

## IN THIS ISSUE

City ALJ Holds First Amendment Requires Exercise of Discretionary Authority for Sourcing Receipts from Providing Credit Ratings

Page 1

Tribunal Affirms Partial Day Count for Statutory Residency Purposes

Page 3

ALJ Finds Taxpayers Participated in an "Abusive Tax Avoidance Transaction"

Page 4

Tax Department Clarifies Availability of Resale Exclusion to Cable and Satellite TV Providers in Light of *EchoStar* Decision

Page 6

Judge Rejects Connecticut Couple's Constitutional Challenge to New York Taxation of Stock Option Income

Page 7

Insights in Brief

Page 7

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**ALERT: GOVERNOR CUOMO SIGNS  
CORPORATE TAX REFORM BILL INTO LAW**

On March 31, 2014, Governor Andrew Cuomo signed into law comprehensive New York State corporate tax reform legislation. Among other things, the law repeals the State bank tax (Article 32), folding it into Article 9-A, which has been substantially revised. Among the many significant changes to Article 9-A are water's-edge unitary combined filing, the adoption of a "bright line" economic nexus standard for taxation, and market-based sourcing for purposes of the apportionment factor. With a few exceptions, the new law will go into effect for tax years beginning on or after January 1, 2015. We will provide additional details about the new law in the next issue of *NY Tax Insights*.

**CITY ALJ HOLDS FIRST AMENDMENT  
REQUIRES EXERCISE OF DISCRETIONARY  
AUTHORITY FOR SOURCING RECEIPTS  
FROM PROVIDING CREDIT RATINGS**

By Irwin M. Slomka

Although state local tax cases are often decided on constitutional grounds, very few are decided under the First Amendment of the U.S. Constitution, which involves freedom of the press. A recent decision by the Chief Administrative Law Judge of the New York City Tax Appeals Tribunal holds that First Amendment principles required that the City exercise its discretionary authority to adjust a corporation's receipts factor under the general corporation tax. As a result, a New York City-based credit rating agency was permitted to source its receipts from furnishing credit ratings using an "audience-based" methodology on the grounds it should be entitled to use the same sourcing method as other "publishers." *Matter of The McGraw-Hill Companies, Inc., TAT(H) 10-19 (GC) et al.*, (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Feb. 24, 2014). The decision is noteworthy for being one of the few cases where a taxpayer successfully invoked the Commissioner's discretionary authority, and particularly for its consideration of First Amendment protections in determining how that discretionary authority should be invoked.

*Facts.* McGraw-Hill, through its Standard & Poor's ("S&P") division, operated a credit rating agency to provide ratings and risk evaluations for debt issues, such as bonds. Debt issuers/obligors hired S&P to prepare credit ratings, which involved assigning ratings (in the form of letter grades) to each debt issue. S&P employed approximately 1,200 analysts who prepared the rating recommendations, which were voted on by

continued on page 2

an S&P ratings committee. Upon approval, the ratings were communicated to the issuer, and then published on the S&P website, which users worldwide could register to access. The ratings were also republished in newspapers, on various websites, and by other media outlets.

The issuers, not the website users or investors, paid S&P for providing the credit rating and for subsequent monitoring. The initial fee was usually a percentage of the offering or the debt instrument. Issuers also paid S&P a monitoring fee for the lifetime of the rating. S&P did not separately charge to publish the rating on its website.

*Amended GCT Returns.* For the tax years 2003 through 2007, McGraw-Hill filed New York City general corporation tax (“GCT”) returns, and included the credit rating fees of its S&P division in its receipts factor, sourced to the City on an “origin” basis. In 2009, McGraw-Hill filed amended GCT returns, requesting refunds for those years totaling approximately \$35 million. The refund claims resulted from sourcing the credit rating receipts based on “customer” — *i.e.*, issuer/obligator — location. The Department of Finance (“City”) issued Notices of Disallowance of the refund claims on the basis that the fees were from the performance of services, and therefore were properly sourced based on where the services were performed. McGraw-Hill filed its 2008 GCT return using the same method to compute the receipts factor as reported in its amended returns and, following an audit, the City issued a Notice of Determination for \$3.2 million, again sourcing the credit rating fees based on origin.

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## **As a financial information publisher, the S&P division “was entitled to the same [First Amendment] protections afforded other members of the press.”**

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Prior to filing the amended GCT returns, McGraw-Hill made two letter ruling requests, seeking approval from the City to treat the credit rating fees as “other business receipts,” sourced based on “customer’s location.” According to the decision, McGraw-Hill considered both the issuer/obligor and the investing public to be its “customers,” but only requested sourcing to the location of the issuer/obligors as a “proxy.” After several meetings between representatives of the taxpayer and the City, no letter rulings were ever issued and McGraw-Hill filed its amended returns as described above. The City then proceeded to issue the Notices of Disallowance and Notice of Determination.

*Positions of the parties.* McGraw-Hill contested the refund disallowances and the tax assessment. In its Petition,

McGraw-Hill asserted, for the first time, that it was entitled to use an “audience-based” receipts factor, “according to the geographic location of Website viewers” of the credit ratings. McGraw-Hill requested a discretionary adjustment to its receipts factor, pursuant to Admin. Code §11-604(8), on the grounds that S&P is a member of the press entitled to First Amendment protections. This meant that S&P should be permitted to source its credit rating fees based on the location of website viewers, similar to the “circulation” methodology permitted to newspaper and magazine publishers for sourcing advertising revenues. The City claimed that the credit rating fees constituted receipts from services, which are sourced to where the services are performed. According to the City, the discretionary adjustment being sought was not justified because an audience factor methodology did not properly reflect the taxpayer’s actual in-City activity.

*ALJ decision.* The ALJ held that, on First Amendment grounds, McGraw-Hill was entitled to a discretionary adjustment to source its credit rating receipts using an audience-based methodology. Her decision involved the following conclusions:

1. S&P’s credit rating fees constituted “other business receipts” under Admin. Code §11-604(3)(a)(2).
2. S&P was a “financial information publisher” by reason of its publication of credit ratings. The ALJ noted that newspaper and periodical publishers are entitled to allocate their advertising receipts based on the publication’s “delivery” within the City. Broadcasters are entitled to source their advertising receipts using an “audience” method.
3. To invoke the Commissioner’s discretionary authority to adjust a taxpayer’s apportionment factors if they do not “properly reflect the activities, business, income or capital of a taxpayer within the city,” a request for discretionary adjustment cannot be made after a statutory Notice of Determination or Notice of Disallowance has been issued, citing 19 RCNY 16-01(C)(1). However, the ALJ concluded that McGraw-Hill had requested discretionary adjustment relief in its letter ruling requests prior to the City’s notices.
4. As a financial information publisher, the S&P division “was entitled to the same [First Amendment] protections afforded other members of the press.” The ALJ found that requiring McGraw-Hill to allocate these receipts based on “origin,” as the City argued, unfairly subjects McGraw-Hill to tax in a manner different from other publishers, which are permitted to source based on audience/readership location. Floyd Abrams, a well-known expert on First Amendment issues, testified that credit rating agencies “could be analogized to journalists,” although the ALJ noted that he testified as to conclusions of law, which she was “not bound to accept.”

5. Although McGraw-Hill's letter ruling requests and amended returns sourced the receipts based on the location of the issuer/obligor, the ALJ found that allocation methodology treated a financial information publisher, like S&P, different from other types of publishers, and thus failed under a First Amendment analysis. According to the ALJ, "S&P credit rating receipts should be allocated in the same manner permitted other publishers." The ALJ cited *McGraw Hill, Inc. v. State Tax Commission*, 75 N.Y.2d 852 (1990), where the Court of Appeals affirmed a decision of the Third Department, holding that the State of New York could not source McGraw-Hill's revenues from advertisements in its magazines to where the services were performed because this represented differential treatment between the print media and the broadcast media, in violation of the First Amendment.

The ALJ accepted the taxpayer's documentation regarding audience location, even though it was "only a rudimentary estimation," as nonetheless being consistent in principle with the circulation/audience methods allowed to other publishers. Accordingly, the ALJ held that McGraw-Hill was entitled to a discretionary adjustment of its receipts factor based on its "audience method" documentation, and was entitled to refunds consistent with that method.

### Additional Insights

The decision, although it may be appealed by the City, is instructive on several issues. First, it holds that income from the furnishing of credit ratings constitutes "other business receipts" under the GCT, sourced to where the income is "earned," rather than income from the furnishing of services, sourced to where the services are performed. In recent years, both the State and the City have sought to recharacterize certain electronically delivered service income as "other business receipts," and this decision could be viewed as being consistent with that approach. Also, while the Court of Appeals had previously treated McGraw-Hill as being a member of the press with respect to its magazine publishing activities, and entitled to First Amendment protections for tax purposes because of that characterization, this decision goes further than the Court's earlier decision by treating it as a publisher for GCT purposes with respect to its S&P credit rating activities.

Also potentially significant is the ALJ's discussion regarding the scope and limitations of the Commissioner's discretionary authority. The ALJ ruled that McGraw-Hill's letter ruling requests were timely-made requests for discretionary adjustment, but also that a request for discretionary adjustment may also be considered by an ALJ following the filing of a Petition under the City Tribunal's general authority to "adjust taxable items." Presumably, the City Tribunal is empowered to rule on whether a discretionary adjustment is appropriate whether or not a taxpayer made the request prior

to filing its GCT return, although the decision does not directly address that question.

Finally, the decision is also instructive regarding the required precision of the alternative apportionment methodology, noting that even a "rudimentary estimation" supporting an alternative apportionment methodology may be sufficient. The ALJ accepted the taxpayer's imprecise estimated proof of "audience location." The decision points out that beginning in 1997, McGraw-Hill reached an agreement with the State to reduce its New York source receipts by issuer/obligor location by 50%, which the ALJ viewed as "an accommodation for circulation allocation issues." The ALJ noted that McGraw-Hill's evidence of "audience" location was more exact than the State's accommodation.

## TRIBUNAL AFFIRMS PARTIAL DAY COUNT FOR STATUTORY RESIDENCY PURPOSES

By Michael J. Hilkin

In *Matter of John and Janine Zanetti*, DTA No. 824337 (N.Y.S. Tax App. Trib., Feb. 13, 2014), the New York State Tax Appeals Tribunal affirmed the determination of an Administrative Law Judge that any part of a day spent in New York counts as a "day" when determining statutory residency for State personal income tax purposes.

Under New York's "statutory residency" test, individuals who maintain a permanent place of abode in New York and spend more than 183 days in the State during a year are treated as residents for income tax purposes. The Department's regulations provide that a "presence within New York State for any part of a calendar day constitutes a day spent in New York State," unless the presence is solely for the purpose of boarding an airplane or other conveyance, or solely while travelling through the State to a destination outside the State. 20 NYCRR 105.20(c).

The Zanettis maintained permanent dwellings in Florida and New York. In 2006, the Zanettis claimed Florida residence, and filed a joint New York nonresident tax return. After an audit, the Department issued a Notice of Deficiency, concluding that Mr. Zanetti was a New York resident under the statutory residency test. The Zanettis and the Department agreed that the Zanettis maintained a permanent place of abode in New York, and that Mr. Zanetti was present within the State for 167 entire days, and outside the State for 172 days. The sole issue in dispute was whether the remaining 26 days of the year, during which Mr. Zanetti either arrived in or departed from New York by private jet and spent time in his New York dwelling, counted as New York days for purposes of the statutory residency test.

# ALJ FINDS TAXPAYERS PARTICIPATED IN AN “ABUSIVE TAX AVOIDANCE TRANSACTION”

By Hollis L. Hyans

In *Matter of Marc S. Sznajderman and Jeannette Sznajderman*, DTA No. 824235 (N.Y.S. Div. of Tax App., Mar. 6, 2014), a New York State Administrative Law Judge upheld an assessment arising from investments in oil and gas partnerships, which were held to be abusive tax avoidance transactions, and therefore also governed by a six-year statute of limitations for assessment.

*Facts.* Petitioner Marc Sznajderman, an experienced investor, became a general partner in Belle Island Drilling Company, a New York general partnership formed in 2001. The partnership, created and controlled by an individual named Richard Siegal, conducted oil and gas drilling ventures, which were designed to generate deductible intangible drilling costs (“IDC”) in the first year of operation. Investors were required to be general partners, which exposed them to greater risk. Mr. Sznajderman investigated the potential investment, including review of statements prepared by investment firms and a review by his accountants, who, although they were not specialists in oil and gas, advised that the documents did not appear to be out of the ordinary or raise any undue concern. Mr. Sznajderman’s financial expert advised that Mr. Sznajderman had a “reasonable opportunity to both make and lose money” on the investments, and that the investment was structured in a manner consistent with arrangements in the oil and gas industry.

A critical part of the deal was a “turnkey arrangement,” under which the driller accepts a fixed fee for developing wells up to the point at which they enter production. Belle Isle entered into a turnkey contract with SS&T Oil Co., Inc. (“SS&T”), an entity also controlled by Mr. Siegal, under which Belle Isle agreed to pay SS&T \$10.8 million, partially in cash and partially in an interest-bearing note in the principal amount of approximately \$7 million. Pursuant to an assumption agreement, Mr. Sznajderman assumed responsibility for a portion of the loan that the partnership had taken from SS&T. The pricing for the turnkey contract entered into by Belle Isle had been determined by Mr. Siegal, and Mr. Sznajderman did not know how the price had been determined.

Mr. Sznajderman signed a subscription agreement to purchase three units for \$840,000, payable in cash of \$300,000 and a full recourse promissory note of \$540,000, with an 8% interest rate. To fund his \$300,000 commitment, Mr. Sznajderman

The Zanettis argued that under New York’s General Obligation Law, which is generally applicable to statutory construction, a “calendar day” consists of 24 hours, and since Mr. Zanetti was not in New York for a consecutive 24-hour period on any of the 26 disputed days, those days may not be treated as New York days. Alternatively, they also argued that, based on the number of hours that Mr. Zanetti was out of New York over the 26 disputed days, Mr. Zanetti spent only 14 full days in the State in 2006 — fewer than the 16 days necessary to reach the threshold 183 New York days. The ALJ rejected both of these arguments, concluding that *Matter of Leach v. Chu*, 150 A.D.2d 842 (3d Dep’t 1989), *appeal dismissed*, 74 N.Y.2d 839 (1989), which upheld the Department’s regulatory method of determining a New York day for statutory residency purposes, controlled in the matter.

The Tribunal has now affirmed the ALJ’s decision. The Tribunal rejected the Zanettis’ contention that the ALJ improperly relied on *Matter of Leach*. Instead, the Tribunal agreed that *Matter of Leach* directly addressed the validity of the Department’s regulation defining a “day” for statutory residency purposes. The lack of a citation in *Leach* to the General Obligation Law did not trump the general principle of *stare decisis*. Further, the Tribunal concluded that the definition of a “calendar day” under the General Obligation Law was intended to apply for purposes of filing periods and deadlines, and thus did not affect the conclusion that the Department’s regulation construing a “day” to include a partial day was both reasonable and consistent with the legislative intent.

## Additional Insights

The Tribunal’s ruling is consistent with decades-old New York tax decisions upholding the Department’s regulation that treats a presence within New York for any part of a day as being counted as a New York day. The validity of that regulation, however, has never been fully considered by the Court of Appeals, and the recent decision in *Matter of John Gaied v. Tax App. Trib.*, 2014 NY Slip Op. 101 (N.Y. Ct. App. Feb. 18, 2014) (discussed in the March 2014 issue of *New York Tax Insights*) may indicate that the court is willing to scrutinize the Department’s and the Tribunal’s interpretation of the statutory residency test. In *Gaied*, the Court of Appeals concluded that there was no rational basis for the Department’s position that an individual who maintains a dwelling in New York for others but does not reside in that dwelling nonetheless has a “permanent place of abode” in New York for statutory residency purposes. The court in *Gaied* relied on the legislative history to the statutory residency test, which indicates that the test is meant to tax as New York residents individuals who are for all “intents and purposes” residents of New York. That legislative history could also lead the New York courts to now conclude that treating any part of a calendar day as a day for statutory residency purposes exceeds the intent and scope of the law.

paid \$100,000 from personal funds and borrowed the balance from another entity controlled by Mr. Siegal. He also executed a separate collateral agreement requiring him to purchase municipal bonds that could be used towards the repayment of his subscription note.

For 2002 through 2011, Belle Isle generated substantial income from oil and gas production, accrued and reported interest income due on its partners' subscription notes, and accrued and deducted interest due on the turnkey note. It made quarterly cash distributions to its partners.

*The audit.* In 2006, the Department of Taxation and Finance began investigating approximately 200 oil and gas partnerships, including Belle Isle, all of which had used the same accounting firm to prepare their partnership returns. The Department also worked with the Internal Revenue Service and taxing authorities in California to gather information on the structure of the partnerships designed by Mr. Siegal, and concluded that the partnerships constituted "tax avoidance transactions."

In 2005, the New York legislature enacted new requirements mandating disclosure of information relating to certain tax shelter transactions, imposing penalties for nondisclosure, extending the statute of limitations for such transactions to six years from the usual three years, and creating a Voluntary Compliance Initiative ("VCI"). See TSB-M-05(4)I (N.Y.S. Dep't of Taxation & Fin., June 1, 2005). In order to come within the extended six-year statute of limitations, the Department issued a Notice of Deficiency to Mr. Sznajderman for 2001 on March 14, 2008, assessing tax and including penalties for failure to participate in the VCI. In 2009, Mr. Sznajderman participated in the VCI, choosing the option which allowed him to retain the right to file a claim for credit or refund, and made a payment of approximately \$98,000.

As permitted under the terms of the VCI, Mr. Sznajderman filed a Petition challenging the assessment. In 2012, the ALJ denied a motion for summary determination, in which Mr. Sznajderman had challenged the applicability of the extended six-year statute of limitations, finding that a hearing was necessary, as reported in the June 2012 issue of *New York Tax Insights*. At the hearing, Mr. Sznajderman continued to argue that the six-year statute was inapplicable, because his investment in the Belle Isle partnership was not an abusive tax avoidance transaction that had tax avoidance as a principal purpose. He noted that the Department had allowed his cash investment as deductible IDC, that his debt was genuine, and that the investment and the partnership transactions had economic substance and significant nontax purposes. The Department argued that the chief purpose of the investment was to avoid or evade income tax.

*The Decision.* The ALJ undertook a lengthy and careful review of the many documents and details surrounding the partnerships, as well as of the federal tax cases that had investigated the

same transactions. He found that the Tax Court had upheld the same investment scheme as the one in Belle Isle in *Zeluck v. Comm'r of Internal Revenue*, T.C. Memo 2012-98, Dkt. No. 10393-09 (T.C.M. Apr. 3, 2012), noting that "[t]he court appeared to go out of its way to confirm the propriety of the transaction." The ALJ found that the underlying subscription note and the assumption agreement constituted genuine debt, just as the Tax Court had done. He analyzed the purchases of investment interests with cash and debt, and concluded that Mr. Sznajderman's investment transaction created genuine debt, supporting his claim that the partnership was not an abusive tax avoidance transaction. The ALJ noted that Mr. Sznajderman's "credible testimony" established he had investigated the partnership and recognized the risks, and also that he "valued the tax incentives outlined in the investment proposal, which he understood had the potential to deliver a deduction estimated to be 2.5 times an investor's cash investment the first year."

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**[The taxpayer] failed to meet his burden of proving the reasonableness of the turnkey contract, and that amounted to "convincing evidence that the transaction has tax avoidance as its primary motive."**

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Although the structure of the investment was found to create genuine debt, the ALJ concluded that a determination was also necessary on whether the terms of the turnkey contract were reasonable and not abusive. On this issue, the ALJ noted that Mr. Sznajderman had no knowledge of how the turnkey contract price was reached, although he knew how important that contract was to the venture. He also found "baffling" Mr. Sznajderman's failure to consult with any oil or gas experts or tax advisers with oil and gas experience, and that he knew, or should have known, that Mr. Siegal's interests conflicted with his own, since Mr. Siegal would profit considerably even if Belle Isle's wells never became productive.

With respect to the turnkey arrangement, the ALJ found that Mr. Sznajderman failed to meet his burden to establish that the contract price was reasonable. The ALJ accepted the testimony of the Department's expert witness that the turnkey price appeared to be exorbitant, although he did note that the expert's analysis and estimate was "rudimentary." Mr. Sznajderman's expert, on the other hand, while testifying that the turnkey contract "appears reasonable relative to standard industry practice," did not have an opinion on the average markup in such a contract, and did not specifically support the turnkey price, stating in his report only that "one would assume that all costs were reasonably covered."

The ALJ therefore concluded that, in the absence of clear evidence of how the turnkey price was calculated, and the lack of any arm's length negotiation, Mr. Sznajderman failed to meet his burden of proving the reasonableness of the turnkey contract, and that amounted to "convincing evidence that the transaction has tax avoidance as its primary motive."

### Additional Insights

Oil and gas partnerships, largely because of their generation of deductions for intangible drilling costs in significant amounts, have been the target of investigation by both the federal government and the Department of Taxation and Finance. It appears that similar partnerships have survived federal challenge, and the ALJ explicitly noted that, although the Department is challenging "various aspects of Mr. Siegal's scheme to create fractional general partnership interests in oil and gas wells, thus qualifying them for IDS deductions, it has been no more successful therein than the IRS or earlier efforts of its own to demonstrate that the structure of the deal was unsound." However, despite sustaining the general structure of the deal, the ALJ's detailed investigation of the terms and pricing of the turnkey contract — an important element in the operation of the partnership — led to the conclusion that Mr. Sznajderman was unable to demonstrate that the pricing of that contract was reasonable or even that he had properly investigated that important element.

## TAX DEPARTMENT CLARIFIES AVAILABILITY OF RESALE EXCLUSION TO CABLE AND SATELLITE TV PROVIDERS IN LIGHT OF *ECHOSTAR* DECISION

By Kara M. Kraman

In a case argued by Morrison & Foerster LLP, the Court of Appeals unanimously held that a provider of satellite television service was not subject to sales or use tax on its purchases of equipment that was leased to customers for a separately stated fee and on which sales tax was collected and remitted. *Matter of EchoStar Satellite Corp. v. Tax Appeals Trib.*, 20 N.Y.3d 286 (2012). The Department has now issued a Technical Memorandum explaining how the *EchoStar* decision "affects the application of the sales and use tax resale exclusion to certain purchases made by satellite and cable television service providers." *Technical Memorandum*, TSB-M-14(3)S (N.Y.S. Dep't of Taxation & Fin., Mar. 7, 2014).

*When resale exclusion will apply.* According to the Technical Memorandum, prior to *EchoStar*, the Department's position was that the resale exclusion was generally not allowed for the purchase of equipment provided to customers by cable or

satellite television service providers. After *EchoStar*, it is now the Department's position that the resale exclusion will apply under certain circumstances. Specifically, the resale exclusion applies to a cable or satellite service provider's purchases of equipment where either the equipment is purchased and then sold outright to its customers, or where the equipment is purchased and then leased to customers provided all of the following conditions are met: (i) the provision of equipment is structured as a lease; (ii) the rental fee is separately stated on the customer invoice; and (iii) the lease payment is directly proportional to the value of the equipment and reflects the cost of the equipment.

To provide cable and television service providers "with more certainty" concerning the sales tax impact under *EchoStar*, the Technical Memorandum also states that except where the equipment is actually sold outright to customers, the Department will treat the equipment as not being resold, and thus will not require that sales tax on the equipment be collected from customers, if certain conditions are met: (i) there is no separate lease agreement for the equipment and the customer service agreement does not contain a separate section that the equipment is being leased; (ii) the customer service agreement does not have an explicit lease term but merely provides that the equipment may be used by the customer during the term of the television service; and (iii) the service provider paid sales or use tax in its equipment purchases and does not seek a refund or credit of the tax paid. This will enable service providers that meet these criteria to avoid a sales tax collection responsibility with respect to the equipment furnished to customers.

*Transitional rules.* The Department has set out "transitional rules" under which cable or satellite television service providers that had paid sales tax on their equipment purchases, and that now qualify for the resale exclusion under *EchoStar*, may be eligible to claim a refund or a credit. However, if the service provider has not collected sales tax on its rental charges for the equipment, the refund amount is limited to the amount of tax the service provider paid on its equipment purchases, less the amount of tax it should have collected on rental charges for that equipment. In addition, the Technical Memorandum states that sales tax will not be assessed on a service provider's sales and rental of equipment to customers prior to December 1, 2013, if the service provider (i) paid tax on its purchase of the equipment and (ii) is not seeking a refund or credit for the tax it paid under the *EchoStar* decision.

Those "transitional rules" also provide that the Department will not assess sales tax on the service provider's sales or rentals of equipment for tax periods prior to December 1, 2013, where the provider paid sales tax on its equipment purchases and does not seek a refund or credit of the tax pursuant to *EchoStar*.

## Additional Insights

The Department's Technical Memorandum, which was issued more than a year after the *EchoStar* decision, appears to serve several purposes. First, it provides clarity to the cable and satellite television industry on the scope of the resale exclusion for equipment purchases. It does this by articulating the parameters under which the resale exclusion will apply and, notably, by making clear when service providers will *not* be considered to be reselling equipment to customers (which would require that they collect sales tax with respect to the resold equipment). Second, by setting somewhat narrow parameters for when the resale exclusion will apply, it limits the availability of the resale exclusion, and consequently, potential refund claims resulting from the *EchoStar* decision. Third, it makes clear that even where the service provider qualifies for resale treatment, and claims a refund of the sales tax paid, the Department will reduce the refund amounts where sales tax has not been collected from customers by the amount of sales tax that *should* have been collected.

# JUDGE REJECTS CONNECTICUT COUPLE'S CONSTITUTIONAL CHALLENGE TO NEW YORK TAXATION OF STOCK OPTION INCOME

By Irwin M. Slomka

In a summary judgment action, a Suffolk County Supreme Court judge has rejected a Connecticut couple's constitutional challenge to the taxation of their stock option income as a New York statutory resident. *Noto v. N.Y.S. Dep't of Taxation & Fin.*, 2014 NY Slip Op. 30578 (NY Sup. Ct., Suffolk Cnty. Mar. 3, 2014).

The Notos are domiciled in Greenwich, Connecticut, and also own a vacation home in East Hampton, Long Island. They spent more than 183 days in New York State in 2005 and 2006, and filed New York State income tax returns as statutory residents. Prior to his retirement from ExxonMobil in 2001, Mr. Noto received stock options from his employer. In 2005 and 2006, Mr. Noto exercised those options, deriving \$24 million in 2005, and \$17 million in 2006. He also received deferred compensation from ExxonMobil. The Notos paid tax to Connecticut, their state of domicile, on their stock option income. It does not appear that Mr. Noto ever worked for ExxonMobil in New York State. On their New York resident tax returns, the Notos claimed a tax credit for taxes paid to Connecticut relating to the stock options, which the Department disallowed.

The Notos brought declaratory judgment motions in Suffolk County Supreme Court on the grounds that the income tax

law was unconstitutional "as applied." They argued that their stock option income — which was not derived from services performed in New York State — was being taxed by both Connecticut and New York in violation of the Commerce Clause of the U.S. Constitution. Among other things, they claimed that by taxing the income because they were statutory residents, the Department was impermissibly burdening interstate commerce by favoring individuals who live and work exclusively in New York over statutory residents who (like the Notos) earn income outside the State. This resulted in double tax, with the income being taxed both by the taxpayers' state of domicile (Connecticut) and by their state of statutory residence (New York).

The Supreme Court judge held that the Court of Appeals decision in *Tamagni v. Tax Appeals Tribunal*, 91 N.Y.2d 530 (1998), *cert. denied*, 525 U.S. 931 (1998) was dispositive of the constitutional challenge regarding double taxation and the Commerce Clause. There, the Court of Appeals rejected a similar Commerce Clause challenge to the New York tax as applied to a statutory resident. As in this case, the taxpayer in *Tamagni* was denied a credit for taxes paid to his state of domicile (New Jersey) on his investment income, which potentially subjected it to double taxation. The judge noted that the *Tamagni* decision rejected a Commerce Clause challenge based on potential double taxation, on the grounds that the New York personal income tax does not substantially affect interstate commerce.

The judge also ruled against the Notos' Due Process Clause challenge, concluding that by owning a vacation home and being present in the State for more than 183 days, the Notos had established the "minimal connection" necessary for Due Process Clause purposes. The judge therefore granted summary judgment in favor of the State.

## Additional Insights

Separate and apart from the Department's sometimes expansive interpretation regarding who is a statutory resident (which recently, in *Matter of John Gaied*, was scaled back somewhat by the Court of Appeals on what constitutes a "permanent place of abode"), the *Tamagni* decision remains a controversial limitation on constitutional challenges to the double taxation of New York statutory residents. Presumably, if the Notos' stock option income had been taxed in the states where Mr. Noto had worked, the Department would have allowed a tax credit for taxes paid to those states on the grounds that the income was derived from sources in those states.

## INSIGHTS IN BRIEF

### Unpaid Taxes Lead to Loss of Driver Licenses

On March 17, Governor Cuomo's office announced that nearly 9,000 New York driver licenses had been suspended due to

the drivers' failure to pay taxes owed to the State, pursuant to legislation enacted in 2013 allowing the State to suspend the license of an individual taxpayer who owes more than \$10,000 in state taxes. *Press Release, Governor Cuomo Announces Initial Results of Tax Scofflaw Driver License Suspension Initiative*, March 17, 2014. According to the press release, over 17,000 drivers were contacted beginning in August 2013, and 6,500 of them paid in full or arranged payment plans, while 2,300 were determined to be ineligible for suspension. Any taxpayer who receives a license suspension notice has 60 days to arrange payment and, if he or she does not do so, will receive a second letter allowing an additional 15 days; if no contact is made, the Department of Motor Vehicles is authorized to suspend the license with no further notice.

### **Unstamped Cigarettes May Now Be Sold Directly to the Oneida Nation of New York**

The New York State Department of Taxation and Finance has announced that State-licensed cigarette agents and federally licensed manufacturers may now sell unstamped cigarettes directly to the Oneida Nation of New York. TSB-M-14(1)M(4) S (N.Y.S. Dep't of Tax. and Fin., Mar. 7, 2014). The new policy is based on a settlement reached in a case pending in federal court, *State of New York, et al. v. Jewell*, 6:08-CV-0644 (LEK/DEP) (N.D.N.Y. Mar. 4, 2014), which, in addition to resolving tax issues, also resolved many unrelated issues, including granting exclusive rights to casino gaming in certain New York areas to the Oneida Nation in return for sharing a portion of gaming revenues with state and local governments, and resolution of land disputes. The agreement also sets minimum pricing standards for cigarettes and requires the Oneida Nation to charge a Nation Tax on certain sales of cigarettes and tobacco products and motor fuel.

### **Appellate Division Affirms Denial of Dismissal of "Qui Tam" Complaint**

The Appellate Division has upheld a July 2013 trial court decision which allowed an action by the Attorney General under the State's False Claims Act to proceed on the claim that Sprint Nextel allegedly failed to collect \$100 million in sales tax on certain wireless calling plans. *State of New York v. Sprint Nextel Corp., et al.*, No. 11848, 103917/11 (1st Dep't Feb. 27, 2014). The Appellate Division agreed that the complaint adequately set forth violations of the False Claims Act and the Tax Laws, and that the company had not established that the Tax Law provision relied on by the Attorney General is preempted by a federal statute or that the False Claims Act should not be given retroactive effect.

### **Caterer's Food Sales to Homeowner's Association Are Held Not Sales for Resale**

A food caterer's sales of prepared food to a Long Island homeowner's association that operated a restaurant have been held to not qualify as nontaxable sales for resale for New York sales tax purposes. *Matter of Whitson's Food Service Corp.*, DTA No. 824629 (N.Y.S. Div. of Tax App., Feb. 27, 2014). A New York State Administrative Law Judge held that the sale for resale exclusion is not available to a food caterer's sales of prepared food, where the caterer also furnishes serving assistance after the food is delivered, and therefore the caterer was required to collect and remit sales tax on its catering charges. The fact that the homeowner's association may have itself charged sales tax on its sales of the prepared food did not absolve the caterer from the caterer's own sales tax responsibilities.



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Consolidated Freightways v. California  
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Current, Inc. v. California  
Deluxe Corp. v. California  
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Hallmark v. New York  
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Hercules Inc. v. Kansas  
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Panhandle Eastern Pipeline Co. v. Kansas  
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Powerex Corp. v. Oregon  
Reynolds Metals Company v. Michigan  
Reynolds Metals Company v. New York  
R.J. Reynolds Tobacco Co. v. New York  
San Francisco Giants v. San Francisco  
Science Applications International Corporation v. Maryland  
Scioto Insurance Company v. Oklahoma  
Sears, Roebuck and Co. v. New York  
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Sparks Nuggett v. Nevada  
Sprint/Boost v. Los Angeles  
Tate & Lyle v. Alabama  
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Union Carbide Corp. v. North Carolina  
United States Tobacco v. California  
UPS v. New Jersey  
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USX Corp. v. Kentucky  
Verizon Yellow Pages v. New York  
Wendy's International, v. Illinois  
Wendy's International v. Virginia  
Whirlpool Properties v. New Jersey  
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