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TWO COMBINED REPORTING DECISIONS HIGHLIGHT ISSUES INVOLVING "PERMISSIVE" COMBINED REPORTING

By Hollis L. Hyans and Amy F. Nogid

The New York State Tax Appeals Tribunal has issued its decision in *Matter of IT USA, Inc.*, DTA Nos. 823780 & 823781 (N.Y.S. Tax App. Trib., Apr. 16, 2014), affirming the Administrative Law Judge's determination permitting two New York taxpayer corporations to file combined Article 9-A reports, also including their parent holding company, despite the absence of substantial intercompany transactions, since they established the existence of a unitary relationship and the lack of arm's length pricing. Meanwhile, in a decision issued just weeks earlier, an ALJ found that combination was not permitted for a different group of companies providing information technology sales and service, finding insufficient connections on the record presented to establish either a unitary relationship or distortion. *Matter of SunGard Capital Corp. and Subsidiaries, et al.*, DTA Nos. 823631 et. al. (N.Y.S. Div. of Tax App., Apr. 3, 2014).

IT USA Case

Facts. IT USA, Inc. ("IT USA") is a United States subsidiary of an Italian clothing company based in Milan, Italy, which in 2001 formed a new corporation, IT Holding USA, Inc. ("IT Holding"), to centralize the operations of IT USA and another affiliate, Manifatture Associate Cashmere USA, Inc. ("MAC"), acquired by the Italian parent in 1999. Employees of IT USA who had also performed administrative services for MAC were transferred to IT Holding and continued to perform services for both IT USA and MAC from IT Holding's commercial domicile in New York City, including all logistical functions, such as ordering inventory from Italy and having it shipped to U.S. customers, and such day-to-day functions as performing credit checks, collection activity, advertising and public relations. IT USA and MAC employed only sales personnel and did not have their own management or administrative employees.

IT Holding used sophisticated software to track shipments and orders from IT USA and MAC and to monitor outstanding receivables for their customers. IT Holding paid a third party a license fee for the software and did not receive reimbursement from IT USA or MAC. IT Holding rented a warehouse to store certain IT USA and MAC merchandise, and it organized fashion shows to display IT USA and MAC luxury clothing. There was no management services agreement, and although a management fee schedule was prepared to allocate compensation paid to IT Holding employees among the companies based on estimated hours, no time records were kept, and the methodology was based on cost, with no markup.

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MAC continually had a negative cash flow and received money from IT USA to fund its operations. No formal loan documents or other evidence of indebtedness were created and no interest was paid; payments of principal were accrued but no cash was transferred. All three companies had the same president, who oversaw all aspects of IT Holding's departments and was in total and sole control of IT USA and MAC, including making all the sales decisions. Certified financial statements included a disclosure that IT USA and Mac were economically dependent on IT Holding.

IT Holding, IT USA and MAC filed combined reports for 2003 through 2004, and on audit the Department of Taxation and Finance determined that they should have filed as separate entities because of the absence of substantial intercorporate transactions and because they did not provide documentation supporting a schedule the companies had submitted showing percentages and dollar amounts of management fees.

The standard for combined reporting. For the years at issue (2003 and 2004), combined reporting was required or permitted under the statute and the regulations when three requirements were met: (1) ownership of substantially all stock; (2) a unitary business; and (3) distortion on separate returns, which was presumed to exist when there were substantial intercorporate transactions.

The Department agreed that the ownership requirements were met, and it does not appear to have seriously contested that a unitary business existed, but contended that the "distortion" requirement was not met, relying heavily on the absence of substantial intercorporate transactions as its basis for denying combined filing status.

The ALJ decision. The ALJ found that the companies were engaged in a unitary business, noting that they were in the same or related lines of business, they conducted related activities, and that IT Holding sold no product of its own but only provided services to IT USA and MAC. The ALJ focused on the "flow of value" among the companies as being "the key to a finding of a unitary business" and found a flow of value in numerous areas, including the common cash management system. He also concluded that distortion existed, relying on many of the same factors that established the unitary relationship.

The Tribunal decision. The Tribunal has affirmed the ALJ's determination and upheld the filing of combined reports. It found that a unitary business existed, relying, as did the ALJ, on the factors set forth in *Matter of Heidelberg Eastern, Inc.*, DTA Nos. 806890, 807829 (N.Y.S. Tax App. Trib., May 5, 1994), and noting that the same factors that give rise to a unitary business may demonstrate distortion on separate returns. The Tribunal found that IT Holding's provision of management, corporate, administrative and logistical services at cost resulted in distortion, and that IT USA and MAC "could not have operated without the wide array of support services provided by IT Holding," noting in particular the provision of management services at estimated cost, without any markup.

It found that a unitary business existed, relying . . . on the factors set forth in *Matter of Heidelberg Eastern, Inc.* . . . and noting that the same factors that give rise to a unitary business may demonstrate distortion on separate returns.

However, the Tribunal did not accept all the ALJ's factual findings, including the ALJ's finding that the failure to transfer funds between shared accounts demonstrated absence of actual payment, finding that the Tribunal has "previously accepted the posting of payments to intercompany accounts as sufficient evidence of payment in the context of controlled intercorporate accounts." It also did not accept the ALJ's finding that the cash management system resulted in distortion, despite agreeing that a common cash management system does indicate a unitary business and could be a "'possible area of distortion,'" noting the absence of documentary evidence, and finding two witnesses' testimony an insufficient substitute, since one was not employed during the audit period and the other failed to testify as to specific transfers and amounts of funds. Nonetheless, the Tribunal found distortion existed in reliance on the many services being provided at cost.

SunGard Case

The companies in the SunGard Group provided information technology sales and services, including data processing, information availability, software solutions and software licensing, through four main business segments "involved in similar and related lines of business": Financial Systems, Public Sector, Higher Education, and Availability Services ("AS"). SunGard Data Systems, Inc. ("SDS") was the parent for the first period of the two periods at issue, and SunGard Capital Corp. ("SCC") was the parent company for the second year. These periods were the first two periods after private equity investors acquired the SunGard Group in a leveraged buyout ("LBO").

SDS provided the SunGard Group's financial, accounting and information security data functions, as well as legal and employee management services; managed budgetary matters, including directing the cash management system and third party debt; and prepared all necessary SEC and other public filings and tax returns. The costs of providing such services exceeded $65 million and $66 million for the two

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periods, respectively. None of the costs were charged out to SDS' affiliates. Further, SDS financed the LBO, with almost $10 billion of debt, guaranteed jointly and severally by SDS and most of its wholly owned subsidiaries; some debt was securitized by affiliates' receivables. The debt instruments contain restrictions on the ability of members of the SunGard Group to issue dividends, sell assets and incur debt.

After the LBO, the SunGard Group consolidated purchasing, human resources and benefits management, and other shared services in SDS. SDS also paid a quarterly management fee to the investors after the LBO, for financial, managerial and operational advice, which was not charged out to SDS' affiliates. Also after the LBO, various groups were formed to promote cross-selling of business to existing clients among the Group's segments.

Audit. The companies in the SunGard Group with New York nexus originally filed separate reports for the short period ended December 31, 2005, and for 2006. Later, SDS and its subsidiaries, and SCC and its subsidiaries, filed amended reports on a combined basis for the two periods. Together the amended reports sought refunds in excess of $2.5 million. On audit, the Department denied the refund claims and issued deficiencies to certain affiliates, taking the position that, while the ownership requirement was met, neither a unitary business nor distortion existed.

ALJ decision. The ALJ agreed with the Department. He held, first, that the submitted record did not demonstrate that the SunGard Group was unitary, despite finding a "common thread" in the nature of the businesses transacted by the Group members and "shared points of connection" among the members. He found that, while there were many intercompany services, the SunGard Group had not established details about the costs of services provided or the significance of AS' services to the other members, even though the list of the services provided by AS appears to include services that are central to the success of the services provided by the other segments, such as managing the infrastructure and network, and maintaining hardware used by the SunGard Group. He also found that functional integration and flows of value attributable to the shared services were not "operational," drawing a distinction between "'corporate oversight' and 'strategic guidance'" on the one hand, and "functional or operational" expertise on the other, finding that the latter was necessary and had not been established.

Although the absence of a unitary business would alone preclude combination under the statute, the ALJ also addressed whether separate reporting resulted in distortion, rejecting the argument that the unreimbursed interest expenses and management fees, the use of a central cash management system, and cross-selling of products and services created sufficient distortion. Further, the ALJ noted that the record reflected "no quantifiable benefit" of SDS' LBO debt to the subsidiaries, that the failure of SDS to charge out approximately $66 million of expenses incurred on behalf of the SunGard Group was insufficiently significant when compared with SDS' total expenses, and there was no evidence in the record regarding the extent of any benefit attributable to the Group members from having a centralized cash management system.

Additional Insights

Taxpayers have seen many more audits seeking to separate groups that filed combined reports in cases where substantial intercorporate transactions are not present and therefore no presumption of distortion arises under the regulations. Nearly 20 years ago, in *Heidelberg Eastern*, the Tribunal reviewed the factors that are needed to demonstrate a unitary business and distortion on separate returns, but in recent years it appears that at least some auditors have regarded the standards of *Heidelberg Eastern* as no longer relevant and have refused to recognize that distortion may well arise even in the absence of substantial intercorporate transactions, forcing taxpayers to take cases to the Division of Tax Appeals to demonstrate the need for combined reporting.

The Tribunal decision in *IT USA* reaffirms those *Heidelberg Eastern* principles, and confirms that many of the same inquiries are necessary for both the unitary business and distortion tests, and that the same factors that demonstrate a unitary business can also support the existence of distortion if there is no arm's length compensation involved. These principles will continue to be relevant even after the statute changed in 2007 (until it changes again for years after 2014 under the newly enacted tax reform legislation) because, for taxpayers seeking to file combined reports, the distortion requirement remained in full force, and combination can still be permitted if distortion arises from separate returns, whether or not substantial intercorporate transactions exist. Therefore, taxpayers that can show they meet the standards for combination – whether or not they have substantial intercorporate transactions – should still be able to file combined reports, in reliance on both *IT USA* and *Heidelberg Eastern*.

It is interesting to consider whether the Tribunal decision in *IT USA*, if it had been issued earlier, would have led to any different result in *SunGard*. Unlike most combined reporting cases, which generally focus more on the distortion requirement, since the Department often agrees that the unitary business requirement has been met, in *SunGard* the Department also argued there was no unitary business, and the ALJ agreed, finding that the evidence in the record did not demonstrate significant, direct and quantifiable evidence to support findings of functional integration, centralized management and economies of scale. Although the record in *SunGard* appeared to include evidence of the existence of each of these elements, the decision found the level insufficient, although the ALJ does not identify the appropriate level of

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each that must be present to establish that a unitary business exists. Based on the many references in the decision to failures of proof in the record, taxpayers seeking combination should consider whether it makes sense to proceed on a stipulated record in lieu of a full hearing, as was done in *SunGard*, or to have a full hearing despite the likely additional costs involved with such a hearing. A full factual hearing may give taxpayers the opportunity to gauge and address the ALJ's concerns and perhaps establish through live testimony or additional evidence the substantiality of the impact of intercompany transactions and the parents' actions on behalf of all of the members of the group.

Due to the recent change for post-2014 years to full unitary combination, the need to demonstrate distortion will disappear, and the unitary business test will assume primary importance. The *SunGard* decision appears to be imposing a stricter test for establishing a unitary business than can be seen in either *Heidelberg Eastern* or *IT USA* and, if upheld, may give rise to a greater difficulty on the Department's part in demonstrating the existence of a unitary relationship among members of a group that it is seeking to combine under the new statute.

NEW YORK STATE CORPORATE TAX REFORM LEGISLATION ENACTED – WHAT YOU NEED TO KNOW

By Irwin M. Slomka

Governor Andrew M. Cuomo has signed into law comprehensive New York State corporate tax reform legislation, effective for taxable years beginning on or after January 1, 2015. Chapter 59, Part A, N.Y. Laws of 2014. The legislation substantially overhauls the New York State corporate tax (Article 9-A), and merges the bank tax (Article 32) into Article 9-A. Without question, the legislation represents the most significant revision to Article 9-A since its enactment in 1944. Here are the most important changes to the State corporate tax:

1. **Economic nexus.** The legislation adopts a "bright line" economic nexus standard for taxation of corporations deriving at least $1 million of receipts annually from activities in New York State, for a corporation having no employees, tangible real property or any physical presence in the State. As has been the case in other states that have adopted economic nexus, the controversial new nexus rules will almost certainly be challenged, particularly on Due Process and Commerce Clause grounds.

2. **Corporate partner nexus.** The statute allows further expansion of corporate partner nexus by permitting the Department of Taxation and Finance to adopt regulations subjecting to tax a corporate partner in a partnership that is doing business in, or deriving receipts from activity in, New York State, regardless of the nature or size of the ownership interest. The Department has not previously sought to tax out-of-State corporate partners holding, for instance, a less than 1% limited partner interest in a New York partnership, and it remains questionable whether a corporation with a less than 1% passive investment in a New York partnership – including a less than 1% investment interest in an LLC taxable as partnership – can, without more, constitutionally be subjected to corporate tax.

3. **Modifies categories of income (business, investment and other exempt income), with only business income subject to tax.** The new law modifies the categories of a corporation's income reportable under Article 9-A, with only business income being taxable and on an apportioned basis. The starting point for business income is federal taxable income for U.S. corporations and, in a significant change, effectively connected income for alien corporations that are not deemed domestic corporations for federal tax purposes. Currently under Article 9-A, an alien corporation having nexus with New York State must start the calculation of entire net income with its worldwide income.

4. **Subsidiary capital treatment eliminated.** The new law eliminates the subsidiary capital classification, including the exclusion for 100% of income from subsidiary capital, in place since the tax was enacted in 1944. Thus, one of the key provisions in Article 9-A, meant to encourage holding companies to locate in New York State, has now been repealed.

5. **Investment income no longer taxable.** The good news is that investment income will no longer be taxable, and New York State's unique "investment allocation percentage" used to apportion investment income will disappear. On the other hand, the definition of investment capital has been significantly narrowed to include only investments in the stock of non-unitary corporations held for more than six consecutive months. Equity instruments, government debt instruments and qualifying debt instruments will now be considered business capital, not investment capital.

6. **Expense attribution.** Nontaxable investment income and other exempt income must be reduced by *interest* expenses directly or indirectly attributable to those items of income, but it is no longer necessary to attribute *non-interest* expenses. Taxpayers will be permitted to make an election to reduce their nontaxable income – investment and other exempt income – by 40% in lieu of computing an interest expense attribution. The election should avoid the considerable uncertainties of expense attribution adjustments on audit.

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7. **Tax rate on business income is reduced to 6.5%, and 0% for qualified New York manufacturers.** The rate reduction for most corporations does not go into effect until tax years beginning on or after January 1, 2016. The new law introduces a zero tax rate on business income for qualified New York manufacturers, effective immediately for tax years beginning on or after January 1, 2014. It also expands the definition of a qualified New York manufacturer to include a corporation (or a combined group) with at least 2,500 employees engaged in manufacturing in New York State and having in-State property used in manufacturing with an adjusted basis for federal tax purposes of at least $100 million at year end.

8. **Capital base cap increased, with phase-out of capital tax rate.** The current 0.15% capital tax rate will be phased out over a six-year period, beginning in 2016, so that by 2021, the tax rate on capital will be zero. Despite the phase-out, the cap on the capital tax, currently set at $1 million per year, will be increased to $5 million per year. In the short run, this will likely be most beneficial to banks, which currently are subject to an Article 32 capital tax that has no cap, but will be a potential detriment to corporations (including REITs) that own New York real property.

9. **Market-based sourcing.** The statute adopts market-based sourcing for all types of receipts and gains in the apportionment factor, and prescribes clearly-defined hierarchies for determining the market state. The new law also contains new sourcing rules for receipts from digital products, and includes detailed new sourcing rules for apportioning income from financial instruments, permitting taxpayers to elect to source all income from "qualified financial instruments" using an 8% allocation factor (intended to represent an estimate of New York's share on the U.S. gross domestic product). The new law continues the current sourcing rules for sales of tangible personal property, property rentals, and various existing customer-based rules for certain businesses and industries, such as for advertisers, services performed for regulated investment companies, and most broker-dealer activities. The sourcing rules in the new law are vastly more detailed than existing law – and, for that matter, than the current regulations.

10. **Adopts water's-edge unitary combined filing.** Under the new combined reporting regime, taxpayers will be required to file combined returns with unitary corporations in which there is a more than 50% stock ownership interest. The distortion test for mandatory combination, including the substantial intercorporate transactions test, is eliminated, leaving much of the future controversies to focus on whether there is a unitary business relationship among the related companies, including holding companies. The law includes several exceptions to unitary combined filing, including an exception for alien corporations that have no federal effectively connected income. Importantly, taxpayers will now be allowed to make a binding seven year election to file on a combined basis with all commonly owned corporations that meet the more than 50% stock ownership test. Except with respect to eligibility for tax credits, the combined group will generally be treated as if it were a single entity.

11. **NOL deductions substantially changed.** Among the key changes to the net operating loss rules are that after 2014 NOLs must take into account the taxpayer's apportionment factor from the loss year, and that the NOL deduction is no longer limited to the NOL deducted for federal purposes. The new law conforms the Article 9-A NOL carryforward period to the 20-year federal carryforward period, and allows a three-year carryback.

12. **Prior NOL conversion subtraction.** Unabsorbed NOLs generated in tax years beginning before January 1, 2015, can no longer be taken. Instead, there is a "prior NOL conversion subtraction," deductible in 1/10 amounts over a 20-year period, taking into account the taxpayer's apportionment factor in the base year before the new law takes effect. Alternatively, taxpayers may elect to claim the conversion subtraction in up to ½ amounts in each of the years 2015 and 2016.

13. **Existing tax credits remain in place.** Existing tax credits (including credit carryovers) largely remain in place, with certain new credits introduced, including a 20% real property tax credit (effective in 2014) for qualified New York manufacturers.

This is only a partial listing of the various changes, and the provisions in the new law are detailed and may contain exceptions to the general rules. As noted above, certain of the changes may be susceptible to legal challenge. At present, the changes apply only to the New York State corporate and bank taxes, and not to the New York City general corporation and bank taxes. If the New York City taxes are not similarly amended, there will be substantial (and unprecedented) nonconformity between the State and City corporate taxes beginning in 2015.

APPELLATE COURT FINDS DUE PROCESS VIOLATION IN RETROACTIVE APPLICATION OF 2010 STATUTORY AMENDMENT

By Hollis L. Hyans

Reversing a decision of the trial court, the Appellate Division, First Department, has held that the application by the Department of Taxation and Finance of a 2010 statutory

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amendment concerning the treatment of installment payments by nonresident shareholders of an S corporation to transactions that occurred in 2007 and 2008 violated the taxpayers' Due Process rights. *Caprio v. N.Y.S Dep't. of Taxation & Fin.*, No. 651176/11, 11231, 2014 NY Slip Op 2399 (App. Div. 1st. Dep't Apr. 8, 2014).

The plaintiffs, Mr. and Mrs. Caprio, were nonresidents of New York. They were the sole shareholders of an S corporation doing business as TMC Services, Inc. ("TMC"), which derived a portion of its income from activities in New York. In 2007, the Caprios sold all of their shares in TMC to a third party for a base price of approximately $20 million, plus an additional payment of $500,000 in 2008, and received promissory notes from the buyer for the installment obligations.

For federal income tax purposes, the Caprios and the purchaser made an election under Internal Revenue Code ("IRC") § 338(h)(10) to treat the stock sales as a sale by TMC of its assets to the purchaser in return for the installment obligations, followed by a deemed liquidation and distribution to its shareholders of the consideration received from the purchaser. In addition to the § 338(h)(10) election, the Caprios elected to report the gain from the deemed asset sale under the installment method, pursuant to IRC § 453, under which gain is generally recognized only when cash payments are actually received. The Caprios reported a capital gain on their 2007 federal income tax return of approximately $18 million, and an additional gain of approximately $1 million in 2008.

The Caprios reported these amounts on their 2007 and 2008 New York nonresident income tax returns as payments received under the installment method in exchange for stock in TMC. They took the position that the gain should be treated as having arisen from the sale of stock, and therefore was not New York-source income, since, under Tax Law § 631(b)(2), gain from the sale of an intangible asset such as stock is not included in the taxable income of a nonresident unless the asset was employed in a trade or business in New York.

In 2009, an Administrative Law Judge held that, under Tax Law § 632(a)(2), nonresident shareholders did not have New York-source income when they sold their stock in an S corporation under an installment agreement. *Matter of Myron Mintz*, DTA Nos. 821806 & 821807 (N.Y.S. Div. of Tax. App., June 4, 2009). A similar decision had been reached by the Tax Appeals Tribunal in *Matter of Gabriel S. & Frances B. Baum*, DTA Nos. 820837 & 820838 (N.Y.S. Tax App. Trib., Feb. 12, 2009). In August 2010, Tax Law § 632(a)(2) was amended to specifically provide that gain recognized by a nonresident shareholder of an S corporation, arising from payments received under an installment obligation, will be treated as New York-source income based on the S corporation's New York business allocation percentage for the year in which the assets were sold. The amendment was made applicable to years beginning on or after January 1, 2007, that were open for assessment or refund.

Audit and decision below. In February 2011, the Department of Taxation and Finance issued Notices of Deficiency to the Caprios for 2007 and 2008, seeking additional tax and interest of nearly $800,000. The Caprios brought suit in the Supreme Court, New York's trial court, claiming that the application of the 2010 amendment to § 632(a)(2) to their 2007 and 2008 tax returns was unconstitutional under the Due Process Clauses of the United States and New York Constitutions. They argued that the 2010 amendments for the first time imposed a tax on gain recognized on payments received from installment obligations under IRC § 453(h)(1)(A), and that the three-and-a-half-year period of retroactivity was excessive. The trial court determined that the retroactive application was permissible and dismissed the action in November 2012.

Appellate Division decision. The Appellate Division reversed the decision below, holding that the 2010 amendments could not be retroactively applied to the years at issue. First, the court noted that while retroactive legislation is disfavored, it is "not necessarily unconstitutional" and can be valid if the period of retroactivity is short and not so "'harsh and oppressive as to transgress the constitutional rights'" of the taxpayer. It cited the decision by the Court of Appeals in *James Square Assocs. LP, et al. v. Mullen*, 21 N.Y.3d 233 (2013), covered in the July 2013 issue of *New York Tax Insights*, as reaffirming a three-prong test to determine whether the retroactive application of a tax statute is constitutional. The three factors are: (1) the taxpayer's forewarning of a change and the reasonableness of reliance on the old law; (2) the length of the period of retroactivity; and (3) the public purpose for retroactive application.

The court found that the Department could point to no legislative history indicating the 2010 amendment was correcting any specific error, as opposed to amending the law to adopt the Department's "purported policy."

Application of these factors led the court to reject retroactivity of the 2010 amendments. With regard to forewarning of the change, which is the "'predominant'" factor, the court found that the Caprios had no actual forewarning, and that the amendment was not even proposed until long after they had entered into the transaction, giving them no opportunity to restructure the transaction. It rejected the Department's position that the plaintiffs could not have relied on the *Mintz* ALJ decision, because it too was issued years after the transaction, instead

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accepting the Caprios' argument that they reasonably relied not on *Mintz* but on the law as it previously existed, which prior to the 2010 amendments did not specifically address a nonresident's receipt of payments under these circumstances. The court found that the Caprios made a "compelling argument" that under previous law the payments were not taxable, noting that under the IRC the payments would be treated as payments for stock, and New York Tax Law generally provided that a nonresident's sale of stock was not taxable. The court also rejected the Department's argument that the Caprios should have known it had a long-standing policy of taxing such transactions, finding the only proof for such a policy was one 2002 PowerPoint presentation made to Department auditors, and there was no evidence that taxpayers were ever informed of such a policy. The court also rejected the Department's argument that the Caprios could not establish reasonable reliance in the absence of an explanation of how they would have structured the transaction differently, finding that the law does not require a demonstration of a specific proposed alternative but only a showing that the plaintiffs structured the transaction in "reasonable reliance" on the prior law.

The court then found that the second *James Square* factor, the length of the period of retroactivity, also favored the Caprios, noting that in *James Square* the Court of Appeals found excessive a retroactive period of 16 months, where here the period of retroactivity was even longer, three and a half years. The court rejected the Department's argument, which had been accepted by the trial court, that longer periods of retroactivity are acceptable when a legislative change is merely curative, finding that the Department failed to demonstrate the amendment was merely curative. The court found that the Department could point to no legislative history indicating the 2010 amendment was correcting any specific error, as opposed to amending the law to adopt the Department's "purported policy."

Finally, although finding it was a "close question," the court also determined that the public purpose for the retroactive application – raising tax revenues by $30 million to implement the 2010-2011 Executive Budget – was "'not a particularly compelling justification.'" Therefore, after review of all three factors, the court determined that retroactive application of the 2010 amendment resulted in a Due Process violation and enjoined the Department from enforcing the Notice of Deficiency issued to the Caprios.

Additional Insights

As can be seen from the cases, the treatment of gains incurred by nonresident shareholders from sales of interests in S corporations has long been a contentious issue in New York. Other taxpayers had litigated very similar issues, and in *Mintz* and in *Baum* an Administrative Law Judge and the Tax Appeals Tribunal had disagreed with the Department's interpretation of the statute. The Department then sought and obtained a statutory amendment, by its terms retroactive, but leaving the vexing question of whether that amendment could constitutionally be applied retroactively. The Appellate Division has now decided that such retroactive treatment violates taxpayers' Due Process rights.

One judge dissented in *Caprio*, agreeing with the court below that that the 2010 amendment was merely curative, and necessary to conform the statute to the Department's policy. The dissent also opined that the plaintiffs could have requested an advisory opinion but did not do so. The majority opinion properly rejects this view, explicitly disagreeing that the Caprios had any duty to have sought an advisory opinion, finding that they had no reason to seek clarification since a reasonable reading of the Tax Law as it then existed was that the transaction was not subject to tax – the same conclusion reached by an ALJ in the *Mintz* case.

While no appeal had been filed as of this writing, it seems likely that the Department will seek further appeal to sustain its efforts to apply the 2010 amendments retroactively. Also, another case raising a similar issue, *Burton v. New York State Dep't of Taxation and Fin.*, 978 N.Y.S. 2d 653 (Sup. Ct Albany Cnty. 2014) (discussed in the February 2014 issue of *New York Tax Insights*), in which the taxpayer abandoned at oral argument its position on retroactivity but continued to argue that the amended statute was unconstitutional, is currently on appeal.

TRIBUNAL AFFIRMS THAT A NONRESIDENT PARTNER'S LOSS FROM THE 2005 DISPOSITION OF PARTNERSHIP INTEREST WAS NOT NEW YORK SOURCE INCOME

By Kara M. Kraman

The Tax Appeals Tribunal has affirmed the determination of an ALJ that a nonresident partner properly included his share of the gain from the partnership's 2005 sale of a New York office building in his New York source income, but improperly included the loss from his 2005 disposition of an interest in that same partnership. *Matter of Craig A. Olsheim*, DTA No. 824218 (N.Y.S. Tax App. Trib., Apr. 10, 2014).

The nonresident partner, Craig A. Olsheim, was a limited partner in a partnership whose sole asset was an office building located in New York City. Because he had inherited his partnership interest, Mr. Olsheim's "outside basis" in the partnership interest (the fair market value of the partnership interest at the time he inherited it) was more than his "inside basis" in the interest (his pro rata share of the partnership's

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adjusted basis in the office building). In 2005, the partnership sold the office building and dissolved.

Mr. Olsheim reported his pro rata share of the gain from the sale of the office building on his New York nonresident personal income tax return. On that same return, he also claimed a capital loss resulting from the dissolution of the partnership. After an audit, the Department issued a Notice of Deficiency, disallowing the loss.

In 2013, an ALJ, relying heavily on *Technical Memorandum*, TSB-M-92(2)I (N.Y.S. Dep't of Taxation & Fin., Aug. 21, 1992), which stated that loss from the disposition of an interest in a partnership that holds New York real property was not New York source income, held that Mr. Olsheim improperly included the loss from the disposition of his partnership interest. While the Tribunal found that the ALJ afforded too much deference to the TSB-M, it ultimately reached the same conclusion and affirmed the ALJ's determination.

The Tribunal explained that whereas New York source income includes gains from the sale of real property located in the State, such as the partnership's sale of its office building in New York City, at the time of the partnership liquidation in 2005, the disposition of an interest in a partnership was considered a disposition of intangible personal property, and intangible property is sourced to New York only to the extent that the intangible is employed in a "business, trade, profession or occupation carried on in this state." Tax Law § 631(b)(2). Based on the fact that there was no evidence in the record that the partnership carried on business in New York (even though it owned New York realty), the Tribunal concluded that Mr. Olsheim could not source his loss from the dissolution of the partnership to the State. The Tribunal noted that had the dissolution taken place after the 2009 enactment of Tax Law § 631(b)(1)(A)(1), which provides that nonresidents must include as New York source income gain or loss from the sale of an interest in a partnership that holds real property located in the State representing at least 50% of the partnership's total assets, Mr. Olsheim have would have been permitted to include the loss as part of his New York source income.

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As the Tribunal noted, under the current law, Mr. Olsheim's loss would have been considered to be from New York sources. The current law does not extend that rule to gain or loss from the sale of an interest in a partnership that principally holds tangible *personal* property, rather than real property, in the State. It should also be noted that the Tribunal's language that the ALJ "afforded undue deference" to the TSB-M is also a reminder that while the Department's Technical Memoranda are useful in ascertaining which position the Department is likely to take, and can be a useful tool in understanding a particular provision the law, they are not binding precedent. Pursuant to the Department's own regulations, Technical Memoranda "have no legal effect but are merely explanatory[,] . . . do not set precedent and are not binding." 20 NYCRR 2375.6(c).

ALJ PROVIDES TAXPAYER LIMITED AWARD OF LEGAL FEES IN WITHHOLDING TAX DISPUTE

By Michael J. Hilkin

In *Matter of Max Oshman*, DTA No. 825941 (N.Y.S. Div. of Tax App., Apr. 3, 2014), a New York State Administrative Law Judge ruled that the Department of Taxation and Finance must reimburse the legal fees of an individual taxpayer who had been improperly assessed as a "responsible person" liable for the unpaid withholding taxes of a limited liability company. However, the taxpayer's reimbursement award was limited to $75 for each hour billed by his attorneys and accountants—the maximum award generally allowed by law—because the taxpayer did not provide any information regarding the existence of special factors to support the reimbursement of fees paid at a higher per-hour rate.

Facts. Following notification from the IRS of the results of a federal audit of a business, Plot Developers LLC, the Department initiated an audit of Plot Developers for the 2007, 2008 and 2009 tax years. Plot Developers had failed to notify the Department of the results of the federal audit, and the federal audit adjustments potentially affected Plot Developers' New York withholding tax liability. The Department made multiple attempts to contact Plot Developers and one of its partners but never received any responses. At no point during its audit, however, did the Department attempt to contact Max Oshman, the Petitioner in this case.

After failing to receive any responses from Plot Developers or the one partner the auditor attempted to contact, the Department issued assessments for unpaid withholding taxes against the business and individuals the Department identified as the business's "responsible persons." The Department assessed Mr. Oshman as a responsible person based on information from a New York return filed by Plot Developers for the 2004 tax year, which listed Mr. Oshman as holding a 33.33% interest in the business at that time.

Subsequently, Mr. Oshman filed a timely request for a conference with the Bureau of Conciliation and Mediation Services ("BCMS"). At the BCMS, Mr. Oshman's representatives submitted documentation showing that Mr. Oshman did not hold an interest in Plot Developers during the years under audit, and thus could not be a responsible person. The Department then canceled the assessments.

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Mr. Oshman requested reimbursement of fees paid to an accounting firm and a law firm that assisted him in challenging the assessments. The accounting firm billed at an hourly rate of $295, and the law firm's invoices showed hourly rates of $275 and $565. Mr. Oshman also provided an affidavit confirming that his net worth remained below $2 million at all times from the date of assessment to the present, the threshold to qualify for attorneys' fees.

The law. Under Tax Law § 3030, a taxpayer may collect reasonable administrative and legal costs incurred in connection with an administrative or court proceeding (including a proceeding before BCMS), as long as the taxpayer is the "prevailing party" in the proceeding. An individual generally will be treated as the prevailing party if he or she (i) substantially prevailed with respect to an amount in controversy or with respect to the most significant issues or set of issues presented in the controversy; (ii) timely submits an application for reimbursement of expenses, along with an itemized statement of any attorneys' fees incurred identifying the time expended and the hourly rate charged by the attorney; and (iii) has a net worth that does not exceed $2 million at the time the action was filed. However, an individual will not be treated as a prevailing party entitled to reimbursement of expenses if the Department is able to establish that its position in the controversy was "substantially justified." The Tribunal has held that a position of the Department will be substantially justified as long as the Department had a "reasonable basis" in both fact and law for having taken the position.

The law further provides that attorneys' fees in excess of $75 per hour are not reimbursable unless there is a determination that an increase in the cost of living or another special factor, such as the limited availability of qualified attorneys for the proceeding, justifies a higher rate. Fees from advisors that are not attorneys will be treated as attorneys' fees as long as the advisor is authorized to practice before the Division of Tax Appeals.

The decision. Because the Department canceled the assessments against Mr. Oshman after the BCMS proceeding, the ALJ concluded that Mr. Oshman "clearly" satisfied the general criteria of being the "prevailing party" with respect to that proceeding. Further, the ALJ found that the Department was not substantially justified in assessing Mr. Oshman because there was no reasonable basis for the assessment, since the Department had relied solely upon information that was approximately four years old and never made an attempt to contact Mr. Oshman prior to issuing the assessment. The ALJ further determined that expenses paid by Mr. Oshman to an accounting firm were reimbursable as attorneys' fees because the accounting firm was qualified to appear before the Division of Tax Appeals.

However, because Mr. Oshman did not provide any information supporting the reimbursement of fees at a rate higher than the statutory cap of $75 per hour, the ALJ limited reimbursement of Mr. Oshman's attorney's fees to the $75 per hour rate.

Additional Insights

The Taxpayer Bill of Rights Act of 1997 added provisions to the Tax Law providing for the reimbursement of "reasonable" administrative and litigation expenses incurred by individuals with a net worth of $2 million or less, and businesses with 500 or fewer employees and a net worth of $7 million or less. Because the law does not allow for such expenses to be reimbursed when the Department loses with respect to a position that was "substantially justified," and the Department is treated as having a sufficiently substantial justification for a position as long as it had a "reasonable basis" for its position, reimbursement awards under the law have been relatively rare. As this case shows, however, a taxpayer may qualify for reimbursement when the Department makes an especially egregious error. Also, it is not necessary to proceed to a hearing before an ALJ to obtain such fees, since in this case the matter was resolved at BCMS and fees were nonetheless awarded.

The law's $75-per-hour cap on attorneys' fees is a significant limitation on the amount of reimbursement awards allowed under the law. However, the law explicitly states that a court may determine that "an increase in the cost of living" or another "special factor," such as limited availability, justifies a higher hourly rate. Since the $75 fee cap has not been adjusted since 1997, when petitioning for reimbursement of attorneys' fees, at a minimum taxpayers should consider taking the position that inflation since 1997 justifies reimbursement at a higher rate.

ALJ FINDS EMPIRE ZONE CREDIT CORRECTLY CALCULATED FOR PERSONAL INCOME TAX PURPOSES

By Hollis L. Hyans

A New York State Administrative Law Judge has held that the individual shareholders of a New York S corporation properly calculated their credits under the State's Qualified Empire Zone Enterprise ("QEZE") program using a tax factor based on their personal income tax filings, and that there is no requirement in the statute that the S corporation's New York apportionment percentage be considered. *Matter of Lisa M. & Gregory E. Henson, et al.,* DTA Nos. 825068 & 825254-825257 (N.Y.S. Div. of Tax App., Apr. 10, 2014).

Facts. Mr. and Mrs. Henson, and all of the other petitioners (the "Individual Shareholders") were indirect owners of Resort Funding, LLC, through their ownership of the shares of two

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S corporations, Hamel Capital, Inc. and Henson Capital, Inc., two members of Resort Funding. Resort Funding had elected to be taxed as a partnership, and both corporations elected to be taxed as S corporations under the Internal Revenue Code and Tax Law § 660, so that the tax attributes of all three entities flowed through to the Individual Shareholders. Resort Funding's only office was in Syracuse, New York, all of its operations were within the Syracuse Empire Zone, and it had been certified as a QEZE. The Individual Shareholders reported and paid New York tax on all income that flowed through to them from Resort Funding, Hamel Capital and Henson Capital, and they paid no income tax to any other state. They claimed the QEZE tax reduction credit, as set forth in Tax Law § 16, on their New York personal income tax returns.

The ALJ found that Tax Law § 16 "clearly requires use of the *shareholder's* portion of income from the QEZE that is allocated to New York State in calculating the tax factor."

The QEZE credit was enacted as part of the Empire Zones Program Act, added in 2000 to provide new tax credits and other incentives to businesses that agreed to create employment and make investments in areas that were economically depressed. The credit is a product of four factors: the benefit period factor, the employment increase factor, the zone allocation factor and the tax factor. Only the last one, the tax factor, was in dispute.

Where the taxpayer is an S corporation shareholder, the statute provides that the tax factor is the product of the ratio of the shareholder's income from the QEZE allocated within New York, divided by the shareholder's New York State adjusted gross income, multiplied by the shareholder's New York State income tax. According to the ALJ, the tax factor is "in essence, the portion of the shareholder's New York State income tax resulting from income from the QEZE allocated to New York." The Individual Shareholders followed this formula in claiming their credits.

On audit, the Department recalculated the tax reduction credits, maintaining that the Individual Shareholders improperly allocated all of Resort Funding's business income to New York State, and instead should have used only Resort Funding's income allocated within New York State, which it defined as the company's income reported on the Individual Shareholders' forms K-1, multiplied by Resort Funding's business allocation percentages as reported on its State partnership tax returns and by the two Subchapter S corporations' business allocation percentages. The Department thereby reduced each of the Individual Shareholders' tax reduction credit by approximately 30% and issued Notices of Deficiency for additional personal income tax.

The Individual Shareholders challenged the Notices, claiming that nothing in the statute or regulations required or even referenced use of the business allocation factor of Resort Funding or the two Subchapter S corporations, and that, as residents, they had allocated all of their income from Resort Funding to New York, so that amount should be used in computing the tax factor. They argued that the intent of the legislature, which had enacted the QEZE program to create employment and encourage investments in economically depressed areas, was to provide a tax reduction credit, and that there was no intent to reduce the amount of the credit simply because the QEZE's products, all of which were manufactured at the certified location, were shipped out of state, thereby reducing its New York sales factor.

The Department, on the other hand, claimed that the adjustment was required to properly determine the amount of income allocated to New York, and that its interpretation of the statute should be given significant weight and judicial deference.

The ALJ's decision. In a decision that closely tracks one issued by a different ALJ a year earlier, in *Matter of Harold A. and Katherine R. Batty and Matter of James E. and Tina L. Pennefeather*, DTA Nos. 824061 & 824063 (N.Y.S. Div. of Tax App., Apr. 4, 2013), the ALJ agreed with the Individual Shareholders. He found that the statute, Tax Law § 16(f)(1), required the computation of the tax factor to be made pursuant to Articles 9-A or 22, "depending on the filing nature of the taxpayer claiming the credit." Resort Funding, Henson Capital and Hamel Capital were all flow-through entities for federal and state purposes, with their tax attributes flowing through to the Individual Shareholders. The ALJ found that Tax Law § 16 "clearly requires use of the *shareholder's* portion of income from the QEZE that is allocated to New York State in calculating the tax factor." (emphasis added). As residents, the Individual Shareholders had allocated all of their income to New York, and that was the amount that the ALJ found should be used to calculate their tax factor.

While acknowledging the Department's argument that its interpretation of tax statutes is ordinarily to be upheld if not irrational or unreasonable, the ALJ found that, when the issue is one of pure legal interpretation of clear and unambiguous statutory language, no deference to the Department is required, since there was no need to consider any special agency expertise.

The ALJ rejected the Department's reliance on language in the instructions to Form IT-604, finding that, to the extent that language could be interpreted to support the Department's interpretation, it improperly differs from or expands the statute, which can be done only by the legislative or regulatory process, not merely through instructions. The ALJ also noted that, while a Technical Services Bureau Memorandum issued

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by the Department did discuss the use of a business allocation percentage, that discussion was in the context of instructions for calculating the tax factor for *corporate* partners, not individual taxpayers. *See Technical Memoranda*, TSB-M-06[1]C and TSB-M-06[2]I (N.Y.S Dep't of Taxation and Fin., Feb. 2, 2006).

Additional Insights

The ALJ's decision recognizes that the legislature intended the credit to parallel the portion of the income that the taxpayer earned and reported to New York because of the QEZE's activity, and that there was no statutory or regulatory reason to even consider the business allocation percentage of the flow-through entities, which were paying no tax to New York State.

This is now the second ALJ decision reaching, on the same grounds and in almost identical language, the same result rejecting the Department's interpretation of the method that should be used to calculate the tax reduction credit available to individual shareholders of S corporations on their personal income tax returns. While ALJ decisions are not precedential, Tax Law § 2010(5), it seems unfortunate that the same issue has to be litigated all over again by different individual taxpayers. If last year's decision in *Matter of Batty and Matter of Pennefeather* had been appealed by the Department filing an exception to the Tax Appeals Tribunal, the result would have been a precedential Tribunal decision applicable to all taxpayers, but it does not appear that such an exception was filed by the Department, which instead seems to have continued to apply its approach to additional taxpayers.

INSIGHTS IN BRIEF

Vessels Found to Be Operating in Interstate Commerce and Therefore Exempt From Sales Tax

An ALJ has found that vessels purchased to operate fishing charter trips were commercial vessels primarily engaged in interstate commerce, and thus exempt from sales tax under Tax Law § 115(a)(8), despite the fact that all trips both began and ended in New York. *Matter of Celtic Quest, Inc.*, DTA Nos. 825281 & 824935 (N.Y.S. Div. of Tax App., Apr. 3, 2014). The ALJ found that the destinations of the voyages were the waters off Connecticut or Rhode Island, which were much more desirable fishing locations than New York waters, and the subject of specific advertising by the vessels' owner and a central element of his business plan, relying on "credible testimony" from the vessels' operator to establish these facts. The ALJ rejected the Department's argument that the petitioner failed to produce trip diaries, maps or other records to document all trips during the period at issue, finding that the Department had relied at the hearing solely on its legal position that all sales were presumptively subject to tax and, having failed to raise such a factual issue, could not raise it after the hearing was closed and the petitioner had no opportunity to introduce additional factual evidence.

Retired SUNY Professor's Distribution from His Rollover IRA Does Not Qualify for State Pension Exclusion

A retired SUNY professor's distribution from a rollover IRA, established from an earlier distribution in complete liquidation of his SUNY pension, did not qualify for the 100% exclusion for pensions paid to State employees under the State personal income tax. *Matter of Peter and Marguerite Kane*, DTA No. 824767 (N.Y.S. Div. of Tax App., Mar. 20, 2014). A New York State Administrative Law Judge held that while the portion of the retired professor's distribution that represented the pension benefit rolled into his IRA was exempt from tax, here the entire amount of his original liquidated SUNY pension had previously been distributed to him tax-free, and therefore the subsequent distributions in issue represented accumulated earnings that were no longer connected to his SUNY retirement benefits within the meaning of Tax Law § 612(c)(3)(i). However, the retired professor did qualify for the $20,000 pension and annuity exclusion under Tax Law § 612(c)(3-a).

Tribunal Upholds Taxation of Nonresident's Gain from Exercise of Stock Options

The Tax Appeals Tribunal, affirming an ALJ decision, has upheld the taxation of a portion of the compensation received by a nonresident individual from exercising stock options for personal income tax purposes. *Matter of Lawrence Gleason*, DTA No. 823829 (N.Y.S. Tax App. Trib., Mar. 18, 2014). The individual, a retired American Airlines employee, had received incentive nonstatutory stock options as an employee, which he exercised in 2006 after his retirement, and then sold the stock, but did not allocate any portion of the gain to the State. The taxpayer argued, among other things, that since the value of the stock appreciated after he retired, the resulting gain had no connection with his New York employment. The Tribunal held that, under *Michaelson v. NYS Tax Comm'n*, 67 N.Y.2d 579 (1986), the gain was properly subject to tax. Noting that the taxpayer did not challenge the Department's calculation of the allocable portion of the gain, the Tribunal held that the ALJ "accurately and adequately" addressed the manner in which the taxable portion of the gain was determined.