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NEW YORK TAX INSIGHTS

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DEPARTMENT OF FINANCE ANNOUNCES UPDATED COMMERCIAL RENT TAX AUDIT POLICY ON BILLBOARDS

By Irwin M. Slomka

The New York City Department of Finance has issued an "Update on Audit Issues" regarding the commercial rent tax treatment of amounts paid for the placement of advertising on billboards and digital signs in Manhattan. *Update on Audit Issues*, Commercial Rent Tax, Billboards, May 28, 2014. According to the Audit Update, the tenant of a billboard lease in Manhattan (for premises south of the center line of 96th Street, and for an annual gross rent of at least $250,000) must file commercial rent tax ("CRT") returns. For businesses that are not in compliance and that are not under audit by the Department, the Audit Update recommends participation in the Department's Voluntary Disclosure and Compliance Program.

For those businesses that are under audit, the Department has announced that it will accept payment of tax and interest for the most recent six CRT years in full satisfaction of the taxpayer's CRT deficiency. The Department's auditors will also consider the impact of the billboard payments on the taxpayer's general corporation tax ("GCT") and unincorporated business tax ("UBT") returns (typically, through adjustments to the property factor of the business allocation percentage). If such adjustments are necessary, "the Department may choose to address the matter separately or as part of a single resolution with the CRT deficiency."

Additional Insights

Over the past year, many businesses have been the subject of CRT audits with respect to their payments to display advertising on digital signs affixed to buildings principally in the Times Square area of Manhattan. The Department has claimed that the payments are for the use or occupancy of commercial premises. The issue has been a contentious one for several reasons. For one thing, although the regulations provide that advertising signs "occupied or used by a tenant" are taxable premises, the Department undertook the CRT audit initiative after many years of non-enforcement. The CRT audit initiative subjected businesses to lengthy (and unexpected) CRT assessments. In addition, there is the legal question of whether the signage arrangements are truly for the use or occupancy of commercial premises within the meaning of the CRT law. The new limited lookback is a

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reasonable effort by the Department to avoid the egregious impact of retroactive enforcement, but does not resolve the underlying question of the taxability of these arrangements.

The Audit Update specifically leaves open for resolution on a case-by-case basis the resulting impact on the GCT and UBT from treating the billboard payments as payments for the use or occupancy of premises. It does not address whether the Department will treat the arrangements as resulting in taxable nexus for a business that has no other connection with the City of New York, although that would appear to be a consequence of the Department's audit policy.

ALJ FINDS NO HEARING RIGHT TO CHALLENGE NOTICE AND DEMAND, AND CORPORATE "PRESIDENT" IS PERSONALLY LIABLE

By Hollis L. Hyans

A New York State Administrative Law Judge has held that an action brought by a restaurant to challenge a Notice and Demand for sales tax could not be sustained, and that the individual who signed on behalf of the company as president could be held personally responsible. *Matter of Ji Chao Zheng & Pacific World Buffet, Inc.*, DTA No. 824597 (N.Y.S. Div. of Tax App., June 5, 2014).

Pacific World Buffet opened a restaurant in Elmhurst, N.Y., in March 2009. It filed a monthly return for the month of December 2009, as required, with a check for approximately $29,000. The return was not signed and the check was returned unpaid by the bank on which it was drawn. A final quarterly sales tax return was filed for the period December 1, 2009, through February 28, 2010, and sometime thereafter the restaurant ceased operations.

On June 17, 2010, the Department issued a Notice and Demand for the $29,000 for which the check had been returned unpaid, plus penalty and interest, and in November 2010 it issued a Notice of Determination to Ji Chao Zheng as a responsible person. Mr. Zheng had signed, as president, the company's application to register for a sales tax certificate of authority; four of the company's monthly sales and use tax returns; three of its quarterly returns; its 2008 corporation franchise tax return and MTA surcharge returns; and, as president, its quarterly combined withholding, wage reporting, and unemployment insurance returns for the first and second quarters of 2009.

Petition and Hearing. Pacific World Buffet filed a petition, signed by Mr. Zheng, as president, challenging the Notice and Demand. Mr. Zheng filed a separate petition challenging the Notice of Determination, asserting that the actual owner and responsible person for Pacific World Buffet is Tin Ming Cheng, and that Mr. Zheng, a cook, and his son were hired by Mr. Cheng on the condition that Mr. Zheng sign the documents as president.

At the hearing, the company conceded that the self-reported amount was correct and that the company was liable. Mr. Zheng, although present at the hearing, did not testify. The sole witness for petitioners was Wei Xin Liu, the second chef at the restaurant, who testified through an interpreter in support of Mr. Zheng's position. Petitioners also submitted the affidavit of Mr. Cheng, in which he stated that he is the owner and responsible person for Pacific World Buffet, and that he promised to pay all taxes due. No articles of incorporation, bylaws, corporate minute book, or books and records of the corporation were introduced into evidence.

The decision. With regard to the company, the ALJ held that the statute clearly provides no right to a hearing in response to a Notice and Demand for taxes reported but not paid. Tax Law § 173-a. Therefore, the Division of Tax Appeals lacked jurisdiction to consider the merits of the company's challenge.

With regard to Mr. Zheng, the ALJ found that he had signed numerous documents as president or responsible person of the corporation, had introduced no evidence that his authority as president was restricted, and had failed to take the stand to testify, resulting in "the strongest negative inference" about his responsibilities. The ALJ found Mr. Liu's testimony to be "vague and very confusing." She gave no weight to Mr. Cheng's affidavit, which provided no details about his alleged ownership of the corporation or his responsibilities, or any no documentation supporting his claim, and noted that it was no defense to Mr. Zheng's liability that another individual might also be a responsible person, since the Department is not required to pursue another responsible person before proceeding against Mr. Zheng. Therefore, Mr. Zheng's liability for taxes and penalties was upheld.

The ALJ . . . . noted that it was no defense to Mr. Zheng's liability that another individual might also be a responsible person.

Additional Insights

From the description of the documentary evidence introduced into the record, it appears the ALJ may have had little choice

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in upholding the assessment against Mr. Zheng, since the documents all appear to have listed him as a responsible person. Moreover, no contradictory documents were introduced, and even if the affidavit and oral testimony had been accepted, they would not establish that Mr. Zheng lacked authority. However, insofar as the only witness testified through an interpreter, which may have contributed to the confusing nature of his testimony, and the likelihood that Mr. Zheng himself may not have been fluent in English or have understood the legal effect of his agreeing to sign the documents in return for being employed – assuming his version of the facts was true – perhaps a solution outside the formal evidentiary requirements of the Division of Tax Appeals might have been a better avenue. For example, the Office of the Taxpayer Rights Advocate might be very valuable to assist the parties in clarifying the nature of their potential liabilities to the State and, perhaps, in arriving at a solution.

ALJ DENIES EQUITABLE RELIEF FROM STATUTE OF LIMITATIONS

By Michael J. Hilkin

In *Matter of Joel and Rona Levy*, DTA No. 825005 (N.Y.S. Div. of Tax App., May 22, 2014), a New York State Administrative Law Judge concluded that there is no legal authority to grant in equity to a taxpayer an extension of the statute of limitations for refunds, and denied the taxpayers' request for a refund filed after the statute of limitations had expired.

Background. In 2002, the Levys hired a new tax return preparer, Todd Newman, for their personal and S corporation returns starting in 2002. Between 2002 and 2007, the Levys received "frequent notices" from federal and state taxing authorities informing them of various missed tax-filing deadlines, and were increasingly unable to reach Mr. Newman, although they retained him as their preparer. The Levys also incurred net operating losses in 2002 and subsequent years, and claimed that Mr. Newman failed to advise them to file amended State personal income returns applying a net operating loss carryback to the 2001 year. The Levys did not file such an amended 2001 State return and refund request until January 2011, well more than three years after the applicable statute of limitations for refunds had closed.

Meanwhile, in 2010, Mr. Newman was convicted of grand larceny and repeated failure to file his own personal income tax returns, and was sentenced to nine years in prison. Although his crimes did not directly affect the Levys or their tax returns, the Levys asserted that Mr. Newman's criminal conduct must have been "distracting" and prevented him from providing competent representation. Thus, after having their refund request on their 2001 amended return denied by the Department as untimely, the Levys petitioned the Division of Tax Appeals for relief in equity.

The decision. Concluding that there are no exceptions to the State's statute of limitations "that allow for consideration of individual circumstances," the ALJ refused to grant the Levys an equitable tolling of the statute of limitations applicable to their 2001 return. The ALJ cited a U.S. Supreme Court case, *United States v. Brockamp*, 519 U.S. 347 (1997), which held that the statutory time limitations for the filing of a federal refund claim could not be equitably tolled, and determined that there was "no reason to interpret" the State's statute of limitations differently, regardless of whether a taxpayer may have "very compelling personal reasons" for requesting equitable relief. Further, the ALJ appeared to question whether the Levys would have deserved relief in equity even if the Division of Tax Appeals had the power to provide it, pointing out that the Levys failed to identify "a causal link" between Mr. Newman's criminal conduct and their own circumstances, and that the Levys continued to use him even after several other "episodes of neglect" on his part.

Additional Insights

The ALJ's decision in this case is consistent with previous New York State cases holding that tax statutes of limitations may not be tolled in equity, regardless of the circumstances leading to a taxpayer requesting a refund after the statute has closed. While bad advice and neglect may serve as the basis for a malpractice claim against a preparer, taxpayers should not expect any relief from the State.

COMPANY THAT PROVIDES OFFICE SPACE AND SERVICES IS SUBJECT TO THE UBT

By Kara M. Kraman

The New York City Department of Finance has released a previously unpublished letter ruling in which it determined that a company that furnished office space to third parties, as well as office services for that space, was subject to the New York City unincorporated business tax ("UBT"). *Finance Letter Ruling*, FLR 13-4937/UBT (N.Y.C. Dep't of Fin., Aug. 19, 2013).

Facts. The ruling involves a limited liability company ("Company") in the business of offering furnished office space for rent in New York City. The Company rented space from various building owners, developed that space into office suites, and then rented out those office suites. Each office suite shared a common reception area and had access

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to lounge and kitchen areas. The rent paid by each office suite occupant included basic reception services and IT assistance, concierge services, cleaning and maintenance services, 24-hour lobby security services, and mail and package delivery. The Company also offered other services to office suite occupants for an additional charge, including conference room usage, unlimited coffee, telephone service, wireless internet service, cable television, and use of the copying machines located in the common areas.

The Company entered into license agreements, rather than traditional leases, with the office suite occupants. The agreements forbade occupants from installing any office equipment, telecommunications lines or connections, computer networking equipment, coffee machines, or other items of their own without the Company's written consent.

The issue presented was whether the Company qualified for the exclusion from the UBT for holding, leasing, or managing real property.

This ruling demonstrates that the protection afforded under the UBT law for certain incidental services provided by a landlord may be limited even where, as here, the incidental services provided are only made available to occupants of the real property.

Law. The UBT is imposed "on the unincorporated business taxable income of every unincorporated business wholly or partly carried on within the city." Admin. Code § 11-503(a). An owner or lessee of real property, other than a dealer, "shall not be deemed engaged in an unincorporated business solely by reason of holding, leasing, or managing real property." Admin. Code § 11-502(d). The UBT law contains an important protection for owners of real property that allows them to provide certain incidental services at the premises without becoming subject to UBT. Specifically, the conduct by the owner at the premises "of a trade, business, profession or occupation, including, but not limited to, a garage, restaurant, laundry or health club, shall be deemed to be an incident to the holding, leasing or managing of such real property, and shall not be deemed the conduct of an unincorporated business, if such trade, business, profession or occupation is conducted solely for the benefit of tenants at such real property, as an incidental service to such tenants." *Id.*

Ruling. The Department ruled that the Company was subject to the UBT, notwithstanding the incidental-services provision in the law, because many of the services being provided by the Company "go far beyond the incidental services contemplated by the statute." The Department found that the focus of the agreements was on the provision of office services by the Company, and noted that the Company identified itself as being in the business of providing "serviced accommodations" in the agreements themselves. It noted that the Company marketed, in addition to the office space, a bundle of office services not generally incidental to the leasing or managing of real property, but necessary to the functioning of an office. Finally, the Company reserved the exclusive right to provide office services by prohibiting the occupant from installing any office, telecommunications, or computer equipment of its own without the Company's consent, and by including a non-compete clause in the agreement prohibiting the occupants from competing with the Company's business of providing "serviced accommodations." Accordingly, the Department concluded that the Company was not leasing real property within the meaning of the exclusion from the UBT under Admin Code §11-502(d), but was providing an office service, which subjected the Company to the UBT.

Additional Insights

This ruling demonstrates that the protection afforded under the UBT law for certain incidental services provided by a landlord may be limited even where, as here, the incidental services provided are only made available to occupants of the real property. The ruling does not address whether the office suite occupants are therefore not subject to the commercial rent tax because they are paying for an office service, not for the use and occupancy of premises.

We note that the letter ruling was one of four UBT letter rulings issued by the Department of Finance in 2013 and 2014 that were published on its website on June 12, 2014. Six previously unpublished rulings involving the real property transfer tax, and two previously unpublished rulings involving the hotel room occupancy tax, were also recently published there.

GAIN FROM SALE OF MEMBERSHIP INTERESTS CARRIED OUT AS A MERGER TRANSACTION IS NOT SUBJECT TO UBT

By Irwin M. Slomka

In a ruling that could afford significant benefits where a New York City unincorporated business is sold, the New York City Department of Finance has ruled that gain from the sales of membership interests in a limited liability company ("LLC") that is subject to the New York City unincorporated

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business tax ("UBT"), but which are carried out as a merger transaction, will not result in gain to the LLC for UBT purposes. *Finance Letter Ruling*, FLR 12-4946 (N.Y.C. Dep't of Fin., Apr. 15, 2014).

Facts. The LLC provides IT management and technology solutions in New York City for the hospitality business. It is taxable as a partnership and subject to the UBT. Its members, mostly individuals, will sell 100% of their membership interests at a gain to a corporate purchaser ("Purchaser"). However, the sales will be structured as a single merger of the Purchaser's wholly owned subsidiary ("Merger Sub") into the LLC, and will be carried out pursuant to the Delaware Limited Liability Company Act and the Delaware General Corporation Law. The reason given for structuring the transaction as a merger, rather than as direct purchases of the members' respective interests, is to avoid having to obtain signatures from every LLC member. For federal income tax purposes, the transaction is treated as the sale of LLC interests by each member, but the Purchaser will treat it as the acquisition of assets from the LLC. The business of the LLC — which will now be solely owned by the Purchaser — will continue after the transaction.

The question presented was whether the gain on the transaction would be considered income of the LLC for UBT purposes. The Department ruled that it would not be, concluding that although structured as a merger of Merger Sub into the LLC, the Department would apply substance over form and treat it as a sale of partnership interests by the individual members.

The Department first determined that the substance of the transaction is the sale of partnership interests, since after the transaction the Purchaser will be the sole owner of the LLC. Under IRC § 741, gain or loss on the sale or exchange of a partnership interest is recognized by the transferor partner. The ruling notes that the facts presented are "more complicated," however, because the merger will result in the complete termination of the LLC, which had been taxable as a partnership. The Department relied on *Revenue Ruling 99-6*, where the IRS ruled that partners who sold their interests to a single buyer should be treated as having sold their partnership interests, even though from the buyer's perspective there has been a sale of partnership assets. According to the Department, the critical fact is that the federal tax precedent does not suggest that the sale should be treated as a sale by the LLC itself.

The ruling then addresses the question of whether the gain is includable in the LLC's unincorporated business taxable income. The computation of unincorporated business taxable income starts with "unincorporated business gross income," which is defined, in part, as "the sum of the items of income and gain of the business . . . *includible in gross income for the taxable year for federal purposes*, including income and gain . . . from the liquidation of the business." Admin. Code §11-506(a) (emphasis added). According to the Department, since unincorporated business gross income is limited to the amount includable as gross income for federal tax purposes — and for federal purposes, the sale of member interests does not give rise to partnership income to the LLC — the resulting gain will not be subject to UBT.

Additional Insights

Although letter rulings are only binding on the Department with respect to the named requester, this letter ruling is noteworthy in several respects. First, the Department applies substance over form in analyzing the transaction to the taxpayer's benefit, rather than taking the position that the taxpayer is bound by the form of the transaction (in this case, as a merger transaction). Second, the ruling confirms that for UBT purposes, the Department will only require the inclusion of income that is includable in the taxpayer's income for federal income tax purposes. Although the ruling does not recite it as a fact, it is assumed that the gain was not reported on the LLC's Federal Form 1065, Schedule K.

[T]he Department applies substance over form in analyzing the transaction to the taxpayer's benefit, rather than taking the position that the taxpayer is bound by the form of the transaction.

It is also significant that the Department adopted an interpretation that results in the gain not being taxed at all under the UBT (the individual members of the LLC are not subject to the UBT), and in the LLC's assets getting a stepped-up basis in the hands of the Purchaser.

Finally, the ruling appears to confirm that the statutory language limiting unincorporated business gross income to income "includible in gross income . . . for federal purposes" will trump the language in the same code section (§11-506(a)) that requires the inclusion of income and gain "from the liquidation of the business," which might have been triggered, since the partnership did terminate as a result of the transaction.

INSIGHTS IN BRIEF

Tax Department Explains Policy on Sales Tax Exemption for Wine Tastings

The Department of Taxation and Finance has issued a memorandum explaining its policy regarding the exemption from sales and use tax for wine furnished at certain wine tastings in New York State. *Sales and Use Tax Exemption*

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for Certain Wine Tastings, TSB-M-14(9)S (N.Y.S. Dep't of Taxation & Fin., June 4, 2014). Section 80 of the Alcoholic Beverage Control Law allows licensed wineries, farm wineries, wholesalers, and importers to conduct wine tastings at their own licensed premises. Tax Law § 1115(a)(33) exempts from sales or use tax wine or wine products furnished by an official agent of a licensed winery at a wine tasting held in accordance with that provision. The memorandum explains the application of the use tax exemption on wine furnished at the tastings (or on the bottles, corks, caps, or labels used to package the wine), and the sales tax exemption on charges by wineries or farm wineries for wine tastings.

Tax Department Reclassifies Certain Items as Exempt Medical Equipment and Prosthetic Aids

Following a comprehensive review of its current guidance regarding the applicability of the sales tax to various medical items sold to the public, the Department of Taxation and Finance has issued a new policy reclassifying certain items as medical equipment or prosthetic aids that are exempt from sales tax. *Tax Department's Reclassification of Certain Items and Devices as Medical Equipment or Prosthetic Aids*, TSB-M-14(8)S (N.Y.S. Dep't of Taxation & Fin., May 27, 2014). Among the newly exempt types of medical equipment or prosthetic aids are bath chairs and seats, prefabricated wheelchair ramps, and power lift chairs. The new policy applies to sales made or services rendered on or after July 1, 2014. The Department will not refund sales or use tax paid on purchases made prior to that date.

Court of Appeals Will Hear the Sprint Nextel "False Claims Act" Case

The Appellate Division, First Department, has granted the request of Sprint Nextel to have its appeal heard by the Court of Appeals. *State of New York v. Sprint Nextel Corp., et al.*, No. 103917/11 (N.Y. App. Div. 1st Dep't June 12, 2014). In February, the Appellate Division upheld a July 2012 trial court decision allowing the Attorney General's action under the False Claims Act to proceed, rejecting Sprint Nextel's claims that the State sales and use tax law relied upon in the suit was preempted by a federal statute, or that the action violated the U.S. Constitution. *State of New York v. Sprint Nextel Corp., et al.*, 114 A.D. 3d 622, 980 N.Y.S.2d 769 (N.Y. App. Div. 1st Dep't 2014). Now the Court of Appeals will review that decision, and the eventual ruling from the State's highest court should provide much-needed guidance in interpreting the first tax enforcement action brought under New York's False Claims Act, which was revised in 2010 to permit claims to be brought in court by "whistleblowers" or by the Attorney General outside the statutory tax dispute resolution system.