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The Top 10 New York Tax Highlights of 2016

By Irwin M. Slomka

It's the New Year, and before we begin afresh, we look back at this past year with our list of the Top 10 New York tax highlights of 2016.

1. **The New York State Tax Department continues to release draft regulations to implement corporate tax reform.** This past year, the Department continued to make available for public comment comprehensive drafts of new regulations relating to the Article 9-A corporate tax reform enactment. It released draft combined reporting regulations (in January 2016), followed by discretionary adjustment regulations (in March 2016) and regulations addressing various aspects of the new customer-based sourcing provisions (in September 2016). In light of the need to have final guidance in place, it is expected that the Department will begin the formal promulgation process for all of its draft corporate tax reform regulations in the upcoming year.

2. **NYC Tribunal and NYS ALJ reach divergent conclusions on applicability of real property transfer taxes.** Two divergent decisions were reached on the taxability of the same real estate transaction involving whether New York State and City transfer taxes were due on a transaction structured as a sale of a 45% membership in a newly formed limited liability company that owned real property in Manhattan. In one decision, the New York City Tax Appeals Tribunal held that the federal "step transaction" doctrine could be applied to tax the transaction as a direct sale of real property, rather than a sale of an economic interest in an entity that owns the property. *Matter of GKK 2 Herald LLC*, TAT(E) 1325(RP) (N.Y.C. Tax App. Trib., July 15, 2016). However, a New York State Administrative Law Judge held that the transaction was not taxable, concluding that New York State could not aggregate an acquisition of a 55% economic interest in a non-taxable "mere change in form" transaction with an acquisition of a 45% minority interest in that same entity resulting from a true sale on that interest. *Matter of GKK 2 Herald LLC*, DTA No. 826402 (N.Y.S. Div of Tax App., May 26, 2016). Both decisions are being appealed.

3. **NYC Tribunal rejects forced combination of bank and its mortgage subsidiary.** The New York City Tax Appeals Tribunal held that a bank was not required to file combined New York City bank tax returns with its Connecticut-based subsidiary that

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principally held non–New York mortgage loans. *Matter of Astoria Financial Corp. & Affiliates*, TAT(E) 10 35 (BT), *et al.* (N.Y.C. Tax App. Trib., May 19, 2016). The City Tribunal found that the mortgage subsidiary had sufficient business purpose and economic substance, and that the substantial intercompany transactions between the subsidiary and the bank were made in exchange for arm's-length charges. Particularly significant was the City Tribunal's conclusion that the New York State Tax Appeals Tribunal decision in *Matter of Interaudi Bank*, DTA No. 821659 (N.Y.S. Tax App. Trib., Apr. 14, 2011), which found actual distortion based on a "mismatch of income and related expense" between a bank and its Delaware investment subsidiary, was not binding precedent and was factually distinguishable because in *Astoria Financial* there was no correlation shown between the mortgage loans and the bank's interest expenses. The Department of Finance had retained (and called to testify at the hearing) the same expert witness who had testified for New York State in *Interaudi Bank*. The City Tribunal decision is final.

4. **NYS ALJ holds that corporation's payments to its captive insurance company are not deductible.** The taxation of captive insurance companies and their corporate affiliates has long been a problematic issue for New York State and City corporate tax purposes, but until now there have been no litigated cases. However, this past year a decision of first impression was issued in *Matter of Stewart's Shops Corp.*, DTA No. 825745 (N.Y.S. Div. of Tax App., Mar. 10, 2016). There, a New York State Administrative Law Judge held that a corporation that had operated a convenience store chain could not deduct the insurance payments made to its wholly owned captive insurance company because the payments did not qualify as valid insurance premiums under federal income tax law. In April 2016, Stewart's Shops filed an exception with the Tax Appeals Tribunal, and a decision is pending.

5. **NYS Tribunal denies sales tax refunds to wireless carrier where amounts were not yet refunded to customers.** The substantial hurdles facing vendors seeking sales tax refund claims were evidenced in *New Cingular Wireless PCS LLC*, DTA No. 825318 (N.Y.S. Tax App. Trib., Feb. 16, 2016). There, the State Tribunal upheld the denial to a wireless carrier of more than $100 million in claimed sales tax refunds, finding that the carrier had not complied with the stringent Tax Law requirement that a vendor first refund the sales tax to those customers that remitted the sales tax. The fact that the carrier had agreed to fund a pre-refund escrow account, under court supervision, to receive and disburse sales taxes refunded by New York State (and other states) was held not to satisfy the statutory pre-condition for granting sales tax refunds. The Tribunal also affirmed the denial of the company's motion to re-open the record to show that it later did fund the escrow account, because the information constituted new evidence not in existence at the time of the administrative hearing. The taxpayer has filed an appeal with the New York courts.

6. **NYC Tribunal holds that HMOs are not insurance corporations and therefore can be combined for corporate tax purposes.** On a tax issue of first impression regarding health maintenance organizations ("HMOs"), the City Tribunal, reversing an ALJ determination, held that HMOs are not "insurance corporations" for general corporation tax purposes, because they are not "doing an insurance business." *Matter of Aetna, Inc.*, TAT(E)12-3(GC) and TAT(E) 12-4(GC) (N.Y.C. Tax App. Trib., June 3, 2016). The City Tribunal thus held that the HMOs were properly includable in a combined GCT return with their parent holding company. Since 1974, insurance corporations have not been subject to the GCT, but the question of whether HMOs qualify as insurance corporations for New York City tax purposes had not previously been the subject of a court or City Tribunal decision. The decision is on appeal to the New York courts.

7. **Appellate court upholds denial of UBT deduction for management fee paid to corporate partner of investment advisor partnership.** In a memorandum decision regarding the unincorporated business tax disallowance for a partnership's payments to partners for services, the Appellate Division, First Department, affirmed a City Tribunal decision that an investment advisor partnership subject to the UBT was required to add back a management fee it had paid to its corporate general partner for the services of the partner's employees, who were also limited partners of the partnership. *Tocqueville Asset Mgmt. L.P. v. N.Y.C. Tax App. Trib., et al.*, 2016 N.Y. App. Div. LEXIS 5183 (1st Dep't, July 5, 2016). The decision confirms that the New York courts (and the City Tribunal) will likely uphold the denial of a deduction for amounts paid to an actual partner for the services performed by employees of the partner, who are also partners in the taxpayer entity.

8. **NYS Tribunal narrowly construes "personal and individual" exclusion for information subject to sales tax.** The imposition of sales tax on the furnishing of retail supermarket pricing information was held to be subject to sales tax in two related State Tribunal decisions. *Matter of Wegmans*

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Food Markets, Inc., DTA No. 825347 (N.Y.S. Tax App. Trib., Mar. 10, 2016); *Matter of RetailData, LLC*, DTA No. 825334 (N.Y.S. Tax App. Trib., Mar. 3, 2016). The Tribunal narrowly interpreted the sales tax exclusion for information that is "personal and individual in nature," holding that so long as the information source is "widely accessible" — here, the pricing information was obtained by auditing the prices of goods on the shelves of competitor supermarkets — it did not matter that the information was not obtained from an electronic or otherwise published database, or that no two reports furnished to clients would be identical. An appeal has been taken to the New York courts.

9. **Property owner not required to file annual protests to challenge 10-year property tax exemption.** In an uneventful year for tax decisions emanating from New York State's highest court, the New York Court of Appeals held that a real property owner that filed a petition with the City of Schenectady challenging the assessed value of the property on the 2008 assessment roll — the relevant year for determining the availability of a partial 10-year business investment property tax exemption — was not required to have filed separate petitions challenging the annual property tax assessments in subsequent years. *Matter of Highbridge Broadway, LLC v. Assessor of the City of Schenectady, et al.*, 2016 N.Y. Slip Op. 03544 (N.Y., May 5, 2016). The Court observed that "it would be a waste of resources" to require the filing of annual challenges where the exemption amount for all 10 years depends on the property's assessment for the 2008 base year.

10. ***Qui tam* actions continue unabated, creating significant uncertainty for New York businesses.** The past year saw a continuation of lawsuits against businesses in which so-called "whistleblower" *qui tam* State and City tax actions are brought by private individuals (including former employees of the businesses being sued). In May 2016, the United States Supreme Court refused to hear an appeal of the New York Court of Appeals October 2015 decision rejecting Sprint Nextel's motion to dismiss a more than $100 million *qui tam* action brought by New York State Attorney General Schneiderman for alleged tax underreporting. *People of the State of New York et al. v. Sprint Nextel Corp., et al.*, No. 127, 2015 NY Slip Op. 07574 (N.Y., Oct. 20, 2015), *cert. denied*, 136 S. Ct. 2387 (2016).

    While that case proceeds on its path, yet another False Claims action brought by a former employee against Moody's — which the Attorney General declined to join, but which is being handled by a private law firm whose website promotes its expertise in making False Claims Act tax claims against businesses — was recently unsealed and survived a motion to dismiss. *State of New York ex rel. Banerjee, et ano v. Moody's Corporation, et al.*, Index # 103997/2012 (Sup. Ct. N.Y. Cnty. Dec. 8, 2016). Although Moody's had entered into several closing agreements with the New York State and City Tax Departments involving the same issue raised in the False Claims Act complaint, concerning the treatment of a captive insurance company for State and City income tax purposes, the court found those agreements did not bar the False Claims Act case, except for one affiliate for one year. Meanwhile, a False Claims action brought against Citigroup Inc. by an Indiana college professor challenging Citigroup's use for New York State purposes of net operating loss deductions that were expressly permitted for federal purposes also proceeds unabated, with a Federal District Court judge recently refusing to dismiss the action and instead remanding the case back to the New York State court where the action commenced. *State of New York ex rel. Eric Rasmusen v. Citigroup, Inc.*, 15-cv-07826(LAK) (S.D.N.Y., Dec. 2, 2016).

    It can be expected that such *qui tam* lawsuits — which also call into question whether resolving cases with the State and City Tax Departments adequately protects a business against a False Claims action for the same tax — will accelerate, unless the ill-advised New York *qui tam* tax legislation enacted in 2010 is repealed or significantly scaled back.

Tax Appeals Tribunal Reduces QEZE Tax Credits Based on S Corporation's Apportionment Factor

By Hollis L. Hyans

The New York State Tax Appeals Tribunal reversed the decision of an Administrative Law Judge and held that the Qualified Empire Zone Enterprise ("QEZE") tax reduction credit allowed to a New York resident may be reduced by applying the business allocation percentage of the Subchapter S corporation giving rise to the income. *Matter of Mark S. and Maria F. Purcell*, DTA No. 825436 (N.Y.S. Tax App. Trib., Nov. 14, 2016).

Facts Regarding the Petitioners

Petitioner Mark Purcell was the sole shareholder of Purcell Construction Corporation ("PCC"), a business that had properly elected to be taxed as a Subchapter S

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corporation pursuant to federal and state law. PCC was certified by the State as a QEZE in 2003. During 2008 through 2010, the years in issue, PCC provided building design and construction activities, designing and creating large structures such as dormitories, barracks, and college residence halls, performing its design work and manufacture at two facilities within the Empire Zone. Some of its construction projects were performed inside New York, and others were outside New York, primarily in Virginia.

The QEZE Credit Claimed

Mr. Purcell filed New York State resident personal income tax returns, and reported and paid tax to New York on the income that flowed through to him from PCC. He also paid tax to Virginia, and claimed a credit for such tax, which was not challenged by the Department of Taxation and Finance and was not the basis of any adjustment. Mr. Purcell claimed a QEZE tax reduction credit, set forth in Tax Law § 16, for each of the years at issue.

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 in this case.

Where the taxpayer is a shareholder in an S corporation, 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. Based on this formula, Mr. Purcell claimed credits ranging between approximately $14 million and $22 million during the years in issue.

On audit, the Department recalculated the tax reduction credits, taking the position that the calculation should have used only PCC's income allocated within New York State, which it defined as the company's income reported on the shareholder's forms K-1, multiplied by PCC's business allocation percentages. The Department's calculations reduced Mr. Purcell's credits for each of the years, and sought additional tax and interest totaling nearly $3 million for all three years in issue.

ALJ Decision

The ALJ had interpreted the phrase "shareholder's income from the S corporation allocated within the state" in Tax Law § 16(f)(2)(C) to mean income that is subject to tax under Article 22, and that where an S Corporation shareholder is a New York resident, all the shareholder's income from the S corporation is subject to tax under Article 22, and no allocation based on the Subchapter S corporation's allocation percentage is warranted. The ALJ found no authority in any statute or regulation for the application of the S Corporation's business allocation percentage where the QEZE tax reduction credit is claimed by a resident shareholder of an S corporation.

Despite finding that the Department's "interpretation might appear, at first, to be a less obvious or natural interpretation of the statutory language," the Tribunal adopted that interpretation and found that the Department "reasonably" used PCC's business allocation percentage.

Tribunal Decision

The Tribunal reversed the ALJ. It found, first, that tax credit statutes are similar to and should be interpreted similarly to statues creating tax exemptions, meaning they must be strictly construed against taxpayers. While noting that it did not defer to the Department's proposed interpretation, since the question was one of pure statutory construction, the Tribunal found the Department's proposed interpretation reasonable, and that petitioners had not met their burden to show that theirs is the only reasonable construction.

The Tribunal determined that the use of the term "allocate" generally means to apportion into separate parts, and by using the term "allocated within the state" to describe the income to which the credit is applied under Tax Law § 16(f)(2)(C), the intent must have been to allocate the Subchapter S corporation's income at the level of the Subchapter S corporation, because the phrase would otherwise be "superfluous" as applied to resident shareholders, since all of a resident shareholder's income is New York income. Despite finding that the Department's "interpretation might appear, at first, to be a less obvious or natural interpretation of the statutory language," the Tribunal adopted that interpretation and found that the Department "reasonably" used PCC's business allocation percentage despite the absence of any language in the statute or regulations applying such an allocation, as there is in the statute for *corporate* shareholders of S corporations.

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The Tribunal also rejected arguments that the statute as applied unconstitutionally differentiated between resident and nonresident shareholders, since nonresident shareholders will receive a credit reflecting the full amount of New York tax attributable to the nonresident shareholder's income from the S corporation, finding that the tax factor for both the resident and nonresident shareholders includes all S corporation income allocated within New York. It also found that the economic development purpose behind the Enterprise Zone program was a significant public interest outweighing any "incidental impact on interstate commerce."

[R]educing the amount of available credit would seem to discourage New York residents from forming businesses in Enterprise Zones.

Additional Insights

Two other Administrative Law Judges had also disagreed with the Department's construction of the QEZE tax credit statute, in *Matter of Harold A. & Katherine Batty* and *Matter of Pennefeather*, DTA Nos. 824061 & 824063 (N.Y.S. Div. of Tax. App., Apr. 4, 2013), and *Matter of Lisa M. & Gregory E. Henson, et al.*, DTA Nos. 825068 & 825254-825257 (N.Y.S. Div. of Tax App., Apr. 10, 2014). Neither of those cases appears to have been appealed to the Tax Appeals Tribunal, and ALJ decisions are not precedential, although the fact that three different ALJs reached the same result might be interpreted as supporting the Tribunal's observation that the Department's position was "a less obvious or natural" one, and maybe was not as reasonable as the Tribunal concluded.

In addition, while the Tribunal has no authority to declare a statute unconstitutional, but only to consider its constitutionality as applied in a specific situation, the Tribunal relied on its conclusion that any impact on interstate commerce is "incidental," but considered only the one petitioner before it without any investigation into how many other similarly situated taxpayers may be affected. The Tribunal also found that the public purpose of increasing economic development in Enterprise Zones outweighed any impact on interstate commerce, but it did not explain how that public interest is furthered by limiting the amount of credit that can be claimed. To the contrary, reducing the amount of available credit would seem to discourage New York residents from forming businesses in Enterprise Zones.

New York City Retracts Policy Regarding Broker-Dealer Sourcing for Non-Registered Broker-Dealers

By Irwin M. Slomka

The New York City Department of Finance has taken the unusual step of disavowing, through an Audit Division pronouncement, two Finance Letter Rulings ("FLR"s) that permitted the application of the securities broker-dealer sourcing provisions under the New York City unincorporated business tax ("UBT") to an unregistered broker-dealer. *Update on Audit Issues*, "Business Income Taxes, Income Allocation" (N.Y.C. Dep't of Fin., Nov. 25, 2016). In those two FLRs, the Department had ruled that a limited partnership engaged in the securities and commodities business qualified for broker-dealer sourcing under the UBT, even though the partnership was not itself a "registered" broker-dealer.

Background

The FLRs (which involved identical facts) pertained to two related limited partnerships: (i) "Manager Partnership," which managed various investment funds in securities and commodities on behalf of investors; and (ii) "Taxpayer Partnership," in which Manager Partnership held a 99% interest. *Finance Letter Ruling*, FLR 12-4934/UBT (N.Y.C. Dep't of Fin., Aug. 19, 2013); *Finance Letter Ruling*, FLR 13-4950/UBT (N.Y.C. Dep't of Fin., Mar. 28, 2014). Manager Partnership, which received management fees from investors in the securities and commodities that it managed, was registered as a "broker-dealer" with the SEC and Financial Industry Regulatory Authority ("FINRA").

Taxpayer Partnership, which was subject to the UBT, solicited investors for Manager Partnership's various investment funds. Taxpayer Partnership was not, however, registered with the SEC as a broker-dealer. According to the FLRs, Taxpayer Partnership "acts as a broker and dealer," "performs all functions of a security broker or dealer, holds itself out to customers as a broker or dealer," and is a "broker and dealer under the 34 Act." Several of the Taxpayer Partnership's employees were "registered representatives" of Manager Partnership.

In order to qualify for "registered broker-dealer" sourcing, a taxpayer must be a "broker or dealer *registered as such*" by the Securities and Exchange Commission or the Commodities Futures Trading Commission. Admin. Code § 11-508(e-3)(2)

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(emphasis added). In the FLRs, the Department ruled that Taxpayer Partnership qualified for broker-dealer sourcing under the UBT, despite the fact that it was not itself a "registered" broker-dealer. It reasoned that the phrase "registered as such by the [SEC]" does not require that a taxpayer actually register with the SEC. Instead, as long as the taxpayer complied with all of the requirements of the SEC to *act* as a broker-dealer in securities, it would qualify for broker-dealer sourcing. The Department reached a similar conclusion with respect to commodities broker-dealers.

Revised Policy

In its new *Update on Audit Issues*, the Department states "that some taxpayers have interpreted . . . broadly" the two FLRs permitting certain unregistered broker-dealers to qualify for broker-dealer sourcing. According to the Department, the FLRs relied on the taxpayer's representations that the Taxpayer Partnership *functioned* as a securities or commodities broker-dealer for securities or commodities regulatory purposes, representations that the Department now concludes, more than three years later, "are not reliable."

[T]he FLRs "do not reflect the current analysis of" the Department regarding application of the broker-dealer sourcing provisions. Instead, the Department will consider application of the broker-dealer provisions "on a case by case basis."

As a result, the *Update on Audit Issues* states that the FLRs "do not reflect the current analysis of" the Department regarding application of the broker-dealer sourcing provisions. Instead, the Department will consider application of the broker-dealer provisions "on a case by case basis," provided that the taxpayer can establish "that [it] is legally acting in the capacity of a registered securities or commodities broker or dealer." However, the Department specifies that it will not permit broker-dealer sourcing "on the same facts presented" as in the FLRs. The *Update on Audit Issues* goes on to state that the Department will not permit an unregistered owner of a registered single-member LLC entity (a disregarded entity for federal and New York City tax purposes) to apply the broker-dealer sourcing rules either "to themselves or their affiliates" for receipts that the SMLLC did not earn in its capacity as a broker or dealer. The new policy does not specify an effective date, but presumably it is made retroactive to all open tax years for UBT and GCT purposes.

Additional Insights

The Finance Letter Rulings (which the Department did not make public until after the appearance of a *NY Tax Insights* article in 2014 discussing them) had reflected a reasonable "substance over form" approach in interpreting the broker-dealer sourcing provisions in the UBT law. While the Department is required to apply the conclusions in its FLRs only with respect to the named taxpayer, and only if the material facts on which the ruling is based are accurate, the Department is bound to apply the tax laws consistently to similarly situated taxpayers. The *Update on Audit Issues* may raise concerns regarding the latter.

Aside from questions of fairness for taxpayers that may have relied in good faith on the FLRs, the Department's reasoning for disavowing the FLRs is somewhat curious. On the one hand, the Department states that the representations in the FLRs were "unreliable." Yet, given the significance of the *Update on Audit Issues*, shouldn't the Department have explained exactly how the representations were "not reliable"? And while the Department states that the FLRs "did not establish" certain facts, FLRs are typically based on a taxpayer's *representations*. If the actual facts revealed upon audit turn out to be different from the facts as represented, it may render the Letter Ruling inapplicable to the named taxpayer, but it is not clear why that specific factual deficiency has caused the Department to now conclude that the FLRs "do not reflect [its] current analysis." It appears that the change in policy goes beyond the "unreliability" of certain factual representations in the FLR request. What may be at play is that the Department has now backed off from applying a "substance over form" approach to the broker-dealer sourcing rules, and now requires that a taxpayer demonstrate that it is "*legally* acting in the capacity of a broker or dealer" with respect to the enumerated receipts.

As for the Department's new policy limiting application of broker-dealer sourcing for unregistered taxpayer owners of a registered SMLLC — which was not addressed in the FLRs — the new policy appears to mean that even though a registered SMLLC is disregarded for tax purposes, its taxpayer member may only qualify for broker-dealer sourcing with respect to the eligible receipts of the SMLLC.

The new policy will directly impact the Department's audit of UBT and general corporation tax returns filed for tax years beginning prior to 2015 consistent with the FLRs. However, the UBT sourcing rules have not been conformed to the new customer-based sourcing under the new Subchapter 3-A corporate tax (and the GCT, also without broad-based customer sourcing, remains

in existence for S corporations). Therefore, the *Update on Audit Issues* also has a continuing impact for some taxpayers in 2015 and beyond.

Court Unconditionally Dismisses Action for Failure to Exhaust Administrative Remedies

By Hollis L. Hyans

Revisiting a decision issued in May 2015, the Supreme Court, New York County, has granted the motion of the New York State Department of Taxation and Finance to unconditionally dismiss an action brought by a taxpayer to challenge results anticipated to arise from an audit, requiring the taxpayer to exhaust administrative remedies before returning to court. *SunGard Capital Corp. v. New York State Dep't of Taxation and Finance*, Index No. 155041/2015 (Sup. Ct. N.Y. Cnty., Dec. 19, 2016).

Background

SunGard Capital Corp. brought this action in 2015 against the Department, as well as a companion action against the New York City Department of Finance ("DOF"), asking for a declaratory judgment that the gain it incurred on the sale of two subsidiaries in 2012 should be excluded from its New York State corporate franchise tax entire net income, consistent with the method it used on its returns as filed. SunGard alleged that it expected the Department to argue, pursuant to the decision in *Matter of Bausch & Lomb, Inc.*, DTA No. 819883 (N.Y.S. Tax App. Trib., Dec. 20, 2007), and the Department's subsequent guidance in a *Technical Service Bulletin*, TSB-M-08(3)C (N.Y.S. Dep't of Taxation & Fin., Mar. 10, 2008), that the gain should have been included in SunGard's 2012 entire net income. SunGard contended that the gain should either be excluded under Tax Law former § 211(4)(b)(2) and Admin. Code § 11-605(4)(b)(2) as gain from the sale of a subsidiary, even if the subsidiary had been a member of a combined tax return; or, in the alternative, that if the gain is not excluded, it should be characterized as investment income rather than as business income, under Tax Law §§ 208(6)(a), 208(8), 208(1-B)(5)(a), 208(1-B)(6)(a), and 210(2), and Admin. Code § 11-602(c)(5).

In *Bausch & Lomb*, the New York State Tax Appeals Tribunal agreed with the taxpayer and held that a loss from the sale of a subsidiary that had been included in the taxpayer's New York combined return was not attributable to subsidiary capital and therefore was includable in the computation of entire net income. The Department then issued TSB-M-08(3)C, setting out its position that the holding in *Bausch & Lomb* also applies to gains from the sale of stock of a corporation included in a combined return.

Initial Motion to Dismiss

In August 2015, the Department (and the DOF) moved to dismiss SunGard's complaint on the ground that the court lacked jurisdiction, since no audit had yet been completed and no tax had yet been determined, and therefore there was no "justiciable controversy" for the court to resolve. The Department also argued that, even if additional tax were to be assessed under the theories outlined in SunGard's complaint, SunGard would be required to exhaust its administrative remedies through the Division of Tax Appeals before it could bring an action in court. The Department also stated that it needed to conduct an audit, and that it was not yet even clear whether SunGard had properly filed a combined return, or that its calculation of tax was correctly based on entire net income rather than on one of the alternate bases that would apply if the result is a higher tax. In response, SunGard contended that the Department's position was already determined, that there were no facts in issue, and that it was facing a "direct and immediate" "threat of harm" entitling it to declaratory relief.

> **The court…found it "appropriate… to simply dismiss the action for lack of subject matter jurisdiction," and to direct SunGard to exhaust administrative remedies before returning to seek any judicial review.**

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

Renewed Motion

In September 2016, the Department moved to renew its original motion to dismiss for lack of jurisdiction, and also moved to reargue, asking the court to modify its original order to delete the requirement that it complete the audit and issue its determination within the 120-day period, claiming that the audit had been delayed due to a lack of cooperation by the taxpayer, and that, in any case, the court had lacked authority to issue a conditional order in the first place because it had lacked jurisdiction. SunGard responded, asking for the action to move

forward since the Department had not issued a notice within the 120-day deadline, denied it had delayed the audit, and contended that all necessary information had been supplied to the auditor, pointing out, in particular, that the question of the correct composition of its combined return had been finally resolved by the decision in *Matter of SunGard Capital Corp., et al.*, DTA No. 823631 *et al.* (N.Y.S. Tax App. Trib., May 19, 2015), in which the SunGard group had been allowed to file combined returns including most of its related entities. SunGard also claimed it had no administrative remedies to exhaust, since no notice had been issued, and that it was raising strict questions of law as well as a constitutional challenge, alleging that the Department's interpretation of the subsidiary capital exclusion results in the taxation of extraterritorial income in violation of the Due Process and Commerce Clauses of the U.S. Constitution. In reply, the Department argued that no constitutional issues had been raised in the pleading.

Decision

The court denied the Department's request for re-argument, finding that the Department had failed to make the required showing that the court had overlooked any question of fact or law in its original decision, but granted the Department's request to renew its original motion. It noted that the Department claimed its audit had been delayed by a lack of cooperation, that SunGard denied it had caused the delay, but that in any case the audit had not yet been completed, and that the outstanding requests for information made it "impossible" for the Department to issue its notice within 120 days. It therefore found it "appropriate. . . to simply dismiss the action for lack of subject matter jurisdiction," and to direct SunGard to exhaust administrative remedies before returning to seek any judicial review.

Additional Insights

Unless the decision is appealed and reversed, it seems that resolution of SunGard's treatment of its gains in the wake of *Bausch & Lomb* will have to await an audit, any eventual Department notice of deficiency, and the usual challenge through the Division of Tax Appeals and Tax Appeals Tribunal. In the nearly nine years since the issuance of the TSB in 2008, no reported cases have dealt with the issue of how such gains should be treated. No similar motion to renew by the DOF appears in the court docket, so the progress of the City audit is not public.

While the trial court's decision did not expressly deal with SunGard's claims that it was not required to exhaust administrative remedies since it was raising questions of law and a constitutional challenge, it implicitly rejected those grounds in determining that SunGard had failed to exhaust administrative remedies. In general, taxpayers are required to exhaust administrative remedies before bringing an action in court, unless one of the recognized exceptions to that requirement is met, such as a claim that a statute is unconstitutional, or that the statute simply does not apply to it. Here, the publicly available record does not explain the nature of SunGard's constitutional challenge in detail, which seems to turn not on an allegation that the statute defining subsidiary capital is unconstitutional on its face, but that it was being unconstitutionally applied to SunGard through the Department's published TSB on how gain would be treated.

INSIGHTS IN BRIEF

Federal Court Remands False Claims Act Case to State Court

A Federal District Court judge has remanded to State court a lawsuit brought against Citigroup Inc. in which the relator contended that Citigroup had violated the New York False Claims Act by claiming net operating loss ("NOL") deductions despite its reliance on IRS notices supporting its position that sales of equity interests to the government under the Troubled Asset Relief Program did not reduce taxpayers' ability to use preexisting NOLs. *State of New York ex rel. Eric Rasmusen*, 15-cv-07826(LAK) (S.D.N.Y., Dec. 2, 2016). The court found that the action does not necessarily present substantial federal questions, since the relator lacks standing to challenge the validity of the IRS notices, and the question of whether New York follows federal law on determining the validity of NOL deductions is a question of state law. While noting that "New York interprets its tax laws in accord with federal law whenever possible," and describing the relator's argument to the contrary as having "dubious merit," the federal court found it lacked jurisdiction and remanded the case back to the State court from which it had been removed.

Tribunal Affirms Denial of Refund for Failure to First Repay Customers

The New York State Tax Appeals Tribunal has affirmed the decision of an ALJ that a car dealership could not obtain a refund of sales tax paid to New York instead of to Connecticut on extended warranties — although the Connecticut Department of Revenue had audited it and determined that the tax was owed to Connecticut — because it had failed to first refund the amounts to its customers. *Matter of Stamford Subaru, LLC*, DTA No. 826071 (N.Y.S. Tax App. Trib., Nov. 23, 2016). The Tribunal relied on Tax Law § 1139(a), which mandates that no refund is available for tax that was "collected from a customer" unless the amount is first refunded to the customer, and rejected the dealership's arguments

that it had fulfilled the repayment requirement by an assumption of the obligation of its customers to Connecticut for the tax.

Tax Appeals Tribunal Upholds Imposition of Tax Preparer Penalties

The imposition of tax return preparer penalties against a registered tax-return preparer, who prepared several hundred New York State personal income tax returns over a three-year period in which taxpayers claimed improper personal property rental expense adjustments, reducing their New York taxable income, has been upheld by the State Tribunal. *Matter of Maria J. Garcia*, DTA No. 826043 (N.Y.S. Tax App. Trib., Dec. 1, 2016). The penalties imposed, at a maximum of $1,000 per understated tax return, had resulted from a tax preparer audit investigation that employed a computer match analysis. The Tribunal rejected the tax preparer's sole arguments on appeal that the penalties were improper because the statutory penalty provision expired effective July 1, 2015, prior to the ALJ's determination in 2016, which the preparer argued constituted an improper retroactive application of the penalties.

New York State Issues Guidance on Applicability of Sales Tax to Food and Beverages Served at Funeral Homes

The New York State Department of Taxation and Finance has issued sales tax guidance resulting from 2016 legislation that, effective January 17, 2017, permits funeral homes in New York State to serve food and nonalcoholic beverages at funerals and wakes. *Technical Memorandum*, "Tax Department Policy on the Application of Sales Tax to Food and Beverages Served in Funeral Establishments," TSB-M-16(10)S (N.Y.S. Dep't of Taxation & Fin., Dec. 16, 2016). According to the *Technical Memorandum*, a funeral home's charges for a funeral service, including any charges for food and drink included in the charge, are not subject to sales tax. However, the funeral home's purchase of taxable food items, such as cold-cut platters, dessert trays and sandwiches, will be subject to sales tax, as will its purchases of cups, plates, and napkins.

NYC ALJ Finds Department Properly Disregarded Accounting Method Employed by Corporation for Installment Sale

A New York City Administrative Law Judge held that the Department of Finance properly invoked its authority to disregard the method of accounting employed by a corporate taxpayer in order to include all of the taxpayer's gain from an installment sale of real property in the taxpayer's final General Corporation Tax return. *Matter of 1018 Morris Park Avenue Realty Inc.*, TAT(H) 14-4(GC) (N.Y.C. Tax App. Trib., Admin. Law Judge Div., Dec. 5, 2016). The ALJ also held that the taxpayer failed to prove that it continued to be subject to tax merely because it maintained a bank account, and therefore should not have filed a final GCT return, which would have allowed it to report the gain based on when the installment payments were received. According to the ALJ, the record "reveal[ed] a striking dearth of relevant proof" that the taxpayer continued to have any operations in New York City after the year at issue.

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