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MORRISON FOERSTER

GAIN ON SALE OF NON-NEW YORK LEASEHOLDS HELD PROPERLY SOURCED TO NEW YORK BASED ON BUSINESS ALLOCATION PERCENTAGE

By Kara M. Kraman

A New York State Administrative Law Judge held that a nonresident shareholder in a corporation that elected New York S corporation status should have included his pro rata share of the gain from the S corporation's sale of four Pennsylvania leasehold interests in his New York source income, based on the S corporation's business allocation percentage. *Matter of Steven E. Breitman*, DTA No. 824268 (N.Y.S. Div. of Tax App., Aug. 1, 2013).

The taxpayer, Steven Breitman, a New Jersey resident, was the owner and president of SEBCO Laundry Systems, Inc. ("SEBCO"). SEBCO provided laundry facilities in apartment buildings by entering into lease agreements with building owners allowing it to occupy space in which it installed its coin-operated laundry equipment. SEBCO operated at approximately 3,000 locations in several states, including New York, New Jersey and Pennsylvania. The owners of four properties located in Pennsylvania notified SEBCO that they were selling the properties. As a result, in 2005, the property owners agreed to purchase SEBCO's leasehold interests in the four properties, resulting in a $500,000 gain to SEBCO, all of which was passed through to Breitman as the S corporation's shareholder.

SEBCO had elected New York State S corporation status. In order to make a New York S corporation election, all nonresident shareholders must agree to pay New York State income tax on their distributive share of S corporation income earned in the State. In this case, Mr. Breitman filed a 2005 New York nonresident income tax return, but did not include any portion of his distributive share of the S corporation's gain in his New York source income or, for that matter, his share of the S corporation's losses in the years 2002 through 2004.

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Following an audit of Mr. Breitman's New York State returns, the Department of Taxation and Finance increased his New York source income for 2005 by the $500,000 gain from the leasehold sales apportioned by SEBCO's business allocation percentage ("BAP") of roughly 40%. The Department similarly apportioned his distributive share of SEBCO's losses in 2002-2004.

Mr. Breitman claimed that none of the gain was subject to New York tax, arguing that application of the tax was unconstitutional because the tax burden resulting from formulary apportionment of the gain was out of all appropriate proportion to SEBCO's business in New York. He also contended that the leaseholds had no connection to New York State to justify subjecting the resulting gain to New York tax.

ALJ Decision. The ALJ rejected Mr. Breitman's arguments, holding that the Department properly sourced a portion of the gain to New York for personal income tax purposes based on SEBCO's BAP. Applying the Article 9-A apportionment rules to a personal income tax case, because the income was derived from an S corporation, the ALJ first noted that the gain from the sale of the leaseholds was not investment income, but rather was business income, and thus apportionable.

The ALJ explained that in order to avoid application of the S corporation's BAP to income from its unitary business enterprise, Mr. Breitman needed to show that the gain from the sales resulted in the sourcing of income to New York that was "grossly disproportionate to SEBCO's business activities in New York." The ALJ held that Breitman failed to prove it was "grossly disproportionate," noting, among other things, that the leasehold interests were an integral and necessary part of SEBCO's unitary business enterprise, and that the sale of those assets did not rise to the level of a discrete and unrelated business activity. Moreover, the ALJ presumed that SEBCO had taken business deductions for the four leaseholds, and had also included the value of those leaseholds in the denominator of SEBCO's property factor.

The ALJ cited to the Court of Appeals decision in *Matter of British Land (Maryland), Inc. v. Tax Appeals Tribunal*, 85 NY2d 139 (1995), where the Court held that the inclusion of gain from the sale of the taxpayer's Maryland property resulted in the unconstitutional taxation of extraterritorial value. However, the Court of Appeals did not reach its conclusion based solely on the fact that the property was located in Maryland, and where, as here, the leaseholds sold were an integral part of a unitary business, their sale was not a discrete and unrelated activity, and the resulting gain could properly be subject to formulary apportionment.

Additional Insights

It is unusual to come across a decision involving the personal income tax that applies Article 9-A sourcing rules and case law. This approach is required by Tax Law § 632(a), which provides that the portion of a nonresident individual's income from an S corporation deemed connected with New York sources is determined under the Article 9-A apportionment rules. Under the Article 9-A precedent, where a corporation's gain is part of the business income of a unitary business, a portion of that gain can properly be sourced to New York – and treated as the New York source income of a nonresident individual shareholder of a New York S corporation – unless the taxpayer can show that such treatment is grossly disproportionate to the corporation's business activities conducted in New York State. The fact that the gain resulted from the sale of non-New York property is not alone enough to exclude it from New York source income under the personal income tax.

TRIBUNAL REVERSES DISMISSAL AND ALLOWS CASE TO PROCEED BEFORE ALJ

By Hollis L. Hyans

In *Matter of Medical Capital Corp*., DTA No. 824837 (N.Y.S. Tax App. Trib., July 25, 2013), the New York State Tax Appeals Tribunal reversed the decision of an Administrative Law Judge, which had dismissed a taxpayer's petition for failing to state a cause of action, and sent the case back for a hearing on the merits.

In the proceeding below, Medical Capital had filed a petition seeking review of a Notice of Deficiency asserting tax due of nearly $48,000. In its petition, it described the appointment of a receiver and the activities that the receiver had conducted, including an extensive forensic accounting which disclosed overstated income of nearly $10 billion, resulting in the filing of amended state and federal returns. Medical Capital's amended federal tax return requested a refund of approximately $14 million. The petition explained that the Internal Revenue Service was still conducting an audit of the amended return, and that further amended returns might be required when the audit was concluded.

The Department of Taxation and Finance moved to dismiss on the grounds that the petition failed to state a cause for relief, since it failed to explicitly contest the $48,000 alleged liability, and contending that the possibility of a "future dispute over a possible refund claim" was insufficient. The ALJ agreed and dismissed the petition, noting that Medical Capital failed to challenge any dollar amount reflected on the Notice of Deficiency, and did not articulate any specific claim that the Notice was incorrect.

The Tax Appeals Tribunal reversed. Applying the same standards as would be applied to a motion to dismiss under CPLR § 3211, the Tribunal found that the pleading should be

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"afforded a liberal construction" in which the petitioner should be given "'the benefit of every possible favorable inference,'" and that a motion to dismiss should not be granted unless the facts as alleged would not "'fit within any cognizable legal theory.'" Under this standard – and despite noting that the arguments in the petition were not entirely clear – the Tribunal found it reasonable to infer that the petitioner has sufficiently alleged that its New York State income was overstated. That was enough to establish that a controversy exists between Medical Capital and the Department sufficient to provide jurisdiction in the Division of Tax Appeals. The case was remanded for a hearing on the merits.

Additional Insights

Given the significant difference in the positions taken by the parties – with the Department seeking a $48,000 deficiency and the petitioner believing its income was overstated by nearly $10 million – the Tribunal's decision appears eminently reasonable. While the pleading did not seem to have clearly articulated a legal theory or a specific challenge, it appears obvious that the parties had expressed quite divergent positions on whether tax is owed and, if so, how much. Particularly when, as here, the company appears to have been represented by two individuals who are not identified as lawyers or accountants, who therefore may not have been familiar with standard drafting practices for petitions, and in light of the broad standards that apply even to pleadings in court under the CPLR, the Tribunal was clearly correct in allowing the matter to proceed.

This was the first decision issued by the newly constituted full three-member Tribunal, which had been operating with only two members for two years until the appointment of Commissioner Roberta Mosely Nero this summer.

FEDERAL COURT DISMISSES CHALLENGE TO TAX PENALTIES UNDER COMITY

By Hollis L. Hyans

In 2010, the federal District Court for the Northern District of New York permanently enjoined the imposition of penalties for selling cigarettes without the required tax stamps on two vendors, who had already pled guilty and been sentenced under criminal provisions of the New York Tax Law. It concluded that the penalties constituted a second punishment prohibited by the Fifth Amendment's ban against double jeopardy. In *Abuzaid v. Mattox*, Nos. 10-1210-cv, 10-1785-cv (2d Cir. Aug. 12, 2013), the Second Circuit Court of Appeals has now reversed, finding that the suit was barred by the comity doctrine, since it interfered with "state tax administration." The Second Circuit went on to hold that, while *issuance* of an injunction would have interfered with the state's administration of its tax laws, the court could nonetheless consider the merits of the challenge, find the claims to be without merit, and *dismiss* the claims with prejudice, thereby barring them from being raised even in state court.

[W]hile *issuance* of an injunction would have interfered with the state's administration of its tax laws, the court could nonetheless consider the merits of the challenge, find the claims to be without merit, and *dismiss* the claims with prejudice.

Facts. The Plaintiffs in this action, Zaid Abuzaid and Arref Kassem, owned small newsstands in New York where cigarettes were sold. In a criminal prosecution resulting from a "sting" operation conducted by undercover agents from the Department of Taxation and Finance, they were arrested and charged under Tax Law § 1814 with criminal evasion of cigarette taxes after buying cartons of cigarettes bearing counterfeit tax stamps. They pled guilty to felony charges, were sentenced (probation for Mr. Abuzaid and conditional discharge for Mr. Kassem), and agreed to forfeit assets. Thereafter, the Department assessed separate tax penalties, under Tax Law § 481(1)(b)(i), for possessing the unlawfully stamped cigarettes. The plaintiffs brought suit in federal District Court, alleging the penalty was punitive in nature and therefore amounted to an unconstitutional second criminal punishment for the same conduct. The Department contended that it was a civil penalty, which does not implicate the double jeopardy provision; that the action could not be brought in federal court because of the Tax Injunction Act ("TIA"), which prohibits federal district courts from enjoining the collection of a tax, as long as there is a "plain, speedy and efficient remedy" in state court; and that the action was also barred by the comity doctrine, which is a discretionary doctrine under which federal courts decline to interfere in state tax matters.

District Court Decision. On the jurisdictional issue, the District Court held that the TIA did not apply, because the penalty was not a "tax." It did not address the question of comity.

The District Court then went on to hold that the penalty was "punitive" under a multi-factor balancing test outlined by the Supreme Court in *Kennedy v. Mendoza-Martinez*, 372 U.S. 144 (1963), finding that it was meant to punish and deter criminal conduct; that it covered conduct that was already a crime; and it assessed penalties in accordance with the offender's mental state, with more severe penalties resulting when the offender "knowingly" possessed the unlawful cigarettes. Since the plaintiffs had already been subject to a prior criminal

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prosecution for the same conduct, the District Court found the penalties violated the Fifth Amendment prohibition against double jeopardy.

The Second Circuit Reverses. Without reaching the TIA, the Second Circuit found that the doctrine of comity barred issuance of an injunction against the penalties. According to the court, "the comity doctrine instructs federal courts to refrain from granting relief to taxpayer-plaintiffs in suits that contest taxpayer liability in a manner that interferes with a state's administration of its tax system." Relying on *Levin v. Commerce Entergy, Inc.*, 130 S. Ct. 2323 (2010), and *Fair Assessment in Real Estate Ass'n, Inc. v. McNary*, 454 U.S. 100 (1981), the Second Circuit found that the injunction issued by the District Court "undoubtedly disrupted and interfered with the state's administration of its tax system," and that whether the assessments made under § 481(1)(b)(i) were "taxes" or "penalties," they are "indisputably part of the state's tax system." The court also found that even if the penalties were criminal in nature, then federal court interference would be barred by the doctrine of abstention under *Younger v. Harris*, 401 U.S. 37 (1971), which applies when there is a pending state proceeding, implicating an important state interest, which affords the plaintiff an adequate opportunity for judicial review. Here, state proceedings were found to be present because Notices of Determination had been issued, there was an important state issue, and the plaintiffs had ample opportunity to obtain review in the state courts.

Nonetheless, after deciding that it lacked jurisdiction, the Second Circuit then went on to determine the merits of the plaintiffs' claims, and decided that the claim of double jeopardy fails, because the penalty imposed by Tax Law § 481(1)(b)(i) was a civil penalty, not a criminal punishment. Applying the same multi-factor test used by the District Court, but emphasizing different factors, the Second Circuit determined that the majority of the factors leaned in favor of classifying the assessments as civil penalties: there was no affirmative restraint imposed; in addition to a punitive and deterrent effect, the penalty also raised revenue to fund health care; and the penalty also applied to violations of a civil tax obligation – the requirement to affix tax stamps.

Finally, after deciding that comity barred issuance of an injunction, and that the double jeopardy rule did not apply, the Second Circuit went on to dismiss the suit "with prejudice," thereby preventing the plaintiffs from bringing their double jeopardy claims before the state court. Having considered and rejected those claims, the Second Circuit expressed a desire to terminate what it described as a "meritless litigation," and said that it found no bar in any of the comity cases to dismissing the action, since eliminating any possible challenge to the penalty would have no adverse effect on the state's administration of its tax laws.

Additional Insights

The decision in *Abuzaid* is interesting for a number of reasons. First, the determination that penalties are treated just the same as taxes is not as straightforward as the Second Circuit suggests. The District Court had noted that the penalty imposed by § 481(1)(b)(i) falls on a different party than the tax, since the tax is paid only by cigarette stamping agents and not by vendors. In addition, other circuits have reached a different conclusion; for instance, the Seventh Circuit concluded that penalties do not constitute "taxes," at least for purposes of the TIA, because they are designed to deter delinquent taxpayers and are not calculated to generate general revenues. *RTC Commercial Assets Trust 1995-NP3-1 v. Phoenix Bond & Indem. Co.*, 169 F.3d 448 (7th Cir. 1999).

Even more striking is the Second Circuit's decision that, having found that the comity doctrine bars consideration of the issue in federal court, it could then proceed to review the issue on the merits and dismiss the case with prejudice, so that the plaintiffs could not maintain their case in the very state courts to which the federal court is supposed to be deferring. The court cites no other decision that has ever adopted such an approach. Instead, the Second Circuit relies on its reading of a Supreme Court case in the context of *habeas corpus* proceedings as support for the idea that, since a federal court can in some circumstances deny relief to an applicant for *habeas corpus* even when the claim has not been properly exhausted in state court, the same result should apply to allow a federal court to consider and dismiss state tax claims that it cannot grant under the comity doctrine. The court does not explain why the *habeas corpus* situation – a context in which the court itself notes that the federal courts had been burdened with "countless meritless challenges to state court convictions" – would have any application to the state tax area, particularly given that the policy behind the TIA and comity is to allow the state courts, which are deemed the most familiar with state tax laws, to adjudicate claims involving state taxes.

WHEN DOES INTEREST START TO RUN ON A TAX REFUND?

By Irwin M. Slomka

The question of when interest begins to accrue on refunds under Article 9-A has long been a source of uncertainty, specifically with respect to refunds that arise during the course of an audit. This is because, while the Tax Law generally permits interest on overpayments back to the date of overpayment, it does not allow interest for any day prior to a claim for refund. A persistent question is when will an overpayment arising during the course of an audit be treated as arising from a claim for refund, which would preclude the accrual of interest prior to the filing of the claim. Recently, a New York State Administrative Law Judge issued an Order

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that treats the issue as an inherently factual one. *Matter of Citigroup Japan Holdings Corp., FKA Nikko Citi Holdings Inc., et al.*, DTA No. 825011 (N.Y.S. Div. of Tax App., Aug. 8, 2013).

As a general rule, interest on an overpayment of Article 9-A tax runs from the date of overpayment. Tax Law §1088(a)(2). However, in the case of an overpayment claimed in an amended return or in a "claim for refund," interest is not allowed "for any day before the date on which such [amended] return or [refund] claim is filed." Tax Law § 1088(a)(3).

The question here . . . . was whether the tax refund was "initiated" by the Department during the audit (thereby invoking Tax Law §1088(a)(2)), or instead resulted from the filing of an "informal refund claim" (triggering Tax Law §1088(a)(3)).

The Department conducted an audit of Nikko Cordial Corporation ("Nikko") for the tax years ending March 2006 through March 2008. During the course of the audit, Nikko's representatives submitted documentation, including a 17-page written analysis, to show that its reported receipts factor was overstated. After further discussions and submissions between Nikko and the Department's auditor, the Department agreed to adjust Nikko's receipts factor, which resulted in an overpayment of $2.3 million in tax.

The Department issued a Consent to Field Audit Adjustments reflecting the overpayment, and stating that interest would be determined under Tax Law § 1088(a)(2) (the general rule on interest on overpayments). Nikko's representative signed the Consent, but not before annotating it to indicate disagreement with the computation of interest and specifically stating that the Consent "[was] not intended to be . . . a claim for a refund . . . ." The Department processed the signed Consent, and in April 2012 issued a refund with minimal interest, and without explanation of how it was calculated. It appears the interest calculation did not reflect interest accrued from the date the original returns were filed, as required under § 1088(a)(2).

Nikko then brought a declaratory judgment action in New York State Supreme Court to compel the payment of interest from the date of overpayment, while also filing a protective Petition with the Division of Tax Appeals ("DTA"). In September 2012, the State court judge dismissed the action for failure to exhaust administrative remedies. Thereafter, Nikko filed a motion with the DTA, seeking summary determination on the merits (or, alternatively, seeking the dismissal of its own petition because, since it did not file a "claim for refund," the DTA did not have jurisdiction, which presumably would have given Nikko another opportunity to have its action heard by the State Supreme Court).

Nikko argued that the refund was made pursuant to an audit, and therefore interest should accrue from the date the returns were filed as required under Tax Law § 1088(a)(2). It claimed that there were no issues of fact, and that it was entitled to judgment as a matter of law. The Department disagreed, contending that the taxpayer's correspondence with the auditor constituted a refund claim or, alternatively, that the signed Consent to Audit Adjustments itself was a refund claim, either of which triggered Tax Law § 1088(a)(3) (barring the accrual of interest prior to the refund claim).

The ALJ issued an Order dismissing Nikko's summary determination motion, but did not rule on the merits. The ALJ began by noting that a refund claim can be "informally made," provided it contains the requisite information so as to put the Department on sufficient notice. The question here, according to the ALJ, was whether the tax refund was "initiated" by the Department during the audit (thereby invoking Tax Law §1088(a)(2)), or instead resulted from the filing of an "informal refund claim" (triggering Tax Law §1088(a)(3)). According to the ALJ, the record contained conflicting accounts of what had transpired, which meant that there were material facts in dispute, making summary determination inapplicable. The ALJ therefore ordered that the case be set for a conference to schedule a hearing.

Additional Insights

The ALJ's denial of summary determination may have been appropriate in light of the seemingly conflicting facts, but the scope of Tax Law §1088(a)(3) is a legal issue of considerable importance. It was enacted to minimize the practice of some taxpayers to delay the filing of refund claims and using the State of New York, in effect, as a "bank" to earn interest on the refunds. A similar issue regarding the meaning of §1088(a)(3) was raised in *ABC Radio Network, Inc. v. State of New York*, 294 A.D.2d 213 (1st Dep't 2002), but there the Appellate Division, reversing a lower court decision in favor of the taxpayer, dismissed the action as untimely and did not rule on the merits.

The ALJ's Order is based on a distinction between a refund "initiated" by an auditor, and an "informal refund claim" submitted to an auditor. Neither of those terms is defined in the law, and given the nature of audits they are not susceptible to precise definition. An audit is necessarily a process in which taxpayers submit documentation to the auditor, sometimes to show that the taxpayer overpaid its tax, even though not "initiated" by the auditor. Should it make a difference how the overpayment was "initiated," and what does it mean to "initiate" a refund? The duty of the auditor is to determine the proper amount of tax, even if it results in a refund. With respect to the application of Tax Law §1088(a)(3), there remains a fundamental question whether refunds determined

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during the audit process should be treated as being made pursuant to an "informal refund claim," similar to claims for refund made outside the audit process.

INSIGHTS IN BRIEF

New Chief Administrative Law Judge for the City Tax Appeals Tribunal

The New York City Tax Appeals Tribunal has announced that Anne W. Murphy is the new Chief Administrative Law Judge. Judge Murphy has long experience in state and local taxes, and has served as a City ALJ for many years. We wish her well in her new position.

Amazon and Overstock Seek Review by United States Supreme Court

As expected, both Amazon and Overstock have now filed Petitions for a Writ of Certiorari with the United States Supreme Court, seeking review of the New York Court of Appeals decision issued in March 2013. That decision upheld as constitutional New York's nearly six-year-old "click-through nexus" statute, which created a presumption of nexus under the sales tax based on an out-of-state vendor's compensation arrangement with in-State residents for referrals of potential customers through a link on the in-State resident's web site. *Overstock.com, Inc. v. N.Y.S. Dep't of Taxation & Fin.*, *et al.*, 20 N.Y. 3d 586 (2013), *petition for cert. filed,* (U.S. Aug. 22, 2013) (No. 13-252), and *Amazon.com, LLC, et al. v. N.Y.S. Dep't of Taxation & Fin.*, *et al.*, 20 N.Y. 3d 586 (2013), *petition for cert. filed*, (U.S. Aug. 23, 2013) (No. 13-259). Amazon argues that review is warranted because, among other things, the Court of Appeals decision raises issues of national importance and contravenes the "bright-line" physical presence requirement under the Commerce Clause, as held by the Supreme Court in *Quill Corp. v. North Dakota* (1992) and *National Bellas Hess v. Dep't of Revenue* (1967). Overstock gave similar reasons, but emphasized that there was conflict among state high courts that particularly warranted the Court's review.

Tax Department Rules That Sales Tax is Due on Conditional Sale

According to the Department of Taxation and Finance, a vendor's 36-month lease agreement with a customer for the furnishing of computer hardware, computer software, and office furniture was a conditional sale. As a result, the vendor must collect sales tax on the entire amount due under the agreement – assuming it is furnishing the customer with *pre-written* software – at the time the agreement is entered into and the property is delivered to the customer, rather than over the term of the agreement. Although the transaction was in the form of a lease agreement, the lease had the essential attributes of a contract of conditional sale or installment sale. *Advisory Opinion*, TSB-A-13(20)S (N.Y.S. Dep't of Taxation & Fin., July 15, 2013).

Tax Department to Rule on Applicability of Sales Tax to Contribution of Property to Limited Liability Company

The Department of Taxation and Finance has indicated on its web site that it has a pending request for an Advisory Opinion on whether a contribution of tangible personal property to a limited liability company for a share in the company is subject to New York State sales tax. http://www.tax.ny.gov/pubs_and_bulls/advisory_opinions/pending_ao_issues.htm. The Department will consider comments received by September 20, 2013. Tax Law § 1101(a)(4)(iv) already provides that a "retail sale" does not include either the transfer of property to a corporation upon formation in exchange for stock, or the contribution of property to a partnership in consideration for a partnership interest.

Materials Supplied by Franchisor's Advertising Program are Not Exempt Promotional Materials

In an Advisory Opinion, the New York State Department of Taxation and Finance has concluded that advertising materials were not exempt from sales and use tax as "promotional materials" under Tax Law § 115(n)(4). *Advisory Opinion*, TSB-A-13(16)S (N.Y.S. Dep't of Taxation & Fin., July 15, 2013). As is common in the franchise industry, the petitioner, a not-for-profit corporation consisting of a franchisor and its franchisee restaurants, collects funds from member restaurants and uses them for promotional purposes, including the production of printed promotional materials put on display in the restaurants, some of which were delivered to the restaurants by common carrier and others by a distributor in its own trucks. The Department concluded that these materials did not meet the statutory definition of exempt promotional materials, since they were delivered to member restaurants rather than to customers, only some of them were delivered by common carrier, and they were not provided "without charge" as required under the statute.

Exception Filed in *Knowledge Learning*

In last month's issue of *New York Tax Insights*, we reported on the decision in *Matter of Knowledge Learning Corporation and Kindercare Learning Centers, Inc.*, DTA Nos. 823962 & 823963 (N.Y.S. Div. of Tax App., June 27, 2013), in which a New York State Administrative Law Judge denied two related companies the ability to file combined reports, finding that (1) in the absence of confirming documents, oral testimony was insufficient to meet the companies' burden of proof regarding the existence of substantial intercorporate transactions; and (2) an inquiry into any distortion that might arise on separate returns was no longer a proper analysis once the statute was amended in 2007, a conclusion that does not appear consistent with the Department's own pronouncements. An exception was filed with the Tax Appeals Tribunal on July 29, 2013. Many combined filers in New York will look forward to clarification of these important issues from the Tribunal.

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