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# NEW YORK TAX INSIGHTS

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# STATE TRIBUNAL REVERSES ALJ AND ALLOWS COMBINED REPORTING

Just as we went to press, the New York State Tax Appeals Tribunal reversed the decision of an Administrative Law Judge and held that two related companies could file combined reports for the 2007 year, in which the statute had changed to require or permit combined reporting whenever there were substantial intercorporate transactions. *Matter of Knowledge Learning Corporation and Kindercare Learning Centers, Inc.*, DTA Nos. 823962 & 823963 (N.Y.S. Tax App. Trib, Sept. 18, 2014). The Tribunal, unlike the ALJ, found that the companies did engage in substantial intercorporate transactions, and explicitly found that employees had been transferred from two entities to a related company, relying on witness testimony as well as evidence such as federal unemployment tax returns and documents indicating the company's strategy and business purpose for creating a single entity, and also found that the transfer had economic substance. Since the Tribunal found substantial intercorporate transactions, it did not need to consider whether distortion otherwise existed on separate returns, but it nonetheless expressly reversed the ALJ's controversial conclusion that distortion is no longer a factor for determining combined reporting after the 2007 statutory change, finding that combined reports may be filed, even in the absence of substantial intercorporate transactions, when "necessary to properly reflect income and avoid distortion."

# TRIBUNAL FINDS OXYGEN CYLINDERS WERE PURCHASED FOR RESALE

By Hollis L. Hyans

The New York State Tax Appeals Tribunal has reversed the decision of an Administrative Law Judge and found that oxygen cylinders purchased by a company engaged in providing oxygen systems to customers were exempt from sales tax as purchases for resale. *Matter of Lincare, Inc.*, DTA No. 823971 (N.Y.S. Tax App. Trib., Sept. 11, 2014).

*Facts*. Lincare, Inc. provided oxygen systems to customers for in-home use. These systems can be an oxygen concentrator system, a stationary liquid oxygen system, a high-pressure (gas) system, or a portable liquid oxygen delivery system, and can also include a backup unit for use if the primary unit fails. The oxygen cylinders at issue are part of all of these different systems. Lincare's only customers were those who

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purchased using U.S. Department of Health and Human Services forms signed by their physicians, providing such information as name and address, diagnosis, narrative description of the items, accessories and options ordered; the charge and the Medicare allowance; and a statement of the prescribed oxygen flow rate. One way the oxygen was provided was with oxygen cylinders, which Lincare delivered full to customers and then retrieved when empty and replaced with full cylinders. Lincare retained ownership while its customers had possession of the cylinders.

Lincare entered into written, month-to-month agreements with customers, and it billed and was reimbursed for the rental of oxygen cylinders under Medicare, Medicaid, private insurance, or a private payment arrangement. Patients paid a monthly fee, which did not vary whether or not the patients used the cylinders for a whole month. The monthly fee included refilling the cylinders, and there were no separate charges for oxygen when cylinders were exchanged or refilled. The standard agreement between Lincare and its customers, referred to as the "Terms and Conditions of Rental," obligated Lincare to "maintain and service the rented equipment" and referenced a "monthly rental fee for all equipment rented hereunder" for a "month-to-month rental." It gave Lincare the right to repossess the equipment upon "failure to pay the rental fees. . . ."

If a cylinder was empty, Lincare replaced it with a full one without an additional charge above the regular monthly charge. On rare occasions, oxygen cylinders were sold to patients, and when that occurred, Lincare charged patients for oxygen separately.

A sample health insurance claim form, used by Lincare to request payment from insurers, referred to payment for two items of equipment – a "concentrator" and a "gaseous portable add-on" – that were rented. The Medicare website describes a "gaseous portable add-on" as "[p]ortable gaseous oxygen system, rental; includes portable container (cylinder). . . ."

Lincare did not pay sales tax when it purchased the oxygen cylinders. It depreciated the cost of the cylinders and carried that cost as part of its fixed assets, and it recognized rental revenue from the fees it received for the rental of oxygen cylinders to its customers.

*Dispute and decision below.* Under New York law, as in most states, sales of tangible personal property for resale are exempt from sales tax. Tax Law § 1101(b)(4)(i)(A). A "sale" of tangible personal property includes a "lease." Tax Law § 1101(b)(5). Therefore, if the cylinders were being rented or leased to patients, no sales tax would be due when they were purchased by Lincare.

Lincare argued that its written agreement with customers treated the form of the transaction as a rental and that this structure was required by Medicare regulations. The Department argued, however, that rather than renting oxygen cylinders, Lincare was actually in the business of selling an oxygen service and that the provision of the cylinders was merely "incidental" to that service.

**[T]he Tribunal concluded that . . . the cylinders were rented and that such rental was a "'significant part of the transaction'" rather than a trivial element.**

The parties had stipulated that reimbursement for oxygen equipment by Medicare was available only on a rental basis; that Lincare did not separately charge for oxygen or for any services related to the cylinders; and that Lincare "billed and was reimbursed for its *rental* of the oxygen cylinders" (emphasis in original). Lincare also conceded that it charged a fixed, monthly fee for the entire oxygen service, dictated by Medicare regulations, that included the cylinder rental and all other components.

Nonetheless, the ALJ concluded that the patients were seeking, and Lincare was providing, "a complete oxygen service paid for with one carefully regulated fee." The ALJ also determined that the equipment rental structure of the transactions in accordance with Medicare requirements was insufficient to prove the cylinders were rented to customers. He concluded that the oxygen, not the equipment or accessories, was of primary importance to the patients, in large part because adjustment of the Medicare reimbursement rate was based on the prescribed oxygen flow rate per minute, without reference to the cylinders.

The ALJ found the "Terms and Conditions of Rental" to be lacking in probative value, since it did not expressly state that it was a part of a monthly agreement, did not identify Lincare, and did not refer to oxygen or cylinders. He found that the lack of detail distinguished the facts from those in *Matter of EchoStar Satellite Corp. v. Tax Appeals Tribunal*, 20 N.Y.3d 286 (2012), in which the Court of Appeals concluded that equipment provided along with a satellite TV service was rented to the customers and qualified as a nontaxable purchase for resale. The ALJ concluded that, based on the record before him, he could not determine that, as had been established in *EchoStar*, the cylinders had been "rented" for a specific charge separate from the charge for the service.


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*Tribunal decision*. The Tribunal reversed the ALJ. It found, first, that the primary purpose of Lincare's business was to provide oxygen systems, including cylinders, to its customers. While acknowledging that a customer's medical need for oxygen was the "catalyst" for the transaction, that medical need could not be met without the equipment, including the cylinders, which was an essential part of the transactions. The Tribunal rejected the ALJ's conclusion, and the Department's argument on exception, that Lincare's true business was an oxygen system service, concluding that the customer's need for oxygen contents is not a basis for concluding that the provision of equipment, along with its contents, constitutes a service for sales tax purposes.

The Tribunal distinguished such cases as *Matter of Upstate Farm Coops., Inc.*, DTA No. 816340 (N.Y.S. Tax App. Trib., May 2, 2002), involving a milk distributor's use of milk crates to deliver milk; *Matter of Genesee Brewing Co.*, DTA No. 817305 (N.Y.S. Tax App. Trib., May 9, 2002), involving wooden pallets used by a beer brewer to deliver beer; and *Matter of Albany Calcium Light Co. v. State Tax Comm'n*, 44 N.Y.2d 986 (1978), involving industrial gases contained in cylinders, for which no charge was imposed. In all three cases, the crates, pallets, or gas cylinders served no purpose other than delivery, while Lincare's oxygen cylinders were used for more than delivery and were found to be part of a system necessary for administration of the oxygen.

The Tribunal also disagreed with the ALJ's conclusion that the "Terms and Conditions of Rental" lacked probative value, since it was attached to the parties' stipulation of facts and was described in the stipulation as a written agreement provided to customers. It also found that health insurance claim forms functioned as invoices for third-party payers, and that the form and the page from the Medicare website adequately demonstrated that Lincare billed a single monthly fee for the rental of oxygen cylinders. In fact, Medicare regulations and publications were found to consistently refer to the rental of oxygen equipment, and the Tribunal rejected the ALJ's reliance on the lack of a separately stated fee for the cylinder, finding such lack was directly attributable to Medicare's control over the form of the transaction. Finally, the Tribunal also disagreed with the ALJ's conclusion that providing oxygen was the controlling factor, since actual oxygen use or consumption had a limited impact on the amount of the monthly fee, which did not vary based on usage. Since oxygen use was a limited factor in the fee, the rental value of the equipment "was necessarily a significant factor" in the fee. Therefore, the Tribunal concluded that the monthly rental fee supports the finding that the cylinders were rented and that such rental was a "'significant part of the transaction'" rather than a trivial element.

### Additional Insights

The Tribunal in this case conducted a detailed review of the stipulated facts and documents and, unlike the ALJ, relied on the language in the stipulation by both parties regarding "rental" of the cylinders, and the submission as a stipulated exhibit of a document titled "Terms and Conditions of Rental." The Tribunal agreed with Lincare that the primary purpose of its business was providing oxygen systems, which clearly required the cylinders, and that the agreements with customers, plus the Medicare documentation and website, supported the fact that the cylinders also were rented. Although not discussed by the Tribunal, it seems clear that the oxygen itself could not be "rented" – it was consumed and not returned – so the many references to "rental" in the agreement and Medicare documentation could only reasonably be referring to the cylinders and other equipment.

The Department cannot appeal the Tribunal's decision to the New York courts.

## APPELLATE COURT DENIES NASSAU COUNTY CLASS ACTION CERTIFICATION IN SUIT AGAINST ONLINE HOTEL RETAILERS, BUT ALLOWS CASE TO PROCEED

By Kara M. Kraman

In the latest development in the ongoing battle between Nassau County and online hotel retailers over hotel tax, the Appellate Division reversed the lower court's grant of class certification for Nassau County and over 50 New York local government entities. *Cnty. of Nassau, etc., v. Expedia, Inc. et al.*, 2014 N.Y. Slip Op 06050 (2d Dep't, Sept. 10, 2014). In a separate opinion released on the same date, the Appellate Division also reversed the lower court's findings and held that Nassau County failed to adequately plead a cause of action to impose a constructive trust against the online hotel retailers, but affirmed the lower court's finding that the county adequately pled causes of action to recover damages for conversion and unjust enrichment. *Cnty. of Nassau v. Expedia, Inc.*, 2014 N.Y. Slip Op 06049 (2d Dep't, Sept. 10, 2014).

Nassau County, like many localities in New York and throughout the country, imposes a hotel tax, pursuant to enabling legislation, on the daily rental rate for each room rented in the county. A person failing to timely pay the hotel tax is also subject to a 5% penalty. The law provides that "[s]uch tax shall be paid by the person liable therefor to the



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owner of the hotel . . . *or to the person entitled to be paid the rent or charge for the hotel or motel room*. . . ." Nassau Cnty. Hotel Tax Law § 3(d) (emphasis added). Based on this statutory language, Nassau County brought an action against online hotel retailers, alleging that they are liable for the hotel tax and that such tax is calculated on the "retail" amount the online hotel retailer charges its customers, not the "wholesale" amount that the online retailer pays to the hotel.

Unlike the New York City hotel tax, the Nassau County hotel tax does not contain an administrative appeal provision. As a result, actions to recover the tax are brought in court, rather than first being heard by the Tax Appeals Tribunal. Nassau County filed its initial complaint over seven years ago in the United States District Court for the Eastern District of New York. *Cnty. of Nassau v. Hotels.com*, 594 F. Supp. 2d 251 (E.D.N.Y. 2007), *vacated*, 577 F.3d 89 (2d Cir. 2009). Although Nassau County successfully appealed the District Court's dismissal of the complaint on grounds of lack of subject matter jurisdiction to the Second Circuit, the case was ultimately dismissed in 2011 without prejudice by stipulation of the parties. Nassau County then refiled its complaint in Nassau County Supreme Court. The court granted the county's motion for an order certifying the action as a class action and denied the online hotel retailers' motion to dismiss the county's complaint for failure to state a cause of action. *Cnty. of Nassau v. Expedia, Inc.*, 41 Misc. 3d 626 (N.Y. Sup. Ct., Apr. 11, 2013). The Appellate Division, Second Department, in two separate opinions, has now reversed the grant of class certification and reversed the denial of the motion to dismiss Nassau County's cause of action to impose a constructive trust.

With respect to the first issue, the Appellate Division found that pursuant to the New York Rules of Civil Procedure, an action "to recover a penalty" may not be maintained as a class action. Since Nassau County was required to recover a penalty equal to 5% of the amount of the tax under the law, the Second Department held that it could not obtain certification as a class.

With respect to the second issue, the Appellate Division held that Nassau County failed to adequately plead a cause of action to impose a constructive trust because it did not allege the existence of a confidential or fiduciary relationship between the county and the online hotel retailers, which is one of the four elements a plaintiff must demonstrate in order to obtain the remedy of a constructive trust.

### Additional Insights

While the issue of whether a municipality may bring a class action suit to collect hotel tax on behalf of other municipalities appears to be one of first impression under New York State law, the issue of whether online hotel retailers must pay hotel tax on the full amount they charge consumers has been the subject of considerable litigation. In November 2013, the Court of Appeals reversed the Appellate Division, First Department, and held that the imposition of New York City hotel tax on the service and booking fees earned by online hotel retailers was not unconstitutional because the enabling legislation granted the City broad authority to impose an occupancy tax. *Expedia, Inc. v. City of New York Dep't of Fin.*, 22 N.Y.3d 121 (Ct. App. 2013). New State legislation explicitly imposing City hotel tax (and State and local sales tax on hotel occupancies) later went into effect, but it does not apply to locally imposed and administered hotel taxes such as the Nassau County hotel tax. *Amendments Affecting the Application of Sales Tax to Rent Received for Hotel Occupancy by Room Remarketers*, TSB-M-10(10)S (N.Y.S. Dep't of Taxation and Fin., Aug. 13, 2010). Whether the New York courts will hold that Nassau County may impose hotel tax on the full amount charged by online hotel retailers remains to be seen.

## FOOD PREPARATION SERVICES PERFORMED BY RELATED PROFESSIONAL EMPLOYER ORGANIZATION ARE NOT SUBJECT TO SALES TAX

By Irwin M. Slomka

The Department of Taxation and Finance has ruled that charges for food preparation services furnished to clients by a wholly owned subsidiary of a food preparation services company are not subject to sales tax, even where the parent corporation separately contracts with the client to furnish the food and related supplies. *Advisory Opinion*, TSB-A-14(34)S (N.Y.S. Dep't of Taxation & Fin., Aug. 27, 2014). The Advisory Opinion addresses the scope of the sales tax rule with respect to exempt sales of food and beverages, where an affiliate of the vendor prepares and serves the food and beverages.

*Facts*. Parent corporation ("Parent") provides various food preparation services for clients, which include the procurement and purchase of food and related supplies for those clients, typically nursing facilities and senior citizen independent housing communities ("Clients"). Parent is considering a new business structure in which the food preparation services at a particular Client location would be performed by employees jointly employed by the Client and by a Professional Employer Organization ("PEO") formed by Parent. A PEO is defined under the New York State Labor Law as a business that enters into professional employer


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agreements with clients, under which it agrees to co-employ the client's employees. N.Y. Lab. Law § 916(4). Under the contemplated structure, Parent would create a new limited liability company ("Subsidiary"), which it would register as a PEO with the New York State Labor Department. The Subsidiary would be qualified to do business in the State.

Parent would contract with the Client to provide administrative services, in particular to procure and purchase from distributors and other vendors food and related supplies for the Client, which it would in turn provide to the Client. The Client would be billed by Parent directly for those services. Subsidiary would separately contract with the same Client to provide food preparation services performed by the Subsidiary's worksite employees. Those food preparation services would include food preparation, cooking meals, serving prepared food, cleaning dishes and utensils, and cleaning and sanitizing kitchen equipment at the Client's location.

Subsidiary would contract directly with the Client for the provision of those food preparation services. Subsidiary would bill the Client for those services, and the Client would reimburse the Subsidiary for the worksite employee wages. Parent would not supervise or provide any on-site management of the Subsidiary's employees.

Parent would not act as agent of Client when making food purchases from distributors. When purchasing food items subject to sales tax, Parent would provide the distributor or vendor with a Resale Certificate (Form ST-120).

Parent and Subsidiary would operate as separate and distinct legal entities and hold themselves out to the public as such. Each would have its own bank account, financial statement, and employees. Every Subsidiary worksite employee will have an employment relationship with both the Subsidiary and the Client.

*Background.* The sale of prepared food and beverages, when sold by restaurants or other establishments for on- or off-premises consumption, or by caterers, is subject to sales tax. This includes where the vendor, or a person "whose services are *arranged for* by the vendor," after delivery of the food or drink "serves or assists in serving, cooks, heats or provides other services with respect to the food or drink." Tax Law § 1105(d)(i)(2) (emphasis added). Food preparation services alone, however, are not an enumerated service subject to sales tax under Tax Law § 1105(c).

*Ruling.* The question presented was whether the Subsidiary's charges to its Client for food preparation services – such as cooking and serving meals at the Client's facilities – provided by the Subsidiary's "worksite employees" would be subject to sales tax, where the Parent separately furnishes the food products to the Client. The Department ruled that, under the specific facts presented, those charges would not be subject to sales tax.

According to the Department, where, as here, the sale of food and the furnishing of food preparation services are performed by separate legal entities, pursuant to separate contracts and separate invoices, and with no supervision or on-site management by the Parent, the Parent will not be considered to be "arranging for" the Subsidiary's food preparation services for that Client. As a result, the Department concluded that the Subsidiary's food preparation service charges will not be subject to sales tax.

**The Advisory Opinion reflects a cautious recognition by the Department that the activities of one related entity will not necessarily be attributed to the other related entity for sales tax purposes if the parties maintain the requisite operational separateness.**

The Department was careful to limit its ruling to the facts presented, mindful that Parent and Subsidiary would be related parties, with substantial control by the Parent, and that sales tax would otherwise be imposed if the food preparation services are arranged by the same vendor that sold the food items. Thus, the Advisory Opinion is expressly conditioned on the separateness of Parent and Subsidiary, and on the recited fact that Parent will not arrange for the furnishing of food preparation services by the Subsidiary, and the Subsidiary will not be involved in the Parent's purchase of food and related supplies.

According to the Department, the analysis would also change if the Subsidiary's activities are "so dominated and controlled" by Parent, or the two entities' affairs are "so intertwined" that Parent and Subsidiary are considered to be "alter egos." In that case, the Department will disregard the corporate structure and treat Parent and Subsidiary as together providing a single taxable catering service.

### Additional Insights

The Advisory Opinion reflects a cautious recognition by the Department that the activities of one related entity will not necessarily be attributed to the other related entity for sales tax purposes if the parties maintain the requisite operational separateness. It should be kept in mind that in addition to requiring operational separateness, the Department will also look to whether the related entities are "alter egos," either



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because the activities of one are dominated and controlled by the other, or the activities are "intertwined." These are necessarily subjective standards that can make it difficult to obtain the desired level of certainty on this issue. These caveats notwithstanding, the Department's ruling provides important guidance to the food services industry (and likely other industries) in structuring their services to avoid unintended (and undesirable) sales tax consequences.

# ALJ FINDS 2010 STATUTORY AMENDMENT CANNOT BE APPLIED RETROACTIVELY

By Hollis L. Hyans

An Administrative Law Judge has held, consistent with a decision by the Appellate Division in April 2014, that the retroactive application to 2008 of a 2010 statutory amendment to Tax Law § 631(b)(2) concerning the treatment of installment payments by nonresident shareholders of an S corporation would violate the taxpayers' Due Process rights. *Matter of Jeffrey M. and Melissa Luizza*, DTA No. 824932 (N.Y.S. Div. of Tax App., Aug. 21, 2014).

The petitioners, Mr. and Mrs. Luizza, were nonresidents of New York. Mr. Luizza owned 100% of the stock of an S corporation that did business in New York and other states, and in December 2007 he agreed to sell the company to an unrelated purchaser. At the purchaser's request, Mr. Luizza agreed to an election to treat the sale as a deemed sale of the company's assets pursuant to Internal Revenue Code ("IRC") § 338(h)(10), but Mr. Luizza wanted the purchaser to reimburse him for any "'costs and negative tax consequences'" of the election. The purchaser requested instead that the tax consequences of the election be addressed up front, so Mr. Luizza and his accountants researched the federal and New York state tax implications, including the effects of Tax Law § 631(b)(2) and other New York State authority available in late 2007 and early 2008. Mr. Luizza was advised by his tax advisors that there would be no tax consequences in New York as a result of the election, and he therefore agreed not to require the purchaser to increase the purchase price or to provide indemnity when the sale closed in March 2008.

Mr. Luizza reported a capital gain of approximately $8 million on his 2008 New York nonresident income tax return but did not include the gain as income attributable to New York sources.

*Background to the 2010 statutory amendment.* In 2009, the Tax Appeals Tribunal 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 where an election had been made under IRC § 338(h)(10). *Matter of Gabriel S. & Frances B. Baum*, DTA Nos. 820837 & 820838 (N.Y.S. Tax App. Trib. Feb. 12, 2009). A few months after *Baum*, an ALJ reached a similar conclusion in *Matter of Myron Mintz*, DTA Nos. 821806 & 821807 (N.Y.S. Div. of Tax. App., June 4, 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 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.

In reliance on the statutory amendment, the Department took the position that the Luizzas had to allocate a portion of the capital gain to New York and issued a Notice of Deficiency for nearly $200,000, including tax and interest.

*Issue and decision.* The Luizzas argued that the retroactive application of the amended Tax Law § 631(b)(2), under the circumstances, violated their right to Due Process. The ALJ agreed. He relied on an analysis of the governing factors that were set out by the Court of Appeals in *James Square Assocs. LP, et al. v. Mullen*, 21 N.Y.3d 233 (2013), which 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.

With regard to the first factor, which has been held to be the "'predominant'" factor, the ALJ found that neither Mr. Luizza nor his advisors had any knowledge or reason to believe in 2008 that there would be a statutory change two years later, that Mr. Luizza reasonably relied on the law applicable at the time of the sale, and that Mr. Luizza was harmed by his reliance, since he did not have the opportunity to seek a higher purchase price or require an indemnity from the purchaser as he originally intended. In analyzing the second factor, the length of the period of retroactivity, the ALJ looked to the Court of Appeals decision in *Caprio v. New York State Dep't. of Taxation and Fin.*, 117 A.D.3d 168, 177 (N.Y. App. Div. 1st Dep't 2014), which had reviewed the same statutory amendment and found that the period of retroactivity, which in that case was three and a half years, was excessive. While the period in *Luizza* was not as long as that in *Caprio*, it was significantly longer than the 16 months found to be excessive in *James Square*, and long enough for Mr. Luizza to have had a reasonable expectation he could rely on the previous statute. The ALJ also rejected the Department's argument that the amendment was merely intended to "clarify the concept of federal conformity." The ALJ found "persuasive" the Court of Appeals' conclusions in


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*Caprio* that there was no legislative history to support the Department's position that the amendment was correcting any specific defect, rather than changing the statute to adopt the position requested by the Department. Finally, the ALJ rejected the Department's argument that the retroactivity had a valid public purpose in correcting the "mistakes" of the Tribunal in *Baum* and an ALJ in *Mintz*, since he concluded the Appellate Division had clearly found that the purpose of the amendment was not corrective but to raise tax revenues by $30 million.

[T]he ALJ found that . . . Mr. Luizza reasonably relied on the law applicable at the time of the sale, and that Mr. Luizza was harmed by his reliance.

### Additional Insights

The arguments made by the Department in this case had been resoundingly rejected by the Appellate Division in *Caprio*, and so it is no surprise that the ALJ rejected them as well, particularly when the facts clearly indicated that the taxpayer specifically researched the issue and reasonably relied on the statutory language as it existed before the statute was amended, and before any public record cases would have put him on notice that the Department was arguing a contrary position.

At press time, it was unclear whether an exception will be filed by the Department. However, since the statute has now been amended, and the new language will apply from 2010 on, it is not entirely clear what public policy would be furthered by the Department's continuing to argue that the new statute must be applied to what must be an increasingly limited group of taxpayers who entered into similar transactions before 2010, are open for assessment or refund for those years, and can prove that they reasonably relied on the prior statute.

# ALJ DENIES INNOCENT SPOUSE RELIEF

By Michael J. Hilkin

In *Matter of Iris Egan*, DTA No. 825114 (N.Y.S. Div. of Tax App., Sept. 11, 2014), a New York State Administrative Law Judge concluded that a married taxpayer was not entitled to innocent spouse relief from deficiency assessments based on disallowances of Qualified Empire Zone Enterprise tax credits ("QEZE credits") that purportedly arose out of the operations of her spouse's businesses, even though her spouse had recently been convicted of bank fraud and sentenced to time in federal prison.

*Background*. Ms. Egan, a college graduate with managerial experience, married Mr. Egan in 1981. Mr. Egan owned various businesses, and Ms. Egan performed many duties for those businesses. Ms. Egan testified that she and her husband "built a very big business *together* very successfully." (Emphasis added.)

The Egans filed joint New York income tax returns for 2005 through 2007, and then filed amended returns for 2005 and 2006 increasing the amount of refund sought based on certain claimed QEZE credits. Ms. Egan did not participate in the filing of the returns, but she signed both the original and amended returns. The refund claims for 2005 through 2007 departed from the Egans' filing history for previous years with regard to the QEZE credits.

Those QEZE credits were passed through to the Egans from S corporations owned by Mr. Egan. The Department notified the Egans that it could not process their 2005 amended return, due to missing forms and information relating, in part, to the QEZE credits, and no further information was supplied by the Egans. However, refund checks were issued by the Department for 2006 and 2007 (the "years in issue"), and Ms. Egan admitted endorsing the check for 2006 but denied endorsing the 2007 refund check. Eventually, due to the failure to provide the Department with substantiating information, the QEZE credits were disallowed, and in 2010 Notices of Determination were issued for 2006 and 2007 to recoup the refunds that had been issued.

In the same year, Mr. Egan was charged with and pled guilty to bank fraud, and in 2011 he was sentenced to 11 years in federal prison and had a judgment of over $85 million entered against him.

Thereafter, Ms. Egan formally requested innocent spouse relief from the asserted deficiencies for the years in issue. Ms. Egan maintained that the QEZE credits were properly claimed, but asserted that the records substantiating the QEZE credits were initially unavailable to her because the corporations were placed under the control of a court-appointed receiver as a result of the federal proceedings against Mr. Egan, and later could not be located. She also appeared to claim that Mr. Egan did not respond to the Department's requests because he was distracted by the federal charges against him. She further maintained that the businesses were owned and operated by Mr. Egan without her direct involvement, and that she is facing financial hardship and now living on retirement and social security income. The Department rejected Ms. Egan's


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request for innocent spouse relief, and Ms. Egan petitioned the Division of Tax Appeals.

*The law.* New York law on innocent spouse relief is modeled on the federal tax code, which provides that a spouse may receive relief from joint and several liability if, among other things: (a) on a joint return there is an understatement of tax attributable to erroneous items of one of the individuals filing the joint return; (b) the innocent spouse establishes that in signing the return he or she did not know or have reason to know of the understatement; and (c) the facts and circumstances establish that it would be inequitable to hold the innocent spouse liable for the deficiency resulting from the understatement. Tax Law § 654(a) (citing I.R.C. § 6015(b)(1)). Under New York case law, the petitioning spouse has the burden of showing he or she satisfies the elements of the innocent spouse relief rule. *Matter of Revere v. Comm'r of Taxation & Fin.*, 75 A.D.3d 860 (N.Y. App. Div. 3rd Dep't 2010).

*The decision.* Finding that Ms. Egan failed to show that "she did not know or have reason to know of the understatements" in the returns filed, the ALJ rejected Ms. Egan's petition for innocent spouse relief. The ALJ focused on the activities of Ms. Egan leading up to her signing the returns for the years in issue, rather than the actions after the Department inquired about the claimed QEZE credits. The ALJ stated that Ms. Egan had "at least a minimum duty or obligation to make some inquiry" regarding the accuracy of the returns and found no evidence that she made any investigation or raised any questions regarding the refunds claimed on the returns. The ALJ rejected Ms. Egan's attempts to separate herself from her spouse's business, stating that Ms. Egan was educated and "was, by her own admission, involved in building the Egans' businesses and in fact worked in such businesses over a significant period of time" and continued to work for the businesses on an as-needed basis during the years in issue. The ALJ also determined that Mr. Egan's federal criminal charges were not related to the QEZE credits claimed in the years in issue and, while acknowledging that Mr. Egan's attention may well have been diverted by his other legal issues from responding to the Department's requests for substantiation of the claimed QEZE credits, that was found insufficient to entitle Ms. Egan to innocent spouse relief.

### Additional Insights

The ALJ's decision is consistent with previous New York State cases rejecting petitions for innocent spouse relief when the petitioner failed to show that he or she did not know *or* have reason to know of the understatements claimed on a joint return at the time of signing the return. To satisfy this requirement, a petitioning spouse lacking actual knowledge of an understatement on a joint return typically must show that he or she made meaningful attempts to verify the accuracy of the return prior to signing it. This decision serves as a warning to taxpayers that New York's innocent spouse provision may provide no relief to taxpayers who solely rely on their spouses to complete their joint tax returns or respond to audit inquiries.

# INSIGHTS IN BRIEF

### Operator of Website for Restaurant Sales Is Not a Vendor for Sales Tax Purposes

The Department of Taxation and Finance has ruled that the operator of a website through which approximately 5,000 restaurants in over 27 cities post menus to offer meals for sale to customers is neither a vendor of restaurant sales nor a co-vendor of the restaurant sales. Therefore, the website operator is not liable for sales tax on the restaurant sales made through its website. *Advisory Opinion*, TSB-A-14(27)S (N.Y.S. Dep't of Taxation & Fin., Aug. 20, 2014). However, since customers pay the website operator for the restaurant meals (including applicable sales tax) by credit card, if the operator fails to remit the full sales tax to the restaurant, the Department expressly reserves the right to collect those amounts from the operator under the "doctrine of moneys had and received."

### Computer Software Device for Disabled to Operate Computers Qualifies as Exempt "Prosthetic Device"

A computer software device that enables a disabled person to operate a computer via an eye blink, eyebrow twitch, or similar activity qualifies as a "prosthetic device" that is exempt from sales and use tax. *Advisory Opinion*, TSB-A-14(28)S (N.Y.S. Dep't of Taxation & Fin., Aug. 20, 2014). The Department of Taxation and Finance concluded that the software meets the three requirements for "prosthetic devices" under 20 NYCRR 528.5(b): (i) the software replaces the disabled person's motor skills to type or control a computer's buttons or mouse; (ii) is primarily used for that purpose; and (iii) is not useful in the absence of a user's disability.

### Wages of Nonresident Member of Foreign Service Temporarily Assigned to the United Nations Constitute New York Source Income of the Nonresident

Wages received by a Florida domiciliary who is a Foreign Service member temporarily assigned by the U.S. State Department to the U.S. Mission to the U.N. in New York City will be subject to New York State nonresident income tax if the wages are includable in federal adjusted gross income, to the extent they are for work performed at the U.S. Mission. *Advisory Opinion*, TSB-A-14(2)I (N.Y.S.


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Dep't of Taxation & Fin., Aug. 20, 2014). Although Tax Law § 631(e) exempts "military compensation" received by nonresidents stationed in New York, there is no similar provision for members of the Foreign Service. The Department of Taxation and Finance noted that the individual could be taxed as a "statutory resident" of New York State and City, however, if he maintains a permanent place of abode in New York and spends more than 183 days of the year in the State.

## Single Bundled Charge for Taxable and Exempt Tangible Personal Property Found Subject to Sales Tax

In an *Advisory Opinion*, TSB-A-14(30)S (N.Y.S. Dep't of Taxation & Fin., Aug. 22, 2014), the Department of Taxation and Finance concluded that a manufacturer and distributor of medical supplies and equipment must charge sales tax on the entire amount billed when, at the request of certain customers, it charges on a bundled basis for both taxable and non taxable transactions in a single line item. Pursuant to 20 NYCRR §§ 527.1(b) & 532.1(b), when taxable and exempt items of tangible personal property are sold as a single unit, tax is due on the entire amount. According to the Department, the use of a single-item charge cannot "transform" purchases formerly considered purchases of tangible personal property into the purchase of an "inventory replacement service," and the seller is not permitted to pro-rate the charge between taxable and nontaxable items based on its internal records when the invoice does not separately state the charges for each item.





 