taxpayer proved that he did not have meaningful access to the apartment occupied by his parents, however, it is difficult to see how the Tribunal will reach a different result.

It should be noted that while taxpayers also have the ability to file a motion to reargue, a motion does not stay the timeliness requirements for filing an Article 78 appeal. In addition, the Tribunal cannot grant a motion to reargue once an Article 78 appeal has been filed.

Estimated Sales Tax Assessment Annulled as Lacking a Rational Basis

By Hollis L. Hyans

In a proceeding brought by a taxpayer to challenge an assessment of sales and use tax, an Administrative Law Judge has ruled that the assessment must be completely annulled, since it lacked a rational basis. *Matter of Primo Coffee, Inc.*, DTA No. 823096 (N.Y.S. Div. of Tax App., Mar. 3, 2011).

The petitioner operated three retail food locations within Penn Station, two at fixed locations and one mobile food cart stationed in the middle of a concourse. They all sold muffins, bagels, and coffee and other beverages; two added sandwiches and salads, and one also sold wine and beer. Petitioner paid rent to Amtrak for the three locations, consisting of a fixed annual base rent and additional rent amounts for each location when annual gross sales exceeded a prearranged threshold amount, referred to as the "breakpoint." The breakpoint amounts were either 12.5 times or 20 times greater than the base rents: for example, for the period 10/1/06 through 9/30/07, the annual base rent for one of the fixed locations was $100,000, and its breakpoint was $2 million. Only one of the locations had sales in excess of its breakpoint figure during the audit period, and it was the only one required to pay excess rent. The setting of breakpoints was not based upon expected sales in particular locations, but rather was based upon a mathematical formula tied to the base rent, and the higher the base rent, the higher the breakpoint. Amtrak's preference was to receive high guaranteed

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Estimated Sales Tax Assessment Annulled as Lacking a Rational Basis

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annual base rent rather than relying on the contingent breakpoint methodology.

The Department conducted an audit of the petitioner's operation. While many records were provided (cancelled checks, federal income tax returns, general ledger, general journal, chart of accounts, etc.), there were no detailed cash register tapes or other source documentation to allow verification of petitioner's sales. The Department therefore determined that the petitioner's records were inadequate, and decided to use an indirect audit methodology. It first tested petitioner's purchase markup, and concluded that petitioner's markup on beer, wine, soda, and bottled water seemed reasonable. It then tried to develop methodologies based on a NYC Restaurant Resource Study for 2000, which detailed various aspects of the restaurant industry in New York City. The petitioner's accountant identified problems with reliance on this study, including the fact that it analyzed full-service restaurants much larger than petitioner's operations that employed numerous waiters, managers, and other service employees, and the Department decided not to rely on that study.

Instead, the Department used a method based on the base rent and breakpoint rent figures, relying on an assumption that each location met its breakpoint figures "because Amtrak would not set a breakpoint figure far removed from a tenant's sales." However, the audit supervisor acknowledged that the assumption that breakpoints were tied to sales was not based on any industry study, research, or personal experience with Amtrak leases.

The ALJ, first, agreed with the Department that petitioner's records were inadequate to allow verification of gross and taxable sales, and the Department therefore was "clearly entitled" to use an indirect audit methodology. However, he found that the Department had not established there was any connection between the breakpoints and the sales levels at each location. It was also critical that an affidavit from Amtrak's leasing agent stated the contrary: that the breakpoints were never designed to correlate to sales, and were simply a multiplier based on the base rent. The ALJ also relied on an email message stating that Amtrak's expectations for gross sales at Penn Station locations average $1,300 in sales per square foot, which was consistent with the annual rent paid by petitioner but not with the breakpoint figures. The ALJ found further support for petitioner's position in lease extensions entered into in 2007, which did not tie the breakpoints to sales reported by the petitioner to Amtrak during the earlier periods, but instead illustrated that the breakpoints were simply related to the new annual rent figures.

SINCE THE PETITIONER ESTABLISHED THAT THE LEASE BREAKPOINTS HAD NO RELATION TO GROSS SALES, THE AUDIT WAS WITHOUT A RATIONAL BASIS, AND THE ASSESSMENT WAS ANNULLED.

Since the petitioner established that the lease breakpoints had no relation to gross sales, the audit was without a rational basis, and the assessment was annulled.

Additional Insights. There are many sales tax cases in which the Department resorts to audit estimation techniques due to the lack of adequate records, and few challenges are successful. When a taxpayer fails to keep and make available complete records, there is a substantial risk that any reasonable audit method will be sustained. This case presents the relatively rare example of a successful challenge to an audit methodology, where the petitioner was able to demonstrate that the rent breakpoints truly had no relationship to its sales figures, the petitioner's position was supported by third-party evidence submitted by its landlord, Amtrak, and the Department was unable to demonstrate any basis to rely on the lease breakpoints other than the "assumption" that the figures must relate to sales.

Merger of Two Residential Cooperatives Subject to Real Estate Transfer Tax Twice

By Kara M. Kraman

The Department of Taxation and Finance has issued an Advisory Opinion holding that the merger of two legally separate private housing cooperative corporations results in application of the New York State real estate transfer tax, not once but twice. *Advisory Opinion*, TSB-A-11(1) R (N.Y.S. Dept. of Taxation & Fin., Feb. 22, 2011).

Two separate residential housing cooperative corporations ("cooperatives"), each owned one of two nearly identical residential towers constructed over an office building that served as a common base. Given that the two cooperatives

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Merger of Cooperatives Subject to Transfer Tax

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shared a common entrance, heating plant and other facilities, as well as building employees and management, they decided to legally merge under New York law. Under the merger plan, one cooperative would be merged into the other and dissolve. The shareholders of the dissolving cooperative would receive newly issued stock in the surviving cooperative. Each shareholder would continue to own the same number of shares as he or she owned prior to the merger, and each shareholder would continue to occupy the same apartment occupied prior to the merger, thereafter under proprietary leases from the surviving cooperative.

The question presented was whether the mergers would be exempt from the State real estate transfer tax ("RETT") because they constitute a mere change of identity or form of ownership, involving no change in beneficial ownership, under Tax Law § 1405(b)(6).

The RETT is imposed on each conveyance of real property in New York, including each transfer of a controlling interest in an entity with an interest in real property. Tax Law § 1401(e). The tax is imposed on transfers of stock in a cooperative housing corporation, even though a controlling interest has not been conveyed. The law exempts conveyances to the extent they effectuate a mere change of identity or form of ownership or organization where there is no change in beneficial ownership. Tax Law § 1405(b)(6). Critically, the exemption does *not* apply in the case of conveyances of real property comprising the cooperative dwellings made to a cooperative housing corporation.

The Department first identified as a transfer the conveyance of a 100% interest in the voting stock of the *dissolving cooperative* to the surviving cooperative under the merger, with the real property thereafter being owned by the surviving cooperative. The Department found this to be a taxable transfer of a controlling interest in real property. Generally, the concurrent transfer of shares in a surviving corporation to the shareholders of the dissolving corporation is not subject to RETT. However, in the case of a cooperative corporation, the conveyance of new voting stock in the surviving cooperative to the shareholders of the dissolved cooperative is also subject to RETT.

Therefore, the Department concluded that while the merger did effectuate a mere change in form to the extent of approximately 50% of the underlying real property — with the cooperative owners thereafter owning 50% of both towers rather than the 100% of one of the two towers owned prior to the merger — the law does not provide a mere change of form exemption in this situation.

The Department also ruled that the original conveyance of new shares of stock in the *surviving cooperative* to the shareholders of the dissolved cooperative is also subject to RETT. However, under 20 NYCRR 575.8(c), a credit may be claimed on those transfers for the proportionate part of the RETT paid on the conveyance of a controlling interest in the dissolving cooperative, to the extent the conveyance of the new stock effectuated a mere change in form.

Under these facts, the tax was held to apply in full to the transfer of 100% of the stock in the dissolving cooperative (with no mere change exemption available), presumably based on the fair market value of the realty. The tax also applies to the transfer of new stock in the surviving cooperative, also based on the fair market value, but with a credit available for RETT paid on the controlling interest transfer to the extent of the 50% mere change in form.

Additional Insights. The Advisory Opinion is a reminder of the considerable pitfalls that exist under the RETT in corporate mergers, and in particular of the very different rules for taxation with respect to transactions involving cooperative housing corporations.

Third Department Upholds Fraud Penalty in Sales Tax Case

By Hollis L. Hyans

In *Rodriguez v. Tax Appeals Tribunal*, No. 508576 (3d Dept., March 3, 2011), the Appellate Division affirmed a determination by the Tax Appeals Tribunal that a liquor store owner willfully and intentionally filed false or fraudulent sales tax returns, and upheld the imposition of the fraud penalty.

The petitioner was the sole owner of a corporation that had operated a small liquor store. The business filed sales tax returns for the taxable periods at issue during 1995 through 1997, but the petitioner had conceded that the returns as originally filed were inaccurate. He blamed his accountant who had prepared the returns, and he replaced that accountant with a new one in 1998. During an audit, the Department determined, from information obtained from petitioner's suppliers, that substantially greater sales were made than were reported, and the matter was referred to the Revenue Crimes Division for investigation and possible criminal prosecution. In 2000, petitioner provided documents to the Revenue Crimes Division, only some of which were copied and returned to him. The Revenue Crimes Division was located at the World Trade Center, and the documents were destroyed during the attack on the World Trade Center in September 2001. In 2006, the Bronx District Attorney decided not to prosecute, and the matter was referred

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Third Department Upholds Fraud Penalty in Sales Tax Case

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back to the Audit Division. By the time a notice of determination, along with a fraud penalty, was issued, petitioner no longer had any copies of the original records that were destroyed on September 11, 2001.

At the hearing before the ALJ, the petitioner challenged the methodology used to perform the audit, and argued that the estimates of unreported sales were grossly exaggerated. He also argued that the failure to properly report tax was not willful or knowingly fraudulent, but was the result of reliance on an accountant, inexperience in the businesses, lack of sophistication, and limited ability to speak English. Because the notices were issued well after the expiration of the three-year statute of limitations, they could only be sustained if the returns were willfully false or fraudulent, that is, filed with intent to evade the tax, which would extend the statute of limitations as well as support the fraud penalty.

The ALJ found that the Department's evidence did not provide "clear and convincing proof" that the petitioner acted "'deliberately, knowingly, and with the specific intent to violate the Tax Law.'" *Matter of Alvin's Wine & Liquor, Inc.*, DTA Nos. 821638 & 821639 (N.Y.S. Div. of Tax App., Nov. 20, 2008). He also found that the Department's attempt to demonstrate willfulness and intent to underreport sales relied on its own estimate of the degree of underreporting, but that those estimates of huge unreported sales had been rebutted by testimony of the petitioner and estimates prepared by an accountant who testified at the trial.

The Tax Appeals Tribunal reversed the ALJ. *Matter of Alvin's Wine & Liquor, Inc.*, DTA Nos. 821638 & 821639 (N.Y.S. Tax App. Trib., Oct. 29, 2009). It relied on the petitioner's failure to maintain cash register tapes and other source documents, the fact that substantial underreporting continued throughout the audit period, the discrepancies between the petitioner's records and payments to suppliers, and the failure to provide the tax preparer with sales invoices, cash register tapes, or other source documents, which it described as "in itself, an additional indication of an intention to evade tax." Because petitioner had failed to keep adequate records, the Tribunal also rejected his attempts to attack the Department's estimates, finding that the taxpayer had not shown by clear and convincing evidence that the audit method was erroneous. It rejected the estimates prepared by the petitioner's accountants, stating that "while the Tax Law permits the Division to estimate sales tax due under appropriate circumstances, it does not extend the same privilege to taxpayers."

The Appellate Division reviewed the record and affirmed the Tribunal. While it found "no direct evidence…that petitioner filed these returns with a fraudulent intent," the Appellate Division held that "circumstantial evidence may be used to prove that a taxpayer has deliberately filed a fraudulent tax return." Here, the court relied on the absence of reliable records, leading the Department to employ an indirect audit methodology, including an analysis of information contained in petitioner's federal income tax returns and in purchase invoices, which, according to the Department, showed that petitioner's merchandise purchases totaled more than three times the claimed sales. Like the Tribunal, the court noted that petitioner, due to the absence of records, had the burden to prove by clear and convincing evidence that the Department's estimates were unreasonable. While noting petitioner's claim that he was an unsophisticated businessman who left the details to others, the court found that the failure to provide reliable records, the significant difference between purchases and reported sales, the financial benefit he derived, and the failure to remedy the errors when he learned about them provided a substantial basis for the Tribunal's conclusion that petitioner "willfully and intentionally" filed false returns.

Additional Insights. There are striking differences in the view taken of this petitioner by the ALJ — who had the opportunity to observe the witness and evaluate his credibility — and the Tribunal and Appellate Division, who were reviewing the record. The ALJ focused on the petitioner's limited English and business skills, his reliance on an accountant who he replaced when he learned the returns filed were incorrect, and the lack of basis for the Department's estimation of gross underreporting. He characterized the petitioner's actions as arising from "[c]arelessness, negligence or inadvertence," which do "not equal fraud." The Tribunal, however, in reviewing the record, found evidence of fraud in purchases of liquor that were substantially greater than reported sales, discrepancies in the petitioner's testimony, and rampant lack of verifiable records. While acknowledging that the petitioner lacked formal education and English was his second language, the Tribunal noted he had been in the U.S. for over 30 years and "testified without apparent difficulty." The Tribunal also dismissed any challenge to the Department's estimation methods because there were no verifiable records. The court then endorsed and accepted the Tribunal's view of the testimony. The court seemed to give no weight to and in fact did not ever mention the history noted by the ALJ, involving the destruction of records in the World Trade Center, the decision by the District Attorney not to prosecute, or the six-year delay in bringing the civil proceeding.

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Target's Investment Tax Credit Carryover Available to Parent in 338(h)(10) Election

By Irwin M. Slomka

Applying principles of federal conformity, the Department of Taxation and Finance has ruled that a parent corporation may succeed to its subsidiary's New York investment tax credit carryover where the parent sells the subsidiary's stock in a transaction for which an I.R.C. § 338(h)(10) election has been made. *Advisory Opinion*, TSB-A-11(3)C (N.Y.S. Dept. of Taxation & Fin., Feb. 18, 2011).

Parent files an Article 9-A return on a combined basis with its affiliated corporations, including its wholly owned subsidiary ("Target") that engaged in a manufacturing business in New York. Target had previously invested in manufacturing property in the State that qualified for the New York investment tax credit ("ITC"). Target was unable to use all of its ITC, and its unused portion was being carried forward over a 15-year carryover period.

During that carryover period, Parent sold all of its stock in Target to a third party, and the parties made a joint election under I.R.C. § 338(h)(10). Under this commonly used election, the stock sale is disregarded and the transaction is treated as a deemed sale of assets by the Target while it was a member of Parent's consolidated group. In addition, for federal purposes, the Target is considered to have distributed the proceeds of the deemed asset sale to its Parent in complete liquidation pursuant to I.R.C. §§ 332 and 337.

I.R.C. § 381 provides rules for succeeding to certain tax attributes of another corporation in the case of certain corporate reorganizations. Where a subsidiary is liquidated pursuant to I.R.C. § 332, the acquiring corporation succeeds to various tax items of the subsidiary, including the general business credit available under I.R.C. § 38. Among the credits covered by the general business credit is the former federal investment tax credit, long since repealed, on which the New York ITC was modeled. Had the federal ITC still been in existence, for federal purposes Parent would have succeeded to any unused federal ITC carryover of the Target.

The question presented to the Department was whether Parent would be entitled to succeed to the unused New York ITC carryover of the Target under Article 9-A. The Department ruled that the Parent could succeed to the Target's unused ITC and remaining carryover period, assuming it could establish the carryover amount.

The Advisory Opinion cited to *Matter of AIL Systems, Inc.*, DTA No. 819303 (N.Y.S. Tax App. Trib., Oct. 21, 2002), where the Tribunal held that in a stock sale for which a § 338(h)(10) election was made, the Department was correct in requiring that the Target "recapture" previously claimed New York ITC because the Target's deemed asset sale was a disposition requiring recapture. The Tribunal found support for the recapture because it was the same treatment that would have resulted with respect to the former federal ITC. In the Advisory Opinion, the Department continued to apply principles of federal conformity under the New York ITC, this time regarding the succession to tax attributes permitted under I.R.C. § 381.

Additional Insights. The Department's ruling is consistent with its prior positions, reflected in the *AIL Systems* decision and elsewhere, interpreting the New York ITC law based on the former federal ITC treatment. The Advisory Opinion does contain a caveat that the Department reaches no conclusion regarding the way Parent and Target will actually be treated for federal purposes under I.R.C. §§ 338 and 381, and the ruling is based on the assumption that the § 381 succession provisions would apply. Although not mentioned in the Advisory Opinion, it is assumed that the deemed asset sale was not a disposition resulting in the recapture of ITC (as was the case in *AIL Systems*). It also appears likely that the "new" Target that is deemed to purchase the assets should be entitled to claim new ITC on the qualifying property.

Insights in Brief

Charge for "Party Package" Taxable in Full

In *Matter of Lake Grove Entertainment, LLC v. Megna*, 2011 NY Slip Op 01380 (3d Dept., Feb. 24, 2011), the Appellate Division affirmed the Tax Appeals Tribunal's determination that charges for party packages were fully subject to sales tax. The petitioner operated a large entertainment complex and offered party packages that included food and beverages, as well as access to activities such as bowling and ice skating, which would not be subject to sales tax if sold separately. Citing the rule that sales tax must be imposed on the total amount of the invoice if taxable and nontaxable portions are not separately stated, and noting that, under the applicable standard of review, the Tribunal's determination will be confirmed if it is supported by a rational basis, even if a different conclusion would have been reasonable, the Appellate Division found that the Tribunal "rationally concluded" the entire party package amount was subject to tax.

ALJ Finds BCMS Request Timely in Absence of Proof of Mailing Date of Notices

In *Matter of 3152 Restaurant, Inc.*, DTA Nos. 823676, 823677, & 823709 (N.Y.S. Div. of Tax App., Mar. 10, 2011), the taxpayers had filed a request for a conference before the Bureau of Conciliation and Mediation Services to challenge notices assessing sales and use tax. The Department moved for summary judgment before the Division of Tax Appeals, claiming the BCMS requests had not been filed within the statutorily mandated 30-day period (applicable to notices that include a fraud penalty). The ALJ found that the Department, while adequately demonstrating its standard mailing procedures, failed to establish the date on which the notices were actually mailed, since the Postal Service postmark was not legible on the certified mail record, and did not introduce any evidence as to the date the notices were actually received. Therefore, the ALJ held that the Department had not met its burden of demonstrating proper timely mailing to start the 30-day filing period, denied summary judgment, and allowed the matters to proceed to a hearing on the merits.

Foreign Government Held Not Entitled to Transfer Tax Refund

The Tax Appeals Tribunal, affirming an ALJ determination, held that a tax-exempt foreign government was not entitled to a refund of real estate transfer tax ("RETT") that it voluntarily paid on the sale of one residential property and the purchase of another, pursuant to its negotiations with the other party to each conveyance. *Matter of Government of the Republic of Madagascar/Permanent Mission of Madagascar to the United Nations*, DTA Nos. 822357 & 822358 (N.Y.S. Tax App. Trib., March 10, 2011). Under the RETT, where the grantor to a conveyance is exempt from the tax, the liability for payment shifts to the other party, unless the other party is also exempt. The Tribunal held that although the foreign government was exempt from the RETT, its payment of the tax was considered to have been made on behalf of the non-exempt party to the transaction pursuant to private negotiations, and therefore was not refundable.

Consideration Paid for Combined Apartments Properly Aggregated for "Mansion Tax" Purposes

A husband and wife each separately contracted to purchase stock in a cooperative housing corporation for two apartments that the seller had previously combined into one, each for a purchase price of less than the $1 million threshold for application of the New York "mansion tax" on residential real property. The total consideration for both apartments was $1.5 million. The Tax Appeals Tribunal, affirming an ALJ determination, held that the Department had properly aggregated the consideration for each transaction, and imposed the mansion tax on the total $1.5 million paid for both apartments.

The Tribunal concluded that the substance of the two purchases was the acquisition of a single combined apartment. *Matter of Michael and Frances Sacks*, DTA No. 822322 (N.Y.S. Tax Appeals Trib., Mar. 10, 2011).