Volume 2, Issue 11 November 2011

MoFo New York Tax Insights

Tribunal Applies "Sham Transaction" Analysis in Upholding Forced Combination of Factoring Subsidiary

By Irwin M. Slomka

Editors

Hollis L. Hyans
hhyans@mofo.com

Irwin M. Slomka
islomka@mofo.com

In its first decision involving combination under Article 9-A in more than three years, the New York State Tax Appeals Tribunal has upheld the forced combination of an out-of-state factoring subsidiary with its parent apparel manufacturer. Based on a "sham transaction" analysis, the Tribunal held that the transactions under which the factoring subsidiary was formed and operated "do not merit tax respect," and therefore the taxpayer failed to rebut the presumption of distortion resulting from substantial intercorporate transactions under the pre-2007 law. *Matter of Kellwood Company*, DTA No. 820915 (N.Y.S. Tax App. Trib., Sept. 22, 2011).

(Continued on page 2)

Inside

1 Combination of Factoring Subsidiary Upheld by Tribunal

4 City Tribunal Holds Lease Payments Made After WTC Destruction Were Not Subject to Commercial Rent Tax

5 ALJ Finds Restaurant's Records Unreliable, but Limits Assessment

7 Comity is Not a Joking Matter for Taxpayers Seeking Review of City Tax Exemption in Federal Court

8 "Next" Means "Next" in Nassau County

9 Guidance Offered on Discounted Purchases Made With Customer Loyalty Cards

10 Insights In Brief

New York State & Local Tax Group

Craig B. Fields
cfields@mofo.com

Hollis L. Hyans
hhyans@mofo.com

R. Gregory Roberts
rroberts@mofo.com

Open Weaver Banks
obanks@mofo.com

Roberta Moseley Nero
rnero@mofo.com

Michael A. Pearl
mpearl@mofo.com

W. Justin Hill
whill@mofo.com

Bee-Seon Keum
bkeum@mofo.com

Rebecca M. Ulich
rulich@mofo.com

Paul H. Frankel
pfrankel@mofo.com

Mitchell A. Newmark
mnewmark@mofo.com

Irwin M. Slomka
islomka@mofo.com

Debra Silverman Herman
dherman@mofo.com

Amy F. Nogid
anogid@mofo.com

Richard C. Call
rcall@mofo.com

Nicole L. Johnson
njohnson@mofo.com

Kara M. Kraman
kkraman@mofo.com

Combination of Factoring Subsidiary Upheld

(Continued from Page 1)

Creation of Factoring Subsidiary

Kellwood Corporation ("Kellwood") is a supplier of mid-priced apparel to retailers and other businesses. Its headquarters are in Missouri, but it also conducts business in New York State and is subject to Article 9-A.

Kellwood was formed in 1961 and initially manufactured clothing for Sears Roebuck & Co. under its private label. By the mid-1980s, Sears had sold its stock interest in Kellwood, and Kellwood diversified its customer base to include a wide range of retailers, such as Macy's, The Gap and Wal-Mart. By the late 1980s and 1990s, the U.S. apparel industry had begun to decline, and many manufacturers faced the possibility of bankruptcy and consolidation. In the face of these challenges, in the late 1990s Kellwood's management considered a plan to consolidate several of its diverse operations, which were spread out among many business units.

At the same time, Kellwood's management considered securitization of its accounts receivable from its retail customers as an alternative financing tool. However, it had been unable to enter into a securitization arrangement because, at the time, its accounts receivable were owned by multiple affiliated legal entities, and to securitize would require that the receivables be owned by a single, bankruptcy-remote special purpose entity.

To further explore these possibilities, Kellwood employed a prominent CPA firm to advise on multistate tax planning ideas. One of the firm's recommendations was the formation of a factoring company. The firm prepared a report in which it proposed a "tax strategy" that would enable Kellwood to realize losses on the sales of its accounts receivable to that factoring company, with substantial gains in the factoring company. The firm's report discussed the tax savings that would result in various non-unitary states, and also identified various business purposes for forming a factoring company. The CPA firm was to be paid by Kellwood based on 40% of Kellwood's first full-year state tax savings.

THE AVOWED NON-TAX BUSINESS PURPOSE TO SECURITIZE THE RECEIVABLES AS A FINANCING TOOL COULD NOT HAVE BEEN REALIZED SINCE KELLWOOD WAS AWARE THAT KFR WAS NOT A BANKRUPTCY-REMOTE ENTITY AND COULD NOT BE USED FOR SECURITIZATION.

To effectuate this plan, in late 1999, Kellwood formed a factoring subsidiary, Kellwood Financial Resources ("KFR"), in Tennessee staffed with as many as 30 credit and collection employees. Kellwood contributed $273 million of customer accounts receivable to KFR upon its formation in exchange for KFR's stock. Thereafter, on a weekly basis, KFR purchased all of Kellwood's net accounts receivable at a discount rate determined by the CPA firm. Kellwood entered into a revolving credit agreement with KFR pursuant to which Kellwood would loan KFR any funds necessary to purchase Kellwood's net receivables.

At the same time, Kellwood formed another subsidiary, Kellwood Shared Services ("KSS"), based in Missouri, to provide centralized payroll, accounts payable, and accounts receivable services. Among KSS's various services was to service and collect KFR's receivables, for which KFR paid it a servicing fee at an 8% mark-up determined by the CPA firm.

KFR was not a bankruptcy-remote entity when created, and was never used by Kellwood as a securitization vehicle.

The Article 9-A Dispute

For the tax years ending January 2000 through January 2003, Kellwood filed its own Article 9-A returns but did not file a combined return with either KFR or KSS. Following an audit, the Department sought to combine both KFR and KSS with Kellwood. Until 2007, the Article 9-A law and regulations provided for combination of related corporations where there was substantial ownership, a unitary relationship, and distortion resulted from separate filing. The presence of substantial intercorporate transactions resulted in a presumption of distortion, and the party challenging that presumption had the burden of proving that no distortion existed, by demonstrating arm's-length pricing. (Under current law, the presence of substantial intercorporate transactions automatically results in combination, regardless of proof of arm's-length pricing.) Kellwood did not dispute that the ownership and unitary business requirements for combination were met or that there were substantial intercorporate transactions. The sole issue in *Kellwood* involved whether the taxpayer successfully rebutted the presumption of distortion.

The Administrative Hearing and Appeal

At the administrative hearing held in 2007, fact witnesses for Kellwood testified about the purpose and implementation of the restructuring that resulted in the formation of KFR and KSS. Kellwood also submitted expert testimony from and a report prepared by an economist regarding the business purpose and

(Continued on page 3)

Combination of Factoring Subsidiary Upheld

(Continued from Page 2)

arm's-length nature of KFR's intercompany charges. The preparers of the CPA firm report recommending the formation of the factoring company did not testify. The Department retained two of its own experts; one testified that there was no business purpose or economic rationale for the existence of KFR; the other testified that Kellwood's transfer pricing analysis was flawed.

The case proceeded on a somewhat circuitous route. In March 2008, the ALJ held that the transactions at issue involving KFR lacked economic substance and business purpose. On appeal, the Tribunal remanded the case back to the ALJ solely to address combination of KSS, the centralized servicing company. Eventually, in March 2010, the ALJ, on remand, determined that Kellwood did meet its burden of proof with respect to KSS. The case was then returned to the Tribunal for consideration of combination involving both KFR and KSS.

The Tribunal Decision

In a 92-page decision, the Tribunal affirmed the ALJ's determination, upholding the combination of KFR, the factoring subsidiary. Citing to *Matter of Sherwin-Williams Co.*, DTA No. 816712 (N.Y.S. Tax App. Trib., June 5, 2003), *confirmed*, 12 A.D.3d 112 (3d Dep't 2004), *app. denied*, 4 N.Y.3d 709 (2005), the Tribunal held that it was proper to first apply a two-pronged test for determining whether the distortion test required combination: First, it was necessary to determine whether the subject transactions – here, the initial contribution and subsequent sales of net receivables to KFR – were entered into for valid, non-tax business purposes (the "subjective prong") and had purpose and substance apart from their anticipated tax consequences (the "objective prong"). Even if the transactions merit tax respect under those two prongs, the taxpayer must then rebut the presumption of distortion by showing that the transactions reflect arm's-length pricing consistent with Internal Revenue Code § 482.

The Tribunal held that the ALJ correctly applied the business purpose and economic substance test of *Sherwin-Williams*. It pointed out that the avowed non-tax business purpose to securitize the receivables as a financing tool could not have been realized since Kellwood was aware that KFR was not a bankruptcy-remote entity and could not be used for securitization. The Tribunal also noted that "the record does prove that tax avoidance in non-combined reporting jurisdictions . . . was a well-considered and contemplated objective behind the factoring arrangements." Thus, the Tribunal held that the transactions involving KFR did not "merit tax respect." Having found that the KFR transactions failed the "objective prong," the Tribunal did not rule on the "subjective prong" – whether the transactions were entered into for a valid, non-tax business purpose, and whether Kellwood proved the arm's-length nature of the transactions.

The Tribunal did reject the forced combination of KSS, the servicing subsidiary. It pointed out that the Department, in its post-hearing briefs, acknowledged that KSS served a valid business purpose, and that the Department only adduced evidence to challenge the arm's-length nature of the Kellwood-KFR transactions, not those involving KSS. It therefore concluded that the Department did not meet its burden to show that the KSS service charges (set at cost plus 8%) were anything other than an arm's-length charge.

Additional Insights. In some respects, the Tribunal's decision is unsurprising, given that the record showed that the factoring subsidiary could not have served as a securitization vehicle – the alleged principal purpose for its formation – because it was not a bankruptcy-remote entity. Moreover, the ample evidence of the state tax minimization purposes for the factoring subsidiary, while not dispositive, undoubtedly gave the Tribunal additional grounds for concluding that the transactions had no purpose or substance other than tax savings.

However, the Tribunal's decision is puzzling in certain respects. For one thing, its statement that, under *Sherwin-Williams*, "the party opposing combined reporting bears the burden of proving that the subject transactions merit tax respect," is overbroad. Since *Sherwin-Williams* involved the presumption of distortion, it seems questionable that the burden of proof is automatically placed on the taxpayer even in situations where the presumption has not been triggered, such as where the Department alleges the existence of actual distortion.

In addition, the Tribunal's application of a "potential profit" test to evaluate whether the transactions have economic substance, and its view that the potential profit test "require[s] taxpayers to show increasing profit," is ripe for confusion. While it may be true that the economic substance test involves ascertaining whether a reasonable possibility of profit exists for a transaction, KFR did make a profit, and the Tribunal cites no authority for placing the burden on a taxpayer to show that its profitability actually increased as a result of the transactions.

City Tribunal Holds Lease Payments Made After WTC Destruction Were Not Subject to Commercial Rent Tax

By Irwin M. Slomka and Kara M. Kraman

The New York City Tax Appeals Tribunal has held that lease payments made to the Port Authority after the destruction of the World Trade Center on September 11, 2001, were not subject to commercial rent tax ("CRT") because there were no "premises" after the total destruction of the buildings. *Matter of 1 World Trade Center LLC, et al.* TAT (E) 07-34(CR), *et al*. (N.Y.C. Tax App. Trib., Oct. 12, 2011).

Background

In July 2001, two months before the terrorist attack on the World Trade Center, the lessees entered into four nearly identical 99-year leases with the Port Authority, each relating to one of four buildings at the World Trade Center ("WTC") site, including the "Twin Towers." The premises were defined in the leases as consisting of the buildings only, and did not include the underlying land. Pursuant to the leases, the tenants made initial rental payments of approximately $491 million in July 2001. In addition to these initial rent payments, the lessees began to make monthly lease payments.

Until the destruction of the WTC on September 11, 2001, the lessees operated the buildings, collected rent from their subtenants, and properly deducted those amounts from their taxable base rent in calculating the CRT due. After the buildings were destroyed, the lessees continued to make rent payments, but no longer collected rent from their subtenants.

Except for a nine-month period after September 11 during which the City of New York took control of the WTC site, the Port Authority retained control over the site during the tax years in issue. In July 2002, the lessees and the Port Authority entered into an "Interim Access Agreement" giving the Port Authority control over the site at least through 2003; the agreement also gave the lessees certain access to the premises for pre-construction work in rebuilding. In December 2003, the parties entered into a new agreement identifying five new sites where five new buildings might be built, none of which was on the original Twin Tower footprints.

CRT Returns and Audit

The commercial rent tax is imposed on "base rent" paid by a tenant of certain taxable commercial premises in New York City, generally premises in Manhattan south of 96th Street. Base rent is reduced by subtenant rentals received or due from a tenant's subtenants with respect to the premises. Taxable premises are defined as real property, and structures thereon, occupied or intended to be occupied in order to carry on a trade, business, or other commercial activity. Admin. Code §§ 11–701.4 and 11–701.5.

The lessees filed CRT returns for the tax year June 1, 2001 – May 31, 2002 (which included the period before September 11), and reported the $491 million in initial rent payments as taxable "base rent," as well as the monthly rental payments thereafter, less the rental payments they received from subtenants, although it appears from the decision that CRT was not paid on the $491 million. On the annual CRT returns filed for the next three tax years (through May 31, 2005), the lessees reported as base rent the monthly rental payments they continued to make to the Port Authority, but subtracted as "subtenant rents" business interruption insurance payments they received from their insurer for the loss of subtenant rental income. As a result, the returns for those years showed no CRT liability for those years.

THE TRIBUNAL HELD THAT THERE WERE NO IDENTIFIABLE PREMISES COVERED BY THE LEASES AFTER SEPTEMBER 11, 2001, SO NO CRT WAS DUE ON RENT PAYMENTS MADE AFTER THAT DATE.

On audit, the Department of Finance ("Department") disallowed the deductions for business interruption insurance proceeds as subtenant deductions, and assessed tax, interest, and penalties. In December 2009, after an administrative hearing, an Administrative Law Judge issued a determination concluding that no CRT was due post-September 11, and that the payments made to the Port Authority were not subject to the CRT because the lessees did not have the right to occupy specific space after the government takeover of the WTC site on September 11, 2001. The Department appealed.

City Tribunal Decision

The City Tribunal upheld the ALJ in concluding that no CRT was due on payments made after September 11, 2001. The Tribunal interpreted the term "premises" under the CRT law as requiring *specified* premises, and it found that no premises existed after September 11, 2001.

The City Tribunal rejected the Department's argument that under the definition of "premises," which includes not only real

(Continued on page 5)

No Rent Tax on Post-9/11 Lease Payments for WTC

(Continued from Page 4)

property but any structure thereon or space therein, the volume of space previously occupied by the buildings continued to exist and constituted taxable premises: "After September 11, 2001, the location and nature of the Premises covered by the Leases were thrown into sufficient doubt that we cannot conclude that there were identifiable premises covered by the Leases after that date for purposes of the CRT." Accordingly, the Tribunal held that there were no identifiable premises covered by the leases after September 11, 2001, so no CRT was due on rent payments made after that date.

However, for the initial rent payments in the amount of $491 million made in July, 2001, the Tribunal rejected the lessees' attempt to prorate those payments over the lease term, and to deduct business interruption proceeds as subtenant rents from the prorated amounts. The Tribunal held that (i) business interruption proceeds are not deductible as subtenant rents for CRT purposes, and (ii) the lessees' contention that the initial rent payments should be prorated over the 99-year lease was unsupported by anything in the record or the leases, noting that in fact the initial rent payments were attributed to the first quarter of the year on the lessees' annual CRT return for the tax year ending May 31, 2002.

The Tribunal therefore affirmed the ALJ's cancellation of the CRT deficiencies attributable to the period beginning September 11, 2001, and modified the ALJ's decision for the period through September 10, 2001, holding that CRT remained due on the initial rent payments and monthly rent payments made before September 11, less any actual subtenant rents received during that period.

Interestingly, in a separate opinion, concurring in part and dissenting in part, one Commissioner agreed that there were no taxable "premises" for CRT purposes during the period during which the City had complete control – between September 11, 2001 and July 1, 2002 -- and for the period beginning when the lessees executed the agreement of December 1, 2003, which established that no buildings would be constructed in the Twin Towers' footprints, but that for the period of July 1, 2002 until December 1, 2003, the lessees had well-defined taxable premises located on the original Twin Towers' footprints that were subject to CRT on the rent paid during that period.

Additional Insights. Needless to say, the unique circumstances concerning the destruction of the World Trade Center, coupled with the complex lease agreement and subsequent modifications, made this a case of first impression. The City Tribunal properly rejected the Department's position that the continued lease payments were made for the taxpayers' occupancy rights with respect to "the original volume of space" formerly occupied by the World Trade Center buildings. The CRT tax law applies to identifiable premises, and not to "volumes of space."

The Department's curious reliance on *Matter of Debenham's, Inc.*, 92 A.D.2d 829 (1st Dep't 1983), *appeal after remand* 117 A.D.2d 344 (1st Dep't 1986), in which payments made for the right to operate shoe concessions within a number of the landlord's department stores, but not in a specific location within the stores, seems far removed from the circumstances where the leased premises are totally destroyed. Indeed, the Department's position that the tax applies to the right to occupy an unspecified "volume of space" would have expanded the scope of the commercial rent tax far beyond anything previously contemplated. Assuming the threshold for taxability were met, would license fees paid to the City of New York for the right to operate buses on Manhattan streets constitute a taxable lease of a "volume of space"? Would the operator of a street parade or fair on Manhattan streets also be subject to the commercial rent tax on payments it makes to the City for the right to operate the parade or fair on a specified route or block, representing a "volume of space"? Under the City Tribunal's decision, the answers to such questions should not be in doubt.

ALJ Finds Restaurant's Records Unreliable, but Limits Assessment

By Hollis L. Hyans

After a careful review of an auditor's attempts to compute taxable sales from external indices, a New York State Administrative Law Judge has largely upheld the auditor's approach, although he significantly modified the calculations in several respects. *Matter of Mad Den, Inc.* and *Matter of Brian Madden*, DTA Nos. 823251 & 823252 (N.Y.S. Div. of Tax App., Sept. 22, 2011).

The taxpayer, Mad Den, had operated a restaurant from 1999 until it closed for substantial renovations on September 30, 2006. Thereafter, space that had long been leased by Mad Den, but which had remained empty, was used to double the size of the restaurant's seating capacity, and the restaurant was sold by Mad Den to unrelated buyers, who reopened it in February 2007.

The Department audited Mad Den for the period from June 1, 2004 through May 31, 2007, and requested production of all available records. Mad Den produced federal income tax returns, a check book, bank statements, and sales figures written on envelopes.

(Continued on page 6)

ALJ Allows Use of External Indices

(Continued from Page 5)

The auditor was told that sales tax returns had been prepared by estimating gross sales from bank statements.

By the time the audit began in August 2007, the restaurant had been sold, disputes had developed with the purchasers, and Mad Den no longer had access to the point of sale computer system that recorded sales at the restaurant. Eventually, the disputes with the purchasers resulted in a lawsuit tried to a jury and, in September 2010, Mad Den was awarded damages against the purchasers for breach of the contract to purchase the restaurant.

THE ALJ DIRECTED A RECOMPUTATION OF THE GROSS SALES USING ONLY THE OCCUPANCY CAPACITY FOR THE ORIGINAL RESTAURANT SPACE.

The auditor noted significant discrepancies between Mad Den's sales tax returns and its federal income tax returns and, given the lack of sales records, determined that the records were inadequate to perform a detailed sales audit. Instead, the auditor resorted to the use of a rent factor computed by reference to a Restaurant Industry Operations Report presenting operating results as amounts per restaurant seat and as ratios to total sales, and issued a Statement of Proposed Audit Change based on use of the Industry Report. Mad Den then filed amended sales tax returns, computed by reference to credit card receipts, showing an increase in taxable sales resulting in revised additional tax due of approximately $121,000, although no tax was paid. The Department then issued a Notice of Determination seeking the same $121,000 in additional tax, plus penalties and interest. Mad Den contested the assessment.

By the time of the ALJ hearing, Mad Den had obtained access to the point of sale records, and submitted snapshot summaries of each day's sales, the guest checks for each order, and credit card receipts. After reviewing the records, the Department concluded that the totals on the snapshots did not match the guest checks; that credit card information and voided sales were missing; pages were missing; and that guest checks could not be tied into other documentation received on audit.

Use of External Indices Generally Upheld

The ALJ held that the Department's resort to external indices was justified. The ALJ's own review of one quarter's records revealed discrepancies similar to those noted by the Department, and the ALJ found inconsistencies between the records produced and the amount of gross sales reported on the federal income tax returns. The ALJ also noted that Mad Den did not use the snapshot reports or the other documentation presented at the hearing to prepare its returns for the entire audit period.

However, the ALJ did reject a portion of the Department's estimate. The auditor had estimated sales based on the seating capacity as it existed after Mad Den sold the restaurant. The ALJ noted that the seating had doubled at the time the restaurant was renovated and reopened by new owners, using the additional space next door. Although that space had been rented by Mad Den beginning prior to the audit period, with a plan to expand the restaurant when the owner had the necessary capital, the space was not in fact used as part of the restaurant during that time. The ALJ directed a recomputation of the gross sales using only the occupancy capacity for the original restaurant space. The ALJ also deemed the Department's claim that it did not have knowledge of the sale of the business as "neither genuine nor credible," noting in particular the court documents from the breach of contract trial, and directed the Department to recompute the tax to limit the audit period to the time the business was actually owned by Mad Den.

Finally, the ALJ upheld the penalties, stressing the fact that, although a point of sale computerized recordkeeping system had been available, those records were not used in filing the original returns, or in filing amended returns, which relied on credit card receipts.

Additional Insights. The importance of not only keeping careful records of taxable sales, but then actually using those records to file sales tax returns, is regularly reinforced by decisions like the one in *Mad Den*. Taxpayers who use casual estimates gleaned from bank records or other indirect sources run significant risks of being unable to substantiate their filings, and then facing both additional tax and penalties. Here, while the restaurant owner no longer had access to complete records when the audit began, he did have access during the majority of the audit period, and the ALJ upheld the tax as well as the penalties because those records – which even themselves did not seem entirely reliable – had not been used in filing returns. The Department frequently relies on the Industry Report used in this audit, and its reliance is generally upheld. *See Matter of Crescent Beach, Inc.*, DTA Nos. 822080-822083 (N.Y.S. Tax App. Trib. Sept. 22, 2011).

However, the *Mad Den* decision also demonstrates that, even in the absence of properly filed returns, auditors must make

(Continued on page 7)

ALJ Allows Use of External Indices

(Continued from Page 6)

proper adjustments, and cannot rely on demonstrably incorrect estimates of restaurant capacity and ownership periods when a taxpayer can demonstrate a significant change in facts.

Comity is Not a Joking Matter for Taxpayers Seeking Review of City Parking Tax Exemption in Federal Court

By Amy F. Nogid

The Second Circuit Court of Appeals has affirmed the federal District Court's dismissal of a complaint which challenged as unconstitutional a partial exemption from the New York sales tax on parking services. *Joseph v. Hyman*, No. 10-3943-cv (2d Cir. Oct. 12, 2011). The court held that improvements for the properties made after the valuation date could not be considered, an extortion of the time to resolve.

Motor vehicles parked in New York are subject to a 10.375% sales tax on parking services (comprised of a 4% State tax; a 6% New York City tax; and .375% Metropolitan Commuter Transportation District tax). New York City imposes an additional 8% sales tax if the parking services are rendered in Manhattan ("Manhattan surtax").

In *Joseph*, a civil rights class action suit commenced in August 2009, the plaintiffs were commuters who park their cars in the City. They asserted that an exemption from the 8% Manhattan surtax available to certain Manhattan residents who purchase long-term parking is discriminatory and violates various provisions of the U.S. and New York State Constitutions. Estimates of the revenue impact of the exemption varied from $3 million to $22 million annually. The plaintiffs argued that, because the various State and City defendants "violated clearly established constitutional law" and "failed to act in an objectively reasonable manner," they were not entitled to the qualified immunity that otherwise protects government officials. The plaintiffs also sought attorneys' fees under 42 U.S.C. § 1988.

Two significant barriers to the plaintiffs' action were the Tax Injunction Act, 28 U.S.C. § 1341 ("TIA"), which bars federal courts from taking any action to "enjoin, suspend or restrain the assessment" of a state tax "when a plain, speedy and efficient remedy" is available in state court, and the doctrine of comity, which comes from the Latin "comitas," meaning friendly, and stands for the proposition that courts of one jurisdiction may accede or give effect to the decisions of another jurisdiction.

At the time this case was briefed at the District Court, two of the main cases dealing with the TIA and the comity doctrine were *Fair Assessment in Real Estate Association, Inc. v. McNary*, 454 U.S. 100 (1981) and *Hibbs v. Winn*, 542 U.S. 88 (2004). In *Fair Assessment*, the U.S. Supreme Court held that comity barred a suit brought in federal court to review a local property tax assessment, despite the fact that the action was brought under 42 U.S.C. § 1983 ("§ 1983"), which allows challenges against state laws to be brought in federal court. The Supreme Court held that comity precluded the commencement in federal court of § 1983 cases challenging state tax systems, as long as the state court remedies were "plain, adequate and complete." However, in *Hibbs*, the Court held that neither the TIA nor principles of comity barred a federal suit challenging a state tax credit on the basis that the credit improperly channeled public funds to pay for parochial schools, because the relief sought by the *Hibbs* plaintiffs would not result in enjoining the collection of a tax or contesting the validity of a tax imposition, but rather challenged only a credit, and the success of the plaintiffs' action would result in greater, rather than diminished, state tax collections.

Several federal circuit courts took a broad view of the route left open in *Hibbs*, and allowed certain actions to proceed in federal court. Then, in *Levin v. Commerce Energy, Inc.*, 130 S. Ct. 2323 (2010), the Supreme Court narrowed the *Hibbs* exception, holding that the comity doctrine was "more embracive" than the TIA, and barred a challenge in federal court to Ohio's taxation of gas marketers which was alleged to be discriminatory.

With that background, the District Court in *Joseph* dismissed the case, finding that no fundamental right was implicated in the parking tax exemption; that plaintiffs were not third party challengers of the tax (unlike the plaintiffs in *Hibbs*, plaintiffs were "objecting to their own tax burden, however indirectly"); and that the state court is "better suited than this Court to identify and implement the remedial option that best comports with the legislative evil." The court also noted that plaintiffs had not alleged that the state remedies were insufficient.

In affirming the District Court's decision, the Second Circuit added little to the analysis, but addressed plaintiffs' assertion that the New York courts could not fashion adequate remedies, concluding that State courts could, if necessary, prevent enforcement of discriminatory tax provisions even if the result was a decrease in state tax revenue. The case was dismissed without prejudice, and resort to the New York State courts remains available to the

(Continued on page 8)

No Federal Court Review of Parking Tax Challenge

(Continued from Page 7)

plaintiffs to challenge the exemption.

Additional Insights. As recognized by the Second Circuit in *Joseph*, after *Levin* the bar to gain entry to the federal court system has been raised, and only those whose claims involve fundamental rights, or who can demonstrate that the state review system is inadequate, will pass the hurdle. Reliance on the notions that a tax credit or an exemption provision is implicated, rather than an assessment, or that a suit is commenced by a nontaxpayer, are unlikely to provide the entry ticket. While it may well be true, as the Iowa Supreme Court recently acknowledged in its decision in *KFC Corp. v. Iowa Dep't of Revenue*, 792 N.W.2d 308 (Iowa 2010), *cert. denied*, 80 U.S.L.W. 3182 (Oct. 3, 2011), that state courts may be "inherently more sympathetic to robust taxing powers of states than is the United States Supreme Court," the route to getting state tax disputes heard by the U.S. Supreme Court is a long one requiring bringing a case through the whole state court system and then hoping for a place on the U.S. Supreme Court's extraordinarily limited docket.

It now remains to be seen whether the challenge to the exemption will be pursued in State court and, if so, how the New York courts will view the constitutional challenges.

"Next" Means "Next" in Nassau County

By Open Weaver Banks

In *Matter of Seidel v. Board of Assessors, County of Nassau*, No. 2010-02740, 2011 NY Slip Op. 07061 (2d Dep't Oct. 4, 2011), the Appellate Division held that Nassau County used the wrong valuation date for a real property tax assessment with respect to separate residences owned by three petitioners residing in Woodmere, New York. The court held that improvements to the properties made after the valuation date could not be considered despite an extension of the time to resolve challenges.

In 2002, the New York Legislature enacted special real property assessment procedures for Nassau County to address the county's "notoriously flawed assessment and assessment review systems." Prior to amendment, procedural rules gave Nassau County ten days to determine homeowner grievances relating to assessment values. As the county was unable to resolve grievances in such a short period of time, taxpayers often overpaid their taxes and received refunds years later, when the grievances were finally resolved. In *Seidel*, the Court noted that Nassau County had a history of financing debt in order to pay these real property tax refunds.

The legislative solution in 2002 was to extend the deadline for Nassau County's final determination and final assessment by a year. The intent of the legislation was to provide additional time for resolution of assessment appeals before taxes were levied in order to limit the number of judicially ordered tax refunds. Accordingly, for the 2008/2009 tax year under review in *Seidel*, the following schedule applied:

> January 2, 2007 – County's publication deadline for tentative assessment roll
>
> March 1, 2007 – Filing deadline for taxpayer grievances
>
> March 10, 2008 – Deadline for County to make determinations on the grievances
>
> April 1, 2008 – County's publication deadline for final assessment roll

For purposes of determining the value of these residences for the 2008/2009 tax year, the Nassau County Administrative Code § 6-2.1(a) provided that "the Board of Assessors shall determine the taxable status and classification of all real property . . . for the second succeeding fiscal year according to its condition, ownership and use as of the second day of January in each year." Thus, the Court found that January 2, 2007 was the "taxable status date" for the 2008/2009 tax year, and therefore the date as of which the properties' value is determined.

All of the property owners in *Seidel* made improvements to their residences after January 2, 2007, but before January 2, 2008, the next tax status date. For the 2008/2009 tax year at issue, the owners contended that their properties should have been valued as they existed on January 2, 2007, the taxable status date. Nassau County's Board of Assessors took the position that the owners' properties should be valued with the new improvements as of January 2, 2008. The County argued that the statute allowed the assessor to change the valuation of property when improvements were made between taxable status dates, while the owners argued that the provision only allowed the improvements to be considered on the "next" assessment role.

The owners commenced a small claims assessment review ("SCAR") proceeding challenging the Nassau County assessments. Due to limited jurisdiction, the SCAR hearing officer was unable to review the owners' claims that their properties should have been valued as of January 2, 2007, and he upheld the assessments. The owners then commenced a proceeding in the New York

(Continued on page 9)

"Next" Means "Next"

(Continued from Page 8)

Supreme Court (New York's trial court) against the Nassau County Board of Assessors and the Assessment Review Commission. The Supreme Court annulled the determinations of the hearing officer, and remitted the matters for a *de novo* review of the applications and a new determination before a different SCAR hearing officer, with the direction that the properties be valued as of January 2, 2007. Nassau County appealed the Supreme Court's decision to the Appellate Division, Second Department.

On appeal, the Appellate Division had to interpret special procedures enacted in connection with the 2002 procedural reforms. The law provides that when the tentative assessment roll (published on the taxable status date) fails to reflect the construction of improvements made after the taxable status date, but on or before the taxable status date applicable to the assessment roll for the following year, the County shall determine a "new assessment." Such new assessment is based on the value of the property as of the second day of January occurring on or after the date of the construction. With regard to the timing of the new assessment, Nassau County Administrative Code § 6-24.1(e) provides that when the County determines a new assessment that is greater than the original assessment, "it shall be entered on the *next following tentative roll*" (emphasis added).

Agreeing with the owners, the Appellate Division in *Seidel* reasoned that "next" means "next." Since the improvements at issue occurred after January 2, 2007, but before January 2, 2008, the Board of Assessors must enter the new assessment on the *next* following tentative assessment roll, which would be the tentative assessment roll for the 2009/2010 tax year that would be filed on January 2, 2008. Therefore, the assessments at issue could not reflect the improvements made after January 2, 2007. By giving the County an extra year to review the grievances before the assessments became final, the statute did not allow it to consider improvements made after the taxable status date.

Additional Insights. The law in question in *Seidel* and other 2002 procedural amendments to the Nassau County Administrative Code are scheduled to expire on December 31, 2012. If allowed to sunset, Nassau County will lose the extra year provided by the 2002 legislation in which to resolve grievances before publication of the final assessment roll. Nassau County real property owners should be aware that the opportunity for resolving a disputed assessment before seeking review of a determination of the Nassau County Assessment Review Commission will again be abbreviated beginning in 2013.

Sales Tax Guidance Offered on Discounted Purchases Using Customer Loyalty Cards

By Kara M. Kraman

The New York State Department of Taxation and Finance has issued a Tax Bulletin addressing the application of sales tax to items purchased at a discount with customer loyalty cards. *Customer Loyalty Cards*, TB-ST-145 (N.Y.S. Dep't of Tax'n & Fin., Sept. 29, 2011). The Bulletin outlines the steps that businesses must take to properly inform customers of the type of discount they are receiving when they purchase an item with a customer loyalty card. It generally follows the policy set forth in the Department's recent pronouncement, "Tax Department Policy on Manufacturer's Discounts Received Using Store Loyalty Cards," TSB-M-11(10)S (N.Y.S. Dep't of Tax'n & Fin., June 29, 2011), discussed in the August 2011 issue of *New York Tax Insights*.

Whether the seller must charge sales tax on the full price or the discounted price of a purchase made with a customer loyalty card hinges on whether the seller is reimbursed for the discount it offers the customer. In general, if the seller is reimbursed for the discount then sales tax is due on the full, undiscounted price of the item. If the seller is not reimbursed for the discount, then sales tax is due on the discounted price of the item.

For example, when a store discount is offered through use of a customer loyalty card, the store itself is providing the discount and is not reimbursed; therefore, the seller only needs to collect sales tax on the discounted price. On the other hand, when a manufacturer's discount is offered through the use of a customer loyalty card, the manufacturer reimburses the seller for the discount, and the store must collect sales tax on the full price of the item.

If use of the loyalty card provides customers with a future discount, a discount that allows the cardholder to accumulate points for future discounts or free merchandise, or a discount on purchases from third party sellers, the taxability of the discounted item depends on whether the seller is reimbursed for the discount by a third party. If the seller receives reimbursement, sales tax must be collected on the full price; if the seller does not, sales tax is due only on the discounted price.

The new Tax Bulletin provides that if the seller fails to properly disclose to the customer that a discount is a manufacturer's discount, the seller must only collect sales tax on the *reduced* price from the customer, and remains liable for the sales tax on the difference between the discounted price and the full price.

(Continued on page 10)

This rule applies to online sales as well as in-store sales. In order to avoid this liability the seller must: (1) identify items subject to a discount by using "Manufacturer's" or "Mfr." on its coupons, in-store circulars, and advertisements; or (2) use store shelf tags that are distinguishable from regular shelf tags based on their size, color and wording, and indicate by "Manufacturer's" or "Mfr." printed on the store tag that the discount is a manufacturer's discount; or (3) post signs near check-out advising customers that some discounts are manufacturer's discounts and others are store discounts and set its cash registers to indicate on the customer's receipt which discounts are manufacturer's discounts and which are store discounts.

Additional Insights. The sales tax rules for discounts offered through the customer's use of a store loyalty card are similar to the rules for discounts in general – the seller must clearly indicate the type of discount being offered. In practice, however, it may be difficult to indicate the type of discount being offered when the customer receives the discount through use of a customer loyalty card because the discount received by the customer may not be promoted by coupons, circulars, or similar advertising. The new Tax Bulletin acknowledges this reality and provides the seller with the safe harbor options outlined above to avoid liability for sales tax.

Insights in Brief

Electronic News Services are Exempt from Sales Tax

New York's sales tax law has been amended to provide an exemption from sales and use taxes for electronic news services and electronic periodicals that have the predominant purpose of presentation of news content and hold themselves out as a news service, magazine, periodical, or similar service. Ch. 583, N.Y. Laws 2011. The new provision appears to be designed to exempt online news sources that are similar to printed news sources, such as the online versions of newspapers and magazines, which are also exempt from sales and use tax if all statutory prerequisites are met. Tax Law §§ 1115(a)(5), 1118(5). The new law will take effect on March 1, 2012, and the Department has announced it will be issuing guidance to provide a detailed explanation of the amendment, including the requirements that must be met in order to qualify.

Taxpayer Bound by Stipulation of Discontinuance

The New York State Tax Appeals Tribunal has affirmed a decision by an ALJ that a party cannot reopen issues that were resolved by a Stipulation of Discontinuance of Proceeding. *Matter of Mohammad Javed*, DTA No. 823219 (N.Y.S. Tax App. Trib. Oct. 6, 2011). The petitioner had challenged an assessment against him for sales and use taxes as an allegedly responsible officer, but before a hearing on the challenge was held, the petitioner's representative and the Department executed a Stipulation for Discontinuance of Proceeding, and the ALJ issued an Order of Discontinuance. The Tribunal held that, in the absence of proof of fraud, malfeasance or misrepresentation of material fact, the petitioner was bound by the Stipulation signed by his representative, and the matter could not be reopened.

Petitioners Not Entitled to Hearing with Respect to Issuance of a Notice and Demand

In *Matter of Benjamin and Sharyn Soleimani*, DTA No. 824288 (N.Y.S. Div. of Tax App., Sept. 29, 2011), an ALJ dismissed the taxpayers' petition protesting a Notice and Demand for Payment of Tax issued against them for personal income tax. The Notice and Demand was issued for the amount of tax shown to be due on the taxpayers' 2007 personal income tax return that remained unpaid. The ALJ held that Tax Law § 173-a, which became effective on December 1, 2004, precluded the taxpayers from obtaining a hearing before the Division of Tax Appeals with respect to the issuance of a Notice and Demand.

Elimination of Two-Year Deadline for Spouses to Request Equitable Relief

The New York State Department of Taxation & Finance has eliminated the two-year deadline previously applicable to spousal requests for equitable relief from joint and several liability under Tax Law § 654. *Equitable Relief*, TSB-M-11(11)I (N.Y.S. Dep't. of Tax'n & Fin., Sept. 27, 2011). This action followed a recent IRS announcement that it was eliminating the two-year deadline for equitable relief which ran from the date of the first collection action by the IRS. The elimination of the two-year deadline applies to future requests for relief, requests currently under review, requests currently in litigation, and previous requests that were not litigated and denied solely on the issue of untimeliness which was based on the applicable period of limitation for collections, credit, or refunds which remains open as of the date of the original application for relief. The elimination of the two-year deadline has no effect on the two-year deadline to request innocent spouse relief or separation of liability under Tax Law § 654.

ABB v. Missouri
Albany International Corp. v. Wisconsin
Allied-Signal, Inc. v. New Jersey
American Power Conversion Corp. v. Rhode Island
Citicorp v. California
Citicorp v. Maryland
Clorox v. New Jersey
Colgate Palmolive Co. v. California
Consolidated Freightways v. California
Container Corp. v. California
Crestron v. NJ
Current, Inc. v. California
Deluxe Corp. v. California
DIRECTV, Inc. v. Indiana
DIRECTV, Inc. v. New Jersey
Dow Chemical Company v. Illinois
Express, Inc. v. New York
Farmer Bros. v. California
General Mills v. California
General Motors v. Denver
GTE v. Kentucky
Hair Club of America v. New York
Hallmark v. New York
Hercules Inc. v. Illinois
Hercules Inc. v. Kansas
Hercules Inc. v. Maryland
Hercules Inc. v. Minnesota
Hoechst Celanese v. California
Home Depot v. California
Hunt-Wesson Inc. v. California
Intel Corp. v. New Mexico
Kohl's v. Indiana
Kroger v. Colorado
Lanco, Inc. v. New Jersey
McGraw-Hill, Inc. v. New York
MCI Airsignal, Inc. v. California
McLane v. Colorado
Mead v. Illinois
Nabisco v. Oregon
National Med, Inc. v. Modesto
Nerac, Inc. v. NYS Division of Taxation
NewChannels Corp. v. New York
OfficeMax v. New York
Osram v. Pennsylvania
Panhandle Eastern Pipeline Co. v. Kansas
Pier 39 v. San Francisco
Reynolds Metals Company v. Michigan Department of Treasury
Reynolds Metals Company v. New York
R.J. Reynolds Tobacco Co. v. New York
San Francisco Giants v. San Francisco
Science Applications International Corporation v. Maryland
Sears, Roebuck and Co. v. New York
Shell Oil Company v. California
Sherwin-Williams v. Massachusetts
Sparks Nuggett v. Nevada
Sprint/Boost v. Los Angeles
Tate & Lyle v. Alabama
Toys "R" Us-NYTEX, Inc. v. New York
Union Carbide Corp. v. North Carolina
United States Tobacco v. California
USV Pharmaceutical Corp. v. New York
USX Corp. v. Kentucky
Verizon Yellow Pages v. New York
Whirlpool Properties v. New Jersey
W.R. Grace & Co.—Conn. v. Massachusetts
W.R. Grace & Co. v. Michigan
W.R. Grace & Co. v. New York
W.R. Grace & Co. v. Wisconsin

When these companies had difficult state tax cases, they sought out Morrison & Foerster lawyers.

Shouldn't you?

For more information, please contact
Craig B. Fields at (212) 468-8193,
Paul H. Frankel at (212) 468-8034, or
Thomas H. Steele at (415) 268-7039

MORRISON | FOERSTER