New York State Bar Association

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TAX SECTION

1995-1996

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To: The Executive Committee

From: Carolyn Joy Lee

Re: **Continuing Legal Education Program**

On November 28 and 29, 1995, the Tax Section co-sponsored the "New York State and City Tax Institute," a two-day program on state and city taxes. The program was co-chaired by Paul R. Comeau and Arthur R. Rosen; numerous members of the Executive Committee participated in the program, as did a large number of high-level state and city tax officials.

I am distributing to you herewith a copy of the outlines and course materials distributed at the program. I thank all of you who participated in the program, and I encourage the Executive Committee to lend continued support to these kinds of programs. They provide a real service to the legal community, and they should continue to be an important part of our work.

CHALLENGING NEW YORK STATE REGULATIONS

New York State and
City Tax Institute
November 28, 1995

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CHALLENGING NEW YORK STATE REGULATIONS

I. TYPES OF REGULATIONS

Regulations are usually classified as either "legislative" regulations or "interpretive" regulations. A legislative regulation is the product of an exercise of delegated legislative power to make law by regulation. An interpretative regulation interprets a statute and is issued without a specific delegation of legislative power.

The general source of the Commissioner of Taxation and Finance's (the "Commissioner") regulatory authority is contained in the first paragraph of Section 171 of the New York Tax Law. This section provides that the Commissioner shall:

> Make such reasonable rules and regulations, not inconsistent with law, as may be necessary for the exercise of its powers and the performance of its duties under this chapter. . . .

In addition to this general grant of regulatory authority, many Sections of the Tax Law provide the Commissioner with specific regulatory authority.

A. Legislative Regulations

A legislative regulation has about the same effect as a statute and is binding upon courts. It is valid if (a) it is issued within the legislative power granted; (b) is issued in a procedurally correct manner; and (c) is reasonable as a matter of due process.

As a matter of constitutional law, older Supreme Court cases indicated that legislative power could not be delegated to an administrative agency. United States v. Shreveport Grain & Elevator Co., 287 U.S. 77, 85 (1932). However, it is now well established that the delegation of authority to issue legislative regulations "has long been recognized as necessary in order that the exertion of legislative power does not become a futility". Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381, 398 (1940). There are

many provisions of the Tax Law which specifically direct the Commissioner to issue legislative regulations.

Legislative regulations have authoritative force. Such regulations "supplement" and "implement" the statute and serve to "effectuate the legislative policy". Rufo v. Orlando, 309 N.Y. 345 (1955). As noted by the Supreme Court in Rowan Cos. v. United States, 452 U.S. 247, 253 (1981), with respect to legislative regulations, "[w]here the Commissioner acts under specific authority, our primary inquiry is whether the interpretation or method is within the delegation of authority."

B. Interpretive Regulations

Regulations which explain or construe the meaning of statutory provisions are interpretive regulations. Section 171 gives the Commissioner general authority to issue regulations to explain and clarify the Tax Law. An interpretive regulation is not controlling on a court. The weight given to an interpretative regulation by a court depends upon a totality of the circumstances. As the Supreme Court noted in Skidmore v. Swift & Co., 323 U.S. 134, 139-140 (1944), in regard to regulations interpreting the Fair Labor Standards Act:

> There is no statutory provision as to what, if any, deference courts should pay to the Administrator's conclusions . . . . This Court has long given considerable and in some cases decisive weight to Treasury Decisions and to interpretative regulations of the Treasury and of other bodies that were not of adversary origin. We consider that the rulings, interpretations and opinions of the Administrator under the [Fair Labor Standards] Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a

> particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.

II. CHALLENGES OF NEW YORK STATE TAX REGULATIONS

A. Theoretical Approach

On a theoretical level, in deciding whether a regulation is to be upheld, courts should first determine whether the regulation is a legislative or interpretive regulation. In the case of a legislative regulation, the test would logically be:

1. Does the regulation relate to the subject matter on which the power to legislate has been delegated;

2. Does the regulation conform to the statutory standards prescribed in the authorizing statute; and

3. Is the regulation valid on constitutional grounds.

In the case of an interpretive regulation, the test should be whether the regulation correctly interprets the statute.

Unfortunately, the case law usually does not conform to this theoretical logic. While the courts in New York consider their decisions based upon certain "tests" for determining whether to follow a regulation, these "tests" usually reflect the result of a judgment rather than describing the basis upon which such judgment was reached. Thus, these "tests" should not be viewed as talismanic touchstones to a decision in testing a particular regulation. In many cases, the result depends upon the court's view of the "reasonableness" of a challenged regulation.

B. Judicial Tests For Reviewing Regulations

The courts in New York have articulated a number of tests for reviewing regulations. Since the "tests" are generally applied to all regulations, not merely tax regulations, non-tax cases should be reviewed to find helpful authority.

1. Does the Regulation Exceed the Statutory Authority?

Since a regulation must be based upon statutory authority, it is axiomatic that a regulation is invalid if it exceeds its statutory authority. The difficult question is determining the outer boundaries of the statutory authority. Usually this test is applied to legislative regulations although courts in New York infrequently note this distinction. It can be applied to interpretive regulations which are considered to legislate (without authority) rather than interpret.

a) Boreali v. Axelrod, 71 N.Y. 2d 1 (1987). The New York Public Health Council, relying upon a delegation of broad authority to make regulations concerning the public health, issued comprehensive regulations restricting smoking in public places. The Court of Appeals held that the regulations were invalid. In a confusing opinion, the court determined that the council had usurped the legislative function and issued regulations that exceeded the statutory authority. The opinion did not discuss the difference between legislative and interpretative regulations, although the regulations in issue clearly were legislative regulations. The dissent pointed out that the breadth of the statutory delegation of power had previously been approved by the court in many areas and the majority's separation of power analysis was confused. The bottom line, however, is that this case held that the legislative regulations exceeded the statutory authority.

b) New York State Health Facilities Ass'n v. Axelrod, 77 N.Y. 2d 340, 348 (1991). The court denied a challenge to broadly drafted Public Health Council regulations since it found that the regulations were within the legislative delegation of regulatory authority. Since the broad policy choices had been made by the Legislature, the regulations were "well within the authority delegated to the agency for the purpose of administering the statute."

c) Mercy Hospital of Watertown v. NYS Dept. of Social Services, 79 N.Y. 2d 197 (1992). Agency's regulations authorizing the use of a statistical sampling audit of medicaid billing was within statutory authorization.

d) Matter of Penthouse International Ltd, 94-1 N.Y.T.C. T-55 (Tax Appeals Tribunal 1994). The Tribunal held that Regulation § 6-2.4(a) which requires a taxpayer to request permission to file a combined report within 30 days after the close of its taxable year was not "an exercise of rule making power in excess of the statutory grant of power. . . ."

2. Does the Regulation Conflict With the Statute?

A regulation can be invalidated because it is considered to conflict with the statutory basis for the regulation. This test is usually applied to interpretive regulations. When the test is not satisfied, it is usually because the courts determine the agency's interpretation of the statute is invalid.

a) Servomation Corp. v. State Tax Commission, 51 N.Y: 2d 608, 612 (1980). The Court of Appeals held that an example in the sales tax regulation was void since "[a]n administrative agency cannot by regulatory fiat directly or indirectly countermand a statute enacted by the Legislature. . . ."

b) Trump-Equitable Fifth Ave. Co. v. Gliedman, 57 N.Y. 2d 588 (1982). A partial real property tax exemption is available under State law for the construction of new multiple dwellings on, among other things, "under-utilized" property. The NYC Department of Housing Preservation and Development issued regulations requiring the property to be "substantially" under-utilized in order to be eligible for the partial exemption. The Court of Appeals held that the regulation was invalid since it was inconsistent with the plain meaning of the statutory language.

c) Fairland Amusements, Inc. v. State Tax Commission, 66 N.Y. 2d 932 (1985). The Court of Appeals ruled that a sales tax regulation defining a "place of amusement" was contrary to the statute it was interpreting and therefore should be disregarded.

d) NYS Cable Television Ass'n. v. State Tax Commission, 59 A.D.2d 81 (3rd Dep't 1977). In 1965 the Department of Taxation and Finance issued an opinion of counsel that cable television services were not

subject to sales tax as "telephony or telegraphy" services. In 1976, an opinion of counsel and regulations were issued which reversed this position on a prospective basis. The court held that the failure of the Department to tax cable television services for a substantial period of time created a presumption in favor of the taxpayer and, after reviewing the prior case law, held that the regulation violated the statute.

3. Does the Regulation Extend or Modify the Statute?

Sometimes an interpretive regulation extends or modifies the statute. In this case, the courts usually hold that the interpretive regulation is invalid. As the Supreme Court long ago held, "[i]f experience shows that Congress acted under a mistaken impression, that does not authorize the Treasury Department . . . to make new laws which they imagine Congress would have made had it been properly informed." Merritt v. Welsh, 104 U.S. 694, 704 (1881).

a) Jones v. Berman, 37 N.Y. 2d 42 (1975). Regulations of the Commissioner of Social Services denying emergency assistance to destitute applicants whose prior grant was lost or stolen were not valid since the regulation added a requirement not found in the existing statute.

b) Velez v. Department of Taxation and Finance, 152 A.D. 2d 87 (3rd Dep't 1989). The court held that a sales tax regulation that subjected a bulk sale purchaser to personal liability for the seller's sales and use tax liability, interest and penalties, was invalid. Since the statute provided that such a purchaser was liable for "taxes", the regulation was an impermissible attempt to extend the statute beyond its terms.

c) Trump-Equitable Fifth Ave. Co. v. Gliedman, 62 N.Y. 2d 539 (1984). In the second Trump decision, the taxpayer was again seeking the partial real property tax exemption in the face of a new regulation. The Court of Appeals held that the new regulations added a requirement for the exemption which does not appear in the statute. While the new requirement would have been valid if it were in the statute, the regulator was not empowered to add new conditions to the statutory benefit.

d) National Elevator Industry, Inc. v. State Tax Commission, 65 A.D. 2d 304, 310 (3rd Dep't 1978), rev'd, 49 N.Y.2d 538 (1980). The court

held that "[a]n administrative agency may not make regulations more restrictive than the statute under which it is promulgated. . . ."

e) Matter of Penthouse International Ltd., 94-1 N.Y.T.C. T-55 (Tax Appeals Tribunal 1994). Regulations which "provide procedural and substantive requirements to guide both the Division and taxpayers with regard to when, how and under what circumstances combined reports may be filed" was valid rule making. Since this was a matter over which the Commissioner had broad discretion, the regulations were virtually legislative in nature.

4. Does the Regulation Have a Reasonable Relationship to Statutory Purpose?

Sometimes a challenged regulation, while not in direct conflict with its statutory base, may be contrary to the clear policy of the statute. In these cases, if the court can be persuaded that the regulation has no reasonable relationship to the purpose of the predicate statute or produces a result inconsistent with the statutory purpose, the regulation can be avoided as unreasonable.

> McNulty v. State Tax Commission, 70 N.Y. 2d 788 (1987). The Commissioner's regulations required that for an individual who filed two separate part year personal income tax returns, one as a resident and one as a non-resident, all partnership gains or losses were to accrue in the taxable period during which the partnership year ended, rather than on a proportionate basis. While the regulation did not violate or extend any statutory provision, the Court of Appeals nevertheless held the regulation was invalid as "inconsistent with law". The court found a clear legislative intention to prorate most forms of income and that the Commissioner's regulation was "out of harmony with the statute. . . ."

5. Is the Regulation Unconstitutional?

A regulation can be challenged as unconstitutional in the same manner that a statute can be challenged. The regulation may be so vague as to raise a due process challenge. A tax regulation can also be challenged as violating other constitutional rights.

a) Matter of J.C. Penney Co., Inc. 89-1 N.Y.T.C. T-267 (Tax Appeals Tribunal 1989). The sales tax regulations provided that promotional materials which are sold for "a minimal charge which does not reflect its true cost" are taxable sales to the original purchaser and not eligible for the resale exclusion. The taxpayer sold its catalogs below cost and gave promotional coupons to offset sales price. It collected sales tax on the sales price to consumers but did not pay tax on its cost to acquire the catalogs. The Commissioner imposed tax based upon the taxpayer's cost. The taxpayer argued that the regulation was unconstitutionally vague since there was no "objective standard" for determining the meaning of the phrase "minimal charge". The Tribunal held that the constitutional due process test requires "only a reasonable degree of certainty so that individuals of ordinary intelligence are not forced to guess at the meaning. . . ." The Tribunal then concluded that the definition of "minimal charge" in the regulation was not unconstitutionally vague.

b) McGraw-Hill, Inc. v. State Tax Commission, 75 N.Y. 2d 852 (1990). Under the franchise tax regulations, for purposes of allocating business receipts, advertising revenues received by radio and television broadcasters were treated as service income allocable based upon where the listeners or viewers were located. Advertising revenues earned by publishers were allocated based upon the location of the advertising sales office. The taxpayer successfully convinced the court that the disparate treatment of broadcasters and publishers was a violation of publishers' First Amendment rights and therefore the regulation was invalid.

c) Milhelm Attea & Bros. Inc. v. Department of Taxation and Finance, 81 N.Y. 2d 417 (1993), rev'd, __ U.S. __, 114 S.Ct. 2028 (1994). The Court of Appeals held that tax regulations seeking to tax wholesale distributors who sell cigarettes delivered to Indian merchants on reservations were held to be barred by Federal statutes which pre-empted state tax regulations. The Supreme Court subsequently reversed this holding based upon its interpretation of the Federal statute that "Indian traders are not wholly immune from state regulation that is reasonably necessary to the assessment or collection of lawful state taxes" and determined that the regulations constituted a reasonable

method of preventing fraudulent transactions. See also Snyder v. Wetzler, 84 N.Y. 2d 941, 942 (1994) ("State tax statutes requiring Indian retailers to collect and remit taxes on sales to non-Indian purchasers, and to keep the records necessary to ensure compliance, violate neither the Commerce Clause nor the constitutional proscription against taxation of Indians absent explicit Congressional consent.").

d) Graham v. State Tax Commission, 48 A.D. 2d 444 (3rd Dep't 1975), aff'd, 40 N.Y.2d 889 (1976). Tax regulations which prohibit a non-resident individual's net operating loss carry-back or carry-over when there is no actual loss on the taxpayer's Federal return (but there is a loss on the taxpayer's New York return) was in conflict with constitutional standards. Offsetting New York losses with non-New York gains was impermissible.

6. Is the Regulation Arbitrary or Capricious?

When all else fails, a regulation may be challenged as "arbitrary or capricious". The cases that rely upon this "test" may either ignore the other tests or simply reflect the court's conclusion with respect to the challenged regulation without further analysis. If the court concludes that the challenged regulation could not have been approved by a reasonable person of good judgment or if the regulation shocks the conscience of the court, it will not be followed. While regulations are frequently challenged on this basis, the challenge is usually unsuccessful.

a) Graham v. State Tax Commission, 48 A.D. 2d 444 (3rd Dep't 1975), aff'd, 40 N.Y.2d 889 (1976). Regulation that did not allow a non-resident to carry over or carry back a net operating loss on his New York return when the taxpayer had no Federal net loss was "unreasonable, arbitrary or capricious, and therefore, invalid".

b) Colt Industries v. New York City Dept. of Finance, 66 N.Y. 2d 466 (1985). The NYC General Corporation Tax Regulations provided for purposes of determining the exclusion for income from subsidiary capital, only dividends, interest and gains from subsidiary capital could be excluded. The taxpayer claimed that management fee income from a subsidiary was excludible as income from subsidiary capital since the regulation was irrational or unreasonable. The Court of Appeals held that the fees were for services so that it was both rational and reasonable to not treat it as income from subsidiary capital.

c) Standard Manufacturing Company, Inc. v. Tax Commissioner, 114 A.D. 2d 138, 141 (3rd Dep't 1986). "In a matter such as this, which requires the analysis of a regulation applied to a particular factual situation, the administrative determination must be respected absent irrationality. . . ."

III. WEIGHT TO BE GIVEN TO REGULATIONS

As previously indicated, valid legislative regulations have virtually the force of a statute. Once a court determines a legislative regulation is valid, it must be applied. With respect to an interpretive regulation that has not been successfully challenged pursuant to the tests set forth above, the weight to be given is less clear. Such regulations are not binding interpretations that must be followed by the courts.

With respect to an interpretative regulation, a court's inquiry is technically not into the validity of the regulation, but rather its correctness or propriety. Nevertheless, most decisions rule on the validity of the regulations. A court may substitute its judgment to the extent it believes that the Commissioner's regulation does not correctly interpret the statute. A court may give a regulation (a) the force of law; (b) no weight or (c) some intermediate degree of weight. Thus, a court has much latitude in considering interpretative regulations.

The language in the cases as to the weight to be given to interpretive regulations is not helpful in predicting future results. If a court agrees with the Commissioner's interpretation, the court will afford "great deference" to the regulation. Where it disagrees with the regulation, it will be given "little weight."

A court will usually follow an interpretative regulation when:

(a) it agrees with the regulation;

(b) the regulation rests upon the Commissioner's specialized expertise and it is satisfied with the rule; and

(c) the regulation is a contemporaneous construction of the statute, longstanding or the statute has been re-enacted while the regulation was outstanding and it is satisfied with the rule.

The Supreme Court has recognized in many cases that an interpretative regulation that is a contemporaneous construction of the statute should be afforded great weight. See Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294, 315 (1933): United States v. Leslie Salt Co., 350 U.S. 383, 396 (1956); Bingler v. Johnson, 394 U.S. 741, 749-50 (1969). However where the Supreme Court disagreed with the contemporaneous interpretation, it has not followed such regulations for "weighty reasons." Commissioner v. Estate of Steinberger, 348 U.S. 187, 199 (1955); Zuber v. Allen, 396 U.S. 168 (1969), cert. denied, 396 U.S. 1013 (1970).

Likewise, the Supreme Court has stated that "the reenactment by Congress, without change, of a statute which had previously received long continued executive construction, is an adoption by Congress of such construction." United States v. Cerecedo Hermanos v. Compania, 209 U.S. 337, 339 (1908). This view, of course, assumes that the Legislature and its staff is fully aware of all regulatory interpretation when legislation is re-enacted, which is not a likely possibility. As a result, the court has stated that "[w]here the law is plain the subsequent reenactment of a statute does not constitute the adoption of its administrative construction." Biddle v. Commissioner, 302 U.S. 573, 582 (1938). In other words, the reenactment doctrine is persuasive only if the court agrees with the regulatory interpretation. For example in National Elevator, the Appellate Division cited the reenactment of the law, three years after a letter ruling of the Commissioner, as legislative ratificant of the letter ruling. This is an extreme example of the re-enactment doctrine and was reversed on appeal by the Court of Appeals.

When the Commissioner interprets his own rules, courts normally indicate that great weight is to be given to such interpretation. However, the Commissioner is nevertheless bound by the plain meaning of his own regulations. See International Harvestor Company v. State Tax Commissioner, 58 A.D. 2d 125 (3d Dep't 1977) ("citizenry should be able to use said rules as a guide for formulating a course of conduct"); Adamides v. Chu, 134 A.D. 2d 776 (3rd Dep't 1987).

IV. RETROACTIVITY

Whether and when a regulation will be given retroactive effect has been the subject of controversy. The general rule, as recently articulated by the Supreme Court is as follows:

> Retroactivity is not favored in the law. Thus . . . administrative rules will not be construed to have retroactive effect unless their language requires this result. Bowen v. Georgetown University Hospital, 488 U.S. 204, 208 (1988).

A. When Is A Regulation Retroactive

The cases in New York have sometimes followed this general directive:

a) Matter of Varrington Corporation, 1995-1A N.Y.T.C. T-430 (Tax Appeals Tribunal 1995). Regulations which changed policy regarding doing business test for corporate limited partners would only be applied prospectively based upon its own terms.

b) Varrington Corporation v. N.Y.C. Dept. of Finance, 85 N.Y.2d 28 (1995). NYC version of corporate limited partner regulations applied retroactively. Although the regulations apparently were not explicitly made retroactive, the Department's interpretation to apply the regulations retroactively was upheld by the Court of Appeals.

c) Linsley v. Gallman, 38 A.D.2d 367 (3rd Dep't 1972), aff'd, 33 N.Y.2d 863 (1973). Presumption that regulation is applied prospectively only.

B. Will Retroactive Changes In Regulations Be Upheld

If a regulation is retroactively changed, the courts have displayed significant reluctance to apply changes in policy retroactively where the taxpayer can show detrimental reliance upon the prior regulations.

a) Hoffman v. City of Syracuse, 2 N.Y.2d 484 (1957). The City of Syracuse commissioner of finance directed liquor retailers to not charge sales tax on the federal and state excise taxes imposed upon liquor sales. Due to a change in interpretation, the commissioner later directed that sales tax be retroactively collected on the full price of liquor sales, including federal and state excise taxes. The Court of Appeals held that the commissioner was estopped from retroactively collecting sales tax from retailers who followed his prior directions.

b) Linsley v. Gallman, 38 A.D.2d 367 (3rd Dep't 1972), aff'd, 33 N.Y.2d 863 (1973). Commissioner changed tax regulations to make non-cash payment of annuity to a non-resident taxable in New York. This was contrary to regulations in place during the taxable years in dispute. The court held that the retroactive application of the regulation would result in the taking of property arbitrarily and would not be allowed.

c) Matter of Dominion Textile (USA) Inc., 1995-2A N.Y.T.C. J-1450 (Division of Tax Appeals 1995). Change in regulation that by its terms was prospective only which changed the definition of investment capital to include options could not be applied retroactively by the taxpayer. Since the new regulation represented a substantial change in policy, the change could be applied prospectively only.

C. Application of Retroactive Regulations

If regulations are intended to be applied retroactively and are not changing existing regulations, generally the courts have considered whether "there are any potentially harsh effects of applying the law retroactively to the taxpayer." Varrington Corporation v. N.Y.C. Dept. of Finance, 85 N.Y.2d 28, 33 (1995). In determining whether there are "potentially harsh effects", the four elements reviewed by the Court of Appeals in Replan

Development, Inc. v. Department of Housing, 70 N.Y.2d 451, 456 (1987), appeal dismissed. 485 U.S. 950 (1988) are frequently considered:

1) The taxpayer's forewarning of the change;

2) The reasonableness of the taxpayer's reliance on the old laws.

3) The length of the retroactive period; and

4) Whether there is a valid public policy for retroactive application.

Recently, however, the Court of Appeals has held that if the taxpayer cannot show detrimental reliance upon prior law, a retroactive change in regulation will be upheld. Varrington Corporation v. N.Y.C. Department of Finance, 85 N.Y. 2d 28, 35 (1995).

D. Retroactive Federal Tax Regulations

Pursuant to Section 7805(b) of the Internal Revenue Code, Treasury is given authority to prescribe when regulations are not to be given retroactive effect. Since retroactive application can create a harsh result, there are certain judicial limitations on retroactive regulations. See Saltzman, IRS Practice and Procedures (Second Edition) ¶3.02 [5]. Moreover, in the recently expressed views of the New York State Bar Association Tax Section in a letter opposing federal legislation to limit the retroactive application of federal tax regulations, "the retroactive application of [federal tax] regulations has not been a major problem to date." NYSBA Tax Section Report #848 (October 2, 1995).

NEW YORK STATE AND CITY TAX INSTITUTE
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DIRECT AND INDIRECT ATTRIBUTION OF NONINTEREST EXPENSES

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Direct and Indirect Attribution of Noninterest Expenses

I. Background

The purpose of expense attribution under the New York Tax Law ("NYTL") is to avoid a double tax benefit resulting from giving favorable tax treatment to income from investment and subsidiary capital while simultaneously allowing a deduction against business income for expenses related to investment or subsidiary capital.

The New York State Department of Taxation and Finance and the New York City Department of Finance have jointly drafted a new State Technical Services Bureau Memorandum ("TSB-M") and corresponding City Statement of Audit Procedure ("SAP"). While the language of the TSB-M is geared towards taxpayers and the SAP is geared towards auditors, the contents of the two documents are identical in meaning.

The TSB-M will be effective for tax years beginning on or after January 1, 1995, and supersedes TSB-M-88(5)C, October 14, 1988, for those years. However, TSB-M-88(5)C continues to apply for attribution of interest expenses.

II. Highlights of the New Approach Outlined by the Proposed TSB-M

1. Taxpayers receive guidance and greater audit certainty in the area of attribution;
2. Mutual State/City acceptance of audit findings on this issue;

3. Attribution will no longer be used to make transfer pricing adjustments;
4. Provides a list of expenses irrebuttably presumed to be directly attributed to business capital;
5. Provides for an operating division's expenses to be attributed to business capital if 95% or more of the division's expenses are business expenses; and
6. Provides an income and asset formula, with income double weighted, to indirectly attribute residual expenses (in addition to the two factor formula, taxpayers may make a one-time election to attribute residual expenses with an asset only formula).

III. New Attribution Rules Set Forth In the Proposed TSB-M

A. Direct Attribution of Noninterest Deductions to Business Capital

1. Noninterest Deductions Irrebuttably Presumed To Be Attributable to Business Capital

The following is a nonexhaustive list of expenses irrebuttably presumed to be attributable to business capital. The taxpayer need only substantiate the nature and amount of each item:

(a) cost of goods sold;

(b) bad debts other than items properly classified as subsidiary or investment capital;

(c) property, excise and sales and use taxes;

(d) real estate rents, depreciation and repairs; and

(e) utilities, including telecommunications costs;

(f) advertising;

(g) noninterest expenses for which reimbursement is received in the form of a management fee treated on the return as business income;

(h) research and development expenses; and

(i) compensation packages of the chief executive officer, chief financial officer and chief operating officer.

2. Direct Attribution of Noninterest Deductions that Proximately, and Not Incidentally, Benefit Business Capital

The following is an nonexhaustive list of expenses directly attributable to business capital if they proximately benefit business capital:

(a) deductible costs of shipping goods to customers;

(b) compensation and other benefits of officers, other than officers described in section III A(1)(i) above, and employees engaged in manufacturing, sales, services, or other activities directly producing business capital or income;

(c) deductible legal expenses incurred in conducting the taxpayer's business;

(d) reimbursed noninterest expense; and

(e) noninterest expenses compensated for by a management fee.

B. Direct Attribution of Noninterest Deductions to Subsidiary Capital

1. The following is a nonexhaustive list of expenses which if they proximately, and not incidentally, benefit subsidiary capital should be directly attributed to subsidiary capital:

   (a) compensation and other benefits of officers, other than officers described in section III A(1)(i) above, and employees engaged in the acquisition, management or disposition of subsidiary capital or income therefrom;

   (b) legal and accounting expense deductions relating to the management of subsidiary capital or income therefrom; and

   (c) computer expense deductions relating to the management of subsidiary capital or income therefrom.

C. Direct Attribution of Noninterest Deductions to Investment Capital

1. The following is a nonexhaustive list of expenses which if they proximately, and not incidentally, benefit investment capital should be directly attributed to investment capital:

   (a) safe deposit box rentals for safekeeping of certificates or other documents relating to investment capital;

   (b) financial news subscriptions utilized exclusively by employees engaged in the acquisition, management or disposition of investment capital or the income therefrom; and

(c) compensation and other benefits of officers, other than officers described in section III A(1)(i), above, and employees engaged in the acquisition, management or disposition of investment capital or the income therefrom.

D. Direct Attribution to More Than One Class of Capital.

1. A particular noninterest deduction may be attributable to more than one class of capital. In that case, the taxpayer should directly attribute a portion of that deduction to each class of capital proximately benefited by the expense which gave rise to that deduction, using a method that is reasonable for that particular deduction. Such a method can be based on one or more factors appropriate given the nature of the deduction. Such factors may include, but are not limited to, time, space, payroll, and numbers of personnel.

E. Special Rule for Operating Divisions

1. If the taxpayer can substantiate that at least 95% of the noninterest expenses of an operating division are directly attributable to a particular class of capital, 100% of the noninterest expenses of that operating division may be directly attributed to that class of capital.

F. Indirect Attribution of Residual Noninterest Deductions.

1. Noninterest deductions that cannot be directly attributed are termed "residual noninterest deductions." Residual noninterest deductions are attributed to subsidiary and investment capital using combined asset and income percentages or, if an election is made as described below, by an asset percentage:

   (a) Election. In order to use an asset percentage to allocate residual noninterest deductions, the taxpayer must elect to do so on a timely return (including extensions) for its first taxable year beginning on or after January 1, 1995 on which the taxpayer reports subsidiary or investment capital. This election is irrevocable, and applies to all subsequent taxable years. The taxpayer may not elect the alternative method on a late or amended return.

   (b) Asset percentage. The asset percentage with respect to subsidiary/investment capital is determined by dividing the average value of the taxpayer's subsidiary/investment capital, without reduction for liabilities, by the total average value of all the taxpayer's assets, without reduction for liabilities.

   For these purposes, real property and marketable securities must be valued at fair market value and the value of personal property other

than marketable securities must be the value thereof shown on the books and records of the taxpayer in accordance with generally acceptable accounting principles.

(c) Income percentage. The income percentage for subsidiary/investment capital is determined by dividing the taxpayer's gross income from subsidiary/investment capital by its total gross income.

(d) Combined asset and income percentage. The combined asset and income percentage is computed by adding together two times the taxpayer's income percentage for subsidiary or investment capital and the taxpayer's asset percentage for subsidiary or investment capital, and dividing the total by three.

IV. Examples Set Forth In Proposed TSB-M

Example 1: Each member of a taxpayer's accounting staff spends 40% of his or her time analyzing whether the taxpayer should restructure its subsidiaries. Each member of the accounting staff spends 20% of his or her time analyzing the taxpayer's investment portfolio. The accounting staff does not spend any other time on issues relating to subsidiary or investment capital or income. The taxpayer attributes 40% of the accounting staff's

salaries and related expenses to subsidiary capital and 20% to investment capital. This method is acceptable.

Example 2: The facts are the same as in example 1. The taxpayer has a total of 100 employees. Ten employees are in the accounting department. Ten employees are in the personnel department. They are responsible for managing the hiring, salaries, pension and medical benefits of all employees of the remaining 80 employees. Five spend 20% of their time on activities related to investment capital and 40% of their time on activities related to subsidiary capital. The 15 employees engaged in activities relating to investment and subsidiary capital represent 25% of the total payroll of the taxpayer.

The taxpayer attributes 5% (25% X 20%) of the salaries and related expenses of the personnel department employees to investment capital and 10% (25% X 40%) to subsidiary capital. This method, based on time and payroll, is reasonable under the circumstances and is acceptable.

Example 3: Income and assets. Corp. X has $10,000 of business income, $4,000 of business capital, $300 of income from subsidiary capital, $1,000 of subsidiary capital, $500 of investment income and $2,000 of investment capital. (Capital is here computed without reduction for liabilities.)

Expenses. Corp. X has $6,000 in noninterest expenses, of which $3,500 is directly attributable to business capital and properly substantiated, including items on the list of expenses presumed attributable to business capital under section III (A)(1) above.

Separate Operating Division. Corp. X has a manufacturing plant that has its own human resources department, keeps separate books and records of expenses and qualifies as an "operating division". $1,000 of the $6,000 of noninterest expenses are attributable to that plant and are not included in the $3,500. Of that $1,000, $400 is wages and salaries, $100 is for equipment rental and depreciation, and $500 consists of items on the list in section III A(2) above. Corp. X can substantiate that at least $950 of the $1,000 is directly attributable to business capital. Therefore, all $1,000 of the expenses of that plant are considered directly attributable to business capital.

The total of directly attributable expenses is $4,500 ($1,000 from the division and $3,000 from the corporation as a whole).

Subsidiary and Investment Capital Percentages

Subsidiary: [$300/$10,800 (income) + $300/$10,800 (income) + $1,000/$7,000 (capital)] /3 = 6.61%

Investment: [$500/$10,800 (income) + $500/$10,800 (income) + $2,000/$7,000 (capital)]/3= 12.61%

Indirect residual noninterest deductions of $1,500 ($6,000 less the $4,500 directly attributed to business capital) are attributed, 6.61% ($99.15) to subsidiary capital and 12.61% ($189.15) to investment capital. The remainder, $1211.70 ($1500- [$99.15 + $189.15]) is attributed to business capital.

The total direct and indirect noninterest expense attribution is $5711.70 to business, $99.15 to subsidiary and $189.15 to investment capital. (Capital is here determined without the deduction of liabilities.)

V. Old Attribution Rules (Post-1986)

A. As set forth by TSB-M-88(5)C:

1. The first step in attributing expenses is to determine which deductions are directly traceable, whether in whole or in part, to subsidiary, investment and business capital.

2. The next step in attributing expenses is to determine the expenses subject to indirect attribution. This is accomplished by:

   (a) Taking total deductions included on line twenty-seven of the federal income tax return;

   (b) Subtracting those deductions required to be added back to federal taxable income in computing entire net income;

   (c) Adding those expenses which were not deducted for federal purposes but which are subtracted from federal taxable income in computing entire net income; and

   (d) Subtracting those deductions which were determined to be directly attributable to subsidiary, investment or business capital.

3. Finally, expenses indirectly attributable to subsidiary and investment capital are determined by a formula consisting of the ratio of the average value of a taxpayer's assets included in subsidiary or investment capital, respectively, to the average value of all of the taxpayer's assets.

The State Tax Implications of Federal Tax Reform:
Outline for Discussion

Four basic reform proposals are currently under consideration:

A. A "Flat Tax";
B. A Consumption-Based Income Tax;
C. A Value-Added Tax, or "VAT"; and
D. A National Sales Tax.

The broad parameters of these taxes and the peculiar implications of each for State and local taxes, are outlined below.

A. Flat Tax

1. Armey/Specter

a. Individuals:

Tax wages at 20%; no tax on interest, dividends, capital gains

Standard deduction

Repeal withholding (substitute monthly estimates)

Interest deduction re: home?

Charitable contributions?

State and local taxes not deductible

Interest on government bonds is taxable

b. Business:

Replace income tax with a VAT (see Section C, below)

Armey would allow a wage deduction, as wages are taxed at the individual level

2. Gephart

Individuals: Progressive (10% and up) flat tax

3. <u>Highlights and Critiques</u>

   a. Simple -- Postcard returns are touted

   b. Visible

   c. Not progressive

4. <u>Issues for States and Cities</u>

   ▸ Lost (or less valuable) deductions for taxes

   ▸ Lost (or less valuable) exemption for interest

   ▸ Absence of information reporting on investment income; lack of nexus to payors to require State reporting

   ▸ Abolition of the IRS?

   ▸ Loss of business income tax regime

   ▸ State coupling with Federal VAT (like Michigan's single business tax)

     - broader base
     - simpler
     - compare border adjustability of different VAT systems

B. Consumption-Based Income Tax

1. <u>Nunn-Domenici "USA" Plan</u>

   a. Individuals: Maintain existing income tax

      Introduce a deduction for net savings

      Graduated rate structure

      Maintain IRS/Maintain withholding

   b. Business: Replace income tax with a VAT

2. <u>Highlights and Critiques</u>

   a. Least radical

b. Progressive, but less progressive than current income tax

c. Encourages savings (and discourages consumption)

d. No real simplification

e. No rate reduction

3. Issues for States and Cities

- Deferral of tax on earnings raises avoidance problems; jurisdiction mismatches (see pension issue)

- Perceived to solve foreign transfer pricing problem because border adjustments remove exports from base (for States, there are lots of borders to adjust)

- VAT may be attractive to States (See VAT)

- Would lose federal income tax on business

- Base may be more stable, but beware exemptions

C. **VAT**

1. Archer/Gibbons

(Various designs) A VAT is similar to sales tax in effect, but different in application. It is essentially a tax on consumption at a single percentage rate, which tax is imposed incrementally at each stage of production up to the final sale. Tax rate x (Sales Price minus Inputs) = Tax due from each producer.

2. Highlights and Critiques

a. Savings are not taxed

b. Broad based

c. Services will be taxable (lowers rate)

d. Collected at business level, not at final point of sale

e. Regressive

f. Exemptions will be necessary for, *e.g.*, food; that will raise rates

3. Issues for States and Cities

- Add-on on top of existing sales taxes (effectively)
- No federal infra-structure for income-based taxes

D. National Sales Tax

1. Lugar

[No written text thus far.]

Point-of-sale tax on ultimate retail sale

Base must be defined

Abolish IRS -- shift administration to the States

2. Highlights and Critiques

a. Encourages savings/taxes consumption

b. Not hidden

c. Has been an effective money machine for the states

d. Rates could be very high

e. Regressive

f. Completely new system of taxation

g. Loss of national tax administration

h. Consider effects of likely exemptions on rates

i. Imposition of sales tax on business purchases cascades the tax

3. Issues for States and Cities

- See also VAT, section C.

- Impinges on important revenue base
- Very high combined rates (especially if replacing state income taxes too)
- Loss of federal income tax infrastructure
- Assumption of federal tax collection/conformity of tax bases?
- Effect on state nexus issues

E. Overarching Issues

Timing of States' analysis and debate, and coordination with federal change

Replacing individual and/or business income taxes; over 80% of the states now have some income based tax system; most cannot maintain that without a federal system to piggyback; fundamentally different systems will lead to considerable complexities; departure from income-based taxes implicates progressivity

Fundamental evaluation of preferred tax system; Political fallout when all bets are off; at State/local level, is there more [in]sensitivity to certain taxpayers or tax bases?

Importance of simplification; effect of federal reform on State tax structures

Effect on State and local economies; on competitiveness

Effect of Federal reform on State tax base; e.g., if savings increase, do sales tax revenue fall; if housing values fall, what happens to property and transfer taxes?

Multistate business taxation -- coordination; constitutional constraints; minimizing duplicative taxes (see e.g., banks); as revenue raising shifts from Federal to State levels, these problems become more severe

Administrative burdens on States and localities, and on taxpayers

Balkanization; transfer pricing; deferral issues

Quality of administration; duplication of effort and of interpretation if/to the extent administration shifts to

States; uncodified aspects of tax enforcement; effects of passing discretion to the States

Compare 1981 experience; 1986 experience

State and local pressures to avoid deficits; sensitivity to vagaries of collections (especially e.g., sales taxes); need for accurate revenue estimating

What does border adjustability mean to the States? How does formula apportionment solve this? How is consumption sourced (e.g.,services)?

Transition issues and effects

Nexus issues -- who is the taxpayer, what transaction is being taxed? (Compare e.g., VAT with, and without, wage deductions)

Federal/State sharing of revenues?

Availability of information; strength of enforcement apparatus

Multiplicity of audits, and of forums for litigation

State taxation of international business; effect of treaties; dealing with treaty issues if tax systems diverge

State-by-State constraints on changing tax laws: supermajorities; state constitutional restrictions

Taxation of financial services is a very significant issue for New York

Carolyn Joy Lee
November 29, 1995

NEW YORK STATE SALES AND USE TAX UPDATE

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I. Some of the recent legislation

A. Exemption for dues paid to housing co-operative and condominium associations for social and/or athletic facilities. Effective December 1, 1995. Shaker Commons Condominium Owners, TSB-A-94(6)S and TSB-A-94(6.1)S.

B. Exemption now provided for receipts from meteorological services. Effective September 1, 1995.

C. New York City exemption for interior decorating and designing. State tax still applies. Effective December 1, 1995.

D. Credit against New York City General Business Tax and Unincorporated Business Tax for the 4% sales tax paid after January 1, 1995. Applies to:

1. installing, repairing, maintaining, or servicing production machinery or equipment; and

2. parts with a useful life of one year or less, tools and supplies.

II. Manufacturers Exemption

A. Statute § 1115 and Reg. § 528.13.

B. Drawings used in the textile industry are considered production equipment and, therefore, exempt from tax. The Design Council Ltd, TSB-A-95(23)S.

C. Doubleday Book & Music Clubs, Inc., Division of Tax Appeals, ALJ, DTA Nos. 811391 and 812014, October 5, 1995.

D. Note New York City credit.

III. Separately stated charges

A. Waste removal containers can be purchased exclusively for resale where they are always rented or leased to customers. CID Refuse Service, Inc., TAT, DTA No. 809934, August 31, 1995.

B. TSB-A-95(28)S, Steve Burnett, Inc.. See below .

C. TSB-A-93(10)S--Mailing service--Folding written or printed matter for insertion in envelopes, sealing, affixing stamps, metering, mailing, and postage.

D. TSB-A-91(10)S--Oil and gas distribution--Purchase of gas measurement, administrative service, and rental charges.

E. TSB-A-89(22)S--Information services--Text operators, foremen, mechanic, overtime, fuel and oil, UPS, administration.

F. TSB-A-92(88)S--Maid and laundry--Laundry service.

G. TSB-A-83-(30)S--Manpower services--Window cleaning, rodent/pest control, trash removal.

H. TSB-A-91(8)S--Pick-up truck rental--Registration fee, insurance charges.

IV. Intangibles

A. Pre-written software taxable as tangible personal property. Tax Law § 1101(b)(4).

1. Provided, however, that where there is a reasonable, separately stated charge or an invoice or other statement for modifications or enhancements, such modifications or enhancements shall not constitute pre-written computer software.

2. Examples of software created to the specifications of the client that are taxable. Steve Burnett, Inc., TSB-A-95(28)S.

B. The professional and other efforts that culminate in a video tape are taxable as the sale of tangible personal property. Video Memories Assoc., Division of Tax Appeals, ALJ, DTA No. 81-2291, July 13, 1995.

V. Capital Improvements

A. Scoreboard allowed because it must be remembered that any capital improvement, i.e. walls, ceilings, roofs, can be removed. The mere fact that it can be removed does not mean that it is not a capital improvement. Matter of the Petition of N. A. E., et al. d/b/a Nassau Sports, Division of Tax Appeals, ALJ, Nov. 18, 1993.

B. Purchases related to IDA projects are exempt.

1. Travelers Group, Inc., TSB-A-95(35)S.

2. Donaldson, Lufkin & Jenrette, Inc., TSB-A-95(36)S.

VI. Audit issues

A. Certificates

1. The taxpayer's good faith receipt of certain resale certificates did not preclude the assessment of motor fuel taxes. In order to have such taxes excluded from an assessment, the taxpayer had to show a properly executed resale certificate, and that the customers providing the certificate were registered distributors. Matter of the Petition of Benak Corporation, Division of Tax Appeals, Tax Appeals Tribunal, August 10, 1995, (DTA Nos. 808633).

2. No need to investigate purchaser or its use of its equipment. Good faith is sufficient. Capelco Leasing Corp., TSB-A-95(15)S.

B. Extent of auditing required

1. Chartair, Inc. v. State Tax Commission, 65 A.D. 2d 44 (3rd Dept.1978).

2. Statistical sampling audits are estimated. Accordingly, consent is required. Marine Midland Bank, Division of Tax Appeals, Tax Appeals Tribunal, May 13, 1993, (DTA No. 807533).

3. This is one of the most frequently litigated issues. Most, if not all, other cases require the adherence to procedures concerning

notification to and acknowledgement by the taxpayer and the extent of "insufficient records" in order for test period, statistical sampling and/or observation tests could apply. Cases of interest include:

a. The Division of Taxation failed to justify the use of external indices to estimate the sales tax due from a delicatessen during an audit, since the auditor did not make an adequate review of the taxpayer's books and records. Petition of Family Deli of Bellmore, Inc., ALJ, DTA No. 810719, July 20, 1995.

b. "Where the taxpayer establishes that the audit methodology is based on an assumption that is fundamentally flawed, the taxpayer has sustained his burden of proof and is not required to show the exact amount of taxes due" Bernstein-on-Essex-Street, TAT, DTA No. 807165, December 3, 1992.

c. Bagel Boss, ALJ, DTA No. 812215, April 27, 1995.

C. Overlapping audits

1. The taxpayer was able to establish the required criteria by showing that there was an overlapping audit with one of its customers, that the audit period with its customer was the same, that the customer agreed to the audit findings, and that there was no agreement to exclude the particular transactions in issue from the customer's audit. Matter of the Petition of Benak Corporation, Division of Tax Appeals, Tax Appeals Tribunal, August 10, 1995, (DTA Nos. 808633).

2. Matter of Gartner Group, Inc., TAT, DTA No. 807983, December 8, 1994.

3. Allied Aviation Service Co. of N.Y., TSB-D-91(51)S, June 27, 1991.

VII. Responsible person

A. Usually a connecting case.

B. Tax Law § 1131(1) defines "persons required to collect [sales] tax" as follows:

"[E]very vendor of tangible personal property or services; every recipient of amusement charges; and every operator of a hotel. Said terms shall also include any officer, director or employee of a corporation or of a dissolved corporation, any employee of a partnership or any employee of an individual proprietorship who as such officer, director or employee is

under a duty to act for such corporation, partnership or individual proprietorship in complying with any requirement of this article; and any member of a partnership."

C. "The question to be resolved in any particular case is whether the individual had or could have had sufficient authority and control over the affairs of the corporation to be considered a responsible officer or employee. The case law and the decisions of this Tribunal have identified a variety of factors as indicia of responsibility: the individual's status as an officer, director, or shareholder; authorization to write checks on behalf of the corporation; the individual's knowledge of and control over the financial affairs of the corporation; authorization to hire and fire employees; whether the individual signed tax returns for the corporation; the individual's economic interests in the corporation ." Matter of the Petition of Frank S. Constantino, Officer of Jordan Elevator Co., Inc., Division of Tax Appeals, Tax Appeals Tribunal, September 27, 1990, (File No. 802335)

D. Liable for interest and penalties.

"[T]o the extent that our decision in Laks [183 A.D.2d 316 (4th Dept, 1992)] can be read as holding that a corporate agent may not be held liable for penalties and interest, it is no longer to be followed. Franklin W. Lorenz, 623 N.Y.S. 2d 455 (4th Dept, 1995).

E. Statute of limitations

On-Site Petroleum Unlimited, Inc., Division of Tax Appeals, ALJ, DTA No. 811604, April 6, 1995

F. Responsible officers are not absolved by the Tax Department's failure to pursue corporate assets. Petition(s) of James Waite (and Michael Waite), Officer(s) of Harrison Radio Corp; Division of Tax Appeals, Tax Appeal Tribunal, Nos. 806363 and 806419, January 12, 1995

VIII. Miscellaneous

A. Hilton Hotels Corp v. Commissioner of Finance of the City of New York, ___ A.D.2d ___ (1st Dept, 1995)

B. 1605 Book Center Inc. v. Tax Appeals Tribunal of the State of New York et al., New York Court of Appeals, No. 10, February 15, 1994, 609 NYS2d 144, 631 NE2d86, 83 NY2d 240 Affirming New York Supreme Court, Appellate Division.

New York State Gains Tax, New York State and City Transfer Taxes, Mortgage Recording Tax

Maria T. Jones
Rosenman & Colin LLP

Carolyn Joy Lee
Roberts & Holland LLP

I. Overview of Taxes

II. Recent Developments

A. Rule Changes

1. **Gains and NYS Transfer Tax**
   - waiver of penalties for reasonable cause (proposed amendment)

2. **NYC Transfer Tax**
   - mere change in form (Administrative Code §11-2106(b)(8), effective June 9, 1994)
   - tiered ownership transfers (NYC Rule §23-02, effective April 24, 1994, with certain grandfather provisions)

3. **Mortgage Recording Tax**
   - negative pledge agreements (TSB-M-95[1] R; 20 NYCRR 641.6[b][9])

B. Tax Appeals Decisions

1. **Nexus**
   Cafcor - NYS Administrative Law Judge - October 5, 1995

2. **Aggregation**
   Marder - NYS Tax Appeals Tribunal - October 5, 1995
   Puttick - NYS Tax Appeals Tribunal - March 16, 1995
   Reinstein Family Trust - NYS Tax Appeals Tribunal - April 6, 1995
   Troutman St. Assocs. - NYS Tax Appeals Tribunal - June 1, 1995

3. **Original Purchase Price**
   Preferred Rentals - NYS Administrative Law Judge - May 18, 1995
   Kalikow Yaphank - NYS Administrative Law Judge - March 9, 1995
   Zeckendorf Columbus - NYS Administrative Law Judge - May 11, 1995
   MTZ Associates - NYS Administrative Law Judge - June 12, 1995
   FBE Broadway - NYS Administrative Law Judge - March 2, 1995

4. **Interest and Penalties**
   Forty Second Street Co. - NYS Tax Appeals Tribunal - April 6, 1995

5. **Liability of Officers**
   Botshon - NYS Administrative Law Judge - January 19, 1995
   MTZ Associates - NYS Administrative Law Judge - June 12, 1995

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TABLE OF CONTENTS

Program Agenda i

Program Faculty iii

SETTLEMENTS, COMPROMISES AND CLOSING AGREEMENTS 3
Michael Alexander, Esq.

NEW YORK CITY PRACTICE AND PROCEDURE: A PRACTITIONER'S PERSPECTIVE 19
NEW YORK STATE PERSPECTIVE 23
Glenn Newman, Esq.

NEW YORK CITY PRACTICE AND PROCEDURE 27
Frances J. Henn, Esq.

NEW YORK CITY PRACTICE 31
Ellen E. Hoffman, Esq.

NEW YORK STATE PRACTICE AND PROCEDURE 43
Mark S. Klein, Esq.

RAISING CONSTITUTIONAL ISSUES IN STATE TAX CASES 49
Steven U. Teitelbaum, Esq.

RAISING CONSTITUTIONAL ISSUES IN STATE OR LOCAL TAX CASES 65
Arthur R. Rosen, Esq. and Craig B. Fields, Esq.

RECENT CONSTITUTIONAL CASES IN NEW YORK STATE 79
Peter L. Faber, Esq.

ALLOCATION OF INCOME BY NONRESIDENTS: NEW YORK'S 1995 AUDIT GUIDELINES 89
NEW YORK RESIDENCY UPDATE: 1994 DEVELOPMENTS 99
NEW YORK RESIDENCY AUDITS 104
1994 NEW YORK TAX CASES 107
Paul R. Comeau, Esq.

RESIDENCY UPDATE: TAX LAW § 605 (b)(1) 131
Robert Plautz, Esq.

PLANNING STRATEGIES AND CONTROVERSIES ASSOCIATED WITH COMBINED REPORTING IN NEW YORK STATE AND CITY 139
Richard W. Genetelli, CPA

NEW YORK CITY UNINCORPORATED BUSINESS TAX 197
Peter L. Faber, Esq.; Maria T. Jones, Esq.; and Robert J. Levinsohn, Esq.

NEW YORK STATE AND NEW YORK CITY CORPORATION TAXES: COMBINATION ISSUES 215
Arthur R. Rosen, Esq. and Craig B. Fields, Esq.

NEW YORK STATE SALES TAX UPDATE 239
Paul R. Comeau, Esq.

PROMOTIONAL MATERIAL: 1989 LEGISLATION AND ITS AFTERMATH UNDER NYS SALES AND USE TAX 259
Paul R. Comeau, Esq.; Mark S. Klein, Esq.; and Robert D. Plattner, Esq.

CONTACTS AT NYS DEPARTMENT OF TAXATION & FINANCE 275

Program Agenda

DAY ONE: PERSONNEL, POLICY, PRACTICE AND PROCEDURE

Meet the new State and City Commissioners and their counsel; hear the latest update on personnel and policy changes which may impact your practice; review current practice and procedure issues.

Overview and Introduction to First Annual NYSBA Tax Institute
Paul R. Comeau, Esq.; Arthur R. Rosen, Esq.

Tax Policy in New York State and New York City
NYS Commissioner Joseph Lhota; NYS Executive Deputy Commissioner Kevin Murray

Personnel and Structural Changes in the New York City Department of Finance and New York State Department of Taxation and Finance
Frances J. Henn, Esq.; Devora Cohn, Esq.; Steven U. Teitelbaum, Esq.

New York State Division of Tax Appeals and New York City Tax Appeals Tribunal; Personnel and Structural Changes and Regulations Update
NYC Commissioner Susan Grossman; NYS Tribunal President John P. Dugan

Dealing with Regulations: Procedure for Issuance, Challenges, Alterations, Challenges in Administrative and Judicial Proceedings; Outlook for the Future
James A. Locke, Esq.; Louis Jacobson, CPA

New York State and New York City Practice and Procedure: Dealing with Discovery, Working with Procedural Complexity, Informal and Formal Mechanisms for Resolving Disputes
Frances J. Henn, Esq.; Ellen E. Hoffman, Esq.; Michael Alexander, Esq.; Mark S. Klein, Esq.; Glenn Newman, Esq.

New York State and New York City Criminal Tax Practice and Procedures: Issues, Procedures, Recent Developments
NYS Deputy Commissioner Robert Sheppard; NYC Enforcement Chief Bruce Kato; Robert S. Fink, Esq.

Raising Constitutional Issues in State or Local Tax Cases: Applicable Rules, Recent Cases, Preserving Issues, Choosing a Forum, the View from Albany and New York City
Frances J. Henn, Esq.; Steven U. Teitelbaum, Esq.; Peter L. Faber, Esq.; Arthur R. Rosen, Esq.

DAY TWO: SUBSTANTIVE LAW

Detailed analysis of selected substantive topics, hear about recent cases and developments from practitioners and administrators with first-hand experience.

New York State and New York City Personal Income and Non-Resident Earnings Taxes and Nonresident Allocations; Residency, Retirement Income, March 1995 Nonresident Allocation Guidelines; Recent Cases and Other Developments

Robert E. Brown, Esq.; Paul R. Comeau, Esq., Robert Plautz, Esq.

New York State and New York City Corporation Taxes: Combination Issues, Expensive Attribution, Recent Developments and Prospects

Ellen E. Hoffman, Esq.; Richard Genetelli, CPA; Arthur R. Rosen, Esq.; Domenic Sciortino; Harold F. Soshnick, CPA

New York State and New York City Gains Transfer and Mortgage Recording Tax Developments

Maria T. Jones, Esq.; Carolyn Joy Lee, Esq.

New York State and New York City Sales Tax and Use Tax: Information Services, Promotional Material, Telecommunications, 1995 Legislation, Recent Developments

Paul R. Comeau, Esq.; Arthur Gelber, CPA; Linda Klang, Esq.; James H. Tully, Jr., Esq.

New York City Unincorporated Business Tax: Flow Through Issues, Out-Of-City Office, Trading for Own Account, Real Estate and Securities Trading Income, Recent Developments

Peter L. Faber, Esq.; Maria T. Jones, Esq.; Robert J. Levinsohn, Esq.

National Trends; Legislative Outlook - Impact of Federal Changes; Comments

Deputy Commissioner Israel Schupper; Assistant Commissioner Jonathan Robin; David Blaustein, Esq.; Carolyn Joy Lee, Esq.; Prentiss Willson, Esq.

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SETTLEMENTS, COMPROMISES AND CLOSING AGREEMENTS

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SETTLEMENTS, COMPROMISES, CLOSING AGREEMENTS

I. Brief summary of statutory and regulatory provisions:

A. Section 170 subd. 3-a whereunder BCMS is created, structured; 20NYCRR Part 4000

B. Section 171 - Powers and Duties of Commissioner

(1) First - "Reasonable rules and regulation"

(2) Second - power to "revise, readjust" Article 9, 9A taxes

(3) Fifteenth - "authority to compromise any taxes or any warrant for taxes"; if (a) tax <u>debtor</u> discharged in bankruptcy, or,

(b) is shown to be insolvent, but

(c) amount payable in compromise must not be less than the amount which could be recoverable through legal proceeding and,

(d) where the amount owing is more than $25,000 the compromise accepted must be approved by a Supreme Court justice. See <u>Matter of Joint Diseases North General Hospital</u> 1989, 148 AD2d 873, 539 NYS2d 511.

(4) Eighteenth - Authority to enter into written agreement regarding a tax liability (or fee). The agreement is final and conclusive, with exception of fraud, malfeasance, or misrepresentation of a material fact. (a) no reopening (b) no modification in any other proceeding.

(5) Eighteenth-a- Authority to compromise civil liability was added effective September 1, 1987 Chapter 282 of Laws of 1986. The majority of today's discussion of Offers in Compromise will be based on this subdivision and regulations promulgated for its administration 20NYCRR Part 5000.

(6) Twenty-fourth- Addresses Advisory opinions, which provide another vehicle for dispute resolution but will not be discussed further today. Regulations can be found in 20NYCRR Part 2376.

C. Article 22 Personal Income Tax §697

(1) Subsection (c) authc..izes Commissioner to abate the unpaid portion of the assessment of any tax which is (a) excessive in amount, or (b) assessed after the statute had run, or (c) erroneously or illegally assessed. No claim for abatement can be filed by a taxpayer.

(2) Subsection (d), Special refund authority where (a) no question of fact or law involved, (b) appears from Commissioner's records that moneys were erroneously or illegally collected or (c) paid under a mistake of fact, the Commissioner is empowered to issue a certificate to the Comptroller for a refund of those monies.

D. Article 27 Corporate Tax Procedure. §1096 sub (c) and (d) are identical to Article 22 provisions in C. above.

E. Article 28, Sales and Use Taxes
§1142 subdivision 6 empowers the Commissioner to revise and adjust taxes imposed by this Article.

F. Article 31-B Real Property Gains Tax
§1448 subdivision 4 is identical to abatement powers in §697 sub.(c).

G. Most of the other Tax Law Articles will refer to either §171 or Article 27 concerning the general powers of the Commissioner.

It should be noted that a review of statutory provisions and regulatory provisions reveals only one instance where the word "settle" appears and that is in the nature of impermissible activity in the old Rules of Practice. Thus, the first subject of the brief outline of my speech "Power to settle cases" is not as easily addressed as one at first glance may imagine.

II. History of Dispute Resolution

A. Pre 1976
(i) Audit Division conducted audits, engaged in efforts to resolve matters where questions of fact existed prior to issuance of statutory notice

(ii) once notice was issued, taxpayers had little recourse but to petition the notice within the time provided by statute. In time, the issue having been joined, the matter would be forwarded to Law Bureau litigators and would be scheduled for a hearing before a Hearing Officer delegated to hear and report to the State Tax Commission.

(iii) State Tax Commission publishes its decision, usually adopting the hearing officer's recommendation, and the exclusive avenue for review was an Article 78

proceeding.

(iv) At no time during this process did litigating attorneys consider settlement. Only isolated incidents of informal conferences to resolve a dispute were rumored to occur. The prevalent theory was matters should be litigated; that the Commission would weed out Departmental error in its decisions and that the court could ultimately determine the propriety of Commission decisions by affirming the Commission decision.

B. Post 1976

The State Tax Commission, under then Commissioner James H. Tully, Jr., became increasingly concerned regarding criticisms of the hearing operations, the lack of opportunity to conclude disputes without adjudicatory proceedings and the appearance of the Commission as, in effect, grand jury, prosecutor, judge and jury. The Commission took the following action to address these concerns:

(1) Effective July 1, 1976 it revoked its old hearing regulations and promulgated as Part 601 of 20NYCRR its new Rules of Practice and Procedure.

(2) The Rules created a Tax Appeals Bureau not involved in any tax administration function preceding the filing of a petition for hearing, and was the only bureau in the Department which reported directly to the Commission itself.

(3) In an innovative and bold initiative, the Commission, by regulation created a prehearing conference unit to promote settlement. To facilitate conferences the Commission also created two new "pleadings", the "perfected petition" and the "answer". Under this structure, the prehearing conference unit (a) reviewed the petition to determine whether a conference would serve the purposes of either narrowing disagreements, define the legal issues involved or to optionally resolve the controversy without need of a hearing, (b) scheduled and held the conferences to pursue these goals, (c) resolve the matters or, prompt stipulations and (d) where unresolvable, determine whether the petition was sufficient or whether to notify the petitioner to "perfect" his petition.

(4) The service of the perfected petition, or notice that the petition was deemed sufficient, entitled the petitioner to an Answer from the Law Bureau within 60 days.

(5) The answer* would occasion joinder of issue and the matter was ready for calendaring a hearing.

(6) This whole process did have two of the effects the Commissioner hoped for: (a) pleadings that fleshed out the facts and disagreements and focused the parties and the hearing officer on what was to be tried, and (b) availability of a vehicle for settlement of cases without need of hearing. On reflection this bold initiative served the public exceedingly well as tens of thousands of matters were resolved without hearing, and, as will be seen, was embraced in part by the Legislature thereafter.

(7) Conferees were empowered to propose resolutions deemed fair and equitable PROVIDED there is a basis in fact and in law. Resolution could not be based on (a) expediency (b) hazards of litigation (c) nuisance value or other form of SETTLEMENT, compromise or abatement where not authorized by law.

(8) In the early 1980's, the Litigation section of the Law Bureau started to engage in resolution of controversies without need of hearing.

C. Chapter 282 of Laws of 1986 created both the Bureau of Conciliation and Mediation Services and the Division of Tax Appeals (effective September 1, 1987) and provides for offers in compromise.

D. The creation of the BCMS and its success in resolving controversies has not impeded Law Bureau resolution of matters. In fact, the law changes and attitudinal changes have increased Departmental receptivity to resolution and broadened the perspective in determining what constitutes a basis for concluding matters. This attitude started under Commissioner Tully and was honed and matured under his successors, Commissioners Bouchard, Chu and Wetzler.

III. Overview of Department Process

A. Roughly 350,000 statutory notices issued

B. Only 9,000 requests for BCMS conferences, or 2 1/2%.

C. BCMS results in the resolution of 90% of those requests.

D. Petitions from Conciliation orders on matters not fully resolved average approximately 1,000 per year.

E. Pre-issuance of assessment screening by auditor and paring down of resolvable matters by BCMS

review (thereby increasing the percentage of questions of law which do not lend themselves as readily to settlement), would prompt the conclusion that settlement should be limited by the time matters reach the Law Bureau. However, of those petitioned notices, a significant number of matters are resolved before, during and even after hearing.

IV. Bureau of Conciliation and Mediation Services Conferences - Overview

A. BCMS is an independent, impartial Bureau that reports directly to the Commissioner.

B. BCMS is not subject to any undue influence from the Department of Taxation and Finance.

C. Goal is, through informal conferences which are more timely and less costly than formal hearings to close as large a percentage of cases received as can be.

D. Requests for conference have averaged 9,000 per year for the last four years. The number of matters concluded per year has ranged between 8,000 and 9,700.

E. Over the seven years BCMS operation, the number of petitions from BCMS orders for hearing before the Division of Tax Appeals has been as low as 900 and as high as 2,100. For the last four years, petitions have been in the 900 to 1,300 per year range.

F. The lion's share of taxes involved are income (49 to 67% over last four fiscal years) and sales (27% to 39% over same period) which constitute roughly 85% of the inventory.

G. During the last four years, the taxpayer has prevailed in 30-32% of BCMS Orders, the Department in 26-30% and partial resolutions were ordered in 40-45% of the conferences.

H. Only one in ten of BCMS matters result in a petition to Division of Tax Appeals.

V. Bureau of Conciliation and Mediation Services Procedure

A. Department appears at conference by audit personnel; proceeding is informal; after reviewing the evidence and

comments, the conferee serves a proposed resolution in the form of a consent on the taxpayer.

B. The taxpayer has 15 days to execute the consent and waive any right to petition for hearing. If the taxpayer does so, the matter is concluded. The consent, absent fraud, malfeasance or misrepresentation, is binding on the Department.

C. If the taxpayer does not accept, the conference is concluded and the conferee will issue a conciliation order within 30 days.

D. The taxpayer, however, can petition for review by the Division of Tax Appeals within 90 days of the date of issuance of the Order.

E. The conference is, from a legal perspective, a settlement discussion. Thus, although the order is binding on the Department, what transpired at the conference cannot be used, except for documentation used as evidence and to be offered anew at hearing. Subpoenaing the conferee will be opposed and successfully so.

F. However, in pursuing resolution with the Law Bureau attorney, anything that transpired at conference may prove of assistance in evaluating resolution. Representatives should not assume that Law Bureau attorneys know what occurred.

VI. DTA Petition - Settlement Thereafter

A. Timeliness - An untimely request for BCMS or an untimely petition for hearing will be opposed by either a motion to dismiss or at hearing. Because of the need for finality echoed by the Tribunal in its decision in Matter of Schoonover, settlement will not ordinarily be considered in such circumstances. Hearings will be bifurcated and only the question of timeliness should be considered initially.

B. Formal vs. Small Claims

(1) The tax practitioner must make an election (where jurisdictional limits permit) of the forum he chooses to try his/her matter. This could involve a question of venue, client resources or the complexity of the issue.

(2) What is small to one party is not to another, eg. a three year estimated sales tax assessment which results in tax of $40,000 per year with penalties and interest could well be a $250,000 matter by conclusion of the proceeding. Whether one wishes to give up the right to appeal as one does in Small Claims is an important consideration, as is

the likelihood of success and the availability of settlement.

(a) Attorneys prepare the answer and ready the file for hearing.

(b) Once this is done, the scenario laid out, the statutory basis for the Department's position and the evidence to support it, the attorney's involvement is concluded and the matter is transferred to Audit personnel to advocate at the hearing. The attorneys will remain available to Audit should there be any questions.

(c) Thus, the window to settle a small claims matter with the attorney is circumscribed, based on his/her limited role. Despite this, I have recently instructed my staff to increase their attention to small claims matters and be more inquisitive regarding settlement.

(d) Since the attorney is rarely involved in small claims hearings, their involvement in a settlement during or after hearing is not feasible. After a determination which, pursuant to law, is not reviewable, settlement is impermissible.

(e) Once the matter is transferred to Audit personnel for advocacy, the chances of settlement decrease. In the early days, such consideration was very rare. Now, with improved legal support, it is more likely, and auditors who are presented new information at the proceeding may be amenable to a settlement at hearing or thereafter.

(f) The outlook of the representative, the manner in which he/she practices is one of the most important factors in whether a matter can be settled. This is true in small claims or formal.

(g) The essential question for the representative is whether to pursue settlement of a small claims matter, or to rely on the more informal nature of a proceeding conducted by nonattorney presiding officers.

C. Formal Hearings

1. In formal hearings, many more opportunities to resolve cases exist. As indicated, the attitude of the taxpayer's representative is the single most important factor in settlement since the pursuit of settlement is in most instances instituted by the taxpayer. This is consistent with the presumption of the propriety of an assessment. Six significant elements that impede settlement are:

(a) Distrust
(b) Budgeting evidence
(c) Unprepared
(d) Unreasonable
(e) Unable to control client
(f) Efforts to bring outside pressure

2. Settlement should be pursued as early as possible. That is cost effective for both parties. However, where unseen evidence or changes in case law or even Departmental policy arise, a matter seen at one time as unreasonable may now be resolvable should the parties be interested. Law Bureau attorneys are encouraged to not preclude resolution at or during hearing. In fact, they are encouraged to review transcripts and discuss matters after hearing and before an ALJ determination should the press of their practice allow it.

3. On occasion, settlement is worth pursuing even after an ALJ determination. Although the practice, as indicated previously, is usually, that it is the taxpayer who should first pursue settlement, it is not rare that we might do so first in the appropriate situation.

4. As matters progress further in the adjudicatory process, settlement opportunities naturally diminish. It is rare indeed that matters are settled once presented to the Tribunal. Nonetheless, we will still consider settlement in appropriate instances.

5. After a Tribunal decision is rendered, the law provides that the exclusive remedy for review is an Article 78 proceeding. However, even after an Article 78 proceeding has been commenced, the Attorney General is empowered pursuant to §171 subd. 18th-a to consider an offer. I am now in the role of a client to whom the Attorney General conveys the offer. Even at this stage, I have evaluated, accepted the offer and concluded the Article 78 proceeding where appropriate.

6. In summary, the Law Bureau is available to resolve any matter that lends itself to resolution. On infrequent occasion, we may differ on what matters those may be or what is a reasonable settlement. That is not necessarily an indictment of either party.

I have studied the statistics in a few areas of our practice and am pleased to advise that the percentage of the matters resolved without need of adjudicatory determination is up sharply.

D. Miscellaneous

(1) Settlements be they negotiated with Law Bureau or as a result of a conference, are not precedential. This is so regarding others or the same taxpayers for subsequent years. However, Offers in Compromise, closing agreements may be drafted in a manner to address other than the years at issue in a petition and may have a binding effect beyond the petitioned years, eg. an agreement that a taxpayer became a

nonresident and absent a significant change in life style will be one for subsequent years.

(2) When a matter is in litigation the auditor with whom you may have dealt with directly on audit and at conference, or may be dealing with directly in an ongoing audit, is now my client. In our proceeding he or she may be my witness. It is inappropriate for a representative to contact another attorney's client without permission. See 20NYCRR 1200.35. However, if I were asked, I may well have no objection and will on occasion encourage the contact where settlement will be served. At a minimum, I wish to be able to counsel my client regarding the parameters of their involvement with the taxpayer's representative.

(3) Adjournments pending settlement are agreeable so long as serious efforts are contemplated and pursued. Too often the adjournment is for the benefit of the unprepared attorney who does not avail him or herself of the additional time. The DTA does not look kindly on undue delay and I do not wish to be a part of it.

(4) Law Bureau attorneys will always try to provide copies of all documents we intend to offer (in advance of hearing where manageable) and would appreciate that courtesy in return. This can only be of assistance in resolving matters. The Tribunal's proposed rules will require a list of documents to be attached to a prehearing memorandum, but documents themselves need no longer be attached.

VII. Closing Agreements.

The Commissioner, by May 1, 1991 resolution filed with the Secretary of State, authorized the Deputy Commissioner of Tax Operations to execute written agreements pursuant to § 171 subd. 18th. The Division of Taxation believed that only an agreement executed by that Deputy Commissioner constituted a closing agreement until the Tribunal found a stipulation to discontinue a proceeding in the Division of Tax Appeals to be such an agreement in Matter of Felix Industries, Inc.

The Department will continue to consider only those agreements executed by the Deputy Commissioner (or the Commissioner himself) as closing agreements. There is no inclination to have that Deputy Commissioner execute the hundreds of stipulations litigation lawyers enter into annually.

Closing agreements, in which a taxpayer agreed to a tax liability (as opposed to an Offer in Compromise pursuant to which the amount of a liability and the terms of payment are

agreed to) were employed on only infrequent occasions by the Audit Division. The Law Bureau did not use it as a resolution tool until very recently. This vehicle concludes matters with finality and also enables us to address more than is petitioned. It can address, for instance, future years in a residency case or provide for concessions or other actions that would not otherwise be a part of an ordinary settlement agreement.

Should the terms provide for a deferred payment arrangement the agreement will usually provide that any default will serve to vacate the agreement and the original amount due minus credit for payments, will once again be due. Closing agreements are also confidential, not like offers in compromise to be discussed next.

The best advice I can give is for practitioners to pursue the resolution of a matter and leave consideration of the vehicle for its best conclusion for subsequent attention.

VIII. Offers in Compromise

A. Section 171 subd. fifteenth has been treated by the Division of Taxation as applicable to closed matters only where no further administrative or judicial review is available. Thus, the only consideration is collectibility and the matter is one solely for the Tax Compliance Division. If they reject the offer that concludes the process. The forms to be used to submit this offer in compromise are DTF-4 (Offer in Compromise - Fully Determined Liability), and DTF-5 (Statement of Financial Condition and Other Information). Since these offers (often confused with subdivision eighteenth-a offers) are not the province of the Law Bureau, I will restrict my discussion to subdivision 18th-a which addresses the compromise of open liabilities and in which Counsel plays a prominent role.

B. 20NYCRR 5000.1(b) provides that subdivision 18th-a offers do not apply to warranted liabilities. They do apply to taxes or other liabilities which are the subject of a statutory notice and can be considered by the Commissioner at any time prior to when there is no longer administrative review. Thereafter, the Attorney General, once a matter is referred to that office, is empowered to compromise tax liability of matters subject to judicial review.

C. The regulations provide that offers in compromise be directed to different locations based on the stage of the controversy. They could be filed with the Commissioner, or the conferee if at the BCMS stage or with the attorney acting as of counsel in a proceeding before DTA. I

recommend that you send them to me directly because the Departmental written procedures will direct all these avenues to transmit to the Director of the Law Bureau who then passes it directly to me to monitor the progress and prepare Counsel's recommendation to the Commissioner. *

D. (1) The offer can be based on doubt as to collectibility and/or doubt as to liability, 20NYCRR 5000.1(a).

(2) If liability is the sole basis, the offer is to be submitted on the DTF-4 Offer in Compromise form. An offer is to be submitted with three conformed copies and should have attached to it, the supporting documents and brief which provide the basis for the doubt as to the liability sought to be compromised.

(3) If the offer is premised solely or in part on doubt as to collectibility, a DTF-5 Statement of Financial Condition and Other Information is necessary. The regulations provide that an acceptable offer based on collectibility must reflect all that can be collected from a taxpayer's income, present or prospective. It is required that the taxpayer has been discharged in bankruptcy or is insolvent.

(4) The offer should generally be accompanied by a remittance of the amount offered or a deposit if the offer provides for installment payments or contains other terms. The form permits the offeror to have the amount submitted either applied against the liability or returned should the offer be rejected.

E. The offer can only be accepted or rejected by the Commissioner and the offeror will receive written notification directly from the Commissioner.

F. The procedure for the evaluation of the offer is as follows:

(1) If the offer is premised solely or partially on collectibility, I forward it to the Director of Tax Compliance Division who has that aspect of the offer analyzed. Within sixty days of the date of the offer, the Director of the Tax Compliance division will notify me of his recommendation on whether the offer should be accepted or rejected. (20NYCRR 5000.6(a)(2)) To make the recommendation, however, the Compliance staff may need additional information or financial data. Understandably, this may result in some delay depending on how expeditiously you are able to respond.

(2) If the unpaid amount of tax is less than $2,500.00, and the offer is based solely on collectibility the Director's recommendation will be submitted directly to the Commissioner; all others are returned to me.

(3) If only collectibility is at issue, Counsel

will usually transmit the Director's recommendation without comment since collectibility is within the province of the Tax Compliance Division. However, on infrequent occasion, Counsel will express an opinion where legal issues require some additional analysis.

(4) Where liability is solely the basis, a Litigation attorney will be assigned to analyze the hazards of litigation in preparation for Counsel's memorandum to the Commissioner recommending acceptance or rejection.

(5) Where liability and collectibility are both bases, the Commissioner has instructed that in close cases where:

(a) the case for collectibility is only found somewhat wanting; and

(b) where the hazards of litigation are deemed significant, but do not of themselves provide a sufficient basis to recommend acceptance; that,

the Counsel may consider the combined effect of both bases and can recommend acceptance thereon.

G. Miscellaneous provisions

(1) Oral communications are strongly discouraged by the Regulations 20NYCRR 5000.6(a)(3).

(2) If the offer is accepted, Counsel's memorandum is to be filed in the Commissioner's office, unless less than $2,500 is compromised.

(3) 20NYCRR 5000.3(f) provides that only one offer regarding a particular liability is permitted whether or not that offer is accepted or rejected.

Pursuant to Regulation §5000.6(a)(1) and (2), the Counsel is to submit a recommendation to accept or reject the offer to the Commissioner <u>OR</u> recommend that he accept a <u>modification</u> of the offer. It makes little sense to recommend a modification the taxpayer is unwilling to make. Thus, my contact with the offeror is essential to forward the modification to the offer which Counsel is recommending for acceptance.

(4) Offers, when accepted by the Commissioner, will be followed by the forwarding of whatever papers are needed for the discontinuance of proceedings protesting the compromised liability. A default in honoring the terms of a compromise will thus result in the full liability being due.

Offers in compromise received in my office started to come in very slowly from 1987 - 1991, perhaps one a month. Thereafter, with the advent of the Federal liberalization of its offer in compromise procedures, a greater interest has been generated in the New York State program.

Though still quite limited, in 1993 the offers we received rose to over thirty and so far this year, just over three dozen. Further increases are anticipated.

In conclusion, I hope my presentation provides you with a clearer perception of Counsel's philosophy. Protracted litigation has and will continue to occur between adversarial advocates. There will always be cases that require litigation for myriad reasons. But for the majority of matters where resolution is available, without the tremendous costs of litigation incurred by both taxpayers and the State, we are willing and able to join with you in that pursuit.

NEW YORK CITY PRACTICE AND PROCEDURE:

A PRACTITIONER'S PERSPECTIVE

GLENN NEWMAN, ESQ.

Roberts & Holland, LLP
New York City

OUTLINE FOR NEW YORK STATE AND CITY TAX INSTITUTE

New York City Practice and Procedure: A Practitioner's Perspective

I. Exit Conferences

   A. Who attends and what to expect

   B. Maximizing settlement possibilities

II. Conciliation Conferences

   A. Who represents the Department of Finance

   B. Scope of the conciliation process

   C. When to use and when to bypass conciliation

III. Petitions to the City Appeals Tax Tribunal

   A. Administrative Law Judge Division

      1. Service of process and filing

      2. Form and content of petitions

      3. Representation on behalf of the City

      4. Pre-hearing conferences

      5. Motion practice

      6. The hearing

   B. Exceptions from ALJ Determinations to the Tribunal

      1. Taking an exception

         a. time and form

      2. Scope of review by the Tribunal

      3. Briefs

      4. Oral argument

IV. Article 78 Proceedings to Appellate Division, First Department

A. Timing, form and service of process

B. Briefs and oral argument

C. Scope of review

V. Other Forums

A. Declaratory judgments -- New York State Supreme Court

B. Federal District Courts

C. U.S. Bankruptcy Courts

Glenn Newman
November, 1995

NEW YORK STATE PERSPECTIVE

GLENN NEWMAN, ESQ.

Roberts & Holland, LLP
New York City

NYS PERSPECTIVE - PRACTICE & PROCEDURE

I. Procedural Complexity

A. Formal Tools - New, Old, Altered

1. Pleadings

A. Answers

B. Prehearing Memoranda

2. Motion Practice

A. Recusal

B. Reopen, Reargue

3. FOIL

4. Bills of Particular

5. Subpoenas

6. Ex Parte Communications

B. Counterproductive v. Useful

1. Counsel's Office Views

2. Counsel's Office Perception of Outside Use

C. Counsel's Office Practice -

1. Tools not to be abused

2. Accessibility as opposed to (a) confrontation, (b) incurring cost and additional effort

3. Fairness

4. Government has obligations to its citizens

5. One caveat

II. Informal Tools

A. Avoid procedural complexity

B. Meet Counsel's objectives for fair and rapid

resolution where available

C. Donal Meyer's implementation; Informal resolution

1. available
2. effective
3. taxpayer's rights protected

III. Counsel's Office Dispute Resolution

A. History, Background

B. Functioning under new Administration

1. Sending Answers, availability, responsiveness

C. Relationship with Private Bar

1. Cooperation
2. Understanding
3. Professional Tone

NEW YORK CITY PRACTICE AND PROCEDURE

FRANCES J. HENN, ESQ.

New York City
Law Department
New York City

New York City Practice and Procedure

I. Jurisdiction

A. Generally - Notice of Determination/Disallowance; Deemed disallowance;
B. Alternatives (Conciliations, small claims, declaratory judgments
C. Service/filing requirements
D. Constitutional issues
E. Lack of as grounds for Dismissal (motions, sua sporte)

II. Answers - rules unclear, our practice

III. Conference procedure -

A. Law Department Conferences
B. Tribunal Conferences

IV. Prehearing Briefs

V. Discovery

A. Bills of Particular
B. Admissions
C. Production of Documents
D. Depositions
E. Subpoenas

VI. Stipulations

VII. Bifurcation/Remand

VIII. Commissioner Review

A. Exceptions
B. Cross exceptions (timing - conflict in rules)

IX. Judicial Review - Article 78's - First Department vs. Third Department rules.

X. Contrast with State Tribunal Rules of Practice and Procedure

Personnel and Structural Changes in The New York City Department of Finance

I. Changes in Finance Representation - who, when, how

II. Practice before the Tax Appeals Tribunal/Contrast with Office of Legal Affairs

A. Differences
1. motion practice
2. discovery
3. briefing
4. staff continuity

B. Similarities

1. professional courtesies
2. pre Tribunal conferences
3. settlements

III. Conclusion

NEW YORK CITY PRACTICE

ELLEN E. HOFFMAN, ESQ.

New York City
Department of Finance
Brooklyn

NEW YORK STATE AND CITY TAX INSTITUTE

November 28-29, 1995
New York, New York

NEW YORK STATE AND NEW YORK CITY PRACTICE (Nov. 28, 2:45-3:15)

I. NEW YORK CITY

A. BUREAU OF CONCILIATION AS A PRE-PETITION OPTION FOR TAXPAYERS

1. Informal Atmosphere
   a. Representative Not Necessary
   b. Written submissions not required apart from original request for Conciliation

2. Conciliator's Role is as Impartial Third Party Mediator/Arbitrator
   a. The Department is represented by a separate advocate

3. Recent Procedural Changes
   a. Status Conferences will be scheduled where appropriate to follow up on additional information submissions or reviews
   b. Withdrawal from Conciliation. Where a case is settled with the Department advocate or original issuing division, the case will be closed through Conciliation Bureau; taxpayers will not be advised to withdraw from Conciliation
   c. New Request Form (attached)
      i. attach all pages of statutory notice
      ii. include power of attorney

4. Effectiveness (statistical performance)

B. LETTER RULINGS AS A PRE-PROTEST OPTION

1. Letter rulings may be requested during audit up to issuance of statutory notice

2. Parameters for rulings (Ruling Package attached):

   a. Rulings will not be issued on factual issues
   b. $250 filing fee required
   c. Rules require rulings to be issued within 90 days
   d. Request can only be withdrawn within 30 days after acknowledgment letter

FINANCE
NEW • YORK

NEW YORK CITY DEPARTMENT OF FINANCE

REQUEST FOR CONCILIATION CONFERENCE

COMPLETE ALL APPLICABLE SECTIONS

Print or type

Name of Taxpayer

Name of Contact Person (corporations or partnerships)

Address (number and street)

City and State | Zip Code

Business Telephone Number

EMPLOYER IDENTIFICATION NUMBER

SOCIAL SECURITY NUMBER

Name of Taxpayer's Representative, if any

Relationship to Taxpayer

Address (number and street)

City and State | Zip Code

Business Telephone Number

EMPLOYER IDENTIFICATION NUMBER

SOCIAL SECURITY NUMBER

☐ **Check if you have filed a petition with the NYC Tax Appeals Tribunal in this matter. IF YOU HAVE FILED A PETITION, DO NOT FILE THIS REQUEST FORM.** ***(See reverse side.)***

A DULY EXECUTED POWER OF ATTORNEY MUST ACCOMPANY THIS REQUEST if the taxpayer is being represented by, or this request is signed by, someone other than: (i) a duly authorized officer of a corporate taxpayer; (ii) a general partner of a taxpayer that is a partnership; (iii) an adult spouse, parent, guardian or the person who prepared the return in the case of a taxpayer who is a minor or who is physically or mentally incapable of representing him or herself.

Enter the tax type involved: ______

Enter the taxable year(s) or period(s): ______

▼ Enter the case number ▼

☐ REDETERMINATION OF DEFICIENCY IS REQUESTED. **A COPY OF THE NOTICE BEING PROTESTED MUST BE SUBMITTED WITH THIS REQUEST.**

Date of Notice of Determination:

Principal due: $ ______

Interest due: $ ______

Penalty due: $ ______

Total amount on Notice $ ______

☐ REFUND IS REQUESTED. **A COPY OF THE NOTICE BEING PROTESTED MUST BE SUBMITTED WITH THIS REQUEST.**

Date of Notice of Disallowance:

No Notice of Disallowance has been received but a claim for refund was filed on: →

(This request may be filed in a GCT or UBT case if at least six months have passed since the claim was filed and no notice of disallowance has been received.)

Amount of refund requested: $ ______

State the basis for making this claim. Include all relevant facts. (Attach additional sheets if more space is required.)

This request is made with the knowledge that a willfully false representation is a misdemeanor under Section 11-4004 of the NYC Administrative Code.

SIGN HERE → ______

▲ Signature of Taxpayer or Representative

______

▲ Name and Title (please print or type) ▲ Date

Mail completed request form to:

Bureau of Conciliation
New York City Department of Finance
345 Adams Street, 3rd Floor
Brooklyn, NY 11201

NOTICE OF TAXPAYER RIGHTS

Notification of Your Right to Protest an Action Taken by the New York City Department of Finance

Pursuant to Chapters 808 and 809 of the Laws of 1992, effective October 1, 1992, the jurisdiction of the NYC Tax Appeals Tribunal has been extended and a Conciliation Bureau has been established by the NYC Department of Finance. The operation of the Conciliation Bureau is governed by Title 19, Ch. 38 of the Rules of the City of New York.

If you disagree with an action taken by the Department of Finance (the issuance of a tax deficiency/determination, the denial of a refund claim), you may contest the action by filing **EITHER** a Petition for a Tax Appeals Tribunal Hearing **OR** a Request for a Conciliation Conference.

CONCILIATION CONFERENCE

A Conciliation Conference is a rapid and inexpensive way to resolve protests without a formal hearing. The conference is conducted informally by a conciliation conferee who will review all of the evidence presented to determine a fair result. After the conference, the conciliator will issue a proposed resolution of the case. If you do not agree with the proposed resolution, the conciliation proceeding will be discontinued and you will have 90 days to file a Petition for a Tax Appeals Tribunal Hearing.

If you wish to request Conciliation Conference, complete this form and return it to the address indicated on the reverse side of this form within the time period stated on the statutory Notice issued to you by the Department of Finance. **IF YOU HAVE ALREADY FILED A PETITION FOR A HEARING WITH THE NYC TAX APPEALS TRIBUNAL, DO NOT FILE THIS REQUEST FORM.** After a taxpayer has filed a petition for a hearing, the NYC Tax Appeals Tribunal may refer the case to the Conciliation Bureau with the permission of the Department of Finance. If you have already filed a petition and wish to request a Conciliation Conference, you must make a written request to the NYC Tax Appeals Tribunal for an order of referral. Failure to timely file your Request or Petition will result in the statutory Notice becoming final and subject to collection.

A duly executed Power of Attorney must accompany this request if the taxpayer is being represented by, or this request is signed by, someone other than: (i) a duly authorized officer of a corporate taxpayer; (ii) a general partner of a taxpayer that is a partnership; (iii) an adult spouse, parent, guardian or the person who prepared the return in the case of a taxpayer who is a minor or who is physically or mentally incapable of representing him or herself.

TAX APPEALS TRIBUNAL HEARING

Administrative Law Judge Hearing

The procedure for a Tax Appeals Tribunal Hearing is begun by filing a Petition for Hearing. The petition must be in writing and must specifically indicate what actions of the Department are being contested.

The hearing is an adversary proceeding before an impartial administrative law judge. The hearing will be recorded. After the hearing, the administrative law judge will issue a determination which will decide the matter(s) in dispute unless either you or the Department requests review by the Commissioners of the Tax Appeals Tribunal. If such a review is requested, the record of hearing and any additional oral or written arguments will be reviewed and the Tribunal will issue a decision affirming, reversing or modifying the administrative law judge's determination, or referring the matter back to the administrative law judge for further hearing.

Small Claims Option

You may elect to have your hearing held in the Small Claims Unit if the amount in dispute is $10,000 or less, exclusive of penalties and interest. The hearing is conducted informally by an impartial presiding officer. The presiding officer's determination is conclusive and is not subject to review by any other unit in the Tax Appeals Tribunal or by any court.

You may request the Rules of Practice and Procedure of the Tax Appeals Tribunal by writing to:

NYC Tax Appeals Tribunal
1 Centre Street, 24th Floor
New York, NY 10007

A request for rules is not considered the filing of a Petition for Hearing for purposes of the time limits, and does not extend the time limits for filing a Petition.

Request for Conc. Conf. 8/95

PRINTED ON RECYCLED PAPER

CITY OF NEW YORK - DEPARTMENT OF FINANCE
REQUEST FOR LETTER RULING

See instructions before completing this form;
numbers in parentheses refer to instructions.

TO BE USED FOR ALL RULING REQUESTS MADE ON OR AFTER NOVEMBER 6, 1989.

Name of Taxpayer Telephone No. (Area Code) Identification No. (1)

Taxpayer's Address (Number and Street)

City and State Zip Code

Name of Representative, if any (4) Telephone No. (Area Code)

Representative's Address (Number and Street)

City and State Zip Code

Tax in issue (General Corporation, Real Property Transfer, etc.)____________________

The taxpayer request a letter ruling on the following issue(s)____________________

Attach additional sheets if necessary.

Does this request relate to any matter regarding which a Notice of Determination or Notice of Disallowance of a claim for refund or credit has been issued to the taxpayer?

/ /Yes / /No

If the answer to the above question is "Yes", please attach a copy of the notice.

Does this request relate to any matter currently under City audit or review or for which there is a pending claim with the City for refund?

/ /Yes / /No

If answer to the above question is "Yes", please provide the Audit or Claim Number ____________________.

Period (Year under audit or review or for which refund claim has been filed ____________________

Date of Notice of Tax Due (if any) ____________________________________.

The taxpayer submits the following statement of facts as the basis for the requested letter ruling: ____________

____

____

____

____

____

____

____

____

____

____

List of documents submitted with this request: (2)

____

____

____

____

Attach additional pages , if necessary, and any documents to be considered.

The taxpayer hereby represents that this request does not cover an issue or set of facts regarding which a Notice of Determination or a Notice of Disallowance of a claim for refund or credit has been issued to the taxpayer.

____

Signature (3) (4) Date

____

____

Type or print name of individual signing request. Title or relationship to taxpayer.

CITY OF NEW YORK - DEPARTMENT OF FINANCE
POWER OF ATTORNEY

Taxpayer's name and address: if a corporation, Appointed Representative's name include address of principal office and state and address of incorporation (Individual or Firm)

The taxpayer named above appointed the person named above as my/its true and lawful attorney, to appear and represent me/it before the Department of Finance in connection with a Request for a Letter Ruling relating to:

Type of Tax and Tax Year(s) or Period(s)

---

with full power to receive a copy of all communications in such matter, including the letter ruling issued in response to this request, and to execute consents to extensions of the time within which the letter ruling must be issued, with full power of substitution and revocation.

All Powers of Attorney heretofore filed or granted for this purpose are hereby revoked (corporate seal)

Signature (include spouse's signature if joint) Title (or relationship to taxpayer) Date

---

This Power of Attorney must be acknowledged before a notary public.

Acknowledgment

State of new York ss:
County of

On this day of , 19 before me came to me known to be the person described in the foregoing Power of Attorney and he/she executed the same, and he/she, being by me duly sworn, did say that he/she is the of the taxpayer-corporation in the foregoing Power of Attorney, and that he/she is empowered to and did execute the same.
(Delete inapplicable material).

Signature of Notary Public Date

Notice of Appearance

I agree to represent the above-named taxpayer in accordance with the above Power of Attorney and hereby give notice that will appear in the above matter. All notices, decisions and other documents are to be sent to me at the address shown above. (If different than above, send attachment with address).
Note: If power of attorney has been previously filed, a conformed copy thereof should be annexed hereto.

____

I am:

/ /an attorney-at-law licensed to practice in New York or another State

/ /a certified public accountant duly qualified to practice in New York or another State.

/ /a person admitted to practice before the Internal Revenue Service or before the U.S. Tax Court.

/ /the taxpayer's spouse, child or parent

/ /Other ______________________________

____

____
Signature of Appointed Representative

____
Title

____

Instructions for Request for Letter Ruling

A COMPLETE LETTER RULING REQUEST FORM AND A $250 PROCESSING FEE MUST BE SUBMITTED FOR ALL LETTER RULING REQUEST RECEIVED BY THE DEPARTMENT OF FINANCE-OFFICE OF LEGAL AFFAIRS ON OR AFTER NOVEMBER 6, 1989.

GENERAL INFORMATION

What is a letter Ruling?

A letter ruling is a written statement setting forth the applicability of statutory provisions of any tax or charge administered by the Department of Finance, to a specific set of facts. Letter rulings are issued on behalf of the Commissioner of Finance by the Deputy Commissioner for Legal Affairs, to whom the Commissioner of Finance's authority to issue letter rulings is delegated.

Other Information Service Provided by the Department of Finance

Based upon the nature of your inquiry, it may not be necessary to obtain a letter ruling.

General information request not requiring a ruling may be answered by calling: (718) 935-6000

or by writing:

Department of Finance
Taxpayer Correspondence Unit
25 Elm Place - 4th Floor
Brooklyn, New York 11201

Practitioners may find out about agency guidelines, statutes, regulations, rulings and procedures on more technical inquiries by calling the Office of Technical Services at (718)403-3761 or by writing:

Department of Finance
Office of Technical Services
345 Adams Street - 5th Floor
Brooklyn, New York 11201

Information concerning City taxes administered by New York State may be obtained from the New York State Department of Taxation and Finance, State Campus, Albany, New York 12227.

When a Letter Ruling will not be Issued

No ruling will be issued:

(a) covering an issue or set of facts regarding which a Notice of Determination or a Notice of Disallowance of a claim for refund or credit has been issued to the taxpayer;

(b) covering an issue or set of facts regarding which any taxpayer has been granted leave to appeal or regarding which the Department of Finance is seeking or has been granted leave to appeal an adverse decision to any court of the State of New York or the United States;

(c) covering an issue which is clearly and adequately addressed by statutes, regulations, published rulings or other official pronouncement of the Department of Finance; or

(d) where the issue presented pertains to subject matter which, in accordance with a public

pronouncement, is under study by the Department of Finance; or

(e) if the conclusion reached in such a ruling would require a factual determination which is properly an audit function.

Hypothetical Facts

The Office of Legal Affairs reserves the right not to issue a letter ruling on hypothetical facts.

Taxes Administered by New York State

Letter ruling will not be issued on questions pertaining to the following city taxes which are administered by the New York State Department of Taxation and Finance: Sales and related taxes, resident personal income tax, non resident earnings tax, mortgage recording tax, leaded motor Fuel tax, and beer and liquor excise tax.

Acknowledgment Letter

Upon receipt of a request for a ruling on the designated form which conforms to the procedural requirements of Title 19 Rules of the City of New York Ch. 16 Relating to Letter Rulings, an acknowledgment letter will be mailed to the person making the request. The letter ruling request will be assigned to a number which will appear on the acknowledgment letter. This number should be used in all future correspondence with the Office of Legal Affairs involving the request.

Withdrawing a Letter Ruling Request

A taxpayer may withdraw a request for a ruling at any time within 30 days of the date of the acknowledgment letter. Thereafter, no request for a ruling may be withdrawn without the written approval of the Office of Legal Affairs. Where a taxpayer withdraws a request for a ruling, the Department of Finance will not return the application fee of $250 accompanying such request. Failure to provide information requested by the Office of Legal Affairs may be deemed a withdrawal of a request for a ruling.

Time in Which Ruling Will be Issued

A ruling will be mailed to the taxpayer or the taxpayer's authorized representative within 90 days of the receipt of a complete request for such a ruling.

The 90-day period within which a ruling must be issued may be extended by the Office of Legal Affairs for a period of up to 30 additional days. In such cases, the taxpayer or the taxpayer's authorized representative will be notified of the extension and the reason therefor. At any time before their expiration, the 90-day or additional 30 -day period may be extended by a written agreement between the taxpayer and the Office of Legal Affairs.

Publication of Letter Ruling

The complete text of a letter ruling may be published, or made available to the public, except that the taxpayer's name, address, identifying numbers and other factual information which may identify the taxpayer will be deleted.

COMPLETING THIS FORM

(1) Enter taxpayer's social security number, employer identification number or other number assigned by the Department of Finance.

(2) Copies of all tax returns, contracts, deeds instruments or other documents relevant to the issues to be decided must be submitted.

(3) (a) A request for letter ruling may be filed by an individual on his own behalf, by a member of a partnership (without filing a power of attorney) on behalf of the partnership, or by an officer or employee of a corporation on behalf of the corporation. Where a corporation acted through an employee, a power of attorney (see page 3) executed by an officer of the corporation must be filed.

(b) The audit spouse, parent or guardian or any person having legal custody of a minor or a person who prepared the tax return of a minor may file a request for a letter ruling on behalf of such a minor.

(c) A committee or conservator appointed pursuant to the Mental Hygiene Law, an attorney-in-fact acting pursuant to Section 5-1601 of the General Obligations Law, or any other person authorized by law, may request a ruling on behalf of an individual who is mentally or physically incapable of making such request.

(4) Any of the following may file a request for a letter ruling on behalf of another individual or a business entity if authorized by a power of attorney (see page 3) signed by such an individual, by a member of a partnership or an officer of a corporation, where such power of attorney is filed with the Department before or concurrently with the filing of the request for a letter ruling.

(a) an attorney-at-law licensed to practice in New York State;

(b) a certified public accountant duly qualified to practice in New york State;

(c) an attorney -at-law or accountant duly authorized to practice in any other State,

(d) a person admitted to practice before the Internal Revenue Service or before the Tax Court of the United States; and

(e) the petitioner's spouse, child or parent.

Be certain that a properly completed power of attorney has been executed where required. (See instruction 3).

(5) A processing fee of $250 is charged for all Letter Ruling Requests received by the Department of Finance, Office of Legal Affairs, on or after November 6, 1989. Checks or money orders for $250 made payable to the "New York City Department of Finance" must accompany all requests.

(6) A completed Request for Ruling, accompanied by a check or money order for $250 should be mailed to:

Department of Finance
Office of Legal Affairs
345 Adams Street, 3rd Floor
Brooklyn, New York 11201

NEW YORK STATE PRACTICE AND PROCEDURE

MARK S. KLEIN, ESQ.

Hodgson, Russ, Andrews, Woods & Goodyear, LLP
Buffalo

NEW YORK STATE PRACTICE AND PROCEDURE

I. Administrative Appeals Procedures - Overview

A. Bureau of Conciliation and Mediation Services

1. Overview
2. Structure
3. Representation of the Taxpayer
4. Procedures
5. Precedential Effect of Conciliation Orders
6. Service of Papers
7. Settlement or Compromises

B. Division of Tax Appeals

1. Overview
2. Structure
3. Representation of the Taxpayer
4. Commencing of the Hearing Process
5. Pleadings in Administrative Law Judge or Small Claims Hearings
6. Motions & Discovery
7. Stipulations
8. Submission Without Hearing
9. Administrative Law Judge and Small Claims UNTS Hearings
10. Review by Tribunal
11. Service of Papers

C. Compromises

1. Overview
2. Procedure
3. Basis for Submission
4. Commissioner's Role
5. Stay of Proceedings

II. Other Remedies

A. Article 78 Proceedings

1. Overview
2. Scope
3. Timing
4. Parties
5. Bonding
6. Grounds for Review

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7. Burden of Proof & Exclusions v. Exemptions
8. Petitioning
9. Oral Argument
10. Decision
11. Appeal to the Court of Appeals

B. Declaratory Relief

1. Overview
2. Advisory Opinions (see below)
3. Declaratory Judgment

C. Declaratory Judgments

III. Advisory Opinions See 20 N.Y.C.R.R. § 2376 et. seq.

A. Applicability

1. Any substantive or procedural question concerning any tax administered by the Department of Taxation and Finance (including certain New York City and Yonkers taxes).

2. Taxpayer may be under audit or have filed a claim for refund.

3. Can also be done on a "no-name" basis with respect to a hypothetical or future set of facts. See e.g. Comeau, TSB-A-90(43)S, Comeau, TSB-A-90(10)S, Independent Oil & Gas Association, TSB-A-91(10)S, Klein, TSB-A-91(11)C, Klein, TSB-A-94(21)S, and Limousine Operators of Western New York, TSB-A-88(55)S.

4. Not generally available once taxpayer has received a 90-day letter and files a petition or a request for a conciliation conference.

5. Not available where taxpayer has requested a declaratory ruling or an opinion of counsel.

6. Can be withdrawn at any time.

B. Form

1. Forms are available (AD 1.8).

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2. Based on specific facts (using examples if appropriate), the law and proposed application of law to the facts.

3. Taxpayers can be represented by self or persons designated under regulations.

4. Rules provide that advisory opinion petitions must provide the following nine items:

a. The name, address and telephone number of the petitioner;

b. The name, address and telephone number of petitioner's representative, if any;

c. The taxable years or periods involved, if any, and the amount of tax in question, if known;

d. A clear and complete statement of the set of facts upon the basis of which the request for advisory opinion is to be framed;

e. An explicit statement of the question to which an answer is sought or of the issues sought to be resolved;

f. A statement as to whether any issue related in the petition for advisory opinion is related to an audit or examination of any return of the petitioner, a claim for a refund, credit or reimbursement, or any matter or proceeding with which the Commissioner or Division of Tax Appeals is involved;

g. The signature of the petitioner or his representative;

h. Correct identification numbers;

i. A signed statement of consent to publication of the advisory opinion upon issuance.

5. **Format**

a. Issue
b. Facts
c. Law
d. Application of law to facts

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e. Opinion requested
f. Conference requested
g. Consent to publication

C. Tax Department Procedures

1. Request goes to Audit Division for review and possible statement of its opinion as to the underlying facts or merits (application of law or regulations).

2. Disputes are forwarded to the taxpayer for a reply (10 day time limit).

3. Technical Services Bureau must make independent determination of issues.

4. Possible referral to Law Bureau for legal advice.

5. Conference possible (at Technical Services Bureau's option). Petitioner should request.

6. Once advisory opinion has been prepared, it is forwarded to the Audit Division for transmittal to the petitioner. If Audit opposes the result, it could be referred to the Commissioner.

7. All advisory opinions are published and made available to the public.

8. 90 day time limit (not uncommon to get one a couple of months late, however).

D. Impact and use of Advisory Opinions

1. Binding against Audit Division - only with respect to named petitioner. Modification possible, but prospective modification only.

2. Not binding against taxpayer or Division of Tax Appeals. See Dairy Barn, 1989-1 N.Y.T.C. T-695.

3. Use of "no-name" form for nexus, audit or compliance problems.

4. Possible use by industry associations (also allows pooling of resources).

5. Follow up with named requests using identical facts.

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RAISING CONSTITUTIONAL ISSUES IN STATE TAX CASES

STEVEN U. TEITELBAUM, ESQ.
Deputy Commissioner and Counsel

New York State
Department of Taxation & Finance
Albany

RAISING CONSTITUTIONAL ISSUES IN STATE TAX CASES

Steven U. Teitelbaum, Esq.
Deputy Commissioner and Counsel
New York State Department of Taxation and Finance

I. APPLICABLE RULES

A. Legislation. Enabling legislation does not provide that Division of Tax Appeals and Tax Appeals Tribunal can address facial constitutionality of statutes. Matter of Lunding, Tax Appeals Tribunal, 2/23/95.

B. Presumption of Constitutionality. Statutes are presumed constitutional at the administrative level. Matter of RAF General Partnership, Tax Appeals Tribunal, 11/9/95; Matter of Allied-Signal, supra; Matter of Bucherer, Tax Appeals Tribunal, 6/28/90; Matter of Lunding, supra; Pyramid Co. of Auburn v. Chu, 177 AD2d 970 (4th Dept. 1991). Statutes should be upheld if they bear a rational relationship to any legitimate state purpose. Id.

C. Facial Constitutionality. Division of Tax Appeals and Tax Appeals Tribunal do not have jurisdiction to determine facial constitutionality of a statute. Matter of RAF General Partnership, supra; Allied-Signal, Inc., Tax Appeals Tribunal, 8/31/95; Matter of Lunding, supra; Matter of Consolidated Rail Corporation, Tax Appeals Tribunal, 8/24/95; Matter of New Milford Tractor Co., Inc., Tax Appeals Tribunal, 9/1/94; Matter of Unger, Tax Appeals Tribunal, 3/24/94; Matter of Brussel, Tax Appeals Tribunal, 6/25/92; Matter of Wizard Corporation dba Wizard Petroleum, Tax Appeals Tribunal, 1/12/89; Matter of Fourth Day Enterprises, Tax Appeals Tribunal, 10/27/88.

D. Exhaustion of Administrative Remedies. Taxpayer must exhaust administrative remedies on challenge of statute as constitutionally applied. Jetro Cash and Carry Enterprises, Inc. v. State Dept. Of Taxation and Finance, 605 NYS2d 538 (3rd Dept. 1993). Taxpayer need not exhaust administrative remedies where facial validity of statute challenged. AT&T v. New York State Department of Taxation & Finance, 191 AD2d 61 (1st Dept. 1993).

E. Constitutionality of Statute As Applied. Cases have consistently held that the Division of Tax Appeals and the Tax Appeals

Tribunal have jurisdiction to determine constitutionality of statute as applied. Matter of New Milford Tractor Co., Inc., supra; Jetro Cash and Carry Enterprises v. State Department of Taxation and Finance, supra; Matter of Waste Conversion, Tax Appeals Tribunal, 8/24/94, affd 585 NYS2d 883; Matter of David Hazen, Inc., Tax Appeals Tribunal, 4/21/88, affd 152 AD2d 765, affd 75 NY2d 989.

– Test for "as applied" versus "on its face" is whether specific facts need to be determined.

F. Regulations. Tribunal has authority to rule on validity of the Division's regulations which are at issue in a case. Tax Law §2006(7); 20 NYCRR 3000.11(e)(3); Matter of New Milford, supra; Matter of JC Penney, Tax Appeals Tribunal, 4/27/89.

II. RECENT AND IMPORTANT CASES

A. Procedural Constitutional Issues.

- **Tribunal Decisions**.

1) Matter of RAF General Partnership, Tax Appeals Tribunal, 11/2/95.

Notices of determination were issued based on an assessment for real property transfer gains tax. Petitioners argued, inter alia, their rights to due process were violated because the notices of determination gave them inadequate notice of the assessment because the date of transfer was incorrect.

Citing Matter of Bucherer, supra, the Tribunal held that statutes at the administrative level are presumed to be constitutional. Further, the Tribunal can consider whether a statute is unconstitutional as applied (Matter of David Hazen, supra) It went on to hold that there is no evidence that Article 31-B has been applied to them in a manner that violates petitioners' equal protection rights.

2) Matter of Allied-Signal, Inc., Tax Appeals Tribunal, 8/31/95.

Petitioner claimed an apportionment formula cannot result in a constitutional application of the tax involved, therefore challenging the facial validity of the statute.

The Tribunal held that it did not have jurisdiction to rule on the facial constitutionality of the statute. At this level, the facial constitutionality of the statute must be presumed.

An Article 78 petition has been filed.

3) Matter of Consolidated Rail Corporation, Tax Appeals Tribunal, 8/24/95.

   Conrail purchased fuel from out-of-state suppliers for use of locomotives that travel both in and out of NYS. Conrail asserts that §301-A of the Tax Law "facially discriminates against interstate commerce in violation of the Commerce Clause of the US Constitution."

   The Tribunal held that its jurisdiction, as prescribed in its enabling legislation, does not encompass constitutional challenges to the facial validity of legislation (Matter of Fourth Day Enterprises, supra) and, thus, could not rule on the issue raised by petitioner.

4) Matter of Lunding, Tax Appeals Tribunal, 2/23/95.

   Petitioner, a nonresident, claimed a deduction on his nonresident return for alimony paid to his ex-wife. The deduction was denied because Tax Law §631(b)(6) provides that the deduction shall not constitute a deduction derived from New York sources for nonresident individuals. The petitioner challenged the statute claiming the statute is unconstitutional under the Privileges and Immunities Clause, the Commerce Clause and/or the Equal Protection Clause of the US Constitution.

   The Tribunal held that it did not have jurisdiction to rule on the facial constitutionality of the statute. At this level, the facial constitutionality of the statute must be presumed.

An Article 78 petition has been filed.

5) Matter of New Milford Tractor Co., Inc., Tax Appeals Tribunal, 9/1/94.

Petitioner is a Connecticut corporation selling tractors and other equipment. Its operations are similar to a car dealership. It owns no real property in New York. The administrative law judge held that petitioner's registration as a vendor did not constitute a sufficient nexus with New York to impose the duty to collect sales and use taxes.

The Tax Appeals Tribunal held that it has authority to rule on the validity of the Division's regulations (Tax Law §2006[7]; 20 NYCRR 3000.00[e][3]; see also, Matter of JC Penney, supra). It held that the resolution of the case depends on the petitioner's contacts (whether it had a sufficient nexus) with New York and is, thus, a question of the constitutionality of the statute as applied. Citing Orvis, infra, the Tribunal held that it had authority to rule on the constitutionality of the statute as applied. There was an insufficient nexus, and the statute violated the Commerce Clause.

6) Matter of Unger, Tax Appeals Tribunal, 3/24/94.

Petitioner raised issue as to whether it is constitutional to impose personal liability upon an officer, director or employee of a corporation for the corporation's failure to comply with Article 28 and 29 of the Tax Law.

The Tribunal determined that although petitioner correctly stated that the Tax Appeals Tribunal has the jurisdiction to determine the constitutionality of a taxing statute as applied, his argument challenged the constitutionality of §1133(a) on its face, and should, therefore, not be considered.

7) Matter of JC Penney, Tax Appeals Tribunal, 4/27/89.

The Division determined that petitioner was selling catalogs at a "minimal charge" for promotional purposes, thereby entitling the Division of Taxation to impose a use tax on

the costs of production. Petitioner claimed the regulation is unconstitutionally vague on its face due to its lack of an objective standard for determining the phrase "minimal charge."

The Tribunal examined as a threshold matter whether this issue is within its scope of review and concluded that it was.

- The Tribunal's enabling legislation does not extend our scope of review to determine the facial constitutional of Tax Law statutes (Matter of Fourth Day Enterprises, Tax Appeals Tribunal, 10/27/88); however, we may determine whether Tax Law statutes are constitutional as applied ... it follows we may determine whether the commissioner's regulations are constitutionally valid, both facially - as in the instant case - and as applied (20 NYCRR 3000.11 [e][3]).

- Whether 20 NYCRR 526.6(c)(4)(ii) is, in fact, unconstitutionally vague: "Due Process requires that only a reasonable degree of certainty so that individuals of ordinary intelligence are not forced to guess at the meaning of statutory terms ... substantially the same rules apply to whether statutes are vague."

- **State Court Decisions.**

1) Empire State Building Co. v. New York State Department of Taxation and Finance, 631 NYS2d 306 (1st Dept. 9/7/95).

   The Appellate Division agreed with the Supreme Court that the question of how the tax assessment against plaintiff is to be calculated, including the application of any deductions, is a matter wholly within the purview of the defendant Department of Taxation & Finance. Judicial review pursuant to CPLR Article 78 is properly reserved for a final administrative determination and exhaustion of administrative remedies.

2) Matter of Waste Conversion, Tax Appeals Tribunal, 8/24/94, affd 585 NYS2d 883.

The petitioner raised the issue of whether the Division properly imposed sales tax on the fees charged by petitioner to its New York customers for the processing and treatment of waste products at its plant in Pennsylvania. If so, the petitioner argued that such taxation is in violation of the Commerce Clause of the US Constitution.

The Court determined that when the claim is made that a statute has been unconstitutionally applied by a state officer, the proper way to proceed is to bring an Article 78 proceeding.

- it is clear that ... plaintiff was required to raise this issue of the proper application of the statute first through the administrative hearing process.

- it is clear that this Tribunal has the jurisdiction to determine whether the Division of Taxation has applied the statute in a constitutional manner.

3) Compass Adjusters and Investigators, Inc. v. Commissioner, 610 NYS2d 625 (3rd Dept. 1994).

   A suit brought by licensed independent adjusters seeking determination as to whether their services were subject to sales tax was properly brought as a declaratory judgment action in Supreme Court.

   The Appellate Division held that, ***in the absence of factual issues***, a declaratory judgment action is an appropriate remedy to challenge the validity or application of a particular statute without exhausting administrative remedies.

4) Jetro Cash and Carry Enterprises, Inc. v. State Dept. of Taxation and Finance, 605 NYS2d 538 (3rd Dept. 1993).

   Plaintiff brought declaratory judgment action seeking, among other remedies, a declaration that the Cigarette Marketing Standards Act was unconstitutional as applied.

   The Appellate Division held that plaintiff failed to exhaust its administrative remedies and affirmed the Supreme Court's

summary judgment in favor of the State.

B. Substantive Constitutional Issues.

1) Matter of Orvis Co. v. Tax Appeals Tribunal of State of New York, Vermont Information Processing, Inc. v. Tax Appeals Tribunal of New York State, Court of Appeals, 6/15/95.

The Court of Appeals in a five-to-two decision reversed the decisions of the Appellate Division in these Article 78 proceedings. The issue decided by the Court of Appeals was whether the petitioners had sufficient nexus with New York State as a matter of constitutional law such that they could be required to collect New York sales tax on their sales to New York customers.

Orvis Company Inc. sells tangible personal property at retail and wholesale. The retail orders were almost entirely via mail with goods shipped from Vermont by common carrier or mail. Orvis' salesmen visited New York retailers to whom it sold merchandise.

Vermont Information Processing, Inc. (VIP) markets computer software and hardware. Most orders were filled through shipments by common carrier or mail. VIP employees visited New York customers approximately 40 times during the three year audit period to resolve problems, give additional instruction on the use of the product and occasionally install software.

The Appellate Division in annulling the Tribunal's holdings that sufficient nexus exists in these matters interpreted the US Supreme Court decision in Quill v. North Dakota as requiring that a vendor have substantial physical presence in a State before it loses the immunity conferred by the Commerce Clause of the US Constitution from the duty to collect a State sales or use tax.

The Court of Appeals rejected the Appellate Division's interpretation that "Quill increased the requisite threshold of in-State physical presence from any measurable amount of in-State people or property." The Court of Appeals held that immunity is lost so long as the vendor's presence is

demonstrably more than the slightest presence.

The Court of Appeals remanded Orvis to the Appellate Division for a decision on issues not addressed by the Appellate Division, i.e. whether Orvis was a vendor as defined in the Tax Law for the period at issue.

Vermont Information Processing, Inc. is seeking certiorari from the US Supreme Court.

2) Tug Buster Bouchard Corporation, et. al. v. New York State Department of Taxation and Finance, Supreme Court, Albany Co. 1994.

The petitioners provide barge and/or towing services within various US ports. New York assessed taxes against petitioners pursuant to §301 of Article 13-A based upon their importation of marine diesel fuel into New York and their consumption of such fuel in New York territorial waters.

Petitioner argues that §301 discriminates against interstate commerce by not allowing a credit against the tax on consumption of fuel for sales or similar taxes paid to other states in connection with the purchase of such fuel. Taxes which place a burden on businesses engaged interstate commerce which is not equivalently borne by businesses engaged exclusively in intrastate commerce are facially discriminatory.

The court agreed and held the tax statute facially discriminates against interstate commerce in violation of the Commerce Clause of the US Constitution.

The appeal was argued November 15, 1995 before the Appellate Division, Third Department.

The Department of Taxation and Finance argued that the petroleum business privilege tax is not discriminatory, reflects no discriminatory intent, and does not have the effect of unduly burdening interstate commerce. The petroleum business privilege tax is internally consistent. The court should have severed the purportedly offensive

provision from the remainder of the petroleum business statute pursuant to a severability clause.

3) (Beeper Case) Radio Common Carriers of NY, Inc. v. State of New York, 158 Misc 2d 695 (New York Co. 1993).

The Supreme Court determined in an action for declaratory relief that the flat monthly fee on beepers imposed by §1150 of the Tax Law violated the Commerce and Due Process Clauses.

To determine whether the tax violated the Commerce Clause, the court applied the test from the US Supreme Court decision in Complete Auto Transit Inc. v. Brady, 430 US 274 (1977), which requires, inter alia, the tax be applied to an activity with a substantial nexus with the taxing State. The court said the tax failed the nexus test because a large group of out-of-state users do not use their beepers within New York and they receive their paging signals from a transmitter site which need not be in New York.

The court found that the tax violated the Due Process Clauses of the US and State Constitutions because there is no link definite or otherwise between New York and out-of-state users. The court held that due process requires some definite link, some minimum connection, between a state and a person, property or transaction it needs to tax. The mere authorizon to use one's beeper in New York was an insufficient connection.

4) Ontario Trucking Association, et al. v. New York State Department of Taxation and Finance, Supreme Court, Albany County.

Plaintiffs, trucking companies and a trucking company association, challenging the constitutionality of franchise taxes as violative of the Commerce Clause, due process, equal protection, the Import-Export clause, and certain treaties.

The State is arguing that the plaintiffs have failed to meet their heavy burden of overcoming the strong presumption of constitutionality which attaches to Tax Law statutes, as

described in Orvis. Moreover, the State argues that the Plaintiffs have not demonstrated why the constitutionality of New York's franchise taxes, as upheld in American Trucking Assn. v. New York State Tax Comm., is no longer good law. Finally, the State argues correlatively that as the Plaintiffs seek tax refunds, they have failed to exhaust their administrative remedies and the case should be dismissed.

Briefs have been filed by both parties and a decision is pending.

5) Geoffrey Inc. v. South Carolina Dept. of Revenue, 437 SE2d 13 (1993), cert. den. 114 S.Ct. 550 (1993).

For purposes of imposing income tax on foreign corporations, nexus requirement of due process clause can be satisfied even when corporation does not have physical presence in taxing state, if corporation has purposely directed its activity at state's economic forum.

6) AT&T v. New York State Department of Taxation and Finance, 155 Misc 2d 553 (New York Co. 1992).

The court held Tax Law §186-a (2-a) is constitutional although the benefit of the deduction provided therein is directly related to the percentage of a telephone company's business in the State of New York.

AT&T challenged the statute because, under the statute, a company with a small percentage of New York business receives a lower deduction than a company having a greater percentage of New York business.

In upholding the constitutionality of the statute under the commerce clause, the court found that the greater dollar benefit of the deduction for some taxpayers pursuant to Tax Law §186-a (2-a) was not unlike the greater dollar benefit of an allowable deduction on a personal income tax return to a high tax bracket taxpayer than to one in a lower bracket.

7) British Land (Maryland), Inc. v. Tax Appeals Tribunal, 85 NY2d 139 (1995).

The Appellate Division confirmed the Tax Tribunal's decision. The primary issue was whether a gain on the sale of Maryland property should be included in petitioner's entire net income subject to the statutory business allocation percentage.

Petitioner acquired a Baltimore, Maryland office building in 1973. When the building was sold in 1984,, petitioner deducted the capital gain from its taxable income in computing its New York franchise tax liability. The Department disallowed the deduction and issued deficiency notices. Petitioner challenged the notices on constitutional grounds, arguing that the gain from the Maryland property had no connection to New York. The Tribunal sustained the notices.

The issue on appeal was whether the State violated the Due Process and Commerce Clauses of the US Constitution by assessing a corporation franchise tax on petitioner's gain from its sale of real property in Maryland. The court upheld the Tribunal's conclusion that the petitioner's New York City and Baltimore real estate activities were part of a unitary business. However, the Tax Appeals Tribunal's determination was annulled and the mater was remanded to the Tribunal for a redetermination of an allocation of petitioner's income more fairly reflecting its business activities in New York.

A settlement was reached.

8) Matter of Tamagni, Division of Tax Appeals, 8/25/94.

The petitioner, a New Jersey domiciliary and a New York statutory resident, challenged New York income tax statute claiming it to be unconstitutional. The petitioner maintained that New York's statute resulted in double taxation of his income as both New York and New Jersey taxed his income.

The Division of Tax Appeals determined that petitioner was facially challenging the constitutionality of the statute and, thus, did not have jurisdiction over the issue.

The petitioner has filed an exception before the Tax Appeals Tribunal and a decision is expected by early December.

III. CHOOSING A FORUM AND OTHER CONSIDERATIONS

A. Administrative Action – Article 78 Review.

1) Application of Statute Challenged. Proper to proceed at administrative level when basis of proceeding is statute has been unconstitutionally applied.

2) Record. Appropriate factual record needs to be developed; administrative hearings necessary for record of facts.

B. Declaratory Judgment in Supreme Court.

1) Need Not Exhaust Administrative Remedies. Petitioner need not exhaust administrative remedies in the absence of factual issues. Compass Adjusters and Investigators Inc. v. Commissioner, 197 AD2d 38 (3rd Dept. 1994); AT&T v. New York State Department of Taxation and Finance, 191 AD2d 61 (1st Dept. 1993).

2) Question of Law. No particular record need be developed when the issue is solely a question of law. CPLR section 7801.

C. Venue.

1) Article 78 Proceedings. Venued in 3rd Department in Albany.

2) Declaratory Judgment Actions. Venued in various departments throughout the state. Different departments may issue conflicting decisions which poses a problem. In addition, taxpayers may prefer venue in a particular department due to precedent in that department and predictability of judge(s) in that department.

D. Other Considerations.

1) Timing. Article 78 and declaratory judgment can be simultaneous.

2) Preserving issues. Petitioner must raise constitutional

issue(s) from start, even if proceeding thru DTA first.

3) Issues. Taxpayers should avoid constitutional issues if possible. Courts "don't like to restructure building after it is built; they prefer to rearrange furniture."

4) Policy implications. Proceeding at administrative level preferable to declaratory judgment action in Supreme Court.

RAISING CONSTITUTIONAL ISSUES IN STATE OR LOCAL TAX CASES

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I. FEDERAL CONSTITUTIONAL LIMITATIONS

A. State Sovereignty

1. U.S. Constitution, Amendment X -- "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

B. **Duo-dimensional Model**

1. Transactional Nexus vs. Presence Nexus

2. Due Process Clause vs. Commerce Clause

C. **Due Process Clause**

1. U.S. Constitution, Amendment XIV, Sec. 1 -- "nor shall any State deprive any person of life, liberty, or property, without due process of law . . . ."

2. Connecticut Gen. Life Ins. Co. v. Johnson, 303 U.S. 77 (1938)

a. "A corporation which is allowed to come into a state and there carry on its business may claim, as an individual may claim, the protection of the Fourteenth Amendment against subsequent application to it of state law."

b. A state may impose tax only on income that is derived from [or related to] activities that occur within its boundaries.

3. Wisconsin v. J.C. Penney Co., 311 U.S. 435 (1940)

a. "That test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return."

4. Exxon Corp. v. Wisconsin Dep't of Rev., 447 U.S. 207 (1980)

   a. "The Due Process Clause of the Fourteenth Amendment imposes two requirements for such state taxation: a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" (citing Mobil Oil Corp. v. Commissioner of Taxes of Vermont.)

5. Quill Corp. v. North Dakota, 112 S. Ct. 1904 (1992)

   a. The Due Process Clause requires only that a corporation have "minimum contacts" with the taxing state. The intent of the Due Process Clause is to ensure fairness and notice.

   b. The presence in a state necessary to satisfy the Due Process Clause is comparable to that needed to support a state court's jurisdiction over a defendant in a civil matter. As articulated in cases such as Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985), that standard is met if the entity purposefully directs its activity into a jurisdiction. The Due Process Clause does not require physical presence in the taxing state.

6. Allied-Signal, Inc. v. Director, Div. of Taxation, 112 S. Ct. 2251 (1992)

   a. "in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax."

7. Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13, cert. denied, 114 S. Ct. 550 (1993)

   a. Delaware holding company that licenses its trademarks and trade names for use by its parent corporation, Toys R Us, in South Carolina has sufficient nexus under the Due Process Clause to subject it to the state's corporate income tax and corporate license fee.

D. **Interstate Commerce Clause**

   1. U.S. Constitution, Art. I, Sec. 8, Cl. 3 -- "The Congress shall have the power . . . To regulate commerce . . . among the several States . . . ."

   2. Dormant Commerce Clause jurisprudence

      a. Interprets the Commerce Clause as implicitly prohibiting, even in the absence of Congressional regulation, unduly burdensome or discriminatory State taxation of transactions or entities engaged in interstate commerce.

   3. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977)

      a. Rejected the rule that a state tax on the "privilege of doing business" is per se unconstitutional when it is applied to interstate commerce and overruled the case that announced that rule, Spector Motor Service, Inc. v. O'Connor, 340 U.S. 602 (1951).

      b. Articulated a four-part test that must be satisfied for a tax not to violate the Interstate Commerce Clause.

         i. The tax must be applied to an activity with a substantial nexus with the taxing state;

         ii. The tax must be fairly apportioned;

         iii. The tax must not discriminate against interstate commerce; and

iv. The tax must be fairly related to the services provided by the state.

4. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983)

   a. The Court elaborated upon the fair apportionment requirement of Complete Auto, dividing it into a two-part test, both parts of which must be satisfied.

      i. Internal consistency -- a tax will be internally consistent if it is structured so that, assuming every state were to impose an identical tax, no multiple taxation would result.

      ii. External consistency -- a tax will be externally consistent if the state has taxed only that portion of the revenues from interstate activity that reasonably reflects the in-state component of the activity being taxed.

5. Quill Corp. v. North Dakota, 112 S. Ct. 1904 (1992)

   a. The Interstate Commerce Clause requires that a corporate taxpayer (or tax collector, in the case of sales and use taxes) have "substantial nexus" with the taxing state.

   b. A corporation "may have the 'minimum contacts' with a taxing State as required by the Due Process Clause, and yet lack the 'substantial nexus' with that State as required by the Commerce Clause."

   c. In the area of use tax collection, the Court held that a corporation must be physically present in a state for that state constitutionally to impose collection responsibilities upon the corporation. The presence in a state necessary to satisfy the Interstate Commerce Clause is uncertain with respect to income and franchise taxes.

6. Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13, cert. denied, 114 S. Ct. 550 (1993)

   a. Delaware holding company that licenses its trademarks and trade names for use by its parent corporation, Toys R Us, in South Carolina has sufficient nexus under the Commerce Clause to subject it to the state's corporate income tax and corporate license fee.

7. Orvis Company, Inc. v. Tax Appeals Tribunal, 86 N.Y.2d 165, 630 N.Y.S.2d 680 (1995)

   a. "We do not read Quill Corp. v. North Dakota to make a substantial physical presence of an out-of-State vendor in New York a prerequisite to imposing the duty upon the vendor to collect the use tax from its New York clientele."

   b. "[A]cceptance of the thesis urged by Orvis and VIP -- that Quill made the substantial nexus prong of the Complete Auto test an in-State substantial physical presence requirement -- would destroy the bright-line rule the Supreme Court in Quill thought it was preserving in declining completely to overrule Bellas Hess. Inevitably, a substantial physical presence test would require a 'case-by-case evaluation of the actual burden imposed' on the individual vendor involving a weighing of factors such as number of local visits, size of local sales offices, intensity of direct solicitations, etc., rather than the clear-cut line of demarcation the Supreme Court sought to keep intact by its decision in Quill."

   c. Vermont Information Processing has petitioned the U.S. Supreme Court for review of this decision.

8. Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 115 S. Ct. 1331 (1994)

   a. In sustaining Oklahoma's imposition of its sales tax on the full receipts from Oklahoma sales of bus tickets for transportation beginning in Oklahoma and continuing in interstate commerce, the Supreme Court refused to find its decision in Central Greyhound Lines, Inc. v. Mealey, 334 U.S. 653 (1948), controlling. In Central Greyhound, the Court had found New York's tax imposed on bus companies to be unconstitutional because the tax rate was imposed on gross receipts that were unapportioned. In Jefferson Lines, the Court stated that it viewed customer-borne transaction taxes (in contrast to doing-business taxes, such as that at issue in Central Greyhound) as not requiring apportionment; the Court concluded that Oklahoma's tax was being imposed on the purchase of bus tickets, and that those purchases took place totally in Oklahoma.

E. **Foreign Commerce Clause**

1. U.S. Constitution, Art. I, Sec. 8, Cl. 3 -- "The Congress shall have the power . . . To regulate commerce with foreign nations . . . ."

2. Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)

   a. When a state seeks to tax the instrumentalities of foreign commerce, two considerations, beyond those articulated in Complete Auto (see discussion above), are invoked. If a state tax contravenes either of these precepts, it is unconstitutional under the Foreign Commerce Clause.

      i. Whether the tax, notwithstanding apportionment, creates a substantial risk of multiple taxation.

      ii. Whether the tax prevents the federal government "from 'speaking with one voice when regulating commercial

relations with foreign governments.'"

3. <u>Itel Containers Int'l Corp. v. Huddleston</u>, 113 S. Ct. 1095 (1993)

   a. Evaluating a Tennessee sales tax imposed on leased containers delivered into the State, the Court determined that the foreign commerce clause tests announced in <u>Japan Line</u> had been satisfied.

      i. Only too expansive a reading of the foreign commerce clause would permit the conclusion "that a state [must] refrain from taxing any business transaction that is also potentially subject to taxation by a foreign sovereign."

      ii. Because Tennessee credits against its own tax taxes any tax properly paid to another jurisdiction with respect to the same transaction, it, at a minimum, reduces the risk of multiple international taxation.

      iii. The argument that the Tennessee tax prevented the United States from speaking with one voice in foreign trade was rejected. The federal government had restricted the ability of States to tax international cargo containers under certain circumstances. Therefore, there was an inference that States could impose tax under those circumstances not identified. Moreover, although the Amicus brief submitted by the United States was not dispositive on this point, the Court did note that the brief specifically stated that the tax would not interfere with the ability of the United States to speak with one voice.

II. CHOICE OF FORUM

A. Declaratory Judgment Actions

1. Availability

   a. Declaratory judgment actions are generally permissible in only three circumstances: (1) where the statute is being challenged as being unconstitutional on its face (as opposed to being unconstitutional as applied to the particular person); (2) where the claim is made that the statute by its own terms is inapplicable; and (3) where the assessment is wholly fictitious and is made without any factual basis solely to extend a period of limitations.

      i. A conciliation conference can be requested prior to initiating a declaratory judgment action, but this may increase the likelihood that the State or City will attempt to have the court action dismissed on the basis that the taxpayer failed to exhaust its administrative remedies after electing to proceed administratively.

2. Benefits

   a. Declaratory judgment actions are heard, in the first instance, by Supreme Court justices who have generally have not heard many tax cases. These justices, who are also taxpayers and who have not spent years working with the taxing agencies, may be more sympathetic with the taxpayer's position.

   b. Appeals from decisions of Supreme Court are directly to the Appellate Division, as opposed to a Tribunal.

      i. Review by Appellate Division from a decision of the Supreme Court is less restrictive than the Article 78 standards of review that are applied to appeals from an administrative tribunal.

c. Assistant Attorney Generals or Assistant Corporation Counsels are assigned to represent the State or City, respectively, in cases before Supreme Court.

   i. It is often easier to deal with Assistant Attorney Generals or Assistant Corporation Counsels than agency attorneys. They oftentimes will return telephone calls more promptly than agency attorneys, and are usually not as emotionally committed to the issue being litigated.

d. Speed of decision

3. Detriments

   a. Often, the State or City will assert that the court action should be dismissed because the plaintiff failed to exhaust administrative remedies. Thus, this issue will need to be fought in addition to the substantive issues.

      i. This can add to the cost of litigating the matter since an additional issue must be briefed and argued.

      ii. This can delay the ultimate resolution of the matter.

   b. If the matter involves a very technical tax argument, the Supreme Court justice may not have the time to spend to develop an appreciation of the parties' arguments due to the large case load that exists.

   c. The action will likely need to be resolved based on a summary judgment motion. It may therefore be necessary to show that no material issues of fact exist.

   d. Due to the number of cases assigned to each Assistant Attorney General and Assistant Corporation Counsel, the State or City will often request several

extensions of time to file their papers. This necessarily delays an ultimate resolution of the matter.

e. The State or City can appeal matters initiated in Supreme Court all the way to the Court of Appeals.

   i. Only the taxpayer can appeal decisions of the administrative Tribunals.

f. Oral argument is at the discretion of the Supreme Court justice and thus the matter may be decided solely on the papers.

   i. If oral argument is granted by the Supreme Court justice, it is usually for only a short period of time (e.g., 15-30 minutes for both sides).

B. **Bankruptcy Courts**

1. Availability

   a. Obviously need a taxpayer that has filed for bankruptcy.

      i. Although an entity may have filed for bankruptcy and thus be before a bankruptcy court, this alone will not allow a responsible officer to challenge a tax assessment in bankruptcy court.

2. Benefits

   a. A bankruptcy judge is conscious of the taxpayer's financial predicament and may therefore be more sympathetic to the taxpayer's legal and factual arguments.

   b. If the bankruptcy is being resolved in a bankruptcy court in another state, there is a stronger incentive for the State or City to settle the matter since it will otherwise be required to incur the additional costs of attending the hearing.

c. If the bankruptcy is being resolved in a bankruptcy court in another state, the judge deciding the matter may be unfamiliar with New York taxes and be deciding issues which concern numerous other taxpayers. This also could increases the chances of resolving the matter without litigation as taxing agencies are often quite nervous of what an adverse decision from such a judge might state.

d. Depending on which bankruptcy court the matter is being heard, the burden of proof may be shifted to the State or City, as opposed to being on the taxpayer.

e. Assistant Attorney Generals or Assistant Corporation Counsels are assigned to represent the State or City, respectively.

   i. It is often easier to deal with Assistant Attorney Generals or Assistant Corporation Counsels than agency attorneys.

   ii. Realizing the difficulty of ultimately succeeding in bankruptcy court, and realizing that even if they are successful that the State or City may still not receive all of the amounts asserted as due, Assistant Attorney Generals and Assistant Corporation Counsels are often amenable to settlement discussions. (They seem to exhibit more concern for the tax revenue involved than the tax issue being litigated.)

3. Detriments

   a. Generally, controversies take a long time to resolve.

   b. If a complex tax argument is involved, bankruptcy court may not be the right place to resolve the matter.

III. **PENDING CASES**

A. John & Janet Tamagni, DTA No. 811237 (N.Y.S. Admin. Law Judge Aug. 25, 1994)

An executive in a New York investment firm, who was domiciled in New Jersey, was held to be a statutory resident of New York for two out of the three years in issue because he spent more than 183 days in New York in each of those years. The ALJ determined that he did not have jurisdiction to rule on the taxpayer's constitutional argument that the New York tax scheme violated the internal consistency test of the Commerce Clause (because the taxpayer could be taxed by both New York and his state of domicile -- with no tax credit -- on all his income from stocks, bonds, and other intangibles).

B. AlliedSignal Inc., DTA No. 806120 (N.Y.S. Tax Appeals Trib. Aug. 31, 1995)

New York's imposition of tax on a nondomiciliary corporation's income from its investment in the stock of other corporations was constitutional despite the absence of any unitary relationship between the investor and investee corporations. The U.S. Supreme Court's decision in Allied-Signal, Inc. v. Director, Div. of Taxation, 112 S. Ct. 2251 (1992), has no effect in New York because New York's investment allocation scheme is different than that considered by the Supreme Court.

C. R.J. Reynolds Tobacco Co. v. Department of Finance, N.Y. Co. Clerk's Index No. 118236/94

A corporation is challenging, as violating the Commerce Clause, New York City's method of computing the deduction for depreciation provided under the General Corporation Tax. Under the method existing during the years in issue, the Administrative Code mandated that a slower depreciation method be used for property located outside New York State than for property located in New York State.

RECENT CONSTITUTIONAL CASES IN NEW YORK STATE

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RECENT CONSTITUTIONAL CASES
NEW YORK STATE

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November 28, 1995

I. General principles involving Constitutional constraints on the ability of the states to tax interstate business.

A. Due Process Clause.

1. General principle: fairness requires that a taxing state have some connection with the object of taxation.

2. Supreme Court test: there must be "some definite link, some minimum connection between the state and the person, property or transaction it seeks to tax." Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954), reh'g denied, 347 U.S. 964 (1954).

B. Interstate Commerce Clause.

1. Although the Commerce Clause merely contains an affirmative grant of power to the United States Congress to regulate interstate commerce, the courts have held that it implies a negative restraint on the ability of the states to impede interstate commerce.

2. General principle: the tax must not unduly burden the flow of interstate commerce.

3. The Supreme Court, in Complete Auto Transit v. Brady, 430 U.S. 274 (1977), has prescribed a four-part test that a state tax must meet if it is not to violate the Commerce Clause.

a. The taxpayer must have a "substantial nexus" with the taxing state.

b. The tax must be fairly apportioned.

c. The tax may not discriminate against interstate commerce.

d. The tax must be fairly related to the services provided by the taxing state.

II. Cases involving connection with the taxing state.

A. Radio Commerce Carriers of New York, Inc. v. State of New York, 158 Misc.2d 695, 601 N.Y.S.2d 513 (Sup. Ct. N.Y. County 1993).

1. Facts.

a. The taxpayer is a "radio common carrier" that is licensed to provide radio paging services.

b. The taxpayer operates transmittal sites throughout its multistate service area, including New York. The transmitters are connected to a terminal that is operated by the taxpayer.

c. A customer buys or leases a paging device ("beeper"). Each beeper has a unique number. When someone calls that number, the terminal sends a signal to the transmitter, which sends radio waves at a frequency to which the beeper has been preset. If the user is within the service area, the beeper signals the user.

d. The signals go across state borders. The carrier does not know what state the user is in when the beeper receives the signal.

e. The taxpayer derives its revenue from two sources:

(1) a uniform monthly airtime charge for use of the radio communications network, and

(2) a charge for rental and maintenance of the beeper.

f. Section 1150(b)(1) of the Tax Law (part of the sales and use tax provisions) imposes a "fee" of one dollar for a month in which a beeper with a paging service is used or is authorized for use.

2. Holding (declaratory judgement).

a. The fee violates the Commerce Clause.

(1) The fee is a tax. It is imposed to raise revenue and not to regulate an industry (or to finance the cost of regulation).

(2) There is no "substantial nexus."

  (a) The nexus test is not satisfied merely because electronic signals pass through the State.

  (b) For out-of-State users who do not use their beepers within New York, the signal comes from a transmitter that may or may not be within the State.

(3) New York may tax more than its fair share of the transactions.

  (a) There is no internal consistency. If similar taxes were imposed by the other states in the service area (New Jersey and Connecticut), multiple taxation would result.

  (b) There is no external consistency. The lack of a credit for taxes paid to other states or an apportionment mechanism means that New York taxes more than that part of the transaction that is attributable to New York.

(4) The tax discriminates against interstate commerce.

  (a) Out-of-State users who never use beepers in New York are taxed to the same extent as are in-State users.

  (b) A tax that bears no relationship to the taxpayer's presence or activities in the taxing state places an undue burden on interstate commerce.

(5) The tax is not fairly related to the presence or activities of the taxpayer in the State.

b. The fee violates the Due Process Clause.

(1) There is no link between New York and the users who live, work, and use their beepers outside the State.

(2) The statute is too vague.

(a) It is administered in accordance with "definitions" and "provisions" applicable to other taxes under the sales tax article "insofar as such provisions can be made applicable to such fee with the limitations set forth herein and such modifications as may be necessary in order to adapt such provisions to the fee so imposed."

(b) "The statute is so indefinite as to require that one guess at its meaning."

(3) The fee results in double taxation because it is imposed in addition to the regular sales tax.

B. British Land, Inc. (Maryland) v. Tax Appeals Tribunal, 85 N.Y.2d 139, 623 N.Y.S.2d 772 (1995).

1. Facts.

a. The taxpayer was in the business of buying and operating commercial real estate.

b. In 1973 the taxpayer bought property in Maryland for $4.8 million.

c. In 1982 the taxpayer bought property in New York for $27.6 million. Before this, it owned no property in New York.

d. In 1984 the taxpayer sold the Maryland property and realized a gain of $13 million.

2. Holding.

a. No part of the gain is taxable by New York.

b. The application of the New York's statutory apportionment formula to the gain attributes income to New York "out of all appropriate

proportion to the business transacted in the state."

(1) The gain attributed to New York was 2200% of the net income of the taxpayer's New York operations based on a separate geographical accounting analysis.

(2) The factors that contributed to the gain (appreciation of the value of the Maryland property, renovations, etc.) occurred before the taxpayer did business in New York.

III. Cases involving discrimination against interstate commerce.

A. Tug Buster Bouchard Corporation v. Wetzler, 1994 N.Y. Misc. LEXIS 474 (1994).

1. Facts.

a. The taxpayer provides barge and towing services at various ports on the east coast.

b. The taxpayer buys diesel fuel from suppliers in New Jersey and other states.

2. The tax.

a. The petroleum business tax is imposed on the use within New York of fuel bought outside the State.

b. No sales tax is imposed on taxpayers that buy and consume fuel in New York.

3. Holding.

a. The petroleum business tax facially discriminates against interstate commerce and violates the Commerce Clause.

b. Fuel purchased outside the State and used within the State is taxed one more time than is fuel purchased and used within the State.

c. Applying the internal consistency test, multiple taxation would result if other states imposed the same tax (?).

d. It is "unproven" that an in-State distributor that has already paid the use tax will pass it on to the final in-State consumer.

B. American Telephone and Telegraph Company v. New York State Department of Taxation and Finance, 84 N.Y.2d 31, 614 N.Y.S.2d 366 (1994).

1. Facts.

a. The taxpayer was required to pay access fees to local telephone companies for using their facilities for long-distance calls.

b. The taxpayer charged its customers for the access fee and paid it over to the local telephone companies.

2. The tax.

a. Tax Law § 186-a imposes a tax on the gross receipts of long-distance telephone carriers.

b. Companies that cannot separately account for New York income must apportion to New York a percentage of their worldwide income based on the percentage of their property that is located in New York.

c. The access fee deduction relating to services performed in New York must be allocated against interstate and international income before apportionment.

3. Holding.

a. The requirement that the access fee be deducted before apportionment, with the result that it is deductible only to the extent of the taxpayer's New York apportionment percentage, discriminates against interstate commerce.

b. An intrastate company would be able to deduct the entire access fee.

c. The application of the apportionment formula to an access fee that has already been determined to be allocable to New York results in a disallowance of part of a deduction that is entirely related to New

York income. Intrastate carriers can deduct the fee in full.

4. The defect in the statute was later cured by legislation.

NEW YORK RESIDENCY AUDITS:
FLORIDA AND NEW YORK ISSUES

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ALLOCATION OF INCOME BY NONRESIDENTS: NEW YORK'S 1995 AUDIT GUIDELINES

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On March 7, 1995 New York finalized a new set of audit guidelines, adding 63 single-spaced pages to the already lengthy Income Tax Field Audit Manual. The guidelines note that

> Income allocation audits based upon the source rules have long been an established program of not only the desk audit operation but also the field program of the New York State Department of Taxation and Finance.

The new guidelines are designed to explain the tax law and regulations concerning income allocation, discuss audit policies and procedures regarding these issues, and provide numerous examples, explanations and case summaries. This article summarizes the newly issued guidelines.

Nonresidents Are Subject to Allocation. In February of 1993 and May of 1994 the Division of Taxation published extensive guidelines discussing the tests that should be applied in determining whether someone is a New York resident (either a domiciliary or a statutory resident). The 1993 and 1994 rules are described and discussed in great detail in various books, articles, bar association reports, and other publications.[1] If an auditor determines that an individual is not a New York resident, questions still remain regarding allocation of the individual's income. The 1995 Nonresident Allocation Guidelines note that an individual may live in one area but work or derive income from another taxing jurisdiction. New York's tax law requires payment of New York taxes whenever a nonresident derives income from New York sources.

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[1] See Paul R. Comeau and Mark S. Klein, *The New York Residency Audit Handbook* (1995-96 Edition) (Guaranty Press, 1995); Paul R. Comeau and Mark S. Klein, *Understanding New York's Nonresident Income Allocation Rules* (1995-96 Edition) (Guaranty Press, 1995); Paul R. Comeau, et al, *Audits of Nonresidents: New York's 1993 Technical and Procedural Guidelines*, Winter 1992 *J State Taxn* 32; Paul R. Comeau et al, *New York Residency Audit Guidelines Seek to Encourage Ties to State*, July/August 1993 *J Multistate Taxn 117*; New York State Bar Association Tax Section, Committee on New York State Tax Matters, *Audit Guidelines and Regulations Governing New York State Residency Audits: Report and Suggestions for Change*, December 29, 1992, reprinted in *State Tax Notes*, January, 1993; New York State Bar Association Tax Section, Committee on New York State Tax Matters, *February 17, 1993 Residency Audit Guidelines: Practical and Suggested Changes*, December 13, 1993.

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New York Source Income. In general, New York source income consists of that portion of Federal adjusted gross income derived from New York sources. This includes income, gains, losses, and deductions attributable to the ownership of real or tangible personal property in the State, or a trade or business carried on in the State. Income from intangibles (such as income from a sale of stock or interest received on a promissory note) is income from New York sources only to the extent that the intangible property is employed in a trade or business in New York State. If a business or occupation is conducted partly in and partly out of New York State, income from the activity is allocated to New York based on Tax Department regulations.

Applicable regulations deal with two key issues: (i) whether a trade, business, occupation or profession is carried on within and without New York for purposes of the statute, and (ii) if so, what portion of the income is attributed to New York. A business is carried on within New York by a nonresident when the nonresident has a place where his or her affairs are systematically and regularly carried on, even though isolated transactions may take place outside New York. The regulations are designed to capture a wide-range of activities "conducted in New York State with a fair measure of permanency and continuity." Tax Reg. § 132.4(a)(2). If the individual is an employee, New York source income includes compensation received "to the extent that [the] services were rendered within New York State." Compensation for personal services performed by a nonresident totally outside New York State are not included in New York source income, even if payment is made from a point in New York. Tax Reg. § 132.4.

Professional Services. When a nonresident conducts a profession in New York State but performs some services at home in another state, New York asks whether the individual can lawfully hold himself out as practicing in the other state. For example, if an attorney is licensed only in New York State but claims that services were performed at his home in New Jersey, New York may not allow an allocation. This result seems incorrect. For example, assume that an accountant or attorney with offices in New York services clients in New Jersey or Connecticut and lives in New Jersey or Connecticut. Will New York argue that 100% of the professional services income is taxable by New York, even if the person spends a significant percentage of time servicing clients located outside the state? In this author's opinion, this would be a questionable and overly aggressive interpretation.

Allocation. If an individual carries on a business or profession both in and out of New York, items of income are usually allocated according to the books and records of the business, but if the books and records do not adequately allocate the income, a three-factor apportionment formula may be used. If an individual is an employee, income is usually allocated based upon days worked in and out of New York State. However, in determining days worked out of New York State, the employee must show that the services were performed outside New York because of employer necessity, rather than employee convenience.

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If New York determines that services were performed in New York State or compensation constitutes income from New York sources, income will be allocated based upon factors for the year when the services were performed, even if the income is received in a later year or the income is paid to someone other than the individual who performs the services. Deferred compensation is treated as personal services income and is taxable to the extent that the prior services were performed in New York State. For purposes of these rules, the term "compensation" includes not only wages but also amounts attributable to terminations of employment, covenants not to compete, and consulting agreements. Interest on deferred payments is treated the same as the earnings themselves. Payments for a covenant not to compete are treated as New York source income to the extent that the business was carried on in New York. Interestingly, the guidelines state that covenant payments received by the seller of a business should be allocated based upon a fraction with New York business income for the current year and the three preceding years as the numerator and total business income as the denominator.

Detailed rules describe the allocation of earnings by nonresident employees and officers. Generally, allocation is based on days worked in and out of New York. Since the allocation is based on working days, non-working days must be identified and eliminated from both the numerator and the denominator. The guidelines tell auditors that a

> careful analysis of all days, both work days and non-working days should be made when confronted with an allocation issue. As you can see, a change in the denominator, by a reclassification of working day to a non-working day, can have a similar effect as the identification of additional days worked in New York.

Work Day Defined. The guidelines also point out that an individual need not work the whole day for the day to constitute a working day. A single, two-minute phone call may not be enough, but a series of two-minute phone calls might suffice. In making a determination, the auditor should apply the same standards to non-New York days as to New York days. What are some of the standards? The travel days required by the employer should be treated as working days, even if these days fall on a Saturday, Sunday or other normal non-working day. Days worked at home for the employee's own convenience should be treated as New York State work days. The guidelines note that "days worked at home generally cannot be used as a proper basis for the allocation of income by a nonresident." The only exception applies when the employer requires performance of the services out of state and the duties, by their very nature, cannot be performed in New York State. This portion of the guidelines, like the cases cited in the guidelines, is, in this author's opinion, rather questionable: "[S]ince a New York resident would not be entitled to a special tax benefit for work done at home, neither should a nonresident." This interpretation may be unconstitutional, since it sources income to New York State even though the state where the services were performed could clearly treat the services as sourced to that state. Furthermore, if a nonresident regularly employed outside New

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York State performed services in New York State at a vacation home, would New York source the services to the other state? Would New York seek taxes on this income? The guidelines are silent on this question. The guidelines provide an example in which a nonresident spends 10 days working at home outside New York state, and notes that "a further change in the allocation would be required" to convert the days from out of New York to New York work days.

Use of Diaries. Individuals who maintain living quarters in New York may keep a diary or daily calendar as evidence of days spent in and out of New York. Interestingly, the nonresident audit guidelines also seem to suggest that all nonresidents who spend any time working in New York should also keep a diary, and should have this diary available for examination by auditors. The guidelines explain that "if the individual indicates in a diary or calendar that he or she was on vacation for a period of time, and this is verified by the employer, a day without documentation in the middle of the period should not be considered a work day or a New York day without specific evidence to that "effect." In fact, the guidelines suggest that a nonresident, even one working primarily outside New York, has the burden to prove that he or she did not work in New York during any portion of each day under audit. Absent clear and convincing documentation, an auditor might recharacterize claimed vacation days, sick days, or out-of-state work days as New York work days. The problem is further compounded by the "convenience" rule, under which a few phone calls to the office from a vacation resort might convert an out-of-state vacation day to a New York work day. Hopefully, auditors will exercise "good judgment" in this area, as suggested by the guidelines, and will not turn these audits into excessively, burdensome, microscopic examinations of day-by-day and minute-by-minute activity, questioning whether the person was in or out of New York, whether the person can prove that he or she was out of New York, whether the person was working on a given day, and questioning or speculating whether work performed out-of-state on a given day was performed there because of "necessity" rather than convenience or was attributable to a fixed place of business or office outside the state, with equally complex questions arising concerning deferred compensation, bonuses, income from intangibles and numerous other items.

Special Categories. The guidelines note that there are special rules for military pay and compensation received by employees of interstate carriers. It is interesting to note that income from interstate rail carriers and motor carriers will be treated as income from sources within the employee's state of residence, while compensation of employees of interstate air carriers may be allocated to New York if the nonresident earns more than 50% of the compensation in New York State. The 50% test is based upon a comparison of the employee's total scheduled flight time in New York compared to scheduled flight time everywhere. This interpretation applies to compensation paid on or after July 6, 1990.

Convenience v. Necessity. When is "homework" required rather than merely convenient? The guidelines contain several examples of "convenience" days, days not eligible for an out-of-state allocation. If the employee writes reports at home, has physical problems which prevent going to the office, or resides in Florida and manages his New York business

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from his Florida home, all these days could be treated as New York days. What if illness forced the move to Florida, where the taxpayer continued to work for a New York City law firm? This would be a "convenience" rather than an employer-mandated necessity. What if a baseball manager worked at home during the off-season? These days would be treated as merely "convenient", and would be treated as New York work days. Each of these examples is based upon a decided case, though most are Tax Commission decisions from the 1980s.[2] What if the employer maintains offices both in and out of New York? For example, what if a physician has offices in both New York and Connecticut, and actually sees patients at both locations? In this example, the services would be treated as out-of-state services because they are performed in an actual physical work site rather than merely at the stereotypical home office. Bringing a briefcase home from the office will not suffice, but visiting customers or working out of an employer's out-of-state office would qualify.

Mid-year Employment Changes. Various situations may arise where an individual changes employment during the year, either shifting from work in one state to work in two states or moving from one employer to another. In these situations, separate allocations may be necessary, and the year may be broken into two or more parts with separate allocations for each portion. In other situations, an employee may work for more than one employer simultaneously, possibly working full time for Company A while serving on the board of directors of Company B. In these situations it is appropriate to determine whether the work performed for one company is related to work performed for the other company in order to select either a separate or combined allocation. In some situations, for example, an employee can allocate based on fractions of days worked.

What if the allocation methods produce inequitable results in a given situation? Tax Reg. § 132.24 states that

> A nonresident individual may submit an alternative method of apportionment and allocation with respect to items of income...attributable to a business...or occupation carried on partly in and partly without New York State.

In some situations, for example, an employee can allocate based on fractions of days worked. The taxpayer must fully document the allocation and explain why it is appropriate. This approach may permit an allocation based upon hours worked in and out of New York rather than days worked.

[2] At that time, the Tax Commission both ran the Division of Taxation (including issuance of regulations and audit policy), and adjudicated disputes between the Division and taxpayers. The author wonders whether the Division of Tax Appeals (an independent body formed in 1987) would reach the same conclusion in these cases.

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Bonuses. Generally, bonuses for services performed in a particular year should be allocated on the same basis as salary for that year.

Pensions. Special rules are provided for pensions or retirement benefits. The detailed discussion of pension and other retirement benefits is "one of the more difficult and confusing areas" of the Guidelines. It is apparent that significant study and revisions will be required. Auditors are told to "carefully examine" any return containing a wage statement from a New York employer which shows no withholding or no New York services. The wage statement may signify receipt of pensions or other retirement benefits, and all or part of the payment may be taxable. Up to $20,000 per year of pension income is excluded for both residents and nonresidents, and Federal and State pensions are also excluded. In addition, a nonresident may exclude any pension or retirement benefit which constitutes an "annuity". For this purpose, an annuity is defined in Tax Reg. § 132.4(d) as a retirement benefit paid pursuant to a written employer plan or agreement, that is payable at least annually, in cash, as a constant rate, for a period that equals or exceeds one-half of the recipient's life expectancy.

Termination Pay. Termination pay attributable to past services is allocable in the same manner as compensation for the past services. On the other hand, payments for buying out an employee's future contact rights are treated as income from the sale of an intangible rather than New York source income. This determination is based on the McSpadden case.

Generally, when termination pay is allocated, the regulations and the guidelines indicate that the allocation should be based upon the year of termination and the three immediately preceding tax years. See generally Tax Reg. § 132.20. If the individual wishes to use a longer period of time, the individual must submit an alternative approach, supported with appropriate back-up documentation showing allocations for earlier years. The guidelines note that

> The Department cannot use a longer period of time than that specified in the regulations. Only the taxpayer may elect to use a longer period.

Guidelines § 313.6J

Deferred Compensation - Stock Options. With respect to stock options, the guidelines provide a rule based upon an interpretation of the Michaelson case. 67 NY2d 579. According to the guidelines, the difference between the exercise price and the option price is compensation, and this compensation should be allocated based upon days worked in and out of New York from the date of grant to the date of exercise. This author's reading of the Michaelson case indicates that it does not support this conclusion. Three precedential Tax Commission decisions seem to reach a contrary conclusion: it appears that the only precedential cases on this subject allocated stock option income based upon allocation factors in the year of

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receipt. The interpretation in the guidelines is not found in any regulation, and a question arises as to whether the interpretation in the guidelines exceeds the authority contained in Tax Law § 631(c), which gives the Commissioner the authority to establish regulations for the apportionment and allocation of income when a business, trade, profession or occupation is carried on partly within and partly without New York State.

Inconsistent Allocation Rules. The allocation rules for pensions, termination pay, covenants not to compete, deferred compensation and current income are most confusing. For example, deferred compensation is generally allocated based upon allocation factors for the year the income was earned, not the year of receipt. Yet in the termination and pension area, the Guidelines state that a four-year allocation should be used based upon the year of retirement or termination and the three immediately preceding years. The allocation is based upon New York compensation divided by total compensation over the four-year period. In the stock option area, the Guidelines state that the allocation is based upon entire period between the dates stock options are granted and the date they are exercised, and the allocation is based upon days worked within and without the state during this period of time (not compensation received from New York sources compared to total compensation). In the covenant not to compete, the allocation is based on the percentage of New York business (determined at the company not the employee level) compared to total business, using a four year allocation. Why do the guidelines use days worked in some cases and compensation in others? Why do they use a four year allocation for termination and covenant pay but a different period for option income? It is apparent that considerable work will be required to clean up the pension, annuity and deferred compensation portions of the Guidelines to correct errors and inconsistencies and provide a more useful explanation of applicable rules. The Guidelines, as they currently stand, are interesting but confusing, creating as many questions as they answer.

Director's fees are briefly discussed. The focus is on the location of the Board. Is this the same as corporate headquarters? Is it based on the location of board meetings? This is unclear. Generally, if services are performed as a member of a Board of Directors and the individual is also an employee of the corporation, days spent in connection with directorship duties would not be included in the fraction when allocating wages from employment. An exception exists if the employee is mandated to act a director by his or her employer. The "necessity" and "convenience" tests are also brought into the director's fees discussion in determining whether a day worked out of New York should be treated as an out-of-state work day.

Professional Athletes are the subject of an extensive discussion reflecting administrative changes which became effective January 1, 1995. Prior to that date, a nonresident professional athlete allocated salary to New York State on the basis of games played in New York compared to total games played, including pre-season and post-season games, but excluding practice days. Interestingly, the case summaries included in the guidelines include a "games played" allocation case, possibly for use in audits of pre-1995 years. Under the new rule, which was adopted by Regulations on October 17, 1994, the "duty day" concept is

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employed, focusing on any day when the individual performs duties for the team. Practices, meetings and other days are included in this calculation. Generally, the new rules are far more generous than the old. One puzzling example states that if an athlete attends an all-star game in New York State as a spectator, the days spent in New York for such game will not be treated as duty days spent in New York, but will be included in total duty days (the denominator of the fraction) for purposes of determining the portion of overall compensation taxable by New York. This result is partially compelled by the definition of a "duty day", as all days from the beginning of the professional team's pre-season through the last game in which the team competes or is scheduled to compete. It is interesting that an all-star game (one in which the "team" is not participating) would be included in the example, even though the team as such does not compete and the individual player mentioned in the example does not even participate other than as a spectator. In general, it appears that the new rules for professional athletes will have the most severe negative impact on nonresidents who are members of New York-based sports teams.

Under certain circumstances, the term "duty days" also includes days when services are performed for the team outside the official season. Special rules cover travel days, disability days, and other situations. For purposes of these rules, the term "member of a professional athletic team" includes not only players but also any other persons required to travel and perform services on a regular basis, such as coaches, managers and trainers. Compensation subject to allocation includes all salaries and bonuses but does not include strike benefits, severance pay, termination pay or certain other payments. Presumably, these forms of compensation are taxable under the general rules, not the special rules for professional athletes. Endorsement income is sourced entirely to New York if the income is received from a New York manufacturing company. This rule seems unusually harsh and inappropriate. The guidelines are silent on the opposite situation: endorsement income paid by a non-New York manufacturer. Presumably, in the interest of balance and fairness, the Tax Department would not tax any of this income if the recipient is a nonresident and the income is paid by an out-of-state company.

The Division of Taxation is currently drafting regulations to permit nonresident members of sports teams to file through use of a group nonresident tax return. The team would seek permission to file in this manner, but members who file this way could inadvertently waive certain rights, and there are other consequences as well. Readers should monitor developments in this area.

Royalties. What about royalties? Occasionally, entertainers or others receive income labelled "royalties". Normally, one would think that royalties are attributable to intangibles and are not sourced to New York unless the intangibles are used in a New York business. However, puzzling case law in New York State indicates that royalties may constitute compensation for New York services and may be taxable under certain circumstances. The key issue is whether the taxpayer retains a proprietary interest in the intangible property, such as a copyright.

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Broadcast Transmissions. Income received by an athlete or entertainer from close circuit and cable television transmissions from events occurring in New York State are subject to special rules. The guidelines imply that if the transmission is a regularly scheduled event, all of the income might be taxed by New York, while if the income is not from a regularly scheduled event, the income is taxable only to the extent that the transmissions are received in New York State. Presumably, this would require a population allocation based upon distribution of the transmission. However, this point is unclear.

Securities and Commodities Brokers. Special rules are provided for securities and commodities brokers doing business both within and outside New York. They are allowed to allocate income based on books and records. Commissions derived from purchase or sales orders are allocated under special rules. For example, if an order is received at a New York State place of business for execution on an exchange located within New York State and originates at the established office of the broker in New York State, 100% of the commission is allocated to New York. If the same transaction originates at an office of the broker outside New York State, 20% of the commission is allocable to New York. If the order originates in New York but is transmitted outside New York for execution, 80% of the commission is allocated to New York. The guidelines permit an alternative approach under certain circumstances if the "Tax Commission" approves. Use of this language is, of course, an error, since the "Tax Commission", as such, was abolished effective September 1, 1987. It appears that the guidelines should refer to either the Division of Taxation or the New York State Tax Commissioner.

Property Income. As previously noted, New York source income also includes income from real or tangible personal property located in New York. Consequently, if New York property is rented or sold, the income is taxable. If property is sold on a deferred payment basis, interest payments are not normally treated as New York source income. This contrasts with the treatment of interest earned on deferred compensation such as pensions. In the case of deferred compensation, the guidelines seem to treat the interest as additional compensation, not as interest derived from intangibles. Case law in New York raises a question concerning whether this interpretation is correct, or whether the original deposit in a deferred compensation account should be differentiated from the subsequent earnings on the account.

Losses and Other Deductions. The guidelines discuss operating losses, capital losses, the nonresident alimony deduction, nonresident standard or itemized deductions, nonresident partner deductions, and so forth.

New York City and Yonkers Allocation Issues. Interestingly, the New York State guidelines contain rules applicable to New York City allocations. Wages and net earnings from self-employment are taxable under the New York City and Yonkers tax provisions to the extent attributable to New York City or Yonkers. If a nonresident receives deferred compensation such as a pension or IRA distribution, allocation rules are used to determine the portion taxable by New York City. The rules are the same as those applied by New York

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State. Thus, with respect to a particular item of income, a nonresident might have a New York City allocation based upon days worked or compensation received for services in New York City and a separate allocation and, perhaps, different percentage based on days worked or compensation received in New York State compared to total services or compensation. For example, a nonresident with a 60% New York State allocation might have only a 10% New York City allocation because of services performed in the State but outside New York City.

Audit History and Follow-Up Audits. In the residency area, a favorable domicile determination in a particular audit usually applies in subsequent audits as well. What about a favorable allocation audit? Unfortunately, the guidelines state that each year stands on its own, and the auditor should not be unduly influenced by prior audit results because patterns in one year may have little bearing on subsequent years. Auditors are expected to exercise "good judgment" if it becomes apparent that a consistent pattern exists. In this way, hopefully, the audit burden will be reduced.

Conclusion. The new guidelines are very complex and, at times, confusing. Many of the interpretations are derived from the regulations and cases, but others appear to be newly-created, crafted to address issues which are surfacing in audits. Guidelines are an excellent tool for communicating information, but should not be used to develop or expand the scope of the law. As auditors and practitioners work with the guidelines, it is anticipated that many questions will arise, resulting in revisions.

New York's Residency Audit Guidelines were first published in February, 1993 and were extensively revised in May of 1994. Similarly, it is expected that the Tax Department will be reviewing and revising the 1995 Allocation Guidelines, balancing revenue needs against taxpayer concerns, and adding greater guidance and clarity in a very difficult area.

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NEW YORK STATE RESIDENCY UPDATE: 1994 DEVELOPMENTS*

By Paul R. Comeau**

Introduction

In 1989, the New York State Department of Taxation and Finance began a new audit program aimed at nonresidents. Since that time, the State has conducted more than 15,000 of these personal income tax audits, assessing well over $750 million. This article traces the history of the audit program, focusing on recent developments.

In October of 1993, I participated in a residency panel discussion as part of the Trusts and Estates Law Section's Fall meeting in Naples, Florida. We focused on the Tax Department's February, 1993 guidelines. Several important developments have occurred since that time:

- the Tax Section of the New York State Bar Association issued a lengthy report on December 13, 1993, listing practitioner comments and suggesting extensive administrative changes in this area[1];
- the Estates and Trust Section established a new committee to collect comments from practitioners and to consider the need for additional changes;
- the Third Department affirmed two "borderline" cases, sustaining the assessments in the *Kartiganer*[2] and *Kornblum*[3] cases;
- the Third Department also affirmed the *Evans*[4] case concerning "maintenance of a permanent place of abode";
- numerous Tribunal decisions were issued, including the important and favorable *Avildsen*[5] and *Burke*[6] decisions;
- the Division of Taxation replaced its February, 1993 residency audit guidelines with a new version dated May, 1994[7];
- in July, 1994, the Governor signed a new law clarifying the domicile definition[8]; and
- the Legislature and Tax Department established an amnesty program for nonfiling nonresidents. This program is effective September 1 through November 30, 1994.

This article discusses these important developments.

New York's Statute and Regulations

New York taxes residents on all income from all sources, but only taxes nonresidents on New York source income. For income tax purposes, the term "resident" includes both domiciliaries and statutory residents. Domicile refers to a person's permanent, primary home, the place he or she returns to, the place where a person's life is centered. Once established, domicile is presumed to continue until the person asserting a change shows, with clear and convincing evidence, that he or she has abandoned the old and established a new domicile. The move requires both intent and actual relocation. Statutory residence, by contrast, is a more mechanical concept, applicable to individuals who are domiciled outside New York, but who maintain a permanent place of abode in the State and spend more than 183 days in New York during the calendar year.

The Problem

Although these basic rules and definitions seem clear and unambiguous, considerable confusion has arisen in various instances. With respect to domicile, what are the tests to determine status? If a person asserts a change, how can he or she prove the change in a "clear and convincing" manner? Will the retention of a New York house or business prevent a change? In the statutory residency area, questions arose concerning the definition of a permanent place of abode and the definition of a "day." For example, is a day a night? A majority of a day? Any part of a day? Does the term "day" include in-patient hospital days or other involuntary days, such as a day in a New York prison? How should a person prove that he or she was **not** in New York for any portion of a day? Who has the burden of proof and what level of proof is required? If a person files as a resident of Connecticut or New Jersey but is treated as a New York resident by State auditors, will Connecticut or New Jersey accept this decision and provide refunds?

Economic Impact and Need for Guidance

In 1989, when New York began its current initiative in this area, it developed a program aimed at identifying and curbing abuses. Some taxpayers who really lived and worked in New York were claiming nonresident status, merely because they had a post office box or other minimal tie with another state. New York properly used its audit program to tax these people and publicize its intent to police the area.

Unfortunately, as the State performed thousands of audits, uneven audit treatment developed from office to office, or from auditor to auditor. Some auditors began to develop very harsh requirements, suggesting that retention of a New York house or even a bank account could result in reclassification as a resident. Practitioners, fearing criticism from uneducated clients caught in the audit web, began advising their clients to sever all New York ties, move businesses out of New York, spend minimal time and

(Continued on Page 8)

(Continued from Page 7)

money in the State and withdraw from all New York organizations.

Tax Section's 1992 Report

Amazingly, between 1989 and 1992, the Division of Taxation performed about 10,000 audits, all without the benefit of uniform audit guidelines. In December, 1992, the Tax Section of the NYSBA issued a lengthy report calling for the adoption of comprehensive residency audit guidelines.[9]

February 13, 1993 Guidelines

The Division of Taxation issued detailed guidelines in February, 1993 and made the new rules available to practitioners and taxpayers. The new rules, which were discussed and reviewed extensively at the Estates and Trust Section's October, 1993 meeting in Naples, Florida, were designed to strike a balance between the State's right to audit and taxpayer rights and concerns. In the domicile area, the guidelines listed six primary, seven secondary and six tertiary factors for auditor consideration. Statutory residence was also defined and discussed.[10]

Tax Section's 1993 Report

Although the guidelines were helpful, practitioners remained alarmed about the scope of the guidelines and individual auditor interpretations. Extensive practitioner comments were collected and transmitted to the Division of Taxation in a lengthy report issued by the NYSBA Tax Section in December, 1993.[11]

May 9, 1994 Guidelines

Many of the concerns were addressed in revised guidelines issued in May, 1994. The list of 20 primary, secondary and tertiary domicile factors was reduced to 14 and divided into two categories: five primary factors and nine other factors. The 1993 Guidelines had listed membership in clubs or organizations as one of the primary factors, but the 1994 Guidelines removed this from the primary list and placed it on the list of other factors. The new guidelines redefined some of the primary factors, especially the "home" factor. Under the new rules, the concept is not limited to a structure. It may also include the community to which the individual has established strong and endearing ties. Thus, the sale of the traditional family home and purchase or rental of other living quarters in the same community may signify a continuance of domicile in the area, although the purchase or retention of housing will not, by itself, prevent a change of domicile. If a person has multiple residences, the auditor should compare the size, value, history, use patterns, domestic help and so forth at the various locations to determine which location is the principal home. The same type of balancing should occur for each of the four remaining primary factors: active business involvement; time spent in each location (including overall living patterns and changes in pattern); near and dear items (*i.e.*, location of rare books, art, antiques, family photos, etc.); and family connections. Auditors are asked to prepare "T" accounts to balance each New York and non-New York factor in an attempt to determine, in an open-minded fashion, the primary domicile. They should "never trivialize steps taken in the new location. . . while magnifying the importance of the remaining New York connections."

> A lack of balance would create a heavy burden of proof for taxpayers, one which they feel they may not be able to overcome simply with statements of intent, or the existence of certain ties in the new location. As a result, some individuals may be given the wrong advice that they can only accomplish the change with the severance of almost all ties to New York.[12]

What if the primary factors, on balance, point to a change of domicile? According to the guidelines, the auditor must then recognize the change and notify the taxpayer of the conclusion.

> If the evidence supports a change in domicile. . . then it is the auditor's responsibility to recognize the change. As a New York State auditor, you have accomplished your "mission" and established that the taxpayer has correctly filed his/her return as a nonresident.[13]

What if the issue remains unclear after a review of primary factors? In these instances, it is appropriate for the auditor to review the nine "other" factors": active involvement in organizations in and out of New York; addresses used on bills, etc.; the location of safe deposit boxes; the location of vehicle licenses and registrations; voting registration and voting patterns; the frequency and nature of use of legal, medical and other professional services in and out of New York; possession of a City parking tax exemption; telephone service; and citations in wills and other documents regarding the location of domicile.

The Guidelines state that only the primary and other factors listed above should be considered. Other items are nonfactors and are irrelevant. Practitioners presenting a case to a conciliation conferee or the Division of Tax Appeals should recognize, however, that the guidelines represent audit policy only; they are not the law. Conferees or courts might well consider and weigh differently so-called nonfactors such as the location of burial plots, the location of bank accounts or the beneficiary of political contributions.

July, 1994 Legislation

One of the nonfactors has gained new stature as the result of the legislative change enacted in July, 1994. Under

(Continued on Page 9)

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the new law, membership in or contributions of time or money to charities **cannot** be considered in determining domicile. Activities and time **can** be considered for day count purposes in a statutory residence determination, but cannot be used as an indication of domicile.[14]

Statutory Residence

The new guidelines do not significantly change the prior interpretations in the statutory residence area. A nondomiciliary with a permanent place of abode in New York will be treated as a statutory resident if he or she spends more than 183 full or part days in New York during the tax year. Part-year statutory residence cannot occur: a full year status determination is made. A "permanent" place of abode must be maintained for at least 11 months of the year or it is not permanent. Therefore, a person who acquires living quarters in March and who stays in New York for the balance of the year is not a statutory resident for that year. A cottage not suited for year round use is not a permanent place of abode, but a summer home with all the amenities of a year round house (cooking, heating, sleeping and bathing facilities) is a permanent place of abode, even if it is located in another part of the State and is only used for vacations.

If a parent pays the bills for a house used by adult children, the house may be the permanent place of abode of the children, not the parent

Once a place of abode is found, day count becomes an issue, and the taxpayer has the burden of proof. Part days in New York are "days" under this test, whether they are spent sleeping, working, vacationing or in other activities, and regardless of the portion of the day spent in the State. Certain in-patient medical days and travel days are excluded. The day count rules often prove to be one of the most burdensome aspects of these audits, since they entail an examination of diaries, calendars, credit card slips, phone bills and other business or personal records.

Recent Cases

The May, 1994 guidelines are a very important development, but recent cases by the Third Department and Tribunal are also helping to shape audits in this area.

Taxpayers who lose at the ALJ level on factual grounds can expect little relief from the Tribunal or Third Department. The Tribunal may overturn an ALJ decision when questions of law are involved, but if the taxpayer loses at the Tribunal level, further appeals may be futile, especially if the case hinges on burden of proof or factual questions. Tribunal decisions in the residency area have been uniformly sustained by the Third Department.

Evans, *Komblum* and *Kartiganer*, all Third Department cases, sustained Tribunal decisions. In *Evans,*[15] the taxpayer did not rent or own living quarters in New York City, but he worked in the City, regularly spent several nights per week staying with a friend, and he had followed this pattern for several years. He was not a City domiciliary, and the ALJ concluded that he was not a statutory resident because he did not own or rent living quarters in the City. The Tribunal reversed and the Third Department agreed with the Tribunal. He had a key, full access, kept clothing and other personal items there and had used the premises for several years. A formal lease or property right was not necessary.

In *Komblum* and *Kartiganer*, the taxpayers spent less than 184 days in New York each year, but the Tribunal and Third Department treated each taxpayer as a New York domiciliary. In *Kornblum*, the factors favoring New York domicile consisted of a retained house, furnishings, utility service, bank and investment accounts and visits to New York during the year. The Florida factors and the taxpayer's retirement and declarations favored Florida, but this was, in the Tribunal's view, a close enough case so that the evidence did not point to Florida in a clear and convincing fashion. In *Kartiganer*, the retention of ownership and control of a New York business prevented a domicile change. This factor, coupled with a New York checking account, driver's license and living quarters, justified the assessment, even though the taxpayers physically resided in Florida nearly nine months each year, owned a home, voted there, had Florida driver's licenses and filed Florida tax returns. Again, this was a close case. According to the Third Department:

> Indeed, while it might be said that the question presented here is a close one, that acknowledgment is the antithesis to the proposition that petitioners have established their Florida domiciliary by clear and convincing evidence.[16]

Against this dismal backdrop, two recent Tribunal decisions offer hope for battleweary taxpayers: *Burke* and *Avildsen*. In *Burke*, the taxpayers spent less than 184 days in New York, but the auditors treated them as domiciliaries. The ALJ and Tribunal both cancelled the assessment. At the Tribunal level, the Division of Taxation argued that family ties existed in New York, Mr. Burke was active in a New York business, and the taxpayers' lives remained focused in New York.

> The underlying tone of all the arguments. . .is that . . .petitioners maintained ties to New York which evince a clear lack of intent to change domicile. However. . .a taxpayer may change. . .domicile without severing all ties to New York State. . .and petitioners did so by moving their focus of home from New York to Florida. . . .[17]

The taxpayers had a house and business in New York and spent summer months in New York, but adequately explained these ties with credible testimony. A change of lifestyle occurred when the taxpayers retired, became passive in their business interests and moved to a stable Florida retirement community.

Avildsen was not a domiciliary of New York City, but

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was domiciled in Wainscott, New York. He was audited by the New York City Finance Department as part of its "Millionaire's Project '91." New York argued that he was a City domiciliary. During the audit, the taxpayer was asked to provide diaries, checks, credit card slips and other records. Much was produced, but several items, such as the diary, a list of doctors and receipts for nondeductible purchases, were not supplied because the taxpayer and his representative considered them irrelevant or personal. The ALJ agreed with the taxpayer on domicile, but concluded that he was a statutory resident because he had not carried his burden of proof on day count issues. His credible testimony was not backed up with documentation. The Tribunal reversed on the proof issue, finding that the credible testimony **was** sufficient to carry the burden of proof.

> [W]e find no support for the [ALJ's] conclusion that testimony alone was insufficient as a matter of law to prove that petitioner did not spend more than 183 days in New York.... Finally... we do not see the practical need for such a rule.

The Tribunal noted that taxpayers who rely on oral testimony will run a great risk because the trier of fact may find that the testimony is not credible. Testimony may be sufficient if the witness convinces the trier of fact that he or she was in a position to know the taxpayer's whereabouts each day, can accurately remember and is able to truthfully recount this information. In the *Avildsen* case, the testimony was credible and the taxpayer carried his burden of proof.

Amnesty

Recent legislation created a new amnesty program,[18] effective September 1 to November 30, 1994. The new program permits a waiver of penalties if a **nonfiling nonresident** who has not been contracted by the Tax Department comes forward, files returns and pays appropriate taxes. This provision will have very limited application in residency situations.

Prospects for the Future

Major changes in the residency audit guidelines are not expected, unless case law or statutory amendments compel modifications. New York is performing approximately 4,000 residency audits each year. There is no indication that this activity will subside in the near future. Consequently, individuals considering a move should familiarize themselves with the law in this area and take steps to shift contacts and activities from New York to the new home state, carefully documenting the steps taken and recording (with third-party verification) their day-to-day location.

Cross-border states such as Connecticut, New Jersey and Vermont are beginning to study New York's audits. Refunds from these states may become more difficult to obtain in the near future as these states, with "residency" definitions paralleling New York's, reach their own conclusions regarding an individual's true "tax home" and refuse to accept or follow New York's audit determinations.

New York's Legislature refined the domicile definition in July, 1994 by excluding certain charitable gifts and activities. The Legislature may be asked to review the entire residency area, and to legislate rules similar to those contained in the current audit guidelines. Similarly, regulations may be sought. Current audit guidelines do not have the force of a regulation or law, and need not be strictly followed by auditors. Furthermore, conciliation conferees are not bound by the guidelines and the Tax Department's own litigating attorneys, as well as ALJs and the Tribunal, need not follow the guidelines. This can result in case law which sustains assessments under circumstances where, under the guidelines, an assessment should not have been issued. Greater uniformity and balance may result if the law is overhauled or if, at a minimum, parts of the guidelines are formalized as regulations or statutory changes.

The New York City and New York State Bar Associations have recommended multistate cooperation to avoid double or triple taxes, at least among the cross border states, and we may see initiatives in the near future. The various states face both state and federal constitutional challenges if they attempt to enforce existing laws in a way that results in multiple taxation without offsetting credits. Our law firm and other practitioners are already raising these issues in New York cases, but we do not have a definitive answer at this time.

We will continue to see considerable activity in this area, and advise practitioners to follow administrative, legislative, Tribunal and Third Department cases closely in an attempt to provide the most timely and accurate advice to clients.

Endnotes

1. New York State Bar Association Tax Section, Committee on New York State Tax Matters, *February 17, 1993 Residency Audit Guidelines: Practical Experience and Suggested Changes*, December 13, 1993.
2. In the Matter of Kartiganer v. Koenig, 194 A.D.2d 879, 599 N.Y.S.2d 312 (3rd Dept. 1993).
3. In the Matter of Kornblum v. Tax Appeals Tribunal of New York State, 194 A.D.2d 882, 599 N.Y.S.2d 158 (3rd Dept. 1993).
4. In the Matter of Evans v. Tax Appeals Tribunal of New York State, 199 A.D.2d 840, 606 N.Y.S.2d 404 (3rd Dept. 1993).
5. Avildsen, 1994-1 NYTC T-461.
6. Burke, 1994-1 NYTC T-540.
7. These newly revised guidelines were promulgated May 9, 1994, and constitute Part 312 of New York's Income Tax District Audit manual.
8. Ch. 607 (A.B. 11668-C), Laws 1994.
9. New York State Bar Association Tax Section, Committee on New York State Tax Matters, "Audit Guidelines and Regulations Governing New York State Residency Audits: Report and Suggestions for Change," December 29, 1992, *reprinted in State Tax Notes*, January, 1993.
10. For a discussion of rules pertaining to the February, 1993 guidelines, see Paul R. Comeau and Mark S. Klein, *The New York Residency Audit Handbook* (1993-94 Edition) (Guaranty Press,

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(Continued from Page 10)

1993); Paul R. Comeau, et al., "Audits of Nonresidents: New York's 1993 Technical and Procedural Guidelines," *Journal of State Taxation*, Winter 1992 at 32; Paul R. Comeau, et al., "New York Residency Audit Guidelines Seek to Encourage Ties to State," *Journal of Multistate Taxation*, July/August 1993 at 117.
11. *Supra* note 1.
12. Guidelines § 312.4(E)(2).
13. Guidelines § 312.1.
14. *See supra* note 8.
15. *See supra* note 4.
16. *Kartiganer, supra* note 2, 599 N.Y.S.2d at 314.
17. 1994-1 NYTC at 554.
18. *See* TSB-M-94(6)C, (4)(I), (6)(M), (6)(S) (8/24/94).

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NEW YORK RESIDENCY AUDITS

Paul R. Comeau, Esq.
Hodgson, Russ, Andrews, Woods & Goodyear, LLP

1. New York State's Residency Audit Program

   -- Overview -- number of audits and results since 1989.

   -- New York wants to insure that you don't owe them any tax even after you think you have moved out.

2. The Rules.

   -- Statutory residence: permanent place of abode and over 183 days.

   -- Domicile: Is your heart still in New York?

   -- Allocation: New York wages, business income, rentals.

   -- Are you still a New Yorker? If not, do you have unreported, improperly accrued or improperly allocated New York source income? Special accrual rules for year of move. Extra scrutiny when a business is sold and avoidance of tax on a large capital gain is dependent upon your being a nonresident as of a particular date.

3. Audit Techniques.

   -- Nonresident tax returns disclose that you still have a New York house or apartment and spend time in New York State.

   -- New York sends a questionnaire.

   -- Follow up letter requests copies of federal returns, copies of checks, copies of credit card and other receipts, utility and phone bills and other information.

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4. You Have the Burden of Proof in New York Cases.

   -- Proof that you do not maintain a "permanent place of abode" in New York and have one elsewhere.

   -- Proof that you permanently moved your heart out of New York. Must abandon old and establish new.

   -- Proof that you spent less than 184 days in New York. What is a day? "Reasonableness" of audit guidelines, Moed.

5. Factors or Tests Used by New York State -- Have you moved your heart? Is the new location really "home"? What happened on the day you left New York? Physical move? Lifestyle event? The domicile tests under New York's new (May 1994) nonresident audit guidelines:

   -- "Big Five" Primary Factors: no single factor is determinative; each should be analyzed and weighed; what patterns do factors show?

      1. Historical Home. Compare use and maintenance, size and value. Applies to geographic area, not just actual residence. Review tax consistency rules.

      2. Business connections. Active business involvement even if from outside of New York. Review compensation and passive activity loss rules.

      3. Items "near and dear" to the taxpayer. The "Teddy Bear" rule. Special scrutiny on moving company.

      4. Where do taxpayers spend their time? Any place in New York State?

      5. Family connections. Based on Buzzard decision.

   -- Other Factors: to be reviewed only if primary factors favor New York domicile or factors for New York and other state are equal.

      -- Active involvement in community, religious, civic or service clubs, fraternal orders, charities (but new law says can't look at volunteer services for charity).

      -- Addresses used on bank statements, vendor bills, financial data and family business correspondence.

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-- Location of safe deposit boxes.

-- Location of boat, auto and airplane registrations.

-- Driver's licenses.

-- Voter registration and voting pattern.

-- Frequency and nature of use of New York lawyers, doctors, brokers.

-- Special resident exemptions, benefits.

-- Phone services, listings, service features, and activity.

-- Recitation of domicile in wills and legal documents.

-- Non-Factors: Any factors not listed as primary or "other" are irrelevant, especially charitable contributions and religious memberships. See Chapter 607, Laws of 1994.

6. Other Tests of Domicile -- Florida Example. Intent plus actual residence in Florida. Acts, declarations and facts weighed. Presumption exists if the person qualifies for the homestead exemption or voting rights or declares Florida domicile. Other factors include ownership of a Florida residence, having Florida licenses and using a Florida address on federal tax returns. Day count is irrelevant.

7. Proving Compliance With the New York 184 Day Test -- records required. Impact of Avildsen and Hull.

8. Proving That Income Is Not From New York Sources -- convenience test. Retirement benefit rules.

9. May 1995 Nonresident Allocation Guidelines.

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STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :

of :

PAUL A. AND ELLEN E. BURKE : DECISION
DTA No. 810631

for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1987, 1988 and 1989. :

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on August 5, 1993 with respect to the petition of Paul A. and Ellen E. Burke, 3322 Casseekey Island Road, Jupiter, Florida 33458. Petitioners appeared by Damon and Morey, Esqs. (Gary M. Kanaley, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Gary Palmer, Esq., of counsel).

The Division of Taxation filed a brief on exception. Petitioners filed a brief in opposition to the exception. The Division of Taxation filed a letter as its reply brief, which was received on December 21, 1993 and began the six-month period of the issuance of this decision. Oral argument was not requested.

The Tax Appeals Tribunal renders the following decision per curiam.

Issue

Whether petitioners were properly subject to tax as residents of the State of New York pursuant to Tax Law § 605(b)(1)(A) for any or all of the years 1987, 1988 and 1989.

Findings of Fact

We find the facts as determined by the Administrative Law Judge except for findings of fact "16" and "18" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

Petitioners, Paul A. and Ellen E. Burke, husband and wife, timely filed (pursuant to extensions granted) New York State nonresident income tax returns (Forms IT-203) for each of the years 1987, 1988 and 1989. On each of such returns petitioners listed their address as 3322 Casseekey Island Road, Jupiter, Florida, and chose filing status "2" ("Married Filing Joint Return"). Attached to petitioners' returns were Wage and Tax Statements (Form W-2) issued by Burke Rental Corporation, 1705 Third Avenue, Niagara

Falls, New York. Such Forms W-2, issued to Paul A. Burke for each of the years at issue and to Ellen E. Burke for the years 1987 and 1988, carry petitioners' address as 471 Mountain View Drive, Lewiston, New York.

On March 11, 1991, the Division of Taxation ("Division") issued to petitioners a Notice of Deficiency asserting additional personal income tax due for the years 1987, 1988 and 1989 in the aggregate amount of $49,435.47, plus interest. As shown via explanatory computational sheets attached to the Notice of Deficiency and via a Statement of Personal Income Tax Audit Changes issued previously to petitioners on November 9, 1990, the Division's Notice of Deficiency followed an audit of petitioners' returns, and was issued upon the premise that petitioners were properly taxable as residents of New York State for the years in question.[1]

Petitioner Paul A. Burke was born in Buffalo, New York on August 17, 1927. He and his family moved to Ohio shortly thereafter, where he was raised and educated. Mr. Burke served in the armed forces, after which he returned to Ohio. Mr. Burke and petitioner Ellen E. Burke were married in Ohio in 1947. Presumably, Mrs. Burke was born and raised in Ohio. They subsequently moved to Buffalo, New York in 1948.

Upon moving to Buffalo, New York, Paul A. Burke went into business with a local real estate broker and began to do some construction work in the western New York area. Paul Burke Construction, Inc., formed in the early 1950's and owned entirely by petitioner Paul A. Burke, was engaged in the construction of residential housing (primarily VA and FHA financed housing), and also performed a modest amount of commercial warehouse construction. This construction activity required Mr. Burke's hands on, day-to-day management and involvement. In this regard, Mr. Burke testified that "without my presence there, there wasn't any construction company." During these early years, Ellen E. Burke performed all of the construction business's accounting, bookkeeping and mortgage placement functions. Petitioners described the construction business as entailing long hours of work (generally 7:00 A.M. to 7:00 P.M.).

In the early 1960's, petitioners purchased a home located at 6654 Errick Road, North Tonawanda, New York. This property included a large house (approximately 5,000 square feet) together with approximately 17 acres of land on which were located several buildings suitable for housing Paul Burke Construction, Inc.'s heavy equipment and building supplies and materials. The property also included a nine-hole golf course. The Burkes also purchased a duplex rental house located immediately adjacent to the property.

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[1]It appears that dollar amounts are not in dispute in this proceeding. That is, if petitioners are held to be taxable as residents of New York, the Notice of Deficiency correctly reflects their New York tax liability and if, conversely, petitioners are not so taxable, their nonresident returns as filed correctly reflected their New York tax liability.

The construction operation continued to expand, building upwards of 100 or more houses per year, until approximately 1977 or 1978. At that point, Mr. Burke began the transition from building houses to developing low-income housing for the elderly.

In connection with the transition from house construction to development of high-rise senior citizen housing, petitioner Paul A. Burke formed Burke Rental Corporation to facilitate the management of various rental real estate properties acquired by petitioners, including duplexes, single-family and apartment houses, as well as the high-rise senior citizen housing that Paul Burke Construction, Inc. was in the midst of developing. Burke Rental Corporation was owned equally by petitioners Paul A. and Ellen E. Burke. The business address of both Paul Burke Construction, Inc. and Burke Rental Corporation was, and continues to be, 1705 Third Avenue, Niagara Falls, New York.

By the late 1970's and early 1980's, the Burkes had acquired ownership of approximately 30 rental properties. In addition, Paul A. Burke had acquired, developed and owned, together in partnership with one William Sanders of Atlanta, Georgia, four high-rise senior citizen apartment buildings as follows:

Property Name	Location	No. of Apartment Units
Urban Park Towers Co.	Buffalo, N.Y.	150 units
Niagara Towers Co.	Niagara Falls, N.Y.	200 units
Tonawanda Towers Co.	Tonawanda, N.Y.	100 units
Riverview Apartments Co.	Elmira, N.Y.	128 units

Mr. Burke also owned, in partnership with one John Gross, a 278-unit mobile home park known as Sabre Park, located in western New York. It appears the Burkes sold the 30 rental properties prior to the years at issue herein. The high-rise properties were described as "section 8" (Federal Housing Assistance Program) housing, under which the Federal government subsidizes a portion of the rent paid by the tenants.

Paul A. Burke testified at length that his intent from the beginning was to get out of the hands-on, daily involvement required in residential housing construction and to acquire a "stable" of rental income properties plus develop and own the high-rise senior citizen apartment buildings as a means of generating a steady stream of retirement income for he and Mrs. Burke. As part of accomplishing this aim, Paul A. Burke transferred some of the senior staff of Paul Burke Construction, Inc. to Burke Rental Corporation. He explained that his ultimate goal was to assemble a management team capable of running Burke Rental Corporation without his presence or input, thus resulting in a self-sustaining entity which would afford Paul Burke the confidence and ability to play a passive role in the business when he and Mrs. Burke retired. More specifically, Mr. Burke described the formation of Burke Rental Corporation, the transfer of some of his senior staff, and his overall plan, as follows:

> "to get into a rental management configuration with the plan of going into high rise development to acquire properties that I ultimately would hold for an unlimited period of time to generate

> a retirement income for myself through a management corporation that would oversee and safeguard my investment."

Mr. Burke further explained that his purpose in forming Burke Rental Corporation was to expand it into "an entity that could have a passive hand." He explained that Burke Rental Corporation was a "policy-oriented corporation that could function with a manager and without my presence."

During the time period 1982 through 1985, Paul Burke began to diminish his day-to-day involvement with the operation of Burke Rental Corporation. By 1985, all of the operations of the business had been turned over to one Judith Bugenhagen, a trusted, long-term employee of Paul Burke Construction, Inc., who had been hired by Ellen E. Burke in the mid-1960's. Mr. Burke testified that Judith Bugenhagen's responsibilities continually expanded over the years from the time of her hiring as his business interests grew. Eventually, Ms. Bugenhagen began to oversee the management of all of the buildings, including purchases of supplies, handling of rental unit repairs, roof inspections and hiring and firing of personnel. During the years at issue, and through the present, Ms. Bugenhagen handles nearly $6,000,000.00 of transactions each year as business manager of Burke Rental Corporation. Ms. Bugenhagen is responsible for auditing, accounting and all legal matters pertaining to all of the Burkes' New York State holdings, as well as all Burke Rental Corporation payroll, accounts receivable, accounts payable and bank accounts including issuance of checks and transfer of funds. Paul A. Burke testified that Ms. Bugenhagen had, and continues to have, complete day-to-day control of all of the business operations of Burke Rental Corporation.

Commencing in or about 1983, petitioners began spending upwards of six months or more away from New York, principally staying in the Bahamas at a condominium they had previously purchased (<u>see</u>, <u>infra</u>). Mr. Burke testified that 1985 became a crucial year with regard to his overall retirement plan, in that he ceased to be actively involved in the day-to-day operations of Burke Rental Corporation and began treating the business as a passive investment. Accordingly, he continued to stay away from the office so as to allow his management team to operate autonomously and to assess its effectiveness.

With a capable management team for Burke Rental Corporation firmly in place, the Burkes purchased a 2,300-square foot condominium in Jupiter, Florida, on November 1, 1985 in a complex called Jonathan's Landing. The Jonathan's Landing condominium was purchased for $226,000.00, and replaced an 1,100-square foot condominium in the Bahamas purchased by the Burkes in the mid-1970's. The Bahamas condominium was sold including its furnishings and, in turn, the Burkes spent considerable amounts to furnish their new Florida condominium. Mr. Burke testified that the change from the Bahamas to Florida was occasioned, in part, because of "instability and drug activities" in the Bahamas and, in part, because the Burkes could not become permanent residents of the Bahamas. Thereafter, in October 1986, the Burkes' Errick Road residence, which had been their home for some 26 years, was listed for sale.

In June of 1986, the Burkes purchased a 4,300-square foot home located at 471 Mountain View Drive, Lewiston, New York. This property, costing

approximately $250,000.00, is near a golf course and country club, which the Burkes joined. Paul A. Burke testified that he and Mrs. Burke looked at summer home properties in the Carolinas, but they did not care for the mountains and found the climate too foggy and wet. He further testified that:

> "Whether we bought in New York or Maine or Vermont or Canada, we were going to buy some other place [outside of Florida]. This house [Mountainview Drive] came along with a lovely view. So, we bought the house."

Petitioners spend approximately five months each year in New York State (150 to 170 days per year).[2] In addition, Mr. Burke testified to taking vacations to other states with friends from Florida even when the Burkes were staying in New York, thus noting that petitioners' actual time spent within New York State has been gradually declining.

The Burkes ultimately sold their Errick Road residence in June of 1987 for $165,000.00. Most of petitioners' household items including living room furniture and accessories, dining room furniture, kitchen appliances, pool table, recreational furniture and various pieces of bedroom furniture were sold for $20,000.00, which was in addition to the $165,000.00 sale price of the residence. Paul A. Burke testified that the "package sale" of the Errick Road property included, among other things, the 17 acres, the golf course, and the rental duplex located next door to the principal residence. Mr. Burke also testified that the management staff of Burke Rental Corporation could not effectively manage the complexities of the home, outbuildings, rental duplex and golf course located on the 17-acre Errick Road property, and thus petitioners sold such premises. Additionally, petitioners both testified that substantially all of their belongings that were of some sentimental or personal value, consisting of 11 boxes of items such as Wedgewood and Stafford china, cut glass collection, cookie-making equipment, photographs and albums, were moved to their Florida condominium in 1985. Petitioners had their 38-foot Chriscraft cabin cruiser moved from a marina on the Niagara River to the Jonathan's Landing Marina in 1985. The boat was also refitted in Florida for deep-sea saltwater fishing, and petitioners were not involved in boating activities thereafter in New York.

In 1990, petitioners sold their Jonathan's Landing condominium and purchased a single-family home in the same Jupiter, Florida area for approximately $600,000.00. Paul Burke testified that he and his wife have expended between $50,000.00 to $60,000.00 to furnish this Florida home.[3]

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[2]The parties stipulated that petitioners have not spent in the aggregate more than 183 days during any of the taxable years in question in New York.

[3]It appears consistent that in each instance where petitioners sold a dwelling (i.e., Errick Road, the Bahamas condominium and, later, the Florida
(Footnote Continued)

We modify finding of fact "16" of the Administrative Law Judge's determination to read as follows:

> In explaining their reasons for desiring to change domicile from New York to Florida, petitioners described their goal as being able to retire in a stable retirement community in Florida. In connection with this goal, petitioners claimed to have ceased active involvement in their New York business interests. Petitioners' only son who had remained in New York died in July of 1988, while petitioners' only surviving son and Paul A. Burke's only brother both lived in Seminole, Florida. Petitioners had many friends in Florida with similar lifestyles and social activities while, as a result of their long absences from New York, petitioners had very few friends remaining in New York. Petitioners enjoyed fishing and playing golf year-round, were actively involved in various community and charitable activities in Florida and were involved in only limited charitable activities in New York.[4]

Petitioners also testified to the following:

(a) Since 1988, petitioners' Florida intangible tax returns were filed in Tallahassee, Florida, and their Federal income tax returns were filed in Atlanta, Georgia, respectively;

(b) All of petitioners' personal obligations such as utilities, credit card bills and travel expenses were, and continue to be, centrally accounted for through the Burke Rental Corporation office located at 1705 Third Avenue in Niagara Falls, New York because of the convenience factor involved;

(c) On average, since 1984, Paul Burke has visited the Niagara Falls, New York business office approximately 10 to 15 times per year and each visit lasted approximately 15 minutes;

(Footnote Continued)
condominium) they also sold the furniture/furnishings and, at the same time, purchased new furniture/furnishings upon acquisition of new dwellings.

[4]The Administrative Law Judge's finding of fact "16" was modified by adding "Petitioners' only son who had remained in New York died in July of 1988" in the third sentence and changing "not involved in any community or charitable activities in New York" to "involved in only limited charitable activities in New York." This finding of fact was modified at the request of the Division to more fully reflect all the details contained in the record (see, Tr., pp. 77-78, 167).

(d) While in Florida, petitioners converse with their business manager, Judith Bugenhagen, once or twice per week mostly regarding petitioners' personal affairs;

(e) Petitioners do not discuss management issues relating to the New York properties or collection of the rentals with Judith Bugenhagen, nor are they advised as to expenses, repairs and/or other day-to-day operations of their business interests in New York;

(f) Petitioners moved most of their liquid investments from New York to Florida in 1985 and 1986, including $2,000,000.00 in Treasury Bills, CD's and cash;

(g) Petitioners have been members of the Jonathan's Landing Golf Club since 1985, and purchased a $17,300.00 membership bond there on October 27, 1986;

(h) Paul A. Burke only began regularly playing golf in 1985, when he ceased active involvement in his business interests.

We modify finding of fact "18" of the Administrative Law Judge's determination to read as follows:

> Petitioners claim a homestead exemption for their Florida residence, and utilized their one-time Federal tax election (gain exclusion) upon the sale of their Errick Road personal residence in 1987. Petitioners each filed a Declaration of Domicile in Florida on or about April 10, 1986, and have filed Florida intangible tax returns since the beginning of 1988. Petitioners were each registered to vote in Florida on April 10, 1986. Paul A. Burke was issued a Palm Beach County Public Library card in 1987, and petitioners each applied for and received Florida drivers' licenses on January 23, 1987. Petitioners' automobiles are registered in the State of Florida. Petitioners use a Paul A. Burke Construction car when they are in New York. Petitioners claimed exemptions from jury duty in New York on January 22, 1987 upon the basis that they were permanent residents of the State of Florida. Petitioners opened a Florida bank account on November 11, 1985. Petitioners also have bank accounts in New York.[5]

[5] The Administrative Law Judge's finding of fact "18" was modified by changing "Burke Rental Corporation" to "Paul A. Burke Construction." The finding of fact was modified at the request of the Division to correctly reflect the record.

Petitioners have no business interests or pursuits in Florida.

Petitioners raised two sons. One son resides in Seminole, Florida. Their other son, now deceased, is survived by two children. Mr. Burke noted that his grandson resides in western New York and his granddaughter resides in a house owned by the Burkes at 767 Lee Avenue, North Tonawanda, New York. He described a few visits with the grandchildren, but explained that the relationships are not particularly close.

Ms. Bugenhagen holds no ownership interests, stock or otherwise, in any of the businesses or rental properties. Mr. Burke acknowledged that either he or his partner, as the ultimate owners, could terminate the employment of Ms. Bugenhagen, or any of the staff. He noted, however, that to do so would not be sensible, not only for lack of any reason to do so, but because the balance of the staff would almost certainly quit thus ruining his management team and requiring him to become involved in the business. In this regard, Mr. Burke testified he would sell the properties rather than go back to work.

Petitioners' business and personal accounting and auditing services are provided by McGladrey and Pullen, a certified public accounting firm based in Atlanta, Georgia, with offices nationwide including offices in New York. Petitioners switched from their long-time New York accounting/auditing firm to McGladrey and Pullen at the request of William Sanders, the other general partner in the high-rise apartment buildings.

Petitioners' wills, drawn by an attorney in New York and executed in New York, list petitioners as residing in Florida.[6] Mr. Burke described the process of making these wills as involving many telephone, facsimile and computer disk communications between petitioners in Florida and an attorney in Buffalo, New York before acceptable wills were drawn. Mr. Burke described execution of the wills in New York as due to the fact that petitioners were in New York when the wills were finally completed. He noted that the wills were later revised (after the years in question), and that the revised wills were executed in Florida.

Mr. Burke explained the retention of both Florida and New York driver's licenses as based on his understanding that neither license, alone, was valid in the other state given the length of time spent in each state. Mr. Burke was allegedly told that if a person is present in New York or Florida for more than 30 days, a license for each state is necessary. He noted that his New York license entitles him to operate heavy equipment/wide-load vehicles (a Class I license), but he testified he has not done so since approximately late 1970 and would not feel qualified to do so now.

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[6]Petitioners' entire wills were not offered in evidence; rather submitted as Division's Exhibits "O" and "P" were the first and last pages of petitioners' wills.

Paul A. Burke holds a pistol permit issued many years ago in New York. He explained, however, that his only gun is and has been kept in Florida for many years. In similar fashion, Mrs. Burke holds an insurance broker's license in New York. She obtained this license in the 1960's when she placed insurance in connection with the Burkes' construction business. She has not used this license since the 1970's but testified that she has not let it lapse because it is something she "earned."

The Burkes described the central accounting and payment of their personal expenses by the management company as a matter of convenience, noting specifically that it "makes no sense" to do this work when the office can do it for them. In this regard, Mr. Burke testified that most of his telephone calls to the business were to confirm with Judith Bugenhagen the propriety of paying the personal charges and expenses, since Ms. Bugenhagen would not know where and when the Burkes ate, shopped, etc. By contrast, he explained the business involved few decisions, in that its operations were well established ("cut and dry"). The high-rise apartment buildings involved 30-year government rent subsidy contracts, with all rent increases government approved and with a set protocol for approval of any major repairs (involving trustee approval, three bids and reserve fund payment approvals as spelled out in a trust indenture). Mr. Burke (and Mr. Sanders in Georgia) receive periodic printouts of rents collected and expenses paid in connection with the high-rise properties.

Burke Rental Corporation was described as headed (managed) by Judith Bugenhagen, who has an office staff of three other people, plus four building managers (one in each building) and approximately 12 additional maintenance staff workers. Judith Bugenhagen plus one other staff person hold registered apartment managers' licenses (called RAM certificates) issued by the National Builder's Association and recognized/required by the Federal government to manage Federally-subsidized housing.

By affidavit, Judith Bugenhagen stated that Mr. Burke visits the Burke Rental Corporation offices approximately 10 to 15 times per year, with such visits averaging 15 minutes in length, and that his visits never last for more than an hour. She, and Mr. Burke by his testimony, indicated these visits related to personal matters. Mr. Burke testified that he believed he visited the offices less frequently than Ms. Bugenhagen estimated, but he offered no estimate of such number of visits.

Mr. Burke receives bi-monthly sheets from Judith Bugenhagen summarizing the results of operations of the businesses and the flow of money in and out of his personal bank account[7] (described as a "catch-all" [apparently a net-result profit] account). Mr. Burke admitted that, as one of two

[7] At some point, petitioners' bank account and the business account(s) were moved from petitioners' long-term bank (Marine Midland) to a new bank (M & T Bank). This move was made at Ms. Bugenhagen's request and was approved by Mr. Burke.

ultimate owners, he had access to audit information regarding income, expenses, operations, etc., but explained that he has not reviewed the same and instead has relied on Judith Bugenhagen and the management team.

Mr. Burke decides where to invest his partnership profits (generally in tax-free municipal bonds or Treasury bills).

Petitioners transferred their primary medical and optical care affiliations to doctors in Florida in or about 1985. When in New York, any medical needs are handled by a physician who, with his wife, are long-time personal friends of the Burkes.

Petitioners testified that their social activities in Florida include golfing, boating and fishing as their most avid pursuits, as well as bridge, dinners and theatre activities. They testified that since they are out of New York for such extended periods it is difficult to step into and out of any regular schedule of social activities with persons who live in New York on a year-round basis. By contrast, petitioners' friends in Florida are on similar schedules with the Burkes (i.e., away from Florida during the summer months) thereby leaving it much easier to step into (pick up and maintain) a full schedule of activities. Mr. Burke testified to regular contacts, mainly involving golf matches and dinners, with only three or four friends when the Burkes are in New York.

Mr. Burke described 1985 as the critical decision year during which petitioners decided to sell the Errick Road and Bahamas properties, purchased the Florida property and commenced looking for another property away from Florida (ultimately settling on the Mountain View Drive property). At this same time, petitioners transferred substantial financial assets (Treasury bills, etc.) and their personal belongings to Florida. Mr. Burke testified that he felt by such time his management team and system was in place and functioning capably, noting that he would not walk away from a several million dollar business investment without such assurance.

The parties entered into a stipulation of certain facts prior to hearing, and such stipulated facts have been included in the Findings of Fact set forth hereinabove. However, with the submission of its brief, the Division advised that it wished to "opt-out" of stipulated fact "23" pursuant to its reserved right to do so per stipulated fact "31". These two stipulated facts read, verbatim, as follows:

> "23. Mr. Burke communicates via telephone with the Niagara Falls, New York office approximately one (1) to two (2) times per week and said telephone conversations last five (5) to fifteen (15) minutes.
>
> * * *
>
> "31. It is further stipulated and agreed that this stipulation is not in any way intended to restrict the presentation of either party's case during this proceeding. Should any of the facts stipulated hereby be contradicted during the course of this proceeding, by testimony or other evidence, either party may opt out of that portion of this stipulation which

is so controverted. This option shall be exercised by notifying the ALJ and the opposing party in writing. The remainder of this stipulation shall remain in full force and effect."

In their briefs, both parties present an analysis of petitioners' Florida telephone bills during the period April 22, 1986 to January 19, 1990. As a general proposition, these analyses support the fact that, on average, one or two telephone calls per week were made from the Burkes' Florida telephone number to the New York office of Burke Rental Corporation and that such calls varied in length from 1 minute to 45 minutes. It is clear, also, that the number of calls in excess of 20 minutes was very small in comparison to the number of calls lasting less than 15 minutes. It is also true that in some months petitioners averaged more than two calls per week to the offices and that in other months they averaged less than two calls per week with no particular pattern of calling emerging. Similarly, on certain days, more than one or two calls were made to the business offices on the same day. Conversely, on other days no calls were placed to such offices. Ultimately, the Division maintains that the telephone calls undermine the testimony and claim that Mr. Burke's business was run autonomously by the office staff without Mr. Burke's active decision-making intervention. In contrast, petitioners maintain that Mr. Burke's testimony and Ms. Bugenhagen's affidavit support the claim that the telephone calls related to personal matters and, in fact, that the total phone time of all of the calls amounted to approximately eight hours per year, an amount clearly insufficient to constitute active involvement in running a several million dollar business operation.

In contrast to Mr. Burke's testimony that Burke Construction Company, Inc.'s activities wound down when the housing construction phased out, the Division points out that such entity's total asset value (per its subchapter S tax report) increased from $121,000.00 in 1987 to $410,000.00 in 1988. The nature of, or reason for, such increase was not specified by petitioners. In addition, petitioners' personal income tax return for 1987 reveals (at Schedule E and Statement 5) that petitioners treated their Mountain View Drive property as rental property, reporting rental income of $9,342.00 and deductible expenses (including depreciation) of $18,655.00 thus claiming a net loss of $9,313.00. This unexplained treatment, which is not claimed for the later years 1988 and 1989, contrasts with petitioners' claim that the property was dormant when not used by petitioners. Finally, the Division points out that petitioners' returns reflect a claim, made via checking the "yes" box on their tax return schedules, of "active participation" in the high-rise housing partnerships. Petitioners claim that the same represents clerical error by petitioners' accountants, noting also that the benefit allegedly gained by petitioners via "active" participation (and denied for "passive" involvement) becomes moot because any such benefit is phased out for taxpayers, such as petitioners, whose adjusted gross income exceeds $150,000.00.

Opinion

The Administrative Law Judge determined that petitioners were properly considered domiciliaries of Florida during the years 1987, 1988 and 1989. The Administrative Law Judge held that, notwithstanding that the Burkes

maintained some ties to New York, a taxpayer may change his or her domicile without severing all ties to New York State and petitioners did so by moving their focus of home from New York to Florida prior to the years in question. Specifically, the Administrative Law Judge noted that "[i]t is significant that petitioners moved their most important personal possessions and memorabilia to Florida . . ." (Determination, conclusion of law "E"). Further, the Administrative Law Judge found that petitioners actively sought to distance themselves from the operations of their New York business interests and configured their business to be managed by others. Moreover, the Administrative Law Judge held that petitioners did not retain significant family ties to New York, and maintained a New York residence as a secondary summer home. Therefore, the Administrative Law Judge reasoned that, in light of petitioners' diminished connections to New York, they had demonstrated the requisite intent to abandon their New York domicile and, thus, change their domicile to Florida.

On exception, the Division asserts that petitioners have not demonstrated a change in domicile. The Division states that the Administrative Law Judge's conclusion to the contrary is incorrect for the following reasons: (1) the implication that Florida family ties are stronger than New York family ties is not supported by the record; (2) the finding that Paul A. Burke was not actively involved in the affairs of his New York business interests is not a rational interpretation of the evidence; (3) the record does not support the premise that petitioners moved their focus of home from New York to Florida prior to the years in question; and (4) the testimony of Paul Burke as to the purpose of the telephone calls to his office is incredible.

In response, petitioners present arguments to support the determination of the Administrative Law Judge.

We affirm the determination of the Administrative Law Judge for the reasons set forth below.

Tax Law § 605(b)(1)(A) provides, in pertinent part, as follows:

> "Resident individual. A resident individual means an individual:
>
> > "(A) who is domiciled in this state, unless (i) he maintains no permanent place of abode in this state, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than thirty days of the taxable year in this state . . . ."

While there is no definition of "domicile" in the Tax Law (cf., SCPA 1103[15]), the Division's regulations (20 NYCRR former 102.2[d]) provide, in pertinent part:

> "(1) Domicile, in general, is the place which an individual intends to be his permanent home -- the place to which he intends to return whenever he may be absent. (2) A domicile once established continues until

> the person in question moves to a new location with the bona fide intention of making his fixed and permanent home there. No change of domicile results from a removal to a new location if the intention is to remain there only for a limited time; this rule applies even though the individual may have sold or disposed of his former home. The burden is upon any person asserting a change of domicile to show that the necessary intention existed. In determining an individual's intention in this regard, his declarations will be given due weight, but they will not be conclusive if they are contradicted by his conduct. The fact that a person registers and votes in one place is important but not necessarily conclusive, especially if the facts indicate that he did this merely to escape taxation in some other place.
>
> * * *
>
> "(4) A person can have only one domicile. If he has two or more homes, his domicile is the one which he regards and uses as his permanent home. In determining his intentions in this matter, the length of time customarily spent at each location is important but not necessarily conclusive. As pointed out in subdivision (a) of this section, a person who maintains a permanent place of abode in New York State and spends more than 183 days of the taxable year in New York State is taxable as a resident even though he may be domiciled elsewhere."

Permanent place of abode is defined in the regulations at 20 NYCRR former 102.2(e)(1) as:

> "a dwelling place permanently maintained by the taxpayer, whether or not owned by him, and will generally include a dwelling place owned or leased by his or her spouse."

As the Administrative Law Judge stated:

> "[t]o effect a change in domicile, there must be an actual change in residence, coupled with an intent to abandon the former domicile and to acquire another (Aetna National Bank v. Kramer, 142 App Div 444, 445, 126 NYS 970). Both the requisite intent as well as the actual residence at the new location must be present (Matter of Minsky v. Tully, 78 AD2d 955, 433 NYS2d 276)" (Determination, conclusion of law "C").

The concept of intent was addressed by the Court of Appeals in Matter of Newcomb (192 NY 238, 250-251):

> "Residence means living in a particular locality, but domicile means living in that locality with intent

to make it a fixed and permanent home. Residence simply requires bodily presence as an inhabitant in a given place, while domicile requires bodily presence in that place and also an intention to make it one's domicile.

"The existing domicile, whether of origin or selection, continues until a new one is acquired, and the burden of proof rests upon the party who alleges a change. The question is one of fact rather than law, and it frequently depends upon a variety of circumstances, which differ as widely as the peculiarities of individuals . . . . In order to acquire a new domicile there must be a union of residence and intention. Residence without intention, or intention without residence, is of no avail. Mere change of residence although continued for a long time, does not effect a change of domicile, while a change of residence even for a short time, with the intention in good faith to change the domicile, has that effect . . . . Residence is necessary, for there can be no domicile without it, and important as evidence, for it bears strongly upon intention, but not controlling, for unless combined with intention, it cannot effect a change of domicile . . . . There must be a present, definite, and honest purpose to give up the old and take up the new place as the domicile of the person whose status is under consideration . . . . [E]very human being may select and make his own domicile, but the selection must be followed by proper action. Motives are immaterial, except as they indicate intention. A change of domicile may be made through caprice, whim, or fancy, for business, health, or pleasure, to secure a change of climate, or change of laws, or for any reason whatever, provided there is an absolute and fixed intention to abandon one and acquire another, and the acts of the person affected confirm the intention . . . . No pretense or deception can be practiced, for the intention must be honest, the action genuine, and the evidence to establish both clear and convincing. The _animus manendi_ must be actual with no _animo revertendi_ . . . .

"This discussion shows what an important and essential bearing intention has upon domicile. It is always a distinct and material fact to be established. Intention may be proved by acts and by declarations connected with acts, but it is not thus limited when it relates to mental attitude or to a subject governed by choice."

The Administrative Law Judge, after considering all of the evidence and testimony presented, concluded that petitioners had demonstrated a change in domicile. Applying the above principles to the facts of this case, we agree that petitioners have proven, by clear and convincing evidence (_Matter of_

Bodfish v. Gallman, 50 AD2d 457, 378 NYS2d 138), their intention to change their domicile from New York State to Florida.

The Division makes several arguments on exception. However, these arguments fail to warrant resolution of this matter in favor of the Division. The underlying tone of all the arguments the Division sets forth is that, during the years in dispute, petitioners maintained ties to New York which evince a clear lack of intent to change domicile. However, we agree with the Administrative Law Judge that, notwithstanding that petitioners maintained some ties to New York, a taxpayer may change his or her domicile without severing all ties to New York State (see, e.g., Matter of Sutton, Tax Appeals Tribunal, October 11, 1990) and petitioners did so by moving their focus of home from New York to Florida prior to the years in question. Our affirmance of the Administrative Law Judge is based upon several aspects of his determination.

First, we disagree with the Division that the finding that Paul A. Burke was not actively involved in the affairs of his New York business interests is not a rational interpretation of the evidence. The Division argues that given the magnitude of the rental operation managed by Burke Rental Corporation that it was unreasonable for the Administrative Law Judge to believe Mr. Burke's testimony that his telephone calls to New York were mostly about personal financial affairs. The Division contends that these telephone calls were about the business and that these telephone calls indicate Mr. Burke's role in the business was not passive, and that Mr. Burke took a more active role when he is in New York.

Several factors support the Administrative Law Judge's conclusion. The most important factor is that the Administrative Law Judge determined that Mr. Burke's explanations as to the content of the telephone calls and the nature of his involvement in the business were credible after hearing the testimony and evaluating its reasonableness. We defer to this evaluation of credibility (Matter of Spallina, Tax Appeals Tribunal, February 27, 1992) and the Division has not pointed to any facts sufficient to override our deference.[8] Also, as the Administrative Law Judge found:

> "the overall amount of telephone contact (some 24 hours over three years) and the limited number of office visits do not seem sufficient to constitute active involvement, or to foster efficiency, in managing the business. Furthermore, Ms. Bugenhagen handled personal business (e.g., central bill paying) for the Burkes. While she would know which business operational expenses

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[8]We do not find it significant that petitioners indicated that they were actively involved in the high rise housing partnerships on their tax returns for the years in question. As stated in the facts, petitioners claim that this was a clerical error from which they received no tax benefit. The Division has not disputed the latter claim.

> needed paying, she would not know which personal bills were valid and should be paid (not having been with the Burkes)" (Determination, conclusion of law "E").

Thus, we agree with the Administrative Law Judge that it is not unreasonable to accept petitioners' explanation that the telephone calls/office visits related primarily to such personal matters. In addition, there is no sense from the description of the business, as finally established, that active involvement by Mr. Burke was required, either on an overall basis or during the part of the year when the Burkes were physically present in New York. As the Administrative Law Judge noted:

> "Such a conclusion [that Mr. Burke was actively involved in his business interests] would run counter to the credible testimony by Mr. Burke that he neither needed nor wanted to be active in the business and that such involvement would undermine the authority and autonomy of Ms. Bugenhagen and her staff -- a result directly contrary to the system petitioners had worked to establish" (Determination, conclusion of law "E").

Next, the Division contends that if petitioners had any family ties they existed in New York. However, as manifested in the findings of fact, petitioners' family and social lives, while not exclusive to, both became centered in Florida prior to the years in question.

The fact that the Burkes continue to maintain a large New York residence, and did not sell their original New York home until 1987, does not indicate[9] that they could not have intended to effectuate a change in domicile. A taxpayer may change his or her domicile without severing all

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[9] In conclusion of law "E," the Administrative Law Judge's determination stated, in relevant part:

> "[p]etitioners sold their long-term home in New York (Errick Road) and purchased a condominium in Florida. At the same time, petitioners sold a condominium in the Bahamas, acquired in the mid-1970's and used extensively over the years by petitioners. . . . Petitioners did acquire a new house in New York after selling their long-term home" (Determination, conclusion of law "E").

Here, the Administrative Law Judge misstates the sequence of petitioners' real estate transactions involving their Bahamas, Florida and two New York properties. Petitioners purchased the Florida condominium prior to the sale of their long-term New York home and acquired a new New York house before this sale. However, this sequence is correctly reflected by the Administrative Law Judge and this Tribunal in the findings of fact.

ties to New York State (see, e.g., Matter of Sutton, supra). The test of intent with respect to changing one's domicile is "whether the place of habitation is the permanent home of a person, with the range of sentiment, feeling and permanent association with it" (Matter of Bodfish v. Gallman, supra, 378 NYS2d 138, 140). In this regard, we agree with the Administrative Law Judge that it is very significant that the Burkes moved their most personal belongings and memorabilia to Florida, including photographs, china and the like.

Finally, the Administrative Law Judge found that the Burkes clearly changed their lifestyle when they changed their domicile from New York to Florida in 1985. The Burkes retired in 1985, became passive in their business interests and retired to a stable Florida retirement community. The Administrative Law Judge found that petitioners were ready to change "to a hands-off, relaxed and recreation/social-oriented lifestyle" in contrast to the long work days and lifestyle the Burkes maintained while they lived in New York prior to 1985.

Based on the foregoing, we agree with the Administrative Law Judge that petitioners have shown, in a clear and convincing manner, that they perfected a change in domicile to Florida prior to the years in dispute.

Accordingly, it is ORDERED, ADJUDGED and DECREED that;

1. The exception of the Division of Taxation is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Paul A. and Ellen E. Burke is granted; and

4. The Notice of Deficiency dated March 11, 1991 is cancelled.

DATED: Troy, New York
June 2, 1994

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition

of

COLIN W. AND DELMA K. GETZ

for Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1986, 1987 and 1988.

ORDER
DTA NO. 809134

Petitioners, Colin W. and Delma K. Getz, by their representative, James E. Conway, Esq., have brought a motion for rehearing,[1] dated June 5, 1992. Petitioners requested that the determination of the Administrative Law Judge dated March 12, 1992 be set aside and a new hearing granted on the issues of (1) the significance of petitioner Colin Getz's service as a member of the Capital District Regional Board of Norstar Bank, (2) the status of the adult son of petitioners who resides in petitioners' residence in Delmar, New York, and (3) a typographical error contained in the determination referring to "1988" as opposed to "1987". Based on the papers submitted by petitioners' counsel on June 5, 1992, an affidavit of Gary Palmer on behalf of the Division of Taxation in opposition to the motion, dated June 9, 1992, and a reply affidavit of James E. Conway, dated June 23, 1992, the following order is rendered.

Section 3000.5 of the Rules of Practice and Procedure of the Tax Appeals Tribunal provides, in relevant part, as follows:

> "Motion Practice. (a) General. To better enable the parties to expeditiously resolve the controversy, this Part permits an application to the tribunal for an order, known as a motion, provided such motion is for an order which is appropriate under the Tax Law and the CPLR....

* * *

[1] Petitioners captioned their papers as "petition for rehearing on limited issues" and filed the petition with the Tax Appeals Tribunal. By letter dated June 12, 1992, the Secretary to the Tax Appeals Tribunal, Robert Moseley Nero, informed petitioners' counsel that a motion for rehearing is properly made before the Administrative Law Judge who rendered the original determination and that, therefore, the file on the case was forwarded to Chief Administrative Law Judge Andrew Marchese for further disposition.

(6) The appropriate sections of the CPLR regarding motions, where not in conflict with this Part, are applicable to the motion being made."

Thus, petitioners may bring a motion for rehearing inasmuch as such motion is appropriate under CPLR 4404 and CPLR 5015. Rule 4404 provides, in pertinent part, as follows:

"(b) Motion after trial where jury not required. After a trial not triable of right by a jury, upon the motion of any party or on its own initiative, the court may set aside its decision or any judgment entered thereon. It may make new findings of fact or conclusions of law, with or without taking additional testimony, render a new decision and direct entry of judgment, or it may order a new trial of a cause of action or separable issue."

In addition, CPLR 5015, entitled "Relief from judgment or order", provides, in pertinent part:

"(a) Grounds. The court which rendered a judgment or order <u>may relieve a party from it upon such terms as may be just</u>, on motion of any interested person with such notice as the court may direct, <u>upon the ground of</u>:

* * *

(2) <u>newly-discovered evidence</u> which, if introduced at the trial, would probably have produced a different result and which could not have been discovered in time to move for a new trial under section 4404; or

(3) <u>fraud, misrepresentation, or other misconduct</u> of an adverse party..." (emphasis added).

With respect to the first basis upon which petitioners request a new hearing, petitioners allege as follows:

"(1) Without prior notice, or request for additional information, the Division, and the Administrative Law Judge, both placed significant reliance on an erroneous assumption that the Petitioner, Colin W. Getz, was a member of the Board of Directors of Norstar Bank of Upstate New York. It is clear from a reading of the testimony that the Petitioner was discussing his part-time attendance at this advisory board meetings [sic], without making the distinction, which the Administrative Law Judge failed to understand, that the advisory board was not the principal Board of Directors of the corporation."

The distinction which petitioners seek to be made on rehearing does not constitute newly-discovered evidence which could not have been discovered at the time of the initial hearing nor which would have produced a different result. Contrary to petitioners' assertion, they were on notice prior to the initial hearing that they were to prepare their case and submit evidence to carry their burden of proof. In any event, the distinction that

petitioners seek on rehearing -- that petitioner Colin Getz was a member of the advisory board and not the principal Board of Directors of Norstar Bank -- was not relevant to the determination. The only reliance in the determination placed on Colin Getz's board membership was the effort made by him to fulfill his duties on the board, in particular his attendance record which indicated his continued ties to New York State.

With respect to the second basis for rehearing, petitioners allege as follows:

> "(2) The Petitioner testified that the adult son of the Petitioners lived in their former principal residence in Delmar, New York, and had continued to do so for a number of years. The Administrative Law Judge seemed to place particular significance on this fact, and that somehow the adult son of the Petitioners was reliant upon the Petitioners, and that Petitioners returned to New York, periodically, to somehow care for and/or support said adult son. It is respectfully submitted that appropriate evidence, to wit testimony by the adult son, as to his employment status, military service, and other matters should be presented to properly focus the attention of the Administrative Law Judge on the insignificance of the total facts connected herewith and to dispel the erroneous conclusions and inferences drawn by the Administrative Law Judge therefrom."

Again, petitioners misconstrue the basis of the determination. Indeed, in the determination I specifically rejected the Division's conclusion that, as a devoted parent, "living with Douglas for six months each year was a matter of priority to Mr. Getz." With reference to petitioners' children, I stated the following:

> "[T]he fact that petitioners have two sons and three grandchildren in Delmar may explain why petitioners chose Delmar to spend their summer months and December holidays but is not conclusive as to petitioners' intent with respect to a change in domicile. Mr. Getz's references to his son Douglas (see, Finding of Fact '8') were made in response to questions concerning his son's caretaking and financial responsibilities with respect to the Delmar house and his decision to maintain the Delmar house, but do not imply, as does the Division's counsel, that it was a priority for Mr. Getz to live with his son Douglas for six months of each year."

In addition, the fact that petitioners' son resided in the Delmar residence did not, as implied by petitioners, work in petitioners' disfavor. The determination contained the following statements on this matter:

> "[P]etitioners' maintenance of the New York residence was multipurpose. It not only provided petitioners with a place to stay during visits but also provided petitioners' son with a place to live. The fact that petitioners also owned a second New York home for the sole purpose of providing financial assistance to another son...and made a similar offer to a daughter living in Georgia supports petitioners' claim that the maintenance of the

family home was for the convenience of their son as well as for themselves. In addition, petitioners' decision to maintain the New York residence apparently involved certain tax planning choices with respect to the disposition of their estate. In sum, petitioners have dispelled the notion that the New York home was maintained purely out of sentiment, feeling or any sense of permanent association."

Contrary to petitioners' assertion, nowhere in the determination was it stated or inferred that petitioners' adult son was dependent or reliant on petitioners for care or support. Notwithstanding the baselessness of petitioners' contentions, petitioners may not use a motion for rehearing to relitigate issues and present additional evidence that was available at the time of the hearing.

With respect to petitioners' request that an amended determination be issued to correct a typographical error, petitioners had made a prior request on the same matter by letter dated May 11, 1992. In response to this prior request, I sent to petitioners a letter dated May 12, 1992 wherein the following was stated:

"Inasmuch as you have already taken an exception and I no longer have the record in the above-entitled case, I will not file an amended decision.

I appreciate your letter giving me the opportunity to make this correction to footnote 7 on page 12 of the decision. However, this error may be pointed out to the Tax Appeals Tribunal on your exception."

Since the date of this letter, petitioners' motion for rehearing was filed with the Tax Appeals Tribunal and referred to the Division of Tax Appeals. Inasmuch as the record is now before me on this motion, an amended determination correcting the typographical error contained in Finding of Fact "20" will be issued and attached to this order. The last sentence in footnote "7" on page 12 of the determination will now state that petitioners conceded that they spent over 183 days in New York State in 1987 (instead of 1988 as incorrectly stated in the determination issued on March 12, 1992). It should be noted, however, that in the March 12, 1992 determination, Conclusion of Law "B" correctly stated that "[p]etitioners concede that they owe income tax for the year 1987."

In a reply affidavit, petitioners' counsel appears to raise the further argument that petitioners were not given a full and fair opportunity to present all the facts and circumstances at hearing because they "[were] not given fair warning or even alerted to the probability that the issues may well be decided upon a narrow finding, which has neither been fully investigated or fully presented, and which is a very narrow, fine and discrete matter of law." Petitioners' counsel also asserted that the auditor in the case made no inquiry to explore the nature of petitioners' country club membership or membership on a business advisory board, "church affiliations, other social clubs, business connections, or other social and non-social activities."

Contrary to petitioners' assertions, there was no indication during the course of the hearing that petitioners were not aware that they had the burden of proof with respect to their case or that all relevant evidence in support of their position was to be presented at the hearing date.

In the Notice of Hearing, dated May 21, 1991, which set the hearing date on June 10, 1991, petitioners were advised as follows:

> "Except as otherwise provided by law, the petitioner has the burden of proof and must establish by a preponderance of the evidence the facts necessary to show that there is no deficiency or that a refund is due. Such proof may be made by sworn testimony of the petitioner's witnesses or by documentary or other evidence introduced during the course of the hearing."

Petitioners were further advised at both the commencement and conclusion of the hearing that all evidence in the case was to be presented during the hearing (Tr. at 5, 118). The parties also were advised at the commencement of the hearing of the following:

> "If there are any questions at any time regarding the procedures we will follow, just request clarification from me and we may stop and try to resolve any questions you may have" (Tr. at 5).

Again, at the conclusion of the hearing, the parties were queried as to whether there were any further issues the parties wished to raise (Tr. at 119).

At no time during the course of the hearing did petitioners give any indication that they did not understand the procedures in presenting evidence or that the case would be decided on the evidence presented during the hearing. Indeed, petitioner Mr. Getz stated that he had consulted with financial advisors on the domicile issue and had read the case law on this topic as well (Tr. at 42-43, 62-63; Determination, dated March 12, 1992, p. 3, ftn. 2). Although Mr. Getz testified that the case law was "obtuse" concerning the requirements for changing one's domicile, it was clear from his testimony that he understood he was responsible for demonstrating that he had changed his domicile.

Finally, petitioners' complaint that the Division's auditor failed to inquire as to petitioners' church affiliations, etc. is irrelevant inasmuch as petitioners had the opportunity and burden of presenting all the evidence in support of their case at the formal hearing. In sum, there is no basis to petitioners' allegation that they were deprived of their right to a full and fair opportunity to present their case.

Accordingly, petitioners' motion for rehearing is denied.

DATED: Troy, New York
July 16, 1992

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE

RESIDENCY UPDATE
TAX LAW § 605(b)(1)

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New York State and City Tax Institute
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28 November 1995

Residency Update
Tax Law § 605(b)(1)

"...depends on the totality of facts in a particular case."
Matter of Evans, Tax Appeals Tribunal, June 18, 1992.

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I. Domicile, Tax Law § 605(b)(1)(a).

A. *Matter of Gray,* Tax Appeals Tribunal, May 25, 1995.

Years at issue, 1987 and 88. Petitioners life long residents of Syracuse, N.Y. Owned substantial corporation in Syracuse. Friends, family and other social ties there. Bad health starts in early 80's and starts to plan for retirement. 1984, buys property in Georgia. Doesn't work out. August 85, rents condo for one year in Florida. Fall of '85, starts looking for property to buy in Florida. November 86, buys property in Florida. Rents another condo in Florida from December 86 to May 87. Rents another condo in Florida from September 87 to October 88. Note: not in Florida summer of 87. But did start plans to build in Florida starting in November 86. Home in Florida eventually built for $619,000. Moves into Florida home in December 88.

Meanwhile, back in Syracuse, in 1981, starts to plan to sell business. Son not interested. "Considered sale to the employees through stock option plan, but this proved not to be feasible." Dates and firmness of this activity not set out or given. "In about 1984", starts to arrange to have the business sold to third party. Finds buyer in "late 1986" and negotiations begun. Announces sale August 12, 1987, closes September 15, 1987.

With respect to Syracuse home, partnership formed in January 87 to give house in Syracuse to children over time. 40% given in February 87.

Tax Appeals Tribunal affirms ALJ findings of fact which include, "the record clearly establishes that the Grays had formed an intention to establish a Florida domicile late in 1985 and took numerous concrete steps towards fulfilling that intention." But taxpayer loses! What's going on here?

B. *Matter of Erdman*, Tax Appeals Tribunal, April 6, 1995.

Years at issue 1986 and 87. Wife was a domiciliary of Florida since 1975. After first husband dies, marries New York domiciliary in 1986. ALJ holds wife a New York domiciliary for 86 and 87 notwithstanding "the only connection [wife] had with New York was the ownership of a single family residence occupied by her daughter and...club membership that had been her former husband's"

Reversed by Tribunal. Husband and wife have separate domiciles. However, Tribunal ducks issue that burden of proof is on State given that wife was a domiciliary of Florida in 85 and State claimed change for 86. What ever happened to presumption that domicile continues! *See, Matter of Newcomb,* 192 NY 238, 84 N.E. 950 (1908).

C. *Matter of Angelico,* Tax Appeals Tribunal, March 31, 1994.

Years at issue 1984 and part 1985. Prior to 1984, both husband and wife were domicilaries of New York. Husband moves out in January 84 under arrangement to pay all expenses for New York home. Husband continues to own New York home jointly with wife. Husband buys and moves into condo in New Jersey. Husband continues to have substantial business interest in New York. Husband and wife get back together in June 85. ALJ finds husband never was in New York home during period at issue and that couple contemplated divorce during this period.

Tribunal holds husband had separate domicile for the year and a half period and that the continued ownership of "home" and business interest in New York are only some factors in determining the "totality of circumstances".

Statutory residence issue not timely raised. *Compare, Matter of Moed,* Tax Appeals Tribunal, January 26, 1995.

D. *Matter of Silverman*, Administrative Law Judge, October 12, 1995.

Years at issue, 1988, 89 and 90. Business in Brooklyn. Historical home Dix Hills, Long Island-three bedrooms, 3,500 sq.ft.-sold in 1982. 1978 bought home in High Falls, Ulster County-1500 sq. ft-used as a vacation home, sold in 1994. Bought home in Florida 1981-1500 sq. ft. In 1982, taxpayer buys apartment near business in Brooklyn, sold circa 1986. Sold business in Brooklyn 1985 at age 67. In 1989 taxpayers buys small studio apartment at Lincoln Center. Various members of family stay there from time to time.

Between 1981 and 1984, spent four months in Florida. Items from Dix Hills moved to Florida. 1988 and 90, stipulation that taxpayer spent less than 183 days in New York. 1989, stipulation that taxpayer spent more than 183 days in New York.

Cars, voting, wills, friends, doctors, attorneys, accountants, etc.-Florida. Note that Dix Hills and High Falls homes were owned at the same time. Therefore, if a person can have only one domicile, obviously only one of those homes in the period 1978 and 1982 could have been the taxpayers domicile. Taxpayers argue that High Falls was bought as vacation home in 1978-makes sense. However, taxpayers also argue that High Falls continued to be a vacation home even after Dix Hills home sold in 1982 and that domicile changed to Florida when taxpayers bought Florida home in 1981. Tax Department argues domicile changed from Dix Hills to High Falls.

Taxpayer wins! Query: If burden of proof on the party asserting a change, shouldn't burden of proof have been on Tax Department to prove change from Dix Hills to High Falls? After all, taxpayers owned Florida Home at time of sale of Dix Hills home. Issue not reached.

II. Statutory Residency, Tax Law § 605(b)(1)(B). "...*maintains a permanent place of abode*..."

A. *Matter of Evans*, 106 AD2d 840, 606 NYS2d 404 (1993)

For 12 years taxpayer shares living and other household expenses with a friend. The friend is a priest and the "abode" is the friend's rectory which is paid for by the church. Taxpayer does not have lease and has no legal right to be there. Stays there only during the week. Keeps business clothes there. Could even have friends there. Had key and "free to come and go at will." Used whatever areas he wished, *i.e.*, kitchen, dining room.

Tribunal holds taxpayer "maintained" the place by making monetary "contributions" to the household. Tribunal also holds that the "abode" is "permanent" within the meaning of the statute because of "the individual's relationship to the place". That is, did it for 12 years, used it regularly during the week and for more than 183 days during years at issue. In so many words, Mr. Evans was living there.

B. *Matter of Moed*, Tax Appeals Tribunal, January 26, 1995.

Husband and wife with separate domiciles. Husband stays at wife's home on average one day a week. Had key to place but would never arrive unannounced and would always call in advance. Husband kept "toilet kit and clean shirt" and "on occasion" a suit at wife's place. Husband made payments to wife. Reason for the payments not given. Tribunal finds that such payments, whatever their nature and amount, are not a *quid quo pro* for staying at wife's home. Therefore, husband did not "maintain" the abode. Nor was it "permanent" given that access was limited, *i.e.*, husband had to call in advance of stays.

In so many words, unlike Mr. Evans, Mr. Moed was using the place to crash.

C. Evidence as to day count.

1. *Matter of Avildsen*, Tax Appeals Tribunal, August 17, 1995.

Do not be mislead. Oral testimony might not be sufficient While the taxpayer in *Avildsen* did not introduce a diary, he did introduce schedules prepared by accountant and had a secretary testify that:

> "At the hearing, Ms. Fetherolf testified that from her personal knowledge and review of the source material [which included airline bills] including desk diaries and calendars she kept, that the schedules furnished to the auditor on August 4, 1989 listing petitioner's location on each day of the years in question were accurate. (Bracketed material added)

The Tribunal also said:

> "If Ms. Fetherolf's testimony had simply been a general statement that petitioner was not present in New York for more than 183 days each year and was based simply on her recollection of events occurring five years ago, rather than on records she had made of these events, it is doubtful that the Administrative Law Judge would have found the testimony credible. Further, in the unlikely event that an Administrative Law Judge would find such a general statement, based solely on recollection, credible, it is possible that we would find such general testimony insufficient to satisfy the petitioner's burden of proof.

2. *Matter of Armel*, Tax Appeals Tribunal, August 17, 1995. Taxpayer won but introduced the following evidence:

> "Petitioners introduced into evidence a letter from Ms. Pat Griffen, a neighbor who watches petitioners' house in Saratoga Springs when petitioners are not in New York. Also in evidence is an affidavit from two friends who reside across the street from petitioners' house in Saratoga Springs. Petitioners further submitted a letter from friends in Saratoga Springs who visit petitioners in Florida. Finally, a fourth signed statement was submitted by six members of a poker club Mr. Armel participates in every Tuesday while in Sarasota. The documents corroborate petitioners' position that they travel back to Florida every year from New York in mid-October and do not return to New York until the following May."

3. *Matter of Reid*, Tax Appeals Tribunal, October 5, 1995.

   In a footnote, Tribunal states, "...taxpayer's burden could be met with credible testimony alone," Taxpayer gave credible testimony as to "general habit of life" in spending every weekend in Connecticut. However, there was corroboration through testimony of a friend as well.

4. Compare *Avildsen, Armel* and *Reid* with *Matter of Hirsch*, Administrative Law Judge, June 13, 1991, with respect to the year 1981..

5. *See also*, Administrative Law Judge determination in *Moed, supra*, for whether five minute jaunt into New York to buy food is a day within meaning of statute.

D. Audit Guidelines.

1. *Matter of Veeder*, Tax Appeals Tribunal, January 20. 1994. *Dicta:* "...auditor could not have been expected to use guidelines not yet in effect at the time of the audit." Does this mean guidelines are relevant at hearing. Keep in mind that in *Avildsen* the Tribunal held that the regulation requiring documentation of days-in and days-out was an audit rule and not binding at hearing. If so, why should guidelines be any different and be binding at hearing? What's good for the goose is good for the gander.

E. Other evidence:

1. Charitable Contributions, Tax Law § 605(c). New law. "...the making of a financial contribution, gift, [etc]... volunteering, giving or donation of uncompensated time...shall not be used in *any* manner to determine where an individual is domiciled." But does this cut both ways. Can a domiciliary of Florida introduce evidence of contributions to Miami UJA. Also, bill provides that not just deductible contributions under IRC § 170(c) qualify; but also, contributions to organizations that must register under State Finance Law § 179-q(7). Contributions to the latter organizations are not necessarily deductible under IRC § 170(c).

III. Appellate Review.

A. Recent cases. All taxpayer loses. Appellate Division usually finds substantial evidence and will not disturb finding of the Tribunal.

1. *Buzzard v. Tax Appeals Tribunal,* 205 AD2d 852, 613 NYS2d 294 (3d Dept. 1994).
2. *Kartiganer v. Koening, et al.,* 194 AD2d 879, 599 NYS2d 312 (3d Dept. 1993)
3. *Kornblum v. Tax Appeals Tribunal,* 194 AD2d 882, 599 NYS2d 158 (3d Dept. 1993).

B. But there were some taxpayer wins at one time. It's not impossible to demonstrate that decision is not based on "substantial evidence" or is "arbitrary" or "irrational".

1. *McKone v. State Tax Commission,* 111 AD2d 1051, 490 NYS2d 628 (3d Dept. 1985), *aff.* 68 NY2d 638, 505 NYS2d 71 (1985).
2. *Bernbach v. State Tax Commission,* 98 AD2d 559, 471 NYS2d 903 (3d Dept. 1984)

C. And there are also some three to two close calls. The following cases should be read for different analysis of "substantial evidence test" in the same case.

1. *Mercer v. State Tax Commission,* 92 AD2d 636, 459 NYS2d 938 (3d Dept. 1983).
2. *Klein v. State Tax Commission,* 55 AD2d 982, 390 NYS2d 686 (3d Dept. 1977), *aff'd* 43 NY2d 812, 402 NYS2d 396 (1977). *But see,* Judge Fuchsberg dissent in *Klien* in the Court of Appeals. Does *Newcomb* have any validity in the 21st Century?

PLANNING STRATEGIES AND CONTROVERSIES ASSOCIATED WITH COMBINED REPORTING IN NEW YORK STATE AND CITY

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TABLE OF CONTENTS

I. Planning Strategies and Controversies Associated With Combined Reporting in New York State and City

- Introduction Page 140
- New York State Statute and Regulations Pages 140-141
- Planning Opportunities Pages 141-142
- Significant Controversies Pages 142-145
- Conclusion Pages 145-146

APPENDIX

- Genetelli and Frankel, "Significant Taxpayer Victory Casts Serious Doubt on Aggressive Use of Forced Combination in New York", CCH State Tax Review, October 2, 1995.

- Genetelli and Zigman, "Planning Strategies to Reduce State and Local Income/Franchise Taxes and Improve Profitability", Journal of State Taxation (Winter, 1995).

- Genetelli, Zigman and Wu, "Tax Alert: Combined Reporting Deadline is Rapidly Approaching in New York", RIA State and Local Taxes Weekly, December 19, 1994.

- Genetelli, Zigman and Bencosme, "Analysis and Planning of Section 482-Type Audits at State and Local Levels", Journal of State Taxation (Winter, 1992).

- Genetelli, "Minimizing State and Local Taxes With Combined (Unitary) Reporting", Journal of State Taxation (Fall, 1991).

I. Introduction.

A. Combined reporting allows a state to apply its apportionment formula to the combined "unitary" tax base of a taxpayer and its "unitary" affiliates, which may include some or all affiliates, regardless of whether the affiliates have business activities in the taxing state.

B. Generally, the combined report totals the profits and losses of all the related unitary corporations, eliminates intercompany transactions, and uses a combined apportionment formula that consists of the total factors for all the included corporations after elimination of intercompany items.

C. In effect, combined reporting allows a state to ignore the separate legal entities by treating a unitary business as one combined taxpayer.

D. Combined reporting is not synonymous with consolidated reporting, which is merely the joint reporting of affiliated corporations which may or may not comprise a unitary business.

II. New York State statute and regulations (comparable provisions exist for New York City).

A. New York Tax Law Section 211.4.

1. Two or more corporations may be required or permitted to file on a combined basis if substantially all of their capital stock is owned or controlled by the same interests and if the Commissioner of Taxation exercises discretion.

2. The Commissioner may not, however, compel the inclusion of a non-New York taxpayer in the combined report unless he deems such a report necessary because of intercompany transactions or some agreement, understanding, arrangement or transaction in order to properly reflect tax liability.

B. 20 NYCRR §§6-2.1 through 6-2.7.

1. Substantially all of the capital stock of the corporations is owned or controlled by the same interests;

2. The corporations must be engaged in a unitary business; and

3. Reporting on a separate basis would distort the taxpayer's New York activities, business, income or capital, or

4. In the case of an attempt by the Department to require combination including a non-New York taxpayer, inclusion must be necessary to properly reflect the taxpayer's tax liability due to intercompany transactions or agreements or understandings that would lead to the inaccurate reflection of income.

III. Planning opportunities.

A. Offset the losses of unprofitable affiliates against the earnings of profitable affiliates, thereby reducing the aggregate state and local taxes paid by the group.

B. Even where no losses are involved, the filing of a combined report by a group of affiliated corporations may still be beneficial due to the impact it may have on the combined apportionment factors as compared to the factors on a separate company basis.

C. Eliminate the adjustment required for expenses attributable to subsidiary capital (for those subsidiaries included in the combined report).

D. Minimize the tax on capital for the group.

1. Maximum tax on capital is $350,000 on a separate reporting basis.

2. This maximum tax also applies to a combined report, regardless of the number of corporations covered by the return.

E. Eliminate the subsidiary capital tax (for those subsidiaries included in the combined report).

IV. Significant controversies.

A. Distortion requirement.

1. Distortion will be presumed if there are "substantial intercorporate transactions".

2. This is, however, only a presumption, which can be overcome.

3. Numerous issues exist with respect to the distortion requirement and the lack of a "bright line" test.

a. What factors should be considered in establishing distortion?

b. How much distortion is necessary to meet the requirement?

4. Is distortion a separate requirement when New York compels combination?

a. The Wurlitzer Company v. State Tax Commission, 35 NY 2d 100 (1974).

b. Matter of Coleco Industries, Inc. v. State Tax Commission, 59 NY 2d 994 (1983).

c. Matter of Campbell Sales Company v. State Tax Commission, 68 NY 2d 617 (1986).

d. Standard Manufacturing Company, Inc. v. State Tax Commission, 69 NY 2d 635 (1986).

e. Petition of Standard Manufacturing Co., Inc., Tax Appeals Tribunal, February 6, 1992.

f. Petition of USV Pharmaceutical Corporation, Tax Appeals Tribunal, July 16, 1992.

g. Petition of Hallmark Cards, Inc., Administrative Law Judge Unit, November 25, 1992.

h. Petition of Medtronic, Inc., Tax Appeals Tribunal, September 23, 1993.

i. <u>Petition of Campbell Sales Company</u>, Tax Appeals Tribunal, December 2, 1993.

j. <u>Petition of Sears, Roebuck and Co.</u>, Tax Appeals Tribunal, April 28, 1994.

k. <u>Petition of The New York Times Company</u>, Tax Appeals Tribunal, August 10, 1995.

l. <u>Petition of Express, Inc., et. al.</u>, Administrative Law Judge Unit, September 14, 1995.

B. Thirty day requirement.

1. Regulations require that an application for combination be submitted within thirty days of a taxpayer's year end.

2. Is an application necessary if all requirements for combination are met?

a. <u>Petition of Autotote Limited</u>, Tax Appeals Tribunal, April 12, 1990.

b. <u>Petition of Chudy Paper Co., Inc.</u>, Tax Appeals Tribunal, April 19, 1990.

c. <u>Petition of Penthouse International, Ltd.</u>, Tax Appeals Tribunal, January 20, 1994.

d. <u>Petition of A.G. Becker Paribas Group, Inc.</u>, Administrative Law Judge Unit, April 21, 1994.

e. Petition of Mohasco Corporation, Administrative Law Judge Unit, May 27, 1993, affirmed, Tax Appeals Tribunal, November 10, 1994.

f. Petition of Exhibitgroup, Inc., Tax Appeals Tribunal, October 19, 1995.

C. Other issues.

1. Passive holding companies.

2. Separate line of business distinction.

3. Statute of limitations.

4. Attribution of expenses to subsidiary capital on a combined basis.

5. Treatment of gain or loss on the sale of a subsidiary.

6. Hybrid apportionment formula/factor relief.

V. Conclusion.

A. Review the costs and benefits of filing on a combined basis.

1. This evaluation must include an assessment of which companies are to be included in the combined report.

2. In addition, the tax impact of combination must be analyzed in the current year, future years, and prior years still open under the statute of limitations.

B. Consider the implications of filing on a combined basis retroactively in light of the holdings in Autotote Limited, Chudy Paper, Penthouse International, A.G. Becker Paribas Group and Mohasco.

C. If combined reporting is detrimental, review the potential exposure associated with forced combination.

1. The pricing of intercompany transactions must be analyzed to determine whether arm's length pricing can be established to rebut the presumption of distortion stemming from substantial intercorporate transactions.

2. Consider whether the holdings in Standard Manufacturing, Campbell Sales, USV Pharmaceutical and Hallmark Cards provide a basis to invalidate any previous combined filings.

APPENDIX

Significant Taxpayer Victory Casts Serious Doubt on Aggressive Use of Forced Combination in New York

*by Richard W. Genetelli, CPA, of Genetelli & Associates, New York, New York, and CCH State Tax Advisory Board Member Paul H. Frankel, Esq., of Morrison & Foerster, New York, New York */*

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New York's aggressive use of forced combination to raise additional revenue has become a hotly contested issue in recent years. Much recent litigation has focused on New York's attempts to combine New York taxpayers with their non-taxpayer affiliates when the ownership and unitary business requirements are met and substantial intercorporate transactions exist. In such instances, taxpayers are compelled to demonstrate that filing on a separate basis does not distort their income and activities in New York because intercompany activities are conducted on an arm's-length basis. The case that follows, *Petition of Express, Inc., et al.* (New York Division of Tax Appeals, Administrative Law Judge Unit, DTA Nos. 812330, 812331, 812332, and 812334, September 14, 1995), demonstrates that properly equipped taxpayers can successfully challenge New York's use of forced combination.

Background

In *Express, Inc.*, four retailers of clothing and accessories successfully rebutted the presumption of distortion stemming from substantial intercorporate transactions so that the Division of Taxation could not require each retailer to file a combined corporate franchise (income) tax report with its respective trademark affiliate. The retailers established that the trademark affiliates were economically viable entities created for numerous business and legal reasons. The retailers further established through expert testimony that their transactions with the trademark affiliates were at arm's length pursuant to the regulations and principles of Internal Revenue Code §482.

Each retailer transferred certain trademarks to a newly created trademark protection company in exchange for 100% of the trademark affiliate's stock in a nonrecognition transaction pursuant to IRC §351. Each trademark protection company was created for the following business and legal reasons

- to insulate the trademarks from litigation;
- to protect the companies from hostile takeover attempts;
- to provide a centralized system to deal with the trademarks on a worldwide basis;
- to allow for the future licensing of the trademarks;
- to insure that the retail operations would not be dragged into lawsuits involving the trademarks; and
- to protect officers and directors of the retail operations from being harassed in litigations.

The royalty fee charged by each trademark protection company to its respective retailer/affiliate for use of the trademarks was intended to be arm's length so that the companies would not be accused of "naked licensing." If an owner of a mark licenses the mark and does not maintain the nature and quality of the goods on which the mark is used by the licensee, the owner can be found to be engaged in naked licensing and the mark can be invalidated.

Upon audit, the Division concluded that each retailer should have filed a combined report with its respective trademark protection company because each retailer was purportedly engaged in a unitary business with such affiliate, the ownership requirement for combination was met, and there were substantial intercorporate transactions between the companies which gave rise to a presumption of distortion. At the hearing, the Division asserted that three types of intercorporate transactions resulted in distortion

- the transfer of the trademarks to the trademark protection corporations;
- the licensing of the trademarks by the trademark affiliates; and
- intercompany loans between the companies.

The Division further asserted that the "seamless integration" of relationships between each retailer and its respective trademark affiliate resulted in "inherent distortion."

Combined Reporting Not Required

The Administrative Law Judge held that combined reports could not be required since the retailers successfully rebutted the presumption of distortion at the hearing. The ALJ first ruled that the trademark companies were viable corporations, each of which was engaged in the registration and protection of the trademarks it owned. The ALJ considered the following factors in reaching this conclusion

- the legal necessity of trademark protection by the trademark companies to protect their assets;
- the extensive activities of the trademark companies with respect to the protection and registration of the marks;
- the numerous other business reasons for choosing to create a trademark company; and
- the fact that during the period at issue the trademark companies maintained proper corporate form and operated through regular shareholders' and board of directors' meetings.

The ALJ next rejected the Division's argument of inherent distortion, stating that such argument would lead to the conclusion that the presumption of distortion is irrebuttable. Such conclusion would be contrary to the established line of cases that hold that the presumption of distortion arising from the existence of substantial intercorporate transactions may be rebutted by a showing of an arm's-length relationship between the related corporations (see *Petition of Standard Manufacturing Co.*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 801415, February 6, 1992; *Petition of USV Pharmaceutical Corp.*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 801050, July 16, 1992; *Petition of Campbell Sales Co.*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA Nos. 805017 and 805018, December 2, 1993; *Petition of Sears, Roebuck & Co.*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 801732, April 28, 1994; *Petition of The New York Times Co.*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 809776, August 10, 1995).

The ALJ then rejected the Division's assertion that the nonrecognition transfers of the trademarks to the trademark companies result in distortion. The ALJ found that the nonrecognition transfers (trademarks exchanged for 100% of the trademark corporation's stock) were arm's-length transfers since the value of a corporation's stock is, by definition, equal to its assets.

Finally, the ALJ ruled that expert testimony established that intercompany royalty and interest rates were at arm's length, thus rebutting the presumption of distortion arising from the existence of substantial intercorporate transactions. First, expert testimony demonstrated that royalty rates fell within an arm's-length range under the comparable-profits method, a method specified in the regulations under IRC §482 as available to determine the arm's-length character of a controlled transfer of intangible property. This finding was supported by further expert testimony that, under a rate-of-return analysis, royalty rates paid by the retailers to their respective trademark affiliates were consistent with arm's-length rates.

Second, expert testimony demonstrated that interest rates on the loans made by the trademark companies to the retailers fell within the safe haven range as provided for in the regulations under IRC §482. Consequently, the Division could not require the retailers to file combined reports with their respective trademark affiliates.

Conclusion

The *Express, Inc.* decision exemplifies the aggressiveness of New York in pursuing combination. More importantly, it also demonstrates that taxpayers can successfully challenge forced combination with proper analysis and a purposeful showing of the facts underlying the case.

[The views expressed above are those of the individual authors and not necessarily those of CCH or the State Tax Advisory Board.]

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*/ Richard W. Genetelli was an expert witness, and Paul H. Frankel represented the petitioners along with Hollis L. Hyans and Craig B. Fields.

Income Taxes— continued from page 3

■ NEW YORK

Nexus Shown Between State and Corporation Generating Income

The business presence and activities in New York of corporations whose securities generated investment income for a taxpayer provided the requisite nexus for imposition of corporation franchise (income) tax on the investment income.

The taxpayer was a multinational corporation, incorporated in Delaware, with activities in all 50 states. Its main areas of business included automotive, aerospace/electronics, industrial/energy, and forest products. The taxpayer had investment income from various high technology companies but had nothing to do with the business activities of those companies.

The Due Process and Commerce Clauses of the U.S. Constitution prohibit a state from taxing the income of a nondomiciliary corporation unless there is some nexus between the income and the state. The tax at issue was imposed on investment income and was allocated by an adjusted investment allocation percentage pursuant to §210.3(b), Tax Law. Since the investment allocation percentage was calculated based on the stock issuer's New York State activities, it clearly reflected the issuer's business presence in New York.

Further, it was not required that a unitary business exist between the taxpayer and the companies in which it invested in order to support imposition of the tax. Each of the issuers of stock had a connection with New York, which was expressed in the taxpayer's investment allocation, and this connection was sufficient to support the tax imposed on the income generated by the stock issued by these corporations. (*Allied Signal, Inc.*, New York Division of Tax Appeals, Tax Appeals Tribunal, DTA No. 806120, September 7, 1995.)

Planning Strategies to Reduce State and Local Income/Franchise Taxes and Improve Profitability

RICHARD W. GENETELLI AND DAVID B. ZIGMAN

State and local ("state") taxes have become increasingly more important and costly for businesses. In many cases, the state tax burden is greater than the federal tax burden, particularly when profits are marginal. Consequently, it is important to minimize the state tax burden by implementing the appropriate planning strategies. In fact, a diagnostic review of a taxpayer's state tax posture should generally be undertaken periodically to determine if all available tax planning opportunities have been considered. The following is an overview of various planning strategies that can reduce a company's overall state income/franchise tax burden and ultimately increase its bottom line.

TAX CONSIDERATIONS BEFORE FORMING A CORPORATION

State tax planning should begin before forming a corporation. Companies often focus primarily on nontax considerations when forming a corporation; however, significant tax savings may be generated by adopting the appropriate strategies when forming a corporation.

Choosing a particular state of incorporation may have significant tax implications. Most states require a domestic corporation (i.e., a corporation incorporated in a state) to file an income/franchise tax return regardless of whether the corporation is actually conducting business in the state. Such filing responsibility can result in a costly

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tax burden. For example, many corporations are incorporated in Delaware for nontax reasons. Delaware, however, imposes an annual franchise tax on domestic corporations (generally based on authorized capital stock) for the privilege of incorporation that can be as high as $150,000 in certain instances.[1] Similarly, New York State imposes a franchise tax (generally based on the greatest of an income, a capital, or an alternative minimum, plus a tax on subsidiary capital) on domestic corporations regardless of whether activities are conducted within the State.[2] The New York State franchise tax liability of such a company may be significant in certain circumstances (e.g., if the corporation has certain passive investments or has substantial sales destined for customers in the State).

Furthermore, certain states tax foreign corporations differently from domestic corporations. Such disparate tax treatment may greatly impact a company's tax liability, and should be considered in selecting a state of incorporation. In Alabama, for example, the franchise tax is imposed on domestic corporations at the rate of $10 for each $1,000 of capital stock, which consists of the aggregate par value of issued stock.[3] Foreign corporations, however, are taxed at a lower rate, $3 for each $1,000, but on a more inclusive base, that is, capital employed in the State[4] (not to exceed the sum of tangible property located in the State and intangible property employed in the conduct of business in the State).[5] The base includes the aggregate par value of issued stock, surplus and undivided profits, long-term debt, debt to certain related corporations, and accelerated depreciation.[6] The constitutionality of the Alabama franchise tax was upheld in *White v. Reynolds Metals Company*.[7]

Another factor that should be evaluated whenever a corporation is formed is the type of stock to be issued (i.e., par versus no-par value). While there may be certain nontax considerations for issuing no-par value shares, the issuance of such shares should generally be avoided from a state tax planning point of view. For example, the initial filing fee imposed by certain states on no-par value shares may be higher than the fee on the same number of par value shares.

1. Del Code Ann Titl 8 § 503.
2. NY Busn Corp Franchise Tax Reg § 1-3.1.
3. Ala code § 40-14-40 (1975).
4. Ala Code § 40-14-41(a) (1975).
5. Ala Code § 40-14-41(c) (1975).
6. Ala Code § 40-14-41(b) (1975).
7. 558 So 2d 373 (1989); cert den US S Ct 89-1587 (4 June 1990).

It is important to review the activities of a company in determining whether returns are required to be filed in the various states. A working knowledge of a company's activities and filing requirements provides the overall foundation for state tax planning. For example, it may be possible to shift certain activities from one state to another in order to minimize the overall state tax liability. In determining whether a company is taxable in a particular state, one must carefully examine the company's activities in light of the law, regulations and court decisions in that state, as well as decisions of the U.S. Supreme Court. Generally, domestic corporations are required to file an income/franchise tax return in their state of incorporation. Foreign corporations, however, are generally subject to income/franchise tax if they qualify to do business or nexus in a state.

Qualification generally refers to the process in which a foreign corporation obtains a certificate to do business in a state. A foreign corporation may be required to qualify to do business by a state if it enters into repeated and successive business transactions in that state, other than transactions in interstate or foreign commerce. If a foreign corporation has sufficient activity in a state to require qualification but fails to do so, the state may deny the corporation certain rights such as access to the courts as plaintiffs, and impose civil penalties.

The issue of whether a foreign corporation has an income/franchise tax filing responsibility based solely on qualification has been the subject of controversy and litigation in recent years. For example, in *The Kelly-Springfield Tire Co. v. Commissioner of Revenue,*[8] a foreign corporation's voluntary qualification to do business in Massachusetts did not constitute a sufficient business activity to deprive the corporation of the protection of Public Law No. No. 86-272 (described in detail below). Therefore, the corporation was not subject to the Massachusetts corporate excise tax based on mere qualification, since the corporation's only activities in the State did not exceed solicitation for purposes of Public Law No. 86-272. A similar decision was handed down o the Connecticut corporation business tax in *The Kelly-Springfield Tire Co. et al. v. Bajorski, Acting Commissioner of Revenue Services.*[9] In determining the potential for nexus based solely on qualification, companies should carefully consider the tax implications before qualifying to transact business in a particular state.

8. Mass ATB (5 May 1993).
9. 228 Conn 137 (1993).

Nexus is the contact necessary to subject a corporation to a state's taxing authority. Generally, a corporation will have income/franchise tax nexus if it has a physical presence in a state (i.e., maintains real or tangible personal property, stores inventory and raw materials, or establishes an office in a state) or performs services in a state. However, a corporation will not have nexus if its activities in a state are within the scope of protection afforded by the federal Interstate Income Law, Public Law No. 86-272.[10]

Public Law No. 86-272 prevents a state from imposing its income tax on a taxpayer whose only activity within the state is soliciting orders for the sale of tangible personal property, provided these orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state. Public Law No. 86-272 applies only to the imposition of state income taxes, and to entities that derive their income from the sale of tangible personal property, rather than intangible property or services.

Throughout the years, the states have offered varying interpretations of Public Law No. 86-272, specifically, what activities are considered to be within the scope of solicitation. Those interpretations resulted in considerable litigation throughout the country, which culminated in the U.S. Supreme Court decision in *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*[11] in which the Court set forth a new standard for determining activities protected by Public Law No. 86-272. "Solicitation of orders" covers those activities that are entirely ancillary to requests for purchases, that is, those activities that serve no independent business function apart from their connection to soliciting orders. Examples of such activities are the use of company cars and free product samples by sales representatives, since their only purpose is to facilitate purchase requests. On the other hand, "solicitation of orders" does not include those activities that a company would have to engage in anyway, but chooses to assign to its in-state sales force. For example, employing salespeople to repair or service a company's products is not ancillary to requesting purchases, since this activity will be performed whether or not the company has a sales force. In setting forth this new standard, the Court refused to hold that all post-sale activities as a rule were not ancillary to requests for purchases.

The Court also held that Public Law No. 86-272 incorporates a *de minimis* rule. Therefore, if a taxpayer's in-state activity other than "solicitation of orders" is sufficiently *de minimis*, the tax immunity conferred by Public Law No. 86-272 is not forfeited. On the other

10. 73 Stat 555 (1959), in US Code § 381.
11. 112 S Ct 2447 (1992).

hand, if the activity establishes a nontrivial-additional connection with a taxing state, the *de minimis* rule does not prevent the loss of tax immunity granted by Public Law No. 86-272.

The protection afforded by Public Law No. 86-272 can significantly limit a company's state tax exposure. However, a certain amount of planning is necessary to insure that this protection is not lost. For example, it is important to establish specific guidelines for sales personnel that conform with the requirements of Public Law No. 86-272 and, specifically, the *Wrigley* case. These guidelines should be memorialized in the appropriate internal documents and materials of the company. For example, the guidelines may be incorporated in a sales manual that can be given to all sales personnel and used in training classes and seminars. In addition, order forms may indicate that orders have not been accepted by sales personnel. By taking precautionary steps, a company may be better able to assert that the activities of its sales personnel do not exceed solicitation, when questioned by a state.

ESTABLISHING THE RIGHT TO APPORTION INCOME

If a multistate corporation is required to file an income/franchise tax return in a particular state, the corporation should determine how much income is attributable to the state. The law and regulations of each state generally contain provisions for apportioning and/or allocating income within and without the state. Such provisions should be reviewed to determine if all income must be apportioned by a statutory apportionment formula, which generally consists of the average of three factors that compare property, payroll, and receipts in the state to their counterparts everywhere. The provisions should also be reviewed to determine whether certain passive income, such as interest, dividends, and capital gains, qualifies as nonbusiness (nonunitary) income that may be allocated (generally to a corporation's commercial domicile or the jurisdiction in which the income-producing property is located).

Even when a state does not provide for the allocation of passive income, such income may generally not be apportioned by a state if derived from non-unitary sources. In this regard, certain states, such as New Jersey, have taken the position that virtually all income of a corporation doing any business in the state is, by virtue of common ownership, part of the corporation's unitary business and, therefore, apportionable. However, in *Allied-Signal, Inc. v. Director, Division of Taxation*,[12] the U.S. Supreme Court held that it was unconstitutional

12. 112 S Ct 2251 (1992).

for New Jersey to tax a nondomiciliary corporation on the capital gain it derived from the sale of a minority stock interest in another corporation when the two corporations were not engaged in a unitary business.

Allied-Signal upheld the unitary business principle, as set forth in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*[13] and *Exxon Corp. v. Wisconsin Department of Revenue*,[14] and as applied in *ASARCO Inc. v. Idaho State Tax Commission*,[15] *F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico*,[16] and *Container Corp. of America v. Franchise Tax Board*,[17] as the appropriate means of measuring the amount of income earned within a state. Those cases prescribe the constitutional (due process and commerce clause) limitations on states attempting to tax value earned outside their borders. Pursuant to those cases, the indicia of a unitary business are functional integration, centralization of management and economies of scale.

Allied-Signal provides further guidance as to when a state may tax the income of a nondomiciliary corporation. The Court noted that a unitary relationship between a payor and payee corporation is not a prerequisite to apportionment if a capital transaction serves an operational rather than an investment function. For instance, a state may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another state if such income forms part of the working capital of the corporation's unitary business, even though there is no unitary relationship between the corporation and the bank.

Based on the principles enumerated in *Allied-Signal*, corporations should consider whether passive income may be excluded from the apportionable tax base in states such as New Jersey. In addition, the *Allied-Signal* decision should be cited to support any filing position that properly excludes such income from the apportionable tax base.

A corporation should also review the requirements for establishing the right to apportion income within and without a state. The requirements that must be met in order to apportion income vary significantly among the states. Common criteria include whether a corporation is carrying on business outside the state,[18] maintaining a

13. 445 US 425 (1980).
14. 447 US 207 (1980).
15. 458 US 307 (1982).
16. 458 US 354 (1982).
17. 463 US 159 (1983).
18. Col Rev Stat § 39-22-303(2).

regular place of business outside the state,[19] or is taxable outside the state.[20]

Generally, a state will seek to tax a corporation on all of its income unless the right to apportion income has been established. If all of a corporation's income is being taxed by a particular state, significant tax savings may be generated by establishing the right to apportion income outside the state.

For example, corporations that maintain a regular place of business outside of New York City may apportion income within and without the City by use of a three-factor formula consisting of property, payroll, and receipts.[21] However, if a corporation maintains all of its property and employees in New York City and sells products throughout the United States, the City would tax all of the corporation's income (i.e., the apportionment percentage would be 100 percent) since the corporation would not have the right to apportion income. If the corporation set up a bona fide office outside of New York City, the right to apportion income would be established, and the tax liability would significantly decrease since, based on the receipts factor, a substantial portion of income would be apportioned outside the City.

In selecting a state in which to establish such an office, consideration should be given to the several states that do not impose an income/franchise tax, as well as those that have a relatively low effective tax rate. However, before a particular state is selected, a review should be made of the various other taxes imposed by the state. For example, Washington imposes a business and occupation tax,[22] and Michigan imposes a single business tax,[23] each of which may be significant. In addition, the potential impact on the corporation's receipts factor in the various states should also be evaluated.

FAIRNESS OF THE APPORTIONMENT FORMULA

The purpose of the apportionment formula is to reflect fairly a multistate taxpayer's business activity in a particular state and avoid overlapping taxation. That purpose is consistent with the principle that a multistate taxpayer must not bear more than its fair share of the state tax burden and must not be exposed to multiple taxation not borne by those operating entirely within the state.[24]

19. NJ Stat Ann 54:10A-6.
20. Pa L No 6 § 401(3)2.(a)(2), Act of 4 March 1971.
21. NYC Gen Corp Tax Rul § 11-63(b).
22. RC Wash Ch 82.04.
23. Mich CL Ch 208.
24. Complete Auto Transit v Brady, 430 US 274 (1977).

If the application of an apportionment formula does not fairly represent the extent of a taxpayer's activity in a state, it may be appropriate to use other methods to determine the amount of income attributable to the state. The use of other methods is recognized in the Uniform Division of Income for Tax Purposes Act (UDITPA). Section 18 of UDITPA provides that, if the apportionment (and allocation) provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state, the taxpayer may petition for, or the tax administrator may require, an adjustment in, or departure from, the standard apportionment method. Section 18 lists, as possible alternatives, separate accounting, the exclusion of one or more factors, the inclusion of one or more additional factors, and any other method to effectuate an equitable apportionment (and allocation) of the taxpayer's income.

The next three sections discuss separate accounting, alternative apportionment formulas, and combined reporting, as alternative methods to correct the distortion of income. These methods are discussed from a planning point of view; however, it is important to keep in mind that these methods may also play a role in determining the fair attribution of income to the various states. For example, a separate accounting analysis may be useful in assessing the fairness of the application of the standard apportionment formula. Therefore, the importance of these methods is not limited to tax planning.

SEPARATE ACCOUNTING IN LIEU OF STATUTORY APPORTIONMENT

Separate accounting has long been recognized as a reasonable means of attributing income to a state.[25] Depending upon a company's in-state activities, and the relationship of such activities to its out-of-state activities, the company may be able to lower its tax liability through the use of separate accounting. By way of background, formula apportionment considers income to be derived from a state in proportion to corporate activities in the state, and divides income accordingly. In conjunction with formula apportionment, specific allocation is generally used to single out items of income that lend themselves to precise geographic location. In contrast, separate accounting attempts to isolate the activity conducted in a particular state in order to develop the directly related net income.

If the use of the statutory apportionment formula in a particular state does not properly reflect income in that state, a company should consider requesting permission to file returns on a separate-account-

25. Hans Rees' Sons, Inc v North Carolina, 283 US 123 (1931).

ing basis. To support the use of separate accounting, certain factors should generally be focused on: the relationship of the business conducted by the division in the state with that conducted outside the state, the level of interdivisional transactions, and the interdependence of the management of the in-state division with that of the out-of-state division. The foregoing factors are not intended to be an all-inclusive list. In addition, separate accounting must clearly reflect the amount of income earned in the state.

Certain jurisdictions favor the use of separate accounting over the use of the statutory apportionment formula. For example, in Mississippi, separate accounting is preferred, and the use of the apportionment formula is only permitted if the records necessary to support the separate-accounting concept are not available.[26]

MODIFYING THE APPORTIONMENT FORMULA

As previously mentioned, the statutory apportionment formula in most states generally consists of an equally weighted three-factor formula consisting of property, payroll, and receipts. Certain states have adopted variations to the three-factor formula. For example, Massachusetts double weights the receipts factor,[27] and Iowa merely employs a single-factor receipts formula.[28]

A multistate corporation may be able to reduce its tax liability in a particular state by modifying the statutory apportionment formula in certain instances. If any component of a company's apportionment formula appears to be out of line when compared with the other components, or the overall apportionment percentage does not properly reflect the activities of the company in the state, the company should determine whether authority exists to alter the apportionment formula.

Most states allow for the elimination, substitution, or modification of one or more of the components of the apportionment formula to properly reflect a company's business income or activities in the state. However, an adjustment to the apportionment formula is generally discretionary and, consequently, permission must first be obtained from the state. For example, Wisconsin provides that a corporation that proves, to the satisfaction of the Department of Revenue, that the use of any one of the components of the three-factor formula provides an unreasonable or inequitable apportionment ratio may omit that factor when computing the apportionment percentage.[29]

26. Miss Code Ann § 27-7-23(c)(2)(B)(iii).
27. Mass GL Ch 63 § 38(c).
28. Iowa Code § 422.33.2.b(4).
29. Wis Stat § 71.25(11).

If an apportionment formula modification is denied by a state even though it seems appropriate, redress may be sought through the judicial process. Many corporations have successfully challenged state tax administrators on the issue of modifying the apportionment formula when discretionary relief is unreasonably withheld. For example, in *Tambrands, Inc. v. State Tax Assessor,*[30] the tax assessor's inclusion of dividends paid by foreign nation affiliates in a corporation's apportionable business income, without including any portion of the affiliates' property, payroll, and receipts in the company's apportionment formula, violated the due process and commerce clauses of the U.S. Constitution. In *Crocker Equipment Leasing, Inc. v. Department of Revenue,*[31] a financial corporation that generated 98 percent of its unitary income from intangible property was permitted to apportion its income to Oregon using an alternative apportionment formula that included intangible property in the property factor. The court found that the exclusion of intangibles from that factor resulted in an unfair reflection of the extent of the company's business activity in Oregon.

A significant area in which corporations have sought to modify the apportionment formula involves the taxation of partnership income. For example, corporate partners may be required to include income from partnerships in the tax base without factor representation for this income. This may result in a disproportionately high apportionment of that income to a state (based on the apportionment factor of the corporate partner) in relation to the level of activity the partnership conducts in the state. An important taxpayer victory regarding this issue occurred in *Homart Development Co. v. Norberg, Tax Administrator.*[32] In *Homart Development*, the tax administrator attempted to tax a corporation's proportionate share of income from partnerships located outside of Rhode Island while excluding a proportionate share of the partnerships' property, payroll, and receipts from the corporation's apportionment formula. The court found the taxation of the partnership income manifestly inequitable in this instance, and allowed the corporation to include a proportionate share of the partnerships' apportionment factors in the corporation's apportionment formula.

An important key to successfully challenging the fairness of an apportionment formula is fully understanding the business of the taxpayer. Facts and circumstances generally play a crucial role in determining whether the modification of an apportionment formula is ap-

30. Me Supp Jud Ct 7 Aug 1991.
31. 314 Or 122 (1992).
32. 529 A 2d 115 (1987).

propriate. For example, in *The Montana Department of Revenue v. United Parcel Service, Inc.*,[33] a motor carrier specializing in a nationwide small package pick-up and delivery service was entitled to use an alternative apportionment method because it was able to show that for its business, the "mileage method" of calculating the sales factor used by the Department of Revenue overstated the amount of revenue attributable to Montana. The mileage method is calculated by dividing the number of miles traveled by the taxpayer in Montana by the total miles traveled by the taxpayer nationally and multiplying the percentage by the total revenue received by the taxpayer. The motor carrier showed that the mileage method overstated its business activity in Montana because its drivers in Montana drove more miles to deliver fewer packages than drivers in any other state, and the average revenue per mile varied substantially from state to state.

COMBINED (UNITARY) REPORTING STRATEGIES

One planning opportunity that should always be considered in minimizing a company's state tax burden is the filing of returns on a combined (unitary) basis. Combined reporting generally ignores separate legal entities and allows related corporations to report the tax liability essentially as if they were one corporation. Filing on a combined basis permits the losses of unprofitable affiliated companies to offset the earnings of profitable affiliates, with the effect of reducing the overall state taxes paid by the group. Even if no losses are involved, a combined report may have a beneficial impact on the apportionment factors, thereby reducing the overall state tax burden. Specifically, the apportioned income of a combined group may be less than the aggregate income apportioned on a separate-entity basis.

Corporations that may be included in a combined report must be determined based on the relevant state tax laws. To qualify to file on a combined basis, most states require that the affiliates be closely related through stock ownership and that there be a great number of interrelationships or intercorporate transactions among the affiliates. The exercise of a high degree of control by the parent of a group is also considered a significant factor. Such activities are generally used in determining whether the affiliates are engaged in a unitary business, a subject considered in a number of court decisions.[34]

A determination to file on a combined basis must include a thorough review of which companies are to be included. For example, not

33. 830 P 2d 1259 (1992).
34. Mobil Oil Corp v Commr Tax Vermont, 445 US 425 (1980); Exxon Corp v Wisconsin Dept Rev, 447 US 207 (1980).

all corporations that are included in a federal consolidated return will necessarily qualify for inclusion in a combined report. In addition, certain states do not allow corporations organized in a foreign country to be included in a combined report,[35] while other states aggressively pursue their inclusion.[36] Generally, entities that are not deemed to be general corporations (e.g., banks, insurance companies, or other specialty corporations) also may not be included in a combined report with other general corporations in many states.[37] In certain instances, more than one combination of companies or only selected companies or divisional operations may be appropriate. For example, limited combinations following a "line of business" or "business segment" approach may be appropriate. The tax consequences of filing on a combined basis may change dramatically depending on the combination; therefore, it is extremely important to consider the various alternatives.

A decision to file on a combined basis must also include an analysis of the tax impact. Different states approach the combined apportionment of income in different ways. For example, in some states, after profits and losses of various affiliates are combined and intercompany transactions are eliminated, income is apportioned according to the combined factors of the group.[38] Other states combine the income of the various members of the group after each member separately determines its apportioned income to the state,[39] which reduces the possibility of diluting the state income of a given affiliate with significant presence in a state by combining income with other affiliates with lower apportionment factors in the state.

In analyzing the tax impact of combination, a corporation must review not only the current year, but also future years and prior years that are open under the statute of limitations. Once a company files on a combined basis, it may be difficult to revert back to filing on a separate basis.[40] Therefore, it is important to determine the tax effect over a number of years, since the effect of combination may be erratic. The result of unitary taxation in any one year may be misleading. For example, combined reporting may have minimal tax effects in the current year but a significant impact in future years.

Depending on the implications of combination, it may be advisable to take steps to strengthen or remove unitary relationships to support a company's position on combination. The facts and circumstances in

35. NY Busn Corp Franchise Tax Reg § 6-2.5(b).
36. Barclays Bank, PLC v Franchise Tax Board of California, 62 USLW 4552 (1994).
37. NY Busn Corp Franchise Tax Reg § 6-2.5(c).
38. NY Busn Corp Franchise Tax Reg § 4-1.2.
39. Conn Gen Stat § 12-223a(3).
40. NY Busn Corp Franchise Tax Reg § 6-2.4(d).

each particular case will determine whether it is possible to restructure corporate relationships to be unitary.

If unitary status is desired (because combination is beneficial), it may be relatively easy to achieve. For example, a formerly "discrete business group" (i.e., one not unitary with its affiliates) could be made unitary in a number of ways, including: exercising day-to-day operational control of subsidiaries; creating intercompany transactions; and centralizing various functions such as accounting, legal, marketing, and capital formation.

Breaking a unitary relationship (because combination is detrimental) is generally more difficult, especially if a substantial flow of value exists among the members of the corporate group. Steps that can be taken to weaken unitary ties among companies include eliminating common officers and directors and reducing common administrative functions or centralized financing. When intercompany ties are widespread, however, those steps may not be practical and other steps should be considered.

If combined reporting produces an overall tax savings for a group, it is generally advisable to use it, since states will actively pursue combined filing if a deficiency results. Companies should be prepared to aggressively support the right to file on a combined basis, or conversely, to disprove that a combined report is proper when a state attempts to force combination. In certain cases, litigation may be necessary to sustain a company's position.

New York is a good example of a state where companies have successfully used the court system to sustain a position on combination. The combined reporting standards in New York State include stock ownership, unitary business, and distortion.[41] Distortion will be presumed for a company if there are substantial intercorporate transactions among that company and the other members of the combined group.[42] Intercorporate transactions are substantial when they account for at least 50 percent of a corporation's receipts or expenses.[43]

A line of New York Court of Appeals cases has deemed the distortion requirement to be irrelevant when New York attempted to compel combination between a non-New York taxpayer and a New York taxpayer based on stock ownership, unitary operations, and substantial intercorporate transactions (see *Matter of Campbell Sales Co. v. State Tax Commission*[44] and *Matter of Wurlitzer Co. v. State Tax Commission*).[45] Under *Campbell Sales* and *Wurlitzer*, New York

41. Id at 6-2.1(a).
42. Id at 6-2.3(a).
43. Id at 6-2.3(c).
44. 68 NY 2d 617 (1986).
45. 35 NY 2d 100 (1974).

could compel a non-New York taxpayer to file a combined report if the stock ownership and unitary business requirements were met, and combination was necessary to properly reflect tax liability because of substantial intercorporate transactions (with no opportunity for the company to rebut the presumption of distortion) or because of an arrangement under which income was not properly reflected.

However, in *Petition of Standard Manufacturing Co., Inc.*,[46] the Tax Appeals Tribunal held that an opportunity to rebut the presumption of distortion must be provided when New York seeks to compel a combined report between a non-New York taxpayer and a New York taxpayer and substantial intercorporate transactions exist. Since Standard Manufacturing reported intercompany transactions based on adjustments related to a Section 482 audit conducted by the IRS, the presumption of distortion was rebutted, and a combined report was not required. A series of subsequent cases involving the involuntary combination of a non-New York taxpayer followed the rationale of *Standard Manufacturing*.[47] Thus, companies were able to effect a change in the interpretation of the combined reporting standards in New York through the use of the court system.

ELECTING DIFFERENT ACCOUNTING METHODS

Another way to reduce a company's income/franchise tax liability is to use an accounting method for state tax purposes different from that which is used for federal tax purposes. Several states have their own income tax law, and consequently, do not use federal taxable income as the starting point in determining state taxable income. Tax savings may be achieved in such states by electing a different method of accounting for state tax purposes.

For example, it may be possible for certain companies to defer state income taxes by electing the completed-contract method of reporting for state tax purposes while using the percentage-of-completion method for federal purposes. Other alternatives that may be available to defer income or accelerate deductions for state tax purposes are the installment method of reporting and an accelerated method of depreciation. However, the impact of making those elections must be carefully considered before implementation.

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46. NYS Div Tax App, Tax App Trib (6 Feb 1992).
47. Petition of USV Pharmaceutical Corp, NYS Div Tax App Trib (16 July 1992); Petition of Medronic, Inc. NYS Div Tax App Trib (23 Sept 1993); Petition of Campbell Sales Co, NYS Div Tax App Trib (2 Dec 1993).

REORGANIZATION CONSIDERATIONS

When filing on a combined basis would be beneficial but is not available under state law, it might be possible to achieve the same result by either merging or liquidating corporations. Even after a merger, some states will seek to determine whether the separate activities of a corporation are unitary, and may require income to be allocated by separate accounting if the segments are found not to be unitary.[48] Mergers and liquidations frequently carry with them federal or other state tax implications (e.g., transfer taxes) that may make the transaction undesirable. Therefore, implications should be considered before any restructuring.

It may also be possible to achieve state tax savings by establishing a separate subsidiary to conduct certain activities. By establishing a separate subsidiary, a parent corporation may be able to isolate in the subsidiary its activities conducted in a particular jurisdiction, thereby minimize its overall state tax burden. The parent corporation would no longer have a filing requirement in the jurisdiction (presuming all nexus-creating activities of the parent are isolated in the separate subsidiary and returns are filed on a separate basis), and the subsidiary would only be taxed on the income generated by the isolated activities. However, if the operations of the parent and subsidiary were unitary, the state could require the filing of a combined report which would reduce the benefit of this planning strategy.

Corporations that earn a significant amount of passive income from investments may find it beneficial to transfer the investments that generate such income to a separate investment subsidiary located in a state that offers favorable tax treatment. The existence of the subsidiary permits the parent corporation to convert what previously was interest income, capital gain, or royalty income from patents and copyrights into intercorporate dividends, which are afforded favorable tax treatment in most states.

The formation of an investment subsidiary must be planned carefully, with a view toward both obtaining dividend treatment and minimizing the tax on the investment subsidiary. The investment subsidiary should have a bona fide office with appropriate personnel to handle its investment holdings. The office should demonstrably be the office of the subsidiary, with the title or leasehold in the subsidiary's name. All executive decisions made by the subsidiary should

48. Tranel, Inc v Commonwealth of Pennsylvania, 558 A 2d (1989), aff'd per curiam by Comm Ct, 593 A 2d 402 (1991); Request for Ruling, Gen Corp Tax, July 27, 1989, City of New York, Dept of Finance, Office of Legal Affairs.

be undertaken, in documented form, at the subsidiary's office, and the subsidiary should generally operate as autonomously as possible.

The location of an investment subsidiary must also be carefully planned. While it is not possible to generalize what the best possible location would be under diverse circumstances, Delaware and New York State should typically be considered.

Delaware exempts from tax corporations whose activities within the State are confined to maintaining and managing their intangible investments, and collecting and distributing the income from investments and from tangible property physically located outside the State.[49] (Although Delaware imposes a franchise tax on investment companies, it can be minimized by limiting authorized shares of capital stock to 3,000 or less.)

New York State generally exempts from corporate franchise (income) tax capital gains, dividends, and interest from subsidiary capital (as long as no part of the interest is deducted by the subsidiary).[50]

Another planning opportunity that may reduce a company's state tax burden is forming of a real estate subsidiary. The primary benefit of forming a real estate subsidiary results from the differences in how owned and rented real property are accounted for in a typical apportionment formula. Owned real property is included in the property factor at some valuation, typically original cost, net book, or fair market value. In contrast, rented real property is typically accounted for in the property factor at eight times net annual rent. Depending on the company's particular factors, the differences among apportionment methodologies may have a significant impact on the apportionment formula.

CONCLUSION

The variations of state tax planning that may be available for a given entity are as diverse as the number of state taxing jurisdictions and the different taxes that they impose. In this complex environment, knowledge, planning, and foresight are keys to successfully minimizing the state tax burden. Taxpayers that adapt their state tax posture to the current state tax environment can greatly influence their state tax liability. With state taxes becoming an increasing cost for businesses, state tax planning can have a profound impact on the profitability of a company.

49. Del Code Ann Titl 30 § 1902(b)(8).
50. NY Tax Law § 208.9(a)(1).

7—Tax Alert: Combined Reporting Deadline Is Rapidly Approaching in New York

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The deadline is rapidly approaching for calendar year taxpayers in New York to request permission to file combined reports. New York State and City require that a written request for permission to file on a combined basis must be received by the State and City within 30 days after the close of a taxpayer's year end. Therefore, requests for permission to file combined reports from calendar-year taxpayers must be received by the State and City no later than January 30, 1995. In addition, with respect to taxpayers currently filing a combined report, a written request for permission to include or exclude a corporation from the combined group must be received by the State and City no later than 30 days after the close of the taxpayer's year end. Consequently, this is an ideal time for taxpayers to review the potential benefits of filing on a combined basis or modifying an existing combined group. In conjunction with these opportunities, taxpayers should focus on developing the appropriate information and documentation necessary to support a combined filing.

Combined reporting can result in significant tax savings for a number of reasons. For example, it permits the losses of unprofitable companies to offset the income of profitable affiliates. Filing on a combined basis may also produce a tax benefit for multistate companies as a result of its impact on the apportionment factors. In addition, combined reporting generally eliminates the tax on subsidiary capital in New York, and may minimize the tax on capital for an affiliated group of companies. Finally, combined reporting may negate the impact of an expense attribution adjustment, a significant audit issue for many taxpayers.

In order to file a combined report in New York, general corporations must meet the following three requirements:

(1) *Capital Stock*—80% or more of the voting stock of the corporations in the combined group must be owned or controlled, either directly or indirectly, by a member of the group or by the same interests;

(2) *Unitary Business*—the corporations to be included in the combined report must be engaged in related activities or the same or related lines of business; and

(3) *Distortion*—filing on a separate basis would result in a distortion of the corporation's activities, business, income, or capital in New York. The distortion requirement is presumed to be met if at least 50% of a corporation's receipts or expenses are derived from qualified activities with group members ("substantial intercorporate transactions").

The State and City require substantial information detailing that the three requirements are met. However, if such information is not available as of the combined report request deadline, it may be possible to perfect a request by providing certain limited information before the deadline, with detailed information to be provided at a later date. It should be noted that although the State and City have similar rules for combined reporting, separate requests for permission must be submitted.

The 30-day rule. A significant development with respect to combined reporting involves the enforceability of the 30-day rule. The holdings in *Petition of Autotote Limited*, New York State Tax Appeals Tribunal, April 12, 1990, and *Petition of Chudy Paper Co., Inc.*, New York State Tax Appeals Tribunal, April 19, 1990, make it clear that the Department of Taxation and Finance ("Department") cannot use the 30-day rule as a basis for denying a taxpayer under audit from filing on a combined basis retroactively if all the requirements for combination are met. New York City has issued a statement of audit procedure to the same effect (Department of Finance Audit Division, Statement of Audit Procedure, AP/GCT-3).

Furthermore, in *Petition of Mohasco Corporation*, New York State Administrative Law Judge Unit, May 27, 1993, affirmed by the New York State Tax Appeals Tribunal on November 10, 1994, it was held that the principles of *Autotote* are not limited to situations where the Department makes an audit adjustment that causes a distortion which can only be cured by filing a combined report. The Administrative Law Judge specifically found that where the Department, on its own initiative, examined the taxpayer's business records as part of the audit process and the records established that separate reporting would lead to distortion, the 30-day rule could not be invoked to prohibit combination even though no ad-

justments by the Division created distortion in the taxpayer's income. (*Mohasco* is also important for its determination that a holding company may be part of a unitary group even if it does not sell goods or services to third parties. The holding company issue is significant for many taxpayers because the results of combination may be altered by the inclusion or exclusion of holding companies in the unitary group.)

More recently, the New York State Tax Appeals Tribunal further amplified the principles of *Autotote* in *Petition of Penthouse International, Ltd.*, New York State Tax Appeals Tribunal, January 20, 1994. In *Penthouse*, the taxpayer requested permission to file a combined report at the hearing that was held after the close of the field audit. The Tribunal held that the request did not meet the requirements of *Autotote* because the issue of combination was never raised during the audit process. The Tribunal reasoned that since the taxpayer did not submit the request until after the audit had been completed, the Department was denied a "meaningful opportunity" on audit to gather the necessary information concerning combination. Based on the holding in *Penthouse*, it is important that taxpayers seeking to raise combination retroactively do so before the completion of the audit process.

Another decision of significance regarding the enforceability of the 30-day rule is *Petition of A.G. Becker Paribas Group, Inc.*, New York State Administrative Law Judge Unit, April 21, 1994. In *A.G. Becker*, the Department entered into a stipulation with a taxpayer to waive the 30-day rule with respect to a request to file on a combined basis if the taxpayer could establish the existence of distortion on a separate reporting basis. The Department had conducted a field audit and decombined a subsidiary because no timely request was made to include the subsidiary in the combined report. The case is one of first impression in that the State removed the 30-day rule as an obstacle to permitting a combined filing. It should be noted that Administrative Law Judge Unit determinations have no precedential value in the Division of Tax Appeals or any New York State judicial proceeding.

Forced combination with non-New York taxpayers. Another significant combined reporting development involves the ability of New York taxpayers to contest attempts at forced combination with non-New York taxpayers. On February 6, 1992, the New York State Tax Appeals Tribunal, in *Petition of Standard Manufacturing Co., Inc.*, redefined the law in New York with respect to the involuntary combination of a non-New York taxpayer. The Tribunal held that an opportunity to rebut the presumption of distortion must be provided where New York seeks to compel a combined report between a non-New York taxpayer and a New York taxpayer, and substantial intercorporate transactions exist. A line of New York Court of Appeals cases had previously deemed the distortion requirement to be irrelevant where New York attempted to compel combination between a non-New York taxpayer and a New York taxpayer based on stock ownership, unitary operations and substantial intercorporate transactions (see *Matter of Campbell Sales Co. v. State Tax Comm.* (1986) 68 NY2d 617, and *Matter of Wurlitzer Co. v. State Tax Comm.* (1974) 35 NY2d 100. Because Standard Manufacturing reported intercompany transactions based on adjustments related to an IRC § 482 audit conducted by the Internal Revenue Service, the presumption of distortion was rebutted, and a combined report was not required.

Since the *Standard Manufacturing* decision, a series of cases involving forced combination with a non-New York taxpayer have been decided in which an opportunity to rebut the presumption of distortion has been provided. Taxpayers who have demonstrated arm's length pricing of intercompany transactions have been successful in contesting forced combination. For example, in *Petition of USV Pharmaceutical Corp.*, New York State Tax Appeals Tribunal, July 16, 1992, the taxpayer rebutted the presumption of distortion by showing that its intercompany transactions were reported based on IRC § 482 adjustments. In *Petition of Campbell Sales Co.*, New York State Tax Appeals Tribunal, December 2, 1993, the taxpayer was able to establish through expert testimony that filing on a separate basis properly reflected its tax liability in New York and, therefore, a combined report was not required. Similarly, in *Petition of Sears, Roebuck & Co.*, New York State Tax Appeals Tribunal, April 28, 1994, the taxpayer demonstrated through expert testimony that intercompany financing transactions were entered into under marketplace conditions so that no distortion was present in filing separate returns. More recently, in *Petition of The New York Times Company*, New York State Administrative Law Judge Unit, July 21, 1994, the taxpayer proved through detailed documentation and expert testimony by a § 482 economist that an intercompany cost-sharing arrangement was the equivalent of an arm's length transaction. The Administrative Law Judge reviewed the cost allocation between the companies under the § 482 regulations concerning intangibles, and found that costs were allocated in the proper relationship to the benefits received.

In order to rebut the presumption of distortion, it must be shown that a combined report is not necessary to properly reflect the tax liability (that is, that intercompany

transactions are conducted on an arm's length basis). If this burden cannot be met, a New York taxpayer may be required to file a combined report with a non-New York taxpayer based on stock ownership, unitary operations and substantial intercorporate transactions. For example, in *Petition of Hallmark Cards, Inc.*, New York State Administrative Law Judge Unit, November 25, 1992, the taxpayer failed to sustain its burden that a combined filing was not necessary to properly reflect the tax liability, and so the combined report was upheld. The taxpayer did not provide the testimony of an independent expert in the field as to the fairness of intercompany fees, and did not address whether the true value of the combined group's income derived from its New York operations could be accurately reflected on a separate return. In *Petition of Medtronic, Inc.*, New York State Tax Appeals Tribunal, September 23, 1993, combination was required where the taxpayer did not establish that its income would be properly reflected on separate returns. Although a federal audit for the relevant years had produced no § 482 adjustments, there was no evidence that the Internal Revenue Service had examined the taxpayer's intercompany transactions, or that such transactions were at arm's length under the principles of § 482.

In light of the above holdings, taxpayers should review the potential exposure associated with required combination in New York. Specifically, taxpayers should review the pricing of intercompany transactions to determine whether arm's length pricing can be established to rebut the presumption of distortion arising from substantial intercorporate transactions. In addition, taxpayers should consider whether the above holdings provide a basis to invalidate any previous combined filings.

Expense attribution and combination. Another significant issue that should be considered in conjunction with the filing of a combined report involves the disallowance of expenses attributable to subsidiary capital. By way of background, taxpayers in New York State are required to characterize all deductions as either directly or indirectly attributable to subsidiary, investment or business capital for post-1986 tax years. Deductions that are directly attributable to subsidiary capital must be added back to federal taxable income in computing entire net income. Deductions that are indirectly attributable to subsidiary capital are determined by a formula, and must also be added back to federal taxable income. This procedure is also followed by New York City for post-1987 tax years.

New York places a strong emphasis on expense attribution as a means of raising revenue. In fact, the Department recently issued proposed guidelines outlining new procedures for attributing expenses to capital. The guidelines would not alter existing policy for attributing interest expense, but might impact the attribution of non-interest expenses.

Certain planning strategies are available to minimize the impact of an expense attribution adjustment. For example, filing on a combined basis would negate the impact of an expense attribution adjustment through the elimination of subsidiary capital with respect to subsidiaries included in the combined report. This strategy should be considered in light of the holdings previously discussed regarding retroactive combination and the enforceability of the 30-day rule. If combined reporting is not feasible, other strategies should be considered, including performing an expense attribution study, and focusing on the components of the expense attribution formula with a view towards reducing the overall attribution percentage.

Action plan. Based on the above, taxpayers should implement the following action plan with respect to combined reporting in New York.

(1) Review the costs and benefits of filing on a combined basis.

—Review which companies should be included in the combined report.

—Analyze the tax impact of combination in the current year, future years, and prior years still open under the statute of limitations.

—If combination is beneficial, prepare and timely file a written request for permission to file on a combined basis (January 30, 1995 is the deadline by which the State and City must receive requests for permission to file combined reports from calendar year taxpayers). (i) Establish detailed documentation supporting the elements of combination in conjunction with the combined report request. (ii) If such detailed information is not available as of the combined report request deadline, a simplified request should be submitted, with the detailed information to be provided at a later date.

—Consider the implications of filing on a combined basis retroactively in light of the holdings in *Autotote, Chudy, Paper, Mohasco* and *Penthouse*. (i) If retroactive combination is beneficial, this issue should be raised as part of the audit process.

—If combination is detrimental, review the potential exposure associated with forced combination. (i) Review the pricing of intercompany transactions to determine whether arm's length pricing can be established to

rebut the presumption of distortion stemming from substantial intercorporate transactions. (ii) Consider whether the holdings in *Standard Manufacturing* and the subsequent cases involving forced combination with a non-New York taxpayer provide a basis to invalidate any previous combined filings.

(2) Review the potential exposure associated with the disallowance of expenses attributable to subsidiary capital.

—Consider planning strategies to minimize the impact of an expense attribution adjustment. (i) Combined reporting. (ii) Expense attribution study. (iii) Reduction of the expense attribution percentage.

(. . . Continued from P. 7)

8—Raw Materials Used in Manufacturing Weren't Exempt From Maryland's Use Tax

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The Maryland Tax Court held that raw materials used in manufacturing fireplace mantels and flashings in Maryland and later installed onto real property outside the state were subject to Maryland's use tax (Thulman Eastern Corporation v. Comptroller of the Treasury, Md. Tax Ct., Sales Tax No. 622, 11-22-94).

Background. The taxpayer manufactured wooden fireplace mantels and flashing in Maryland using various raw materials in its production process. The finished products were installed by the taxpayer onto real property located in as well as outside Maryland. The taxpayer didn't pay use tax on the raw materials, based on the manufacturing materials exemption under Tax-General § 11-101(f)(3)(ii). The comptroller, however, disagreed, and assessed use tax on the raw materials used in the production of property that was ultimately installed by the taxpayer onto real property located outside Maryland.

The taxpayer had relied on the court's prior decision in *Comptroller v. PPG Industries, Inc.*, Md. Tax Ct., Sales Tax No. 243, 4-16-87, where it held that a company that manufactured products in the state and installed them onto real property of purchasers, both in and outside the state, was exempted from paying use tax on purchases of the raw materials because they were used in manufacturing. The court had found that at the end of the manufacturing process, but before the installation, the raw materials had been produced into "tangible personal property for sale"; and the fact that the property was subsequently incorporated on realty out-of-state didn't affect the characterization of the property or of the taxpayer as a manufacturer.

Court reverses itself. After analyzing Tax-General §§ 11-101 and 11-102, along with relevant case law, the Tax Court reversed its prior decision and held that a manufacturer of property in Maryland who later on installed that property onto realty in another state was subject to Maryland's use tax on the raw materials used in the production of the property. *PPG Industries* misinterpreted the law and held that tangible personal property included property that was installed onto realty. This was contrary to the well-established principle that materials lose their characterization as tangible personal property once they are incorporated into a building and thus become real property.

Tax-General § 11-101(f)(3)(ii) only excludes "tangible personal property in a production activity as a material or part of other tangible personal property to be produced for sale." Because the raw materials used ultimately became part of real estate at the end of the taxpayer's involvement with the materials, the exclusion from the use tax didn't apply. Although, the taxpayer was a manufacturer of a product that qualified as tangible personal property before its installation, the form of the product as it left the taxpayer's hands determined its characterization for use tax purposes.

Commerce Clause and double taxation. The taxpayer also argued that the tax violated the Commerce Clause of the U.S. Constitution and resulted in double taxation since the taxpayer also paid a use tax to states where it delivered and then installed the finished products. The court rejected this argument since the raw materials being taxed were actually used in Maryland, and not in other states.

9—Three Important Developments in North Carolina Taxation

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North Carolina Governor James B. Hunt, Jr., has announced a proposed package of tax cuts and the proposed repeal of the intangibles tax.

Analysis and Planning of Section 482-Type Audits at State and Local Levels

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The economic recession of the past few years has resulted in decreased revenues and budgetary shortfalls for most state and local taxing authorities (collectively referred to hereinafter as the "states"). In response, the states have taken measures to raise additional revenues by various means, including tax rate increases, new sales tax impositions on services, and aggressive audit policies. Intercompany transfer pricing is an audit issue that historically was not aggressively pursued by the states. Many states did not focus on this issue for a variety of reasons. For example, some states relied on combined reporting, which effectively treats affiliated companies as a single entity, thereby avoiding the need for a review of intercompany transactions. Other states relied on the Internal Revenue Service to address the various issues related to intercompany pricing, since federal taxable income is generally the starting point in calculating state taxable income. However, the need for additional revenue has led a number of states to aggressively focus on "Section 482-type audits." Consequently, it is very important from a planning perspective for taxpayers to focus on certain strategies to minimize the impact of a state Section 482 adjustment.

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TRANSFER PRICING AND INTERNAL REVENUE CODE SECTION 482

Transactions between affiliated corporations may be negotiated at prices that do not reflect fair market value. Such pricing may occur because free market conditions are absent when related entities transact business. As a result, items of income and expense may shift between related members. At the federal level, such shifting of income and expenses may cause income to escape United States taxation.

Example 1. Presume Company X is a U.S. company, and is affiliated with Company Y, a non-U.S. company that conducts no business in the United States. If Company Y sells a product to Company X at an inflated price, income will shift out of the United States because Company X's cost of goods sold will increase, thereby reducing its federal taxable income. Since Company Y is not required to file a federal income tax return, the shifted income will not be taxed by the federal government.

The provisions for consolidated income tax returns[1] may negate many transfer pricing issues among affiliated corporations at the federal level. This is because certain intercompany transactions are generally eliminated in the computation of federal consolidated taxable income.[2] However, the consolidated return provisions are elective,[3] and the Internal Revenue Service cannot require an affiliated group to file on a consolidated basis. Furthermore, certain corporations, including those organized outside the United States,[4] are not permitted to join in the filing of a consolidated return. As a result, the consolidated return provisions cannot completely prevent income and expenses from shifting between affiliated group members. In the above example, income will shift out of the United States irrespective of whether Company X participates in a federal consolidated return, since Company Y cannot be required to join in such a filing.

When intercompany pricing issues are not resolved by a consolidated income tax filing, the Internal Revenue Service has another means of adjusting income and expenses. Internal Revenue Code Section 482

1. IRC § 1501 et seq.
2. Reg § 1.1502-13.
3. IRC § 1501.
4. IRC § 1504(b)(3).

permits the Internal Revenue Service to redistribute, reallocate or reapportion certain items of gross income, deductions, credits or allowances among affiliated group members in order to prevent the evasion of taxes or to more clearly reflect the income of any group member. Section 482 attempts to place controlled taxpayers on an equal footing with uncontrolled taxpayers by adopting an arm's-length standard for pricing intercompany transactions. The arm's-length standard requires affiliated corporations to set transfer prices at the amount at which the transactions would have occurred between unrelated parties. By utilizing Section 482, the Internal Revenue Service is able to adjust transactions between affiliated corporations to reflect negotiations under free market conditions.

At the state level, the shifting of income and expenses between members of an affiliated group presents additional issues not relevant for federal purposes. As a result of transactions within an affiliated group, income may shift from one state to another, reducing the group's overall state tax liability if such income shifts to a state with a lower tax rate. This may occur when income shifts from a taxpayer in a given state to a nontaxpayer in that state that conducts all of its business activities in a lower income tax state. This may also occur when income shifts to a taxpayer with a lower apportionment percentage in the given state that conducts the remainder of its activities in a lower income tax state.

Example 2. Presume Company A is a Texas taxpayer and is affiliated with Company B, a non-Texas taxpayer. If Company B sells a product to Company A at an inflated price, income will shift out of Texas because Company A's cost of goods sold will increase, thereby reducing its Texas taxable income. Since Company B is not required to file a Texas tax return, the shifted income escapes Texas taxation. If Company B is only taxable in a state such as Nevada, which does not impose a corporate income tax, the shifted income will not be taxed at the state level. Similar principles apply if Companies A and B are both Texas taxpayers, but Company B apportions a lower percentage of its income to Texas than Company A and apportions the remainder of its income to Nevada.

INVOLUNTARY COMBINATION OR CONSOLIDATION

One method used by the states to eliminate the effect of intercompany transactions is requiring an affiliated group of companies engaged

in a unitary business to file on a combined or consolidated basis. Generally, under state combined or consolidated reporting provisions, the members of an affiliated group compute their state tax base and apportionment factors as if the companies were a single entity. Pursuant to such a filing, intercompany transactions are generally eliminated. While the states apply a number of different approaches to determine the existence of a unitary business, unity is generally presumed to exist if there is a high degree of interrelationship and interdependence among the activities of the related companies.

An affiliated group of corporations can, of course, challenge a state's attempt to impose involuntary combination or consolidation. For example, if combination is required, an affiliated group may be able to contend that it is not engaged in a unitary business. If such contention is supported by the facts, the affiliated members will be permitted to file separate returns, since a state cannot constitutionally require the combined reporting of non-unitary businesses.[5]

An affiliated group may also be able to argue that a state has exceeded its statutory authority in requiring the group to file on a combined or consolidated basis. For example, in *Polaroid Corp. v. Commissioner of Revenue*,[6] Polaroid and its subsidiaries conducted a unitary business in the United States and in numerous foreign countries. The Commissioner of Revenue redetermined the Massachusetts taxable income of the affiliated group for 1979 and 1980 based on worldwide unitary apportionment of the combined income of the related members. After receiving an assessment, Polaroid challenged the Commissioner's statutory authority[7] to employ a unitary business approach in determining taxable net income. The court found that the Commissioner's authority to use a unitary business approach could not be exercised on a selective, case-by-case basis. Rather, such authority was exercisable only pursuant to reasonable rules of apportionment promulgated in accordance with the statutory procedures for adopting administrative regulations. Since Massachusetts had not adopted such regulations, the court, after also considering the legislative history of the relevant statute, held that the Commissioner exceeded his authority in requiring worldwide unitary apportionment.

An affiliated group may also be able to prevent certain states from requiring combination or consolidation if it can demonstrate that such

5. See Container Corp of Am v Franchise Tax Bd, 463 US 159 (1983).
6. 393 Mass 490 (1984).
7. Mass Gen L, ch 63, § 39A.

a filing is not necessary to properly reflect the tax liability of the group. The necessary documentation to support such an argument may take the form of intercompany pricing in reliance on Internal Revenue Code Section 482 adjustments, or other reliable evidence showing that intercompany transactions are being reported on an arm's-length basis. The key to prevailing on this issue is to establish that intercompany transactions reflect economic reality. For example, in *Matter of the Petition of Standard Manufacturing Co., Inc.*,[8] New York attempted to require Standard Manufacturing and its subsidiary to file on a combined basis. However, because Standard Manufacturing had been the subject of an Internal Revenue Code Section 482 audit, and had reported its income to New York based on the results of such audit, the Tax Appeals Tribunal held that combined reports were not necessary to properly reflect Standard Manufacturing's franchise tax liability.

Standard Manufacturing is an important case since it redefined the law in New York with respect to the involuntary combination of a non-New York taxpayer at a time when the State's authority to require such a filing was the subject of controversy and confusion. By way of background, the combined reporting standards in New York include stock ownership, unitary business, and distortion (*i.e.*, reporting on a separate basis distorts the activity, business, income or capital of a taxpayer in the State) requirements.[9] Distortion is presumed to exist where substantial intercorporate transactions occur between affiliated corporations.[10]

The presumption of distortion may generally be rebutted by a showing that combination is not necessary to properly reflect tax liability.[11] However, a line of New York Court of Appeals cases had deemed the distortion requirement to be irrelevant where New York attempted to compel combination between a non-New York taxpayer and a New York taxpayer (see *Matter of Campbell Sales Co. v. State Tax Commission*[12] and *Matter of Wurlitzer Co. v. State Tax Commission*[13]). Under *Campbell Sales* and *Wurlitzer*, New York could require a non-New York taxpayer to file a combined report with a New York taxpayer if the stock ownership and unitary business requirements were met and substantial intercorporate transactions existed between the

8. Div of Tax App, Tax App Trib (Feb 6, 1992).
9. NY Franchise Tax Reg § 6-2.1(a).
10. NY Franchise Tax Reg § 6-2.3(a).
11. NY Franchise Tax Reg § 6-2.3(d).
12. 68 NY 2d 617 (1986).
13. 35 NY 2d 100 (1974).

companies (with no opportunity to rebut the presumption of distortion).

The determination in *Standard Manufacturing* explicitly disapproved of the analysis used by the Court of Appeals in *Campbell Sales.* The Tax Appeals Tribunal held that an opportunity to rebut the presumption of distortion must be provided where New York seeks to compel a combined report between a non-New York taxpayer and a New York taxpayer, and substantial intercorporate transactions exist. Since Standard Manufacturing reported intercompany transactions based on adjustments related to a Section 482 audit conducted by the Internal Revenue Service, the presumption of distortion was rebutted, and a combined report was not required.

The rationale of *Standard Manufacturing* was followed four months later in *Matter of the Petition of Campbell Sales Company*[14] ("*Campbell II*"). In *Campbell II*, New York again sought to compel a combined report between a non-New York taxpayer and a New York taxpayer based only on the stock ownership and unitary business requirements, and substantial intercorporate transactions. As in *Standard Manufacturing*, the petitioner in *Campbell II* was given an opportunity to rebut the presumption of distortion. Campbell was able to establish through expert testimony that filing on a separate basis properly reflected its tax liability in New York and, therefore, a combined report was not required. Significantly, although an Internal Revenue Code Section 482 adjustment was not present in *Campbell II*, the Administrative Law Judge looked to the principles inherent in Section 482 for guidance. The Administrative Law Judge noted that such principles were consistent with the goal of avoiding distortion by implementing arm's-length standards between related parties.

More recently, in *Matter of the Petition of USV Pharmaceutical Corporation*,[15] New York attempted to impose forced combination with a non-New York taxpayer on facts similar to those in *Standard Manufacturing*. The Tax Appeals Tribunal applied its analysis in the *Standard Manufacturing* decision and afforded USV Pharmaceutical an opportunity to rebut the presumption of distortion. USV Pharmaceutical did so by showing that its substantial intercompany transactions were reported based on Internal Revenue Code Section 482 adjustments. The Tax Appeals Tribunal concluded that Section 482

14. Div of Tax App ALJ Unit (June 11, 1992). It is our understanding that the Division of Taxation will appeal this decision.

15. Div of Tax App, Tax App Trib (Jul

and New York Tax Law Section 211.4 share the common purpose of properly reflecting income, and that Section 482 adjustments rebut the presumption of distortion that arises from a unitary relationship and substantial intercorporate transactions.

STATUTORY DISALLOWANCE OF INTERCOMPANY TRANSACTIONS

As previously noted, intercompany transactions between members of a combined or consolidated income tax return at the state level are generally eliminated in computing the tax base. However, many states lack the authority to compel the filing of a combined or consolidated report. Furthermore, even in those states with such authority, certain affiliated corporations, such as those not engaged in a unitary business, may not be required and/or permitted to file in the same combined or consolidated return. In this regard, intercompany transactions between related entities are generally eliminated only if both entities are members of the same combined or consolidated return. Therefore, the states have focused on alternative methods to combination or consolidation to reattribute income and expenses among related entities.

A number of states address intercompany pricing issues by statutorily disallowing certain intercompany expenses and excluding certain intercompany income. For example, New York disallows deductions directly or indirectly attributable to subsidiary capital,[16] and generally excludes interest, dividends and capital gains attributable to subsidiary capital.[17] Subsidiary capital is generally defined as investments in the stock of subsidiaries, plus all indebtedness from subsidiaries (other than accounts receivable acquired for services rendered or property sold to customers in the ordinary course of business) on which interest is not deducted by the subsidiary under Article 9-A, 32 or 33 of the New York Tax Law.[18] In New Jersey, interest expense paid directly or indirectly to holders of 10 percent or more of a corporation's stock is generally disallowed in computing New Jersey taxable income. However, a corporation may deduct ten percent of such expense or $1,000, whichever is greater.[19]

Last year, Ohio enacted legislation with the express intent of minimizing revenue loss from income shifting between related entities.

16. NY Tax Law § 208.9(b)(6) and NY Franchise Tax Reg § 3-2.3(a)(7).
17. NY Tax Law § 208.9(a)(1) and NY Franchise Tax Reg § 3-2.4(a)(1).
18. NY Tax Law § 208.4.
19. NJ Stat Ann § 54:10A-4(k)(2)(E).

These "anti-passive investment company" provisions are quite detailed and complex, and generally apply to transactions with investment or holding companies, rather than transactions with operating companies. The legislation disallows, for certain Ohio taxpayers, interest expense and intangible expenses, such as license fees and royalties paid, between certain related Ohio and non-Ohio taxpayers.[20] The law also requires an Ohio taxpayer to include in Ohio taxable income its proportionate share of gains and losses of a related non-Ohio taxpayer from certain stock, security or debt sales or dispositions.[21] The purpose of this latter provision is to curtail the transfer of ownership of stock or other intangibles to an out-of-State affiliate prior to sale to avoid Ohio franchise tax.

STATE SECTION 482-TYPE AUDITS

Over the past few years, the Internal Revenue Service has placed a greater emphasis on transfer pricing as a source of revenue for the federal government. Similarly, a growing trend among the states is also to directly audit intercompany transactions to reattribute income and expenses among related entities. To facilitate such audits, a number of states, including California, have sought and received assistance from the Internal Revenue Service regarding Section 482-type issues. In fact, the Internal Revenue Service has instituted a program to train state auditors to conduct Section 482-type examinations.

At the state level, Section 482-type adjustments are generally applied to clearly reflect income between related entities doing business in different states. Many states have obtained authority to adjust the pricing of intercompany transactions by enacting statutes or regulations similar to Section 482 of the Internal Revenue Code. For example, New Jersey recently adopted regulations which grant the Division of Taxation broad authority to make adjustments to receipts, expenses, assets and liabilities between certain affiliated entities.[22] The regulations are intended to clarify the Division's position regarding transfer pricing issues, and place New Jersey taxpayers on notice that the Division intends to begin examining intercompany and shareholder transactions to ascertain whether such transactions reflect economic substance and a fair and reasonable tax liability to New Jersey. It should be noted that since New Jersey has a two-year statute of limitations

20. Ohio Rev Code Ann § 5733.042.
21. Ohio Rev Code Ann § 5733.04(I)(
22. NJ Corporate Income Tax Reg § 1

for refund claims[23] and a five-year assessment period,[24] inequities may result from the reassignment of income from one affiliate to another without the availability of an offsetting credit or refund.

Alternative authority to perform, in effect, a federal audit at the state level is derived from the fact that some states which use federal taxable income as the starting point for computing state taxable income presume that the correct measure of the state tax base is income required to be reported to the federal government. Under such a presumption, the state takes the position that an audit of the federal base is appropriate. For example, New York City has aggressively pursued the audit of federal income and expense items even in cases where a taxpayer has already undergone a federal audit.

A prime example of a state focusing on the audit of intercompany transactions is Connecticut. In an unreported decision, *Cigna Corporation v. Bannon, Commissioner of Revenue Services, State of Connecticut,*[25] the use of discretionary authority by the Commissioner of Revenue Services was upheld in disallowing a loss on a fair market value sale of securities between affiliated corporations. Connecticut General Statutes Section 12-226a, a provision similar to Internal Revenue Code Section 482, authorizes the Commissioner to adjust items of income, deductions and capital, and to eliminate assets in computing any apportionment percentage, where any agreement, understanding or arrangement between a taxpayer and any other corporation causes the activity, business, income or capital of the taxpayer to be improperly or inaccurately reflected to Connecticut. The statute further provides that where related corporations enter into a transaction with each other on terms that create an improper loss or net income, the Commissioner may reattribute fair profits between the parties. Based on this statute, the court held that the Commissioner was within his discretionary authority in disallowing the loss where he contended that the transaction between the related entities was not at arm's-length and created an artificial loss, notwithstanding that the sale was made at fair market value.

The states, however, have not always been successful in their attempts to make intercompany adjustments between affiliated corporations. For example, in certain instances, the adjustments proposed by a state have been determined to go beyond the scope of adjustments

23. NJ Corporate Income Tax Reg § 18:8-6.3.
24. NJ Stat Ann § 54:10-A-19.1(b).
25. 1991 Conn Super LEXIS 1102.

that would be permitted at the federal level under Internal Revenue Code Section 482. In other instances, a state's proposed adjustments may be well within the permitted scope of Internal Revenue Code Section 482, but the state grant of authority to make such adjustments is not as broad as that permitted under the federal statute. As a result, an increasing number of taxpayers are contesting the reattribution of income and expenses among related entities at the state level. From a planning perspective, taxpayers should carefully monitor the applicable statutes, regulations, rulings and cases, and develop the documentation necessary to support the pricing of an intercompany transaction.

An example of a successful taxpayer challenge to a state Section 482-type adjustment is *Presto Products, Inc. v. Wisconsin Department of Revenue.*[26] In *Presto Products*, a subsidiary corporation was permitted to deduct interest paid to its parent on money borrowed at commercially reasonable rates during the same year in which the subsidiary also paid dividends to the parent. The Department of Revenue had attempted to disallow the deduction based on the authority of former Wisconsin Statutes Section 71.11(7m) (now codified as Wisconsin Statutes Section 71.10(1)), a statute similar to Internal Revenue Code Section 482. The Tax Appeals Commission held that there was no reason to disallow the deduction in order to prevent tax evasion or to clearly reflect income. In doing so, the Tax Appeals Commission relied on Treasury Regulation Section 1.482-1(b)(1), and stated that the purpose of the examination under (former) Section 71.11(7m) was to determine whether a transaction was conducted on an arm's-length basis.

In another taxpayer victory, *Matter of the Petition of Hilton Hotels Corporation; Hilton New York Hotel Corporation,*[27] New York was unable to use the authority of New York Tax Law Section 211.5, a provision comparable to Internal Revenue Code Section 482, to reallocate to a subsidiary corporation a gain derived by its parent corporation on the sale of a hotel owned by the parent. The subject hotel was originally transferred from the parent to the subsidiary as a contribution of capital. Subsequently, the hotel was transferred back to the parent as a dividend, and was sold by the parent at a substantial gain.

The Audit Division contended that the transfer of the hotel to the parent was made pursuant to an agreement, understanding or arrange-

26. 1990 Wisc Tax LEXIS 21.
27. Div of Tax App, ALJ Unit (Feb 24, 1989).

ment which resulted in an improper or inaccurate reflection of business, income or capital to New York within the meaning and intent of the New York statute. Consequently, the Audit Division collapsed the transaction by ignoring the dividend and taxing the sale of the hotel as if it had been owned and sold by the subsidiary. This resulted in a significant tax liability since the subsidiary allocated 100 percent of its income to New York, whereas the parent allocated only 2.2 percent of its income to New York.

The Administrative Law Judge, in the absence of case law interpreting the New York statute, looked to federal case law under Internal Revenue Code Section 482, and applied a business purpose standard. The Administrative Law Judge concluded that there was no improper or inaccurate reflection of activity, business, income or capital to New York because the transfer of the hotel by the subsidiary to its parent as a dividend prior to the sale had a valid business purpose.

Another successful challenge to an attempted state Section 482-type adjustment occurred in *Chateau de Ville, Inc. v. Commissioner of Revenue.*[28] In *Chateau de Ville*, a Massachusetts parent corporation made advances to its out-of-State subsidiaries. There was no intent that these amounts be repaid since the subsidiaries were unprofitable and needed the funds to remain in business. In this regard, no loan documents were executed, no interest was charged, and the amounts were not generally treated as bona fide indebtedness.

The Commissioner of Revenue attempted to impute interest on the advances under the authority of Massachusetts General Laws, Chapter 63, Section 39A. The Commissioner contended that this statute provided him with the same powers as conferred on the Secretary of the Treasury by Internal Revenue Code Section 482. Chapter 63, Section 39A (and Section 33) authorizes the Commissioner to make certain adjustments in determining the income of a corporation which is a subsidiary of, or is closely affiliated by stock ownership with, another corporation. Pursuant to this provision, the Commissioner may adjust a taxpayer corporation's net income by (1) eliminating payments to affiliates which are "in excess of fair value," and (2) including in a taxpayer corporation's income "fair compensation" for "commodities sold to" or "services performed for" affiliated corporations. In addition, the Commissioner is authorized, in the absence of evidence to the contrary, to base his determination of "such net income" on an affil-

28. 1989 Mass Tax LEXIS 27.

iated group's federal consolidated income or Massachusetts combined income as adjusted "by reasonable rules of apportionment."

The Appellate Tax Board held that the imputation of interest was not within the scope of the Massachusetts statute with regard to adjustments of income between affiliated corporations. Thus, the Commissioner did not have the same broad powers as conferred by Internal Revenue Code Section 482. Despite the *Chateau de Ville* decision, Massachusetts has continued the practice of imputing interest on intercompany advances. Two other cases, *AMIWoodbrooke, Inc. v. Commissioner of Revenue*[29] and *New York Times Sales, Inc. v. Commissioner of Revenue*,[30] are currently pending on this issue.

In addition to contesting the validity of a state Section 482-type adjustment, taxpayers may be able to implement tax planning strategies to minimize the impact of such an adjustment. In this regard, the use of combined or consolidated reporting may provide a significant state tax benefit. As previously noted, the members of a combined or consolidated report generally compute their state tax base and apportionment factors as if the companies were a single entity. Pursuant to such a filing, all intercompany transactions are generally eliminated. Consequently, the impact of a state Section 482-type adjustment may be neutralized by a combined or consolidated filing.

Combined or consolidated reporting may provide other state tax benefits beyond the scope of intercompany pricing. For example, filing on a combined or consolidated basis generally permits affiliated multistate companies to offset the losses of unprofitable affiliates against the earnings of profitable affiliates, with the effect of reducing the aggregate state taxes paid by the group. Even where no losses are involved, a combined or consolidated report filed by a group of affiliated corporations may effect apportionment factors to reduce the aggregate state tax liability of the group. In New York, filing on a combined basis eliminates the tax on subsidiary capital, as well as potential expense attribution issues.

When filing, a combined or consolidated report is beneficial, but if such method of filing is not available under the applicable state law, the same result may be obtained by either merging or liquidating corporations. However, mergers and liquidations must be considered in light of other business and tax considerations. For example, at the state level, a liquidation might result in the imposition of various transfer

29. Appellate Tax Board Docket No 183711.
30. Appellate Tax Board Docket No 161857.

taxes. Therefore, taxpayers must evaluate the costs and benefits of a merger or liquidation before entering into such a transaction.

CONCLUSION

Given the existing budgetary environment, it can be anticipated that the states will intensify their efforts with respect to Section 482-type audits in the future. This, coupled with such corollary issues as involuntary combination/consolidation and statutory intercompany transaction disallowances, will result in a significant increase in the state tax liability of many taxpayers.

Taxpayers must closely scrutinize intercompany transactions so as to properly position themselves with respect to state tax audits in the future. With the appropriate planning, this issue—like many others—can be controlled, and the cost associated therewith can be significantly minimized.

Minimizing State and Local Taxes with Combined (Unitary) Reporting

RICHARD W. GENETELLI*

The filing of returns on a combined (unitary) basis is an important state and local tax planning opportunity that should not be overlooked. In deciding whether to use this filing method to minimize tax, it is extremely important that a taxpayer thoroughly analyze the opportunities and inherent pitfalls related thereto. While the immediate benefits of combined reporting may be obvious, the long-term implications may not be apparent at the time the initial decision is made to file on a combined basis.

A determination to file on a combined basis must include a thorough review of which companies are to be included. The concept of combined reporting generally ignores separate legal entities and allows related corporations to report the tax liability essentially as if they were one corporation. Combined reporting may not require the inclusion of all corporations in a controlled group. In fact, limited combinations following a "line of business" or "business segment" approach may be appropriate. In certain instances, more than one combination of companies or only selected companies or divisional operations may be appropriate. The tax consequences of filing on a combined basis may change dramatically depending on the combination, and therefore it is extremely important to consider the various alternatives.

A decision to file on a combined basis must also include an analysis of the tax impact. A taxpayer must review not only the current year, but also future years and prior years that are open under the statute of limitations. Once a taxpayer files on a combined basis, it may be difficult to revert back to filing on a separate basis.[1] Therefore, it is important to determine the tax effect over a number of years, since the effect of combination may be erratic. The result of unitary taxation in any

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one year may be misleading. For example, combined reporting may have minimal tax effects in the current year but a significant impact in future years.

This article reviews the general principles of combined reporting on both a domestic and worldwide basis, as well as some of the factors that should be considered in determining whether a combined report might be beneficial. The focus is then shifted to combination in two major states, New York and California, with an overview of the filing environment in each state.

What Is Combined Reporting?

Combined reporting is a method of determining taxable income whereby the total income or loss of a unitary group is combined and allocated by the use of a combined apportionment formula. Filing on a combined basis permits the losses of unprofitable affiliated companies to offset the earnings of profitable affiliates, with the effect of reducing the overall state and local taxes paid by the group.

The apportionment formula used to allocate the income of a combined group usually consists of three factors: (1) property in a state as compared to total property; (2) payroll in a state as compared to total payroll; and (3) receipts in a state as compared to total receipts. Even where no losses are involved, a combined report may have a beneficial impact on the apportionment factors and thereby reduce the overall state and local tax burden. Specifically, the apportioned net income of a combined group may be less than the aggregate income apportioned on a separate entity basis.

If combined reporting produces an overall tax savings for a group, it is generally advisable to employ this method of reporting, since states will actively pursue combined filing if a deficiency will result. Corporations that may be included in a combined report must be determined based on the relevant state and local tax laws. In order to qualify to file on a combined basis, most states require that the affiliates be closely related through stock ownership and that there be a great number of interrelationships or intercorporate transactions among the affiliates. The exercise of a high degree of control by the parent of a group is also considered a significant factor. These activities are generally used to determine whether a unitary business exists; a subject considered in a number of court decisions.[2]

It should be noted that not all corporations that are included in a federal consolidated return will necessarily qualify for inclusion in a combined report. Also, certain states do not allow corporations organized in a foreign country to be included in a combined report while other states aggressively pursue their inclusion. Entities that are not deemed to be general corporations (e.g., banks, insurance companies,

or other specialty corporations) also may not be included in a combined report with other general corporations in many states.

In deciding whether combination might be beneficial, one must recognize that different states approach combined apportionment of income in different ways. For example, in some states, after profits and losses of various affiliates are combined and intercompany transactions are eliminated, income is apportioned according to the combined factors of the group.[3] Other states combine the income of the various members of the group after each member separately determines its apportioned income to the state.[4] Obviously, this latter approach negates the possibility of diluting the state income of a given affiliate having significant presence in a state by combining income with other affiliates with lower apportionment factors in the state.

A critical requirement in filing on a combined basis is the existence of a unitary business. Ascertaining which companies in a corporate group are unitary is often difficult, since the requirements for unitary business status are based on loosely defined terms such as "flow of value," "contribution and dependency," and "distortion." In determining whether a corporate group has a unitary business, guidance can be obtained from a number of sources, including legislation, administrative regulations, case law, and unitary questionnaires.

After it has been determined whether and to what extent the corporate group's business is unitary, the next step is to ascertain whether unitary status is beneficial or detrimental. Obviously, management will then want to find out what steps can be taken to either strengthen or remove unitary relationships, depending on the implications of filing on a unitary basis. The facts and circumstances in each particular case will determine whether it is possible to restructure corporate relationships to either be or not be unitary. If unitary status is desired, it may be relatively easy to achieve. For example, a formerly "discrete business group" (one not unitary with its affiliates) could be made unitary in a number of ways, including exercising day-to-day operational control of subsidiaries, creating intercompany transactions, and centralizing various functions such as accounting, legal, marketing, and capital formation.

Breaking a unitary relationship is generally more difficult, especially if a substantial flow of value exists between the members of the corporate group. Steps that can be taken to weaken unitary ties between companies include eliminating common officers and directors and reducing common administrative functions or centralized financing. When intercompany ties are widespread, these actions may not be practical and other strategies should be considered.

When filing on a combined basis is beneficial, but such method of filing is not available under applicable state law, it may be possible

under certain circumstances to achieve the same result by either merging or liquidating corporations. Note that even after a merger, some states will seek to determine whether the separate activities of a corporation are unitary, and may require income to be allocated by separate accounting if the segments are found not to be unitary.[5] Mergers and liquidations frequently carry with them federal or other state and local tax implications (e.g., transfer taxes) that may make the transaction undesirable. Therefore, it is suggested that these taxes be considered prior to any restructuring.

Combined Reporting in New York

Combination is required or permitted in New York where substantially all the capital stock of the corporations is owned or controlled by the same corporation or interests, the corporations are engaged in a unitary business, and either (1) a failure to file combined reports would distort the taxpayer's New York activities, business, income, or capital, or (2) in the case of an attempt to compel combination of a non-New York taxpayer, combination is necessary to properly reflect tax liability because of substantial intercorporate transactions or an arrangement under which income is not properly reflected.[6] "Substantially all" is defined as ownership or control of at least 80 percent of the corporation's voting stock.[7]

The unitary business test for New York is whether the corporation's activities are related to the activities of the other corporations in the group, such as manufacturing goods or performing services for other group members, selling goods acquired from other group members, or financing sales of other members in the group.[8] The existence of centralized management should also be considered in determining whether a unitary business exists.[9] A holding company that merely receives dividends from subsidiaries is not considered to be engaged in a unitary business with its subsidiaries.[10]

Distortion is clearly a separate requirement in addition to the stock ownership and unitary business requirements where

1. A New York taxpayer requests permission to file a combined report;
2. New York requires a New York taxpayer to file a combined report; and
3. A non-New York taxpayer requests permission to file a combined report.

Distortion will be presumed if there are substantial intercorporate transactions.[11] Intercorporate transactions are substantial when they account for at least 50 percent of a corporation's receipts or expenses.[12] Transactions considered to be intercorporate transactions

are those that are directly connected with the business conducted by the taxpayer, such as:

- Manufacturing or acquiring goods or property or performing services for other group members;
- Selling goods acquired from other group members;
- Financing sales of other members in the group; or
- Performing related customer services using common facilities and employees.[13]

Service functions, such as accounting, legal, and personnel services, will not be considered when they are incidental to the business of the corporation providing the services.[14] Dividends are not considered when determining whether substantial intercorporate transactions exist.[15]

The presumption of distortion where substantial intercorporate transactions exist can be rebutted.[16] For example, in *Matter of the Petition of Digital Equipment Corporation*,[17] a taxpayer that reported intercompany transactions pursuant to an Internal Revenue Code Section 482 audit was not required to file a combined report to properly reflect income. Since the IRS continues to focus on intercompany pricing issues, taxpayers can be expected to rely with greater frequency on Section 482 adjustments as evidence of arm's length pricing.

A controversy currently exists as to whether distortion is a separate requirement where New York attempts to compel a non-New York taxpayer to file a combined report. One line of New York Court of Appeals cases appears to eliminate the distortion requirement in this situation (see *Matter of Campbell Sales Co. v. State Tax Commission*[18] and *Matter of Wurlitzer Co. v. State Tax Commission*[19]). Under *Campbell Sales* and *Wurlitzer*, New York could compel a non-New York taxpayer to file a combined report if the stock ownership and unitary business requirements were met, and combination was necessary to properly reflect tax liability because of either substantial intercorporate transactions (with no opportunity for the taxpayer to rebut the presumption of distortion) or an arrangement under which income was not properly reflected.

The *Campbell Sales* and *Wurlitzer* decisions are inconsistent with other Court of Appeals cases that hold that distortion of income is mandatory with respect to New York requiring that a combined report include a non-New York taxpayer (see *Matter of Standard Manufacturing Co., Inc. v. State Tax Commission*[20] and *Matter of Coleco Industries, Inc. v. State Tax Commission*[21]). Under this line of authority, a non-New York taxpayer could not be compelled to file a combined return in New York absent a showing of distortion, and the taxpayer

would be given the opportunity to rebut the presumption of distortion if substantial intercorporate transactions existed.

A recent determination, *Matter of Petition of Standard Manufacturing Co., Inc.*,[22] explicitly disapproved of the analysis used by the Court of Appeals in *Campbell Sales*. The Administrative Law Judge held that a non-New York taxpayer should be permitted to rebut the presumption of distortion where New York seeks to compel a combined report and substantial intercorporate transactions exist.

> "A contrary interpretation...that would not permit a party to rebut the presumption merely because the subsidiary is a foreign corporation and not a New York taxpayer, is not acceptable given the case law...and, in particular, *Matter of Standard Manufacturing Company, Inc....*"

Administrative Law Judge determinations have no precedential value in New York judicial proceedings,[23] so it is unclear whether this decision will influence future findings on this issue. Nevertheless, given the statutory purpose of avoiding distortion of and more realistically portraying true income, it appears that a non-New York taxpayer may have a favorable chance of prevailing if it can be shown that filing on a separate basis does not distort income for New York purposes.

New York permits combined filing only upon application within 30 days of the close of the taxpayer's year.[24] A recent determination, *Petition of Autotote Limited*,[25] may provide an opportunity for taxpayers under audit to file on a combined basis retroactively. The parties in this case stipulated that the requirements for combined filing had been met. The taxpayer did not, however, make a timely application for permission to file on a combined basis, and New York refused to permit combination on this ground.

The Tax Appeals Tribunal held that it was an abuse of discretion not to permit combined filing where the facts developed on audit made it clear that distortion existed. This exception to the 30 day rule is limited to taxpayers under audit, as was made clear in *Petition of Chudy Paper Co.*[26] Despite this interpretation, *Autotote* may be relevant in future determinations based on its assertion that the goal of combined reporting is to accurately reflect income subject to taxation in New York.

Combined Reporting in California

California requires combination when a group of corporations conduct a unitary business and income is derived from sources both within and without California.[27] Members of a unitary group deriving income solely from California sources are allowed to file on a combined basis[28] or may be required to file on such a basis if necessary to

properly reflect income.[29] California is a worldwide unitary combination state but allows taxpayers to elect to compute income on a water's edge basis[30] (as discussed below).

To establish the existence of a unitary business, there must be either (1) a unity of ownership, operation, and use (three unities test),[31] or (2) a substantial contribution or dependency of the entities with respect to their businesses, including actual control by the taxpayer over the activities of the other entity for which combination is sought (contribution or dependency test).[32] The presence of functional integration, economies of scale, and centralized management indicate that a business is unitary under both of these tests.[33]

The three unities test was set forth in *Butler Bros. v. McColgan.*[34] It provides that in order to establish a unitary nature of a business, a unity of ownership, operation (evidenced by central purchasing, advertising, accounting, and management divisions), and use in the centralized executive force and general system of operation must all be shown. The contribution or dependency test, set forth in *Edison California Stores, Inc. v. McColgan,*[35] states that if the operation of the portion of the business done within the state is dependent on or contributes to the operation of the business without the state, the operations are unitary. The ownership requirement is implicit in this test. The Franchise Tax Board takes the position that to meet the requirement for unity of ownership, a single individual or entity must own more than 50 percent, directly or indirectly, of the voting stock of each corporation to be included in the unitary group.[36]

The California regulations provide factors that, if present, create a strong presumption that the activities of a taxpayer constitute a single trade or business. These factors are:

1. Same general line of business for all activities;
2. Vertical integration of divisions or segments; and
3. Strong central management coupled with central departments such as financing, advertising, research, or purchasing.[37]

In the past, few diverse business cases (businesses neither in a same general line of business nor vertically integrated) have resulted in a unitary finding based on the presence of strong central management. Many of the California decisions seem to have placed an emphasis on functional integration when determining the unitary issue.[38] These findings appear to disregard the regulatory presumption that the activities of a taxpayer are unitary when strong central management exists. However, in a recent case, *Mole-Richardson Co. v. Franchise Tax Board,*[39] a corporation engaged in lighting equipment manufacturing and sales, and farm and ranch operations, was found to be conducting a unitary business substantially based on its strong centralized management. The Court of Appeals held specifically that

functional integration is not a new concept in determining the unitary issue and that it encompasses central management within its scope. *Appeal of Sierra Production Service, Inc.*[40] followed *Mole-Richardson* in supporting the California regulations, holding that functional integration is not a new test, but is merely a descriptive term covering the basic elements of a unitary business including strong central management and meaningful central services. In fact, the State Board of Equalization admonished the Franchise Tax Board for failing to apply its own regulations (i.e., when strong central management is present, the diverse activities of a taxpayer are presumed to be unitary).

California's worldwide unitary reporting method was upheld by the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board.*[41] In *Container*, the Supreme Court held that there was no constitutional bar to California's application of worldwide combination to a multinational group of corporations engaged in an unitary business in the state, at least when the parent of the group was a domestic corporation. However, the Court explicitly left open the question of whether it would reach the same conclusion if a state had sought to apply worldwide unitary combination in a case in which the combined group's parent was a foreign rather than a domestic corporation.

Several recent cases have tested the constitutionality of California's worldwide unitary reporting method. *Barclays Bank International Limited v. Franchise Tax Board*[42] involves a British parent with U.S. subsidiaries. The Court of Appeal ruled that California's worldwide combined reporting method violates the Foreign Commerce Clause of the U.S. Constitution because it implicates foreign policy issues that must be left to the federal government, and violates a clear federal directive. This case is being appealed. *Colgate-Palmolive Co., v. Franchise Tax Board*[43] involves a U.S. parent with foreign subsidiaries. The court held that the worldwide unitary reporting method interferes with the authority of the executive branch of the federal government to carry out foreign policy and therefore violates the Commerce Clause of the U.S. Constitution. This case is also being appealed. Finally, in *Alcan Aluminum Ltd. v. Franchise Tax Board,*[44] cases brought by foreign parents against the Franchise Tax Board were dismissed on the ground that the parents were barred by the Tax Injunction Act, 28 USC Section 1341.

Historically, California has been in the forefront with respect to worldwide combined reporting. However, California recently enacted a law permitting multinational corporations to elect to file combined/ unitary tax returns on a water's edge basis, rather than a worldwide basis, for income years beginning in 1988.[45] Some of the more significant provisions of the California law include

- An annual election fee;[46]
- An irrevocable 5-year binding commitment;[47] and
- A domestic disclosure spreadsheet requirement.[48]

Certain multistate corporations are believed to be leaning toward forgoing the water's edge election in California for a variety of reasons. Some individuals believe that the legislation is severely flawed. In addition to the election fee, which many taxpayers feel as a matter of principle is unfair, the legislation itself adds numerous requirements, first to qualify and thereafter to stay qualified.[49] The length of the election period also creates a great deal of uneasiness. Furthermore, the business community is concerned that California will take a particularly aggressive position with respect to those who elect to be taxed on a water's edge basis. The *Barclays*[50] and *Colgate-Palmolive*[51] cases have raised many questions about the constitutionality of California's worldwide combined reporting method. Consequently, many businesses have decided to wait and see what will happen in these cases before making any final decisions.

The spreadsheet provisions in California require that corporations provide data with respect to the income reported to each state in which returns are filed, the state tax liability, and the method used to apportion or allocate income to each state.[52] This information may be used by California to identify issues related to nonreporting of income, nexus, full accountability and the apportionment factors (including sales recapture). Therefore, it is important that a review be made of a company's posture with respect to the filing of a domestic disclosure spreadsheet.

Conclusion

Combined (unitary) taxation may in certain cases result in an increase in the state tax burden of a group of corporations. When combination reduces the tax, the filing of a combined return should be carefully evaluated, especially when it is clear that the companies are unitary. This evaluation must include an assessment of which companies are to be included in the combined report. In addition, the taxpayer must review the tax impact of combination not only in the current year, but in future years and prior years still open under the statute of limitations.

A thorough understanding of all relevant law, regulations, court cases, and administrative opinions is necessary in order to effectively navigate through the pitfalls and opportunities presented by combined reporting. Taxpayers must exercise extreme caution when assessing the implications of a combined filing, since the tax consequences can be significant.

1. See New York Business Corporation Franchise Tax [hereinafter cited as NY Franchise Tax] Reg § 6-2.4(d).

2. See Mobil Oil Corp. v. Comm'r of Taxes, 445 US 425 (1980); Exxon Corp v Wisconsin Dep't of Rev, 447 US 207 (1980).

3. See NY Franchise Tax Reg. § 4-1.2.

4. See Conn Gen Stat § 12-223a(3).

5. See Tranel, Inc v Pennsylvania, 558 A2d 925 (1989); Request for Ruling, Gen. Corp. Tax, July 27, 1989, City of New York, Dep't of Finance, Office of Legal Affairs.

6. NY Franchise Tax Reg. § 6-2.1(a).

7. NY Franchise Tax Reg. § 6-2.2(a)(2).

8. NY Franchise Tax Reg. § 6-2.2(b)(1).

9. See American Int'l Group, Inc v Tully, 89 AD 2d 687 (1982), aff'd, 59 NY 2d 832 (1983).

10. NY Franchise Tax Reg. § 6-2.2(b)(3), Ex. 3.

11. NY Franchise Tax Reg. § 6-2.3(a).

12. NY Franchise Tax Reg. § 6-2.3(c).

13. Id.

14. Id.

15. NY Franchise Tax Reg. § 6-2.3(f), Ex. 8.

16. NY Franchise Tax Reg. § 6-2.3(d).

17. TSB-H-85(29)C (Oct. 14, 1985).

18. 68 NY 2d 617 (1986).

19. 35 NY 2d 100 (1974).

20. 69 NY 2d 635 (1986).

21. 59 NY 2d 994 (1983).

22. Div. Tax Apps., ALJ Unit (June 21, 1990).

23. NY Tax Law § 2010.5.

24. NY Franchise Tax Reg. § 6-2.4(a).

25. Div. of Tax App., Tax App. Trib. (Apr. 12, 1990).

26. Div. of Tax App., Tax App. Trib. (Apr. 19, 1990).

27. Cal. Rev. & Tax. Code § 25101; see Edison Cal. Stores, Inc v McColgan, 30 Cal. 2d 472 (1947).

28. Cal. Rev. & Tax. Code § 25101.15.

29. Cal. Rev. & Tax. Code § 25102.

30. Cal. Rev. & Tax. Code § 25110.

31. Butler Bros v McColgan, 17 Cal. 2d 664, aff'd, 315 US 501 (1942).

32. Edison Cal. Stores, Inc v McColgan, 30 Cal. 2d 472 (1947).

33. See Mobil Oil Corp v Comm'r of Taxes, 445 US 425 (1980); FW Woolworth Co v Taxation and Rev Dep't, 458 US 354 (1982).

34. See supra note 31.

35. See supra note 32.

36. Cal. Rev. & Tax. Code § 25105.

37. Cal. Code Regs. tit. 18, Reg. 25120(b).

38. See Appeal of Hooker Indus., Inc., State Board of Equalization, No. 87-SBE-033 (May 7, 1987).

39. 220 Cal. App. 3d 889, modified, 221 Cal. App. 3d 425a (1990).
40. State Board of Equalization, No. 90-SBE-010 (Sept. 12, 1990).
41. 463 US 159 (1983), aff'g, 117 Cal. App. 3d 988 (1981).
42. 1990 Cal. App. Lexis 1256.
43. No. 319715 (Sacramento Super. Ct. July 20, 1989).
44. 110 S. Ct. 661 (1990).
45. See supra note 30.
46. Cal. Rev. & Tax. Code § 25115.
47. Cal. Rev. & Tax. Code § 25111.
48. Cal. Rev. & Tax. Code § 25401d.
49. See Cal. Rev. & Tax. Code § 25110(b).
50. See supra note 42.
51. See supra note 43.
52. Cal. Rev. & Tax. Code § 25401d(d).

NEW YORK CITY UNINCORPORATED BUSINESS TAX

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OUTLINE OF LEGISLATIVE PROPOSAL ON

U.B.T. INVESTMENT ACTIVITIES

May 15, 1995

I. If an individual or unincorporated entity, other than a dealer, is engaged solely in trading for its own account, in the ownership, or disposition not in the ordinary course of trade or business, of unincorporated entities that qualify for the self-trading exemption, or, in addition, in activities not otherwise constituting the conduct of a business in the City, it is not subject to the tax. § 11-502(c)(2).

A. Trading for its own account means the purchase, holding, or sale of property generally, or the entry into, assumption, offset, assignment, or other termination of a position in property.

1. Property generally eligible for the self-trading exemption includes, without limitation:

a. real and personal property;

b. property qualifying as investment capital and stocks, notes, bonds, debentures, and other evidences of indebtedness;

c. interest rate, currency, or equity notional principal contracts;

d. foreign currencies;

e. interests in, or derivative financial interests (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described above; and

f. any publicly traded commodity. § 11-502(c)(1)(A).

2. Property the trading of which does not qualify for the self-trading exemption includes:

a. debt instruments issued by the taxpayer;

b. accounts receivable held by a factor;

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c. property held for sale to customers in the ordinary course of trade or business;

d. debt instruments acquired in the ordinary course of trade or business for funds loaned, services rendered, or property sold, rented or otherwise transferred;

e. interests in unincorporated entities; and

f. positions in property described in 1 or 2 above entered into, assumed, offset, assigned or terminated by a dealer therein. § 11-502(c)(1)(A).

B. Definition of "dealers" that are not protected by the self-trading exemption. § 11-501(l).

1. A dealer generally is a taxpayer that in the ordinary course of trade or business:

a. holds or disposes of property that is held for sale to customers; or

b. regularly offers to enter into, assume, offset, assign, or terminate positions in property with customers.

2. An individual or entity will not be a dealer solely because he or it owns an interest in a dealer or because a dealer owns an interest in the entity.

C. The receipt of $25,000 or less of gross receipts during the year from an unincorporated business conducted wholly or partly in the City will not result in a loss of the self-trading exemption. § 11-502(c)(3).

II. If an unincorporated entity is "primarily" engaged in activities qualifying for the self-trading exemption and/or in the acquisition, holding or disposition, other than in the ordinary course of trade or business, of interests as an investor in unincorporated entities doing business in the City, it will be taxed on its income from an unincorporated business conducted in the City but income from self-trading activities (as defined in I above) conducted by it or by an unincorporated entity (in which it owns an interest) that qualifies for the full or partial exemption will be exempt from tax and will not be "tainted" by the taxpayer's business activities. § 11-502(c)(4)(A).

A. A taxpayer is "primarily" engaged in these activities if at least 90 percent of its total assets consist of qualifying property, based on value. § 11-502(c)(4)(B).

B. Qualifying property. § 11-502(c)(4)(C).

1. Property that qualifies for the self-trading exemption. (See I.A.1. above.)

2. An interest in an unincorporated entity that does not do any business in the City.

3. An interest in an unincorporated entity that does business in the City that is held as an investor. An interest is held as an investor if:

a. the taxpayer is not a general partner in the entity and is neither authorized under the entity's governing instrument to manage or participate in, nor manages or participates in, its day-to-day business operations, or

b. the entity qualifies under the 90 percent rule as being primarily engaged in the activities qualifying for this partial exemption, and the taxpayer does not receive a distributive share from such entity's in-city business that is materially greater than its share of any other items of such entity. § 11-502(c)(1)(B).

C. Valuation of property.

1. Marketable securities and real estate are valued at fair market value. Other assets are valued at accounting book value.

2. The value is average monthly gross value.

3. Commissioner of Finance has discretion to reduce gross value by liabilities or eliminate assets so as to properly and accurately reflect the taxpayer's primary activities. § 11-502(c)(4)(D).

D. Income that is exempt from the tax if the taxpayer qualifies includes:

1. dividends, interest, and payments with respect to securities loans;

2. income from notional principal contracts;

3. other income, gains, and losses (other than as a dealer) from positions in property that qualifies for the self-trading exemption.

4. income, gains, and losses from the disposition of interests in unincorporated entities that are primarily engaged in activities that give rise to the partial exemption from tax discussed in this Section II, to the extent that such items are attributable to self-trading activities of the owned entity.

5. other income from investment and trading-related activities (commitment fees, etc.). § 11-506(c)(9) and (10)

III. A taxpayer that does not qualify for the self-trading exemption and is not primarily engaged in the activities described in Section II that qualify it for a partial exemption from tax is taxable on all of its income from City sources if it engages in a business in the City. Income qualifying as income from investment capital will be allocated within and outside the City under the investment allocation percentage.

IV. Flow-through principles.

A. If a taxpayer owns an interest in an unincorporated entity, the entity's business activities will be attributed to the taxpayer. § 11-502(a).

B. The mere passive ownership of an interest in an entity that is not conducting business in the City will not be treated as the conduct of a business in the City by the owner. § 11-502(a). If the taxpayer performs services in the City on behalf of such an entity, the performance of services may constitute a business and fees received for such services may be taxable (and the activities could cause the entity to be treated as doing business in the City).

C. Investment income from a "carried interest" in an entity (i.e., where the taxpayer's interest is disproportionate to its capital contribution) does not lose its character and is not treated as business income regardless of how the interest was acquired (i.e., even if acquired in exchange for the performance of services). This will not apply with respect to guaranteed payments or other payments that are treated

under section 707 of the Internal Revenue Code as not being made to a partner. § 11-506(a)(2).

4/24/95

MEMORANDUM IN SUPPORT

TITLE

AN ACT to amend the administrative code of the city of New York, in relation to the applicability of the city unincorporated business tax to certain investment activities and certain activities incidental to the holding, leasing or managing of real property, and in relation to the carryforward of a credit allowed against such tax and the city general and banking corporation taxes for certain unincorporated business tax payments

PURPOSE

The purpose of this bill is to promote a more favorable tax environment for unincorporated entities in New York City by continuing the effort, begun with legislation enacted in 1994, to reform the City unincorporated business tax as it affects investment activities and certain activities incidental to the ownership and operation of real estate, and to minimize multiple taxation of partnership income that is includable in the taxable income of partners that are themselves subject to City business income taxes. Passage of this bill should help to attract new businesses to the City and keep existing businesses here at a very modest cost in foregone tax revenue.

BACKGROUND--THE 1994 LEGISLATION

Chapter 485 of the Laws of 1994 made substantial changes to the New York City unincorporated business tax (UBT) affecting the treatment of investment and real estate activities and income, and also enacted a credit that partners subject to City business income taxes can claim for their shares of the unincorporated business taxes paid by partnerships of which they are members.

Investment Activities. Subdivision (c) of section 11-502 of the New York City Administrative Code provides that individuals and unincorporated entities, other than dealers holding property primarily for sale to customers in the ordinary course of business, are not subject to the UBT solely by reason of the purchase and sale of property or the purchase, writing or sale of stock options for their own account (the "self-trading exemption"). If a person is purchasing and selling property for that person's own account and is also engaged in business activities, those business activities may "taint" the trading activity, causing the income from the purchase and sale of property to be subject to the UBT.

The 1994 legislation added to section 11-502(c) a provision stating that the UBT will not apply if a person who purchases and sells property for that person's own account does not receive more

than $25,000 of gross receipts during the taxable year from the conduct of an unincorporated business in the City. The amendment made it clear that if a taxpayer's receipts from an unincorporated business carried on in the City exceed the threshold, the taxpayer is not eligible for the self-trading exemption.

The 1994 legislation also revised the rules under which taxable income from certain stocks and securities is allocated to the City for purposes of the UBT. The legislation prescribed a new set of rules for allocating income from "investment capital," the definition of which was patterned after the definition of "investment capital" for purposes of the New York City General Corporation Tax. The allocation of income from investment capital under the revised rules generally results in a lower allocation of such income to the City for many taxpayers than under the allocation rules applicable to business income under the UBT.

Real Estate Activities. Subdivision (d) of section 11-502 of the Administrative Code exempts from UBT an owner, lessee or fiduciary engaged exclusively in holding, leasing or managing real property. Prior to the 1994 legislation, if an owner, lessee or fiduciary engaged in any business activity in addition to holding, leasing or managing real property, both the business activity and the real estate activity were subject to the UBT. The 1994 legislation amended section 11-502(d) to preserve the existing exemption for real estate activities even if other business activities are also carried on. The amendments to subdivision (d) further provided that if the owner, lessee or fiduciary carries on any business at the real property, including, for example, a garage, restaurant, laundry or health club, that business will be considered incidental to holding, leasing or managing real property and not an unincorporated business, provided the business is conducted solely for the benefit of tenants as an incidental service to the tenants, and is not open or available to the general public.

Credit For UBT Paid. The 1994 legislation enacted a credit provision under which a partner that receives a distributive share of income from a partnership subject to the UBT can claim a credit against its liability for the UBT, City general corporation tax (GCT) or City banking corporation tax (BCT) for its share of the UBT paid by the partnership. (Before the enactment of this credit, a partnership could claim a limited exemption from its UBT base for amounts included in the income of partners subject to the City business income taxes.)

The amount of this new credit is equal to the lesser of the amounts calculated under two different measures. The first measure is the partner's pro rata share of the tax paid and credit claimed by the partnership in which it is a direct partner. The second measure limits the amount of the credit by reference to the incremental effect of the distributive share on the partner's tax

liability. If a partner is subject to the UBT, the credit cannot exceed the amount by which the partner's tax liability (before all credits) exceeds the tax it would owe (before all credits) if it did not have a distributive share from the partnership. If a UBT-paying partner is a member of more than one partnership, the sum of such partner's credits with respect to all of the partnerships cannot exceed its total tax liability (before all credits). Similar limitations are provided for partners subject to the GCT and BCT, with additional calculations required to reflect tax rate differentials among the UBT, GCT and BCT.

Tax paid by a remote partnership in a multi-tiered partnership structure does not enter directly into the calculation of a partner's credit. However, it is reflected indirectly by the inclusion of the "credit claimed" in the calculation mechanism, which serves to pass the credit through tiers. Thus, even though the partner only looks to partnerships in which it is a direct partner to calculate its credit, because the credit takes into account credits taken by those partnerships, it minimizes the possibility of a double tax on a distributive share that flows through tiers from a more remote partnership.

Mandate to Form Working Group

While commentators on the 1994 legislation welcomed the relief it provided, they had additional concerns not addressed by the 1994 bill. As a result, the 1994 legislation added section 11-503(j)(6) to the Code, which required the New York City Commissioner of Finance to convene a working group of representatives of the New York City Department of Finance, affected industries and other interested persons to study the UBT treatment of investment activities and garages open or available to the public that also provide space to building tenants, to study the impact of the new credit in circumstances where the existence of losses and loss carryovers may affect a partner's ability to fully utilize the credit to which it would otherwise be entitled, and to prepare a report based on the deliberations of the group. Specifically, the group was to take into account economic development, tax administration and other goals of tax policy, and to consider alternatives to existing law that would reduce disincentives to investment in corporations and other entities doing business in the City, including exempting income from investment activities from the UBT. That working group was convened in October, 1994 and several subcommittees were formed to consider these issues.

SUMMARY OF PROPOSED AMENDMENTS TO 1994 LAW

Expansion of Self-Trading Exemption

The memorandum in support of the 1994 legislation states in connection with the self-trading exemption that the 1994 bill did

not address the question of under what circumstances receipts from activities other than those specifically exempted by Code section 11-502(c), i.e., the purchase and sale of property and the purchase, writing and sale of stock options, would be considered receipts from an unincorporated business conducted in whole or in part in the City. Moreover, the statute does not contain a definition of property that may be purchased or sold in an exempt transaction.[1]

To better reflect the types of investment vehicles that are the subject of routine investment activity of investors in today's markets, section 3 of the bill adds a definition of property for purposes of the self-trading exemption that includes stocks and securities as well as notional principal contracts, foreign currencies, publicly-traded commodities and derivative financial instruments (including options, forward or future contracts, and other instruments) in property, as defined. Certain securities not qualifying as investment capital, as defined in the rules governing the definition of investment capital for purposes of the GCT, are excluded, as are all interests in unincorporated entities. Property and positions in property held by dealers in such property or positions in property, respectively, are also excluded.

In addition, to better reflect the types of transactions commonly engaged in by investors, section 3 of the bill amends the self-trading exemption to include the entry into, assumption, offset, assignment or other termination of a position in, as well as the purchase and sale of, property in the categories of exempt trading activity.

Finally, bill section 3 amends the self-trading exemption to make it clear that the ownership of an interest in an unincorporated entity that itself qualifies for the self-trading exemption will not disqualify the owner of that interest from the exemption.

Partial Exemption for Investors

In considering the economic development aspects of investment activities, the investment subcommittee of the UBT working group focussed on the effect on investment decisions of the "tainting" of investment income by the receipt of more than $25,000 of gross receipts from the conduct of an unincorporated business in the City. The concern was that unincorporated entities engaged in activities that would otherwise qualify for the self-trading exemption would not risk subjecting the income from those

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[1] The amendment of Code section 11-502(c) in 1977 to exempt the purchase, sale and writing of stock options implies that such options were not included in the definition of property prior to that amendment.

activities to tax by investing in businesses in the City or by expanding into the City businesses in which they had previously invested.

Section 3 of the bill amends section 11-502 of the Code to exempt from the UBT income from self-trading activities for unincorporated entities that are primarily engaged in trading for their own account or in the ownership, as an investor, of interests in unincorporated entities engaged in unincorporated business activities in the City. This provision is in addition to the self-trading exemption, which is retained and clarified by the bill, as described above. Specifically, bill section 3 adds to section 11-502(c) of the Code a new paragraph (4), which provides that if an unincorporated entity is "primarily engaged" in activities qualifying for the self-trading exemption and/or the acquisition, holding or disposition of interests, as an investor, in unincorporated entities carrying on any unincorporated business in the City, the self-trading activities of the taxpayer (including those of a "primarily engaged" entity in which the taxpayer owns an interest that are attributed to the taxpayer), will not be subject to the UBT.

An unincorporated entity qualifying for the partial exemption will be allowed to exclude from its unincorporated business gross income any income and gains from activity qualifying for the self-trading exemption, including income with respect to securities loans, and other substantially similar income and gains from ordinary and routine trading and investment activity to the extent determined by the Commissioner of Finance. It is expected that rules will be adopted under this provision that will exempt, for example, commitment fees, standby fees, breakup fees and similar fees commonly received by investors who receive such fees as an incident to their investment activity. Correspondingly, such taxpayers will not be allowed any deduction for losses and expenses directly or indirectly attributable to such exempt activity.

90 Percent Asset Test. For purposes of this partial exemption, an unincorporated entity will be considered to be "primarily engaged" in the designated activities if at least 90 percent of the gross value of its assets is represented by assets qualifying for the self-trading exemption, interests in unincorporated entities not carrying on any unincorporated business in the City, or investments in unincorporated entities carrying on any unincorporated business in the City held by the taxpayer as an investor. In determining whether a taxpayer meets the above test, the average gross value of the assets over the year will be taken into account under rules patterned after those applicable to the New York City General Corporation Tax. The Commissioner of Finance is, however, given discretion to use net values or to exclude assets if he or she deems it necessary to properly reflect the primary activities of the taxpayer. For example, office furniture and fixtures of a taxpayer may be apportioned between qualifying

and nonqualifying assets or excluded. In addition, if a taxpayer holds securities purchased on margin or securities hedged by offsetting positions, the Commissioner may use net values in applying the 90 percent test.

"Investor" Defined. For purposes of the partial exemption, a taxpayer will be treated as owning an interest in an unincorporated entity as an investor if the taxpayer is not a general partner, is not authorized by the entity's governing instrument to manage or participate in the day-to-day business of the entity, and is not actually managing or participating in such day-to-day business. A taxpayer can also qualify as an investor in an unincorporated entity, regardless of the taxpayer's involvement in management or status as a general partner, if the unincorporated entity itself qualifies as primarily engaged in the designated activities (i.e., the entity meets the 90 percent test), provided the taxpayer receives substantially the same share of each item of income, gain, loss and deduction of the entity. This latter proviso is designed to preclude taxpayers from abusing the partial exemption through special allocations. Activities performed by a taxpayer that are customarily performed by investors to preserve their investments will not be considered managing or participating in the day-to-day business of an unincorporated entity. For example, a taxpayer who invests in an entity may be entitled to representation on the entity's oversight body. Mere representation of the taxpayer as an investor on a body whose sole responsibility is oversight of the entity will not be considered managing or participating in the day-to-day business of the entity. Similarly, if an investor, to protect its investment, is entitled to review and/or veto the monthly budget and/or certain major decisions of the entity's management, such review and/or the exercise of such veto will not be considered managing or participating in the day-to-day business of the entity. If an investor is authorized to manage or participate in the day-to-day business only upon the occurrence of certain unanticipated events, then such investor will not be deemed to be managing or participating in the day-to-day business until the event occurs and, where necessary, the investor elects to manage or participate in the day-to-day business. For example, the right of an investor to manage the business if there is a default on payments to the investor will not be deemed to be managing the day-to-day business until the payments are not made and the investor declares the default. For purposes of determining whether a taxpayer will be considered to be managing or participating in the day-to-day business, activities performed by employees, officers or partners of a taxpayer will be imputed to the taxpayer but only to the extent that the employee, officer or partner is performing the activity as an employee, officer or partner of the taxpayer.

Dealers

Both this bill and the current UBT law use the term "dealer."

Since the term is not currently defined, section 1 of the bill amends Code section 11-502(a) to add a definition for purposes of the UBT law. The term "dealer," as defined, includes a person that (i) holds or disposes of property that is stock in trade of the taxpayer or is otherwise held for sale to customers in the ordinary course of the taxpayer's business or (ii) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in property with customers in the ordinary course of a trade or business. An entity will not be considered a dealer based solely on its ownership of an interest in another entity that is a dealer or based solely on the ownership by a dealer of an interest in it. This provision is not intended to preclude, where appropriate, treating as a dealer an entity that is controlled by, controlling or under common control with a person or entity that is a dealer where transactions between the entity and the dealer or other facts and circumstances indicate that they are engaged in a unitary dealer business.

"Carried Interests"

The current UBT law provides no guidance regarding the treatment of a partner's distributive share of income from a partnership if a partner acquires a partnership interest under circumstances in which the partnership interest might be viewed as having been acquired for services.[2] Section 5 of the bill amends Code section 11-506(a) to make it clear that the character of the partner's distributive share of income, gains, losses or deductions from the partnership is to be determined as if those items were realized directly by the partner, regardless of how the interest in the partnership was acquired or whether the distributive share received is disproportionate to the interest of the partner in the partnership's capital. This provision will not apply to payments to a partner treated under Internal Revenue Code section 707 as occurring between a partnership and a nonpartner. This provision is not intended to affect the treatment of a taxpayer's distributive share of income, gains, losses or deductions from a partnership as qualifying for the self-trading exemption or as taxable income, gain, loss or deduction from an unincorporated business in the taxpayer's hands. However, under this provision, a partner's disproportionate share of a partnership's investment income would retain its character as investment income in the partner's hands even if the partner also is receiving a fee for managing the partnership's business, which fee is subject to the

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[2] The memorandum in support of the 1994 legislation indicated that the Department of Finance would promulgate rules under that legislation to provide that a partner's distributive share of income of a partnership qualifying as investment income would retain that character to the partner regardless of how the partnership interest was acquired and regardless of whether the partner was a general or limited partner.

UBT as compensation income. If the partner does not qualify for the partial exemption, its share of the investment income from the partnership would be subject to the UBT but would continue to be treated as investment income allocated using the investment allocation rules enacted by the 1994 legislation.

Flow-Through Issues

The bill also clarifies certain issues regarding the application of the UBT to persons owning interests in other unincorporated entities, reflecting the flow-through nature of partnerships. Section 2 of the bill amends Code section 11-502(a), which defines the term "unincorporated business," to provide that if an individual or unincorporated entity carries on in whole or in part in the City two or more unincorporated businesses, all the businesses will be treated as a single business.

In addition, that Code section is amended to provide that an unincorporated entity is to be treated as carrying on any business activity carried on in whole or in part in the City by any other unincorporated entity in which the first entity owns an interest, and, conversely, that the ownership by an unincorporated entity of an interest in another unincorporated entity not carrying on any business activity in whole or in part in the City will not be considered the conduct of an unincorporated business in the City.

This latter provision is not intended to preclude the taxation, where appropriate, of an entity that provides services in whole or in part in the City to another unincorporated entity located outside the City, nor is it intended to preclude an unincorporated entity from being treated as engaged in an unincorporated business in whole or in part in the City, where appropriate, by reason of activities carried on in the City on its behalf by a partner.

Finally, section 5 of the bill amends Code section 11-506(a) to clarify that the unincorporated business gross income of an unincorporated entity includes the income or gain from the sale of an interest in another unincorporated entity attributable to an unincorporated business conducted in whole or in part in the City by that other unincorporated entity.

Real Estate Activities

Section 4 of the bill amends subdivision (d) of section 11-502 with respect to the UBT treatment of garages open to the public that also provide space to tenants in the building that houses the garage.

Under subdivision (d), as amended, if an owner, lessee or fiduciary that holds, leases or manages real property also operates at such real property a garage, parking lot or other similar

facility that is open or available to the general public, the operation of that garage, parking lot or other facility will be considered an unincorporated business subject to the UBT. However, the provision by any such owner, lessee or fiduciary of parking, garaging or motor vehicle storage service on a monthly or longer term basis at such a facility to tenants in the building as an incidental service to such tenants will not be deemed an unincorporated business even if the garage is open or available to the public. As a result, the income from such tenants received for monthly or longer term parking, garaging or storage service will not be subject to the UBT while the income received from monthly or longer term parking service for nontenants and from all other parking, garaging or storage service provided to tenants and nontenants will be subject to UBT. Losses and expenses of the garage or parking operation will not be deductible for UBT purposes to the extent directly or indirectly attributable to the building tenants that are monthly or longer-term parkers.

Due to the difficulty of verifying on audit the identity of persons receiving transient parking services at a facility, the partial exemption for parking, garaging or storage services provided for building tenants is limited to income received for monthly or longer term parking services. As an additional measure to facilitate verification, taxpayers claiming the partial exemption for parking income from tenants must attach to their UBT return such information with regard to the provision of monthly or longer term parking, garaging, or storage services to tenants as the Commissioner of Finance may require. It is anticipated that the Commissioner will require a schedule to be included with the return showing, among other things, the name of each tenant receiving such services and the amount received from each such tenant for such services. Section 4 of the bill amends subdivision (d) of section 11-502 to provide that if a taxpayer's UBT return omits in any material respect the required information relating to parking services provided to tenants at a garage, parking lot or similar facility, the provision of all parking, garaging and storage services to tenants at that facility will be taxable as an unincorporated business.

Technical Corrections. Sections 7 and 9 of the bill amend certain provisions of sections 11-506 and 11-507 added by the 1994 legislation to make it clear that the exclusion from unincorporated business income for income and deductions from the holding, leasing or managing of real property that is not deemed an unincorporated business applies to all persons receiving a distributive share of such income or deductions, not just to the owner, lessee or fiduciary holding the property. Section 6 of the bill adds a new paragraph 14 to subdivision b of section 11-506 to clarify that under the 1994 legislative amendments, losses from the disposition of real property qualifying for the exemption for holding, leasing or managing of real property are not deductible for UBT purposes.

UBT Credit Carryforward

In various contexts where a partner receiving a distributive share of income from a partnership also has losses or loss carryovers, the effect of the losses or loss carryovers may be to nullify the value of the new credit for UBT paid. The reason for this is that one of the measures of the allowable credit is the incremental tax effect on the partner of its distributive share. If the partner has its own operating loss, a net operating loss carryover, or a distributive share of a loss from another partnership, the partner's income without the distributive share that generates the credit may be less than zero. As a result, its tax without that distributive share will be zero. To the extent that the distributive share raises the taxable income from a number less than zero to zero, the distributive share has no incremental effect on the tax owed (i.e., the tax remains at zero). Therefore, the distributive share does not generate a credit. However, the distributive share may nullify the loss and therefore prevent the taxpayer from carrying the loss to another taxable year.

In order to help minimize loss of the credit in these situations, sections 11, 12 and 13 of the bill amend the relevant UBT, GCT, and BCT sections to change the way in which the incremental tax effect of a distributive share is calculated. Under current law, the partner's tax is calculated with and without the distributive share in question. Under the bill, these calculations are modified so that various types of losses are added back before the "with and without" calculations of tax liability are made. The result of this is that a taxpayer may be "allowed" a credit that exceeds the amount that the taxpayer can take in a given year. In such case, the excess can be carried forward and taken against a tax liability in one of the succeeding seven taxable years.

For GCT and BCT taxpayers, the calculation is similar to the UBT calculation, with modifications to equalize the effective tax rates. In addition, for GCT and BCT taxpayers, the bill provides that the credit allowed is always calculated as if the taxpayer were on the respective entire net income bases. This is a change from current law, under which the credit is calculated with reference to the base on which the partner would pay tax in the absence of the credit.

Although for GCT taxpayers the credit is always calculated as if the taxpayer were subject to tax on the entire net income base, the credit may also be taken against the alternative tax measured by entire net income plus compensation paid to officers and certain shareholders (the "income plus compensation base"). In such case, there is again a rate equalization provision under which one dollar of credit reduces the tax by sixty-six and thirty-eight one hundredths cents. Similarly for BCT taxpayers, the credit is calculated as if the taxpayer were subject to the basic tax measured by entire net income; however, the credit may also be taken against the alternative tax measured by alternative entire

net income. In such case, there is a rate equalization provision under which one dollar of credit reduces the tax by seventy-five cents. (In a taxable year in which a GCT or BCT taxpayer is liable for tax on any of the other tax bases, a credit may be "allowed," but in order to be actually "taken," it must be carried over to a year in which the taxpayer is liable for tax under one of the above specified income bases.)

Effective Date

The amendments made by the bill are generally effective January 1, 1996 and applicable to taxable years beginning on or after that date. However, the technical amendments described in a previous section of this memorandum, which are designed to clarify certain provisions of the 1994 legislation, are made effective as of the July 1, 1994 effective date of the 1994 legislation and applicable to taxable years beginning on or after that date.

REASONS FOR SUPPORT

This bill represents a continuation of the effort begun last year to reduce the burden of the City unincorporated business tax and thus foster an improved economic climate for unincorporated entities operating in the City. The bill is the product of a cooperative undertaking by the City and representatives of affected industries and professional groups to make the tax more equitable and to help encourage additional investment in the City. The bill addresses favorably each issue that the working group was directed to consider.

As more fully discussed in the preceding sections of this memorandum, the bill will enable investment firms to carry on a broad range of investment activities without the risk that those activities will be subjected to the UBT, and will also afford tax relief to real property owners who provide certain parking or garaging services to building tenants. Partners subject to City business income taxes will also be able to more fully utilize the credit enacted last year for their shares of unincorporated business taxes paid by partnerships of which they are members.

These important improvements in the unincorporated business tax can be implemented at a relatively minor cost to the City. In FY96, there will be no revenue loss as a result of these changes. The revenue cost is estimated to be $1 million in FY97, $4 million in FY98 and $5 million in FY99.

Accordingly, the Mayor urges the earliest possible favorable consideration of this bill by the Legislature.

NEW YORK STATE AND NEW YORK CITY CORPORATION TAXES: COMBINATION ISSUES

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Morrison & Foerster
New York City

I. **OVERVIEW OF REQUIREMENTS FOR COMBINATION**

A. There are three requirements that must be fulfilled before combined reports will be permitted or required. (Tax Law Section 211.4; Reg. Sec. 6-2.1 through 6-2.5.) These requirements are:

1. 80% or more of the voting stock of one corporation is directly or indirectly owned or controlled by the other corporation;

2. The corporations are engaged in a unitary business; and

3. Distortion of the taxpayer corporation's activities, business, income, or capital would result from separate reporting (see B immediately below).

B. Combined returns covering any corporation that is not a taxpayer may not be required unless necessary to reflect properly the tax liability of one or more taxpayer corporations included in the group because of (1) substantial intercorporate transactions, or (2) some agreement, understanding, arrangement, or transaction whereby the activity, business, income, or capital, of any taxpayer is improperly or inaccurately reflected. (Tax Law Section 211(4).)

C. An alien corporation may not generally be included in a combined report. (Reg. Sec. 6-2.5(b).)

1. However, Foreign Sales Corporations (FSCs), including those that are alien corporations, may be included in a combined report. (Reg. Sec. 6-2.5(b).) Only 8/23 of a FSC's income, however, will be included in such a combined report. (Reg. Sec. 3-2.2(d).)

D. Effective April 1, 1994, I.R.C. Section 936 corporations may not be included in a combined report. (Tax Law Section 211.4.)

E. The regulations provide that a request for permission to file a combined report must be received by the Department of Taxation and Finance

no later than 30 days after the close of the taxpayer's taxable year. (Reg. Sec. 6-2.4(a).)

1. **Penthouse International, Ltd.**, DTA No. 806745 (N.Y.S. Tax Appeals Tribunal, Jan. 20, 1994).

   A corporation was not permitted to file a combined corporation franchise tax report with certain affiliated corporations. The corporation's reliance on the Tax Appeals Tribunal's decision in Autotote Limited (April 12, 1990) -- where the taxpayer was permitted to file on a combined basis despite its failure to request permission to so file within 30 days after the close of its taxable year, as required by the Division of Taxation's regulation -- was misplaced. In the instance case, unlike in Autotote, the issue of combined reporting was not raised until the Administrative Law Judge hearing and thus the Division was not afforded a "meaningful opportunity" to determine whether the corporation and its affiliates met the regulatory criteria for filing a combined report. Importantly, the Tribunal provided that when a taxpayer requests permission to file on a combined basis, a presumption that combined reporting is proper is created.

2. **Exhibitgroup, Inc.**, DTA No. 811850 (N.Y.S. Tax Appeals Trib. Oct. 19, 1995)

   A parent corporation was permitted to file a combined corporation franchise tax report with its wholly-owned subsidiary, although the parent had not requested permission to so file within 30 days of the close of its taxable year as required by the Division of Taxation's regulation. Reliance on the 30 day rule to deny combination was inappropriate since the Division conceded during the course of the administrative hearing that the parent and its subsidiary met the requirements for combination. It was irrelevant that the Division had obtained the information which formed the basis for the concession during settlement negotiations following the Conciliation Conference.

F. New York State and New York City have taken different positions with respect to the ability to include in combined reports corporations whose tax years have closed (i.e., the statute of limitations period for assessment has expired). New York State's position is that before a corporation will be permitted or required to be included in a combined report, its tax year must be open. New York City, on the other hand, takes the position that combined reports are used to determine the proper tax liability of each taxpayer and that, therefore, a combined report can be permitted or required to determine a taxpayer's liability regardless of whether the tax years of the other corporations included in a combined report are open.

1. **Turbodyne Corp.**, DTA No. 812134 (N.Y.S. Admin. Law Judge May 25, 1995)

   A corporation was not permitted to file combined corporation franchise tax reports with its parent and its brother/sister corporations, despite fulfilling the requirements for combined reporting, since the statute of limitations was closed for the affiliates. Support for this conclusion was found in Reg. Sec. 8-1.3(a), which provides that all taxpayers covered by a combined report are liable for the tax and may be assessed for the entire combined tax liability. An Exception to the Tax Appeals Tribunal has been filed by the corporation in this matter.

G. The regulations were amended on October 23, 1993 to "clarify" the Division of Taxation's policy regarding the computation of the subsidiary capital tax when a combined report is filed. The amended regulation, contrary to the State Administrative Law Judge determination in United Parcel Service General Services, Co., DTA No. 807254 (N.Y.S. Admin. Law Judge, Dec. 5, 1991), provides that the subsidiary capital of each corporation included in a combined report (in contrast to the subsidiary capital of each included corporation that is a taxpayer) is to be included in the computation of the subsidiary capital tax (with intercompany eliminations). (Reg. Sec. 3-6.1(c).) The relevant statute states that the subsidiary capital base "shall be computed at the rate of nine-tenths of a

mill for each dollar of the portion of the taxpayer's subsidiary capital allocated within the state as hereinafter provided." (Tax Law Section 210.1(e).)

II. THE OWNERSHIP REQUIREMENT

A. Tax Law Section 211.4 requires that the taxpayer corporation "owns or controls either directly or indirectly substantially all the capital stock" of the affiliates to be included in the combined report.

B. The regulations provide that the term "substantially all" means ownership or control of 80% or more of the voting stock of the corporation. (Reg. Sec. 6-2-2(a)(2).)

1. To be considered an "owner", the shareholder corporation must have both the right to vote and the right to receive dividends. (Reg. Sec. 6-2-2(a)(2).)

2. The existence of "control" is determined by the facts of each case. (Reg. Sec. 6-2-2(a)(2).)

3. The reference in the regulations to "voting stock" rather than "voting rights" could cause controversy in connection with multiple classes of stock with different voting rights.

III. THE UNITARY BUSINESS REQUIREMENT

A. Historical Underpinnings

1. Initial Use -- the unitary business doctrine was initially used by states to value railroads and telegraph companies for property tax purposes.

   a. Adams Express Co. v. Ohio State Auditor, 166 U.S. 185 (1897)

      i. Application of property tax to include express companies' intangible property upheld.

ii. "Every state within which it [the express company] is transacting business, and where it has its property, more or less, may rightfully say that the $16,000,000 of value which it possesses springs not merely from the original grant of corporate power by the state which incorporated it, or from the mere ownership of the tangible property, but it springs from the fact that that tangible property it has combined with contracts, franchises, and privileges into a single unit of property; and this state contributes to that aggregate value not merely the separate value of such tangible property as is within its limits, but its proportionate share of the value of the entire property."

2. Underlying Principle -- the underlying principle of the unitary business doctrine is the disregarding of boundaries

   a. Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920)

      i. Apportionment of the entire net profits derived from a unitary business that was partly conducted in the taxing state using a single-factor property formula was upheld.

      ii. "The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. . . . The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which . . . reached, and was meant to reach, only the profits earned within the State."

b. Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271 (1924)

i. British corporation that manufactured ale in England and sold the ale in England and through branch offices in Chicago and New York was subject to New York franchise tax even though the corporation had no net income for federal income tax purposes.

ii. "as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places -- the process of manufacturing resulting in no profits until it ends in sales -- the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business."

B. **General Tests and Characteristics of Unitary Businesses**

1. The Three Unities Test

a. Butler Bros. v. McColgan, 17 Cal.2d 664 (1941), aff'd, 315 U.S. 501 (1942)

i. Foreign corporation engaged in the wholesale merchandise business and operating distributing houses in seven states, including California, was engaged in a unitary business due to the existence of the following factors: "(1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation."

ii. "It is only if its business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer." (citations omitted.)

2. Contribution or Dependency Test

   a. Edison California Stores v. McColgan, 30 Cal.2d 474 (1947) -- "If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate."

3. Common Characteristics

   a. Functional Integration

   b. Centralization of Management

   c. Economies of Scale

C. **Modern U.S. Supreme Court View**

1. Cases Elaborating on Factors

a. Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980)

i. Mobil, a New York corporation with its principal place of business (its commercial domicile) in New York, was subject to tax in Vermont on an apportioned share of the dividends it received from its subsidiaries and affiliates that were doing business abroad because Mobil was engaged in a unitary business with those corporations.

ii. "the linchpin of apportionability in the field of state income taxation is the unitary-business principle. In accord with this principle, what appellant must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State." (footnote omitted.)

iii. "appellant has made no effort to demonstrate that the foreign operations of its subsidiaries and affiliates are distinct in any business or economic sense from its petroleum sales activities in Vermont. Indeed, all indications in the record are to the contrary, since it appears that these foreign activities are part of appellant's integrated petroleum enterprise."

iv. Where the intrastate and extrastate activities form part of a single unitary business, "separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional

integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'"

v. "We do not mean to suggest that all dividend income received by corporations operating in interstate commerce is necessarily taxable in each State where that corporation does business. Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business."

b. ASARCO, Inc v. Idaho State Tax Comm'n, 458 U.S. 307 (1982)

i. Dividends, interest, and capital gains received by ASARCO from corporations in which it owned interests were not subject to Idaho tax because a unitary business relationship did not exist between ASARCO and the other corporations.

ii. Court rejected Idaho's expansion of the concept of unitary business to include income from intangible property that is acquired, managed, or disposed of for purposes relating or contributing to the taxpayer's business (i.e., corporate purpose). "We cannot accept, consistently with recognized due process standards, a definition of 'unitary business' that would permit nondomiciliary States to apportion and tax dividends '[w]here the business activities of the dividend payor have nothing to do with the

activities of the recipient in the taxing State . . . .'" (citing Mobil.)

c. F.W. Woolworth Co. v. Taxation & Rev. Dep't of New Mexico, 458 U.S. 354 (1982)

i. Dividends received by Woolworth, a corporation commercially domiciled in New York, from four subsidiaries (three of which were wholly owned) were not subject to New Mexico tax because Woolworth was not engaged in a unitary business with the corporations.

ii. "the potential to operate a company as part of a unitary business is not dispositive when, looking at 'the underlying economic realities of a unitary business,' the dividend income from subsidiaries in fact is 'derive[d] from unrelated business activity which constitutes a discrete business enterprise.'" (citations omitted.)

iii. "the proper inquiry looks to 'the underlying unity or diversity of business enterprise', not to whether the nondomiciliary parent derives some economic benefit - as it virtually always will - from its ownership of stock in another corporation." (citations omitted.)

iv. "Each of the foreign subsidiaries at issue operates a 'discrete business enterprise,' with a notable absence of any 'umbrella of centralized management and controlled interaction.' New Mexico, in taxing a portion of dividends received from such enterprises, is attempting to reach 'extraterritorial values,' wholly unrelated to the business of the Woolworth stores in New Mexico."

d. Allied-Signal, Inc. v. Director, Div. of Taxation of New Jersey, 112 S. Ct. 2251 (1992)

i. New Jersey could not tax Allied-Signal on the gain its predecessor (Bendix) recognized from the sale of stock of a New Jersey corporation because Bendix and the other corporation were not engaged in a unitary business and the gain was from an investment function and not an operational function.

ii. "Because of the complications and uncertainties in allocating the income of multistate businesses to the several States, we permit States to tax a corporation on an apportionable share of the multistate business carried on in part in the taxing State. That is the unitary business principle."

iii. "the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. Container Corp. says as much. What is required instead is that the capital transaction serve an operational rather than an investment function."

iv. "the existence of a unitary relation between the payor and the payee is one means of meeting the constitutional requirement. . . . We did not purport, however, to establish a general requirement that there be a unitary relation between the payor and the payee to justify apportionment, nor do we do so today."

v. "the mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one."

vi. The Court rejected New Jersey's "'ingrained acquisition-divestiture policy.'" "The hallmarks of an acquisition which is part of the taxpayer's unitary business continue to be functional integration, centralization of management, and economies of scale. Container Corp. clarified that these essentials could respectively be shown by: transactions not undertaken at arm's length; a management role by the parent which is grounded in its own operational expertise and operational strategy; and the fact that the corporations are engaged in the same line of business." (citations omitted.)

2. Combining Unincorporated Divisions

a. Exxon Corp. v. Wisconsin Dep't of Rev., 447 U.S. 207 (1980)

i. Wisconsin could constitutionally apply its statutory apportionment formula to Exxon's total corporate income even though Exxon's functional accounting separated its income into three distinct categories of marketing, exploration, and refining, and Exxon only performed marketing operations in Wisconsin, because the marketing activities were an integral part of Exxon's unitary business.

ii. "In order to exclude certain income from the apportionment formula, the company must prove that 'the income was earned in the course of activities unrelated to the sale of petroleum products in the State.' The court looks to the 'underlying economic realities of a unitary business,' and the income must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" (citing Mobil Oil.)

iii. "While Exxon may treat its operational departments as independent profit centers, it is nonetheless true that this case involves a highly integrated business which benefits from an umbrella of centralized management and controlled interaction."

3. Combining Corporations

a. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983)

i. Container Corporation was found to be engaged in a unitary business with its overseas subsidiaries that were incorporated in the countries in which they operated. California was therefore allowed to apply its formulary apportionment formula to the income that those subsidiaries earned.

ii. "When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use - either through economies of scale or through operational integration or sharing of expertise - of the parent's existing business-related resources."

iii. Taken in combination, the following factors demonstrated that the state court's conclusion that Container Corporation was engaged in a unitary business with its subsidiaries was within the realm of permissible judgment: "appellant's assistance to its subsidiaries in obtaining used and new equipment and in filling personnel needs that could not be met locally, the substantial role played by appellant in loaning funds to the subsidiaries and guaranteeing loans provided by others, the 'considerable interplay between appellant and its foreign

subsidiaries in the area of corporate expansion,' the 'substantial' technical assistance provided by appellant to the subsidiaries, and the supervisory role played by appellant's officers in providing general guidance to the subsidiaries."

b. Barclays Bank PLC v. Franchise Tax Board & Colgate Palmolive Co. v. Franchise Tax Board, 114 S. Ct. 2268 (1994)

The U.S Constitution does not impede application of California's worldwide combined reporting method as applied to either foreign-based (Barclays Bank) or U.S.-based (Colgate-Palmolive) mulitinational corporations. Barclays argued that California's taxing system discriminated against foreign commerce by imposing a greater compliance burden and expense on foreign-based corporate groups than domestic-based groups. The Court agreed that compliance disproportionately imposed on out-of-jurisdiction enterprises would not pass Commerce Clause scrutiny; however, that was not the case here since Barclays' worldwide income was computed not on the basis of certain financial statements as required by regulation but pursuant to another regulatory provision that allows "reasonable approximations" of financial data in appropriate cases. The Court concluded that Barclays thereby avoided large compliance costs and thus failed to demonstrate that California's tax system in fact operates to impose inordinate compliance burdens on foreign-based mulinations. With respect to the taxpayers' argument that the state's use of the worldwide combined reporting system frustrated federal foreign policy in violation of the Foreign Commerce Clause, the Court relied on congressional inaction in reaching its conclusion that Congress implicitly has permitted the states to use worldwide combination to tax multinational corporate groups.

D. **New York's Approach To The Unitary Business Doctrine**

1. Tax Law Section 211.4 does not explicitly require that corporations be engaged in a unitary business before combination will be permitted or required.

2. While the regulations do require that corporations be engaged in a unitary business before combination will be permitted or required (Reg. Sec. 6-2.1(a)), the term "unitary business" is not defined in the regulations. Instead, the regulations merely provide illustrative examples without limiting the meaning of the term to those examples.

   a. The New York State Tax Appeals Tribunal has provided that the regulations comport with the key indicia of a unitary business developed by the U.S. Supreme Court (i.e., functional integration, centralization of management, and economies of scale). See USV Pharmaceutical Corp., DTA No. 801050 (N.Y.S. Tax Appeals Trib. July 16, 1992).

3. British Land (Maryland), Inc., DTA No. 806894 (N.Y.S. Tax Appeals Trib. Sept. 3, 1992), aff'd, 202 A.D.2d 867, 609 N.Y.S.2d 439 (3rd Dept. 1994), rev'd on other grounds, 85 N.Y.2d 139, 623 N.Y.S.2d 772 (1995)

   a. The Tribunal summarized the current status of the unitary business principle as enunciated by the U.S. Supreme Court and applied these principles to determine that a corporation's ownership and operation of two properties exhibited these three characteristics and therefore that the corporation was conducting a unitary business.

4. Sears, Roebuck and Co., DTA No. 801732 (N.Y.S. Tax Appeals Trib. Apr. 28, 1994)

   a. Relying on its decision in British Land and the U.S. Supreme Court cases discussed therein, the Tribunal held that Sears and its affiliate, Sears Roebuck Acceptance Corporation (SRAC), a

Delaware-based finance subsidiary, were engaged in a unitary business.

b. "[D]espite the separate corporate structures Sears has not shown that it and SRAC were engaged in discrete business enterprises. Rather, the facts show an overwhelming interdependence between the two -- a clear underlying unity of the business enterprise."

IV. THE DISTORTION REQUIREMENT

A. Tax Law Section 211.4 provides that a combined report including a non-taxpayer corporation will be permitted or required only if it is necessary in order properly to reflect the tax liability of a taxpayer corporation. The Tax Law imposes no such requirement regarding combined reports including only taxpayer corporations.

B. The regulations, however, provide a distortion requirement with respect to the inclusion of both taxpayer corporations and non-taxpayer corporations in a combined report. (Reg. Sec. 6-2.1, 6-2.3, and 6-2.5a.)

C. The regulations do not provide a definition of the term "distortion". They do, however, specify that distortion of a taxpayer's activities, business, income, or capital will be presumed to result from separate reporting if there are substantial intercorporate transactions among the corporations. (Reg. Sec. 6-2.3(a).)

a. The substantial intercorporate transactions requirement may be met if as little as 50% of a corporation's receipts or expenses are from one or more qualified activities. (Reg. Sec. 6-2.3(c).)

1. It is not necessary that each corporation have substantial intercorporate transactions with every other member of the combined group. What is necessary is that each corporation have substantial intercorporate transactions with one other corporation or with a combined or combinable group of corporations.

2. "Qualified activities" are transactions directly connected with the business conducted by the taxpayer and include:

   i. manufacturing or acquiring goods or property or performing services for other corporations in the group;

   ii. selling goods acquired from other corporations in the group;

   iii. financing sales of other corporations in the group;

   iv. performing related customer services using common facilities and employees.

3. Service functions (such as accounting, legal, and personnel services) will not be considered as qualified activities when they are incidental to the business of the corporation providing such service.

b. Cases interpreting these provisions have held that if substantial intercorporate transactions exist between corporations, then a presumption of distortion will arise. The corporations will thus be permitted or required to filed a combined report unless the presumption is rebutted by evidence establishing that separate reporting does not result in the distortion of the taxpayer's activities, business, income, or capital. (USV Pharmaceutical Corp., DTA No. 801050 (N.Y.S. Tax Appeals Trib. July 16, 1992); Standard Mfg. Co., DTA No. 801415 (N.Y.S. Tax Appeals Trib. Feb. 6, 1992).)

D. Cases Regarding The Distortion Requirement

1. **USV Pharmaceutical Corp.**, DTA No. 801050 (N.Y.S. Tax Appeals Tribunal, July 16, 1992).

   USV successfully thwarted the Division of Taxation's attempt to force it to file combined New York State corporation franchise tax reports with its wholly-owned subsidiary, an I.R.C. Section 936 corporation which was not itself a New York taxpayer, because USV

established that combined reports were not necessary to reflect properly its New York tax liability. Although a presumption of distortion existed (since the stock ownership, unitary business, and substantial intercorporate transactions tests of the Division's regulations were met), USV rebutted the presumption with the results of an I.R.C. Section 482 audit of USV and the subsidiary and the corresponding adjustments which the Tribunal found established arm's length pricing between the corporations.

2. **Medtronic, Inc.**, DTA No. 800306 (N.Y.S. Tax Appeals Tribunal, Sept. 23, 1993).

   The New York State Division of Taxation was allowed to require Medtronic to file combined corporation franchise tax reports with its two wholly-owned subsidiaries, which were not themselves New York taxpayers, because Medtronic failed to establish that its income would be properly reflected on separate reports. Since the stock ownership, unitary business, and substantial intercorporate transactions tests of the Division's regulations were met, a presumption of distortion was created. Medtronic was unable to rebut this presumption because (1) it was unable to establish that the federal I.R.C. Section 482 audit that it had undergone had specifically examined the intercorporate transactions between it and the subsidiaries and had found the transactions to be at arm's length, and (2) the testimony of the witnesses produced by the company was insufficient to establish that the intercompany transactions were at arm's length pursuant to I.R.C. Section 482 standards (which the Tribunal utilized for this purpose).

3. **Campbell Sales Company**, DTA Nos. 805017-8 (N.Y.S. Tax Appeals Tribunal, Dec. 2, 1993).

   Campbell Sales Company ("Sales") could not be forced by the Division of Taxation to file combined corporation franchise tax reports covering its parent, Campbell Soup Company, because Sales established that combined reports were not necessary to reflect properly its New York tax liability. Although a

presumption of distortion arose from Sales' filing on a separate company basis, Sales was able to rebut this presumption by establishing that the nature and pricing of the intercorporate transactions were at arm's length under the principles of I.R.C. Section 482 and its related regulations.

4. **Sears, Roebuck and Co.**, DTA No. 801732 (N.Y.S. Tax Appeals Tribunal, April 28, 1994).

   Sears could not be required by the Division of Taxation to file a combined report covering its affiliate, Sears Roebuck Acceptance Corporation (SRAC), a Delaware-based finance subsidiary. Although the Tribunal reversed the ALJ's holding that Sears and SRAC were not engaged in a unitary business, the Tribunal found that forced combination was inappropriate since the loans from SRAC to Sears were made at arm's length rates, and thus there was no distortion.

5. **Heidelberg Eastern, Inc.** and **East Asiatic Company**, DTA Nos. 806890 and 807829 (N.Y.S. Tax Appeals Tribunal, May 5, 1994).

   The Division of Taxation's refusal to permit the East Asiatic Company (EAC) to file combined reports covering its wholly owned subsidiary, Heidelberg, was in error. The Tribunal affirmed the ALJ's decision that the corporations established that they satisfied the requirements for filing a combined report (i.e., capital stock, unitary business, and distortion). The ALJ had found that distortion was present because there was no compensation or reimbursement to EAC for financing, financial management, or common managers.

6. **New York Times Co.**, DTA No. 809776 (N.Y.S. Tax Appeals Trib. Aug. 10, 1995)

   A newspaper publishing corporation could not be forced to file combined corporation franchise tax reports with its wholly-owned sales subsidiary, since although the two were engaged in a unitary relationship and there were substantial intercorporate transactions between them, those transactions were at arm's

length (pursuant to a cost-sharing arrangement) and accordingly no distortion resulted from separate reporting.

In the determination below, the Administrative Law Judge held that the publishing corporation was allowed to file combined reports with an 80%-owned "shell" corporation (whose only asset was a 50% partnership interest in an operating partnership). The two corporations had centralized management, were functionally integrated, enjoyed economies of scale, and had substantial intercorporate transactions which were non-arm's length, resulting in distortion of income unless combined reporting were allowed. The Division of Taxation did not file an Exception with respect to this part of the determination.

7. **Silver King Broadcasting of N.J., Inc.**, DTA No. 812589 (N.Y.S. Admin. Law Judge Aug. 10, 1995)

   A subsidiary of a holding company with over 80 first- and second-tier subsidiaries was not required to file combined corporation franchise tax reports with the holding company and all corporations included in the holding company's federal consolidated returns because it rebutted the presumption of distortion of income by demonstrating that the substantial intercorporate transactions between the corporations were at arm's length pursuant to the standards of I.R.C. Section 482.

8. **Express, Inc. et al.**, DTA Nos. 812330-812332, 812334 (N.Y.S. Admin. Law Judge Sept. 14, 1995)

   The Division of Taxation could not force four affiliated retailers to file combined franchise tax reports with their respective trademark protection affiliates. The retailers rebutted the presumption of distortion arising from the existence of substantial intercorporate transactions by establishing that the royalty fees paid by the retailers were arm's length royalty fees pursuant to I.R.C. Section 482 and by establishing that the interest rates charged on intercompany loans fell within the "safe

haven" interest rates provided in the Section 482 regulations.

9. Article 32 of the Tax Law

   a. **U.S. Trust Corp.**, DTA No. 810461 (N.Y.S. Admin. Law Judge Dec. 22, 1994)

      A nontaxpayer banking corporation can be forcibly combined with affiliates for banking franchise tax report purposes if combination is necessary to reflect a taxpayer's liability properly. Here, despite the existence of a unitary relationship between the taxpayer and its Delaware holding company, there was no distortion of income because (1) capital contributions in which no gain was recognized were not "intercorporate transactions" and did not create distortion and (2) the Delaware holding company was not a mere "shell" since it was established for valid business purposes and had substance. There was no need for the Division first to make specific I.R.C. Section 482-type adjustments before resorting to combination.

NEW YORK STATE SALES TAX UPDATE

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NEW YORK STATE SALES TAX UPDATE

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I. NEW SALES TAX DEVELOPMENTS

A. Hot Topics

1. New legislation:

a. New exemption for goods and services for acquisition and maintenance of guide, learning and service dogs. Tax Law § 1115(s). *See also* TSB-M-95(10)S.

b. New York City exemption for interior decorating and designing services.

c. Exemption for dues paid to co-op/condo association for social/athletic facilities. This reverses *Shaker Commons Condominium Owners*, TSB-A-94(6)S and TSB-A-94(6.1)S.

d. Effective September 1, 1995, cigarette stamping agents will be required to pre-pay a portion of the sales taxes due on cigarettes. The pre-payment will be made upon the purchase of State excise stamps and the amount of pre-paid tax will ultimately be passed down to the retail vendor.

e. Note: Exemption for coin-operated car washes was vetoed.

2. New cases hold that a few visits per year trigger sales tax nexus. *Orvis*, __N.Y.2d__ (1995) and *Vermont Information Processing*, __N.Y.2d__ (1995) (Decided June 4, 1995).

3. The Audit Division was barred by the three-year statute of limitations from assessing tax against a corporate officer because a waiver of the statute submitted by the corporation and signed by another corporate officer (although valid against the corporation) did not extend the statute of limitations against this officer. The corporation and the officer were separate taxpayers with their own separate statutes of limitations. *Russack*, 1995-2 N.Y.T.C.

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J-102 and *On-Site Petroleum Unlimited*, 1995-2 N.Y.T.C. J-1016. *See also Harold Rashbaum, As Officer of U.S. General Supply Corp.*, 1994-1 N.Y.T.C. J-207, aff'd. 1995-1 N.Y.T.C. T-__.

4. Sales taxes (plus interest from the date of sale) are collectable from your customers. Statute of limitations is four years for sales of goods, six years otherwise. *Pallette Stone v. Guyer Builders*, __NYS2d__ (3d Dep't. 1995).

5. *Laks*, 590 N.Y.S.2d 958 (4th Dep't. 1992) has been reversed. A responsible officer is now liable for the corporation's interest and penalties. *See Lorenz v. Department of Taxation and Finance et al*, **623** N.Y.S.2d **455** (4th Dep't. Feb. 3, 1995). This case is being appealed.

6. Expenditures for work performed on the Woolworth Building during the audit period qualified as capital improvements, notwithstanding the fact that the taxpayer had expensed the costs for income tax purposes, rather than capitalizing them. The ALJ applied the statutory definition of a capital improvement under the sales tax and concluded that the work qualified for the exclusion. *F.W. Woolworth*, 1994-1A N.Y.T.C. T-1361.

7. Waste removal containers can be purchased exclusively for resale where they are always rented or leased to customers. *CID Refuse Service, Inc.*, 1995-1 N.Y.T.C. T-__.

8. A taxpayer's creation of a multi-media software product is subject to sales tax as the sale of tangible personal property in the form of disks containing data. *See* Tax Law § 1101(b)(14). *Steve Burnett, Inc.*, TSB-A-95(28)S.

9. Tax Law § 1115(a)(4) exempts prosthetic aids used to correct or alleviate physical incapacity in human beings

- **a.** A hair prosthesis is exempt from tax where it can be demonstrated that the prosthesis is to be used as a result of a medical problem, and not for cosmetic purposes *Hair Club For Men*, TSB-A-95(9)S.

- **b.** An optical reading device is exempt. *Audio Reading Concepts*, TSB-A-95(4)S.

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c. An artificial kidney is exempt. *Althin CD Medical*, 1995-2 N.Y.T.C. J-1124.

d. Numerous dental supplies are exempt. TSB-A-95(27)S.

e. But an adjustable bed is taxable. *Craftmatic*, __N.Y.S.2d__.

f. And so are adult diapers used in a nursing home. *Maggio*, TSB-A-94(49)S.

10. *WFC Tower A Company*, 1995-1 N.Y.T.C. T-170. *See also Gartner Group, Inc.*, 1993-3 N.Y.T.C. J-80, Aff'd. 1994-1A N.Y.T.C. T-1410 and *Allied Aviation*, 1991-1 N.Y.T.C. T-701: overlapping audit policy. Requires audit, no agreement to keep item out, same periods, signed letter and payment.

11. Although the serving of process is not subject to sales tax, sending faxes of documents, delivering photocopies within New York and retrieving and researching legal documents from public records are taxable sales. *Kavanagh*, TSB-A-93(67)S. Same result for reprints of resumes by fax, laser printer, photocopier, etc.. However, up to three newly typed resumes will be exempt as a typing service. *Debbie Dziedzic*, TSB-A-94(28)S.

12. An MRI tractor/trailer unit is exempt from sales tax to the extent the tractor/trailer qualify under Tax Law § 1115(a)(26). However, the MRI unit is not considered "equipment" for a tractor/trailer and is therefore subject to sales tax. Additionally, under New York's "cheese board rule", if the tractor/trailer cannot be purchased separately from the MRI unit, the combination of the items must be considered as one, and the entire charge for the tractor/trailer/MRI unit would be subject to sales taxes. *Maxum Health Services Corp.*, TSB-A-93(22)S.

13. Although flags of the United States and of New York State are exempt from sales and use taxes, the exemption does not apply to confederate flags, colonial flags, historic flags, flag patches, decals or pins with a design of a flag that are used for display on clothing or other items or kits composed of plastic parts that resemble the flag when assembled. Additionally, when a flag is sold in a package kit that includes other items that are subject to sales tax (such as a pole, lanyard and bracket), or when a flag is sold attached to a pole, rod or staff, the entire sale is subject to tax unless the price of the flag is separately stated on the bill or sales slip given to the customer. Additionally, the price of the flag must be reasonable in relation to the entire charge. *See Sales Tax Newsletter*, Vol. 22, Number 2, September, 1995.

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14. No use tax on natural gas brought in from out of state. *Penn York*, 1992-2 N.Y.T.C. T-1181.

15. In a rare case, purchases for resale can be established by oral testimony even in the absence of resale certificates (9,000 Sony walkmans sold to one buyer who is no longer on good terms with the taxpayer and thus had no reason to lie on the witness stand). *Intercontinental Audio and Video, Inc.*. 1994-2A N.Y.T.C. J-2890.

16. Statistical sample audits are estimated, accordingly, consent is required. *Marine Midland Bank*, 1993-2 N.Y.T.C. T-469.

17. Note issues involving tax on deliveries.

18. Other sales tax audit rules. Before test period or statistical sample can be used, auditor must *ask* for records in writing. *Yel-Boms*, 1990-1 N.Y.T.C. T-351. Auditor cannot assume records are *inadequate*. *Meeks*, 1993-3 N.Y.T.C. J-620. If taxpayer brings in new accountant or other reasonable circumstances, auditor must allow reasonable postponement of audit. *Imperial Floor Covering*, 1993-3 N.Y.T.C. J-294. Each extension of audit requires new request for records. Auditor cannot assume that records are defective. *Great Neck Service Station*, 1988-1 N.Y.T.C. T-115. If taxpayer sells both taxable and nontaxable items, auditor must devise reasonable audit methodology. Cannot assume everything is taxable. *Bernstein*, 1992-1A N.Y.T.C. T-1479 and *Auriemma*, 1992-2 N.Y.T.C. T-1108.

19. Without records, a one-day observation audit can establish a three-four year liability. *See e.g.*, *Hollywood Grocery Stores*, 1995-2 N.Y.T.C. J-131 and *Bagel Boss*, 1995-2 N.Y.T.C. J-1185. Major business charges were disregarded.

20. Transfer of direction and control over property can trigger tax consequences.

a. Rental of crane - following foreman's orders, working hours, conditions, etc. 20 N.Y.C.R.R. § 526.7(e)(4).

b. Rental of bus/transportation services. *Coren*, TSB-A-95(13)S.

c. Limo rides. *WNY Limousine*, TSB-A-_____

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d. Funeral processions. *Buckley Funeral Home*, 199 Misc. 195 (Sup. Ct. 1950) Aff'd. 277 AD 1096 (1st Dep't. 1950).

e. Manufactured Homes - are they purchased installed or as tangible personal property? *G & I Homes*, TSB-A-95(11)S.

21. Reward credits issued by shop-at-home club (credits good for merchandise) were taxable based on actual value of credits (1099 value). *Popular Club Plan* 1995-1 N.Y.T.C. T-__.

22. New medical supply/equipment rental initiative.

23. Some auditors conduct withholding tax audits too.

24. All of the professional and other efforts that culminate in a video tape are taxable as the sale of tangible personal property (the tape). *Video Memories Assoc.*, 1995-3 N.Y.T.C. J-__.

25. Medical alert services are exempt from tax. *MSS Electronics*, TSB-A-95(34)S.

26. Fees for advertising on the internet are not taxable. *Levy*, TSB-A-95(33)S.

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II. INFORMATION SERVICES

A. The Law

B. What is taxable?

- Section 1105(c)(1) of the New York Tax Law imposes tax on retail sales of the following service:

> The furnishing of information by printed, mimeographed or multigraphed matter or by duplicating written or printed matter in any other manner, including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons . . . .

C. What is excluded?

- Section 1105(c)(1) provides an exclusion for:

> The furnishing of information which is personal or individual in nature and which is not or may not be substantially incorporated in reports furnished to other persons, and excluding the services of advertising or other agents, or other persons acting in a representative capacity, and information services used by newspapers, radio broadcasters and television broadcasters in the collection and dissemination of news.

D. Recent Legislation

- New exemption for meteorological services. Tax Law § 1105(c)(1).
- Effective September 1, 1995, the threshold for mandatory participation in the electronic funds transfer program will be reduced from $4 to $1 million of annual sales tax liability.

E. The Current Status of Information Services

- On August 7, 1995, in his letter accompanying the amendment excluding meteorological services from the tax on information services, Governor Pataki stated:

> By administrative edict, the prior administration pursued avenues of taxation on the basis of an expansive -- and erroneous -- interpretation of tax law. This abusive practice has subjected honest, law-abiding taxpayers to unwarranted assessments, endless notices of determination, and years of litigation from tax auditors with marching orders from the top -- all stemming from a policy in search of endless revenue streams from alleged taxes never authorized by the Legislature.

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Taxation by administrative fiat must end. It will end under my administration.

The information services industry is an industry which New York should nurture, not overtax. I therefore will direct the Department of Taxation and Finance to re-evaluate all informal rulings issued publicly or internally regarding the taxation of information services by administrative edict under the sales and use tax and to develop a policy which encourages the information services industry to locate or remain in New York.

- The Audit Division is currently reevaluating its view of the information service tax and the scope of the exclusions.

F. What is a Taxable "Information Service"? -- The Cases and Rulings

- A mailing list transferred as part of the bulk sale of a gas station was not an "information service" subject to sales tax. Although literally a collection of information had been made and furnished, the Court of Appeals concluded that this was not an "information service" because the gas station was not in the business of "collecting, compiling or analyzing" this information. What this means is that the sale of information as such is not necessarily an "information service". *Matter of Audell Petroleum Corp. v. State Tax Commission*, 69 N.Y.2d 818, 513 N.Y.S.2d 962 (1987).

- Reports generated by two research consortia were not "information services", notwithstanding the fact that information was collected and furnished in a written report. The Tribunal concluded that the "essence" of the transaction was research and development and refused to find an information service simply because a written report was furnished. *Matter of Rochester Gas and Electric Corp.*, Tax Appeals Tribunal (January 4, 1991).

- A dating service was not taxable as an information service because its function was not "to collect and disseminate information." Focusing on the service, "in its entirety, as opposed to... components", the Tribunal concluded that the service was not an information service. *Matter of SSOV '81 d/b/a People Resources*, Tax Appeals Tribunal (1995).

- Maintaining a customer's own information, and providing computerized access is not an information service because no new information or intelligence is transferred to the customer. *Price Waterhouse LLP*, TSB-A-95(12)S.

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- Consistent with this view are *Trump Shuttle, Inc.*, TSB-A-93(58)S and *CyCare Systems, Inc.*, TSB-A-93(18)S which hold that personalized data processing services are not taxable as information services.

- A service that guarantees the funds of its customers' checks is not subject to New York sales and use taxes. *H.O. Penn Machinery Co.*, TSB-A-95(26)S.

- Telephone sales solicitation is not an information service. *Alan/Anthony, Inc.*, TSB-A-92(6)S.

- A computer software program that integrates insurance underwriting guidelines, policies and procedures (*i.e.* information) with proprietary premium discount formulas and customized computer programming is not an information service -- it is computer software. *Matter of Insurance Automation Systems, Inc.*, Tax Appeals Tribunal (February 23, 1995).

- Multiple listing services are taxable as information services. *Mohawk Valley Listing Service, Inc.*, TSB-A-89(24)S.

- Furnishing DMV reports is a taxable information service. *Matter of Allstate Insurance Co. v. State Tax Commission*, 115 A.D.2d 831, 495 N.Y.2d 789 (3d Dep't. 1985), *aff'd*, 67 N.Y.2d 999, 502 N.Y.S.2d 804 (1986).

- The Tax Department has confirmed that the following search services are **not** subject to sales tax until further notice:

  (1) Uniform Commercial Code searches,
  (2) tax and tax lien searches,
  (3) pending suit searches,
  (4) judgment searches,
  (5) mechanics liens searches,
  (6) bankruptcy searches,
  (7) case retrieval searches to obtain copies of public hearing transcripts and/or document reports,
  (8) business document searches (*e.g.* articles of incorporation), and
  (9) business availability searches.

- Additionally, the following services are <u>not</u> even potentially subject to sales and compensating use taxes:

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(1) business document, UCC and business name filings,
(2) filing preparation services,
(3) vile watch services (keeping, in essence, a "tickler" system of a customer's current filing for purposes of informing the customer what filings are expiring),
(4) acting as registered agent to receive service of process, and
(5) arranging for the publication of public notices.

- Nevertheless, non-attorney computer searches of databases are taxable. *Corsearch, Inc.*, TSB-A-88(58)S.

- The State has specifically withheld any advice concerning the tax status of real property searches and the proposal to tax title abstracts has been rescinded. Letters from Steven Teitelbaum to Mark Klein dated May 22, 1995 and August 24, 1995.

G. What is Personal or Individual In Nature? -- The Cases and Rulings

- Information services are "personal or individual in nature" when the customer defines the parameters of search and the investigation and report are tailored to a client's specification. *Matter of New York Life Insurance Co. v. State Tax Commission*, 80 A.D.2d 675, 436 N.Y.S.2d 380, 383 (3d Dep't. 1981), *aff'd sub nom*, *Metropolitan Life Ins. Co. v. State Tax Commission*, 55 N.Y.2d 758 (1982).

- Generally, stand-alone laboratory reports (e.g. soil testing) are exempt as personal or individual in nature. TSB-M-95(8)S. However, they may result is a taxable "repair" service if they are coupled with a later repair based on the report. *See, e.g.*, *Klein*, TSB-A-94(21)S, where zebra mussel monitoring was exempt as an information service, but held taxable as maintenance under 1105(c)(3) and/or (5).

- A taxpayer that sells an ultrasound image in conjunction with a written report (*i.e.* diagnosis) enjoys the exclusion for reports that are personal or individual in nature. However, if the taxpayer merely sells the image without a report, the sale would be taxable as a sale of tangible personal property. *Thunder Ridge Ultrasound Service*, TSB-A-95(22)S.

- A home inspection service (with a report) is excluded from tax as an information service that is personal or individual in nature. If it is sold to a prospective home purchaser, it would not be taxable. However, if it sold to the homeowner directly, it would be taxable as real property maintenance under Tax Law § 1105(c)(5). *Matocha*, TSB-A-90(12)S.

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- Marketing consultation services analyzing a client's internal sales data and preparing a written marketing plan with recommendations for improving sales and profits, pricing, promotion and advertising and sales strategies are personal or individual in nature and, hence, excluded. *Crowley Web & Associates*, TSB-A-95(2)S.

- Individualized oral consultation services are, similarly, excluded as personal or individual in nature. *Hodgson, Russ, Andrews, Woods & Goodyear*, TSB-A-92(31)S.

- Financial account verification services are taxable because the information is derived from public sources. *Chex Systems*, TSB-A-95(14)S.

- Analyzing results of a customer's unique survey is personal or individual in nature. *Steger*, TSB-A-94(16)S.

H. "Common Database" Cases

- Information from a common database which is merely "distilled" into summary form for presentation in a report is not personal or individual in nature. *Matter of Twin Coast Newspapers, Inc. v. State Tax Commission*, 101 A.D.2d 977, 477 N.Y.S.2d 718 (3d Dep't 1984), *appeal dismissed*, 64 N.Y.2d 874, 487 N.Y.S.2d 553 (1985).

- Customizing the presentation of information or including only selective pieces of information from a common database does not change the fact that the information in the report was "gleaned" from, and existed in, a common database. It is not personal or individual in nature. *Matter of Towne-Oller and Associates, Inc. v. State Tax Commission*, 120 A.D.2d 873, 502 N.Y.S.2d 544 (3d Dep't 1986).

- Tailoring a report to specific parameters of a customer did not change the fact that the information in the report was "extracted" from a common database and was not personal or individual in nature. *Matter of Rich Products Corporation v. Chu*, 132 A.D.2d 175, 521 N.Y.S.2d 865 (3d Dep't 1987), *leave denied*, 72 N.Y.2d 802, 530 N.Y.S.2d 554 (1988).

- An on-line computer system that generates estimates of the cost to repair damaged vehicles for insurance companies was not excluded as personal or individual in nature. The report contained common price information that

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was not unique to the customer. *Matter of ADP Automotive Claims Services, Inc. f/k/a Collision Estimating Services, Inc. v. Tax Appeals Tribunal*, 188 A.D.2d 245, 594 N.Y.S.2d 96 (3d Dep't 1993).

- A Report consisting of economic projections focusing on the customer's industry or market that consisted in large part of general economic and demographic data was not personal or individual in nature even though some of the information in the report was data related to the customer's specific input. *Matter of Data Resources, Inc.*, TSB-H-87(205)S (Aug 28, 1987).

- When information in a common database is only used as a tool to create new and different information which comprised the information actually appearing in the report, the existence of the database did not defeat the exclusion. *Matter of Westwood Pharmaceuticals, Inc. v. Chu*, 164 A.D.2d 462, 564 N.Y.S.2d 1020 (4th Dep't 1990), *leave denied*, 77 N.Y.2d 807, 569 N.Y.S.2d 610 (1991).

- Existence of common database as tool used in performing risk analyses of customer-specific portfolios did not defeat exclusion where "raw data" in the common database did not appear in the report itself. *Matter of Standard & Poor's Compustat Services, Inc.*, Division of Tax Appeals (June 23, 1994).

I. Where Does a Sale of Information Services Take Place?

- Information services are taxable based on the point of delivery of the report. When the report is furnished "on-line", delivery takes place at the access terminal. If multiple terminals have access, the total charge is apportioned to each terminal and sourced accordingly. When multiple hard copy reports are furnished, the total charge is allocated based on the numbers of copies shipped to each location. *Matter of Comeau,* TSB-A-90(43)S.

J. Audit Issues

1. Number of Audits and Audit Selection

- Total number of audits:

  ⇒ 530,000 registered vendors;
  ⇒ 1,200 largest companies which are always audited; and
  ⇒ 4,800 others.

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- Selection for audit is based on industry-wide sweeps, target groups (service stations, doctors/lawyers, printing industry, etc.), referrals from other audits, "snitches", and so forth.

2. **Audit Parameters**

- Auditors look at three areas:

  ⇒ Expenses - usually recurring - use of test period or statistic sample preferred.

  ⇒ Sales - usually sampled, depends on level of sales activity: guest checks - register tapes - taxable ratio.

  ⇒ Capital acquisitions - full detail usually preferred, items usually reconciled with cash disbursements journal.

3. **Technical Audit Issues**

  ⇒ Where to hold audit
  ⇒ Access to information
  ⇒ Consent to extend Statute of Limitations
  ⇒ Test period consent
  ⇒ AU-3 - 60-day rule
  ⇒ Penalties: regular (30%), interest (12%) and omnibus (10%)
  ⇒ Exemption certificate issues
  ⇒ Withholding tax audits also performed

4. **Overlapping Audit Policy**

- The Audit Division has a policy which provides a credit based on an overlapping audit of a customer/vendor. In order for the policy to apply, the other audit must be concluded, paid-up, with no agreement to keep the item out, and for the same period. *Matter of WFC Tower A Company*, Tax Appeals Tribunal (1995); *see also Matter of Gartner Group, Inc.*, Tax Appeals Tribunal (1995) and *Matter of Allied Aviation*, Tax Appeals Tribunal (1991).

K. **Officer/Responsible Person Liability**

- An officer assessment was barred by the three-year statute of limitations even though a valid waiver extending the statute of limitations for the corporation existed. The corporation and the officer were separate

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taxpayers with their own separate statutes of limitations. The corporate extension did not apply to the officer. *Matter of Bleistein*, Tax Appeals Tribunal (July 27, 1995).

- The Fourth Department reversed its prior holding in *Laks* and concluded that a corporate officer can be held liable for the corporation's penalties and interest as well as the base tax. *Matter of Lorenz v. Department of Taxation and Finance*, ___ A.D.2d. ___, 623 N.Y.S.2d 455 (4th Dep't. Feb. 3, 1995). The *Lorenz* decision is on appeal. The Third Department has consistently held that an officer can be held liable for the corporation's penalties and interest.

L. **The TOP 7 Things You Need to Know About Information Services**

1. Focus on the "essence" of the service in its entirety, not just its components.

2. Nexus can be triggered by almost <u>any</u> physical presence.

3. Allocation rules for destination of sale allow for planning.

4. Technological changes require constant monitoring of taxable status of "products" as they evolve.

5. Audit methodology issues and overlapping audits.

6. Responsible persons/officer assessments can include penalties and interest. Statute of limitations may provide relief.

7. Based on Governor Pataki's message, now is the time to negotiate information service issues with the Tax Department!

III. TEST PERIOD AUDITS

A. State takes the position that without detailed cash register receipts ("scanner" type registers), a grocery store's records are inadequate. *Licatta v. Chu*, 64 N.Y.2d 873 (1985); *Goldberg*, TSB-A-85(55)S; *Jamron*, TSB-H-85(95)S.

B. However, test period audits can be used to establish refunds. Cash register tapes that do not indicate whether each item sold is taxable are still sufficient to prove gross sales. *Raemart Drugs, Inc. v. Wetzler*, 555 N.Y.S.2d 458 (3d Dep't. 1990).

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C. A one-day test period or observation audit can be used to determine the tax for a three and one-half year audit period. *See Lombard v. Wetzler*, 602 N.Y.S.2d 972 (3d Dep't. 1993) and *Tak Diner*, 1991-2 N.Y.T.C. T-151. Burden is on taxpayer to demonstrate that audit methodology is flawed and taxpayer must prove by clear and convincing evidence the amount of tax assessed was erroneous.

D. However, auditor still must first ask if adequate records are available. He cannot assume that they are not. *Meeks*, 1993-3 N.Y.T.C. J-620. *See also Chartair*, 411 N.Y.S.2d 41 (3d Dep't. 1978) 65 A.D.2d 44, *LaPinta*, TSB-H-86(65)S.

E. And auditor must allow reasonable postponement of audit (e.g., where new accountant brought on board) before resorting to estimate. *Imperial Floor Covering*, 1993-3 N.Y.T.C. J-294.

F. Need separate requests for each extension of audit period. Can't assume records defective for all covered periods. *Adamides v. Chu*, 134 A.D.2d 776 (3d Dep't. 1988) and *Great Neck Service Station*, 1988-1 N.Y.T.C. T-115.

G. Where taxable and non-taxable items are sold, auditor must devise reasonable methodology. Can't assume all sales are taxable. *Bernstein on Essex*, 1992-1A N.Y.T.C. T-1479 and *Auriemma*, 1992-2 N.Y.T.C. T-1108. Even with test period audit, audit methodology must be reasonably calculated to reflect taxes due. *Ristorante Puglia*, 102 A.D.2d 348 (3d Dep't. 1984).

H. Auditors who agree to redo a test period audit do not have to use the results of the second audit. They can use a weighted average of the two. *Sidney Wallach*, 614 N.Y.S.2d 647 (1994).

I. Tax Department need not issue subpoenas to perform test period audit. *Continental Arms*, 72 N.Y.2d 976 (1988). Obligation is on taxpayer to cooperate.

J. A desk audit that does not request all books and records is invalid. *Best Palka*, 1990-2 N.Y.T.C. J-907.

K. Burden is on the taxpayer to prove the audit methodology is unreasonable. If you cannot proceed without the auditor's presence, use your subpoena power. *Flanagan*, 1990-1 N.Y.T.C. T-387.

L. Statutory notice must be based on valid evidence before it is issued, not afterward. Undocumented industry profitability indexes (without any factual support) were rejected. *Fokos Lounge*, 1991-2 N.Y.T.C. T-173.

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M. An auditor's request for books and records must go beyond a "weak and casual" request. It must be explicit. *Yel-Bom's*, 1990-1 N.Y.T.C. T-351. *See also Delaware Drapery*, 1991-2 N.Y.T.C. T-861.

N. Failure to check estimate box is not fatal to assessment. *Julia Coffee Shop*, 1992-2 N.Y.T.C. T-551, and *Negat*, 1992-2 N.Y.T.C. T-477.

O. Mark up percentage provided by taxpayer is still indirect method. Therefore requires consent to test period of inadequate records. *Continental Carpet*, 1992-2 N.Y.T.C. T-1099.

IV. TRANSFERS OF BUSINESS

A. Formation of a Business

1. The transfer of a sole proprietor's business to a partnership solely in exchange for the partnership interest was not subject to tax, even though the partnership assumed liabilities of the proprietorship. *Beautiful Visions Co.*, 1994-1 N.Y.T.C. J-1.

2. Transfers to a new corporation must be made within a reasonable time after organization of the new corporation. *Noar Trucking*, 527 N.Y.S.2d 597 (3d Dep't. 1988). Remedy: contributions to capital.

B. Asset Transfers

1. On or After Organization of Corporation
2. Acquisition of Assets

3. Stock Transfers, Reorganizations and Liquidations

a. Stock Transfers
b. Corporate Distributions
c. Reorganizations

4. Personal Liability of Officers and Owners

a. Responsible Officers

(1) Responsible officer rules get much tougher. *See Kadish*, 1990-1 N.Y.T.C. T-819 (bankruptcy of corporation is irrelevant) and *LaPenna*, 1991-1 N.Y.T.C. T-203 (parents who had nothing to do with business but designated as "officers" were held responsible).

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(2) There is personal liability for non-trust funds. Includes use taxes. *Neil I. Woolf*, 1991-4 N.Y.T.C. J-1385.

(3) But "president" of corporation (for appearances only) not responsible if he wasn't involved in financial affairs of company. *Bruce Turiansky*, 1994-1 N.Y.T.C. T-76. Burden is on taxpayer to show that apparent authority is not actual authority. Must demonstrate preclusion from exercise of authority. *Peter J. Napoli*, 1995-1 N.Y.T.C. T-—.

(4) And controlling shareholder and officer of corporation not liable where he was misled by others. *Russack* 1995-2-N.Y.T.C. J-1102.

5. Obligations upon Termination of Business

a. Bulk sale purchaser's liabilities are derived directly from bulk sale seller; but amount does not include interest or penalties. *Velez*, 547 N.Y.S.2d 444 (3d Dep't. 1989).

b. Bulk sale interest and penalties will be imposed on a transfer after the issuance of a notice of determination and demand, though. *Joyce Gaughan*, 1992-2 N.Y.T.C. T-625.

c. Bulk sales liabilities are cumulative. *Acres Storage*, 535 N.Y.S.2d 165 (3d Dep't. 1988).

d. Responsible officers can be liable for penalties and interest. *See Dac's Trucking*, 1991-1 N.Y.T.C. T-229 and *Hall*, 1990-1 N.Y.T.C. T-157.

V. EXEMPTION CERTIFICATES

A. No need to investigate purchaser or its use of equipment. 20 N.Y.C.R.R. § 532.4. **Good faith is all that is required. *Copelco Leasing Corp.*, TSB-A-95(15)S.**

B. In order to be facially valid, exemption certificates must correctly name the purchaser. *Entech Management*, 1994-1 N.Y.T.C. T-612.

C. Seller of service business assets as part of ongoing business cannot accept manufacturing equipment exemption in "good faith". *24 Hour Air Pump Services*, 1992-4 N.Y.T.C. J-1995.

D. Burden entirely on seller. *Academy Beer*, 609 N.Y.S.2d 108 (3d Dep't 1994).

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E. But a faulty certificate can be amended to reflect the original intent of the parties. *Lloyd Mansfield Co., Inc.*, 1995-1 N.Y.T.C. T-812.

F. **Reasonable Cause**

1. Limited education, business experience and reliance on accountant can constitute reasonable cause. *Fedele*, 1988-3 N.Y.T.C. J-2047.

2. Taxpayer's exemplary record of filing for years prior to and after failure to file can constitute reasonable cause. *Day*, TSB-H-85(195)I.

3. Reasonable cause can be based on new purchaser's inability to review corporate books and records. *Bold Country Carwash*, TSB-H-86(79)S.

4. Taxpayer's first audit and good faith mistake of fact (not law) can constitute reasonable cause. *Film Factory*, TSB-H-86(47)S.

5. So can ill health and inability to run business. *Caleri*, 1988-1 N.Y.T.C. T-223. *See also*, *Bartz*, TSB-H-86(56)S where the taxpayer had a severe heart attack.

6. So can reliance on court opinion (even if ultimately reversed). *Adel*, 1989-2 N.Y.T.C. J-509.

7. Where taxpayer's check bounced because the State levied on his account, penalty was cancelled. *HPS Capitol*, TSB-H-85(191)S.

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PROMOTIONAL MATERIAL: 1989 LEGISLATION AND ITS AFTERMATH UNDER NYS SALES AND USE TAX

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1. CURRENT STATUS AND RECENT HISTORY

A. Current Status

1. Tax Treatment in Flux
2. Multiple Issues
3. Pending Legislation and Regulations
4. Administration in Transition

B. Recent History

1. Pre-1989
2. 1989 Legislation
3. Post-1989

   a. 1991 Shipping Charges
   b. 1991 Notice on Postage for Mailing Promotional Materials
   c. 1992 TSB-M
   d. Draft Regulations
   e. Proposed Legislation

II. ISSUES

A. Complexity

1. Complexity of the Typical Transaction - Multiple Vendors
2. Mailing Services
3. Mailing Lists and Mailing List Enhancements
4. Postage and Shipping Charges
5. Principal/Agent Issues
6. Self-Use
7. Co-op Advertising

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B. Administrative Burdens

1. Single Use v. Blanket Exemption Certificates
2. Direct Pay Permits
3. Non-Nexus Advertisers
4. Determining Mailing Percentages
5. Complexity

C. Constitutional Issues

1. Taxation of Services Performed Out-of-State (e.g., mailing lists, shipping)
2. Nexus Issues Created by Use of New York Vendor.
3. Nexus Issues Created by Using Printer with New York Nexus.

D. Disincentives to Do Business With New York Vendors

1. Overview
2. Situation in Other States
3. Economic Evidence of Lost Business Activity
4. Individual Case Studies of Lost Business Activity

III. LOOKING FORWARD

A. The Economic Front
B. The Regulatory Front
C. The Legislative Front

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STATE OF NEW YORK

3928--A

1995-1996 Regular Sessions

IN SENATE

March 28, 1995

Introduced by Sens. SKELOS, DeFRANCISCO, LACK, LARKIN, MALTESE, MARCELLINO, MARCHI, MAZIARZ, RATH, SEWARD, TRUNZO -- read twice and ordered printed, and when printed to be committed to the Committee on Investigations, Taxation and Government Operations -- committee discharged, bill amended, ordered reprinted as amended and recommitted to said committee

AN ACT to amend the tax law, in relation to exemption of promotional material from the sales and compensating use tax and to repeal subdivision (n) of section 1115 of the tax law relating thereto

The People of the State of New York, represented in Senate and Assembly, do enact as follows:

1 Section 1. Subdivision (n) of section 1115 of the tax law is REPEALED
2 and a new subdivision (n) is added to read as follows:
3 (n) (1) The sale, storage, use or other consumption in this state of
4 promotional materials mailed or delivered by the seller, the seller's
5 agent, or a mailing house, acting as the agent for the purchaser,
6 through the United States postal service or by common carrier to any
7 other person at no cost to that person who becomes the owner thereof
8 shall be exempt from the tax under this article.
9 (2) Services otherwise taxable under paragraph one or two of subdivi-
10 sion (c) of section eleven hundred five of this article relating to
11 promotional materials exempt under paragraph one of this subdivision
12 shall be exempt from tax under this article. Such services shall
13 include but shall not be limited to mailing lists used to send promo-
14 tional materials, which lists shall be treated as information services
15 for purposes of this subdivision regardless of the medium in which they
16 are provided, and activities conducted in conjunction with mailing
17 lists.
18 § 2. This act shall take effect March 1, 1996.

EXPLANATION--Matter in *italics* (underscored) is new; matter in brackets
[ ] is old law to be omitted.

LBD09127-04-5

NEW YORK STATE ASSEMBLY
MEMORANDUM IN SUPPORT OF LEGISLATION
submitted in accordance with Assembly Rule III, Section 1 (e)

SENATE

3928-A

REVISED MEMO

( ) Memo on original draft of bill
(x) Memo on amended bill

BILL NUMBER: Assembly 6086-B Senate 3928-A

SPONSORS: Member(s) of Assembly: SCHIMMINGER, HARENBERG, DINAPOLI, DESTITO, et al.

Senators: SKELOS

TITLE OF BILL:

AN ACT to amend the tax law, in relation to exemption of promotional material from the sales and compensating use tax and to repeal subdivision (n) of section 1115 of the tax law relating thereto

SUMMARY OF SPECIFIC PROVISIONS:

Subdivision (n) of section 1115 of the Tax Law is repealed and a new subdivision (n) is added. This new subdivision (n) would provide an exemption from sales and use tax for (1) the sale, storage, use or other consumption in the State of promotional materials; and (2) services relating to promotional materials including mailing lists, which are treated as information services for purposes of the application of the exemption.

JUSTIFICATION:

Direct print marketing is a huge and growing industry nationwide. It is also an extremely competitive industry in which New York's role is substantial but diminishing. For example, New York State employment in the printing industry was over 41,000 in 1987 but only 31,000 in 1993.

The reason for this drop is due to the current statutory framework. Prior to September 1, 1989 the State's sales and use tax treated promotional materials as follows: promotional materials mailed from New York into New York were subject to sales tax; promotional materials mailed from outside New York into New York were not subject to tax; promotional materials mailed from New York to other states were not subject to tax. Quite obviously, this framework encouraged the use of out-of-state companies, who could send promotional materials into the state free from tax.

Legislation enacted in 1989 was designed to correct this inequity, primarily by making promotional materials delivered into New York from out-of-state subject to use tax. The goal of the legislation was to "level the playing field" by taxing promotional materials whether staying in or entering New York State, while exempting material sent out of New York State.

The 1989 legislation has been a failure. Current law continues to discourage the use of New York business. Stories of business switching to out-of-state vendors or even eliminating New York from nationwide mailings abound. An explicit exemption in the law for the sales and use of promotional materials would go a long way toward providing a "level playing field" for New York businesses and would also create parity in the tax treatment of direct print marketing and other forms of advertising including television, radio, newspaper and magazine, none of which are subject to tax.

PRIOR LEGISLATIVE HISTORY: New bill.

FISCAL IMPLICATIONS: Minimal to the state.

EFFECTIVE DATE: This act shall take effect March 1, 1996.

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-M-92(4)S
Sales Tax
July 7, 1992

THE SALES AND USE TAX AND PROMOTIONAL MATERIALS

Effective September 1, 1989, three amendments to the New York State Sales and Use Tax Law impacted on the tax status of promotional materials. Since that time, the Department has received numerous requests for clarification concerning the overall effect these changes have on tax policy in this area.

I. A new paragraph (12) was added to section 1101(b) of the Tax Law to define promotional materials as any advertising literature, applications, order forms and return envelopes related to such advertising literature, free gifts, complimentary maps or other items given to travel club members, annual reports, promotional displays, Cheshire labels and similar items of tangible personal property used for promotional purposes. Promotional materials also include property related to advertising literature that has been personalized through the use of the recipient's name or other information uniquely related to such person. However, promotional materials do not include invoices, statements and the like.

Prior to this amendment, the Tax Law did not specifically define the term promotional materials, although the Tax Department had defined it in 1979 in a policy memorandum titled "The Taxability of Promotional Materials Sent into New York State" (TSB-M-79(9)S). The new definition effectively incorporates much of the Department's prior definition, but also expands the prior definition to include outside mailing envelopes, Cheshire labels and materials which were personalized (contents of envelopes that are addressed or identified for a particular individual). Billing invoices, account statements, personal responses to customer correspondence and the like, which were not considered promotional material before September 1, 1989 continue to be excluded from its definition under the new law.

II. A new subdivision (n) was added to section 1115 of the Tax Law to provide that promotional materials mailed, shipped or otherwise distributed from a point within this state, by or on behalf of vendors or other persons, to their customers or prospective customers located outside this state, for use outside this state, are exempt from sales and compensating use taxes. This new subdivision also provides that certain services relating to mailing lists or to activities directly in conjunction with mailing lists are exempt from such taxes when the services are performed on or directly in conjunction with exempt promotional materials.

Before the addition of this exemption, the purchaser of promotional materials had to pay tax and show that such materials were shipped outside the state for use outside the state in order to claim a refund of the tax from the Tax Department pursuant to section 1119 of the Tax Law. Services performed on mailing lists in this state were taxable without any right to refund. Accordingly, this new exemption with respect to mailing list services represents a major change in the taxability of such services in that, among other things, the exemption can be claimed in the first instance, rather than through a refund claim.

TP-9 (9/88)

III. The definition of the term 'use' in Section 1101(b)(7) of the Tax Law was amended to provide that 'use' also includes the distribution of tangible personal property, such as promotional materials.

This expanded definition of 'use' effectively expands the imposition of the compensating use tax to cover the use of promotional materials coming into this state. Prior to this change, the former statutory definition of 'use' permitted the owner of promotional materials to avoid New York State sales and use taxes by purchasing from out-of-state printers and mailers.

When these changes are viewed together, they establish a tax plan that exempts sales of promotional material that are delivered to the buyer, the buyers agent or designee, inside New York State, if the buyer, agent or designee will then have such property delivered to points located outside this state; and taxes, where applicable, any promotional materials, regardless of point of sale or origin, that are ultimately delivered to locations inside this state.

Example (1) A New York vendor purchases catalogs from a printer. The vendor will mail or in some other manner have the catalogs delivered to customers and prospective customers located outside New York State. The New York vendor is allowed to purchase such catalogs from the printer without the payment of sales or use tax pursuant to the exemption provided in Section 1115(n) of the Tax Law.

Example (2) A multi-state vendor with sales offices in New York purchases catalogs from a printer outside this State. The multi-state vendor will mail or in some other manner have the catalogs delivered to customers or prospective customers located in New York State. The multi-state vendor owes a compensating use tax based on its cost of the catalogs which are delivered to locations inside New York State. (The authority for the imposition of this compensating use tax is Sections 1110 and 1101(b)(7) of the Tax Law).

The following chart helps illustrate the difference between the tax status of certain purchases related to promotional material both before and after September 1, 1989.

Promotional Materials	Before 9/1/89	As of 9/1/89
. Contents of Envelope (non-personalized)		
- Mailed from N.Y. to N.Y. destinations	Taxable	Taxable
- Mailed from N.Y. to destinations outside N.Y.	Exempt*	Exempt
- Mailed from outside N.Y. to N.Y. destinations	Exempt	Taxable

*Exempt Through Refund

Promotional Materials	Before 9/1/89	As of 9/1/89
. Contents of Envelope (personalized)		
- Mailed from N.Y. to N.Y. destinations	Taxable	Taxable
- Mailed from N.Y. to destinations outside N.Y.	Taxable	Exempt
- Mailed from outside N.Y. to N.Y. destinations	Exempt	Taxable
. Outer envelopes & outer labels		
- Mailed from N.Y. to N.Y. destinations	Taxable	Taxable
- Mailed from N.Y. to destinations outside N.Y.	Taxable	Exempt
- Mailed from outside N.Y. to N.Y. destinations	Exempt	Taxable
. Mailing Lists (Purchase or Rental)		
- List Received In N.Y.	Taxable	Taxable based on percentage of N.Y. mailings
- List Received Outside N.Y.	Exempt	Taxable based on percentage of N.Y. mailings
. Related Services (merge/purge, label affixing, glue affixing, imprinting, keying enhancement, etc.)		
- Service Performed in N.Y.	Taxable	Taxable based on percentage of N.Y. mailings
- Service Performed Outside N.Y.	Exempt	Taxable based on percentage of N.Y. mailings

Promotional Materials	Before 9/1/89	As of 9/1/89
. Mailing Services (stuffing, sorting, metering, folding, bursting, sealing, zip coding, stamp affixing, etc.)		
- Service Performed in N.Y.	Exempt	Exempt
- Service Performed outside N.Y.	Exempt	Exempt

When purchasing promotional materials that are eligible for the exemption provided by section 1115(n), the purchaser of such material must present the seller with a properly completed Exempt Use Certificate, Form ST-121, in order to receive the tax benefit at the time of purchase. Since the exemption is limited to promotional materials that are for distribution outside the state and since it is likely that not all the promotional materials being purchased will qualify for the exemption, it will be necessary for the purchaser to indicate directly on the exempt use certificate what percentage of the purchase is exempt from tax.

Accordingly, in those instances where the purchaser of promotional material buys such material in bulk and knows the exact percentage of the total purchase that is eligible for exemption, the purchaser can indicate to the vendor the amount of the exempt percentage on the Exempt Use Certificate (Form ST-121). The vendor is then permitted to charge sales tax only on the portion of the charge which is not eligible for exemption. The exempt use certificate will be revised so as to include a space for the purchaser to indicate the exempt percentage. Since these percentages cannot be expected to remain constant from purchase to purchase, exempt use certificates used to purchase promotional materials will be recognized as single purchase certificates <u>only</u>.

Prior to September 1, 1989, promotional materials purchased in bulk and delivered into New York State were subject to sales or use tax at the moment such materials were delivered to the purchaser or his designee inside this state. If the promotional materials were subsequently shipped out-of-state in bulk, the purchaser was eligible for a refund of the tax paid for that portion of the materials shipped outside the state pursuant to section 1119 of the Tax Law. Section 1119 was not affected by changes reported in this memorandum concerning promotional materials. Therefore, promotional materials which are purchased tax paid are still eligible for refund, when applicable.

The exemption provided in section 1115(n) is available to any person registered with the Tax Department as a vendor, whether such vendor is located inside or outside New York State. The vendor must provide to the seller of the promotional materials a properly completed "Exempt Use Certificate", Form ST-121. A purchaser of promotional materials that is eligible for exemption pursuant to section 1115(n) but who is not registered as a vendor for sales tax (e.g., a person who sells a nontaxable service) is not allowed to issue an

exemption document and must therefore pay the sales tax on such materials at the time of purchase. That purchaser may then claim a refund for that portion of the sales tax paid attributable to the material sent outside the state. To claim a refund, the purchaser must file an Application for Refund or Credit, Form AU-11, with the Tax Department within three years of the date the tax was payable.

Purchases of promotional materials from an out-of-state supplier who is not authorized to collect New York State sales taxes will be subject to a use tax if any portion of the promotional material is delivered into New York. The reporting and payment of the use tax is due with the filing of the purchaser's sales and use tax return if the purchaser is a registered vendor. If the purchaser is not a registered vendor, the purchaser should file a Use Tax Return, Form ST-130, within 20 days after the taxable use occurs.

When promotional materials are purchased from a vendor who will also ship such material to the customer's intended recipients, the vendor of the promotional material is permitted to charge tax only on the portion of the materials that are mailed or otherwise delivered to points located within New York State. A vendor who charges sales tax on only a portion of the total charge to the customer must maintain adequate records to substantiate that the materials which were not taxed were delivered outside New York State. This documentation must be retained to substantiate exempt out-of-state deliveries for audit purposes.

Services performed on mailing lists used to distribute promotional materials are subject to the sales or use tax in the same proportion that New York State addresses contained in the mailing list bear to the total number of addresses contained in such list.

Note: The Collection and Reporting Instructions for Printers and Mailers (ST 152) and the related Supplementary Instructions, Publication 831, may continue to be used for the computation of the sales tax due on promotional materials delivered in New York State. However, where the information relating to promotional materials contained in the Collection and Reporting Instructions (ST-152) is inconsistent with that contained in this memorandum, the information in this memoranda controls.

(b) Such fine for each violation shall be [ten] *twenty* dollars as noted on the traffic violation notice, except that the fine shall be $50 for each handicapped parking space violation.

561.6 Notice, hearing and disposition.

(b) (2) The complaint (traffic ticket) shall also indicate the fine schedule for the violation and advise that if the person charged does not dispute the violation such fine must be paid at the office of [the director of public safety] *parking management* within five calendar days of the date of issuance.

(b) (3) The notice shall recite that a hearing to appeal the alleged violation may be requested in writing within 72 hours after being served with the ticket by appearing in person at the office of [the director of public safety] *parking management*.

Text of proposed rule or revised proposed rule and any required statements and analyses may be obtained from: William H. Anslow, Senior Vice Chancellor for Finance and Management, State University of new York, State University Plaza, Albany, NY 12246, (518) 443-5179

Data, views or arguments may be submitted to: Same as above.

Public comment will be received until: 45 days after publication of this notice.

Regulatory Impact Statement

1. Statutory Authority: Education Law, Section 360(1).

2. Legislative Objectives: To provide for safety and convenience of students, faculty, employees and visitors within and upon the property, roads, streets and highways under the supervision and control of the State University through the regulation of vehicular and pedestrian traffic and parking.

3. Needs and Benefits: Amendments related to parking and registration will allow State University to better regulate and enforce rules for vehicular traffic and parking.

4. Costs: None.

5. Local Government Mandates: None.

6. Paperwork: None.

7. Duplication: None.

8. Alternatives: There are no viable alternatives.

9. Federal Standards: It does not exceed federal standards.

10. Compliance Schedule: The campus will notify those affected as soon as the rule is effective. Compliance should be immediate.

Regulatory Flexibility Analysis for Small Businesses

No regulatory flexibility analysis for small businesses is submitted with this notice because the proposed rule does not impose any requirements on small businesses. This proposed rule making will not impose any adverse economic impact on small businesses or impose any reporting, recordkeeping or other compliance requirements on small businesses.

Rural Area Flexibility Analysis

No rural area flexibility analysis is submitted with this notice because the proposed rule does not impose any requirements on rural areas. The rule will not impose any adverse economic impact on rural areas or impose any reporting, recordkeeping, professional services or other compliance requirements on rural areas.

Department of Taxation and Finance

NOTICE OF EXPIRATION

The following notice has expired and cannot be reconsidered unless the Department of Taxation and Finance publishes a new notice of proposed rule making in the NYS *Register*.

Tax exemption for promotional materials shipped outside the State

I.D. No.	Proposed	Expiration Date
TAF-40-94-00034-P	October 5, 1994	October 5, 1995

A Promotional Mailing - The Typical Cast of Characters

Introduction

The preparation and distribution of a printed direct mail marketing piece involves a series of transactions and a whole host of distinct businesses, far greater in number than one might imagine. The attached flow chart illustrates a typical direct mail marketing effort, described below.

A department store (DS) with locations in New York and many other states wishing to promote a new line of sleepwear decides to do a direct marketing piece to individuals that are not credit card holders. DS begins its effort on two fronts. It hires an ad agency (Adco) to design a promotional piece, and contracts a mailing list broker to assist in acquiring mailing lists for the planned marketing effort. Adco undertakes its design work, perhaps subcontracting particular facets of its assignment. Mailing list broker, meanwhile, contacts a variety of mailing list managers (who represent mailing list owners) and ultimately contracts with three different companies represented by three different list managers for the one-time use of their respective mailing lists.

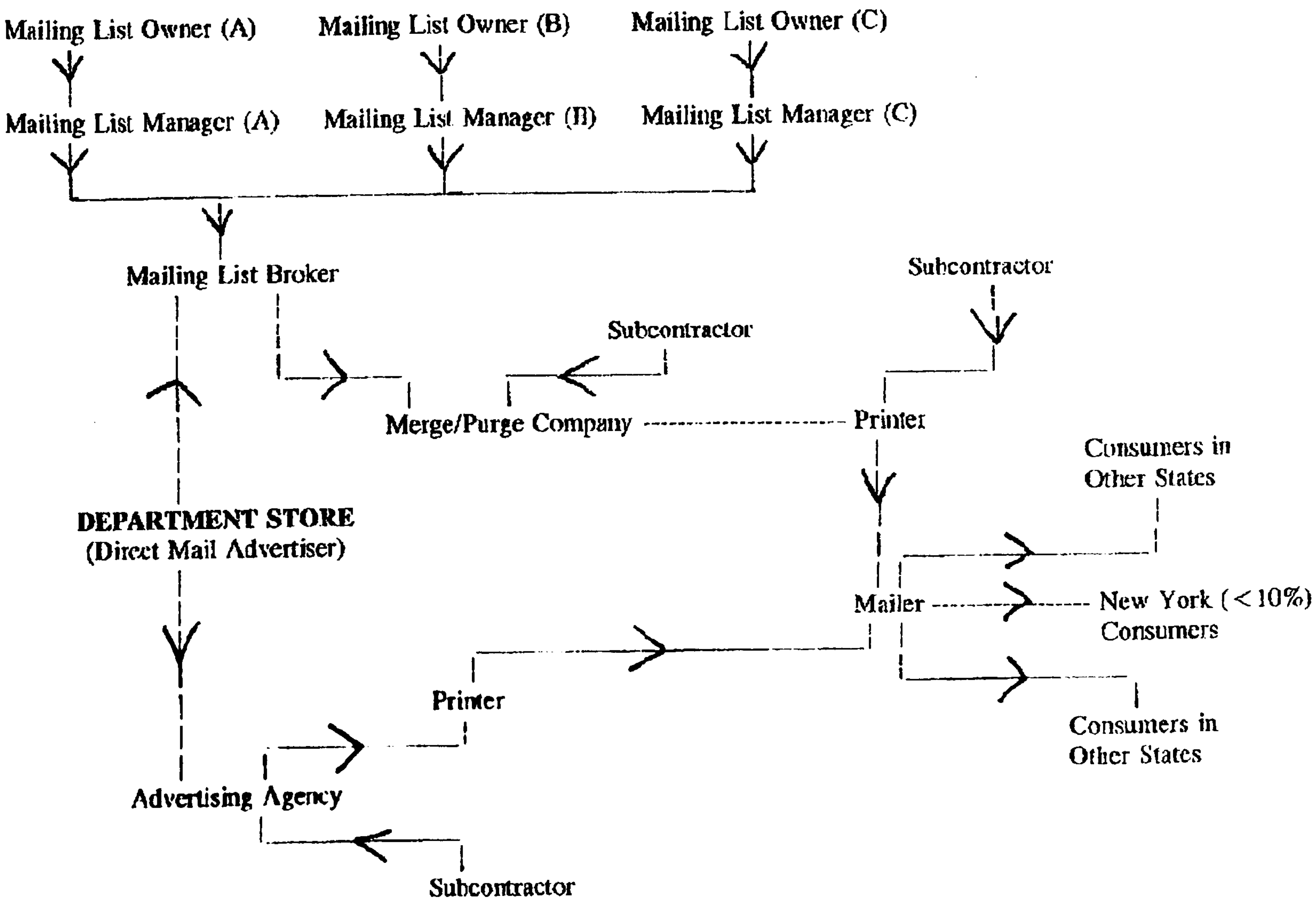
Upon instructions from DS, the mailing list managers send their mailing lists on magnetic tape to a computer service company (MP). MP subcontracts with yet another company that formats the tapes to MP's specifications. MP then performs a merge/purge service, eliminating duplicate names while merging the three mailing lists into one.

MP then forwards its lists to Printer #1, where outer envelopes are addressed.

Meanwhile, Adco has sent its promotional piece to a second printer. Printer #1 sends the envelopes and Printer #2 sends the promotional pieces to Mailer, where the promotional pieces are folded and inserted into envelopes and subsequently delivered to the Post Office. Less than 10% of the mail is destined for New York addresses. More than a dozen businesses have participated.

Under current sales tax law, DS will ultimately be responsible for use tax on those mailings delivered to New York consumers. Along the way, however, each and every New York vendor in the chain will be required to collect sales tax on the taxable goods or services it provides. Moreover, unless the vendor receives an exemption certificate stating the exact percentage of the mailing that is subject to New York tax, the vendor must charge tax as if 100% of the mailing will be to New York customers, with DS subsequently eligible to apply for a refund. On audit, a vendor without proper documentation will be held liable for the tax it should have collected - potentially calculated on the premise that 100% of the mailing was delivered into New York.

A Promotional Mailing - The Typical Cast of Characters



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CONTACTS

NEW YORK STATE
DEPARTMENT OF TAXATION AND FINANCE

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE

Bankruptcy Matters

All mail sent to the Department should be addressed to:
NYS Department of Taxation and Finance
Bankruptcy and Special Procedures Unit
Tax Compliance Division
Room 504 Building 8
W. A. Harriman Campus
Albany, New York 12227

All telephone inquiries re: liabilities and proofs of claim:
Bankruptcy and Special Procedures Unit
(518) 457-3160

All telephone inquiries re: bankruptcy legal issues:
Elaine Wallace Braden, Office of Counsel
(518) 457-2070

Estate Tax Matters

All mail sent to the Department should be addressed to:
NYS Department of Taxation and Finance
Estate Tax Audit - 855
W. A. Harriman Campus
Albany, New York 12227

All telephone inquiries re: estate tax matters:
Estate Tax Audit
(518) 457-6598

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